Hamburg Institute
of International
Economics

Tax sovereignty and feasibility of international regulations for tobacco tax policies

Michael Bräuninger

HWWI Research

Paper 152

Hamburg Institute of International Economics (HWWI) | 2014
ISSN 1861-504X

Corresponding author:
Prof. Dr. Michael Bräuninger
Hamburg Institute of International Economics (HWWI)
Heimhuder Str. 71 | 20148 Hamburg | Germany
Phone: +49 (0)40 34 05 76 - 330 | Fax: +49 (0)40 34 05 76 - 776
braeuninger@hwwi.org

HWWI Research Paper
Hamburg Institute of International Economics (HWWI)
Heimhuder Str. 71 | 20148 Hamburg | Germany
Phone: +49 (0)40 34 05 76 - 0 | Fax: +49 (0)40 34 05 76 - 776
info@hwwi.org | www.hwwi.org
ISSN 1861-504X

Hamburg Institute
of International
Economics

Tax sovereignty and feasibility of international regulations for tobacco tax policies

Michael Bräuninger

The study was commissioned by Japan Tobacco International (JTI). The HWWI retained full editorial control and takes full responsibility for the content and any errors or omissions.

Table of contents

Abstract **4**

1 | Introduction **4**

2 | Tax Sovereignty versus International Coordination and/or Harmonization **5**
2.1 | Economic considerations 5
2.2 | Treatment of Tax Sovereignty in the FCTC and COP 5 13

3 | Earmarking **16**
3.1 | Economic considerations 16
3.2 | Treatment of Earmarking in the FCTC and COP 5 18

4 | Conclusion **21**

References **22**

Abstract

Taxation is a fundamental part of national sovereignty. The two dominant components of tax sovereignty are the ability to generate revenue and have full control over fiscal policy. Therefore, the key components of a state's expression of sovereignty are the right to determine tax rates, structures and the use of tax revenues.

With a view to implementing of the WHO Framework Convention on Tobacco Control (FCTC) provisions on Article 6 – tax and price measures for tobacco products, Parties did not envisage adopting the guidelines to support the implementation of this article. The main reason behind this decision was that prescriptive obligations were inappropriate and unacceptable, because they would infringe on tax sovereignty, while national tax regulations would not permit an international body or treaty to create obligations in this important area. However, subsequently a decision was made to develop Article 6 guidelines. As a consequence the guidelines' content now deviates significantly from countries' original intentions and the FCTC Treaty.

1 | Introduction

This study analyses FCTC Treaty Article 6 – price and tax measures for controlling tobacco, focusing on the international regulations of these measures. Particular attention is paid to the question of whether national tax laws should be subject to regulation by international agreements, such as the WHO Framework Convention on Tobacco Control (FCTC).

Today, there is a general agreement that raising tax revenues and protecting public health are high-priority objectives with respect to the taxation of tobacco products. Economic considerations suggest that tobacco products should be taxed according to their externality costs, see Cnossen (2005). This study examines the parameters to determine the optimal tax level in an individual country. Given the findings obtained from the analysis, the first part of this study will analyze whether tax policies should be internationally coordinated and/or harmonized, or whether taxes should be left to the individual countries' sovereign choice.

After this general analysis of international and country-specific tax policies, the study discusses how the FCTC deals with these questions. Article 6 of the FCTC Treaty places strong emphasis on the sovereignty of individual countries and does not promote any international coordination and/or harmonization. An analysis of the Parties' negotiations on Article 6 in the Intergovernmental Negotiating Body (INB) sessions makes this even more apparent. Six INB negotiation sessions, which took place between October 2000 and February 2003, are well documented and their records can be used as evidence for countries' intentions. Parties' intentions will then be contrasted with the recent negotiations at the Conference of Parties 5 (CoP) held in Seoul, Republic of Korea, 12–17 November 2012, where the draft Article 6 guidelines on price and tax measures were discussed. It will be shown that the draft guidelines deviate significantly from the Parties' intentions when negotiating the FCTC text in detail, whilst the aim of the guidelines is to give general guidance on the treaty provisions.

The second chapter of this study deals with the earmarking of tax revenues. It starts with an economic discussion of earmarking, which analyses whether there are any economic conditions under which earmarking is economically sound policy. Subsequently, it is argued that the economic robustness of these conditions is highly unlikely in real-life. It will be then emphasized that there is no case for the earmarking of tobacco tax revenues for tobacco control, as promoted by the draft Article 6 guidelines. Afterwards, it will be shown that Parties specifically excluded earmarking of tobacco tax revenues from the Article 6, on the grounds that it would infringe upon Parties' national tax sovereignty. The INB discussions show that many countries with longstanding experience in the area of tobacco taxation refused any kind of earmarking. In some cases they even emphasized that earmarking would lead to conflicts with national constitutions, which is in fact the case in many countries. Again, the economic analysis and discussion in INB will then be compared to recent discussions at the CoP 5. As a result, it will be shown that the provisions of the draft guidelines are contradictory to the original intentions stated in the FCTC, as well as to economic considerations.

2 | Tax Sovereignty versus International Coordination and/or Harmonization

2.1 | Economic considerations

The two dominant components of tax sovereignty are the ability to raise revenue and have full over control of fiscal policy. Therefore, the key components of a state's expression of sovereignty are the right to determine tax rates, structures and the spending of tax revenues.

Currently the CoP to the WHO FCTC discusses the draft guidelines for FCTC Article 6 on tax and price measures. The draft guidelines imply that a certain tax level fits all countries. This effectively means the harmonization of tax rates on a global level. To examine the consequences of tobacco tax harmonization, the optimal level of taxation in an individual country is analyzed. This will yield the parameters determining the optimal tax level. This study then discusses whether these parameters are likely to be similar or different across a number of countries. First, it is assumed that maximizing tax revenue is the only aim of the taxation of tobacco products. As a result, potential negative effects of a reduction of tobacco consumption on the welfare of smokers or potential positive effects on their health are not taken into account. In a second step, it is assumed that the government's other target is to reduce negative externalities for health reasons. In a third step, the government takes into account the consumers' preferences.[1]

An increase in taxes leads to an increase in tobacco prices. In general, this will cause a decline in demand. Figure 1 assumes a declining linear demand function *D*. A tax increase should then lead to a rise in tax revenue. However, the decline in demand leads to a reduction of tax revenue. At a zero tax rate, there is no tax revenue and at a prohibitively high tax rate, there is no demand and tax revenue is zero as well. In between, there is a rate which maximizes tax revenue. Figure 1 shows this with a Laffer-type curve, in which the maximum tax revenue is t'. If tax revenue is the only aim of taxation, the country should choose this revenue maximizing tax. The demand effect of taxes becomes much stronger if there is not only a choice between smoking and non-smoking, but also the possibility to smoke non-taxed tobacco products. Then an increase in the tobacco tax may lead to a decline in the volume of duty paid tobacco products, rather than a fall in total tobacco consumption. Still, even with non-taxed tobacco consumption there is a revenue-maximizing tax level. However, in this case the economic and social costs of illegal tobacco consumption can significantly reduce the revenue benefits; see Bräuninger and Stiller (2010) for a discussion of these effects in Germany.

If the country wants to reduce smoking to prevent the external costs imposed on non-smokers, then the optimal tax is above the revenue maximizing tax level. In Figure 1, the optimal tax with respect to the externality is t^*. However, as long as there is a revenue target, the optimal tax will be below the prohibitive level at which demand and tax revenue drops to zero. This holds even more if there is substitution from taxed consumption to untaxed consumption. Box 1 sets out a model to analyze optimal taxation formally. If taxation takes account of consumers' preferences the optimal level of taxation might be below the revenue maximization level. In Figure 1 this tax level is $t^\#$. In addition, this tax level can be chosen by governments as optimal to consider the substitution of untaxed for taxed consumption.

Now let us consider some changes in economic or regulatory conditions. An increase in income leads to a higher optimal tax. Stronger regulation on smoking reduces the

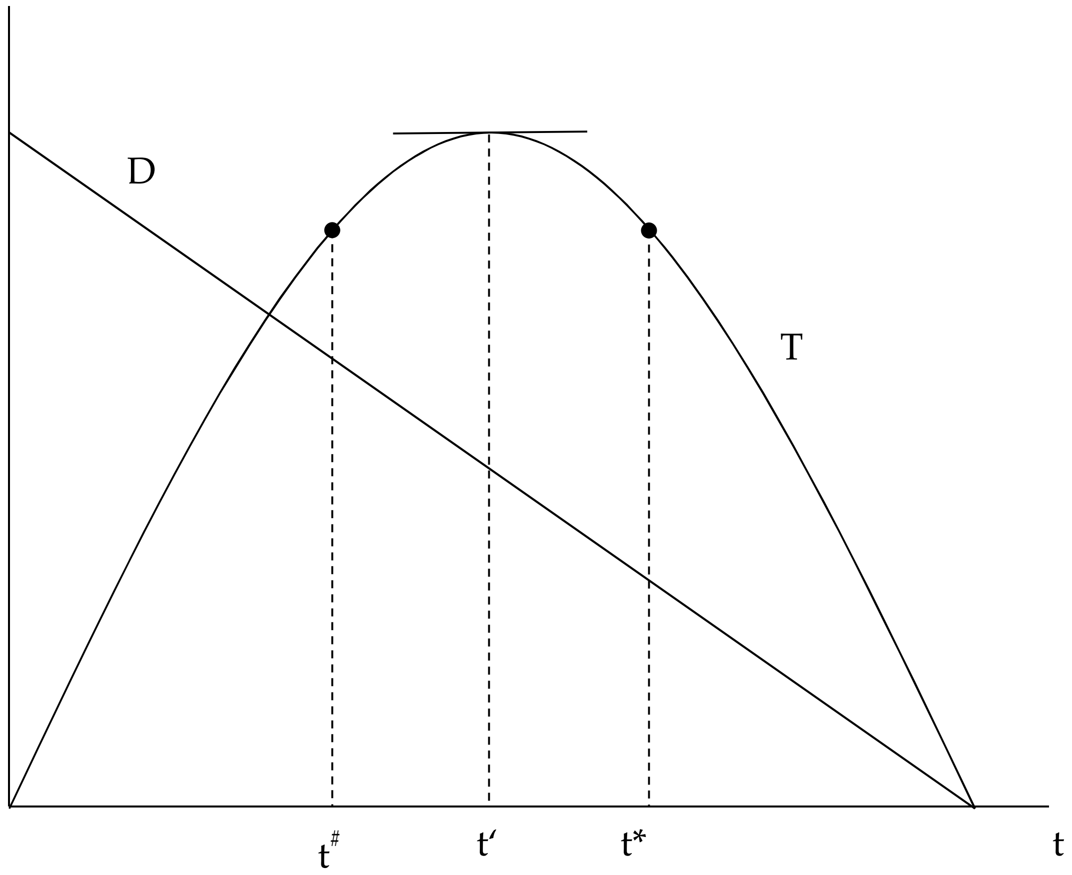
[1] For models of tobacco taxation in a political economy context see Buchanan and Vanberg (1988) and Prinz (2009).

negative externality of smoking. If non-smokers are protected by regulations such as a smoking ban in public buildings, then the case for correcting externalities by increasing the tax becomes smaller. Hence, the importance of raising revenue can carry more weight. However, tax collection may be undermined by illicit trade, which is an issue in countries with relatively weak law enforcement and high tax levels that make tobacco smuggling profitable.

In general, countries differ with respect to income and to regulation regarding tobacco. Hence, the optimal level of taxation differs across countries: it is for each country to set its own tax levels depending on income, regulations, different national cultures, level of education and the illicit tobacco consumption.

Figure 1

Optimal tobacco taxation



t excise

T tax revenue

D demand

t* optimal excise, with respect to externalities

t‘ revenue maximizing excise

t# optimal excise, taking account of consumers’ preferences

Since income varies over time, the demand might shift up or down. As a result, the optimal tax varies over time. In 2012, tobacco tax revenue declined in six of the EU15-countries[2] versus the previous year. In Portugal, the decline was 6% and 3% in Spain. In these countries the decline in tax revenue is most likely linked to lower consumption of taxed tobacco due to the economic crisis: GDP in Portugal declined by 3.5% and in Spain by 1.6% (Eurostat).

[2] Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden and United Kingdom.

In 2012, tobacco excise tax revenue in Ireland was 6 % lower compared to 2002 despite multiple tax increases. The decline of tax revenue is not primarily driven by the economic crisis effect but is instead due to the fact that tax rates are probably on the right hand-side of the Laffer-curve, as confirmed by the Irish Office of the Revenue Commissioners itself: "It seems likely that a Laffer type effect exists in the cigarette market in Ireland and the current level of taxation may be beyond the optimum." (Reidy and Walsh, 2011).

Box 1

A simple model of optimal tobacco taxation

Let us assume that the government maximizes the median voter's welfare function. Welfare W depends positively on tax revenue T. Smokers value smoking and their welfare increases with consumption. However, there is a negative externality of smoking which reduces welfare. Tax revenue T is given by: $T = tx$ where t is the excise tax and x is total consumption. The welfare of smokers increases proportionally to the square of consumption S =s x^2. The externality grows proportional to the square of consumption $E = x^2$. The weight of the externality is e and therefore the government optimizes the welfare $W = tx - (s\text{-}e)x^2$.

Aggregate tobacco consumption (x) depends on income y, awareness of health risks h and on the price level p. We assume a linear demand function $x(y,h,p) = A(y,h) - \alpha p$, where A is a function of income and awareness of health risks with $\partial A / \partial y > 0$ and $\partial A / \partial h < 0$ and α determines the price sensitivity of demand. Assuming perfect competition (the alternative assumption of monopoly power does not change any of the following results), the gross price of tobacco is the sum of the marginal cost (c) and the excise tax: $p = c + t$.

Maximization of the welfare function gives the optimal tax:

$$t^* = \frac{(1 + 2\alpha(e - s))(A - \alpha c)}{2\alpha(1 + \alpha(e - s))} \tag{1}$$

If e > s, then the optimal tax is greater than the revenue maximizing tax rate, and if e < s then the optimal tax is below the revenue maximizing tax rate. From equation (1) we can derive the effects of parameter changes:

– As an increase in income (y) leads to an increase in A, and this yields an increase in the optimal tax.

– As better public awareness of health risks (an increase in h) leads to a reduction in A, it causes a decline in the optimal tax.

– The enlarged illicit supply of tobacco increases the price sensitivity α, which leads to a decline in the optimal tax.

– Stronger smoking regulations reduce the externality e and therefore allow a revenue maximization strategy to be pursued.

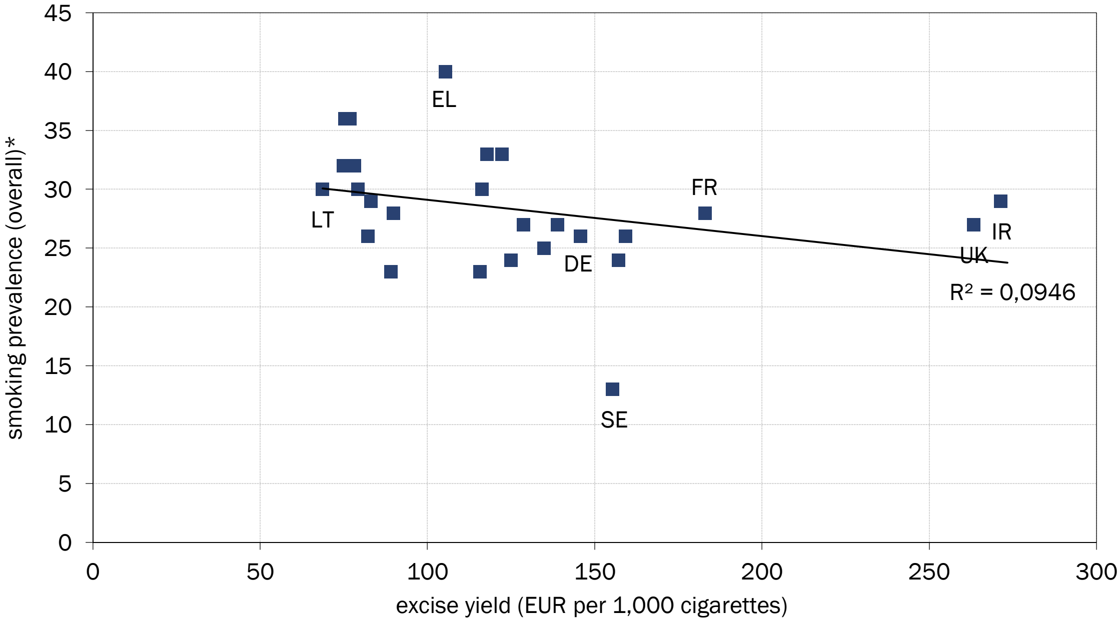
The main result of the analysis above is that the optimal tax depends on country-specific parameters. However, nations do not act in a vacuum in determining tobacco tax policy. If countries have open borders and mobility between them is high, different tax levels might encourage illicit cross-border trade. This could be reduced by more harmonized tax levels and systems on tobacco products. However, even in the EU – a single market with no national borders – there are still substantial differences in tobacco taxation between EU member states, due to significant differences in incomes. In 2014, excise on tobacco varied between €72.62 per 1000 cigarettes in Lithuania, and €288.02 per 1000 cigarettes in the United Kingdom (European Commission 2014). As both countries rank in the middle of group regarding the smoking prevalence (30 % and 27 %, respectively, according to Eurobarometer[3]), these differences show no direct relationship to smoking behavior. Likewise, the country with the highest smoking prevalence (Greece: 40 %) only has a medium level of excise yield. The correlation between the excise tax level on tobacco and smoking prevalence is very weak, see Figure 2, which shows the importance of other factors such as consumer affordability, education, cultural differences, regulations and law enforcement measures.

Ireland has one of the toughest tobacco control regulations and the second highest tax levels in the EU. It is one of a handful of countries to implement a retail display ban on tobacco since 2009. Paradoxically, however, Ireland's smoking rate remains higher than the EU average, according to Eurobarometer, and youth smoking in Ireland is the highest in the EU at around 40 %. Therefore, as Ireland's experience shows, stringent tobacco control regulation and high tax are not strongly associated with low smoking prevalence.

[3] See European Commission (2012b)

Figure 2

Tobacco tax and smoking prevalencein the EU (2012)



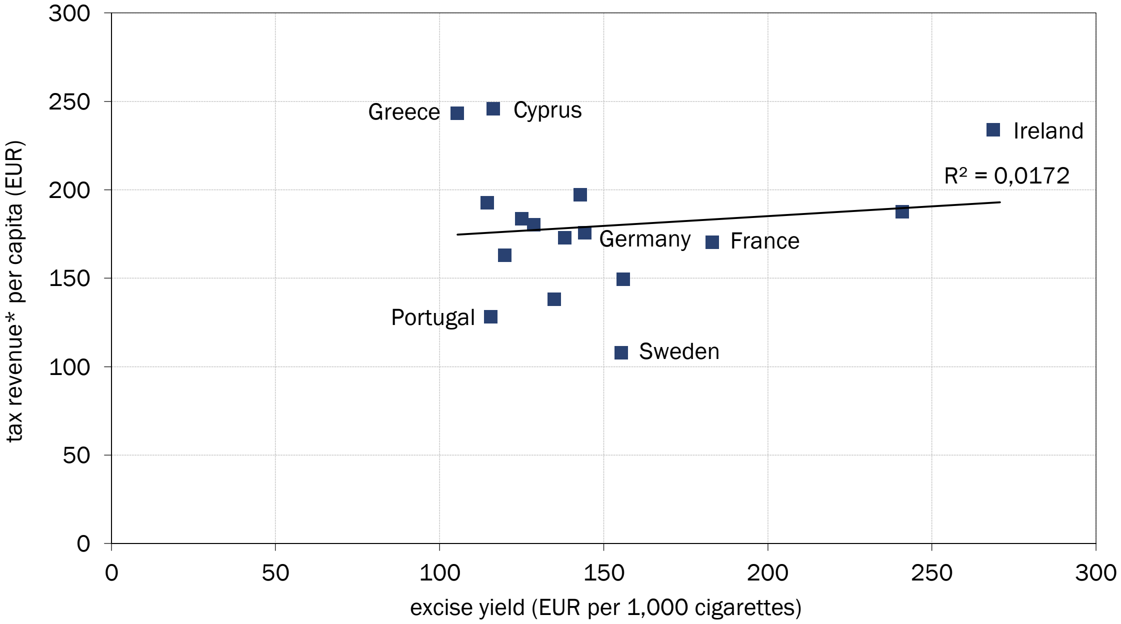
* 2011 and before

Quellen: European Commission (2012a, 2012b); HWWI.

Because of cultural differences, educational opportunities, costs of living, consumer affordability and many other characteristics, there is no detectable statistical relationship between the excise tax yield and overall tax revenues per capita of a country, see Figure 3. As a result, the correlation between excise yields and tax revenues is also weak: the R^2 of a regression of excise yields on tax revenues for the EU countries is less than 10%. Most of this correlation stems from the fact that Eastern European countries have lower excise yields and lower tax revenues than Western European countries. If the regression is carried out for Western EU countries only, the correlation is nearly zero (R^2 = 0.02). Greece and Cyprus have relatively low excise yields but high tax revenues. Ireland has very high excise yields, an average smoking prevalence, but high tax revenue per capita. Sweden has an average excise yield, a low smoking prevalence and low tax revenue.

Figure 3

The Non-correlation of excise yields and tax revenues (2012)



* Revenues from taxes on consumption (excise duties and similar charges) other than VAT.
Quellen: European Commission (2013); Eurostat 2014; HWWI.

To some extent the correlation of taxes and smoking behavior is distorted by illicit trade. Illicit trade is the outcome of demand and supply. While smokers demand cheaper products or specific products not sold on the legal domestic market, illegal tobacco manufacturers (supply side) seek to increase their sales and penetrate new markets.

Decreasing affordability in the new accession countries in Eastern Europe and the low tax burden in neighboring countries have led to an increasing illicit market in the Eastern border EU countries. In the Western and Central EU countries, the counterfeit and contraband share of the consumption has remained constant over the last years (KPMG 2013).

In conclusion, significant country differences mean that the parameters for determining the optimal tax level, and therefore the tax level itself can vary vastly from country to country. Consequently, the harmonization of tax rates on a global level does not make any economic sense and, in fact, may have negative effects due to countries' vulnerability to illicit tobacco trade.

In addition, the analysis of EU member states' experiences shows that the correlations between excise yields and the prevalence of smoking, as well as tax revenues are very weak or non-existent.

2.2 | Treatment of Tax Sovereignty in the FCTC and COP 5

The health aspects of tobacco taxation are clearly reflected in the WHO FCTC. Article 6 states that price and tax measures are an effective and important instrument to reduce tobacco consumption. However, it leaves it open to countries to pursue their own national tobacco tax policies.

Therefore, the convention does not impose any actual binding obligation on the parties with regard to tax and price policies for tobacco products. Article 6(2) of the convention only provides that the parties are to adopt or maintain measures '*as appropriate*' which '*may include*' implementing tax policies and, '*where appropriate*', price policies.

Box 2

FCTC Article 6(2)

Without prejudice to the sovereign right of the Parties to determine and establish their taxation policies, each Party should take account of its national health objectives concerning tobacco control and adopt or maintain, as appropriate, measures which may include:

a) implementing tax policies and, where appropriate, price policies, on tobacco products so as to contribute to the health objectives aimed at reducing tobacco consumption; and

b) prohibiting or restricting, as appropriate, sales to and/or importations by international travelers of tax- and duty-free tobacco products

In general, countries strongly opposed giving up tax sovereignty. Even in the EU, where tobacco tax policy has been regulated by an EU directive for many decades, tax sovereignty of member states remains important, see Box 3.

Box 3.

Tax Harmonization and Tax Sovereignty in the EU

In the European Union, tax harmonization and tax sovereignty have been negotiated over many years. In 1993, the EU introduced arrangements for tobacco tax regulation. These regulations were the result of a long discussion which started after the Commission proposed full harmonization of excise duties on tobacco products in 1985. However, the member states came to the conclusion that full harmonization of the excise duty rates throughout the European Union is not necessary for the proper functioning of the internal market. Therefore, the current Community framework for the taxation of tobacco products provides only a common structure for excise duty on tobacco products, as well as minimum rate levels, above which Member States are free to set their national rates according to their own national circumstances. To avoid conflict between EU decisions and national sovereignty, the collective decision-making on taxation requires unanimous voting, which is the case only for a very few matters of great importance, along with foreign policy and defense. The importance of tax sovereignty is reflected in the following quotes by member state governments:[4]

Irish Minister of Finance: "One of the key components of a state's expression of sovereignty is the right to determine the level of expenditure and the tax rates and structures required to support it. . . . This is a basic part of the democratic process. . . . By having unanimity in taxation matters, we can reach decisions which reflect the concerns and core interests of every member state."

The British government: "We have been very clear – nothing on tax. Tax is the province of the national states. Anything to do with tax is about sovereignty, and the Treasury must have control over how and what is collected."

The Chair of the European Joint Transfer Pricing Forum, Bruno Gibert, speaking from the French perspective: "Sovereignty and tax are very linked. It dates back to the way we built our democracy . . . during a revolution . . . against the way taxes were levied. The French Revolution in 1789 was clearly started over tax issues. So parliamentary control on taxes is very deeply rooted in people's minds."

An analysis of the Parties' negotiations on Article 6 in the Intergovernmental Negotiating Body (INB) sessions makes this even more apparent. Six INB negotiation sessions, which took place between October 2000 and February 2003, are well documented and the records can be used as evidence for the countries' intentions. Parties' intentions will then be contrasted with the recent negotiations at the Conference of Parties 5 (CoP 5) held in Seoul, Republic of Korea, 12–17 November 2012, at which the draft Article 6 guidelines on price and tax measures were discussed.

In the negotiation of the FCTC within the INB, these objections were emphasized by spokesmen of different countries. Mr. Rajala who represented the EU stated that "*the text should also ensure that the provisions on taxation did not indicate or imply any limitation of sovereignty over taxation policy*." (INB 5/2002).

And Dr. Novotny (of the United States of America) pointed out that "*under its*

[4] Citations are taken from Ring (2008).

Constitution, the United States Government could not cede tax policy to any international body" (INB 2/2001). Further below, Box 4 presents more statements quoted from the INB discussions.

Box 4

Further statements in INB discussions

Mr TAKAKURA (Japan), On the issue of tax, his Government did not consider it appropriate to introduce uniform taxation of tobacco products into a framework convention, as national taxation systems had been developed against a variety of historical and cultural backgrounds. (INB 1/2000).

Mr IGAWA (Japan) In regard to Article 6, taxation policy was a critical part of any national agenda. Since the factors underlying tax policy decisions were left to each individual Party it was inappropriate for the convention to dictate a uniform objective for national tax policies. (INB 5/2002)

Dr TATA (India) said he agreed with speakers who maintained that tax laws were a sovereign right of nations and were not subject to regulation by international agreements, but only by national authorities. (INB 2/2001).

Ms NOFTLE (Canada) said that her country supported the underlying principles reflected in the proposed text of Article F, in the belief that price and tax increases could complement an effective health policy strategy aimed at reducing tobacco consumption and prevalence. Canada nevertheless considered that all aspects of the design of specific prices and tax measures rested with individual Member States and therefore proposed the deletion of any reference to the progressive harmonization of tobacco product prices. Accordingly, paragraph F.1 should read as follows: *"The Parties recognize that price and tax measures can be an effective component of a comprehensive effort to reduce tobacco consumption. [...] consistent with the proposal of the European Community and with her proposal with regard to paragraph F.1, her Government supported an approach in which each State Party would have the level of flexibility in tax policy appropriate to its circumstances."* (INB 2/2001).

Ms SUH (Republic of Korea) said that her Government agreed in principle that a tobacco pricing policy was a useful measure for controlling tobacco demand. However, since the selection and implementation of tax policies should reflect the specific circumstances of each country, it was necessary to be circumspect. (INB 2/2001)

Ms BALOCH (Pakistan) said that since tax policies were an essential prerogative of States, it was difficult to harmonize regulations between States with different economic and political systems. (INB 2/2001).

In summary, parties unanimously agreed that tax laws should not be subject to regulation by international agreements but only by national authorities. Therefore, prescriptive obligations were inappropriate and unacceptable because national tax regulations would not permit an international body or treaty to create obligations in this important area.

The draft guidelines presented for consideration at CoP 5 contain some apparent contradictions. One of the key points that deserve particular attention is that Chapter 3.2 "Level of tax rates to apply" starts with:

"As recognized in Guiding Principle 1.1, Parties have the sovereign right to determine and establish their taxation policies, including the level of tax rates to apply. There is no single optimal level of tobacco taxes that applies to all countries because of differences in tax systems, in geographical and economic circumstances, and in national public health and fiscal objectives."

However, the statement is followed by the recommendation of a single tax level of 70 % of the retail price, which is based on the WHO recommendation. In essence, the draft guidelines promote precise obligations on how the Parties should determine and establish their taxation policies. This not only clearly contradicts the previous statement but also the wording and the spirit of the FCTC Article 6(2). Prescriptive measures were rejected in the INB discussions and, therefore, should not be included in the guidelines to ensure no interference with the sovereign rights of the Parties in respecting the treaty.

3 | Earmarking

3.1 | Economic considerations

Earmarking is defined as the practice of designating or dedicating specific revenues to the financing of specific public services. If we assume a welfare maximizing government, it will always choose optimal tax and public spending levels. In that case, there is no rationale for earmarking. Following Buchanan (1963), there might be a case for earmarking when the political decision-making process is explicitly taken into account.[5] However, the Buchanan model has been criticized for several reasons. McMahon and Sprenkle (1970) set up a more realistic model, in which the demand for public goods and production costs of public goods might change over time. As a result, earmarking is likely to lead to non-optimal solutions. The reasons are:

1) Earmarking impedes quick adjustment to changes in costs and to changes in demand. Therefore, earmarking inhibits the attainment of production efficiency, efficient allocation of services among users, and exchange efficiency.
2) Earmarking requires supplementary aid to adjust for dynamic changes in tax revenue or changes in the production cost of the public good.

[5] In the Buchanan model, general tax funding requires two decisions by voters. First, they have to decide on the bundle of public goods provided. Second, they decide on the budget size, taking the shares of different public goods as given. Earmarking 'unbundles' the public goods and allows choosing freely which quantities of the public goods should be provided at which prices (tax). If expenditures were financed through a system in which citizens voted directly on a series of tax/expenditure issues, the "package deal" approach that characterizes the annual process of budget negotiation in many countries could be avoided. Voters would be given a wider scope for public choice, and the resulting budget allocations would, arguably, more accurately reflect citizens' preferences.

Bös (1999) shows that departures from the direct democracy assumption in the Buchanan model might change its results. This is of particular relevance since most countries have no direct-democracy elements in their political decision process on taxation. Bös (1999) analyses an institutional design of earmarking which seems to be empirically more relevant. There are several agents (ministries): one of them (the finance ministry) levies the earmarked tax and another (the ministry of health) spends the money. Both agents are monitored by the parliament. When politicians maximize expected votes, they are likely to choose earmarking. However, the theoretical model shows that the costs of public goods are inefficiently high.

Besides the theoretical arguments against earmarking, there have been several empirical investigations into the efficiency of earmarking. McCleary (1991) looks at the arguments for and against earmarking. He illustrates the discussion with case studies from the World Bank and summarizes that *"[t]he lessons from the real world appear to bear out the skepticism of the majority about earmarking: in general, it has not worked very well."*

Bird and Jun (2005) argue that earmarking is sensible in the case of user charges. In these cases it introduces market logic into the budgetary process. However, if there is no benefit linked to earmarking, then it is rather tenuous. Allen and Radev (2006) show that in general earmarking induces rigidities in the general budget, and thereby reduces the flexibility of decisions by an elected parliament. In their IMF Working Paper, they conclude: "[earmarking deprives] *elected officials of the freedom to allocate funds among competing expenditure programs in accordance with currently perceived needs*." As a result, compared to an elected parliament's decisions, some parts of the budget are overfunded and some parts of the budget are underfunded.

More recently, Oxford Economics (2013) has shown that earmarking generally means that designated expenditure programs are subject to less scrutiny than the parts of government budgets that are subject to comprehensive reviews. This encourages rent-seeking behavior: earmarking provides an incentive for interest groups to lobby for increases in the earmarked taxes. As a result, the interest group benefits from the receipts and others have to pay.

Under these circumstances and judged on its own merits, it is highly questionable that it is appropriate to put forward a recommendation on tax earmarking for all countries, if indeed it is appropriate for any country. To understand why such a recommendation could arise, it is helpful to look at public choice theory. While the legislative procedure or decision-making may differ significantly from country to country, there are always three groups of individuals involved: voters, politicians, and bureaucrats. Public choice theory assumes that they all follow their own self-interest. Voters elect those politicians who best represent their interest. Politicians maximize their own welfare by winning elections. The third influential group is made up of bureaucrats. They seek to increase their budgets in order to increase their own power and influence. This leads to a growth in public budgets which potentially reduce social efficiency. Given these assumptions, it is likely that earmarking is an attempt by bureaucrats to maximize their budget. Therefore, as argued above, earmarking as a general and a global recommendation is most likely to be inefficient. It is likely to increase health related or tobacco control budgets and therefore the influence of bureaucrats in that sector.

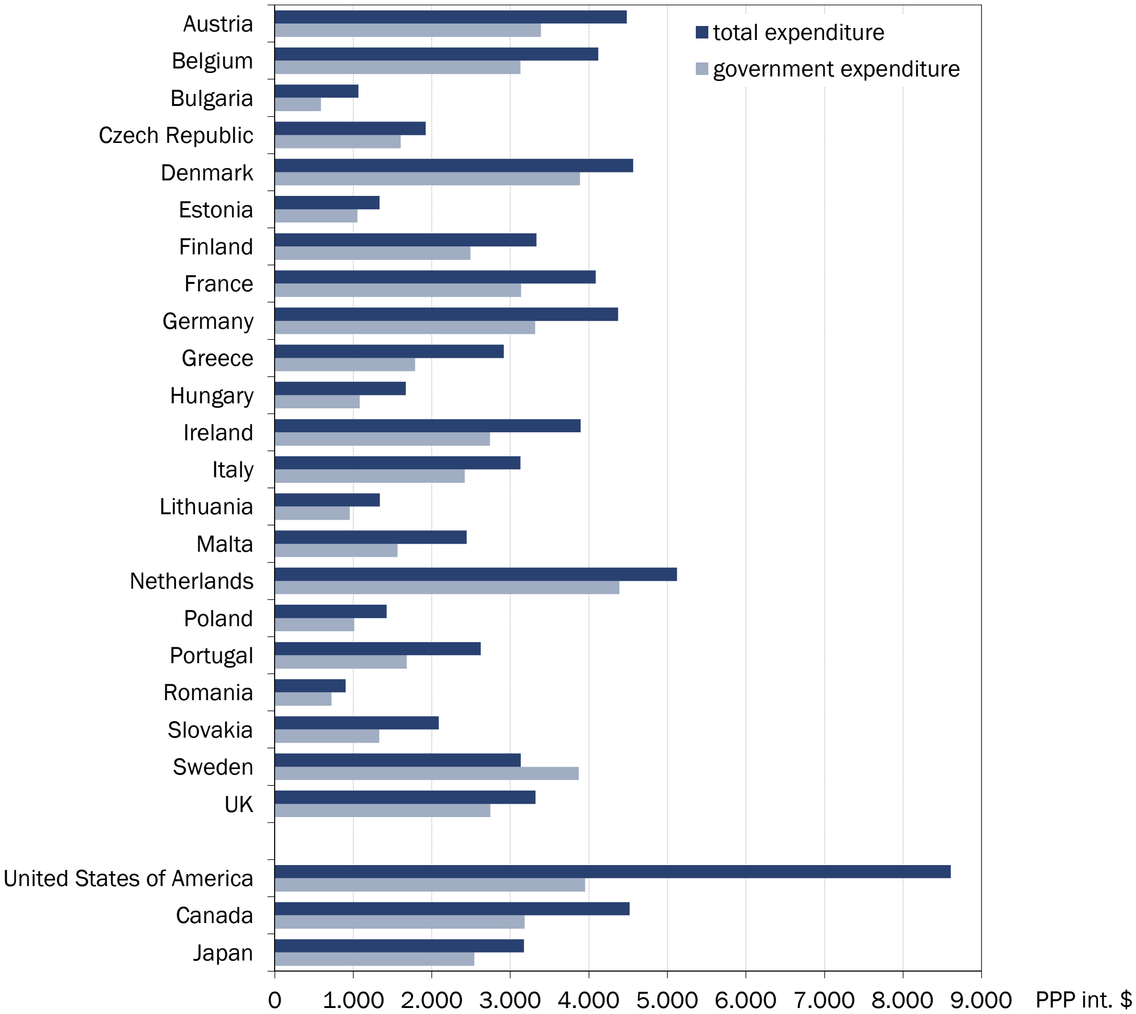
3.2 | Treatment of Earmarking in the FCTC and COP 5

According to the WHO database (World Health Organization 2012), earmarking is not Parties' best practice. Only 14 countries dedicate tobacco tax revenues for special purposes and not necessarily for tobacco-control programmes as recommended by the draft Article 6 guidelines. Given its own assessment and the general weaknesses of earmarking, it is illogical that the World Health Organization (2011) recommends earmarking of tax revenues for tobacco control.

Even the global recommendation to dedicate revenue to health care systems would be inappropriate as the right to determine the use of tax revenues is one of the key components of a state's expression of sovereignty. Countries are very different and so it is unlikely that earmarking is optimal for all of them: Section 2 of this paper shows that there are large differences in the optimal tobacco tax level. With regards to the tax revenue use, the differences might be even more pronounced. In some countries the health care system is more or less privately financed. In contrast, there are countries where health care is mainly tax financed, while in a third group of countries it is financed by social security programs. Furthermore, there are large differences in the absolute level of health expenditures, partially explained by income level. Figure 4 shows the difference in total and public expenditures on health for the EU countries.

Figure 4

Per capita expenditure on health 2011



Source: WHO (2014); HWWI.

With respect to earmarking of tobacco taxes, van Walbeek, a scholar whose research interests are primarily in the economics of tobacco control acknowledges: "*Even though some countries earmark a portion of their tobacco tax revenue for tobacco control, or for public health in general, we know very little about the success or failure of such efforts, and to what role earmarking can play in reducing the impact of higher tobacco taxes on the poor.*" [6]

Earmarking was also suggested in INB discussions on FCTC. Different speakers proposed an inclusion of a subparagraph with the recommendation to earmark or allocate the revenue from tobacco taxes to tobacco control programs, see Box 5. However, all these proposals have been rejected by the vast majority of the Parties.

[6] van Walbeek et al. (2013)

Box 5

Three rejected proposals from the INB discussion

Mr BATIBAY (Turkey) … In paragraph 3, he proposed that the text be amended to read as follows: "The Parties undertake to finance national tobacco control strategies, plans, programmes, policies and legislation. To this end a part of tobacco tax revenue may be allocated to such activities." (INB 1/2000)

Dr ABOU-ALZAHAB (Syrian Arab Republic) suggested that reference should be made in paragraph F.2 to the allocation of a certain percentage of taxes on tobacco products to bodies responsible for combating illicit traffic in such products. That would pave the way for imposition of higher taxes on tobacco in the future. (INB 2/2001)

Mr SHEVCHOUK (Ukraine) commented that his delegation supported the Chair's text but proposed incorporating in subparagraph 2(b) the concept that part of the income from price increases and tax measures should be given to the authorities involved with tobacco control, unless such wording was already included elsewhere in the convention. (INB 3/2001)

The main reason for the rejection of earmarking was that it would not be compatible with national tax constitutions and laws and it would undermine national tax sovereignty. Dr Hou Peisen (China): "*In conclusion, it was suggested that no specific percentage be established for tax revenue and that paragraph 3 might read ´All Parties undertake, according to their own national conditions, to provide financial support for the strategy of tobacco control.´*" (INB 1/2000)

The issue of the earmarking of tobacco tax revenues was again a controversially discussed at the CoP 5 to the WHO FCTC in November 2012. In the introduction of Summary Records of Committees the Chair of the working group on price and tax measures states that:

"The chapter on use of revenues financing of tobacco control, which concerned the thorny issue of earmarking, had been included as a compromise." (Conference of the Parties to the WHO Framework Convention on Tobacco Control 2012).

The debate on this compromise was intense and delegates from different countries were very skeptical. At the beginning of the conference Mr. Seychell, the delegate from the European Union, referred to the former conference and said: "*the European Union was satisfied that the key conditions […] had been met: fiscal and health experts had been involved in the development of the draft guidelines; tax sovereignty had been outlined as the first overarching guiding principle; and allocation of tax revenues – earmarking – remained the full responsibility of each Party. The European Union's efficient tobacco taxation policy could serve as an example." (p. 5)*

Despite concerns of this type, it was suggested to add the recommendation: "*Parties could consider, while bearing in mind Article 26.2 of the WHO FCTC, and in accordance with national law, dedicating revenue, for example from tobacco taxation or part of it, to tobacco-*

control programmes, such as those covering awareness raising, health promotion and disease prevention, cessation services, economically viable alternative activities, and financing of appropriate structures for tobacco control."

Mr. Diemer (European Union) expressed his serious concern on this position. However, he agreed that "*the European Union could, in a spirit of compromise, accept its inclusion in the set of guiding principles and recommendations provided that the words ´for example from tobacco taxation or part of it´ were deleted."* The Chinese spokesman was even more critical and emphasized that "*China's legal system would not allow for the earmarking of tax revenues*." (p.81) As a response the Committee Chair answered: "*She understood the concern expressed by the representative of China, but asked him to remember that it* ***was just a recommendation, not a guideline;*** *that the word '****earmarking'*** *was not mentioned; that taxation revenue was cited only as an example; and that there were several safeguards in the text, such as the word '****could'*** *in the phrase '****the Parties could consider*** *… dedicating revenue … to tobacco-control programmes', and the words '****in accordance with national law****.'*"(p.81, own emphasis)

As a result it could be summarized, that it was only agreed to include the recommendation with respect to earmarking because it can be ignored if countries wished to do so. In the final recommendation Parties agreed to delete the words "for example from tobacco taxation or part of it".

4 | Conclusion

The FCTC Treaty Article 6 text puts strong emphasis on the tax sovereignty of individual countries and does not promote any international coordination and/or harmonization. Furthermore, Article 6 does not state anything with respect to earmarking. In contrast the draft Article 6 guidelines not only undermine nations' tax sovereignty but infringe the Treaty provisions and intentions of Parties. To comply with the spirit of the Treaty and the intentions of 168 signatory countries, it is critical that Parties' tax sovereignty is respected in all aspects of the guidelines. This requires a rejection of the guidelines as they currently stand when they are debated at the Sixth Conference of the Parties of the WHO FCTC, which is scheduled to be held in Moscow, on 13-18 October 2014.

References

Allen, R.; Radev, D. (2006): Managing and controlling extrabudgetary funds, International Monetary Fund.

Bird, R.; Jun, J. (2005): Earmarking in theory and Korean practice, ITIC.

Bös, D. (1999): Earmarked Taxation – Welfare versus Political Support, CESifo Working Paper 207.

Bräuninger, M.; Stiller, S. (2010): Ökonomische Konsequenzen des Konsums von nicht in Deutschland versteuerten Zigaretten, Studie im Auftrag des Deutschen Zigarettenverbandes, Hamburg.

Buchanan, J.; Vanberg, V. (1988): The politicization of market failure, Public Choice 57 (2), 101–113.

Buchanan, J. M. (1963): The economics of earmarked taxes, The journal of political economy 71 (5), 457–469.

Conference of the Parties to the WHO Framework Convention on Tobacco Control (2012): Summary Records of Committees, 6 pp. Accessed 4 February 2014.

Cnossen, S. (2005): Theory and Practice of Excise Taxation, Oxford University Press

European Commission (2014): Excise Duty Tables, Part III – Manufactured Tobacco, REF 1039 rev1, January 2014.

European Commission (2013): Excise Duty Tables, Part III – Manufactured Tobacco, REF 1038 rev1, July 2013.

European Commission (2012a): Excise Duty Tables, Part III – Manufactured Tobacco, REF 1034 rev1, January 2012.

European Commission (2012b): Attitudes of Europeans towards Tobacco, Special Eurobarometer 385, http://ec.europa.eu/public_opinion/index_en.htm.

KPMG (2013): Project Star 2012 Results.

McCleary, W. (1991): The Earmarking of Government Revenue: A Review of Some World Bank Experience, World Bank Res Obs 6 (1), 81–104.

McMahon, W.W.; Sprenkle, C.M. (1970): A theory of earmarking, National tax journal 23 (3), 255–261.

Oxford Economics (2013): Are earmarked taxes on alcohol and tobacco a good idea? Evidence in Asia, International Tax & Investment Center, 11 pp.

Prinz, A.L. (2009): The Political Economy of Smoking Regulation and Taxation, Public Choice 141 (3/4), 291–303.

Reidy P, Walsh K (2011). *Economics of Tobacco: Modelling the Market for Cigarettes in Ireland*. Dublin: Office of the Revenue Commissioners, Research and Analytics Branch.

Ring, D.M. (2008): What's at Stake in the Sovereignty Debate?: International Tax and the Nation-State, Virginia Journal of International Law 49, 55-234..

van Walbeek, C.; Blecher, E.; Gilmore, A.; Ross, H. (2013): Price and Tax Measures and Illicit Trade in the Framework Convention on Tobacco Control – What We Know and What Research Is Required, Nicotine & Tobacco Research 15 (4), 767–776.

World Health Organization (WHO) (2014): Online Database, www.who.int.

World Health Organization (WHO) (2011): WHO technical manual on tobacco tax administration, Geneva, Switzerland.

World Health Organization (WHO) (2012): 2012 global progress report on implementation of the WHO Framework Convention on Tobacco Control, Geneva, Switzerland.

World Health Organization (WHO) (2003): WHO Framework Convention on Tobacco Control, Geneva, Switzerland.

HWWI Research Papers

since 2012

151 Entwicklung und Determinanten des Siedlungsabfallaufkommens in Deutschland
Jan-Ove Erichsen, Friso Schlitte, Sven Schulze, Juni 2014

150 Changing patterns of electricity use in European manufacturing: a decomposition analysis
Lars Wenzel, André Wolf, June 2014

149 Who is overeducated and why? Probit and dynamic mixed multinomial logit analyses of vertical mismatch in East and West Germany
Christina Boll, Julian Sebastian Leppin, Klaus Schömann, May 2014

148 Welfare implications of power rationing: an application to Germany
Lars Wenzel, André Wolf, February 2014

147 Overeducation among graduates: An overlooked facet of the gender pay gap? Evidence from East and West Germany
Christina Boll, Julian Sebastian Leppin

146 Pane e Cioccolata: The Impact of Native Attitudes on Return Migration
Augustin de Coulon, Dragos Radu, Max Friedrich Steinhardt, December 2013

145 Does better education cause higher income?
Malte Hoffmann, Uwe Jensen, December 2013

144 Towards a new measure of a country's competitiveness: applying canonical correlation
Lars Wenzel, André Wolf, November 2013

143 Economics of Extreme Weather Events in Cities: Terminology and Regional Impact Models
Malte Jahn, Oktober 2013

142 Regional Diversity in the Costs of Electricity Outages: Results for German Counties
Simon Piaszeck, Lars Wenzel, André Wolf, September 2013

141 A Zidane Clustering Theorem - Why top players tend to play in one team and how the competitive balance can be restored
Henning Vöpel, September 2013

140 Short-term Forecasting with Business Surveys: Evidence for German IHK Data at Federal State Level
Lars Wenzel, André Wolf, August 2013

139 Sektorale und regionale Betroffenheit durch den Klimawandel am Beispiel der Metropolregion Hamburg
Xenia Frei, Julia Kowalewski, June 2013

138 Equal matches are only half the battle.Why German female graduates earn 33% less than males
Christina Boll, January 2013

137 Protection against major catastrophes: an economic perspective
Lars Wenzel, André Wolf, January 2013

136 The political economy of trade and migration: Evidence from the U.S. Congress
Paola Conconi, Giovanni Facchini, Max Friedrich Steinhardt, Maurizio Zanardi, December 2012

135 Political Determinants of Budget Deficit in Pakistan: An Empirical Investigation
Mumtaz Anwar, November 2012

134 The Impact of Distance in Seaborne Trade: An Analysis of Bilateral Container Transport Flows
Franziska Biermann, November 2012

133 Forecasting Regional Growth in Germany: A panel approach using Business Survey Data
Lars Wenzel, October 2012

132 Public Sector Employment and Fertility in Germany
Nora Reich, September 2012

131 The effect of market access on the labor market: Evidence from German reunification
Ulrich Zierahn, September 2012

130 Monocentric Cities, Endogenous Agglomeration, and Unemployment Disparities
Ulrich Zierahn, September 2012

129 Impact of Benefit Sanctions on Unemployment Outflow – Evidence from German Survey Data
Katja Hillmann, Ingrid Hohenleitner, September 2012

128 Who leaves and when? Selective outmigration of immigrants from Germany
Torben Kuhlenkasper, Max Friedrich Steinhardt, June 2012

127 Inter-industrial relations and sectoral employment development in German regions
Julia Kowalewski, June 2012

126 Regionalization of national input-output tables: empirical evidence on the use of the FLQ formula
Julia Kowalewski, June 2012

125 Does Dual Citizenship Increase Naturalization? Evidence from Indian Immigrants in the U.S.
Daniel Naujoks, May 2012

124 The Estimation of Reservation Wages: A Simulation-Based Comparison
Julian S. Leppin, April 2012

123 Trade and Economic Growth: A Re-examination of the Empirical Evidence
Matthias Busse, Jens Königer, April 2012

122 Immigration and Election Outcomes – Evidence from City Districts in Hamburg
Alkis Henri Otto, Max Friedrich Steinhardt, April 2012

121 Renewables in the energy transition – Evidence on solar home systems and lighting fuel choice in Kenya
Jann Lay, Janosch Ondraczek, Jana Stöver, April 2012

120 Weniger Rechtsverletzungen durch mehr Informationen? Arbeitsmarkterfahrungen und Informationsbedarf bulgarisch- und albanischsprachiger Zugewanderter in Berlin
Vesela Kovacheva, Dita Vogel, Mai 2012

119 Creative professionals and high-skilled agents: Polarization of employment growth?
Jan Wedemeier, March 2012

118 Unraveling the complexity of U.S. presidential approval. A multi-dimensional semi-parametric approach
Michael Berlemann, Soeren Enkelmann, Torben Kuhlenkasper, February 2012

117 Policy Options for Climate Policy in the Residential Building Sector: The Case of Germany
Sebastian Schröer, February 2012

116 Fathers' Childcare: the Difference between Participation and Amount of Time
Nora Reich, February 2012

115 Fathers' Childcare and Parental Leave Policies – Evidence from Western European Countries and Canada
Nora Reich, Christina Boll, Julian Leppin, February 2012

114 What Drives FDI from Non-traditional Sources? A Comparative Analysis of the Determinants of Bilateral FDI Flows
Maximiliano Sosa Andrés, Peter Nunnenkamp, Matthias Busse, January 2012

The **Hamburg Institute of International Economics (HWWI)** is an economic think tank. The HWWI is a non-profit research organisation (gemeinnützige GmbH), privately funded, independent and committed to the principles of a Social Market Economy. Through our research work, we assume responsibility for and contribute to a free, progressive and open society.

Value-free science, open-ended research and methodological pluralism characterise our work. By doing so, we commit ourselves to rules on Safeguarding Good Scientific Practice.

The HWWI operates in the following research areas, acting in a scientific and consultancy capacity:

- Economic Trends and Global Markets,
- Regional Economics and Urban Development,
- Sectoral Change: Maritime Industries and Aerospace,
- Institutions and Institutional Change,
- Energy and Raw Material Markets,
- Environment and Climate,
- Demography, Migration and Integration,
- Labour Economics, Economics of Education, Family Economics,
- Health and Sports Economics,
- Family Owned Business, and
- Real Estate and Asset Markets.

Hamburg Institute of International Economics (HWWI)

Heimhuder Str. 71 | 20148 Hamburg | Germany
Phone: +49 (0)40 34 05 76 - 0 | Fax: +49 (0)40 34 05 76 - 776
info@hwwi.org | www.hwwi.org