

Tobacco Taxes in Latin America

Policy Brief N° 7/2019

MEXICO

ACCELERATING EFFECTIVE
TOBACCO TAXES IN MEXICO:
**SPECIAL TAXES, CONSUMPTION,
INEQUALITY AND POVERTY**

This Policy Brief was prepared by the South American Network on Applied Economics/Red Sur and presents the main findings and policy recommendations resulting from the background study for Mexico, by CIAD, Centro de Investigación en Alimentación y Desarrollo, within the UIC-Red Sur project “Tobacco taxes in Latin America”, as part of a global project coordinated by The University of Illinois at Chicago’s (UIC) Institute for Health Research and Policy and supported by the Bloomberg Initiative to Reduce Tobacco Use.

TAX STRUCTURE OF TOBACCO IN MEXICO

INTRODUCTION

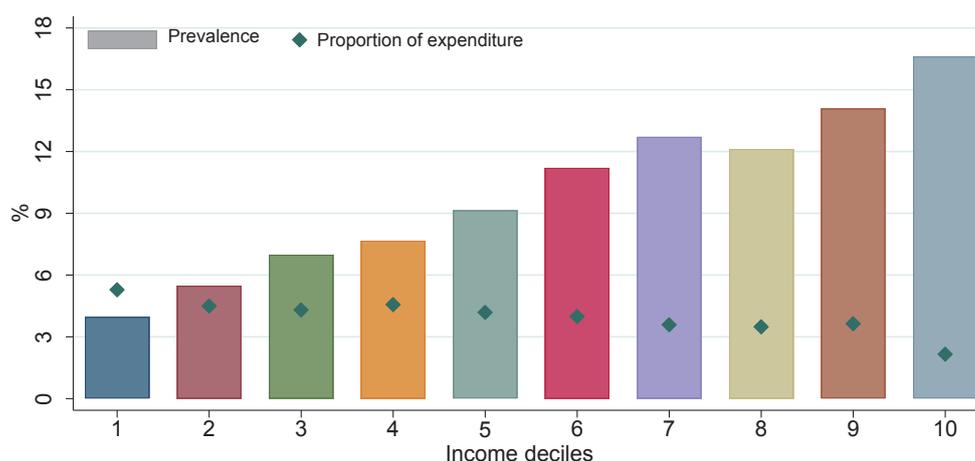
This study evaluates the consumption effects of special tobacco taxes in Mexico. It also analyses the distributive effects under four tax reform scenarios. In the international context, cigarette prices in Mexico are lower than prices in other countries, and have lagged over the past several years. Also, Mexico has an additional difficulty in resource allocation to fight tobacco related illnesses: On the one hand, Mexico has one of the lowest healthcare budgets in Latin America. On the other hand, due to decreased non-tax revenues since 2015, particularly oil revenues, healthcare budgets, which often comprise up to 25% of the total budget, have been severely restricted. Furthermore, tobacco taxes have not been modified since 2011.

In 2016, Mexico's overall smoking prevalence was 17.6%. At the same time, half of the population lives in poverty. Therefore, a tobacco tax increase should have the direct impact not only to reduce consumption, but also to support healthcare costs related to tobacco use, especially for households living in poverty with high tobacco expenditures.

As noted in Graph 1, Mexico has a higher prevalence of tobacco consuming households as income levels increase. In the first decile, about 4% of households have tobacco expenses, which represents an average of 5.5% of total expenses (monetary current expenditure). On the contrary, the highest prevalence of tobacco use is among households in the 10th decile, reaching 17%. However, this expense only represents 2% of total expenses.

As shown in Graph 1, the prevalence of tobacco consumption in the highest income decile (10th decile) is four times higher than in the lowest decile (1st decile).

Figure 1. Prevalence of households with tobacco expenditure and proportion of expenditure on tobacco. Mexico, 2016)



Source: Developed by CIAD based on ENIGH, 2016.

In 2016, 43.4 percent of households in Mexico lived in poverty. Tobacco consuming households in conditions of poverty (32.8% of tobacco users) represented 4.2% of the total number of poor people in the country. This is a relatively low percentage.

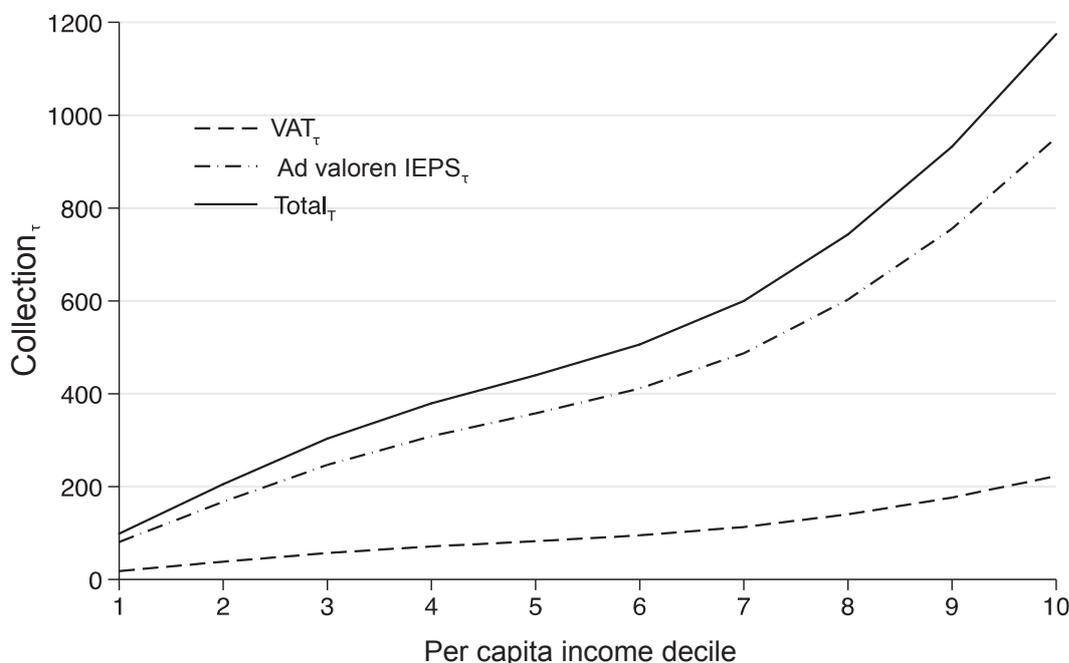
The greatest number of poor households with tobacco expenses (518,517 families) is in urban areas. However, there are more non-poor tobacco users in rural rather than urban areas, about 70% of families. For this reason, Mexico's tobacco control public policies must focus on the whole country, and especially in areas with a higher risk of poverty.

Since 2010, tax revenues from special tobacco taxes have maintained the same level at 0.2% of GDP. In 2018, revenues from this tax barely represented the 36% of healthcare expenses related to tobacco use and its treatment, which in turn represented 0.55% of GDP.

Mexico's special tax on tobacco is a mixed structure. Its *ad valorem* and specific components have remained the same since 2011 (160% and 0.35 Mexican pesos per cigarette respectively). The importance of the special tax in relation to the total collection is considerably higher than VAT due to the strong effect that it has on the *ad valorem* component (its nominal tax is ten times higher than VAT [160 vs. 16%]), as well as the specific component (which levies the cigarette per unit).

In Mexico, the specific component of the tax is not adjusted for inflation. Therefore, as time passes, the tax effect has been lost. On the other hand, Mexico has one of the lowest legal taxes for tobacco in Latin America (just above Colombia and Paraguay). Indirect taxes (special tax and VAT) represent 68% of the product's final price. This tax is still below the 75% recommended by the World Health Organization (WHO).

Figure 2: Tobacco tax collection per decile, Mexico 2016 (million pesos -mp- annually)



Source: Developed by CIAD based on ENIGH, 2016.

Graph 2 summarizes the contribution of each decile to indirect taxes paid. For every peso obtained by indirect taxes on tobacco, 0.32 cents come from richer households, while poorer households contribute 0.03 cents (eleven times less). Richer households (in absolute terms) contribute more as a reflection of high tobacco expenses. However, the smaller collection from the lower deciles does not imply that poorer people are not affected by tobacco taxes.

RESEARCH FINDINGS

The four reform scenarios produced by CIAD in this research are the following: a) the modification of the tax's specific component, increasing it to reach 1.35 Mexican pesos; b) increase the *ad valorem* component up to 240%; c) increase both the *ad valorem* and specific excise tax components to 260% and 0.80 Mexican pesos, respectively to reach 75% WHO recommended tax (excise plus VAT) retail price; and d) increase the *ad valorem* component up to 240% and the specific component to 2.35 Mexican pesos so that domestic price is adjusted to international levels.

The most important findings of this study are:

- Contrary to tobacco use trends in other countries, prevalence among poorer people is the lowest relative to people in higher-income deciles of the population. As highest income deciles have a greater prevalence and consume higher priced brands, a higher share of tax revenues come from taxpayers in the highest income decile. This results in a progressive redistributive effect.

- The estimated price elasticity for cigarette demand is around -0.58 , which is in line with previous empirical studies in Mexico. Elasticity of smoking participation is -0.12 plus conditional elasticity of cigarette consumption -0.46 .

- There is little variation in conditional price elasticity by income level, however some preliminary evidence suggests conditional price elasticity is lower in the first decile than in the higher income decile. Therefore, it is expected that poor smokers who

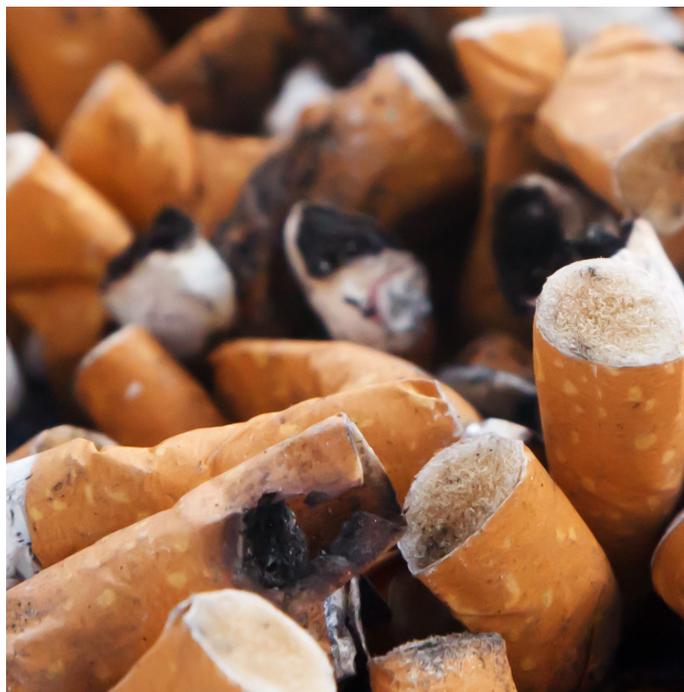
keep smoking after the tax increase will reduce their consumption relatively less than wealthy smokers.

- The amendment of the IEPS should increase the amount of the specific component in a greater amount than the *ad valorem* rate because the specific tax: a) is required to be updated above inflation periodically; and b) produces a greater reducing effect in consumption.

- The increase of the specific tax component does not increase the regressivity of the tax, because much of the tax burden of the specific component falls on higher-income smokers.

- The tobacco tax increase will have a limited impact on poverty. Even in the most aggressive scenario, poverty will increase 2.6% among those who continue to smoke after the tax increase. For this reason, tobacco tax increases should be part of a comprehensive package of tobacco control policies to encourage smokers to quit.

- The effect of tax reforms on inequality would also be limited. In the first two scenarios the increase of Gini index would be less than a percentage point. In the third and fourth scenarios would be 1% and 1.07% respectively. Although the last two scenarios establish more aggressive tax reforms, their impact on inequality within their group would be relatively low and imperceptible at the national level.



POLICY RECOMMENDATIONS

This research finds that with the additional revenues from tobacco tax increases, it is possible to contribute to the fight against poverty caused by the relative regressivity of the tax. In order to design a better tobacco tax, it is necessary to increase the specific tax component (from 0.35 to 2.25 Mexican pesos for 2016 value, and update the at least for inflation). This would guarantee a greater influence of the excise tax on the final price of tobacco.

The influence of the special tobacco tax is relatively low on smoker poverty levels. Poor smokers who continue to smoke could be compensated by a transfer, preferably by a basic food basket. The basket will largely compensate continuing smokers affected by the increase in tobacco prices.

Tobacco tax revenues should be directed to two main areas:

1. Strengthening national health programs against tobacco use: Increase the coverage of healthcare for illnesses related to tobacco use through social insurance that provides health services to low-income populations. Also, the revenues should be used for a health program aiming to fight tobacco-related illnesses, including a complete medical check-up to detect illnesses produced by tobacco use.
2. Assigning a transfer to population groups in poverty, comprised of a food basket (of the most consumed foods among poor people: eggs, beans, milk and tortillas) through food allowance (food stamps). Use government distribution channels, called Diconsa-Liconsa, or through money transfers by cards and labelling the benefit only to acquire the four types of foods included.

Lastly, this research recommends the implementation of the tax reforms included in the third and fourth scenarios: a) in the lower income deciles, smoking households would reduce their tobacco use up to 36%, while in higher income deciles it would reduce it by 23%; b) the variation of the cigarette's price would be up to 42.8%. It would be higher in lower deciles (47.5%); c) it has been noted



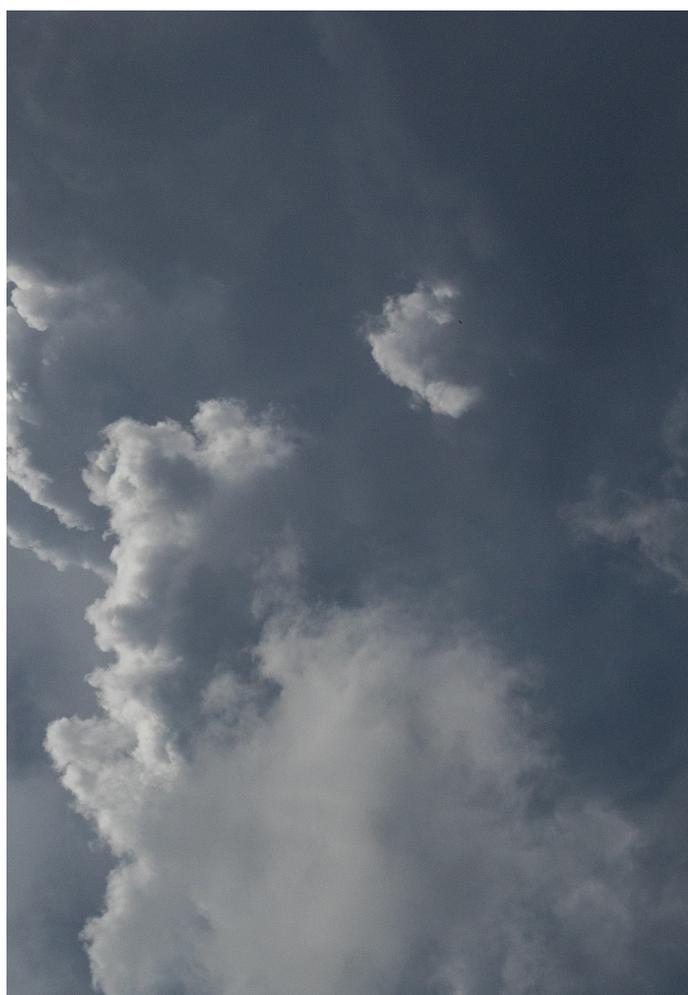
small increments in poverty levels among smoking households.

Even though indirect taxes (excise tax plus VAT) currently represent 67% of tobacco's price in the country, this total tax share is still below the 75% recommended by the WHO. Under any tax amendment scenario, it is necessary to update the specific component of the special tax in accordance to inflation levels, so that it does not lose its purpose of reducing consumption.

A subsidy to the basic food basket would compensate the most for the poverty among continuing smokers caused by the increase of the tobacco price tax. These groups could acquire more goods labelled as food and, at the same time, taxes would reduce tobacco consumption and would indicate a change in their consumption patterns. However, this research reveals that a healthcare cost subsidy would only compensate smoking households experiencing chronic poverty. To implement the recommendations mentioned as a public policy it is necessary that the Mexican government legislates in favour of the allocation of tax revenues coming from tobacco. If the pertaining law is not modified, the additional resources gathered would still be used in other areas of public expenses. Due to the factors noted before, this task should be included in the legislative agenda, start an amendment, and later implement the changes recommended in this investigation.

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Within this global initiative, Red Sur led the regional research “Tobacco taxes in Latin America”, which mobilized seven research centers to study the different options for tobacco tax policies in Argentina, Brazil, Ecuador, Mexico and Peru.

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