



RESEARCH PROJECT ON TOBACCO TAXATION IN  
WEST AFRICA «FISCAL SOLUTIONS FOR MAXIMUM  
REDUCTION OF SMOKING IN WEST AFRICA»



## EFFECTIVENESS OF TOBACCO PRODUCT TAXATION SYSTEMS IN ECOWAS MEMBER COUNTRIES: TAX INCIDENCE APPROACH

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### INTRODUCTION

*Increasing taxes is considered the most effective measure to reduce the consumption of tobacco products. To enable taxation to play this role, ECOWAS adopted a new Directive on the taxation of tobacco products in December 2017. It provides a set of measures including a rise in taxes with a mechanism for regular rate increases. The resulting tax revenue will be paid partly by the consumer and partly by the producer. The higher the consumer share, the more the increases can discourage consumption and the more effective the tax system. However, this mechanism only works if the tax increases are shifted by the manufacturer to the consumer and the latter is sensitive to the price of tobacco. In order to analyze the impact of these two factors in the ECOWAS countries, CRES undertook a research entitled «Effectiveness of tax systems for tobacco products in ECOWAS countries: tax incidence approach. This policy brief shows the main findings of the research on the transmission of tax increases to the consumer of tobacco products.*

### METHODOLOGY

The price of a locally produced pack of cigarettes is made up of the producer's transfer price, excise tax revenue, commercial margins and value-added tax (VAT) revenues. The impact is measured by the variation of the manufacturer's price of the producer. This manufacturer's price is made up of the manufacturing costs of the cigarettes and its profit margin. With unchanged manufacturing costs, the variation in this manufacturer's price, following a 1% tax increase, for example,

measures the shifting rate of the tax on the consumer. If this manufacturer's price does not vary, the tax is fully shifted onto the consumer. If it decreases, the manufacturer's has shifted onto the consumer only part of the increase in the tax by reducing his profit margin. In the case where the manufacturer's price increases, the firm has not only shifted the totality of the increase in the tax onto the consumer but took the opportunity to increase its profit margin.

Formal relations measuring the tax shifting parameter and the consumer share are obtained from the profit maximization conditions of the manufacturer. The empirical application is made for Senegal, whose tax system on tobacco products is similar to that of the other fourteen ECOWAS countries. Thus, the results can be generalized to a large extent to other countries in this economic community.

## RESULTS

### *Tax Increases over-shifted onto the consumer*

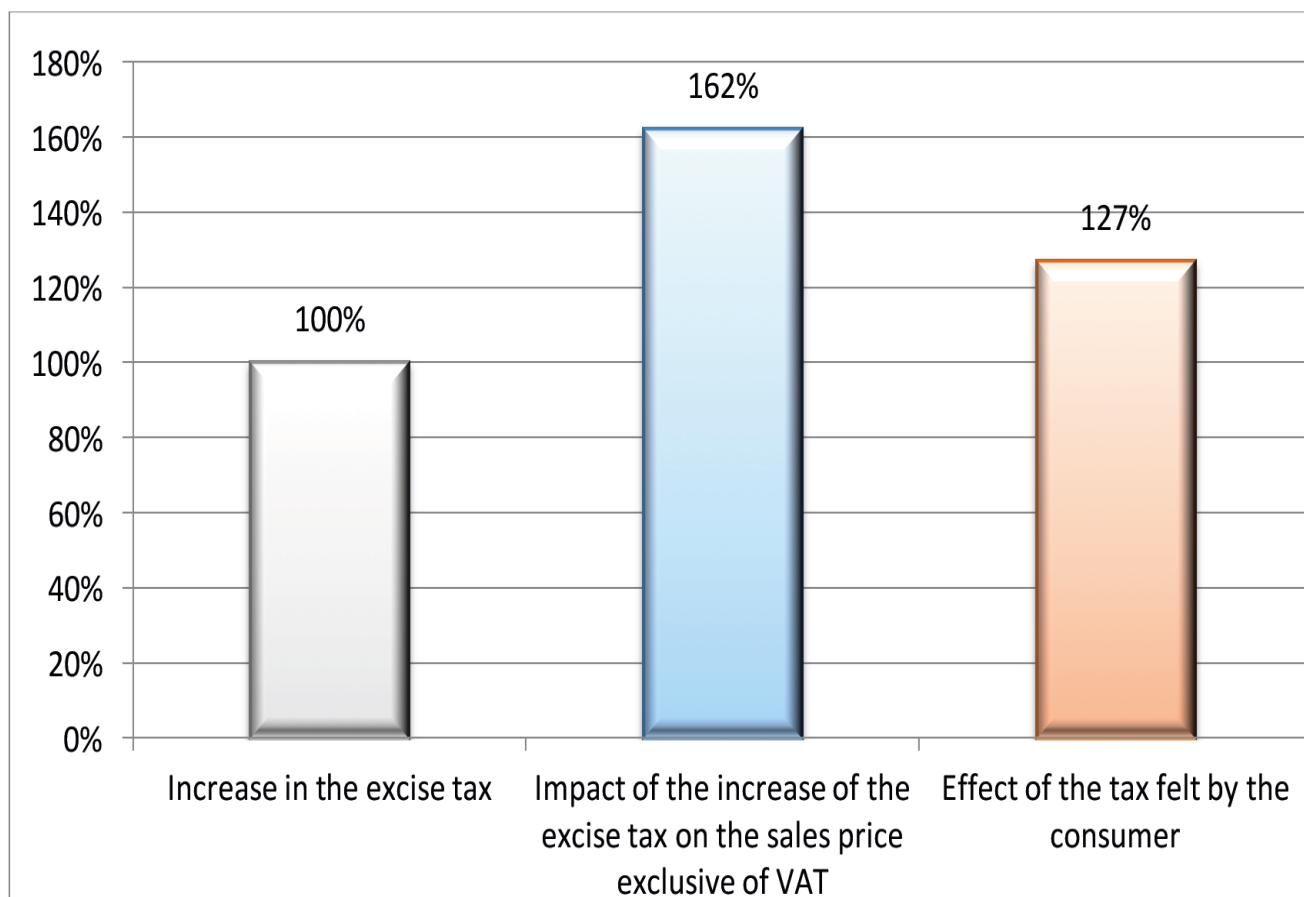
The results in the figure below show that when taxes increase by CFAF 100, the sale price of tobacco products to distributors increases by CFAF 162. Thus, the repercussion is done in a

more than proportional way. The tobacco industry not only shifts all of the tax increases onto the consumer, but benefits from this increase to increase its profit margin.

***However, the effect of this repercussion on the consumer is diminished by the non-taxation of commercial margins.***

Will the increase of 162 FCFA in the manufacturer's price of the manufacturer result in an increase in the selling price of the pack of cigarettes of the same size? The estimations that have been made indicate that the effect felt by the tobacco consumer of an ECOWAS country is

only 127%. As the tax is applied on the manufacturer's price, the commercial margin is not taxed. The initial effect of the pass-through is diminished by the presence of a commercial margin that the tax does not hit. Significant tax increases result in insignificant price increases.



## LESSONS AND RECOMMENDATIONS

A number of lessons and recommendations can be drawn from the results of this research in terms of the implications of tobacco control policies in ECOWAS countries.

### *Lessons learnt*

Three main lessons can be drawn from these results.

1. The first lesson concerns the possibility of using tax increases to reduce the consumption of tobacco products. When there is an increase in taxes, there is a fear that the industry will want to keep prices unchanged so as not to discourage the consumer, even if it means paying part of the tax increase. But the result on the tax shifting parameter shows that not only does it subject the consumer to the entire increase. It even benefits from it to widen its profit margin. This reaction shows that tax increases are effective in raising the selling prices of tobacco products.
2. The second lesson is that the effectiveness of tax increases can be improved if commercial margins are taxed. Since excise taxes on tobacco products are based on the manufacturer's price, the commercial margin is not taxed. This untaxed component of the price reduces the final effect on the consumer of an increase in taxes despite the manufacturer's over-shifts these tax increases.

### ***Recommandations***

The results of this research and the lessons that flow from it make it possible to formulate the following recommendations.

- Continually increase excise taxes on tobacco products to have a consequent rise in prices that discourages consumption;
- Change the excise tax base by including commercial margins so that the consumer is fully impacted by tax increases. The retail price must be the tax base.

The International Development Research Center (IDRC) has funded the Consortium for Economic and Social Research (CRES) for the second phase of its research project on the taxation of tobacco products. This phase is entitled «Tax Solutions for Optimal Tobacco Reduction in West Africa». One of the objectives of this phase was to make the diagnosis of the tax system that the ECOWAS countries apply to tobacco products.

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