

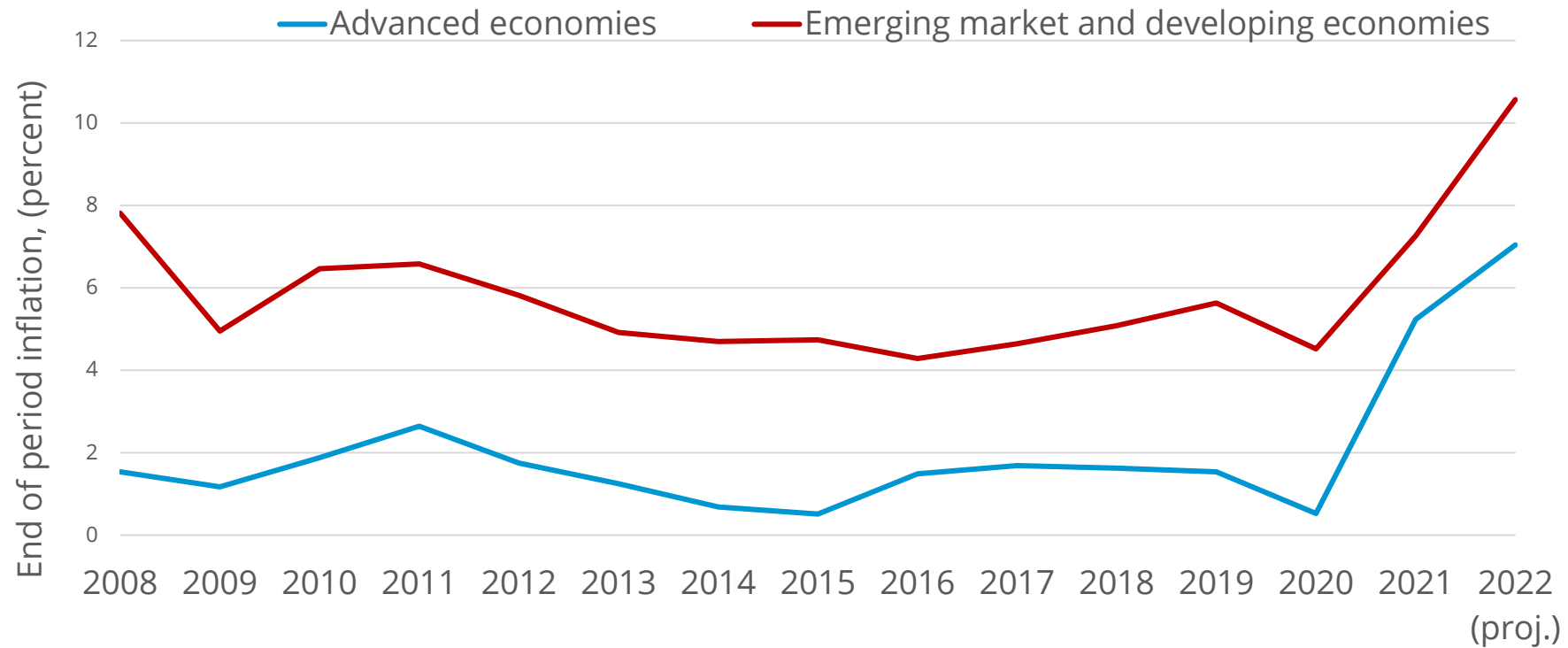
HEALTH TAXES AND INFLATION

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Motivation

- GTP knowledge notes respond to specific questions around health taxes and key issues raised during health tax reforms.
- The purpose of this note is to provide policy makers an overview of relevant issues and feasible policy choices for health taxes in the context of rising inflation, with a focus on taxing tobacco, alcoholic drinks, and sugar-sweetened beverages (SSBs).

Inflation on the rise



Source: IMF WEO October 2022

The impact of inflation on health taxes

- The value of specific health taxes on tobacco, alcohol, and SSBs value is eroded by inflation. i.e. pesos per pack, pesos per liter, per gram of added sugar.
- 70 percent of countries use specific or hybrid specific–ad valorem excises on cigarettes, compared to 22 percent that use ad valorem only in 2020.
- 58 percent of the 43 countries with SSB taxes in 2019 had specific taxes typically levied on the volume or sugar content of beverages (World Bank 2020).
- Excises on alcohol often similar to that on cigarettes, with the specific excise set in relation to the volume of alcohol in the beverage, and face similar revenue vulnerabilities from high inflation
- In addition to the reduction of excise revenue, there can be a further effect from inflation since excises often enter into the base for sales tax (or value-added tax), resulting in a decline of sales tax revenue in inflation-adjusted terms.

Health tax erosion

- Many examples of health tax erosion due to inflation. KN discusses two well-documented cases with double digit inflation where specific excises were not increased commensurately (Brazil and South Africa).
- In 2022, no tobacco excise tax increases took place in **India** for the second consecutive year.
- In **Pakistan**, the 2022 budget includes tobacco tax increases of 25 percent, but this lags behind inflation of over 30 percent since the last tax increase in 2019.

Indexation

- The real value of an excise tax can be maintained by indexation to prices (consumer price index or CPI) or incomes.
- In practice, the indexation of specific excises to address the risk of tax erosion by inflation is not widespread.
- For cigarettes, just over a quarter of countries have automatic indexation (33 countries out of 126 countries that have specific or hybrid specific–ad valorem cigarette excises) . e.g., Mexico, the Philippines, South Africa, and Turkey.

Indexation in practice

The type of indexation and its frequency varies.

- **Kenya** makes an annual inflation adjustment to specific excises using the annual average inflation rate during the previous financial year.
- **Argentina** and **Dominican Republic** index to inflation on a quarterly basis.
- **Chile** indexes specific tobacco excises monthly to the projected monthly inflation rate.
- In **Turkey**, specific alcohol and tobacco excises are automatically indexed in January and July for the increase in the producer price index over the previous six months (unless a Presidential Decree is issued to adjust the automatic indexation).
- NB January 2023 tobacco/alcohol/SSB indexation in **Ecuador** reversed, and tobacco indexation in **Peru** postponed to June 2023.

Does raising health taxes Impact inflation?

- Raising health taxes would generally not be a significant contributor to overall inflation as tobacco, alcohol, and SSBs are a small share of the total consumption basket.
- For example, a 10 percent increase in excise taxes on alcohol and tobacco would translate to an increase in annual inflation of between 0.06 and 0.36 percent in simulations on a sample group of 9 countries for which data is available.
- More broadly, the overall fiscal stance (expansionary or contractionary) is a more important indicator of the budget's impact on inflation than increases in one or more indirect taxes (taxes on goods and services).

Inflation targeting and health taxes

- 45 countries use some kind of inflation targeting monetary policy framework.
- Most countries that target inflation set a band or ceiling to inflation, using the consumer price index as the variable to measure inflation, as this is a well-known and understood indicator.
- While health taxes can contribute modestly to inflation, central banks will draw a distinction between transitory contributors to inflation, such as indirect taxes including health taxes, which do not require a monetary policy response, and longer-term or underlying imbalances (e.g., excess demand), that do require a monetary policy response.

Alternative inflation measures

- The practice of calculating inflation excluding the effect of indirect taxes (fuel, alcohol, tobacco, and any SSB excise taxes) has merit and can be useful in countries with an inflation targeting regime to assess the monetary policy stance as one of several indicators of underlying inflationary pressures.
- Examples in the European Union and the United Kingdom.



Policy considerations for health taxes & inflation

- Tax authorities should regularly monitor the impact of inflation, wages, and income growth on the affordability of harmful products and on excise tax revenue.
- Specific taxes on unhealthy products should be regularly adjusted or, preferably, automatically indexed to consumer price inflation (or $CPI+x\%$). This can also protect health spending where taxes are earmarked to health budgets.
- Calculating consumer price inflation excluding indirect taxes, i.e. excise taxes, sales tax, value added tax, is also an emerging good practice as it enables an assessment of underlying inflation excluding the first-round effects of indirect tax increases including health taxes. This may be particularly useful in countries with inflation targeting regimes as one of several measures of inflation.

Thank you!

- For references and more case study examples see the Knowledge Note available at:
- <https://www.worldbank.org/en/programs/the-global-tax-program/publication/gtp-health-taxes-kn-series>

