UNDERSTANDING AND MEASURING CIGARETTE TAX AVOIDANCE AND EVASION

A METHODOLOGICAL GUIDE

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Executive Summary

THIS METHODOLOGICAL GUIDE updates and expands the 13-year-old World Bank Toolkit on how to estimate the scope of tobacco smuggling. It draws on the results of numerous empirical studies that tested the applicability of five methods described in the Toolkit while critically evaluating new methods that emerged in response to the evolving nature of illicit tobacco trade, the policy debates surrounding the issue, and the development of new technologies.

This guide covers not only smuggling of tobacco products, but also tax evasion related to illicit tobacco trade and legal tax avoidance, since the methods to estimates these phenomena are often intertwined. It also provides guidance on how to assess the quality of existing estimates, including those offered by the tobacco industry. Unlike the World Bank Toolkit, this guide does not cover the topic of how to reduce tax avoidance and tax evasion and instead refers the reader to the WHO FCTC Protocol to Eliminate Illicit Trade in Tobacco Products.

THE DEFINITIONS SECTION begins by defining key variables. It explains the difference between "smuggling", "illicit trade", "tax evasion" and "tax avoidance", and describes behaviors that constitute either tax evasion or tax avoidance. Tobacco products that avoid/evade all or a portion of the required taxes are defined as "low-tax" products, while the rest of tobacco products fall into the category of "full-tax" products.

THE FIRST CHAPTER lays the theoretical foundation for the methods and describes the impact of tax avoidance and tax evasion on the supply of and demand for tobacco products, on tax revenue, on the price elasticity of demand, and on the affordability of tobacco products.

We provide insight into the economic, social, and political determinants of tax avoidance and tax evasion, including factors such as price/tax differences, the tax structure, the costs of obtaining low-tax products, the costs of overcoming legal and regulatory obstacles, informal distribution networks, and the level of corruption. This chapter demonstrates how tax avoidance and tax evasion impact average cigarette prices, the price elasticity of tobacco demand, brand proliferation, and other tobacco control policies.

This chapter concludes that tax avoidance/ evasion may reduce, but do not eliminate, the effectiveness of tobacco tax increases in reducing tobacco use and raising revenues. The motivation for a government to address tax avoidance/evasion is directly linked to the size of the revenue loss while the effectiveness of the interventions depends on the level of enforcement. The level of enforcement is directly linked to the level of investment to combat tax evasion/avoidance.

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THE SECOND CHAPTER is central to the Guide and describes 11 methods of measuring the scope of tax avoidance and tax evasion: surveys of tobacco users, examination of cigarette packs obtained from smokers, examination of discarded cigarette packs, examination of cigarette packs obtained from retail, comparison of sales with consumption (gap analysis), econometric modeling, comparison of tax paid sales with estimated consumption, comparison of actual and projected tobacco tax revenue, key informant interviews, monitoring tobacco trade, and analyzing seizures of illegally transported tobacco.

The chapter begins with a brief overview of the main principles of conducting research, which are applicable to all methods. It then provides a step-by-step description of the specifics of each the method, starting with those most frequently discussed in the literature, followed by approaches that are unique to certain market conditions and approaches suffering from multiple weaknesses. Each method has a background section that links it to theory, a list of pros and cons, and a recommendation when a particular method should be used. The application of each method is demonstrated by examples.

The chapter concludes that there is not a single method that will produce a definitive estimate, because all of them have advantages and disadvantages. Since the weakness of a particular approach can be exacerbated by specific market conditions, it is important to use local specific knowledge and creativity when applying these methods. Given the complexity of tobacco tax avoidance and evasion and the methods' limitations, it is important to triangulate the estimates of the scope of the problem using different methods. Many studies apply the same method over time in order to capture changes in the scope of tax avoidance/evasion rather than generating a single point estimate of its scope. Such an approach addresses some methodological weaknesses of the methods and is useful for evaluating the impact of policies and other factors with a possible impact on tax avoidance/evasion.

THE THIRD CHAPTER guides the reader through a series of studies and analyses the quality and reliability of their estimates while taking into account the agendas of those who fund and/or conduct research on tobacco tax avoidance/evasion. It outlines a set of criteria and then applies them to evaluate eight studies.

It concludes that studies supported by the tobacco industry cannot be trusted due to lack of transparency and the use of potentially contaminated data. The industry estimates are consistently and substantially higher compared to those produced by independent researchers.

IN CONCLUSION this Methodological Guide recommends using multiple methods that suffer from the minimum weaknesses, executing them according to the principles of rigorous research, and triangulating the results in order to cross-validate the estimates and minimize the methodological limitations of individual methods. Such an approach will result in methodologically sound and objective quantitative estimates of tobacco tax avoidance and tax evasion.