

# **Achieving Tobacco Control Policy Goals in Ukraine via Economic Tools**

Policy Paper

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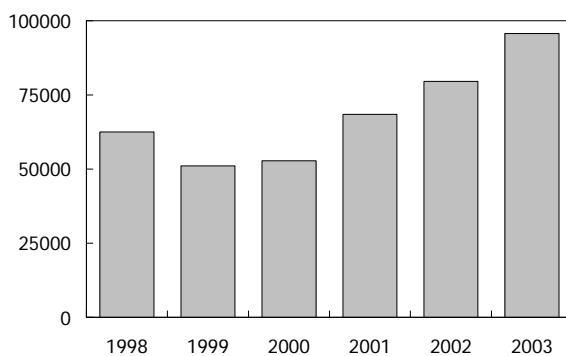
Tobacco Economics Research and Advocacy

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## Policy issue

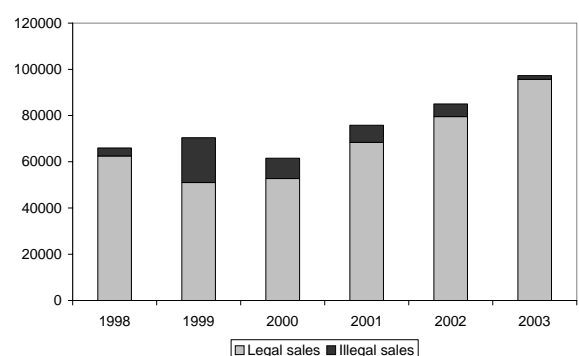
Smoking is a serious threat to public health in any country. Ukraine is not an exception and each year, tobacco kills thousands of Ukrainians – these are deaths that can be easily prevented. Moreover, according to statistics, in the past years, tobacco consumption has been quickly growing in Ukraine. The major factors determining the trend are decreasing prices, increasing volumes of advertising, and growing household incomes.

**Figure 1. Legal domestic sales of cigarettes in Ukraine**



Source: State Statistics Committee, own calculations

**Figure 2. Estimate of total cigarette consumption in Ukraine**



Source: own calculations.

There is a social consensus that tobacco consumption is harmful – even the tobacco industry is forced to recognize the harm of tobacco. Therefore, it is crucial for the country to take actions in order to prevent public health deterioration due to smoking.

One may ask “Why deal with the tobacco problem while the country has lots of public health problems?” The answer is simple: reduction in smoking allows saving thousands of lives while not requiring any significant resources from the government.

One may also ask “Why the government should interfere with a special policy if everybody understands the harm of tobacco and may make their decisions?” The answer is as follows:

- When people start to really understand the harm of tobacco (namely, feel it), it is too late to quit (or difficult to quit). When people start smoking, they lack proper information and do not realize what the outcome of their decision will be.
- It is in the nature of any business, including the tobacco business, to maximize profits. Therefore, one should understand that any business, including the tobacco business, will do its best in order to promote sales and maximize profits.

The arguments listed above prove the necessity for the government to take a lead in developing and implementing strict tobacco control policies aimed at reducing smoking prevalence and tobacco consumption.

## Policy options

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Studies conducted in many countries indicate that such measures as increasing tobacco taxes and banning tobacco advertising and promotion activities are at the top of the list of the most effective tobacco control tools. At the same time, advertising restrictions have no effect since if advertising of one type is banned, there are other types of advertising to effectively promote tobacco consumption. The study conducted in Ukraine indicates that the same is true for Ukraine taking into account local peculiarities.

**Tobacco taxation** is considered to be one of the most effective tools allowing to reduce tobacco consumption. Changes in taxation levels have direct impact on the price of cigarettes. The tool is especially powerful for lower-income countries where people are more sensitive to price changes given their low incomes. Consequently, even small increases in the taxation level allow for notable decreases in tobacco consumption.

As the study in Ukraine and many other countries reveal, higher tobacco taxes ensure more tax revenues to the government: the analysis of Ukrainian data proves that in order to maximize tobacco tax revenues, excise taxes should be increased at least two-fold.

The following major options of tobacco taxation are analyzed in this paper:

- Option 1. The tax rate remains unchanged.
- Option 2. During next 2 years, the tax rate increases by 25% each January.
- Option 3. Starting January 1, 2005, the tax rate is increased by 50%.

Of course, the list of options is not exhaustive. The major goal is to determine what will be the effect of a one-time large increase and a gradual increase in the tax rate. These options are compared with the “doing nothing” policy option.

**Advertising and promotion bans** are regarded to be effective tools for reducing tobacco consumption as well. The power of advertising in promoting sales of any goods is well-known especially when significant resources are spent to develop and implement advertising campaigns. There is nothing special about cigarettes to consider that the

effect of advertising on cigarette sales is different compared to other goods. This was proved based on the real Ukrainian data.

Currently, tobacco is at the top of the list of the goods advertised outdoor (one of the tobacco advertising channels allowed in Ukraine). Therefore, tobacco advertising bans are needed to stop tobacco promotion.

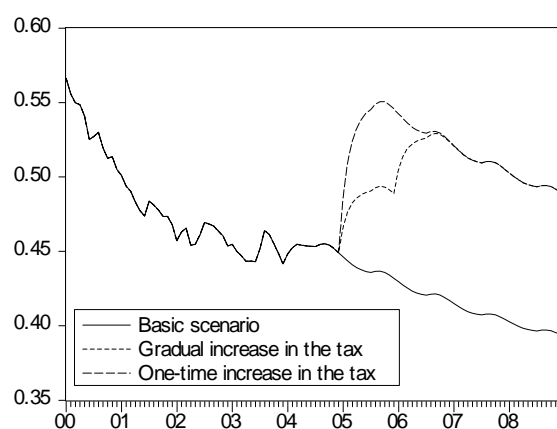
Basically, there are two main options regarding tobacco advertising: ban it or not. As many research papers showed, partial restrictions on advertising are not effective in reducing smoking. The same holds true for Ukraine: although tobacco advertising is restricted (e.g. ban of advertising on TV, radio, some restrictions on advertising in press), cigarette consumption is growing to some extent due to increased volume of advertising by the tobacco industry.

## Outcomes of different policy options

### ***Increased tobacco taxes***

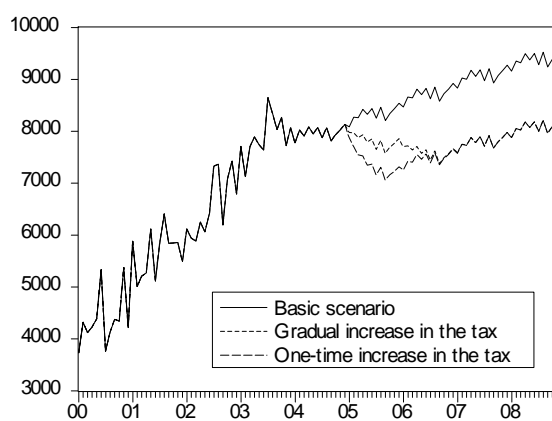
The following graphs illustrate the impact of the three tobacco taxation policy options on cigarette prices, cigarette consumption, and government revenues. The forecast horizon is 2004-2008.

**Figure 3. Policy options and cigarette prices**



Source: Own calculations.

**Figure 4. Policy options and cigarette consumption**

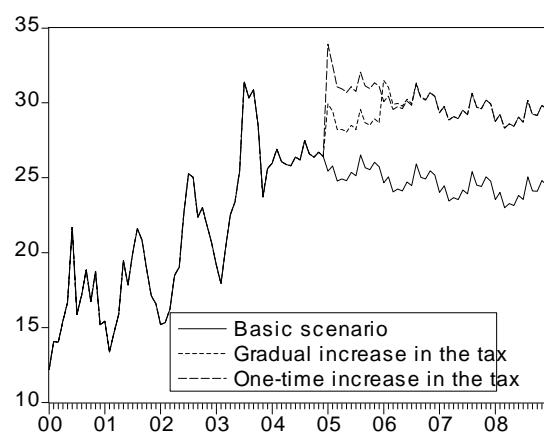


Source: Own calculations.

As can be seen, under the “doing nothing” scenario, cigarette prices are lower, as well as government revenues, while cigarette consumption is higher. The two scenarios envisaging tax increases differs only in the indicators for the year 2005 when the “gradual increase” scenario gives lower revenues and prices together with higher cigarette consumption if compared to the “one-time increase” scenario. After 2005, the

indicators are roughly the same under the both scenarios envisaging tax increases. Therefore, it may be better for the government to choose the “gradual increase” scenario as it maybe politically easier to implement.

**Figure 5. Policy options and government revenues**



Source: Own calculations.

The table below provides comparative analysis of the outcomes of the three policy options.

**Table 1. Tobacco taxation: Comparative analysis of the policy options**

	Option 1 ("doing nothing")	Option 2 (gradual increase)	Option 3 (one-time increase)
Consumption	Gradually increasing	Two-step decline, then –gradual growth. At the end of the forecasting period, consumption is lower compared to basic scenario and equal to that under "one-time increase" scenario	One-time decline, then –gradual growth. At the end of the forecasting period, consumption is lower compared to basic scenario and equal to that under "gradual increase" scenario
Government revenues	Lower than under other scenarios	After the two increases in the tax rate, revenues are the same as under the scenario 3, higher than under scenario 1. But total tax collection during the period is lower than under Option 3.	Cumulatively for the whole forecasting period, the revenues are larger than under other scenarios.
Cigarette bootlegging into Ukraine	Unchanged.	Slight two-step increase if no changes in Russian tax.	Slight one-time increase if no changes in Russian tax.

Tobacco industry revenues	Not affected by the government. Gradually growing due to increased consumption.	Decline in two steps. Given the low elasticity of demand, the industry can offset the effect through increasing the price further.	One-time decline. Given the low elasticity of demand, the industry can offset the effect through increasing the price further.
Tobacco industry employment	Tobacco control measures and subsequent declines in cigarette production will not represent a big problem for farmers growing tobacco: currently, despite cigarette production is growing, tobacco farming is declining. Regarding the employees involved in cigarette production, the effect of reduced production is not clear. In recent years, employment in cigarette manufacturing declined despite an extremely fast growth of cigarette production. Therefore, no positive correlation was found between the production volumes and employment.		

After reviewing the comparative table, one may ask: “Why the impact of higher taxes on smuggling into Ukraine is expected to be only moderate?” The answer is received after analyzing the past data.

The analysis indicates that a 10% increase in the Ukrainian excise rate will lead to at most 0.07% drop in legal domestic sales due to increased smuggling.

The huge volume of smuggling in 1999 was caused by really large differentials in the tax rates between Ukraine and Russia. In that year, the tax rates differed by over 6 times. However, in the next year, the share of smuggling dropped to around 14% of the market, while the Ukrainian excise rate was still 3.5 times higher than the Russian rate.

In 2003, the tax rates in the two countries did not differ significantly, while the estimated volume of smuggling was negligible. Therefore, even noticeable increases in the Ukrainian tax rate will not cause extensive smuggling.

### ***Banned tobacco advertising***

In case there are no changes to the legislation regarding tobacco advertising, one may expect continuation of the growing trend of the tobacco advertising volumes (since this turns to be an effective tool for the tobacco industry to promote cigarette consumption). This will lead to increased cigarette consumption having even larger effect in the long-run.

In case tobacco advertising is banned, cigarette consumption will definitely decline leading to improved public health. In particular, as the study shows a 10% decrease in the outdoor advertising volumes causes a 0.73% decline in domestic sales of cigarettes.

Regarding the impact of tobacco advertising ban on the advertising industry, we may conclude the following:

First, tobacco advertising constitutes a significant share of the total volume of outdoor advertising (over 30% of all outdoor advertising expenditures as of 2001), while the share in printed mass-media is moderate (around 3% of all press advertising expenditures as of 2001). At the same time, the shares of outdoor and printed media advertising in the advertising market comprise around 10% each. Therefore, tobacco advertising ban will mainly affect outdoor advertising sector, while the advertising market as a whole will not be greatly affected by the ban.

Second, according to 2003 advertising market overview, the share of outdoor tobacco advertising in the total volume of outdoor advertising started to decline. Compared to 2002, in 2003, the share of the category “Tobacco” dropped by approximately 6%, while the total market grew by over 30%. Such a growth in the market was mainly caused by increased volumes (and market shares) of advertising of other categories (for instance, telecommunications and cars), representing dynamically developing markets.

Finally, while making decision regarding the ban of tobacco advertising, the government should be interested in knowing attitude of the general public towards such a policy. As surveys in different countries reveal, usually, the public supports such actions by the government. According to a nation-wide survey conducted in Ukraine in November 2000, 49% of respondents supported a total ban of tobacco advertising<sup>1</sup>.

## **Conclusions and policy recommendations**

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The following major conclusions and policy recommendations can be drawn from the above analysis:

- Cigarette consumption in Ukraine is growing quickly. The major factors determining the trend are decreasing prices, increasing volumes of advertising, and growing household incomes.
- The excise tax is a powerful tool for reducing cigarette consumption and increasing state budget revenues. The tax rates in Ukraine can be increased at least two times as soon as possible. This will reduce cigarette consumption, increase budget revenues, and will have only moderate effect on the volume of smuggling to Ukraine, while more tough government control over smuggling may reduce the volume of smuggling.

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<sup>1</sup> See ADIC-Ukraine, “Economics of tobacco control in Ukraine from the public health perspective”, 2001.

- Advertising is a powerful tool for promoting cigarette consumption in Ukraine. The ban of tobacco advertising will definitely reduce cigarette consumption while the effect on the advertising industry as a whole will not be dramatic. According to some surveys, there is a public support in favour of the tobacco advertising ban.
- Tobacco control measures and subsequent declines in cigarette production will not represent a big problem for farmers growing tobacco: currently, despite cigarette production is growing, tobacco farming is declining. Regarding the employees involved in cigarette production, the effect of reduced production is not clear. In recent years, employment in cigarette manufacturing declined despite an extremely fast growth of cigarette production. Therefore, no positive correlation was found between the production volumes and employment.