



*Citation for published version:*

Branston, JR & Gilmore, A 2015, The extreme profitability of the UK tobacco market and the rationale for a new tobacco levy. University of Bath.

*Publication date:*

2015

*Document Version*

Publisher's PDF, also known as Version of record

[Link to publication](#)

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# The extreme profitability of the UK tobacco market and the rationale for a new tobacco levy

By

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## Disclaimer

Dr Branston received a small amount of funding from ASH to facilitate this research. The report was also informed by research funded by the National Institute for Health Research (NIHR). The views expressed in this publication are those of the authors and not necessarily those of the NHS, the National Institute for Health Research, the Department of Health, or ASH. The responsibility for any errors remains entirely with the authors.

## Introduction

We have previously pointed towards the extreme profitability of the UK tobacco manufacturing/import market (henceforth tobacco market) when suggesting that the public interest would be served by regulating tobacco companies using utility company style price-caps (Gilmore *et al.*, 2010; Branston and Gilmore, 2014). The profitability of the tobacco industry is now topical as the current UK government, and the main opposition Labour party, have both outlined plans for a levy on the UK tobacco industry. The basic idea is that the industry should explicitly pay more towards the costs their products impose upon society and which are currently born by all taxpayers. Implicit within this idea is that the industry is earning significant profits from which a fuller contribution could be made towards the societal costs engendered. Thus, we seek to examine the current profitability of the UK market and comment upon the different possibilities that exist for such a levy since the details are not yet fixed. To that end, in section A of this paper we explore the profitability of the UK tobacco market during the last five years, and then in Section B we comment upon the possibilities that exist for such a tobacco levy and how the industry might make a larger financial contribution. Finally our conclusions are presented in Section C.

## A. Tobacco industry profitability in the UK market

### 1. Market Share

Given that profit data for the UK tobacco market isn't universally published, the starting point for estimating UK market profitability is the market share accounted for by the major companies operating in the UK. We obtained market share data broken down by tobacco product type (cigarettes, Cigars, and RYO tobacco) from the Euromonitor passport service. This is reported in tables 1a, 1b, and 1c below

**Table 1a: Company Market Share (% by volume) in the UK cigarette Market**

	2009	2010	2011	2012	2013
<b>Imperial</b>	40.9	40.8	40.9	36.8	35.6
<b>JTI</b>	35.7	35.8	36.5	36.5	38.1
<b>PMI</b>	9.0	9.0	8.8	8.7	8.3
<b>BAT</b>	7.5	7.5	8.1	8.6	9.0
<b>Others<sup>α</sup></b>	6.8	7.0	5.7	9.5	9.1

Source: Euromonitor

<sup>α</sup> others includes private label and the remainder of the market

**Table 1b: Company Market Share (% by volume) in the UK cigar Market<sup>β</sup>**

	2009	2010	2011	2012	2013
<b>Imperial</b>	18.4	17.8	17	17.6	18.3
<b>JTI</b>	30.4	31.2	30.6	29.1	28.0
<b>Swisher International</b>	2.7	2.7	2.5	2.4	2.3
<b>Scandinavian Tobacco Group</b>	2.2	2.2	2.3	2.2	2.1
<b>Hunters &amp; Frankau</b>	1.2	1.1	1.0	1.1	1.1
<b>Others<sup>α</sup></b>	45.1	44.9	46.6	47.8	48.5

Source: Euromonitor

<sup>β</sup> excluding cigarillos

<sup>α</sup> others includes remainder of the market

**Table 1c: Company Market Share (% by volume) in the UK RYO Tobacco Market**

	2009	2010	2011	2012	2013
<b>Imperial</b>	49.7	47.2	43.8	41.6	38.6
<b>JTI</b>	27.3	29.3	32.5	34.8	37.6
<b>BAT</b>	7.4	7.9	8.2	8.2	8.3
<b>Others</b>	15.6	15.5	15.4	15.5	15.5

Source: Euromonitor

<sup>a</sup> others includes the remainder of the market

In order to work out company market shares for the entire tobacco market, these individual product market shares need to be weighted by the respective tobacco products' share of the total UK tobacco market. The tobacco product type share of the total market is given in table 1d below.

**Table 1d: Product Market Share (by value) of the UK Tobacco Market (£ million)**

	2009	2010	2011	2012	2013
<b>Cigarettes</b>	13,248.9	13,898	14,776.8	15,189.6	15,418.1
<b>Cigars</b>	631.7	603	581.4	557.4	534
<b>Smoking Tobacco<sup>u</sup></b>	1,468.8	1,634	18,02.3	1,976.7	2,165.6
<b>Total</b>	15,349.4	16,135.0	17,160.5	17,723.7	18,117.7

Source: Euromonitor

<sup>u</sup> 95% of smoking tobacco is RYO, with the remainder being pipe tobacco.

The information in table 1d tells us that in 2009, for example, cigarettes represented 86% of the overall UK tobacco market value, and hence that the company market shares for cigarettes should be given an 86% weighting when calculating the overall company market shares for the combined UK tobacco market. Similarly Cigars should be weighted at 4% and smoking tobacco at 10%.

Combining such weightings with the company market shares for the different products allow the estimation of the individual company market share for the entire UK tobacco market, and this information is presented in table 1e below.

**Table 1e: Company Market Shares in the UK tobacco market**

	2009	2010	2011	2012	2013
<b>Imperial</b>	40.8	40.6	40.4	36.7	35.4
<b>JTI</b>	34.7	35.0	35.9	36.1	37.7
<b>PMI</b>	7.8	7.8	7.6	7.5	7.1
<b>BAT</b>	7.2	7.3	7.8	8.3	8.7
<b>Others</b>	9.6	9.4	8.3	11.4	11.1

Source: Authors calculation using data presented in tables 1a,1b and 1c.

The surprising result was that Imperial, the long-time market leader in the UK has actually lost market share in recent years, mainly to JTI the historical second player. This can be seen most vividly in the market for smoking tobacco as presented in Table 1c where Imperial’s market share declined from 49.7% in 2009 to 38.6% in 2013, whilst market share for JTI increased from 27.3% in 2009 to 37.6% in 2013. A less extreme change is seen in the market for cigarettes (Table 1a) where Imperial went from a 40.9% market share in 2009 to 35.6% in 2013, whilst JTI moved from 35.7% in 2009 to 38.1% in 2013.

This market share breakdown now needs to be utilised with profit data for each of the major market participants in order to estimate the total profitability of the entire industry. Each of these five major market participants is thus considered in turns (sections 2 to 6 below) in order to build-up an industry wide picture of profitability. Where actual data is available it is reported, but where it is not, estimates are calculated using the methods detailed below. When estimates are calculated, a number of different scenarios are presented in order to explore the sensitivity to the assumptions taken. These different scenarios are then also used when calculating entire industry profitability in section 7.

## **2. Imperial Tobacco**

Imperial Tobacco (IT), has long been the market leader for tobacco products in the UK and as such they have traditionally produced figures for their specific UK performance as detailed in Table 2 below.

**Table 2: The Profitability of Imperial Tobacco in the UK**

	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>
<b>Net Revenue (£ Million)</b>	893	911	869	936	915
<b>Adjusted Operating profit (£ Million)</b>	601	614	577	627	623
<b>Profit Margin</b>	0.673	0.674	0.664	0.670	0.681

Source: various Imperial Tobacco annual reports and author’s calculation thereon.

The table shows that IT is a very profitable organisation, and despite losing market share in recent years, it has been able to earn consistently high profits with a very large profit margin. By way of a comparison, Branston (2014) reports that firms in comparable consumer staple industries typically made a profit margin in the range of 12-20%.

## **3. Japan Tobacco International**

JTI does not produce profit data for the UK alone as individual national markets are aggregated in the Japan Tobacco accounts. However, the origins of the UK operations of JTI

were the UK based Gallaher company, and this still exists as a subsidiary company for which the accounts are a matter of public record. The Gallaher subsidiary is a focussed UK manufacturer and distributor of tobacco with very limited international operations.

**Table 3a: The profitability of Gallaher Limited in the UK**

	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>
<b>Turnover (£ Million)</b>	4,473	4,539	4,580	4,740	4,797
<b>Duty paid (£ Million)</b>	3,574	3,642	3,777	3,938	3,935
<b>UK Operating Profit (£ Million)</b>	312	345	140	156	152
<b>UK Turnover (£ Million)</b>	4,253	4,344	4,510	4,711	4,766
<b>UK turnover as a proportion of total turnover</b>	0.951	0.957	0.985	0.994	0.994
<b>Estimated UK Duty (£ Million)</b>	3,398.2	3,485.5	3,719.3	3,913.9	3,909.6
<b>Estimated UK Net Revenue (£ million)</b>	854.8	858.5	790.7	797.1	856.4
<b>Profit Margin</b>	0.365	0.402	0.177	0.196	0.177

Source: various Gallaher Limited annual reports and author's calculation thereon.

Whilst Gallaher provides information on UK profits and UK revenue, it doesn't provide information on UK net revenues (revenue after duty is paid) which are need to calculate UK profit margins. Duty is given only for total sales, so we assigned to the UK market a proportion of total duty paid in line with the UK revenues as a proportion of total company revenues. The resulting figures look to be in line with the net revenues reported by Imperial.

However, the reported figures for Gallaher can't be taken as a perfect record of the profitability of JTI in the UK market. At the end of 2010, Gallaher was re-organised such that a number of brands previously owned directly by the company were sold to another JTI subsidiary, and as a result data from this point onwards shows that company "profit is substantially lower than [in] prior years, reflecting lower margins earned by the company as a limit risk distributor for brands now owned by JTI SA" (Gallaher, 2011, P.4). This doesn't mean that JTI tobacco operations in the UK were suddenly less profitable, but simply that the profits derived are accounted for in different JTI subsidiaries for which data is not available. As such, it is necessary to estimate UK profitability using the published data as a guide and this is what is done in table 3b. Given the large market share account for by JTI, differing estimates of profitability will have a significant impact on the overall profitability of the UK tobacco market. As such we present a number of scenarios for the possible profitability of the company, each of which is explained below.

**Table 3b: Estimated Profitability of JTI in the UK**

	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>
<b>Conservative scenario (£ million)</b>	312	345	288.6	290.9	312.6
<b>Less conservative scenario (£ million)</b>	312	345	317.9	320.4	344.3
<b>Gallaher scenario (£ million)</b>	458.6	460.6	424.2	427.6	459.5
<b>Imperial scenario (£ Million)</b>	510.6	529.0	512.5	615.8	663.3

Source: author's own calculations.

Our 'conservative scenario' uses the 0.365% margin observed in 2009 to estimate profitability in the UK market for the years 2011-13 for which the published profit information is unreliable due to the accounting change. This margin is applied to the estimated net revenue calculated for each year in table 3a. Similarly, our 'less conservative scenario' used the 40% margin observed in 2010 in the same fashion. However, these estimates seem very low when compared to the reported profit figures for Imperial. Furthermore, Gallaher as an independent company reported EBITA margins (a similar concept to operating profit margin) for the UK market of 53.2% in 2004 and 54.1% in 2005, just before it was taken over by JTI (Gallaher, 2006). Therefore in our 'Gallaher scenario' we estimate profits based on a return of 53.65% (the average of 2004 and 2005) as all indications are the market in recent is at least as profitable as it was at that point in time. The difference between this rate of profit and that reported by the JTI Gallaher subsidiary as detailed in table 3a might be due to other accounting changes introduced after the purchase by JTI. We therefore suggest that the Gallaher scenario figures could be very plausible given the reported data for Imperial which has a similar market share, and also in light of the fact that the JT stated that for the 2013 financial year they had a market share of 40.7% but 41.0% of the market value suggesting that the company was slightly more profitable than average (JT, 2014, pp.30). Finally we present our most aggressive 'imperial scenario' where we assume that JTI was able to earn the same rate of profits IT, and hence the profit figures for this are generated by using JTI's market share (reported in table 1e) at the Imperial profit rate for that year. For instance, in 2009 IT had a market share of 40.8% and earned £601m, suggesting that each 1% of the market was worth £14.72m in profit, and thus we can estimate that JTI, with 34.7% of the market would have earned £510.6m.

#### **4. Philip Morris International**

Philip Morris International (PMI) does not provide UK-specific data since it reports on an EU basis, the detail of which is reported in table 4a below. They do have a subsidiary operating in the UK but the finances of this are such that it can't possibly represent anything like their full operations in the UK given their observed market share.

**Table 4a: The profitability of PMI in the EU**

	2009	2010	2011	2012	2013
<b>Net Revenue (US\$ Million)</b>	9,041	8,983	9,212	8,526	8,596
<b>Operating Income (US\$ Million)</b>	4,506	4,502	4,560	4,187	4,238
<b>Profit Margin</b>	0.498	0.501	0.495	0.491	0.493

Source: various PMI annual reports and author's calculation thereon.

The profit margins detailed for PMI in the EU are approximately in line with the observed profitability of IT in the UK and also the reported (and estimated) UK profit data for JTI. However, this information isn't on its own sufficient but it can help in the development of some estimates for the profits earned in the UK market and this is what is reported in table 4b below. As with JTI, we present various profit scenarios.

**Table 4b: Estimated Profitability of PMI in the UK**

	2009	2010	2011	2012	2013
<b>Conservative scenario (£ million)</b>	84.7	87.2	80.7	93.3	89.9
<b>Gallaher scenario (£ million)</b>	91.2	93.3	87.5	101.9	97.8
<b>Imperial scenario (£ million)</b>	114.4	117.3	108.2	127.3	124.1

Source: author's calculation using data presented in previous tables.

Our conservative scenario estimates the profitability of PMI using the observed net revenue information for IT, adjusting this for the appropriate market shares of the two companies, and then applying the report EU level of profitability. For instance, in 2009 IT had a market share of 40.8% and net revenue of £893m. Therefore each 1% of market share was worth £21.9m of revenue. Thus, if PMI were able to perform at this level, then they would have generated net revenues of £170m given their market share of 7.76%. The reported profit rate of 49.8% for the EU as a whole suggests this level of revenue generation would have created profit for the UK market of £84.7m. A similar calculation was done using the reported revenues for Gallaher Limited. These have not been presented due to the change in accounting practices utilised part way through the period of interest. For reference such calculations implied profits for PMI of £95.4m in 2009, but then there was a significant dip from 2011 (£82.7m) and onwards when the account change was introduced, suggesting such an approach would be unreliable.

The profile of PMI in the UK is such that their operations are concentrated towards the premium end of the cigarette market, selling brands such as Marlborough and Chesterfield. These products will be amongst the most profitable since they have amongst the highest retail prices but incur very similar costs of production to other cigarettes brands. As such it is likely that the EU profit rates under-estimate the profitability of the UK market for PMI. In order to account for this we present the 'Gallaher' scenario where the profit margin is



assumed to be the 53.65% profit rate that Gallaher Plc averaged in the UK market over 2004 and 2005. Similarly, we also present our most aggressive Imperial scenario where we assume that PMI was able to earn the same rate of profits as IT reported in each year, and hence the profit figures for this are generated by using PMI's market share at the IT profit rate for that year.

## **5. British American Tobacco**

British American Tobacco (BAT) does not provide UK-specific data since it includes the UK within its 'Western Europe' market area, which also includes: Belgium; The Czech Republic; Denmark; France; Germany; Italy; Netherlands; Poland; Romania; Spain; Sweden; and Switzerland. The performance of this region for BAT is detailed in table 5a below. Like with PMI, they do have a subsidiary operating in the UK, but the finances of this are such that it can't possibly represent anything like their full operations in the UK given their market share.

**Table 5a: The profitability of BAT in their Western Europe Region**

	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>
<b>Revenue (£ Million)</b>	3,884	3,419	3,600	3,442	3,635
<b>Adjusted Profit (£ Million)</b>	994	1,054	1,228	1,186	1,273
<b>Profit Margin</b>	0.2559	0.3083	0.3411	0.3446	0.3502

Source: various BAT annual reports and author's calculation thereon

The profitability of BAT in this region seems to be significantly less than the other profit data considered thus far. It might be that BAT is simply less profitable than the other manufacturers or more likely, that the wider regional nature of the accounting sees the profitable UK market mixed with other less profitable markets in Europe. In order to account for both possibilities we again develop several estimates for the profits earned in the UK market and these are presented in table 5b below.

**Table 5b: Estimated Profitability of BAT in the UK**

	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>
<b>Conservative scenario (£ million)</b>	40.2	50.2	57.5	72.7	78.2
<b>Gallaher scenario (£ million)</b>	84.3	87.4	90.4	113.3	119.8
<b>Imperial scenario (£ million)</b>	105.7	109.8	111.9	141.4	152.0

Source: author's calculation using data presented in previous tables.

Our three scenarios utilise the same basic approaches as were detailed for PMI, except that the BAT market share and regional profit information is used. All of these scenarios are consistent with the rising returns observed for the wider Western Europe region as reported in table 5a and also the increasing market share detailed in table 1. Furthermore, they also seem to be in line with comments that BAT made in its annual reports for the period in question. For instance, when reporting on the 2010 corporate performance they report that the UK market generated a “significant increase in profits” (BAT, 2011, p.30), whilst for 2011 the UK generated “higher profit” (BAT, 2012, p. 30), whilst the reports for 2012 and 2013 both suggested that UK “profits grew strongly” (BAT, 2013, p28; BAT, 2014, p.34).

## 6. Others

The remainder of the UK tobacco market, which we have labelled as ‘others’, is more difficult to estimate because by definition it includes all other companies that operate in the UK market, including cigar focussed firms and those making own label or more niche brands. In order to estimate the profitability of this sector we again present several scenarios.

**Table 6: Estimated Profitability of the Remainder of the UK Market**

	2009	2010	2011	2012	2013
<b>Conservative scenario (£ million)</b>	0	0	0	0	0
<b>Less Conservative scenario (£ million)</b>	53.5	65.2	61.0	100.5	100.3
<b>Gallaher scenario (£ million)</b>	112.2	113.5	95.9	156.5	153.6
<b>Imperial scenario (£ million)</b>	140.7	142.6	118.7	195.4	195.0

In our conservative scenario we assume that the remainder of the market is so fragmented that it doesn’t generate any significant profits. This is however, highly unlikely when (for instance) we consider the fact that at least 50% of the cigar market is included in this ‘other’ category for each of the years in question. As such our less conservative scenario assumes that remainder of the UK market is as profitable as the Western Europe tobacco market reported by BAT in each year. This is at the low end of the reported profitability we have examined thus far, and allows for the fact that some parts of the market might generate low profits, whilst other parts are as highly profitable. Finally, we also present our Gallaher and Imperial scenarios in order to illustrate the likely upper limit for profitability in order to consider the possibility that these niche firms could be relatively small but highly profitable. The methodology for calculating all of these profits estimates is the same as that employed when discussing PMI and BAT above. For example, in 2009 IT had net revenues of £893m and adjusted profits of £601m from a market share of 40.8%, which suggests that each 1% of the market was worth £21.9m in revenues and £14.7m in profits. In 2009 the other

segment of the market was 9.5% of the total, which suggests net revenues of £209m, and thus profits for our gallaher scenario of £112.2m given the aforementioned assumption of a profit margin of 53.65%. It also suggests profits for our imperial scenario of £140.7m given the £14.7m IT earned from each 1% market share.

## **7. Overall Profitability of the UK Tobacco market**

Combining all the profit estimates for the individual companies from the sections above allows us to work out estimates of the profitability for the entire tobacco sector in the UK. We present these estimates for total profitability using the different scenarios that we have developed for each of the companies above.

**Table 7: Estimated Profitability of the UK Tobacco Market**

	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>
<b>Conservative scenario (£ million)</b>	1,037.9	1,096.4	1,003.8	1,084.0	1,103.7
<b>Less Conservative scenario (£ million)</b>	1,091.4	1,161.7	1,094.1	1,214.0	1,235.7
<b>Gallaher scenario (£ million)</b>	1,347.2	1,368.9	1,275.0	1,426.4	1,453.7
<b>Imperial scenario (£ million)</b>	1,472.5	1,512.7	1,428.4	1,707.0	1,757.5

In all scenarios we use the actual reported data for IT, and then our conservative scenario utilises our conservative estimate for each element of the market. Our less conservative estimate utilises the less conservative estimate where developed, and the conservative estimate where it isn't. It is interesting to note that all scenarios show a slight reduction in aggregate profitability in 2011. This is a reflection of the fact that all scenarios rely to a greater or lesser extent on either the profit or revenue data reported by IT, and both of these fell in 2011 before recovering thereafter. It is unclear for the exact reasons for this anomaly in the performance of IT as the company simply cites a change in "trade buying patterns" alongside the continued reduction in cigarette volumes for the dip relative to the previous years (Imperial Tobacco, 2012, p.22). The existence of this explains why the aggregate estimates for 2011 move slightly away from the observed upward trend in the other years covered.

All estimated scenarios show that in recent years the UK tobacco market has generated operating profits of more than a billion pounds, and even the conservative scenario shows profits reaching £1.1bn by 2013. Furthermore, all but our rather unrealistic conservative scenario show that profits have risen by more than 10% during this five year period, despite this being a time of falling total tobacco sales. For instance cigarettes have declined from

47,725 million sticks in 2009 to 38,390 million sticks in 2013, and whilst it is true some of this will have been compensated for by increases in RYO tobacco sales, the overall trend in overall sales volumes is a clearly downwards (Euromonitor).

It is perhaps a little optimistic to suggest that all tobacco companies operating in the UK would be as profitable as IT (as per the Imperial scenario) but the profit margin of 53.65% assumed in the Gallaher scenario can be seen to be very realistic in that it is consistent with the reported profit rate for IT, JTI, and PMI which account for the vast majority of the UK market. As such it seems reasonable to estimate that the profits generated in 2012 and 2013 were in the region of £1.5bn annually.

### ***B. The Proposed Levy on Tobacco Companies***

Such large annual profits, the deadly nature of tobacco and the on-going need to address the government budget deficit have made the issue of a special levy on tobacco manufacturing/import companies politically attractive, with the UK government conducting a public consultation on this issue between December 2014 and February 2015. However, this isn't a UK phenomenon in that Hungary is also considering a one-time tax on tobacco industry revenues<sup>1</sup> and the US has the tobacco industry 'user fee' as established by the Family Smoking Prevention and Tobacco Control Act of 2009. The idea in the UK context is still at a very early stage in that it isn't yet clear how such a levy would be applied to the tobacco industry. Since there are a number of options that could be considered for such a policy, we now seek to comment upon the various possibilities that exist in regards to the introduction of a special tobacco levy.

### **8. A revenue based levy**

One suggestion is that the levy would be implemented on company revenues, as this would be administratively easy to implement. This might be done on a fee per stick (or stick equivalent) basis or simply as a proportion of the total sales revenue generated for each company. Both are essentially market share based approaches, with the market share being determined by sales volumes in the first case and by revenue earned in the second. At first glance such a levy would suggest it is just another sales tax on tobacco products but with a different name. In many ways this is true and recent experience suggests that such a tax rise would simply be passed on to consumers in the form of higher retail prices. However, such price increases are seen to be one of the most effective tobacco control measures available (IARC, 2011) and therefore anything that might raise the price that consumers have to pay for tobacco should be welcomed. Previous work suggests that a

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<sup>1</sup> See [http://www.portfolio.hu/en/economy/hungary\\_to\\_slap\\_special\\_tax\\_on\\_tobacco\\_companies.28688.html](http://www.portfolio.hu/en/economy/hungary_to_slap_special_tax_on_tobacco_companies.28688.html)

proportionate form of tobacco taxation is likely to exacerbate retail price differentials between brands and products, and hence that a fixed fee per stick approach should be preferred (Gilmore *et al.*, 2010).

The industry would no doubt counter the introduction of such a levy with suggestions that they pay enough tax already and high prices would increase incentives for smuggled and/or illicit tobacco. Such arguments are not new and it is for an elected government to decide rates of tax on any and all products, and smuggling is an issue of law enforcement rather than a fundamental weakness in the suggested levy. Furthermore, existing work shows that while making such arguments (i.e. that price rises stimulate the illicit market) tobacco companies have continued to increase their prices and profits (see Gilmore and Reed, 2014; Gilmore *et al.*, 2013; and Howell, 2012). They are unlikely to have increased their prices to the extent they did if they genuinely believed this was the main driver of the illicit trade.

The key difference that might differentiate such a levy from existing tobacco taxation is the idea that the money generated could be hypothecated for measures to reduce the harm caused by tobacco to society, such as encouraging quitting and discouraging uptake. If this were to be done then it would be a recognition that tobacco is unique in causing harm no matter what the quantity of consumption and hence that the industry should pay to help current users stop, and/or to explicitly contribute towards the cost their products impose on the NHS. Furthermore, such a levy could be differentiated from existing tobacco taxation if it were managed completely independently of existing tobacco taxes and was calculated annually based on the financial needs of the services that are being funded. In this way, such a tobacco levy might be a British equivalent of the 'user fee' established in the USA.

The UK doesn't have a strong tradition of hypothecated taxes in that most revenue is pooled centrally and then used to fund the chosen overall spending patterns. However, there are some precedents, such as the TV Licence scheme, which is a tax in all but name and which generates money that is hypothecated inasmuch as it is primarily used to fund the activities of the BBC. Furthermore, the UK is also under-going political change with further devolution being offered to Scotland, and to a lesser extent, Wales and North Ireland. These changes include reform of taxation where the raising and spending of more taxes will now be devolved, and as such we are starting to see changes in the traditional UK way of centralised tax and spending. This presents possibilities for a hypothecated revenue based tobacco levy.

Another parallel might be the Energy Companies Obligation, where larger companies in the energy industry are required to invest in energy efficiency of their customers. Funds are not granted to the government but are spent by the industry on appropriate activities (see Ofgem for further details). Similarly a tobacco levy could be viewed as being in line with the levies that are paid by utility companies in order to fund their sector specific independent

regulation.<sup>2</sup> A tobacco levy could therefore be independent of the government in the same way as these examples, with the money directly paid to the appropriate cause, such as tobacco cessation services. Such an approach would also be consistent with the idea of a fixed fee approach to such a levy in that the harm caused by tobacco is the same irrespective of which particular brand is consumed, so a fixed fee is consistent with the 'user pays principle' embodied in the whole idea of a revenue based levy.

A revenue based levy would be easy to apply given the existing mechanisms that facilitate the collection of the taxation that are currently applied to tobacco products. However, it would engender no wider change in the tobacco industry in that the companies would still have the incentive (as now) to behave in a way that would maximise their profits which would also continue to accrue to their shareholders. As we have already seen, these profits are considerable in the UK and given the harm that tobacco products cause, they are clearly being earned at the expense of the health and wellbeing of the British public. Furthermore, under the European Tobacco Tax Directive there are limits on the extent to which governments can levy specific (i.e. not proportional) taxes on tobacco products, which will clearly limit the scope for the type of revenue based levy that could be applied.

## **9. A profit based levy**

Another approach to a new tobacco levy might be one based on the profit made by the tobacco manufacturing/import industry, as this would be something that the industry couldn't simply pass on to consumers. This might be politically attractive in that it could be directly publicised as the industry being forced to surrender some of their massive profits to cover some of the costs they are imposing on society, especially if the resulting revenues were to be explicitly hypothecated as discussed above. Indeed, since the monies raised would be coming directly from the companies, it could be considered desirable that some of the money raised be hypothecated for further work on illicit tobacco, as then the industry would be paying to address a problem it has been found to be complicit. Not only would this help raise further tax revenue but it would also help remove any future arguments that illicit tobacco prevents future public health measures.

Given that BAT and Imperial are both headquartered in the UK, any profit based tobacco levy would need to be explicitly targeted at just the UK market operations (i.e. the manufacture for and sale of tobacco products to UK consumers) rather than their entire corporate activities reported in the UK. If the latter was attempted then the companies would simply re-locate their base outside the UK, costing jobs and corporate taxes.

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<sup>2</sup> See, for example, <http://waterbriefing.org/home/regulation-and-legislation/item/9710-ofwat-confirms-increase-in-water-companies-licence-fee-cap-to-fund-2014-price-review>

Something more targeted at the UK market operations would not encourage such action since such a levy would be paid irrespective of whether the companies were to leave the UK or not.

The drawback of this particular approach is that it would be a lot harder to implement than a levy on revenue. As we have seen in the earlier part of this paper when considering the profitability of the UK operations of JTI (and also to a lesser extent the operations of PMI), accounting changes and corporate forms can be easily introduced which significantly reduce the profits reported in any one jurisdiction. Profits that are hidden are clearly hard to tax. However, such issues can't be insurmountable. The UK government has already announced its intention to bring forth tax reform to address the lack of taxation paid by large transnational companies (such as Google, Amazon or Starbucks) who have a large turnover in the UK but funnel the associated profits outside the UK via the use of subsidiaries registered in other locations, thereby avoiding UK corporate taxes. Tobacco companies might well be doing this too given the observed accounting changes introduced by JTI and the small size of the aforementioned UK subsidiary of PMI. The exact detail of this so called 'Google Tax' are as yet unclear but the stated aim is clearly very relevant to the idea of a profit based tobacco levy. It suggests that companies won't be able to hide their profits with accounting tricks in the future. Furthermore, any insights gain from following this Google Tax approach might be supplemented by the use of historical data, such as that developed earlier in this paper, and companies could even be required to make relevant data available as part of a law to introduce such a levy. Furthermore, even if such approaches result in estimates of corporate profits that are imperfect, such estimate would still allow a profit-based levy to be imposed as it would just mean the levy didn't raise as much in practice as it could in theory generate. This sounds less than perfect but in practice applies to all taxes, as no tax actually generates its full yield due to tax avoidance and tax evasion.

A profit based levy would no doubt be harder (and likely more costly) to implement as a scheme, but it has the advantage of being something completely new and a form of taxation that the industry itself would have to pay. The industry would not be able to shift the burden onto consumers because the levy would be calculated based on their profits earned rather than their sales figures or revenue. More profit for the industry, or any particular company within it, would mean higher levy payments. As such it would slightly reduce the incentive the industry faces when seeking higher profits, as any additional profits earned would not accrue entirely to shareholders as some of this would now be captured in higher levy payments. The effects of this change in incentive is likely to be small, depending on the size of the levy implemented, but it is certainly conceivable that on occasion such a levy would mean the likely benefits to the company of any particular policy (e.g. marketing to children) would now be smaller relative to the costs of pursuing it (e.g. loss of goodwill should the policy be revealed).

## 10. A price cap alternative

Both approaches to a tobacco levy have much merit, and are therefore to be encouraged, especially if the resulting funds were to be appropriately hypothecated. In many ways both variants for the levy represent a continuation of existing tobacco control strategies and might therefore be appropriately viewed as a welcome next step. However, neither has the extent of the benefits that would be realised with the policy of capping the wholesale prices tobacco manufacturers are able to charge. This policy has been outlined in detail previously (Gilmore et al., 2010; Branston and Gilmore, 2014) but in short an industry regulator capping price would bring a variety of public health benefits and would also raise significantly more tax revenue since the majority of the current manufacturer profits (as detailed above) would be captured as tax revenue.<sup>3</sup> As such it could be considered a more desirable and bolder alternative to a levy. Indeed, it is also very much in keep with current UK government thinking given the consultation on the levy to raise money from the tobacco industry, and the recent introduction of a cap on the rate of interest that that can be charged by so-called 'payday lenders' such as Wonga.<sup>4</sup>

However, capping prices and a tobacco levy need not be seen as being mutually exclusive either/or type of ideas, as a levy might be a useful intermediate step that helps to facilitate the introduction of price caps in the future. Since price caps would actually reduce the prices that manufacturers are free to charge, such a capping scheme would actually

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<sup>3</sup> As summarised in Branston and Gilmore (2014, p. 2) "Public health benefits occur both because of the reduction in profits and the incentives this engenders, and because a regulatory agency charged with capping tobacco manufacturers' prices would be required to investigate all aspects of the tobacco industry, thus exposing it to greater scrutiny than ever before. Most obviously, price-cap regulation prevents the tobacco industry from using price to market its products or undermine the impact of tobacco excise policies because maximum prices would now be set by the regulator and reduced industry profits would significantly impair its ability to cut any prices below these. Price differences between brands/products would, therefore, be mainly based on the costs of production rather than attempts to segment the market by price, which should significantly reduce the problem of down-trading to cheaper brands/products. Indeed, the suppression of pricing strategy from the arsenal of the transnational tobacco companies would be a complementary policy to other tobacco control measures, as it would essentially prevent the companies from using price changes as a defence in response to public health measures, such as plain packaging, and might even reduce their future resistance to such measures as their profitability becomes partially insulated from them, as the price caps set would take account of the impact of such measures. Furthermore, price-cap regulation could offer a means of controlling other unwanted industry practices, such as price fixing, cigarette smuggling and marketing to the young, as the regulator would be able to identify such activity and then take it into account when setting the price caps. For example, by forbidding, or tightly restricting the marketing budget if the companies are marketing to children. Companies could be regulated based only on their legal activities (so that they do not benefit from illegal activities, such as smuggling) and potentially even penalised for any undesirable activity in order to provide a strong incentive to act responsibly. There is also significant potential to generate indirect public health benefits through the reduction in the money the industry has available to spend on lobbying or fighting public health measures."

<sup>4</sup> See <http://www.bbc.co.uk/news/business-30641877>, accessed on 20<sup>th</sup> January 2015



complement the introduction of a revenue based tobacco levy in that the rate of such a levy could be increased at the point the caps were introduced so that retail prices don't drop. Furthermore, a profit based levy might actually 'pave the way' for price caps in that it would allow the government to argue that price caps were implemented not to raise money from company profits (since the profit based levy does that already) but for public health reasons, thus helping to simplify the legal process of introducing such a measure.

ASH funded a preliminary investigation into the compatibility of such price caps with EU law, and this suggested that various aspects of the Tobacco Tax Directive (TTD), and EU rules on competition, free movement of goods and establishment might prove problematic. However, nothing can be definitive in this regard until an attempt is made to introduce such a policy and the arguments played out in the setting of a court. Such a bold tobacco control strategy will always give rise to legal challenges from the industry when the companies have so much profit to lose. The nature of the law is that there will always be grounds on which a case could be brought. Furthermore, there are routes to see how such legal difficulties might be bypassed or mitigated. For instance, the major political party in the current UK coalition government (the Conservative party) has committed to pursuing a re-negotiation of the UK's relationship with the EU, so freedom to implement price caps might be one such consideration requested. Moreover, reform has recently taken place in regards to the EU position on the growing of GM crops. This was previously an issue decided upon at the EU level, but after disagreement between member states as to the attractiveness of GM crops, reform was agreed in January 2015 which changed this to be an issue determined at the national level, thus allowing some countries to block GM crops whilst others authorise it.<sup>5</sup> Such changes and wider political environment suggest that the UK government should take advantage of the forthcoming review of the TTD to seek appropriate revisions to facilitate the implementation of price caps.

### ***C. Conclusions***

We have developed estimates that show that the manufacture of tobacco products for the UK market is enormously profitable, with the industry generating more than a £1bn each year on very high profit margins. These profits are earned by producing a product that is estimated to cost society in England approximately £12.9bn a year (ASH, 2014). The UK wide figure will be considerably more. It is therefore no surprise that politicians are finding it attractive to contemplate the industry being made to pay more through a new tobacco levy. A revenue based levy would be relatively easy to implement but would need to be differentiated if it wasn't seen to be just another sales tax on tobacco produced. One obvious way would be to hypothecate the revenue generated, so the levy in essence becomes a 'user fee' paying to reduce the harm caused by tobacco to society. Such a levy

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<sup>5</sup> See <http://www.bbc.co.uk/news/world-europe-30794256>, accessed on 20<sup>th</sup> January 2015

would likely be passed on to consumers. A profit based levy would be something genuinely new, would be impossible to pass on to consumers, but would be more challenging to implement. As we detailed above when looking at JTI, accounting changes can be introduced which hide profits in particular markets, so measures to address this would need to be included in such an approach to the levy. Finally we would suggest that any form of tobacco levy should be considered an intermediate goal because utility style price caps offering better financial and public health prospects.

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