A Comprehensive Pricing Strategy for Tobacco Products

Price as Promotion

A significant body of research evidence from around the world shows that the most effective intervention to reduce tobacco use is to increase tobacco prices through tobacco tax increases.1 On average, a 10% increase in price leads to a 4% drop in total consumption, with half the decrease due to continuing smokers smoking fewer cigarettes and half due to smokers quitting and youth not starting.[2] Moreover, various studies also show that smokers who seek out ways to minimize the price they pay for cigarettes make fewer cessation attempts and are less likely to reduce their tobacco consumption.[3]

A recently published review of the scientific literature by Public Health Ontario's Scientific Advisory Committee emphasized the importance of price/tax interventions to achieving continued progress in tobacco control:[4]

> *"Increased price of tobacco through taxation is a highly impactful method to reduce the prevalence of smoking and the overall consumption of tobacco. Other price measures also have the potential to reduce smoking prevalence and tobacco consumption by further increasing prices, limiting tobacco industry revenues while increasing prices, and supporting taxation."*

The effectiveness of Canada's high tax policy, however, has been eroded over the past fifteen years for a number of reasons. The tobacco industry's adoption of a multi-tier pricing strategy, with cigarettes available at three to five different price bands, enables the companies to keep price-sensitive smokers smoking and to offer affordable options to price-sensitive youth. Tobacco companies further undermine the impact of high taxes by over-shifting a tax increase onto premium brands, raising the price of premium brands by more than the tax increase, while raising the price of the cheaper brands by less than the tax increase. This results in a widening of the price gap between the highest and lowest price cigarettes.

Recognizing the important influence of price on tobacco use, tobacco manufacturers and retailers employ a range of price-based strategies to promote sales, and price-based promotion has become a dominant feature of the Canadian market. Not only do companies offer premium, discount (value), and budget cigarette brands, but they also offer a lower per-pack price for the purchase of more than one pack of cigarettes. Another popular incentive is including a tobacco accessory such as a lighter with the purchase of a pack of cigarettes for a nominal or no additional cost. In addition, selling cigarettes in packs of both 20 and 25 cigarettes is a long-standing form of price promotion.

Prominent price signs, both indoors and outdoors, have become a common feature in tobacco retailers and also serve to promote tobacco products.

A comprehensive pricing strategy to prevent tobacco companies and retailers from using price to promote tobacco use and undermine tobacco control measures is urgently needed. Most of the policy options described below could be implemented by either the federal or the provincial/territorial governments or a combination of the two. The goal of a pricing strategy is the prohibitive pricing of tobacco products, whereby prices are high enough to serve both as an inducement for current users to quit or reduce their consumption and as a barrier for youth and young adults to enter the market.

The Canadian Market

Before examining the range of options that could be included in a comprehensive pricing strategy, it is important to understand a few key characteristics of the Canadian market. The Canadian tobacco market is an oligopoly in which three companies account for almost 100% of the cigarette market and a slightly smaller share of the total tobacco market. The tobacco excise tax system in Canada is consists of high specific taxes—a fixed monetary amount per quantity (e.g., cigarette or gram of roll-your-own tobacco)—as opposed to ad valorem taxes, which are levied as a percentage of the wholesale or retail price of the tobacco product.[5]

As Gilmore and colleagues explain, this situation "gives cigarette companies immense pricing power which in turn is exacerbated by tobacco tax policies, the most effective tobacco control policy available."[6] Because excise taxes make up a large proportion of the final price of tobacco products and the manufacturer's revenue a much smaller share, small increases in the manufacturer's share have a minimal impact on demand but result in large increases in tobacco company revenue. Without normal competition in the market, tobacco companies can raise prices at will, generating sustained high profits.

Policy Recommendations

Require industry disclosure

While the approximate division of the Canadian cigarette market by price tier is known, the fact that prices both within and across all price tiers vary by type and location of outlet and by jurisdiction means that very little is known about the average prices paid by smokers in different demographic groups. Given the importance of price to tobacco use, tobacco companies should be required to disclose information on the wholesale and retail prices of their products, by brand and brand variant.

As well, consistent with Guidelines under the Framework Convention on Tobacco Control to prevent industry interference in policy-making,[7] tobacco companies should be required to disclose all activities to influence government tax/price policies, including activities to exaggerate the size of the contraband market in order to prevent tax increases. In a systematic review of 36 unique studies, Smith and colleagues concluded that tobacco companies use a wide range of tactics to influence tax policies, which largely mirror the tactics they use to influence policy more generally:[8]

> *"The industry's combined use of front groups and credible allies helped conceal the origin of industry tax-related arguments and campaigns.… Tobacco friendly experts, consultancy, public relations and advertising firms were all similarly employed to obscure industry*

involvement. Other tactics, such as mass media and publicity campaigns … worked to drum up support for industry positions."

Establish a manufacturers' levy

A manufacturers' levy or licensing fee is a fee on all tobacco manufacturers and importers, apportioned according to market share. The federal government should impose a levy on all tobacco companies that sell their products in Canada and ensure that the fee is sufficient to recover all the costs of a robust federal tobacco control strategy—in the range of $100-$200 million per year.

A manufacturers' levy has been implemented in several countries, including France in 2017[9] and the US in 2009.[10] For the 2016-17 fiscal year, US$635 million or 86% of the US Food & Drug Administration's total tobacco control budget was recovered from its annual fee on the tobacco industry.[11]

Given the substantial nature of this type of levy, tobacco companies would likely pass the cost onto consumers by raising their prices. Regardless of the reason, price increases on tobacco products serve to reduce consumption.

Prohibit incentive payments to retailers

Given the tight restrictions on tobacco advertising and promotion in Canada, tobacco manufacturers have increasingly relied on retailers to communicate with customers and boost tobacco sales, recognizing retailers as an essential component of their marketing strategies. Testimony given by convenience store stakeholders during legislative hearings in Quebec included details of loyalty programs in which retailers are pressured to sign performance-based contracts with tobacco companies.[12] Bonuses and perks such as vacations are awarded to retailers who meet sales volume targets. Tobacco manufacturers also offer rebates to retailers for selling a particular brand below a maximum retail price. To meet sales targets and avoid losing their contracts and associated perks, retailers will sell tobacco at deeply discounted prices, sometimes even at a loss.

A provision banning incentive payments to retailers has been in force in Quebec since November 26, 2016.[13] A similar provision should be implemented by the federal or provincial/territorial governments.

Prohibit discounts for volume purchases

In the past purchases of cigarettes by the carton (8 packs) were popular with smokers, as buying in bulk lowered the per-pack price. However, significant tax and price increases over the past decade have made carton sales virtually obsolete, other than in duty-free stores. Instead, as illustrated in the photo on page one, retailers promote sales of two- and three-pack bundles as a way for smokers to reduce their cost, as well as sales of a pack of cigarettes together with an accessory at substantially less than the combined cost of the two.

Provincial/territorial or federal legislation should prohibit manufacturers and retailers from offering a reduced retail price on a pack of cigarettes on the basis of quantity purchased and from offering a tobacco accessory to consumers for less than the wholesale price.

Limit manufacturers to one pack size

Historically, tobacco companies in Canada have sold cigarette brands in two sizes of pack—20 and 25 cigarettes. Packs of 20 cigarettes provide a lower cost option for smokers who are more price-sensitive. Conversely packs of 25 are often better value for money by offering a lower per unit cost. Internal industry documents

Experience in Australia underscores the need to limit tobacco companies to one package size, containing a prescribed number of cigarettes. Following the introduction of plain packaging and a series of tax hikes, all tobacco companies operating in Australia have introduced packs of odd numbers, such as 21, 22, 23, and 26 cigarettes. This has proven an effective marketing ploy, differentiating a brand visually from its competitors, making packs available at additional price points, and in some cases providing extra value in the form of bonus cigarettes at no additional cost.[14]

The federal governments should ensure that this type of price-based promotion does not undermine tobacco control in Canada by mandating a single pack size as part of the regulations for plain and standardized tobacco packaging.

Minimize product substitution

A number of studies, as well as experience in Canada, demonstrate that a change in the relative price of tobacco products as a result of an unequal tax increase can lead to substitution among tobacco products. In Canada, large excise tax increases on cigarettes accompanied by lower/no tax increases on roll-your-own tobacco have given rise to increased sales of roll-your-own at the same time as cigarette sales declined.[15] Thus part of the expected reduction in cigarette consumption in response to the tax increase was offset by increased use of roll-your-own, since it was taxed at a lower per unit level.

Researchers emphasize the importance of comparable tax increases on all tobacco products in order to maximize the impact on consumption.[16] Health groups in Canada have long called for the excise tax on fine cut tobacco to be equalized with the rate applied to manufactured cigarettes.[17] In the 2013 federal budget, the government raised the excise on 1 gram of fine cut tobacco to equal that on one cigarette;[18] however, the weight of loose tobacco needed to make a cigarette has declined substantially since the conversion factor of 1 gram of fine cut equals 1 cigarette was established. In fact, major brands of fine cut now require as little as 0.45 grams to roll one cigarette.[19] Thus for all intents and purposes, the federal tax rate on roll-your-own remains about half that of manufactured cigarettes. Provincial/territorial governments continue to tax roll-your-own at much lower rates that cigarettes.

Index tobacco tax increases to inflation

The real value of a tax increase is eroded by inflation and by growth in real income, both of which make tobacco more affordable in real terms. As noted economist Frank Chaloupka has stressed, "For tobacco tax increases to have their maximum impact on consumption, the real value of the increase must be sustained."[20]

In 2014, the federal government increased the excise tax on cigarettes by 24% to make up for twelve years of failing to adjust the tax to at least keep pace with inflation, and committed to making inflationary adjusts in the tax rate every five years.[21] In its 2017 budget, the Ontario government increased taxes by one cent per cigarette and announced a further increase of two cents per cigarette in both 2018 and 2019, a move that replaced the inflation-based tax increases announced in the 2016 Budget.[22]

Rather than periodically playing catch-up, a preferable approach would be for the federal and all provincial/territorial governments to put in place a mechanism to automatically adjust tobacco taxes to keep pace with inflation.

Regularly increase excise taxes

In addition to keeping pace with inflation, tobacco taxes need to be increased to at least keep pace with real growth in income or tobacco products actually become more affordable. However, in order to maximize the potential of excise tax increases to reduce tobacco consumption, taxes should be raised enough to reduce the affordability of tobacco products, by ensuring that increases in real price exceed increases in real income.[23].

End duty-free sales

The WHO Framework Convention on Tobacco Control calls for Parties to adopt measures to prohibit or restrict, as appropriate, sales of tax- and duty-free tobacco products.[24] Tax- and duty-free sales reduce government revenues and erode the effects of tax and price measures intended to reduce the demand for tobacco products, and cannot be justified for a product that kills half its long-term users.

In its 2014 budget, the federal government eliminated "the preferential excise duty treatment of tobacco products" available in duty-free stores. However, neither provincial/territorial tobacco taxes nor retail taxes are applied to duty-free products.

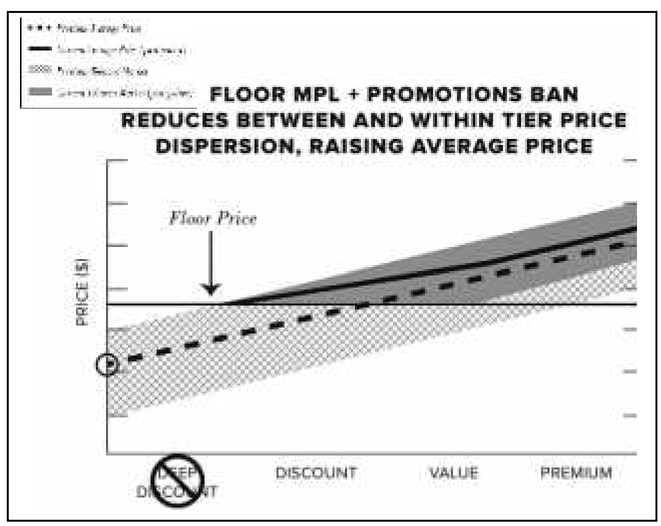
A related issue is the personal exemption for tobacco products that allows returning Canadian travellers age 18 and older to import free of duty and taxes *all* of the following—200 cigarettes, 200 grams of roll-your-own tobacco, 200 tobacco sticks, *and* 50 cigars. This exemption should be eliminated.

Policy Options

Impose a minimum price

A number of US states and cities have implemented minimum price laws (MPL). Several studies assessing these laws have found that prices were lower across trade channels in states with a minimum price than in states without one, although not substantially lower. However, prices were higher in New York City, where a minimum price is combined with a prohibition on price promotions.[25] Tynan and colleagues point out that one of the weaknesses of the MPL in US states is that they impose a minimum mark-up on tobacco products, which could be lower than the mark-up typically applied in a free market.[26] A more effective approach could be the imposition of a uniform minimum price. However, industry price-discounting measures serve to undermine minimum prices.

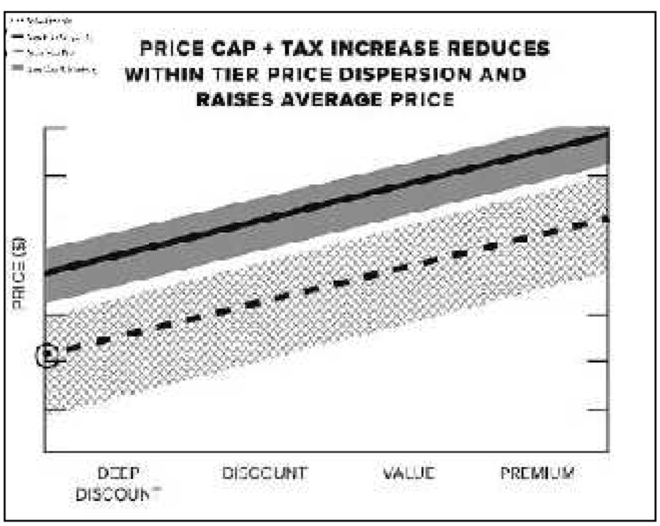
As the graph below illustrates, a minimum price combined with a ban on price-based promotions reduces price dispersion both within and between price tiers and increases average price.



A major drawback of a mandatory minimum price is that it can result in higher profits for tobacco companies and retailers. Governments can mitigate this outcome by implementing a large tax increase at the same time as the minimum price goes into effect. As Golden and colleagues emphasize, "Although isolated implementation may be necessary where tax hikes are politically challenging, most of these [non-tax] policies will be most effective as complements, rather than substitutes, to excise taxes."[27]

Impose a maximum price

A maximum price would cap the price and hence the profitability of the industry's most lucrative "premium" brands; this in turn would induce the industry to raise the prices of their discount brands in order to increase their profitability. However, since tobacco companies are now global, they may be able to offset lost profits from a price capping policy in Canada by increasing the profits generated in another market.[28] If this were to happen, there would be less of a reduction in the price difference between price tiers. Thus the ability of a maximum price to reduce price differentiation depends on the extent to which the industry is able to profit-shift.



Golden and colleagues caution that a maximum price alone reduces price differences within a price tier, but also lowers average price. However, as the graph at left shows, a price cap accompanied by a large excise tax increase reduces within tier price differences and raises average price.[29]

Regulate the price of cigarettes

In a free market economy such as Canada's, government-regulated prices are rare, but not unheard of. For example, five provinces regulate gas prices,[30] some provinces regulate the price of electricity,[31] and the federal Patented Medicines Prices Review Board regulates the ex-factory price of patented pharmaceuticals, but does not have the authority to regulate prices throughout the distribution chain, i.e. from the factory gate to the consumer.[32] In these cases, price is regulated to keep goods that are considered essential financially accessible to consumers.

In the case of tobacco products, the goal of price regulation would be very different—to eliminate the industry's use of a pricing strategy to promote tobacco consumption, in particular, their use of low-priced brands to target price sensitive consumers. Under this model, governments would set a high uniform price for all cigarette brands (and equivalent quantities of roll-your-own) and at the same time would increase the excise tax such that tobacco companies do not benefit from the price increases by earning higher profits.

The concept of a Regulated Market Model (RMM), first put forward by researcher Ron Borland in 2003,[33] incorporates the idea of a government-regulated uniform price. Borland argues that a free market system imposes a number of constraints that make it impossible to achieve optimal regulatory control over tobacco products. Under an RMM, manufacturers supply product to an agency at arm's length from government; this agency controls all aspects of marketing and sale—including price—and acts to reduce tobacco consumption and shift use to less harmful products.

While this model may offer the optimum solution for public health by providing the maximum control over tobacco prices, it is also the most radical and the least politically feasible, at least in the short term.

Conclusions

Both the federal and provincial/territorial governments need to accord a high priority to the issue of tobacco pricing. Some measures can and should be implemented in the short term, including restrictions on retail price signage, a ban on any form of price discounting for volume buys, and a ban on all incentive payments to retailers to promote tobacco sales. These can be implemented by either level of government.

A substantial levy on all manufacturers/ importers, administered by the federal government, would provide much-needed funding for tobacco control and would likely result in industry-imposed price increases.

Tax reforms are also needed in the short term by both levels of government to equalize the tax rate on cigarettes and a comparable quantity of roll-your-own tobacco and thereby reduce product substitution and also to ensure that tobacco taxes at least keep pace with inflation and income growth.

To inform the development of a comprehensive pricing strategy for tobacco products, mandatory disclosure by tobacco companies of their wholesale and retail pricing policies and practices is needed, as well as disclosure of their efforts to interfere with tobacco control policies. In addition, detailed study of the relative merits of significant non-tax price controls in the Canadian context that would reduce or eliminate the price differential between price tiers, including a minimum, maximum, or fixed price for cigarette packs, is required on an urgent basis.

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