



**The Knesset  
Research and Information  
Centre,  
Budget Control  
Department**

**Description and Analysis of Taxation on  
Cigarettes and Rolling Tobacco, Consumption  
Patterns, and State Revenue**

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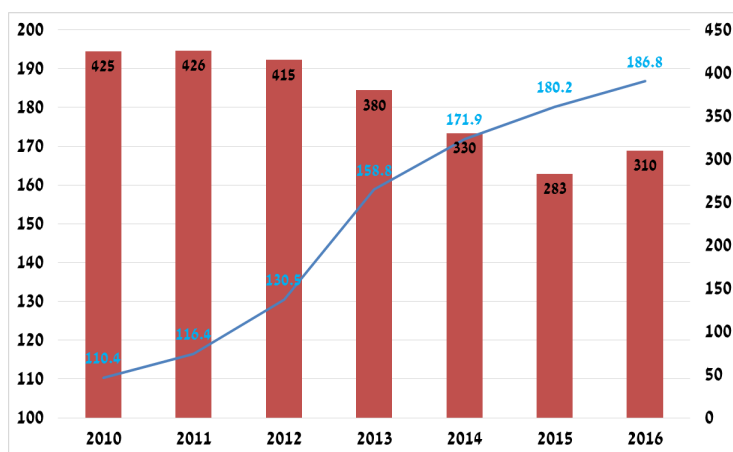
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## SUMMARY

This document was prepared at the request of MK Yehuda Glick. It describes and analyses the effects of the disparity in the taxation on cigarettes and on hand rolling tobacco (henceforth: rolling tobacco) in Israel, on consumption patterns. The document presents data regarding the rates of smokers in Israel and in the OECD countries; an assessment of the impact of the taxation component on the price of cigarettes and rolling tobacco; an assessment of the effect of the difference in taxation on cigarettes versus rolling tobacco on consumption patterns, and on state revenue; an assessment of the impact of changing the taxation method on cigarettes on state revenue, and the standpoints of the distribution companies. The document does not deal with taxation of new products, such as electronic cigarettes.

**Smoking and the derivative costs:** The rate of smokers aged 18 and above in Israel in 2016 was around **22.5%**, compared to a rate of around **19.7%** in 2015 (aged 21 and above). The Ministry of Health estimates the negative external costs caused by smoking to be NIS 12.7 billion per annum.



The left chart<sup>1</sup> shows that in the years 2009-16 the price index of cigarettes and tobacco (blue line) rose by around 86.8%. **The consumption of cigarette packs fell from around 425 million in 2010 to around 283 million in 2015, and increased again to around 310 million packs in 2016.**

**Imports and production:** There are three major cigarettes and rolling tobacco distributors in Israel: Globrands, Philip

Morris and Dubek. The quantity of cigarette imports and domestic production in 2016 was around 313 million packs, of which around 280 million were imported and around 33 million domestically produced.

**In the years 2012-16 the value of imported tobacco increased from around 2.3 million to around 30.2 million USD - an increase of 1,236.5%**, compared to an increase of around 11.5% in the value of cigarette imports during the same period.

**Taxation and revenue:** In 2016 **the total purchase tax for a pack of 20 cigarettes was around NIS 19.3 on average**, which is around 65.5% of the consumer price of a pack, while the total purchase tax and VAT constitute **around 80% of the price of a pack**. In 2016, the average purchase tax on rolling tobacco **was around NIS 18.1 for a 40g pouch of rolling tobacco**, which is equivalent to roughly 57 hand rolled cigarettes weighing 0.7g each. The estimate is that the average purchase tax constitutes around 42.8% of the consumer price for tobacco, while the total of purchase tax and VAT constitute **around 57.3% of the price of tobacco**. Thus, there is a significant taxation disparity between rolling

<sup>1</sup> This chart appears as chart 7 and discussed in detail in section 4.3. Below.

tobacco and cigarettes, which encourages smokers to switch to tobacco, and caused a cumulative loss of revenue **of around NIS 1.5 billion** in the years 2012-2016. State revenue from purchase tax in 2016 was around NIS 6 billion for cigarettes and around NIS 310 million for rolling tobacco - a total revenue **of around NIS 6.3 billion**.

**The estimated effect of equalizing the purchase tax on rolling tobacco:** A comparison based on the weight of tobacco consumed by the consumer of cigarettes and of rolling tobacco, suggests that the tax should be raised to around NIS 1,375 per kilo, which is about 3 times the current Specific purchase tax collected – around NIS 453 per kilo. The significance of such a rise will be to roughly double the consumer price of rolling tobacco. Should the suggested change in the purchase tax for rolling tobacco occur, and under the assumption that consumption will indeed fall, the expected increase in revenue to the state will be around NIS 243 million per annum, or around NIS 632 million per annum without a decrease in consumption. **The estimated effect of changing the taxation method on cigarettes to a Specific tax:** A Specific tax leads to the convergence of cigarette prices. Relatively low priced brands will approach the price of higher priced brands. Dubek brands are relatively low priced, and therefore, were a Specific tax system implemented exclusively, the increase in consumer prices would apply in particular to the Dubek brands. A changeover to an exclusive Specific tax method may increase state revenue from cigarettes, should the purchase tax be above NIS 19.3 (the current weighted sum collected for a single pack), and vice versa. Thus, for example, a Specific tax of NIS 22 per cigarette pack, is expected to add around NIS 1 billion per annum (including the collection of the accompanying VAT) to the state treasury, from which the expected reduction in cigarette consumption should be deducted.

## 1. Restrictions designed to reduce the use of tobacco products

### 1.1. The Framework Convention on Tobacco Control (FCTC)<sup>2</sup>

The FCTC entered into force in February 2005, and has been signed by 168 states. The Convention provides an international framework for tobacco control, and its aspiration is to reduce the prevalence of tobacco use by various means, including taxation, advertising and promotion restrictions (ultimately prohibiting the advertisement of tobacco products altogether), and restrictions on selling methods. The goal of this Convention is to significantly reduce the use of tobacco products, and thus to protect the public from the negative health, social, environmental and economic consequences of tobacco consumption, and exposure to it.

The Convention deals both with means to reduce demand for tobacco products and the effects of passive exposure to them, and with means to restrict the supply of these products. Means to reduce **demand** include among other things, **pricing and taxation policies**; reducing the exposure to the harmful effects of smoking by restricting it in public spaces; restrictions on advertising of tobacco

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<sup>2</sup> World Health Organization, [WHO FRAMEWORK CONVENTION ON TOBACCO CONTROL](#), Accessed: March 15 2011.

products;<sup>3</sup> education and increasing awareness regarding the harmful effects of smoking, and encouraging the quitting of smoking. With regards to **supply**, the Convention proposes several measures and actions, such as the prohibition of illicit trade in tobacco products; prohibition of sales to minors; prohibition of the distribution of free cigarettes and tobacco products to the public in general, and to minors in particular; a total ban on the placing of tobacco vending machines etc.

## 1.2. Environmental taxation policy

The theoretical basis for utilizing economic tools in dealing with pollution and health hazards is the existence of **negative externalities**. This is referred to in economic theory as **market failure** – each manufacturer, seller and consumer maximizes his personal benefit, but from the point of view of the general public this results in **little and even negative social benefit**, and therefore **regulatory intervention, such as taxation and subsidies**, is required. For example, negative externalities are created when smoking is not priced in terms of damage to health, loss of work days, fatalities etc. Environmental taxation is the principal measure to force economic entities to include the negative externalities they cause in their pricing (or to internalize them).<sup>4</sup>

The main objective of environmental taxation is pollution reduction (of air, water and soil), rather than fiscal goals (increasing state revenue). This objective is attained primarily by **changing production and consumption patterns** of processes and products that are harmful to the environment, such as the reduction in cigarette and tobacco consumption that will lead to a reduction in state revenue. Success will depend, *inter alia*, on taxing the factor with the most immediate affinity to the activity one is trying to influence.

## 1.3. Recommendations of the World Health Organization (WHO) regarding taxation policies<sup>5</sup>

According to the WHO, purchase tax can be an effective means for regulating the use of tobacco products, while promoting public health and generating revenue. Of the various taxes on tobacco products, the purchase tax is the most important in achieving the health goal of reduced tobacco consumption, as it is individually applied to each segment of the market, while raising the prices of

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<sup>3</sup> Restrictions on the advertising and marketing of tobacco products is an additional measure that can be utilized to attempt to restrict the negative external effect of smoking. However, despite advertising restrictions in the various media channels, and the requirement to include warnings on cigarette packs, in 2015 the tobacco companies in Israel spent around NIS 63.5 million on advertising and marketing, compared to around NIS 37.6 million in 2007 - a nominal increase of 69%. For more information see: Aharon Blank, [The efficiency of policy measures to limit advertising and marketing of tobacco products](#), according to the report of the U.S. National Cancer Institute and the World Health organization of 2017". (Hebrew), the Knesset Research and Information Center, March 9, 2017.

<sup>4</sup> In this spirit the OECD set in 1972 the **Polluter Pays Principle (PPP)**, according to which the private sector, rather than the state, bears the cost of pollution reduction. Beyond the relevance of the PPP to taxation, it was originally devised to align the policy of denying subsidies to polluting industries, in order to prevent distortions in commerce and international investments.

<sup>5</sup> World Health Organization, Tobacco Free Initiative (TFI), WHO [Report on the Global Tobacco](#), 2017, p. 94. [Accessed: May 22, 2017.](#)

these products compared to the prices of other products and services. The main recommendations of the WHO regarding taxation of tobacco products are as follows:

- **Taxation should constitute at least 70% of the final consumer price** excluding VAT. The way the purchase tax is administered greatly affects the final outcome regarding the number of smokers. Thus, the WHO recommends placing the emphasis on applying more Specific taxes and less Ad Valorem taxes, which will lead to a decrease in the market segment of the lower priced brands. **It should be noted that in Israel, taxation on cigarettes is set at around 65.5% of the price excluding VAT** (see Chart 3), and taxation on rolling tobacco is set at 43% of the price excluding VAT (see Chart 4).
- **Maintaining an efficient tax enforcement system, in a manner that will minimize levels of tax evasion**, which is inclined to occur at higher rates when the weight of total taxes in the price is relatively high. In this connection, Globrands and Philip Morris reported that the illicit trade in cigarettes in Israel is continuously growing together with the increase in taxation. Globrands estimates the illicit trade to be around 20% of the quantity of taxed tobacco.<sup>6</sup> Philip Morris estimates the loss to state revenue is over a billion NIS annually.<sup>7</sup> A more effective enforcement system is based on a simple taxation method. Thus, in some countries the taxation on cigarettes is excessively complicated, based on specific characteristics: with or without filter, length, weight, packaging, sales volume etc. Such complications may contribute to tax evasion.
- **The rate of increase of the Specific tax should be higher than the rate of increase of the consumer price index, and the rate of increase of average salaries.** In this manner, the ability to spend money on tobacco products is reduced, thus also reducing the rate of smokers.
- **Minimizing incentives for smokers to switch to cheaper brands or products as a response to an increase in taxes.** In other words, it is necessary to equalize the tax rates on different tobacco products (for example cigarettes and rolling tobacco), and not to enable disparities in taxation among various products. As stated above, **in Israel there are taxation discrepancies between cigarettes and rolling tobacco** (for details see section 3.4 below). The WHO recognizes the right of governments to independently determine the tax mix that suits them, but indicates in its reports that a more equitable taxation on the different products, the consumers' motivation to switch from expensive products to the cheaper ones declines, making the taxation policy (with regards to smoking reduction) more effective.

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<sup>6</sup> Gadi Netzer, Globrands CEO, JTI position. Email: August 21 2017.

<sup>7</sup> Omer Glazer, Manager of Fiscal Affairs at Philip Morris. Email: September 3 2017.



## 2. Smoking rates in Israel and the OECD countries

### 2.1. Smoking rates in the population

According to the Minister of Health Report on Smoking in Israel 2016, the estimated rate of smokers in the population **aged 18 and above** in Israel in 2016 was **22.5%**.<sup>8</sup> It should be noted that in the 2015 report, the rate of smokers aged 21 and above was **19.7%**.<sup>9</sup>

Table 1 below presents the rates of smokers in the population by sector in 2016

**Table 1 – The rates of smokers in the adult population by sector in 2016 (aged 18 and above)**<sup>10</sup>

Population Sector	Rate of Smokers
<b>Women</b>	<b>16.0%</b>
Jewish women	18.1%
Arab women	9.6%
<b>Men</b>	<b>30.9%</b>
Jewish men	27.8%
Arab men	43.3%

The data in Table 1 shows that in 2016 the rate of smokers among men was around 30.9%, and among women around 16%. Within the Arab population there is a substantial difference between men and women: among Arab men the rate of smoking was around 43.2% compared with around 9.6% among Arab women; among Jewish men this rate was around 27.8% compared to around 18.1% among Jewish women. It should be noted that among the overall Arab population the rate of smokers was 23.1% compared to 22.5% among the Jewish population.

The following chart presents the rate of daily smokers within the OECD countries. Daily smokers are those who smoke every day rather than sporadically. According to the OECD publication, most of the surveys are not uniform, with differences in the surveying method, and in particular in the range of age groups surveyed. Thus, for example, in Israel in 2014 the survey included persons aged 21 and above, while other countries included different age ranges.

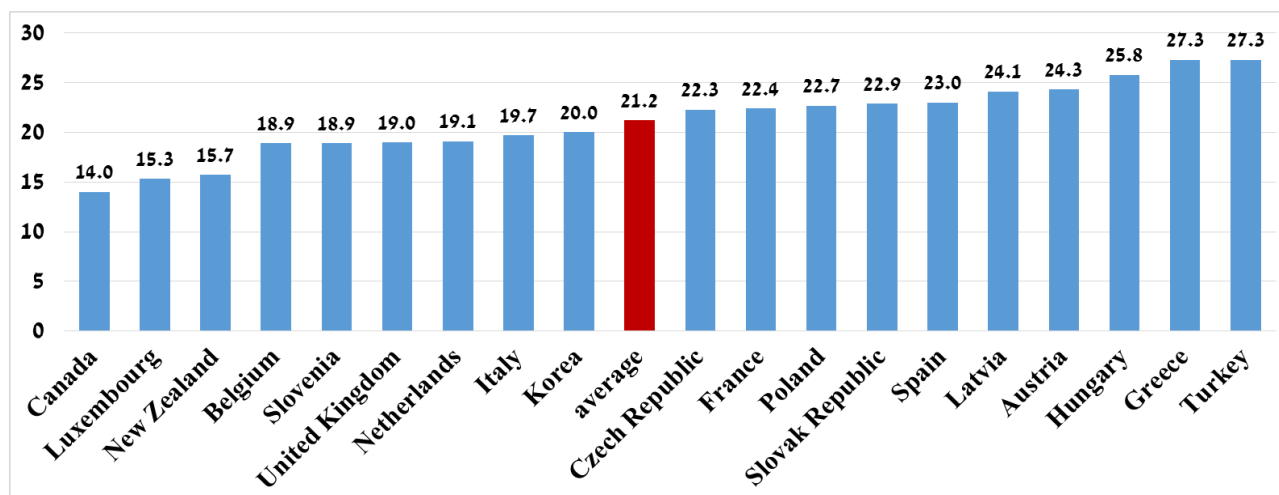
Chart1 below shows data from OECD countries for which this datum exists for 2014, and in which the surveyed age was 15 and above.

<sup>8</sup> Ministry of Health, "[The Minister of Health Report on Smoking in Israel 2016](#)", May 2017. (Hebrew) page 14.

<sup>9</sup> Ministry of Health, "[The Minister of Health Report on Smoking in Israel 2015](#)", May 2016 (Hebrew), page 13.

<sup>10</sup> See footnote 8.

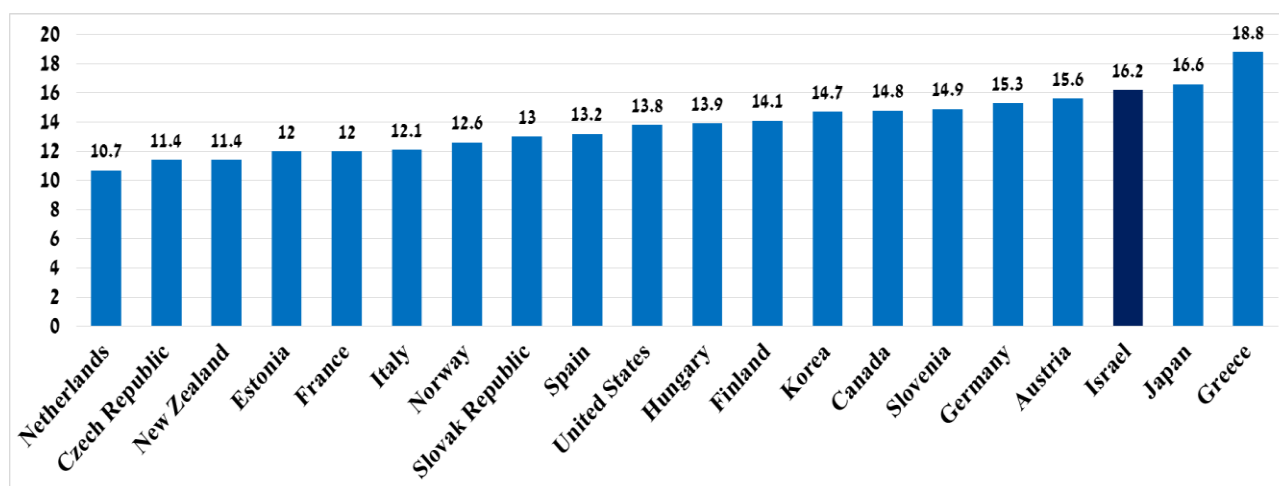
**Chart 1 - Rate of daily smokers in OECD countries in 2014 (in %, age 15+)<sup>11</sup>**



The data in Chart 1 shows that in 2014, the rate of daily smokers aged 15 and above in the countries included was around 21.2% on average. According to the OECD, the rate of daily smokers aged 21 and above in Israel was 17.1%. It should be noted that the smoking rates among youths aged 15-21 may differ between Israel and the other countries compared, and therefore the rate of smoking in the general population may be different. As stated, the surveying methodology and age ranges are not identical in all these countries, and therefore these results should be taken only as an approximate comparison.

Chart 2 below presents the average number of cigarettes consumed by daily smokers in the OECD countries aged 15 and above in 2014. The chart includes all the countries for which this datum is available for 2014.

**Chart 2 – The number of cigarettes consumed by daily smokers in OECD countries in 2014<sup>12</sup>**



<sup>11</sup> OECD, [OECD Statistics](#), Fact book 2015-2016, Dataset: Non-Medical Determinants of Health, April 2017.

<sup>12</sup> Ibid.



The data presented in Chart 2 shows that in 2014 the average number of cigarettes consumed by daily smokers in Israel was around 16.2, which is lower only than in two other OECD countries appearing on the chart. The data presented in Charts 1 and 2 show that in Israel the rate of smokers is lower than the average in the countries surveyed, but that the average number of cigarettes smoked per smoker is higher. As already stated, one must take into consideration the methodological differences, and those in age groups surveyed.

## 2.2. Smoking among children and youths<sup>13</sup>

A Ministry of Health survey for the years 2015-2016 reveals that in the middle-school age group, the rate of those reporting that they smoke cigarettes was 2.6% among Jewish boys and 1.7% among Jewish girls, compared to 1.2% among Arab boys and 0% among Arab girls. These rates increase in the high-school age group to 14.4% and 7.1% among Jewish boys and girls respectively, compared to 10.6% and 0.8% among Arab boys and girls respectively.

The rate of Israeli tenth graders who reported having smoked at least once, was around 20%., compared to an average rate of around 17% within this age group in Europe.

## 2.3. Economic evaluation of the negative externalities caused by smoking

In the Minister of Health Report, the negative external costs were estimated at a number of levels, as elaborated in Table 2 below.

**Table 2 – Estimated negative external costs caused by smoking (2016, in billion NIS)<sup>14</sup>**

Cost Factor	Cost	In %
Mortality due to passive smoking	9.1	71.7%
Loss of output due to work disability and sick leave	1.9	15.0%
Direct and indirect cost to the health system*	1.7	13.4%
<b>Total external costs</b>	<b>12.7</b>	<b>100%</b>

\* Calculated as the product of 830 deaths multiplied by NIS 11 million per person

The estimates presented in Table 2 show that according to the Ministry of Health **the total negative external costs amount to around NIS 12.7 billion**. This estimate does not include **mortality caused by active smoking, which is estimated at around 7,247 persons annually**, since these were defined as **internal costs** for which smokers take responsibility by the mere fact of being smokers. Moreover, in addition to these data (and unrelated to the negative external costs), Israeli households spend around NIS 8.1 billion annually on purchasing cigarettes, not including other tobacco products.

<sup>13</sup> See footnote 8, page 6.

<sup>14</sup> Ibid. page 112.

Table 3 below presents the monthly expenditure on cigarettes and tobacco products according to income quintiles, as determined in the Household Expenditure Survey Of the Central Bureau of Statistics.

**Table 3 – The monthly household expenditure on cigarettes and tobacco products by income quintiles (2014, in NIS)<sup>15</sup>**

Expenditure	Average	1	2	3	4	5	Quintile ratio (5/1)
<b>Cigarettes, tobacco and smoking products</b>	<b>133.6</b>	<b>177.6</b>	<b>159.4</b>	<b>136.6</b>	<b>116.8</b>	<b>77.9</b>	<b>0.44</b>
Of which: cigarettes	126.2	167.9	150.0	129.2	108.6	75.5	0.45
Total expenditure for household consumption	15,053	9,630	11,779	14,304	17,131	22,424	2.33
Weight of expenditure on cigarettes and tobacco	0.9%	1.8%	1.4%	1.0%	0.7%	0.3%	-1.5%

The data presented in Table 3 show that the average monthly household expenditure on cigarettes and tobacco products in 2014 was NIS 133.6 and constituted around 0.9% of the total expenditure for consumption. The monthly expenditure of households in the lowest income quintile amounted to NIS 177.6 (1.8% of the total expenditure for household consumption) compared to a monthly expenditure of NIS 77.9 in the highest income quintile (0.3% of the total expenditure for household consumption). These data indicate that the tendency to smoke is significantly higher among lower income households. It should be noted that prices of products and services in the household consumption basket are updated on a monthly basis by means of the consumer price index published by the Central Bureau of Statistics. Changes in the price of each category of products or services is determined on the basis of its relative weight in the total expenditure for household consumption, which is updated in January every other year.

Table 4 below shows the weight of expenditure on cigarettes and tobacco in an average household in the years 1999-2007.

**Table 4 - The weight of expenditure on cigarettes and tobacco in an average household<sup>16</sup>**

<sup>15</sup> The Central Bureau of Statistics, Household Expenditure Survey 2014, Table 1.1 – ["Monthly income and expenditure for consumption \(single items\) in household quintiles, according to net income per standard person"](#). Accessed: June 25, 2017.

<sup>16</sup> The Central Bureau of Statistics, Price Statistics Monthly - May 2017, ["Table 1.7 – The weight of primary and secondary consumption groups in the consumer price index, according to the latest updated"](#). (Hebrew) Accessed: June 25, 2017



Month	Weight
January 1999	1.180%
January 2001	0.980%
January 2003	1.090%
January 2005	1.130%
January 2007	1.050%
January 2009	0.925%
January 2011	0.945%
January 2013	1.011%
January 2015	1.346%
January 2017	1.694%

The data in Table 4 shows that the weight of the expenditure on cigarettes and tobacco within total expenditure in the consumption of an average household in January 2017, was 1.69%. In addition, in recent years there has been an increase in the weight of expenditure on cigarettes and tobacco from an ebb of 0.925% in January 2009 to a peak of 1.69% in January 2017, apparently resulting from the increase in taxation on cigarettes, and changes in consumption patterns. It should be noted that the increase in taxation on cigarettes, leading to an increase in their price, also leads to an increase in the consumer price index, by the multiplication of the change in price in the expenditure weight (as stated above, currently 1.69%).

### 3. Taxation and revenue

#### 3.1. Imports and domestic production

There are three major distributors of cigarettes and rolling tobacco in Israel: Globrands, Philip Morris and Dubek. Globrands and Philip Morris import the cigarettes distributed by them, while Dubek produces several brands in Israel as well as marketing imported brands. The Minister of Health Report reveals that according to Storenext data, the financial market share of Philip Morris is around 60.2%, that of Globrands is around 28.9%, and that of Dubek is around 10.6%.<sup>17</sup>

#### **Table 5 – Value of Cigarettes and rolling tobacco imported to Israel (in USD)**<sup>18</sup>

<sup>17</sup> Market shares: Ministry of Health, [The Minister of Health Report on Smoking in Israel 2016](#), May 2017; page 131. Dubek's market share: Friedman, Yunger & Co. law firm on behalf of Dubek, comments on the draft document. Email: July 13, 2017.

<sup>18</sup> The Central Bureau of Statistics, "Imports and exports, by merchandise and countries – annual data, Cigarettes containing tobacco". (Hebrew).

Year	Cigarettes	Rolling tobacco	Weight of tobacco value of import value
2012	190.3	2.3	1.2%
2013	200.9	7.1	3.4%
2014	209.3	12.9	5.8%
2015	195.7	22.9	10.5%
2016	212.1	30.2	12.4%
<b>Rate of change</b>	<b>11.5%</b>	<b>1,236.5%</b>	<b>11.3 percentage points</b>

Table 5 shows that in the years 2012-2016 there was an increase in the value of rolling tobacco imports from around USD 2.3 million to around USD 30.2 million - a drastic change of **1,236.5%**, while in the same period there was only a mild increase in the value of cigarette imports - of **11.5%**. As a result, **the weight of tobacco imports increased from around 1.2% in 2012 to around 12.4% in 2016**, - an increase of 11.3 percentage points. The Tax Authority stated that **the level of imports and domestic production of cigarettes in 2016 was 312.9 million packs, and the level of rolling tobacco imported in 2016 was 694,889 kg.**<sup>19</sup>

According to the data published by the Central Bureau of Statistics in 2016 around 279.8 million packs were imported,<sup>20</sup> and consequently the estimated number of packs domestically produced was around 33.1 million packs.<sup>21</sup> Furthermore, according to the data published by the Central Bureau of Statistics **the average import price of a pack of cigarettes (20 cigarettes) was around USD 0.79 per pack, which are around NIS 2.9.**<sup>22</sup>

### 3.2 Taxation on cigarettes and rolling tobacco

In July 2017 the taxation on cigarettes was made up of two components:<sup>23</sup>

- **Ad Valorem tax of 270% of the common wholesale price.**
- **Specific tax of NIS 393.82 per 1,000 cigarettes**, which equals around NIS 7.9 per 20 cigarettes pack. There is a **minimal specific tax of about NIS 754.4 per 1,000 cigarettes** which are around NIS 15.1 per pack.

<sup>19</sup> Kobi Bozo, Chief Coordinator (Economics) in the Tax Authority. Email: May 9, 2017.

<sup>20</sup> See footnote 18.

<sup>21</sup> Similar data appeared in the Minister of Health Report on Smoking for 2016: around 280 million imported packs of cigarettes and around 30 million from domestic production.

<sup>22</sup> The average exchange rate between the USD and the NIS in 2016 was 3.8335 NIS per USD. Bank of Israel, "Exchange rates".

<sup>23</sup> Jakob Bozo, Chief Coordinator (Economics) in the Tax Authority. "[Customs duties and purchase tax tariffs](#)". (Hebrew) Accessed: July2, 2017.



**The taxation on tobacco is based on a Specific tax of NIS 452.66 per 1,000 grams of tobacco**, and there is no Ad Valorem tax on the wholesale price.<sup>24</sup> According to the Minister of Health Report on the basis of the state revenue reports, in 2016 revenue from purchase tax on cigarettes alone was around NIS 6.032 billion, of which around NIS 5.462 billion were from imported cigarettes (90.6%), and around NIS 570 million from domestic production (9.4%). Revenue from purchase tax on rolling tobacco was around NIS 310 million, and there are additional intakes from taxation on other tobacco products, such as hookah tobacco, cigars etc.<sup>25</sup> Dividing the data on state revenue from cigarettes in 2016 (around NIS 6,032 million) by the data on imports and domestic production (as stated above, around 312.9 million packs), reveals that the average tax collected on a pack of cigarettes was **around 19.3 NIS per pack** in 2016, including all the purchase taxes but excluding VAT. Together with the VAT, the total tax collected on a pack of cigarettes is estimated at NIS 22.6.

### 3.3. Taxation on cigarettes and rolling tobacco by selected brands

Given the taxation data presented above, and the retail price (wholesale price plus taxes), one may calculate the price before tax, and the tax components for tobacco products. Table 6 below, presents the wholesale prices prior to taxes on various brands of cigarettes (including import costs, marketing, distributing and distributors profits); taxes (Specific tax and Ad Valorem tax, excluding VAT); wholesale prices after taxation (the price paid by the retailer to the distributor including taxes). As stated above, the average import price of a cigarette pack in 2016 was around NIS 2.9, though it should be noted that the specific import prices by brand were not obtained.

**Table 6 – Wholesale price prior to taxation, taxes and wholesale price after taxation, by selected brands (in NIS)**<sup>26</sup>

Globrands					
Datum	LD	Pall Mall	Camel/ Winston	Kent	Average
Wholesale price before tax (1)	3.3	3.7	4.3	5.2	<b>4.1</b>
Specific tax in NIS	7.9	7.9	7.9	7.9	<b>7.9</b>
Ad Valorem tax	8.8	10.0	11.7	14.1	<b>11.1</b>
Total tax excluding VAT (2)	16.7	17.8	19.6	21.9	<b>19.0</b>

<sup>24</sup> There is an additional general tax of 12% of the import price on rolling tobacco, but imports from EU countries, the Mercosur countries (Argentina, Brazil, Paraguay, and Uruguay) and from the USA are exempted from this tax. Philip Morris reported that *de facto* this tax is not paid, while Globrands reported that it is paid. It should be noted that this is a relatively negligible tax, estimated at 0.20 to 0.40 NIS per pack, depending on the import price of the tobacco.

<sup>25</sup> See footnote 8.

<sup>26</sup> Common retail price: data gathered from supplier to retailer receipts, May 2017, and Globrands retail pricelist, January 2017.



<b>Globrands</b>					
Wholesale price after tax (1+2)	19.9	21.5	23.9	27.2	<b>23.1</b>
<b>Philip Morris</b>					
<b>Datum</b>	<b>Next</b>	<b>L&amp;M</b>	<b>Marlboro</b>	<b>Parliament</b>	<b>Average</b>
Wholesale price before tax (1)	3.9	4.6	5.2	5.9	<b>4.9</b>
Specific tax in NIS	7.9	7.9	7.9	7.9	<b>7.9</b>
Ad Valorem tax	10.6	12.3	14.1	15.8	<b>13.2</b>
Total tax excluding VAT (2)	18.5	20.2	21.9	23.7	<b>21.1</b>
Wholesale price after tax (1+2)	22.4	24.8	27.2	29.5	<b>26.0</b>
<b>Dubek</b>					
<b>Data</b>	<b>Time</b>	<b>Golf</b>	<b>Noblesse</b>	<b>Average</b>	
Wholesale price before tax (1)	3.7	3.9	3.9	<b>3.8</b>	
Specific tax in NIS	7.9	7.9	7.9	<b>7.9</b>	
Ad Valorem tax	9.9	10.5	10.5	<b>10.3</b>	
Total tax excluding VAT (2)	17.8	18.4	18.4	<b>18.2</b>	
Wholesale price after tax (1+2)	21.5	22.3	22.3	<b>22.1</b>	

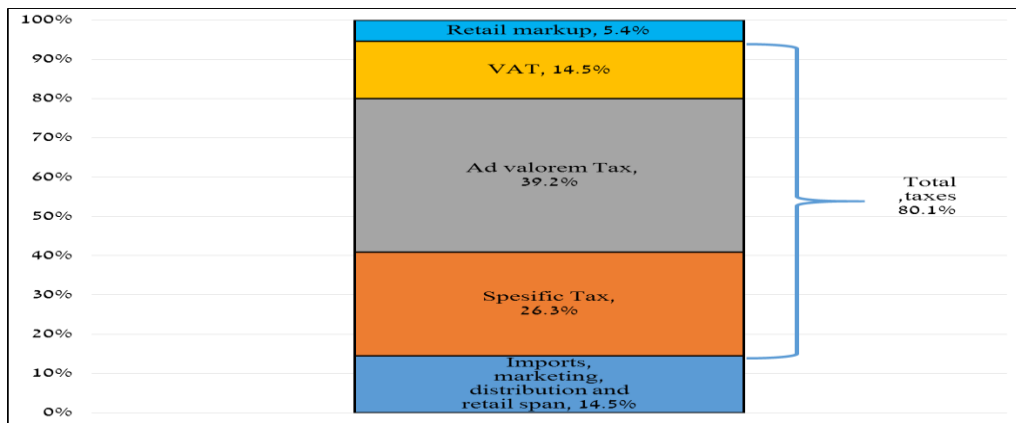
The data presented in Table 6 shows that the wholesale price per pack of cigarettes of selected brands is around NIS 4.1 for Globrands, around NIS 4.9 for Philip Morris and around NIS 3.8 for Dubek. The average total tax excluding VAT as presented is around NIS 19, 21.1 and NIS 18.2 respectively (simple average of around NIS 19.3 per pack for all brands). The wholesale prices after tax is around NIS 23.1, NIS 26 and NIS 22.1, respectively. It is worth noting that Philip Morris brands as a whole should not necessarily be regarded as more expensive, as the data presented here is for selected brands and had all brands been presented, the results may have been different.

### **3.4. Estimated total taxation on cigarettes and rolling tobacco**

Chart 3 below presents the estimated average weight of the various components in the value chain of the different cigarette brands. The estimate is an average of all brands presented above. Furthermore, the estimate assumes retail prices, including a VAT rate of NIS 30 for Globrand brands, NIS 32 for Philip Morris brands and NIS 28 for Dubek brands.

#### **Chart 3 – Estimated average cost weights according to components in a cigarette pack<sup>27</sup>**

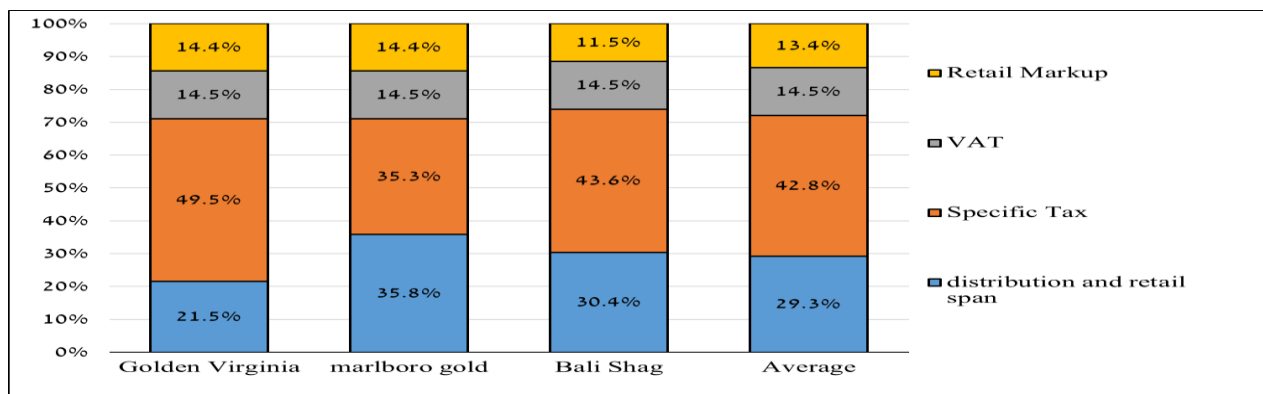
<sup>27</sup> This estimate was calculated using the brands' averages as presented in Table 6.



The data in Chart 3 show that **the average tax estimate per pack of cigarettes is around 80% of the retail price (including VAT, which is applied to both the Specific tax and the Ad Valorem tax),** of which around **65.5% is Specific tax and Ad Valorem tax.** The remaining 20% consists of the other cost and profit components. The Minister of Health Report includes a State Revenue Administration analysis of the estimated ratio of total taxation in the consumer price in Israel and in other countries in January 2015. The result of the estimate obtained was 80.4%,<sup>28</sup> which is close to the estimate presented in Chart 3 above.

Similarly, an estimate of the average weight of the various components in the value chain of three different rolling tobacco brands was calculated, as presented in Chart 4 below. As mentioned above, there is only a Specific tax per kilo of tobacco on rolling tobacco, and therefore the disparities in the rate of taxation on the different tobacco brands result from the weight of the tobacco pouch and the consumer price.

**Chart 4 – Estimated average cost weights by components of rolling tobacco<sup>29</sup>**



<sup>28</sup> See footnote 8, Table 12-8.

<sup>29</sup> Tobacco brands: Golden Virginia, Globrands (50g); Marlboro Gold, Philip Morris (30g); Dubek's Bali Shag (40g). The consumer price of each brand is the average of 4 price quotes for each of them. The prices were obtained from two major retail chains and two specialized tobacconists in Jerusalem and in Tel-Aviv.

The analysis shows that **the total estimated weight of taxation on rolling tobacco is 57.3% of the retail price**, including VAT at a rate of around 14.5%. As mentioned above, the estimated weight of taxation on cigarettes is around 80.1% - in other words, **a substantial discrepancy of 22.8 percentage points**. Philip Morris reported that in terms of the consumer price, the weighted average price of a pack of cigarettes is NIS 30, while the average price of rolling tobacco (with a conversion rate of 0.7g per cigarette) is NIS 14.7 - in other words, a price gap of about double in value between prices of the products when comparing the amount of tobacco contained in each.<sup>30</sup> Similar results were obtained in the Knesset Research and Information Center analysis, as presented in Table 8.

### 3.5. Taxation comparisons with the European Union countries

Chart 5 below presents the weighted average in % of the overall tax (Specific tax, Ad Valorem and VAT) on cigarettes of the consumer price in EU countries and in Israel.

**Chart 5 – Percentage of total tax on cigarette consumer prices by countries (in %, January 2017)<sup>31</sup>**

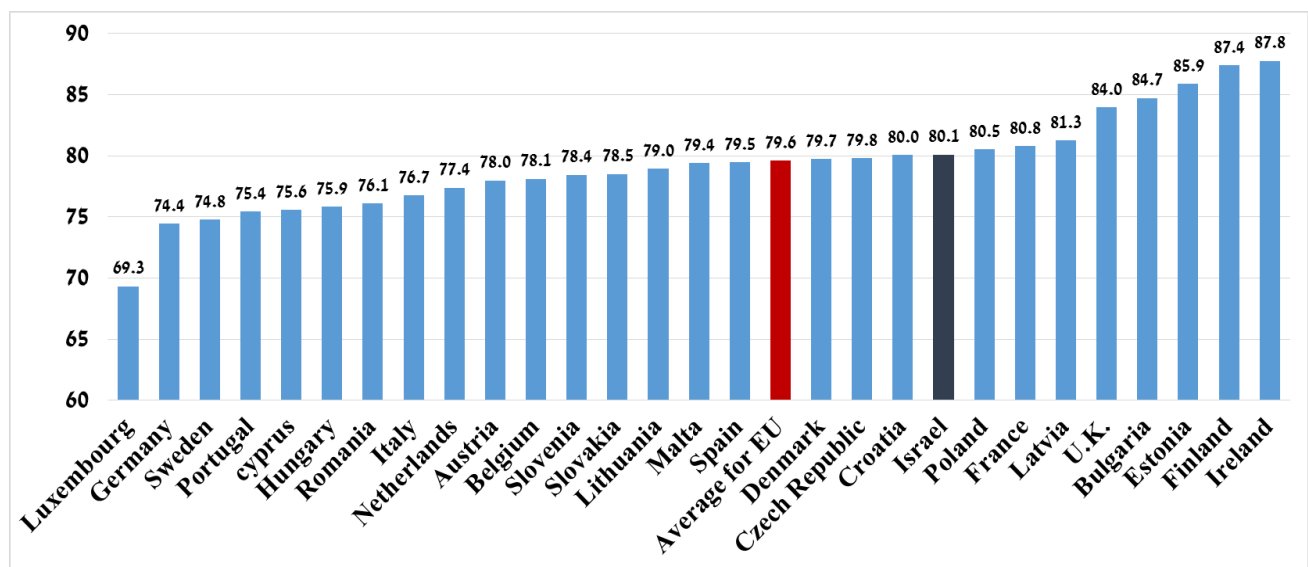


Chart 5 shows that the overall weight of taxation on cigarettes in the consumer price, is slightly higher in Israel (80.1%) compared to the EU average (79.6%). Thus, compared to 28 countries of the EU, Israel is located between Poland and Croatia which are in the 9<sup>th</sup> and 10<sup>th</sup> places respectively. It should be noted that these countries have different VAT rates.

Chart 6 below presents the Specific tax per kilo of rolling tobacco in the EU countries in which only such a tax is applied. The Euro exchange rate for the period compared was NIS 4.0438 on January 1, 2017.<sup>32</sup>

<sup>30</sup> Omer Glazer, Financial Manager at Philip Morris. Email, September 3, 2017.

<sup>31</sup> European Commission. [Excise Duty Tables](#), Accessed: June 20, 2017, Excise Duty Tables for January 2017.

<sup>32</sup> Bank of Israel, "Exchange rates", the exchange rate on January 1, 2017. Accessed: June 20, 2017.



**Chart 6 – The Specific Tax applied to rolling tobacco in the EU countries (Euro, January 2017)**<sup>33</sup>

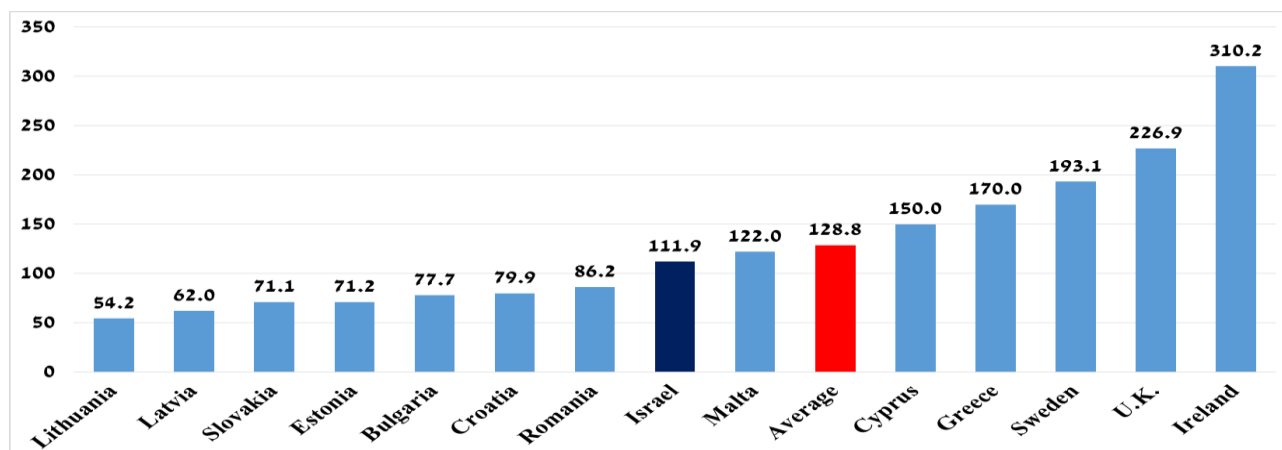


Chart 6 shows that in terms of the level of taxation on rolling tobacco, the Specific tax in Israel (around 112 Euro per kilo) is lower than the average tax in EU countries that apply a Specific tax (around 128.8 Euro). It should be noted that about half of the EU countries apply a Specific tax only on rolling tobacco, while the other half apply both an Ad Valorem tax and a Specific tax, and therefore when considering both taxes, the weight of taxation in Israel is substantially lower than the average weight of taxation in EU countries.

#### 4. Analysis of changes in the tax rate on consumption patterns, the consumer price, and state revenue

##### 4.1. Changes in consumption patterns: the switch from cigarette consumption to rolling tobacco

The disparities in taxation on cigarettes and on rolling tobacco are a significant factor that encouraging changes in consumption patterns, and a sharp increase in the consumption of rolling tobacco (see Table 5 above). From the Minister of Health Report, and reports of the WHO<sup>34</sup> it transpires that the existing tax distortion between cigarettes and rolling tobacco, causes a change in the preferences of smokers, and a switch from the purchase of cigarette packs to tobacco for hand rolling, instead of considering the option of quitting smoking altogether, or reducing smoking. **This situation seriously impairs the efficiency of the taxation policy as an effective and proven tool for reducing smoking and its harmful effects, and preventing youngsters from starting to smoke, as well as a cumulative loss of revenue of over NIS 1 billion to the state treasury in recent years.** In this connection, the economic program for the years 2013-14 proposed that the Ordinance on Customs Duties, Exemptions and Purchase Tax on Goods, 7572-2012, be amended, **in order to set a purchase tax rate of NIS 800**

<sup>33</sup> Same as footnote 31.

<sup>34</sup> World Health Organization, "[Technical Manual on Tobacco Tax Administration](#)", 2011.



**per kilo of tobacco.**<sup>35</sup> Nevertheless, the purchase tax **rose to NIS 450 per kilo of tobacco**, and this, according to the letter of the Deputy Minister of Finance, in order to avoid an extreme upheaval in the economy, and to implement a rise in the tax (should it occur) in a gradual manner.<sup>36</sup>

The estimates regarding loss of state revenue due to tax differentials between rolling tobacco versus cigarettes, and also due to cigarette smuggling from abroad (in order to evade high domestic tax payments), as noted in the Ministry of Health Report, was around NIS 130 million in 2013, NIS 250 million in 2014, and over NIS 300 million in the following years.<sup>37</sup>

In this connection, it was also noted in the Ministry of Health Report that after the taxation on cigarettes and tobacco had been raised in 2013, an increase of around NIS 800 million in state revenue was expected from the additional taxation, but in practice revenue reached around NIS 740 million, apparently resulting from the overall decrease in the rate of smokers, as well as the switch of smokers to rolling tobacco, which is taxed at a significantly lower rate compared to cigarettes.<sup>38</sup> In addition, according to a press release by the Ministry of Finance, a decrease took place in state revenue in the segment of the item 'purchase tax on imports' in June 2017 compared to June 2016, which is explained as resulting from a decrease in the import of petroleum derivatives, and due to the switch to imports of rolling tobacco at the expense of highly taxed cigarettes.<sup>39</sup> According to the Ministry of Finance, in June 2017 revenue from purchase tax on imports was around NIS 1,282 billion, compared to around NIS 1,564 billion in June 2016 - a fall at a nominal rate of around 18%. Deducting the cancellation of the purchase tax on mobile phones, and the decrease in imports of motor vehicles, a fall of around 5% in the collection of purchase tax on imports remains, which is explained as resulting from a switch from imported cigarettes to imported rolling tobacco (due to the disparity in taxation), and resulting from a fall in the import of petroleum derivatives. This reduction is estimated at around NIS 75 million in June, or around NIS 900 million at an annual rate.

#### **4.2. The estimated effect of raising the Specific tax on rolling tobacco, on the consumer price**

In Table 7 below, the estimate resulting from a simulation of raising the Specific tax on rolling tobacco, by pouches weighing 30, 40 and 50 grams is presented. In January 2017 the Specific tax on rolling tobacco was, as mentioned, NIS 425.7 per kilo. The added increase in the Specific tax will also lead to a rise in VAT, and consequently the sum of the added increase in the Specific tax and VAT will

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<sup>35</sup> The Ministry of Finance, "The Economic Program for the years 2013-14" chapter on taxes, p. 236, (Hebrew); [Minister of Health Report on Smoking in Israel 2016](#), p. 112 (See footnote 8).

<sup>36</sup> Deputy Minister of Finance, letter to Yehuda Glick, [Re: Ordinary Question to Minister No. 814 regarding tax of rolling tobacco](#), 27 March, 2017. (Hebrew)

<sup>37</sup> See footnote 8, p. 135.

<sup>38</sup> Ibid. p. 112

<sup>39</sup> Ministry of Finance, ["Press Release -Budget implementation, and state revenue from taxation in June 2017"](#). July 9, 2017, (Hebrew).



constitute an overall addition to the price of a pouch (assuming that the retailers will maintain the same retail markup level per pouch).

**Table 7 - Simulation of raising the Specific tax and the price of tobacco by pouches weighing 30, 40, and 50 grams (in NIS)<sup>40</sup>**

Specific tax (in NIS per kg)	Current	Possible tax						
	452.7	500	600	700	800	900	1,000	1,250
Specific tax per pouch: <b>30 grams</b>	13.6	15.0	18.0	21.0	24.0	27.0	30.0	37.5
Addition of rise in Specific tax	-	1.4	4.4	7.4	10.4	13.4	16.4	23.9
Added rise in price	-	<b>1.7</b>	<b>5.2</b>	<b>8.7</b>	<b>12.2</b>	<b>15.7</b>	<b>19.2</b>	<b>28.0</b>
Specific tax per pouch: <b>40 grams</b>	18.1	20.0	24.0	28.0	32.0	36.0	40.0	50.0
Addition of rise in Specific tax	-	1.9	5.9	9.9	13.9	17.9	21.9	31.9
Added rise in price	-	<b>2.2</b>	<b>6.9</b>	<b>11.6</b>	<b>16.3</b>	<b>20.9</b>	<b>25.6</b>	<b>37.3</b>
Specific tax per pouch: <b>50 grams</b>	22.6	25.0	30.0	35.0	40.0	45.0	50.0	62.5
Addition of rise in Specific tax	-	2.4	7.4	12.4	17.4	22.4	27.4	39.9
Added rise in price	-	<b>22.8</b>	<b>8.6</b>	<b>14.5</b>	<b>20.3</b>	<b>26.2</b>	<b>32.0</b>	<b>46.6</b>

An analysis of Table 7 reveals that it is possible to regulate the new desired price for a pouch of rolling tobacco as a function of the change in the Specific price. Thus, for example, the application of a new tax of NIS 800 on rolling tobacco, will increase the price for a pouch weighing 30 grams by around NIS 12.2: NIS 10.4 of which as a result of an increase in the Specific tax, and around NIS 1.8 of which as a result of an increase in VAT to the new consumer price. Thus, for example, if on Marlboro Gold tobacco weighing 30, and sold today for around NIS 38.5,<sup>41</sup> a price rise of around NIS 12.2 will occur, it will be sold for around NIS 50.7, which constitutes an increase of around 31.7% to the current price.

It should be noted that even though the distributors indicate to the retailers recommended consumer prices for each brand, these recommendations are not binding on the retailers, who are entitled to sell them at whatever price they may see fit. We note that even though the retailer purchases the cigarettes from the distributor at a price that includes VAT, he is credited for the relative part of the VAT that he paid the distributor (input VAT) of the higher VAT in accordance with the consumer price (transactions

<sup>40</sup> Processed by the Knesset Research and Information Center. The current tax: the Tax Authority, "[Import tax and purchase tax tariffs](#)". (Hebrew ) Accessed: July 2, 2017.

<sup>41</sup> The average price of four retail stores.

VAT), so that the final profit to the retailer is partially affected by the rate of the VAT, most of which is "loaded" by the end of the process onto the consumer (depending on the flexibility of demand).<sup>42</sup>

Table 8 below presents the estimated result of an increase in the Specific tax that is currently applied to rolling tobacco, so that it will be equalized to the total Specific tax and the Ad Valorem tax applied today on a pack of cigarettes, which amounts to an average of around NIS 19.3 per pack of cigarettes. The calculation was based on the number of cigarettes that can be prepared from a tobacco pouch, with the weight of tobacco in a single cigarette taken to be around 0.7 grams.<sup>43</sup>

**Table 8 - Estimated effect of equalizing the tax on rolling tobacco with the tax on cigarettes<sup>44</sup>**

Weight of a rolling tobacco pouch	30 grams	40 grams	50 grams	Specific tax
Current Specific tax (in NIS per pack) (1)	13.6	18.1	22.6	Around NIS 453 per kg
The number of cigarettes that may be prepared from tobacco (100% utilization)	42.9	57.1	71.4	
<b>New Specific tax per rolling tobacco pouch (NIS per pouch) (2)</b>	<b>41.3</b>	<b>55.1</b>	<b>68.8</b>	<b>NIS 1,375 per Kg</b>
New consumer price, according to a Specific tax of NIS 1,375 per kg	70.8	84.7	99,7	
<b>Addition of Specific tax including VAT (in NIS per pouch) [1.17*(2-1)]</b>	<b>32.4</b>	<b>43.3</b>	<b>54.1</b>	

An analysis of Table 8 reveals that according to the estimate effect of equalizing the Specific tax applied today on rolling tobacco to that applied to cigarettes (based on the weight of the tobacco), the tax should be raised to around NIS 1,375 per kilo.<sup>45</sup> As mentioned above, the tax today amounts to around NIS 453 per kilo - in other words, an increase of around 204% in the Specific tax - approximately **three times the current tax**.

The application of a tax of around NIS 1,375 per kilo of tobacco, implies an increase in the consumer price of around NIS 32.4 per pouch of 30 grams, around NIS 43.3 per pouch of 40 grams, and round NIS 54.1 per pouch of 50 grams. **The implication is a close to 2 fold increase from the current price.** In this connection, the report of the Director of State Revenue for 2014 pointed out that the Shekel value of the purchase tax on a pack of cigarettes is NIS 19.3, compared to NIS 9.2 for rolling tobacco

<sup>42</sup> If, for example, the retailer purchases a pack of Winston cigarettes at NIS 23.92 without VAT, and the consumer purchases the pack at a price, for example, of NIS 30, including VAT (a price without VAT of NIS 25.64), the retailer will earn NIS 1.72 in this case, which is the difference between NIS 23.92 and NIS 25.64.

<sup>43</sup> The tobacco of several cigarette brands was weighed, and the results were 0.7 grams for each.

<sup>44</sup> Processed by the Knesset Research and Information Center.

<sup>45</sup> A Specific tax on rolling tobacco that will lead to an equalization of tax compared with cigarettes is NIS 41.3 per pouch of 30 grams, or around NIS 1.375 per gram, or around NIS 1,375 per kilo of tobacco.

in equal value terms to a pack of cigarettes. The conclusion is that in order to equalize the level of taxation on rolling tobacco to that on cigarettes, it is necessary to double the tax on rolling tobacco.<sup>46</sup>

In the letter of reply to MK Yehuda Glick by the Deputy Minister of Finance, to a question posed to the Minister, which was sent in March, 2017, it was noted that equalizing the tax on rolling tobacco to the tax on cigarettes is expected to lead to a Specific tax of around NIS 1,250 per kilo.<sup>47</sup> However, in an additional letter of May, 2017, the Deputy Minister pointed out that the Ministry of Finance was not planning to raise taxes in any sphere, since the policy of the Ministry of Finance is to reduce the tax burden, and increase free income as far as possible.<sup>48</sup> In this connection, in a report by the Tax Authority, which surveyed revenue from the motor vehicle sector, it was noted that the central goal of applying a purchase tax is to internalize the external costs caused to the public in the course of consumption, or the production of the product. Thus, the report noted that similarly to the case of motor vehicles, a purchase tax is also applied to fuel, cigarettes etc. In terms of the taxation on motor vehicles, it transpires, according to the report, that the maximal purchase tax on motor vehicles of up to 3.5 tons, is 83%, and on this tax there is a deduction related to the level of pollution, which varies from 1 to 15 (1 being the best grade).<sup>49</sup> In other words, the lower the level of pollution, the higher the tax exemption, and the lower the tax paid on the motor vehicle. This formula changes from time to time, and as of January 2017 new models are categorized as being of a higher pollution level compared to identical models from 2016, and as a result the tax on them in 2017 is higher. In other words, *de facto* the Ministry of Finance occasionally raises taxes, despite its declared policy of reducing the tax burden.

#### **4.3. The estimated effect of raising the Specific tax on rolling tobacco, on decreasing consumption, and on state revenue**

The expected addition to state revenue depends on two main factors: a new Specific tax on tobacco, and a change in consumption.

**A new Specific tax on tobacco:** It emerges from the data in table 8 above that according to the estimate, the equalization of taxation on rolling tobacco with that on cigarettes will lead to an increase of the Specific tax on rolling tobacco to around NIS 1,375 per kilo. In addition, as mentioned above, within the framework of the approval of the 2013-14 budget there was an intention to increase the Specific

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<sup>46</sup> The Ministry of Finance, "[Report of the Director for State Revenue for the years 2013-14, Chapter 12 - purchase tax](#)", (Hebrew) Accessed: July 2, 2017.

<sup>47</sup> Deputy Minister of Finance, letter to Yehuda Glick, [Re: Ordinary Question to Minister No. 814 regarding tax on rolling tobacco](#), 27 March, 2017. (Hebrew)

<sup>48</sup> Deputy Minister of Finance, letter to Yehuda Glick, [Re: Direct Question to Minister No. 2078 regarding the equalizing the tax on rolling tobacco to that on cigarettes](#), 16 May, 2017. (Hebrew)

<sup>49</sup> The Tax Authority, [Taxation and select data on the motor vehicle branch in Israel](#). (Hebrew). Accessed: June 20, 2017.



tax from around NIS 290 per kilo to around NIS 800 per kilo, but finally the updated increase in the Specific tax was around NIS 450 per kilo (after updates around NIS 452.7 per kilo).

**Change in consumption:** according to the TFI cluster<sup>50</sup> of the WHO, the rule of thumb is that an increase of 10% in the price of a pack of cigarettes is expected to reduce demand by around 4% in states with a relatively high per capita product (such as Israel) or around 5% in states with a relatively low per capita product.<sup>51</sup>

**Table 9 - Main changes in purchase tax on cigarettes (in NIS per pack)**<sup>52</sup>

<b>Date of change</b>	<b>AD Valorem tax (in %)</b>	<b>Specific tax</b>	<b>Minimum tax</b>
June 2009	225.7	4.1	8.0
September 2011	260.6	4.3	9.5
July 2012	278.6	5.5	12.0
May 2013	270.0	7.8	15.0
Today (September 2017)	270.0	7.9	15.1
<b>Change</b>	<b>44.3 percentage points</b>	<b>93.5%</b>	<b>88.8%</b>

The data presented in Table 9 demonstrates that from June 2009 to the present the Ad Valorem tax increased by 44.3 percentage points; the Specific tax increased by around 93.5%; the minimal tax per pack is today around NIS 15.1 - an increase of 88.8% since June 2009. Furthermore, the last tax increase took place in May 2013 (the tax today is an update of the Shekel tax based on what exists). Naturally, tax increases increase in turn the prices of cigarettes, which contribute to a decrease in consumption.

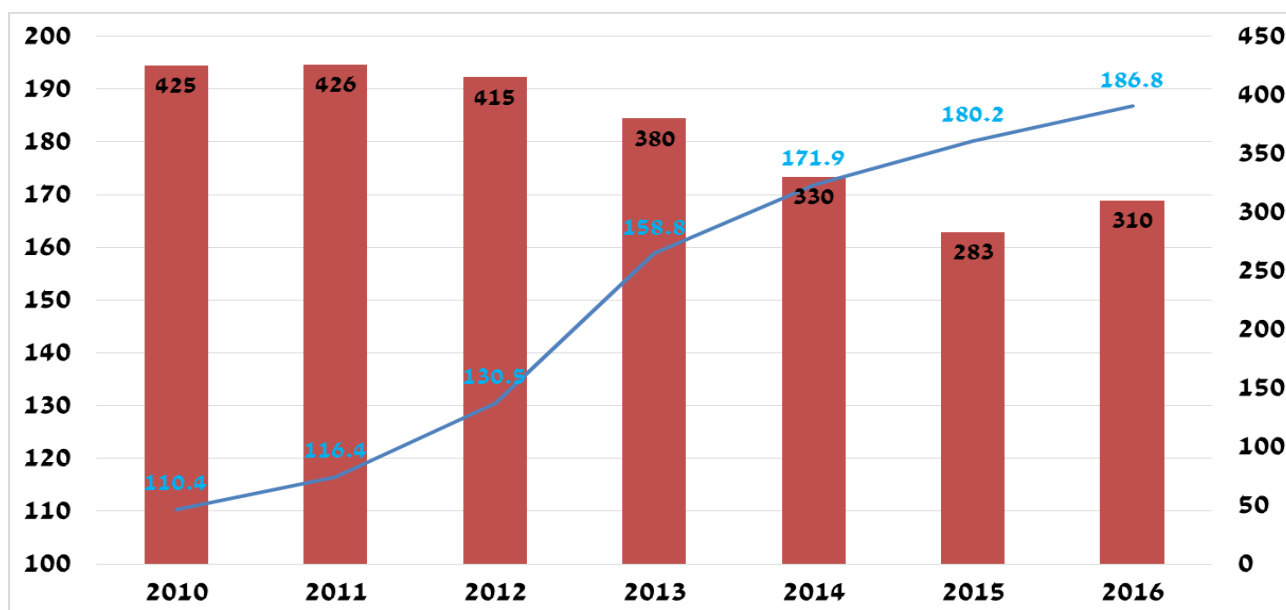
Chart 7 presents the price index of cigarettes and tobacco, since 2009. Most of the consumption is of cigarettes, so that the index primarily expresses the rise in cigarettes prices.

<sup>50</sup> TFI: Tobacco Free Initiative (the initiative for preventing smoking).

<sup>51</sup> World Health Organization, [Tobacco Free Initiative \(TFI\) - Taxation](#). Accessed: June 18, 2017.

<sup>52</sup> Tax Authority, ["Customs and purchase tax tariffs"](#). (Hebrew). Accessed: July 2, 2017.

**Chart 7 - The price index and the consumption quantity (2009=100, packs in millions)**<sup>53</sup>



The data presented in Chart 7 show that in the years 2009-16 the price index for cigarettes and tobacco rose by around 86.8%. One may observe a leap in the price index in 2013, which resulted, *inter alia*, from the increase in the Specific tax in May of that year (see Table 9). The consumption of packs of cigarette fell consistently from around 425 million in the years 2010-11 to a low of around 283 million in 2015, followed by a rise to around 310 million in 2016. It is possible that the increase in the consumption of cigarettes in 2016 resulted from the erosion in the effect of purchase tax on cigarettes, since the last significant tax increase occurred, as mentioned, in May 2013. Furthermore, it is possible that the 7.3% average increase in real salaries for employees in the economy, from the beginning of 2015 until the end of April 2017, also contributed to the rise in consumption.<sup>54</sup>

Table 10 below presents several options for a new Specific tax on rolling tobacco, and the addition in state revenue resulting from each of them, before and after the assumption of a decline in consumption that is shown on the table in the case of each new tax. The current data in the table are based on the average consumer price of rolling tobacco weighing 40 grams. Furthermore, the revenue from the purchase tax on rolling tobacco in 2016 was around NIS 310 million.

<sup>53</sup> **Cigarette and tobacco index:** the Central Bureau of Statistics, [Database of prices and price indexes of Israel](#), cigarettes and tobacco index (2009=100). (Hebrew); **Quantities:** Report of the Minister of Health on Smoking in Israel, various years.

<sup>54</sup> Bank of Israel, [Average real monthly salary index for a salaried employee](#), (Hebrew), Accessed: July 9, 2017.

**Table 10 - Estimated additional revenue resulting from an increase in the Specific tax on rolling tobacco (in millions of NIS)<sup>55</sup>**

Specific tax (in NIS per kg)	Current	Possible tax				
	452.7	800	900	1,000	1,250	1,375
Average consumer price (in NIS, 40 grams)	41.9	58.2	62.9	67.5	79.2	85.1
Addition of increase in price in NIS per pack (in %)	-	16.3 (39%)	21.0 (50%)	25.6 (61%)	37.3 (89%)	43.2 (102%)
Revenue from purchase tax	310	548.0	616.5	685.0	856.2	941.9
<b>Addition of revenue from purchase tax</b>		<b>238.0</b>	<b>306.5</b>	<b>375.0</b>	<b>546.2</b>	<b>631.9</b>
Decrease in consumption in %	-	15.6%	20.0%	24.4%	35.6%	41.2%
Revenue after reduction in consumption	-	462.7	493.5	517.6	551.3	553.4
<b>Addition of revenue after decrease in consumption</b>		<b>152.7</b>	<b>183.5</b>	<b>207.6</b>	<b>241.3</b>	<b>243.4</b>

From the analysis in Table 10 it transpires that the estimated addition in revenue will be between NIS 238 million and NIS 637 million, depending on the new Specific purchase tax rates proposed in the table, assuming that there will be no change in consumption. According to the rule of thumb of the WHO, a price increase of 10% on a pack of cigarettes is expected to reduce demand by around 4%, and therefore increasing the purchase tax is expected to reduce consumption of rolling tobacco by between 15.6% and 41.2%. The estimated addition to revenue, given a reduction in consumption, is estimated at between NIS 153 million and NIS 243 million, depending on the purchase taxes as indicated in the table. It should be noted that the analysis of the estimated reduction in the consumption of rolling tobacco as a result of a possible increase of the Specific tax, does not take into account the natural increase that took place in the consumption of rolling tobacco in recent years.

This analysis can also serve as an estimate for the loss of revenue from taxation, due to disparities between the purchase tax on cigarettes compared to rolling tobacco. Table 11 below presents the estimated loss of revenue due to the taxation disparities in the years 2012-16, under the same assumption of a decrease in consumption for every level of a new Specific tax, as it appears in table 10.

<sup>55</sup> The estimate is based on the average prices of 3 brands of rolling tobacco: Golden Virginia of Globrands (50 grams); Marlboro Gold by Philip Morris (30 grams); and Bali Shag by Dubek (40 grams). Processed by the Knesset Research and Information Center.



**Table 11 - Estimated revenue loss resulting from taxation disparities between cigarettes and rolling tobacco in the years 2012-16 (in millions of NIS)<sup>56</sup>**

Year	Current	Possible Specific tax in NIS per kg				
	452.7	800	900	1,000	1,350	1,375
2012	7	25	27	28	30	30
2013	37	140	150	157	167	168
2014	60	230	245	257	274	275
2015	106	408	435	456	486	488
2016	121	463	493	518	551	553
<b>Cumulative loss of revenue</b>		<b>1,266</b>	<b>1,350</b>	<b>1,416</b>	<b>1,509</b>	<b>1,515</b>

The estimates presented in Table 11 show that the cumulative loss of revenue due to taxation disparities between cigarettes and rolling tobacco in the years 2012-16 could amount to between NIS1.27 billion NIS 1.5 billion, depending on the Specific taxes proposed above. As stated, this estimate assumes a reduction in the consumption of rolling tobacco, but it is reasonable to assume that in so far as the purchase taxes will be equalized, part of the consumers will switch (or return) to smoking ordinary cigarettes with a high purchase tax from the start, and therefore in terms of total purchase taxes from cigarettes and rolling tobacco together, it is possible that this estimate is undervalued, and the losses will be greater. As stated in article 4.3., according to the Minister of Health Report we are speaking of a cumulative loss of revenue of around NIS 1 billion.

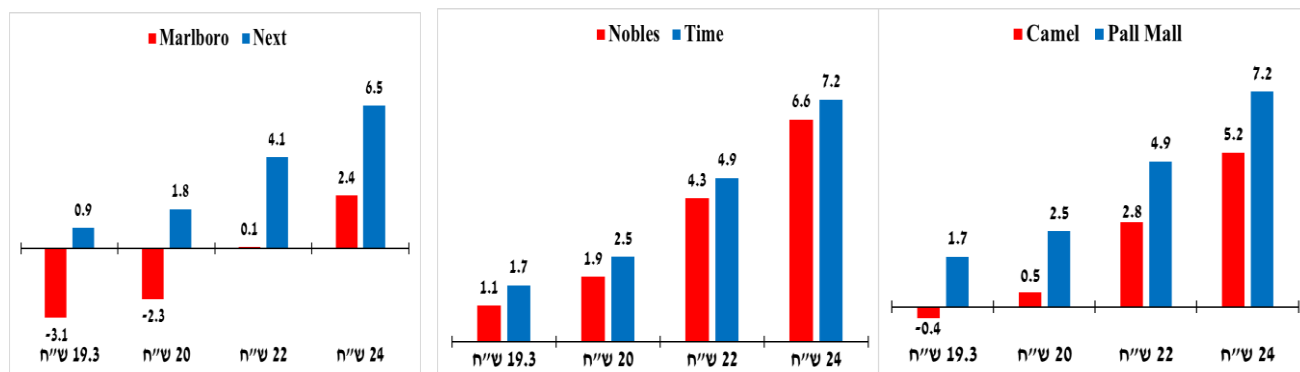
#### **4.4. Estimated change in the taxation system for cigarettes, to a Specific tax only**

Chart 8 below presents the estimated change in the consumer price, if only a Specific tax were applied on cigarettes, instead of a purchase tax that is made up of an Ad Valorem tax and a Specific tax. Two brands at different prices are presented for each distributor, with the blue columns relating to the brand with the lower price between the two. For each brand the change, should a Specific tax be applied at a rate of: NIS 19.3 (the estimate of the average purchase tax today); NIS 20; NIS 22; NIS 24, is presented.<sup>57</sup>

<sup>56</sup> Data for current revenue: Ministry of Finance, "Report of the Director of State Revenue", various years. (Hebrew) Processed by the Research and Information Center.

<sup>57</sup> The purchase tax in NIS per pack of cigarettes is an abstract sum that derives from two components of the purchase tax: a Specific tax and an Ad Valorem tax (see details in article 4)

### **Chart 8 - Estimated change in the consumer price with a Specific tax only on cigarettes (NIS)<sup>58</sup>**



From the analysis one may observe that if the taxes on cigarettes were Specific only, a convergence of prices would occur: the price of cigarettes at a relatively low price would approach that of the cigarettes at a relatively high price (see retail prices in table 6). Thus, for example, a Specific tax of NIS 20 per relatively highly priced brand, such as Marlboro, would lead to a reduction in the price by around NIS 2.3, but would raise the price for the Next brand by around NIS 1.8. The Dubek brands are relatively low priced in the scale of prices, while the Philip Morris and Globrands brands offer a wider range of prices, both low and high. The result is that if only a Specific tax were applied, the rise in consumer prices would occur especially among the Dubek brands.

#### **4.5. Estimated revenue resulting from changing the taxation for cigarettes, to a Specific tax only**

The average intake for purchase tax on a single pack of cigarettes in 2016 was, as stated, around NIS 19.3. Thus, a changeover to a purchase tax which is Specific only, could increase state revenue if the purchase tax will be higher than NIS 19.3, and vice versa. Table 12 presents the estimated revenue from cigarettes resulting from a change in the tax method to a Specific tax.

**Table 12 - Estimated revenue from cigarettes resulting from a change in the tax system for cigarettes to a Specific tax only (in billions of NIS)<sup>59</sup>**

Specific tax (in NIS per pack)	Revenue	Difference in revenue from purchase tax	Difference in revenue from purchase tax and VAT
<b>19.3 (in 2016)</b>	6.03		
<b>20</b>	6.26	+0.23	<b>+0.27</b>
<b>22</b>	6.89	+0.85	<b>+1.00</b>
<b>24</b>	7.51	+1.48	<b>+1.73</b>

<sup>58</sup> Processed by the Knesset Research and Information Center.

<sup>59</sup> Processed by the Knesset Research and Information Center.



The data presented in Table 12 shows that a change to a system of a Specific tax only on cigarettes could increase state revenue, as a function of the level of the Specific tax that will be determined. Thus, for example, a Specific tax of NIS 22 per cigarette pack (representing a Specific tax of NIS 1,100 per 1,000 cigarettes), is expected to add to the state treasury around NIS 1 billion per annum, including the collection of VAT, and the assumption that there will be no change in the mix and quantity of consumption. As stated, an additional effect of the changeover to a Specific tax beyond the change in revenue, is the convergence of the prices of the various brands. As a result, a change to a Specific tax only is expected to alter the demand for the various brands, in a manner similar to the reform performed in the taxation of liquor - the consumers switched over to purchasing more expensive brands of alcohol due to the convergence of prices that resulted from the change in the purchase tax method to a Specific tax only, based on the quantity of alcohol (around NIS 85 per liter of alcohol).<sup>60</sup>

## 5. The standpoints of the distribution companies

### 5.1. Dubek<sup>61</sup>

Below are Dubek's main comments about the taxation issues raised in this document:

The two issues concerning taxation reviewed in this document are: a changeover to a Specific tax on cigarettes, and an increase in the existing Specific tax on rolling tobacco. These changes will constitute a continuation of a discriminatory tax policy from which Dubek has suffered for years. Dubek is the only cigarette manufacturer in Israel that employs many employees (a significant number of them of advanced age), and provides employment to thousands of families within the framework of its marketing (wholesalers and sellers), purchases from manufacturing enterprises in Israel (printing, glues etc.) and additional services (transportation, cleaning etc.).

Dubek is in fierce competition in face of imported cigarettes, produced by giant corporations that allot vast budgets to promoting their products. Thus, over the years Dubek's share of the market has diminished extensively, from around 75% in 1991 to around 10% today. Subsequently, the number of the company's employees has decreased significantly, especially due to the increase in the scope of sales of foreign produced brands. The dominant factor that affected this decrease was the changeover from a basis of a relative purchase tax only (a percentage tax) to a combination of a Specific tax and percentage tax, which discriminates Dubek compared to the foreign brands.

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<sup>60</sup> For further information see: Victor Fatal, the Knesset Research and Information Center, "[Description and analysis of the effect of a change in the taxation method on consumption patterns in the market for alcoholic beverages](#)". (Hebrew) February 21, 2016.

<sup>61</sup> The office of Attorneys Office Friedman, Yunger & Co., in the name of Dubek, a letter relating to a draft of this document. Email: July 13, 2017.

The Specific tax is not equitable since it has a harsher effect on low priced products. Since the price of cigarettes produced in Israel is usually lower than those produced abroad, the increase in the Specific tax will negatively affect cigarettes produced in Israel more significantly. Since the Specific tax is also linked to the consumer price index, an increase in the index enhances the rate of the price increase, which usually translates into harm to consumers from the weaker population groups, who consume lower priced cigarettes. Until some ten years ago the Specific tax was around NIS 1 per pack, and today it is around NIS 8 per pack.

## 5.2. Globrands<sup>62</sup>

The Globrands Company in Israel represents two international tobacco corporations: BAT and JTI, so that the standpoints of the two corporations were received from Globrands.

The issue of the illicit trade is common to and important to the standpoints of both, and must be taken into consideration in the taxation policy. The two main proposals examined in this document are: a change to a Specific tax on cigarettes and a raising of the existing Specific tax on rolling tobacco. These proposals are expected to increase the price for tobacco products at the lower edge of the price scale for the two product categories. Therefore, in searching for cheaper alternatives by those continuing to smoke, the incentive to choose tobacco products that are not taxed (smuggled or illicit products) will grow. Both BAT and JTI claim that the illicit products constitute around 20% of the total quantity of cigarettes consumed in Israel.

The following are the main comments of Globrands regarding the taxation issues raised in this document:

According to the standpoints of BAT and JTI regarding the taxation of rolling tobacco, **it is recommended to preserve the disparity in taxation between cigarettes and rolling tobacco.** According to BAT it is important that the level of taxation should remain at its current level, and under no circumstances should it increase to over two thirds of the taxation on cigarettes. According to JTI the taxation on rolling tobacco should remain lower than that on cigarettes for the following reasons:

- Rolling tobacco is a semi-finished product, and consumers must perform separate purchases of rolling paper, and invest time in manual preparation;
- Rolling tobacco is consumed primarily by consumers who are sensitive to price;
- It is not possible to fully consume the tobacco in any form of packaging, since part of it is usually thrown away because it cannot serve for rolling (stems, crumbs etc.);
- Rolling Tobacco serves a "buffer function" between cigarettes and illicit tobacco. In this manner the tobacco plays a role in protecting government revenue from tobacco taxation, and therefore the

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<sup>62</sup> **Standpoint of British American Tobacco (BAT):** Gadi Netzer, CEO of Globrands Ltd. Email message, July 30, 2017. **Standpoint of Japan Tobacco International (JTI):** Gadi Netzer, CEO of Globrands Ltd. Former Marketing Manager JTI. Email: August 21, 2017.

taxation on rolling tobacco should remain lower than on prepared cigarettes. Thus, for example, JTI argues that since 2012 an exaggerated rise in taxation on tobacco has occurred, which led to a significant illicit trade.

According to the standpoint of JTI regarding taxation on cigarettes, it is advisable to continue to apply moderate tax increases (if required) as well as a tax structure that is well balanced. A gradual increase of the Specific tax as part of future costs, will help to further promote the optimal balance towards a 50-50 ratio between the Specific taxation and Ad Valorem taxation in percentage terms (that also includes the excise value and the VAT value). Today, the fix tax component on cigarettes is around 35% of the total tax burden (including VAT) of the average price (see Chart 3).

According to JTI, a balanced tax structure ensures that distortions resulting from the competition remain at a minimal level, while effectively attaining the government's goals regarding public health and revenue generation. Thus, for example, Germany and Switzerland are positive examples of a moderate and balanced tax policy, which attained stable revenue and high market stability.

On the other hand, according to BAT: since the tax on cigarettes is in any case already high, there is no need to change the tax structure on cigarettes. A change of the taxation structure in the direction of a higher Specific tax, will lead to cheap products being less accessible and to illicit trade. Furthermore, a tax rate of at least 70% of the consumer price, not including VAT, will further enhance the illicit trade, which was estimated at around NIS 1.4 billion in 2016. According to BAT, if after the 2017-18 budget the level of illicit trade will diminish significantly, it will be possible to consider changes in the tax policy, and even then it will be necessarily to implement it in stages, in order to avoid an additional rise in the illicit trade.

According to the standpoints of the two companies, the retail price of cigarettes in Israel is already quite high. Thus, for example, according to JTI, the consumer must spend around 12% of his daily free income in order to purchase a pack of cigarettes at the average price. Furthermore, cigarettes in Israel are more expensive than in the EU, and their price reach around 7.74 Euro per unit, compared to 4.66 Euro on average in the EU. Furthermore, revenue from excise on tobacco products already provides a significant contribution to revenue from taxes: around NIS 6.3 billion in 2016. Gradual increases of tax rates enable an understanding of the market's reaction to higher prices, since tax rates that are excessively high are liable to reduce revenue. A change in the taxation system could cause a fall in tax collection, and thus endanger revenue from taxes in future, since the flexibility of demand can also be greater than 1 (a price increase of 1% will lead to a reduction in consumption of over 1%).

### 5.3. Philip Morris<sup>63</sup>

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<sup>63</sup> Omer Glazer, Financial Manager of Philip Morris in Israel. Email: September 3, 2017



Considering the two taxation issues examined in this document, beyond the Specific tax on cigarettes, and the increase of the existing Specific tax on rolling tobacco, one is speaking of an increase in the price of the cheap products - rolling tobacco and cheap cigarettes. According to Philip Morris, the three distributors have relatively balanced market shares in the cheap cigarette section (around 37% for Philip Morris, around 34% for Globrands, and around 29% for Dubek) and in the rolling tobacco segment (around 42% for Dubek, around 30% for Philip Morris and around 27% for Globrands), therefore one is speaking of relatively balanced damage among the three distribution companies, caused by the rise in consumer prices.

The taxation disparities, and the differences in price between cigarettes and tobacco substitutes (such as rolling tobacco) make the taxation on cigarettes less effective: the greater the price disparities, so the incentive of the consumers to switch to cheaper alternatives is greater (down-trading). There is a gap of 69% between the taxation on cigarettes and the taxation on rolling tobacco, whereas the European average is 48%. In other words, there is still room to increase the tax on rolling tobacco and thus decrease the disparity, and the proof of this is the switch to the consumption of rolling tobacco that occurred in particular due to the tax increases in the years 2012-13. According to Philip Morris, the total decrease in the consumption of tobacco (cigarettes and rolling tobacco), is relatively low over the years. The company's estimate of imports and domestic production in 2010 was around 415 million packs - a total of around 372 million cigarette packs in equal value terms.

Regarding cigarettes, there should be no increase in the taxation on them, since the resulting price increases will further intensify the problem by making the tobacco alternatives more attractive for the consumers, and thus reduce the positive effect of the tax increase both on public health and on state revenue. State revenue will fall both because of the switch to cheaper substitutes, and due to the turning to illicit trade. Furthermore, according to Philip Morris, it transpires from an international comparison of taxes on cigarettes, ignoring VAT, that in Israel total taxes without VAT amount to around 65%, compared to an average of around 62% in the EU states.

Regarding the changeover to a fix tax on cigarettes, such a move will not necessarily lead, according to Philip Morris, to a change in prices since this depends on the pricing decisions of the distributors, who may decide to absorb part of the tax cost. In so far as the prices will indeed change, this could lead, according to the company, to changes in the consumption of certain brands, and not necessarily to a decrease in the consumption of cigarettes as a whole.

As to the price and taxation policy on tobacco, the Framework Convention on Tobacco Control adopted article 6 of COP6<sup>64</sup> in 2014, "Price and tax measures to reduce the demand for tobacco ", which clearly

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<sup>64</sup> COP6 - The sixth session of the Conference of the Parties of the FCTC.

stipulates that a unified Specific tax is the suitable tax method to be applied on tobacco products, as may be seen from the following quote: "A uniform specific tax is easy to implement and administer, because only the volume, and not the value, of the product needs to be ascertained. Since tax revenue are based on volumes rather than on prices, revenue from a uniform specific tax are easier to forecast, more stable, and less dependent on industry pricing strategies".<sup>65</sup>

According to the Philip Morris, the changeover to a Specific tax, as far as possible, for cigarettes, and the increase in the tax on rolling tobacco compared to cigarettes, is highly recommended by the World Health Organization for reducing smoking, and strengthens the effect of the taxes in favor of public health. The Ad Valorem tax gives precedence to cheap products and enables the consumer to choose cheaper options of tobacco products, and thus there is a blow to the intention of the legislator, and the taxation policy is not sufficiently effective. Furthermore, the World Bank also recommends that as a first step all tobacco products should be taxed at a uniform and consistent rate.<sup>66</sup>

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<sup>65</sup> Guidelines for implementation of Article 6. Price and tax measures to reduce the demand for tobacco. [Article 3.1.2](#).

<sup>66</sup> The World Bank, "[Tobacco Control Program](#)", September 22, 2017.