

Taxing Harmful Habits

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TAXES ON SMOKING, DRINKING, AND SUGAR SHOULD BETTER ALIGN WITH THE HARM THEY CAUSE

“Nothing can be said to be certain, except death and taxes,” Benjamin Franklin famously wrote in 1789. But what if the latter could at least delay the former? That’s one reason for excise taxes on unhealthy products like alcohol, tobacco, and sugar.

Such taxes are an attractive way to both mobilize much-needed domestic tax revenue and encourage healthier behavior, especially in low-income countries as aid budgets are drying up. Nudging people to smoke and drink less also helps reduce public health expenditures.

In fact, such “sin” or “behavioral” taxes have existed for millennia: Taxes on beer were recorded in ancient Egypt as early as 2400 BCE. They endure, in part, because they are relatively easy to collect. But in recent years, fresh challenges have arisen as a plethora of new products have entered the market. Think of e-cigarettes, nicotine pouches, and low-alcohol beer. To achieve health goals, policymakers must keep up with these developments and streamline their often-patchy taxation systems. Combining tax and health data makes this job easier.

Steady revenue

When budgets are tight, excise taxes—including on tobacco, alcohol, and sugar—have proved a reliable and politically palatable source of government revenue, yielding on average about 2 percent of GDP in both advanced and developing economies. They are becoming more popular in developing economies but have recently declined in advanced and emerging market economies, mainly because of revenue erosion through inflation and changes in consumer behavior. Taxes on smoking yield the most revenue, followed by alcohol. Those on sugary drinks—still relatively uncommon—typically raise more modest revenue.

How can governments optimize both the tax intake and health benefits from such taxes? Simply raising rates won’t do the trick: Sooner or later, smokers and drinkers—rather than quitting—will shift to untaxed or illicit alternatives. A better understanding of health risks and of how consumers and producers respond to taxes can guide policy decisions. This calls for a comprehensive approach built on three principles: Capture *all* unhealthy products, align tax rates with the potential harm to health, and cooperate across borders to limit evasion and smuggling.



Catch 'em all

Most countries impose some excises on unhealthy behavior, but examples of leaky tax nets abound. In Hong Kong SAR, for instance, wine is not taxed at all, but distilled spirits face rates exceeding 100 percent. In the African nation of São Tomé and Príncipe, palm wine, one of the country's most widely consumed beverages, is exempt; all other alcoholic drinks are taxed. And in Ethiopia, khat leaves, a popular recreational stimulant associated with oral, cardiovascular, and mental health problems, remain untaxed despite heavy taxes on alcohol and tobacco. Closing such loopholes could boost revenue and improve public health.

Price the harm

But policymakers need to think more broadly about how to change unhealthy behavior. Ideally, the level of taxation should reflect the degree of harm a product is likely to cause while still safeguarding overall revenue.

The difficulty lies in defining that harm, both directly to the consumer and indirectly to others (for example, secondhand smoke or drunk driving). The

harm depends partly on what a product contains—such as ethanol in alcoholic drinks, added sugar in sweetened beverages, toxic chemicals in tobacco products—and partly on how these substances or their components are administered. It also depends on consumption patterns: how much people use, how frequently, and whether they combine them with other harmful consumption. Such behavior is impossible for policymakers to observe or account for when setting tax rates. So a workable approach is to tax products on the amount of the harmful substance and its mode of administration (such as burning versus heating tobacco), based on average consumption patterns.

This idea is not new. Spirits, for example, have long been taxed more heavily than beer or wine, reflecting their higher alcohol content. What has changed is the evidence base. Advances in medical research, together with better data on the relationship between substances, modes of administration, and health risks, now make it easier to link taxation and harm systematically and consistently.

Many countries already tax drinks based on sugar or alcohol per liter so that they can better capture the health risks associated with new prod-

ucts entering the market. This strategy aligns with broader societal trends as consumption patterns in many advanced economies shift: When baby boomer parents reach for a cocktail, their Gen Z children increasingly opt for a mocktail instead.

As part of a long-term strategy, such harm-based taxation also encourages suppliers to adjust their product portfolios. German brewers’ nonalcoholic beer, for example, already accounts for about 9 percent of sales, and research and development are focused on producing an expanded range of such varieties. Once the industry knows the direction of travel in taxation, it will adjust.

Harm of smoking

Nicotine products present a particular challenge. As smoking bans take hold and preferences change, alternatives to traditional cigarettes—from e-cigarettes to heated tobacco products to nicotine pouches—cater to those who can’t kick the habit. The good news is that many of these new products, while still harmful, reduce exposure to toxicants (see Chart 1). It therefore makes sense to tax them at a lower rate, which can be adjusted as research becomes available and revenue needs evolve.

New Zealand is a good example of how taxation may help wean people off smoking. Over the past 15 years, successive governments have increased the

excise rates for combustible tobacco products by 10 percent or more a year, in a deliberate strategy to widen the tax differential with less harmful alternatives. Overall, the proportion of people smoking cigarettes dropped from 18 percent in 2012 to 8 percent in 2024; the uptake of less harmful e-cigarettes increased from near zero to 14 percent over the same period. Causality is hard to establish, but it seems plausible that rising price differentials in part caused this shift. Tax revenues rose until 2020 but have since declined somewhat.

The EU is encouraging members to pursue a similar strategy. Most already differentiate between combustible and noncombustible tobacco products in their excise tax regimes. The European Commission’s recently published draft Tobacco Excise Directive proposes minimum rates for 13 product categories; taxes cigarettes and loose tobacco at similar levels; and sets significantly lower rates for e-cigarettes, heated tobacco products, and nicotine pouches. No tobacco or nicotine product is exempt from taxation, and rates are set to keep pace with or exceed inflation.

When pricing goes wrong

In many low-income countries and emerging market economies, however, tax rates provide perverse incentives. In particular, harmful smoking and drinking products, often locally produced, face low excises. In South Africa, for example, the tax on a unit of alcohol in traditional African beer is roughly one-fiftieth what it is on a unit of alcohol in other beer. Similarly, India taxes bidis, locally produced cigarettes made of unprocessed tobacco, significantly lower than filtered cigarettes, and smoke-free alternatives are banned. Such misalignment falsely signals lower health risks, sustains consumption in often more dangerous products, and diverts investment toward the wrong industries. While often justified on distributional grounds, such pricing is therefore counterproductive when it comes to protecting low-income groups, who often disproportionately consume traditional products.

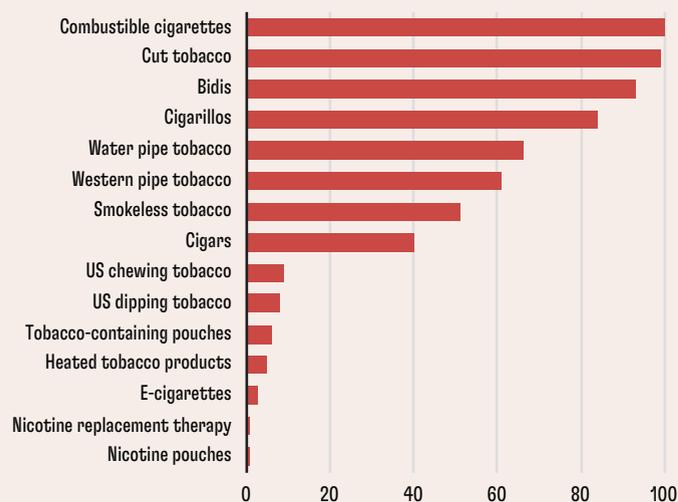
Looking across Group of Twenty countries and product types, the picture for harm-based taxation is mixed (see Chart 2). Taxation is most comprehensive for tobacco, somewhat less so for alcohol, and very patchy for sugary drinks. Sometimes bans replace taxation—for example, for novel tobacco products in Argentina and Türkiye; Saudi Arabia doesn’t tax alcohol, because until recently it was outlawed altogether. Still, there has been much progress in just the past few years; previously, policymakers rarely set tax rates with health considerations in mind. But there is considerable scope to better align tax rates with the harm of the substances they are meant to target.

CHART 1

Degrees of harm

Alternatives to traditional cigarettes reduce toxicant exposure, and it’s sensible to tax them at a lower rate.

(relative spectrum of potential harm of 15 nicotine product categories)



SOURCE: Murkett, Rugh, and Ding 2022.

CHART 2

Misaligned taxes

There is considerable scope to better align tax rates with the harmful substances they are meant to target.

(alignment of health taxes with potential harm across products in G20 countries)



SOURCE: Updated from van Oordt and Mensah 2024, with information from country authorities.

NOTE: **Misaligned:** Some products are untaxed and others misaligned. **Partial alignment:** All or most products are taxed, but relative rates distort incentives (e.g., noncombustible products are taxed like combustible products). **Strong alignment:** Tax rates are proportionate to relative health risk or harm across all or the majority of subproducts.

Cooperation across borders

To get the most out of harm-based health taxes, countries must work together to account for regional market dynamics. Large tax differences across borders can motivate consumers to seek out cheaper options next door, reducing both health impact and revenue.

For example, when Finland substantially lowered its alcohol tax in 2004, sales of spirits surged to 150 percent in some towns on the border with Sweden. A recent study in Norway, another heavy taxer of alcohol, used COVID-era border closings and store-level data to identify similarly large cross-border shopping effects. EU-wide, annual cross-border alcohol purchases are estimated at 1.4 billion liters, resulting in excise duty losses of some €4 billion annually.

The problem is not limited to densely populated and border-free Europe. Paraguay’s very low tobacco taxes, for example, have turned it into a hub for cigarettes traveling to higher-tax neighbors: These cheap products now make up roughly 20 percent of Brazil’s cigarette market and cost that country about \$400 million in lost revenue each year.

Where such cross-border shopping is illegal, stricter enforcement can certainly help. But ultimately only a closer dialogue across countries and stronger consensus on the classification of ever-evolving new product lines will prevent the erosion of harm-based tax regimes.

The way forward

Taxation is more than a fiscal instrument; it is a powerful lever for shaping healthier societies. Linking excise taxes to relative health risks can reduce preventable diseases while supporting sustainable revenues, particularly when applied comprehensively and consistently. Conversely, loopholes, misaligned incentives, and fragmented approaches lead to revenue losses and continued exposure to avoidable harm. Tax systems must therefore shift with evolving consumption patterns and product offerings.

That shift cannot happen in isolation. It requires internationally shared principles on how to curb cross-border arbitrage and illicit trade. Global institutions such as the IMF, and especially regional bodies like the EU and the African Union, are pivotal in advancing frameworks that align taxation with harm and promote innovation toward safer products. Such advances will strengthen both public health and fiscal resilience. **F&D**

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