Why high cigarette taxes hurt the economy

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The government’s recent announcement increasing levies on cigarettes in the form of the National Calamity Contingent Duty (NCCD) has created uncertainty for the legal cigarette industry. The legal domestic cigarette industry also faces a huge challenge from illicit and smuggled cigarettes. This action will also put additional pressure on the already serious job scenario in India. The tobacco industry, which is highly labour-intensive (especially the farming end of it), is bound to be adversely impacted.

An increase in tax on cigarettes is damaging for the domestic industry. Already, the livelihood of 26 million Indian farmers and farm labourers is under pressure due to high taxation. Their cumulative drop in earnings is estimated at over 85,000 crore between 2013-14 and 2018-19. In fact, smuggled and illicit cigarettes are estimated to use 17 million kg of unaccounted tobacco, which ends up depriving Indians of jobs and creating them in other tobacco growing countries.

The level of taxation on a commodity like tobacco products also has a bearing on people’s health. The government holds that by increasing tax rates on cigarettes, it can bring about a reduction in its consumption and thus the health hazard for people can be minimised. However, it is clear from government data itself that an increase in tax rates on cigarettes leads to a commensurate rise in the share of the grey market. Such products of inferior quality are more injurious to health than are genuine tax-paid products.

The NCCD will further the incidence of cigarette smuggling in India. The ill-effects of the rampant sale of smuggled and illic- it cigarettes include the opening of the hawala route to transferring money, generation of black money which is a direct result of money laundering, and serious security concerns, as illicit trade and smuggling has an established link with terrorism. Top terror groups like al-Qaeda, Taliban, ISIS and Hezbollah have been using proceeds from smuggling and illicit trade to fund their nefarious agendas.

The Ficci Cascade study estimates that cigarette smuggling increased from 67,183 crore in 2015-16 to 87,780 crore in 2017-18, leading to a lost profit of 21 per cent for domestic tobacco manufacturers. These estimates are based on data from government sources or international agencies such as UN Comtrade. The tax burden on cigarettes trebled between 2012-13 and 2017-18. Adding successive year-on-year increases in excise rates between 2012-13 and 2016-17, the annual growth rate (CAGR) of 15.7 per cent.

Tax collections, however, increased at a CAGR of only 4.7 per cent, indicating sub-optimal revenue collections, resulting from unduly high duty rates. In 2017-18, the GST rate, contrary to the revenue neutral principle, as promised by the government, significantly increased the tax burden on legal cigarettes by 19 per cent.

Taxation has a critical impact on volumes of both legal and illicit cigarettes. Policy makers often lose sight of the fact that the higher the rate of tax, the higher the illegal profit in evasion. There has to be perfect compatibility between higher rates of taxation and higher efficiency levels of enforcement agencies to check evasion effectively. Therefore, striking the right balance in setting the tax rate is critical. While taxation on legal cigarettes was increasing, the trade in illicit and smuggled cigarettes increased from 52 million kg in 2013 to 264 billion sticks in 2018, a 21 per cent jump. Stability in tax rates ensured that the illicit cigarette market grew, albeit at a relatively slower pace.

In India, cigarettes account for only 9 per cent of the total tobacco consumed, with the remainder comprising non-cigarett e and illicit products, on which the tax burden is almost negligible. While overall tobacco consumption in India increased from 320 million kg in 1981-82 to 544 million kg in 2017-18, the share of legal cigarettes fell from 86 million kg to 52 million kg during this period. Clearly, while tobacco continues to thrive, it is the legal cigarettes that continue to bear the brunt. International studies show that countries which impose higher taxes on cigarettes in India are the second-highest in the world, and prices in India are much higher than in neighbouring countries and many developed countries.

So, it is important to reconsider the decision to hike taxes on cigarettes. This would lead to increased revenue and greater job creation, address health concerns, rein in anti-social elements and curtail the generation of black money.