Curbing illicit trade through smarter tax structures and stronger enforcement

Opinion by ***P C Jha*** **| August 20, 2025**

India, Aug. 20 -- As India marks eight years of the GST, it is an apt moment to reflect on the journey so far, build on its progress and strengthen the framework for the future. GST has been one of the most significant tax reforms in independent India. It has enhanced transparency, improved compliance, and helped strengthen the revenue base. However, a recent commentary has questioned whether the GST framework adequately addresses tobacco taxation. While reducing tobacco consumption is a legitimate public health goal, the push for structural reforms in tobacco taxation such as raising GST on tobacco to the peak rate of 40 per cent, or extending the compensation cess indefinitely must be viewed through a wider lens.

India is the world's second-largest producer and a key global exporter of tobacco. The crop sustains more than 4.5 crore livelihoods, contributes substantially to the national exchequer - generating more than Rs 72,000 crore in tax revenues annually, and an additional Rs 12,000 crore in foreign exchange through exports. While it may be argued that taxation on this product is a recognised tool for tobacco control, excessively high tax burdens on legal cigarettes have historically penalised legal business and incentivised illicit trade.

The policy makers are of the view that if taxes on cigarettes are high, the consumption would come down, and the cause of public health would be served better. But the ill-effects of such excessive taxation are evident. According to WHO Global Health Observatory Data 2024, India is one of the most expensive cigarette markets in the world where its affordability was significantly lower than many countries. This has predictably resulted in a shift in consumption to tax-evaded, sub-standard, and cheaper products. With little choice left, consumers adopt for illicit options as they are cheaper, do not display health hazard warnings, and put less load to their pockets. In all this, they are inadvertently contributing to a parallel illicit economy and exposing them to avoidable larger risks to life as these illicit products are made in unhygienic and unhealthy environment with no concern for quality. Therefore, it cannot be denied that even for this item, a genuine quality product is definitely much less harmful than the illicit ones. A situation like this, defeats the Government's well-intentioned objective of controlling the sale and curbing consumption of health injurious products.

Some also argue that the problem of illicit trade is overstated. But such assertions often rely on limited-scope studies using questionable sampling methods. It will be important to note that since possessing smuggled cigarettes is illegal, vendors are unlikely to disclose illicit packs, making the findings unreliable.

Such studies, therefore, risk misleading policymakers and diverting attention from the real and growing problem of cigarette smuggling. They appear aligned with vested interests who may benefit from policy shifts that weaken enforcement focus or drive market arbitrage.

On the contrary, illicit trade in cigarettes has emerged as one of the most formidable challenges before our nation. Euromonitor International reported that illicit cigarette volumes in India hit a record 33.2 billion sticks in 2023, comprising over 1/4th of the market. Seizures of smuggled cigarettes in just the first six months of 2024 were valued at Rs 250 crore, with full-year estimates nearing Rs 600 crore. Global research reports suggest that seizures represent just 3-4 per cent of actual volumes - implying a much larger illicit market worth estimated between Rs 17,000 to Rs 23000 crores.

Another serious aspect of smuggling is its adverse impact on security and employment in the country. This happens because when the demand is met through smuggling, it creates employment opportunities abroad at the cost of India. A FICCI study of September 2022, estimated that large scale smuggling of cigarettes in the country resulted in a loss of employment to the tune of 3.70 lakh in the year 2019-20. Also, that a larger chunk of unaccounted profit generated through this illicit trade is used to finance terrorist and insurgent activities to destabilise the country. Here, it will be important to state that while our enforcement agencies have demonstrated commendable vigilance in thwarting smuggling attempts, it is imperative that they continue to stay ahead of the curve, and therefore, it will be most critical that they are armed with the latest and superior technological tools that will empower them to effectively deal with this growing menace. Additionally, penal provisions have to strengthened against the smugglers to have the requisite detrimental impact.

While enforcement remains vital, it must be complemented by a tax structure that reduces incentives for evasion. One area that merits consideration is the current reliance on value-based, ad valorem taxation on cigarettes. In fact, there is strong economic merit in strengthening the specific tax component here. Historically, India transitioned from ad valorem to a specific duty structure in 1987 due to widespread litigation and tax disputes under the former regime where cigarettes were subjected to ad valorem excise duties. For two decades, this structure delivered transparency, predictability, and strong tax collection. However, with the introduction of VAT in 2007 and GST in 2017, the share of ad valorem taxation has grown again. While GST is inherently value-based, cigarettes, prone to undervaluation require a stronger specific component to ensure revenue certainty. Moreover, specific taxation supports broader policy goals. It incentivises the production of high-quality tobacco products, supports millions of Indian farmers involved in premium tobacco cultivation, and aligns with international best practices. Globally, the trend is similar. In 2008, 54 countries relied primarily on ad valorem taxes. By 2022, only 34 did. Nations like the UK, Sweden, Thailand, and Romania have adopted hybrid models, with a stronger emphasis on specific taxes. A balanced mix, with a dominant specific component, would be ideal for India as well.

Similarly, the GST compensation cess, set to sunset in March 2026 has been another flashpoint and has raised concerns. It may be important to note that it was introduced with a clear statement that it would be temporary, intended to compensate the States for the losses that they may incur upon the introduction of GST. Post GST, the cascading effect of taxes have been eliminated and the GST collections are increasing and therefore, compensation cess should be ideally discontinued. However, if a substitute is deemed necessary, consideration must be taken that it does not increase the existing tax burden. India stands at a historic juncture in its journey toward becoming a Viksit Bharat by 2047. A stable tax system that encourages investment, simplifies compliance, and ensures long-term economic resilience is essential to achieving this vision. After all, stability in taxation is not just good economics, it is essential for nation-building. In sectors like tobacco, where taxation intersects with public health, agriculture, and trade, policy must be rooted in consistency and long-term thinking. For products that are particularly vulnerable to smuggling and tax arbitrage, a sustained and predictable tax regime is needed, one that balances revenue protection with public health objectives. As we mark the eighth anniversary of GST, this is a timely moment to reinforce what works - a coherent, enforceable, and growth-aligned tax structure that supports India's long-term, sustainable economic growth.

The writer is the former Chairman, Central Board of Indirect taxes & Customs (CBIC) and Advisor, FICCI CASCADE

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