

Towards Balanced Cigarette Taxation

As the compensation cess nears its end, India's debate on cigarette taxation must balance revenue, health goals and enforcement realities—drawing on decades of domestic experience and global best practices

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The 56th GST Council meeting marked a significant moment in India's indirect tax administration, bringing, inter alia, the structure of cigarette taxation back into the policy focus, especially with the compensation cess nearing its end. Given that cigarettes are a highly regulated and socially sensitive product, the choice of tax structures must rest on the reality of past experience, striking a right balance among fiscal, administrative, and public health considerations. India's own fiscal journey with tobacco and past reforms offer sound lessons on what is effective and what should perhaps be avoided.

Before 1983, cigarettes were taxed under an ad-valorem excise regime. This system led to frequent disputes between the government and assesseees, particularly regarding the inclusion of Post-Manufacturing Expenses (PME) in the assessable value, resulting in protracted litigation and blocking of revenue for long periods. The ad-valorem system soon proved ineffective. In theory, ad-valorem taxes linked collections to product pricing. However, in practice, they created scope for disagreement, valuation disputes, and administrative complexity. After the resolution of the PME disputes, the government introduced an MRP-based levy on cigarettes, which led to widespread undervaluation and duty evasion. However, this system also turned out to be counterproductive on two counts. First, it created a spiralling effect on taxation, where even a small increase in tax rates resulted in a disproportionately higher increase in retail prices. Second, in order to avoid paying tax based on a higher MRP, some unscrupulous operators would show a lower MRP, while the amount charged to the consumer was transacted in cash. The regime, therefore, became distortionary, difficult to enforce, and incentivised evasion of taxes.

Subsequently, a decisive shift came in the Union Budget of 1987, when the government moved from an ad-valorem system to a specific levy based on the physical length of the cigarette. Eminent economists such as Dr Raja Chelliah and Dr Vijay Kelkar also endorsed the specific levy model as being transparent, predictable, and resistant to manipulation. The structure was simple, easy to administer and resulted in higher tax collection. Excise duty collections from cigarettes grew more than twenty-fold over the next three decades, enabling both the government and the cigarette industry to operate in a more predictable fiscal environment. During this period, the Indian cigarette industry also evolved from a purely commoditised market into one offering differentiated, consumer-centric products catering to varied consumer needs.

However, with the introduction of VAT in 2007 and GST in 2017, the share of ad valorem taxation has become much larger again. The VAT regime coincided with a phase of strong anti-tobacco activism that resulted in several policy changes, leading to measures such as the enactment of the Cigarettes and Other Tobacco Products Act (COTPA), restrictions on public smoking, and steep increases in overall tax incidence. In fact, India took the lead in this regulatory approach through COTPA, even before formally signing the WHO Framework Convention on Tobacco Control (FCTC), which was adopted later. While these measures advanced the much-needed health objectives, they also produced some unintended retarding effects. Regulatory overreach, such as large pictorial warnings and high taxes, led to a significant surge in the availability of illicit cigarettes in the country, fuelling the growth of both smuggled and domestically manufactured unaccounted and tax-evaded products, including look-alike packs sold at deep discounts by fly-by-night operators. These products entered the market at price points barely covering the cost of the cigarette, further undermining the legal industry. The widening gap between legal and illicit products, a rise in ultra-low-priced alternatives, and greater enforcement challenges became visible trends.

Further, the rise of illicit cigarettes resulted in huge losses of tax revenue and posed much more serious health hazards than the legal ones. This is because the cigarettes available in the grey market are made in unhygienic conditions without any concern for the quality of tobacco and other ingredients.

Today, the rapid proliferation of multiple illicit brands across varied price points has posed serious challenges for the legal cigarette industry. A range of differentiated products offered by international players now commands a notable share of the market. For instance, products such as ESSE, positioned in slim and lower-priced formats, have gained popularity among younger consumers by creating an impression of containing less nicotine and therefore, being less harmful. It is pertinent to note the history and growth of illicit trade in the country. With the enactment of COTPA and ratification of the FCTC treaty, anti-tobacco activism in India, led by NGO's, gained significant momentum. The NGO's were at the forefront, influencing taxation and regulations. With overactive anti-tobacco activism leading to a substantial change in taxation policy, raising the burden of tax beyond the affordability of the common citizen, coupled with gory imagery on Indian cigarette packaging, this has given a huge boost to the cheaper, tax-not-paid cigarettes, which do not carry the excessive warnings required under the law of the land. According to Euromonitor International, until 2004, the illicit trade of cigarettes stood at 11.1 billion cigarettes, forming approximately 10.3 per cent of the Indian market. With the massive increases in taxation, starting from 2005–06 to 2017–18, the illicit trade of cigarettes has

grown over threefold to more than 36 billion cigarettes. Illicit trade now stands at 26.1 per cent of the total cigarette trade, i.e. over one-fourth of the market size. This has led to the market today resting in the hands of trade mafias. It is established in several international studies that antisocial elements use this money to fund ulterior motives, including destabilising countries and engaging in terrorist activities. It is also estimated that revenue loss to the exchequer on account of illicit cigarettes is to the tune of about Rs 21,000 crore per annum.

Against this backdrop, the recent decision of the GST Council to tax tobacco at the retail sales price appears to revisit the pre-1987 model. It may be relevant to mention here that globally, taking a leaf out of India's over three-decade-long cigarette taxation policy, several countries have now adopted specific-duty structures with a view to avoiding manipulation, reducing valuation disputes, and simplifying tax administration. In fact, as of 2024, 137 out of 178 countries have adopted a blend of ad-valorem and specific structures —historically, a model that India itself had adopted in its early stages. In 2008, this number was 101, reflecting a clear global shift towards this framework.

Today, India stands at an important juncture in its economic journey, with the goal of becoming a Viksit Bharat by 2047. A stable tax framework is indispensable to fulfil this ambition since it encourages investment, reduces compliance frictions and supports long-term economic planning. As India debates the next steps in tax design under the GST for tobacco, the choice is not between change and continuity but between time-tested stability and avoidable uncertainty. It is hoped that on cessation of compensation cess, the final fiscal policy will take cognisance of the historical facts, perspectives and international experiences to adopt a balanced approach - learning from India's own history of tobacco taxation while aiming to disincentivise illicit trade without making major structural changes in the tax system and keep the tax incidence stable. Such a framework will result in a robust policy for the law-abiding industry. A policy measure of this kind, as in the process of development, views balance not as a compromise, but as the foundation for sustainable long-term growth.

Such an approach is worth consideration since, at the same time, it would serve the revenue and health concerns. Also, being easier, it would be conducive to tax compliance and would address enforcement challenges. Not giving due weightage to these important points would not be advisable, as the same would work contrary to the interests of both the public and the government.

Views expressed are personal. The writer is Advisor, FICCI CASCADE & Former Chairman, Central Board of Indirect Taxes & Customs

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