



Ministry of Health
& Family Welfare
Government of India

Tobacco Taxes in India:
**AN EMPIRICAL
ANALYSIS**

Tobacco Taxes in India: An Empirical Analysis

Highlights

Key Messages

- The current excise and VAT tax rates are not sufficient to increase the prices of tobacco products so as to make them less affordable.
- The prices of tobacco products have not increased substantially in India; they are even cheaper than the essential commodities like the food items.
- Affordability (in relation to income) of tobacco products is not only increasing at the national level (except for recent years) but has also increased amongst the poorest households of India.
- Tax burden on tobacco products is not in line with the WHO FCTC recommendations. Further, in the recent period, the share of tax burden is declining.
- The manufacturing of bidis and smokeless tobacco in the unorganised sector; and production of various cigarette brands under different segments/lengths is rendering tobacco tax policies ineffective.
- The study recommends that the tax on all type of tobacco products should be increased substantially and further the tobacco tax regime should be broadened to include unorganised sector manufacturing under tax net. The tax exemptions on production of less than 2 million bidis should be eliminated and tax slabs on cigarettes based on length should be eliminated in a phased manner.

Introduction

India faces the challenge of rising burden of non-communicable diseases (NCD), alongside the high prevalence of communicable diseases. The NCDs alone account for more than half of the deaths, which is further exacerbated by the high prevalence of tobacco use in the country. The disease burden due to tobacco poses enormous and inequitable economic loss to society and also presents a formidable challenge to the country's health care systems. As per Ministry of Health and Family Welfare estimates total economic cost attributable to tobacco use from all diseases in the year 2011 amounted to Rs. 1,04,500 crores (US\$ 22.4 billion) in India, which is equivalent to 1.04 percent of GDP (MOHFW, 2014)¹. Thus, tobacco use is not only responsible for high mortality burden (8-9 lakh deaths annually) but also leads to high economic cost and pushes many into abject poverty. Among the economic measures outlined in the World Health Organization Framework Convention on Tobacco Control (WHO FCTC), tobacco taxation is considered as the most cost effective intervention to reduce tobacco consumption. India has initiated various tax and non-tax policy measures for tobacco control for over a decade, yet tobacco is consumed widely across different socio-economic stratum in the country (GATS-India, 2010).

¹MoHFW (2014), Economic Burden of Tobacco Related Diseases in India, Ministry of Health and Family Welfare, Government of India in collaboration with WHO and Public Health Foundation of India.

In this context, a study of the effectiveness of tobacco tax policy assumes utmost importance. In order to evaluate the impact of tobacco taxation, this study examines whether current tax levels are adequate to make the tobacco products less affordable. It also examines the level of tax burden, price change due to tax increase as well as the manufacturing practices of various tobacco industries in India. The study covers the period from 2006 to 2013 and includes cigarette, bidi and smokeless tobacco (Zarda/Kimam/Surti, Pan Masala and Chewing tobacco) products.

Data and Methods

This study is largely based on secondary data sources collected by government and non-government agencies. In order to understand the overall structure and growth of tobacco manufacturing, the unit level records of latest three 2000-01 (56th), 2005-06 (62nd) and 2010-11 (67th) rounds of National Sample Survey Organization (NSSO) (for unorganized manufacturing) and Annual Survey of Industries (ASI) for the same years (for organized manufacturing)² are explored. The structure of individual tobacco manufacturers is studied using Centre for Monitoring Indian Economy (CMIE) PROWESS data. The price behaviour of tobacco products is studied by analysing data on Wholesale Price Index (WPI), Retail Price Index (RPI) and unit price like the retail price provided by Labour Bureau, Ministry of Labour & Employment. The tax structure and rates of tobacco products are obtained from Ministry of Finance, Government of India (GOI). Affordability is estimated both at national and household level. The per capita income (Gross Domestic Product-GDP) for national and Monthly Per-capita Consumption Expenditure (MPCE) (as proxy of household economic status) for households are used. GDP data are explored from National Account Statistics and MPCE from three latest (namely, 2005-06, 2009-10 and 2011-12) Consumer Expenditure Survey rounds of National Sample Survey Office (NSSO) provided by Ministry of Statistics and Programme Implementation (MOSPI), GOI. The study estimated the current as well as inflation adjusted (at constant 2004-05 price) tax rate. The trends in prices of tobacco products are examined by comparing tobacco-specific wholesale, retail and consumer price index with general and food price index. For affordability, the price increase was compared with per capita GDP and MPCE. Excise tax burden is the ratio of the excise duty as a percent of the retail price of specific tobacco products. Further, to arrive at the total tax burden, the VAT rate, imposed by states, is added in the estimated excise tax burden across states of India.

Key Findings of the Study

The relative wholesale price index (WPI) of all tobacco products (smoking and smokeless) show an increasing trend between 2005-06 to 2012-13, but this has been consistently lower than the essential commodities like food items (Fig-1).

- The relative price indices of individual tobacco products are not only lower to those of food items but are also declining over the period (Fig-2). The relative WPI of bidi after 2010-11 shows an increasing trend, but despite this increase, it has still not exceeded the WPI of food items in 2012-13. The increase in inflation of demerit goods like tobacco products should be more than the essential commodities like food, but worryingly the case is reverse.

²The Annual Survey of Industries (ASI) covers all factories registered under Sections 2m(i) and 2m(ii) of the Factories Act, 1948 i.e. those factories employing 10 or more workers using power; and those employing 20 or more workers without using power. The survey also covers bidi and cigar manufacturing establishments registered under the Bidi & Cigar Workers (Conditions of Employment) Act, 1966 with coverage as above.

Fig 1: Relative WPI of Food & Tobacco Products

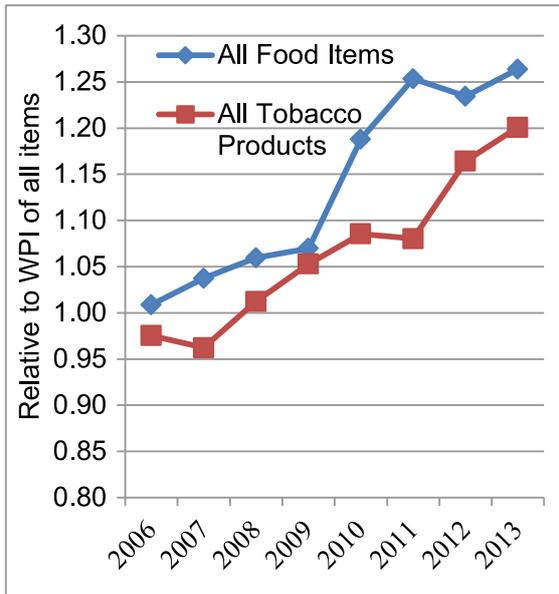
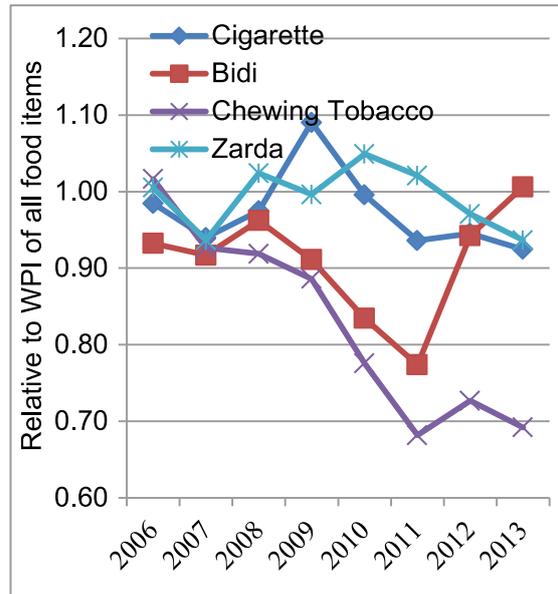


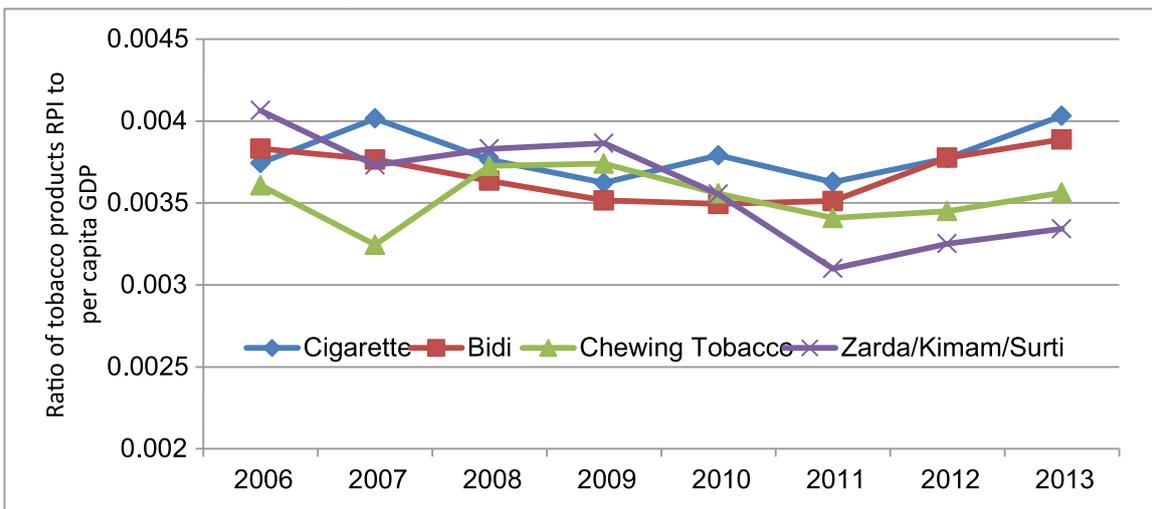
Fig 2: Relative WPI of specific tobacco products



Source: http://eaindustry.nic.in/download_data_0405.asp

- Affordability of tobacco products, when comparing the prices of tobacco products to the per capita national income, is increasing from 2006-11 (Fig-3). This clearly indicates that the increase in tobacco prices is not enough to offset the increase in per capita income. There is a nominal decline in affordability in the last two years, possibly because of slow growth in per capita income caused due to sluggish performance of Indian economy during this period.

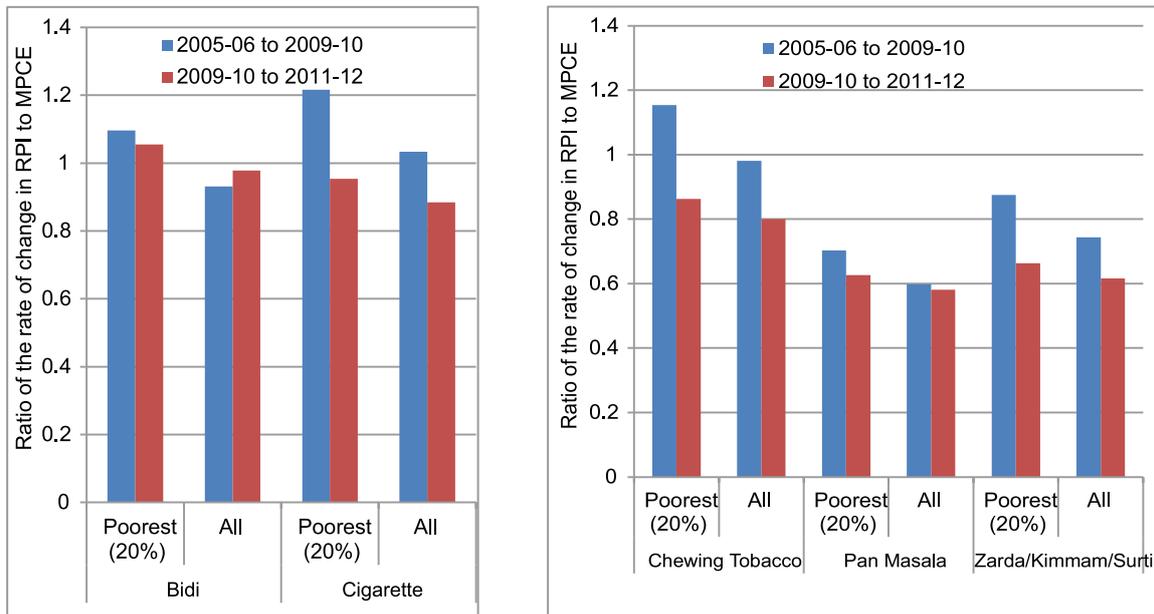
Fig 3: Affordability of Tobacco Products in Relation to Income at National Level
(declining trends mean increased affordability and vice-versa)



Source: Retail Price Index (RPI) data from Labour Bureau and GDP from National Account Statistics, GOI.

- The affordability of tobacco products has not only been rising in relation to per capita income at the aggregate level but these products have become more affordable even among the poorest households of India (Fig-4).

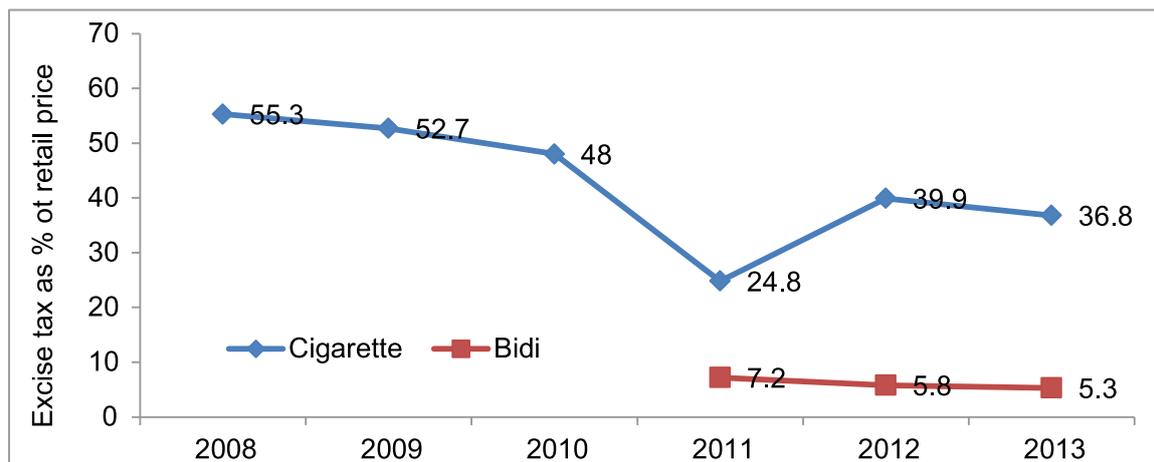
Fig 4: Affordability of Tobacco Products at Households Level
(Affordability in relation to MPCE status: a declining share means increasing affordability)



Note: MPCE (monthly per capita expenditure) is taken as a measure of economic status of the sample households. Ratio is estimated using rate of change of both RPI and MPCE series between the periods.
Source: RPI data from Labour Bureau and MPCE from Consumption Expenditure Survey rounds of NSSO for respective years.

- The excise burden on cigarettes was found to be 36.8 percent in 2013 which is much lower than the WHO recommended level of 70 percent. In case of bidis (the most popular form of smoking in India), the excise burden was extremely low at 5.3 percent in the same year. Further, the excise burden on both bidi and cigarette is showing declining trends over the study period (Fig-5).

Fig 5: Excise Burden across Smoking Tobacco Products

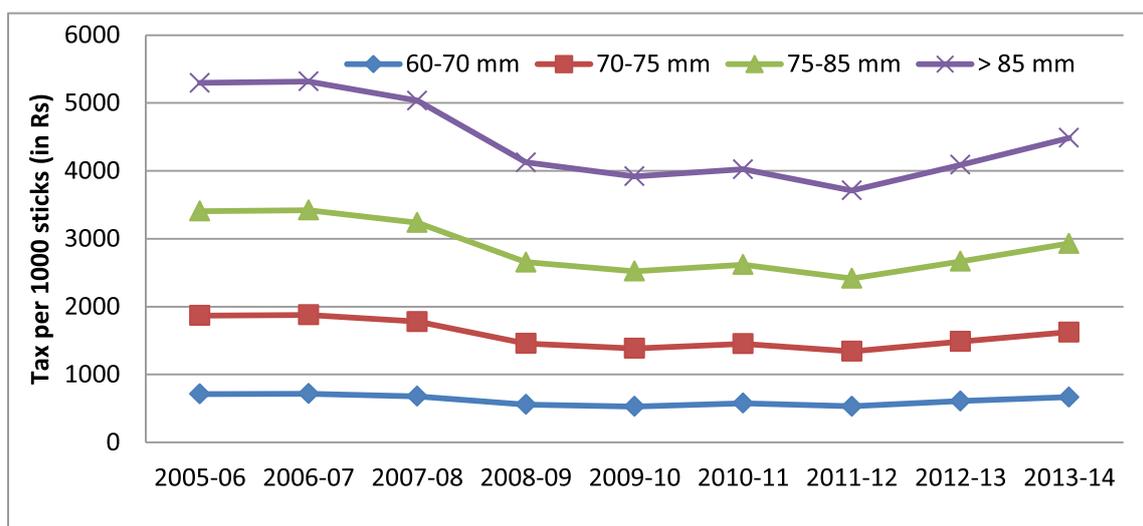


Source: Retail price from Labour Bureau and Excise duty from Ministry of Finance, GOI

- The total tax burden (excise plus VAT) was found to be as low as 20% in the case of bidis and 59% in the case of cigarettes in 2013. The total tax burden varies widely across the states (mainly due to differential VAT rates) – being as low as 31%, 36% and 39% in Punjab, Chhattisgarh and Haryana respectively and as high as 81% in Rajasthan.

- A large segment of bidi manufacturing remains outside of tax net due to an unorganised production structure. Around 56 percent of the bidi manufacturing (i.e., value of output) was generated under the unorganised sector in 2010-11.
- In 2010-11, bidi constituted 58 percent of the value of the output generated by smoking industry, whereas the revenue generated was just 3 percent of the total excise revenue. This is not only because of low taxation on bidis (the excise duty on bidi was merely Rs 16 for 1000 sticks for man-made and Rs 28 for machine-made bidis in 2012-13) but also due to production of bidis in the unorganised manufacturing sector.
- During the study period, the nominal value of excise tax rate on filtered cigarettes is increasing, while inflation adjusted (at 2004-05 prices) excise tax rate is showing declining trends over the period compared to the initial/base year 2005-06. The declining rates are visible in most of the length segments of cigarettes (Fig-6). This indicates that the increase in excise rate has not been adjusted to rise in inflation in India.

Fig 6: Inflation Adjusted Excise Duty on Filtered Segment of Cigarettes (at 2004-05 prices)



Source: Estimated using data from Ministry of Finance, GOI.

Key recommendations

1. **Tax increases on tobacco products to be indexed to inflation:** The study clearly shows that there is an increase in the affordability of tobacco products due to low rates of increase in tobacco taxes in comparison to increase in per capita income. The Ministry of Finance should ensure that the increase in tobacco taxes be adjusted with inflation, measured through Consumer Price Index (CPI).
2. **Urgent need to increase excise duty on all tobacco products:** Considering the low excise burden on tobacco products, it is recommended that there should be a substantial increase in the excise on all tobacco products so as to meet the global standards of tobacco tax burden at 70 per cent as recommended by the World Health Organization.

3. **Broaden tobacco tax regime to include unorganised sector:** There is an urgent need to broaden the tobacco tax net by including and imposing excise on the unorganised manufacturers. As per the Factories Act 1948, if the number of hired workers is less than 10, the enterprise will be considered as unregistered or production under unorganised sector. The Ministry of Labour and Employment should not allow this exemption in case of tobacco manufacturing and mandate compulsory registration of every tobacco manufacturer.
4. **Uniformly tax bidi regardless of mode of production:** It is essential to substantially increase the taxes on bidis and abolish distinction between handmade and machine-made bidis for the purpose of levying excise duty.
5. **Eliminate tax exemptions on production of bidis:** The small producer exemptions (for production of up to 2 million sticks) must be abolished completely and each stick of bidi must be taxed at an increased rate by the Ministry of Finance. This exemption encourages bidi manufacturers to outsource the production activity/rolling and leads to tax evasion.
6. **Reduce tax slabs in cigarettes based on length:** Reduce the length based tier system for cigarette taxation to a maximum two tiers in order to simplify tax administration. The cigarette industry generally manipulates prices through product differentiation strategy (by launching different brands of cigarettes under a particular length). The Ministry of Finance should review it periodically and impose excise accordingly.
7. **Move towards GST and until such time recommend uniform VAT at state level:** To achieve optimal benefit from tobacco taxation, it is recommended to move towards the Goods and Services Tax (GST) regime. While doing so, the Government should categorise all tobacco products as demerit goods and thus levy a higher rate of GST on them. In addition, the Centre should retain central excise on tobacco products in order to raise tax revenue and protect public health by making tobacco products significantly less affordable over time. However, until GST is rolled out, the differential VAT rates across states should be equalised at the highest currently prevailing rate that is imposed by states on all tobacco products. Uniform tax rates across states will help curb illicit inter-state movement of tobacco products.