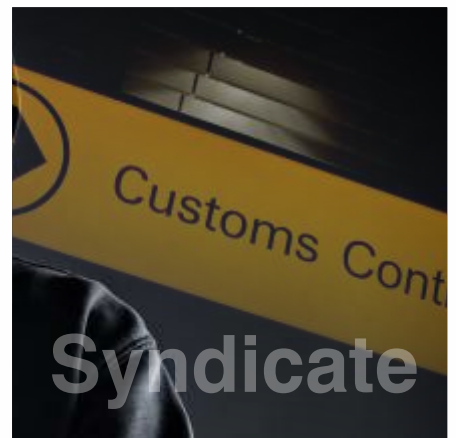
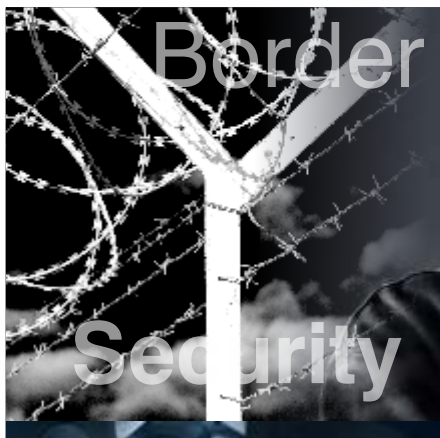




# NEED FOR POLICY REFORMS TO COMBAT ILLICIT MARKETS

## Case study on Tobacco Industry

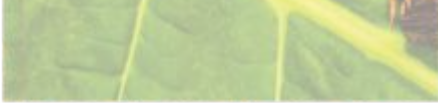


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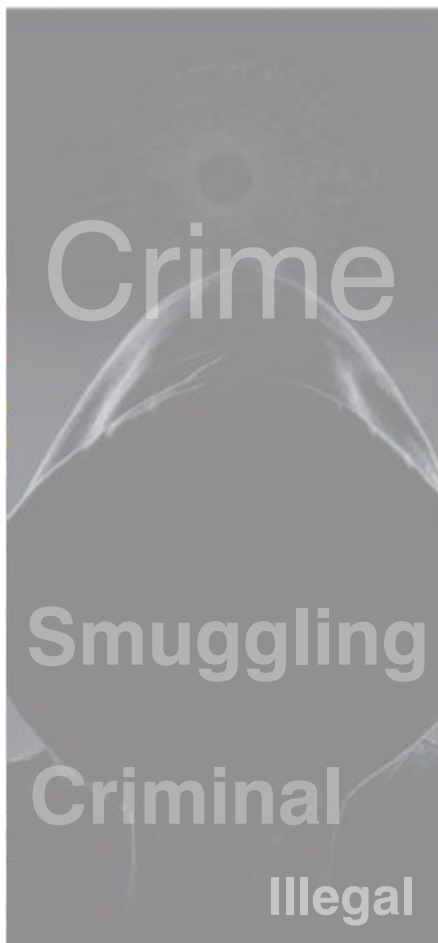


Cross Border



Border

Security



Crime

Smuggling

Criminal

Illegal

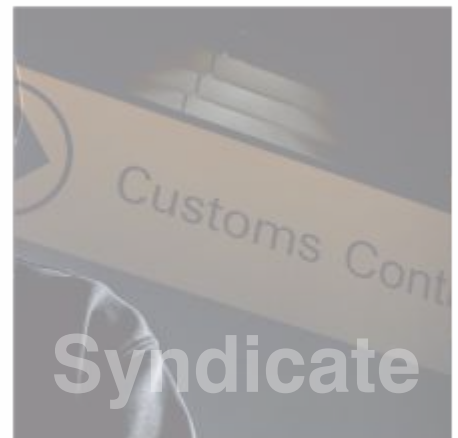


Illicit

Taxes



Terrorism



Customs Control

Syndicate



Parallel

Economy

TAX



Inter-state



## Foreword



Illicit trade is assuming alarming proportions resulting in tremendous economic and social damage worldwide. Moreover, such illicit operations have close links to terror organizations and criminal networks. In fact, it is today one of the biggest challenges faced by India and its industry, tarnishing the country's image in the global arena.


FICCI has been at the forefront of advocating policy framework on various aspects affecting industry. Taking up the agenda of curbing illicit trade, FICCI's Committee Against Smuggling and Counterfeiting Activities Destroying the Economy [CASCADE] has not only initiated research to assess the extent of the menace but has also gone one step further to outline its impact on our society.

In pursuance of its agenda, FICCI CASCADE will undertake a series of sector specific reports on **Need for Policy Reforms to Combat Illicit Markets**. These reports will assess the magnitude of the menace in these sectors and the reforms required to address it. The sectors will be those which are mostly impacted by smuggling and counterfeiting in India.

I am delighted to see this report on Need for Policy Reforms to Combat Illicit Markets – Case Study on Tobacco industry. The report talks about trade of illicit cigarettes, which constitute a significant component of the tobacco industry and is leading to the loss of revenue to government, loss of business to the legitimate industry, livelihood opportunities, adversely impacting farmers, besides being a threat to national security.

I would like to thank and congratulate all the stakeholders who have contributed towards this study particularly Thought Arbitrage Research Institute (TARI). It is hoped that this study would provoke further debate on extent of this problem, and help chart out means to safeguard the legal industry.

I wish FICCI-CASCADE success in its future initiatives.



Dr. A. Didar Singh  
Secretary General  
FICCI



## About this report

This report has been prepared by Thought Arbitrage Research Institute (TARI) for FICCI Committee Against Smuggling and Counterfeiting Activities Destroying the Economy (CASCADE).

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- Whistleblowing / Vigil Mechanism
- CSR & Sustainability
- Economics & Public Policy

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# Executive Summary

## Why illicit cigarette is a concern for India

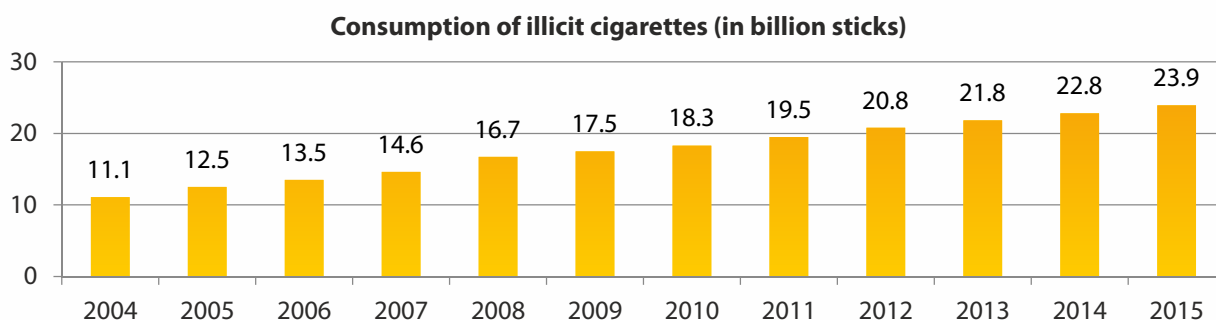
India is the second largest tobacco producer and exporter in the world after China. Cigarette and other tobacco products provide a source of livelihood to nearly 45.7 million of Indians – farmers, farm labours, women and tribals – and contribute a good deal to the rural economy. The industry generates a significant share of the country's excise duty and state taxes, amounting to more than Rs 30,000 crore annually. Exports of leaf tobacco and tobacco products generate foreign exchange earnings of around Rs 6,000 crore.

However, a growing consumption and trade of illicit cigarettes, which constitute a significant component of the tobacco industry, is a cause of grave economic and security concern for India. The illicit trade is defined as any practice or conduct prohibited by law and which relates to the production, shipment, receipt, possession, distribution, sale or purchase, including any practice or conduct intended to facilitate such activity. There are broadly three categories of illicit trade – smuggling, tax-evaded manufacturing and counterfeiting.

In India, 1/5th of cigarette industry is illegal<sup>1</sup>. Multi-agency studies involving Indian industry, government agencies and international entities such as USDA and Euromonitor International, show that consumption of illicit cigarettes have been growing steadily. FICCI-CASCADE studies have shown that the size of illicit markets in cigarettes and other tobacco products – which includes primarily cigarettes, chewing tobacco, bidi, khaini, cheroot, hookah tobacco, leaf tobacco, zarda, kimam, surti and snuff etc. – has grown from Rs 8,965 crore in 2012 to Rs 13,130 crore in 2014. This is a significant jump by 28.7%<sup>2</sup>.

Statistics<sup>3</sup> show that the consumption of illicit cigarettes has been steadily going up in India – from 11.1 billion sticks in 2004 to 23.9 billion sticks in 2015. The following graph plots the steady rise in illicit consumption of cigarettes in these years.

### Rising consumption of illicit cigarettes in India



Source: Tobacco Board (GOI), USDA and Industry estimates

<sup>1</sup>Tobacco Institute of India, 2015 report available at <http://www.tiionline.org/publications/tii-booklets/>

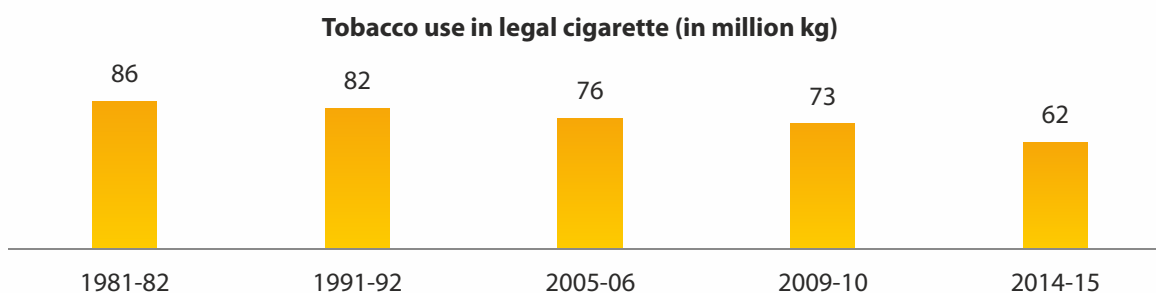
<sup>2</sup>Illicit Markets: A Threat to Our National Interests, FICCI-CASCADE study, 2015

<sup>3</sup>Tobacco Board (GOI), USDA and Industry estimates



While the consumption of illicit cigarettes is going up, use of tobacco in legal cigarettes is steadily going down. From 86 million kg in 1981-82, use of tobacco for legal cigarettes has gone down to 62 million kg in 2014-15<sup>4</sup>. The following graph captures the trend during the period.

### Declining tobacco use in legal cigarettes in India



Source: Tobacco Board (GOI), USDA and Industry estimates

The growing illicit consumption and trade of cigarette should concern India for five obvious reasons:

- Loss of revenue to government
- Loss of business to the legal industry
- Livelihood opportunities provided by the legal industry
- Adverse impact on farmers and farm labour, working conditions and welfare consequences
- Threat to national security

## Study of consumption and trade in illicit cigarettes

The present study has been carried out by TARI in collaboration with IMRB International, a WPP company and global leaders in market assessments and surveys, to develop a better understanding of the consumption and trade of illicit cigarettes in India through a country-wide survey.

For the purpose of the survey, a detailed questionnaire was prepared for the consumers, including those who smoked illicit cigarettes, and retailers selling illicit brands. A sample size of 1,200 smokers and 250 retailers in over 10 cities were selected in both urban and rural areas representing all four regions of north, south, east and west. This is probably the largest sample surveyed for such a study in India.

The study focussed on five areas:

- Impact of price on consumption of illicit cigarettes
- Demographic implications of illicit consumption
- Impact of graphic health warnings (GHWs) on consumption
- Supply side view on illicit trade and
- Enforcement issues about illicit trade

<sup>4</sup>Tobacco Board (GOI), USDA and Industry estimates





## Results and findings

The study, supported by the survey and literature review, throws up some important conclusions. It has been found that as the price of the legal cigarettes goes up due to higher tax, *consumers are willing to trade down and patronise smuggled cigarettes or cheap and tax-evaded locally manufactured cigarettes – depending on their socio-economic and demographic profile. Most of them (74%) are willing to do so even when they know that such cigarettes would jeopardise their health and wellbeing.*

This negates the basic assumption of the authorities that higher price would deter smokers. This is also the logic given to justify imposition of higher taxes on cigarettes year after year. Instead of stopping consumption, rise in price seem to be leading to a switch to cheaper illicit alternatives. The survey, however, did not reveal that with the rise in price the smokers would stop consuming cigarettes.

An increase in price by Rs 1 per stick of cigarette is found to be yielding a minimum of 20% in volume sale to tax-evaded locally manufactured cigarettes in the case of lower price bands (Rs 6-8 per stick) and about 38% loss in volume sale to smuggled cigarettes in case of smokers of both low and high price bands (Rs 8-11 per stick). With every rupee rise in price, the loss of volume sale goes up further.

As various studies in India and outside show, rise in the price of cigarettes incentivises smuggling and other illicit activities, drives the business underground, creating a clear threat to national security.

The supply side view also shows that two factors drive illicit trade in cigarettes – *price and consumer preference for products without warnings*. A vast majority of retailers said they are stocking and selling illicit cigarettes because of higher profit margins, making it clear that *any rise in price of the legal cigarettes will only make them stock and push the sale of illicit brands of cigarettes even more*. Rise in the prices of the legal cigarette would thus be a loss making proposition for the legal industry.

There is a clear demographic pattern among those who smoke illicit cigarettes. Those smoking tax-evaded locally manufactured cigarettes are found to be older in age, belong to the poorer socio-economic segments (Class C, D and E) and who have been smoking for a long time.

On the other hand, those who smoke popular smuggled cigarette brands are younger in age, many of them being the first timers and belong to the higher income group (Class A).

*Thus, it is the young and the poor who are more vulnerable to illicit trade in cigarettes.*

Absence of graphic health warnings (GHWs) seems to be adding to the illicit consumption. Seemingly, it makes such cigarette packs attractive and the product presumably safe for consumption which works to the disadvantage of the legal industry that has to comply with such requirements.

The study also finds that poor distribution and supply are the two key constraints for the retailers for not stocking illicit cigarettes in higher quantity. If the distribution and supply network improves, a majority of them are willing to stock illicit cigarettes in larger quantities. This would indicate that inadequate vigilance is leaving scope for illicit trade. Therefore, the enforcement mechanisms need to be further tightened to eliminate illicit trade in cigarettes.



## Recommendations

It is imperative that the illicit trade in cigarette is eliminated through various mechanisms, both at policy and regulatory frameworks levels. Some of the salient measures that should be taken, and which follow from the findings of the survey and literature review, are the following:

- High tax being the main driver of illicit trade in cigarette, there should be a *balanced tax policy*. There should be no further increase in excise on cigarettes, which will enable the industry to recover and lead to optimisation of revenue for both the government and industry. Going forward, a balanced tax policy will be more appropriate for both.
- Once the legal industry recovers from the onslaught of illicit trade, specific duty rate increase could be indexed to inflation.
- All tobacco products under the GST regime should be taxed at a standard rate plus central excise duty, keeping it revenue neutral at current rate.
- The existing multi length-based specified excise duty structure should be continued to enable the industry to offer products to various socio-economic segments of the society.
- The legal industry should be allowed to serve the segment patronising cheap and illicit cigarettes. Lower slab of cigarettes at less than 60 mm should be considered to let the legal industry compete with illicit cigarettes.
- The focus of the policy should be on tobacco and *all tobacco products*, rather than just cigarettes. Cigarettes constitute only 11% of the total tobacco consumption in terms of volume but contribute 87% of the total excise revenue, while the non-cigarette tobacco products which constitute 85% of consumption in volume (illicit cigarettes constituting the rest 4% of consumption in volume) contribute only 13% to revenue. A bulk of tobacco products (68% of all tobacco consumption, according to a study<sup>5</sup>) goes untaxed because of being manufactured in the unorganised sector with little statutory oversight.
- This means, the bulk of tobacco consumption (85%) is either taxed at a very low rate or goes untaxed.
- Consumer awareness programmes should specifically target the new and young smokers who are attracted towards illicit cigarettes because of cheaper price and attractive packaging in absence of graphic health warnings (GHWs).
- The current regulation mandates cigarette packets to carry pictorial or graphic health warnings (GHWs) on 85% of the surface area on both sides. Given the fact that a Parliamentary committee has suggested restricting such warnings to only 50% of the surface area, the government must review its policy of 85% pictorial warnings.
- Enforcement mechanisms need to be tightened to curb manufacturing of illicit cigarettes and smuggling. The industry also needs to improve its vigil mechanism.
- India needs to frame its own policies and regulations to eliminate illicit trade in cigarettes taking into consideration its unique situation, rather than following the western models.

Such measures will go a long way in curbing the illicit consumption and trade in cigarettes in India

<sup>5</sup> Report on the impact of current tax framework on the tobacco sector in India and suggestions for its improvements, 2014, ASSOCHAM and KPMG



## Key Recommendations

- *High tax being the main driver of illicit trade in cigarettes, there should be no further increase in tax to enable the legal industry to recover and optimize revenue.*
- *In future, specific duty rate increase could be indexed to inflation.*
- *All tobacco products under GST should be taxed at uniform rate, keeping it revenue neutral at current rate.*
- *Focus of the policy should be on tobacco products, rather than cigarettes which constitute only 11% the total tobacco consumption (volume).*
- *Existing multi-length based specified excise duty structure should continue.*
- *Allowing cigarettes of less than 60 mm in length should be considered to compete with illicit cigarettes.*
- *Existing policy of 85% pictorial warning must be reviewed in view of Parliamentary committee suggestion of limiting it to 50% of the surface area.*
- *Enforcement mechanisms need to be tightened to check smuggling and manufacturing of illicit cigarettes.*
- *India should frame its own policy on tobacco control keeping its own realities in mind, rather than following western models.*



# Tobacco Industry in India

## CHAPTER 1

Tobacco is an important commercial crop in India, generating enormous socio-economic benefits in terms of agricultural employment, farm incomes, revenue generation and foreign exchange earnings. It provides livelihood to 45.7 million people, including farmers, farm labour, rural poor, women and tribals.

Indian tobacco is appreciated world-wide for its rich, full-bodied flavour and smoothness and is found in cigarettes manufactured in many countries across the world<sup>6</sup>. It is the second largest tobacco producer and exporter in the world after China. The industry generates a significant share of the country's excise duty and state taxes, amounting to about Rs 30,000 crore annually<sup>7</sup>. Exports of leaf tobacco and tobacco products generate foreign exchange earnings of around Rs 6,000 crore.

As per the Central Tobacco Research Institute (CTRI), 10 distinct types of tobacco are grown in 15 states of the country, which include cigarette (FCV, burley, Oriental) and non-cigarette types (bidi, chewing, hookah, natu, cheroot, cigar and HDBRG). It is a labour intensive industry as leaf harvesting and curing – two crucial phases in tobacco production – are primarily manual activities.

The tobacco industry comprises a group of economic activities covering cultivation of raw tobacco, manufacturing and processing, distribution and retailing of tobacco leaf and tobacco products. Tobacco growing, processing and exports make a significant contribution to national income and national employment. The tertiary activities in the industry include entities dealing with agricultural inputs like seeds, fertilisers, pesticides etc. and those involved with packing, transportation and exports.

For tobacco growers in India, it is a remunerative crop compared to food crops such as greens and cereals. It grows on soil of poor fertility and can withstand variations in weather conditions better than other crops, especially in the states of Andhra Pradesh, Karnataka and Gujarat. Problems of pests and diseases are much less severe in tobacco than for alternative crops such as cotton, chillies and groundnuts. The FCV tobacco is grown in India in four agro-climatic zones, namely, traditional black soils (TBS), northern light soils (NLS) and southern light soils (SLS) in Andhra Pradesh and Karnataka light soil (KLS) in Karnataka.

Millions of people find employment in growing tobacco, processing and other activities, including a large number of women who are engaged in bidi rolling and plucking tendu leaves used for making bidis. Even though bidi rolling is an alternative employment opportunity to the women in the rural areas they are able to earn a substantial income compared to other sectors. The different styles of tobacco produced in different zones meet the demands of the customers of different countries. As a result of which the tobacco crop gives higher return to the farmers in the states like Andhra Pradesh and Karnataka.

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<sup>6</sup> <http://www.ibef.org/exports/tobacco-industry-india.aspx>

<sup>7</sup> Industry sources





## Structure of the Industry

The main types of tobacco grown in India are:

- Flue Cured Virginia (FCV), grown primarily in Andhra Pradesh and Karnataka;
- Burley & Oriental;
- Suncured Country, Fire Cured Kentucky and Bidi of different varieties grown in Andhra Pradesh, Telangana, Gujarat, Maharashtra and Karnataka;
- Cigar varieties; and
- Chewing Tobacco grown in Anand area of Gujarat.

India is the second largest exporter of FCV tobacco in the world, exporting to more than 100 countries. According to the Tobacco Board, India exported 264,384 ton of tobacco and tobacco products in 2013-14.

### The top export destinations for tobacco products are:

Commodity	Top Export Destinations (by quantity)
Cigarettes	Belize, Singapore, Saudi Arabia, Panama, Jordan, UAE, USA, Libya and Kuwait
Cut Tobacco	UAE, Yemen, Cyprus, Cambodia, Azerbaijan, Ukraine, South Korea and Colombia
Chewing Tobacco	UAE, Afghanistan, Saudi Arabia, Malaysia, Nepal, USA, Bahrain and Yemen
Hookah Tobacco Paste	Saudi Arabia, Tunisia, South Africa, Brazil, Egypt, UAE, Yemen, Iran and UK
Bidis	UAE, Afghanistan, Singapore, Iran, Bahamas, Trinidad & Tobago and USA
Snuff	China, UAE, Afghanistan and UK

Source: Tobacco Board

In terms of volume, cigarettes constitute a tiny part of the total tobacco consumption – 11% legal cigarettes, 4% illicit cigarettes and 85% other tobacco products.

However, in terms of value, cigarettes contribute 87% of the total excise revenue. That is because bidis, chewing tobacco and other tobacco products are taxed at very low rates and regulations are lax.

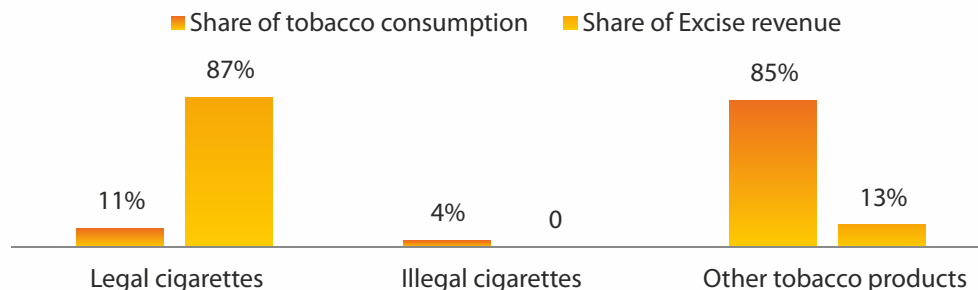
A 2014 study shows that 68% of *all tobacco consumption escapes taxation* because they are manufactured in the unorganised sector with little statutory oversight.

<sup>8</sup>Ministry of Finance and Tobacco Board and industry estimates

<sup>9</sup>Report on the impact of current tax framework on the tobacco sector in India and suggestions for its improvements, 2014, ASSOCHAM and KPMG



## Cigarettes represent 11% of tobacco consumption but contribute 87% of excise revenue



Source: Excise revenue – Ministry of Finance (GOI); Tobacco consumption – Tobacco Board & industry estimates

The largest tobacco producing states in India are: Uttar Pradesh, Karnataka, Maharashtra, Andhra Pradesh, Bihar, Delhi, West Bengal, Gujarat and Assam. These 9 states contributed 94% of production in terms of value, according to the Government of India's Annual Survey of Industries (2012).

On the other hand, the high consumption states are: Andhra Pradesh, Maharashtra, Uttar Pradesh, West Bengal, Tamil Nadu, Kerala, Bihar, Rajasthan, Karnataka, Gujarat and Madhya Pradesh. According to the 68th round of NSSO survey, these 12 states contributed about 84% of the total consumption.

The Indian tobacco market (including all tobacco products produced in India whether in a factory, home or unorganised units) is estimated to have grown to approximately Rs 1,44,000 crore in 2015<sup>10</sup>.

<sup>10</sup> Industry estimates



# Study of Consumption and Trade of Illicit Cigarettes

## CHAPTER 2

### What is illicit market?

World Health Organisation defines illicit trade as any practice or conduct prohibited by law and which relates to the production, shipment, receipt, possession, distribution, sale or purchase, including any practice or conduct intended to facilitate such activity<sup>11</sup>.

There are three broad categories of illicit trades<sup>12</sup>:

- **Smuggling:**

When products are diverted from the legitimate supply chain and sold in a country different from the intended market without paying taxes. Worldwide, studies estimate that between 6% and 8.5% of global cigarette consumption is smuggled<sup>13</sup>.

The smuggling can either be *bootlegging*, which means cigarettes are legally purchased in one country but consumed in another without paying applicable tax/duties in that country or *wholesale*, which means cigarettes are sold without paying tax even in the country of origin<sup>14</sup>.

- **Tax-evaded manufacturing:**

When products manufactured within the country and sold in the domestic market without payment of taxes. In India, domestic tax-evaded illegal cigarettes are a significant proportion of illegal trade. Such cigarettes are normally available at Rs 1 per stick or around that price range, selling at a price considerably less than even the amount of the tax applicable on them. Such illegal cigarettes undermine tobacco control measures and are of suspect quality and potentially more damaging<sup>15</sup>.

- **Counterfeit products of original licence holders:**

When products protected by intellectual property rights (IPR) are manufactured without authorization from the rights owner and tend to resemble closely the original product packaging. According to a 2008 OECD survey, trade mark infringement was found to be the most common form of counterfeiting in the tobacco industry.

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<sup>11</sup>WHO Framework Convention on Tobacco Control (FCTC)

<sup>12</sup>The Threat of Growing Illegal Cigarette Trade in India, The Tobacco Institute of India, July 2015, available at <http://www.tiionline.org/bookpublications/threat-of-growing-illegal-cigarette-trade-in-india-july-2015/>

<sup>13</sup>Chapter 15, Tobacco Control in Developing Countries, World Bank and World Health Organization, 2000; available at: <http://siteresources.worldbank.org/INTETC/Resources/375990-1089904539172/365TO392.PDF>

<sup>14</sup>Ibid

<sup>15</sup><http://www.financialexpress.com/article/healthcare/happening-now/punitive-taxation-extreme-tobacco-control-regulations-fuel-growth-in-illegal-cigarette-trade-in-india/78792/>



## Size of illicit market and what drives its growth

In India, 1/5th of cigarette industry is illegal<sup>16</sup>. Multi-agency studies involving Indian industry, government agencies and international entities such as USDA and Euromonitor International, show that consumption of illicit cigarettes have been growing steadily.

In a first of its kind study, FICCI-CASCADE estimated the size of illicit markets in tobacco industry – primarily cigarettes and also includes *chewing tobacco, bidi, khaini, cheroot, hookah tobacco, leaf tobacco, zarda, kimam, surti and snuff* etc. The study estimated the size of illicit market to be 20.2% of the total tobacco industry in 2012 – up from 15.7% in 2010.

The findings are presented in the table below:

### The top export destinations for tobacco products are:

Industry (without bidi)	2012		Grey Market		
	Total Supply* (in crore)	Total Consumption* (in crore)	2012		2010
			Total Loss (in crore)	%age	%age
Tobacco	Rs 30,439	Rs 38,138	Rs 7,699	20.2%	15.7%

\*Based on NSSO/ASI/GDCIS data for 2012

The calculations were based on analysis of available data published by the government sources for the year 2011-12. It was found that illicit trade exists in all industry segments, which may be in the form of sale of counterfeit products, smuggled goods, or tax evaded goods.

As per industry sources, the Indian tobacco market (excluding bidi and production of all tobacco products made in non-factory enterprises including home and tiny units) was estimated to be worth Rs 65,000 crore in 2014. Based on the industry projections, the loss of sales to the industry has been calculated as per the formula:

$$\text{Estimated size of industry in 2013-14} \times \text{Grey market percentage (2011-12)} = \text{Estimated loss of sales to industry}$$

$$\text{Rs 65,000 crore} \times 20.2\% = \text{Rs 13,130 crore}$$

Thus, the loss of sales to the industry for 2014 was estimated to be Rs 13,130 crore.

The estimated loss for 2012 had been ascertained to be Rs 8,965 crore by an earlier FICCI CASCADE study.

### Loss of sales to industry (in Rs crore)

Industry	2014	2012
Tobacco	13,130	8,965

Source: *Illicit Markets: A Threat to Our National Interests*, FICCI-CASCADE study, 2015

<sup>16</sup> Tobacco Institute of India, 2015 report available at <http://www.tiionline.org/publications/tii-booklets/>



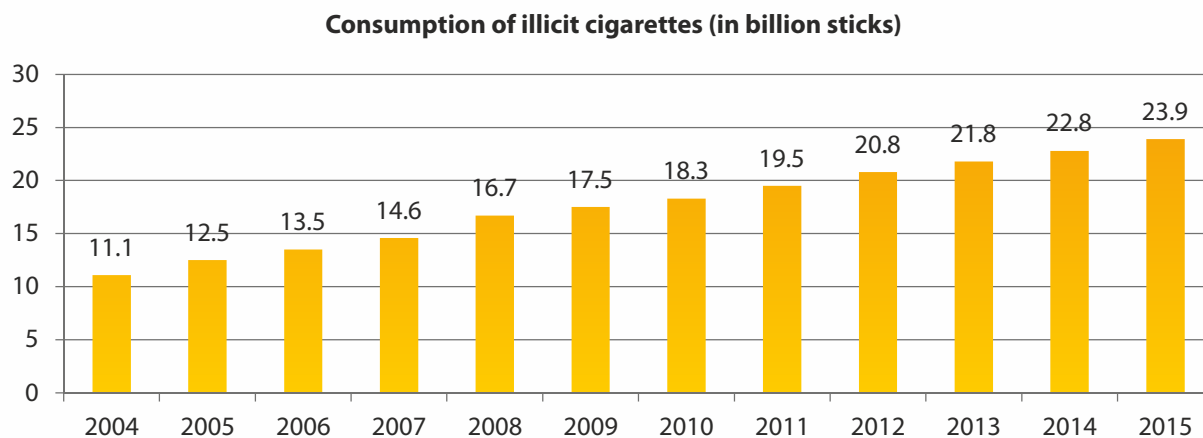


The loss of sales to the tobacco industry increased from Rs 8,965 crore in 2012 to Rs 13,130 crore in 2014<sup>17</sup>.

While this study estimated the size of illicit market in the *entire tobacco industry*, other studies and estimates throw up interesting data about the *consumption and growth of illicit cigarettes in India*.

Estimates by Tobacco Board, USDA and industry sources show that the consumption of illicit cigarettes is steadily rising – from 11.1 billion sticks in 2004 to 23.9 billion sticks in 2015. The following graph captures the growth in illicit consumption of cigarettes.

### Rising consumption of illicit cigarettes in India

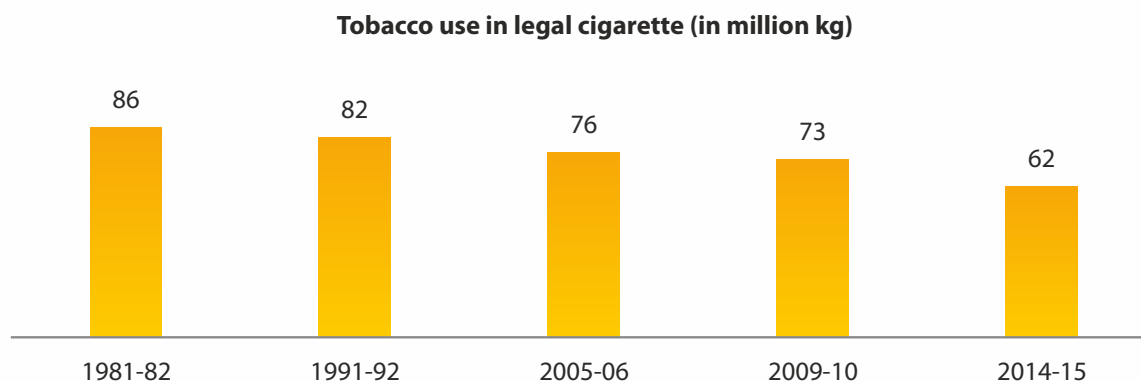


Source: Tobacco Board (GOI), USDA and Industry estimates

The growth in consumption of illicit cigarettes is accompanied by a decline in use of tobacco in legal cigarettes.

From 86 million kg in 1981-82, use of tobacco for legal cigarettes has gone down to 62 million kg in 2014-15<sup>18</sup>. The following graph shows the steady decline.

### Declining tobacco use in legal cigarettes in India



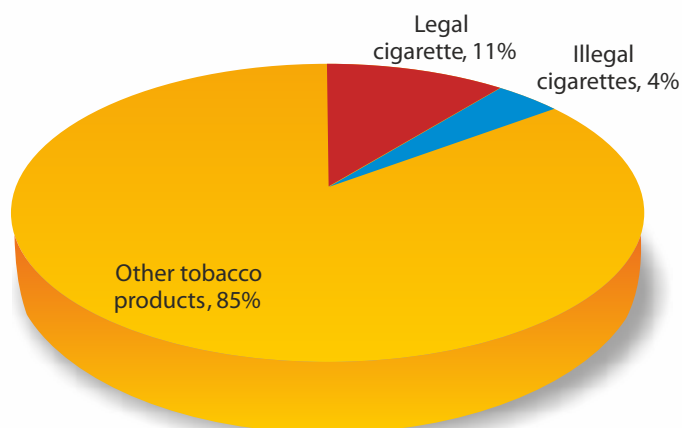
Source: Tobacco Board (GOI), USDA and Industry estimates

<sup>17</sup>Illicit Markets: A Threat to Our National Interests, FICCI-CASCADE study, 2015

<sup>18</sup>Tobacco Board (GOI), USDA and Industry estimates



In India, legal cigarette constitutes 11% of the total tobacco consumption in volume. Illicit cigarettes constitute 4% and the rest 85% come from chewing tobaccos, bidis, khaini, cheroot, hookah tobacco, leaf tobacco, zarda, kimam, surti and snuff etc<sup>19</sup>. This is in sharp contrast with the trend in Western countries where smoking of cigarettes constitutes 90% of the total tobacco consumption.



Source: Tobacco Board and Industry estimates

Government data on seizure of smuggled cigarettes also reflects a growing incidence of illicit trade in India. In Lok Sabha, the government disclosed that from April 2012 to July 2015, 24.83 million sticks of smuggled cigarettes worth Rs 54.43 crore were seized.

### Seizure of smuggled cigarettes

Year	Nos. (in million)	Value (in Rs crore)
2012-13	5.17	4.53
2013-14	2.64	13.83
2014-15	11.43	28.89
2015-16 (until July, 2015)	5.59	7.18

Source: Lok Sabha answers on July 24, 2015<sup>20</sup>

NSSO data of 2012 and 2010 shows that consumption of cigarette and other tobacco products has gone up across the states which can be attributed to increasing disposable incomes, changing demographics and urbanisation<sup>21</sup>. In a recent report, Dun and Bradstreet<sup>22</sup> has estimated that expenses of the Indian consumer on food, beverages and tobacco, both rural and urban, will continue to increase for a foreseeable future and hence consumption will keep on rising.

However, the supply of legal tobacco products including cigarettes has been relatively constant, which is also reflected by stable tax collection on production during this period. This implies that illegal tobacco products, including cigarettes, have been fuelling consumption and create a threat to national interest.

Cigarettes being highly taxed, easy to transport and having an attractive risk-to-reward ratio, are among the most illegally traded goods in the world<sup>23</sup>.

<sup>19</sup>Tobacco Board and Industry sources

<sup>20</sup>Source: Lok Sabha answers on July 24, 2015

<sup>21</sup>Illicit Markets: A Threat to our National Interests, FICCI CASCADE, 2015

<sup>22</sup>Dun and Bradstreet-Manappuram Finance Limited, India 2020 Economy Outlook, hart 1.12: Rising share of discretionary spending over the years

<sup>23</sup>The Threat of Growing Illegal Cigarette Trade in India, Tobacco Institute of India, 2015



## The factors driving the growth of illicit cigarette trade are:

- *High and discriminatory taxation*
- *Excessive regulations like 85% graphic health warnings (GHWs) on either side of the cigarette packs while illicit cigarettes come without or with softer warnings implying that these are risk-free*
- *Arbitrage opportunity due to high tax rates on cigarettes*
- *Wide disparities in tax-driven prices in different tax jurisdictions*
- *Exploitation of free trade zones/concessions*
- *High incentives and low risks*
- *Porous borders/lack of surveillance*
- *Technology*

High and discriminatory taxation, as in the case of highly taxed cigarettes versus lowly taxed bidis, is the most critical driver of illicit tobacco markets. This is followed by differential tax regimes of states providing arbitrage opportunities, high incentives and low risks and other factors.

New technology has helped in making the counterfeit cigarettes the fastest-growing category of illicit tobacco trade. It is simple to produce look-alike packaging, with sophisticated and less expensive computer scanners and printers. Many cigarettes sold through the internet are illicit because taxes are not paid, whether by retailers or smokers. The internet sellers also provide a useful sales outlet for smuggled or counterfeit cigarettes, and few of them safeguard against illegal purchases by underage smokers. With the growth of online trading websites, it has become possible for ordinary people owning computers to become tobacco smugglers from their homes<sup>24</sup>.

## Why should illicit cigarettes concern India?

A United Nations Office on Drugs and Crime (UNODC) report<sup>25</sup> says: "The ramifications of counterfeiting affect everyone, with Governments, businesses and society being robbed of tax revenue, business income and jobs. The flood of counterfeit and pirated products creates an enormous drain on the global economy by creating an underground trade that deprives Governments of revenue for vital public services and imposes greater burdens on taxpayers.

'It also leads to more public resources being spent on fraud-detection methods by public sector authorities and larger intelligence and policing budgets being needed to counter sophisticated schemes and networks. Counterfeit goods also undermine employment, as products are copied and produced illegally, thereby displacing sales of original merchandise and reducing the turnover of legitimate companies.'

Illicit cigarette consumption and trade, thus, leads to loss of revenue for government and industry, has socio-economic implications and pose a threat to security of the country.

<sup>24</sup> *Tobacco-Free Kids, Illicit Tobacco Trade Illegal Profits and Public Peril*, available at [http://global.tobaccofreekids.org/files/pdfs/en/ILL\\_overview\\_en.pdf](http://global.tobaccofreekids.org/files/pdfs/en/ILL_overview_en.pdf)

<sup>25</sup> *Counterfeit goods: a bargain or a costly mistake?*, UNODC available at <http://www.unodc.org/toc/en/crimes/counterfeit-goods.html>



## 1. Loss to government

Globally, illicit tobacco market may account for as much as one in every 10 cigarettes consumed. The European Commission estimates that illicit trade in cigarettes costs the EU and their Member States over €10 billion annually in lost tax and customs revenue<sup>26</sup>.

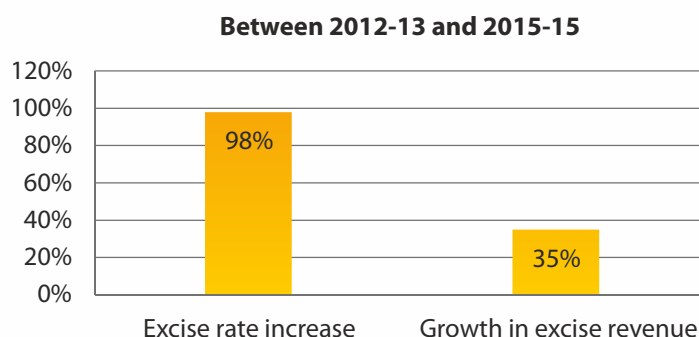
As we have noted earlier, the size of illegal market in tobacco has grown from 15.7% in 2010 to 20.2% in 2012 causing a huge loss to the government. The FICCI CASCADE study of 2015 calculated the loss to the government in 2014 at Rs 9,139 crore.

This was calculated on the basis of loss of direct tax (income tax) and indirect tax (value added tax, import duty and excise duty) caused by the operation of illicit markets in the tobacco industry. This loss included the direct tax component of Rs 1,261 crore and indirect tax Rs 7,878 crore.

In 2012, the loss of revenue to the government had been worked out to be Rs 6,239 crore<sup>27</sup>.

Interestingly, another study<sup>28</sup> shows that while the tax on tobacco has grown substantially, the revenue collection has not kept pace. Between 2012-13 and 2015-16, tax on tobacco grew by 98% while revenue grew only by 35%. Since consumption has been growing, it would only mean tax evasion or growth of illicit markets to meet the consumption needs.

### Difference between growth in tax rate and revenue



Source: The Tobacco Institute of India

## 2. Loss to industry

The same study (FICCI CASCADE, 2015) estimated the loss to the industry due to illicit tobacco markets at Rs 13,130 crore in 2014 – up from Rs 8,965 crore. The loss increased significantly, by approximately 46%, in comparison with previous estimate for 2012.

*The combined loss – to the government and industry – works out to be Rs 22,269 crore in 2014 (Rs 9,139 crore plus Rs 13,130 crore). This is almost equal to the total health outlay of the central government – Rs 24,549 crore in the union budget of 2015-16.*

But a direct loss of business is not the only loss. Illicit markets increase the cost of business sharply as legal industry needs to use technology, design, marketing and other measures to counter the illicit markets and protect their business.

<sup>26</sup><http://www.who.int/campaigns/no-tobacco-day/2015/event/en/>

<sup>27</sup>Illicit Markets: A Threat to our National Security – The Tobacco Industry, FICCI CASCADE, 2015

<sup>28</sup>The Tobacco Institute of India





### 3. Labour, environment and welfare consequences

A grey market product is often produced in a sweatshop under the radar of law, usually under grim working conditions. A counterfeiter has little regard for any aspect of law, including labour laws that prescribe basic working conditions. Child labour is rampant in this grey market but adult workers have little to cheer about. For most workers in the grey market, their next meal comes from the next day's work; entitlements like provident fund, gratuity, paid leave and other protection afforded by law by-pass the grey market altogether.

Labour employed by the grey market operators would generally work under unsafe and unhealthy working conditions with negligible rights of forming a labour union and other means of enforcing their labour rights of collective bargaining and industrial action in case of any mistreatment in the hands of management. This would not only result in issues of labour exploitation but also human rights violation.

There are three main effects of illicit markets on employment:

- The primary effect is the reduction in employment as a direct result of fall in sales and profits.
- A secondary effect is when firms who supply or service these sectors also reduce employment as demand for their services decline.
- The third effect occurs when induced-demand falls as a consequence of the reduction in expenditure by the employees directly employed in the sector.

As illicit market operators make greater profits from their work, they have even more incentive to produce greater quantities of goods which fuels wasteful consumption habits. This leads to overdraw of resources to flood the market with cheap and substandard goods.

Illicit markets impact government's social welfare programmes too. Government loses on tax collection and has to spend higher amounts on public awareness initiatives, law enforcement, handling of seized goods and public welfare costs. Public institutions are also weakened when such grey market or illegitimate producer networks use corruption as a means to further their anti-social activities.

### 4. Threat to national security

The illicit cigarette trade can pose serious security threat as there is evidence, globally, that organized transnational criminal groups are involved in it and money earned through it is used to fund serious criminal activities, including terrorism<sup>29</sup>. In absence of data or research, the same might not be said about India but the threat cannot be ignored.

Globally, cigarette smuggling is considered a low-risk, high-reward criminal activity. The traffickers can make millions with little risk of detection or harsh punishments. It allows traffickers and their networks to circumvent borders; proceeds can be used to finance insecurity and instability<sup>30</sup>.

A number of international studies have been conducted in the past which highlight the involvement of counterfeiting and piracy of tobacco products in financing terrorist activities. International Consortium of Investigative Journalists (ICIJ)<sup>31</sup> reports that some of the world's most feared terror outfits like Hezbollah, Taliban and al-Qaeda have been found to be involved in smuggling cigarettes, as are the Real Irish

<sup>29</sup> United States General Accounting Office, 'Terrorist Financing: US Agencies Should Systematically Assess Terrorists Use of Alternative Financing Mechanisms', Report to Congressional Requesters GAO-04-163, available at <http://www.gao.gov/new.items/d04163.pdf> and <http://www.fctc.org/what-is-the-fctc/the-work-of-the-fca/illlicit-trade/the-facts>

<sup>30</sup> The Global Illicit Trade in Tobacco: A Threat to National Security, Department of State, US, December 2015

<sup>31</sup> Terrorism and tobacco (2009), International Consortium of Investigative Journalists, available at <http://www.icij.org/project/tobacco-underground/terrorism-and-tobacco>



Republican Army (Real IRA) and the Kurdistan Workers' Party (PKK). Louise Shelley, a transnational crime expert at George Mason University and adviser to the WEF on illicit trade, has been quoted as saying that terrorist financing through cigarette smuggling is huge because "no one thinks cigarette smuggling is too serious, so law enforcement doesn't spend resources to go after it"<sup>32</sup>.

Raids on counterfeiting operations in California have led to the discovery of Hezbollah flags, photos and other memorabilia. In one case, a female cigarette counterfeiter was arrested at the Los Angeles airport on her way to Lebanon with \$230,000 in cash strapped to her body. While the woman claimed to be traveling for vacation, it was presumed that the funds were being transported to Hezbollah<sup>33</sup>. Several similar examples have been reported related to other illicit products as well.

For instance, in Australia, according to an assessment by the Australia Crime Commission<sup>34</sup>, involvement in Australia's illegal tobacco market is perceived by organised crime groups as a low risk, high profit activity in which large profits can be made with minimal risk detection or significant penalties. Organised crime has sustained access to cheap tobacco product overseas which can be illegally imported, avoiding tax obligations to the supply the tobacco market in Australia. Minimal quantities of illegal tobacco are produced domestically. The assessment further states that in 2011-12 the ACBPS (Australian Customs and Border Protection Service) detected and seize 46 sea cargo importations of illegal tobacco, comprising a combined 175 ton of tobacco and 122 million cigarettes with duty evaded on these estimated at 128 million Australian dollars.

The UK government in their Report of October 2014 estimated that they lose about 1.3% of their total tax collection due to criminal networks, mainly from smuggling.

So far as India is concerned, lack of adequate data based on search and seizure makes it difficult to link or correlate the increase in illicit markets to terror funding. However, official data shows that seizure of smuggled cigarettes has been growing rapidly, causing serious concerns. In 2012-13, smuggled cigarettes worth Rs 4.53 crore were seized. The value of seizure went up to Rs 13.83 crore in 2013-14 and Rs 28.89 crore in 2014-15. In the first four months of 2015-16, the seizure was worth Rs 7.18 crore<sup>35</sup>.

It calls for strategic intelligence gathering and preparation of robust databases to establish and determine the extent of a link between smuggling and terror funding, which are clearly missing at present. Given the security implications, if not outright financial considerations, there is little to argue against carrying out such exercises. This would be the first step to contain illicit trade and its corollary, terror and ensure that genuine business interests do not suffer.

## 5. Livelihood generation

Tobacco is an extremely important commercial crop in India, generating enormous socio-economic benefits in terms of agricultural employment, farm incomes, revenue generation and foreign exchange earnings.

Tobacco production provides direct and indirect employment to millions of Indians. According to an estimate, about 45.7 million<sup>36</sup> are directly engaged in tobacco production. Six million farmers are engaged in tobacco growing across the country, another 20 million are farm labourers who find livelihood in those farms. About 8.5 million are involved in bidi making, 4 million in plucking tendu leaf and 7.2 million in trading and retail business.

<sup>32</sup> *Ibid*

<sup>33</sup> *Hezbollah Presence In The United States Is No Surprise*, By: Sylvia Longmire, [www.hstoday.us](http://www.hstoday.us), January 10, 2012

<sup>34</sup> *Organised Crime in Australia, 2013, an assessment by the Australian Crime Commission*

<sup>35</sup> *Lok Sabha answers on July 24, 2015*

<sup>36</sup> *Fact Sheets, Tobacco Institute of India, available at <http://www.tiionline.org/facts-sheets/livelihood/>*



## Direct Employment in Tobacco Sector

Type	In million
Farmers	6
Farm labour	20
Bidi/Factory workers	8.5
Tendu leaf pluckers	4
Trade/retailers	7.2

Source: The Tobacco Institute of India

In addition to these 45.7 million people who are directly dependent on tobacco industry, there are millions of others who indirectly earn their livelihood, such as people engaged in packaging, warehousing, flavour and fragrance, paper, jute, mentha, areca nut, transporters etc.

About 15 states in the country grow tobacco significantly influencing the economy and prosperity of the farming community. In India, tobacco cultivation, trade and processing is largely undertaken in rural areas. The sale of tobacco leaf generates public revenue as well as cash flow for farmers and rural communities. Along with this, market support such as minimum support price (MSP) helps generate a large contribution to rural economy of some of the states like Andhra Pradesh, Karnataka, Gujarat, Uttar Pradesh, Bihar, Tamil Nadu and Maharashtra.



# Study of Consumption and Trade in Illicit Cigarettes in India

## CHAPTER 3

The present study seeks to develop a better understanding of the nature of consumption and trade in illicit cigarettes in India through a country-wide survey.

*As defined and explained in the earlier chapter, illicit cigarettes could be (a) smuggled (b) tax-evaded locally manufactured and/or (c) counterfeits infringing on the intellectual property rights (IPR).*

For the purpose of this survey, a detailed questionnaire was prepared for the consumers, including those who smoked illicit cigarettes, and retailers selling illicit brands. A sample size of 1,200 smokers and 1,120 retailers in over 10 cities were selected in both urban and rural areas, which is probably the largest sample surveyed for such a study in India.

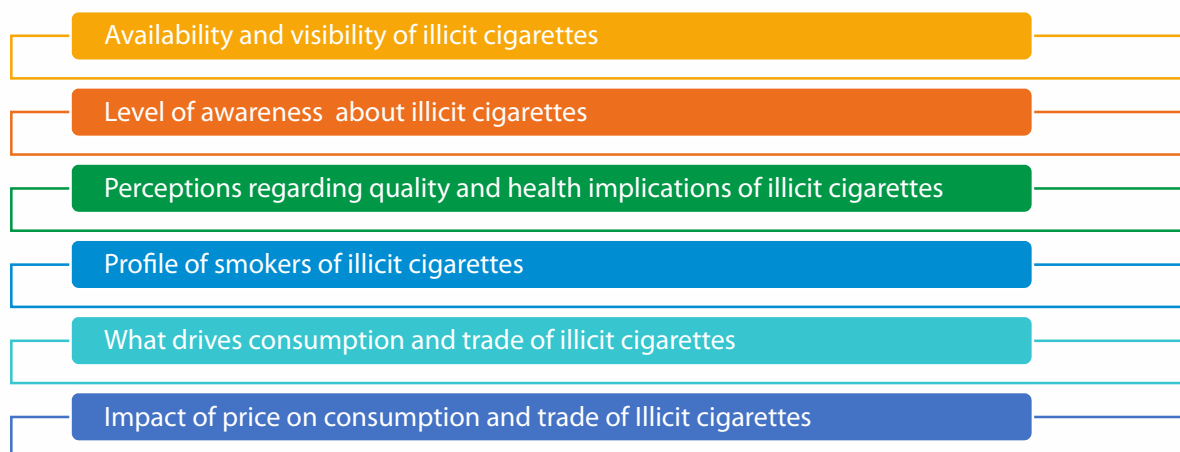
The survey focused on two kinds of illicit cigarettes.

- Smuggled cigarettes of both cheap (Rs 5-8 per stick) and popular (Rs 10 or more per stick) brands like *Djarum Black, Gudang Garam, One and Only, Dunhill Switch, Win, Paris, Peacock and Ruili River* and
- Tax-evaded locally manufactured cheap brands priced at Rs 1 like *Harbour, Sunils Filter, Midland and Forever*

The locations selected for the survey spanned both urban and rural areas. For the tax-evaded locally manufactured brands, urban and rural areas of East Godavari, Ranchi/Palamu, Guna and Baran districts were selected. For the smuggled brands, urban centres of Delhi, Bangalore, Hyderabad, Warangal, Kolkata, Guwahati, Mumbai, Pune and Kolhapur were selected.

*The survey was carried out between December 2015 and January 2016.*

The survey focussed on the following areas:







## Research Design and Methodology

Two modules were conducted for this Study:

- **Smoker Module**
- **Retailer Module**

### **Smoker Module looked at the consumption and other aspects of illicit cigarette brands:**

- Smokers were approached outside cigarette selling shops and were recruited for the detail diagnostics section. The respondents were then brought to a CLT (Central Location Testing) venue and the detailed diagnostics section was administered.
- To attain minimum criteria of smokers of illicit products, the sample size was boosted in markets where minimum sample of smokers of illicit products was not achieved through this approach.

### **Retailer Module:**

- Retailer Module was conducted through observation and interaction with the Retailers in cigarette selling shops.
- Akin to Smoker Module, the Retailer sample was boosted to meet minimum criteria of illicit brand handlers.

Retail Interviews & Smoker Interviews were carried out in areas with high presence of illicit brands to ensure a better understand on the illicit segment.

## Key information areas

### **For smokers/consumers**

- Demographics: Age & NCCS
- Cigarette Purchase behaviour
- Regular Brand, Cigarette smoking & Regular Brand duration
- Occasional Brand, Previous & Substitute brand
- Awareness Trial for Illicit
- Pack Attractiveness of Illicit vs legal
- Pack Preference of Illicit vs legal
- Intention to Purchase Illicit brand on increase in price of regular brand
- Image standing on Quality, Strength of Illicit vs. Legal
- Price perception of Illicit vs. Legal
- Impact on Health – Illicit vs. legal



### For retailers

- Retail Availability & Visibility
- Reasons for Stocking/Non Stocking Illicit brands
- Intention to stock illicit
- Proportion of illicit packs sold in a day
- Price Margin in Illicit brands
- Smoker profile buying illicit
- Country of Manufacture & conduit markets (derived)
- Intention to Stock among non-stockist of illicit
- Popularity of Illicit brands among retailers

### Sample size and coverage for smuggled brands of cigarettes (both cheap and popular)

Zone	City	All Smokers	All Retailers	Smokers of Illicit Brands	Retailers Stocking Illicit Brands
North	Delhi	100	100	5	10
South	Bangalore	100	100	5	10
	Hyderabad	100	100	5	10
	Warangal	75	75	10	20
East	Kolkata	100	100	5	10
	Guwahati	75	75	10	20
West	Mumbai	100	100	5	10
	Pune	75	75	10	20
	Kolhapur	75	75	10	20
<b>TOTAL</b>		<b>800</b>	<b>800</b>	<b>65</b>	<b>130</b>

### Sample size and coverage for tax evaded locally manufactured brands of cigarettes (RSFT)

State	District	Urban/Rural	All Smokers	All Retailers	Smokers of Illicit Brands	Retailers Stocking Illicit Brands
South :						
AP	East Godavari	Urban	50	50	10	20
		Rural	50	30	10	10
East :						
Jharkhand	Ranchi	Urban	50	50	10	20
	Palmau	Rural	50	30	10	10
West :						
MP	Guna	Urban	50	50	10	20
		Rural	50	30	10	10
North :						
Rajasthan	Baran	Urban	50	50	10	20
		Rural	50	30	10	10
<b>TOTAL</b>			<b>400</b>	<b>320</b>	<b>80</b>	<b>120</b>



## Key Findings of the Study

## CHAPTER 4

This chapter presents the key findings of the survey, analyses and interprets them with the help of literature review to reach at intelligible inferences and conclusions. It focuses in great details the consumers' attitude towards illicit cigarettes, particularly how it influences their consumption behaviour, the segments that patronise different illicit cigarette brands as also what motivates retailers to stock and sell illicit cigarettes etc. Conclusions and inferences are presented at the end of each section.

### 1. Impact of Price on Illicit Consumption

Governments around the world use higher tax to curb consumption of cigarette and other tobacco products. In the past few years, cigarette price in India has gone up primarily because of increase in tax. Excise duty on cigarette has galloped in the past five years – by 22% in 2012-13, 18% in 2013-14, 22% in 2014-15, 13% in 2015-16 and 10% (by way of Additional Excise) in 2016-17.

#### 1a. Price Elasticity of Cigarettes: Effect of Taxes on Consumption

Many studies have defined the levels of elasticity of demand and at what price points or taxes a consumer will be deterred and not consume tobacco or tobacco products. However, most such studies do not take into account the availability and supply of smuggled and counterfeit cigarettes – which are cheaper since these are tax-evaded products – and their impact on consumption behaviour.

#### Key takeaways

##### Findings:

- Rise in cigarette tax tends to encourage switching to smuggled and other illicit brands of cigarettes
- Smokers in the lower price bands (Rs 6-8/stick) tend to trade down to cheap (Rs 5-8 per stick) and tax-evaded cigarettes (Rs 1 per stick)
- At higher price bands (Rs 11/stick) smokers tend to switch to popular smuggled brands (Rs 10 more more)
- The propensity to switch to smuggled brands is significantly higher than that to tax-evaded cheaper alternatives
- Perceived poor quality and potential health hazard do not deter smokers from switching to illicit cigarettes
- Young and wealthier prefer smuggled cigarette; while socio-economically poor and heavy smokers prefer tax-evaded cheap cigarettes
- Absence of graphic health warnings (GHWs) could be making illicit cigarettes more attractive
- If the distribution networks of illicit cigarettes expand the trade in illicit products is likely to grow.

##### Implications:

- Switching means a huge loss of potential volume sale of legal cigarette – at least about 20% in lower price brands and 38% in higher price brands
- Price rise has the potential to cause revenue loss to the industry and government and incentivizes illicit trade



A review of literature shows that higher taxes on cigarettes tend to induce two unintended impacts. *It induces smuggling and domestic legal markets tend to cede space to the illicit trade and it also induces consumers to switch over to the cheaper alternatives.*

Cigarettes have a particular appeal to smugglers because taxes often account for a large share of their prices, making them a highly profitable product to smuggle<sup>37</sup>. It is a worldwide phenomenon and smuggling is considered an obstacle to the use high tax as a deterrent to tobacco consumption.

A 2012 study on the effect of taxes on cigarette consumption in South Africa found that "...the level of cigarette smuggling in South Africa is, in fact, significant, constituting between 40% and 50% of the total market, and that cigarette tax hikes have to a large extent contributed to its continued existence and growth by creating a financial incentive to smuggle."<sup>38</sup>

In Canada, taxes have been shown to increase the size of black markets and to cause economic activity to move underground as price-sensitive individuals look for creative ways to evade taxation. Studies have shown that in the tobacco industry, consumers' willingness to switch from smoking legally purchased cigarettes and tobacco to contraband products increases with tax hikes<sup>39</sup>.

An econometric analysis by Jean-Francois Ouellet, Associate Professor of Marketing at HEC Montreal, and his co-authors Mariachiara Restuccia, Alexandre Tellier and Caroline Lacroix, on the consumer behaviour in Canada found that each additional dollar in taxes raises the propensity to resort to consuming contraband cigarettes by 5.1%.<sup>40</sup>

A Taiwan study says for an increase of each Taiwanese dollar (TN\$) in the price of legal cigarettes, the probability of a consumer (who previously did not smoke smuggled cigarettes) to shift to smoking smuggled cigarette increases by 26.1%.<sup>41</sup>

In India, switching over to cigarettes of smaller length or bidi, or vice versa, in response to the change in tax incidence is not an unknown phenomenon<sup>42</sup>.

'Cigarettes in India' – a 2015 report of Euromonitor International, international strategic market research body – says, *increasing taxation in India is boosting the illicit trade of domestic non-duty paid brands as well as smuggled products from Nepal, Bangladesh and China. Legal cigarette is projected to suffer a retail volume CAGR decline of 9% mainly on account of ongoing increases in excise duty.*<sup>43</sup>

In fact, a 2014 study says taxes or prices of cigarettes have no impact on its consumption in India. The study, on the consumer behaviour in Indian states published in the Indian Journal of Cancer<sup>44</sup>, said that contrary to many other studies it found that the prices of cigarettes as well as bidis didn't have any impact on their consumption. This could be due to the fact that the form of purchase (pack or loose) and the particular states in this study highly influenced the price and consumption behaviour. It also found that the smokers who had higher daily consumption bought cigarettes or bidis in packs so that they could spend less per unit.

<sup>37</sup> David Merriman et al, *How big is the worldwide cigarettes muggling problem?*  
[siteresources.worldbank.org/INTETC/Resources/375990.../365TO392.PDF](http://siteresources.worldbank.org/INTETC/Resources/375990.../365TO392.PDF)

<sup>38</sup> *Cigarettes taxes and smuggling in South Africa: Causes and Consequences*, Lemboe and Black of Bureau for Economic Research, University of Stellenbosch, <https://ideas.repec.org/p/sza/wpaper/wpapers161.html>

<sup>39</sup> *The Effect of Cigarette Tax Rates on Illicit Trade: Lessons Learned in Canada* Kutrick et al [http://reason.org/files/cigarette\\_tax\\_illicit\\_trade.pdf](http://reason.org/files/cigarette_tax_illicit_trade.pdf), 2012

<sup>40</sup> *Ibid*

<sup>41</sup> Jie-Min Lee et al, *Effect of Price and Smoking Characteristics on the Decision to Smoke Smuggled Cigarettes in Taiwan*, 2008,  
<http://www.ncbi.nlm.nih.gov/pmc/articles/PMC1564447/>

<sup>42</sup> Prakash C Gupta and Samira Asma, *Bidi Smoking and Public Health*, in collaboration with WHO and MoHFW, 2008

<sup>43</sup> *Cigarettes in India*, Euromonitor International, November 2015

<sup>44</sup> PS Pawar et al (2014) *The relation between price and daily consumption of cigarettes and bidis: Findings from the Tobacco Control Policy Evaluation* available at <http://www.indianjancancer.com/article.asp?issn=0019-509X;year=2014;volume=51;issue=5;page=83;epage=87;aulast=Pawar>





The assertion finds an echo in the 2015 FICCI CASCADE study which analysed the relations between illicit consumption and varying tax rates in several Indian states. It concluded that high tax rates tend to have the opposite effect. *That is, high taxes have not reduced consumption; rather high taxes have resulted in the legal industry losing volume of sale. Consumers either resort to smuggled and tax evaded cigarettes or counterfeits.*<sup>45</sup>

Growth of illicit market has other implications. The consumers are deceived and face serious and unforeseen health risks. Researchers have detected signs that counterfeit cigarettes have higher (and sometimes considerably higher) levels of tar, nicotine, lead cadmium and carbon monoxide causing higher health risks.

For consumers who willingly purchase counterfeit cigarettes, there is little risk (apart from the obvious potential health risks) from their purchasing decision, as they are unlikely to be apprehended and prosecuted for such purchases.

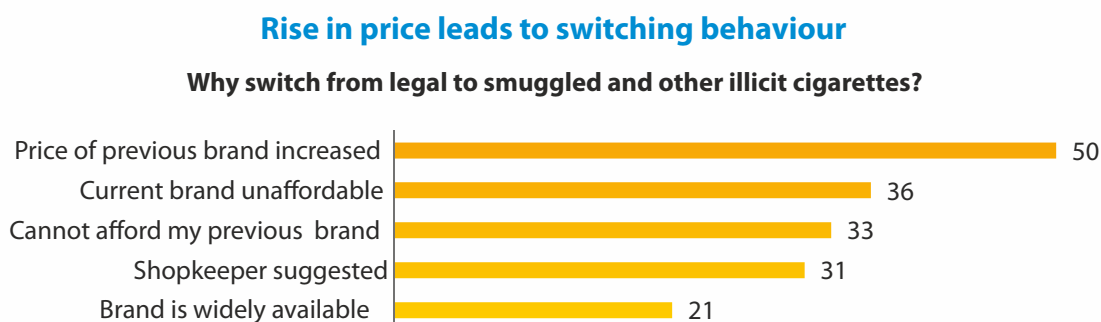
Further, the lower cost of counterfeit cigarettes is likely to encourage higher consumption, especially amongst financially disadvantaged sectors of society and the young. Cheap counterfeit tobacco products cut across the efforts of health authorities to blunt the consumption of tobacco through high taxation<sup>46</sup>.

## Survey Findings

The current survey, carried out confirms the literature review.

Price of cigarettes, mainly caused by a consistent rise in taxes, turns out to be the most significant factor influencing consumer behaviour, i.e., higher prices induce them to switch over to cheaper alternatives, including smuggled and other forms of illicit cigarettes.

The response of consumers is tabulated below:



The survey shows that

- High price drives the most (50% of respondent smokers) to switch to illicit and cheaper alternatives.
- Unaffordability, again a function of price or tax, drives the next biggest chunk (36% of respondent smokers) to move away from their own brands to illicit brands.
- Price sensitivity is very high among the smokers patronising cheap and illicit cigarette brands, compared to those who smoke expensive brands.

<sup>45</sup>Illicit Markets: A Threat to our National Interests, FICCI-CASCADE, 2015

<sup>46</sup>ibid



The *price elasticity* of cigarettes is higher for middle and low income countries like India, than the high income ones. The elasticity is more for people in rural areas with low income compared to those in urban areas with higher income. The elasticity is also more for lower priced tobacco products than higher priced ones<sup>47</sup>.

*In case of smuggled brands, the shift from legal to illegal ones is also driven by price but is more inelastic and additional factors like absence of warnings and peer choices also come into play.*

The survey also throws up similar empirical tendencies in the behaviour of consumers for hypothetical price rise, which has been plotted in the following set of graphs.

### 1. Intention to switch to cheap and tax-evaded cigarette (Rs 1 RSFT)



*Left graph:*

When the price of Rs 8/stick cigarette goes up, the consumers are willing to switch to the cheap and illicit cigarette (trade down) - which are tax evaded cigarettes. When prices go up by Rs 1, Rs 2 and Rs 3, the corresponding willingness to switch are 20%, 24% and 29%, respectively.

*Right graph:*

When the price of Rs 6/stick cigarette goes up by Rs 1, Rs 2 and Rs 3, the consumers are willing to switch to cheap and illicit cigarette are 29%, 34% and 38%, respectively.

What does this mean for the legal industry?

**That a rise in the price by Rs 1/stick in the lower band of cigarettes (Rs 6-8/stick) would lead to a loss of 20% (1//5th) to 29% (close to 1/3rd) in volume sale of legal cigarette. And as the price go up further, the loss of volume sale goes up further.**

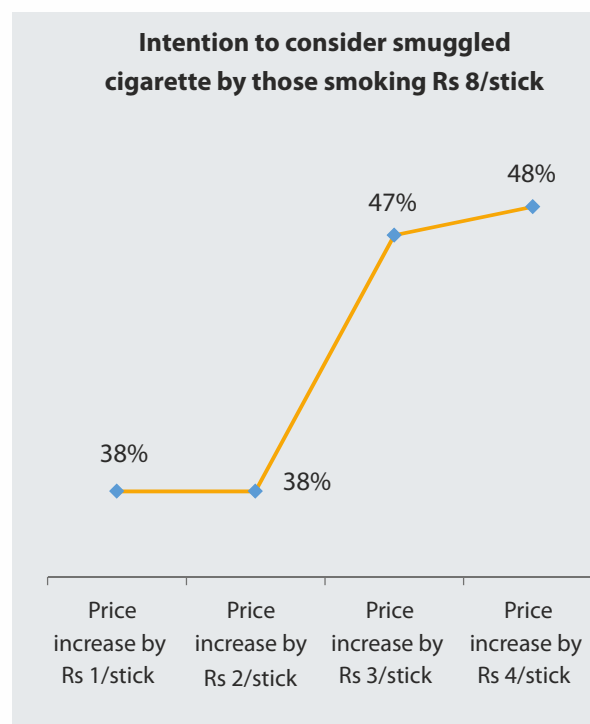
*Also, price sensitivity is far higher in case of consumers smoking Rs 6/stick cigarette, than for those smoking Rs 8/stick cigarette.*

<sup>47</sup> Prabhat Jha et al, *The Economics of Tobacco and Tobacco Taxation in India*, Paris: International Union Against Tuberculosis and Lung Disease; 2010



## 2. Intention to switch to popular (Rs 10 or more per stick) smuggled cigarette

When consumers asked about their preference for smuggled and popular cigarette brands in case of price rise, what they said have been plotted in the following set up graphs.



*Left graph:*

When the price of Rs 11/stick cigarette goes up by Rs 1, Rs 2, Rs 3 and Rs 4, the willingness of consumers to switch to smuggled cigarette goes up by 59%, 60%, 61% and 63%, respectively.

This is the extent of volume loss in the sale of legal cigarette that can be expected when the price goes up.

*Right graph:*

When the price of Rs 8/stick cigarette goes up by Rs 1, Rs 2, Rs 3 and Rs 4, the willingness of consumers to switch to smuggled cigarette goes up by 38%, 38%, 47% and 48%, respectively.

What it means for the legal industry?

*That a rise in the price by Rs 1/stick would lead to a loss of 38% to 59% in volume sale of legal cigarette to smuggled cigarettes. As the price go up further, the loss to the legal industry goes up further.*

A significant difference here is that the tendency to switch to smuggled brands in the higher price brand (Rs 11/stick) is significantly higher than the lower (Rs 8/stick).

This is contrary to the earlier case in the lower price bands (Rs 6/stick to Rs 8/stick). As was seen in the earlier set up graphs, those smoking the lower priced cigarette (Rs 6/stick) showed a higher tendency to switch.



***Taken together, the two sets of graph suggest that those who smoke relatively cheaper brands have a tendency to trade down to cheap and tax-evaded cigarettes, while those in the higher price brands tend to switch to popular smuggled brands when price rises.***

As we will see in the segments to follow, this behaviour is influenced by socio-economic and demographic profile of the smokers.

However, it may be pointed out that smugglers target not only low-income groups, but also youth. Research in the Iranian capital, Tehran, and in southern Thailand has shown that youth are more likely than older people to smoke smuggled cigarettes. Heavy smokers are another target for tobacco smugglers. Research in 16 countries has indicated that on the whole, heavier and more addicted smokers are more likely to engage in tax avoidance and evasion, while smokers who intend to quit are less likely to do so<sup>48</sup>.

To sum up, we may conclude that *smokers are willing to trade down and patronise cheap and illicit cigarettes or switch over to smuggled ones with the price of legal cigarette rises.*

This is a cause of worry as (we will find later in this chapter) 74% of smokers are willing to smoke illicit cigarettes even when they know or believe that such cigarettes could pose a bigger health hazard.

*The survey did not, however, reveal if rise in price would lead to smokers giving up smoking, an argument authorities forward to justify tax hikes. As evident in other countries, with rise in prices the consumer moves to cheaper and illegal cigarettes supplied by criminal and other vested interest groups, creating a present and clear national threat.*

### **1b. Tax arbitrage: Effect of taxes on interstate trade**

A World Bank study, 'How big is the worldwide cigarette smuggling problem?' by David Merriman, Ayda Yurekli, and Frank J. Chaloupkaby says, *"The presence of smuggling constrains the use of higher taxes as one element of a comprehensive tobacco-control policy in at least three important ways."*

*"First, smuggling reduces the maximum revenue that can be raised by cigarette taxes since, as tax rates increase, the quantity of smuggled cigarettes is also likely to increase. Second, attempts to control smuggling may absorb both private and law-enforcement resources. Third, smuggling may present opportunities for corruption that lower the legitimacy of law enforcement authorities. Estimates of the magnitude and determinants of cigarette smuggling are, therefore, important inputs to the design of tobacco-tax policy"*<sup>49</sup>.

In India, FICCI-CASCADE studied the impact of high and differential taxation policy in India on smuggling. States have been increasing VAT levies on cigarettes and other tobacco products. The study assessed the effect on consumption and tax collection in states. Time series data showed consumption has either remained static or gone up.

Bihar, Rajasthan, Tamil Nadu and West Bengal are the ones in which VAT rates have gone up most in the study period (2007-08 to 2011-12). In 2007-08, these states had the same VAT rate, that is, 12.5%. In 2009-10 Maharashtra and Rajasthan increased it to 20%. The rate increased marginally in Bihar in 2011-12 to 13.5%. In the same year it increased to 20% in Tamil Nadu, and in Rajasthan it jumped from 20% to 40%.

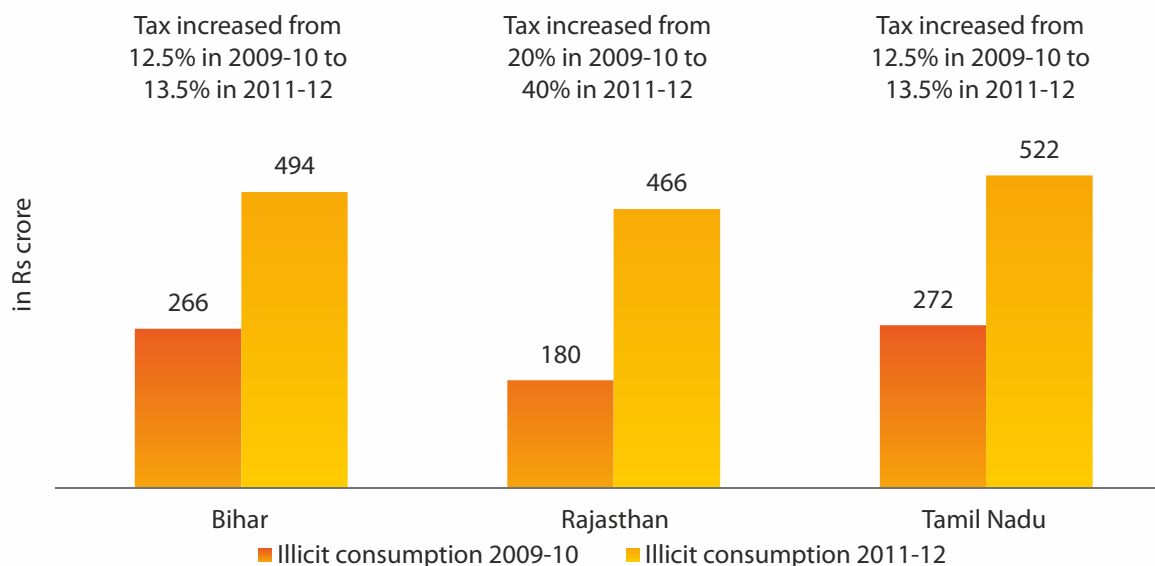
<sup>48</sup> *Illegal Trade of Tobacco Products: What You Should Know to Stop It, WHO, 2015*

<sup>49</sup> <http://siteresources.worldbank.org/INTETC/Resources/375990-1089904539172/365TO392.PDF>





### Changing Illicit Consumption & Tax Rates (excluding bids)



The impact of rise in VAT was stark.

Illicit consumption went up substantially in all states in 2011-12, in comparison to 2009-10 as the graph above shows.

*This growth was due to both smuggling and diversion from other states<sup>50</sup>.*

The data also showed that while in most states tax rates increased only marginally or remained static, consumption and tax collections increased, significantly in some cases. Rajasthan is also one of the states where consumption exceeded production. If consumption had been sourced through the legitimate market, tax collection and cigarette consumption would follow a similar pattern. This is obviously not the case with Rajasthan, where it appears that the illicit market (smuggled and counterfeit or tax evaded cigarettes imported from other states) is a significant source of supply for consumers.

It was also noticed that *high and varying tax rates resulted in inter-state tax arbitrage where one state with high taxes seemed to be losing revenue to other states with lower taxes.*

This could be reasonably illustrated in the case of Rajasthan, where VAT on cigarettes increased substantially<sup>51</sup>.

These conclusions are similar to conclusions reached globally in relation to sales in a resident state and their tax collections when taxes are increased by neighbouring states. In the USA, it is estimated that a 10 % increase in taxes in neighbouring states, increased sales in the consuming state by .8%.

While the current survey did not go into the issue, it could be reasonably be argued that something similar could be happening.

<sup>50</sup> Ibid

<sup>51</sup> <http://siteresources.worldbank.org/INTETC/Resources/375990-1089904539172/365TO392.PDF>



## 2 Illicit Cigarettes and Socio-economic and Demographic Implications

Who are more vulnerable to smuggled and other illicit cigarettes that price (tax) rise seem to trigger?

According to WHO<sup>52</sup>, illicit trade makes tobacco products more affordable and accessible to people from low income groups, as well as children. Illicit tobacco products are typically sold at lower prices, thereby increasing consumption among the youth and increases health inequalities within the society.

Contraband cigarettes generally avoid other restrictions and health regulations, such as requirements for health-warning labels (GHWs) in the local language, regulations on additives, and others. The potential profits associated with large-scale cigarette smuggling create incentives for organized crime networks to develop as a relatively low-risk source of revenues for these networks.

Various studies have shown that that socio-economic profile reflecting income levels of consumers determines their smoking behaviour. The behaviour is different in urban and rural areas in India. Study of expenditure elasticity estimates show that costlier cigarettes are “luxury” goods in the economic sense in both rural and urban India, whereas bidis and leaf tobacco are not. The estimates suggest that a 10% increase in rural household expenditure would lead to a 23.7% increase in cigarette consumption. This underscores affordability: income increases in a rapidly growing economy carry the risk of more than proportionate increases in cigarette consumption<sup>53</sup>.

The survey throws up a distinct pattern. The findings are tabulated in the graph below.

### Low income groups and heavy smokers prefer tax-evaded brands

	Profile of smokers	Legal cig. smokers (%)	Cheap (Rs 5-8/stick) illicit cig. smokers (%)	Popular (Rs 10/stick or more) smuggled cig. smokers (%)
Demographics	Average Age in Years	29.9	34.8	29.4
	Socio Economic Class: C,D,E	25	54	74
Smokergraphics	Average Daily Smoking (sticks)	5.8	7.1	4.2
	No. of Years of Smoking	4.6	6.1	4.6

The graphs show while the average age of those smoking cheap illicit cigarette is 34.8 years that of those who smoke smuggled cigarette is 29.4 years. Those patronising cheap illicit brands have been smoking for 6.1 years and those smuggled popular brands for 4.6 years.

Further, the average daily consumption is 7.1 sticks for the illicit cheap cigarette smokers, while that for popular smuggled cigarette is 4.2.

<sup>52</sup> *Illegal Trade of Tobacco Products: What You Should Know to Stop It*, WHO, 2015

<sup>53</sup> Prabhat Jha et al, 2010, *The Economics of Tobacco and Tobacco Taxation in India*, Paris: International Union Against Tuberculosis and Lung Disease



The views of retailers also confirm the profile of smokers consuming smuggled brands as presented in the graph below.

### Low income groups and heavy smokers prefer tax-evaded brands

Profile of consumers	Cheap smuggled cigarettes (Rs 5-8/stick)	Popular smuggled cigarettes (Rs 10/stick or more)
Young consumers	59	64
Consumers with less money	63	66
Those who are newly initiated	25	27

More than 50% retailers in the survey sample said those smoked smuggled cigarettes were young while 25% or more thought they were first timers ('newly smoking').

Thus the main findings could be summarised as follows:

*Those smoking cheap and illicit cigarettes are found to be older in age, belong to the poorer socio-economic strata (Class C, D and E) and have been smoking for a long time.*

*On the other hand, those who smoke rather popular smuggled brands of cigarettes are younger, many of them being the first time smokers, belong to a higher income group (Class A) and consumer less number of cigarettes.<sup>54</sup>*

## 3. Impact of Quality on Illicit Cigarette Trade

We know price rise drives consumers towards either cheaper tax evaded cigarettes or smuggled and popular ones. Do factors like quality of products or potential health hazard play any role in consumer behaviour?

A 2012 study on the effect of taxes on cigarette consumption in South Africa found that there is much evidence "indicating that illegal cigarettes are of inferior quality which, combined with the tax induced shift to smuggled cigarettes, suggests that cigarette tax hikes could have the perverse effect of raising rather than lowering the overall negative externality."

The survey supports such assertion too. The response of consumers to quality and other aspects have been tabulated below.

### Low income groups and heavy smokers prefer tax-evaded brands

Brand Imagery (in %)	Legal cigarette	Illicit cigarette
Poor Quality	14	75
Strong Cigarette	17	72
Impact of health is worse	15	74
Price is Just Right	15	74

<sup>54</sup>Cigarettes taxes and smuggling in South Africa: Causes and Consequences, Lemboe and Black of Bureau for Economic Research, University of Stellenbosch, <https://ideas.repec.org/p/sza/wpaper/wpapers161.html>



The survey shows that illicit cigarettes are considered *poor in quality and have health consequences worse than the legal cigarettes*.

In fact, 75% of all smokers believe that illicit cigarettes are poorer in quality and 74% believe such cigarettes impact their health far worse than the legal cigarettes.

*Yet, 74% said they believed that it is the cheaper price of illicit brands ('the price is right') which drives consumers to smoke them.*

It can be concluded that *youngsters and first time smokers are more likely to try illicit cigarettes because of rise in price (tax) in spite of their own understanding and perception that such products posed a higher risks to their health and productivity.*

## 4. Impact of Graphic Health Warnings (GHW) on Illicit Consumption

Another factor driving consumers towards tax-evaded locally manufactured and smuggled cigarettes could be the absence of huge graphic warnings on such products.

Worldwide studies have established that graphic health warnings (GHWs) on cigarette packets act as a deterrent. The International Tobacco Control Policy Evaluation Project (ITCP) is an international cohort study that consists of surveys of adult smokers in nineteen countries and focuses on tobacco control policy evaluation.

According to the research on tobacco warning labels, adult and youth smokers report that large, comprehensive warning labels reduce smoking consumption, increase motivation to quit and increase the likelihood that they will remain abstinent following a quit attempt<sup>55</sup>.

Evidence from international body of literature further shows that pictorial cigarette pack warnings may be more effective than text-only warnings. That is because relative to text-only warnings, pictorial warnings attracted and held attention better; garnered stronger cognitive and emotional reactions; elicited more negative pack attitudes and negative smoking attitudes and more effectively increased intentions to not start smoking and to quit smoking<sup>56</sup>.

*Therefore, it may be assumed that absence of GHWs on smuggled cigarette brands may have the opposite effect on youth.*

The present survey, as presented below, reinforces that assumption since a sizeable proportion (31% to 46%) of those who smoke smuggled brands find them *'more attractive'* than the leading legal brands. Considering that most smokers were regular smokers of legal brands, the fact that a significant proportion of them (56% to 73%) said they *'prefer to carry'* packs of illicit brands can be explained by the *absence of such GHWs*.

<sup>55</sup>Tobacco Warning Labels: Evidence of Effectiveness, Campaign for Tobacco-Free Kids available at <https://www.tobaccofreekids.org/research/factsheets/pdf/0325.pdf>

<sup>56</sup> Seth M Noar et al (2015), Pictorial cigarette pack warnings: a meta-analysis of experimental studies University of North Carolina at Chapel Hill, US, available at <http://tobaccocontrol.bmj.com/content/early/2015/05/03/tobaccocontrol-2014-051978.full>





### Attractiveness of smuggled and other illicit brands is significant

Pack Attractiveness – Among those aware of illicit brand	Popular smuggled brands (Rs 10/stick or more)	Cheap smuggled brands (Rs 5-8/stick)
Illicit brands looks more attractive	31	46
Lead brands in the market looks more attractive	66	51
No difference on pack attractiveness	3	3

### Acceptance level for smuggled and other illicit cigarettes is significant

Pack carrying Preference- Among those aware of brand	Popular smuggled brands (Rs 10/stick or more)	Cheap smuggled brands (Rs 5-8/stick)
Prefer to carry illicit brand packs	24	42
Prefer to carry lead brands in the market	73	56
No preference	3	3

While the survey did not specifically probe the reason for a good deal of attractiveness and acceptance of smuggled and other illicit brands, a few surmises can be made.

A relatively higher acceptance level of cheap smuggled brands, as against popular smuggled brands, may point to attractive pack design at a very low price, adding value to the pack.

*Absence of GHWs may also be the cause of such attractiveness and acceptance since illicit products do not adhere to the government of India mandated textual and graphic warnings.*

If that is indeed the case, then absence of textual and graphic warnings could be helping consumption of illicit cigarettes *at the cost of those who adhere to and comply with the legal requirement of carrying such warning on their products.*

There are other risks too. Smuggled products and counterfeits are marketed under well-known brand names, the consumers may associate poor quality with the original brand hampering the image and reputation of genuine brands and lost revenue if the consumer switches brands. It may also lead to the closure or consolidation of manufacturing facilities, leading to job losses and downstream effects on local economies and government revenue<sup>57</sup>.

*It is thus, a double whammy for the legal industry, which not only loses business but also is at the risk of damage to reputation and worse.*

Worldwide, different countries use health warnings differently, in size and in nature – textual or graphic. Here is how the leading tobacco producing countries in the world, which together produce 90% of global output, do it<sup>58</sup>:

<sup>57</sup> *The Economic Impact of Counterfeiting and Piracy, OECD, 2008, as cited in Socio-economic Impact of Counterfeiting, Smuggling and Tax Evasion in Seven Key Indian Sectors, FICCI-CASCADE, 2012*

<sup>58</sup> *TTI's presentation to Parliamentary committee on sub-ordinate legislations on tobacco, 2016*



### Types of warnings

Country	Warning Type	Size (%)
China	Text	30 (front and back)
India	Graphic	40 (front)*
Brazil	Graphic	50 (0% front, 100% back)
USA	Text	only on side panel
Malawi	No warning	0
Zimbabwe	Text	20 front and back

\*At the time of survey. From April 1, 2016, GHWs should cover 85% of the surface area on both sides of pack

Further, US, China and Japan, who together produce 51% of tobacco use textual health warning, not graphic or pictorial health warnings (GHWs).

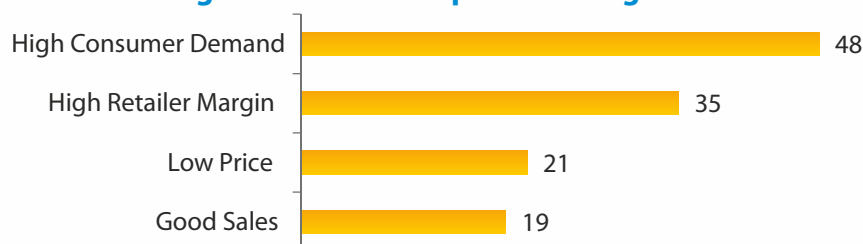
In India, the Ministry of Health and Family Welfare has increased the size of graphic warning to 85% of the surface area on both sides from April 1, 2016. The stakeholders have strong reservations to this increase. A Parliamentary committee even suggested that the warning to be restricted to 50% of the display area<sup>59</sup>.

*If at 40% of graphic warning on legal cigarettes, the smuggled cigarettes seemed more attractive to the consumers, as the survey finds, 85% of graphic warning is likely to provide further incentive for smuggled cigarettes.*

## 5. The supply side view on illicit trade

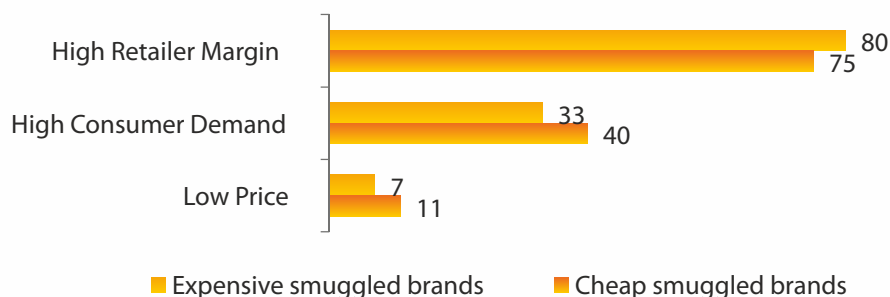
The empirical evidence on consumption behaviour thrown up by the survey is reflected in the behaviour of retailers also. Profit emerged as one of the primary driver of their business, as is the case with any other. When asked what makes them store and trade in illicit cigarettes, the retailers listed their reasons as presented in the following graphs.

### Reason for stocking tax evaded cheap brands: High Demand & Profit



<sup>59</sup> Parliamentary Committee on Sub-ordinate Legislations, 2016: The Cigarette and Other Tobacco Products (Packaging and Labelling) Amendment Rules, 2014, 2016





What the survey shows is that for illicit cheap brands, high consumer demand and handsome margins make it very attractive for retailers to stock these brands. 35% retailers said during the survey that they were motivated to stock and sell illicit brands of cigarettes because the profit margin was higher than the regular brands. The illicit cigarettes being tax-evaded and hence cheaper, also has a higher volume of sale.

In case of smuggled brands, more than 75% of the retailers listed high profit margin as the main motivating factor for them to store and sell illicit brands.

High consumer demand played an equally important role. While 48% said demand was the main force for illicit cheap brands, more than 33% listed it as a driving for smuggled brands.

The survey also showed while retailers believed all illicit cheap brands were locally manufactured, 80% thought smuggled brands were manufactured outside India and smuggled in from various countries. When asked what they think about the origin of such cigarettes, what they said has been tabulated below.

### Source of smuggled brands

Country of origin	% of retailers	Explanation
Paris (France)*	26	Very likely due to the 'Paris' brand
Indonesia	20	Mentioned high in Warangal and Ludhiana
China	16	Mentioned high in Guwahati
Bangladesh	8	Mentioned mostly in Kolkata

\*In the survey, retailers 'perceive' that Paris brand of cigarettes originate from Paris (France)

*What the survey implies is that there is a clear motive for a vast majority of retailers to stock and sell illicit cigarettes, which is a higher profit margin.*

*It would also indicate that the rise in the price of legal cigarettes will only make the retailers to stock and push the sale of illicit brands of cigarettes more.*

*Rise in the price of legal cigarette would thus be a loss making proposition for the legal industry.*

*Consumer attractiveness/demand is likely to increase for packs which do not carry any warning, giving an impression that those packs may be safer.*



## 6. Enforcement and Illicit Cigarette Trade

Studies show that high taxation is not the only driver of illicit trade in cigarettes. Illicit trade also result from lack of control on cigarette manufacturing and the movement of cigarettes and other tobacco products across international borders to facilitate illicit trade. Also, it is run by criminal organisations with sophisticated systems for distributing smuggled tobacco products. Illicit trade is more common in low-income countries than high<sup>60</sup>.

International experiences also show that wherever enforcement mechanism is good, particularly in developed countries, it has led to cut down in illicit trade.

A significantly lower counterfeiting level was noticeable in countries and territories where distribution is controlled, and consumers can only buy cigarettes in regulated outlets. The reason for this might be that in case of strict regulation, consumers know that the cigarettes they buy in places other than authorised stores are likely to be illicit<sup>61</sup>.

Availability of distribution network is, thus, key to the illicit trade.

The survey shows a significantly high number of retailers are motivated by high profit margin and willing to stock and sell illicit cigarette if distribution and availability improves.

*That is, if distribution improves the availability will improve and the legal industry will yield volume to illicit trade.*

*What this would suggest is that a balanced tax regime and a balanced regulatory framework as well as tight vigil at the international borders are needed to stop smuggling of illicit cigarettes. It would also entail the tobacco industry to tighten their distribution network and maintain a constant vigil to ensure that their legal business is not affected by the illicit trade.*

<sup>60</sup>Joossens L, Merriman D, Ross H, Raw M. The impact of eliminating the global illicit cigarette trade on health revenue. *Addiction* 2010; 105:1640–95.

<sup>61</sup>Socio-economic Impact of Counterfeiting, Smuggling and Tax Evasion in Seven Key Indian Industry Sectors, TARI-FICCI-CASCADE, 2012





# Conclusions of the Study

## CHAPTER 5

The survey and literature review presented in the preceding chapters provide a clear picture about the state and pattern of consumption and trade in illicit cigarettes. Those could be summarised as follows:

- Illicit cigarette – tax-evaded, smuggled and counterfeit products – are typically sold at lower prices, thereby increasing consumption. The illicit trade, thus, undermines tax policies, facilitates consumption and causes revenue loss to the government and the legal industry.
- High and discriminatory taxes on cigarette in India are the primary drivers of illicit trade. High taxes make cigarettes unaffordable to a large segment and pushes business to the underground, thereby helping illicit trade to grow.
- A high price elasticity of cigarette shows that more the price of cigarettes rise due to higher taxes, more people switch over to cheaper alternatives like tax-evaded locally manufactured cigarettes and the smuggled ones, rather than stop smoking. This is contrary to the reason advocated by the authorities to justify higher tax on cigarette.
- Illicit trade also means a huge loss of business to the legal industry, as switching to cheaper alternatives mean a huge loss of volume sale to the legal industry and an incentive for illicit trade. As illicit trade grows, loss to the legal industry increases.
- An increase in price by Rs 1 per stick of cigarette is found to adversely affect about a minimum of 20% in volume sale to tax-evaded locally manufactured cigarettes in the case of lower price bands and about 38% loss in volume sale to smuggled cigarettes in case of smokers in the higher price bands. With every rupee rise in price, the loss of volume sale goes up further.
- Illicit trade means less revenue for governments, which means the government has less to spend on governance and socio-economic development, especially in a low-income country like India which largely depend on consumption taxes. It siphons tax revenues away from governments, limiting its ability to spend on public service.
- Smokers from poor socio-economic backgrounds and heavy smokers tend to trade down to tax-evaded cheaper cigarettes when price rises.
- Young, new smokers and those in the higher income group tend to switch to popular smuggled cigarettes when prices go up.
- In absence of graphic health warnings (GHWs) on illicit cigarettes – as these are not subjected to the legal restrictions and compliances – such cigarettes appear attractive to a significant segment of smokers, especially the new and young ones even when they are aware of the risks to their health and productivity.
- It is the poor, new smokers and youngsters who are chiefly attracted to illicit cigarettes on account of affordability (right price). This has adverse impact on health and productivity of the individuals and the nation as a whole.



- High profitability and high demand drive retailers to stock illicit cigarettes.
- It is the supply constraints that seem to be preventing retailers to stock and sale more smuggled and other illicit brands.
- The current policy is cigarette-centric while its consumption constitutes only 11% the total tobacco consumption in terms of volume. Illicit cigarettes account for another 4% and the rest, 85% of tobacco consumption, is accounted by non-cigarette tobacco products – chewing tobacco, bidi, khaini, cheroot, hookah tobacco etc.
- In terms of tax revenue, legal cigarettes contribute the bulk, 87% of the total excise revenue, while the non-tobacco products contribute only 13% to revenue. A study shows that 68% of all tobacco consumption escapes taxation because they are manufactured in the unorganised sector with little statutory oversight<sup>62</sup>.
- Illicit cigarette trade helps organised criminal gangs and terror organisations to fund their activities. Such activities include drugs, human and arms trafficking, armed insurgencies and terror attacks.

## Recommendations

It is imperative that the illicit trade in cigarette is eliminated through various mechanisms, both at policy and implementation levels. Some of the salient measures that should be taken, and which follow from the findings of the survey and literature review, are the following:

- High tax being the main driver of illicit trade in cigarette, there should be a balanced tax policy. There should be no further increase in excise on cigarettes, which will enable the industry to recover and lead to optimisation of revenue for both the government and industry. Going forward, a balanced tax policy will be more appropriate for both.
- Once the legal industry recovers from the onslaught of illicit trade, specific duty rate increase could be indexed to inflation.
- All tobacco products under the GST regime should be taxed at a standard rate plus central excise duty, keeping it revenue neutral at current rate.
- The existing multi length-based specified excise duty structure should be continued to enable the industry to offer products to various socio-economic segments of the society.
- The legal industry should be allowed to serve the segment patronising cheap and illicit cigarettes. Lower slab of cigarettes at less than 60 mm should be considered to let the legal industry compete with illicit cigarettes.
- The focus of the policy should be on tobacco and all tobacco products, rather than just cigarettes. Cigarettes constitute only 11% of the total tobacco consumption in terms of volume but contribute 87% of the total excise revenue, while the non-cigarette tobacco products which constitute 85% of consumption in volume (illicit cigarettes constituting the rest 4% of consumption in volume) contribute only 13% to revenue. A bulk of tobacco products (68% of all tobacco consumption,

<sup>62</sup> Report on the impact of current tax framework on the tobacco sector in India and suggestions for its improvements, 2014, ASSOCHAM and KPMG



according to a study<sup>63</sup>) goes untaxed because of being manufactured in the unorganised sector with little statutory oversight.

- Consumer awareness programmes should specifically target the new and young smokers who are attracted towards illicit cigarettes because of cheaper price and attractive packaging in absence of graphic health warnings (GHWs).
- The current regulation mandates cigarette packets to carry pictorial or graphic health warnings (GHWs) on 85% of the surface area on both sides. Given the fact that a Parliamentary committee has suggested restricting such warnings to only 50% of the surface area, the government must review its policy of 85% pictorial warnings.
- Enforcement mechanisms need to be tightened to curb manufacturing of illicit cigarettes and smuggling. The industry also needs to improve its vigil mechanism.
- India needs to create its own policies and regulations to eliminate illicit trade in cigarettes taking into consideration its unique situation, rather than following the western models.

Such measures will go a long way in curbing the illicit consumption and trade in cigarettes in India.

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<sup>63</sup> Report on the impact of current tax framework on the tobacco sector in India and suggestions for its improvements, 2014, ASSOCHAM and KPMG







## About FICCI

Established in 1927, FICCI is the largest and oldest apex business organisation in India. Its history is closely interwoven with India's struggle for independence, its industrialization, and its emergence as one of the most rapidly growing global economies. FICCI has contributed to this historical process by encouraging debate, articulating the private sector's views and influencing policy. A non-government, not-for-profit organisation, FICCI is the voice of India's business and industry.

Federation of Indian Chambers of Commerce and Industry  
[www.ficci.com](http://www.ficci.com)



## About FICCI CASCADE

In the recent past India's economic growth story has attracted world's attention bringing new challenges for the domestic economy. One of the challenges currently faced is the growing illicit trade in counterfeits, pass offs and smuggled goods. These activities are also threatening brands not only in every region of the country but across the globe.

Contraband and counterfeit products hurt the integrity of the brand, further diluting the brand owner's reputation. This not only results in erosion of sales of the legitimate product but further [CASCADE]s onto affect the consumers in the form of health and safety hazards. With the above insight the Federation of Indian Chambers of Commerce and Industry (FICCI) took the initiative to dedicate a forum by establishing the Committee Against Smuggling and Counterfeiting Activities Destroying the Economy - CASCADE on 18th January, 2011.

FICCI Committee Against Smuggling and Counterfeiting Activities Destroying Economy  
(CASCADE)

[www.ficcicascade.com](http://www.ficcicascade.com)

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