
POLICY NOTE: TOWARD A MORE BALANCED AND CERTAIN TOBACCO EXCISE POLICY

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Tobacco Excise (*Cukai Hasil Tembakau/CHT*) policies in Indonesia are, in general, far from stable. Admittedly, CHT policies frequently result in polemics and are dilemmatic. The consideration always involves four objectives, namely controlling the consumption of tobacco products, optimizing state revenues, maintaining the competitiveness of the tobacco products industry, and protecting the welfare of the workforce. Moreover, the directions of all the policy objectives are not necessarily in line with one another.

DDTC Fiscal Research has compiled an analysis pertaining to the most crucial policies for the national tobacco product industry (*Industri Hasil Tembakau/IHT*) in a Policy Note entitled “Balanced and Certain Tobacco Excise Policies”. Hopefully, this document serves as the **materials to be considered by the government to formulate balanced, stable, and certain CHT policies based on empirical studies that are supplemented with on-field facts.**

A. Background

The main regulation on CHT in Indonesia is Law No. 39/2007 on Excise (the 2007 Excise Law), in which the tariff is further regulated through Minister of Finance Regulations (MoF Reg.) subject to yearly updates. At present, CHT is regulated under MoF Reg. 146/2017 *juncto* MoF Reg. No. 156/2018 *juncto* MoF Reg. 152/2019 concerning CHT Rates. Upon further examination, the annually amended legal provisions do not only regulate CHT rates.

MoF Reg. 146/2017 along with its amendments regulate several other aspects that impact on IHT business actors, i.e. in the form of classification of layers in the CHT system, Banderole Price (*Harga Jual Eceran/HJE*), and a monitoring system for real prices prevailing in the field or known also as Market Transaction Prices (*Harga Transaksi Pasar/HTP*). Based on reviews conducted

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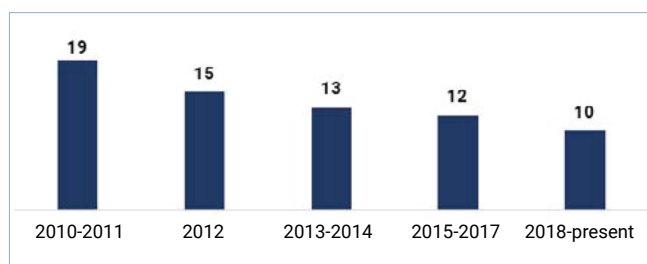
by DDTC Fiscal Research, there are at least three fundamental issues are related to CHT policies under the current regulations.

The first fundamental problem relates to the highly complex tariff structure of tobacco products. This is confirmed in the empirical findings of a study by the World Bank which states that the CHT tariff strata system in Indonesia is among the most complicated in the world, namely a multi-layer system based on tobacco products, the amount of production, and HJE per unit.¹

Whereas in fact, such a complex CHT tariff classification scheme is now abandoned and not commonly applied in various countries.² This is because a simpler CHT tariff structure facilitates the monitoring function and reduces administrative costs. In addition, a non-complex CHT tariff structure is considered to be more in line with the cigarette consumption control function.³

Referring to MoF Reg. 152/2019, Indonesia imposes 10 strata of tariffs on cigarettes. The development of the **number of CHT tariff strata** in Indonesia based on this complex multilayer system is indicated in Figure 1. Furthermore, the tariff structure can be seen in Table 1.

Figure 1 Development of Indonesian CHT Tariff Strata from by Year⁴



Source: Regulation on CHT tariffs in the form of Minister of Finance Regulations (MoF Reg)

On the other hand, the government has, in fact, attempted to address the potential problem through MoF Reg. 146/2017 which presents a roadmap for the gradual simplification of CHT tariff strata to reach 5 cigarette layers in the Machine-made Clove Cigarettes (*Sigaret*

Table 1 Current CHT Tariff Strata Classification System for Cigarette Products in Indonesia

Tier of Tobacco Product Manufacturers		Layer Code	Threshold of HJE (per cigarette/gram)	Excise Tariff (per cigarette/gram)
Type	Tier (based on production threshold)			
SKM	1	1A	\geq Rp1,700	Rp740
	2	2A	$>$ Rp1,275	Rp470
		2B	Rp1,020 \leq HJE \leq Rp.1,275	Rp455
SPM	1	1	\geq Rp1,790	Rp790
	2	2A	$>$ Rp1,485	Rp485
		2B	Rp1,015 \leq HJE \leq Rp.1,485	Rp470
SKT/SPT	1	1A	$>$ Rp1,460	Rp425
		1B	Rp1,015 \leq HJE \leq Rp.1,460	Rp330
	2	2	$>$ Rp535	Rp200
	3	3	$>$ Rp450	Rp110

Source: MoF Reg. 152/2019

Kretek Mesin/SKM), Machine-made White Cigarettes (*Sigaret Putih Mesin/SPM*), Handmade Clove Cigarette (*Sigaret Kretek Tangan/SKT*) categories in 2021. Under these regulations, excise tariff strata are simplified to achieve three main objectives, namely optimizing CHT revenue, increasing compliance of tobacco product manufacturers or importers, and simplifying the administration system in the excise field. This simplification, however, has been canceled following the issuance of MoF Reg. 156/2018.

The second fundamental problem relates to adjustments to unstable CHT and HJE tariffs, both among tiers and types of tobacco products. As is known, on average, the government increased CHT tariff by 10.9% from 2010 to 2018. However, it did not increase in 2019 as stipulated under MoF Reg. 156/2018. Conversely, there was a significant surge in tariffs in 2020, by 23% for CHT and 35% for HJE following the issuance of MoF Reg. 152/2019.

In short, it can be said that the stipulation of CHT and HJE tariffs does not have a consistent pattern. In the context of CHT, the government stipulation may greatly affect the productivity of market players as outlined in the Laffer Curve concept.⁵ Laffer explains that the policy

1 Rong Zheng et al, *Cigarette Affordability in Indonesia: 2002 – 2017* (Washington DC: World Bank Group, 2018), 28.

2 U.S. National Cancer Institute and World Health Organization, *The Economics of Tobacco and Tobacco Control. National Cancer Institute Tobacco Control Monograph 21* (Geneva: World Health Organization, 2016), 171 – 172.

3 See: Frank J Chaloupka, Ayda Yurekli, and Geoffrey T. Fong, "Tobacco Taxes as A Tobacco Control Strategy," *Tobacco Control* Vol. 21 (2012); Caryn Bredenkamp, Roberto Magno Iglesias, and Kai-Alexander Kaiser, "Ten Principles of Effective Tobacco Tax Policy," *Knowledge Brief* (World Bank Group: July, 2015).

4 CHT tariff strata here refers to three major conventional tobacco products: Machine-made Clove Cigarettes (*Sigaret Kretek Mesin/SKM*), Machine-made White Cigarettes (*Sigaret Putih Mesin/SPM*), and Handmade Clove Cigarette (*Sigaret Kretek Tangan/SKT*).

5 See: A. B. Laffer, *Handbook of Tobacco Taxation: Theory and Practice*

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to increase cigarette excise may be counter-productive when CHT tariffs are too high. Such a policy may result in some disincentives, i.e. business people's decision not to produce or innovate, thus leading to non-optimal state CHT revenues, whereas excise revenue in Indonesia remains dominated by CHT contributions.

Moreover, the inconsistency of the policy of tariff increase is rather distortive to the purpose of stipulating HJE, for example in the context of influencing the behavior of illegal cigarette distribution. This is mainly due to the fact that if the HJE tariff increase is too high, consumers opt to consume illegal products at lower prices given that HJE is the price that heavily influences consumers' decision to spend their money.

Finally, the third fundamental problem relates to the aspect of control on tobacco product consumption.

One aspect to be taken into account in the CHT regulation is market conditions in which the prices of tobacco products circulating in the market (*Harga Transaksi Pasar/HTP*) do not match the prices listed on banderoles on the packaging (*Harga Jual Eceran/HJE*). Consequently, this leads to predatory pricing and price war among manufacturers. The function of excise as the cigarette consumption controller, thus, becomes difficult to implement.

Problems arising on the field were not regulated in any CHT-related policy. In response, to carry out more optimal oversight functions, the government finally issued MoF Reg. 146/2017 which set a minimum threshold of 85% on the ratio of HTP to HJE.

The derivative regulation that also takes the form of a monitoring scheme related to this matter, however, stipulates a more loose application of the HTP/HJE ratio to less than 85% insofar as the cigarettes are sold in less than 50% of the monitored area. The derivative regulation takes the form of the Director General of Customs and Excise Regulation, namely PER-Dirjen BC Number PER-37/BC/2017 *juncto* PER-12/BC/2018 *juncto* PER-25/BC/2018.

As an illustration, under MoF Reg. 146/2017, cigarettes with an HJE of IDR 10,000/pack may only be sold at above Rp8,500. The provisions under PER-37/BC/2017, however, allow sales at less than Rp8,500 provided that the sale is not made in more than 40 customs survey locations.⁶ Ultimately, the Directorate General of Customs and Excise (DGCE) tasked with monitoring the survey areas in the form of 80 customs offices is able to stipulate a 'reduction in the market price of cigarettes' at a maximum of 40 survey locations in the controlled area.

This derivative regulation of MoF Reg. 146/2017 has indirectly compensated for the discrepancy between HJE and HTP practices that may undermine the legitimacy of the HJE function. In the end, the function of HJE as the key instrument that determines purchasing power in the context of controlling the tobacco product consumption cannot be implemented optimally.

As an illustration, there are only 37 locations for controlled regional customs and excise offices throughout Java, namely the Customs and Excise Primary Service Office (*Kantor Pelayanan Utama Bea dan Cukai/KPUBC*) and Customs and Excise Control and Service Office (*Kantor Pengawasan dan Pelayanan Bea dan Cukai/KPPBC*), including the office of KPPBC in the airports and ports that do not conduct HTP and HJE control surveys.⁷

The illustration also indicates potential ineffectiveness of regulations based on the minimum HTP ratio by 85% of HJE. Even though cigarettes on the island of Java (with a large population concentration) are sold at less than 85% of HJE, the provisions regulated under PER-37/BC/2017 remain unviolated.

In retrospect, MoF Reg. 146/2017 has, in fact, accommodated all solutions to the three potential problems above. However, in its development, the amendments and derivative regulations of MoF Reg. 146/2017 actually result in discrepancies with the objectives of the most comprehensive CHT policies. This development subsequently leads to several 'loopholes' of the current provisions, especially in the context of providing certainty for business players and promoting balanced market competition for national IHT.

B. Implications of the Current CHT Policies

Based on the outlined fundamental issues, DDTC Fiscal Research analyzes the current CHT provisions. Broadly speaking, three aspects are affected, namely state revenues, industrial dynamics, and consumption control.

B.1 Impact on State Revenues

The untargeted policies on CHT through the issuance of MoF Reg. 156/2018 which revokes the simplification and the excessive increase in CHT and HJE tariffs under MoF Reg. 152/2019 may result in sub-optimal state revenues. This is mainly caused by the increasingly conducive business climate of IHT in Indonesia. Conceptually, this

(San Fransisco: 2014).

6 Survey location in this Policy Note refers to the customs office in which the survey is conducted or the location where the implementation of the minimum HTP and HJE ratio is supervised.

7 The survey location data is sourced from MoF Reg. 188/2016 on the Organization and Work Procedures of the Vertical Agencies of the Directorate General of Customs and Excise. The types of office unit taken into account are Prime Customs and Excise Office (*Kantor Pelayanan Utama/KPU*) (type A, type B, type C) and Customs and Excise Secondary Control and Service Office (type A, type B, type C), referring to the definition of Offices as the monitoring location of Market Transaction Prices as regulated under MoF Reg. 146/2017.

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Table 2 Calculation of Potential 2020 CHT Revenues

No.	Variable	Source/Calculation	Value
(1)	Excise per Pack of Cigarettes	Ministry of Finance	12,005
(2)	HJE per Pack of Cigarettes	Ministry of Finance	28,548
(3)	Percentage of HJE Increase (%)	Ministry of Finance	35%
(4)	Consumption per Month (Pack of Cigarettes)	DDTC Fiscal Research's Calculation	14.32
(5)	Number of smokers (Million individuals)	DDTC Fiscal Research's Calculation	70.57
(6)	Cigarette Excise Revenues per Individual per Month (Rp)	(1) x (4)	171,913
(7)	Cigarette Excise Revenues per Individual per Year (Rp)	(12) x (6)	2,062,956
(8)	Total CHT Revenues per Year WITHOUT extra effort (Trillion Rp)	(5) x (7)	145.58
Extra Effort			
(9)	Assumed Percentage of Illegal Cigarette Circulation (%)	-	1
(10)	Decrease in Illegal Cigarette Circulation (Billion cigarettes) ⁹	1% x 332	3.32
(11)	Additional Revenues from extra effort (Trillion Rp)	DDTC Fiscal Research's Calculation	17.99
(12)	Total CHT Revenues per Year WITH extra effort (Trillion Rp)	(8) + (11)	163.58

Source: SUSENAS-BPS and Ministry of Finance (processed by DDTC Fiscal Research, 2020)

type of policy may distort business decisions, thus, may undermine state revenues.⁸

On another note, the increase in CHT tariffs by 15% in 2016 has actually resulted in CHT revenues not reaching the target along with the decline in industrial production volume by 1.8%. DDTC Fiscal Research subsequently conducted a simulation taking into account the variables that would impact on the condition of IHT in Indonesia.

Based on the results of the simulations, **the magnitude of the increase in CHT tariffs per year that may maintain a balance between CHT revenues, control the consumption of tobacco products, and IHT conductivity is in the range of moderate increases on a simple average.** Further, based on this simulation also, the tariff scenario within such a range may reduce the prevalence of smokers more significantly compared to the excessive increase in CHT and HJE tariffs.

The model used in this estimation adopts the 2SLS (Two-Stage Least Squared) model, also known as the double-hurdle model.¹⁰ The elasticity based on the 2SLS model is calculated to obtain the elasticity of the prevalence and

intensity of smoking.¹¹ This elasticity value is crucial as its magnitude can determine the accuracy of the estimation of state revenues and other quantitative impacts caused by CHT policy changes.¹² One example is the effect of switching similar products with lower CHT rates.

The government has targeted excise revenues from tobacco products which were last adjusted to Rp164.95 trillion as outlined in Presidential Regulation No. 72/2020. Furthermore, **the government has raised tariffs excessively, 23% for CHT and 35% for HJE.** In fact, the increase in the tariffs of the two components determining the price of cigarettes that were stipulated within a matter of months before the implementation may not necessarily guarantee the optimal realization of state revenues.

Considering the achievement of targets and the conditions and provisions related to the current CHT and HJE, DDTC Fiscal Research subsequently performed calculations on potential 2020 CHT revenues. First, for scenarios without extra effort. This first scenario assumes that the government has not succeeded in suppressing the circulation of illegal cigarettes, which may reduce CHT revenues, resulting in a broader shortfall. The calculation results show a shortfall of Rp27.57 trillion (84% of the

8 Martin Feldstein, "Rethinking the Role of Fiscal Policy," American Economic Review: Papers & Proceedings Vol. 99 No. 2 (2009): 556–559.

9 The assumed value of illegal cigarettes refers to illegal cigarettes in 2018. Edi Suwiknyo, "Pemerintah Beri Sinyal Kendalikan Produksi Rokok," (May 2019). Internet, can be accessed at: <https://ekonomi.bisnis.com/read/20190517/257/923896/pemerintah-beri-sinyal-kendalikanproduksi-rokok>.

10 Further explanation on the assumption and modelling, see: John G. Cragg, "Some Statistical Models for Limited Dependent Variables with Application to the Demand for Durable Goods," *Econometrica* Vol. 39, No. 5 (September 1971): 829-844 and Andrew Jones, "The UK Demand for Cigarettes 1954–1986, A Double-Hurdle Approach," *Journal of Health Economics* Volume 8 Issue 1 (March 1989): 133-141.

11 Based on the assumptions and the selection of other determinant variables, DDTC Fiscal Research obtained an elasticity value of -0,0477 for the probability of a person's participation in smoking and an elasticity value of -0.5075 of the quantity of cigarette demand against price changes.

12 On another note, DDTC Fiscal Research conducted a similar study in 2017 to estimate potential CHT revenues per year. Based on then conditions, it was found that the optimal increase in CHT tariffs per year was in the range of 5% to 10% on a weighted average with the estimated value of CHT revenues for 2017, 2018, and 2019 compared to the realization of IDR143.8 trillion (- 2.65%); Rp148.9 trillion (-2.64%); and Rp.153.6 trillion (-3.33%).

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Figure 2 Comparison of Minimum CHT Burden of Tier 1 with Tier 2A SKM and SPM (in IDR/stick)



Source: Regulations on CHT tariffs in the form of Minister of Finance Regulations (MoF Reg.).¹³

2020 State Budget target that was set through Law No. 20/2019).

Second, the calculation scenario based on extra effort. This scenario assumes that the government has succeeded in reducing the distribution of illegal cigarettes to 1% of the number of legal cigarettes circulating in a year (3.32 billion cigarettes). Referring to the results of the second estimate, the cigarette excise revenues will be more optimal. Based on the calculation results, the projection of revenue realization that will be obtained is 163.58 trillion rupiah with a shortfall of Rp9.57 trillion (94.47% of the 2020 State Budget target that was set through Law No. 20/2019).

In fact, with the decline in the state revenue targets to reduce the impact of the economic downturn due to Covid-19, the two scenarios above have not been able to achieve the targets set by the government. Under Presidential Regulation No. 72/2020 issued in June 2020, CHT revenue target has been reduced to Rp164.95 trillion. Referring to this new target, DDTC Fiscal Research estimates that there will be a shortfall without extra effort and with an extra effort of Rp19.36 trillion (88.26%) and Rp1.37 trillion (99.17%) respectively.

B.2. Impact on Industrial Dynamics

There are at least two 'loopholes' of the current CHT provisions in relation to the dynamics of IHT in Indonesia. The negative consequences include **the burden of CHT and HJE tariffs which are uncertain and unbalanced** as well as **the abuse of lower CHT categories by large IHT business players**, mainly due to the very complex tariff strata system.

B.2.1 Uncertain and Unbalanced CHT and HJE Burden

B.2.1.1 Intertier: SKM and SPM

One of the implications of the unbalanced and uncertain pattern of CHT tariff and HJE increase related to the simplification of the tariff strata is evident in the **unbalanced CHT burden**. Figure 2 shows an illustration of patterns of movement of minimum CHT tariffs for SKM and SPM that change on an annual basis.

In addition to not having a definite pattern, both for the increase and gap of the SKM and SPM CHT tariffs, there is an increasingly broader gap between the upper tier and the lower tiers. In the context of SKM, the gap of tier 1 to tier 2 was initially 36% in 2015. This gap has widened to 57% in 2020. Furthermore, in the context of SPM, the gap of intertier CHT tariffs in 2020 was around 63%, whereas it was only around 57% in 2015.

Under taxation provisions that apply to IHT in Indonesia, CHT is one component in the proportion of taxation that also affects the amount of other taxation variables of the product concerned, namely Cigarette Tax.¹⁴ The stipulates of CHT rates is crucial as other HJE-related provisions also have been set by the government, namely the Minister of Finance Regulations on CHT tariffs as last amended by MoF Reg. 152/2019.

¹³ MoF Reg. 205/2014, MoF Reg. 198/2015, MoF Reg. 147/2016, MoF Reg. 146/2017, MoF Reg. 156/2018, and MoF Reg. 152/2019.

¹⁴ Cigarette Tax amounts to 10% of CHT as stipulated under Law No. 28/2009 concerning Regional Taxes and Regional Revenues.

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Figure 3 Development of Comparison of CHT and Minimum HJE Burdens for SKM and SKT¹⁵ (in IDR/stick)



Source: Regulation on CHT tariffs in the form of Minister of Finance Regulations (MoF Reg.)¹⁶

In this regard, CHT which is the determining variable of the earmark tax on cigarettes **will, in turn, significantly determine the amount of profits received by companies as the government itself has set the minimum HJE in the stated provisions.**¹⁵¹⁶

Therefore, the extremely wide gap between intertier CHT tariffs may incentivize manufacturers in IHT to employ a variety of measures to pay lower excise, i.e. by utilizing CHT tariffs in lower tiers. In other words, manufacturers who are currently in tier 2 will choose to stay there rather than have to 'upgrade' to tier 1. Another method that may be used is maintaining production below the required capacity so as not to exceed the production threshold of 3 billion per year and dividing production through the establishment of new manufacturers through affiliated parties.

Upon further examination, it can also be seen that there are large differences in the gap of the CHT burden for tiers 1 and 2 in each category of machine cigarettes. Thus, **there is a major tendency in IHT manufacturers or business people, both in the SKM and SPM categories, to remain in the lower tier.** This condition shows the inevitable 'loopholes' in the currently applicable CHT policies.

B.2.1.2 Between Product Types: SKM and SKT

Further, the comparison of economic burden for types of hand and machine products deserves the government's attention. The comparison of CHT and HJE burdens for SKM and SKT is illustrated in Figure 3.

Similar to the comparison of CHT burden for SKM and SPM, the CHT and HJE burdens for these two types of clove tobacco products do not have a certain pattern either. Here, one important finding from the comparison of the tax burden on tobacco products produced using machines and hands is that **the burden for SKT is relatively higher than SKM**, especially in terms of HJE.

In light of HJE, its amount for SKT is higher compared to SKM. In fact, until 2019, the burden of CHT tariffs on the upper tier SKT was also higher compared to the lowest tier SPM. The CHT tariff burden pattern that resulted in a higher CHT tariff burden on SKM compared to SKT did not change until 2020.

Moreover, in terms of the tariff gap, there is a tendency that the gap of CHT and HJE tariffs between SKM and SKT positions put the CHT and HJE tariffs of SKM above SKT. This condition indicates the government's effort to provide relief for the hand cigarette sector. In the foreseeable future, however, the difference in tariff gap between SKT and SKM needs to be optimized in favour of workers in SKT. The current HJE tariff needs to be adjusted to narrow the gap between HJE SKT and HJE SKM. In contrast the current CHT tariff gap needs to be widened from the current CHT gap of only around 7% (Rp30).

Based on the above explanation, it is evident that the treatment in terms of cost burden in the form of CHT and HJE has not shown partiality in the labour-intensive SKT segment and tends to benefit the producers of machine-based tobacco products. In contrast, as is known, the production capacity for machine products is far greater compared to production using hands.

¹⁵ The selected SKM tier was the lowest (SKM 2B) compared to the highest SKT tier (1A). The selection of tiers for comparison is based on the SKT production capacity which is far lower than SKM.

¹⁶ MoF Reg. 205/2014, MoF Reg. 198/2015, MoF Reg. 147/2016, MoF Reg. 146/2017, MoF Reg. 156/2018, and MoF Reg. 152/2019.

B.2.2 Abuse of Lower CHT Rate Strata by Large Producers

At present, the CHT tariff strata in Indonesia are complex and multi-layered with 10 layers. Cigarette companies that have large capital and production capacity may **take advantage of the complexity of the CHT tariff strata through the production restriction system to stay in tier 2.**

In addition, due to the continuous increase in CHT tariffs, producers have greater potential to avoid the burden of excise through the exploitation of lower tariff layers. The method that can be used is through a strategy of limiting production and performing acquisition of manufacturers at the lower layer.¹⁷ In the Indonesian context, in general, the loopholes are employed to limit the amount of production below the threshold of 3 billion sticks per year.

The loopholes in current policies enable large entities in the Tobacco Product Industry to take advantage of CHT tariffs for tier 2 or tier 3. Whereas in fact, from the perspective of business tier entities, these IHT business players should be in the top tier of each category. In other words, the increase in the CHT tariff strata tier for large companies to tier 1 will result in fairer business competition, especially for small and medium manufacturers.

The current condition is the opposite in which small and medium companies in tiers 2 and 3 have to compete directly with large entities through the imposition of the same CHT and HJE tariffs. In the end, business competition in the national IHT becomes less fair and balanced.

Based on the mapping of CHT of SKM, SPM, and SKT products from various IHT companies in Indonesia with reference to their parent entities in terms of 2019 banderoles, DDTC Fiscal Research found several companies with 'giant' parent entities in IHT entitled to CHT tariffs 'relief' for tiers 2 and 3. In fact, these companies are affiliated – both directly and indirectly – with big players in IHT.

Based on the classification of parent entities with cigarette products of each of these companies as well, DDTC Fiscal Research found that simplification that refers to MoF Reg. 146/2017 will not injure small manufacturers. On the contrary, this simplification may close the gap where large manufacturers play in tiers intended for small manufacturers. Furthermore, the merging of the SKM and SPM production threshold into Machine Cigarettes (*Sigaret Mesin/SM*) will impact on large multinational companies. Local business players that manufacture medium-scale IHT will not be affected or 'forced to rise' to the top tier either.

This reflects the condition that companies with local parent entities generally only produce one type of machine cigarettes, whether in the form of SPM only or SKM only, thus, the total cigarette production of its entity is maintained below 3 billion cigarettes per year. This condition differs from companies with overseas parent entities which generally produce both types of machine cigarettes, SKM and SPM.

B.3. Impact on Tobacco Product Consumption Control

Conceptually, it can be said that the violation of the market transaction price (*Harga Transaksi Pasar/HTP*) being below the price stated on the package (HJE) is a form of direct discounted price given to consumers. The monitoring system employed by the government in this regard has been prepared through the contents of the policies regulated under MoF Reg. 146/2017 and PER-37/BC/2017 *juncto* PER-12/BC/2018 *juncto* PER-25/BC/2018.

MoF Reg. 146/2017 deserves appreciation for being the first regulation that considers aspects of the on-field implementation of HJE, namely in the form of HTP. Regarding the real situation of HJE implementation, MoF Reg. 146/2017 stipulates two types of violations that will be subject to legal sanctions. *First*, if HTP for some types of tobacco products exceeds the HJE threshold per cigarette or per gram above. *Second*, if the HTP is less than 85% HJE as stated in the tobacco banderoles.

Unfortunately, PER-37/BC/2017 *juncto* PER-12/BC/2018 *juncto* PER-25/BC/2018 seems to deviate from what is intended by MoF Reg. 146/2017. The Director General of Customs and Excise Regulation gives flexibility to producers to sell products with an HTP/HJE ratio of less than 85% in a maximum of 40 survey locations in the controlled area **to provide a gap for IHT business players to obtain a 'reduction in the market price of cigarettes' through the scheme of room provision** for producers as stated in the Analysis Method of Monitoring Market Transaction Prices as per Appendix XII of PER-37/BC/2017.

“(1) The Director at the Directorate General of Customs and Excise who carries out duties and functions in the technical field and excise facilities through the Head of Office shall submit a notification letter based on the results of Customs and Excise Officers' monitoring within a certain period of Tobacco Manufacturers or Importers selling tobacco products at Market Transaction Prices above the minimum HJE in the above layers or selling tobacco products at Market Transaction Prices of less than 85% of the HJE listed on the banderoles and having a brand or brand score (SMi) of more than 50%.

¹⁷ Denny Vissaro, "Menimbang Arah Kebijakan Cukai Rokok," *Perspektif Perpajakan Koran Bisnis Indonesia* (October 2019).

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(2) The provisions referred to in paragraph (1) refer to the following calculation:

$$SM_i = \frac{E_i}{80} \times 100\%$$

(with added emphasis)

Referring to the above provisions, SM_i value is allowed insofar as not exceeding 50%. This also implies that violations of HTP set below 85% of HJE may be tolerated by up to 40 survey locations. Furthermore, when MoF Reg. 146/2017 was revised to MoF Reg. 156/2018 and then MoF Reg. 152/2019 or when PER-37/BC/2017 was finally revised to PER-12/BC/2018 and PER-25/BC/2018, the provisions on 'reduction in the market price of cigarettes' did not change either. **Consequently, the legitimacy of the inclusion of HJE becomes invalid when a purchase transaction by end consumers occurs.**

Moreover, competition between IHT business players may be unhealthy as HTP may be set below 85% of HJE. This is due to the possibility of IHT business players taking advantage of these loopholes to apply pricing schemes through cross-subsidies among types of cigarette products.

One measure is to sell premium cigarettes at prices far higher than cheap cigarettes to expand the market base of non-premium cigarettes.¹⁸ Ultimately, the function of controlling cigarette consumption becomes difficult to optimize.

In addition to justifying the subsidies for IHT business players, the provision of direct price discounts to consumers can be said **contrary to the health promotion efforts** initiated by the government through Government Regulation No. 109/2012 as stated below.

"(1) The Government controls Tobacco Product Promotion.

(2) Provisions on the control of Tobacco Product Promotion referred to in paragraph (1) shall be carried out as follows:

a. does not give away free of charge, price discounts, gifts of Tobacco Products, or other products related to Tobacco Products;

....."

(with added emphasis)

Furthermore, the 'reduction in cigarette market prices' may also result in **an unbalanced price war between large and small manufacturers**. This is because large manufacturers have more competitive advantages from an economic perspective. Thus, producers with greater capital and production capacity will be able to reduce production costs and control prices to achieve broader market targets. Conversely, smaller manufacturers have more limited options.

The complex CHT tariff strata system also renders substantial 'costs' for the authorities, in particular, to supervise and monitor the compliance of IHT entrepreneurs. Consequently, **the objective of increasing the CHT tariff** to control consumption is difficult to achieve if the HJE discrepancy-based policy is maintained.

C. Policy Recommendations and Proposal

Considering the potential fundamental problems as well as the logical implications of the current policies, DDTC Fiscal Research formulates three main recommendations to revise the legal provisions related to the current CHT policies.

On another note, the sequence of elaboration in this Section constitutes the ideal stages that can be classified into short-term or long-term policies. In its implementation, however, the policies undertaken can also occur in parallel or not in sequence. These are due to various considerations of the probability of on-field implementation easiness as well as support from various stakeholders.

C.1. Continuing the Roadmap for the Simplification of CHT Tariff Strata (MoF Reg. 146/2017)

The simplification of CHT tariff strata as per MoF Reg. 146/2017 –which began with the merging of the production threshold of SKM and SPM into Machine Cigarettes (Sigaret Mesin/SM)– can be deemed one of the policies with the highest urgency in the context of IHT in Indonesia. It should also be clarified beforehand that simplification compiled under MoF Reg. 146/2017 will not result in an oligopoly or monopoly.

If only viewed from the decreasing number of manufacturers on an annual basis, the argument that simplification results in an oligopoly or monopoly seems inappropriate. The simplification concept that refers to MoF Reg. 146/2017 ensures that all tiers of IHT manufacturers will be accommodated through the availability of 5 layers, as shown in table 3.

As such, simplification based on MoF Reg. 146/2017 will ensure that small and medium-sized manufacturers will survive with the availability of a tariff layer for Tier 2 for SM and Tier 3 for hand cigarettes.

¹⁸ N. Nargis, A.K.M. Ghulam Hussain, M. Goodchild, A.C.K. Quah, and Geoffrey T Fong, "The Tobacco Industry Uses Pricing to Undermine Tobacco Tax Policy: Evidence from Bangladesh," *The International Tobacco Control Policy Evaluation Project* (2018): 26-27.

Table 3 Simplification of CHT Tariff Strata as Per MoF Reg. 146/2017 Through Merging Production Threshold

Type of HT	Gradual Simplification of CHT Tariff Strata							
	Production Volume Per Year	2017	2018	2019 ²⁰	Type of HT	Volume	2020	2021
SKM (with cloves)	> 3 billion cigarettes	1	1	1	SM (Machine-made Cigarettes) – Combination of SPM and SKM	> 3 billion cigarettes	1	1
	≤ 3 billion cigarettes	2	2	2				
SPM (without cloves)	> 3 billion cigarettes	4	4	3		≤ 3 billion cigarettes	2	2
	≤ 3 billion cigarettes	5	5	4				
		6	6					
SKT (clove cigarettes)	> 2 billion cigarettes	7	7	5		SKT	> 2 billion cigarettes	3
		8	8	6	4			
	0.5 – 2 billion cigarettes	9	9	7	0.5 – 2 billion cigarettes		5	4
		10						
	100 – 500 million cigarettes	11	10	8	≤ 0.5 billion cigarettes		6	5
	≤ 100 million cigarettes	12						

Source: MoF Reg. 146/2017 (processed by DDTC Fiscal Research)

The manufacturers most affected by the simplification of the CHT tariff strata are large manufacturers that can no longer take advantage of the lower CHT rates as the current practice.

In the end, **contrary to the current stigma that simplification will result in a monopoly or oligopoly, simplification guarantees fairer business competition, especially for large manufacturers.** Furthermore, the decreasing number of cigarette manufacturers may be caused by policies beyond MoF Reg. 146/2017, such as provisions on restrictions on the minimum area of IHT factories¹⁹ and other non-fiscal policies.

One of such regulations is Perpres No. 39/2014, which stipulates that investment permits are only granted to small-scale and medium-scale cigarette industries in partnership with the large-scale cigarette industry with a Business License in the same type of business. It is these legal provisions that allow large foreign players to enter Indonesian IHT through acquisitions and/or mergers with local manufacturers.²⁰

Through simplification, the level playing field among IHT business actors is more equal, both in terms of production capacity and economic capability. Conversely, small manufacturers with low production capacity are still entitled to the lowest rates and not injured.

19 Article 3. Minister of Finance Regulation Number 200/PMK.04/2008 the Procedures for Granting, Freezing, and or Revoking the Registration Identity Number of Entrepreneur Providing Excisable Goods of Tobacco Product Manufacturer and Importers (MoF Reg. 200/2008).

20 The implementation of the 2019 simplification has been canceled.

Ultimately, competition in a more balanced IHT will be a logical consequence of the adoption of MoF Reg. 146/2017-based simplification where companies will compete with each other in the same capacity. Through this fair competition, the tendency of small producers to sell their products illegally due to unfair competition can also be minimized.

This simplification is also in line with the concept of an effective HT taxation system. With respect to the first recommendation, an empirical study also found that complicated tax rate strata systems are highly vulnerable to tax avoidance by IHT businesses, especially if there is a significant tariff increase.²¹ Simplification can, therefore, serve as a crucial instrument for the government to close these tax avoidance loopholes.

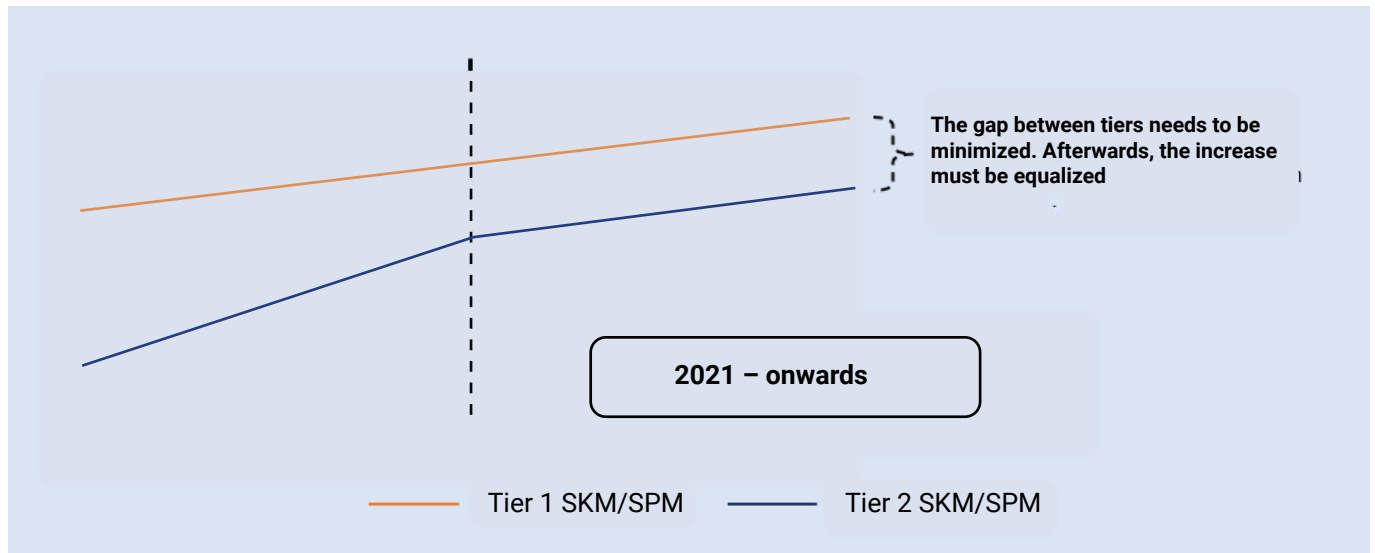
Further, simplification can lead to a more efficient administration system.²² Finally, **other than closing the 'loopholes' of the current policies, CHT revenue may also be optimized** due to the reduction in compliance-based administrative costs. This is also supported by other empirical studies that confirm the advantages of CHT simplification in the case of Indonesia to optimize the function of state revenues, control of illegal cigarettes, and reduce the prevalence of cigarette consumption.²³

21 Ce Shang, Frank J Chaloupka, Nahleen Zahra, and Geoffrey T Fong, "The Distribution of Cigarette Prices Under Different Tax Structures," *Tobacco Control* Vol. 23 (2014); 3 – 4.

22 Stuart Adam, "The Economic Approach to Tax Design," in J. Mirrlees ed., *Tax By Design* (Institute of Fiscal Studies: 2011), 21 – 45.

23 Arthur B. Laffer, "Achieving Public Policy Goals via Tobacco Taxation in Indonesia," (2015) Internet, can be accessed at: <http://www.laffercenter.com/wp-content/uploads/2015/07/Achieving-PublicPolicy-Goals-Via-Tobacco-Taxation-in-Indonesia.pdf>.

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Figure 4 Illustration of the Ideal Condition to Determine Optimal CHT and HJE Gap Patterns for Tier 1 and Tier 2 SKM and SPM

Source: DDTC Fiscal Research

C.2. Setting the Optimal Value of the CHT and HJE Tariff Gap

On the one hand, the increase in CHT and HJE tariffs without a consistent pattern leads to uncertainty for IHT business actors. On the other hand, the increase in CHT tariffs for cigarette products in Indonesia requires adjustments to inflation due to the specific tariff system.²⁴

With 10 CHT layers still in effect today, tobacco product consumers have various options of substitution when price increases. If the CHT tariff continues to increase, but is not followed by simplification, the differences in CHT tariffs among layers become higher. Therefore, **prior to determining a regular and consistent CHT tariff pattern of increase, the government must first simplify it.**

In light of the CHT tariff pattern of increase, two main considerations deserve the government's attention. **The first consideration is reducing the gap between CHT and HJE tier 1 and tier 2 for machine cigarettes.** The primary reasoning underlying the first consideration is to prevent IHT business players from taking advantage of the gap to stay in tier 2 when the company has similar competitive advantages to other companies in the higher CHT tariff tiers.

As there are gaps that may incentivize business players to take advantage of the CHT tier 2 tariff, the narrowing of the CHT tariff gap between cigarette machine tiers will reduce the number of manufacturers that try to avoid the higher CHT rates in the above tiers. Finally, the functions

of CHT for state revenue and consumption control may be implemented optimally.

Further, after the CHT tariff gap is narrowed, the **pattern of increases** of both SKM and SPM (which will later become SM) **must be equalized** to prevent exploitation of Tier 2 CHT by large manufacturers. The illustration can be seen in Figure 4.

The second consideration is widening the gap between CHT and HJE tariffs between machine cigarettes and hand cigarettes to protect IHT workers. In this context, it should be understood that if a labour-intensive hand cigarette company wishes to remain able to operate, policies that can accommodate the needs of business actors in terms of reducing production costs are required.

One of such a policy is stipulating HJE and CHT tariff pattern of increases which show partiality on SKT as currently the CHT tariff and HJE SKT burden is relatively higher than machine cigarettes, both SKM and SPM. DDTC Fiscal Research, thus, proposes that the gap between CHT and HJE tariffs between SKT and machine cigarettes in the lowest tier should be widened. This is mainly due to the nature of SKT business actors, that are labour-intensive, but with limited production capacity.

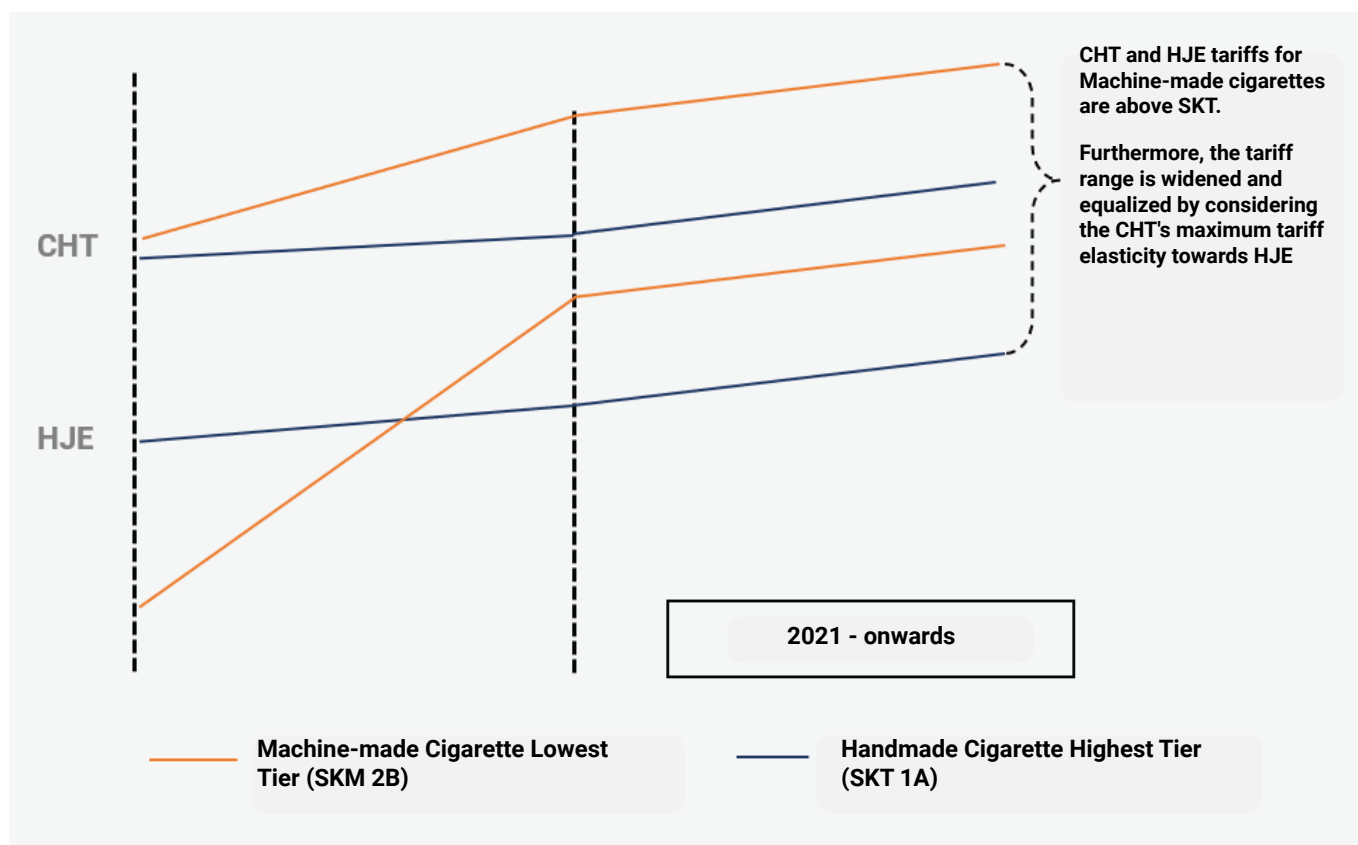
The second consideration is crucial due to current circumstances in which CHT and HJE tariffs for machine cigarettes are lower compared to SKT. The HJE tariff for the highest tier SKT is above the lowest tier SKM.

Put simply, the pattern of increases can be seen in Figure 5. The technical order of the application is to pursue a higher position for CHT and HJE tariffs for machine

²⁴ Frank J Chaloupka, Ayda Yurekli, and Geoffrey T Fong, "Tobacco Taxes as A Tobacco Control Strategy," Tobacco Control Vol. 21 (2012): 177 – 178.

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Figure 5 Illustration of Ideal Condition for CHT and HJE Tariff Gap for Handmade Cigarette's Highest Tier and Machine-Made Cigarette's Lowest Tier



Source: DDTC Fiscal Research

cigarettes compared SKT, then to widen the gap between CHT and HJE tariffs between machine cigarettes and SKT, and finally to equalize the pattern of increases of CHT and HJE.

Furthermore, after the two considerations are accommodated in the form of regulations, the government should also determine the proportion of elasticity of CHT tariff increases to HJE tariffs. This is because HJE is a significant determinant factor for consumers to be willing to spend their money to purchase a product.²⁵ Conversely, the CHT tariff burden in the case of Indonesia is borne as a producer cost structure rather than shifted to consumers.²⁶ **Thus, CHT tariff-related policies may have a significant effect in relation to state revenues, whereas HJE tariff-related policies are closely related to the function of controlling tobacco product consumption.**

On the one hand, in the event that the proportion of CHT tariff increase is set higher than the increase in HJE then there is a concern that the consumption control function

is not optimal due to the low selling price of cigarettes. On the other hand, if the percentage of HJE increase is higher than the proportion of CHT increase, state revenues become suboptimal due to revenue forgone from the disproportionate CHT tariff increase.

Therefore, a certain carefully calculated value is required to obtain the appropriate nominal elasticity of CHT tariff increase to HJE tariffs. In this regard, **DDTC Fiscal Research proposes that the increase in CHT should be equivalent to HJE increase.** The CHT elasticity value against HJE is expected to optimize state revenues and control tobacco product consumption in a balanced manner through a consistent and directed pattern of increase.

C.3. Removing HTP and HJE Ratio Discrepancies to Optimize the Function of Tobacco Product Consumption Control

In light of the monitoring system of HJE implementation through HTP policy, DDTC Fiscal Research submits two proposals for this monitoring system in the future. **First**, removing provisions that allow the ratio of HTP and HJE to be below 85%. **Second**, gradually equalizing the ratio of HTP and HJE to 100% “

25 L. Bruttel, "The Effects of Recommended Retail Prices on Consumer and Retailer Behaviour," *Economica* Vol. 85 No. 339 (2016): 649–668.

26 See: Ade Hidayat and Nasruddin Djoko S, "Impact Of Specific Excise Rate Simplification On Cigarette Consumption and Government Revenue in Indonesia," *World Customs Journal* Volume 10 No. 1 (2016).

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In other words, if the authorities have to discretion to find merely one survey location in which HTP is not the same as HJE, the relevant IHT business actor is indicated to have committed a violation and may be subject to the consequences of applicable law.

For companies, this proposal is expected to guarantee fair and balanced competition and minimize the intertier cross-subsidy scheme of one manufacturer. In addition, the price war that occurs among producers may also be minimized.

For the government, the proposed elimination of the 'cigarette market price reduction' is also in line with efforts to control cigarette consumption. In addition, with narrowed survey locations, the government can also **streamline administrative costs for monitoring** related to the function of controlling tobacco product consumption.

C.4. Effectively Implementing the Blueprint of CHT Policy

In the context of CHT policies, the availability of blueprints will increase the predictability and stability of future policies. Moreover, this blueprint indicates the government's consistency and political commitment to implementing policies with certainty. Specifically, in the context of IHT, **blueprints are highly crucial to ensure the implementation of recommendations that may encourage certain, balanced, and targeted CHT policies.**

For IHT businesses, blueprints are a form of certainty that can minimize distortions in business decision making, in particular, related to investment. In addition, for the government, the drafting of a national CHT policy blueprint will improve efficiency in terms of the cost of drafting other provisions in this industry which are carried out routinely on an annual basis.

As such, policy-making resources can be allocated to other areas, such as optimizing the administrative and monitoring functions, and policy formulation pertaining to other excise objects. Moreover, a rule of law should not be subject to frequent amendments as it can reduce the legal certainty aspect.²⁷

In the context of developing a CHT policy blueprint, the government also needs to integrate CHT policy with other related policies. On the one hand, these provisions may take the form of policies that are beyond the Ministry of Finance's authority, such as policies issued by the Ministry of Industry and the Ministry of Health which impact the prevalence and consumption of tobacco products.

On the other hand, the Ministry of Finance's internal policies other than the CHT tariff system also need to be integrated. Some of these policies include an expansion of excise policies, optimization of CHT administration, and increasing compliance among CHT payers, including eradicating illegal cigarettes. These policies certainly have a significant portion to optimize the role of the relevant blueprint.

Presently, the government has integrated Indonesia's vision and mission in the form of the 2020-2024 Medium-Term Development Plan (*Rencana Pembangunan Jangka Menengah/RPJMN*) document as stipulated in Presidential Regulation No. 18/2020. In the context of IHT, various strategies and plans to achieve various national goals are carried out through the issuance of MoF Reg. 77/2020.

The Ministerial Regulation that was published on June 2020 explains several fiscal reforms for IHT within the next five years. The fiscal reforms referred to are the part of the Ministry of Finance's strategy to reach national goals as summarized in RPJMN 2020-2024. One of them is the simplification of the tariff structure of tobacco product (*Hasil Tembakau/HT*) or the simplification of CHT tariffs.

Accordingly, **DDTC recommends that all CHT policy directions in the next few years will be realized in the form of a blueprint that is in line with the RPJMN 2020-2024.** As for the current context, the spirit of the simplification of the excise tariff structure itself actually has taken a part in the Ministry of Finance's strategic plan which has been stated in MoF Reg. 77/2020.

However, this simplification framework still needs to be clarified and emphasized by the existence of CHT-related legal products that can become a blueprint of simplification as well as together with other relevant areas, such as the determination of CHT and HJE tariff gap. In other words, the blueprint related to simplification must also be ensured to be implemented in harmony with the determination of the optimal tariff gap for CHT and HJE between groups and between types of products as described in this Policy Note. One of these ways is to consider the continuation of the CHT simplification roadmap as previously regulated in MoF Reg. 146/2017.

Furthermore, the legal product for the CHT policy blueprint itself can be stipulated in the form of a Minister of Finance Regulation (*Peraturan Menteri Keuangan/PMK*). The reasons to opt this hierarchy of law are because the government has already implemented a CHT tariff simplification roadmap through MoF Reg. 146/2017 and there is another same-level regulation, MoF Reg. 77/2020, that has become one of the main foundations for the consideration of the CHT policy blueprint. Therefore, the feasibility and visibility of applying the legal product in the form of MoF Regulation

²⁷ Hans Gribnau, "Equality, Legal Certainty and Tax Legislation in the Netherlands Fundamental Legal Principles as Checks on Legislative Power: A Case Study," *Utrecht Law Review* (2013): 70.

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for a medium-term IHT policy has been calculated previously by the government.

In addition to the simplification of the CHT tariff structure that is aligned with the determination of the optimal tariff range such as the explanation above, it is also possible that the government can prepare the other blueprints related to CHT provisions in the form of MoF Reg. For example, the provision to close the "gap" between the HTP and HJE ratio to control cigarette consumption.

Considering the various abovementioned advantages, the formulation of the CHT policy blueprint is critical. In addition, **the CHT policy blueprint must also be ensured to be effectively implemented in order to provide sustainable legal certainty.** These long-term and medium-term ideas are then expected to resolve various problems and conflicts in Indonesia's tobacco industry.

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