

## ACHIEVING PUBLIC POLICY GOALS VIA TOBACCO TAXATION IN INDONESIA

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### Executive Summary

For many countries around the world, the challenge of administering effective tobacco taxation has been to ensure the optimal level and structure of taxation that achieves the public health and public finance goals of governments. As I pointed out in my book, *Handbook of Tobacco Taxation: Theory and Practice*,<sup>1</sup> many people believe that tax policies on tobacco products should be made purely on moral grounds, without consideration of economics. The reality is very different.

Indonesia and its Ministry of Finance have been pioneers on the tobacco taxation side by abandoning a problematic ad valorem system in 2007 in favor of moving toward a specific tax system, which is the preferred system from a revenue, health, and ease of administration perspective. Indonesia also introduced the “Tobacco Excise Roadmap” in 2009, which calls for the gradual elimination of the inefficiencies that arise from a multi-tiered system. Numerous countries around the globe have been making similar policy changes in the following years.

The current Indonesian excise tax structure has 12 tax tiers as of 2015 (versus the four as planned in the “Tobacco Excise Roadmap”), with tiers based on: 1) product type (kretek or conventional cigarettes, also called “whites”), 2) type of production (machine-made or hand-made), 3) annual production volume by company (above 2 billion cigarettes, between 350 million and 2 billion cigarettes, between 50 and 350 million cigarettes, and below 50 million cigarettes), and 4) retail price (or banderole price).

The delay in the implementation of the “Tobacco Excise Roadmap” has generated inefficiencies in the following areas:

- a) Lack of government revenue optimization (i.e. too many tax tiers that can lead to exploitation by companies);
- b) Unfair treatment between companies (i.e. companies exploiting the production volume criteria to bear less tax);
- c) Unfair treatment between hand-made and machine-made cigarettes (i.e. certain machine-made cigarette types continue to bear a lower excise vs. certain hand-made cigarettes); and,
- d) Illicit trade (as a result of the complex multi-tiered excise structure, the incentive to buy or sell illegal cigarettes has risen and thus it should come as no surprise that the products meant to bear higher excise rates are found bearing banderoles with lower excise rates).<sup>2</sup>

As described earlier, the recent policy shifts toward a specific excise tax system and toward the “Tobacco Excise Roadmap” are Indonesia’s solutions for addressing the inefficiencies of its excise tax system. However, many issues persist due to the lack of full implementation of the “Tobacco Excise Roadmap,” which is evident from the large number of tiers that continue to exist in the current excise tax structure. Hand-made kretek, a heritage product that has significantly higher employment levels per unit of production than machine-made kretek, must have the appropriate tax differential relative to machine-made kretek in order to support the government’s objective of maintaining employment within this sector (which is also stipulated in the Indonesian Excise Law).<sup>3</sup>

The contribution of tobacco taxes to government coffers will continue to be an important source of revenue. However, it is crucial to implement an excise tax system that supports stable and predictable collection, while ensuring that excise tax increases are not undermined by illicit trade and instead translate into commensurate government tax revenue increases.

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<sup>1</sup> Laffer, Arthur B. *Handbook of Tobacco Taxation: Theory and Practice*. San Francisco: Laffer Center at the Pacific Research Institute, 2014.

<sup>2</sup> Satriawan, E., Adji, A. “Survey of Illegal Cigarettes 2012,” *Universitas Gadjah Mada*, 2012. The study estimates that the illicit cigarette consumption rate in 2012 reached 8.4 percent at the national level.

<sup>3</sup> Elucidation of Indonesian Excise Law No. 39/2007.

## Achieving Public Policy Goals via Tobacco Taxation in Indonesia

For many countries around the world, the challenge of administering effective tobacco taxation has been to ensure the optimal level and structure of taxation that achieves the public health and public finance goals of governments. As I pointed out in my book, *Handbook of Tobacco Taxation: Theory and Practice*,<sup>4</sup> many people believe that tax policies on tobacco products should be made purely on moral grounds, without consideration of economics. The reality is that tobacco taxes represent an essential source of tax revenue for many countries, but on the other hand the public health goals of reducing smoking incidence cannot be understated. Accordingly, policymakers need to consider national, political, social, and economic factors prior to determining the correct tobacco excise structure and tax levels. While these factors are relevant for each and every country, the Indonesian experience with tobacco excise taxation will be the focus of this memo.

As one of the most highly populated countries in the world, Indonesia is also a major market for tobacco products. In 2014, the total production volume reached 354 billion sticks in Indonesia.<sup>5</sup> In addition, the steady growth of Indonesian exports of tobacco products over the past few years has placed Indonesia into the top list of tobacco exporting countries worldwide.<sup>6</sup>

The tobacco sector in Indonesia is also an important source of employment (employing approximately 6 million Indonesians)<sup>7</sup> in farming (tobacco and clove), production, distribution, wholesale, and retail. Particularly important and unique to Indonesia is the high level of employment generated on the cigarette production side by the hand-made cigarette industry.

Tax revenue from tobacco products is also immensely important for Indonesia. Excise tax is the third largest contributor to the state tax revenue, after income tax and VAT.<sup>8</sup> Additionally, only three types of products contribute to the excise tax revenue: tobacco products, alcoholic beverages, and ethyl alcohol. Moreover, 95 percent of the total excise tax revenue in Indonesia is derived from tobacco products.<sup>5</sup> In 2014, the tobacco industry is estimated to have contributed IDR 112 trillion to government excise tax revenues alone, or 9.8 percent of total state tax revenue (IDR 1,143 trillion).<sup>9</sup>

In the vast majority of Asian countries, the tobacco excise to total tax revenue ratio ranges between 0.5 to 3 percent, making Indonesia a major outlier at 9.8 percent.<sup>10</sup> This is in stark contrast to Indonesia's extremely low total tax to GDP ratio.<sup>11</sup>

Around 93 percent of the cigarette market in Indonesia is dominated by "kretek" cigarettes, a type of cigarette that contains tobacco and clove, while the other 7 percent is the so-called "white" cigarettes, or tobacco only cigarettes.<sup>12</sup> Kretek cigarettes are divided into two major segments—machine-made filter kretek cigarettes and the hand-made non-filter kretek cigarettes. Machine-made filter kretek cigarettes are currently the fastest growing segment in Indonesia, while the prevalence of hand-made non-filter kretek cigarettes is declining.<sup>13</sup>

### Tobacco Taxation in Indonesia

There are different types of excise tax systems and structures applicable to tobacco products around the world, which vary depending on the country's policy objectives. Tobacco taxes provide for a stable revenue generator for all countries, and other socio-economic factors (e.g. protecting employment or recognizing the overall economic output of

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<sup>4</sup> Laffer, Arthur B. *Handbook of Tobacco Taxation: Theory and Practice*. San Francisco: Laffer Center at the Pacific Research Institute, 2014.

<sup>5</sup> Zatrika, Asep Munizat. "Cigarette excise tariff increase again by July 2015," statement from Susiwijono Moegiarso, *Kontan.co.id*, February 9<sup>th</sup>, 2015.

<http://nasional.kontan.co.id/news/tarif-cukai-rokok-naik-lagi-mulai-juli-2015>

<sup>6</sup> Indonesia Ministry of Trade, Central Bureau of Statistics.

<sup>7</sup> Hendratmo, Wisnu. "Tobacco Industry and Its Contribution to National Economy" *Media Industri*, No. 2/2009, page 53, Department of Industry, 2009.

<sup>8</sup> Indonesia Revised State Budget Law 2014.

<sup>9</sup> Supriyadin, Jayadi. "State Revenue Only Fulfil 94% of The Target" statement of Minister of Finance press conference on 2014 state revenue realization, *tempo.co*, January 5<sup>th</sup>, 2015. <http://www.tempo.co/read/news/2015/01/05/087632983/Pendapatan-Negara-Hanya-Tercapai-94-Persen>

<sup>10</sup> Source: *Phillip Morris International*

<sup>11</sup> Indonesia's total tax to GDP ratio stands around 11.9% based on 2015 data from *The Heritage Foundation website* on 2015 Macro-economic Data.

<http://www.heritage.org/index/explore?view=by-variables>

<sup>12</sup> Owi. "Cigarette production shows declining trend," statement from Susiwijono Moegiarso, *JPNN*, September 9<sup>th</sup>, 2014.

<http://www.jpnn.com/read/2014/09/09/256566/Produksi-Rokok-Tak-Lagi-Mengebul>

<sup>13</sup> Owi. "Cigarette production shows declining trend," statement from Susiwijono Moegiarso, *JPNN*, September 9<sup>th</sup>, 2014.

<http://www.jpnn.com/read/2014/09/09/256566/Produksi-Rokok-Tak-Lagi-Mengebul>

the industry) are also incorporated into the broader policy making. The typical example for Indonesia is the hand-made kretek industry which, apart from being a unique heritage product, provides for the vast majority of employment in Indonesia's cigarette manufacturing sector.<sup>14</sup>

In recent years there has been an increased focus on tobacco taxation structure as manifested in academic literature and empirical studies. Clear advantages of single tiered specific systems (e.g. revenue predictability, ease on administrative burden, and ability to achieve health objectives) as well as notable disadvantages of *ad valorem* systems (e.g. undervaluation issues, administrative complexity, the triggering of price wars, and dependency of government revenues on pricing decisions of manufacturers or consumer preferences) have been mentioned in literature as well as in empirical studies.<sup>15</sup> Major international organizations such as the IMF and the World Bank have also recognized the advantages of the simplified, specific structures. Additionally, countries that have been in the forefront of tobacco control have historically used single tiered specific systems (e.g. United States, Singapore, Australia, and New Zealand). Furthermore, countries that have traditionally relied on *ad valorem* systems, among them many developing countries, have either moved to a fully specific system (most recently Philippines) or have substantially reduced the *ad valorem* element, recognizing key deficiencies of such a structure. Even within the EU, which requires a mixed system (i.e. both *ad valorem* and specific components) as mandated by the EU Tobacco Excise Directive,<sup>16</sup> many European countries have moved towards reducing the *ad valorem* element substantially or to the minimum as allowed by law (Germany, UK, Ireland, Netherlands, Denmark, Sweden, Poland, Greece, and Portugal).

Two quotes from the EU Commission and the IMF illustrate this thinking:

*"Specific duties reduce relative price differences and minimise the variability of prices. Consequently specific duties have an advantage from a health point of view. Specific duties also have a number of other benefits. A scenario that sets all duties to specific duties would entail a narrowing of price differences at EU level by 50%. Therefore, greater reliance on specific duties can lead to further approximation of retail selling prices within the EU. Furthermore, as they are based on consumption volumes rather than on prices, specific duties are more stable, easier to forecast and to administer and increase the stability of tax revenues.*

*In conclusion from an internal market, budgetary as well as a health point of view, specific duties have clear advantages and more flexibility should therefore be provided to those Member States that place greater reliance on specific excise duties."*<sup>17</sup>

*"If a primary purpose of the excise is to discourage tobacco consumption, a strong case can be made for specific excises that would impose the same tax per stick. Specific taxes also are easier to administer because it is only necessary to determine the physical quantity of the product taxed, and not necessary to determine its value."*<sup>18</sup>

Indonesia has been one of the pioneers, and in the forefront of emerging economies, when in 2007 it began the gradual move from a multi-tiered *ad valorem* system to a multi-tiered fully specific system (a mixed system existed during the transition period from 2007 to 2008). Moreover, recognizing the numerous deficiencies of a multi-tiered system, the Fiscal Policy Unit (BKF) published the "Tobacco Excise Roadmap," which foresaw a reduction from 19 tiers to 2 tiers by 2016. The move toward reducing the number of tiers was influenced by the benefits of implementing such a system, such as the ease of administration,<sup>19</sup> reduced complexity and tax fraud, revenue optimization, and achieving public health objectives. In addition, Indonesia has employed annual increases of the specific tax to ensure that the excise tax amount remains constant in real terms and does not erode over time. The full implementation of the "Tobacco Excise

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<sup>14</sup> Kelana, Irwan. "Ministry of Industry Regulates Incentives for Hand-made Cigarette Workers," statement from Minister of Industry, Mohammad S. Hidayat, *Republika Online*, September 22<sup>nd</sup>, 2015. <http://www.republika.co.id/berita/koran/industri/14/09/22/ncaqeb5-kemenperin-atur-insentif-pekerja-skt>

<sup>15</sup> For a thorough review of the literature, please refer to my book: Laffer, Arthur B. *Handbook of Tobacco Taxation: Theory and Practice*. San Francisco: Laffer Center at the Pacific Research Institute, 2014.

<sup>16</sup> EU Council Directive 2011/64/EU. [http://ec.europa.eu/taxation\\_customs/taxation/excise\\_duties/tobacco\\_products/legislation/index\\_en.htm](http://ec.europa.eu/taxation_customs/taxation/excise_duties/tobacco_products/legislation/index_en.htm)

<sup>17</sup> Commission of the European Communities, "Report from the Commission to the European Parliament and the Council: on the structure and rates of excise' duty applied on cigarettes and other manufactured tobacco products, 2008. <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52008DC0460>

<sup>18</sup> "Tobacco Taxation: A View From The International Monetary Fund," in Appendix A of Jha, Prabhat, and Frank J. Chaloupka, eds. *Curbing the epidemic: governments and the economics of tobacco control*. World Bank Publications, 1999.

<sup>19</sup> Siregar, Mahendra. "Presentation Vice Minister of Finance on Indonesia Experience", Asia-Pacific Tax Forum Bandung, September 26<sup>th</sup> to 27<sup>th</sup> of 2012.

Roadmap” has shown some considerable delays as the number of tiers in 2015 still stands at 12 instead of the four that were planned, but these delays can be partially explained.

The current Indonesian excise tax system remains complex due to its four-dimensional nature, which is based on product type, production type, annual production by company, and retail price. Cigarettes are separated into the following three categories: machine-made kretek, hand-rolled kretek, and white cigarettes. The annual production volume tiers are broken down into the following four groups: over 2 billion cigarettes, between 350 million and 2 billion cigarettes, between 50 and 350 million cigarettes, and below 50 million cigarettes per cigarette/production type.<sup>20</sup> Within each tier, there is a defined minimum banderole price per stick. Therefore, it is not surprising that such a system is prone to exploitation by manufacturers who will always seek to minimize their excise burden.

Let’s analyze the dimensions one by one and refer to the issues they bring to the system.

Table 1  
Indonesia – 2015 Excise Tariff System

|                     | Category | Production Volume Tier | Price Tier (Banderole/Stick) | Specific Rate (IDR/Stick) |
|---------------------|----------|------------------------|------------------------------|---------------------------|
| Hand-Rolled Kretek  | Tier1    | >2 billion             | >826                         | 290                       |
|                     |          |                        | 606 - 825                    | 220                       |
|                     | Tier 2   | 0.35 - 2 billion       | >418                         | 140                       |
|                     |          |                        | 385 - 417                    | 125                       |
|                     | Tier 3   | 0.05 - 0.35 billion    | ≥286                         | 85                        |
|                     |          |                        | ≤0.05 billion                | ≥286                      |
| Machine-Made Kretek | Tier1    | >2 billion             | ≥800                         | 415                       |
|                     | Tier 2   | ≤2 billion             | >588                         | 305                       |
|                     |          |                        | 511 - 588                    | 265                       |
| White Cigarettes    | Tier1    | >2 billion             | >820                         | 425                       |
|                     | Tier 2   | ≤2 billion             | >520                         | 270                       |
|                     |          |                        | 425 - 520                    | 220                       |

Cigarette/production types: The two distinct categories are the machine-made (machine-made kretek-SKM and machine-made conventional/white-SPM) and the hand-made kretek (SKT) products. The vast labor intensive hand-rolled kretek industry is subsidized by the excise differential, which has been implemented to protect employment under the Excise Law of Indonesia.<sup>21</sup> The size of the excise differential depends on the policy goals of the government—or in other words, how the government wishes to balance the objectives for public health, employment and revenue. The hand-made kretek segment, that contributes thousands of jobs, is in gradual decline due to changing consumer preferences and thus requires careful consideration.<sup>22</sup> However, for the machine-made cigarettes, there is little or no justification on the basis of government revenue, public health, or employment goals for differences in tax rates between machine-made kretek (SKM) and machine-made white (SPM) cigarettes. Moreover, anomalies that are difficult to explain persist, whereby white cigarettes in the higher production volume tier bear much higher excise rates relative to white cigarettes in the lower production volume tier, and SPM cigarettes in the lower volume tier bear much lower excise when compared to SKM cigarettes on the lower production volume tier.

<sup>20</sup> Indonesian Minister of Finance Decree No 205/2014.

<sup>21</sup> Elucidation of Excise Law no 39/2007.

<sup>22</sup> Owi. “Cigarette production shows declining trend,” statement from Susiwijono Moegiarsa, JPNN, September 9<sup>th</sup>, 2014. <http://www.jpnn.com/read/2014/09/09/256566/Produksi-Rokok-Tak-Lagi-Mengebul>

Annual production volume: As an initial overall comment, I am not aware of any other country around the world that applies different excise tax treatment based on the annual production volume by company. Almost every country around the world, including Indonesia, provides different types of incentives (e.g. corporate tax or social security deductions) to protect their SMEs. As every cigarette is equally harmful to health, it is difficult to justify from a public health perspective such a large excise discount as exists for smaller producers. The preferential excise treatment for smaller producers has also provided ground for exploitation by companies (i.e. tax loopholes). The current system allows, for example, a company to produce up to 2 billion cigarettes of each SKM, SPM, and SKT,<sup>23</sup> for a total of 6 billion cigarettes, and be classified as a “small” company and enjoy much lower excise tax rates. Such production volumes translate to trillions of Rupiah in sales revenue and billions of Rupiah in profit—it thus seems extremely difficult to classify such companies as small companies, especially given that the profits are extraordinary. It is almost certain this was not the intention of policymakers when establishing these rules.

Banderole price: Different tax tiers based on banderole price exist for the hand-rolled kretek as well as for the lower production volume tiers in the machine-made segments. By eliminating the tax tiers based on the banderole price for the higher production volume tiers in the machine-made segments, the government has avoided many of the same issues that arise in an *ad valorem* system. For instance, under a system with different tax tiers based on prices, consumers may decide to smoke a cheaper product, which would negatively impact government tax revenues vis-à-vis lower and more unpredictable revenue streams. Moreover, based on the public health objective, all cigarettes are equally harmful and there is no reason for differences in the amount of excise born by differently priced cigarettes.

### **Excise Tax Levels**

Tobacco taxation entails complex matters that require consideration of a number of political and socio-economic factors prior to implementing a tobacco excise tax structure and level. Amongst these factors are: elasticity of demand, affordability, and unintended consequences such as illegal trade, smuggling, and decreased revenues.

As much as possible, tobacco sales should go through legitimate tobacco companies and government should have constructive relations with tobacco companies. In other words, you don't want to tax cigarettes to the point that consumers are no longer purchasing cigarettes from tobacco companies and instead are buying them from illegal channels.

In order to compare excise tax levels internationally, three benchmarks exist: a) excise incidence (which is the excise tax yield in relation to the Retail Selling Price (RSP) or Banderole Price); b) excise yield (usually the monetary amount of excise tax per 1,000 cigarettes); and, c) affordability (which is the excise tax yield over some measure of income, such as GDP per capita or nominal private consumption per capita).

In my book, I explain extensively why excise incidence not only fails to provide meaningful information about tax policy when making cross-country comparisons but it also does not provide a good indicator of how tax policy changes over time. The same stands for the excise yield as a benchmark, since it only becomes meaningful when comparing the excise yield relative to a measure of income; and this is what affordability is all about.

Decisions on the tax level are the prerogative of each individual country and will therefore depend on each country's unique circumstances. The illicit trade is an additional important element that must be taken into account when setting tax rate policy. More importantly, Indonesia with its vast geography and islands is extremely vulnerable to illegal activities—such activities are difficult to control once they are well-established due to the lucrative nature of the illegal trade. In Indonesia, illicit trade, as analyzed in studies conducted by University of Gadjah Mada as well as University of Indonesia,<sup>24,25</sup> has been gradually increasing at an alarming rate. Since many illegal cigarettes are the result of the misallocation of banderoles, a simpler excise tax structure (i.e. fewer tax tiers) is an essential part of the solution for addressing the illicit trade.

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<sup>23</sup> Indonesian Minister of Finance Decree No 205/2014.

<sup>24</sup> Satriawan, E., Adji, A. “Survey of Illegal Cigarettes 2012,” *Universitas Gadjah Mada*, 2012. The study estimates that the illicit cigarette consumption rate in 2012 reached 8.4 percent at the national level.

<sup>25</sup> Ahsan, Abdillah, et al. “Illicit cigarette consumption and government revenue loss in Indonesia.” *Globalization and health*, 10.1 (2014): 75, 2014. The paper finds that the Indonesian illicit cigarette trade reached 8 percent in 2013, with the estimated loss in state excise tax revenue at around IDR 4 to 9 trillion.

## **Recommendations**

Maintaining my strong views on the sovereign right of every country to define its own tax policy, I will refrain from making any specific recommendations. My prior observations should serve as a guide to the policymakers who are tasked with developing the best tobacco tax policy.

Additionally, the Indonesian Ministry of Finance and the Fiscal Policy Agency (BKF) have been pioneers in tobacco taxation by abandoning the *ad valorem* system in favor of a specific excise tax system and by introducing the “Tobacco Excise Roadmap,” both of which represent policy shifts designed to help achieve the government’s long-term health, revenue, and employment goals.

In my view, the solution and direction for Indonesia has been outlined in the “Tobacco Excise Roadmap,” which already encompasses many of the acknowledged best practices on tobacco taxation. A complete implementation is the remaining element needed for Indonesia.