

CONFRONTING ILLICIT TOBACCO TRADE:



A GLOBAL REVIEW OF COUNTRY EXPERIENCES

INDONESIA: TACKLING ILLICIT CIGARETTES

TECHNICAL REPORT OF THE WORLD BANK GROUP
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INDONESIA

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Tackling Illicit Cigarettes

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Chapter Summary

Indonesia exhibits a high prevalence of smoking among adults. Indeed, among adult men, the rate of tobacco use is the highest in the world. Among Indonesian smokers, 95 percent use kretek, a tobacco and clove cigarette that is produced domestically. The biggest machine-made kretek (sigaret kretek mesin) producer, who also sells the most expensive cigarette in the market, has a 63 percent market share. This highlights that most smokers can still afford the most expensive brand. Cigarettes are affordable in Indonesia.

Although the government of Indonesia has not ratified the Framework Convention on Tobacco Control (FCTC), it already implements some tobacco control policies. It relies on a specific multitiered tobacco product excise system that protects domestic, especially kretek, producers, but also fosters a wide range of prices. However, the affordability of cigarettes represents a public health challenge: public health is deteriorating because cigarettes are inexpensive.

There are three types of taxation on cigarettes: the excise tax, the value-added tax, and local cigarette taxes. While the excise tax is aimed at controlling consumption, local cigarette taxes are effectively designed to increase the revenue of local governments.

The average excise tax rate is 49.1 percent of the retail price, which is below the 70 percent recommended by the World Health Organization (WHO). The value-added tax is 9.1 percent

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of the retail price, and the local cigarette tax is 10 percent of the excise tariff. Combined, the average total tax burden on a cigarette is around 62.7 percent of the retail price. Although this seems quite high, the cost is so low that even primary-school students can afford to buy cigarettes using their daily school allowance. (Individual cigarettes are widely offered for sale.)

The illicit trade in cigarettes nonetheless increases cigarette consumption, because the price is even lower as a consequence of the tax evasion. The greater cigarette consumption threatens public health and government revenue.

The Indonesian tobacco industry is tolerant of current public policy making on cigarettes. It often points to the illicit trade in cigarettes in arguing for lower tobacco excise taxes.

Indonesia has comprehensive excise regulations that govern many aspects of excise administration. The enthusiasm for local autonomy has created avenues for the enforcement of regulations on illegal cigarettes because local governments are also mandated to carry out some enforcement of two fiscal mechanisms, tobacco excise revenue sharing and the local cigarette tax. The government has used excise stamps for cigarettes since 1950. The security features of the excise stamps are quite difficult to counterfeit. The inclusion of the successful supervision of the trade in illegal excise goods in working contracts and key performance indicators since 2017 has had a positive impact on the enforcement activities of the Directorate General of Customs and Excise (DGCE) on illegal cigarettes. The DGCE, which is under the Ministry of Finance, runs the High-Risk Excise Control Program, a flagship program under the Customs and Excise Strengthening Reform Program launched by the Ministry of Finance in December 2016.

Domestic free trade zones (FTZs) have generated challenges in the enforcement of regulations on illegal cigarettes because cigarette production and trade in the FTZs are exempted from excise duties. The problem arises because non-FTZ areas are becoming exposed to the cigarette trade in the FTZs. The DGCE has explained that, if there were no excise exemption in the FTZs, then their burden of enforcement would decrease by 40 percent.

As a result of the reform in the excise tax and enforcement, the number of enforcement operations aimed at illegal cigarettes has increased by a factor of almost four, from 996 operations in 2014 to 3,950 in 2017. The estimated share of the domestic illicit trade in the total cigarette market thus shrank from 12.1 percent in 2016 to 7.0 percent in 2018. The decline is evidence that raising the tobacco excise tariff in 2016–18 and accompanying this with enforcement has been an effective reform.

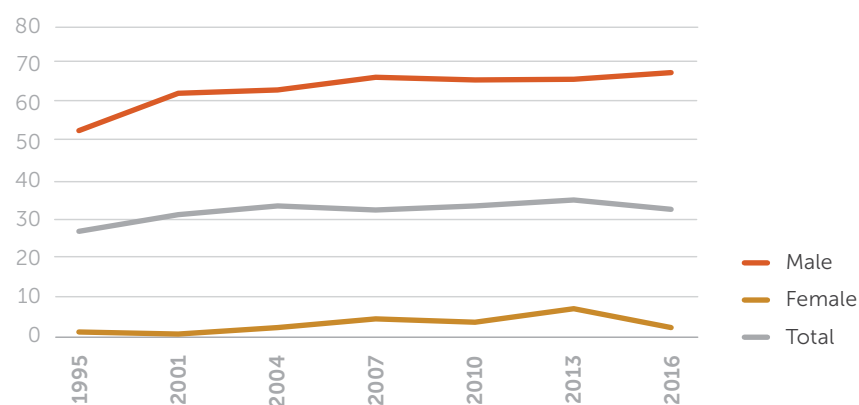
For the future, the institutional capacity of the excise administration in the DGCE should be enhanced. Moreover, raising the tobacco tax and the price of cigarettes would help significantly reduce the affordability and consumption of cigarettes. The tobacco excise system should also be simplified to reduce the incentives for illegal cigarette activities.

1. Background

Tobacco Use in Indonesia

The prevalence of smoking among adults in Indonesia rose from 27.0 percent to 32.8 percent over the period 1995–2016 (Figure 14.1). However, from 2013 to 2016, it declined from 36.3 percent to 32.8 percent. The prevalence of smoking among adult men exhibited a rising trend, from 53.4 percent in 1995 to 68.1 percent in 2016. This is among the highest prevalence rates globally.

Figure 1. Smoking Prevalence among Adults (15+), by Sex, Indonesia, 1995–2016



	1995	2001	2004	2007	2010	2013	2016
Male	53.4	62.2	63.1	65.6	65.8	66.	68.1
Female	1.7	1.3	4.5	5.2	4.1	6.7	2.5
Total	27	31.5	34.4	34.2	34.3	36.3	32.8

Source: Zheng et al. 2018.

Note: Tobacco use includes daily and occasional cigarette smoking and tobacco chewing.

Most Indonesian smokers (74.2 percent) begin smoking at between 10 and 19 years of age (Table 14.1). The share of new smokers among the 10–14 age group almost doubled, from 9.0 percent to 17.3 percent, in 1995–2013. Indonesia has recently begun to register a demographic dividend. The proportion of the productive-age population is large and will peak in 2030–35, when the dependency ratio will be at its lowest. The rise in young smokers can potentially ruin the benefits of the demographic dividend. The future burden of disease related with tobacco use can compromise the potential improvement in welfare.

Table 1. Age at First Use of Tobacco, Adults (Ages ≥ 15), Indonesia, 1995–2013

AGE	1995	2001	2004	2007	2010	2013
5–9	0.6	0.4	1.7	1.9	1.7	1.5
10–14	9.0	9.5	12.6	16.0	17.5	17.3
15–19	54.6	58.9	63.7	50.7	43.3	56.9
20–24	25.8	23.9	17.2	19.0	14.6	16.3
25–29	6.3	4.8	3.1	5.5	4.3	4.4
30+	3.8	2.6	1.8	6.9	18.6	3.6

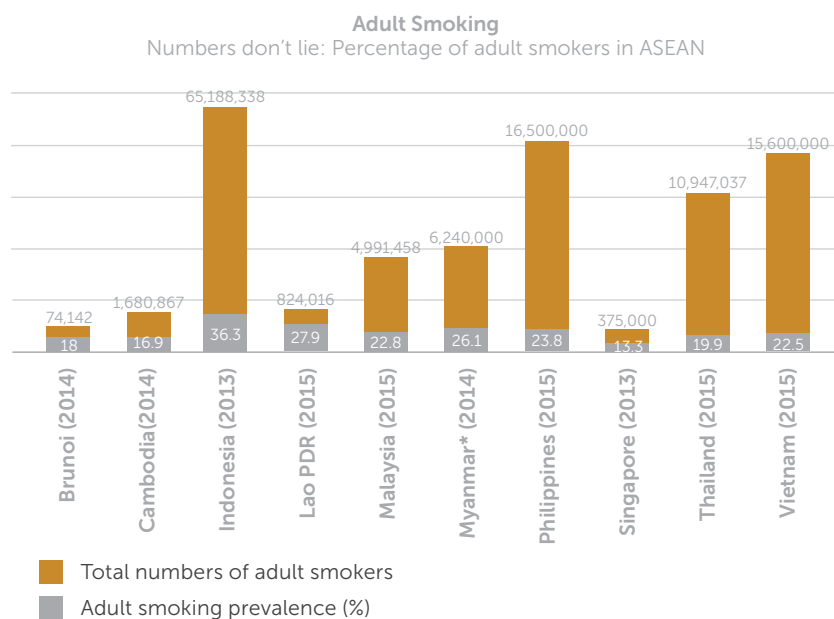
age cohort, %

Source: TCSC 2015.

Note: Tobacco use includes daily and occasional cigarette smoking and tobacco chewing.

The number of smokers in Indonesia in 2013 was 65.2 million (Figure 14.2). Indonesia accounts for the highest number of smokers in the region. This is because of the large share of adult smokers among the large population. The prevalence of smoking among adults in Indonesia is the highest in the region (36.3 percent). The high smoking prevalence and the large size of the population have drawn multinational tobacco corporations to enter the cigarette market in Indonesia.

Figure 2. Adult Smoking Prevalence and Total Number of Smokers, ASEAN Countries



Source: Lian and Dorotheo 2016.

Note: ASEAN = Association of Southeast Asian Nations.

The number of deaths attributed to tobacco was 230,862 in 2015. The macroeconomic losses associated with tobacco use consist of four components, as follows: expenditure for the purchase of cigarettes; lost disability-adjusted life years; productive years lost to morbidity, disability, and premature mortality; and medical expenditures associated with tobacco-attributable disease. In 2015, the total macroeconomic losses caused by tobacco use in Indonesia have been estimated at US\$45.9 billion (Kosen et al. 2017).

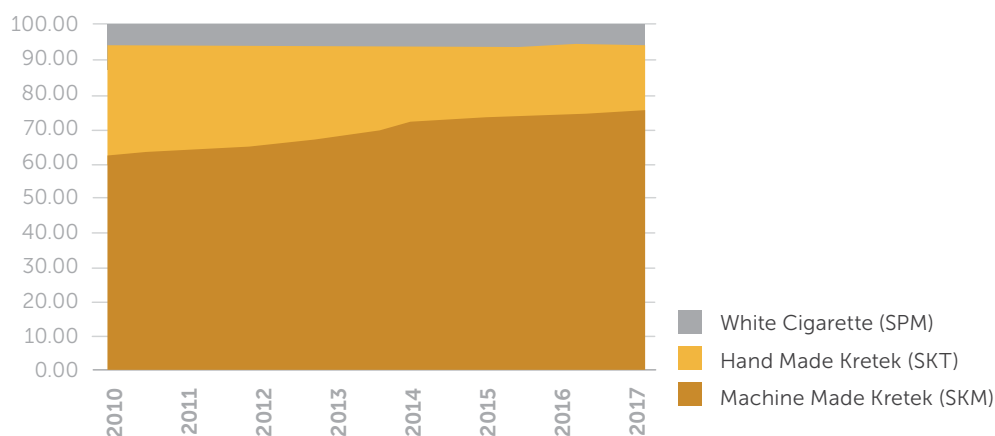
Market Share and Consumer Preferences

In Indonesia, there are three types of cigarettes: machine-made kretek (sigaret kretek mesin), hand-rolled kretek (sigaret kretek tangan, which contains tobacco and clove), and white (tobacco-only) cigarettes (sigaret putih mesin). Kretek is a cigarette consisting of tobacco, clove, and other ingredients. It is domestically produced in Indonesia. In 2010–17, there was a shift in market share toward machine-made kretek (Figure 14.3). This market share rose from 62.3 percent in 2011 to about 74.8 percent in 2017. At the same time, the market shares of hand-rolled kretek and white cigarettes were shrinking. The market share of the former fell from 31.4 percent to 20.2 percent in 2010–17. The market share of white cigarettes (mostly international brands) dropped from almost 6.3 percent to a little less than 5.0 percent over the same period. This has several implications. First, the cigarette industry in Indonesia has recently become more capital intensive. Hence, the industry demand for labor will fall because of the substitution effect between labor and machines. Second, the greater concentration on machine-made kretek will mean that the industry can sell more cigarettes more efficiently, thereby raising their profits significantly. This situation represents a public-health threat.

Because of the Ministry of Finance regulation on tobacco excise, the cigarette industry is stratified by type of cigarette, production group, and minimum price group. The three types of cigarettes are white cigarettes, hand-rolled kretek, and machine-made kretek. The two production groups of machine-made cigarettes (both white and kretek) are defined as: (1) below 3 billion and (2) above 3 billion individual cigarettes a year. There are four production groups for hand-rolled kretek: below 25 million, 25 million–100 million, 100 million–2 billion, and above 2 billion individual cigarettes a year. The last category, the minimum price group, depends on Ministry of Finance decisions, so that there are one or more price groups in each excise tier.

This stratification system was launched around the time of Indonesian independence in 1945. The government has maintained the system, with some modification, ever since. The system is designed to protect domestic and kretek producers in the face of competition from multinational cigarette corporations. However, from a public-health perspective, the tiered excise system creates wide price discrepancies, thereby hindering the effectiveness of tobacco price increases in controlling consumption (Fiscal Policy Board 2016).

Figure 3. Market Shares, by Type of Cigarette, Indonesia, 2010–17



	2010	2011	2012	2013	2014	2015	2016	2017
White Cigarette (SPM)	6.28	5.87	6.08	5.99	5.71	5.77	5.47	4.98
Hand Made Kretek (SKT)	31.41	30.37	28.63	25.43	21.67	20.88	20.72	20.23
Machine Made Kretek (SKM)	62.31	63.75	65.29	68.58	72.62	73.35	73.82	74.79

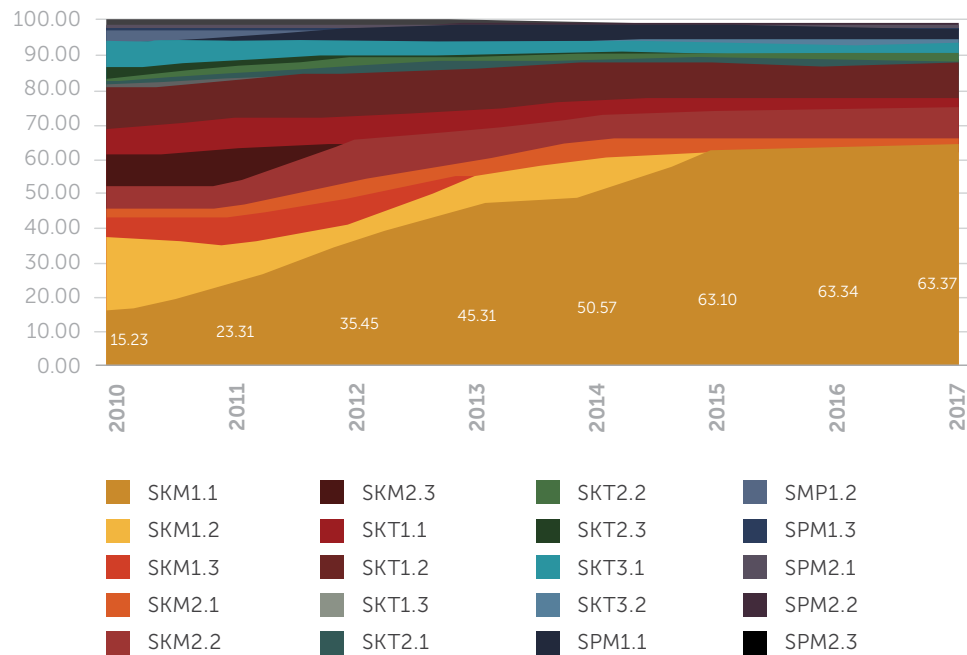
Sources: Zheng et al. 2018.

The cigarette industry in Indonesia is becoming more concentrated on the largest production group of machine-made kretek, more than 3 billion units per year (machine-made kretek 1) (Figure 14.4). This group has a 63.4 percent market share and the highest price. The other type of cigarette producers who have a dominant market share are hand-rolled kretek production group 1 and price group 2 (hand-rolled kretek 1.2) and machine-made kretek production group 2 and price group 2 (machine-made kretek 2.2). These cigarettes also have a relatively higher price. This is an anomaly, given that products at higher prices typically draw lower demand.

The Status of Tobacco Control Policies

Indonesia is the only country in Asia that has not ratified the Framework Convention on Tobacco Control (FCTC). The government has nonetheless implemented some degree of tobacco control, such as the national tobacco control roadmap, tobacco taxation, graphic health warnings, a limited ban on tobacco advertising, and local regulations on smoke-free areas in public places (Table 14.2).

Figure 4. Cigarette Market, by Type, Production Group, and Price Group, Indonesia, 2010–17



Sources: Zheng et al. 2018.

Indonesia's Tobacco Tax Policies

Indonesia imposes three types of taxes on tobacco products: the tobacco excise tax, the value-added tax, and the local cigarette tax. As noted above, the tobacco excise system is brand-specific and multi-tiered, based on the type of the product, the production group, and the minimum price group (Table 14.3). This complicated system creates wide price gaps that hinder the effectiveness of increasing tariffs and prices to reduce consumption. The system also creates complicated administrative requirements and generates incentives for illicit cigarette activities through the production of counterfeit excise stamps. However, the government raises the excise tariff and the minimum retail price on cigarettes every year at a rate greater than the inflation rate, and it thus decreases the affordability of cigarettes (Zheng et al. 2018). The government also plans to simplify the multitiered system from 10 tiers in 2018 to five tiers in 2021. The maximum allowable excise tariff is 57 percent of the retail price (Law No. 39 year 2007), and the 2017 excise tariff averaged 49.1 percent of the retail price (Ministry of Finance 2016). The second tax on tobacco products is the value-added tax. In 2017, the tariff was at 9.1 percent of the retail price. The third tax on cigarettes is the local cigarette tax implemented in 2014. The rate is at 10.0 percent of the excise tariff. Therefore, the average total tax burden on tobacco products is 62.7 percent of the retail price.

Table 2. Status of Tobacco Control, Indonesia, 2018

TOBACCO CONTROL POLICY	STATUS	REGULATION
Framework Convention on Tobacco Control	Not signed; not ratified	
National tobacco control roadmap	The policy target is to decrease smoking prevalence by 1 percent a year (2015–19) and decrease prevalence by 10 percent in 2024 relative to 2013 (from 36 percent to 26 percent).	Ministry of Health Regulation No. 40 year 2013 on Roadmap of Controlling the Health Impact of Tobacco Use
Tobacco tax	Multitiered excise system (10 tiers) based on type of product, production scale, and price range. The system hinders the effectiveness of tobacco excise policy to reduce tobacco use because it encourages downward substitution. The government also levies local taxes and value added taxes on cigarettes. The average excise tariff is 49 percent of the retail price, compared with the WHO recommendation of 70 percent. The local tax tariff is 10 percent of the excise tariff (4.9 percent of the retail price). The value added tax is 9.1 percent of the retail price.	Tobacco excise: Ministry of Finance Regulation No. 146/PMK.010/2017 Tobacco Product Excise Tariff
Tobacco advertising, promotion, and sponsorship ban	Limited ban on tobacco advertising on television. The ban allows advertising from 9.30 pm, when adolescents may still be watching, to 5 am local time. There is an increasing trend toward a ban on local outdoor tobacco advertising.	Government Regulation No. 109 year 2012 on Health Protection of Addictive Substances in the form of Tobacco Use. Several cities have issued local government regulations to ban outdoor tobacco advertising, for example, Jakarta Province, Bogor City, and Pekalongan City
Graphic health warnings	Graphic health warnings cover 40 percent of each pack of cigarettes (since 2014).	Government Regulation No. 109 year 2012 on Health Protection of Addictive Substances in the form of Tobacco Use
Smoke-free areas	It is mandatory for local governments to make public places smoke free by issuing local government regulations.	Government Regulation No. 109 year 2012 on Health Protection of Addictive Substances in the form of Tobacco Use

Source: World Bank analysis.

Note: WHO = World Health Organization

Although this rate seems quite high, making cigarettes less affordable, the majority of Indonesians can still afford to buy cigarettes. Indeed, the most-sold cigarette group is the one sold at the highest price. Based on the Ministry of Finance regulation, the minimum price of cigarettes ranges from Rp 4,800 (US\$0.34) to Rp 15,120 (US\$1.08) per pack of 12. The regulation allows cigarettes to be sold individually. Even primary-school children ages 7–12 can afford cigarettes, because their daily allowance averages Rp 10,000, which is sufficient to buy seven of the most expensive cigarettes (Susanto 2017).

Table 3. Tobacco Excise System, Indonesia, 2017–18

TYPE OF CIGARETTE	PRODUCTION GROUP	2017			2018		
		TIERS, NUMBER	MINIMUM RETAIL PRICE	EXCISE TARIFF, RP	TIERS, NUMBER	MINIMUM RETAIL PRICE	EXCISE TARIFF, RP
Machine-made kretek	1 (3 billion units or more)	1	1,120	530	1	1,120	590
	2 (less than 3 billion)	2	820	365	2	895	385
		3	655	335	3	715	370
White cigarettes	1 (3 billion and more)	4	1,030	555	4	1,130	625
	2 (less than 3 billion)	5	900	330	5	935	370
		6	585	290	6	640	355
Hand-rolled kretek	1 (2 billion or more)	7	1,215	345	7	1,260	365
		8	860	265	8	890	290
	2 (500 million–2 billion)	9	730	165	9	470	180
		10	470	155			
	3 (25 million–500 million)	11	465	100	10	400	100
	3B (below 25 million)	12	400	80			

Source: Ministry of Finance 2016, 2017a.

The Context of the Illicit Trade in Cigarettes

Indonesia is an archipelago of more than 10,000 islands. This is a challenge for law enforcement because of the wide area to be monitored. However, more than 60 percent of the population live on Java, where most of the tobacco industry is also located, in East Java, Central Java, and West Java. The cigarette market is dominated by kretek, a tobacco and clove cigarette, that is mainly produced domestically. The market share for kretek (machine-made or hand rolled) is 95 percent (Zheng et al. 2018). Hence, the demand for international white, tobacco-only cigarettes is low. This implies that the demand for smuggled white cigarettes is also low, but there could be high demand for illegal domestically produced kretek cigarettes.

Based on Ministry of Finance definitions, there are six types of illegal domestic cigarettes in Indonesia, as follows: unpacked cigarettes, cigarettes packed without excise stamps, cigarettes packed with forged or otherwise counterfeit excise stamps, cigarettes packed with excise stamps with incorrect business excise identification numbers, cigarettes packed with wrong designations, and cigarettes packed with used excise stamps (Ahsan et al. 2014). Another identifier of illegal cigarettes is the lack of a graphic health warning, which has been mandatory for every pack of cigarettes sold in Indonesia since June 24, 2014.

The regulations related to illicit cigarettes are listed in the Excise Law, No. 11 year 1995, and the revision, Law No. 39 year 2007. The responsible institution is the DGCE. After Indonesia's reformasi era (1998), local governments enjoyed greater power and autonomy, including enforcement in the illicit trade in cigarettes. Because of the tobacco excise revenue-sharing mechanism, the central government mandated that local governments contribute to the enforcement exercise on illicit cigarettes in their jurisdictions. Moreover, the DGCE, in enforcing regulations, may request assistance from the police and army. If such a request is made, the institution receiving it must fulfill the request (Law No. 39 year 2007, article 34).

The tobacco industry is readily accepted as a partner in the public policy-making process in Indonesia. It is still perceived as an important stakeholder. The excise law even states that the government must consider the aspirations of the tobacco industry in determining any increase in the tobacco excise tariff. While the interference of the tobacco industry in public policy making may be strictly prohibited in other parts of world, it is mandated in Indonesia by the current excise law (Law No. 39 year 2007, article 5). The tobacco industry often lobbies against raising the tobacco excise tax by referencing the need to inhibit the market for the less-expensive illicit cigarettes.

2. The Reform in Tackling Illicit Cigarettes

The Legal Framework

The approach adopted by the government to reduce the illicit trade in cigarettes is mainly embodied in Law No. 11 year 1995 and the partial revision in Law No. 39 year 2007. The former is a comprehensive law on excise collection and enforcement. It consists of 14 provisions (Table 14.4). This case study explores the regulations on illicit cigarettes contained in these laws and other government directives. It examines regulations on licensing, bookkeeping and monitoring, point-of-tax collection, excise-free and exemption facilities, restrictions on sales of tobacco products, details about cigarette production plants, and sanctions.

LICENSING

The government requires every factory owner, warehouse owner, importer, distributor, and retailer of excised goods to have a special license, the business excise identification number for excised goods producers. However, a special license is not required of distributors and retailers of tobacco products. The requirement only applies for ethyl alcohol and alcoholic beverages (Law No. 39 year 2007, article 14). The government can revoke the license for any one of eight reasons: no activity for one year; licensing requirements are no longer being met; the license holder no longer legally represents a legal entity or an individual who resides outside Indonesia; the license holder has been declared bankrupt; the license holder has not fulfilled the provisions laid out in paragraph (3), on inheritance of the license; the license holder has been sentenced for violating the provisions of this law; and the license

Table 4. Legal Provisions, Law No. 11 Year 1995 on Excise

NO.	TITLE	DESCRIPTION
1	General rule	General definitions used in the law
2	Excise goods, tariffs, and reference prices	Type of excise goods, tariffs, and reference prices
3	Payment and special facility	Procedure for payment and special facilities
4	Billing, refunds, and expiration	Administration and regulations on billing, refunds, and expiration
5	Licensing	Regulation on licensing
6	Bookkeeping and enumeration	Detailed procedures on recording and enumeration by the relevant authorities
7	Warehouse	Regulations on warehousing
8	Inflow, release, transportation, and trade	Regulations on inflow, release, transportation, and trade
9	Prohibition	Details on prohibition related to excise administration
10	Mandated authority in excise enforcement	Span of authority in excise enforcement by various institutions
11	Objection, appeals, and lawsuits	Procedures for objections and appeals
12	Criminal provision	Details on the criminal provision and sanctions
13	Investigation	Regulations and procedures in investigation
14	Other	

Source: World Bank analysis of Law No. 11 year 1995, on excise.

holder violates the provisions of article 30, the prohibition of production other than as stated in the license.

BOOKKEEPING AND MONITORING

Factory owners and warehouse owners involved with excised goods, including tobacco products, must register, in an inventory book, any product that has been produced at the factory, has entered the factory, or has been removed from the factory. Factory owners must periodically notify the head of the local Customs and Excise Office of details about their output (article 14). Factory owners and warehouse owners who do not record goods as required are liable to an administrative fine equal to the excise value that has not been recorded (article 16).

A customs and excise officer may at any time monitor the excised goods, including tobacco products, in the factory or warehouse. The owner of the factory and storage building must provide the officer with any equipment needed for the monitoring process (Law No. 11 year 1995, article 20). If the quantity of a product found during the monitoring process is less than the amount specified in the accounts, the factory or warehouse owners may be entitled to

receive a maximum 10 percent rebate (article 21). In the factory, import facility, or retail sales location where excise stamps are affixed, used excise stamps and used packs of cigarettes with excise stamps in good condition may not be stored (Law No. 39 year 2007, article 32).

POINT-OF-TAX COLLECTION

On domestically produced cigarettes, the excise tariff must be paid when the goods are released from the factory or warehouse. On imported cigarettes, the excise tariff must be paid when the product is imported for final consumption. The excise may be paid without affixing an excise stamp or the stamp may be affixed after the payout. If the payment of the excise tariff is associated with affixing the excise stamp, then the stamp must be affixed in accordance with the provisions of the law; otherwise, the tariff shall be considered unpaid (Law No. 39 year 2007, article 7).

EXCISE-FREE AND EXEMPTION FACILITY

An excise-free facility indicates that an excise tax is still levied on the tobacco product, but the owners do not have to pay the excise tariff if they meet certain conditions. There are five conditions under the excise-free facility, as follows: if the product is to be transported to locations outside the customs area, if it is exported, if the product enters a factory or warehouse, if it is used as a raw material or auxiliary material for the production of other final excised goods, and if it has been destroyed or damaged before being released from the factory, or warehouse, or prior to import approval (Law No. 39 year 2007, article 8).

An excise exemption may be granted on excise goods, tobacco products included, if these meet one of six conditions, as follows: if they are used as raw materials or auxiliary materials in the production of nonexcised final products; if they are used for scientific research and development; if they are to be used for the purposes of representatives of foreign governments or their officers who are assigned to Indonesia and based on reciprocal principles; if they are carried by passengers, transport crews, border crossers, or on consignment from abroad in specified amounts; if they are used for social purposes, for example, for disaster relief; and if they are being sent to bonded areas, that is, special areas set aside mainly for processing export goods (Law No. 39 year 2007, article 9). The maximum amount of excise exemptions on tobacco products per traveler is 200 cigarettes, 25 cheroots, or 100 grams of shredded tobacco or other tobacco product (Ministry of Finance Regulation No. 188/PMK.04/2010, article 9).² For transport crews, the maximum amount of excise exemptions on tobacco products is 40 cigarettes, 10 cheroots, and 40 grams of shredded tobacco or other tobacco product (Ministry of Finance Regulation No. 188/PMK.04/2010, article 11).

² Peraturan Menteri Keuangan Republik Indonesia No. 188/PMK.04/2010 tentang Impor Barang yang Dibawa oleh Penumpang, Awak Sarana Pengangkut, Pelintas Batas dan Barang Kiriman (Ministry of Finance Republic Indonesia Regulation No. 188/PMK.04/2010 on Import Goods Bring by Passenger, Crew, Border Crosser and Shipment Goods).

RESTRICTIONS ON THE SALE OF TOBACCO PRODUCTS

There is no prohibition on the sale of tobacco products over the Internet or in duty-free shops. However, the sale of tobacco products through vending machines, the sale of tobacco products to minors ages under 18, and the sale of tobacco products to pregnant women is prohibited (Government Regulation No. 109 year 2012, article 25).³

REGULATIONS ON PRODUCTION AND STORAGE PLANTS

Before applying for a business excise identification number (Nomor Pokok Pengusaha Barang Kena Cukai), a factory owner or importer must submit an application to the DGCE for an inspection of the location, building, or place of business. The location, building, or places of business where the tobacco products are manufactured or stored must comply with four provisions (Ministry of Finance Regulation No. 200/PMK.04/2008, article 3), as follows.⁴ First, the building must not be directly connected to other buildings or areas that are not part of the factory for which permission is sought. Second, the building must not be directly contiguous with or in a residential area. Third, the building must be adjoined to and accessible from public roads. Fourth, the building must have an area of at least 200 square meters (2,150 square feet). This regulation makes cigarette production more difficult and is considered a tool to control tobacco production.

SANCTIONS

There are two types of enforcement mechanisms regarding illicit cigarettes, administrative provisions and criminal provisions. The administrative enforcement provisions are associated with penalties involving only the payment of fines. The criminal enforcement provisions are associated with penalties involving imprisonment or the payment of fines. The criminal provisions are contained in Law No. 11 year 1995 on the excise tax and the revision Law No. 39 year 2007 (Table 14.5).

THE GOVERNANCE AUDITING AND INSPECTION PROCESS

All municipal, provincial, and national government units are subject to internal audit and inspection, including the DGCE in enforcing regulations on illicit cigarettes. The internal inspections are conducted by the government internal control officers through audits, reviews, evaluations, monitoring, and other supervisory activities (Government Regulation No. 60 year 2008, article 48).⁵ The internal government supervisory officers include

³ Peraturan Pemerintah Republik Indonesia No. 109 tahun 2012 tentang Pengamanan Bahan yang Mengandung Zat Adiktif Berupa Produk Tembakau bagi Kesehatan (Republic Indonesia Government Regulation No. 109 year 2012 on Health Protection of Addictive Substances in the form of Tobacco Use).

⁴ Peraturan Menteri Keuangan Republik Indonesia No. 200/PMK.04/2008 tentang Tata Cara Pemberian, Pembekuan, dan Pencabutan Nomor Pokok Pengusaha Barang Kena Cukai untuk Pengusaha Pabrik dan Importir Hasil Tembakau (Republic of Indonesia Ministry of Finance Regulation No. 200/PMK.04/2008 on Procedure of Getting, Freezing and Revoking Identity Number for Tobacco Product Owner and Importer).

⁵ Peraturan Pemerintah Republik Indonesia No. 60 Tahun 2008 Tentang Sistem Pengendalian Intern Pemerintah (Republic Indonesia Government Regulation No. 60 year 2008 on Government Internal Controlling System).

Table 5. Examples of Criminal Provisions, Excise Law No. 39 Year 2007

ARTICLE	STATEMENT
50	Any person without a license, as provided in article 14, who is running a factory or a storage facility or who imports excisable goods that require the payment of affixed excise stamps and who thereby causes losses to the state shall be subject to imprisonment of no more than five years and a fine of no less than 2 times and no more than 10 times the excise value that should have been paid.
54	Anyone offering, delivering, selling, or providing for sale any excisable goods that is not packaged for retail sale or to which an excise stamp has not been affixed, as provided for in article 29, paragraph (1), shall be subject to imprisonment of at least one year and at most five years and (or) a fine of at most 10 times the excise value that should have been paid.
58	Anyone offering, selling, or trading excise stamps to unauthorized persons or buying, receiving, or using excise stamps to which they are not entitled shall be subject to imprisonment of at least one year and at most five years and (or) a fine of at most 10 times the amount of the excise that should have been paid.

Source: Law No. 39 year 2007, on the excise.

representatives of the Government Internal Financial Audit Board, the Inspectorate General, and other internal auditors and control personnel, such as provincial inspectorates and district or city inspectorates (Government Regulation No. 60 year 2008, article 49). All government units are also subject to external supervision by the Financial Audit Board and the Corruption Eradication Commission.

INTERNATIONAL COLLABORATION TO TACKLE THE TRADE IN ILLICIT CIGARETTES

As a member of the Association of Southeast Asian Nations, Indonesia cooperates with other countries in the region in tackling the trade in illicit cigarettes. Border security is coordinated among the countries of the regional association, for example. Indonesia is also active in the annual meeting of the Association of Southeast Asian Nations Forum on Taxation, discussing many taxation issues, including illicit cigarettes.

The Institutional Framework

The leading institution on illicit cigarette regulation and enforcement is the DGCE. The DGCE has a dedicated directorate for enforcement and prevention to make sure that all regulations on the excise tax are followed by all stakeholders. If needed, the DGCE may request assistance from the police and army (Law No. 39 year 2007, article 34).

Local, municipal, and provincial governments are also involved in enforcement in the illicit trade in cigarettes. Under Indonesia’s tobacco excise revenue-sharing mechanism, 2 percent of the tobacco excise revenue going to the central government is transferred to provinces that produce tobacco and cigarettes. Recently, 17 provinces were receiving these funds. The funds may only be used by the local governments for five activities (Law No. 39 year 2007, article 66A), as follows: quality improvements in raw materials, industrial development and monitoring, development of the social environment, implementation of the regulations on the excise tax, and eradication of illegal excised goods.

Five activities are aimed at the eradication of illegal excised goods, especially cigarettes. First, the collection of information on tobacco products on which counterfeit excise stamps have been affixed during distribution or at the point of sale. Second, the collection of information on tobacco products on which excise stamps have not been affixed during distribution or at the point of sale. Third, the collection of information on tobacco products on which excise stamps have been affixed during distribution or at the point of sale that bear incorrect names or business excise identification numbers. Fourth, the collection of information on tobacco products on which excise stamps have been affixed that bear an incorrect category designation, such as a stamp indicating a product is hand-rolled kretek, though the product is machine-made kretek, during distribution or at the point of sale. Fifth, the collection of information on tobacco products on which previously used excise stamps have been affixed during distribution or at the point of sale.⁶

Local governments that have received these funds must carry out these activities at least twice a year. In conducting these activities, the heads of the local governments must cooperate and coordinate with the head of the local DGCE office (Ministry of Finance Regulation No. 222/PMK.07/2017, article 10).

The other avenue taken by local governments in enforcing the regulations on illegal cigarettes is the local cigarette tax mechanism. Since 2014, the government has applied a local cigarette tax mandated by Law No. 28 year 2009 on local taxes and retribution. This local tax earmarks 50 percent of the revenue for public health, law enforcement on the illicit trade in cigarettes, and the establishment of smoke-free areas. Every local government in Indonesia received this local cigarette tax revenue based on the size of the population. However, because this is provincial tax revenue, the central government, the Ministry of Finance in this case, does not provide detailed guidance on using the funds for enforcement.

The Technological Solution

The DGCE has long been using excise stamps as fiscal markers for tobacco products and alcohol. All tobacco products that are domestically produced or imported must bear an excise stamp on the packaging. This regulation was introduced on July 1st, 1950, under Government Regulation No. 2 year 1950, which was a revision of the Dutch colonial tobacco excise regulation. To prevent forgery, the government has added features to the excise stamps that were difficult to falsify.⁷ These features include information on the type of cigarette production, the excise tariff, and the fiscal year; the garuda bird symbol (a legendary bird); a banderol with the price, the number of cigarettes, and a slogan, "Cukai Hasil

⁶ Smokers can resell used excise stamps that are in good condition. They merely remove the stamp carefully from the pack and then sell it to another cigarette producer, who benefits to the extent that the used excise stamp is less expensive.

⁷ Peraturan Direktur Jenderal Bea dan Cukai No. PER-29/BC/2017 tentang Bentuk Fisik dan atau Spesifikasi Desain Pita Cukai Hasil Tembakau dan Pita Cukai Minuman yang Mengandung Etil Alkohol tahun 2018 (Directorate General Customs and Excise Regulation No. PER-29/BC/2017 about Design Specification of Excise Stamp for Tobacco Product and Alcoholic Beverages 2018).

Tembakau Indonesia” (Indonesia, excise on tobacco product); and the logo of the DGCE. The regulation established government stamps of distinct colors according to the rate of the excise. Thus, green represented a 30 percent excise; black, 40 percent; and dark blue, 50 percent. However, the color is changed every year, and colors are also added to the stamp depending on the type of cigarette (Directorate General Excise and Customs Regulation No. 29 year 2017). In 2018, the DGCE used five colors to represent the cigarette type, as follows:

- » Blue, combined with orange: machine-made kretek, white cigarettes, hand-rolled kretek, group 1
- » Red, combined with orange: machine-made kretek, white cigarettes, hand-rolled kretek, group 2
- » Purple, combined with red: hand-rolled kretek, group 3
- » Gray, combined with green: shredded tobacco, cigarettes wrapped in corn leaf, and rhubarb cigarettes
- » Gray, combined with orange: imported tobacco products

The DGCE also produced stamps of different sizes. There are three series by stamp size, as follows:

- » Series 1: 0.8 centimeters wide and 11.4 centimeters in length
- » Series 2: 1.3 centimeters wide and 17.5 centimeters in length
- » Series 3: 1.9 centimeters wide and 4.5 centimeters in length

Each excise stamp contains a hologram, a feature that is difficult to forge. The size of the holograms is as follows:

- » Series 1: 0.7 centimeters wide
- » Series 2 and 3: 0.5 centimeters wide

On the hologram were two acronyms BC and RI, which stand for Bea dan Cukai (customs and excise) and Republik Indonesia (Republic of Indonesia), respectively. Excise stamp series 1 and 2 were used for hand-rolled kretek, some white cigarettes, shredded tobacco, cigarettes wrapped with corn leaf, and rhubarb cigarettes. Excise stamp series 3 was used for machine-made kretek, some white cigarettes, and cigars.

The DGCE also issued specially coded stamps for selected producers whose products were prone to be linked to illegal activities because of similar features, as follows:

- » Producers of group 2 who manufactured machine-made kretek and white cigarettes
- » Producers of groups 2 and 3 who manufactured hand-rolled kretek and white cigarettes
- » Producers of shredded tobacco, cigarettes wrapped with corn leaf, and rhubarb cigarettes

To detect whether excise stamps are authentic or counterfeit, DGCE officers use ultraviolet light and a magnifying glass to determine if the stamp contains the microtext “INDONESIA,”

the excise tariff, and the acronym RI, which becomes BC if the stamp is rotated to the left. Under ultraviolet light, the stamp will not glow, but absorb the rays and show images, writing colors, a hexagon symbol, and red fibers.

The track and trace system (TTS) for tobacco products includes monitoring production and tracking the movement of and the trade in tobacco products using the unique identifiers on the tobacco products. The system has not been implemented in Indonesia so far. It is not clear why the government does not require the tobacco industry to pay for as well as implement such a system.

Enforcement Reform in the DGCE

An in-depth interview has been conducted with the DGCE official responsible for enforcement against the illegal cigarette trade to learn what has been done by the DGCE.⁸ The DGCE performance report for 2015–17 and other DGCE materials have also been analyzed. This subsection describes the relevant missions and human resources of the DGCE, a performance contract between the DGCE and the Ministry of Finance, key performance indicators that represent milestones, and the reform of the enforcement mechanism.

THE RELEVANT MISSIONS AND HUMAN RESOURCES OF THE DGCE

There are three missions of the DGCE, namely:

- » To facilitate trade and industry
- » To safeguard the Indonesian border and protect Indonesians from smuggling and other illegal trade (which would thus include law enforcement on the illicit trade in cigarettes)
- » To optimize state revenues from customs and excise taxes

The DGCE has 20 branch offices spread throughout Indonesia. They are located in Aceh, Bali, Banten, Central Java, East Java, East Kalimantan, East Nusa Tenggara, Jakarta (headquarters), Maluku, North Sulawesi, North Sumatra, Papua, Riau, Riau Islands, South Kalimantan, South Sulawesi, West Java, West Kalimantan, West Nusa Tenggara, West Sumatra, and Yogyakarta. In addition, there are 104 Customs and Excise Supervisory and Service Offices and three Main Customs and Excise Service Offices. These are located in Batam, Soekarno-Hatta Airport, and Tanjung Priok Seaport. Currently, 14,169 people work at the head office, regional offices, the main service office, supervisory and services offices, and the operation facilities office. Of the total, 12,219 are men (86.2 percent), and 1,950 are women (13.8 percent).

⁸ The in-depth interview was conducted with the head of the section on tobacco excise enforcement, Directorate of Enforcement and Investigation, DGCE, at the DGCE, Jakarta, on July 13, 2018. See also Ministry of Finance (2016), (2017a), (2017b).

PERFORMANCE CONTRACT AND KEY PERFORMANCE INDICATORS

Through the interview with the chief DGCE officer, it was learned that the reform in illegal cigarette enforcement was marked by a new dedicated key performance indicator on enforcement. The reform was launched in 2017. The key performance indicator was agreed in the performance contract between the DGCE and the Ministry of Finance. The key performance indicator in enforcement is accompanied by information on the target performance to be achieved each year. Before this key performance indicator existed, enforcement activity in DGCE was unplanned and sporadic. DGCE enforcement activities are now better coordinated and more comprehensive nationwide.

The 2016–18 performance contracts between the DGCE and the Ministry of Finance set 14 targets and the corresponding indicators. One target is related to effective law enforcement, and the indicator is the rate at which DGCE investigations are judged complete by the state prosecutor’s office. The effectiveness target is 60 percent (table 14.6).⁹ Illegal cigarette enforcement was part of this target. In 2017, there were two additional indicators related to law enforcement: the winning percentage of appeals in the tax court (the 2017 target was 35 percent) and the percentage of successful supervisions of illegal excised goods, among which the illicit trade in cigarettes is dominant (the target was 70 percent). In 2018, the three indicators of effective law enforcement remained the same, but the targets associated with each indicator were increased. The target for indicator 1, the share of DGCE investigations marked complete by state prosecutors, was 70 percent. For indicator 2, the winning share of appeals in tax court, the target was 38 percent. For indicator 3, the successful supervision of illegal excised goods, the target was 70 percent.

Table 6. DGCE Performance Indicators, Effective Law Enforcement, Indonesia, 2016–18

2016		2017		2018	
INDICATOR	TARGET, %	INDICATOR	TARGET, %	INDICATOR	TARGET, %
DGCE investigation judged complete by state prosecutors	60	DGCE investigation judged complete by state prosecutors	65	DGCE investigation judged complete by state prosecutors	70
		Winning share of appeals in tax court	35	Winning share of appeals in tax court	38
		Successful supervision of illegal excised goods	70	Successful supervision of illegal excised goods	70

Source: Ministry of Finance 2016, 2017a, 2017b.

⁹ The dossier on the investigation of the DGCE is transmitted to the State Prosecutors Office, which is responsible for filing the case with the courts. The prosecutor can mark the DGCE investigation as complete or not complete.

Indicator 3, the successful supervision of illegal excised goods, involves a series of supervision activities on the distribution of tobacco products using market operation schemes. The market operations consist of three programs. First is the monitoring of the banderol price and the market transaction price on products. The difference between the banderol price and the market transaction price determines whether the DGCE undertakes a follow-up action.¹⁰ Second is the distribution of information on the regulations on illegal cigarettes to the public, mainly the cigarette seller and the consumer. Third are enforcement activities such as investigation, seizure, and prosecution on activities related to the trade in illicit cigarettes (Ministry of Finance 2017a).

Planning for supervision activities on illegal excised goods is launched in the beginning of the year and involves consideration of smoking prevalence, the share of smokers in the population, income per capita, the size of the market, the available human resources, and the available budget in each DGCE unit. The implementation of supervision activities is undertaken by DGCE units following reception of a letter of assignment and a letter of enforcement authorization. After transmitting enforcement authorization letters, the DGCE follows up according to several options depending on the context and the nature of the illegal activities. These options are as follows

- » Imposition of an administrative sanction, that is, a fine
- » Investigation
- » Determination whether seized goods are under the control of ownership of the state
- » Blocking the seized goods and closing down the location
- » Recommending an additional audit
- » Reexport of the goods
- » Recommending that excise banderols no longer be provided to relevant suppliers
- » Delegation of the case to other institutions
- » Freezing the business excise identification number
- » Revocation of the business excise identification number
- » Destruction of the seized goods
- » Cancellation of export license
- » Issuance of an authorization letter to a related institution for further action
- » Changing the excise tariff
- » Return of the seized goods to the owner

¹⁰ If the market transaction price, that is, the actual consumer price, is higher by more than 5 percent of the banderol price, then the DGCE will group the product in the upper group of excise tariffs. The market transaction price cannot be lower by more than 15 percent of the banderol price, the price decided by the DGCE based on producer characteristics (type of cigarette and production and price group) and the corresponding tier in the regulation.

In 2017, over 97 percent of the planned supervision activities were carried out during the year by the various DGCE units (Table 14.7). This surpassed the target of 70 percent. This achievement could not be compared with the results during the previous year because 2017 was the first year this indicator was used.

REFORM OF THE ENFORCEMENT MECHANISM

Table 7. Planning and Realization, Supervision Activities on Illegal Excise Goods, 2017

INDICATOR	QUARTER 1	QUARTER 2	TOTAL TO Q2	Q3	TOTAL TO Q3	Q4	YEAR
Plan	10.0	30.0	30.0	60.0	60.0	70.0	70.0
Result	65.4	69.5	69.5	78.6	78.6	97.1	97.1

percent

Source: Ministry of Finance 2017a.

The DGCE organizational reform launched in 2017 was implemented through the Custom and Excise Strengthening Reform Program (Program Penguatan Reformasi Kepabeanan dan Cukai). The program was designed to increase organizational effectiveness in responding to public expectations and supporting national development goals. The program was launched on December 20, 2016, by the Ministry of Finance. It has four main components, as follows:

- » The High-Risk Importer Control Program (Program Penertiban Importir Berisiko Tinggi)
- » The High-Risk Excise Control Program (Program Penertiban Cukai Berisiko Tinggi)
- » The Synergy Program of the DGCE and the Directorate of Taxation
- » The Ease in Doing Business Fostering Program

The objective of the excise control program is to reduce the distribution of and trade in illegal excisable goods, especially cigarettes. Some of the program activities related to tobacco products are the following:

- » The STOP Illegal Cigarette Campaign is conducted through the distribution of information on laws and regulations, STOP Illegal Cigarettes stickers, videos, and other media
- » In-depth follow-up research based on recommendations of regional cigarette control offices
- » Enforcement and post-enforcement activities

There are four challenges facing the program (Ministry of Finance 2017a). First, the increase in the tobacco excise tariff is tending to push up the demand for illegal cigarettes. Second, the target for the maximum share of illegal cigarettes in total consumption is 6.0 percent, but, based on current estimates, the share was 10.9 percent in 2017. Third, other types of

smoking products are rapidly coming on line, such as electronic cigarettes and vape. Fourth, links among the DGCE offices throughout the country require improvement.

The DGCE Directorate of Enforcement and Investigation has developed an action plan to monitor tobacco products. The plan revolves around the following:

- » Supporting massive, coordinated, and nationwide distribution of literature on illegal cigarettes
- » A synchronized enforcement program targeting producers of illegal cigarettes and enforcement of the laws on money laundering
- » Monitoring illegal cigarettes as a key performance indicator
- » The registration of cigarette machines as a mandatory part of the application process for business excise identification numbers
- » Promoting the eventual tobacco industry-wide implementation of the integrated digital inventory system for tobacco

The directorate has also created a special team to monitor full time the compliance with regulations on the excise tax. The team members all have a cross-disciplinary background. The team is responsible for expanding enforcement activities significantly and thereby reducing illegal cigarette consumption. In support of the excise monitoring team, the Ministry of Finance issued Regulation No. 144/PMK.02/2016 on incentives for the excise enforcement team. The regulation is designed to help motivate the team to achieve the goals. The incentive includes a monetary premium, the amount of which depends on the level of achievement of the goals. To improve coordination in excise and custom enforcement activities, the Ministry of Finance has also signed a relevant memorandum of understanding with the army (2017) and the national police (2012) on excise and custom enforcement. The memorandum is aimed at strengthening the enforcement effort by the DGCE, especially in the area of illegal cigarettes.

CHALLENGES IN OPERATIONS AGAINST ILLEGAL CIGARETTES

Operations focusing on points of production and distribution of illegal cigarettes have been carried out by regional and central DGCE offices. The operations have been supported by police and the army. The main challenge facing these operations is the resistance of the people living around the factories. The factory owners incite local residents against the officers. Under these circumstances, operations have usually been canceled. Meanwhile, DGCE officers have begun working closely with local governments to win the hearts of the people. Operations aimed at means of transportation and at points of sale have been easier because there is no resistance from local residents. The officers confiscate illegal cigarettes brought by vehicles and sold in shops without encountering any resistance.

DOMESTIC FREE TRADE ZONES: A CHALLENGE FOR ENFORCEMENT

There are four FTZs in Indonesia: Sabang (Aceh Province) and Batam, Bintan, and Karimun (Riau Islands Province). Within these FTZs, otherwise excisable goods are not subject to duties, value-added taxes, or excise taxes. This is clarified in Law No. 36 year 2000, article 1:¹¹

Free Trade Zone and Free Seaport are an area within the territory of Republic of Indonesia separated from the customs area so that it is free from imposition of import duty, value-added tax, sales tax on luxury goods, and excise.

The law thus establishes that the production of and trade in cigarettes in the FTZs are not subject to excise. Cigarettes produced and distributed in the FTZs are exempted from the excise stamp. The price is therefore much lower. The problem is that the cigarettes leak out of the FTZs. The cigarettes become illegal because the packs bear no excise stamps. This obliges the DGCE to undertake extra effort in supervising and enforcing cigarette control activities. If the government were to remove the reference to the excise tax in Law No. 36, article 1, the overall burden of the DGCE with respect to illegal cigarettes would be reduced by around 40 percent.¹²

3. Result of the Reform

Increasing Illegal Cigarette Enforcement Operations

One component of the Custom and Excise Strengthening Reform Program of the Ministry of Finance is the High-Risk Excise Control Program. The aim of this program is to combat illegal commerce and unfair competition in excised goods, especially to secure the lost government revenue. Several activities related to illicit cigarettes in this program are the STOP Illegal Cigarette Campaign, research based on recommendations of regional cigarette control offices, and sustainable enforcement and post-enforcement activities. The program has more than tripled the number of enforcement operations, from 996 in 2014 to 3,950 in 2017 (Figure 14.5).

The rising number of enforcement operations has significantly raised the number of illegal cigarettes seized (Figure 14.6). This number increased by a factor of 3.6, from 94.2 million cigarettes in 2013 to 341.9 million in 2016. The monetary value of the seized cigarettes also rose, by a factor of 4.5, from Rp 52 billion (US\$3.6 million) in 2013 to Rp 232.5 billion (US\$16.1 million) in 2016 (Figure 14.7).

¹¹ Undang-undang Republik Indonesia No. 36 year 2000 tentang Kawasan Perdagangan Bebas dan Pelabuhan Bebas (Republic of Indonesia, Law No. 36 year 2000 on Free Trade Zone and Seaport).

¹² In-depth interview with the head of the Section of Illegal Cigarette Enforcement, Directorate of Enforcement and Investigation, DGCE.

Figure 5. Illegal Cigarette Enforcement Operations, Indonesia, 2014–17

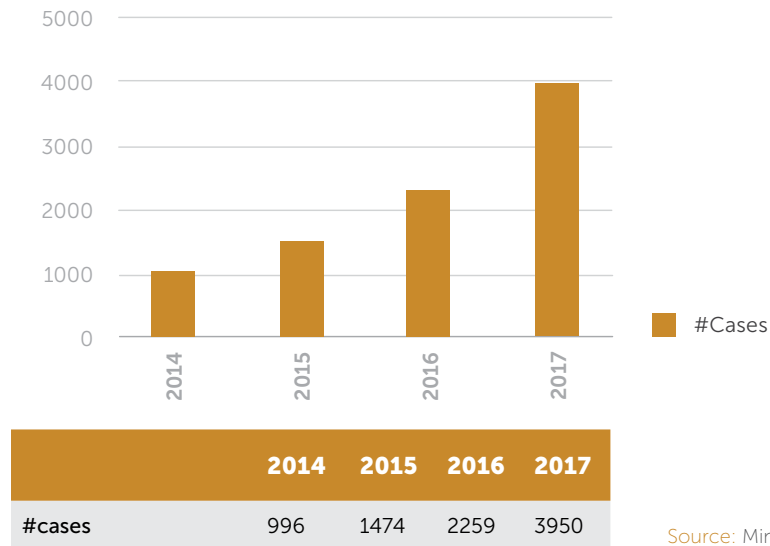


Figure 6. Number of Illegal Cigarettes Seized, Indonesia, 2013–16

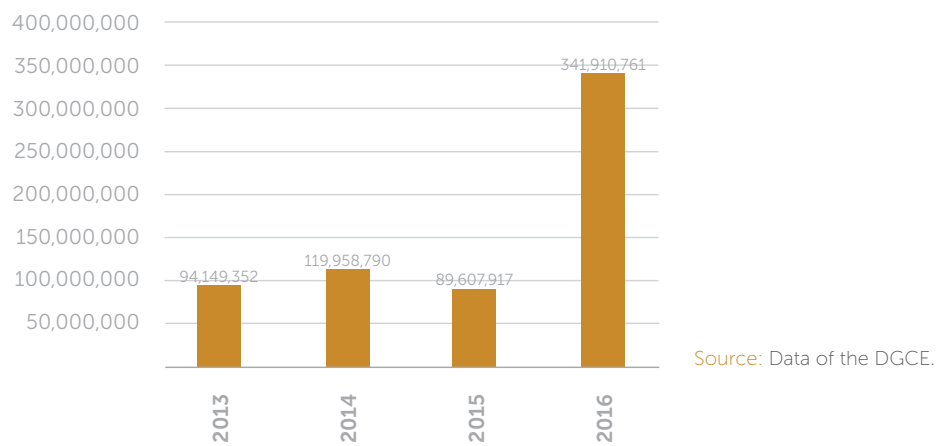
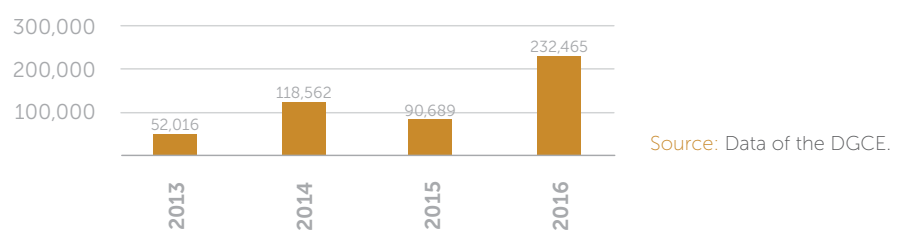


Figure 7. The Value of Seized Illegal Cigarettes, Indonesia, 2013–16 (Rp, Millions)

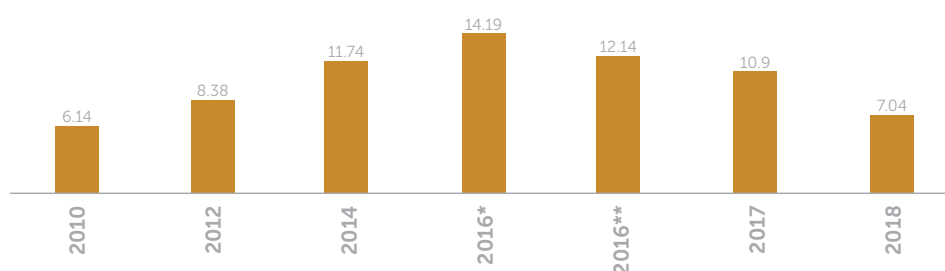


The Decline in the Market Share of Illegal Cigarettes

Several studies have estimated the market share of illicit cigarettes in Indonesia. Relying on a comparison of legal cigarette sales and domestic consumption estimated from surveys, Ahsan et al. (2014) estimate the consumption of illicit cigarettes at 8 percent of the total market in 2013. In their study, Satriawan, Adji, and Jaya (2010) survey 256 villages in 64 municipalities in 16 provinces. They collected 18,200 packs of cigarettes and examined them to estimate the market share of illegal cigarettes in Indonesia. Based on in-depth interviews with DGCE officials and the survey material, the study presents a reduction in illegal cigarettes as a target in Indonesia. The authors project that, by 2018, the market share of illegal cigarettes would reach as little as 6 percent. However, based on estimates of the Universitas Gajah Mada, the market share of illegal cigarettes was slightly more than 7 percent in 2018.

The DGCE deserves a great deal of appreciation. The market share of illegal cigarettes has decreased significantly, although it has not reached the target. The estimated share fell 42 percent, from 12.1 percent in 2016 to 7.0 percent in 2018 (Figure 14.8). This also shows that a rise in the tobacco tax rate is not always followed by the greater use of illegal cigarettes, as the tobacco industry claims. A substantial reform in enforcement has succeeded in decreasing the prevalence of illegal cigarettes in Indonesia. The government should therefore be more confident in raising the tobacco excise tariff and the price of cigarettes because, with effective enforcement, illegal cigarettes can be suppressed.

Figure 8. Estimated Market Share, Illegal Cigarettes, Indonesia, 2010–18

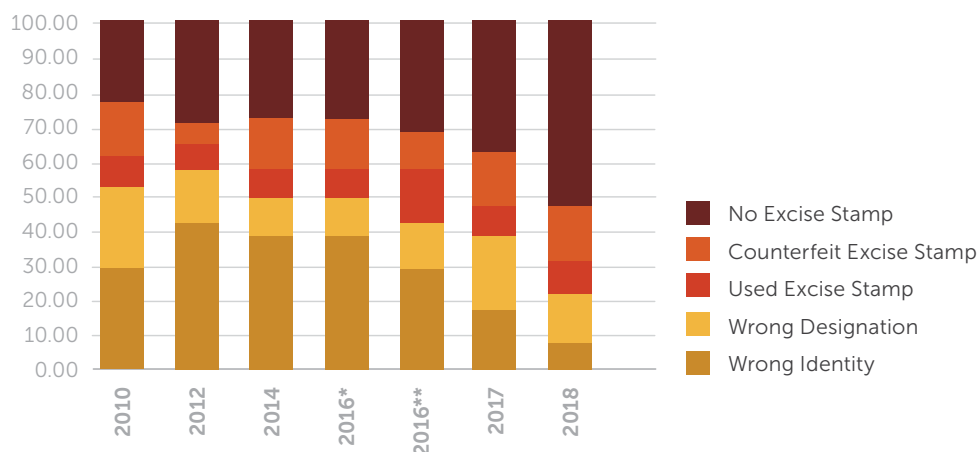


Sources: Data of the DGCE; Ministry of Finance 2017a; Nursalikhah 2018; Satriawan, Adji, and Jaya 2010.

* Projection of the DGCE. ** Estimate of the Universitas Gajah Mada.

According to the DGCE, there are five types of illegal domestic cigarettes: cigarettes in a pack without an excise stamp, cigarettes in a pack with a forged or counterfeit excise stamp, cigarettes in a pack with a used excise stamp in good condition, cigarettes in a pack with an excise stamp with the wrong business excise identification number, and cigarettes in a pack with an excise stamp with the wrong designation (Ahsan et al. 2014). In 2018, the trade in illegal cigarettes was dominated by cigarettes in packs without excise stamps (52.6 percent), while, in 2010–14, the trade was dominated by cigarettes in packs with wrong identity numbers (Figure 14.9).

Figure 9. Composition of the Illegal Cigarette Trade, Indonesia, 2010–18



	2010	2012	2014	2016*	2016**	2017	2018
No Excise Stamp	23.1	29.2	28.1	28.1	32.4	37.5	52.6
Counterfeit Excise Stamp	16.2	5.7	14.4	14.4	9.6	15.5	15.8
Used Excise Stamp	7.6	7.1	8.8	8.8	16.1	8.8	9.1
Wrong Designation	24.6	15.5	10.0	10.0	13.0	21.2	14.9
Wrong Identity	28.6	42.4	38.7	38.7	29.0	16.9	7.7

Sources: Data of the DGCE; Ministry of Finance 2017a; Nursalikah 2018; Satriawan, Adji, and Jaya 2010.
 * Projection of the DGCE. ** Estimate of the Universitas Gajah Mada.

4. Lessons Learned and Policy Recommendations

Lessons Learned

Indonesia has a detailed and comprehensive tobacco excise tax administration. Regulations on tobacco excise taxes are issued by top policy makers. There is a dedicated excise Law No. 39 year 2007 and several ministerial implementation regulations. Many aspects of the tobacco trade are regulated, from production to distribution and marketing. The tobacco industry is thus a highly regulated business. The excise stamp technology is also quite advanced. These factors represent serious hurdles to illicit cigarette activities.

However, these advantages are offset because of the complicated tobacco excise system. The system currently relies on 10 tiers, each with a different excise stamp specification. This favors illicit cigarette activities because of the numerous ways in which excise stamps and cigarette packs may be misappropriated for the illegal trade. Thus, for example, tobacco producers in a lower tier who pay lower excise tariffs can resell used excise stamps or affix their excise stamps to higher-tiered cigarettes at higher prices. The multitiered excise system

means that the process involved in ordering, printing, distributing, and affixing the excise stamps is a long one. The recent 10-tiered excise system where each tier has different excise stamp specification will make a longer process.

The estimated market share of illegal domestic cigarettes shrank from 11.7 percent to 7.0 percent in 2014–18. The market is dominated by cigarette packs with no excise stamp (52.6 percent). This represents a success of the efforts of the DGCE reforms in enforcement. During the same period, the government raised the tobacco excise tariff annually by more than the inflation rate. This is proof that increasing the tobacco excise tariff is not necessarily a significant factor in illegal cigarette activities. Comprehensive and concerted enforcement efforts are key to suppressing these activities.

Policy Recommendations

ADDRESSING THE ILLICIT CIGARETTE TRADE

- » Focus efforts on addressing the illicit trade especially through prosecution of tax evasion in domestic production, where, because of the strong consumer preference for kretek, the risk of smuggling is not yet large
- » Improve the institutional capacity of excise tax administration

The DGCE is responsible for the implementation of customs and excise regulations. It must monitor all border areas to make sure that customs duty procedures are implemented effectively. It must also implement all excise tax regulations, which mostly deal with tobacco products. However, there is an imbalance in resource allocation in terms of human resources, budgets, and institutional support. Excise tax administration is too complicated and faces more challenges than customs administration. This is because the DGCE must supervise a large tobacco industry and manage a tremendous amount of excise revenue. To address these challenges, the government should improve institutional capacity, especially in excise tax administration. This can be accomplished by increasing budgets, human resource capacity, and institutional support for excise tax administration and enforcement.

LINK BETWEEN ILLICIT CIGARETTES AND TOBACCO TAX REFORM

- » The experience of other countries indicates that the main determinant of the illicit tobacco trade is poor tax administration and enforcement, not high prices (Marquez and Moreno-Dodson 2017). This is also the model of the trade in Indonesia: rising tobacco taxes and prices are not the main determinant of the illicit trade.
- » The government should be more confident in improving the tobacco tax system because this system is not the main determinant of the illicit trade.

Improving the tobacco tax system involves two steps:

- » Go big and go fast: increase taxes and prices to reduce cigarette affordability and consumption
- » Simplify the tobacco excise system

The simpler the tobacco excise system, the better the result. Currently, the government plans to simplify the system from one based on 10 tiers in 2018 to one based on five tiers in 2021 (Ministry of Finance Regulation No. 146/PMK.10/2017).¹³ Although it is considered a significant advance, the five-tier system to be implemented over the next four years is still sufficiently complicated to facilitate the illicit cigarette trade. Ideally, there should be only one excise tariff for all cigarettes because they all have a similar negative health impact.

However, for the sake of employment, a two-tiered system would be acceptable. One tariff would be for machine-made cigarettes and large-production hand-rolled kretek; the other, at a slightly lower excise tariff, would be for small-production hand-rolled kretek. This change will reduce the incentive for illicit cigarette activities and will decrease cigarette consumption and, hence, save lives.

¹³ Peraturan Menteri Keuangan Republik Indonesia No. 146/PMK.010/2017 tentang Tarif Cukai Hasil Tembakau (Ministry of Finance Republic Indonesia Regulation No. 146/PMK.010/2017 on Tobacco Product Excise Tariff).

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“To tackle illicit trade is to tackle accessibility and affordability of tobacco products, to be more effective on the control of the packaging and to reduce funding of transnational criminal activities whilst protecting the governmental revenues from tobacco taxation.”ⁱ

– **Dr. Vera Luiza da Costa e Silva**
Head of the Secretariat of the WHO Framework Convention on Tobacco Control

“Governments around the world must waste no time in incorporating all the provisions of the WHO Framework Convention on Tobacco Control into their national tobacco control programmes and policies. They must also clamp down on the illicit tobacco trade, which is exacerbating the global tobacco epidemic and its related health and socio-economic consequences.”ⁱⁱ

– **Dr. Tedros Adhanom Ghebreyesus, Director-General**
World Health Organization

“Tobacco still remains the biggest avoidable cause of premature death in the EU, and the illicit trade in tobacco facilitates access to cigarettes and other tobacco products, including for children and young adults. In addition, millions of euros in tax revenues are lost every year as a result of the illicit trade.”ⁱⁱⁱ

– **Commissioner Vytenis Andriukaitis**
Health and Food Safety / European Commission

“Given their light weight, small size, and high value, tobacco products are susceptible to fraud through illegal trade, production, and cultivation. . . . Illegal trade is a context-specific activity that has various modus operandi and therefore requires multi-dimensional context-specific solutions.”^{vi}

– **Patrick Petit (Senior Economist) & Janos Nagy (Senior Economist)**
Fiscal Affairs Department / International Monetary Fund

“Effective tobacco tax regimens that make tobacco products unaffordable represent a 21st century intervention to tackle the growing burden of noncommunicable diseases. We are convinced that, working together with WHO and other partners in support of countries, we will be able to prevent the human tragedy of tobacco-related illness and death, and save countless lives each year.”^v

–**Dr. Tim Evans (Senior Director) & Patricio V Márquez (Lead Public Health Specialist)**
Health, Nutrition and Population Global Practice / World Bank Group

