

ECONOMICS OF TOBACCO TAXATION IN SRI LANKA

Prevailing tobacco taxation policy:
An upsurge in the illicit cigarette
market

About RIUNIT

The Research Intelligence Unit (RIUNIT) is a pioneering research firm that values creativity, innovation, integrity and market intelligence. We offer research-based consulting focused on all key sectors of the economy. The RIUNIT is registered in the UK with its offices based in London. In 2003, the RIUNIT established its Asia regional office in Colombo, Sri Lanka, where the company continues to grow and serve an international client base. Over the years, the RIUNIT has entrenched itself as the premier research and consultancy firm for many top corporations and development institutions across the globe, including Fortune 500 companies. We have representation in multiple locations across Africa, Asia, Europe and the Middle East. Our work has been recognised for its originality and quality, with award-winning kudos, as we endeavour to provide timely market intelligence and promote sustainable practices to all our clients. Our research and advisory services include:

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Abbreviations

ATO	Australian Taxation Office
CAGR	Compound Average Growth Rate
CBSL	Central Bank of Sri Lanka
CCPI	Colombo Consumer Price Index
CESS	A form of Tax on Tax
CTC	Ceylon Tobacco Company
DCS	Department of Census Statistics
DHS	Demographic and Health Survey
EU	European Union
EUR	Euro
FATF	Financial Action Task Force
FBI	Federal Bureau of Investigation
FED	Federal Excise Duty
FCTC	Framework Convention on Tobacco Control
FICC	Federation of Indian Chambers of Commerce and Industry
GDP	Gross Domestic Product
GHW	Graphic Health Warning
HDI	Human Development Index
HIES	Household Income Expenditure Survey
ISIS	Islamic State of Iraq and Syria (Islamic State of Iraq and the Levant)
ITTF	Illicit Tobacco Taskforce
JPGL	John Player Gold Leaf
KRA	Kenya Revenue Authority
LKR	Sri Lankan Rupee
NBT	Nation Building Tax
NCPI	National Consumer Price Index
No.	Number
NZ	New Zealand
PAL	Ports & Airport Levy
PKR	Pakistani Rupee
PMI	Philip Morris International
PPP	Purchasing Power Parity
PTC	Pakistan Tobacco Company
RIP	Retail Index Price
RIU	Research Intelligence Unit
STF	Special Task Force
TIRSP	Tax included retail price
UK	United Kingdom
UNODC	United Nations Office on Drugs and Crime
US	United States
USD	United States Dollar
VAT	Value Added Tax
WAP	Weighted Average Price
WHO	World Health Organisation

Executive summary

Sri Lanka's commendable standing in the Human Development Index, surpassing regional averages, reflects its strides toward becoming a developed nation. Notably, the country's robust healthcare system, high life expectancy, and impressive literacy rates highlight its commitment to human welfare. These achievements have been lauded by the World Health Organization (WHO), particularly in the realm of tobacco control.

Sri Lanka's proactive approach to combat smoking prevalence has garnered global recognition. Early ratification of the Framework Convention on Tobacco Control (FCTC) exemplifies its dedication to curbing tobacco consumption. Adherence to diverse WHO guidelines, encompassing graphical health warnings on packaging, total advertising ban, high taxation, smoke-free public spaces, and restrictions on sales to individuals under 21, reflects the nation's resolve to safeguard public health. Despite these commendable efforts, high taxation on legal cigarettes leads to growth of the illicit cigarette market. It is essential to broaden the discourse beyond the legal cigarette sector. The ongoing conversation often centres solely on legal cigarettes, inadvertently sidelining the burgeoning illicit market. Neglecting these aspects can erode the hard-fought progress and imperil the government's health objectives.

This report delves into the profound economic ramifications stemming from consistent tax hikes on legal cigarettes, shedding light on their unintended consequences for public health and government revenue. Against a backdrop of an island nation grappling with economic challenges, including default on debt and depletion of foreign reserves, this study examines the escalating impact of excessive taxation on legal cigarettes and the subsequent surge in the illicit cigarette market. The findings underscore the need for policymakers to reevaluate their taxation approach, striking a balance between discouraging smoking, safeguarding public health, and ensuring sustainable fiscal revenue.

The Research Intelligence Unit's (RIUNIT) 2022 survey highlighted a reduction in the illicit share of cigarettes from 21% to 16%, primarily attributed to economic downturns. Factors such as foreign exchange crisis, import restrictions, and increased law enforcement efforts contributed to this decline. However, the economic strain faced by the nation in the past year, compounded by recent government policy initiatives, has dampened average consumer disposable incomes. The 20% increase of excise taxes in January 2023 and by 20% once more in July 2023 has collectively resulted in an upswing in the illicit cigarette market from 16% in 2022 to a projected 29% in 2023, reaching an illicit consumption of 900 million sticks by year-end.

The excise tax hikes of 20-137% on legal cigarettes, implemented in 2023, played a pivotal role in pushing consumers toward illicit alternatives. Combined with inflation, these tax hikes significantly eroded real wages, compelling smokers to seek cheaper options. This has driven the average price of legal cigarettes up by 47%, resulting in a significant drop in volume of legal cigarette sales in 2023. In contrast, the affordability and variety of illicit cigarettes, priced between LKR 80-100, have enticed smokers, leading to a notable 67% growth in the illicit market in 2023 compared to 2022.

The consequences of this trend extend beyond the realm of economics. The surge in the illicit cigarette market raises concerns about public health and exacerbates the revenue shortfall for the government. The projected revenue loss for 2023 due to this illicit trade is estimated at LKR 79 billion, amplifying the country's economic challenges. While taxation remains a tool for both discouraging tobacco consumption and generating revenue, the unintended growth of an illicit market due to excessive taxation threatens to undermine both health and fiscal objectives.

To rectify this issue, policymakers must recalibrate their taxation strategies, call for tough penalties and strong enforcement and enable consumer awareness and education. The ongoing research carried out by Research Intelligence Unit (RIUNIT) seeks to illuminate key policy concerns surrounding the resurgence of illicit markets. By addressing these challenges, policymakers can strike a harmonious balance between health and fiscal targets, ultimately safeguarding the economic wellbeing of the population and securing the government coffers.

01

**OVERVIEW OF
THE ILLICIT TOBACCO
MARKET**

1.1 Definition of illicit trade

According to the Financial Action Task Force (FATF), illicit trade in tobacco products is categorised by the supply, distribution, and sale of smuggled, counterfeit, or cheap, white tobacco products (FATF, 2012). These illicit market products evade taxes and duties.

According to the WHO, illicit trade in cigarettes involves the following:

1. Illicit manufacture: cigarettes produced in illegal or covert facilities and not declared to the tax authorities, and
2. Illicit importation: cigarettes produced/bought in one jurisdiction then illegally transported to another to avoid applicable taxes

Illicit importation is more prevalent in Sri Lanka.

1.2 Common forms of illicit tobacco and identifying illicit products

Counterfeit: Tobacco products with unauthorised trademarks or trade names, with intent to deceive consumers and avoid paying duties.

Grey Market: Tobacco products are produced by a legitimate manufacturer for consumption in one country, but along the supply chain the product has been diverted to another country. Diversions frequently occur in Free Trade Zones (FTZ) with the tobacco manufacturer often unaware that its product has been diverted.

Illicit Whites: Also known as “cheap whites,” these are cigarettes legally produced in one country for the sole purpose of being exported and illegally sold in another country without duties being paid.

Loose Tobacco: Loose tobacco may be used to illegally manufacture cigarettes or other tobacco products, such as roll-your-own tobacco, without payment of tax.

Below are some common indicators of illicit cigarette packs:

- Below market average prices
- No local pictorial health warnings
- Print, spelling errors, inconsistent lettering on product packaging
- Unlisted and unregistered importer or manufacturer or brands

1.3 How smuggling entities work

A common term in smuggling is ‘bootlegging’, which is the purchase of cigarettes from low or no tax jurisdictions for resale in higher tax jurisdictions without appropriate taxes being paid. Illicit tobacco can be smuggled into the country by both air and sea transport. Direct smuggling is where smugglers use illegal entry points to avoid customs inspection and directly introduce tobacco products via sea or land from neighbouring countries. On the other hand, indirect smuggling implements deceptive methods such as concealing cigarettes in secret compartments aboard ships, vehicles or vehicle parts, wood, luggage, furniture, toys, boats, tires, textiles. Additionally, foreign migrant workers are also reported to have been engaged in smuggling illicit cigarettes into the country.

1.4 Drivers of illicit trade

The factors driving illicit trade can be categorised into three main groups: socio-economic, infrastructure, and political and administrative drivers.

1. Socio-Economic Drivers:

- Poverty and Economic Inequality: High levels of poverty and economic inequality within a country can make consumers more inclined to seek cheaper alternatives, such as illicit tobacco products.
- Urbanization and Population Growth: Rapid urbanisation and population growth can create larger markets for illicit products, including cigarettes.
- Globalisation, Mobility, and Transient Populations: Increased globalisation and the movement of people across borders can facilitate the flow of illicit goods such as cigarettes, to various markets.
- Price and Tax Differentials: Disparities in cigarette prices and tax levels between countries or regions can incentivize consumers to purchase cheaper, untaxed, or low-taxed products, thus fueling illicit trade in cigarettes.

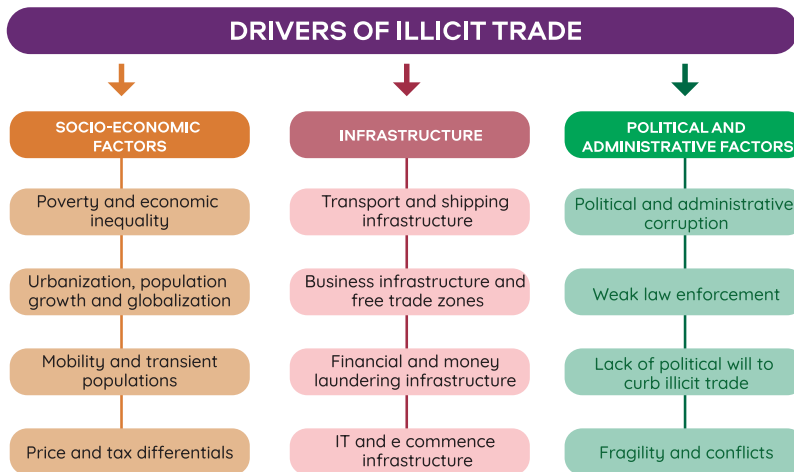
2. Infrastructure Drivers:

- Transport and Shipping Infrastructure: The effectiveness and reach of a country's transportation and shipping infrastructure can significantly impact the ease with which illicit goods, such as cigarettes, are transported.
- Business Infrastructure and Free Trade Zones: Free trade zones and lax business regulations can attract illicit trade operations that exploit these favourable conditions.
- Financial and Money Laundering Infrastructure: Countries with inadequate financial controls and money laundering regulations may inadvertently support illicit trade through the movement of funds.
- IT and E-commerce Infrastructure: The existence of robust information technology and e-commerce infrastructure can facilitate online sales of illicit tobacco products.

3. Political and Administrative Drivers:

- Political and Administrative Corruption: Corruption within a country's political and administrative systems can create opportunities for illegal trade activities to go undetected or unpunished.
- Weak Law Enforcement: Inadequate law enforcement and regulatory oversight can enable the proliferation of illicit trade.
- Lack of Political Will: A lack of commitment from political leaders to combat illicit trade can hinder efforts to address the issue effectively.
- Fragility and Conflicts: Countries experiencing political instability, fragility, or conflicts may struggle to enforce regulations, making it easier for illicit trade networks to operate.
- These drivers interact in complex ways and vary from one region to another, making the challenge of combating illicit trade in cigarettes a multifaceted issue that requires coordinated efforts at multiple levels – from local to international – to effectively address and mitigate its impact.

Figure 1: Drivers of Illicit Trade



1.5 Scale of the global illicit tobacco market

According to the estimation of the World Health Organisation (WHO), one in every ten cigarettes smoked is illicit. The illicit tobacco business is a rapidly growing, global, multi-billion-dollar operation that annually robs tax revenue of governments. In the mid-90s, smuggling was estimated to be 6%-8.5% of global cigarette consumption (Merriman, Yurekli, & Chaloupka, 2000). According to British American Tobacco (BAT), it is estimated that over 456 billion cigarettes are sold illegally in the global tobacco market each year. The Transnational Alliance to Combat Illicit Trade (TRAC-IT) estimates the global tax loss of US\$40.5 billion for the governments.

1.6 Control of illicit tobacco

Under Article 15 of FCTC a protocol has been established to prevent illicit trade in tobacco products which states that the convention should deal with all forms of illicit trade in tobacco products, including smuggling, illicit manufacturing and counterfeiting. This was incorporated to reduce the impact of consuming low quality illicit tobacco products. Sri Lanka became a Party to the WHO Framework Convention on Tobacco Control in 2005 and acceded to the Protocol to Eliminate Illicit Trade in Tobacco Products in 2016.

02

**ILLICIT CIGARETTE MARKET
IN SRI LANKA; INSIGHTS ON
THE MARKET BEHAVIOUR**

2.1 How illicit cigarettes are marketed and sold in Sri Lanka

The RIUNIT consumer survey 2022 showed that a substantial number of illicit cigarettes are found to be sold through family/friends/work colleagues, known re-sellers, shopping malls, and small retail shops. Illicit cigarette smokers have also reported illicit cigarette purchases through hotels, restaurants, and cafes (HoReCa). Alarming, a significant amount of these illicit cigarettes are also reported to have been purchased through small retail shops/supermarkets/grocery stores.

According to consumer insights taken through the survey conducted by RIUNIT (2022) large chain supermarkets were indicated as meeting points for dealing illicit cigarettes, rather than 'sources' for illicit cigarettes. The goods may even be sold at a premium and hand-delivered to an agreed location.

Primarily, illicit cigarettes enter the country by both air and sea. Traffickers often disguise themselves as inbound tourists and passengers to smuggle cigarettes concealed in baggage through airports. Some traffickers try to smuggle illegal tobacco through boats, often disguised as fishermen. In addition to these, traffickers hide illicit cigarettes inside containers. In this way they will be able to smuggle large quantities in one go.

Three key agencies that are involved in detecting and seizing illicit cigarettes are Sri Lanka Customs Departments, Sri Lanka Navy, and the Special Task Force (STF). At the airport and the seaports, Customs Department carries out inspections to detect and seize illicit cigarettes. Meanwhile, the Sri Lankan Navy keeps a close eye on smuggling routes across the sea, whilst the STF is empowered to seize any illicit tobacco product which manages to cross the borders. Illicit cigarettes to Sri Lanka mainly flow from Dubai, China, and Vietnam.

2.2 Prices of illicit cigarettes in Sri Lanka

Within the domain of illicit cigarette trade, a notable tactic employed by sellers is the utilisation of price differentials. This strategy leads to considerable fluctuations in prices across different regions. In specific areas, these illicit cigarettes can be acquired for as little as 30% of the cost of legal counterparts. Conversely, premium pricing is observed in certain locations (Colombage, Morais, & Wickramasinghe, 2018). This approach not only ensures competitiveness but also results in substantial profit generation. High-income individuals often gravitate towards exclusive brands sold at a premium, while the majority of smokers opt for mid to low-end alternatives. Notably, the most pronounced threat to the legitimate cigarette industry arises from these lower-priced illicit options due to their significant price differentials.

The findings of our primary survey underscore the disparity in pricing between the most consumed local cigarette, John Player Gold Leaf, and the popular imported brand, Manchester. This price gap stands at LKR 30. The legal cigarette market experienced a 47% increase in average prices subsequent to an excise adjustment in January and July 2023. This policy change led to the retail price of the frequently purchased legal cigarette LKR 125 in July 2023. Conversely, the RIUNIT research and related sources highlight that the average illicit cigarette commands a market price ranging from LKR 80-100. This affordability, coupled with the availability of diverse varieties, renders illicit cigarettes more appealing to smokers.

Table 1: Price of a legal vs Illegal cigarette pack

20 cigarettes pack	
	As at November, 2023
Legal	2500
Illegal	1800

Source: RIUNIT research data

*legitimate cigarettes price is based on market price for John Player Gold Leaf as of November 2023

2.3 Size of the illicit market in Sri Lanka

After clear observation and surveillance conducted by RIUNIT based on some of the high-level industry sources, it yielded noteworthy insights into the landscape of the illicit cigarette market. According to the findings, the illicit cigarette market captured a substantial share, accounting for 22% of the total cigarette market before the excise led price increase in July, 2023. This translates to an impressive volume of 0.72 billion cigarette sticks for the same year. However, post the July excise increase of 20%, consumer affordability was stretched further and the illicit market stands at 0.9 billion increasing the illicit cigarette market share to an estimated 29%. A marked escalation was evident when compared to the preceding year, signifying a remarkable increase by 13 percentage points over the course of 2022. In specific terms, the illicit cigarette market encompassed 0.54 billion units in 2022.

These figures highlighted a significant expansion in the illicit cigarette sector, indicating both its growing prominence and its impact on the broader cigarette market. The rise in market share by such a considerable margin underscores the need for a comprehensive understanding of the underlying factors driving this growth. This shift not only carries implications for the sustainability of the legitimate cigarette industry but also demands a closer examination of the various forces at play within the illicit cigarette market. As this trend continues to evolve, it becomes increasingly important to address the root causes and explore potential strategies to mitigate the expansion of the illicit cigarette trade.

Table 2: Primary research findings - Pre July price increase

Estimated total cigarette consumption per month (FMC + Illicits)	268,731,607 sticks
Illicit consumption per month	58,731,607 sticks
Illicit consumption - Annual	716,779,284 (0.72Bn) sticks
Illicit cigarette % as a % of total cigarettes	22%

Source: RIUNIT compilation based on data from market sources

Table 3: Primary research findings - Post July price increase

Estimated total cigarette consumption per month (FMC + Illicits)	256,887,204 sticks
Illicit consumption per month	74,887,204 sticks
Illicit consumption - Annual	898,646,448 (0.9Bn) sticks
Illicit cigarette % as a % of total cigarettes	29%

Source: RIUNIT compilation based on data from market sources

03

TAXATION LANDSCAPE FOR CIGARETTES

3.1 Impact of taxation on illicit trade

The government of Sri Lanka implemented a series of strategic measures aimed at regulating the tobacco and alcohol markets. Notably, the excise duty on both alcohol and cigarettes underwent significant adjustments. Commencing from midnight on 3 January 2023, the government initiated a significant increase of 20% in the excise duty for these commodities. This initial step set the tone for subsequent changes in the taxation landscape.

Continuing this trajectory of fiscal adjustments, a subsequent alteration was introduced on July 01 2023, with excise taxes being once again revised upwards by an average of 20%. This dual increase within a short span of time highlighted the government's commitment to addressing key concerns in these sectors, particularly related to health and revenue generation. Consequently, an aggregate excise hike of remarkable proportions, ranging from 44% to 137%, emerged during the transition from the inception of 2022 to the conclusion of the 3rd quarter in 2023.

This sequence of excise duty revisions exhibits a proactive approach on the part of the government to impact both consumption patterns and Treasury dynamics. The substantial upward adjustments in excise taxes are anticipated to have far-reaching implications, impacting consumer behaviour, market trends, and revenue streams. In particular, these adjustments hold the potential to influence purchasing decisions, market competitiveness, and industry revenue.

The below tables depict the taxation landscape for legal cigarettes as for the year 2023, the government raised excise taxes in two instances within the first three quarters of 2023.

Table 4: Taxes applicable on legal cigarettes - 2023

Corporate tax	40%
Tobacco tax	LKR 10 per kilo of tobacco
Import duty	20% for manufactured sticks
CESS	160% for imported cigarettes
PAL	Imported cigarettes are exempt
Excise tax	Length below 60 mm – LKR 16,030 per 1000 sticks. Length 60 – 67 mm - LKR 41,540 per 1000 sticks. Length 67 – 72 mm - LKR 59,180 per 1000 sticks Length 72 – 84 mm - LKR 67, 000 per 1000 sticks Length exceeding 84 mm - LKR 74,590 per 1000 sticks.
VAT	15%
SSCL	2.5% for all types of manufactured cigarettes

Sources: Government gazettes, Customs and Ministry of Finance 2023

Table 5: Tax revisions for legal cigarettes 2014 - 2023

2014	Excise tax increased (see Table 3 and Figure 3). VAT and NBT on cigarettes were consolidated into a single exercise tax.
2015	Excise tax increased (see Table 3 and Figure 3)
2016	Excise tax increased (see Table 3 and Figure 3). VAT reintroduced on cigarettes. NBT reintroduced on cigarettes for both retail and wholesale.
2018	Excise tax increased (see Table 3 and Figure 3).
2019	Excise duty increased twice in the year (see Table 3 and Figure 3). NBT levied on cigarette production was abolished in December. VAT was cut from 15% to 8% in December.
2021	Import duty on imported cigarettes was reduced to 15%. CESS on imported cigarettes increased to 165%.
2022	VAT Increased from 8% to 12% and then to 15% SSCL introduced in October at 2.5%
2023	Import duty on manufactured cigarettes increased to 20%. CESS reduced to 160% for imported cigarettes. Excise tax hikes (20% with effect from 03 January 2023 and for the second time by 20% with effect from 01 July 2023)

Sources: Government gazettes, and news articles published online, 2014-2023

Table 6: Excise tax revisions 2014-2013

Size (per 1000 cigarettes)	2015	2016	2017	2018	Q1 2019	Q2 2019 (May)	Q3 2019 (July)	Q4 2019 (October)	Q4 2019 (December)	2020	2021	2022	Q1 2023	Q3 2023 (with effect from July 01, 2023)
Length below 60mm (LKR)	6,975	11,675	11,675	11,675	11,675	11,675	11,675	11,675	13,360	13,360	6,750	6,750	13,360	16,030
Length 60-67mm (LKR)	12,675	17,375	17,375	17,375	19,500	19,500	19,500	19,500	22,300	22,300	28,850	28,850	34,620	41,540
Length 67-72mm (LKR)	14,660	20,500	20,500	20,500	23,000	23,000	37,600	33,000	37,650	37,650	41,100	41,100	49,320	59,180
Length 72-84mm (LKR)	23,750	30,500	30,500	33,550	37,580	37,600	37,600	37,600	43,100	43,100	46,600	46,600	55,920	67,000
Length Exceeding 84mm (LKR)	27,240	34,250	34,250	37,675	42,200	42,200	42,200	42,200	48,350	48,350	51,800	51,800	62,160	74,590

Source: Ministry of Finance

The illicit cigarette market experienced a significant shift, with its market share declining from 21% in 2021 to 16% in 2022. This decline was primarily ascribed to the prevailing economic challenges stemming from the foreign exchange crisis and government-imposed import restrictions during that period. The value of the Sri Lankan Rupee (LKR) dipped by nearly 32% from January to April 2022 to hover at LKR 300 per USD, becoming the world's worst performing currency.

However, a noteworthy reversal in this trend has become evident with the subsequent year. The gradual stabilisation of the nation's economy has contributed to a resurgence of the illicit cigarette market, projecting the market share at 29% in 2023.

3.2 Excise taxation on affordability of legal cigarettes vs illicit cigarettes

Since 2018, Sri Lanka has consistently held the distinction of being the most expensive nation globally for purchasing cigarettes, as gauged by purchasing power parity (PPP) (WHO, 2021). This unique status places the price of cigarettes in Sri Lanka's context notably above the range observed in high-income countries, including developed economies like Singapore and Australia.

Moving on to the current time frame-2023, being hit by an overall aggregate of 44-137% excise increment in 2023, the case doesn't look much ruddy.

The disparity between illicit and legitimate cigarette prices has notably expanded, reaching LKR 30 per cigarette, owing to the prevailing high tax environment as mentioned above. The recent 20% excise tax increase, effective from 01 July 2023, has been seen to propel the cost of the most purchased legal cigarette stick from LKR 100 to LKR 125. This widening price gap between illicit and legitimate cigarettes is a direct outcome of the taxation policies in place. As the tax burden

on legal cigarettes grows, it inadvertently exacerbates the appeal of lower-priced illicit alternatives, making them an increasingly attractive option for consumers who's real incomes have been hit by the economic crises and consequent IMF driven tax hikes. The latest excise tax hike further accentuates this trend, amplifying the economic incentives for consumers to explore cheaper avenues for their cigarette purchases.

04

**THE TREND IN THE TRADE
OF ILLICIT CIGARETTE
MARKET**

4.1 Illicit market share and consumption over the years

The cigarette market in Sri Lanka has witnessed a dynamic interplay between legal and illicit sales over the past few years. The table xx illustrates the illicit cigarette sales data from 2017 to the projected figures of 2023.

During 2017 and 2018, legal cigarette sales remained relatively consistent at around 3,150 million sticks, with illicit sales accounting for approximately 14% of the market share each year. However, a noteworthy shift occurred in 2019, as legal cigarette sales dropped to 2,621 million sticks, while illicit sales increased to 614 million sticks, representing a 21% share of the market. The year 2020 further amplified the trend, with legal sales declining to 2,287 million sticks and illicit sales spiking to 722 million sticks, translating to a significant 24% market share for illicit cigarettes. The legal cigarette market regained some ground in 2021, reaching 2,384 million sticks, while illicit sales amounted to 633 million sticks, accounting for a 21% market share.

Then again, an interesting turnaround was observed in 2022, as legal cigarette sales rebounded to 2,825 million sticks, and illicit sales decreased to 538 million sticks, resulting in a lower illicit market share of 16% mainly attributed to the economic turmoil the country had experienced due to the FOREX crisis and the import controls which came into play. However, for reasons mentioned above, the projected data for 2023 anticipates legal cigarette sales is estimated to be less than 2.3 billion sticks and illicit sales at 900 million sticks, contributing to an illicit market share of 29%.

Table 7: Excise tax revisions over the years resulting in an upsurge of an illicit market

	2017	2018	2019	2020	2021	2022	2023	
							H1	H2
Illicit cigarette sales (sticks sold in millions)	602	600	614	722	633	538	716	900
Excise duty (72-84mm) per 1000 sticks	30,500	33,550	43,100	43,100	46,600	46,600	55,920	67,000
Illicit share	14%	14%	21%	24%	21%	16%	22%	29%

Source: RIUNIT compilation based on data from industry sources

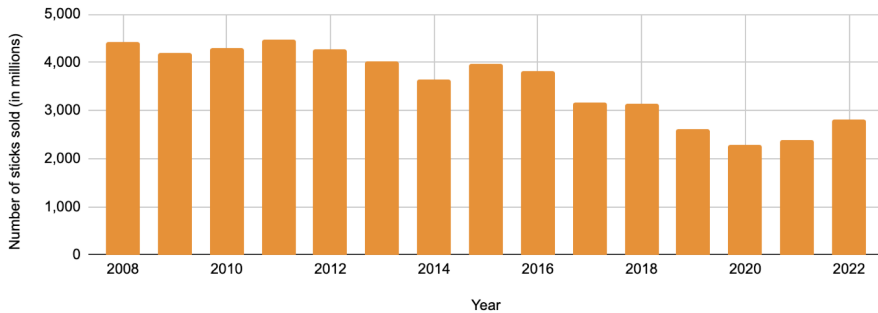
4.2 Reasons for illicit market growth

The landscape of cigarette consumption in Sri Lanka has been significantly influenced by a series of excise tax revisions over the years. These revisions have, inadvertently, contributed to the growing allure of illicit cigarettes within the smoking population due to their affordability.

In recent years, the government implemented substantial excise tax hikes, ranging from approximately 20% to a staggering 98%, on legal cigarettes. The enforcement of these tax increases from January 1, 2023, played a pivotal role in prompting a shift among consumers towards illicit cigarettes. A subsequent excise tax increment of 20%, introduced on July 1, 2023, further compounded the economic strain on consumers. Coupled with the prevailing inflationary pressures and continuous tax hikes, the real purchasing power of consumers experienced a notable decline.

Consequently, the average price of legal cigarettes saw a marked increase, reaching LKR 125 after the excise hike in July 2023. The escalating cost of legally marketed cigarettes acted as a significant incentive for consumers to explore more economically viable options, which often included illicit cigarettes.

Figure 2: Legal cigarette sales 2008-2022



Source: RIUNIT compilation based on Ministry of Finance

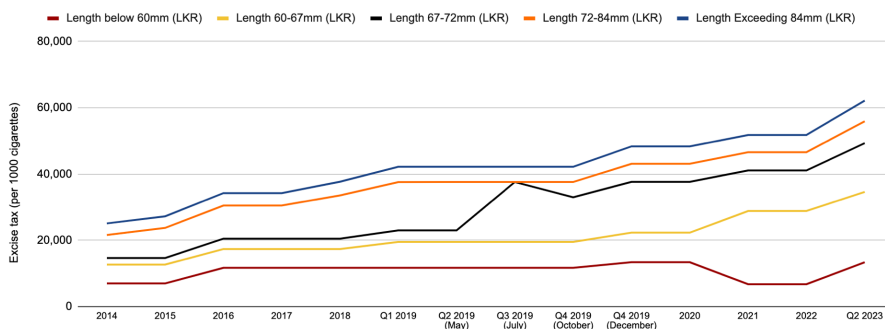
Moreover, the sustained decline in real wages over this period significantly impacted the affordability of legal cigarettes, further making the illicit market more attractive. As consumers faced these economic challenges, many sought cost-effective alternatives, leading to a notable surge in the consumption of illicit cigarettes.

The historical trend of declining legal cigarette sales, experiencing over a 25% decline in legal cigarette volumes from 2015 to 2022, further underscores the lasting impact of these economic pressures on consumer choices.

Illicit cigarettes exhibit an average market price spanning LKR 80-100. This price range significantly enhances their attractiveness to smokers, chiefly due to their affordability and the diversity of options available. The allure of these illicit offerings lies in their budget-friendly nature, effectively undercutting the higher prices of their legitimate counterparts.

Furthermore, the accompanying figure provides a representation of the progression of excise tax amendments over the years, contributing to the broader context of the market dynamics.

Figure 3: Excise tax revisions 2014-2022



Source: RIUNIT compilation based on Ministry of Finance

05

IMPLICATIONS OF ILLICIT TRADE

5.1 Loss of Government revenue

Table 8: Calculation of the revenue loss to the Government from illicit cigarettes 2023

Total cigarette consumption per month (FMC + Illicits)	256,887,204 sticks
Illicit consumption per month	74,887,204 sticks
Illicit consumption - Annual	898,646,448 (0.9Bn) sticks
Average tax per stick (LKR)	87.5
Revenue loss to the Government (LKR billion)	79

Source: RIUNIT ongoing research and market sources

The ongoing research conducted by RIUNIT has yielded crucial insights into the illicit cigarette market, with significant ramifications for government revenues. The market size for illicit cigarettes in 2023 is estimated to have reached a substantial 900 million sticks.

Between the years 2021 and 2022, the estimated loss of government revenue is estimated to be a staggering LKR 60 billion. Predominantly, an equivalent to the size of the (average) amount which is spent by the government on samurdhi payments (Ministry of Finance, 2022). Looking ahead to 2023, the projected government revenue loss is anticipated to amount to LKR 79 billion.

5.2 Threat to legal industry sustainability

The legal cigarette industry continues to grapple with a challenging scenario characterised by the persistent expansion of the illicit cigarette market. This ongoing phenomenon has led to a significant erosion of the legal industry's market share.

The repercussions of this trend are multi-faceted. The loss of market share attributed to a surging demand for more affordable illicit products presents an ongoing challenge. This can be attributed to the growing disparity in prices between taxed legal cigarettes and untaxed illicit alternatives. The task of curbing the expansion of the illicit trade necessitates robust collaboration across stakeholders, bringing together the government, law enforcement entities, the legal industry, employees, value chain partners, and the community at large.

The ramifications extend far beyond market dynamics, as the illicit trade exerts significant impacts on a larger scale.

- **Erosion of Government Tax Revenue:** The flourishing illicit market erodes potential government tax revenue, undermining financial resources allocated for essential services and developmental initiatives. The illicit trade has resulted in an annual loss of around \$2 trillion which the tax revenue linked to the illicit cigarette trade alone counts to around \$40.5 billion.
- **Livelihood Threats:** The entire value chain of the legal cigarette industry, from farmers and suppliers to retailers and distributors, faces threats to their livelihoods due to diverted demand for untaxed products. Illicit trade deprives legitimate companies of significant financial revenues, limiting the ability of businesses to invest in research

and development and create new jobs. 90 thousand jobs lost in the EU linked to illicit counterfeit medicines.

- **Health Challenges:** Cheaply produced illicit goods are not subject to quality control, posing additional health risks to consumers, challenging national health objectives by evading established health standards.
- **Potential Criminal Activities:** Illicit trade often creates opportunities for criminal activities, such as smuggling, with potential consequences for law enforcement and national security. One of the sparkling examples is the rising violence from terrorist organisations in the Sahel region, including ISIL & Al-Qaida who benefit from illicit trades in that region.

As previously highlighted, the illicit cigarette market's estimated size in Sri Lanka post the excise increase in January 2023 stands at a substantial 716 million, while post excise tax increase in July 2023 inflated the market size further to 900 million. This not only translates into fiscal losses for the nation but also represents a direct revenue loss for legitimate industry participants who contribute to the economy through job creation and tax payments. The impact of illicit trade is felt across the legal business spectrum, affecting farmers, suppliers, retailers, manufacturers, distributors, and consumers alike. Law-abiding distributors and retailers experience diminished sales due to reduced demand for legal products, further exacerbating the economic challenge.

The legal industry is deeply committed to preserving the welfare of the communities engaged in the tobacco cultivation value chain. Supporting over 1,163 contracted tobacco farmers (CTC Annual Report, 2022) while working towards enhancing capacity through agricultural inputs, technical assistance, and financial security through guaranteed buy-back at agreed-upon prices. Collaborative pricing determination with the 'Farmers' Union' and relevant governmental authorities reflects its transparency in ensuring the economic well-being of these communities. Over 87,000 individuals are benefitted through corporate social investment initiatives driven by major players in the legal industry showcasing their dedication to sustaining not only the industry but also the communities it supports (Oxford economics, 2020).

5.3 Increased criminal activity and threat to national security

In recent years, the illegal trade of cigarettes has transcended its conventional boundaries to morph into a sophisticated form of transnational organised crime, introducing a host of substantial and escalating threats to both national security and public safety. While the movement of illicit goods has long been a concern, the realm of cigarette smuggling has evolved into a formidable criminal enterprise with multifaceted implications.

Cigarettes are one of the most smuggled products in the world and cigarette smuggling is considered a form of transnational organised crime. As such, this activity poses significant and increasing threats to national security and public safety. A perception study on the illicit market found that in all the European countries, close to a third of respondents think that black market cigarettes are one of the most important sources of revenue for organised crime (European Commission, 2016). According to the Italian Minister of Health Care, the value of illicit trade of tobacco products in Italy gives organised crime double the revenue they generate from selling cocaine and heroin.

There has been less focus, however, on the role that hubs of illicit trade play in fostering poly-criminality and enhanced connectivity between criminal networks, terrorist organisations, and a wide range of enablers. The anonymity offered by shell companies registered in secrecy jurisdictions allows illicit trade actors to disguise their operations and launder illicit proceeds. Panama's role as an offshore secrecy jurisdiction was exposed in the 2016 Panama Papers with leaked records of a myriad of shell companies. Although recently Panama has made some progress in this area, it remains among the Financial Action Task Force grey-list countries. In 2022, the Financial Action Task Force added Dubai to this list due to deficiencies in its regime to counter money laundering, terrorist financing, and proliferation financing. In 2021, for example, the U.S. Treasury designated the Islamic Revolutionary Guard Corps and Hizballah financial facilitators who headed a network of nearly 20 individuals and front companies located in Dubai and other jurisdictions used for "the movement and sale of tens of millions of dollars' worth of gold, electronics, and foreign currency" (U.S. Treasury 2021, September 27).

According to Dr Louise Shelley, University Professor at George Mason University and Director of the Terrorism, Transnational Crime and Corruption Center (TraCCC), "Oil is not ISIS' only source of revenue... Still more funding comes from the sale of counterfeit cigarettes" (Philip Morris International).

Not only are criminal networks expanding through the trafficking in illicit tobacco products, but this activity also facilitates and provides funding for other criminal activities. These include money laundering, bulk cash smuggling and trafficking in humans, weapons, drugs, antiquities, diamonds, and counterfeit goods (Parliament of Australia, 2015).

5.3.1 Examples of large-scale illicit cigarette seizure cases

- Following an anti-illicit cigarette operation, Hong Kong Customs seized 64 million sticks of suspected illicit cigarettes contained in six containers. In November 2022, Customs officers intercepted three suspicious container trucks, each hauling a 40-foot container, at two container yards in the downtown area for examination. Upon inspection, approximately 31 million sticks of suspected illicit cigarettes were uncovered. A follow-up investigation by the officers led to the seizure of approximately 33 million sticks of illicit cigarettes in three additional 40-foot containers at the container yards. The estimated market value and duty potential were approximately HK\$180 million and HK\$120 million, respectively.
- Project Crocodile aims to track down suspicious cigarette shipments through a mechanism of export and arrival notifications between departure and destination countries. Since 2004, RILO AP has been acting as the coordinator and regional intelligence hub for combating illicit cross-border trade of tobacco and tobacco products. It is an ongoing project that involves the exchange of export, arrival, and seizure notifications through a standard notification pro forma. Twenty-four Customs administrations from RILO AP have participated in Project Crocodile. In 2022, RILO AP handled 60 export notifications and 5 arrival notifications for suspicious cigarette shipments. When the shipments were intended for non-project participants in the region, RILO AP coordinated with the relevant Customs administration to disseminate information and/or monitor the movement of the shipment. Additionally, when the shipments were intended for non-AP ports, RILO AP liaised with the relevant RILO offices or international enforcement organisations to further disseminate information and monitor the movement of the shipment. Through this project, Member administrations timely exchanged information and monitored suspicious cigarette shipments, contributing to the successful

suppression of tobacco smuggling within and across the AP region. In 2022, Members reported the seizure of 12.4 million sticks of cigarettes. This fruitful result demonstrated the successful exchange of intelligence, cohesive cooperation, and the effective functioning of the project mechanism, signifying a significant achievement in suppressing the smuggling of illicit tobacco. In May 2022, Portuguese Customs intercepted a container that had departed from Thailand based on intelligence exchanged with Thai Customs. Consequently, a total of 12 million sticks of "Manchester" brand (Queen and Red variants) cigarettes were seized. The containers had been falsely declared as containing "Carpets and other textile floors."

- Hong Kong Customs detected a large-scale illicit cigarette smuggling case on August 15 and seized about 17 million suspected illicit cigarettes at the Kwai Chung Customhouse Cargo Examination Compound. The estimated market value was about \$62 million with a duty potential of about \$42 million. Through risk assessment and intelligence analysis, Customs selected and inspected two 40-foot seaborne containers, arriving in Hong Kong from Cambodia and declared as carrying dried cassava, that morning. Upon inspection, Customs officers seized the batch of suspected illicit cigarettes inside the containers (Press release of Government of Hong Kong dated 18 August 2023).
- New Zealand (NZ) has had multiple large scale illicit cigarette seizures this year. A Malaysian businessman was charged in August 2020 over allegedly importing 2.39 million cigarettes inside a container from Malaysia on July 27 and trying to avoid a USD 2 million tax bill. This is NZ's largest ever single-seizure tobacco smuggling case. In September 2020, they arrested multiple personnel involved in another shipment that took place in July which involved 2.2 million illicit cigarettes attempting to evade USD 1.8 million in excise tax. This shipment was also sent from Malaysia and declared as 175 roof extension units and the cigarettes were hidden inside stacks of metal frames. This case led to the discovery of more illicit cigarette units in different parts of New Zealand. Authorities have linked these operations to Malaysian organised crime syndicates. Malaysian syndicates had already been involved in trafficking drugs and smuggling illegal immigrants. However, this was the first time the NZ customs agency had seen cigarettes smuggled on such a large scale. "In recent years, Customs has conducted several investigations involving Malaysian syndicates, which show that members are often sent to New Zealand to smuggle and distribute the commodities. These syndicates often use a shell or inactive company to try to give the appearance of legitimate operations, and we believe this case is no different," the Customs investigations manager Bruce Berry said. He added that Customs had largely seen Chinese-branded cigarettes exported from China in the past, however, "the Malaysian-exported cigarettes have been a game-changer in terms of the distinctive packaging, sophistication of concealment and the significant volumes per shipment. This is something that our partners in Australia have been seeing for some time – it's all driven by greed and profit." (NZ Herald, 2020).

The maximum penalty for smuggling illicit cigarettes in Sri Lanka is LKR 1 million which is less than USD 3,000 - a small price to pay for a large-scale operation in which a container of illicit cigarettes can be worth up to LKR 700 million. Given the softer penalties compared to higher profits, criminals have invested in and developed sophisticated mechanisms to smuggle goods into Sri Lanka.

5.4 Challenges to national health objectives, increase of Government expenditure, and wider economic impact

Absence of Quality Control in the illicit products is one of the key challenges to the national health objectives. Illicit goods are often manufactured without adherence to essential quality control measures. This absence of oversight means that there are no mechanisms in place to ensure that the products are safe for consumption or use. As a result, consumers are exposed to significant health risks.

One of the most concerning aspects of illicit alcohol production is the presence of methanol. Methanol is a highly toxic substance that can lead to severe health consequences when ingested. Consumers who unknowingly consume methanol-contaminated alcohol are at risk of experiencing seizures, organ failure, and even death.

The diffusion of counterfeit pharmaceuticals and substandard personal protective equipment compounds the challenges to national health objectives. Counterfeit medications may lack the necessary active ingredients, contain incorrect dosages, or even have harmful substances. Such products can be ineffective in treating illnesses, exacerbate health conditions, or lead to severe side effects, making it difficult to achieve desired health outcomes. Furthermore, counterfeit PPE puts individuals at risk of contracting infectious diseases and endangers healthcare workers on the frontlines. It also contributes to microbial resistance as substandard or counterfeit drugs may not adequately treat infections, leading to the development of drug-resistant pathogens.

Tobacco products kill over 8 million people per year (WHO, 2023). In Sri Lanka, these risks translate to approximately 12,300 annual deaths (The Tobacco Atlas), with the year 2016 alone witnessing an estimated 20,000 deaths attributed to tobacco use (UNDP, 2019). While these figures underscore the pervasive health hazards associated with legal tobacco consumption, the emergence and proliferation of illicit, unregulated, and inexpensive alternatives like beedi threaten to exacerbate this already dire situation.

The illicit market introduces a disturbing dimension, with certain contraband products found to contain substantially higher levels of hazardous substances. Notably, some of these illicit products have been discovered to contain elevated amounts of cadmium, lead, and arsenic – heavy metals that pose grave health risks. Furthermore, these products contain significantly increased levels of tar, nicotine, and carbon monoxide, which further magnify the detrimental health impact (Coventry Telegraph, 2015). An escalation in the illicit market share could compound the negative health outcomes and elevate mortality rates.

Beyond the immediate health implications, this surge in negative health outcomes cascades into broader societal challenges and economic repercussions. The escalation in tobacco-related diseases diverts precious resources from government health policies aimed at counteracting smoking-related harm. Scarce funds that could be allocated to anti-smoking campaigns and healthcare costs are rerouted to manage the consequences of these preventable diseases. This represents an unfortunate diversion of resources that could otherwise be invested in preventive measures and healthcare improvement.

The indirect economic toll stemming from deteriorating public health is notable. An influx of tobacco-related ailments places an increased burden on healthcare systems and demands additional resources for the treatment and care of affected individuals. The escalating healthcare

expenditures absorb budgets that could otherwise be deployed to enhance public health infrastructure and address broader health needs.

Sri Lanka, by most accounts, has made commendable strides in mitigating the challenges posed by smoking. However, counterfeit and smuggled cigarettes persist as challenges. Smuggled cigarettes, in particular, evade various restrictions and health regulations, such as the requirement for graphic health warnings (GHWs) in the local language. These contraband products present serious health implications for consumers, as their quality standards remain unverifiable. This exacerbates the already intricate landscape of public health, as consumers are exposed to unregulated and potentially more hazardous products, undermining the nation's health objectives and imposing an additional burden on the healthcare system.

06

**REGIONAL EXAMPLES OF
THE ILLICIT CIGARETTE
MARKET**

6.1 Malaysia

The Confederation of Malaysian Tobacco Manufacturers (CMTM) has recently disclosed a concerning statistic regarding the prevalence of illicit cigarettes in Malaysia. Despite a slight decrease from 56.6% in 2022 to 55.3% in 2023, the prevalence of illegal cigarettes in the country remains exceptionally high by international standards. This issue continues to be a matter of significant concern for public health and economic reasons.

The decline in illicit cigarette prevalence is attributed to anti-illicit measures implemented, which include rigorous control over the transshipment of tobacco products and enhanced enforcement efforts against the distribution of illegal cigarettes. These measures have yielded positive results, notably in Kelantan, where illicit incidence dropped from 70.6% in 2020 to 50.2%, thanks to heightened enforcement actions.

It is imperative that these anti-illicit initiatives be maintained and sustained. Although there has been progress, the fact that more than half of the cigarettes in Malaysia are still illicit remains a substantial concern. This high prevalence is partly driven by consumers' preference for illicit cigarettes, which are more affordable, priced between RM4 and RM8 per packet, compared to legal cigarettes with approximately RM9 in taxes per packet, selling at a minimum of RM12. This taxation shortfall is estimated to cost the government approximately RM5 billion annually in uncollected taxes.

Coastal smuggling, especially in the east coast region of Peninsular Malaysia, is a growing concern. Criminal syndicates exploit porous borders to smuggle cigarettes into the country, further exacerbating the illicit trade problem. It is imperative that the government takes decisive action against this form of smuggling to curb the illicit cigarette market.

The Illicit Cigarettes Study (ICS) in Malaysia for 2023 has identified an alarming trend in the sale of cigarette cartons with fake tax stamps. The prevalence of such cartons has risen to 8.5% from 4.9% in 2018, reflecting an increasing challenge for authorities. Currently, there are over 20 brands of cigarette packets with fake tax stamps in Malaysia, a number projected to grow if the issue is not promptly addressed. The Royal Malaysian Customs Department is urged to take swift and decisive action against rogue importers involved in the production of fake tax stamps.

In a move to combat the illicit cigarette trade, Deputy Finance Minister Datuk Seri Ahmad Maslan recently announced a 10% reward program for intelligence sharing. This incentive aims to encourage individuals to provide information that will lead to impactful enforcement actions against those responsible for illegal cigarette production and distribution.

6.2 India

Amid the COVID-19 pandemic, due to air travel restrictions, criminal groups based in the United Arab Emirates (UAE) shifted their tactics towards utilising containerized sea cargo and trucks for smuggling cigarettes into India. In 2021, India experienced a notable surge in the market share of illicit cigarettes, accounting for an estimated one-third of the entire cigarette market. A substantial 65% of these illicit cigarettes originated from Dubai, as reported by the Directorate of Revenue Intelligence (DRI) in 2021.

A closer examination of recent seizures reveals that a wide range of foreign cigarette brands, spanning high-end, mid-range, and low-end varieties, were smuggled into India in significant

quantities. Many of these shipments either originated in or passed through Myanmar and/or made stops in Sharjah and Dubai in the UAE. In fact, available sources indicate that for smuggled cigarettes, approximately 47% originate from Myanmar, 22% from the UAE, and the remaining 31% from a couple of other countries. The impact of COVID-19, and the associated air travel restrictions, led to an increased reliance on containerized sea cargo and trucks for cigarette smuggling into India.

These trends have positioned India as the fourth-largest illegal cigarette market globally, making up more than a quarter of the total market, according to Euromonitor International. The legal cigarette industry in India has borne the brunt of this thriving illicit market, with legal cigarette consumption witnessing a decline in volumes. In contrast, the illicit market has experienced consistent growth, reaching a staggering 28 billion sticks in the 2019-20 period.

Research findings indicate that the proliferation of illicit trade in cigarettes cannot be solely attributed to high taxation. Instead, it stems from a combination of factors, including stringent regulations and a deficiency in overseeing cigarette manufacturing and the cross-border movement of cigarettes and other tobacco products. These regulatory gaps collectively contribute to the facilitation of illicit trade in tobacco.

Furthermore, it's important to note that this illicit trade is often orchestrated by criminal organizations equipped with highly sophisticated systems for the distribution of smuggled tobacco products. These criminal networks exploit various channels to ensure the illicit distribution of cigarettes across international borders. It's worth mentioning that this issue is more prevalent in low-income countries as opposed to their higher-income counterparts. The economic disparities between these nations further compound the challenges associated with combating this illicit trade.

6.3 Pakistan

Pakistan stands as one of the world's largest consumers of tobacco, a distinction shadowed by the concerning prevalence of illicit cigarettes within its borders. A report from the Express Tribune (2013) ranked Pakistan third in the Asian continent, with an alarming 26.7% share of illicit cigarettes. The impact of this illicit trade on Pakistan's revenue has been substantial, with losses escalating from Rs 27 billion in 2012 to more than Rs 80 billion annually.

The extent of the issue becomes more pronounced through the lens of Oxford Economics. In the calendar year 2021, illicit cigarette consumption accounted for a staggering 38% of all cigarettes consumed. This consumption spanned over 200 illicit cigarette brands, all being sold below the mandated minimum price. Consequently, the nation suffered an estimated loss of Rs 77.8 billion in evaded taxes throughout 2021.

The confluence of two pivotal factors, namely the expanding share of the illicit cigarette market and the steep surge in excise rates, is a narrative that is not unfamiliar to the public. This intersection became apparent with the introduction of the September 2018 supplementary budget, followed by the June 2019 Federal Budget. These initiatives saw Tier 2 excise rates, representing a substantial 92% of the total industry volume, soaring from Rs 854 per thousand to Rs 1,650 per thousand.

The trajectory of excise taxes has consistently shown an upward trend. By 2017, Pakistan had already claimed the ignoble distinction of being the highest-ranked market globally for the volume of illicit cigarettes consumed. The persistent availability of these illicit products well below

the stipulated minimum price has provided fertile ground for the thriving illicit cigarette market in Pakistan.

This continuous leap in excise rates and flourishing illicit cigarette trade raises critical questions about the effectiveness of policies and the complex dynamics shaping the nation's tobacco landscape. Striking a balance between revenue generation and curbing the illicit market's growth becomes paramount. The challenge lies in crafting regulatory frameworks that not only deter the proliferation of illicit products but also ensure the affordability of legal alternatives, thereby safeguarding public health, revenue streams, and the broader socio-economic fabric of the nation.

Table 9: Illicit cigarette market share by Pakistan 2010-2021

2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
18.9%	19.2%	22.0%	22.0%	23.0%	27.7%	40.6%	40.0%	33.2%	36.9%	37.6%	36.7

Source: Pakistan Tobacco Company Annual Reports 2010-22

Pakistan's legitimate tobacco industry is facing an unprecedented challenge as it grapples with the surge of illicit cigarette sales. Recent developments within the industry have showcased a dire need for comprehensive strategies to combat the thriving illegal market, which is rapidly eroding the viability of legitimate tobacco producers.

In a striking move, Pakistan Tobacco Co. (PTC) has signalled its struggle to compete by scaling back production. The company's intention to re-export four cigarette-making machines and the closure of eight out of ten production lines at its Jhelum facility reflect a harsh reality – the battle against illicit cigarette sales is taking a toll on the legitimate industry's operations.

The surge in illicit trade has been amplified by a significant tobacco tax increase. In February, the federal excise duty spiked by over 200%, leading to a dramatic price hike for legally taxed tobacco products. This abrupt escalation drove consumers towards cheaper untaxed locally manufactured alternatives and smuggled cigarettes. The immediate aftermath saw a drastic 50% plunge in the production of duty-paid tobacco products in March, as reported by the Pakistan Bureau of Statistics. The legitimate large-scale industry, in contrast, experienced a comparatively milder decline of 25%.

PTC representatives have reported alarming figures indicating a 32.5% surge in the volumes of duty-not-paid (DNP) cigarettes and a staggering 67% increase in smuggled cigarette volumes since January. This unsettling trend has pushed the illicit sector's market share to surpass 42.5% of Pakistan's total tobacco market.

In the fiscal year 2022-2023, the legitimate tobacco sector accounted for 41.4 billion sticks, while the illicit sector matched closely with 41.6 billion sticks. Regrettably, projections indicate that the illicit sector's share will surge to 53.4 billion sticks in 2023-24, largely attributed to the recent excise duty hike. This would entail a shift of approximately 11.8 billion sticks from legitimate to illicit channels. The drastic hike in excise duties has created a complex web of consequences. The surge in prices for legitimate products has widened the affordability gap between legal and illicit alternatives. This gap has incentivized consumers to turn to DNP cigarettes and smuggled brands, consequently driving a significant decline in domestic volume for legitimate producers.

As the legitimate industry contends with a dire downturn, the urgent call for stronger enforcement measures resonates. Collaborative efforts involving rigorous law enforcement and comprehensive strategies are paramount to curb the proliferation of illicit cigarette products. Without swift and sustained actions, the legitimate tobacco industry's sustainability hangs in the balance, while the illicit market continues to flourish, causing both revenue losses and potential negative impacts on public health.

6.4 Transshipments of illicit cigarettes through Central American and U.S. free zones

Panama's free trade zones have become a central hub for the illicit cigarette trade in Latin America. Cigarettes are shipped directly to these zones from various sources, including Asian countries and Paraguay, with stopovers in Caribbean free zone ports. Once in Panama, the cargo is then redirected to intermediary free trade zones in different countries, including the United States and Central American free zones. From these intermediary zones, containers filled with illicit cigarettes are further shipped to hubs near major consumer markets, not necessarily coastal cities, and then distributed to urban wholesalers. Throughout this journey, the cargo is consistently labelled as "in transit," placing the responsibility for control on authorities at the final destination port. However, in reality, most of this illicit cargo is rerouted to avoid customs scrutiny at the destination port. Smugglers employ two primary methods for this: 1) they engage customs logistics operators to bypass required free zone checks, and 2) they set up shell companies for illicit operations, closing these companies after one-time or limited use.

In 2021, substantial disparities were observed between the number of exported and imported cigarettes in Panama and Belize, amounting to 4 billion and 5.4 billion cigarettes, respectively. These discrepancies far exceeded the actual domestic consumption levels in both countries, as they only represented legally declared cigarettes. Moreover, a significant quantity of cigarettes arriving in free zones in both countries goes undeclared. Calculating the exact criminal profits from this trade is challenging. Still, by examining changes in value along the illicit cigarette supply chain, it becomes evident that smugglers can substantially inflate the original cigarette value through free zone transshipments. For instance, when analysing cigarette consumption data by brand in conjunction with profit margins, a conservative estimate of the annual proceeds from illicit cigarette sales in Central America in 2021 ranged from US\$150 to US\$250 million.

6.5 Australia's illicit tobacco taskforce

The illicit tobacco market in Australia presents a significant challenge, with estimates of its size varying from USD 0.5 billion to USD 6 billion, indicating a serious threat to government revenue and public health. In response, the Australian Government has undertaken a series of measures to curb the growth of this illegal trade, focusing on strategic taxation adjustments, enhanced law enforcement capabilities, and multi-agency collaboration.

Recognizing the potential risks associated with frequent tobacco tax increases, the Australian Government has embarked on a multifaceted strategy to address the issue. One notable approach has been the reinforcement of tobacco tax administration and the creation of a comprehensive multi-agency task force, known as the Illicit Tobacco Taskforce (ITTF), established in July 2018. This task force is driven by the goal of investigating and dismantling organised crime groups that employ the proceeds from illicit tobacco to fund other criminal activities. Led by the Australian Border Force (ABF), the ITTF integrates the expertise and capabilities of various agen-

cies including the Department of Home Affairs, the Australian Criminal Intelligence Commission (ACIC), the Australian Transaction Reports and Analysis Centre (AUSTRAC), the Commonwealth Director of Public Prosecutions (CDPP), and the Australian Taxation Office (ATO).

Empowered with a range of legislative powers and options, the ITTF acts as a formidable weapon in the fight against illicit tobacco trade. One of its key accomplishments has been the seizure and destruction of over 131 tonnes of illicit tobacco in the 2019–20 financial year, representing an estimated excise revenue of USD 126 million. Additionally, the collaboration between the ATO, police, and ABF during this period led to the execution of 19 search warrants and the exposure of over 184 acres of illicit tobacco cultivation.

The Australian Government’s comprehensive approach extends beyond the ITTF’s activities. It involves measures such as improving border control to ensure the collection of tobacco duties and taxes, allocating additional resources to monitor domestic tobacco crops, implementing prohibited import controls for tobacco, and upgrading the ATO’s excise systems. These actions demonstrate a concerted effort to target the main sources of illicit tobacco within the country. Although significant strides have been made in addressing illicit tobacco trade, the Australian Government remains vigilant, continuously refining its strategies to counteract evolving methods employed by criminal networks.

07

**RECOMMENDATIONS TO
CURB ILLICIT TRADE**

To effectively combat the escalating illicit cigarette trade in Sri Lanka and safeguard the progress made in public health, a multifaceted approach is imperative. The government should focus on adopting a balanced tax policy, strengthening enforcement measures, enhancing penalties, and raising public awareness. The following recommendations based on our ongoing research findings provide a comprehensive strategy to address this pressing issue

- The surge in the illicit cigarette market is mainly thrived by the affordability factor present in these goods mainly since taxes on legal cigarettes have been increasing year on year significantly. To curb this trade, a well-balanced tax policy must be implemented to lower the cost of legal cigarettes and make them affordable to consumers.
- Efforts on executing large scale detections stay as key, where allocation of funds to acquire and maintain modern detection equipment, such as high-tech scanners strengthen the efficiency of identification and interception of illicit cigarette shipments. It should be ensured that these detection tools are adequately staffed and operated round-the-clock for maximum effectiveness. Also, Investing in training programs to equip law enforcement officials with the necessary skills to identify and respond to illicit trade activities promptly is vital.
- Currently profit of smuggling a 40 foot container of 10Mn sticks is estimated to be LKR 700 million whereas the maximum fine is only LKR 1Mn. It is utmost vital to reevaluate existing penalties and sanctions for engaging in the illicit trade to make them more severe and impactful. Consider adopting penalty structures similar to successful models, such as Malaysia's minimum fine of USD 25,000 or a minimum jail term of 6 months for convicted smugglers, traffickers, suppliers, and sellers of contraband cigarettes.
- According to RIUNIT's ongoing research findings and other market studies, 76.1% of the population remains unaware of the legal implications of purchasing illicit products. Therefore it is important to launch comprehensive public awareness campaigns on the impact of illicit trade targeting this specific segment.
- The need for partners in government and fully staffed law enforcement agencies with a clear mandate to act against illicit tobacco trade is paramount. Clear ethics policies and fair compensation for law-enforcement agencies to overcome corruption as well as funding intelligence efforts, enabling law-enforcement agencies to investigate criminal networks are key efforts to combat illicit trade
- Rigorous capacity-building initiatives should be implemented for law enforcement agencies involved in anti-illicit trade operations. It is also important to increase the number of dedicated officers focused on tackling illicit trade, supported by continuous training to stay ahead of evolving smuggling techniques. Capacity building, assistance, and training of customs and border guards at major ports is another important domain as more than 80% of the trade in most developing countries is transported in cargo containers (UNCTAD n.d.).

- Introducing performance-based incentives for officials engaged in curbing the illicit trade, thereby motivating and rewarding their proactive efforts will keep them sustained in their great efforts. Also, adequate resources should be allocated for these officials such as additional personnel, technological advancements, and data analytics tools to enhance the government's ability to combat the trade.
- Seized products and manufacturing machinery should be routinely destroyed, and the assets of convicted tobacco traffickers should be forfeited.
- Establish a dedicated task force with a specific mandate to combat the illicit market, allocating resources and personnel accordingly. Prioritise provinces with high smoking prevalence, such as the Central, North Western, Uva, and Western provinces, for intensified enforcement and awareness efforts.
- Money laundering and illicit finance are the drivers of organised crime and illicit trade. A lack of transparency in beneficial ownership and financial secrecy in offshore jurisdictions are fertile grounds for all types of smuggling. The Government needs to expand national lists of predicate crimes such as drug trade, smuggling, human trafficking, and tax evasion which represent entry conditions for money laundering. In addition, it is recommended for the government to build and maintain good collaboration with financial organisations as they play a critical role in providing evidence and data on financial flows supporting illicit trade activities.
- Cross-border human trafficking supply chains generate multiple inter-jurisdictional challenges, including conflicting obligations at the country level, different national interpretations of money-laundering risks linked to human trafficking, a lack of unified methodologies in case reporting between jurisdictions, and domestic barriers on reporting, among other issues. Addressing such complex inter-jurisdictional challenges is impossible without cross-border public-private partnerships. Coordinated and committed action by local and international public and private sectors on a continuous basis is vital in the process of tackling this illicit trade.
- Adopting and enforcing policies ensuring transparent and accountable practices for Free Trade Zones (FTZs) by drawing on recommendations developed by international and regional organisations, e.g., the WTO, the WCO, and the OECD.

08

CONCLUSION

In light of the extensive analysis presented, it becomes unequivocally clear that the sustained trajectory of excessive taxation on legal cigarettes has yielded unintended consequences that pose significant challenges to both public health and government revenue. The interplay between economic downturns, escalating taxation, and consumer behaviour has fostered an illicit cigarette market, undermining the objectives set forth by policymakers.

The findings of this report resonate with a vital call for a recalibration of taxation policies. While taxation remains a potent tool for discouraging tobacco consumption and generating revenue, the outcomes of excessive taxation have proven counterproductive. The surge in the illicit cigarette market, driven by heightened affordability and variety, has not only weakened the nation's fiscal foundation but has also cast a shadow over public health concerns.

As policymakers navigate the balance between health and fiscal objectives, it is imperative to consider alternative approaches. Reinvigorated strategies that address the concerns of both smokers and the government are paramount. Achieving this equilibrium requires nuanced solutions that mitigate the growth of illicit markets while safeguarding public health and sustaining revenue streams. It is our fervent hope that this comprehensive study will guide policymakers toward a more effective, holistic approach that preserves the economic welfare of the populace, supports the government's revenue base, and ensures the wellbeing of the nation.

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