

ECONOMICS OF TOBACCO TAXATION IN SRI LANKA

THE BEEDI INDUSTRY OF SRI LANKA

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Abbreviations

CAGR	Compound Average Growth Rate
CBSL	Central Bank of Sri Lanka
CCPI	Colombo Consumer Price Index
CESS	A form of Tax on Tax
DCS	Department of Census Statistics
FCTC	Framework Convention on Tobacco Control
FICC	Federation of Indian Chambers of Commerce and Industry
FMC	Factory Manufactured Cigarettes
GHW	Graphic Health Warning
ITTF	Illicit Tobacco Taskforce
LKR	Sri Lankan Rupee
NBT	Nation Building Tax
No.	Number
PAL	Ports & Airport Levy
PPP	Purchasing Power Parity
RIP	Retail Index Price
RIUNIT	Research Intelligence Unit
STF	Special Task Force
TIRSP	Tax Included Retail Price
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

The report explores Sri Lanka's beedi industry, analysing how taxation, market dynamics, and smuggling influence its trajectory. It emphasises the industry's presence in a low-tax environment and highlights the taxation disparity between beedis and legal cigarettes. Additionally, it scrutinises the impact of tendu leaf smuggling on the beedi market.

The implications of this report extend beyond the pages, echoing a loud and clear call for action. Sri Lanka has the opportunity to reshape its beedi industry, bridging the taxation gap it possibly could fill, (given its growth trajectory due to the affordability factor under the current tax structure), combating tendu leaf smuggling. The insights provided herein navigate the path forward. A path that strives for equilibrium, informed choices, and a future where the nation's economic and public health interests converge.

01

INTRODUCTION

The Sri Lankan beedi industry, with its rich historical roots dating back to 1956, has long been a significant contributor to the nation's tobacco products market. Crafted by combining locally grown tobacco with imported tendu leaves, beedis have held a distinct place in the cultural frame of the country. However, recent trends in consumption and taxation have raised considerable concerns about the industry's impact on the economy, public health, and the integrity of the tax system.

This report delves into the multifaceted landscape of the Sri Lankan beedi industry, examining its historical evolution, growth trajectories, taxation structure, and the pressing issue of illicit trade. While beedis have traditionally held a significant position within the tobacco market, the industry's expansion, coupled with imbalanced taxation, has led to complex consequences that warrant careful consideration.

Over the past several years, the consumption of beedis has witnessed an unprecedented surge, growing by a staggering 100% between 2015 and 2023. This remarkable growth has resulted in beedis capturing a substantial 67% share of the tobacco products market by 2023. However, the tax revenue generated from this flourishing industry is disproportionately low, accounting for a mere 2% of the total government revenue collected from the tobacco sector. This stark contrast in revenue contribution between the beedi and legal cigarette industries points to a taxation imbalance that necessitates urgent attention.

One of the most pressing issues related to the beedi industry is the prevalence of illicit trade. With an estimated 62% of the beedi market relying on smuggled tendu leaves, the government faces a significant challenge in curbing this underground economy. This illicit trade not only undermines legal channels but also contributes to substantial revenue losses for the government. In 2023 alone, the fiscal losses due to the smuggling of tendu leaves amounted to a staggering LKR 19 billion, a figure that highlights the potential of this untapped revenue source in bolstering the country's fiscal health.

As the Sri Lankan beedi industry continues to exhibit growth projections, with an expected increase of over 10.36% in sales during 2023 according to ongoing research, it becomes predominant to address the issues of taxation equity and illicit trade. By unravelling the complexities of this industry, its historical context, growth patterns, and the underlying causes of its challenges, this report aims to provide policymakers, stakeholders, and the public with a comprehensive understanding of the complexities associated with the Sri Lankan beedi industry.

Through a thorough analysis of the industry's history, growth dynamics, taxation policies, and the impact of illicit trade, this report seeks to offer insights into potential avenues for reform. By addressing these issues head-on, Sri Lanka has the opportunity to strike a balance between economic growth, fiscal responsibility, and public health considerations, ultimately steering the beedi industry towards a more sustainable and equitable future.

02

**OVERALL BEEDI
CONSUMPTION
(VOLUME)
& MARKET SHARE**

2.1 Trends in beedi sales

The sales of beedis in Sri Lanka over the span of the past decade and a half present a dynamic and evolving pattern, reflecting the intricate interplay of various factors that have influenced the industry. Analysing the annual sales data from 2008 to the projected figures for 2023 provides valuable insights into the growth trajectory, market fluctuations, and potential implications for the industry and the economy as a whole.

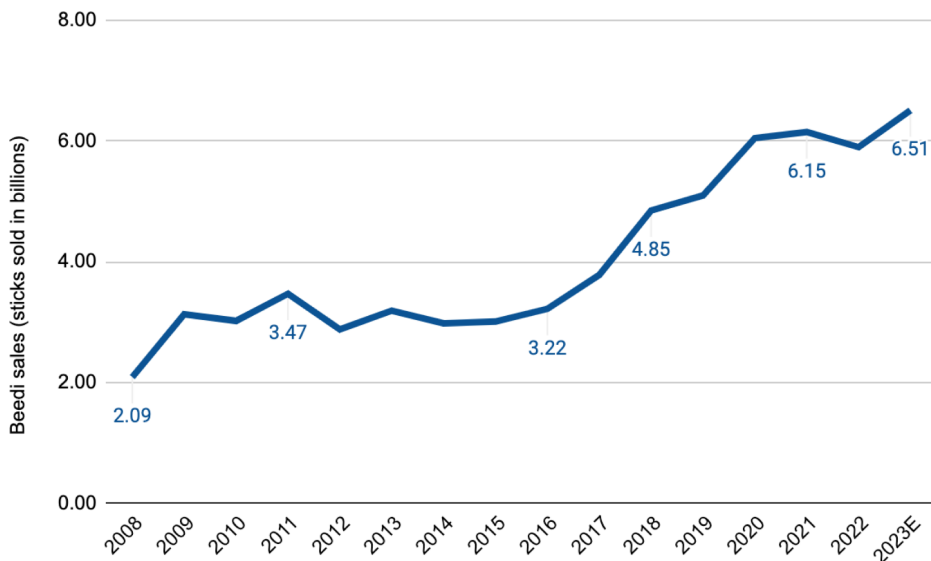
The data (as referred in table 1) reveals a general upward trend in beedi sales, with noticeable fluctuations observed throughout the years. Starting in 2008 with sales of 2.09 billion sticks, the industry exhibited moderate growth until around 2010. During this initial phase, the sales figures hovered around the 3 billion mark, indicating a relatively stable market.

However, the subsequent years from 2011 to 2014 witnessed a more pronounced increase in sales, with figures reaching a peak of 3.78 billion sticks in 2017. From 2017 onwards, the beedi industry entered a phase of steady growth and notable expansion. The sales figures consistently exceeded previous records, reaching new highs in subsequent years. Notably, 2018 saw sales cross the 4.8 billion mark, marking a significant milestone in the industry's growth trajectory.

The year 2020, amid global challenges posed by the COVID-19 pandemic, demonstrated resilience in the beedi market as sales remained relatively steady compared to previous years.

Looking ahead to 2023, the projected beedi sales figures suggest a continuation of the upward trend. With an estimated sales volume of 6.51 billion sticks, the industry appears poised for further expansion. This projection aligns with the general growth trajectory observed over the past several years.

Figure 1: Beedi Sales 2008-2023 (including both legal and illicit)



Source: RIUNIT compilation based on past studies and market sources

2.2 Market size and share of beedi

Over the past several years, the Sri Lankan tobacco market has witnessed a remarkable shift in market dynamics, with the market share of beedis consistently on the rise. The data spanning from 2017 to the projected figures for 2023 paints a vivid picture of the increasing dominance of the beedi industry within the larger tobacco market, signalling noteworthy changes in consumer preferences and market trends.

The progressive increase in the market share of beedis within the Sri Lankan tobacco market over the years is intricately linked to a pivotal factor: the noticeable discrepancy in taxation policies between beedis and factory-manufactured cigarettes (FMC). This taxation asymmetry has led to a marked advantage for beedis in terms of affordability, propelling their market share upwards from 2017 to 2023. At the heart of the shift lies the substantial variation in taxation between the two primary tobacco products. Beedis, benefiting from lower tax rates compared to FMCs, have emerged as a more cost-effective option for consumers seeking tobacco products. This economic appeal has significantly influenced consumers' preferences, resulting in a steady increase in beedi consumption.

The underlying pricing advantage that beedis possess due to their tax-favoured status has played a pivotal role in reshaping the market dynamics. Consumers, faced with a more budget-friendly alternative, have increasingly opted for beedis over FMCs. This competitive edge has had a cascading effect on the market, leading to a surge in beedi consumption. The trend of beedis consistently capturing a larger share of the market has been a direct outcome of their affordability relative to FMCs. Commencing at a 50.11% market share in 2017, beedis have consistently gained ground year by year. By 2021, beedis had already secured a substantial 67.09% of the market, pointing up the shift in consumer preferences. The evolving landscape of the tobacco market prompts critical considerations for policymakers. While the tax disparity has facilitated beedis' market share expansion, it also presents challenges from both economic and public health perspectives.

We speculate that the trend of beedi's increasing market share is projected to continue. With an estimated market share of 66.84% in 2023 as shown in table 2, beedis are anticipated to remain a dominant force in the Sri Lankan tobacco market. This projection suggests that the factors driving the preference for beedis remain robust, despite potential shifts and challenges within the industry.

Table 1: Market share of beedi 2017-2023

	2017	2018	2019	2020	2021	2022	2023E
Market share of beedi (as a % of the total tobacco market)	50.11%	56.40%	61.19%	66.78%	67.09%	63.69%	66.84%

Source: RIUNIT calculations

03

THE SUPPLY CHAIN

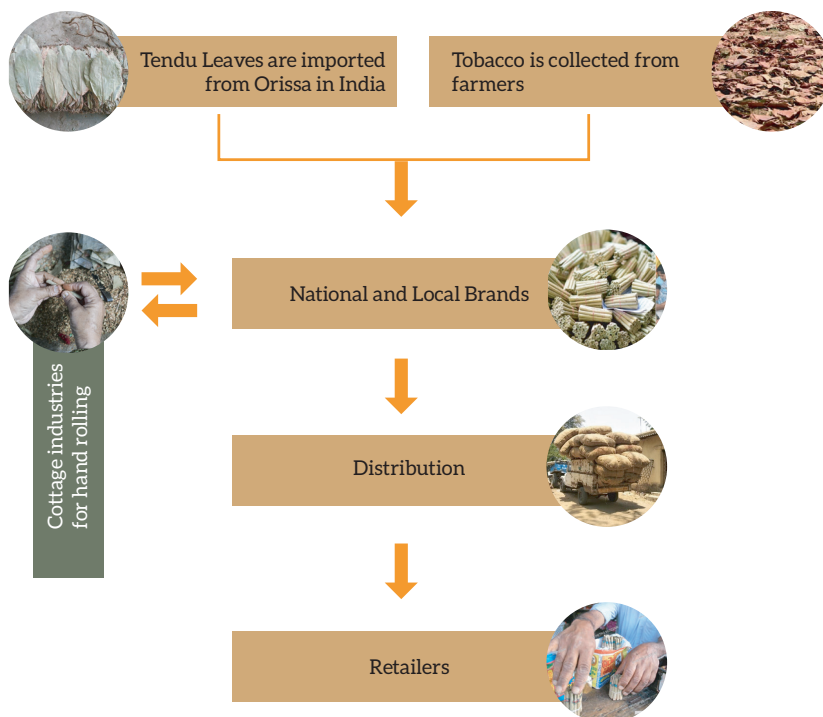
The supply chain of the beedi industry commences with the procurement of tobacco leaves, marking the inception of a journey that combines elements of local sourcing, cross-border trade, and cottage industry engagement. The process of crafting beedis encompasses several stages, each contributing to the final product that occupies a significant share of the Sri Lankan tobacco market.

A pivotal stage in the beedi production process involves the fine wrapping of tobacco in a Tendu leaf. This leaf, imported from the Indian state of Orissa, serves as a casing that encapsulates the tobacco. This stage is predominantly carried out within a cottage industry framework, with a considerable number of households at the village level participating on a casual basis. The decentralised nature of this phase bolsters local engagement and employment opportunities.

The wrapping process is emblematic of the cottage industry dynamics within the beedi supply chain. Operating on a smaller scale, these cottage industries not only facilitate the production of beedis but also provide livelihoods to a significant number of households. This decentralised engagement serves as a cornerstone of the industry’s resilience and grassroots economic contribution.

In the realm of beedi production, the spectrum of players is diverse. While there exist 590 registered and licensed beedi producers in Sri Lanka, a parallel cohort of smaller players thrives within the domain of the cottage industry. The relatively low cost of acquiring a beedi licence has fueled this diverse landscape of participants.

Figure 2: Supply chain of beedi



Source: RIUNIT, 2023

04

**CONTRIBUTION TO
LIVELIHOODS**

Within the framework of the beedi industry in Sri Lanka, a diverse workforce is engaged in the hands-on process of rolling beedis. This workforce, largely operating within the cottage industry paradigm, comprises individuals from diversified backgrounds whose livelihoods are linked to the production of this cultural product. Their contributions extend beyond economic sustenance, playing a role in fostering inclusivity and adaptability.

According to the Social Development Network (SDN), the beedi industry provides employment for over 8,000 families across the country. This network of workers constitutes a vital web of livelihoods that spans different communities, contributing to local economies and social dynamics. The cottage industry's decentralised nature fosters a sense of community engagement and economic interdependence.

The informal nature of tendu leaves entering the country has led to a situation where the Department of Customs acknowledges limited attention to this aspect. This phenomenon highlights the complex interplay of informal economies and regulatory oversight, underscoring the challenges in managing an industry that is deeply entrenched in the fabric of daily lives.

A noteworthy facet of the cottage industry's workforce is the substantial participation of women. Many women, while managing household responsibilities, engage in rolling beedis on a flexible basis. This presents a unique opportunity for economic empowerment, enabling women to contribute to their households' income while engaging in multiple roles.

Furthermore, sources reveal that the beedi manufacturing sector provides employment for a significant number of disabled and differently abled individuals. This inclusivity exemplifies the industry's adaptability in offering opportunities to those who might face barriers in traditional employment settings. While the cottage industry workforce forms an integral part of the beedi production cycle, it is essential to address challenges associated with the informal nature of this engagement. Ensuring fair wages, safe working conditions, and access to social protections becomes imperative to safeguard the well-being of these workers. Additionally, promoting sustainability and ethical practices within the industry can enhance both economic and social outcomes.

05

**MARKET
DISTORTIONS**

The beedi industry of Sri Lanka, while an integral part of Sri Lanka's cultural and economic landscape, grapples with significant market distortions that spread from the fine dynamics of tendu leaf sourcing. These distortions, rooted in a combination of smuggling practices and the challenge of local feasibility, cast a shadow over the industry's equilibrium and regulatory integrity.

One of the most notable market distortions is the smuggling of tendu leaves into the country through sea. This covert practice not only evades taxes but also erodes the revenue base that should rightfully contribute to the nation's coffers. Reports of bribery of customs officials paint a concerning picture of regulatory subversion, undermining the integrity of legitimate trade channels.

Although a locally grown substitute for tendu leaves exists in the wilds of Monaragala and Badulla, the feasibility of widespread local cultivation remains uncertain. While local farming could potentially address the supply-demand imbalance, challenges such as cultivation costs, labour requirements, and environmental considerations render the prospect less viable. The local substitute must contend with stiff competition from both smuggled and legally imported tendu leaves.

The presence of smuggled tendu leaves, alongside those imported through proper channels, creates a market distortion that skews the equilibrium of the beedi industry. The disparity in sourcing methods introduces a discordance in costs and availability, leading to unfair competition and exacerbating the already complex issue of taxation discrepancies.

Combating smuggling requires concerted efforts to enhance customs enforcement, reinforce legal frameworks, and foster cooperation between stakeholders. Additionally, exploring strategies to enhance the feasibility of local tendu leaf cultivation might offer a long-term solution to the sourcing imbalance. Creating a balanced market environment necessitates a holistic approach that includes regulatory reforms and anti-smuggling measures. By levelling the playing field, the beedi industry can operate on a fairer landscape, ensuring that taxes are paid equitably and the industry's growth aligns with legal and ethical considerations.

06

**LOCAL BEEDI PRODUCTION
AND TENDU LEAF
SMUGGLING**

The landscape of Sri Lanka's beedi industry is marked by a dual narrative: the legitimate local production of beedis and the illicit undercurrents of tendu leaf smuggling that underpin a significant portion of the market. As the projected total beedi sales for 2023 reach 6.51 billion sticks, this dynamic interplay between legal and illicit practices paints a complex picture of the industry's intricacies. A substantial portion of the beedi market is sourced through legitimate local production. This involves the combination of imported tendu leaves and beedi tobacco to craft beedis that cater to consumer demand. This segment adheres to regulatory frameworks and contributes to the formal economy, accounting for a portion of the projected 6.51 billion sticks sold in 2023.

Contrasting this legitimate production, the undercurrents of tendu leaf smuggling have cast a shadow over the industry. According to research conducted by RIUNIT alongside market sources, a significant portion of the beedi market which is approximately 62.75% is driven by illicit practices. Smuggled tendu leaves are employed in the production of illicit beedis, contributing to an estimated 4.1 billion sticks.

The monthly beedi sales calculated using import data and other sources illuminate the extent of these contrasting practices. The data suggests that 2,425 million sticks annually, can be attributed to legitimate local production using imported tendu leaves and beedi tobacco. However, a staggering 4.1 billion sticks which is equivalent to 62.75% of the entire beedi market are believed to be manufactured using smuggled tendu leaves.

Table 2: Calculation of illicit beedi share 2023

Total beedi consumption per month	542,636,527 sticks
Total beedi consumption- Annual	6,511,638,324 (6.51Bn) sticks
Monthly beedi sales *	202,083,980 sticks
Illicit Beedi consumption per month	340,552,547 sticks
Illicit beedi consumption – Annual	4,086,630,564 (4.1Bn) sticks
% of illicit beedi in the market	62.75%

*Source: RIUNIT estimations based on primary surveys and other studies.
* Monthly beedi sales are calculated using import data and conversion method*

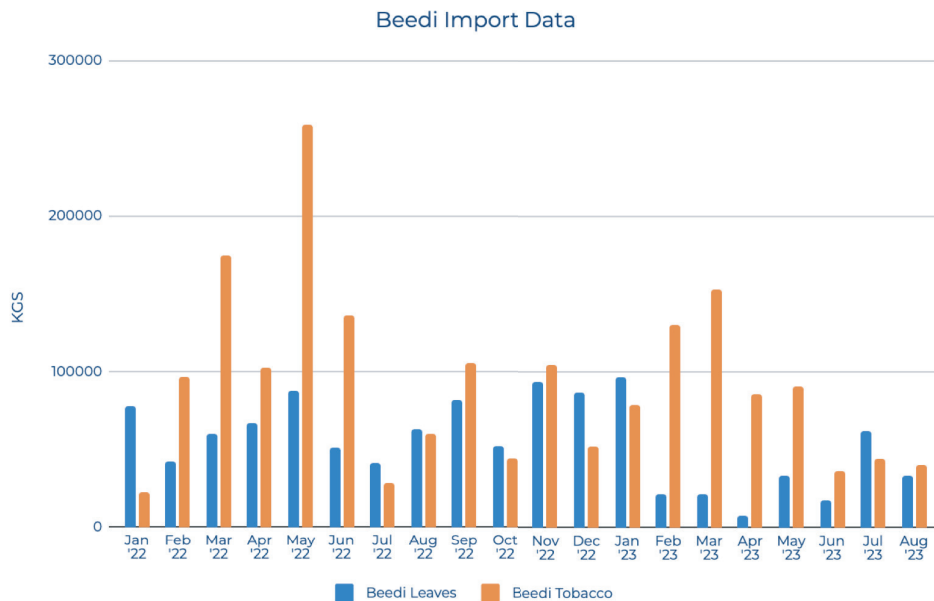
The importation of beedi leaves and tobacco constitutes a significant facet of Sri Lanka's beedi industry, offering a glimpse into the intricate sourcing strategies that shape the market. The import figures for 2022 and the early months of 2023 paint a vivid picture of the industry's reliance on global supply chains, underpinning its production and market dynamics.

In the year 2022, a total of 803,916 kilograms of beedi leaves were imported, alongside 1,185,695 kilograms of beedi tobacco. These imported materials serve as foundational components, contributing to the manufacturing of beedi that cater to consumer preferences. This practice reflects the industry's integration with global markets, as it taps into external resources to fulfil domestic demand.

The trajectory continued into the early months of 2023, where the aggregate amount of legally imported beedi leaves from January to August 2023 totaled 293,747 kilograms. Correspondingly, the figure for legally imported beedi tobacco for the same period reached 657,516 kilograms.

During the period spanning from January to August 2023, the legally imported Tendu leaves fueled a production output of 1.03 billion beedis. The figure is based on our assumption that 1kg of tendu leaves could craft 3500 standard 6cm beedis. When extrapolated on an annual basis, this legally sanctioned import counts to 440,621kgs which translates into a production value of 1.5 billion beedis. However, we see an unsettling contrast on the figures related to the amount of tendu leaves smuggled into the country with an influx of 1.2 million kilograms, a volume that eclipses the legal imports thrice over.

Figure 3: Beedi imports 2022-2023



Source: Sri Lanka Customs and media reports
 Note: Data includes seizures by the Sri Lanka Customs, Sri Lanka Police, Excise Department of Sri Lanka and the Special Task Force (STF)

As illustrated in Figure 2, there has been a significant decrease in the import of beedi leaves in the year 2023 when compared to the quantities imported in 2022. This decline in imports has raised questions about the substantial increase in total beedi sales, which have surged by an astounding 10.34% to reach 6.51 billion sticks in 2023. Given the dramatic decrease in the legitimate supply of beedi leaves, it is indeed a cause for concern and suspicion that such a substantial rise in sales may be attributed to illicit or illegal means.

07

**BEEDI TAXATION OVER
THE YEARS
AND CURRENT TAX**

7.1 Policy and regulatory environment

Incepting under the Tobacco Tax Act No. 08 of 1999, the beedi industry embarked on its journey without immediate tax obligations. Manufacturers and importers registered under the Commissioner of General of Excise without the imposition of taxes. It wasn't until 2010 that the industry was brought into the taxation fold, a significant transition from the initial exemption.

The subsequent years witnessed a series of fluctuations in taxation parameters, reflecting a government's endeavour to optimise revenue while adapting to market realities:

In 2015, the CESS tax on tendu leaves escalated from LKR 250 to LKR 350 per kilo, aligning with shifts in market dynamics. A significant pivot occurred as the import cess on beedi (tendu) leaves increased remarkably from Rs. 350 to Rs. 2,000 per kilo in the following year. This move signalled the government's intent to leverage taxation as a tool for fiscal control and policy direction. In 2018, a slight movement in import duty transpired, with the rate ascending from LKR 350 to LKR 750 in May, only to retract to LKR 350 in July.

In 2019, the CESS duty on Tendu leaves escalated further to LKR 3,500 per kilo, accompanied by adjustments in the PAL and VAT rates.

2021 was a year with a significant policy shift accentuated by adjustments across multiple fronts. Import duty on manufactured beedi rose from LKR 4000 to LKR 4250 per kilo, while import duty on beedi tobacco increased from LKR 165 to LKR 200 per kilo. Simultaneously, import duty on Tendu leaves saw a reduction from 30% or LKR 250 to 15% or LKR 125 per kilo.

Policy shifts in the years 2022-2023 saw alterations in VAT rates and the introduction of specific taxes per locally manufactured beedi.

Table 5 poses a summary of the adjustments and shifts in the policy and regulatory related to the beedi industry.

Table 3: Tax revisions on beedi 2015-2023

2015	The CESS tax on Tendu leaves were increased from LKR 250 to LKR 350/- a kilo
2016	July - The CESS tax on Tendu leaves increased from LKR 350 to LKR 2,000/- a kilo September - The CESS tax on Tendu leaves increased from LKR 2,000 to LKR 3,000/- a kilo.
2018	Import duty on beedi increased to LKR 750 in May. Import duty on beedi decreased to LKR 350 in July.
2019	CESS duty on the importation of Tendu leaves was revised to LKR 3,500 per kilo (in March). PAL increased to 10% in December. VAT cut from 15% to 8% in December. NBT was abolished in December.

2021	<p>Import duty on manufactured beedi increased from LKR 4000 per kilo to LKR 4250 per kilo. Import duty on beedi tobacco increased from LKR 165/- to LKR 200/- per kilo. Import duty on Tendu leaves was reduced from 30% or LKR 250 to 15% or LKR 125 per kilo.</p> <p>CESS on Tendu leaves was revised from LKR 3500 to LKR 3625 or 15%.</p>
2022	<p>CESS was increased to LKR 5000 per kg</p> <p>VAT Increased from 8-12% and then 12-15% 8% to 15%</p>
2023	<p>Tobacco tax of LKR 2/= per locally manufactured beedi</p> <p>CESS was reduced to LKR 3500 per kg.</p>

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

08

**SMUGGLING OF
TENDU LEAVES
OVER THE YEARS**

Inside Sri Lanka's beedi industry, a shadowy undercurrent has been steadily gaining momentum - the smuggling of tendu leaves, a critical component in the manufacture of beedis. The year 2023 has witnessed a sharp upsurge in this illicit trade, with implications that reverberate across the industry and the overall economy.

The figures stand as both a testament and a concern: the illicit share of tendu leaves used in the beedi manufacturing process has surged from 57.90% in 2022 to a staggering 62.75% in 2023. This means that out of the 6,511 million beedis sold in 2023, a significant 62.75% are crafted from smuggled tendu leaves.

The reasons behind this surge in tendu leaf smuggling are multi-faceted. While financial incentives are at the forefront, driven by the potential for substantial profits, the underlying factors are more nuanced. Disparities in taxation between legal and smuggled tendu leaves play a pivotal role, creating a financial gap that attracts illicit actors. The complexity of the supply chain and potential gaps in law enforcement also contribute to the ease of engaging in such activities.

The growing trend of tendu leaf smuggling casts a long shadow over various aspects of the industry and beyond. For the beedi industry itself, this trend disrupts the level playing field, undermines legitimate businesses, and distorts market dynamics. Additionally, the government grapples with the revenue loss, curtailing its ability to harness the industry's potential for contributing to the national coffers. Moreover, the integrity of cross-border trade and the larger ecosystem of regulation are both compromised.

Table 4: Illicit beedi share 2017-2023

	2017	2018	2019	2020	2021	2022	2023E
Beedi sales (sticks sold in billions)	3.78	4.85	5.10	6.05	6.15	5.90	6.51
Growth of beedi sales (YoY %)	17.39%	28.31%	5.15%	18.63%	1.65%	-4.07%	10.36%
Illicit beedi share %	26-29%	26-29%	42-45%	47.85%	52.64%	57.90%	62.75%

Source: RIUNIT compilation based on Department of Census and Statistics data

When legitimate market products become expensive, consumers often turn to unconventional avenues to access them at a lower cost, while some seek to capitalise on the gap between demand and affordability. Sri Lanka's tobacco landscape reflects this reality, with individuals and entities drawn towards circumventing official channels to procure tendu leaves, a critical ingredient for beedi production, at a more advantageous price point.

Sri Lanka's Navy stands as a steadfast guardian of the nation's maritime borders. The navy's annual reports offer a glimpse into the growing trend of tendu leaf smuggling. In the past year, the Sri Lankan Navy reported a staggering 21.7% increase in the seizure of beedi leaves, a total of 14,983 kg captured from Indian dinghy boats. This increase from 12,310 kg in 2021 and 5340 kg in 2020 paints a vivid picture of an underground trade gaining traction.

Tendu leaves, a valuable commodity subject to import taxes, find their way into Sri Lanka's borders through a labyrinth of unofficial routes. The Northern sea area, Mannar, and the Northwestern coastal region emerge as key hotspots for this illicit trade. The Sri Lankan Navy, equipped with a surveillance system that adapts based on incoming intelligence, stands as a barricade against these illicit activities. Yet, the smugglers employ strategies to evade capture, often discarding their cargo at sea to escape detection.

Price comparison becomes the driving force behind tendu leaf smuggling. With import taxes raising the price of tendu leaves when procured through legal means, consumers weigh the cost disparities between Sri Lanka and neighbouring India. The quest for affordability, coupled with the lure of profits for those facilitating the trade, drives the ongoing trend of tendu leaf smuggling.

09

**IMPACT OF NEWLY
IMPLEMENTED TOBACCO
TAX ON BEEDI AND LEGAL
CIGARETTES**

In 2023, Sri Lanka's beedi industry witnessed a pivotal moment with the government's introduction of a transformative proposal within the Tobacco Tax Act. This proposition, slated to take effect on January 1st, 2023, imposes a tax of Rs. 2 on each beedi stick produced domestically.

This significant taxation shift, proposed in the 2023 Budget, is anticipated to yield an additional LKR 3 billion in state revenue according to the calculations of the Excise Department of Sri Lanka, thereby fostering more equitable taxation within the tobacco market. While this introduction of the Rs. 2 tax is a commendable effort in reducing taxation disparities (chapter 10), its implementation has encountered obstacles of accruing those taxes mainly due to the lack of a robust tax collection mechanism.

Notably, the CESS, which was raised in 2022 to LKR 5000 per kilogram, was swiftly reduced to LKR 3500 within a short span, urging the ongoing need for comprehensive tax reform to ensure fairness and sustainability in Sri Lanka's tobacco industry. The raise in CESS was a crucial policy measure in order to curb the disparity underlying in the taxation of the tobacco market. Given the large market size of beedi compared to other tobacco products such as factory manufactured cigarettes, the tax contribution has been lagging behind at a significant comparison, while the efficiency and productivity of beedi taxes has been at the brink of stagnation due to the inefficiency in the tax collection and the overall administration of taxes.

10

**DISPROPORTIONATE TAX
CONTRIBUTION IN THE
TOBACCO MARKET**

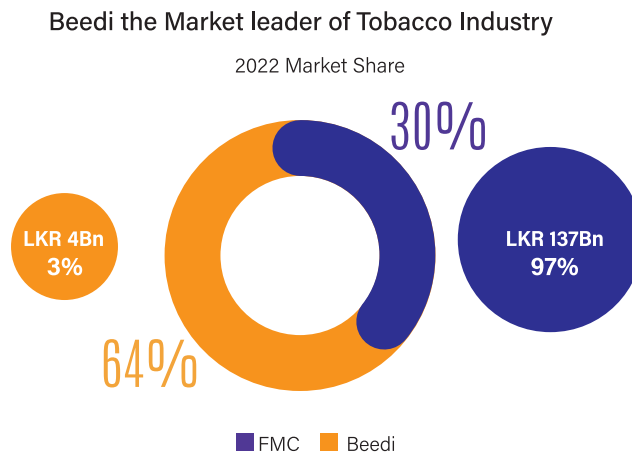
As the 2022 data comes into focus, a striking discordance emerges between legal cigarette sales and the beedi industry in Sri Lanka. This section delves into the depths of this disproportionate tax contribution within the tobacco market, underscoring the disparities, implications, and considerations that define this intricate scenario.

Legal cigarette sales in 2022 stood at 2.82 billion sticks, a substantial figure that reaped a significant tax revenue of LKR 136.85 billion (CTC Annual Report 2022). By contrast, the beedi industry commanded an even larger sales volume, reaching 5.9 billion sticks - more than twice the volume of legal cigarettes. Despite this considerable market share, the estimated government tax revenue contribution from the beedi industry pales in comparison, amounting to a meagre LKR 2.9 billion.

The heart of the matter lies in the disproportionate tax revenue contribution between legal cigarettes and the beedi industry. In the broader context of the entire tobacco market, the startling discrepancy becomes clear. Government revenue from the beedi industry constitutes a mere 3% of the total, while the legal cigarette industry shoulders a staggering 97% of the total tax burden. This glaring inequality in tax distribution unveils a taxation landscape that challenges the equilibrium between revenue generation and industry vitality.

The implications of this taxation imbalance resonate across multiple dimensions. For the beedi industry, the disproportionate taxation can impact its growth potential, financial viability, and overall competitiveness. The legal cigarette industry, on the other hand, is carrying the share of the tax burden, potentially influencing consumer choices and market dynamics. At a broader level, the revenue disparity holds implications for government revenue streams, fiscal policies, and the pursuit of equitable taxation.

Figure 4: Sales and Government tax revenue contribution in the tobacco industry (2022)



Source: RIUNIT calculations and CTC Annual Report 2022

Between 2016 and 2019, the beedi industry experienced a remarkable average annual growth rate of 16.57%. This seismic shift found its origins in a pivotal moment - the implementation of excise tax hikes during the fourth quarter of 2016. This watershed event set off a chain reaction that would redefine the industry's landscape, propelled by the interplay between taxation, consumer preferences, and market dynamics.

Central to this transformative journey was the shift in consumer behaviour spurred by excessive excise tax hikes on a particular segment of the cigarette market. The 59mm legal cigarette, Capstan, stood at the forefront of this shift. A staggering 67.38% rise in excise tax share per stick in 2016 ignited a cascade of changes that reverberated far beyond the realm of cigarettes. As the cost of conventional cigarettes soared, consumers looked for alternative options that offered greater affordability while still satisfying their cravings for nicotine.

The introduction of a new tax revision in January 2023 has taken the excise tax on the 59mm tier to new heights, a staggering 98% increase. The excise tax was increased twice in 2023 - 20% in January and by another 20% in July. This leap in taxation threatens to further intensify the trajectory of the beedi industry. The question that looms is whether history will repeat itself, with consumers once again seeking solace in more affordable alternatives, ultimately fueling the growth of the beedi market.

The growth of the beedi industry borne from excessive cigarette taxation is a reminder of the complex nature of economic dynamics. It highlights the need for policymakers to embrace a nuanced perspective that considers the broader repercussions of taxation decisions. As Sri Lanka's tobacco landscape evolves, a balanced approach that safeguards government revenue while maintaining equilibrium within the industry becomes imperative.

11

**FISCAL LOSSES
TO THE GOVERNMENT**

Sri Lanka's battle with the burgeoning illicit beedi market stands as a moving testament to this interplay, where revenue losses have reached staggering proportions, painting a striking picture of the complex repercussions that the island nation could face.

The illicit beedi market's unchecked growth has sent shockwaves through the Sri Lankan economy, with its impact stretching far beyond the surface. As the implications of smuggling seep into the fabric of the nation, the government's coffers bear the brunt of substantial fiscal losses.

According to RIUNIT calculations, the revenue losses to the government in the years 2021 and 2022 collectively counted up to an amount of LKR 13 billion. Moving on to 2023, the projections seem unparalleled with the preceding years as the magnitude of the losses is a hard-hitting reality which estimates the revenue loss as high as a staggering LKR 19 billion. This increase has been passed through by the effects of the much widened beedi market - a shocking 10.36% rise in beedi sales compared to 2022, coupled with the rise in the illicit beedi share by 5 percentage points compared to the previous year.

This drain on the country's financial resources is not merely a numerical anomaly; it translates into consequences which are material for the nation's development aspirations specially at a period where the country battles on achieving its strong fiscal targets to meet expectations of the overall stakeholders of the country. The untapped revenue source, obscured by the shadow of illicit activities, holds the key to addressing Sri Lanka's fiscal deficit. These uncollected funds could play a pivotal role in steering the nation towards optimal fiscal outcomes.

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**CONCLUSION AND
POLICY
RECOMMENDATION**

The alarming growth of the illicit beedi market, fueled by disparities in taxation and smuggling activities, has cast a spotlight on the need for strategic, cohesive, and equitable policy interventions. The repercussions of this burgeoning underground industry ripple far beyond revenue losses, impacting public health, economic stability, and the country's overall development trajectory.

As we reflect on the findings, the path forward reveals itself with equal clarity. A balanced approach to taxation that takes into account industry dynamics, consumer preferences, and government revenue needs is paramount. The policy recommendations presented with this report provide a compass for guiding the transformation of the beedi industry.

1. A staggering LKR 19 billion has been wiped off as potential fiscal revenue for the year 2023, due to smuggling. While the immediate focus is on plugging revenue leakage from the illicit activity, the overarching aim should be to dismantle the structures that enable these activities. This entails bolstering border security by improving conditions for information exchange and strengthening the capacity for prohibition of cross-border illicit activities, and intensifying collaborative efforts with neighbouring nations to curb the inflow of smuggled goods.
2. Implement an approach to level taxation between legal cigarettes and beedi. One approach we suggest is to increase import duty and CESS on beedi.
3. Build an effective mechanism to collect the newly implemented LKR 2 tax from all manufacturers, whilst a close monitoring of input raw materials and output should be made mandatory.
4. Develop mechanisms to capture revenue from informal beedi manufacturers and small players operating under the radar. Expanding the tax base will ensure equitable revenue generation.
5. Provide capacity-building, technical training and support to upgrade and enhance the capacities and technical knowledge of law enforcement on tendu leaf smuggling.
6. Implement stricter penalties for tendu leaf smuggling and advanced tracking systems to discourage illicit activities.
7. Invest in intelligence sharing, and cross-border collaboration to enhance surveillance and interception of smuggled tendu leaves. This will curtail illicit trade channels.

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