



Economics of
Tobacco Taxation
in Sri Lanka

**MACROECONOMIC
POLICY SERIES**

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Economics of Tobacco Taxation in Sri Lanka

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About the RIU

The Research Intelligence Unit (RIU) is a pioneering research firm that values creativity, innovation, integrity and market intelligence. We offer research-based consulting focused on several key sectors of the economy.

The RIU was first registered in the UK with its office based in London. In 2003, the RIU 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 RIU 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:

- Investment appraisal
- Market and financial feasibility
- Market surveillance and surveys
- Marketing strategies
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Foreword

As we emerge from a global economic crisis triggered by the pandemic, the current time presents policy makers and business leaders with an opportunity to re-examine some of the perennial issues that have continued to plague the domestic economy. At the frontline of the challenges facing Sri Lanka is that of increasing government revenue by eliminating, or at least minimising the untaxed economy. The consequences of failing to address these leakages in the Treasury will have very significant impacts on the macro economy.

More than ever, policy makers need to address the issue of illicit markets that erode the fiscal revenues of the Treasury. Whilst it is encouraging to note that the Government has accepted and acknowledged the existence of illicit markets in its 2021 budget proposal, policy makers still have ways to go to identify a feasible solution to tackling the menace. Tobacco taxation is a case in point where the politicisation of the issues over many years has resulted in the emergence of a thriving illicit market and a consequent sub-optimal achievement of both the health and fiscal targets.

The report has been compiled using primary data generated from the RIU consumer survey and all available secondary data from the Government, industry sources and Interviews with Ceylon Tobacco Company PLC as it is the sole licensed manufacturer of cigarettes in Sri Lanka.

The purpose of this document is to enlighten readers on the effects of the current tobacco taxation policy in Sri Lanka. It does so by carrying out a comprehensive and detailed treatment of the analysis of tobacco taxation. Using available data for 2021/22, we have carefully and objectively conducted our analysis with a holistic approach that considers tobacco taxation in the context of its entwined relationship with beedi and smuggled cigarettes.

From the consumption side, we have extracted the findings from our primary research into consumption of illicit tobacco covering the entire island. This survey of smokers, which has given us unprecedented insights, along with available secondary data forms the basis of our analysis.

The Research Intelligence Unit (RIU) has always been an organisation that has addressed issues of national interest and has been advocating pursuance of prudent and pragmatic policies that avoid spurring the growth of illicit markets. In addition to tobacco, Sri Lanka is affected by illicit markets that exist in other sectors such as agriculture, alcohol, and pharmaceutical products, that all result in fiscal revenue leakage for the Government. As part of our ongoing battle against illicit markets that erode government revenue, we are delighted to present this report **“Economics of Tobacco Taxation in Sri Lanka: Insights on the nature and size of the illicit market”** as our contribution towards addressing the gap in research relating to tobacco taxation. In this report, we provide insights on consumer behaviour, the impact of taxation, the growth in trade of the illicit tobacco market, the magnitude of the loss of revenue to the government, loss of business to the legitimate industry and the threat it poses to law and order in the country.

I would like to thank all those individuals, government agencies and the private sector who have contributed towards this study. It is hoped that this study stimulates and provokes further debate and will act as a catalyst and guiding document for future researchers and policy makers.

D.R. Madawela
Founder & CEO - RIU

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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 has taken significant steps to curb smoking prevalence and these efforts have been met with praise by the WHO. The WHO Framework Convention on Tobacco Control (FCTC) carries its efforts in developing a regulatory strategy to address tobacco control. It asserts the importance of demand reduction strategies for tobacco such as price and tax measures as well as supply issues such as the illicit trade in tobacco products. The underlying reason behind the development of the WHO Framework Convention was to respond to the globalisation of the tobacco epidemic. The international movement of contraband and counterfeit cigarettes has been a major facilitator of spreading the tobacco epidemic. The Island was one of the first to ratify the Framework Convention on Tobacco Control (FCTC) and has followed multifarious WHO guidelines related to pictorial health warnings on packaging, ban on sponsorships, a ban on smoking in enclosed public places and a ban on sales to persons under 21. However, the discussion on progress usually centres on the legal cigarette industry and often ignores the presence of other tobacco products such as beedi as well as a growing illicit market. Both can undermine the progress made thus far by weakening the Government's health objectives.

In this report, we provide a macro level overview on the tobacco industry in Sri Lanka with the aid of preliminary results of an ongoing primary survey, along with a time series analysis of the tax policy framework that has been implemented by successive governments. This report also delves into the efficiency of tax policy that has caused significant market distortions from legitimate to illicit. This undermines the Government's efforts to deter smoking, which in turn has led to a growth in the illicit tobacco market in Sri Lanka.

Moreover, the current excise taxation puts a greater burden on low-income groups than the upper income groups, eroding the real incomes of low-income individuals. The tobacco excise tax policy in Sri Lanka appears to be characterised by inconsistent elasticity, and low predictability of tax revenues, which could be a result of the improper tax structuring and/or revenue leakages from the growing illicit market.

The year 2022 marks a significant and challenging time period for most commodities where the country had to fight with a crippling shortage of foreign currency and galloping inflation as well as deal with the steps brought to tighten the fiscal and monetary policy. The findings of our research point to several changes that have resulted from the ongoing economic downturn. Firstly, we have observed a trend amongst consumers to down-scale their preferred brand, moving to cheaper options. A second observation that we have made is that per capita consumption has actually increased during 2022 as compared with 2021. This is evident to be the post covid recovery as many openings of restaurants and bars were happening and the social behaviour was normalising gradually in 2022, opening doors for more consumption than at the times of the pandemic. The most likely explanation for the increasing trend of the consumption of cigarettes can be further detailed with reference to the fact that the year 2021 was plagued by several very disruptive lockdowns that had a significant impact on the availability of many commodities, including cigarettes. Thirdly, we can note that the available data points to a greater number of detections in 2022. Hence it appears that the actions of the authorities have had a stifling impact on the supply of illicit cigarettes into the market. Finally, our primary research also points to the fact that the overall scarcity of foreign currency in Sri Lanka in 2022 has also served to reduce the capacity of smugglers to bring in illicit products. This too has contributed to reducing the share of illicit cigarettes in the market.

Consequently, this report finds that the estimated illicit cigarette consumption volume for the year 2022 is 539 million. Accordingly, the illicit share of the market in 2022 dropped to 16% as compared with 2021 when the illicit share was estimated at 21%



01

Introduction

1.1 Economic overview

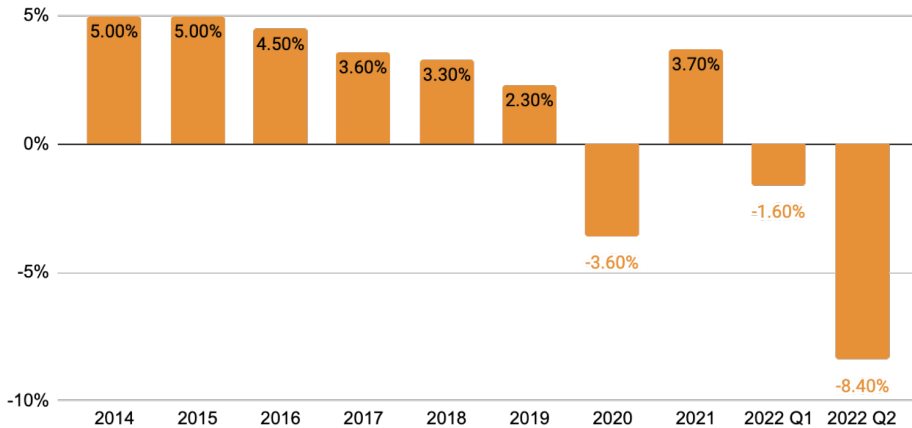
Sri Lanka is an island covering 65,620 sq,km with a population of 21.4 million and is currently categorised as a lower-middle-income country by the World Bank, with a GDP per capita of USD 3,699 in 2022 as compared with USD 3,743 in 2021. Sri Lanka boasts a literacy rate of 91.9%, the highest in South Asia and has traditionally maintained human development indicators that are comparable with those of advanced countries. Following the 30 years of civil war that ended in 2009, the economy grew at an average 5.3% during the period 2010-2019, reflecting a peace dividend and a determined policy thrust towards reconstruction and growth. However, the growth rate since 2018 has faltered.

The pandemic's effect on Sri Lanka's GDP was substantial after a troubling year in 2020 which saw a negative GDP growth of -3.6% and GDP per capita falling from USD 3,852 in 2019 to USD 3,681 in 2020. This was the first contraction in 19 years, driven by understandably weak performances in a number of sectors, inclusive of tourism, construction, mining, tea and textile industries. The country saw a recovery in 2021, with GDP growth of 3.4%, however GDP per capita further contracted to USD 3,665. According to the latest Central Bank of Sri Lanka, the economic data for Q2 2022 shows a contraction of -8.4% GDP for the second quarter.

According to many local and international economists, the national economy was expected to enter troubled waters after 2020 when it became apparent that meeting sovereign debt obligations would be challenging. Despite warnings and credit rating agency downgrades, the government remained heedless as the country soon became engulfed in an economic storm characterised by currency devaluation, galloping inflation, shortages of fuel and other essentials for daily life as the economy came to a grinding halt by Q2 2022.

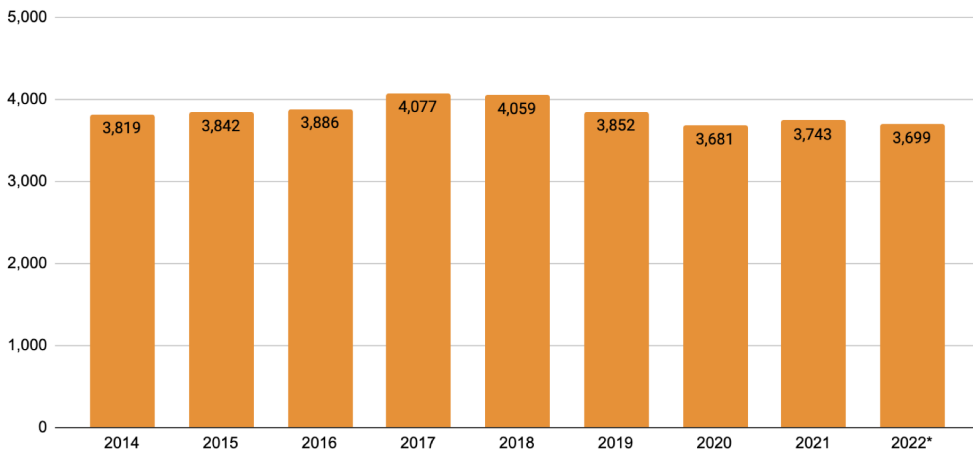
As the situation continued to deteriorate through the first half of 2022 with people having to endure power-cuts and long fuel ques, the intensity of civil protests continued to mount. The pressure on the political leadership of the country proved too great as we witnessed the resignation of the Central Bank Governor, the finance minister, the Cabinet, the Prime Minister and finally the President himself. By the start of Q3, the largely peaceful protests, commonly known as 'Aragalaya', meaning struggle, could claim victory in its objective to topple the regime deemed responsible for bringing the country's economy into the brink of disaster. However, the hard job of getting the economy back on the rails lay ahead for the newly appointed head of state. Consequently, the intensity of the protests eased as the new leadership focused on ensuring the supply of urgently needed imports such as fuel as well as preparing the groundwork for an IMF agreement. With a staff level agreement with the IMF being secured in September topping the list of improvements that include currency stability and a QR code system of fuel distribution, the easy record of the new leadership has been regarded as positive by commentators.

Figure 1: Annual GDP Growth 2014-2022



Source: CBSL, 2022

Figure 2: GDP per capita (USD) 2014-2022

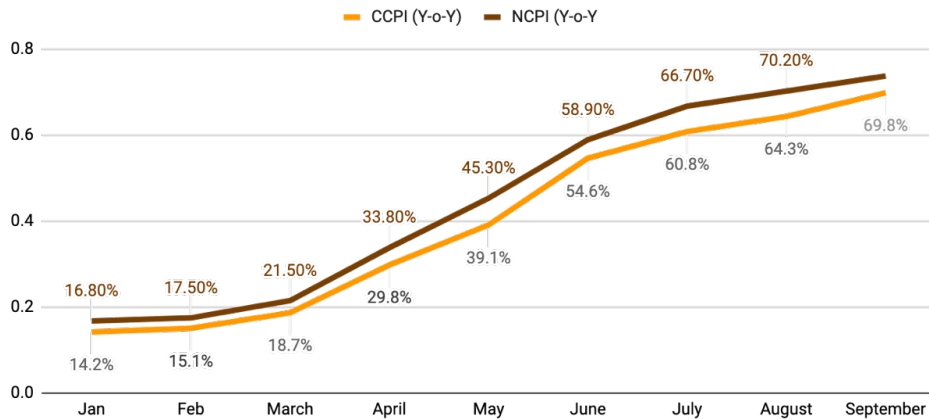


Source: Statista, 2022

In a regional and global context, rising inflation is a post-pandemic phenomenon that is affecting almost everyone in both the developing and developed world. India and Bangladesh for instance are both grappling with high single-digit inflation whilst Pakistan has recorded 21.3% inflation for June 2022.

Inflation has been a key feature of the economic crisis in Sri Lanka as the Colombo Consumer Price Index (CCPI) passed the landmark double-digit level during Q4 2021 and continued to gather pace throughout 2022. The current rate of inflation as measured by the CCPI is estimated at over 66% (October 2022).

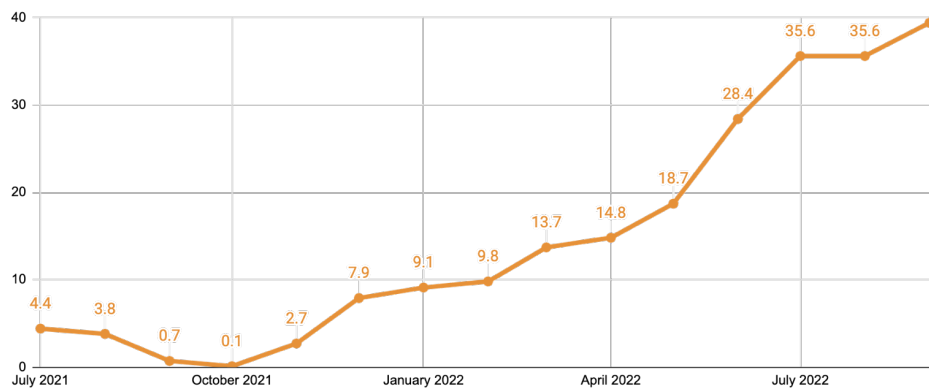
Figure 3: CCPI and NCPI 2022



Source: Statista, 2022

Galloping inflation impacts on all segments of the population but it tends to be particularly devastating on the lower income groups whose disposable incomes for essentials like food, fuel and transportation declines. Alcohol and tobacco inflation up to September 2022 stood at 39.4%.

Figure 4: Alcoholic Beverages and Tobacco Inflation 2021-2022



1.2 Industry overview and contribution to the economy

In Sri Lanka, cigarettes and beedi are the main forms of consumption, followed by tobacco with betel leaf that is popular among many urban and rural communities.

Ceylon Tobacco Company PLC (CTC) is the only licensed manufacturer of cigarettes in the country. The company carries out its entire seed-to-smoke operation locally. Beedi, which is a more popular form of tobacco usage among the low-income rural communities in Sri Lanka, is manufactured by wrapping crushed tobacco in Tendu leaf imported from India (World Bank Group Global Tobacco Control Program).

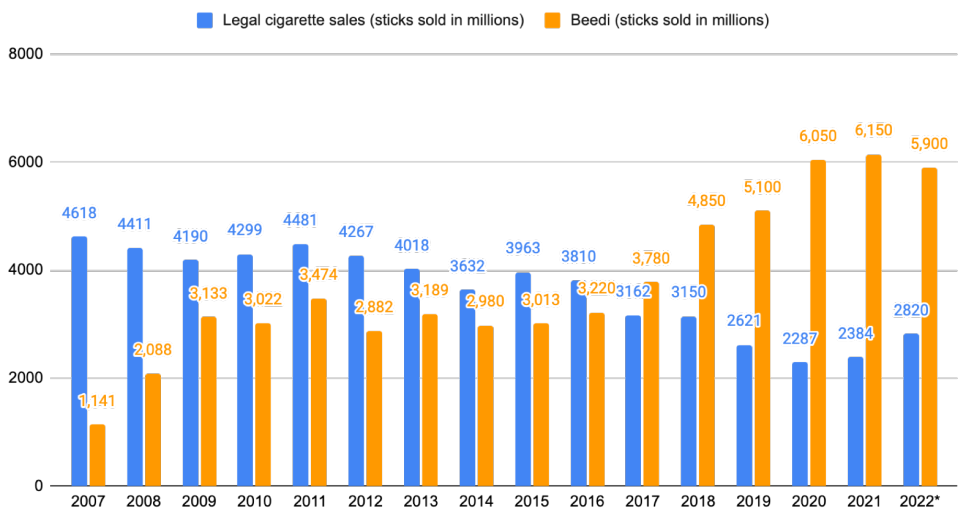
According to the World Population Review (2022), the estimated overall smoking rate in Sri Lanka was 22.9% for 2022, while the male and female smoking rates were estimated to be 43.2% and 2.7%, respectively.

Figure 5 provides a broader picture of Sri Lankan tobacco consumption trends. Excluding illicit products, the consumption of cigarettes in 2022 is estimated to be 2.82 billion sticks.

This significant decrease in demand for legal cigarettes especially in the period of 2015 to 2021 can be attributed to excise hikes through which consumer affordability is stretched to breaking points, resulting in the growth of the illicit cigarette market which will be discussed in the later sections of this report. The other factor that can support in analysing the trend is education and greater awareness of the health risks of smoking.

It is also important to note that as illustrated below, the impact of rising taxation on cigarettes and the consequent rise in prices has led to a substitution effect that has benefited the lower priced beedi products. The estimated consumption of beedi for 2022 is 5.9 billion. The consumption of beedi has witnessed a growth of over 100% since 2015. By contrast, legal cigarette consumption is characterised by a 40% decline over the period of 2015 to 2022.

Figure 5: Beedi and Cigarette Consumption historical trends 2007-2022



*2022 is the estimated consumption (volume) of cigarettes and beedi
 Source: CTC Annual Reports 2016-21, CTC Data 2022

Tobacco is also a major source of revenue to the Government. The tax contribution for the government revenue from the factory manufactured cigarettes by CTC for the year 2022 is estimated as LKR 121 billion. The tobacco industry affects over 71,000 direct and indirect workers, farmers, retailers, and others, and supports over 300,000 livelihoods across its value chain (Ceylon Tobacco Company, 2022). The industry value chain comprises the tobacco cultivation, processing and manufacturing, distribution and retailing of products, thereby creating numerous job opportunities.

Tobacco cultivation is carried out by 23,450 farmers (Oxford Economics, 2020) spread across the island and their livelihoods are supported by the industry. CTC sources 100% of its tobacco leaf

requirement from 1,613 contracted tobacco farmers, and by doing so, injected LKR 1.62 billion to the rural economy through leaf purchasing throughout 2021 (Ceylon Tobacco Company, 2021).

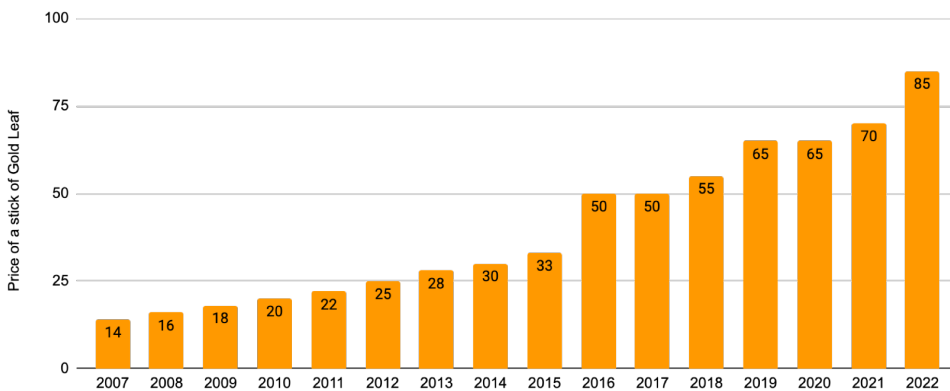
According to the Excise Department of Sri Lanka (2019), around 457 registered manufacturers are involved in the beedi manufacturing industry, where over 8,000 families rely on this industry. However, a few large players enjoy an oligopoly with clear segregation on distribution areas.

1.3 Policy environment

The tobacco industry in Sri Lanka is one of the most highly regulated in the world. Tobacco regulation was first introduced in 1953 when the Tobacco Tax Act No. 27 came into force. The subsequent Tobacco Tax Act No. 08 of 1999 replaced the initial tobacco laws and all tobacco products, including cigarettes, beedi and cigars were subjected to taxes. After the implementation of the new Act, the Government has been consistently changing the tax regulations as will be shown later in this report.

Cigarettes have become one of the most taxed commodities in the market due to significant government interventions over the years. Figure 6 shows that prices have increased over three-fold over the period 2010-2022, with it doubling between 2016-2019. In 2022 the economic collapse triggered the increase of VAT and other taxes which led the cigarette prices to rise by 21.4% compared to 2021. The VAT hike to 12% from 8% effective from 1 June 2022, the following raise to 15% effective from 1 September 2022, and the SSCL of 2.5% effective from 1 Oct 2022 pushed the price of a stick to LKR 85 as at 20 October 2022.

Figure 6: Exit Prices of a stick of John Player Gold Leaf 2007-2022



Source: RIU compilation based on market information as at 20 October 2022

Compared to cigarettes, the beedi industry, is underregulated and pays a low amount of taxes, thereby causing discriminatory treatment within the overall tobacco industry (see next section for more information).



02

Tobacco taxation and its effects

2.1 Tobacco taxation in Sri Lanka

Tobacco companies fall into the highest corporate tax bracket, along with gambling, gaming, and liquor companies.

Sri Lanka has a five-tier specific excise tax regime on cigarettes, with the length of the cigarette as the base for tax variations. Excise taxes are the main component of tobacco taxation, while cigarettes are also subject to Value Added Tax (VAT). The Value Added Tax (VAT) was reduced from 15% to 8% on 01 December 2019, where it was increased to 12% from 01 June 2022. Due to the concerns raised on the tax base to match the fiscal consolidation targets, the VAT was again increased to 15% with effect from 1 September 2022.

SSCL was newly introduced at the rate of 2.5% with effect from 1 October 2022. As a step to increase import duties, 100% surcharge was levied as well on foreign cigarettes with effect from 01 June 2022.

Beedi is not subject to any form of excise duty, but Tendu leaves (a.k.a. beedi leaves) are subject to Customs Import Duty and Cess (CESS) during importation.

The tax regulations as at 20 October 2022 are detailed below.

Table 1: Taxes applicable on the tobacco manufacturers and products as at October 2022

	CIGARETTES	BEEDI
Corporate tax	40%	40%
Tobacco tax	LKR 10 per kilo of tobacco	LKR 10 per kilo of tobacco
Import duty	15% for manufactured sticks 85% or LKR 200 per kilo for unmanufactured tobacco	75% or LKR 4250 per kilo gross weight per kilo for manufactured beedi 85% or LKR 200 per kilo for imported beedi tobacco 15% or LKR 125 per kilo for beedi leaves
Surcharge of customs duty (for imported tobacco only)	100%	100%
CESS	165% for imported cigarettes 30% for imported tobacco	30% for imported beedi tobacco 30% for manufactured beedi 15% or LKR 3625 per kilo for imported beedi leaves
PAL	10% for imported tobacco Imported cigarettes are exempt	10% for beedi tobacco, manufactured beedi and imported beedi leaves
SSCL	2.5%	2.5%
Excise tax	Length below 60 mm - LKR 6,750 per 1000 sticks. Length 60 – 67 mm - LKR 28,850 per 1000 sticks. Length 67 – 72 mm - LKR 41,100 per 1000 sticks Length 72 – 84 mm - LKR 46,600 per 1000 sticks Length exceeding 84 mm - LKR 51,800 per 1000 sticks.	None
VAT	15%	15%

Sources: Government gazettes, Customs and Ministry of Finance 2022.

Tobacco taxes have undergone several revisions every year, with close attention to the excise tax. To simplify tobacco taxation, in 2014 the Government consolidated VAT and NBT into excise tax. As a result, excise revenues were boosted by over 40% but VAT revenue declined. In 2016, the Government re-imposed VAT on cigarettes while increasing the excise tax, on top of the already consolidated excise which included VAT and NBT. This resulted in the price of cigarettes increasing by over 50%. In 2022, the VAT was increased twice, pushing the prices further. In addition, the Social Security Contribution Levy (SSCL) came into effect from 1 October 2022 at a rate of 2.5% on taxable turnover.

Table 2: Tax Revisions 2014-2022

	CIGARETTES	BEEDI
2014	Excise tax increased (see Table 3 and Figure 7). VAT and NBT on cigarettes were consolidated into a single excise tax.	n/a
2015	Excise tax increased (see Table 3 and Figure 7)	The CESS tax on Tendu leaves was increased from LKR 250 to LKR 350/- a kilo
2016	Excise tax increased (see Table 3 and Figure 7). VAT reintroduced on cigarettes. NBT reintroduced on cigarettes for both retail and wholesale.	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	Excise tax increased (see Table 3 and Figure 7).	Import duty on beedi increased to LKR 750 in May. Import duty on beedi decreased to LKR 350 in July.
2019	Excise duty increased twice in the year (see Table 3 and Figure 7). NBT levied on cigarette production was abolished in December. VAT was cut from 15% to 8% in December.	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	Import duty on imported cigarettes was reduced to 15%. CESS on imported cigarettes increased to 165%. Excise tax increased (see Table 3 and Figure 7).	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. CESS on Tendu leaves was revised from LKR 3500 to LKR 3625 or 15%.
2022	VAT increased from 8% to 12% effective from 01 June 2022 100% surcharge of customs duty VAT increased from 12% to 15% with effect from 01 September 2022 SSCL at a rate of 2.5% came into effect from 1 October 2022	VAT increased from 8% to 12% effective from 01 June 2022 100% surcharge of customs duty VAT increased from 12% to 15% with effect from 01 September 2022 SSCL at a rate of 2.5% came into effect from 1 October 2022

Sources: Government gazettes, and news articles published online, 2014-2022

Excise tax change is a tool that the Government frequently uses to influence cigarette prices. With the 2019 July revision, the 67-72mm cigarettes saw a massive hike and were at the same level as the 72-84mm tier. This move had essentially combined the 67-72mm and 72-84mm tiers together into a single 67-84mm excise tier. However, this adversely affected government revenue and as a result, the Government revised their decision in October 2019. Excise taxes were separated into two independent tiers once again as rates for each length increased by varying amounts (see Table 3).

Table 3: Excise tax revisions 2014-2022

Size	2014	2015	2016	2017	2018	2019*	2020	2021	2022
Length 60-67mm	12,675	12,675	17,375	17,375	17,375	22,300	22,300	28,850	28,850
Length 67-72mm	14,660	14,660	20,500	20,500	20,500	37,650	37,650	41,100	41,100
Length 72-84mm	21,610	23,750	30,500	30,500	33,550	43,100	43,100	46,600	46,600
Length Exceeding 84mm	25,100	27,240	34,250	34,250	37,675	48,350	48,350	51,800	51,800

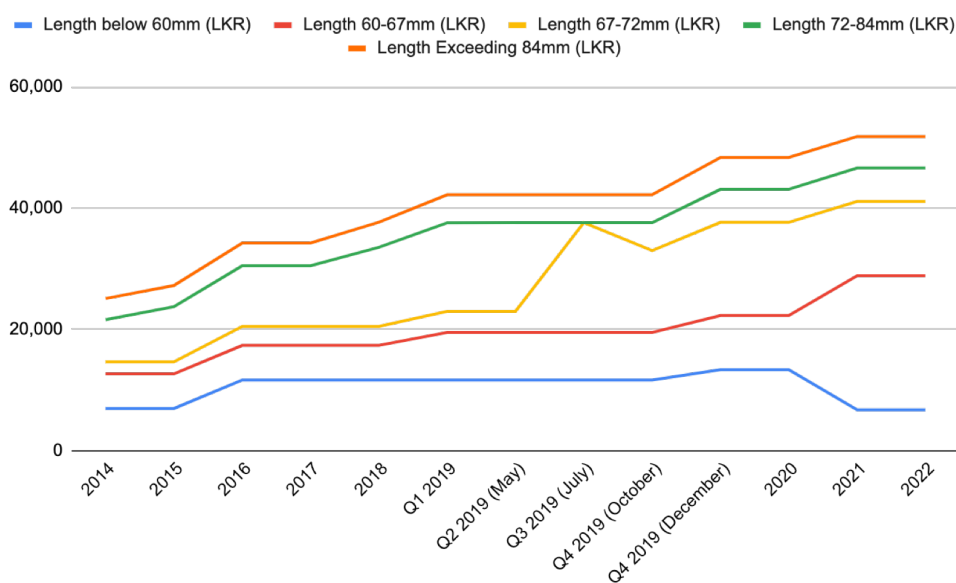
Source: Ministry of Finance

Notes:

Excise tax prices are in LKR per 1000 sticks

* 67-72mm prior to setting the excise tax to 37,650 in December 2019, this value was previously revised to LKR 37,600 in July 2019, and to LKR 33,000 in October 2019

Figure 7: Excise tax revisions 2014-2022



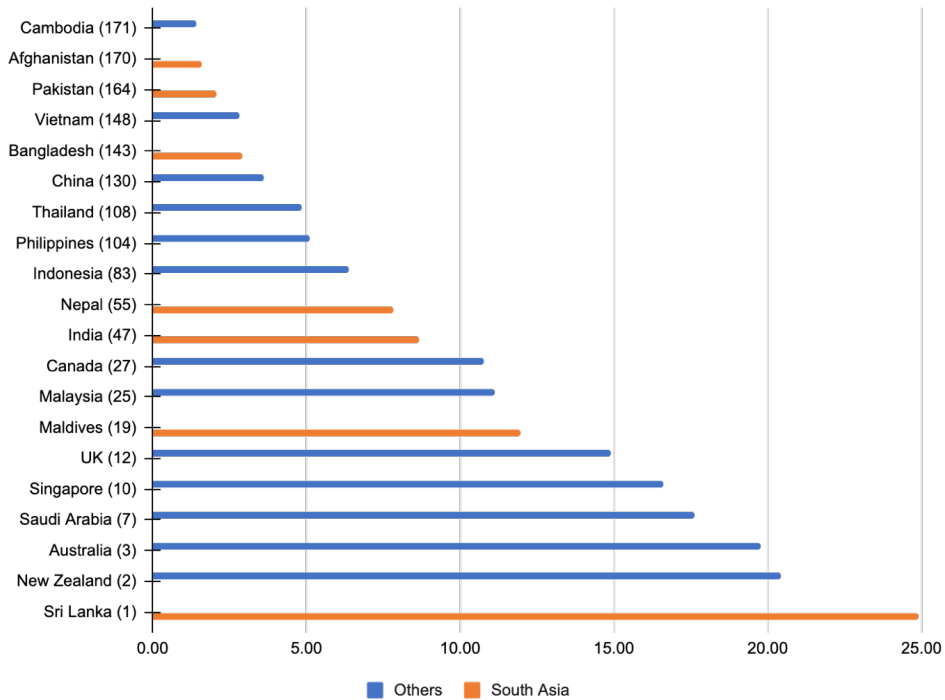
Source: Based on Ministry of Finance data, 2014-2022

2.2 Tax impacts on pricing

2.2.1 Tax impact on cigarette pricing

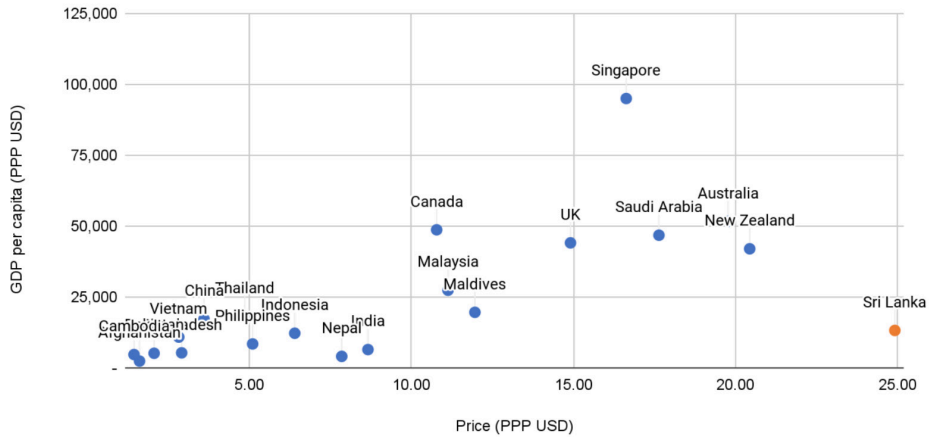
Sri Lanka has been the most expensive country in the world to purchase cigarettes, in terms of the purchasing power parity since 2018. As per Figure 5, the price of cigarettes in Sri Lanka in international dollars is above the range of high-income countries such as Singapore, Australia etc.

Figure 8: Price of a 20-stick pack of the most sold brand in international dollars 2020



Source: WHO, 2021
Note: country rank in parenthesis

Figure 9: Cross country comparison: GDP vs price of the most sold cigarette brand 2020

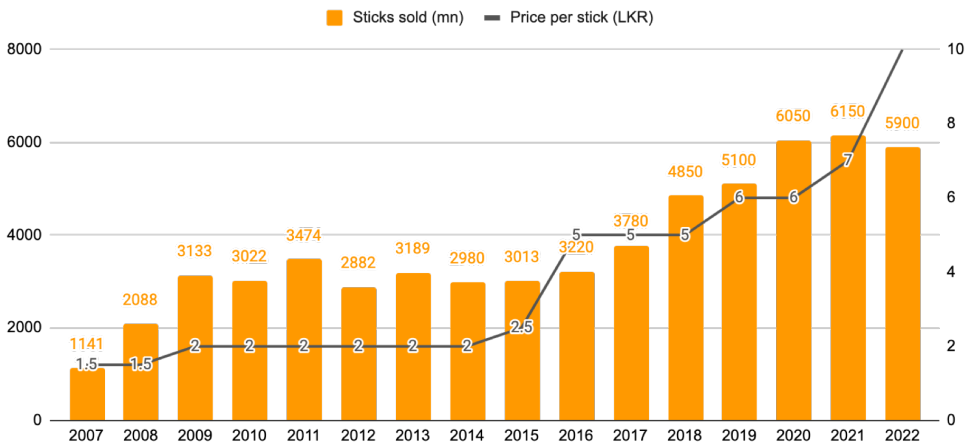


Source: RIU compilation based on WHO 2021 and statistic times

2.2.2 Tax impact on beedi pricing

Beedi has had comparatively low taxes over the years and continues to be taxed at low rates. The tax share of beedi is set as 13% for beedi manufactured using locally sourced tobacco and 21% for beedi manufactured using imported tobacco. In 2016, with the increment of CESS on Tendu imports, the prices of beedi doubled, however, consumption did not decline. During the next two years, following the 52% increase in cigarette prices, the price of beedi remained constant. Beedi sales grew at a rapid pace (50% growth in two years) indicating a substitution effect from cigarettes to beedi due to the relative affordability of beedi. In 2021, the estimated consumption of beedi was 6.2 billion sticks. The total beedi consumption for this year is estimated to be 5.9 billion sticks.

Figure 10: Beedi sticks sold vs Price of a stick



Source: RIU compilation based on CTC Annual Reports (2016-21), and market data 2022

Source: Based on Department of Census and Statistics data, 2008-2022

Table 4: 2022 tax share of beedi manufactured using locally sourced tobacco (Case 1)

CASE 1	AMOUNT (LKR)
HS Code for Tendu leaves	1404.90.10
Average CIF value per kg	1,000
Import duty (15%)	150
PAL (10%)	100
CESS (15%)	3625
VAT (15%)	746
SSCL (2.5%)	*
Tax on Tendu leaves	4,621
Tax per stick*	1.32
Tax share per stick (@ LKR 10 per stick)	13%

Note: *1kg of Tendu leaf produces 3500 standard 6cm beedis (CTC, 2022)

*Impractical to calculate SSCL Value without the exact selling price of the tendu leaves. (it's a very small value, hence can be disregarded)

Table 5: 2022 tax share of beedi manufactured using imported tobacco (Case 2)

CASE 2	AMOUNT (LKR)
HS Code for Tendu leaves	1404.90.10
Average CIF value per kg	1000
Import duty (15%)	150
PAL (10%)	100
CESS (15%)	3625
VAT (15%)	746
SSCL (2.5%)	*
Tax on Tobacco only	4,621
Cost of Beedi tobacco	2403.19
CIF	1200
Import duty (85%)	1020
PAL (10%)	120
CESS (30%)	360
VAT (15%)	423

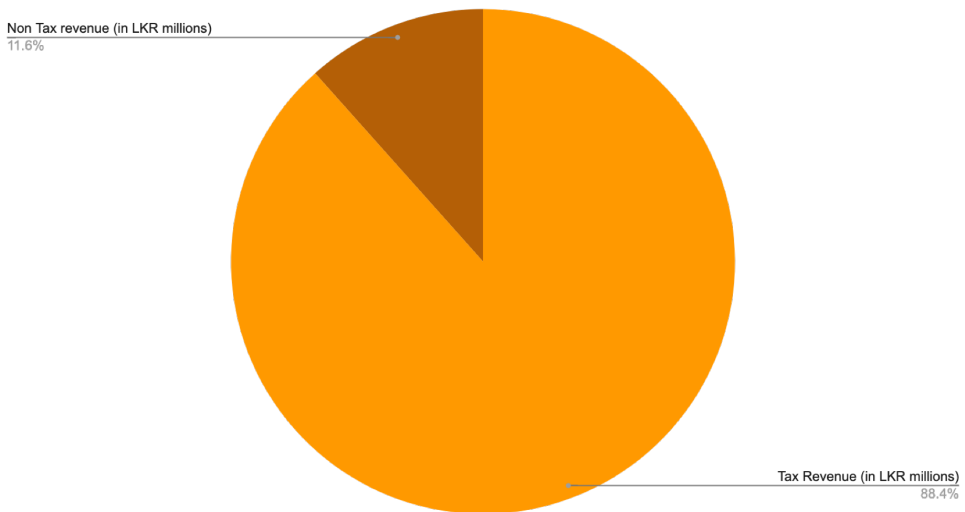
SSCL (2.5%)	700
Tax on tobacco	2,623
Total tax a kilo	7,244
Tax per stick**	2.07
Tax share per stick (@ LKR 10 per stick)	21%

Notes: **1kg of Tendu leaf produces 3500 standard 6cm beedis (CTC, 2022)
 Cost per kg of Tendu leaves and Tobacco. Tax on tobacco is ONLY applicable provided they are imported.
 The price per stick is LKR 10.00
 *Impractical to calculate SSCL Value without the exact selling price of the tendu leaves.
 (it's a very small value, hence, can be disregarded)

2.3 Tax revenue analysis

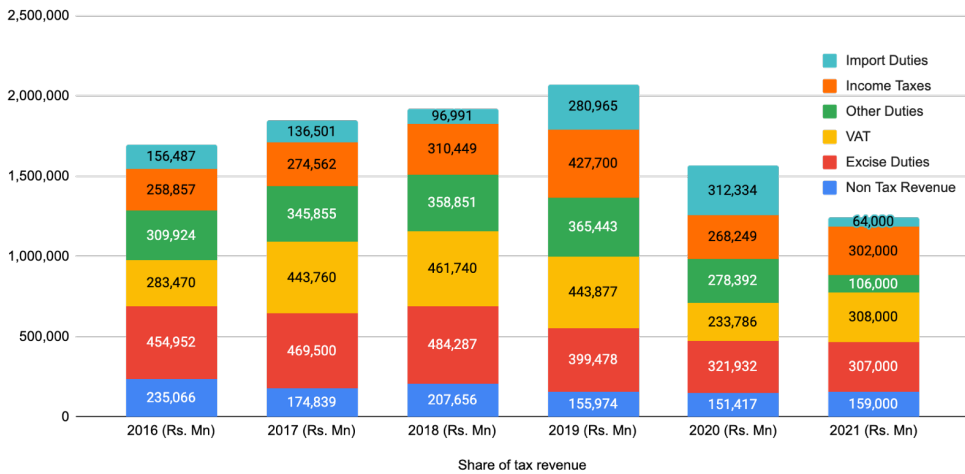
According to the 2022 budget estimate, the government expects its revenue to be 88.6% from tax revenue and 11.6% from non-tax revenue. Excise tax in 2021 was 23.6% of Government's tax revenue. Therefore, it plays a significant role when the Government determines the fiscal policy that needs to be implemented. In 2021, the tobacco excise tax yielded over LKR 307 billion in revenue.

Figure 11: Government revenue overview 2022



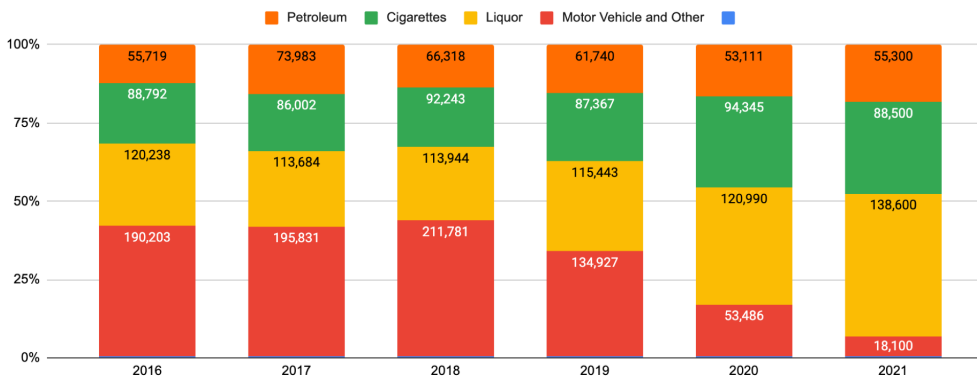
Source: Based on CBSL Annual Report 2021, Budget Estimates 2022

Figure 12: Share of Tax Revenue



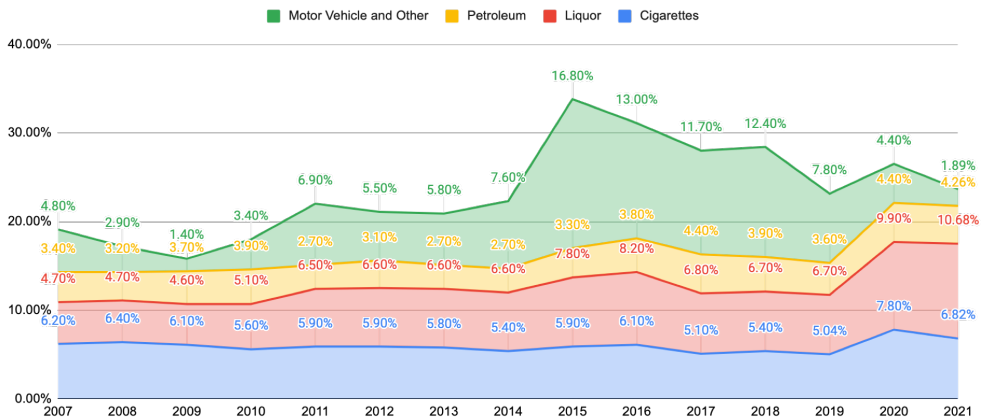
Source: Based on CBSL Annual Report 2021, Budget Estimates 2022

Figure 13: Share of Tax Revenue



Source: Based on CBSL Annual Reports 2007-2021

Figure 14: Excise tax contribution to Tax Revenue by Sectors 2007-2021



Source: Based on CBSL Annual Reports 2007-2021

The above diagram shows the contribution of each type of Excise tax by sector to the total tax revenue. A deteriorating nature was seen in the share of cigarette excise taxes from 2007 to 2019. In 2020, however, the tax share for cigarettes increased to its highest level (7.8%), which had a growth of 2.8% compared to 2019. Again in 2021, there was a 1% drop in the share of cigarette excise taxes, compared to its previous year.

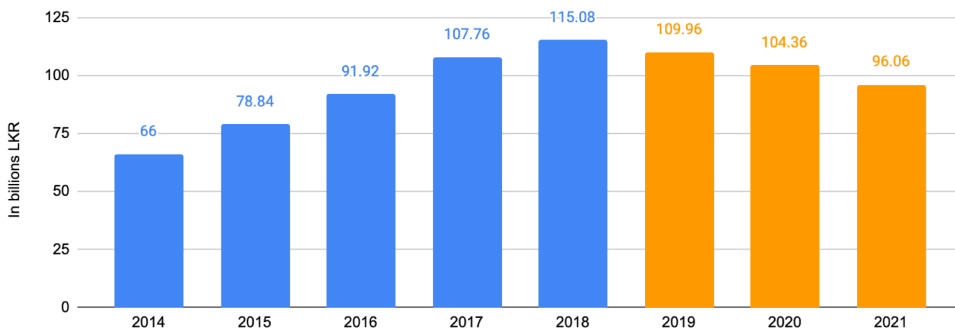
An overview of the relative share of tax contributions by sector shows that excise taxes have fluctuated over the years. From 2016 to 2019, however, there was a significant drop in shares for all primary sectors. This decline of excise tax began when prices increased sharply in 2016. Excise tax on motor vehicles was reduced significantly in 2015, causing a massive increase in revenue from that sector. However, with subsequent tax increases, revenue declined, clearly indicating it had reached its threshold. With the influx of new vehicles, demand for petroleum increased, causing further growth of excise revenue from petroleum imports. This analysis shows that inconsistent tax increases may generate more revenue in the short run in some cases but will not be sustainable in the long run.

A closer inspection of the below diagram reveals that excise tax revenue from cigarettes has overall, been increasing from LKR 30 billion in 2007 to just over LKR 94 billion in 2020. There was a large increase in excise tax revenue in 2015, as can be seen in Figure 15. This was due to sales taxes (VAT and NBT) being consolidated into the excise tax in October 2014.

In 2016 the Government pushed up prices by 52% - a large margin - which caused a slight improvement in revenue of 17% in the same year, but the rate of growth declined in 2017.

In 2019, revenue decreased again owing to the increase in prices of cigarettes in March of that year. There was a 100% price increase from 2016 to 2019 causing the rate of growth to further decline. Nevertheless, as indicated in the chart, 2020 provisional data showed that the rate of growth in revenue recovered as Legal cigarette prices remained unchanged. In 2021, the revenues declined by over 8% amidst the increase of excise taxes. The excise taxes in the year 2022 is yet unchanged following the increase in 2021 but carries high probability of an amendment with the tax hikes followed throughout the year.

Figure 15: Government revenue from tobacco taxation

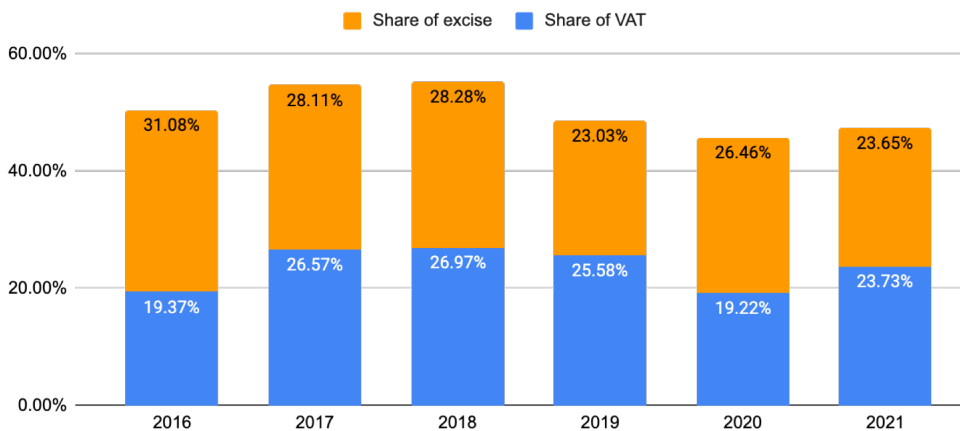


Source: Based on CBSL Annual Reports 2007-21

Prior to 2014, cigarettes were subject to VAT and generated a sizable revenue for the Government. In 2014, VAT and NBT on cigarettes were consolidated into the excise tax. In 2016, the Government re-imposed VAT on cigarettes. The VAT share declined over the years to 1.08% by 2019 despite a higher VAT rate than 2014 due to dwindling sales of legitimate cigarettes.

Moving to the current landscape, the year 2022 marks an important time period for the tobacco products where the prices had to push further with the multiple VAT increments coming into place. VAT was increased to 12% from 8% with effect from 1 June 2022, and again increased to 15% effective from 1 September 2022. Due to the introduction of the SSCL with effect from 1 October 2022, the price of a JPGL stick stands at LKR 85 as at 25 October 2022.

Figure 16: Share of Excise tax and VAT



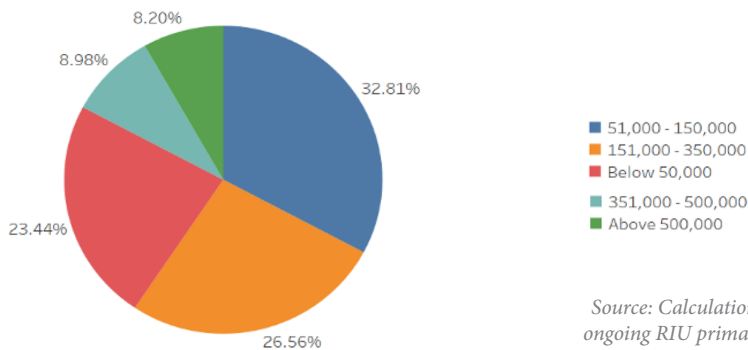
Source: CTC Annual Reports 2016-2021, CBSL Annual Reports 2016-2021

2.4 Distributional effects of excise taxation

Due to the upward revisions in excise taxes each year, the tax burden on consumers has increased. An important consequence to note is the distribution effect of tax which indicates that the income of one group is transferred to another. Figure 17 clearly demonstrates the fact that the lower income groups are taxed greatly in comparison to the higher income groups, and this erodes their income. This is because regressive taxation is in place, and it is a tax form that is often criticised since it disrupts the even distribution of income and worsens poverty.

Generally, all sales taxes are regressive in nature, but the magnitude may differ. The reason is that high-income earners save and invest a larger share of their income compared to low-income earners. Therefore, low-income earners spend a larger share of their income on consumption. It is evident in Sri Lanka, that the tax burden is greater on lower-income earners than on higher-income earners.

Figure 17: Tax burden of cigarettes by income groups 2022



Source: Calculations based on the ongoing RIU primary survey, 2022

2.5 Efficiency of excise taxation

The increase in revenue from any tax can be divided into two parts; one is the response to increased national income and the other is due to changes in the variables, other than national income. These influence the tax revenue and the most important is the discretionary changes in tax rates or the tax base. The responsiveness of the tax revenue to changes in national income without any change in all the other factors which influence it, is termed as tax elasticity. However, if changes are considered, it is referred to as tax buoyancy. These two serve as indicators of the efficiency of a tax.

Our estimations for the 2008-2021 period indicate the tax elasticity to be 0.59. In other words, a 1% increase in taxes only generates a 0.59% increase in excise revenue. This means low responsiveness to tax increases as quite evident from Table 6. In addition, the tax buoyancy is estimated to be 0.37 which indicates that the excise revenue only grows by 0.37% if the economy grows by 1%. Another factor that determines the efficiency of excise taxation is the predictability of the revenue from the tax changes. As highlighted (Colombage, Morais, & Wickramasinghe, 2018), in the past, the government revenue forecasts for excise tax show significant deviations from actual outcomes.

All these observations point to inefficiencies of the tobacco excise policy and calls for reviewing the basis for tax increments which need to be reasonable and not ad hoc. These inefficiencies could be a result of the improper tax structuring and/or revenue leakages from the growing illicit market.

Table 6: Responsiveness of revenue to tax increases 2008-2021

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Excise increment (72-84mm)	6%	9%	16%	8%	14%	20%	30%	10%	28%	0%	10%	29%	0%	8.12%
GDP growth	6%	4%	8%	8%	9%	3%	5%	5%	5%	3%	3%	2%	-3.6%	4.32%
Excise revenue growth	19%	1%	8%	22%	8%	9%	-2%	40%	11%	-3%	7%	-5%	8%	-4.66%

Source: RIU calculations based on CTC and CBSL annual reports 2008-21



03

**The nature
of the illicit
tobacco
market**

3.1 Overview of the illicit tobacco market

3.1.1 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.

3.1.2 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

3.1.3 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.

3.1.4 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 (TRACIT) estimates the global tax loss of US\$40.5 billion for the governments.

3.1.5 Control of illicit tobacco

Under Article 15 of the Framework Convention on Tobacco Control (FCTC), a protocol has been established to prevent illicit trade in tobacco products. This states that the convention should deal with all forms of illicit trade in tobacco products, including smuggling, illicit manufacturing, and counterfeiting. This was 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.

3.2 Illicit tobacco market in Sri Lanka

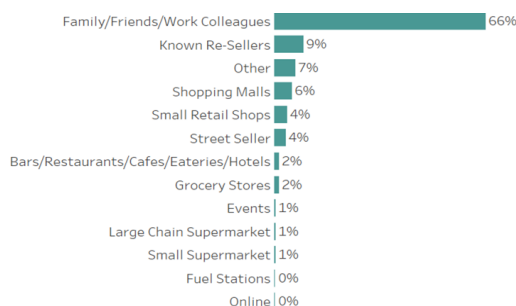
According to the WHO, Sri Lanka is one of the most expensive countries to purchase cigarettes in 2020, based on Purchasing Power Parity (PPP) (WHO, 2021). Therefore, Sri Lanka is seen to be a “high price hot spot” and a prime target for the global illicit tobacco trade.

The street value of a container of illicit cigarettes can be worth approximately LKR 600 million. However, the maximum fine for smuggling a large container load of cigarettes is only LKR 1 million. Consequently, smugglers exploit this system and make substantial profits which are lenient on punishment and lucrative in terms of the market. For example, in May 2021, over 200 million cigarette sticks were attempted to be illegally imported into the country from the Jebel Ali Port in Dubai. This stock was fortunately seized by Sri Lanka Customs thereby protecting the Government from a revenue loss of ~LKR 9 billion. In August 2022, Sri Lanka Customs seized 810 cartons of illicit cigarettes consigned from Oman, estimated at a market value of around LKR 16 million. In the month of October 2022, 24 million sticks were detected by the Sri Lankan Customs.

3.2.1 How illicit tobacco is marketed and sold in Sri Lanka

According to the ongoing RIU consumer survey, 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). Alarmingly, a significant amount of these illicit cigarettes is also reported to have been purchased through small retail shops/supermarkets/grocery stores.

Figure 18 : RIU Survey 2022 - Illicit tobacco sources



Regarding the above figure 18, it should be noted here that in some cases, such as large chain supermarkets, these locations were indicated as meeting points for dealing illicit cigarettes, rather than 'sources' for illicit cigarettes.

Examples of illicit tobacco marketing using online platforms is shown in Figure 19. The goods may even be sold at a premium and hand-delivered to an agreed location.

Figure 19: Illicit cigarettes sold via an online trading platform

The screenshot displays a grid of posts from an online trading platform. Each post includes a user profile picture, a name, and text describing the product. Some posts have images of cigarette packs. The posts are as follows:

- miyubb**: Marlboro Red Spacks have ... Per pack 1100/= Can currier. Drop a mail. 3 weeks ago / Reply.
- Karenp**: Esse lights 9,000, foreign dunhil switch 11,000. 7 months ago / Reply.
- Shiva srikanth**: Benson 20/200 rs 11000. 1 month ago / Reply.
- Karenp**: Foreign Benson 11,000. 7 months ago / Reply.
- Shaluka**: Need a carton.if you have send me the details. 7 months ago / Reply.
- Chathura Madushan**: Marlboro summer fusion one carton available Double switch Contact me. 4 months ago / Reply.
- Karenp**: Esse menthol 10,000. 1 month ago / Reply.
- Jinaaaa**: Any one have Benson foreign one please let me know... janith.gunaratne@icloud.com. 7 months ago / Reply.
- Miqthadh**: Manchester royal red available Per carton This is a New prices 6,500/= Contact 0741196989. 1 month ago / Reply.
- Nihal**: If any one delivered one cigarette pack to peradeniya. 4 months ago / Reply.

Source: yamu.lk

Since this is a highly clandestine operation, dealers usually sell illicit cigarettes to known customers only. It has been reported that vendors at times mix the illicit with legally manufactured cigarettes and sell them to unwitting customers at regular prices.

3.2.2 Prices of illicit tobacco products in Sri Lanka

A price differential is the strategy that illicit cigarette sellers adopt, and the prices can vary significantly in different areas. In some places prices can be as low as 30% of the value of legal cigarettes, while in other locations, the price is at its premium (Colombage, Morais, & Wickramasinghe, 2018). This allows them to be competitive and to generate high profits. Some exclusive brands can be sold at a premium and are generally bought by high income individuals. Most smokers use mid and low-end cigarettes, and these illicit products pose the greatest threat to the legitimate industry due to marked price differentials.

According to our primary survey, the price difference between the most consumed local cigarette (John Player Gold Leaf) and most consumed imported cigarette brand (Manchester) is LKR 30.

Table 7: Price comparison of the most consumed illicit vs legitimate tobacco brand 2022

	PER STICK*	
	Illicit	Legitimate
Price of most consumed cigarette brand*	55	85

Source: RIU ongoing primary survey data 2022

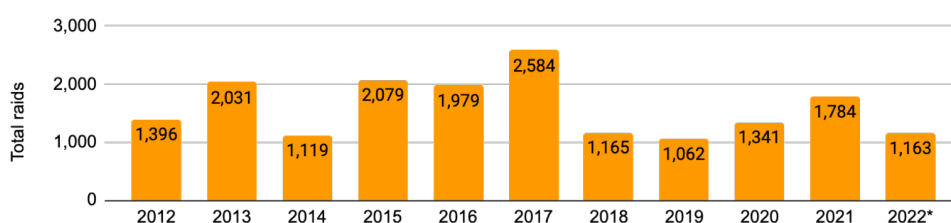
* Illicit is based on June – August 2022 survey data median for Manchester, and legitimate is based on market price for John Player Gold Leaf as of 20 October 2022

3.2.3 Detection and enforcement in Sri Lanka

Contrasting to the previous year, the awareness of the legal implications of purchasing/consuming illicit tobacco in Sri Lanka has been high. According to our survey insights, the respondents from the Central province were mostly aware of these implications and about the criminality involved with the business of smuggling tobacco. 1163 raids have been done around the island seizing over 47 million sticks of illicit as at 20 October 2022.

There are five key agencies that are involved in detecting and seizing illicit tobacco in Sri Lanka. These are the Sri Lanka Customs Department, Navy, Police, Special Task Force (STF) and the Excise Department. The Customs Department carries out inspections at air and seaports to seize any illicit tobacco. Meanwhile, the Sri Lankan Navy keeps a watchful eye on smuggling routes across the sea, whilst the STF and the Excise Department are empowered to seize any illicit tobacco products found in-market. It has been reported by Customs officials that most brands of illicit cigarettes have been detected to have been smuggled from China, Turkey, and Vietnam, and selected states in the UAE.

Figure 20: Total raids 2012-2022

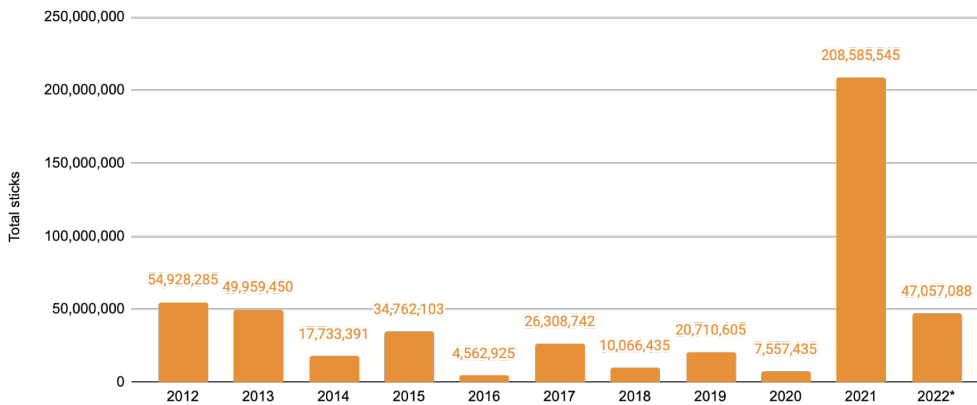


Source: Customs detection data, media reports and CTC

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

*Value for 2022 is as at 20 October 2022

Figure 21: Total sticks detected 2012-2022



Source: Customs detection data, media reports and CTC

Note: Data includes seizures by the Sri Lanka Customs, Sri Lanka Police, Excise Department of Sri Lanka and the Special Task Force (STF)
*Value for 2022 is as at 20 October 2022

Figure 20 and 21 above gives a deeper understanding of the movements in illicit cigarettes during the last decade. The sudden price hike in legal cigarettes in 2016 led to a spike in the demand for illicit cigarettes in 2017. This, in turn, resulted in seizures amounting to 26 million sticks of illicit cigarettes during the year. It served as an indicator of the role the prices of legal cigarettes had on the illicit trade. In 2020, 7.6 million illicit sticks of cigarettes were detected and seized.

In 2021, there is a significant bump in cigarette detections, despite the number of raids being usual. As mentioned earlier in this report, over 200 million sticks of smuggled cigarettes brought into the country from the Jebel Ali port in Dubai were detected in May 2021. This contributed to the spike in detections in 2021. Also, as at 20 October 2022, the number of sticks detected was over 47 million.

Although Figure 21 shows how many illicit cigarettes have been detected, it is widely known that local enforcement agencies do not have sufficient capacity in terms of human resources and technology to detect all or even most illicit products (Colombage, Morais, & Wickramasinghe, 2018; RIU, 2018). However, the enforcement space has seen some positive results and progress in 2021.

In April 2022, the largest stock of smuggled cigarettes was raided by the STF Organised Crime Unit which had been smuggled into the country duty free and through Sri Lanka Customs. 200,000 packs containing 4 million cigarettes were found, which valued at Rs. 280 million. 24 million smuggled cigarettes were detected in the month of October 2022.

However, owing to the size of the illicit market, there is much more that needs to be done to truly combat the illicit cigarette industry in the country.

3.3 Size of the illicit market in Sri Lanka

Due to the illegal nature of the business which prevents extensive research and conclusive results, the true size of the illicit tobacco market has always been one that is debated in Sri Lanka. One study (Colombage, Morais, & Wickramasinghe, 2018) reveals that 28% of smokers interviewed had consumed illicit cigarettes during the span of a week. This demonstrates the extent and prevalence of the illicit market, and it is more widespread than had been previously assumed. Therefore, one essential step in understanding the illicit market involves estimating the total market size of illicit tobacco.

3.3.1 Illicit market during 1995-2021

The earliest indication of the size of the illicit cigarette market was reported in a study conducted by the WHO (Merriman, Yurekli, & Chaloupka, 2000). According to this study, in 1995 the illicit share was 10% of the total market. In the 4th edition of the Tobacco Atlas (2012), the illicit share in Sri Lanka was recorded as below 10% in 2012. Thereafter till 2017, no attempt was made by any individual or entity, to accurately estimate the size of the illicit cigarette market. Moreover, there are no records on the size of the beedi market prior to 2017.

RIU's annual estimation of the illicit share of the tobacco industry since 2017 generates some interesting revelations and based on the study's approach and further research, we found that the illicit cigarette share in Sri Lanka was estimated to have increased over the years, from below 10% in 2012 to an estimated value of 21% in 2021.

The sizable illicit market indicates growing attention from criminals to engage in this lucrative business and the loss of potential revenue for the legitimate industry and the Government.

3.3.2 Estimation of illicit share for 2022

The RIU's ongoing island wide consumer survey provides insight into the nature and extent of the illicit tobacco market in Sri Lanka. The extensive primary research covers all provinces, as well as the rural, urban and estate sectors.

Preliminary results of the survey showed that consumption of illicit cigarettes was found to be at 16% among the most prevalent provinces of smoking, Western, North-Western, and Central.

This illicit share percentage, at 16%, was a considerable drop from the illicit share of previous year (21%). During the period of this study, the average monthly per capita consumption was found to be 140. The result far more defines the extent of the increased trend of tobacco smoking among the same population as in the previous year. The increase of the monthly tobacco consumption was by almost 30 cigarettes per capita. This increase could be attributed to multiple factors.

1. Due to the multiple price changes of legal cigarettes that happened as a result of the economic turmoil in this year, the downgrade seemed much higher among consumers where the consumers who were consuming John Player Gold Leaf had shown a drastic shift to low budget options.
2. Except in the month of May where civil protests occurred, the production, distribution, and the consumption has been normal and consistent in contrast to the previous year, where the entire supply chain was disrupted due to the lockdowns and the pandemic.

3. According to the Ceylon Tobacco Company, the sales by volume in 2022 is projected to increase by 10%-15% of the previous year.
4. The drop in the illicit share would be a result of the import restrictions, FOREX Shortage, detections and stricter enforcements.

Essentially, considering the period of the study, the real landscape for illicit distribution in Sri Lanka for 2022 is likely to be lower than the previous year. To estimate the overall numbers for 2022, we set varying degrees of importance to the surveys carried out in 2021 and 2022 and allocated 9 weightage points for this year's survey based on the qualitative assumptions derived through the importance and the significance of the survey data. This translates to an average monthly per capita consumption rate of 140 (daily consumption rate of 4.7). Based on this number, we can estimate the total consumption of cigarettes in Sri Lanka and the illicit share.

Table 8: Estimation of the illicit tobacco market in Sri Lanka for 2022

	2022
Estimated Sri Lankan Male population over the age of 21 in millions *	6.9
Sri Lanka tobacco use percentage: upper 95% credible limit (WHO, 2019)	29.10%
Estimated smokers in millions	2.01
Per capita monthly cigarette consumption (RIU 2022 survey estimate)	140
Total monthly cigarette consumption in millions	280.3
Cigarette consumption volume estimate 2022 in millions	3,364
Estimated legal cigarette consumption volume for 2022 in millions**	2,825
Estimated illicit cigarette consumption volume for 2022 in millions	539
Estimated illicit share	16.03%

Notes:

**Based on calculations using Department of Census and Statistics 2022 data*

***Based on calculations using CTC data up to 20 October 2022*

Table 9: Summary of illicit shares over time 1995-2022

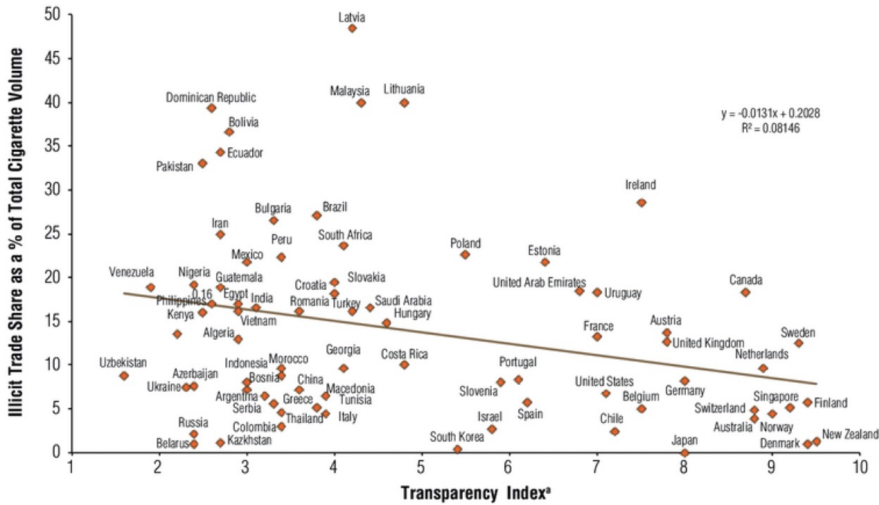
	1995	2012	2017	2018	2019	2020	2021	2022
Illicit cigarettes share	10%	< 10%	14-18%	14-18%	19%	23-25%	21%	16%

Source: RIU estimations based on primary surveys and other studies.

3.4 Global examples of the illicit tobacco market

Illicit tobacco levels are constantly rising and remain a global concern. In this section, we look at some of the cross-country experiences on the size and growth of the illicit market.

Figure 22: Illicit cigarette market share by country 2015



Source: Research on Illicit tobacco trade by Frank J. Chaloupka et al., 2015

3.4.1 European Union (EU)

Many European countries have two distinct cigarette markets, one legal regulated market which is declining and an illegal unregulated market that is growing (Maftei, 2012). A study conducted in Europe showed that 74% of smokers who had used illicit cigarettes in the past did so because illicit smokes are cheaper (European Commission, 2016).

According to KPMG’s annual study, Illicit cigarette consumption in the European Union (EU) was shown to have increased by 3.9% in 2021 or by 1.3 billion cigarettes, totalling up to 35.5 billion cigarettes amidst the decline shown in the total consumption of cigarettes. Report from PMI had shown that an additional 10.4 billion euros would have been raised by governments in the EU if these cigarettes had been legally purchased.

France remains the largest market for illicit cigarettes in the EU, equating the increase as 3.4 billion extra illicit cigarettes flooding into the market. The total illicit consumption amounted to 15.1 billion cigarettes, which is 8.1% of the total consumption in the EU.

3.4.2 Malaysia

Malaysia has long been fighting the scourge of counterfeit goods or illegal tobacco trade. The heart of that fight is the high prevalence of illicit cigarettes and how they rob the country of an estimated RM5 billion in unpaid taxes every year.

According to the Illicit Cigarettes Study (ICS) in Malaysia 2021 conducted by the international market research company Nielsen, illicit cigarette prevalence in Malaysia stood at 57.3%, which conveys the fact of the illegal sale of a cigarette for every legal cigarette sale. First half of 2022 did show a boom in the illicit trade where the incidence of the contraband grew to 58.4% in March 2022, according to the latest Illicit Cigarettes Study in Malaysia 2015-2022 by Nielsen Inc.

The large price differential between illicit cigarettes and legal duty-paid products has been the main cause which entices consumers to opt for the contraband. For example, the legitimate industry is required by law to sell a pack of legal duty-paid cigarettes at not less than RM12 per pack. In contrast, illicit cigarettes are sold at between RM4 to RM6 per pack.

3.4.3 Pakistan

Pakistan is among one of the largest consumers of tobacco in the world. According to the Express Tribune (2013), Pakistan ranked third with the highest share of illicit cigarettes (26.7%) in the Asian continent. Pakistan's revenue loss from illicit cigarette trade has increased to more than Rs 80 billion per annum from Rs 27 billion in 2012.

According to the purview of Oxford Economics, the illicit consumption of cigarettes accounted for 38% of cigarettes consumed in the calendar year 2021, with over 200 illicit cigarette brands selling below the minimum mandated price. As a result, an estimated Rs 77.8 billion in taxes were evaded during 2021.

The coinciding of the two events, which are the rise in the illicit cigarette market share and the sharp rise in the excise rates is not new to the audience. With the September 2018 supplementary budget followed by another June 2019 Federal Budget, Tier 2 excise rates, which represent 92% of the total industry volume, were increased from Rs 854 per thousand to Rs 1,650 per thousand. Excise taxes continued to increase and in 2017, Pakistan became the highest-ranked market by volume of illicit cigarettes consumed. Illicit cigarettes, which are widely available in Pakistan, remained well below the minimum price and thus the illicit tobacco market continued to thrive.

Table 10: Illicit 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 2010-21

3.4.4 Philippines

The Philippine government has lost nearly PHP3 billion (\$588.17 million) in tax revenues since 2019 due to smuggling or illegal entry of cigarettes into the country, according to reports from Philstar. Since the Tobacco Tax Law was approved in 2019, the Bureau of Customs (BOC) has been able to intercept 127,675 master cases of illicit cigarettes.

The estimated value of the seized cigarettes reached PHP 9.73 billion, more than half of which was accounted for in 2020 at PHP 5.77 billion. The government forfeited PHP 2.9 billion in excise revenues between 2019 and January 2022 due to smuggling of cigarettes.

However, a 2019 study by the EU-ASEAN Business Council reported that the Philippines loses \$ 213.4 million, which is more than PHP 11 billion to tobacco smuggling. According to this paper, roughly eight billion sticks circulate every year and authorities miss out on the opportunity to tax them due to the lack of intelligence work.



**Why should
illicit cigarettes
concern Sri Lanka?**

4.1 Revenue loss to the Government

The illicit tobacco trade has resulted in huge losses to the Government in the form of lost taxes, as exemplified by the international illicit trade cases described in the previous sections of this report.

Building on the analysis in Table 11, RIU calculated the revenue loss to the Sri Lanka Government from illicit tobacco. Our estimate for the 2022 revenue loss due to the illicit tobacco market is LKR 32 billion.

Table 11: Calculation of the revenue loss to the Government from illicit cigarettes 2022

	2022 estimate
Illicit share	16%
Estimated illicit cigarette market volume for 2022 (million)	539
Average tax per stick (LKR)*	60.23
Revenue loss to the Government (LKR billion)	32

Notes:

*Based on calculations using CTC data

In addition to the above, there are indirect financial implications of the illicit trade. For example, the profits that criminals make from smuggled cigarettes can fund illegal activities such as drug smuggling and terrorism as well as these activities may extend to other items being brought into the market such as illicit alcohol, recreational drugs, or pharmaceuticals. Criminals can also further advance their transporting and packaging methods, making illicit items more undetectable. Corruption attempts could be possible with criminals trying to influence enforcement agencies by offering substantial bribes. These criminal business expansion activities can lead to increased illicit sales and fiscal losses and the longer this problem is left untouched, the larger and more uncontrollable it becomes with potential terrorism links.

The financial losses can also extend beyond taxes. For example, with increased and widespread illicit activity, additional enforcement personnel and financial investments would be required.

International fiscal gain results from successfully decreasing illicit trade are evident in other sections of this report.

4.2 Loss of employment along the value chain

As indicated previously, the illicit cigarette market in Sri Lanka is estimated at 539 million sticks for the year 2022. While this results in fiscal losses to the country, it is also a loss of revenue to legitimate players in the industry who contribute to the economy via creating jobs and paying taxes. Illicit trade affects multiple stakeholders in the legal business, including farmers, suppliers, retailers, manufacturers, distributors, and consumers. Law-abiding distributors and retailers also lose out on sales due to the reduced demand for legal products.

The tobacco industry in Sri Lanka affects over 71,000 direct and indirect workers and retailers (Ceylon Tobacco Company, 2022).

4.3 Increased criminal activity and threat to national security

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.

Evidence shows that many high-profile terrorist organisations such as Al-Qaeda and ISIS operate smuggling rings due to higher profit margins and the relatively lower risk. The founder of the Signed-in-Blood Battalion, a terrorist organisation, is known as “Mr. Marlboro” as he was involved in cigarette smuggling to raise funds for his organisation (Parliament of Australia, 2015).

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).

Examples of large-scale illicit cigarette seizure cases are listed below:

- Operation Royal Charm and Operation Smoking Dragon led by FBI undercover agents posing as underworld criminals, highlight the convergence of illicit markets and national security issues. USD 40 million worth of counterfeit cigarettes and other illegal items such as methamphetamines, counterfeit pharmaceuticals, counterfeit money, and weapons were smuggled into the USA. Eighty-seven individuals were indicted from Canada, China, Taiwan, and the USA (UNODC, 2011). This case reveals the potential magnitude of tobacco related criminal operations and association of other harmful illegal products.
- An INTERPOL operation named Black Poseidon which was aimed at the illicit tobacco trade industry in Eastern Europe led to the discovery of large-scale illicit cigarette production in Ukraine. More than 1,400 individuals were arrested or under investigation and 7.3 million trafficked goods were seized (INTERPOL, 2012). The manufacturing capacity of this source was estimated at 100,000-125,000 individual packs of cigarettes per day. The INTERPOL operation seized machinery, 30 tons of cut tobacco and 350,000 ready to sell individual cigarette packs worth approximately USD 560,000 (Parliament of Australia, 2015). In addition to the cigarettes, Operation Black Poseidon led to the seizure of illicit agrochemicals, clothing, electronics, food, toys, and vehicle spare parts. The goods in total were worth 123 million Euros. “The high number of arrests and illicit goods seized during Operation Black Poseidon, highlights the international scale of illicit trade and the benefits national police, customs and other law enforcement agencies derive from working closely together with representatives of regulatory bodies and the private sector, to stop the criminal networks behind this crime,” said

John Newton, the head of INTERPOL's Trafficking in Illicit Goods unit (INTERPOL Red Notice Removal Lawyers, 2012).

- 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).
- In one of India's largest seizures since the COVID-19 lockdown in the country, USD 1.6 million worth of illicit cigarettes were discovered by the Directorate of Revenue Intelligence (DRI) from a container in Navi Mumbai in June 2020. Anil Rajput, Chairman, FICCI CASCADE said that "cigarette smuggling is a big racket across the globe and India continues to remain a hotbed for this menace. Even as the country is grappling with the coronavirus crisis, the seizures of such goods remain high" (The Times of India, 2020). A FICCI press release in relation to these seizures' states that cigarette smuggling "creates large scale destabilisation by fomenting crime and funding insurgency and terrorism" (FICCI, 2020).
- Operations carried out by the European Anti-Fraud Office (OLAF) recorded a seizure of nearly 370 million illegal cigarettes in 2020, where the majority were reported to be smuggled from countries outside the EU but destined for sale on EU markets. OLAF estimated that the black-market cigarettes would have caused losses of around Euro 74 million in customs and excise duties and VAT to EU and Member State budgets.

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 600 million. Given the softer penalties compared to higher profits, criminals have invested in and developed sophisticated mechanisms to smuggle goods into Sri Lanka.

4.4 Challenges to national health objectives

All tobacco products do have their own health risks and ordinary legalities are certainly partly responsible for the 7 million tobacco related deaths per year globally (CDC, 2020) and 12,300 annual deaths in Sri Lanka (The Tobacco Atlas). In 2016, tobacco use caused an estimated 20,000 deaths in Sri Lanka (UNDP, 2019). However, the growing numbers of illegal, unregulated, cheap alternative products such as beedi can further worsen these numbers.

Some of these illicit products have contained five times as much cadmium, nearly six times lead and high levels of arsenic. They also contain 160% more Tar, 80% more nicotine and 133% more carbon monoxide (Coventry Telegraph, 2015). If the illicit product market share increases, we can expect worse health outcomes and deaths.

Negative health outcomes can have indirect effects on government health policy objectives as it deprives funds for anti-smoking campaigns and healthcare costs. Moreover, additional health resources will be required to treat those that are affected by tobacco related diseases.

By most accounts, Sri Lanka has made great progress in meeting the challenges of reducing the harm caused by smoking. Although counterfeit cigarettes in the market are relatively low, smuggled cigarettes continue to be a problem. These smuggled cigarettes avoid various restrictions and health regulations, such as requirements for graphic health-warnings (GHWs) in the local language. These cigarettes could have serious health implications for its users as there is no way to verify the quality standards.

4.5 Increased smoking prevalence

As illicit cigarettes evade taxes and cost relatively lower than legal cigarettes, they would attract new smokers who are not willing or cannot afford to pay high prices, for example, school or university students. The lower prices of Illicit cigarettes may also increase the tendency for individuals to consume higher quantities which will lead to health complications.

As discussed in the Challenge to National Health Objectives section of this report, illicit tobacco products may contain higher levels of nicotine, making these products even more addictive and increasing tobacco desirability. As a consequence, this can also potentially increase cigarette demand and smoking prevalence in the country.

Illicit cigarette packages often do not contain graphic health warnings (GHW) which will further remove the intended psychological effects associated with prevention.



05

**Combating
illicit tobacco
trade**

As part of the RIU illicit market survey, illicit cigarette smokers in Sri Lanka were asked what would make them shift from illicit tobacco to locally manufactured cigarettes. Availability of more options of tobacco products in the local market seemed to be the general theme in this regard, with 55.4% indicating that they would like to see different flavours, taste options and brands. 29.2% considered price to be an important factor. This indicates that part of the illicit market problem is solvable through addressing gaps in the local market. However, concurrent measures such as public awareness campaigns are necessary in order to educate the public of overall tobacco consumption risks.

The below describes some of the policy related international examples of controlling illicit tobacco trade.

5.1 Australia's illicit tobacco taskforce

There are several estimates on the size of the illicit tobacco market in Australia. The estimates from the Department of Immigration and Border Protection (USD 0.5 billion to USD 2.3 billion), KPMG (USD 2.5 billion) and others range up to USD 6 billion (Hawkins, 2018). According to the Australian Taxation Office, illicit tobacco costs the Australian community USD 477 million in lost revenue each year (Australian Taxation Office ATO, 2020).

Significant steps have been taken by the Government to address illicit trade. Among these are tobacco tax increases, strengthening the administration of tobacco imports and the creation of a multi-agency task force to increase investigatory and enforcement capability (The World Bank, 2019).

With the numerous tobacco tax increases, the Australian Government recognised the potential implications regarding illicit trade. Budget papers by the Treasury acknowledged that, "Changes to taxation arrangements for tobacco have the potential to increase illicit tobacco activity". For this reason, the measures were supported with USD 5.7 million over two years to expand the Department of Immigration and Border Protection's Tobacco Strike Team (The World Bank, 2019). The Australian Government announced the new Illicit Tobacco Taskforce (ITTF) in May 2018 along with several other budget measures aimed at dealing with illicit tobacco trade as part of the 'Black Economy Package - combating illicit tobacco'. The objective of the ITTF which was later established in July 2018, was "to investigate, prosecute and dismantle organised crime groups who use the proceeds of illicit tobacco to fund other criminal activity, as well as ensure the appropriate revenue is paid to the Australian Government." (Australian Taxation Office ATO, 2020). The taskforce is led by the Australian Border Force (ABF), thereby facilitating access to the expertise and advanced capabilities of the ABF. The capabilities of 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) were also integrated into the operations of the ITTF, making it a multi-agency task force. The ITTF therefore can act by utilising a range of options and legislative powers at its disposal.

As part of the ITTF's activities, the ATO seized and destroyed over 131 tonnes of illicit tobacco in the 2019–20 financial year, worth an estimated excise revenue of USD 126 million. Nineteen search warrants were executed and over 184 acres of illicit tobacco were uncovered by the ATO with the help of the police and the ABF (Australian Taxation Office ATO, 2020).

Along with the ITTF establishment, the Australian Government announced other key measures to target the main sources of illicit tobacco in the country. These measures include collecting tobacco duties and taxes at the border, additional resources to monitor domestic tobacco crops, introducing a prohibited import control for tobacco and an ATO excise systems upgrade. The fiscal impacts of these measures are estimated below.

Table 12: Financial impact of the 'Black Economy Package - combat illicit tobacco'

	2018-19	2019-20	2020-21	2021-22	SUM
Total — Revenue (USD million)	8	2,418	142	182	2,750
Total — Expense (USD million)	15	22	29	34	100
Total — Capital (USD million)	4	0	3	5	13
Fiscal impact	-11	2,396	109	143	2,637

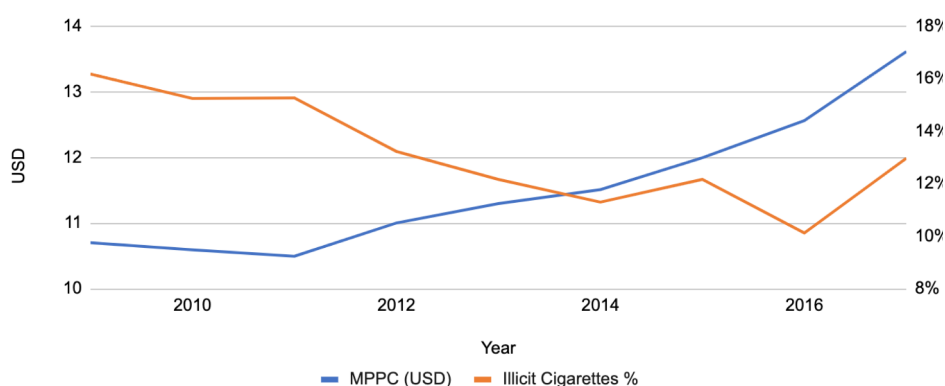
Source: Australia Foreign Affairs and Trade 2021

Despite capital and expenses totalling to USD 113 million, it was expected that the measures introduced would bring in USD 2.6 billion in overall fiscal resources in just four years. Note that due to applying customs duties to tobacco products already stored within warehouses, there is a one-off high 2019-20 revenue amount.

5.2 Ireland's approach and effective enforcement

Ireland managed to reduce illicit cigarettes from 16% in 2009 to 10% in 2016. The illicit market share appeared to increase again since 2016. However, this is understood to be due to the legal cigarette consumption declining faster than the consumption of illicit cigarettes.

Figure 23: Illicit cigarettes vs Most Popular Price Category (MPPC) cigarette prices in Ireland



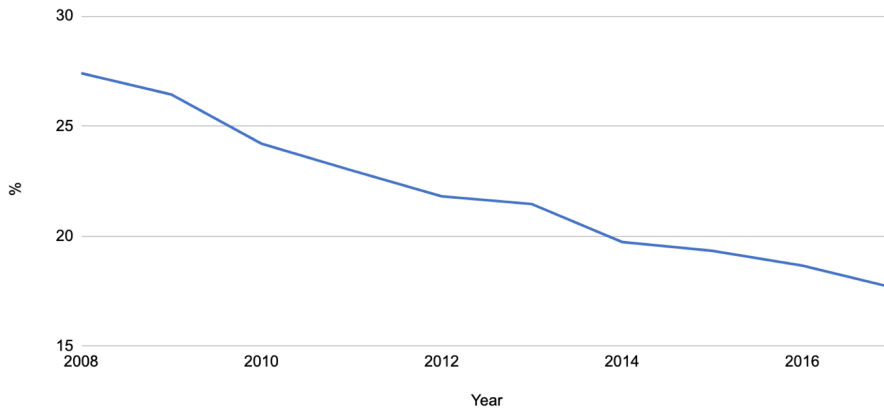
Source: The World Bank 2019

Ireland periodically increased taxes, including a 10-year period when taxes were changed 9 times. The country now imposes the highest duty rates on tobacco products in the European Union, including roll-your-own tobacco. The main driver of illicit flows is linked to the effectiveness of

customs and tax enforcement, rather than price alone.

Ireland adopted several measures to reduce general tobacco consumption. Smoking prevalence of illicit tobacco in Ireland declined from 27.6% in 2007 to 17.6% in 2017, while excise revenue remained stable between EUR 1 billion and EUR 1.4 billion per year, perhaps partly due to the revenue gained from penalty payments.

Figure 24: Smoking prevalence in Ireland, 2007-2017



Source: Health Service Executive, *Smoking Prevalence Tracker Half Year - 2017* as cited by *The World Bank, 2019*

Ireland's successful approach could be seen as ideal, however in the current Sri Lankan climate, this approach may not be feasible. Sri Lanka's illicit market is already soaring, and the tobacco industry directly and indirectly supports over 71,000 people. Therefore, a step-by-step approach will be required in Sri Lanka to deal with the illicit problem, one with minimal socio-economic disruptions.



06

**Conclusion
and
recommendations**

6.1 Conclusions

As compared to the previous year (2021), the overall illicit cigarette consumption in 2022 has decreased to 539 million from 627 million. Consequently, the illicit share has dropped to 16% this year from 21% last year. According to the findings of this report, which is based on primary data along with available secondary data, there are several factors that have combined in order to reduce the illicit share of tobacco in the market.

- Per capita consumption has actually increased during 2022 as compared with 2021. The most likely explanation for this trend can be found with reference to the fact that the year 2021 was plagued by several very disruptive lockdowns that had a significant impact on the availability of many commodities, including cigarettes. Hence per-capita consumption in 2021 was lower compared to 2022 where the only interruption was due to the civil unrest that took place during several weeks of H1 2022.
- An observed trend amongst consumers to down-scale their preferred brand, moving to cheaper options.
- The available data points to an increase in detections in 2022. Hence it appears that the actions of the authorities have had a stifling impact on the supply of illicit cigarettes into the market.
- Our primary research points to the fact that the overall scarcity of foreign currency and import restrictions in Sri Lanka in 2022 has also served to reduce the capacity of smugglers to bring in illicit products. This too has contributed to reducing the share of illicit cigarettes in the market.

However, the loss to the Treasury from the illicit trade in cigarettes is still very damaging from a Finance Ministry perspective. The fiscal revenue loss for the year 2022 is estimated at around LKR 32 billion.

According to the RIU survey, 68% of people island wide have admitted to consuming illicit cigarette products over a wider period that includes pre-covid years. Such a high number should prompt cause for serious concern among policy makers in Sri Lanka that illicit tobacco consumption is a long-term challenge that, if unaddressed, will continue to lead to increasing revenue losses for the Government.

The smuggling business is typically operated by criminal elements who pose a threat to national law and order as well as security. We have presented examples of many countries that have suffered a deterioration in security and faced the threat of terrorism, due to the connection between smuggling and nefarious elements that operate within and beyond borders. These countries have identified illicit tobacco trade as one of the modus operandi for terrorist financing for high profile terrorist groups such as Al-Qaida. This is mainly because the illicit tobacco trade is a high profit low risk operation that fuels the overall spread of criminality in society. Thus, the Government must not rule out the threat it poses to the country and must take action to track down supply chains.

6.2 Recommendations

Despite progress made to cut down the illicit market in the country, aided by macroeconomic conditions, it is imperative that the Government continues to adopt a comprehensive, but pragmatic tobacco policy to achieve national health objectives, maximise revenue and to curb the growth of the illicit tobacco market.

Some of the salient measures that should be considered following the findings of this study are:

- Setting up of a dedicated task force to crack down on the illicit market, with greater attention on the Western, North-western, and the Central provinces. Whilst detections and raids have been successful in 2022, the smugglers are expected to return in full force once the currency scarcity and import restrictions normalise.
- While fixing loopholes in the tax system, the Government must strengthen enforcement by investing in modern equipment for detection, capacity building for officials and increasing incentives. The Government took steps to aid detections by installing high tech scanners over the past decade. However, it needs to be ensured that these are being operated efficiently with adequate staff. Particularly port and airport enforcement mechanisms need to be tightened to curb the smuggling of illicit cigarettes and beedi.
- Those engaged in the illicit market see their activities as low risk and highly rewarding. Therefore, penalties should be revisited and made more stringent, as in Ireland, to increase this risk for potential offenders and to deter such activity. In Malaysia, the minimum fine was increased in 2019 for smugglers, traffickers, suppliers, and sellers of contraband cigarettes, to USD 25,000 or a minimum jail term of 6 months or both, if convicted.
- Some 55.4% of illicit cigarette smokers interviewed in the RIU survey indicated that the availability of more options (e.g., flavours, brands) in the local market would make them consider switching from illicit cigarettes to locally manufactured cigarettes. 29.2% mentioned lower prices would be a reason to switch. This indicates that addressing demand and pricing issues in the local market will help to address the illicit market. However, quality standards need to be ensured and concurrent measures such as public awareness campaigns are necessary in order to educate the public of overall tobacco consumption risks.
- The growing usage of beedi is a threat to national health objectives. For the year 2022, the estimated beedi consumption counts to 5.9 billion sticks. Therefore, the focus of tax policy should be on tobacco and all tobacco products, rather than just cigarettes.
- Whilst tobacco products in general pose serious health risks to consumers, illicit products can have even greater risks. However, the awareness of the legal implications among the public on the usage or any trade related to Illicit cigarettes seemed to be higher compared to last year's survey. Nevertheless, public awareness campaigns should be put into action to bridge the knowledge gaps.

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