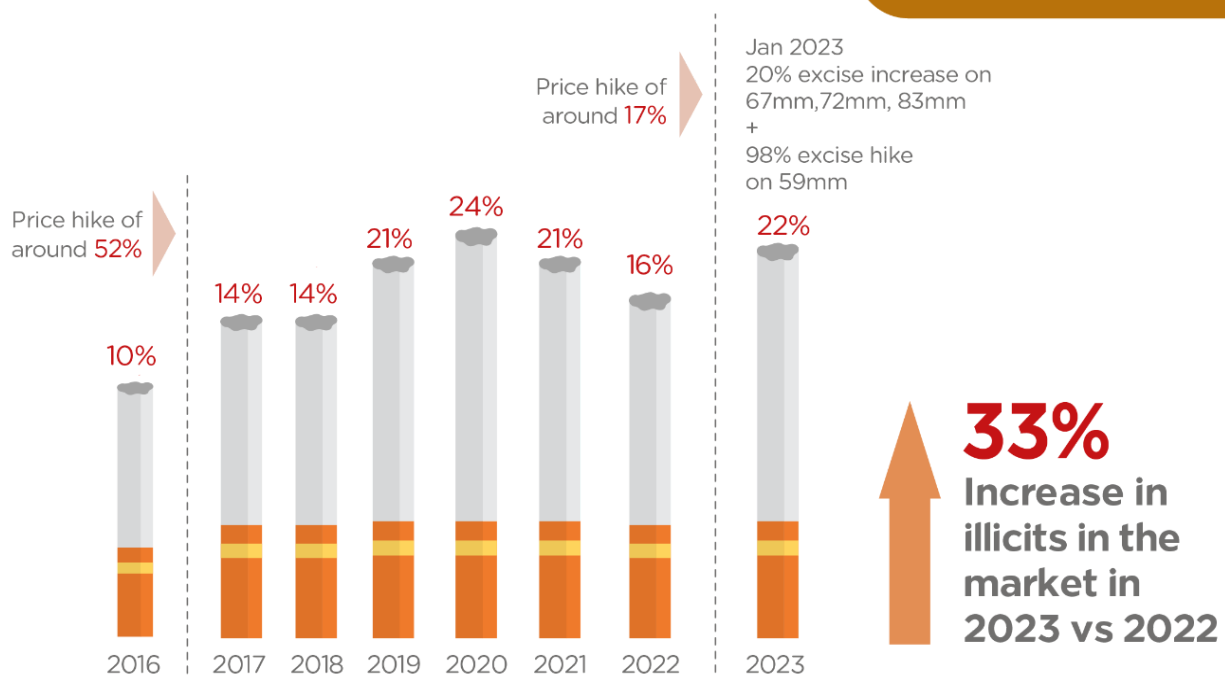
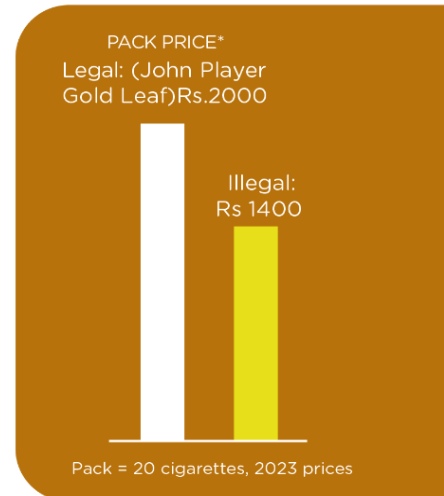


Prevailing tobacco taxation policy: An upsurge in the illicit cigarette market

SRI LANKA'S TOBACCO TRADE

ILLICIT SECTOR MARKET SHARE



LKR
52+ Bn

Projected state revenue loss in 2023 due to illicit cigarettes

LKR
60 Bn

state revenue lost from 2021-2022 due to illicit cigarettes

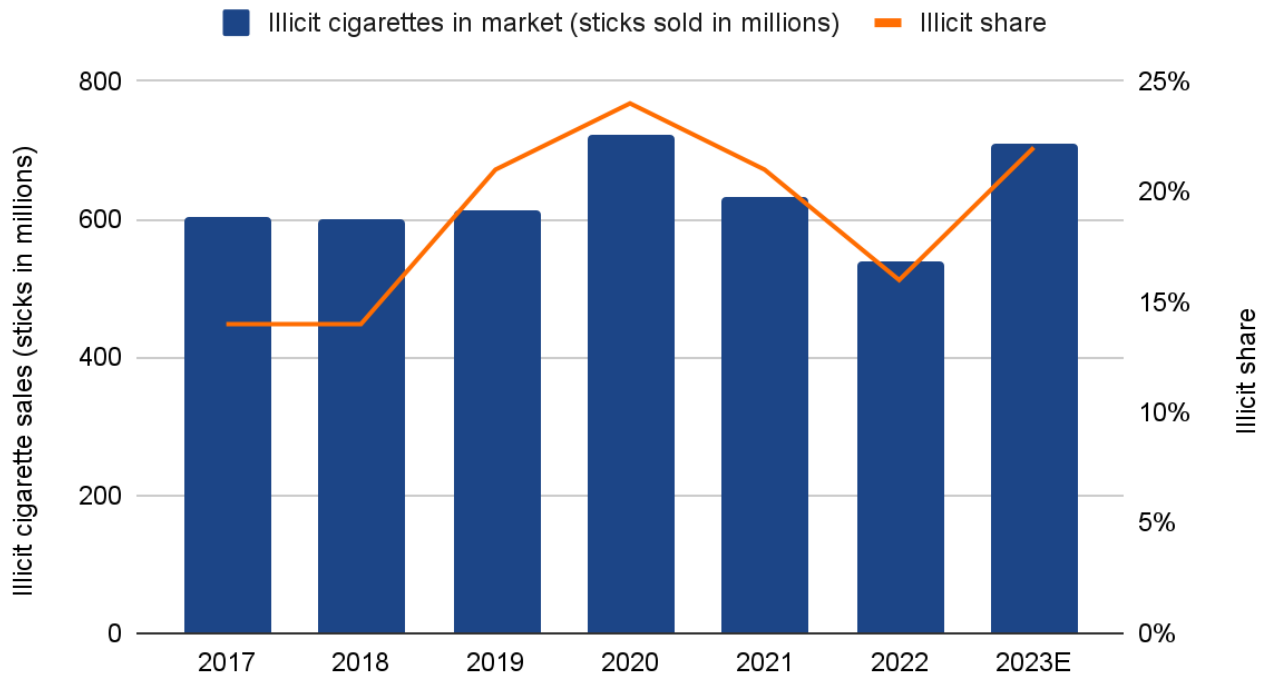
The excessive excise taxation on tobacco in Sri Lanka has led to unintended consequences, driving smokers towards cheaper cigarette options and giving rise to a thriving illicit market

The consistent tax hikes imposed by the Government over recent years has created an economic burden for the population, worsened by the country's default on debt and depletion of foreign reserves in 2022/23. This latest report aims to shed light on the impact of excessive taxation on legal cigarettes, including its implications for public health and Government revenue. The survey conducted by the Research Intelligence Unit (RIUNIT) in 2022 highlighted a decrease in the illicit share of cigarettes from 21% to 16%. This decline was mainly attributed to the economic downturn the country faced. Complementarily, the foreign exchange crisis and the import restrictions held accountable for the major attributes for the decline of the illicit trade. In addition, a higher number of raids and consumers downscaling their preferred brands which were competitively priced with the product on offer in the illicit market was also observed.

However, the economic downturn the island nation had to experience over the past 12 months, which is still unfolding along with the recent policy initiatives of the Government to counteract the situation, have affected the average consumer's disposable income. According to industry sources, an upsurge in the illicit cigarette market from 16% in 2022 to a projected 22% in 2023 is evident. It is estimated that at the end of 2023 the volume of illicit cigarettes in the market would be 716 million sticks. Consequently, the illicit market is currently at its most prevalent since 2020.

The below figure 1 represents the growth in the illicit market from 2017-2023. The amount for 2023 is an estimate computed with reference to multiple industry sources regarding the illicit market surveys. On the other hand, the total cigarette consumption of Sri Lanka between 2017-2023 has been shrinking at a CAGR of 2.52% according to the estimations of RIUNIT.

Figure 1: Growth in the volume of illicit cigarettes and the market share 2017-2023

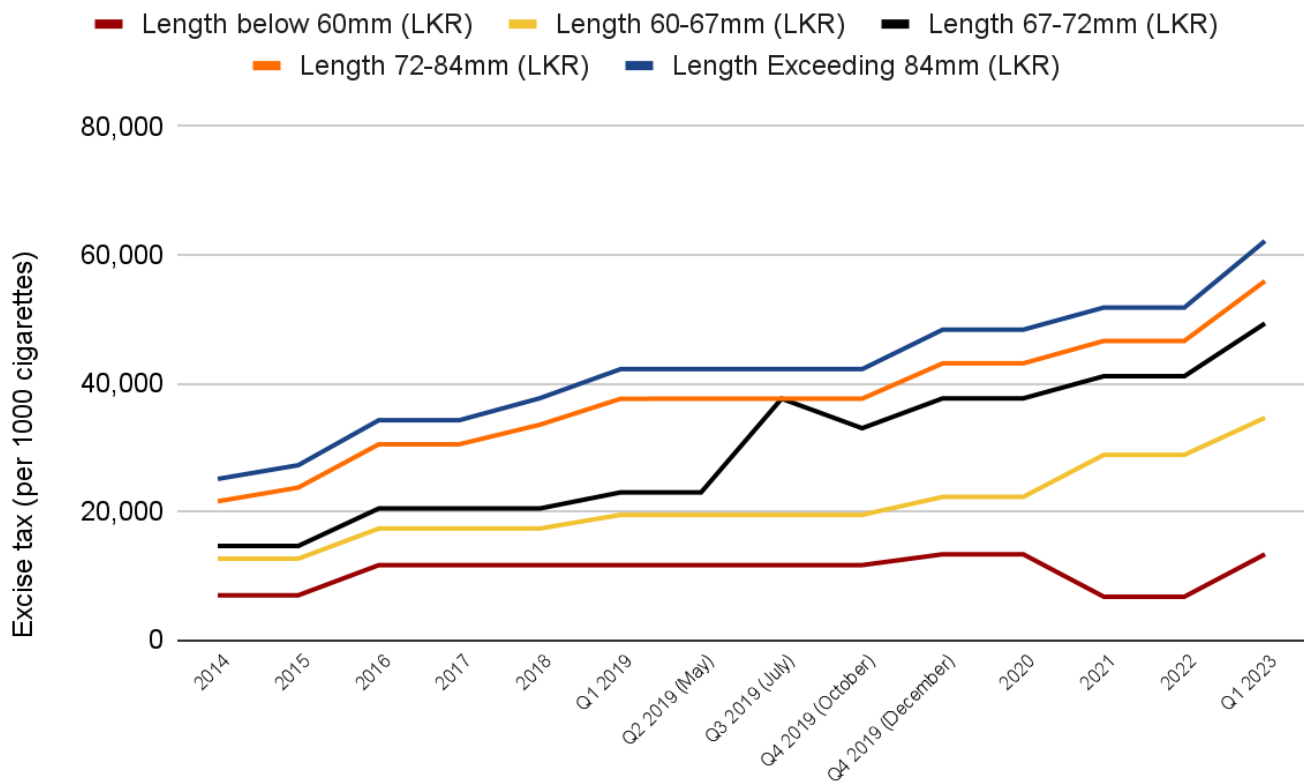


Source: Compiled based on data from past RIUNIT market research studies and ongoing research

Excise tax revisions over the years has made the illicit cigarettes more attractive to the smoking population due to its' affordability

The excise tax hikes of approximately 20%-98% on the legal cigarettes, implemented from January 1, 2023, played a significant role in consumer shifts to illicit cigarettes. Combined with prevailing inflation and tax hikes, the real wages of consumers have been severely depleted, leading smokers to opt for cheaper cigarette alternatives. Consequently, the average price of legal cigarettes increased by 17.65% post the excise hike in January 2023 marking the retail price of the most purchased legal cigarette as LKR 100. The sales of legal cigarettes has decreased at an annual average rate of 3.66% from 2008-2023. According to RIUNIT research and related sources, the average market price of an illicit cigarette ranges from LKR 70-80, making it more attractive to smokers due to their affordability and availability of varieties. Figure 2 depicts the excise tax amendments over the years.

Figure 2: Excise tax revisions 2014-2023

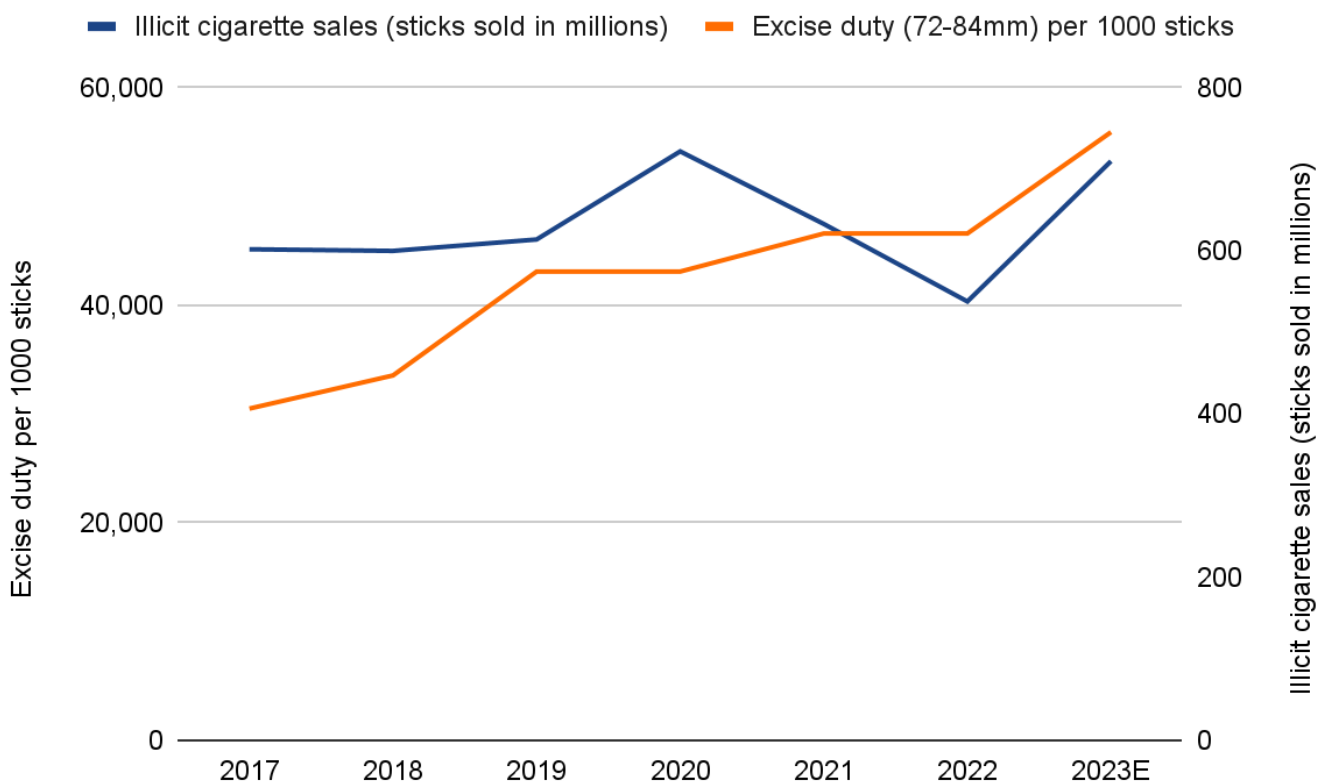


Source: Ministry of Finance

The economic burden passed onto the average consumer has been quite evident through the growth of illicit cigarette market share in 2023

Illicit cigarettes prevalent in the market experienced a notable 33% growth in 2023 compared to the previous year. Figure 3 represents the relationship between the excise tax revisions and the movement of illicit cigarettes prevalent in the market. It is evident that the excise tax hikes over the past few years have clearly aggravated the illicit cigarette market while hindering the legal cigarette sales which ultimately pose questions on the achievement of fiscal objectives set by the Government.

Figure 3: Excise tax vs Illicit cigarette sales volume 2017-2023



Source: RIUNIT compilation based on Ministry of Finance

Note: The legal cigarette sales in 2023 are estimated based on excise tax revision in January 2023 and other market factors

The total state revenue lost through the illicit trade of cigarettes from 2021-2022 totals to over LKR 60 billion

The upsurge in the illicit cigarette market not only poses public health concerns but also results in significant revenue loss for the Government. The projected revenue loss for the year 2023 through this illicit trade would amount to LKR 52Bn, further exacerbating the country's economic challenges.

Excessive taxation of legal cigarettes over the years has resulted in an upsurge of an illicit market and a consequent sub-optimal achievement of both the health and fiscal targets

While taxation serves as an essential tool for discouraging tobacco consumption and generating Government revenue, excessive taxation can have unintended consequences. The substantial tax hikes on legal cigarettes over the years have inadvertently led to the growth of an illicit market, undermining the achievement of both health and fiscal targets. To strike a balance, policymakers must consider the implications of excessive taxation and explore alternative approaches that simultaneously discourage smoking, protect public health, and ensure sustainable revenue streams.

The economic burden faced by the population, combined with tax shocks and inflation, has driven smokers towards cheaper alternatives. As a result, legal cigarette sales have declined, while illicit cigarette sales have witnessed significant growth. To achieve a balance between health and fiscal objectives, policymakers need to reevaluate taxation policies and explore comprehensive strategies that address the concerns of both smokers and the Government. The final report of our ongoing research is set to be released during Q3 of 2023 where we hope to highlight some of the key policy concerns that have re-triggered a rise in illicit markets.



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www.riunit.com
info@riunit.com