

CIGARETTE TAX REFORMS TO REDUCE TOBACCO CONSUMPTION AND INCREASE GOVERNMENT REVENUE

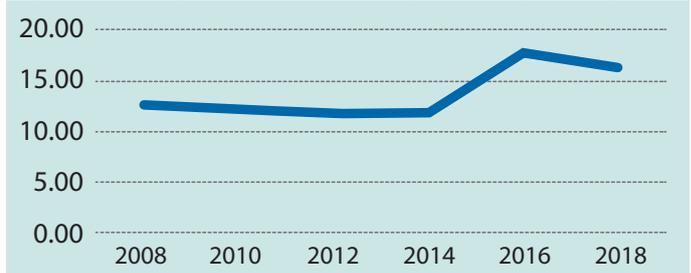
Tobacco is extremely harmful to health and has been found to increase the risk of many non-communicable diseases including cancer, heart diseases, and respiratory illnesses (The Tobacco Atlas, 2018). According to the World Health Organization (WHO), 8 million people died due to tobacco related illnesses in 2017. The adverse effects of tobacco are not limited to the untimely deaths. Tobacco cost the economic and social lives of people in numerous ways. These direct and indirect costs of tobacco amounted to Rs. 89.37 billion (the equivalent of 6.1% of Sri Lanka’s government revenue¹) in 2015; this was smaller than the government revenue from tobacco taxes in the same year (5.5%).

According to the WHO, significant increases to tobacco taxes is the best means of controlling tobacco consumption (World Health Organization, 2019). After studying tax systems in different countries, best practices are identified in the WHO-FCTC for taxing tobacco products in different countries. The WHO-FCTC recommends a simple tax structure and regular tax increases to account for inflation and income effects. The WHO-FCTC also recommends the imposition of equivalent taxes to all tobacco products to prevent cheaper alternatives and tightening the tobacco tax administration to reduce tax evasion and tax avoidance.

Issues with the current tax structure

Sri Lanka has been taxing tobacco since 1953. Sri Lanka levies a mixture of taxes on tobacco among which excise taxes are noticeable. From 1999 the tobacco tax was extended to include manufactured tobacco such as, cigarettes, cigars, beedis and piped tobacco, further the Minister in charge was given authority to change the tax rate by an order published in the government Gazette. Although excise tax rates on tobacco has increased

Figure 1 Percentage of GDP Per Capita Required to Buy 2000 Cigarettes



Source: WHO Report on the Global Tobacco Epidemic, 2019

regularly, these changes were done without any basis. Despite high prices, cigarettes are still affordable for Sri Lankans due to rising incomes, based on the WHO affordability index² (Figure 1). Further, at present cigarettes are taxed using a 5-tier structure based on the length of cigarettes.

Proposed revisions to the tax structure

In line with WHO recommendations, IPS proposes that Sri Lanka should implement inflation-adjusted excise tax increases on all cigarettes, and gradually move towards collapsing the 5-tier cigarette tax rates to a uniform specific excise tax rate.

We propose an incremental approach for revising the cigarette taxes (as summarized in Table 1) in the 4-year period between 2020-2023. We propose aligning cigarette excise tax adjustments to inflation, in the first two years, followed by simplifying the different tiers of taxes to a uniform tier, in the last two years. Along with this, it is important that the government should specify a maximum length for the tobacco portion of the cigarette. This is necessary as in the past, tobacco manufacturers have changed the length of the cigarette and the length of the filter of the cigarette to reduce the effective tax rate.

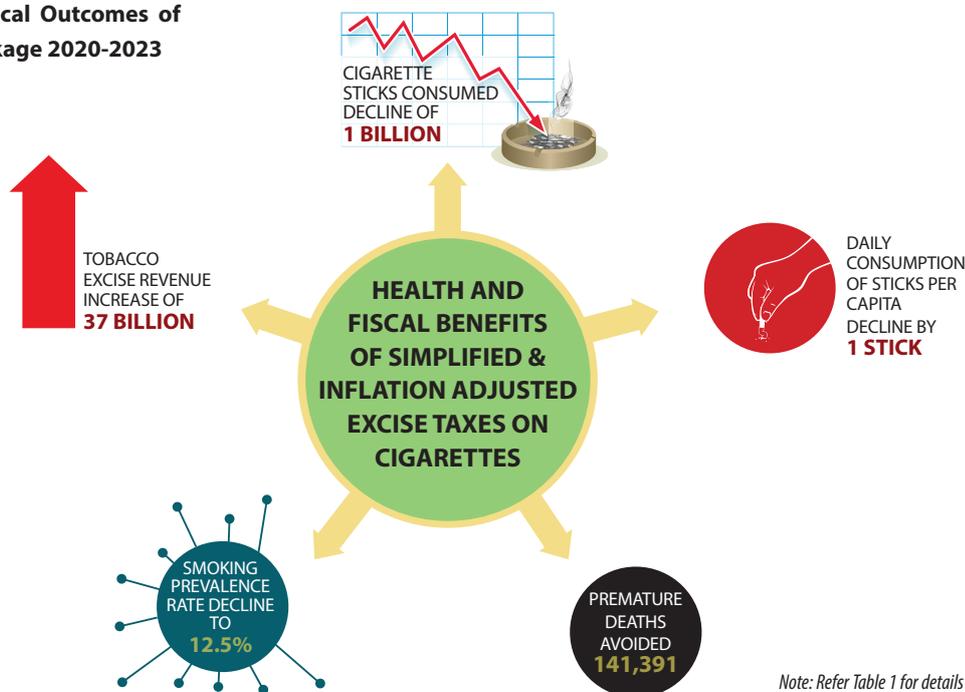
Table 1 Cigarette Tax Policy 2020-2023

Policy Change	Year	Details
Policy Change 1 – Inflation adjusted excise tax increase	2020	Increase excise tax rates by 15% for all tiers
Policy Change 2 - Inflation adjusted excise tax increase	2021	Increase excise tax rates by 10% for all tiers
Policy Change 3 – Reduce number of tax tiers & Inflation adjusted excise tax increase	2022	Collapse two lower tiers into one. Increase tax for the four new tiers by 5%
Policy Change 4 – Adopt uniform tax rate & Inflation adjusted excise tax increase	2023	Collapse four tiers to one tier by increasing tax on all tiers up to rate of the highest tier

¹Authors calculation based on World Bank (2015), Economic and Social Costs of Tobacco and Alcohol in Sri Lanka

²WHO Report on the Global Tobacco Epidemic, 2019

Figure 2 Health and Fiscal Outcomes of Cigarette Tax Policy Package 2020-2023



Note: Refer Table 1 for details of policy implementation

How the proposed revisions benefit the economy

There are both health and fiscal benefits to implementing the above policy package. Specifically, IPS calculations predict³ the following health and fiscal outcomes if the above reforms are implemented:

- **Government revenue⁴ from tobacco will increase** up to Rs 132 billion by 2023 up from Rs 95 billion in 2019
- **Cigarette consumption will decline** from 3.1 billion sticks consumed in 2019 to 2.1 billion sticks in 2023
- **Smoking prevalence (of +15 years) will decline** to 12.5% by 2023
- **Daily consumption of sticks per capita will fall** from 3.5 sticks in 2019 to 2.8 sticks in 2023
- **The total number of premature deaths from tobacco use that can be avoided** in the future amounts to 141,391

These reforms are a win-win for both health and fiscal policy as follows:

- **Health Policy** - Reducing tobacco consumption reduces the health cost burden for both people and the government
- **Fiscal Policy** - The government can increase its tax base at no cost, especially in the context of having to compensate for reduced government revenue following recent VAT and PAYE tax cuts

Is there a link between tobacco taxation and illicit trade?

While industry lobbyists are resistant to cigarette tax increases - arguing that they cause a rise in illicit tobacco trade and beedi consumption - the evidence suggests otherwise. According to the WHO, there is a negative correlation between illicit trade share and cigarette prices, globally⁵. Instead, it is the existence of informal trade channels, easily crossed borders, weak governance, ineffective customs/tax administration, corruption and complicity of producers/importers, among other reasons, that cause large scale illicit trade of tobacco. Hence illicit trade should be controlled through organizational changes in tax administration such as (more investigations, more tax and customs officers) and technology, rather than by keeping cigarette taxes/ prices low.

Has beedi consumption increased due to cigarette tax increases?

In addition, the Alcohol and Drug Information Centre's (ADIC) survey data indicate that beedi consumption has in fact declined over time, despite the narrative that consumption has increased in response to cigarette tax increases. As a percentage of current smokers, the share of beedi users has declined from 11% in 2013 to 5% in 2018. Further, in 2017, only 2.5% of current smokers were found to be substituting away from cigarettes to beedi, following cigarette price increases; in contrast, 87% reduced cigarette usage and 3% switched to low-price cigarettes. This data contradicts the argument that smokers replace formal cigarettes with illicit cigarettes and beedi.

³Predictions are made using the TeTSIM model designed by the WHO FCTC Knowledge Hub at University of Cape Town

⁴Excise duty

⁵WHO FCTC Knowledge Hub and Euromonitor data

100/20, Independence Avenue,
Colombo 7,
Sri Lanka
T: +94 11 2143100 / 2665068,
F: +94 11 2665065
www.ips.lk