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POLICYINSIGHTS

INSTITUTE OF POLICY STUDIES OF SRI LANKA

ILLICIT TOBACCO TRADE: EVIDENCE-BASED INSIGHTS

Key Insights

High excise taxes are widely recognised as effective in reducing tobacco consumption. However, besides tax disparities and cross-border price differences, the illicit tobacco trade is driven by affordability, corruption, weak regulatory enforcement, and sociocultural influences. Results of a recent study by the Institute of Policy Studies (IPS) indicate that smuggling occurs in various forms at the border. However, official data from Sri Lanka Customs does not support claims that high taxes increase smuggling. The results of the study specifies that effective tobacco control requires tax increments coupled with measures to control smuggling. Strengthening border control, law enforcement, penalties, digital tax stamps, regional cooperation, and public awareness are essential to combat smuggling and improve the effectiveness of tobacco tax policies.

Introduction

The World Health Organization (WHO) Framework Convention on Tobacco Control (FCTC) recommends a minimum of 75% share of tax on the retail price of tobacco products and the adoption of the WHO protocol to eliminate illicit trade of tobacco products. Maintaining a high tax rate (Excise Tax) is often regarded as a successful method for abating tobacco product consumption worldwide.

The licit industry participants claim that elevated tax rates are the primary driver of increased contraband and thus advocate lower tax rates on tobacco products. However, it is found that contrary to the tobacco industry's arguments, taxes and prices have only a limited share in the illicit cigarette market at the country level (Chaloupka, Straif, & Leon, 2011). Globally, illicit trade is also driven by affordability, the extent of corruption, enforcement efficacy, and cultural and sociological causes (Laffer, 2016). Cross-country estimates have revealed that a one-point improvement in the Corruption Perception Index (CPI) is linked to a 2% reduction in tobacco smuggling (Merriman et al., 2013).

However, due to data inadequacies, the context and scale of the illicit market are not well characterised or

sufficiently quantified using accepted methods. Occasionally, erroneous reports appear in public media claiming very high levels of smuggling. These reports typically rely on unverified data sources and methods. Policy decisions may be misguided by such reports and related industry arguments (Weerasekera, 2019). Literature suggests that just over 11% of the global cigarette market is considered illicit and operates as a global industry (Gallien & Weigand, 2021).

Smuggling enables the sale of products below the market price, making products more affordable for consumers, particularly low-income individuals and youngsters, while neglecting labelling and packaging standards, such as visual warnings, hampers the effectiveness of local tobacco control policies. It deprives the government of tax revenue and strains healthcare costs. Global research on identifying the relationship between high tax rates and smuggling has given mixed results due to varying circumstances under which taxes are levied, inaccurate calculations, industry-funded research, and the direct and indirect involvement of industry in smuggling activities. Evidence substantiates the illicit trade and the existence of an illegal market for tobacco products in Sri Lanka.

Considering its importance, IPS has recently conducted a scoping study on tobacco product smuggling, utilising verified data sources and internationally accepted methods to understand the smuggling context, estimate the smuggling statistics, and provide recommendations and insights for future policy-making and further studies. The results of this study are given below.

Results

Smuggling occurs in various forms at the border; a greater understanding of these channels is needed to formulate policies to arrest smuggling at the border. Passenger luggage often facilitates cigarette smuggling, especially via duty-free zones and transits. Other smuggling occurs through seaports and freight containers, showing organised operations.

Official data from SLC on seized cigarettes does not support the public narrative which suggests that high taxes lead to increased smuggling. Seized volumes that were reported do not show a pattern in relation to the tax rate (Infographic 1).

Consumption estimates derived from available secondary data cannot be used to evaluate smuggling since these differ from the sales (issued) volumes reported by CTC and vary across sources. The HIES survey accounts for 10% of legal cigarette sales by the CTC. Other surveys (ADIC, GATS, STEPS) also report lower volumes than those sold by CTC despite having higher coverage rates (49%, 57%, and 84%).

Results show that corruption also results in smuggling. The mirror statistics (Missing Trade USD

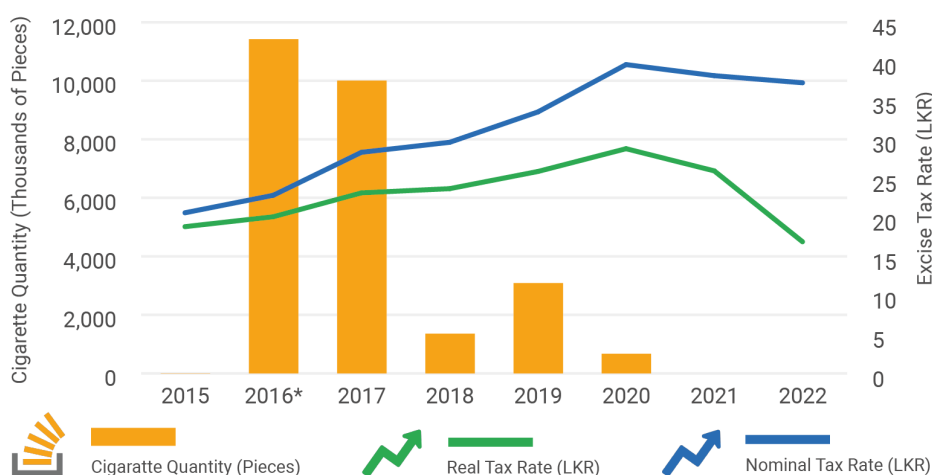
values) for the primary illicit trade destinations show clear underreporting in Customs data. A positive value (Exports minus Imports) indicates underreporting by the importing country's customs. In recent years, the UAE, India, and Singapore have consistently shown positive figures (Table 1).

A significant amount of misinformation circulates in the media, often stemming from unverified methodologies and unreliable data sources. This study attempted to estimate smuggling based on internationally accepted methodology and verified data sources. According to the authors' calculations for 2015, smuggling can be at most 13.5% but is likely reported to be much less than that. The industry statistics (by CTC) state the illicit market share is about 6%, assuming one-tenth of the smuggled cigarettes are detected. RIUNIT estimations show an increase from 14% in 2017/2018 to 22% in 2022, assuming illegal cigarette substitute sales drop, based on 3,150 Mn sticks of fixed consumption. Another study indicates that illicit trade in 2017 was as high as 15.57% based on cigarette butt analysis. In some countries, the industry engages in smuggling through hoarding and interstate tax evasion, but no such involvement by CTC has been reported in Sri Lanka.

Recommendations

The cost of smuggling must be raised through higher penalty payments, prosecution, and reward mechanisms for the officers and the public. To improve the effectiveness of tax policies, it is equally important to tighten border control and law enforcement measures aimed at combating illicit trade.

Sri Lanka Customs Reporting on Number of Illegal Cigarettes Seized vs Average Excise Tax Rate Per Year



Source: Author's Compilation based on data from Sri Lanka Customs.

Table 1
Mirror Statistics of Cigarettes from 2015-2022 (Value)

Year	Value Difference in US Dollar Thousand (Export value- Import Value)				
	UAE	Singapore	India	Indonesia	China
2015	-40	1913	2930	1524	-280
2016	-36	2718	3779	5	1077
2017	3086	317	900	0	2995
2018	4934	2181	1188	0	1991
2019	8766	1556	593	0	562
2020	8160	615	455	0	-153
2021	27106	483	447	-6	-19
2022	9021	40	1543	0	-65

Source: Author's compilation from ITC and COMTRADE databases.

Enriching tracing and tracking mechanisms through advanced technology and regional collaboration as suggested by the WHO FCTC. The digitalisation of customs procedures enhances transaction transparency, thereby strengthening the authorities' ability to detect and control smuggling.

Prohibiting cigarette sales in duty-free zones would help cut down incentives for smuggling on a regional and global scale. The EU has implemented a track-and-trace system to combat illicit trade in tobacco products. **Licensing the entire supply chain**, encompassing wholesalers and retailers, enhances traceability and control over operations.

Retail sales and transportation of illegal tobacco should be banned with legal enforcement. Introducing **digital Excise Tax stamps for legal cigarettes** can help detect illegal cigarettes. These stamps were effectively introduced in Ecuador, Indonesia, the Philippines, Ireland, and the EU. **Introducing a reward system for the public** for providing information on contraband cigarette sales would help control local retail sales.

Raising public awareness about illicit cigarettes and their health impacts can help reduce demand.

Methods to improve the representativeness of consumer surveys should be widely discussed and incorporated to obtain more accurate consumption estimates.

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This Policy Insight draws on findings from an IPS study on "Tobacco Smuggling in Sri Lanka - A Scoping Study" conducted by IPS researchers Erandathie Pathiraja, Nishamini Ihalagedera, and Ruwan Samaraweera.

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