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48.3
PERCENT
Excise tax rate (Capstan)
2007-2009

70.9
PERCENT
Excise tax rate (JPGL)
2006

59.3
PERCENT
Excise tax rate (JPGL)
2014

Image courtesy of *American Liberty Pac*

Parliament Should Have a Formula for Regulating Cigarettes

Variations in the tobacco excise tax affects Rs. 10s of billions in government revenue. Taxation and pricing has been inconsistent. The lack of a consistent method allows wide discretion to officials in determining the tax. Parliament should adopt a formula to keep taxation in line with national policy, treat stakeholders fairly, and prevent discretion from being abused.

Every year, on the 31st of May, the World Health Organisation (WHO) and partners mark World No Tobacco Day (WNT day). This day is set apart to highlight the health risks associated with tobacco use and to advocate for effective policies to reduce tobacco consumption. According to WHO "Tobacco kills nearly six million people each year, of which more than 600,000 are non-smokers dying from breathing second-hand smoke". The focus of 2014 WNT day is to "raise taxes on tobacco, reduce tobacco consumption, and save lives". This *insight* explains why this year's theme has a message for the Sri Lankan parliament.

THE SRI LANKAN MARKET CONTEXT

This *insight* will focus on the application of the WHO focus to the market in cigarettes. There are other forms of tobacco consumption in Sri Lanka, such as beedi's and betal chewing; however, cigarettes remain the most significant vehicle for tobacco consumption.

The application of this WHO theme – reducing consumption by raising taxes – must take into account the specific market context wherein Ceylon Tobacco Company (CTC) has a monopoly in the production and sale of cigarettes.

Given this monopoly status, the government does not simply regulate the taxes – through section 3 of the Excise (Special Provisions) Act, No. 13 of 1989 – but, by convention, also provides direction on the pricing of cigarettes. In fact, by setting taxes in terms of absolute rupee values, rather than as a percentage of price, the government exercises almost a direct control over the pricing of cigarettes.

That means in Sri Lanka the adjustment of taxes achieves two objectives. It directs the increase in price and determines the portion of price collected in taxes. Therefore, translating WHO's 2014 WNT day focus into action in Sri Lanka involves evaluating goals not just for tax revenue, but also for pricing. However, scrutinising the past data exposes a problem: the tax and price setting system for cigarettes in Sri Lanka has a serious flaw – it is ad hoc, and in the clutches of political and bureaucratic discretion.

DISCRETION: THE GREAT WEAKNESS OF CIGARETTE PRICING AND TAXATION IN SRI LANKA

The current provisional estimates are that the special excise tax on cigarettes will have brought about 58 billion rupees in revenue to the government in 2013. This is around 5% of government revenue – making it an important variable to manage.

Yet, none of the financial institutions in Sri Lanka, from the Ministry of Finance, to the Treasury to the Central Bank follow a coherent method or formula for the taxation or pricing of cigarettes. Recent analysis by Verité Research has demonstrated a lack of systematic decision making in Sri Lanka's history of cigarette taxation and pricing.

The lack of a formula or a coherent method need not be a surprise. Economic studies teach us that policy or regulatory discretion at the levels of high office can be quite lucrative. High officials who enjoy the privilege of such discretion hence have an incentive to protect it – and very few above them to challenge it.

The greatest weakness of cigarette pricing and taxation in Sri Lanka can therefore be boiled down to a single word: **Discretion**.

The adjustment of taxes achieves two objectives. It directs the increase in price and determines the portion of price collected in taxes. The tax and price setting system for cigarettes in Sri Lanka has a serious flaw – it is ad hoc, and in the clutches of political and bureaucratic discretion.

DISCRETION AND ITS VULNERABILITY TO ABUSE

Consumers spend about 100 billion rupees purchasing cigarettes in Sri Lanka and there is space for much of that spending to accrue to the government as taxes. The tax revenue opportunity is large because of the gap between the cost-of-manufacture and consumer-willingness-to-pay. Presently, the cost of manufacturing a cigarette averages to around 1 rupee, while the retail price of the most popular cigarette is 28 rupees. Therefore, setting taxes systematically – according to a formula – is a matter in which 10s of billions of rupees in government revenue are at stake.

Economic studies on corruption suggest that, typically, high-level discretion of this sort has two alternative manifestations: (1) Demonstrating power, by actions that adversely affect the entity being "pressurised". (2) Rewarding the entity that "complies", at the expense of the public interest.

The application of official discretion on the taxation and pricing of cigarettes, therefore, can be very costly. It can be costly to government coffers and society, when the discretion is abused to reward CTC; and can be costly to CTC when the discretion is abused to apply pressure on it. A transparent even-handed policy on taxation and pricing is not open to such abuse.

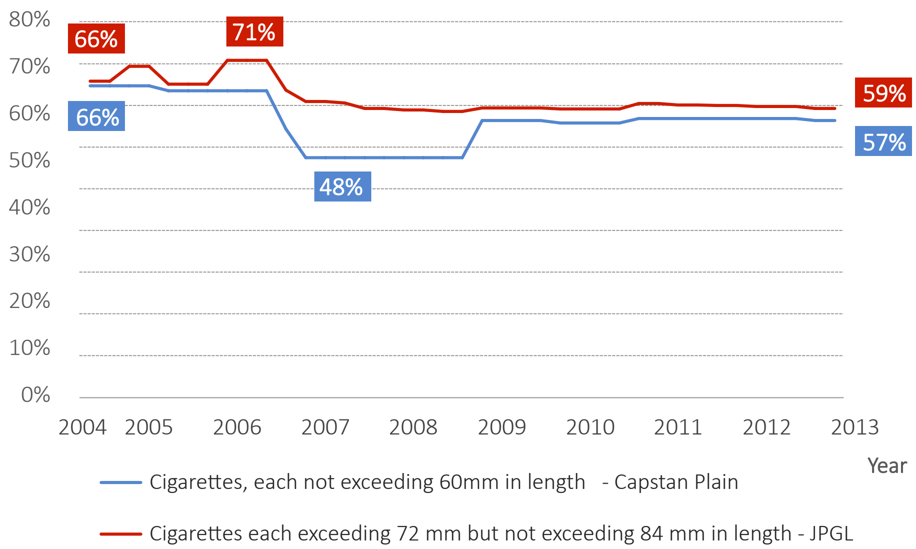
It is indeed possible that the good traditions of government have ensured that this hugely consequential discretion has always been used responsibly and never for the private or political gain of those who wield it. The point is, however, that the very existence of such discretion certainly makes the system of pricing and taxation of cigarettes in Sri Lanka today vulnerable to abuse.

The analysis that follows shows that there have been times that the discretion has resulted in wide departures from the norm in the taxation and pricing of cigarettes.

CIGARETTE TAXATION HAS BEEN INCONSISTENT

The failure to adjust taxes in some systematic manner can result in large revenue losses to the government, and can also put the operations of CTC in jeopardy and uncertainty.

Exhibit1: Percentage of excise tax in retail price



Source: Government Statistics and Verité Research Analysis

That both of these things have occurred at times can be seen through Exhibit 1. It shows annual variations in the percentage of excise tax to price since 2004. This is tracked for the two largest selling cigarette brands: John Player Gold Leaf (JPGL), which accounts for 83% of the market, and Capstan, which accounts for 11% of the market.

The variations in excise tax rates post 2004 have generally favoured CTC. For Capstan, they have fallen from 65.6% to 57.22%. For JPGL, changes have also mostly favoured CTC dropping from 65.88% to 59.32% at present (Exhibit 1).

In this period, there is a wide variation in the rates. For capstan, the high point in taxation was 2004 when it was 65.6%. It hit a low point of 48.3% for about two years from 2007 (~ 17% variation). For JPGL the high point 70.9% in 2006 and the low point was 58.6% in 2008 (~ 12% variation) (Exhibit 1).

CIGARETTE PRICING HAS BEEN INCONSISTENT

A moderate and systematic method for increasing the pricing of cigarettes would be to see that prices are adjusted every year to keep step with the increase in per-capita GDP – thereby, mitigating the increase in affordability that comes with average income growth.

Recent analysis by Verité Research shows that over a long period of time 1981-2000, this has indeed been the case. On average, the price increase of cigarettes in the 20 years from 1981 to 2000 has been the same as the per capita GDP increase during that time.

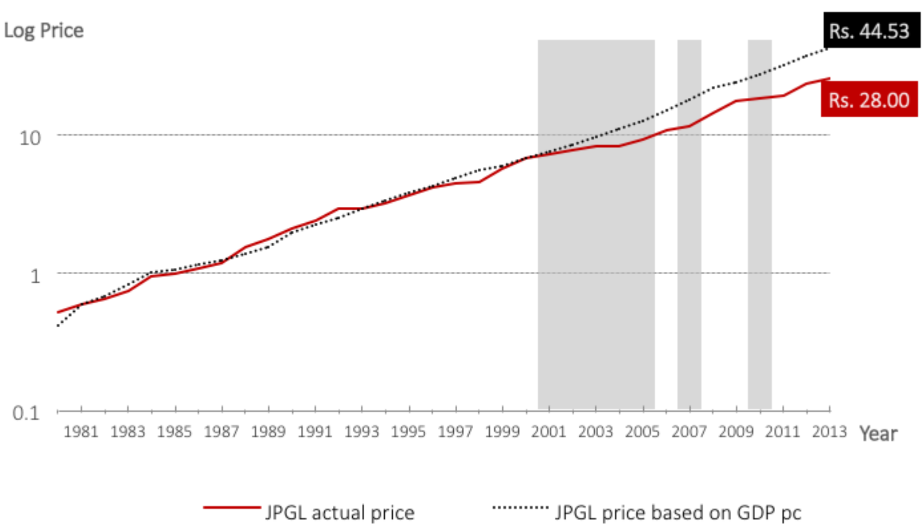
But those adjustments in the 20 years were not made in an entirely systematic manner. There are significant periods in which the price has been under-adjusted and significant periods in which it has been over-adjusted. However, during this period the deviations from the "correct" adjustment were not large, except in 1997 and 1998 when there was significant under adjustment. But from 2001 onwards a wide inconsistency arises between the growth of per capita GDP and the increases in the price of a cigarette (see Exhibit 2).

2001-2005 THE GREATEST UNDER-ADJUSTMENT IN PRICES

If the overall pricing objective – keeping price increases in line with growth in per capita GDP had been followed, then the price of a JPGL by December 2013 would have been 44 rupees. However, at present it is 28 rupees – demonstrating the weakness of leaving the decisions to political and bureaucratic discretion, instead of establishing a transparent system (see Exhibit 2).

The period 2001 to 2005 sees the greatest under-adjustment in the price of cigarettes, and it is the knock on effect of that which, at present, makes cigarettes significantly under-priced. Post 2005, apart from two years, 2007 and 2010, the rate of price adjustment was generally in-keeping with the rate of increase in per-capita GDP. But the policy failure from the exercise of discretion between 2001 and 2005 has not been addressed.

Exhibit 2: Comparison of changes in JPGL price per capita GDP growth



Source: Government Statistics and Verité Research Analysis

TIME TO WAKE UP THE PARLIAMENT

The responsibility for the proper management of the country's finances rests finally with the parliament of Sri Lanka. And yet, to date, the parliament has restricted itself to merely asking questions about specific pricing adjustments without calling for a clear and transparent method to be adopted for the pricing and taxation of cigarettes.

The data presented here shows that there are established fundamentals for a formula on the pricing and taxation of cigarettes, and that it can even be squarely justified on the historical averages in Sri Lanka, in addition to the policy guidelines of the WHO.

It's an opportune time for parliament to step in on this important issue that involves a significant piece of government revenue, and has major health consequences.

The current exercise of political/bureaucratic discretion has led to disorder and disparities in the pricing and taxation of cigarettes, and the discretion remains vulnerable to abuse. A transparent formula adopted by parliament, and in keeping with government policy, can restore fairness, parity and order. All honest stakeholders should prefer this to the current practice. It's time to wake up parliament.■

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