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Verité Research is an independent think-tank based in Colombo that provides strategic analysis to high level decision-makers in economics, law, politics and media.

Ashvin Perera
Hafsa Haniffa
Researchers

Nishan de Mel
Series Editor

45
LKR BILLIONS
Extra revenue in 2023 if price/tax formula is implemented

85
LKR BILLIONS
Cumulative revenue foregone from 2020 to 2022 due to not implementing price/tax formula

50
PERCENT
Tax reduction implemented in 2021 budget for cigarette brand with the second highest market share


Image courtesy of Unsplash

Cigarette Taxation Formula — The Cost of Forgetting

In 2019 the government introduced a policy where taxes and prices on cigarettes would be based on an indexation formula. Forgetting to implement the policy is costly: it has resulted in a foregone revenue of 85 billion from 2020-2022 and will cost a further 45 billion in 2023.

Sri Lanka is presently facing the most severe economic crisis in its history. The main problem is that Sri Lanka's debt has become unsustainable. That means, the expected revenues of the government are insufficient to meet the expected expenditure to run government and pay interest on government debt. One of the critical adjustments required for economic recovery is to substantially increase government revenue.

Price/tax formula as response to economic crisis.

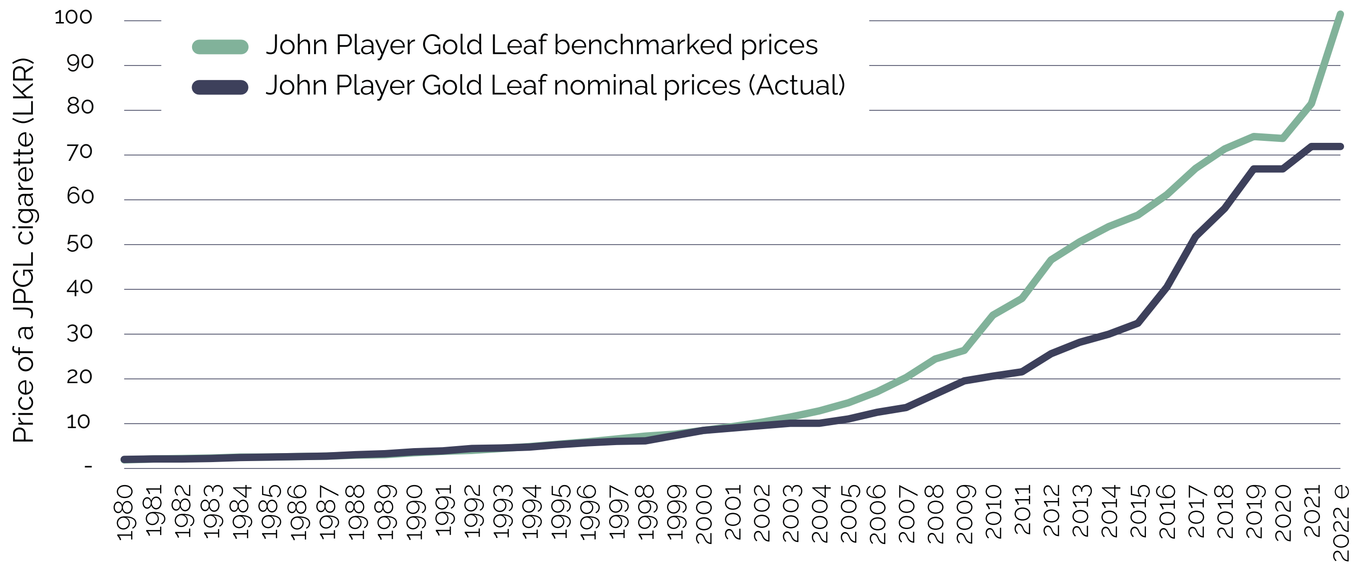
In order to achieve an increase in revenue, a pricing formula on fuel and electricity has been mooted. The benefit of a formula is that it adjusts prices in line with economic fundamentals on a timely and sustained basis, overcoming the delays and inconsistencies created by leaving price adjustments to discretionary, ad-hoc policy action.

However, presently there has been forgetfulness in terms of another pricing formula that has been presented in previous budgets. That is the formula on the pricing and taxation of cigarettes.

Will the new budget pick up cigarette taxation, from where it was left in 2019?

The budget speech in March 2019 announced a policy aimed at a formula

Exhibit 1: Affordability of JPGL (based on the nominal price and the benchmark price)



based on systematically indexing the prices of cigarettes in line with nominal GDP growth. In the words of the then Finance Minister "Excise duty on cigarettes will now be based on indexation with a minimum annual duty increase capturing annual inflation and GDP growth. This will ensure revenue protection and control affordability."

A previous insight by Verité Research calculated that the government would have raised an extra 20 billion in revenue from cigarette taxes in 2020 if taxes had been adjusted in line with the price/tax formula articulated in the 2019 Budget; and if these tax adjustments were calibrated and applied rationally according to the length of the cigarette, to all the different brands of cigarettes in the market.

The present insight sets out the calculation of that revenue consequence from 2021 to 2023. It finds that that Sri Lanka will have forgone LKR 85 billion in the three years from 2020 to 2022 due to the failure to implement the price/tax formula. Rectifying this failure would increase revenue from cigarette taxation by LKR 45 billion in 2023.

Presently, there is a gap between knowledge and action. With Sri Lanka about to announce a revised budget, in the throes of its economic crisis, it would do well to implement the cigarette taxation formula, with immediate effect, and begin to recover the significant revenue lost from failing to do so.

Gap between knowledge and action.

Several past insights by Verité Research and similar research interventions by the Institute of Policy Studies (IPS) and the National Authority on Tobacco and Alcohol Taxation (NATA) have repeatedly pointed out that the failure to engage in the proper taxation of cigarettes has a significant consequence on revenue.

The methodological guidance necessary for implementing the cigarette taxation formula has been published and is accessible to the government. However, Sri Lanka has since failed to apply this policy announced in the budget (see: *A Technical Case for Affordability Based Pricing of Cigarettes*, September 2014, Verité Research Working Paper).

The calculations find that if the price/tax formula is implemented the government can increase its revenue by 45 billion in 2023. To put this additional revenue collection into perspective, it can double the support in the form of Samurdhi payments which are intended to provide relief to the poorest and most vulnerable bottom three income deciles in Sri Lanka.

In addition to the revenue benefits, social benefits in the form of reducing

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Exhibit 2: Formula based price and tax for 2022 and 2023

Brand	Indexed Price 2022 (in LKR)	Applicable Taxes 2022 (per stick)	Indexed Price 2023 (in LKR)	Applicable Taxes 2023 (per stick)
JPGL	99.39	74.54	119.27	89.45
Capstan	70.99	53.24	85.19	63.89
Navycut	85.19	63.89	102.23	76.67
Bristol	85.19	63.89	102.23	76.67
Benson & Hedges	99.39	74.54	119.27	89.45
Dunhill	99.39	74.54	119.27	89.45

* Nominal GDP increase in 2022 and 2023 have been estimated as 25, 20 percent respectively, based on current inflation rates and projections.

the health-related harm from cigarette consumption, which also contributes to lower health care costs, can be achieved with the proper implementation of the formula on cigarette taxation.

How to apply the formula on cigarette taxation?

The methodological and technical guidance for pricing and taxation of cigarettes in Sri Lanka is based on the Verité Research working paper cited above, resolves three critical analytical issues: (1) Finding the benchmark price for the most consumed type of cigarette (2) Specifying the criteria on which the benchmark price of cigarettes should be updated (3) Applying a coherent method for price differentials between different types of cigarettes.

Applying the methodology as per the working paper, and further guidance from the Verité Research and NATA publication on Sri Lanka's compliance with the global Framework Convention on Tobacco Control shows that the current price of the JPGL cigarettes is 29 rupees below the benchmark price (figure 1). Applying the benchmarked criteria of 75% tax in price for cigarettes, the targeted taxation per cigarette by brand is given in exhibit 1. (See: FCTC Evaluation Sri Lanka's compliance with Article 6, 2016, Verité Research & NATA)

The methodology requires an estimation of the benchmark price for JPGL which is calculated to maintain the same level of affordability that the cigarette brand had from 1981 to 2000. Affordability is maintained by growing the price of JPGL cigarettes by the growth in nominal GDP. This is conservatively estimated to be 25% in 2022 and 20% in 2023. This is a conservative estimate, because the annualized rate of inflation for the first four months of 2022 alone is 49.5% and, for food inflation the annualized rate for that period, is 60%.

Prices for the other cigarette brands are then calculated by adjusting the benchmark price relative to the length of the other brands in order to prevent substitution between cigarettes.

The 75% tax in price applied to the price estimates provides the target tax amounts. The calculated revenue lost is the difference between the estimated tax revenue if the formula was implemented, against current/applied taxes and revenue. Recognizing that reduced quantities will be sold at higher prices, the quantity sold is estimated by applying a price elasticity of demand of 0.5, based on the international norm for cigarette demand calculations, to estimate sales under revised prices in relation to the quantity sold in 2019.

The forgetting of the cigarette taxation formula since 2020.

A previous insight, "*Cigarette Tax Indexation, Getting It Right and Getting it Wrong*" (Verité Research , August 2019) showed that the cigarette taxation formula, despite being announced in the budget in 2019, was forgotten when it came to implementation. This forgetfulness has continued and become a pattern in the years that followed. There were three instances in which cigarette taxation and prices were amended since November 2019 (when a presidential election was held in Sri Lanka), where the formula remained forgotten, and taxation policy remained ad-hoc and adverse to revenue improvement.

Instance 1 (December 2019): Excise taxes on cigarettes ranged from 11.67 rupees to 42 rupees per stick. This was increased to amounts ranging from 13.36 rupees to 48.35 rupees per stick for different cigarettes. However, this only offset the removal of VAT and NBT taxes from cigarettes, and therefore did not impact either the price or the tax in price of cigarettes.

Instance 2 (2021): The price of the most consumed cigarette brand in Sri Lanka, JPGL increased from 65 rupees in 2020 to 70 rupees in 2021, without any change in the taxation until November 2021. As of May 2022, it remained at the same price. Taxation on other brands were similarly flawed.

Instance 3 (November 2021): The 2021 budget speech announced an increase in the price of cigarettes by 5 rupees (even though the law only empowers government to set the taxes, not the price). The overall tax rate as a percentage of the price of cigarettes, however, was reduced in this instance. For the cigarettes of less than 60mm, which had the second highest market share, the tax per cigarette stick was reduced from LKR 13.36 to LKR 6.75, a reduction of almost 50% .

At a time when the government is required to increase revenue to ensure debt sustainability and is increasing VAT despite the annualized inflation being about 50%, there is a strong case for applying the cigarette price and tax formula to increase government revenue and reduce the tax burden on other forms of essential consumption.

The failure to implement the tobacco price/tax formula means that the government has forgone and continues to forgo a significant stream of revenue. The cumulative foregone revenue since 2020 up to the end of 2022 amounts to 85 billion. If tobacco price/tax formula is implemented properly it is expected to generate an additional revenue of LKR 45 billion in 2023. In times of rising cost of living and severe economic hardship failing to optimize the revenue stream from cigarette taxation would constitute a significant failure in public finance management. ◆