VERITÉ RESEARCH
Strategic Analysis for Asia

PROPOSAL TO INDEX AND RATIONALIZE CIGARETTE TAXES

DETAILS OF THE SUBMITTER

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THE PROPOSAL (SUMMARY OF THE REVENUE MEASURE)

Make a three-part reform to cigarette taxation: (1) restore the tax share to the World Health Organization's recommended 75% of the retail price; (2) ensure a minimum indexation of cigarette excise taxes to keep pace with nominal GDP-per-capita growth; and (3) replace the current five length-based excise bands with a single specific excise rate – as also recommended by the WHO. The full package would raise at least LKR 30 billion a year while reducing down-trading and improving the transparency of cigarette taxation.

SHORT ABSTRACT

Cigarette tax increases are an effective revenue measure because demand is price-inelastic: consumption falls by less than the percentage increase in price. Sri Lanka almost met the WHO's 75% tax-share benchmark in 2018, but by 2026 the effective tax share has fallen to 66.8% – as the government failed to increase excise taxes at the same pace as the company increased prices. The proposal increases revenue through restoring the tax level, prevents future tax erosion through minimum indexation, and counters industry strategy of shifting consumers to shorter cigarettes with lower total taxes. It raises much-needed revenue while supporting public-health objectives.

TOPLINE VIEW

Objective of the Proposal

- ☐ Economic Growth
- ☒ Governance
- ☐ Justice and Rights
- ☒ Social Welfare
- ☐ Other: ....

Implementing Agency:	Ministry of Finance
Primary Beneficiaries:	General Public
Revenue Estimate:	+LKR 30 Billion
Policy Type:	Revenue Increasing

HOW IT ADVANCES THE OBJECTIVES

1. **Governance:** Introduces a transparent rule for cigarette taxation through a 75% benchmark, an automatic minimum indexation to nominal GDP and a single specific excise tax on all cigarettes. This reduces undue discretion and delays in taxation adjustments, and closes the loopholes of down-trading. This proposal also helps Sri Lanka meet its WHO Framework Convention on Tobacco Control commitments.

2. **Social Welfare:** Raises revenue through an existing tax instrument while reducing cigarette affordability in line with public-health goals. The additional revenue can support social spending or help reduce pressure on other consumption taxes on essential goods.

CASE FOR THE PROPOSAL

The tax share on cigarettes has fallen to a 16-year low

On the back of the 2022 economic crisis, Sri Lanka raised taxes on almost all goods, services and incomes — VAT rose from 8% to 18%, a 2.5% Social Security Contribution Levy was added, and income-tax rates climbed to 36%.

Cigarette taxes moved in the opposite direction. The effective tax share on cigarettes fell from 74% in 2018 to 66.8% in 2026 (by 7.2 percentage points), reaching a 16-year low[i]. **Cigarettes may be the only product where tax revenue declined while the producer's revenue rose.**

The erosion has been driven by inaction, not design

The erosion occurred because most of the tax on a cigarette is a specific excise. Unlike VAT, a specific excise does not rise automatically when retail prices rise. When the producer raises prices and the excise is not adjusted, the tax share falls. Between 2017 and 2024, government levies on cigarettes rose by only 27.5%, while the producer's net-of-tax revenue rose by 92.4%.[ii] A rule-based tax system would have prevented or reduced this gap.

Mechanism of execution: the reform addresses three escalating failures

Sri Lanka is failing at three escalating levels, and the proposal addresses each.

1) **Level one: Restore the 75% tax share**

The first reform is to restore the WHO benchmark that taxes should account for at least 75% of the retail price.[iii] Sri Lanka met this benchmark in 2018 and can restore it again through a gazette, without new legislation or parliamentary approval. Restoring the 75% tax share, even with no change in retail price, would yield about LKR 17.3 billion in additional revenue a year[iv].

Mechanism for reform: Through a gazette notification to set the excise tax to a level that makes total tax equal to 75% of price.

2) **Level 2: Restores rule-based, transparent taxation**

The second reform is indexation. Article 6 of the WHO Framework Convention on Tobacco Control, which Sri Lanka ratified in 2003, calls for tobacco taxes to be raised regularly to keep pace with inflation and income growth.[v] Sri Lanka's March 2023 IMF programme required an automatic indexation mechanism for excise duties, but the commitment was dropped at the programme's second review.[vi] Combined with the 75% benchmark adjustment, it would raise the annual revenue gain to about LKR 30 billion.

Mechanism for reform: Through **scheduled** Gazette notifications applying the formula, and measures to prevent forestalling – for example, laws to criminalize and punish the activity and applying the tax on the pattern of excess production prior to the tax change.

3) **Level 3: Move to a single specific excise rate**

Sri Lanka's five length-based bands allow smokers to shift from higher-taxed cigarettes to cheaper, lower-taxed cigarettes. This has weakened revenue: the market share of longer, higher-taxed cigarettes has fallen from about 83% to 54%.[vii] A single specific excise rate would remove this down-trading route and simplify administration. The economic logic and international evidence for this design are set out in the Annex.

Mechanism for reform: Through a gazette notification to **set the same specific duty across all existing cigarette length bands**. This achieves the economic effect of a single rate without first changing the legal structure.

Expected fiscal impact: revenue rises even as smoking falls

The fiscal impact is positive: about LKR 17.3 billion from restoring the 75% benchmark, and at least LKR 30 billion with indexation. The single-rate structure protects this gain by removing lower-taxed alternatives and reducing classification complexity. Administratively, the reform is simple because it works through existing excise powers and replaces five bands with one clear rate.

In summary, the proposal corrects the immediate tax shortfall, prevents future erosion, and closes a structural loophole. It raises revenue while supporting public-health objectives and improving the governance of cigarette taxation.

RISKS TO IMPLEMENTING THE PROPOSED REVENUE STRATEGY, AND MITIGATION MEASURES

1) **Risk:** By making cigarettes less affordable – especially shorter, cheaper cigarettes under the single rate – the reform discourages young people from starting to smoke, so over the long term the smoker base shrinks and cigarette tax revenue declines.
   - ⇒ **Mitigation:** Treat cigarette tax as a transitional revenue source and build diversified alternative revenue streams now, so long-term fiscal stability does not rely on cigarette taxation.

2) **Risk:** Illicit and smuggled cigarettes are claimed to erode cigarette tax revenue gain.
   - ⇒ **Mitigation:** Sri Lanka is already a Party to the WHO Protocol to Eliminate Illicit Trade in Tobacco Products and should fully implement its measures – which includes pairing all taxation measures with stronger customs enforcement and monitoring.

3) **Risk:** Forestalling – releasing a large volume of cigarettes at the old, lower tax rate just before a tax increase. The producer pays the old rate on the whole stockpile and sells it afterwards, so the higher tax on those cigarettes is lost permanently; and because indexation makes each tax increase predictable, the producer can repeat this before every scheduled rise.
   - ⇒ **Mitigation:** As recommended earlier, bring in anti-forestalling measures and anti-forestalling laws – for example, laws to criminalize and punish the activity and retrospectively apply the tax on detected patterns of excess production prior to the tax change.

PUBLISHED SUPPORTING ANALYSIS

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WHO Technical Manual on Tobacco Tax Policy and Administration. World Health Organization, Geneva (2021). https://www.who.int/publications/i/item/9789240019188

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ANNEX: WHY A SINGLE EXCISE RATE SHOULD NOT REDUCE REVENUE

Economic logic: tax per cigarette rises by more than sales fall

Excise revenue depends on the tax collected per cigarette and the number of cigarettes sold. Revenue falls only if the percentage fall in sales is larger than the percentage increase in tax collected per cigarette. The WHO summarises the evidence for low- and middle-income countries as showing that a 10% price increase reduces consumption by about 4%.[viii] This means higher cigarette taxes can raise revenue even as smoking declines.

A single rate protects the tax base by ending down-trading

Under a tiered system, smokers can respond to a tax increase by switching to lower-taxed cigarettes instead of quitting or paying the higher tax. A single specific rate removes that escape route.

Philippines: revenue more than doubled after tier simplification

The Philippines provides a clear example. Its 2012 Sin Tax Reform Act collapsed four cigarette excise tiers into a single unitary specific rate. In the first year of implementation, cigarette excise collections rose by about 111%, from PhP 32.2 billion in 2012 to PhP 67.9 billion in 2013, while sales volume fell by roughly 16%.[ix]

REFERENCES AND END NOTES

[i] Nishan de Mel and Raj Rajakulendran, “The cigarette that got a tax cut,” Daily FT (2026), based on Verité Research analysis. The weighted-average tax-in-price across cigarette brands stood at 74% in 2018 — close to the WHO’s 75% benchmark — and had fallen to 66.8% by 2026.

[ii] “Who benefitted from the cigarette tax hike?” publicfinance.lk, Verité Research (2025). Between 2017 and 2024 the monopoly producer’s net-of-tax revenue rose 92.4% while levies paid to the government rose 27.5%.

[iii] World Health Organization, WHO Technical Manual on Tobacco Tax Policy and Administration (Geneva: WHO, 2021), which recommends that taxes account for at least 75% of the retail price of cigarettes.

[iv] “The Curious Case of Cigarette Taxes Falling While Almost Every Other Tax Went Up,” publicfinance.lk, Verité Research (2026). The tax break on cigarettes is worth an estimated LKR 17.3 billion a year in 2026, recoverable by restoring the tax share to the 75% benchmark.

[v] Verité Research, FCTC Evaluation: Sri Lanka’s Price and Tax Measures to Reduce the Demand for Tobacco. Article 6 of the WHO Framework Convention on Tobacco Control (adopted 2003; ratified by Sri Lanka in 2003) calls for tax and price measures, including regular tax increases that keep pace with inflation and income growth.

[vi] International Monetary Fund, Sri Lanka: Request for an Extended Arrangement under the Extended Fund Facility (IMF Country Report No. 23/116; Press Release No. 23/79), Extended Fund Facility approved 20 March 2023, under which Sri Lanka committed to revenue-based fiscal consolidation including excise-duty measures.

[vii] Verité Research, A Technical Case for Affordability-Based Pricing of Cigarettes (Working Paper), which analyses the price differentials across Sri Lanka’s length-based cigarette bands and the resulting substitution toward cheaper, lower-taxed brands.

[viii] World Health Organization, WHO Technical Manual on Tobacco Tax Policy and Administration (Geneva: WHO, 2021): a 10% increase in cigarette prices reduces consumption by about 4% in low- and middle-income countries (price elasticity of demand of approximately -0.4).

[ix] Republic of the Philippines, Republic Act No. 10351 (Sin Tax Reform Act of 2012); Philippine Bureau of Internal Revenue data on cigarette excise collections and sales volume; Tobacconomics Cigarette Tax Scorecard; and WHO/International Tobacco Control Project evidence on uniform specific excise structures.