Sustainable Development Policy Institute

Tax Policy for Dairy Sector Transformation: Incentivizing Formalization and Sustainable Production

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Figure A: Stakeholders engagement.

Executive Summary

A significant economic, nutritional and social upheaval has been caused throughout Pakistan's dairy value chain by the Finance Bill 2024–25s imposition of an 18 percent sales tax on packaged dairy products. While the tax aimed to boost revenue, it has inadvertently penalized the formal sector—contracting its market share, displacing over 40,000 farmers, and undermining food safety standards. At the same time, it has driven consumers toward the informal sector, where milk is largely adulterated and unregulated, escalating public health risks and healthcare costs. The packaged milk prices have surged by PKR 60–70 per Liter, placing safe dairy products beyond the reach of low- and middle-income households. Formal processors now operate below 50% capacity, and over 500 milk collection centers have shut down, weakening rural livelihoods and reversing years of investment. The informal sector, exempt from taxation, continues to grow—resulting in a PKR 1.3 trillion shift in sales away from the formal economy.

A lower, nutrition-sensitive tax rate of 5% is urgently needed to restore balance. International best practices show that most countries apply 0–5% VAT on milk, recognizing its essential role in nutrition and public health. A 5% rate, combined with standard income taxation and safety compliance incentives, would expand formal sector participation, increase government revenues sustainably, and promote health outcomes.

Revising the tax framework is not merely a fiscal adjustment—it is a public health, rural development, and economic stabilization imperative. Reverting to a 5% sales tax on packaged milk is a critical first step toward formalization, investment revival, and affordable access to safe, hygienic dairy products for millions of Pakistanis.

Introduction

Pakistan ranks as the fourth-largest milk producer globally, with an annual output exceeding 70 million tons, involving over 8 million rural farming families and contributing substantially to GDP. Yet the sector is over 90-92% informal where milk is traded without quality checks, taxation, or transparency. The shift in 2024 from 0% to 18% sales tax on packaged milk has disproportionately burdened the formal sector which ensures quality and traceability while enabling the growth of informal, unsafe alternatives. The packaged milk market, already small at 8% share has contracted further under this fiscal pressure (PDA, 2025).

The Impact of the 18% Sales Tax on the Dairy Ecosystem

The sales tax hike has significantly weakened the formal dairy sector with packaged milk sales declining by over 20%. This decline directly benefits the informal sector, which gained PKR 1.3 trillion in sales due to price differentials (Khan et al., 2023). As a result, companies adhering to food safety standards are now operating at under 50% capacity, while over 500 milk collection centers have been shut down. This supply chain disruption has forced farmers to sell milk at lower rates to informal vendors, reducing their incomes and disincentivizing investment in hygienic practices and infrastructure. The financial crisis has already displaced more than 40,000 farmers, depriving them of PKR 1.3 billion in annual support from formal processors.

Taxation policies on essential food items, such as packaged milk, can severely affect household health outcomes. For instance, the price of packaged milk has risen by up to PKR 70 per liter (Khan et al., 2023), making it unaffordable for many low- and middle-income families—64% of whom earn below PKR 50,000 per month. This outcome reflects the findings of McKenzie (2005), who emphasizes that even modest price shocks in essential goods disproportionately undermine consumption capacity and well-being among the poor.. Consequently, consumers have turned to cheaper but unsafe loose milk. Scientific studies show that 45% of loose milk in Pakistan is unsafe, while 65% of samples tested were found adulterated (Khan et al., 2023) with harmful substances such as urea, starch, boric acid, and formalin. These substances are associated with increased risk of diarrhea, tuberculosis, and other waterborne and enteric diseases. The shift to unregulated milk not only threatens individual health but also imposes a significant burden on the healthcare system, effectively nullifying any short-term revenue gains from the higher sales tax (Ibrahim et al. 2023).

Fiscal Miscalculations: Why the Revenue Model is Flawed

While the 18% sales tax initially appeared to boost tax collection, the contraction of the formal dairy sector threatens long-term sustainability. With volumes shrinking and informal sales rising, the government's revenue base is narrowing rather than expanding. The informal sector, which remains untaxed, is the only gainer in this scenario. According to PDA forecasts, a 5% sales tax, coupled with standard corporate income tax of 30%, has the potential to yield over PKR 500 billion annually from 25 billion liters of tradable milk (Figure 1). Importantly, a lower tax rate would incentivize more consumers and producers to enter the formal sector, enabling sustainable revenue collection through broader compliance. Even a modest 1–2% shift from the informal to formal market could significantly boost government earnings year-on-year (Sattar, 2022).

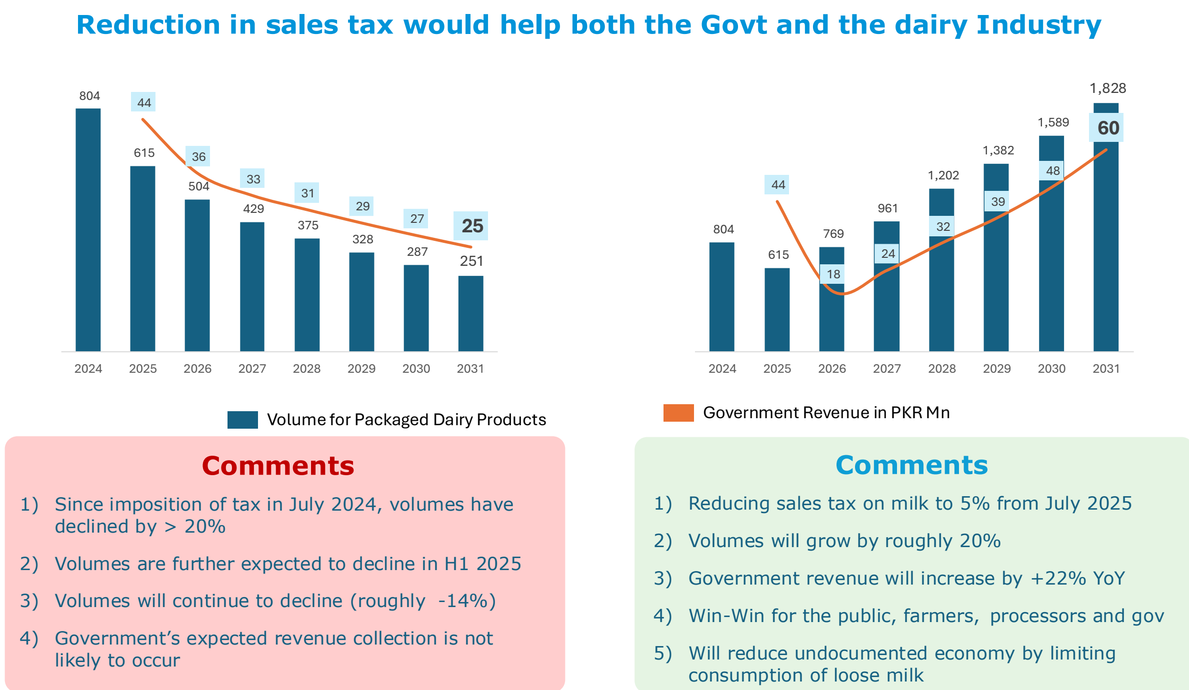

Figure 1: Impact of Sales Tax Reduction on Packaged Dairy Product Volumes and Government Revenue

Table 1: Cost-Benefit Analysis: Reducing Sales Tax on Packaged Dairy from 18% to 5%

Aspect	Costs of 18% Sales Tax	Benefits of Reducing to 5% Sales Tax
Impact on Dairy Sector	20% decline in packaged milk sales; closure of 500+ milk collection centers; processors operating below 50% capacity.	20% volume growth projected within the first year; revival of farmer procurement and dairy processing operations.
Impact on Farmers	Displacement of 40,000+ farmers; loss of PKR 1.3 billion/year in farmer support.	Restoration of milk procurement from farmers; stabilization of rural incomes and livelihoods.
Impact on Government Revenue	Shift of PKR 1.3 trillion to the untaxed informal sector; long-term erosion of formal tax base.	Sustainable expansion of formal sector and tax base; projected revenue parity with 18% rate by 2028.

Impact on Consumer Prices	Packaged milk price increased by PKR 60–70 per liter, making safe milk unaffordable for low- and middle-income families.	Lower packaged milk prices improve affordability for 64% of households earning under PKR 50,000/month.
Impact on Public Health	Increased consumption of unsafe loose milk (45% unsafe, 65% adulterated), leading to higher incidence of diarrhea, TB, and enteric diseases; higher healthcare costs.	Increased consumption of safe, regulated milk; reduction in disease burden and healthcare expenditure.
Impact on Investment	Abandonment of PKR 1.3 billion/year investment in farm and dairy infrastructure; stagnation of sector growth.	Revival of investments in farms, milk processing plants, and cold chains; strengthening rural economies.
Impact on Employment	20% layoffs in the dairy industry; higher rural unemployment.	Job recovery across dairy value chains; expansion of employment opportunities.
Impact on Exports	Loss of potential growth in dairy exports ($150 million/year opportunity under threat).	Strengthened competitiveness for dairy exports, especially to Pakistani diaspora markets.

Global Best Practices: Learning from International Examples

Pakistan's dairy taxation policy stands in stark contrast to global norms, as shown in Figure 2. Most countries recognize milk as an essential nutritional commodity and either exempt it from VAT/GST or apply a minimal rate between 0% and 5%. Countries like India, Bangladesh, Turkey, and Malaysia impose zero or nominal taxes on milk to promote public health and nutrition. Even in jurisdictions where food is taxed, milk is generally taxed at one-third or one-fourth the rate of other items. No country imposes a tax as high as 18% on milk. In fact, taxing milk beyond 10% is globally unprecedented. Pakistan's current tax rate thus deviates sharply from international standards and undermines the sector's competitiveness, both locally and globally.

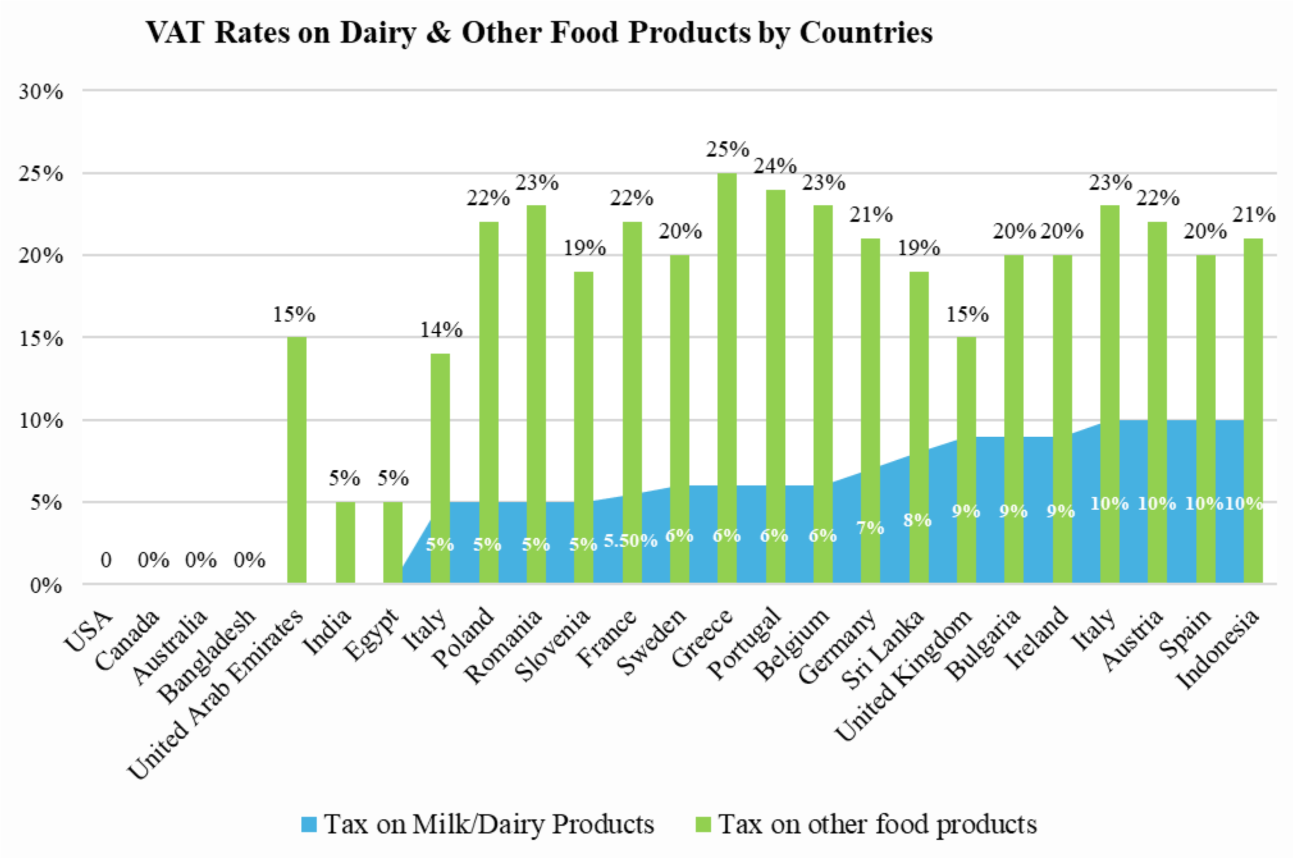

Figure 2: VAT Rates on Dairy & Other Food Products by Countries.

Understanding the Root Cause: Why the Hike Happened and Why It's Misguided

The government's primary rationale for the 18% sales tax was to enhance revenue by expanding the taxable base. However, this policy failed to consider the structural dynamics of Pakistan's dairy sector, which remains largely informal. Imposing a steep tax on the formal segment, which is just 8% of the total market, was akin to penalizing the only regulated part of the industry while letting the untaxed sector expand unchecked. Instead of increasing compliance, the policy triggered a reverse migration toward the informal economy. In effect, this move discouraged tax-paying entities and reduced the incentive to produce, process, and sell milk safely and legally. Furthermore, the abrupt shift from zero-rating to high taxation disrupted long-term planning and investment by major dairy players, resulting in loss of market confidence and operational cutbacks.

Consequences of Inaction: Risks of Continuing the Current Policy

If the 18% sales tax remains in place, Pakistan risks a cascading failure across multiple domains. Public health will continue to deteriorate due to increased consumption of unsafe milk. Healthcare costs will rise sharply, especially in rural and underserved areas where medical access is already limited. The formal dairy sector, a source of employment, investment, and food safety, will shrink further, potentially leading to the closure of major processing units. Farmer incomes will fall, deepening rural poverty and undermining the agricultural economy. Additionally, the opportunity to develop a robust export market, estimated to grow to USD 150 million annually, will be lost. In the end, the government may find itself with lower tax receipts, higher healthcare costs, and a weakened rural economy, all due to a policy that was poorly aligned with ground realities.

Towards a Balanced and Nutrition-Sensitive Tax Framework

The current taxation on dairy products overlooked the vital role that milk plays in rural livelihoods and public health. Since more than 90% of the industry is still unorganized, therefore high taxes on processed milk have exacerbated structural imbalances by discouraging formal businesses and hastening the transition to unsafe and unregulated milk. Since a significant amount of loose milk is discovered to be contaminated by bacteria or adulterated, this change will not only jeopardize efforts to improve food safety but also place a heavy financial burden on consumers and the healthcare system. The newly introduced taxation policy risks undermining both food affordability and access to safe, hygienic milk for low- and middle-income households. Equally concerning is its impact on dairy farmers' income security, as the added tax burden creates negative spillover effects on farm-level revenue generation. Therefore, lowering the GST to 5% on these goods would promote the expansion of the formal sector, improve food safety, and advance long-term financial and health goals. The sector's resilience would be further increased by complementary measures like funding for cold chain, infrastructure, equitable pricing for farmers, and incentives for clean production methods. Fiscal tools should be used to support a stable rural economy, a competitive export-ready dairy industry, and a healthier populace in addition to raising money.

Recommendations: A Path Toward Equitable and Sustainable Reform

To rescue the dairy sector and realign policy with public and economic interests, the government should urgently adopt the following measures:

- **Amend the Finance Bill 2025–26** to revise sales tax on packaged milk from 18% to 5%, recognizing milk as an essential food item critical to national nutrition and food security.
- Reclassify packaged milk as a "**nutrition-sensitive essential commodity**" under Pakistan's Tax Code, exempting it from high GST/VAT categories and aligning it with global best practices where dairy is taxed minimally or not at all.
- Conduct a formal **Government-commissioned Cost-Benefit Analysis (CBA)** comparing the economic and health outcomes of 18% vs. 5% taxation on packaged milk, factoring in revenue sustainability, healthcare savings, and rural livelihood protection.
- **Link dairy sector taxation policy with national public health goals**, such as reducing stunting (currently at 37% among children under 5) and improving maternal and child nutrition by increasing safe milk consumption.
- **Introduce conditional incentives tied to formalization**, such as reduced sales tax rates (5%) exclusively for dairy companies meeting safety, traceability, and compliance standards (e.g., registered milk collection, cold chain maintenance).
- **Implement a phased monitoring system for tax revenue growth**, where the government reviews sector performance annually, adjusting tax rates based on documented growth in the formal dairy sector and overall tax collection.
- Establish a "**Formal Dairy Sector Promotion Program**" under FBR and Ministry of National Food Security, with targets to formalize an additional 2–3% of the dairy sector annually through lower taxation, registration drives, and digital milk traceability systems.
- **Benchmark Pakistan's dairy tax policy with peer economies** (such as India, Bangladesh, Turkey, Malaysia) and document these best practices in an official whitepaper to justify the 5% taxation before Parliament and the public.

These measures would collectively enable sustainable sector growth, increased government revenues, and significantly improved public health outcomes.

Conclusion

Pakistan's dairy sector is at a critical juncture. The imposition of an 18% sales tax on packaged milk has inflicted harm across the value chain, from consumers and farmers to processors and public health systems. This policy brief presents a compelling case for reverting to a 5% sales tax rate, a globally aligned and economically sound decision that would restore balance, growth, and resilience to one of the country's most vital industries. Through rational taxation and inclusive reform, Pakistan can achieve its goals of fiscal strength, health security, and economic empowerment.

Way Forward

The path ahead demands decisive and timely action to restore growth, health security, and fiscal stability within Pakistan's dairy sector. Reducing the sales tax on packaged milk from 18% to 5% must be prioritized in the Finance Bill 2025–26 as a first and critical step. This tax reform should be accompanied by a structured sectoral strategy that emphasizes expanding the formal dairy market, ensuring public access to safe and nutritious milk, and incentivizing rural development through renewed investment.

A multi-stakeholder approach involving government bodies, industry associations, health experts, and consumer advocacy groups must be initiated immediately to build consensus around the benefits of this policy shift. Continuous monitoring of sector performance post-reform will be essential, including formal mechanisms to track milk formalization rates, investment revival, public health outcomes, and revenue collection trends.

By adopting a reduced, nutrition-sensitive tax policy and coupling it with supportive regulatory and investment frameworks, Pakistan can unlock the full potential of its dairy sector, safeguarding livelihoods, improving national health indicators, formalizing the economy, and ensuring long-term sustainable revenue growth.

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