Tapping into the Tobacco Industrial Profits

Understanding Tobacco Taxation in Pakistan

Waseem Iftikhar Janjua
Syed Ali Wasif Naqvi

Tobacco Control Policy Brief 3/21
Table of Contents
Definitions.............................................................................................................................................................................................................4
Overview ...............................................................................................................................................................................................................5
Challenges ............................................................................................................................................................................................................5
The Inevitability of Tobacco Taxation..........................................................................................................................................................6
Understanding Tobacco Taxation in Pakistan ..........................................................................................................................................6
Understanding the Economy of Smokeless/Chewing Tobacco (Naswar)......................................................................................8
Policy Recommendations................................................................................................................................................................................8
Conclusion .........................................................................................................................................................................................................10
References..........................................................................................................................................................................................................11
Tapping into the Tobacco Industry Profits – Understanding Pakistan’s Tobacco Taxation

Definitions

**Ad valorem Tax:** This tax is levied on selected products based on the value, such as retail selling price. Ex-factory of the tobacco industry’s price.

**Consumption:** This is the absolute quantity of tobacco products used in the aggregate.

**Exercise Tax:** Also referred to as Excise Duty, means the tax imposed on the sale or production of selected products including tobacco products.

**Forestalling:** Stockpiling the tobacco product just before the likely increase in the budget, usually done by the tobacco industry to allow the continuous sale of cheaper cigarettes even after an increase has been announced in the budget.

**General Sales Tax:** Based on the retail price this form of tax is imposed on a variety of products.

**Import tax:** Also referred to as the Import Duty levied on the imported products. The current rate of Import Duty was enhanced from 65% to 100% in the 2020-21 budget (Hayat, 2020).

**Mixed or Hybrid Tax:** It includes a specific as well as ad valorem tax component.

Share of the Excise Tax in Retail Price: It is the percentage of the retail price of a tobacco product, including all the relevant taxes, and is accounted for by excise tax on the product.

**Specific Excise Tax:** This tax is based on the quantity of the product, such as the number of tobacco sticks or the weight of tobacco.
Overview

Tobacco taxation is the most effective way to control the spread of tobacco use and reduce demand for it (WHO, 2019). Governments in low-middle income countries face a serious dilemma in earning revenue without annoying the high taxpayers such as the tobacco industry. The government in Pakistan, also burdened by the public pressure, finds it politically challenging to implement new taxes, and is revenue starved. The situation gets further compounded by the fears and sometimes ill-founded claims by the tobacco industry, for example, excessive restrictions on tobacco industry resulting in unemployment, expanding uncontrolled illicit/illegal/smuggled cigarettes market, burden on the national economy, and consequent unfair burden on poor. Contrary to these claims, tobacco taxation has been used around the globe as the most appropriate tool for utilizing the earned revenues to meet issues such as health burden.

Tobacco Industry claims to be one of the largest, tax contributors in Pakistan – a claim made by pharmaceutical, cement, fertilizer, and beverages industries as well. Literature shows that raising the tobacco tax is the most cost-effective way for reducing tobacco use. Over 100 studies, including a significant number of studies from the Low and Middle Incomes Countries (LMICs), clearly demonstrate that tobacco taxes are a powerful tool for the reduction in tobacco consumption, simultaneously providing for a steady stream of revenues for the government (Chaloupka, Yurekli, & Fong, 2012).

Yet another study involving 490 million male smokers from 13 LMICs revealed that an increase in tax causing a price increase of 50%, would result in 67 million men quitting smoking (Consortium, 2018). The study further revealed that 449 million years of life would be gained across all participants, and the health and financial gains for the poor will be 20% more as compared to the wealthy participants of the study.

A study done in Pakistan by Burki et al. (2013) contends that in a suggested uniform specific tax that accounts for 70% of the cigarette price, is instrumental in the reduction of 7.5% consumption, simultaneously adding Rs. 27.2 billion in the national exchequer as tax revenue. Such pricing–tax relation leads to 500,000 users quitting, resultantly saving an estimated 180,000 deaths and preventing another 725,000 new smokers (especially youth) from taking up smoking. In this vein, this brief is aimed at understanding the current tax system in Pakistan and making recommendations for an efficient yet robust tax regime.

Challenges

Pakistan faces multifaceted challenges concerning taxation. Tobacco taxation related problems include: (1) tobacco industrial pressures (both domestic as well as multinational tobacco industries trying to sell more of their products, make profits, and blame each other for tax evasion); (2) lack of resolve/implementation measures required for ensuring due tax is paid between the crop and the point–of–sale; (3) blaming the illicit/illegal/smuggled market; (4) revenue pilferage at collection point (done by the tax collection authorities, resulting in loss of valuable exchequer); (5) the government is constrained by the desire to collect more revenue, but the institutional (technical and human) infrastructure may not be fully supported; (6) lack of technical, human and administrative capacity at FBR could be another source of frustration; (7) there is a need to have a simple taxation system to avoid tax evasion, and generate taxes in a sustained manner; (8) FBR, aims at collecting a given target amount of taxes, however, due to some unavoidable circumstances they achievement might fall short of the target, and finally; (9) smokeless tobacco industry (including snuff/snuss, naswar, gutka, paan and other chewing tobacco products) market is completely unregulated and unaccounted for taxation.
One of the repeated arguments made by the tobacco industry is the loss of jobs in farming and manufacturing due to increased tobacco taxes, which could exert further pressures on the government’s promises for job creation. To the contrary, Pakistan Tobacco Board, which is responsible for promoting tobacco, estimates almost 150,000 people related directly and indirectly to the tobacco including vendors. Further, CTFK (2013) data shows that very few Pakistanis are involved in tobacco related employment, both in agriculture and manufacturing. The farming accounts for 0.4-0.5% of overall agricultural employment, while only 0.1% are associated with the manufacturing of tobacco products. Similarly, WHO FCTC Article 6 and its guideline, show that there is either no net impact on employment or, more likely it will increase in a small number of jobs, for example in monitoring segment and other sectors. Detailed research is needed looking into tobacco crop diversification programs, that support farmers and training focusing on alternate jobs could be funded by the tobacco revenue.

The Inevitability of Tobacco Taxation

Consistent with the national taxation, provisions of the WHO Framework Convention on Tobacco Control (WHO FCTC), contend that effective tobacco taxes not only decrease multiple externalities through reduced consumption and prevalence, but also contribute to the reduction of government’s expenditure for the health care costs directly attributable to tobacco consumption. FCTC Article 6 and the guideline thereof further point to the tobacco use responsible for increasing economic burden significantly, higher health costs, higher indirect costs associated to the premature loss of life, disability due to tobacco-associated diseases, and loss in productivity.

WHO study reveals that raising the tax to account for at least 70% of the retail price has multiple benefits: (1) it leads to significant price increase; (2) induces quitting; (3) prevent new users to start smoking; (4) decrease in several forms of cancer and tobacco-related deaths; (5) improved national health; (6) generate a significant increase in tobacco tax revenues, and; (7) with price elasticity at play, prevents brand-switching. It is however important to note that the chances of ‘quitting’ are more in the case of low-income individuals, while brand-switching is a possibility among high-income individuals. Therefore, such consistent steps help the government lower the health cost (by increasing the number of quitters) and generate extra revenue through stringent measures and implementation. The government also needs to increase taxes in-line with inflation and an increase in real income. The evidence shows that in LMICs smoking increases with the rise in income. National research on this issue is scant in Pakistan and there is a need to study this aspect through locally collected scientific and empirical evidence.

In these trying economic environment and COVID-19 pandemic, when the health system is operating at maximum capacity and is chocked to the brim due to increasing cases, Pakistan needs to develop a comprehensive and long term tobacco taxation policy that promises to have four outcomes: (1) fosters reduction in consumption through high taxation; (2) as a result of reduced consumption seek improved public health; (3) generating enough revenues to cater for budgetary shortfalls for sectors such as health, tobacco control, and education; (4) develop policy in line with the SDGs 1 and 3 and; (5) plan effectively for long term revenue generation and utilization through a sustained taxation policy.

Understanding Tobacco Taxation in Pakistan

Multiple taxes are levied on tobacco products around the globe. However, ‘excise tax’ is the best and time-tested tool which ensures that tobacco product prices are increased relative to other commodities, goods, and services, and can best be utilized to meet health costs. Single-rate specific taxation is ideally suited to raise the price of tobacco products such as cigarettes and reduce the share of cheap brands. For example, if the prices of two packs of different cigarette brands are Rs. 50/- and Rs. 100/-, single-rate increase of Rs. 50/- per pack would mean that the
new prices of the same brands would be Rs. 100/- and Rs. 150/- respectively.

The second, ad valorem tax or Value Added Tax (VAT) is also an effective tool to collect revenues, but this will have minimal effect on the rate of tobacco consumption. VAT, by definition, is a tax imposed at different rates depending upon the stage of processing. For example, as the tobacco is received at Green Leaf Thresher (GLT), it could be taxed, as it goes to the manufacturing unit and is shaped into a cigarette, it could be taxed again, since the value has been added to it, and third possible place of taxation could be the point of sale. However, this is not the most appropriate method to ensure a reduction in consumption, because the tax increase at the point of sale will be a much smaller part of the overall increase in VAT, and the customers can afford to pay, make brand shifts, besides tobacco industry evading this through forestalling. The selection of any one of the above would depend upon the target revenue. However, for long term benefits, single-rate specific taxation is ideally suited for a country like Pakistan.

Simplicity is also important in the taxation system to keep the lower monitoring costs, prevent tax avoidance, and ensure sustained revenues. Tax avoidance includes illicit trade and illicit production, it may involve genuine and counterfeit products. Very high taxes induce smuggling, especially when enforcement is weak or is absent, penalties are less and justice is delayed. In Pakistan, the penalty for violating tobacco laws is Rs. 10,000 across the board (including for a retailer, wholesaler, and a manufacturer) with an additional possibility of two years as a jail term. Such weak and unjust penalties generally turnout to be ineffective and counterproductive.

Tobacco taxation literature shows that increasing tobacco-product taxes increases tax revenues over the short to medium term. Tax constitutes a small percentage in the price of the product, and therefore increase in tax will have a lesser percentage of people quitting. Many countries around the world have used increased tobacco revenues to fund tobacco control research, activities, health promotion activities, and health-care systems. In Pakistan a tiered system of taxation is followed for revenue collection. The reason for the implementation of the three-tier system, as argued by the FBR was instituted for curbing counterfeit production. Health officials and tobacco control experts disagreed with this as it did not help in reducing consumption and also resulted in loss of billions in tax evasion (by tobacco industry). Most significantly, introduction of third-tier, without a ban on product-tier shifting by the tobacco industry, resulted in increased production, enhanced sales, and consumption, and loss of revenue, because the popular brands were moved from higher tiers to lower tier.

For understanding purposes, for example, if a pack of cigarette was priced at Rs 85/- in January 2017, its price was increased to Rs 90/- in June 2017. This gave a false impression that with the price increase revenues will go up. By the creation of a new tier, the same pack of cigarette fell into the second tier from the top tier, causing a reduction in revenue to Rs. 33.4/- per pack, as compared to Rs. 68.72/- per pack (charged under the two-tier system). Consequently, due to the introduction of the third tier in the tobacco taxation regime, the revenues fell from Rs 114.27 billion in 2015-16 to Rs 83.76 billion in 2016-17 (Reporter, 2019). Moreover, according to the statistics in 2017-18, the profits of Philip Morris (manufacturers of Marlboro) went up by 160% and Pakistan Tobacco (subsidiary of British American Tobacco), increased by 105% as per their financial statements. The tobacco market is highly and disproportionately concentrated in two companies: Philip Morris and the British American Tobacco. Total cigarette production during 2017-18 was around 83 billion sticks, and in the break-up of market share multi-national companies traded 96 to 98 percent of the total market while the local industry share was between 2 to 4 percent (CTFK, 2013). This also refutes the tobacco industrial claims of a 40% share of smuggled/counterfeits. For taxation purposes, the third tier was abolished and Pakistan reverted to the tow-tier system in 2019 (Group, 2019).
Tobacco taxation is closely related to the most desirable e-tracking system. In Pakistan, it will be the first step at the industrial level to gauge production in potentially tax-evading sectors, where production is hidden and minimized to evade taxes at the manufacturing level. The Request for Proposals (RfP) for tax stamps was first issued in 2007 by the FBR and was intended to focus on sugar, beverages, cement, fertilizer, and tobacco industries. This concept of this Track & Trace System encompasses semi-visible high quality security features on the tax stamps. Such stamps will incur minimal costs to the government of Pakistan, as the cost will be reimbursed through a minor price increase. These stamps need to be installed at the manufacturing units and would be monitored remotely as well on-site. On the farming side of the tobacco crop, the system needs to gauge the exact amount/extent of production that becomes usable. In the case of tobacco, this can best be monitored at the Green Leaf Thresher (GLT) sites. There is a total of 10 GLTs in Pakistan and all 26 tobacco manufacturers buy from these GLTs. Four GLTs in Khyber Agency have yet not been regularized but will add to existing known GLTs after FATA’s merger in KPK. Such a system is ideally suited for Pakistan to be installed at all production sites (GLTs, cigarettes, smokeless tobacco, and ports of entry), besides all production, manufacturing, and points of sale.

**Understanding the Economy of Smokeless/Chewing Tobacco (Naswar)**

SDPI has already published a micro level analysis of the tobacco increase on the chewing tobacco popularly referred to as naswar (see e.g. Naqvi, 2019). The culture of chewing tobacco use is fostered and perpetuated by the complete informality of the economic environment. The manufacturers, mostly grow or buy the cheap quality tobacco and process the product in small household facilities, supplying and selling in non-standardized plastic pouches. These attributes make naswar as the cheapest sold intoxicant. Absence of any regulations (no taxes, no Graphic or Pictorial Health Warnings, no ban on advertisement, no ban on point-of-sale display, etc.) make a pinch carcinogen of choice.

The same study by SDPI calculated that an average pack of naswar offers almost 21 pallets/pinches per pack and weighs almost 43.6 grams. The average cost is set at Rs 76.50 per KG and at a retail price of Rs 10/- per pack, 23 packs (in one KG) are retailed for Rs. 230/-. This shows an average per KG profit of more than Rs 150/-. Adding the low cost labour and other additives in manufacturing, and mass production, the cost per KG, if assumed as Rs. 100/- the gross profit stands at for Rs. 130/- per KG. As per the Tobacco Board statistics, almost 4000 million KGs of tobacco was used for production of naswar during 2017-18. When sold at the estimated profit, naswar industry is earning more than Rs. 520 billion in untaxed profits per year (Naqvi, 2019). The importance of taking the naswar industry under the taxation regime cannot be over emphasized. The health burden caused by using naswar such as oral cancer is cared for by the national health system, without any contribution from the profiteers.

**Policy Recommendations**

1. Policy guidelines provided by the WHO FCTC need to be implemented in letter and spirit as Pakistan has been the signatory to the Convention since 2004. Tobacco tax policy in Pakistan should follow a simple, yet efficient system to meet the public health as well as fiscal needs. Taxation is contextual and the circumstances vary between all countries and care needs to be exercised in implementing the tax policies based on the regional or global researches and interventions.
2. The taxation policy can follow the specific or mixed excise system with a minimum stipulated floor tax, as this system houses significant advantages over the pure ad valorem system of taxation.
3. In setting the tobacco tax levels, efforts should be made to focus on the final retail price rather than the tax rates. In this regard, the WHO (2010) in the Technical Manual On Tobacco Tax Administration recommends that tobacco excise taxes should account for a minimum of 70% of the retail price. A higher share of the taxes in
the price will discourage smoking initiation, and prevent the tobacco industry from tax evasion. A World Bank report suggests that the annual rates of excise tax increase in Pakistan should at least be 30% for the lower tier and 15% for the higher tier, which will ensure the reduction in consumption and growth in tobacco revenue (Group, 2019).

4. Pakistan needs to establish a long-term coherent policy on the structure of tobacco taxation and monitoring. Taxes need to be revised on yearly basis including the target tax rates. The target MUST include the cost of the health burden on the national exchequer.

5. The tax system needs to be designed in a way that minimizes the incentives for smokers to shift to the cheaper product in a similar category or to a cheaper brand. This step would also entail strict implementation of a tax regime on the local manufacturers and stringent measures against the smugglers.

6. The Track and Trace System (when in place) must include taxation from the Green Leaf Threshers to warehouses, from warehouse storage to the manufacturing facility, from production to retails, and at the point-of-sale. End-to-end monitoring can best be ensured by Track & Trace and tax-stamps.

7. Effective measures to forestall any release of excessive tobacco products (from the tobacco industry to the wholesalers/retailers) just before the annual budget. This will prevent the sale of cheaper cigarettes even after the increase in tax/price announced in the budget. This will also include the Track & Trace system to levy the taxes on the tobacco products held by the tobacco industry at warehouses/storage.

8. The tobacco taxation system needs to be made simple and effective. A comprehensive taxation assessment monitoring and evaluations system (TAMES) needs to be developed and incorporated. This will ensure an increase in tax revenues and a decrease in consumption, a decrease in illegal trade, and curb counterfeit tobacco in the market.

9. FBR should initiate the Track & Trace System and tobacco product in every form (both smoking and non-smoking) bear a tax stamp. Such tax stamps need to be added to the tobacco bales at GLTs and cigarette packs and non-smoking tobacco at the manufacturing sites, besides ports of entry for legally imported products.

10. As suggested by SDPI (Iftikhar & Naqvi, 2021), the cheapest and most effective way to follow for Pakistan is an award of Government-to-Government consultation and contract for implementing effective tobacco Track & Trace.

11. Placement of Tax Stamps on a pack of cigarettes is another contentious issue and, in this regard, Pakistan’s international treaty obligations (FCTC and its guidelines) must be kept in mind. The placing of stamps should be on the side of a cigarette pack, and the space for pictorial and textual WARNING should at no cost be compromised.

12. Taxation policy must include the same stamps at the port of entry to be purchased and placed by the importer. As recommended by the FBR, such tax stamps need to contain multiple semi-visible security features.

13. Need to include a tax on imported e-cigarettes and smoking devices such as Juul etc. The E-cigarette market in the US alone is likely to reach $ 44 Billion by 2024. It would be naïve to think that such devices will not make it to low and middle-income countries such as Pakistan. These electronic smoking devices are being imported after paying the duty, however, they are not being regulated at the point-of-sale.

14. Small tobacco manufacturers in Kashmir and some other parts of the country should be brought under the same tax regime. Any gaps left (such as tax exemption) would make the entire exercise futile and hard to implement.

15. One of the most significant yet neglected area of naswar regulation (including taxation, graphic health warning and track and trace), needs to be brought into policy formulation in an urgency. Although it is a cultural taboo, yet this multi-billion rupees profiting industry cannot remain unnoticed and untaxed.

16. The tobacco taxation policy should include robust implementation through multiple penalty brackets. Any smuggled or counterfeit product being manufactured, imported, or found in the market should be confiscated
and those responsible should be fined an amount commensurate to the quantity recovered and the size of the business violating. Such penalties should ensure deterrence and rates should vary between shopkeepers, wholesalers, and manufacturers.

17. Laws prohibiting the sale and import of tobacco products by international travelers and ban on the sale of tax-free tobacco products on the Duty-Free stores on the airports/ports of entry.

18. Article 26.2 of the WHO FCTC encourages all signatories to dedicate a specific portion of the tobacco revenue for tobacco control programs. These programs could include raising awareness through advocacy regarding health promotion, disease prevention, cessation services, economically viable alternates, tobacco control structures, and training of those involved in tobacco taxation and control.

19. All the above-mentioned recommendations will be counterproductive if the requisite powers are not granted to the tax officials, after their appropriate training. The initial phase of the process will entail extra measures. However, in the long run, the system of reporting and enforcement will prove to be an asset for the national exchequer. In this regard, SDPI can play a pivotal role through fully qualified Trainers, always forthcoming to support the governmental initiatives at the national and provincial levels.

Conclusion

Pakistan is one of the top ten countries in tobacco consumption. Multinational and local tobacco industries continue to earn millions and in the process damage health, increase the burden of disease in the already fledgling health system of the nation. Pakistan needs to develop long term sustainable taxation policies. Although taxes are levied on tobacco products in almost every budget, yet the tobacco industry finds ways to evade taxes. As mentioned above chewing tobacco is one of the least attended, most neglected domains which continues to defy all attempts at regulation. Ironically the profits (over 520 billion per year), go to the individual pockets, without benefitting the state, yet the entire brunt of health burden caused due to naswar, continues to choke the health system. There is an urgent (albeit extremely unpopular) need to bring naswar and all other forms of chewing tobacco under regulatory and tobacco control regime.

The recommendations made in this policy brief need to be considered in spirit both at federal as well as provincial levels. Multiple loopholes need to be plugged and the implementation process needs to be made robust for healthy revenue generation. Tobacco tax revenues need to be judicially distributed with a focus on supporting the health system. COVID-19 has pressurized the national health system and smokers must find sufficient deterrence in the studies carried out, showing a relationship between tobacco consumption during the pandemic. The tobacco industry in Pakistan continues to find ways to enhance business through the innovative use of technology necessitating a stringent tobacco control regime and taxation (Iftikhar & Naqvi, 2020). The deadly impact of tobacco industry practices has been noticed and reported by the SDPI (cf Janjua, 2019; Janjua & Naqvi, 2019, 2020; Naqvi & Janjua, 2019, 2020).
References