

Policy Brief # **61**

**Pre-Budget 2018-19 Policy
Brief:**

**Govt. Kitty Vs Public Health –
The Case of Reduction in Prices
of Cigarettes in Pakistan**

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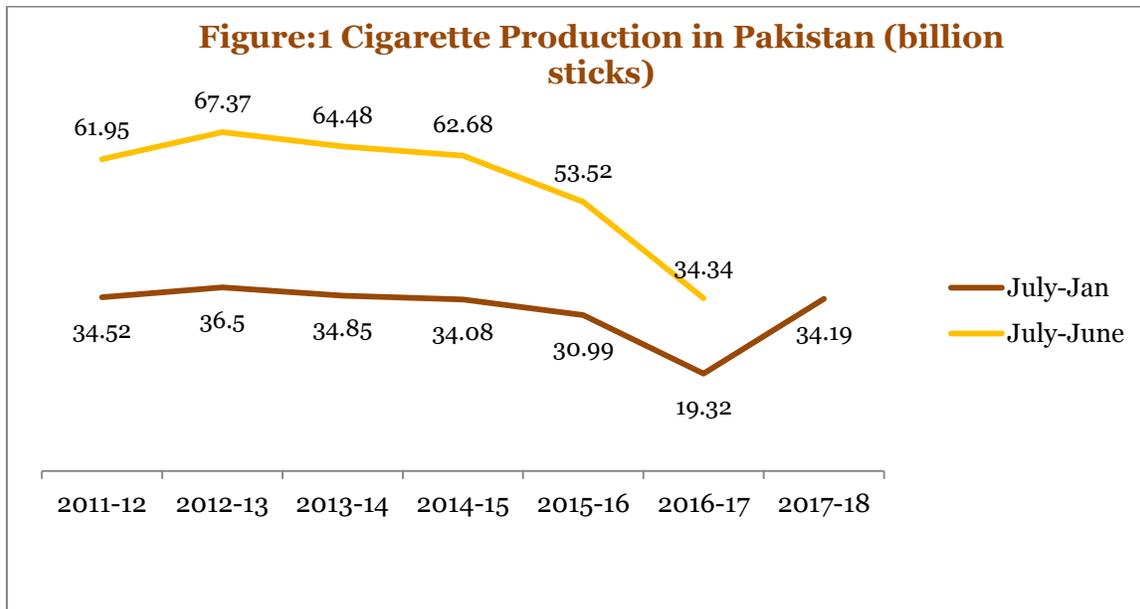
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Pre-Budget 2018-19 Policy Brief

Government Kitty vs Public Health: The Case of Reduction in Prices of Cigarettes

1. (i) Cigarettes are the most commonly used medium for tobacco consumption. Annual cigarette consumption in Pakistan is around 86.7 billion sticks¹ (49 billion in 1997²). Annual local production averages above 57 billion sticks³.



Source: Quantum Index of Large Scale Manufacturing Industries (QIM), Pakistan Bureau of Statistics

- (ii) Rest of the demand is predominantly met by illicit market of cigarettes which is a grave concern for legitimate cigarette industry. State Bank of Pakistan has identified that tax evasion in cigarette sector generally takes place in one of the following three forms⁴:
- a- On import for the commercial use (also known as International Transient Brands) on which applicable taxes include duties, excise and sales tax. These products may have had no taxes paid on them at all, or may have had lower taxes paid.
 - b- The undeclared local production or Duty-Non-Paid (DNP) whereby products are produced and consumed but without the payment of local taxes. These products may be manufactured in approved factories but not declared to the authorities, or these may be manufactured in an informal setup.
 - c- The third is counterfeit products which are also an infringement of Intellectual Property Rights (IPR). These products are identical or near identical copies of a genuine branded product. By definition such products are illegal, as the manufacturer is not authorized by the brand owner to use the counterfeited brand assets. Counterfeits may be produced for the local market or exported.

¹ Oxford Economics, Asia Illicit Tobacco Indicator

² Euromonitor International, 2012

³ Last seven years average calculated from data of Pakistan Bureau of Statistics.

⁴ State Bank of Pakistan's First Quarterly Report for Fiscal Year 2017.

2. (i) Data of volume of illicit trade has two major sources i.e. tobacco industry and independent third party source. Historically, the data has had been reported by the tobacco industry itself by using the retail’s audit data. They report that during the six years period 2008-13 the illicit trade had witnessed a growth of 43.5%⁵. And in June 2017, **peak level 41.2%** cigarettes were being sold illegitimately⁶. With the increase in illicit trade, the estimated government’s revenue loss from illicit trade had reached PKR 62 billion in 2016 from PKR 27 billion in 2012⁷.
- (ii) This high figure of illicit trade was used by tobacco industry to strengthen its case for the introduction of 3 Tier FED structure. With introduction of 3rd tier, the prices of cigarettes dropped and consumption increase. These trends prompted independent studies to assess the volume of illicit trade in Pakistan. One recent study - commissioned by Pakistan National Heart Association and Human Development Foundation⁸ and launched on 5th April 2018 - has come up with a finding that the **volume of illicit trade is not more than 9%**. That study used the retail data only for selection of its study locale. But it conducted a very robust sample collection on its own. That is why one is convinced that the volume of illicit trade reported in that study is closer to the reality.
3. According to Tobacco industry, the increase in Federal Excise Duties during past few years raised price differential between legally and illegally traded cigarettes⁹. As a result, legitimate industry lost its market share to the illicit one, also causing loss to government revenue as explained in Para 2(i) above. To increase its revenue and reduce illicit trade, Federal Govt. introduced a three tier FED structure in the Finance Act 2017 as explained in the table below:

Table:1 FED Structure for Cigarettes

Tier	Price per pack (in Rs.)	FED per pack (in Rs.)
Previous rates		
Period: 01 July 2016 to 30 Nov 2016		
1	More than 80	68.72
2	Up to 80	30.68
Period: 01 Dec 2016 to 29 May 2017		
1	More than 88	74.10
2	Up to 88	32.98
Current Rate		
Period: 30 May 2017 to till date		

⁵ Pakistan Tobacco Company, Annual Report 2015.

⁶ Pakistan Tobacco Company, Annual Report 2017.

⁷ Oxford Economics, Asia Illicit Tobacco Indicator

⁸ Ross, H., Islam, Z.U., Aftab, S., Janjua, J. 2018. Study to Assess the Volume of Illicit Cigarette Brands in Pakistan. (This study has been technically guided by Tobacco Control Cell, Ministry of National Health Services, Regulation and Coordination.)

⁹ Phillip Morris Pakistan Limited, Financial Statement of the Period Ended September 2017

1	More than 90	74.80
2	More than 58.5 up to 90	33.40
3	Less than 58.5	16.00

Source: KPMG¹⁰

4. (i) While enacting the revised FED structure in 2017, the Federal government didn't put any restriction on transfer from Tier 2 to Tier 3. However, there was a restriction on transfer from Tier 1 to Tier 2. Before the 2017 change there were plenty of cigarettes which had retail price slightly above or below the threshold limit to fall in the Tier 3. This allowed the cigarette manufacturers to conduct their business operations within the third tier.

Table:2 Retail Prices of Various Brands Before Three Tier FED

Brand	Retail Price in 2017 before introduction of 3 rd Tier
Red&White KSF	Rs. 62.25
Morven	Rs. 62.25
Diplomat	Rs. 58.1
Capstan	Rs. 61.53
Embassy	Rs. 57.26
Gold Flake	Rs. 61.53

Source: The Consumer Network (2017)¹¹

The above table indicates that two brands were already being sold within the 3rd tier threshold price. Other brands would have to be brought down just 2-3 rupees to bring them in 3rd tier and reduce the chargeable FED by 50% from Rs 33 to Rs. 16.

(ii) It is noteworthy to mention here that under Finance Acts of 2016 and 2015 a restriction on mobility from one tier to the other was placed. Moreover, media reports highlight the fact that information about tax cut was leaked to tobacco industry four days before its announcement. The dealers were given directives to finish the stock of cigarettes falling in the price of 3rd Tier (that was not announced by then) urgently. This issue was recently raised by Pakistan National Hearts Association in the meeting of Standing Committee of National Health Services, Regulation and Coordination¹².

5. In addition to introduction of 3rd tier, FBR also set up Inland Revenue Enforcement Network (*IREN*) to launch a blanket crackdown against the tax evaders, cigarette smugglers and counterfeit cigarettes. *IREN* confiscated 1.63 billion illegal cigarette sticks last year which roughly amount to 20% of the overall 9% illicit trade volume of 7.083 billion cigarettes.
6. Moreover, a withholding tax of 5% was also levied on the tobacco purchasing to monitor the tobacco value chain for illicit trade. That tax has to be collected by Pakistan Tobacco Board at the time of collection of tobacco development cess.

¹⁰ KPMG, 2017. Budget Brief 2017: An Economy and Tax Commentary

¹¹ The Consumer Network of Pakistan. Tobacco Taxation in Pakistan

¹² The Dawn. 2018. Govt. told to look into the leakage of information about cut in Tobacco Tax. Published on 9th April 2018.

7. (i) Two questions at hand are that did volume of illicit trade declined and did the government revenues increase in the FY17-18 with introduction of 3rd Tier? Recent data of tobacco industry indicates that some positive progress has been made regarding the former but not regarding the latter.

(ii) Illicit trade declined by 6.5% from 41.2% in June 2017 to 34.7% in December 2017¹³. Cigarette production during the three month period from Jul-Sep 2018 increased by 92% as compared to previous quarter. During seven months period from July 2017 to January 2018 it witnessed a growth of 77% as compared to the same period last year (SPLY). This increase has brought the cigarette production at the average output level as also shown in the Figure 1 above.

(iii) Two leading companies having a collective legitimate market share of 98%¹⁴, Pakistan Tobacco Company (PTC) and Phillip Morris Pakistan Limited (PMPL) witnessed a sharp rise in their gross turnovers/sales volume after the price reduction triggered by 3 Tier FED structure. Sales volume of PTC picked up 23% in 3rd quarter of year 2017 as compared 2nd quarter. The sale volumes of PMPL also rose during the third quarter of 2017 which are reflected in a Profit Before Tax of Rs. 786 million as compared to Loss Before Tax of Rs. 881 million during SPLY.

(iv) The excise duty paid by PTC and PMPL also reflect interesting trend. During the 3rd quarter (post introduction of 3rd Tier) Gross Turnover of PTC increase by 6%¹⁵. However, the FED paid by PTC declined by 2% in quarterly comparison. PMPL witnessed a growth of 41% in its gross turnover in quarterly comparison. But its FED payments rose by only 17%¹⁶.

Table: 3 Comparative Analysis of Excise Duty and Gross Turnover of Market Leaders

Two Leading Tobacco Companies	Excise Duty Paid (Rs. Billion))		Gross Turnover (Rs. in Billion)	
	Three Months Ended		Three Months Ended	
	30-Sep-17	30-Jun-17	30-Sep-17	30-Jun-17
Pakistan Tobacco Company	13.002	13.301	30.184	28.448
	(2% Decrease w.r.t. Previous Quarter)		(6% Increase w.r.t Previous Quarter)	
Phillip Morrison Pakistan Limited	3.210	2.728	9.057	6.420
	(17% Increase w.r.t Previous Quarter)		(41% Increase w.r.t Previous Quarter)	

Source: Financial Statements of PTC and PMPL for the Periods Ended June 2017 and September 2017.

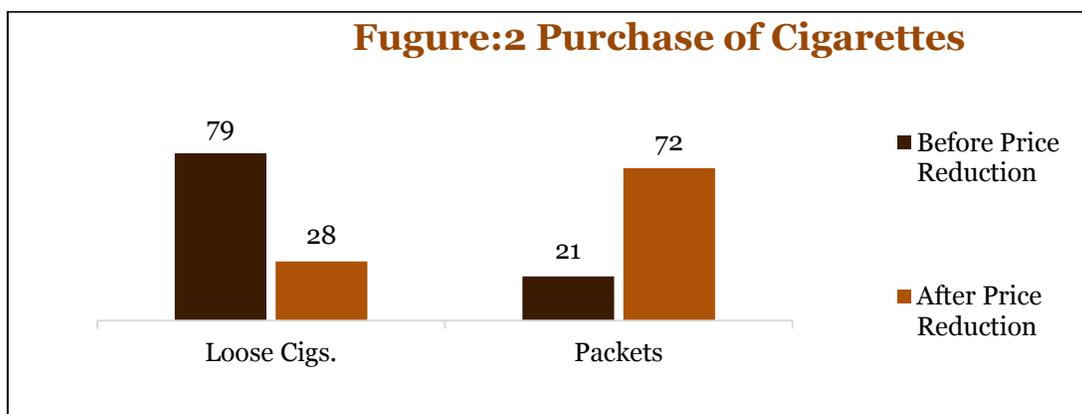
¹³ Pakistan Tobacco Company, Annual Report 2017.

¹⁴ Burki *et al*, 2013. The Economics of Tobacco and Tobacco Taxation in Pakistan. Paris: International Union Against Tuberculosis and Lung Disease.

¹⁵ However, the sales volume had picked up 23%. This shows that picked up sales were made at lower prices.

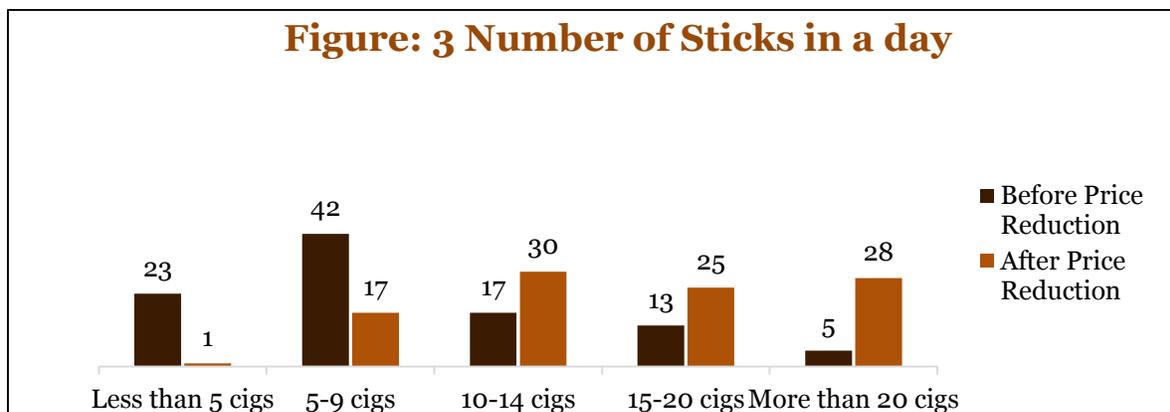
¹⁶ According to some unpublished work, FBR Revenue increased by 11% after introduction of 3rd Tier. But there was a 'deadweight' revenue loss of Rs. 11 billion because the increased sales were made at lower price and FED rate. Had the same volume of sales been made at pre-3rd Tier prices and FED rate, the exchequer would have earned an extra Rs. 11 billion.

8. The introduction of 3rd tier has completely ignored the health burden on individuals and society which would grow because of reduction in prices it has brought along. With over 23.9 million tobacco¹⁷ users and 125,000¹⁸ dying every year because of tobacco induced diseases¹⁹, Pakistan is one of the developing countries with very high tobacco prevalence and mortality. Lung and mouth cancer have higher prevalence as compared to other forms and cancer. Both of these are etiologically linked with tobacco use because tobacco smoke is a mixture of gas and particles that contain over 4000 chemicals, 60 of which are known to cause cancer.
9. (i) It has been found that the reduction in price due to 3rd tier has actually resulted in purchasing and smoking behavior of the smokers. Before price reduction 79% of smokers used to buy loose cigarettes. After price reduction that number reduced to 28%. Instead they started buying packets. Before price reduction 21% were buying packets. But after price reduction, that proportion increased to 72%.



Source: Aftab Associates (2017)²⁰

- (ii) Smoking behavior witnessed an upward rise. Before price reduction, 23% smokers were smoking less than 5 cigarettes a day. But after price reduction that number declined to only 1%.



Source: Aftab Associates (2017)²¹

¹⁷ Global Adult Tobacco Survey, 2015

¹⁸ Tobacco Atlas, 2018. Pakistan Fact Sheet

¹⁹ The Tobacco Atlas, 5th Edition, World Lung Foundation: 2015

²⁰ Aftab Associates, 2017. Impact of Key Brands Price Change on Smoking Habits.

²¹ Ibid.

- 10- As compared to other countries, average price of a cigarette pack is significantly low. In the region, average price of cigarette pack is the lowest one in Pakistan.

Table: 4 Cross Country Comparison of Cigarette Price

Country	Average Price of Marlboro (in USD)
Pakistan	1.25
Sri Lanka	6.41
Saudi Arabia	6.4
India	3.08
Bangladesh	2.56
Iran	2.39
China	3.17

Source: Numbeo (2017)²²

- 11- What about the discrepancy in production data and the illicit trade volume data? In the Para 1(i) consumption and production figures have been reported. The consumption is 86.7 billion cigarettes per year. And official production figure is above 55 billion per year on average. The remainder, almost 41%, as claimed by tobacco industry is illicit trade. But the recent study referred to in Para 2(ii) asserts that the volume of illicit trade is not more than 9%. That study had set a six point criteria for tagging a cigarette pack as illicit.

Table:5 Volume of Illicit Cigarette Trade in Pakistan

Criteria	Number of Packs	% of Total Sample of 7,496 Packs
Packs that don't comply with pictorial health warning	717	9%
Packs that don't comply with textual health warning	274	3.44%
Packs with textual warning in foreign language	444	5.58%
Duty Free	46	0.58%
Packs that didn't have price printed on them	717	9%
Packs with GST not printed on them	717	9%

Source: Ross *et al* (2018)²³

This mismatch in data leads the author to question (not assert) that what if the legitimate companies under report their production figures to evade the FED and themselves selling some part of their production illicitly? This form of tax evasion comes under the 'undeclared local production category' as explained in Para 2(ii-b) above. They must be printing the warnings, price and GST. But the law enforcers couldn't differentiate whether the pack being sold in the market is duty evaded or not. Why would legitimate sector under report? To convince the

²² Numbeo, 2017. Asia: Price Rankings by Country of Pack of Cigarettes (Marlboro) (Markets)

²³ Ibid., 2

government about high illicit trade and then advocate for introduction of a subtle price reduction mechanism in the form of a tricky low FED regime designed to curb illicit trade and support government kitty.

12- Policy Recommendations

- (i) There should be policy coherence amongst various stakeholders. On one hand we have smoking promotion actors like Pakistan Tobacco Board which promotes tobacco cultivation or FBR which has protected local industry at the cost of increased smoking prevalence. On the other hand we have Ministry of National Health which recently banned the sale of loose cigarettes to minors to reduce the smoking prevalence. Actions by both are contradictory. What we need is a collaborative effort for phase wise reduction in smoking prevalence through price increase. The policy makers should decide in overall national interest, not just sectoral interests.
- (ii) Along with policy coherence, there should also be policy rationalism. Illicit trade is an issue of enforcement while taxation is a policy related matter. Thus, illicit trade should have been brought down through better enforcement not through reduction in prices of cigarettes. Instead of going for tax related measures, the focus should be on strong enforcement of laws that can address illicit trade. Success achieved by IREN should be replicated and up-scaled in the coming years.
- (iii) Considering the rise in smoking intensity due to price reduction brought about 3rd tier, the government should reconsider that policy. Some studies conducted earlier in this regard have recommended that a uniform high FED be imposed. But making the FED too high could further increase illegal trade of cigarettes and untoward behavior by regular smokers. That is why it is being proposed that the current FED structure should be reverted back to the old two tier structure. Along with it, the enforcement mechanisms like IREN should be further strengthened for containing the illicit trade.