Policy Brief

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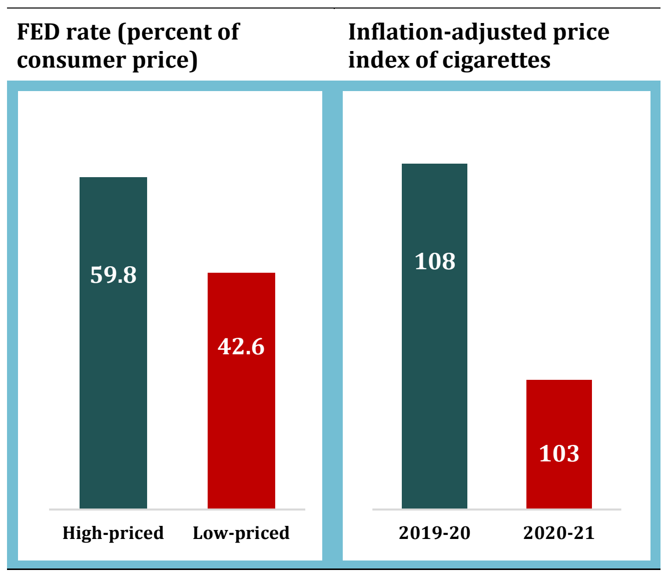
The Cost of Inaction: Implications of the Cigarette Tax Policy in Pakistan

Pakistan is a signatory to the WHO Framework Convention on Tobacco Control (FCTC), which requires the country to implement taxation and pricing policies on tobacco products to reduce their consumption. Effective tobacco taxation is considered the most effective means of reducing tobacco consumption and generating revenues for public health promotion. However, tobacco tax policies in Pakistan have not been able to achieve these objectives fully, and Pakistan remains a high-burden tobacco-use country where almost one in five adults (about 30 million individuals) use tobacco in some form.[1] Consequently, the prevalence of tobacco-related diseases is high, and tobacco use is associated with more than 160,000 deaths every year in the country.[2] In addition, tobacco use poses the substantial economic cost of tobacco-induced diseases. A recent study[3] has revealed that the health and economic costs of tobacco use are more than five times the tax receipts.

Domestically produced cigarettes in Pakistan are subject to two main taxes—Federal Excise Duty (FED) and General Sales Tax (GST)—in which the FED accounts for almost 80 percent of the revenue from the sector. The FED is the major cigarette tax, and is applied on two price tiers: low-priced and high-priced (or premium brands).[4] The FED rate structure favors the low-priced brands, resulting in a large excise tax gap between the two tiers. The excise tax rate on low-priced and premium brands is 42.6 and 59.8 percent of the retail price, respectively, which leads to a high price gap between the brands. For instance, current market price of a premium brand is 2.25 times higher than a low-priced brand. The price gap creates opportunities for smokers to find cheaper cigarettes.

The average excise tax share is 45.4 percent of the retail price, much lower than the widely-accepted benchmark of 70 percent.

The FED rates have not been changed since July 2019, making cigarettes cheaper and affordable due to a combination of two factors: no change in excise tax and increases in nominal income and inflation. The value of the inflation-adjusted price index declined from 108.4 in 2019–20 to 102.8 in 2020–21.

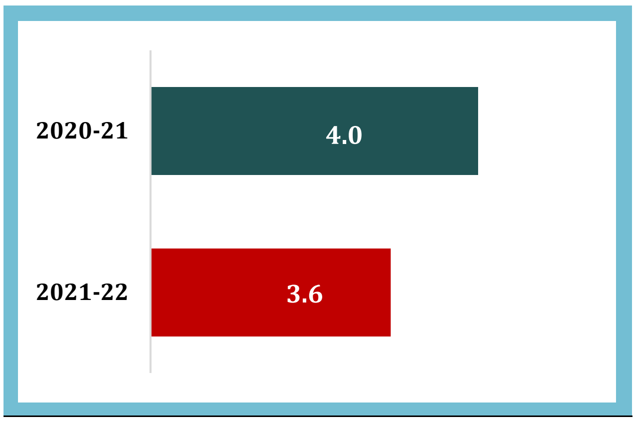


The policy of inaction would have profound negative implications regarding tax revenue and health outcomes.

Given that the tax rate has not changed for the last two years, it was expected that the government would enhance the FED rate in the fiscal year 2021–22. However, the Finance Act 2021 passed by the National

Assembly on June 30, 2021 remained silent on this subject. This will make cigarettes cheaper in 2021–22 if the ex-factory prices are not increased, which is more likely because these prices had not changed since July 2019 when the FED was increased. Therefore, cigarettes would become more affordable. The estimates show that about 4 percent of per capita income was required to purchase 2000 cigarettes in 2020–21, which would decline to 3.6 percent in 2021–22.

Percentage of per capita income required to purchase 2000 cigarettes in Pakistan



This policy of inaction would have profound negative implications on tax revenue and health outcomes as estimated by SPDC through a tax simulation model.[5]

The estimates are based on three scenarios:

1. No change in FED
2. 30 percent increase in FED rate
3. 20 percent increase in FED rate (to keep the affordability at the 2020-21 level)

The results show that no change in FED would result in 232,000 more smokers and 81,000 more smoking-attributable deaths of adults in Pakistan during 2021–22 while having marginal gains in revenues (Rs 5.8 billion) due to a 4.4 percent increase in cigarette consumption/taxable sales.

No change in the FED would result in 232,000 more smokers and 81,000 more smoking-attributable deaths of adults during 2021-22.

In contrast, an increase of 30 percent in the FED would result in additional revenue of Rs 30 billion, 220,000 fewer smokers and 77,000 lives saved. Similarly, the constant affordability scenario (20 percent increase) would lead to additional revenue of Rs 34 billion but would have relatively low health benefits—79,000 fewer smokers and 27,000 lives saved.

Tax Increase and Illicit Trade

Although research evidence demonstrates that tobacco taxes have no substantial impact on the illicit trade of cigarettes, the cigarette industry in Pakistan frequently claims that higher taxes encourage illicit or undocumented trade as smokers seek out non-tax-paid cigarettes because they are cheaper. Even the Federal Board of Revenue (FBR) has adopted this argument at times.

Simulated impact of cigarette taxation

	Change in FED rate		
	No change	30 percent increase	20 percent increase
Change in cigarettes consumption/taxable sales (million packs)	113	-107	-39
Percent change in consumption/taxable sales	4.4	-4.2	-1.5
Additional FED (Rs billion)	4.4	24.4	27.9
Additional GST (Rs billion)	1.4	5.3	6.4
Total Additional Revenue (Rs billion)	**5.8**	**29.7**	**34.3**
Change in the number of adult smokers	232,000	-220,000	-79,000
Change in the number of future smokers	256,000	-243,000	-87,000
Change in smoking -attributable adult deaths	81,000	-77,000	-27,000

In the context of Pakistan, the undocumented trade of cigarettes can be divided into two broad categories: undeclared local production and undeclared imports – the first being the major contributor to this phenomenon. The FED and GST are collected at the manufacturing stage, and the FBR relies on voluntary declaration of production by the manufacturers to determine the tax liability of the firms. Without an integrated information system or effective audit, self-declaration encourages under-reporting of production to avoid taxes. A study by SPDC estimated that the extent of under-reporting was 22 percent in 2017.[6] The other type of illicit trade (non-duty-paid imports) is evident from the sale of cigarettes in the market without graphic warnings and printed retail prices, reflecting the challenges that FBR faces in terms of effective tax administration. While the presence of such trade is evident, no data are available to validate the effect of a tax increase on the illicit trade of cigarettes in Pakistan. Therefore, the assumption of an expected increase in illicit trade cannot form the basis for not increasing taxes.

Recommendations

An increase of 30 percent in the FED rate would help the government achieve its commitment to reducing tobacco use and tobacco-related morbidity, mortality, and associated economic costs. Such an increase would also advance Pakistan's obligations as a signatory country to the WHO FCTC as well as generate much-needed revenues for reducing the fiscal deficit.

In addition to tax measures, monitoring mechanisms and enforcement of pertinent laws should also be improved, including a track and trace system as announced by the Finance Minister in his Budget Speech for 2021-22.

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[1] SPDC estimates based on GATS 2014 and population projection for 2021.

[2] Institute of Health Metrics and Evaluation. Global Burden of Disease, GBD Compare. University of Washington, 2019.

[3] The Economic Cost of Tobacco-Induced Diseases in Pakistan, Research Report, Pakistan Institute of Development Economics (PIDE), 2021.

[4] In addition to FED, General Sales Tax (GST) is also applied at the rate of 17 percent on manufacturing and sales of tobacco products.

[5] Modelling the Revenue and Health Implications of Tobacco Tax Policy in Pakistan: Options for the Federal Budget 2021-22, Policy Brief, Social Policy and Development Centre (SPDC), 2021.

[6] Quantifying the Potential Tax Base of Cigarette Industry in Pakistan, Research Report, Social Policy and Development Centre, 2019.

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