

## Increasing Tobacco Taxes Can Save Lives and Raise Revenue: Better Tax Administration Will Maximize the FED’s Potential

### Key Points:

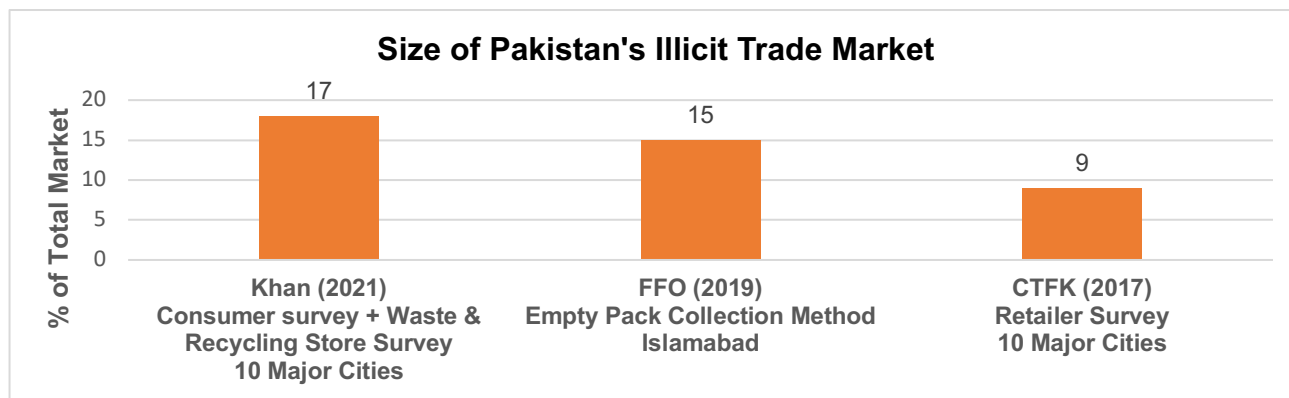
- **The size of the Illicit cigarette market in Pakistan is small and does not match the tobacco industry’s claims.**
- **Undeclared production by tobacco manufacturers is the key issue in Pakistan.**
- **Across the world, countries are successfully increasing cigarette taxes even in the presence of illicit cigarette trade.**

### Introduction

Rigorous evidence from across the world demonstrates that increasing the price of tobacco products through higher taxation is the most effective way to reduce tobacco consumption. However, the average excise tax share in Pakistan at 45.4 percent of the retail price of cigarettes is much lower than the widely accepted benchmark of 70 percent.<sup>1</sup> The cigarette industry in Pakistan argues that higher taxes drive illicit trade, claiming smokers seek out non-duty-paid cigarettes because they cost less. The national tax collection agency, the Federal Board of Revenue (FBR), has also adopted this argument.<sup>2</sup> This policy brief summarizes evidence on illicit trade in Pakistan. It shows that undeclared production is the key cause of illicit trade in Pakistan and better tax administration, particularly to prevent tobacco industry under-reporting, will maximize the revenue potential of the federal excise duty.

#### 1. The size of the Illicit cigarette market in Pakistan does not correspond to the tobacco industry’s claims.

Recent studies have used multiple methods to examine the size of the illicit cigarette market. Estimates of the illicit trade market, as a percentage of the total cigarette market in Pakistan, range from 9 percent to 17 percent.



Source: Khan (2021)<sup>4</sup>; FFO (2019)<sup>5</sup>; CTFK (2021)<sup>6</sup>

In contrast, the Pakistan Tobacco Company claims that illicit trade was 33 percent of the total sales volume in 2019.<sup>3</sup>

## 2. Undeclared production by tobacco manufacturers is the key component of illicit trade in Pakistan.

The Federal Board of Revenue (FBR) relies on voluntary declaration of production by the manufacturers to determine the tax liability of the firms. In the absence of an integrated information system or effective audit, self-declaration leads to failures in tax collection by creating an incentive for under-reporting of production to avoid taxes.

Analysis of financial panel data from the three cigarette manufacturers listed on the Karachi Stock Exchange reveals that approximately 4 billion cigarette sticks were underreported in 2020-21. The year-by-year estimates show that cigarettes were under-reported by 7.8 percent, 7.9 percent, and 8.6 percent in 2018-19, 2019-20, and 2020-21, respectively.<sup>1</sup> Collectively, the government is estimated to have lost more than PKR 23.5 billion in revenue over the last three years.

Year	Under-reporting		Effective Tax Rate	Revenue Loss
	(Million sticks)	(%)	(PKR per stick)	(Million PKR)
2018-19	4,733	7.8%	1.48	7,027
2019-20	3,651	7.9%	1.96	7,165
2020-21	4,457	8.6%	2.08	9,283
<b>Aggregate</b>	<b>12,840</b>	<b>8.1%</b>	<b>1.83</b>	<b>23,475</b>

*Source: SPDC, Forthcoming*

## 3. AJK cigarette industry is not a big player in Pakistan's tobacco industry.

It is also argued that FBR cannot tap the full revenue potential of the tobacco sector due to illicit trade originating from Azad Jammu and Kashmir (AJK), a self-governing jurisdiction administered by Pakistan. However, research by Social Policy and Development Centre (SPDC) indicates that the AJK cigarette industry is not a big player in Pakistan's tobacco industry since the share of AJK represents only about one percent of the total production of cigarettes in Pakistan.<sup>7</sup>

**4. Countries are successfully increasing cigarette taxes even in the presence of illicit cigarette trade.**

Peer-reviewed literature has shown that the illicit cigarette market is relatively larger in countries with low taxes and prices while relatively low in countries with higher cigarette taxes and prices. Non-price factors, such as governance and tax administration, are much more important determinants of the size of the illicit tobacco market.<sup>8-9</sup> In addition, countries such as Turkey, Mongolia, and South Africa have successfully increased taxes and revenues in the presence of illicit trade.<sup>10</sup>

**5. Control of illicit trade in tobacco products is the subject of its own international treaty.**

Governments across the world have responded to the illicit trade by focusing on technological solutions, mainly to control the supply chain, such as implementing track and trace systems (T&T) independent from industry influence that accurately measure domestic production and imports and exports. In Pakistan's context, where underreported declared production is a key component of illicit trade, under an effectively implemented T&T system, it will no longer be possible for companies to declare production voluntarily – the government will be able to track each suspicious pack to the origin facility and shift.

The WHO FCTC Protocol to Eliminate Illicit Trade in Tobacco Products outlines strategies to reduce and prevent illicit trade in tobacco products, including controlling the supply chain, addressing unlawful conduct, ensuring criminal offenses successfully deter participation in illicit markets, and promoting international cooperation, such as information sharing.

## References

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## About Tobacconomics

Tobacconomics is a collaboration of leading researchers who have been studying the economics of tobacco control policy for nearly 30 years. The team is dedicated to helping researchers, advocates and policymakers access the latest and best research about what's working—or not working—to curb tobacco consumption and the impact it has on our economy. As a program of the University of Illinois at Chicago, Tobacconomics is not affiliated with any tobacco manufacturer. Visit [www.tobacconomics.org](http://www.tobacconomics.org) or follow us on Twitter <https://twitter.com/Tobacconomics>