Policy Brief

Social Policy and Development Centre May | 2023

Excise Tax Increase on Cigarettes:

A Laudable Policy that Needs to be Sustained

The current fiscal year has been unusual for cigarette tax policy in Pakistan. The government took commendable measures of substantially increasing the rates of Federal Excise Duty (FED) on cigarettes, which was unprecedented in two aspects. First, the tax changes were made three times during the ongoing fiscal year. Second, the last rise was around 150 per cent, the largest one-time increase in excise tax rates so far. This tax increase was introduced in the backdrop of the severe economic crisis that Pakistan's economy is currently facing in terms of low foreign reserves, a depreciating currency, high inflation and a high fiscal deficit. During the eighth month of the current fiscal year, the government imposed new taxes of Rs170 billion to minimize the fiscal deficit in order to meet the understanding reached with the International Monetary Fund for Extended Fund Facility. The new tax measures included substantial enhancement in the rates of excise tax on cigarettes, which is a bold policy measure in the right direction and is expected to reduce cigarette consumption and enhance government revenues.

Chronology of tax changes

Under the Finance Act 2022, the government revised the FED rates on domestically-produced cigarettes with effect from July 1, 2023. FED rates were increased by 13.5 per cent and 12.1 per cent for high-priced (premium) and low-priced (economy) brands, respectively (Figure 1). This was a long-awaited change since the rates had not been revised since July 2019.

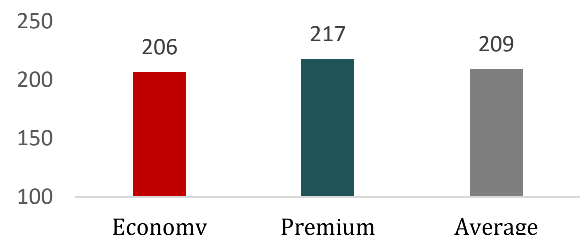
Subsequently, Tax Law (Amendment) Ordinance 2022 was promulgated on August 23, 2022, to generate additional revenue from various sectors of the economy, including the tobacco sector. The FED rate per 20-cigarette pack was increased from PKR 37 to PKR 41 for economy brands and from PKR 118 to PKR 130 for premium brands—a weighted average increase of 10.7 per cent.

More recently, Finance (Supplementary) Bill 2023 was introduced on February 14, 2023. Under this legislation, cigarette tax rates were substantially enhanced by 146 per cent and 154 per cent for economy and premium brands, respectively. In this way, the overall tax increase, compared to 2021-22, has been over 200 per cent (Figure 1).

Figure 1: Changes in FED rates on cigarettes

	FED Rate (PKR per 20-cigarette pack)			
	Low-priced/ Economy		High-priced/ Premium	
	Rate	change	Rate	% change
2019-20	33		104	
2021-22	33	0.0%	104	0.0%
July 01, 2022	37	12.1%	118	13.5%
August 22, 2022	41	10.8%	130	10.2%
February 14, 2023	101	146.3%	330	153.8%

Overall increase in FED Rates from 2021-22 (%)



Sources: Finance Act 2021, Finance Act 2022, Tax Laws (Amendment) Ordinance2022, Supplementary Finance Act 2023

Changes in cigarette prices

With the tax rate enhancements, cigarette prices also increased during this period. As shown in Figure 2, per pack price of the most popular economy brand increased from PKR 80 to PKR 211, while the price of a premium brand rose from PKR 179 to PKR 483—in percentage terms; the overall price increase was 164 per cent and 170 per cent, respectively.

It is important to note that cigarette manufacturers have also kept increasing their net-of-tax prices (producers' prices). For instance, the producers' price of the economy brand increased by 121 per cent, much higher than the prevailing inflation rate. As per the Pakistan Bureau of Statistics, the National Consumer Price Index for February 2023 increased by 31.6 per cent over the corresponding month of the last year (February 2022).

Figure 2: Changes in cigarette prices

PKR per 20-cigarette pack

	Producers' price	FED	GST	Total price
Economy brand				
2021-22	35.2	33.0	11.6	79.8
2022-23 (Jul-Aug)	46.3	37.0	14.2	97.5
2022-23 (Aug-Feb)	50.5	41.0	15.6	107.0
2022-23 (Mar-Jun)	77.6	101.0	32.2	210.8
Growth (%)				
2021-22	-	-	-	-
2022-23 (Jul-Aug)	31.7	12.1	22.3	22.2
2022-23 (Aug-Feb)	8.9	10.8	9.7	9.7
2022-23 (Mar-Jun)	53.8	146.3	106.8	97.0
Cumulative	120.5	206.1	177.4	164.2
Premium brand				
2021-22	49.0	104.0	26.0	179.0
2022-23 (Jul-Aug)	78.6	118.0	33.4	214.0
2022-23 (Aug-Feb)	78.6	130.0	35.5	244.0
2022-23 (Mar-Jun)	79.0	330.0	73.6	482.7
Growth (%)				
2021-22	-	-	-	-
2022-23 (Jul-Aug)	60.3	13.5	28.5	19.6
2022-23 (Aug-Feb)	0.0	10.2	6.1	14.0
2022-23 (Mar-Jun)	0.6	153.8	107.7	97.8
Cumulative	61.3	217.3	183.0	169.6

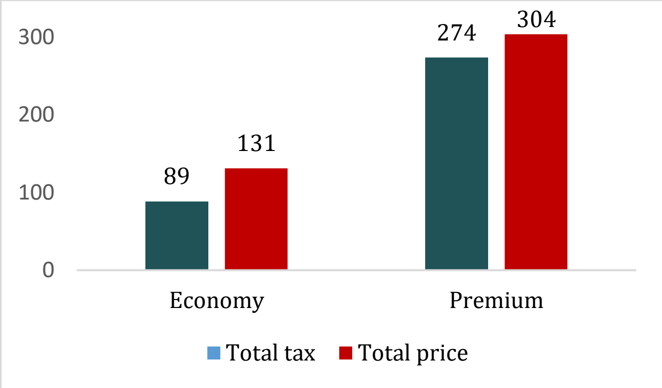
Sources: Finance Act 2021, Finance Act 2022, Tax Laws Ordinance2022, Supplementary Finance Act 2023, Price estimates by SPDC

Note: Prices of the most popular brands are used to represent economy and premium brands, Casptan and Gold Leaf, respectively.

Altogether, the total tax on economy brands (FED and GST) rose by PKR 89 per pack (from PKR 45 to PKR 133). On the contrary, the consumer price increased by PKR 131. Similarly, the price increase of premium brands was more than the tax increase. This way, the cigarette industry has over-shifted the tax increase.

Figure 3: Increase in total tax and price

PKR per 20-cigarette pack



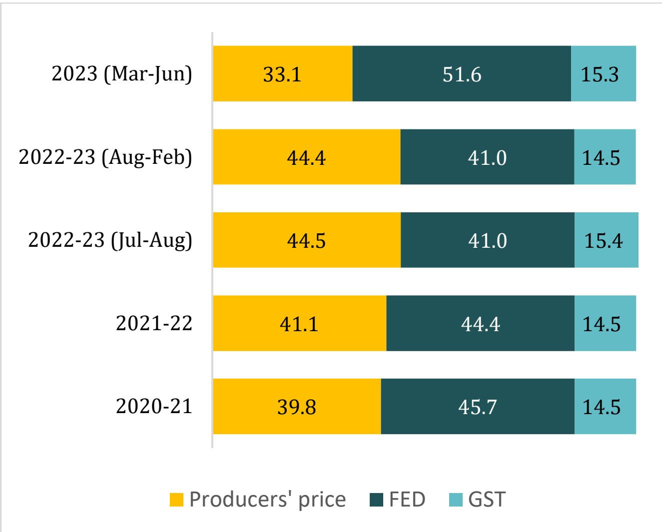
Sources: Finance Act 2021, Finance Act 2022, Tax Laws Ordinance2022, Supplementary Finance Act 2023, Price estimates by SPDC

Share of FED in retail price

As shown in Figure 4, the FED share (weighted average) in retail price continuously declined from 45.7 per cent in 2020-21 to 41.0 per cent in 2022-23 (Aug-Feb). During the same period, the producers' price increased from 41.1 per cent to 44.4 per cent.

After a tax increase of over 150 per cent in February 2023, the FED share rose to 51.6 per cent—though it has not increased as much due to tax over-shifting by the cigarette industry and remains lower than the widely-accepted benchmark of 70% (Figure 3).

Figure 4: Components of consumer price (weighted average), %



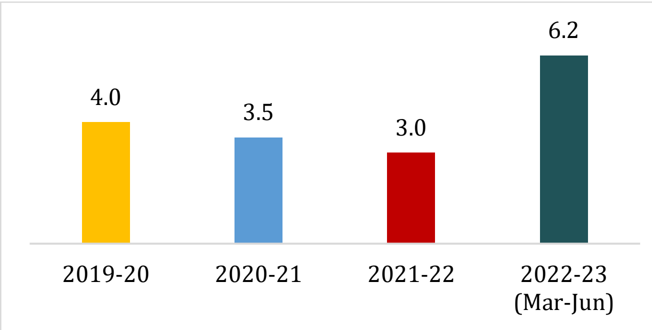
Sources: Finance Act 2021, Finance Act 2022, Tax Laws Ordinance2022, Supplementary Finance Act 2023, Prices estimates by SPDC

Cigarette Affordability

Cigarette affordability, also known as the relative income price ratio, is the percentage of per capita GDP required to purchase 2000 cigarettes. According to SPDC's estimates, 4 per cent of per capita income was required to buy 2000 sticks of the most-sold brand in 2019-20, which gradually decreased to 3 per cent in 2021-22 since tax rates were not enhanced and cigarettes became more affordable (Figure 5).

After the recent hike in tax rates, cigarettes have become less affordable. The estimates show a large increase in the relative income price ratio, as 6.2 per cent of per capita income is now required to purchase the same quantity of cigarettes.

Figure 5: Cigarette affordability



Source: IMF's macroeconomic projections; Price estimates by SPDC

Tax Increase and Illicit Trade

While the government has shown its determination to curb cigarette consumption through enhanced taxation, the cigarette industry has been trying to undermine these efforts by putting forward the argument that higher taxes would lead to i) a fall in licit production and government revenues, ii) adverse effects on firms' profitability, iii) and increased illicit trade of cigarettes.[1]

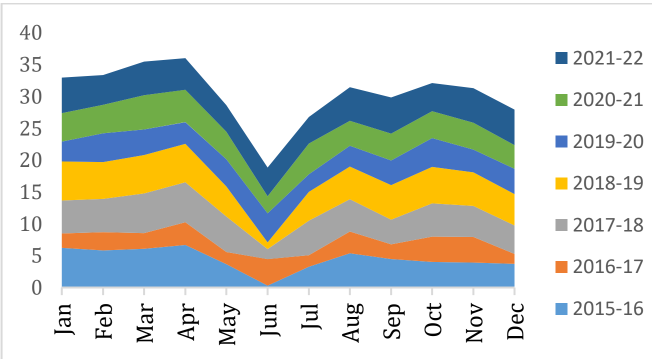
This argument appears to be overplayed due to the following reasons:

- Cigarette manufacturers have over-shifted the tax burden to consumers to increase their profitability.
- Prices of smuggled cigarettes have also increased during this period,[2] perhaps due to the massive devaluation of the Pakistani currency and a general pattern in the market that the prices of illicit cigarettes track with the trend of licit cigarette prices.
- The Track and Trace (T&T) system for electronic monitoring of cigarette production is already in place, which involves the affixation of tax stamps on cigarette packs. Three large companies, which constitute over 90 per cent of the domestic production, have been integrated into the system. At the same time, the Federal Board of Revenue (FBR) has also initiated the process of registering brands of other manufacturers. These measures should help control the under-reporting of production by the cigarette industry.

Cigarette Consumption and Tax Revenues

SPDC regularly uses a tax simulation model to estimate the effects of proposed and actual tax changes on cigarette consumption, revenues, and health outcomes. This exercise could not be undertaken due to the unavailability of the latest data on cigarette production and tax revenue after the last tax change was introduced in February 2023. Moreover, there appears to be much uncertainty about the reported production after the tax increase. Research evidence suggests that the cigarette industry has used various tactics, such as front-loading and abrupt changes in production, to avoid tax hikes and influence tax policy.

Figure 6: Trend in monthly cigarette production in Pakistan, *billion sticks*



Source: Pakistan Bureau of Statistics.

Figure 6 illustrates the declared monthly production of Pakistan's cigarette industry from 2015-16 to 2021-22. A curious pattern is observed, which relates to tax policy announcements. The fiscal year in Pakistan runs from July to June. The production declared by the industry in the months preceding the budget is significantly higher than the production reported in the months following the budget. This indicates that the industry uses front-loading to avoid taxes. Also, declared production in June is significantly lower than the rest of the months, reflecting the industry's intention to pressure the government to hold back the tax increase.

Although a continuation of the front-loading practices at the level of the historical trend is less likely due to the T&T system, the possibility of manipulating the declared production cannot be ignored. As shown in Figure 7, the reported production for the first seven months of 2022-23 indicates more fluctuations as compared to the trend of the past two years. For instance, there was an abrupt decline in the production reported for July 2022—only 1,021 million sticks as compared to 4,160 in July 2021 and 4,820 million in July 2022. This situation creates uncertainty about the production pattern for the next few months, particularly because the major tax hike was introduced in February 2023.

Figure 7: Monthly cigarette production in recent years, *million sticks*

	2019-20	2020-21	2021-22	2022-23
July	2,739	4,820	4,160	1,021
August	3,237	3,935	5,264	4,308
September	3,885	4,192	5,688	5,075
October	4,514	4,244	4,406	4,645
November	3,584	4,214	5,443	4,341
December	3,953	3,707	5,588	3,977
January	3,078	4,502	5,557	4,908
February	4,524	4,483	4,666	4,171
March	4,026	5,372	5,291	-
April	3,392	5,111	4,955	-
May	4,293	4,296	4,167	-
June	4,564	2,674	4,510	-

Source: Pakistan Bureau of Statistics.

Nevertheless, based on the evidence from earlier research, a significant reduction in cigarette consumption is expected. The price increase leads to reduced consumption in two ways: reduction in smoking intensity (number of cigarettes consumed per day) and quitting. A recent study by SPDC on smokers' response to price changes suggests that taxation has enormous potential for discouraging smoking. The study found that due to increased cigarette prices three years ago, 29 per cent of the total smokers smoked fewer cigarettes. Altogether, 12.8 per cent of smokers attempted either quitting or seriously thought about quitting after the price increase.

Therefore, given the responsiveness of smokers to cigarette prices, it is likely that the current tax reform would reduce cigarette consumption and generate more revenues due to the enormous increase in tax rates.

The Way Forward

The excise tax rate enhancement during the current fiscal year is a laudable step in the right direction. This will help achieve the goals of the tobacco control policy in Pakistan.

The policy of making cigarettes less affordable through tax-led price increases needs to be continued. Over-shifting the recent tax increase by the cigarette industry (i.e., raising prices more than tax increases) indicates the potential for raising prices, which should be capitalized upon by the government instead of leaving it to the industry.

Also, the general inflation rate is high in the country and has been persistently rising. For example, CPI increased to 36.4 percent on a year-on-year basis in April 2023 as compared to 13.4 percent in April 2022. Given this trend, it is proposed that for the fiscal year 2023-24, FED rates should at least be indexed to inflation.

Moreover, the recently introduced Track & Trace System provides an excellent opportunity for FBR to tackle the issue of illicit trade, which needs to be extended to all other cigarette manufacturing companies currently not integrated.

[1]Several newspaper articles/reports have been published during the last few weeks that present industry's argument about illicit trade and tax revenues. See for example:
- https://tribune.com.pk/story/2403104/rise-in-illicit-cigarette-sales-feared
- https://tribune.com.pk/story/2405137/hike-in-fed-on-cigarettes-likely-to-dent-govt-revenue
- https://en.dailypakistan.com.pk/04-Mar-2023/heavy-taxation-can-force-consumers-to-shift-towards-illicit-cigarettes

[2] For instance, information collected by SPDC from a few retailers in Karachi and Lahore reveals that price of a popular smuggled brand (Pine) has increased from PKR 80 to PKR 150.