

## Facts vs Industry Narrative:

### *Cigarette Production and Taxation in Pakistan*

During the current fiscal year, the government has demonstrated its commitment to curbing cigarette consumption in Pakistan by increasing rates of Federal Excise Duty (FED) on cigarettes. The tobacco industry, however, has been trying to thwart these initiatives by creating a false narrative about the implications of higher taxation in terms of reduced production of tax-paid cigarettes and the consequent reduction in tax revenues. It has been claimed by the industry that the tax hike would negatively impact the profitability of the cigarette industry and encourage the trade of non-tax-paid cigarettes.<sup>1</sup> This policy brief aims to present some facts related to these claims and argues that the current tax reform would result in generating more tax revenues for the government despite the reduction in cigarette production.

#### Chronology of tax changes

The rates of FED on cigarettes were revised three times during the fiscal year 2022-23, after three years of stagnation (Figure 1).

- a. The first change was introduced in effect from July 1, 2022, where excise tax rate on high-priced (premium) and low-priced (economy) brands were increased by 13.5 percent and 12.1 percent, respectively.
- b. The second change was promulgated on August 22, 2022, with an increase of FED rates by over 10 percent.
- c. The third change was made on February 14, 2023 through Finance (Supplementary) Bill 2023. Under this legislation, FED rates were substantially enhanced by 146 per cent and 154 per cent for economy and premium brands, respectively.

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 to 2021-22	33		104	
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%

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

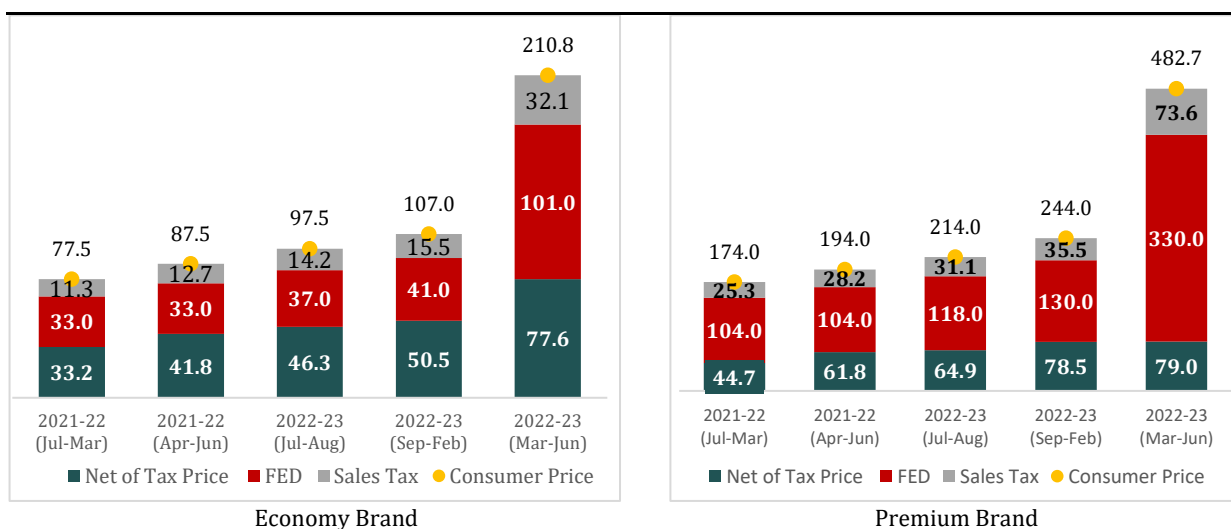
#### Trends in cigarette prices

Figure 2 depicts the trend in per-pack prices for the most popular economy and premium brands in 2021-22 and 2022-23. During the first nine months of 2021-22, printed consumer prices remained stable at PKR77.5 and PKR174 for the most sold economy and premium brands, respectively. In April 2022, the prices increased to PKR87.5 and PKR194 for the same respective brands; and in percentage terms, the net-of-tax price increase was 25.7 percent and 38.2 percent, respectively. So, the increase in the printed consumer prices was due to increase in producers' prices (net-of-tax prices) since tax rates remained unchanged.

During the current fiscal year 2022-23, the printed consumer prices of the economy brand increased from PKR87.5 to PKR210.8 per pack. Similarly, consumer prices of the premium brand increased from PKR194 to PKR482.7 (Figure 2). However, the increase in printed consumer prices was due to two factors: the tax increases and increases in producers' prices. The cigarette manufacturers continued to raise their net-of-tax prices in tandem with increases in tax rates. For example, on February 14, 2023, the government increased the FED rate on economy brands by more than 146 percent; the manufacturer also increased the net-of-tax price by more than 53 percent in March 2023. Altogether, the net-of-tax price of the economy brand has

increased by 133 percent since March 2022, far exceeding the prevailing inflation rate. According to the Pakistan Bureau of Statistics, the National Consumer Price Index for March 2023 increased by 35.4 percent over the previous year's corresponding month. Similarly, net-of-tax prices of premium brand also increased much faster than the inflation rate.

Figure 2: Changes in cigarette prices (PKR per 20-cigarette pack)



Sources: Finance Act 2021, Finance Act 2022, Tax Laws Ordinance 2022, Supplementary Finance Act 2023, Prices estimates by SPDC  
 Note: Prices of the most popular brands are used to represent economy and premium brands, Casptan and Gold Leaf, respectively.

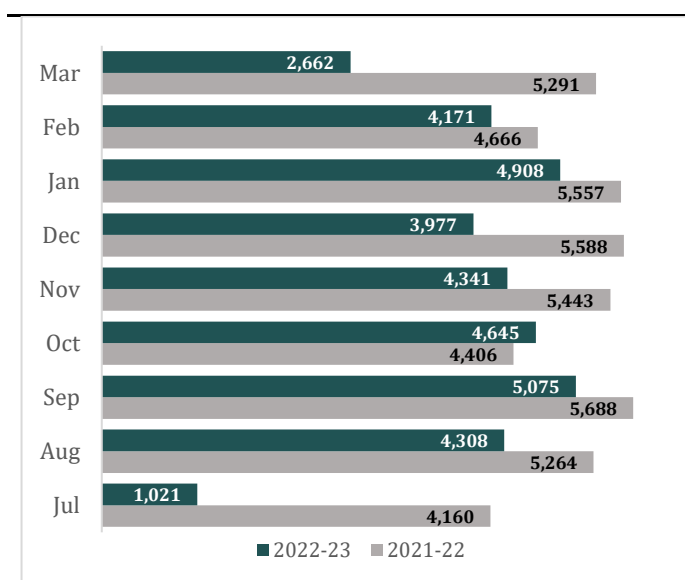
## Linking cigarette prices and production

The law of demand, a fundamental economic principle, states that at a higher price, consumers will demand a smaller quantity of a good, and vice versa. However, this law fails to explain the trend of cigarette production in Pakistan (assuming production links to demand). As shown in Figure 2, the largest increase in cigarette prices occurred in March 2023, while the largest decrease in production occurred in July 2023. The trend in monthly cigarette production since 2011-12 indicates that this is not the first time that cigarette production has fallen to one billion sticks. In 2015-16, monthly cigarette production fell to a meagre 296 million sticks, with no corresponding change in prices. Earlier research has shown that the Pakistani cigarette industry has used various tactics, such as front-loading and abrupt changes in production, to avoid tax hikes and influence tax policy.<sup>2</sup> That is why fluctuations in cigarette production are not explained by changes in prices or taxes.

## Impact of tax revenues

Based on SPDC's cigarette tax simulation model, the estimates of the net impacts of changes in tax rates and production on tax revenues are presented in Figure 4. There appears to be decreases in FED and General Sales Tax (GST) revenues during July-August 2022 compared to the same period in the previous year. This drop is attributed to a massive decrease in output and a marginal increase in the FED rate. Subsequently, FED and GST revenues increased in both periods. Estimates for the nine months (July-March) show a net increase in FED revenues of PKR3.7 billion and a net increase in GST revenues of PKR3.3 billion. Overall, a PKR7 billion increase in tax revenues is estimated over the same period in the previous fiscal year.

Figure 3: Trends in production (millions of cigarette sticks)



Source: Pakistan Bureau of Statistics, Government of Pakistan

Figure 4: Impact on Tax Revenues

	Jul- Aug	Sep-Feb	Mar	Jul-Mar
Estimated FED revenue (Billion PKR)				
2021-22	18.5	61.6	10.4	90.5
2022-23	11.8	66.3	16.1	94.2
<b>Change in FED revenues</b>	<b>-6.7</b>	<b>4.7</b>	<b>5.7</b>	<b>3.7</b>
<b>Relative Change</b>	<b>-36.4%</b>	<b>7.6%</b>	<b>55.3%</b>	<b>4.1%</b>
Estimated GST revenue (Billion PKR)				
2021-22	5.9	19.6	3.6	29
2022-23	4.2	23.5	4.8	32
<b>Change in GST revenues</b>	<b>-1.7</b>	<b>3.9</b>	<b>1.1</b>	<b>3.3</b>
<b>Relative change</b>	<b>-29.1%</b>	<b>19.8%</b>	<b>31.7%</b>	<b>11.3%</b>
Estimated total tax revenue (Billion PKR)				
2021-22	24.4	81.2	14.0	120
2022-23	15.9	89.7	20.9	127
<b>Change in total tax revenues</b>	<b>-8.5</b>	<b>8.6</b>	<b>6.9</b>	<b>7.0</b>
<b>Relative change</b>	<b>-34.7%</b>	<b>10.6%</b>	<b>49.2%</b>	<b>5.9%</b>

Source: SPDC estimates based on Figure 2 and Figure 3

## Insights from financial statements of cigarette companies

Financial reports of three publicly traded companies, Pakistan Tobacco Company (PTC), Phillip Morris Pakistan (PMPK), and Khyber Tobacco Company, are used to assess the impact of FED rate changes on net turnover and gross profit of these companies, as well as to validate tax revenue estimates. The analysis covers the first nine months of fiscal years 2021-22 and 2022-23. These three companies are the country's major cigarette producers, accounting for more than 90% of total cigarette production in Pakistan.

Figure 5: Turnover, profit and tax paid by cigarette companies (Billion PKR)

	Jul 2022- Mar 2023	Jul 2021- Mar 2022	Increase	Growth
<b>Total of FED and GST</b>				
Pakistan Tobacco Company	105.4	94.9	10.5	11.1%
Phillip Morris Pakistan	19.5	18.6	0.9	4.8%
Khyber Tobacco Company	2.5	1.0	1.5	158.7%
<b>Total</b>	<b>127.5</b>	<b>114.5</b>	<b>13.0</b>	<b>11.3%</b>
<b>Net turnover</b>				
Pakistan Tobacco Company	72.4	57.5	14.9	25.9%
Phillip Morris Pakistan	15.5	13.6	1.9	14.1%
Khyber Tobacco Company	5.8	1.2	4.6	402.6%
<b>Total</b>	<b>93.7</b>	<b>72.3</b>	<b>21.4</b>	<b>29.7%</b>
<b>Gross profit</b>				
Pakistan Tobacco Company	36.9	27.2	9.7	35.5%
Phillip Morris Pakistan	6.6	5.3	1.2	23.0%
Khyber Tobacco Company	2.1	0.3	1.8	652.2%
<b>Total</b>	<b>45.6</b>	<b>32.9</b>	<b>12.7</b>	<b>38.7%</b>

Source: Estimates based on Annual, Half-Yearly and Quarterly Financial Statements of PTC, PMPK and KTC

As shown in Figure 5, total tax revenue paid (including FED and GST) increased from PKR114.5 billion in July21-March22 to PKR127.5 billion in the first nine months of the current fiscal year, representing a growth of 11.3 percent. The total tax paid by these companies is very close to SPDC's estimates of PKR127 billion. However, SPDC's estimates, which are based on the reported production of the overall industry, appear to be on the conservative side. Thus, the actual indirect tax collection from the cigarette industry is likely to be even higher.

In contrast to tax paid, financial data show a nearly 30 percent increase in the companies' net turnover collectively. This is puzzling because the increase in tax rates is much higher than the increase in net-of-tax prices (Figure 2). In this situation, the growth in tax revenue should have outpaced the growth in net turnover of these companies. Similarly, the companies' aggregate profit growth is reported to be 39 percent. This significant growth contradicts the industry's claims about the negative effect of tax increases on their financial performance. In this case, the KTC stands out with a massive increase in gross profits and net turnovers but relatively low growth in paid tax revenues.

## Conclusion

The analysis presented above shows a massive increase in cigarette tax rates and net-of-tax prices, decreased production, increased government revenue from cigarettes, and a significant rise in the profit of companies. This contradicts the cigarette industry's claims about the negative impacts of higher cigarette taxes.

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<sup>1</sup> 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>
- <https://tobaccoreporter.com/2023/05/29/pakistan-asked-to-reconsider-tax-hike/>

<sup>2</sup> See for example:

- 'Excise Tax Increase on Cigarettes: A Laudable Policy that Needs to be Sustained', SPDC Policy Brief, May 2023, available at: <https://spdc.org.pk/publications/excise-tax-increase-on-cigarettes-a-laudable-policy-that-needs-to-be-sustained>
- 'Estimating the Under-Reporting of Cigarette Production in Pakistan', Tobacconomics Working Paper Series, Paper No. 22/9/2, available at: <https://spdc.org.pk/publications/estimating-the-under-reporting-of-cigarette-production-in-pakistan>

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