

This policy brief is based on a research study entitled Quantifying the Potential Tax Base of Cigarette Industry in Pakistan conducted by Social Policy and Development Centre (SPDC).

The untapped tax potential of the cigarette industry in Pakistan

Tobacco taxation is widely acknowledged as a robust policy instrument to scale back tobacco consumption. Effective and optimal tobacco taxation can serve the dual objective of public health promotion and revenue generation. The effectiveness of this tool, however, depends heavily on the mechanisms of tax collection.

In Pakistan, domestically produced cigarettes are subject to two major taxes – Federal Excise Duty (FED) and General Sales Tax (GST) – where the FED accounts for almost 80 percent of the revenue from the sector. Both taxes are collected at the manufacturing stage.

Currently, 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 inefficiencies in tax collection by creating an incentive for under-reporting of production to avoid taxes.

Under-reporting is one of the key components of illicit trade in Pakistan. While some studies have provided the evidence of illicit trade in general, there is absence of research on measuring the extent of under-reporting of domestic production of cigarettes in the country. This policy brief presents estimates of under-reporting of production by the cigarette industry and finds evidence of a considerably high level of under-reporting of cigarette production by the firms.

Domestic Cigarette Production

Currently, domestic annual production of cigarettes in Pakistan is about 60 billion sticks. Trend analysis of last 14 years shows that the production remained fairly stable between 61-67 billion sticks until 2014-15 (with the exception of 2008-09). However, massive

fluctuation in production has occurred in the last three years. For instance, in 2016-17 declared production declined by almost 36 percent and increased by 72 percent in 2017-18. This fluctuation raises concerns over the validity of declared production.

The cigarette manufacturing industry in Pakistan is largely dominated by two firms – Pakistan Tobacco Company (PTC) and Philip Morris Pakistan (PMPK) – constituting over 90 percent of the legal production. Aggregate net turnover of these firms has increased more than four-fold during 2004 and 2018, from Rs 18 billion to Rs 69 billion, respectively.

Figure 1: Trend in cigarette production – Billion sticks

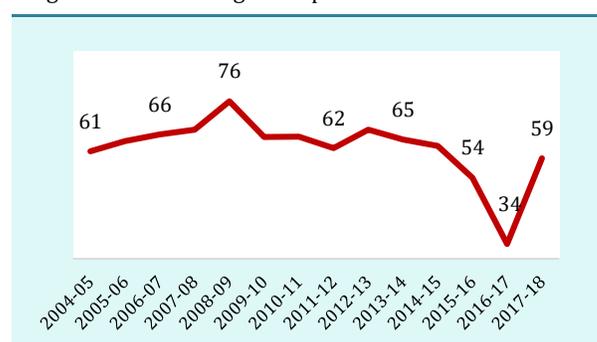
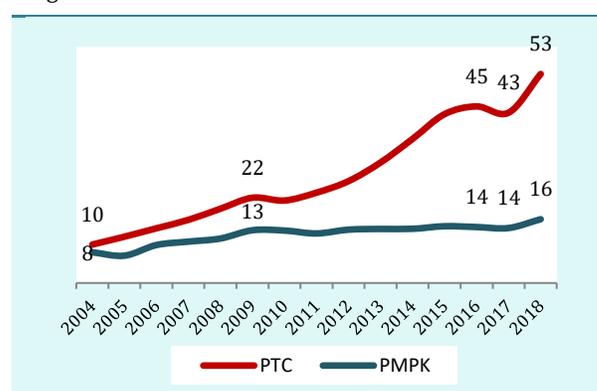


Figure 2: Net turnover of the firms – Billion Rs



Tobacco firms usually argue that higher FED causes a decline in their sales and profitability. However, the analysis reveals that from 2015 to 2017, when tobacco firms reported a decline in their production, profit margins remained substantially higher compared to the previous years.

For instance, during 2010 to 2014, gross profit margins of PTC and PMPK averaged about 32 percent and 28 percent, respectively; and substantially increased afterwards. In fact, in 2017 – a year of substantial decline in production – profit margins were 47 percent and 36 percent, respectively.

Extent of Under-reporting

The estimates of supply function based on monthly time series of production and prices of cigarettes indicate that the firms under-reported their production by 47 percent and 27 percent in fiscal years 2016-17 and 2017-18, respectively.

In absolute terms, the estimated production in 2016-17 is around 50.5 billion sticks whereas the declared production was only 34.3 billion sticks, resulting in under-reporting of 16.2 billion sticks. Similarly, estimated under-reporting is 15.6 billion sticks in 2017-18.

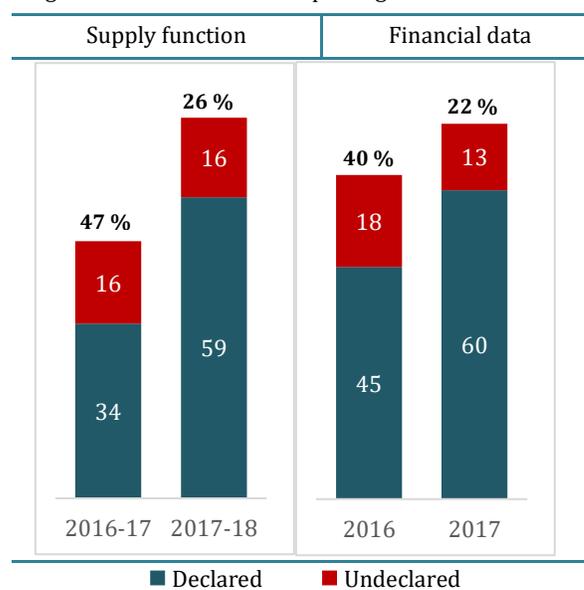
Results of another econometric model based on financial panel data suggest that under-reporting was 39.5 percent and 21.5 percent in 2017 and 2018, respectively.

In terms of number of sticks, the extent of under-reported production was 18 billion and 13 billion sticks, correspondingly.

This level of under-reporting of cigarette production in Pakistan has significant negative implications for government tax revenue. **Revenue loss due to undeclared production is estimated to be Rs 31 billion while by including GST revenue, it becomes Rs 37 billion** (considering the average FED rate of Rs 1.93 per cigarette in 2016-17, calculated by dividing total revenue by the volume of sales).

Improvements in tax administration aiming at fully tapping the tax potential of tobacco sector can lead to a substantial increase in revenues, which would also help in promoting public health objectives.

Figure 3: Extent of Under-reporting – Billion sticks



Policy Recommendations

- At present FED is collected at factory level on declared production. If the FED is linked with GST collection and the GST is collected in VAT mode, it will help reduce tax evasion. GST should be collected at three stages – factory, distributors, and wholesalers/retailors.
- While FBR is already in the process to implement a system for electronic monitoring of production, the implementation process should follow the existing best practices particularly from developing countries.
- FBR should also monitor tax evasion by analyzing the financial data of the companies. Such analysis will help build a robust tax collection mechanism for future.
- Analysis of monthly data reveals that the production is generally high during the months before the announcement of federal budget. This is largely an outcome of uncertainties in tax policy. A medium-term tax policy guideline should be followed to avoid major changes in tax rates

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