Policy Brief

Social Policy and Development Centre

December | 2018

This policy brief is based on a research study entitled *Macroeconomic Impacts of Tobacco Use in Pakistan* conducted by Social Policy and Development Centre (SPDC).[1]

Tobacco Control in Pakistan:

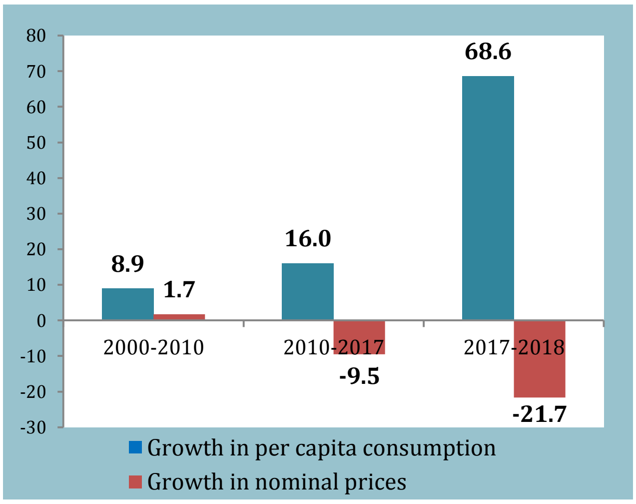
The Impact of Tax Reduction Policy

Tobacco taxation is widely considered as one of the crucial policy measures for reducing tobacco use. A review of more than 100 international studies concluded that "Significant increases in tobacco taxes are a highly effective tobacco control strategy and can lead to significant improvements in public health."[2] Similarly, a high uniform specific excise tax is considered to be the best instrument for raising cigarette prices and reducing tobacco use.

Pakistan is among the high-burden countries with respect to the prevalence of tobacco use and its implications for public health. Tobacco taxation in Pakistan serves a dual objective of public health promotion and revenue generation. However, the level of taxes on tobacco in the country continues to be below the WHO-recommended level of 70 percent and cigarette prices are among the lowest in the world. Average tax rate on cigarettes is around 52 percent and federal excise duty (FED) is the major tobacco tax contributing to about 80 percent of the revenue. However, the structure of FED is complex and is based on price-tiers that favour cheaper brands, which leads to substitution among brands by the consumers.

The FED structure has historically been a complicated mix of a specific tax on low-priced brands, an *ad valorem* tax on high priced brands, and a combined specific and *ad valo*rem tax on mid-priced brands. In 2013, the *ad valorem* tax was withdrawn with the introduction of a two-tier structure of specific taxes based on range of retail prices (exclusive of GST). Until 2016-17, the two-tier system remained intact with annual upward revision of tax rates of both the tiers. ***The data suggests a strong negative relationship between prices and consumption of cigarettes in Pakistan. Therefore, high tobacco taxes can play an instrumental role in curbing tobacco use in the country.***

Figure 1: Relationship between price of cigarettes and cigarette consumption in Pakistan



However, in 2017, the federal government introduced a three-tier excise duty structure for cigarettes – with a new tier for the low-priced brands. The tax rate applicable on the new tier was reduced by 48 percent, from Rs 1.5 per stick to Rs 0.8 per stick.[3] The reason for this move, as stated by the Federal Finance Minister, was to "document and curb the menace of illicit trade of sub-standard low-priced cigarettes."[4]

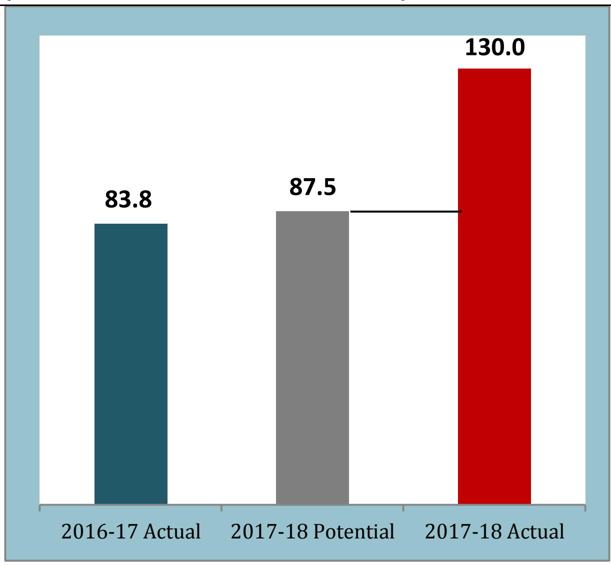
According to the study, the effective (or average) rate of FED on low price cigarettes declined from 40.1 percent in 2014 to only 28.7 percent in 2018. Consequently, a significant decline of 22 percent was observed in the overall price index of cigarettes in 2017-18. This led to a massive increase in the domestic production of cigarettes from 34.3 billion sticks in 2016-17 to 59.1 billion sticks in 2017-18.

On the other hand, contrary to the government's expectation, the three-tier structure (with reduced tax rate) failed to generate additional tax revenue for the national exchequer. In 2017-18, domestic production of cigarettes increased by 72 percent, while tax revenue increased by only 4.5 percent. The introduction of a three-tier structure actually led to a decrease in the effective rate of excise duty. This decrease in tax rate not only led to the reduction in the price of cigarettes but also resulted in shrinking the growth in tax revenue.

In order to gauge the revenue loss due to the introduction of the three-tier excise duty structure, the study estimated the potential tax revenue by analyzing the trend in effective excise duty per cigarette. The estimates show that effective excise duty declined from Rs 1.9 per stick to Rs 1.2 per stick due to introduction of the new three-tier structure.

Based on an econometric analysis, potential tax revenue (including FED and GST) from cigarettes for fiscal year 2017-18 was estimated to be Rs 130 billion. The actual tax revenue from the cigarette industry for 2017-18 was Rs 87.5 billion.[5] ***Therefore, the revenue loss due to the three-tier structure is Rs 42.5 billion***.

Figure 2: Potential Loss in Tax Revenue
(Federal Excise + General Sales Tax) *Rs billion*



Thus, the introduction of the new FED structure along with a reduced tax rate for low-priced cigarettes has not only led to a significant increase in the consumption of cigarettes but also resulted in substantial revenue loss which is equal to over 50 percent of the revenue collected in the previous year. Thus, the results do not validate the government's claim regarding additional revenue by reducing illicit trade through reducing prices for the lowest tier.

It is therefore, recommended that the price-tier-based structure of the federal excise duty be abolished, and a single, high, uniform tax be applied to all types of cigarettes, which would not only help curb tobacco use in the country but would also contribute in generating more revenues that can be used for promoting public health.

Policy Brief prepared by Muhammad Asif Iqbal

The Social Policy and Development Centre (SPDC) is funded by the University of Illinois at Chicago's (UIC) Institute for Health Research and Policy to conduct economic research on tobacco taxation in Pakistan. UIC is a core partner of the Bloomberg Philanthropies' Initiative to Reduce Tobacco Use. The views expressed in this document cannot be attributed to, nor do they represent, the views of UIC, the Institute for Health Research and Policy, or Bloomberg Philanthropies.

Notes:

1. Khalida Ghaus, Wasim Saleem, Muhammad Sabir and Muhammad Asif Iqbal. Macroeconomic Impacts of Tobacco Use in Pakistan. Social Policy and Development Centre (SPDC), Karachi. i*n press*
2. Frank J Chaloupka, Ayda Yurekli and Geoffrey T Fong, "Tobacco taxes as a tobacco control strategy", *Tobacco Control* 2012;21:172-180.
3. An upward revision of FED rates was also made in September 2018 but the three-tier structure remained intact.
4. Federal Budget Speech 2017-18, Ministry of Finance, Government of Pakistan.
5. Data source: News report referring to FBR documents published in daily Business Recorder, September 2, 2018.