Policy Brief

Social Policy and Development Centre May | 2022

Pakistan has lost nearly PKR 30 billion from under-reported cigarette production in the past three years

Key Points

- The government is estimated to have lost **PKR 29.5 billion** in cigarette tax revenue during the last three years due to under-reporting of cigarette production by manufacturers.
- Under-reporting is estimated to be around **eight percent of declared production** annually, or an average of four billion cigarettes each year.
- The current self-declaration system incentivizes firms to under-report their production to evade taxes.
- Monitoring and enforcement should be manageable because only two firms dominate the cigarette manufacturing industry in Pakistan.

Introduction

Global evidence has established that tobacco taxation is an effective policy tool for reducing tobacco consumption. In Pakistan, however, tax policies have fallen short, and inefficiencies in the tax collection system persist. Consequently, Pakistan remains a high-tobacco-burden country where nearly one in every five adults uses tobacco in some form.[1]

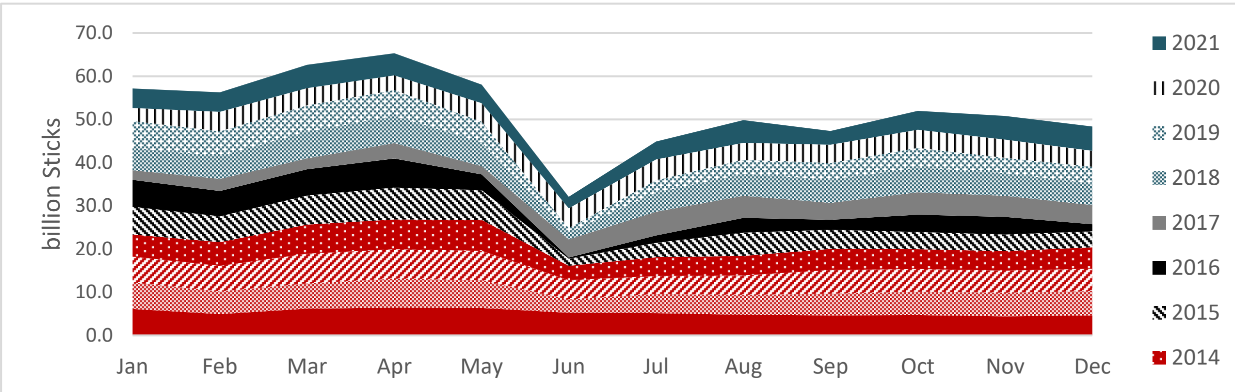
In Pakistan, domestically produced cigarettes are subject to two major indirect taxes – the Federal Excise Duty (FED) and the General Sales Tax (GST). The FED accounts for almost 80% of the revenue from the sector. Both taxes are collected at the production stage. The cigarette manufacturing sector in Pakistan is an example of an imperfect market, with only three companies dominating domestic production. Despite the small number of large manufacturers, the Federal Board of Revenue (FBR) relies on manufacturers' self-declaration of production to determine their tax liability. In the absence of an effective audit system, this mechanism contains a built-in incentive to under-report production to evade taxes and thus causes inefficiencies in the tax collection.

Under-reporting of production is a critical component of illicit trade in Pakistan. This policy brief summarizes the estimates of a forthcoming study by the Social Policy and Development Centre (SPDC) on the under-reporting of domestic production of cigarettes from 2018-19 to 2020-21.

Trends in monthly cigarette production suggest front-loading by the tobacco industry.

The trend for the monthly production of cigarettes reveals an intriguing pattern about the timing of fiscal policy announcements—declared production in the months preceding the budget (January to May) is much higher than production declared after the budget (from June to December). This suggests that the tobacco industry uses front-loading to avoid tax hikes. Furthermore, the reported production in June is much lower than the rest of the months, perhaps intending to pressure the government to refrain from raising taxes.

Monthly cigarette production trends in Pakistan



Source: Quantum Index of Large Scale Manufacturing Industries, Pakistan Bureau of Statistics, https://www.pbs.gov.pk/qim

Three companies account for 90 percent of the tobacco market.

There are three companies listed on the Karachi Stock Exchange: Pakistan Tobacco Company (PTC), Phillip Morris Pakistan (PMP), and Khyber Tobacco Company (KTC). These companies account for over 90 percent of the formal market share.[2] PTC is the industry leader in cigarette manufacturing, with a share of almost 80 percent of the total declared production by these companies in the first half of 2021, followed by PMP (18 percent) and KTC (less than two percent). The share of PTC has increased over the years from 65 percent in 2012.

The Extent of Under-reported Production

From 2018-19 to 2020-21, an average of four billion cigarette sticks were underreported each year. According to year-by-year forecasts, cigarettes were under-reported by 7.8 percent, 7.9 percent, and 8.6 percent in 2018-19, 2019-20, and 2020-21, respectively.

Under-reporting of cigarette production has serious implications for tax revenue in Pakistan. Altogether, the loss of FED revenue owing to unreported production is estimated to be PKR 23.5 billion during the last three years. When including GST revenue, it becomes PKR 29.5 billion.

Under-reported production and revenue loss

Year	Production		Under-reporting		Revenue loss		
	Declared	Estimated	Billion sticks	%	FED	GST	Total
	Billion sticks				Billion PKR		
2018-19	60.7	65.4	4.7	7.8	7.0	1.8	8.8
2019-20	46.1	49.7	3.6	7.9	7.2	1.8	9.0
2020-21	51.6	56.0	4.4	8.6	9.3	2.4	11.7
Total	**158.4**	**171.1**	**12.7**	**8.1**	**23.5**	**6.0**	**29.5**

Source: Sabir, M., Saleem, W., & Iqbal M.A. (2022), Forthcoming[3]

Implications and Policy Recommendations

The under-reported production permits the industry more flexibility in pricing—they can charge less for cigarettes if they so choose to attract or retain customers. Improvements in tax administration aimed at tapping the full tax potential of the tobacco industry would result in a significant increase in revenues, as well as an increase in input costs for manufacturers, which would likely increase prices and lead to lower consumption.

This analysis demonstrates how to monitor tax evasion by analyzing company financial data. More research that links financial data to production would aid in the development of a strong tax collection mechanism in the future.

FBR has recently initiated the process of putting in place the System of Electronic Monitoring of Production (SEMP), which can help enhance revenue, reduce counterfeiting, curb illicit trade, and avoid front-loading. Given that front-loading is a common practice in the cigarette industry, SEMP can be used to discourage it by tying the validity of tax stamps to one fiscal year, allowing the inventory of cigarettes with old stamps to be adjusted according to any change in the tax rate.

---

1. Pakistan: Tobacco Fact Sheet 2022. https://spdc.org.pk/publications/pakistan-tobacco-fact-sheet-2022
2. Iqbal M.A., Sabir M., & Saleem W. (2019). Quantifying the Potential Tax Base of Cigarette Industry in Pakistan, Research Report, Social Policy and Development Centre (SPDC).
3. Sabir, M., Saleem, W., & Iqbal M.A. (2022). Estimating the Under-reporting of Cigarette Production in Pakistan (Tobacconomics Working Paper No.#). *Tobacconomics*. *Forthcoming*.

The Social Policy and Development Centre (SPDC) is funded by the University of Illinois Chicago's (UIC) Institute for Health Research and Policy to conduct economic research on tobacco taxation in Pakistan. UIC is a 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.

Social Policy and Development Centre
7th Floor, Aman Tower, IBA City Campus, Kayani Shaheed Road, Karachi
+92 316 1113113 | www.spdc.org.pk | spdc@spdc.org.pk