



**Report of the Roundtable on
Calibrating Tax Policy to Create Level Playing Field: Case of Tobacco**

by

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April, 2015**

A roundtable discussion on calibrating tax policy with reference to tobacco taxation in Pakistan was organized by the Shahid Javed Burki Institute of Public Policy at NetSol at Sereena Hotel, Islamabad on 13th March 2015. The case of tobacco taxation and the research report developed by KPMG on the subject served as the basis for discussion.

The objectives of the round table were:

- propose various options to the government for calibrating a rational taxation policy with a view to optimizing the revenue collections from tobacco sector;
- ensure level playing field for the private sector by, inter alia, undertaking effective measures to control illegal sector including the use of local illicit, smuggled and counterfeit cigarettes,
- establish the importance of inclusive and participatory process in policy making to reduce rationality deficit, create better synergy between private and public sectors and achieve a more responsive and win-win policy propositions, and
- stimulate, empirical and evidence-based discussion, leading to the formulation of a comprehensive policy framework by the government for furthering its social and economic agenda.

Around 35 eminent experts representing a rich amalgam of the intellect of academia, the insightful perspective of the private sector, the policy making acumen of the state apparatus and the advocacy and agenda setting role of the media participated with a view

to ensuring a better understanding and synergy between private and public sectors; and leading to possibly a more responsive and win-win approach to policy formulation in the pursuit of government's social and economic agenda.

List of the participants is attached

Dr. Tasneem Zafar, chairperson Department of Economics of Government College University Lahore, served as the moderator for the round table discussion.

The participants welcomed the initiative on this issue of vital significance and appreciated holding of inclusive dialogue among the key stakeholders to deliberate on the possible policy options and approaches with a view to ensuring establishment of a conducive frame work and operational environment for the formal private sector to optimize its development and expand fiscal and growth space. It was observed that sub-optimal policy choices and adhoc fiscal regimes were one of the major impediments in the proliferation of the informal sector and creating even playing field for the formal sector to pave the way for sustainable development and growth. The following points were in particular highlighted:

- ✚ Given the enormity and magnitude of the development challenges, the engagement of the private sector by the government in its development effort was sine qua non for sustainable development, growth with equity and poverty reduction solutions in view of the role of business in creating jobs and employment, providing goods and services and generating tax revenues to finance essential social and economic infrastructure for development. A conducive environment has to be created or the formal sector to play its vital role.
- ✚ At the same time, it is absolutely essential for the private sector and businesses to adopt responsive and socially responsible practices and principles based business models to effectively contribute to the achievement of the national development goals.
- ✚ WHO Framework Convention on Tobacco Control envisages price and tax measures as effective and important means of reducing tobacco consumption and achieving national health objectives. However, the Government needs to recognize the wider implications of these measures: the extent to which the illicit trade of tobacco

products, with all the associated concerns including health, legal and economic, governance and corruption, will be fomented; the impact of excessive taxation on the poor households in terms of the disposable income for meeting basic food, nutrition, health and education needs.

Some of the speakers pointed out that Pakistan's complicated, mixed and tiered cigarette taxation structure imposes different excise taxes based on retail cigarette prices. In the regional context, the excise tax structure on cigarettes in Pakistan, India and Bangladesh is very complex and complicated e.g. India levies excise duty based on the length of cigarettes, Bangladesh on the final price of cigarettes and Pakistan on the VAT exclusive price. However, tobacco taxation is very important for two reasons i.e., for raising tax revenues; and then addressing the health hazards, economic costs and negative externalities attached to it. Given the multiple policy objectives, the determination of right level and structure of tobacco tax, therefore, assumed great significance in the context of Pakistan.

Overview Presentations

An industry overview about the Tobacco sector was provided by a representative of the Pakistan Tobacco Company which, inter alia, highlighted the volume of tax generated by the government. relative higher level of incidence of tax on tobacco and cigarettes, the proliferation of illicit cigarette market, the weakness in the law enforcement mechanism and the consequent loss of tax revenues besides direct adverse impact on the formal tobacco sector. He underscored the need for inclusive and rational approach to enacting and formulating the taxation policy.

The overview was followed by a presentation by the Economics and Regulation Director, KPMG London who basically presented the findings of the KPMG report entitled 'A review of cigarette taxation in Pakistan'. The report provides evidence of increasing tax incidence on cigarettes in Pakistan and consequent price hikes in real terms. This increase in real price of the cigarettes, however, is not accompanied by intended decrease in consumption as smokers are shifting towards illicit cigarettes. Moreover, the increased taxation fail to generate extra revenue for the government due to shifting away of cigarettes' demand from

duty paid to more affordable smuggled/illicit alternatives. This was palpable indication of the failure of government's policy both on health frontier and on revenue frontier.

He underscored that between 2008 and 2013, total cigarette taxes on the weighted average priced brand increased by Rs. 6.2 in real terms (i.e. inflation adjusted) per pack of 20 cigarettes. Although over the same period, the pre-tax price of cigarettes (i.e. price excluding all duties and sales taxes) fell by Rs. 0.8 per pack of 20 cigarettes. Resultantly, the average pack price increased from Rs. 35.6 to Rs. 41, making taxes and duties responsible for all the retail price increase. This rise in the price of duty paid cigarettes contributed to a widening price differential between the duty paid cigarettes and illicit cigarettes from Rs. 9.4 to Rs. 17 per pack. The trend of increasing cigarette taxation continued into 2014. On 4 June 2014, the government introduced a change to cigarette tax rates for the fiscal year 2014-2015. The result was an increase in the total tax per pack cigarette, in nominal terms, from Rs. 27.6 in the first half of 2014 to Rs. 34.6 for the second half.

On the other hand, between 2008 and 2013, the average household real income grew by 1.5 percent, which was remarkably lower than the income growth of 25 percent, between 2003 and 2008. The combination of the slowdown in the household income growth and rising duty paid cigarette prices, made cigarettes over 13 percent more expensive relative to consumer incomes in 2013 compared to 2008. Using Euromonitor forecast of average household incomes as well as the average price of duty paid cigarettes in 2014, it has been estimated that cigarettes were 30 percent more expensive relative to incomes for consumers in 2014 compared to that of 2008.

This led to a decline on the sale of duty paid cigarettes as they became less affordable for consumers. Between 2008 and 2013, duty paid cigarette sale volume fell by 10.1 percent. The higher price of these duty paid cigarettes increased the incentive for consumers to look for lower priced alternatives; and resultantly between 2008 and 2013, illicit cigarette consumption increased by 24.8 percent.

The participants also took notice of mainly the three main sources of illicit cigarettes in Pakistan. Local illicit cigarettes, produced primarily by local manufacturers, account for 84.5 percent of the total illicit cigarette consumption. Secondly domestically manufactured

counterfeit cigarettes turn out to be 3.5 percent and lastly cigarettes smuggled into Pakistan from neighboring countries which constitute about 12 percent of the total illegal cigarette consumption in the country.

The participants were also informed about the impact of price increase of cigarette on the consumption. Despite the price rise in the years, 2008 to 2013, there was only a marginal decline in the incidence of smoking i.e., about 0.2 percent which reflects that increase in cigarette taxes fomented the consumption of illicit cigarettes in addition to the possibility of consumers switching over to alternative tobacco products. In addition, the quantified loss of revenues and sale duty owing to illicit cigarettes consumption in the financial years 2008 – 2009 amounted to 13.7 percent. Moreover, if taxes had been collected on all illicit cigarettes consumed in the fiscal year 2013-2014, the raised tax revenues would have fetched additional 24.4 percent, equating to around Rs.21. billion.

Discussion and Analysis

A number of participants, however, observed that the KPMG report had a very narrow focus and that it did not consider non-smoking alternatives of tobacco use. Additionally the time period/ duration and frequency of data used in the report was also not robust enough to lead to conclusive finding and conclusive results. It was observed that analysis in the report did not go deep enough; greater time dimension coupled with elaboration on variables that affect smoking behavior could have added to the robustness of the findings and conclusion. Moreover, lack of analysis of non-smoking tobacco usage and incidence of tax on it failed to capture the situation in its entirety.

On high real prices, one of the participants pointed out that tax as a percentage of cigarette prices in Pakistan is around 60 percent which is far less than World Bank's 70 percent bench mark. And given large proportion of youthful population in Pakistan, policymakers should try to make cigarettes more unaffordable for the young ones. This implies even larger taxes on more popular brands.

The lack of vision and clarity as to the objectives of taxation on tobacco was identified by many participants as one of the major causes for the rationality deficit in the policy. More

specifically, government's objectives vis a vis taxing cigarettes were not clearly articulated. If government's objective was to maximize its revenue, a decrease in the tax rate could have increased the tax revenue by making smoking more affordable. On the other hand, if public health considerations were constituted the prime objective, taxation should have been coupled with a package of education, sensitization and awareness measures regarding deleterious impact of smoking on health. Participants mostly from government side, in turn, pointed out that arbitrary target setting for revenue collections at times skewed the policy process and led, inter alia, to larger distortions in the tobacco economy to the great detriment of the formal sector.

There was a wide spread view as to the policy and institutional fragmentation and coordination dysfunction within the Government apparatus. The overlap and duplicity of mandate and nebulosity in the area of operation and jurisdiction permeated vertically and horizontally at various levels which prevented coherence, synergy and optimality in the policy and decision processes. More specifically, the Federal Board of Revenue and/or the Ministry of Finance while setting the policy objectives or targets for revenue collection hardly consulted with Ministries of Health, Environment or other related Ministries and government outfits in the tobacco and taxation sectors. Similarly despite plethora of laws, regulations and enactments provided for curbing illicit manufacturing or trade, the law enforcement agencies and function suffered from institutional and operational weaknesses besides evasion of responsibility through "passing the buck" phenomenon or raising jurisdictional issues. Absence of the representative Ministry of Health in the round table which had a major health dimension, it was stressed, was a clear evidence of this malady. The participants underscored the need of assigning precise duties and functions to various departments, a condition necessary for effective implementation.

Some participants pointed out specific number of illicit cigarette manufacturing units (29) and their locations but bewailed the inability of the executive authority to carry out law enforcement function because of the powerful interests involved and the political backing. Similarly the volume and scale of cross border trade of cigarettes was also known along with the trade routes but the porous nature of the border, difficult terrain, lack of

established writ of the government and the widespread tentacles of the "mafia" involved in the trade frustrated attempts, if any, of the law enforcement agencies.

It was also pointed out that 70+ legal and regulatory instruments were available with the law enforcement agencies and as such there was no dearth of sanctions and authority of law to control the illicit cigarette manufacture and trade. What was required was the implementation and enforcement of these laws and frameworks by the entities authorized to do so. Many participants emphasized the need for greater and more effective law enforcement for curbing illicit cigarette manufacturing, trade and sale and achieving health objectives.

The issue of tax elasticity and tax violation was also raised. It was argued that while tax elasticity was generally estimated and focused upon in studies about taxation, the incidence of tax violation and evasion was consistently ignored. The need for factoring both in articulating the policy options was emphasized.

Many commentators impressed upon the context specificity of Pakistan which ought to be weighed while devising and designing public policy and solutions. For instance, the porous border on Western frontier cannot allow only tax based instruments to succeed; other accompanying instruments e.g., public awareness, security and enforcement dynamics, alternative income generation opportunities etc., have to be integrated to find a comprehensive and practical solution to the problem. The involvement of local authorities and administrations is also emphasized. Due to weaknesses in the local structure tobacco sellers are offering both duty paid and illicit cigarettes.

Some commentators raised the issue of weak intellectual property rights that makes it easy for tobacco sellers to sell counterfeit cigarettes besides encouraging the illicit manufacturing and trade.

One view was that the sovereign right to smoke should not be infringed or constrained by the government through unreasonable policy and regulatory instruments while the others advocated the severity of policy and enforcement against smoking due to the externality and passive smoking imposed upon the non-smokers.

The importance of intellectual property rights was also highlighted which in case of Pakistan was still very weak and nascent in ensuring the interests and rights of the IP owners. Consequently, the counterfeit and illicit manufacturing, trade and sale proliferated without any check or control to the great disadvantage and business loss of the formal sector. The lack of adequate tracking and tracing systems to monitor and follow tobacco products throughout the production and distribution chain further aggravated the problem.

Conclusions and recommendations:

The round table discussion on '**Calibrating Tax Policy to Create Level Playing Field: Case of Tobacco**' addressed important issues at the heart of tobacco taxation involving larger policy, institutional, and implementation and enforcement dimensions on the one hand and, on the other, issues like the appropriate level of taxation; structure of tobacco taxation; the revenue stream vs the health hazards and negative externalities; illicit trade and manufacturing and the impact on the formal sector with associated resource, enforcement and public health implications. In this regard replacing Pakistan's complex tiered structure with a simple uniform specific tax on all cigarettes could be a good policy option as it will eliminate the possible tax avoidance caused by misreporting and misclassification of different brands, and will reduce the incentive on the part of consumers to switch to less expensive brands in case of price increase caused by tax increase.

The objectives of Framework Convention on Tobacco Control of 2003 to curb the incidence of tobacco use cannot be effectively achieved only through taxation and price related interventions. At the same time, a level playing field for the private sector is absolute imperative for stimulating and sustaining economic activity, creating jobs and generating revenues for government to implement its social and economic development agenda. In the specific case of tobacco sector, mere taxation as an instrument of curbing tobacco use will not be rewarding unless there are efforts to discourage criminality and illicit manufacturing and trade (smuggling, counterfeit, duty evasion, etc) in the tobacco sector. Finally, there is a need to improve tobacco tax administration and collection, increased enforcement to reduce tax evasion and avoidance, and bringing all tobacco products in to

tax net. Last but not the least, for public health issues, there should be serious efforts to reduce information failures through labels on cigarette packets and media campaigns.

Recommendations:

There has been a growing recognition that many of the most pressing problems are too complex for the public sector to face and address alone. An inclusive approach involving all the material stakeholders both for diagnostics and prescriptions is absolutely imperative for sustainable development.

In this connection, the role of the private sector has become extremely important to addressing the major issues of economic growth, equity and poverty reduction as the businesses and commercial activity generates employment and wealth through trade, investment and finance for development. The private sector can also bring key resources to the fore – knowledge, expertise, access and reach – that are often critical to advance the development goals. This entails creation of environment and space within the macro-economic framework for the formal private sector in conjunction with the public sector to fully harness its potential and play its vitally significant role. This would be only possible if such a framework does not allow the informal and especially the illicit businesses, trade and manufacture to proliferate and squeeze the formal regular private sector out of space. It is also important that public sector does not occupy the full fiscal, development and financial space; refrains from fiscal, taxation and policy instruments which constrain the growth of private sector; and recognizes, in the wake of complexity and enormity of development challenges, the role which a robust and dynamic private sector can play in enabling the government realize its social, economic and development agenda. In short, therefore, a level playing field is sine qua non for maximizing and synergizing the role of different sectors in the economy and creating win-win situation.

Against this backdrop, the following set of recommendations has emerged as a result of the roundtable:

Policy Level:

- A macro-economic policy and strategic framework should be established by the government to create an enabling fiscal, financial and development environment for the private sector to fully harness its potential and dynamism and to contribute to the government's efforts to meet its social and economic objectives;
- Government needs to clearly articulate its policy objectives and set the contours and level playing field for various actors, sectors and entities to play their roles in the implementation of those objectives;
- These policy objectives should be formulated through an inclusive process so that input and perspectives of all the relevant actors/entities enrich the policy process and reduce the possible areas of deficit for better implementation and realization of intended results.
- The taxation policy with regards to tobacco use and consumption should not be governed by the revenue considerations only, for, excessive raise in the tax and consequent cigarette price, as demonstrated by KPMG report, may lead to revenue loss, little impact on tobacco consumption and may foment consumption of illicit cigarettes and ensuing stimulus to illicit trade and manufacture.
- Loopholes in the legislation on combating illicit trade particularly with regards to punishment, enforcement and cooperation/coordination among the institutions involved should be plugged
- The intended objective of reducing the demand for consumption through increase of prices and taxes should be so orchestrated as not to encourage the illicit trade.
- The Ministry of Health in pursuance of the UN/WHO Framework Convention on Tobacco Control should, through a participatory and consultative process and in collaboration with all relevant sectors including public institutions, universities and civil society organizations, formulate a clear policy and action plan to control tobacco use and protect the people, particularly, the youth from its adverse effect on health and mortality.

- A defined policy on formal and informal education on combating tobacco, tobacco products should be enacted to sufficiently cover the harmful effects of tobacco on human health.
- The Intellectual Property related laws together with truth in labeling laws and coding systems (place and date of manufacture) should be made more stringent to curb and control counterfeit tobacco products.
- The municipal laws and regulations and inspection systems with provision of heavy penalties and summary trials should be enacted and instituted to prevent manufacture and sale of counterfeit and illicit cigarettes.
- The existing legal regulations that prohibit the sale and distribution of tobacco products to minors under 18 should be strengthened to provide for deterrent penalties on the violators.
- The existing legal regulations should be strengthened to curb the use of symbols or descriptors on packs, packages and labeling to mislead or deceive the public.
- The education policy should provide for inclusion in the curricula, right from the primary standards, the fatal impact of tobacco consumption on health
- Government should structure social policies to shift tobacco cultivation to alternative crops.

Institutional:

- A coordinated and cohesive approach needs to be evolved to clearly delineate the roles and responsibilities of various departments entities involved both in establishing the taxation regime as well achieving health objectives.
- The capacity deficit of the state apparatus to follow inclusive policy making should be strengthened through training and technical assistance. A techno-managerial-professional approach to policy making has to be augmented by input and perspective of the civil society and private sector.
- Ministries and Departments of Health, Education, Environment, Planning, Interior and Federal Board of Revenue at the Federal and Provincial levels competence and

capacity should be strengthened to coordinate the formulation of policy and upstream regulatory framework

- A coordination mechanism through a Steering Committee chaired by Ministry of Interior with representatives of all relevant institutions should be established in order to provide solutions to problems faced by the illicit trade, smuggling and counterfeit tobacco products.
- The law enforcement and regulatory function to curb and control illicit manufacture, trade and sale should be made optimally operational to implement the relevant laws, rules and regulations.
- A monitoring and performance evaluation system should be introduced to assess the efficacy, efficiency and effectiveness of various agencies involved in enforcement. This could be achieved through result matrix by inventorizing the institutions involved, capabilities and capacities, the jurisdictional issues and responsibilities, cooperating institutions, possible barriers, performance indicators and extent of achievement of results.
- The custom services and FIA should be strengthened to prevent, monitor and investigate smuggling and illicit trade.
- The technological equipment and IT systems with the ability to detect smoking substance should be provided to customs services for checking trailers and containers at border crossings
- Capacity to destroy all illicit and illegal products by Customs, Police and Ministry of Interior by environmentally friendly methods should be created.
- Accredited laboratories should be established in compliance with national and international standards and regulations to monitor and evaluate ingredients and emissions of tobacco product and to integrate these with WHO Tobacco Laboratory Network.

Resources

- Results based resource allocation coupled with incentive mechanism should be introduced to improve the improvement of law enforcement agencies;

- The Steering Committee should be provided with the resources to carry out research and study with a view to encouraging evidence and research based policy formulation and action plan to control illicit trade and manufacturing.

National Action Plan

A 5 year National Action Plan on Control of Tobacco Use should be formulated through participatory and inclusive process by packaging a troika of measures:

- (a) Demand reduction measures through (i) public information, sensitization and education; (ii) smoking cessation by putting in place support mechanism; (iii) right mix of pricing and taxation not to encourage illicit trade or manufacture; (iv) preventing passive exposure to minimize harm to health by legislative measures; (v) prohibition of advertising, promotion and sponsorship to directly or indirectly encourage tobacco consumption; (vi) product control and testing through accredited laboratories integrated with WHO Tobacco Laboratory Network; and (vii) informing consumer about the content of tobacco products
- (b) Supply side measures to reduce supply of illicit tobacco products through (i) control of illicit trade, counterfeit products and illicit manufacturing of cigarettes; (ii) prevention of sale of tobacco products by unauthorized agents and outlets and street vendors; (ii) prevention of tobacco product to young people; (iii) monitoring and control of tobacco production and identifying alternative agricultural products or economic activity; (iv) promotion of economically attractive alternative agriculture
- (c) Institution of Monitoring and Accountability System to curb smoking and to control illicit trade and manufacturing and sale of counterfeit tobacco products through (i) establishing national data system on the production, sale and consumption; (b) evaluate effectiveness of relevant policies and legal instruments and institutions and organizations involved in controlling illicit trade; (c) periodic reporting to serve as accountability tool.

Annex 1

List of Participants

Calibrating Tax Policy to Create Level Playing Field: Case of Tobacco

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