



Working Paper # WP-2016

January 19, 2016

Dealing with the problem of illicit cigarettes

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Introduction

The recent Nielsen study on tobacco consumption in Pakistan and the role in it of the cigarette-manufacturing industry highlighted the problem posed by the production or import of what it called “illicit cigarettes.” The Study correctly states that “illicit trade in cigarettes, whether in the form of smuggling, local tax evasion or counterfeit is a global phenomenon with one in every 10 cigarettes and tobacco products reported to be illicit. Experts are of the view that it would be hard to find a more ideal candidate for illicit trade than cigarettes. The product is small, lightweight and profitable for illicit trade because the sale price is many times the cost of manufacture. All countries, be they developed, developing or in transition, suffer multiple consequences of this illicit trade.¹ Despite the adoption overtime of a comprehensive fiscal and regulatory frameworks, the illicit segment has almost a quarter (23.7 percent) of the overall cigarette market, with 89 percent of this illicit segment made up of the LTE cigarettes. As we will note later, Pakistan has a very high component of illicit cigarettes in total consumption.

Like so many other countries around the world, Pakistan has adopted a combination of public policies to reduce the consumption of tobacco. But not all the policies were aimed on curbing the use of tobacco. The focus, as in some other parts of the world, has been on the manufacture and consumption of cigarettes. The approach has not succeeded – the objectives policymakers had set for themselves have not been achieved. The main reason for the relative failure of public policy is the “switching effect” – consumers by and large have switched to the consumption of tobacco in other forms. Consumption of illicit cigarettes is an important part of this switch. But that is not the only switch. Pakistanis also consumes in large numbers “bedis” – a locally manufactured product made of rolled tobacco leaves.

This note first defines the problem of illicit cigarettes, then identifies the various public policy choices that can be made to address it, and concludes with some suggestions as to the most attractive approach the policymakers could adopt to address the problem.

Illicit cigarettes: The problem

“Illicit cigarettes” are defined as those that enter the consumption stream in order to avoid the taxes manufacturers and consumers have to pay in the production-consumption cycle.

¹Nielsen, *The Challenge of Illicit Trade in Cigarettes: Impact and Solutions for Pakistan*.

Governments levy tobacco taxes for at least two reasons: to use the price mechanism to discourage consumption generally and to raise revenues. In Pakistan, the tobacco crop is also taxed in order to pay for research aimed at increasing the productivity of the land devoted to growing it. In the developed parts of the world the first is the most important reason; in developing countries such as Pakistan, the second has considerable significance. The third is relatively rare. It is a legacy of the colonial era.

If taxes produce a steep price-gradient – the difference between the cost of manufacture and the price consumers have to pay –the result is the arrival in the market of cigarettes that are able to escape the tax net. Those which are able to escape taxes are termed illicit. They constitute a large part of the cigarette market.

There are several avenues through which illicit cigarettes arrive in the market in Pakistan. Steep price gradient makes it attractive to import the item, thus escaping both customs duties and levies on manufacturing. This means smuggling the finished product from abroad. This is an activity that has long bedeviled the Pakistani economy. There is evidence that the Afghan transit trade that allows Pakistan's landlocked neighbor to use its roads and railways for bringing in goods and commodities from Karachi and Port Qasim has resulted in a great deal of smuggling. A significant amount of the cigarettes imported formally by Afghanistan never reach their declared destinations and find their way into Pakistan. Some that get to Afghanistan are smuggled back into Pakistan. There is a large difference in custom duties charged by the two countries on cigarettes. The Afghan Transit Agreement signed in 2010 is an attempt to reduce – possibly end—this leakage but it is not working.² There is also domestic manufacture of illicit cigarette located in places that are poorly administered. Cigarette manufacture is not a complicated process. Mardan, a district in Khyber-Pakhtunkhwa province is a major producer of raw tobacco and has become a large center for the manufacture counterfeit items. Some of the local but informal manufacture of cigarettes is of brand items. Non-brand items can also be produced and sold if the consumers are not brand-conscious. This is the case for lower-income groups in Pakistan. For illicit manufacture smuggled paper and acetate tow for filters are used for producing the final product. A considerable part of the total illicit consumption takes the form of non-branded items.

If the demand for illicit cigarettes becomes a significant part of total consumption both objectives of public policy are defeated. Total tobacco consumption will not be reduced by the hoped-for amount and the government loses a substantial part of the revenue it was expecting to raise from this particular source. This is the case in Pakistan – an important part of the conclusion reached by the above cited Nielsen study.

Public policy choices

Consensus among health scientists developed fairly quickly that tobacco consumption could lead to serious health problems. According to the World Health Organization (WHO), “tobacco use is among the leading preventable causes of death. Each year, the global tobacco epidemic kills nearly 6 million people, including more than 600,000 who die from exposure to second-

²See Zubair Khan, *Pakistan-Afghanistan Cooperation on Trade: Political Economy Analysis*, Asia Foundation, Islamabad, 2015.

hand smoke. It is on track to kill more than 8 million people by 2030, by which time approximately 80 percent of the deaths would occur in low- and middle-income countries.”³

It has also come to be recognized that cigarettes more than most other forms of tobacco do more damage to health. They use several chemicals to improve the taste and delivery of the smoke that is the vehicle of tobacco consumption. With increased information, pressure built up on governments to reduce this form of tobacco consumption. The concept of multi-pronged and therefore comprehensive control on tobacco consumption came about through academic advances reported in a journal that was dedicated to the cause. The *Tobacco Control* journal published refereed articles based on research including those carried out in clinics. Progress was initially at the local level. For instance, legislation was introduced in New York City in 2002 aimed at curbing the use of tobacco. In addition to the work done at the WHO some of the important development agencies also got involved in researching the effect on health and life-expectancy in several countries in which they were operating. To take one example: In 1992-93, the World Bank carried out a major study on the impact of tobacco consumption on public health in China. This work ultimately resulted in the adoption of fairly rigorous measures by Beijing to bring tobacco consumption under control. The emphasis was on imposing restrictions on cigarette consumption in public places. The Chinese did not use taxes to reduce consumption.

The work done by several international agencies led to the establishment of the World Health Organization Framework Convention Alliance which was responsible for the passage of the first international public health treaty, the Framework Convention on Tobacco Control or FCRTC for short. WHO subsequently produced an internationally-applicable essential elements of a tobacco control strategy that has the following six components:

- **M**onitoring of tobacco use
- **P**rotecting people from tobacco smoke
- **O**ffering people help to quit tobacco smoking
- **W**arning about the health consequences of tobacco use
- **E**nforcing bans on tobacco advertising, promotion and sponsorship
- **R**aising taxes on tobacco

This came to be known as the MPOWER strategy, the acronym picking up the first letter from the proposed actions. ⁴It should be noted that the fiscal system for influencing the quantum and pattern of consumption came last in the list of public policy priorities.

There are basically three types of public policies that have been used mostly in combination to achieve reduction in the use of tobacco. They are: the price mechanism, administrative controls and education. All three are used simultaneously. That they overlap significantly is shown by some recent developments in the way administrative controls have been deployed. In several countries manufacturers are required to print graphic pictures of the damage to health possibly caused by tobacco consumption. This is now being done in the United States, Europe and

³ World Health Organization, *Global Health Observatory (GHO) Data*, Geneva, May 2015.

⁴ World Health Organization, *MPOWER*, Geneva, 2011

several East Asian countries. The assumption is that the shock-effect of the pictures displayed on the packets would discourage consumption. The further assumption is that by looking at the pictures when the item is being purchased, the consumer will be deterred. However, available studies show that the overall effect on consumption of this particular form of tobacco use is, at best, marginal. The ill-effect of tobacco consumption is now well-recognized. By putting pictures on cigarette packets it only serves to remind the consumers of what they already know.

The most effective administrative approach has been to limit the space in which tobacco consumption can be undertaken. This, as already indicated, was the approach followed by China. Once health scientists were able to establish a link between health and “secondary smoke,” the space in which consumption could take place began to be limited. Cigarette smoking was banned in such closed spaces as aircrafts, trains and buses. Smoking in public places such as offices and restaurants was also banned. In some states in the United States, smoking is not allowed in front of schools and hospitals. Increased public awareness also resulted in enforcing these restrictions.

Table: Tax in incidence of cigarettes in Pakistan and world regions (percentage of the retail price)

South-East Asia	30.5
Eastern Mediterranean	49.8
Western Pacific	55.5
Africa	57.6
The Americas	57.9
Global Average	59.4
Pakistan	62.5
Europe	68.9

As shown in the above table, Pakistan has a very high rate of cigarette tax. It is 3 percentage points higher than the global average and considerably higher than the regions in which there are a large number of developing countries. Pakistan deviation from the norm is for a simple reason: fiscal policy was never the result of the state’s wish to control tobacco consumption. Various tobacco taxes were levied to generate resources for the government. This policy orientation goes back to the colonial times.

Suggestion: A New Regulatory paradigm

The Nielsen’s Study’s data points to the failure of the tobacco policy in Pakistan to control and reduce the consumption of the item. The main reason for failure is the ease with which consumers are able to switch to the use of cigarettes that escape the tax net. “In 2013, Pakistan ranked 4th highest in Asia on the basis of share of illicit cigarette segment in total cigarette market in the county. In Pakistan, approximately one out of every four cigarettes sold is illicit, which is 137 basis points higher than the global average. In 2014, more than 19.5 billion illicit cigarettes are sold in Pakistan every year, and this illicit segment continues to grow. During the last six years, the illicit segment has grown by 43.5 percent and the tax-paid cigarette volume has declined by 11 percent. On an average more than one billion cigarettes are added to the

illicit segment in Pakistan.”⁵ This is a serious indictment of the failure of public policy in achieving its stated objectives. There is a clear need for a new regulatory framework for controlling the consumption of tobacco products.

Pakistan’s experience with tobacco policies points to a number of conclusions. Three of these are important for our purpose. First, the country has as yet to adopt a comprehensive approach towards the consumption of tobacco. A constituency for controlling consumption does not exist. Some of the policies that were adopted such as the ban on advertising cigarette brands in sporting events came not from domestic preferences but from external pressure on the manufacturers. The Pakistani market is controlled by essentially two companies, one based in the United States and the second in Britain. There is a large, powerful and active constituency in these two countries working on reducing the consumption of tobacco. These firms have accepted the demand of strong anti-smoking lobbies that they should not advertise their products in sporting arenas. This will be so not only in the countries where their headquarters are located but also in those where their products are sold. The Pakistani ban is the result of this agreement. Other major changes in tobacco policy were also the consequence of developments outside the country. For example, Pakistan International Airlines imposed the “no-smoking” ban on its flights when it became the requirement of the International Air Transport Association, IATA.

Second, the use of fiscal policy was never intended as a measure to discourage tobacco consumption. It was aimed mostly at increasing government revenues. Cigarette manufacturing with concentrated foreign ownership was an easy target to hit for raising government’s tax income. However, with the steepening of the manufacturing-cost consumer-price gradient incentives were created for the introduction of illicit cigarettes. The easy availability of this unregulated product has had adverse health consequences.

Third, the government needs to adopt a holistic approach towards influencing the extent of tobacco consumption. Tax policy should be one element of this approach. There should be careful assessment of the impact the growing share of illicit cigarettes has had on public health.

The optimum policy approach

An optimum public policy for Pakistan aimed at reducing tobacco consumption should combine the three elements discussed above. Fiscal policy should continue to be used but the gradient should not be as sharp as it is today. Revenue generation for the government should not be the determining factor as it has been for many years. The government has to adopt a different approach for improving its resource situation.

In devising an approach the government should determine the “tipping point” at which the amount of tax creates incentives to feed the market by tapping the illicit sources of supply. Going beyond the point will prove to be counterproductive. At the same time administrative

⁵Nielsen, *The Challenge of Illicit Trade in Cigarettes: Impact and Solutions for Pakistan*.

measures should be adopted. Smoking should be banned from enclosed places, choosing those where implementation can be done without encouraging rent seeking behavior.

From the data collected by Nielsen, it is obvious that the focus on fiscal policy is doing more harm than good in controlling cigarette consumption. We propose a complete overhaul of the structure of various taxes on tobacco at the several points of the chain: from the growth of tobacco crop, to the use of the product to manufacture cigarettes, to their distribution and to their final sale. The result of the present system is a serious perversion of the entire chain. The most disturbing aspect of this is the production and consumption of illicit cigarettes. The tax structure needs to be simplified and rationalized. Generation of revenues for the government should be a secondary objective of the policy. Reducing consumption should be the primary focus. Using a simple measure of price elasticity implicit in the Nielsen data suggests that reducing the total incidence of tax by as much as 50 percent will profoundly and negatively affect the production of illicit cigarettes. It will reduce the incentives for those who are currently employed in illicit production by bringing the incidence of tax close to the level of the country's neighbors. That should help reduce the amount of smuggling. Such a significant reduction in the overall incidence of tax will increase the production of "licit" cigarettes while decreasing overall consumption. Government revenues will also increase.

While this suggestion can be read as based on the generally discredited "Laffer curve," it applies to the case of tobacco taxes in Pakistan. The Laffer curve for cigarettes shows the relationship between the incidence of tax and the amount of revenue generated. At zero or hundred percent tax no revenue gets generated. The point at which maximum revenue is raised can be read from the graph. While there are good empirical reasons not to use the curve for the entire economy it can be used for individual products as we have done for the manufacture and consumption of cigarettes in Pakistan. The economist Arthur Laffer himself explained his model in terms of two interacting effects of taxation: an arithmetic effect and an economic effect. The former is simple: it calculates revenue by multiplying the tax rate by the value of the product being taxed. The economic effect is, however, controversial. It assumes that the tax rate will be change the tax base. This has happened in the case of Pakistan by reducing the amount of production to which the tax will be applied.

Conclusion

Our main recommendation is that the government should completely overhaul the structure of taxes levied on tobacco and its products. Islamabad should aim to reduce the total tax incidence by as much as one-half. This will reduce the incidence of illicit manufacture and marketing of cigarettes without hurting the revenues generated by the taxes. The government should also examine the possibility of replacing the existing excise duty on manufacture by a tax on consumption. We see little purpose in continuing the colonial era provincial tobacco boards. Their purpose was the undertake research to improve the productivity of the land committed to growing the tobacco crop. The boards were financed by a levy on the land on which the crop was grown.

In devising an optimum approach towards reducing tobacco consumption, policymakers in Pakistan have to keep in view the weakness of the country's institutional base combined with

the near-absence of concern about public good. Administrative controls work only when they don't generate rent-seeking activities on the part of those responsible for enforcing them. They also work when there is greater awareness among people of their usefulness. Disregard for traffic rules and indifference towards trash disposal are some of the indications of why social pressure on discouraging smoking in public places will not work as well in Pakistan as it does in developed countries and some developing nations.

We also recommend overhauling the institutional structure by merging the dozen or so organizations currently involved in regulating various aspects of the production-consumption chain.