

# HIGHER TOBACCO TAXES IN PAKISTAN COULD INCREASE REVENUE & IMPROVE PUBLIC HEALTH

POLICY BRIEF

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Based on "Tobacco Taxation and Consumption in Pakistan". Durre Nayab, Muhammad Nasir, Junaid Alam Memon, Mahmood Khalid and Anwar Hussain. 2018.

Revenue generation is important for any country, but for a country like Pakistan, where the tax base is very small, the issue becomes very complex. Tobacco taxation increases this complexity as health costs due to tobacco consumption are as much a reality as is the need for generating revenue. With the tobacco industry contributing a major chunk of the total revenue collected on account of excise duty in the country the issue becomes trickier.

Different tax regimes have been introduced at different times in the country, some under the pressure of the health advocates while others under the influence of the tobacco lobby. Never the less, the prime aim of the authorities remains revenue generation.

Any inquiry in the effects of tobacco taxation and consumption requires the estimation of tobacco price elasticities as they tend to be vital indicators of tobacco demand. Literature suggests that price elasticity of cigarette demand in low- and middle-income countries lies between  $-0.50$  to  $-1.00$ , meaning that a 10% increase in prices would reduce consumption between 5-10%. Variations also exist between short- and long-run elasticities.

## Tobacco Consumption in Response to Prices

Tobacco in Pakistan is primarily consumed in two forms: smoking cigarettes and chewing tobacco.

Different regions and provinces show different trends in tobacco pricing and consumption. For instance, price of cigarettes is slightly higher in the rural areas as compared to urban; while the price of chewed tobacco does not vary significantly across regions. Provincial variations are, however, found in the prices of cigarettes and chewed tobacco, with the products being expensive in Balochistan and Sindh and cheaper in Khyber Pakhtunkhwa (KP).

This study found that the price elasticity of cigarettes in Pakistan is  $-1.07$ , meaning that a 10% percent increase in the price of cigarettes will decrease its demand by almost the same percentage (i.e. 10.7%).

One explanation for this high price elasticity comes from the distribution of cigarette consuming households across income groups. Since majority of the consumers come from the lower income group, they are more responsive to price changes. The long-term price elasticity of cigarette demand is estimated to be  $-1.17$  in Pakistan, meaning that a 10% increase in prices would reduce consumption by 11.7%. The price elasticity for chewed tobacco in Pakistan is  $-0.55$ , suggesting that a 10% increase in the price of chewed tobacco products will decrease its demand by 5.5%.

These price elasticity estimates of cigarette and chewed tobacco products are significant for the rural regions, but not for the urban regions. A plausible reason for this could be the rural-urban difference between the prevalence of tobacco consumption. Since most of the urban consumers are from the higher income group, an increase in price may have negligible effect on their demand for tobacco. In contrast, the rural consumers, constrained by their budgets, would be forced to cut down their tobacco use in face of a price hike.

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**The impact of increasing tobacco taxes is incremental as higher tobacco taxes lead to a reduced use of tobacco among the poor, a group that often lacks access to health care and suffer disproportionately, economically as well as in health, due to tobacco-related illnesses.**

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Examined on a provincial basis, the price elasticity of chewed tobacco product is negative and statistically significant for KP and Balochistan; while, it is insignificant for Punjab and Sindh. These estimates indicate differing demand for chewed tobacco products across provinces. The chewed tobacco products include an important commodity “naswar”, which is heavily consumed by the Pashtun ethnicity whose majority resides in KP and Balochistan. The price elasticity estimates for both the tobacco products show that consumers in lower income groups would see a drop in consumption in response to higher prices.

Pakistan classifies cigarettes in three different tiers for tax purposes. Previously there were only two tiers. One of the simulation exercises in this study shows improvements in tax revenues and public health outcomes in a two-tiered system compared to a three-tiered system.

## Policy Recommendations

Tax-administration in Pakistan is based on a small tax base, massive tax evasion and an inefficient tax system, which is not peculiar to tobacco sector alone. The government has to look at the tobacco industry as a source for tax-revenue as well as a cause for higher health costs. Certain steps, however, need to be taken to change the current tax situation. These include:

- The government needs to realize that federal excise duty (FED) on tobacco is not a value added tax(VAT), and its primary purpose is to discourage tobacco consumption instead of revenue generation. The impact of increased prices on consumption found in this study suggests that the government could set tax increases based on targets to reduce consumption
- Programs need to be initiated that use technological solutions for monitoring, enforcement and compliance as well as devising strategies to break the political influence of the tobacco industry. There is also a need to build a social compliance that promotes a dislike for tax evasion, and increases public demand for tax invoices along with a refusal to purchase smuggled goods. Until these issues are addressed performance of the Federal Board of Revenue (FBR) will remain sub-optimal.
- The current three-tiered tax structure, introduced on the pretext of controlling illicit trade, has resulted in ‘illicit profiteering’ for the tobacco companies. Tinkering with the retail price of tobacco products, the industry has increased its profit to tax ratios. Ideally a single-tier tax structure should be in place, which would lower the administrative effort required for implementation, give less incentives to tobacco companies for tweaking prices and increase the tax rate overall. But this could increase illicit trade. As a first step, a two-tiered tax structure, with increased tax rates, is recommended.
- Revenue generation on tobacco should be linked to the health costs incurred because of tobacco consumption, with earmarking for improved healthcare programs. Without this earmarking any revenue generated is offset if it leads to a mounting economic health cost because of increased tobacco consumption.

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**From the policy perspective, the introduction of a three-tiered tax structure by the government and the subsequent increase in sales of cigarette is also an evidence of high responsiveness of cigarettes to price variations. This high value of price elasticity confirms the effectiveness of tax policies in reducing cigarette demand by increasing the cigarette prices.**

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