

Tobacco Taxation in Pakistan and AJK: Myth vs. Reality

Increasing the price of tobacco products through higher taxation is widely acknowledged as the most effective way to reduce tobacco consumption. Although evidence shows that tobacco taxation does not have a significant impact on the illicit trade of cigarettes¹, a common argument of the cigarette industry in Pakistan is that higher taxes drive illicit trade. The industry claims that smokers seek out non-duty-paid cigarettes because they are cheaper. Even the national tax collection agency, Federal Board of Revenue (FBR), has adopted this argument at times.²

Illicit trade can be divided into three categories: undeclared local production, undeclared imports, and tax avoidance. While the first is a major contributor to the illicit trade of cigarettes in Pakistan (SPDC, 2019)³, the other two also pose challenges for tax collection.

It is largely argued that FBR is unable to fully tap the tax potential of the tobacco sector. Illicit trade originating from Azad Jammu and Kashmir (AJK) is commonly referred to as a major source of concern in this regard, both by FBR and the cigarette industry. It is important to mention that AJK is a region administered by Pakistan as a self-governing jurisdiction and is a non-tariff area.

Differentials in regulatory mechanisms and tax rates (leading to price differences) between Pakistan and AJK are believed to be important factors contributing to the flow of illicit cigarettes into Pakistan.⁴ It is generally believed that the tobacco industry in AJK has the advantage of not paying excise duty nor sales tax on goods produced in AJK, including cigarettes, which are sold in AJK as well as in Pakistan. A recent study by PIDE (2018) documented the interviews of FBR officials who

supported this view. For instance, the study reported an interview with an FBR official in which the official stated:

...these entities, which are producing cigarettes in AJK, are registered with AJK revenue authorities and cannot be enforced with [the] Pakistan FED [tax] structure. They take advantage of 100% price differences and sell cigarettes at cheap prices. Whereas now the tobacco consumers understand that these cheap cigarettes are not low in quality, hence [they] use them as legitimate sources of tobacco consumption.

It is also argued that Pakistani cigarette manufacturing companies tend to shift their production to AJK when FBR increases tax rates.⁵ Given this background, this policy note attempts to answer the following questions:

- What is the size of the tobacco industry in AJK, and what are their linkages with firms based in Pakistan?
- What is the tax policy of AJK in relation to the Federal Excise Duty (FED) in Pakistan?
- Is the sale of non-duty-paid cigarettes in Pakistan a legal or administrative issue?

The Cigarette Industry in AJK

There are two cigarette manufacturing companies registered in AJK: Walton Tobacco Company and National Tobacco Industries, both of which mainly produce low-price brands. No reliable data on the

The AJK cigarette industry amounts to only one percent of the total cigarette production in Pakistan.

production of cigarettes in AJK are readily available.⁶ A member of AJK's Chamber of Commerce and Industry, however, stated that the market size of the tobacco industry in AJK is relatively small. He estimated that it accounts for approximately one percent of the total production of cigarettes in Pakistan.⁷ This claim also corresponds to a report of a special committee of the Senate of Pakistan.⁸

Regarding connections between the AJK industry and the firms based in Pakistan, the financial statements of Pakistan Tobacco Company (PTC) reveal that PTC has a subsidiary named Phoenix (Private) Limited (PPL). PPL was incorporated in 1992 in AJK but has not yet commenced commercial production.⁹ Meanwhile, financial statements of the Khyber Tobacco Company (KTC) report sums paid in royalties to AJK-based firms – Walton Tobacco Company and National Tobacco Industries – under its “cost of sales” accounting category.¹⁰ This indicates a commercial link between KTC and the AJK-based companies.

FBR Tobacco Taxes and AJK

In Pakistan, domestically produced cigarettes are subject to two major taxes: Federal Excise Duty (FED) and General Sales Tax (GST). By definition, the FED is a production tax, while the GST is a consumption tax. The debate about tobacco taxation largely focuses on the FED, since the GST is applicable on almost all products with only minimal exceptions such as basic food items. The FED, meanwhile, is levied on select items – including cigarettes – largely for the purpose of curtailing their consumption and production. Ideally the GST should be collected at the wholesale/retail stage while the FED be collected at the manufacturing stage. In practice, however, both taxes are collected at the manufacturing stage.

The Federal Excise Act, 2005, provides the legal framework for the levy and collection of the FED, which is amended periodically through finance acts or statutory regulation orders (SROs). Chapter 1 of the Act explains:

(13) “goods” means goods leviable to excise duty under this Act or as specified in the First Schedule and includes goods manufactured or produced in

non-tariff area and brought for use or consumption to tariff area;

(17) “non-tariff area” means Azad Jammu and Kashmir, Northern Areas and such other territories or areas to which this Act does not apply.

As per the above definitions, AJK is a non-tariff area where the Federal Excise Act, 2005, is not applicable. This means that FBR cannot collect FED on goods produced in AJK. However, another article (13) of the same Act provides that excise duty will be applicable if goods are “produced or manufactured in the non-tariff areas and are brought to the tariff areas for sale or consumption therein.” As per the Act, cigarettes manufactured in a non-tariff area and brought into Pakistan for consumption will be subject to excise duty at the rate 65 percent of the retail price.¹¹ In practice, if cigarettes are brought from AJK into Pakistan, the traders must show a valid invoice from the AJK revenue department confirming that the excise duty (as applicable in AJK) has been paid. Otherwise, FBR is authorized to collect the applicable tax.

Pakistan and AJK have the same tobacco taxation laws.

Tobacco Taxes in AJK

AJK is governed by the Interim Constitution Act, 1974. Tobacco companies in AJK need to be registered in AJK under the Companies Ordinance, 1984. In interviews regarding tobacco taxation, tax officials of AJK¹² confirmed that the AJK government has adopted the fiscal laws of Pakistan. Thus, the applicable structure and rates of the FED are the same in Pakistan and AJK. The AJK Finance Act, 2019, clearly states:

...the Federal Excise Act, 2005, as adapted and enforced in Azad Jammu and Kashmir, hereinafter referred to as the said Act, except otherwise legislated by an Act of the assemble, all the amendments, except in Sections 2(23a), 7(2) and 22(13), made in the said Act and all rules, notifications, circulars and other orders made or issued there under, as enforced in Pakistan, at any

time on or after the 16th day of March 2019, and before the commencement of this Act, shall also, as far as practicable, be deemed to have been made, at the same time, in the said Act, as enforced in Azad Jammu and Kashmir by virtue of the Azad Jammu and Kashmir Finance Act, 2005.

The existence of similar tobacco taxes was also confirmed by the tobacco industry in AJK through their petition in the High Court.¹³ As part of their petition against seizure of cigarettes by FBR, the company admitted that the excise duty of Rs1,649 per 1,000 sticks was levied on cigarettes along with 17 percent GST, which is the same rate that was applicable in Pakistan at that time (December 2017).

As far as the revenue from tobacco is concerned, the budget documents of AJK indicate that annual collection of excise duty on tobacco has hovered around RS 1.0 billion for the last few years. Interestingly, this accounts for approximately one percent of the FED collected by FBR, which confirms the one-percent estimate given by an interviewee (described above).

Figure 1: Revenue from Excise Duty on Tobacco in AJK (Rs billion)

	Budget Estimates	Revised Estimates
2014-15	1.42	1.24
2015-16	1.50	1.11
2016-17	1.15	n.a.
2017-18	1.50	0.93
2018-19	1.30	1.00
2019-20	1.60	n.a.

Source: Budget documents of Government of AJK.

Illicit Trade and Tax Administration

The lax tax administration in AJK is another concern for FBR officials and other stakeholders when it comes to illicit trade of cigarettes in Pakistan. Interestingly, this viewpoint was also endorsed by AJK’s Assistant Tax Commissioner who (in an interview with SPDC) stated that tax administration in AJK is weak. Due to a small workforce and security reasons, he explained that it is very difficult for AJK tax authorities to conduct raids to confiscate the illicit goods in AJK. He

further added that tax administration is a main concern of the AJK tax authority, and they are working on making improvements in this area.

Although the AJK tax administration is relatively weak, this does not absolve FBR from its responsibility of law enforcement.

Nevertheless, weak administration on the part of AJK authorities cannot absolve FBR from the responsibility of law enforcement. The latter needs to improve its system of monitoring and tracking the supply chain of cigarettes. Apart from applicable excise duty (65 percent) on non-duty-paid cigarettes brought from AJK into Pakistan, the law also penalizes all those who sell cigarettes without a printed retail price and health warning on the pack. The Federal Excise Act, 2005, states:

(9) Where any goods are chargeable to duty on the basis of retail price under this Act and the retail price is not indicated on the goods 1[and in case of cigarettes, retail price, health warning and name of the manufacturer is not mentioned] in the manner specified therein or in the rules made there under, the duty shall be charged at the rate of 500 per cent ad valorem in case of cigarettes, and 40 per cent ad valorem in case of goods other than cigarettes.

In addition to improving monitoring at all entry points to Pakistan, the local wholesale and retail trade of illicit cigarettes can easily be targeted. For instance, it is not uncommon at retail markets or shops in Pakistan to find illicit brands being sold (that is, without graphic health warning and printed retail price). This situation reflects a significant opportunity for FBR to improve efforts to curb illicit trade.

Conclusions

- There are no official data available on the size of the tobacco industry in AJK. The anecdotal evidence indicates that the AJK cigarette industry is not a big player in Pakistan’s tobacco industry, since the share of AJK in relation to total

production of cigarettes in Pakistan is only about one percent.

- Fiscal laws regarding the FED and the GST on cigarettes are the same in AJK and Pakistan.
- Tax administration in AJK is relatively weak, which provides space for the production of illicit cigarettes or evasion of applicable taxes.
- FBR is also confronted with challenges in terms of effective tax administration to curb illicit trade. This is evident from the sale of cigarettes without graphic warnings and printed retail prices. FBR needs to improve its monitoring mechanisms and enforcement capacity of pertinent laws to curb the illicit trade of cigarettes.
- Tobacco tax evasion is more of an administrative issue than a legal one.

The Way Forward

Rather than blaming AJK for tobacco tax evasion, an alternative route is to improve the capacity of tax administration in both AJK and FBR through the following ways:

- Implementation of an electronic track and trace system in both AJK and Pakistan will help strengthen tax administration.
- Strong coordination among federal and provincial governments can play an important role in taking action against the retail sale of illicit cigarettes. Specifically, FBR and local/provincial authorities should work together for effective implementation of the Vend Act, 1958, dealing with licensing issues of tobacco vendors, which may also help in curbing the sale of illicit tobacco products.

Notes

1. See for example: Rossouw, Laura, et al. The impact of tobacco taxation on illicit cigarette trade in selected low- and middle-income countries. *Tobacco Induced Diseases*. October 2019.
2. For instance, this argument was made by FBR before a special committee of the Senate of Pakistan. (Source: Report of the Special Committee on Causes of Decline in Tax Collection of Tobacco Sector, 2018)
3. Quantifying the potential tax base of cigarette industry in Pakistan. Research Report. SPDC. 2019.
4. Nielsen (2015). The challenge of illicit trade in cigarettes: impacts and solutions for Pakistan. (This research was undertaken by Nielsen at the request of Pakistan Tobacco Company (PTC) and Philip Morris Pakistan.)
5. For instance, Regional Tax Office Peshawar (RTO) wrote a letter to FBR saying that, due to increase in FED, firms are moving their business to AJK where they can operate without being subjected to the rigorous pattern of enforcement (The News, August 31, 2017).
6. SPDC contacted the concerned department in AJK, but the data were not provided by them.
7. Meeting of SPDC team member was held with Mr. Waqas Ahmed, Assistant Director, AJK's Chamber of Commerce & Industry on December 19, 2019.
8. See footnote No. 2
9. Pakistan Tobacco Company, Financial Statements, September 30, 2019.
10. Khyber Tobacco Company, Annual Report 2019.
11. First Schedule, Federal Excise Act, 2005 (entry# 12).
12. Interviews were held with the following officers: Mr. Wasim Latif, Assistant Commissioner, AJK Excise Circle, Muzaffarabad (November 13, 2019); Mr. Atif Javed Abbasi, Research Officer, Finance Department AJK, Muzaffarabad (November 13, 2019); and Mr. Ihsanullah Khan, Assistant Deputy Commissioner, Excise Circle, Mirpur (January 27, 2020).
13. "Cigarettes manufactured in AJK: LHC spells out applicability of Excise Act," *Business Recorder*, December 29, 2017.

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 partner of the Bloomberg 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