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SENATE OF PAKISTAN



House of the Federation

REPORT OF THE SPECIAL COMMITTEE ON CAUSES OF DECLINE IN TAX COLLECTION OF TOBACCO SECTOR

PRESENTED BY

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CONVENER

SENATE SECRETARIAT

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BACKGROUND

In the financial year 2016-17, Tax Collection in the Tobacco Sector of the country suddenly plummeted and fell from **Rs. 114,275 Million (collected during fiscal year 2015-16) to Rs. 83,764 Million per annum**. The matter was taken up by the **Public Accounts Committee (PAC)** of the Parliament. However, due to dissolution of the National Assembly, upon completion of its term, the PAC also stood non functional from May, 2018. Keeping in view the urgency and importance of the matter, the Honorable Chairman, Senate of Pakistan, with the approval of the House constituted a Special Committee on 17th July, 2018, namely, **Special Committee on Causes of Decline in Tax Collection of Tobacco Sector** to probe into the reasons of decline in tax collection and suggest a way forward to curb the same.

2. The composition of the Committee is given as under:-

(1)	Senator Kalsoom Parveen	Convener
(2)	Senator Sherry Rehman	Member
(3)	Senator Ch. Tanvir Khan	Member
(4)	Senator Molana Abdul Ghafoor Haidri	Member
(5)	Senator Muhammad Azam Khan Swati	Member
(6)	Senator Mushahid Hussain Syed	Member
(7)	Senator Hidayat Ullah	Member
(8)	Senator Dilawar Khan	Member
(9)	Senator Anwar ul Haq Kakar	Member
(10)	Senator Sardar Muhammad Shafiq Tareen	Member
(11)	Senator Muhammad Ali Khan Saif	Member
(12)	Senator Dr. Ashok Kumar	Member

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EXECUTIVE SUMMARY

3. After a sudden decline in tax collection from the tobacco sector, the third tier of taxation (lowering of taxes) was introduced for cigarettes manufactured in the country. This was done on the basis of various reports claiming that the market share of the legitimate sector had been eroded due to smuggling of international brands, production of duty non paid and production of counterfeit cigarettes. The third tier was meant to increase tax revenues for the government to similar figures as seen in the year 2016. Because the three tier policy was introduced as a knee-jerk reaction rather than a result of a thorough study of the sector, the three tier policy had a minimal positive impact on the tax revenues of the government but instead benefited the multinationals in increasing profits substantially. This committee heard all relevant stake holders and came to the conclusion that the causes of decline in taxes were directly attributable to the lowering of taxes in the three tier system.

METHODOLOGY ADOPTED BY THE COMMITTEE

4. The Committee held several meetings with all the stakeholders to get their input on the matter. The Committee also paid visits to the manufacturing units of Cigarettes located at Swabi, Mardan and Jehlum and also had interaction with the tobacco growers to imbibe first hand information before reaching the final conclusion.

STAKE HOLDES WITH WHOM THE COMMITTEE INTERACTED

5. The Committee held interaction with the following stake holders of the Tobacco Sector:-

- (1) Federal Bureau of Revenue (Revenue Division)
- (2) Auditor General of Pakistan
- (3) Pakistan Tobacco Board
- (4) Ministry of National Health Services and Regulations
- (5) Ministry of Commerce.
- (6) Pakistan Tobacco Company
- (7) Phillips Morris International Company
- (8) Pakistan National Heart Association
- (9) Azad Jammu & Kashmir Chamber of Commerce & Industry
- (10) Owners of local manufacturing units of Cigarettes
- (11) Growers and Commercial Traders of Tobacco
- (12) Owners of Green Leaf Threshing Units (GLT)



VIEW POINT OF AUDITOR GENERAL OF PAKISTAN (AGP)

6. The detailed and thorough report submitted by the Auditor General of Pakistan attributed the decline in Tax in Tobacco Sector to the weak enforcement mechanism of the FBR which provided space for black marketing. The report also contradicted view point of the FBR regarding benefits accrued from bringing in third tier of Federal Excise Duty on Cigarettes because after the introduction of third tier the sales turnover of Pakistan Tobacco Company and Phillip Morris International showed upward trend reflecting an increase of 31% in case of PTC and 33% in case of Phillip Morris International during the year 2017-18. Despite massive increase in sales turnover 32 % of both companies of Rs. 143.769 billion in 2017-18 as compared to Rs. 109.215 billion in 2016-17, the collection of FED in the same period remained 65.432 billion which is 13% less as compared to FED to sales in the previous year. If both companies even succeed to regain their previous peak turnover of 2015-16 Rs. 155.979 billion even then the total collection of FED will remain about Rs. 65 billion in the coming years as compared to FED collection of Rs. 89.255 billion during 2015-16 leaving a short fall of Rs. 24.255 billion. Reduction in price due to third tier in the FED has also resulted an increase in smoking in the country. The FBR could not explain properly the reasons of 42 % decline in FED. The Report pointed out sale of counterfeit and smuggled cigarette in the country, poor enforcement to prevent smuggling and manufacturing of counterfeit cigarette by the FBR. The Auditor General of Pakistan recommended to increase the Federal Excise Duty on annual basis in line with the guide lines of the Framework Convention on Tobacco Control (FCTC).

VIEW POINT OF FBR REGARDING DECLINE IN THE TAX COLLECTION

7. The overall tobacco industry in Pakistan was manufacturing around 80 billion sticks of cigarettes per day with a decline of 0.4% per annum in the last five years. There are two main components of the tobacco industry viz legitimate taxpaying industry and illegally operating illicit sector. The FBR stated that illicit trade share was approximately 36.2 % during the fiscal year 2017-2018. The FBR had been collecting FED on the basis of 2-tier, since 2013-14. In 2015-16, total collection of FED from tobacco sector was Rs.90.435 billion out of which two major Multinational Companies i.e. PTC and Philip Morris International contributed Rs.89.255 billion and Rs.1.487 billion contributed by the local manufacturers. In 2016-17, total collection from tobacco sector was Rs.66.131 billion out of which two major aforementioned multinational companies contributed Rs.64.644 billion while local manufacturers contributed Rs.1.487 billion. To cope with the situation, FBR introduced a 3-tier based FED structure in Finance Bill, 2017, in which third tier was introduced with almost 50% cut in the FED rate on the premise that because

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of previous high FED rate for second tier, the prices of the duty paying legitimate brands got so high that the consumers started substituting them with non-duty paid illicit brands available in the market at price range of Rs.25 to Rs.30 per pack of 20 cigarettes. However, the revenue collection observed sharp decline in the financial year 2016-17 and fell from Rs.114,275 million to Rs.83,764 million. Main reason for this shortfall was that prices of cigarettes, particularly of tier-2 consumed by lower and middle income groups marketed by duty paying cigarette industry, rose to the price levels of around Rs.72 per 20 cigarettes whereas cigarettes marketed by non-duty paying illegitimate cigarette industry were available in the market in the price range of Rs.25 to Rs. 30 per 20 cigarettes packet which led to decline in the market share of duty paying legitimate multinational companies, M/s Pakistan Tobacco Company and M/s Philip Morris International which contributed approximately 98% of tax revenues from tobacco industry. The FBR stated that market share of the aforesaid companies fell from 67.72% to 36.60% in the financial year 2016-17. The reason for decline was that tier-2 brands marketed by multinational companies were priced around Rs.72 per 20 cigarettes packet whereas tier-2 brands marketed by non-duty paying segment were available in the price range of Rs. 25 to 30 per 20 cigarettes packet.

8. The FBR to regain lost revenues of the Government introduced a third tier of FED through Finance Act, 2017, prescribing FED @ Rs. 800 per thousand cigarettes which has enabled duty paying cigarette industry to market lower brands at around Rs.48 per 20 cigarettes packet. Introduction of third tier in FED helped duty paying industries in regaining their lost volumes of sale which led to increase in the revenues of the Government. The FED and Sales Tax Revenue Collection stood at Rs.87,529 million in the financial year 2017-18, which marked an increase of almost Rs.4 billion as compared to the revenues collected in the financial year 2016-17.

VIEW POINT OF PAKISTAN TOBACCO BOARD

9. The Director General, Pakistan Tobacco Board (PTB) gave a comprehensive briefing about functioning of the PTB, production of tobacco in the country, collection of Cess and 5% Advance Tax on tobacco collected in the year 2017-18. He informed the Committee that the Federal Government has imposed 5% Advance Tax on purchase of Tobacco through Finance Act, 2017, to curtail illegitimate sale of cigarettes. Taxes of Rs. 461.42 million had been collected from the companies and contractors of the tobacco during the last fiscal year.

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VIEW POINT OF THE MINISTRY OF NATIONAL HEALTH SERVICES, REGULATIONS AND COORDINATION

10. The Ministry of National Health Services, Regulations and Coordination apprised the Committee that they had opposed the introduction of third tier in the Federal Excise Act on cigarettes because it was in contradiction with the guidelines of the World Health Organization (WHO) Framework Convention on Tobacco Control (FCTC) to which Pakistan was a signatory. The third tier introduced by the FBR had substantially increased smoking in the country without any financial benefits. The ministry recommended to abolish the third tier of the FED and requested the Government to restore previous rates of the FED in order to curb increasing trend in smoking.

VIEW POINT OF PAKISTAN NATIONAL HEART ASSOCIATION

11. Ch. Sana Ullah Ghumman, General Secretary, Pakistan National Heart Association (PANAHA) stated that their association working for sensitization of society about heart diseases since the last 34 years. Ninety percent of cardiac diseases were due to smoking in Pakistan. Every year, 160,000 people die due to smoking. Pakistan was a signatory to Framework Convention on Tobacco Control (FCTC) of the WHO and is legally bound to control tobacco use. The biggest and proven weapon to curb smoking increased taxation. But, unfortunately, by introducing third tier in FED, the FBR made a substantial cut in the taxes on cigarettes. Regarding the FBR claim of 40% increase in sale of illegitimate cigarettes, PANAHA contradicted the same because they had conducted a country wide survey which revealed that the illicit trade stands at 9% instead of 40% as claimed by the FBR. The PANAHA went to the Federal Ombudsman against the decision of the FBR to introduce third tier in the FED and won the case. However, the same was knocked out by a presidential directive on technical grounds.

VIEW POINT OF THE MINISTRY OF COMMERCE

12. The Additional Secretary, Ministry of Commerce stated that they were not taken on board by the FBR while revising tax policies regarding tobacco sector despite the fact that Pakistan Tobacco Board falls in the domain of the Ministry of Commerce.

VIEW POINT OF THE PAKISNT TOBACCO COMPANY AND PHILLIP MORRIS INTERNATIONAL

13. The representatives of the Pakistan Tobacco Company and the Phillip Morris Pakistan requested for provision of level playing field to all the manufacturers in the country. They requested the FBR to take action against the companies which offered cash awards while selling their product. They assured full support to the Govt in implementation of all regulations

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and policies pertaining to the manufacturing of the cigarettes in the country. They stated that main reason for decline in tax collection in tobacco sector was due to illicit trade of the cigarettes which during the 2017-18 had increased to 35.2% from 21.8%. Due to that reason their brands could not compete the low priced brands sold by the local manufacturers. Resultantly, their sales dwindled which caused huge decline in tax collection in tobacco sector. Introduction of third tier in Federal Excise had helped them to regain their lost share in the market.

VIEW POINT OF AZAD JAMMU AND KASHMIR CHAMBER OF COMMERCE AND INDUSTRY

14. The representative of the AJ&K Chamber of Commerce and Industry informed that the total market share of AJK based cigarette manufacturers was 1% of the total cigarette market in the country. They stated that a share of 88% belongs to the Multinational Companies and 2% to the KPK based manufacturers as indicated in a report formulated by the Sustainable Development Policy Institute (SDPI). The non-duty paid and smuggled cigarettes grab almost 9% of the remaining market share. Secondly, import of cigarettes from AJK into Pakistan was not cause of decline in tax collection in tobacco sector of Pakistan because the tobacco sector of AJK regularly paying FED and Sales Tax on the production of cigarettes to the Revenue Authorities of AJK. Therefore, the decline in tax collection could not be attributed to the cigarette manufacturing companies operating in AJK.

VIEW POINT OF LOCAL MANUFACTURING UNITS OF CIGARETTES LOCATED IN THE PROVINCE OF KHYBER PAKHTUNKHWA

15. The Owners of the local manufacturing units of cigarettes located in KPK submitted that the FBR under S.R.O No. 487 is monitoring their units on 24/7 basis despite the fact that under the relevant provisions of the aforesaid SRO the manufacturing units cannot be monitored round the clock. They mentioned that they regularly pay all due taxes on the production of cigarettes by them. Therefore, duty evasion on the cigarettes manufactured by them is impossible.

VIEW POINTS OF GROWERS AND COMMERCIAL TRADERS OF TOBACCO

16. The representatives of tobacco growers and Tobacco Dealers Association brought forth the problems being faced by their community and stated that a population of approximately five million people earning their livelihood from the tobacco sector. But, now the whole community confronted with colossal problems and there trade almost dwindled to a naught due to multifarious taxes levied by both the provincial and federal governments. This year, local manufacturers of cigarettes made almost no purchase of tobacco due to imposition of

Rs.300/ Kg of tobacco advance tax by the FBR, vide SRO No 1149, which was previously Rs.10/ Kg of tobacco. Total sum of taxes levied on one Kg tobacco imposed by Provincial and Federal Governments came to Rs.350/ Kg. Such a heavy taxation made business impossible for them. Most of the Green Leaf Threshing Units (GLT) and local manufacturing units said FBR did not take them into confidence while revising and formulating tax policy viz a viz tobacco sector. They demanded immediate withdrawal of the SRO No 1149.

FINDINGS OF THE COMMITTEE

17. The Committee, after hearing the view point of all the stakeholders came to the conclusion that the major cause of decline in Tax Collection in the year 2016-17, in tobacco sector was primarily due to the introduction of the third tier which resulted in lower taxes on cigarettes. The incident of illicit trade had not been independently studied, which merely blamed the sale of smuggled and counterfeit cigarettes in the country. Introduction of third tier in the Federal Excise Duty could not substantially enhance revenue of the government as expected while formulating the policy. Furthermore, the third tier, as reported by the M/O National Health Services, Regulations and Coordination and PANAHA was in contravention of the WHO Framework Convention on Tobacco Control to which Pakistan was a signatory. Complete lack of coordination amongst all the stake holders was also noticed because the Ministry of Commerce, Pakistan Tobacco Board, tobacco growers and the Ministry of National Health Services, Regulations and Coordination stated that the FBR never consulted them while formulating tax policies for tobacco sector in the country. It was further noted that the FBR did not have proper resources to fully monitor the GLTs, cigarette manufacturing units and smuggling and sale of counterfeit cigarettes in the country. The Committee also found that SRO No 1149 whereby rate of FED on unmanufactured tobacco had been enhanced from Rs.10/ Kg to Rs. 300/ Kg through an amendment in the Finance Supplementary (Amendment) Act, 2018, had brought highly negative impact on the growers, commercial traders and dealers of tobacco. Pakistan Tobacco Board also reported the same after conducting a survey in tobacco producing areas. It was also reported that due to the aforesaid SRO export of the tobacco by commercial dealers had almost become negligible which resulted in unemployment in the area. The Committee further noticed that the matter pertaining to the cigarettes manufactured in the AJK could be taken up with the respective government but the illicit units operating in the regions formerly known as FATA could neither be stopped from working nor be brought under taxation due to exemption of the tax granted to the areas.

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ACHIEVEMENTS OF THE COMMITTEE

18. Persistent supervision of the Committee brought about substantial improvement in revenue collection of tobacco sector:-

(1) RATES OF FED WERE ENHANCED FOR ALL TIERS

- (i) FBR had revised the rates of FED for all three tiers w.e.f. 18-09-2018. A comparison of rates of FED of three tiers is given as below:-

Tier	Previous Rate of FED	Revised Rate of FED
1.	Rs.3970/1000 Cigarettes	Rs.4500/1000 cigarettes
2.	Rs.1,776/1000cigarettes	Rs.1840/1000 Cigarettes
3.	Rs.854/1000 cigarettes	Rs.1,250/ 1000 Cigarettes

- (ii) **Supervision of GLT Units.-** In order to curb evasion of duty on cigarettes and to monitor purchases and procurement of un-manufactured tobacco for manufacturer of cigarettes, FED Rules, 2005, amended providing for posting of IR officers at GLT for monitoring of production and transfer of tobacco and proper documentation thereof.
- (iii) **Issue of SRO 1149.-** In order to protect the business interests of the growers and commercial dealers of un-manufactured tobacco, the Member, FBR held a meeting with the stake holders. The Chairman, FBR assured the Committee to resolve the issue.
- (iv) **Tracking of Cigarette packs.-** FBR was now in pursuance of introducing of tracking of cigarette packs being sold in the country by introducing modern tracking system.
- (v) **Display of data of production and sales of cigarettes in the country on their website.-** On recommendation of the Committee, the FBR started to display data of production and sales of cigarettes in the country on the website of FBR.
- (vi) **Closure of illegal tobacco manufacturing units in the country.-** On the recommendation of the Committee, the FBR reported to close two illegal cigarette manufacturing units operating in RTO Peshawar region. Now, no illegal cigarette manufacturing unit was operating in the country.

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