

THE CHALLENGE OF ILLICIT TRADE IN CIGARETTES

IMPACT AND SOLUTIONS FOR PAKISTAN



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ABOUT THE REPORT

Over the years a number of researches and reports on the issue of illicit trade in cigarettes in Pakistan have been published. Each of those reports used different methodologies to determine the incidence of illicit trade in Pakistan. The methodology used in this Report (The Challenge of Illicit Trade in Cigarettes: Impact and Solutions for Pakistan) for the measurement of size, trends and dynamics of illicit trade in cigarettes in Pakistan is Retail Audit, which is detailed in Chapter 3. Unless otherwise stated, all quantitative data used in this report is from the Retail Audit that Nielsen regularly conducts. Based on the Retail Audit methodology, Nielsen estimates illicit to be at least 23.7% of the overall cigarette market in Pakistan, and 89% of which is local tax-evasion.

In addition to determining the incidence of illicit segment in Pakistan, in-depth analysis has been

done of key issues. First, key drivers of growth of illicit segment in Pakistan have been examined. Secondly, multiple consequences of illicit trade for the Government, society and consumers have been analyzed. Thirdly, illicit segment supply chain, both inside and outside Pakistan, has been mapped. Fourthly, the extensive regulatory framework already in place in Pakistan to control illicit trade in cigarettes has been elaborated. Lastly, further steps that can be taken to curtail the growth of illicit segment have been proposed for consideration of decision-makers.

This research has been undertaken and compiled by Nielsen in July 2015 on the request of Pakistan Tobacco Company Ltd. (PTC) and Philip Morris Pakistan Limited. Nielsen exercised academic freedom and full editorial control on the research. The opinions and conclusions expressed in this report are those of Nielsen.



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KEY HIGHLIGHTS

4th

HIGHEST

PAKISTAN'S RANKING IN ASIA

on basis of share of illicit segment in overall consumption (2013)

2+

BILLION

CIGARETTES

smuggled into Pakistan annually

23.7%

CIGARETTES

sold in Pakistan are illicit

17.3

BILLION

LOCAL TAX-EVADED

cigarettes sold in Pakistan (2014)

89%

OF ILLICIT CIGARETTES

sold in Pakistan are Local Tax-Evaded



IN ILLICIT TRADE
in last 6 years in Pakistan



DECLINE IN OVERALL
smoking incidence (2008-2013) in Pakistan



ANNUAL GOV. REVENUE
lost due to illicit trade in cigarettes



EMPOWERED IN PAKISTAN
to curtail illicit trade



REGULATING EVERY STEP
of the cigarette industry supply chain



EXECUTIVE SUMMARY

EXECUTIVE
SUMMARY

GLOBAL PHENOMENON

Illicit trade in cigarettes, whether in the form of smuggling, local tax evasion or counterfeit, is a global phenomenon, with 1 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, mostly due to high levels of local tax in most countries. All countries, be they developed, developing or in transition, suffer multiple negative consequences of this illicit trade.

ILLICIT IN PAKISTAN HIGHER THAN GLOBAL AVERAGE!

In 2013, Pakistan ranked 4th highest in Asia on the basis of share of illicit cigarette segment in total cigarette market in the country. In Pakistan, approx. 1 out of every 4 cigarettes sold is illicit, which is 137 basis points higher than the global average. In 2014, more than 19.5 billion illicit cigarettes were sold in Pakistan. On average, more than 1.6 billion illicit cigarettes

are sold in Pakistan every month, and this illicit segment continues to grow. During the last six years, the illicit segment has grown by 43.5% and the tax-paid cigarette volume has declined by 11%. On average more than 1 billion illicit cigarettes are annually added to the illicit segment in Pakistan.

WHAT IS DRIVING GROWTH OF ILLICIT SEGMENT?

This high prevalence is driven by a multitude of demand and supply factors. As fiscal and regulatory burden on tax-paid segment increases, more and more consumers are purchasing illicit substitutes that are either cheaper (due to tax-evasion) or are non-compliant (due to lack of health warnings). Macro-economic factors including rates of employment, income, and inflation also impact affordability of cigarettes and hence the level of illicit trade. Pricing and regulatory

differential with neighbouring Afghanistan also plays a key role in continued inflow of smuggled cigarettes into Pakistan (in 2014 more than 2 billion cigarettes were smuggled into Pakistan). High profit margin that retailers make by selling illicit products also drives the growth of such tax-evaded products. Above all, lax enforcement of fiscal and regulatory laws is the key factor that influences the incidence of illicit trade in Pakistan.

89% OF TOTAL ILLICIT IS LOCAL TAX EVASION (LTE)!

In 2014, 17.3 billion local tax-evaded (LTE) cigarettes were sold in Pakistan, which is 21.1% of the total cigarette market in Pakistan. These LTE cigarettes are extremely cheap. The average selling price of LTE brands in Pakistan is Rs. 27 per packet, which is far below the minimum tax per packet of Rs. 33.80. Selling a packet of cigarettes below the minimum applicable tax is

itself clear evidence of tax evasion. On the other hand, most of the tax-paid brands are priced at Rs 57. In the last four years alone, this price differential between tax-paid and tax-evaded brands has increased by a 100%. This growing price gap between the two segments is fuelling the growth of LTE cigarettes in Pakistan, making it 89% of the total illicit segment.

MANUFACTURING OF LTE CIGARETTES

Manufacturing and distribution of LTE cigarettes in Pakistan is not some covert operation. An elaborate and well established supply chain is there to ensure the availability of these products across the country. Cigarette making itself is an elaborate process. Manufacturing and marketing of such a huge quantity of cigarettes (17.3 billion LTE cigarettes in 2014) involves extensive operations involving buying of raw materials, treatment

of raw material, conversion into manufactured cigarettes, storage facilities and an extensive country wide distribution network. The under-declaration of raw materials, including tobacco crop, cigarette paper, and filter rods, helps in under-declaration of volume of cigarettes manufactured that ultimately assists in evasion of excise duty and sales tax on cigarettes (final taxable product).

MULTIPLE NEGATIVE CONSEQUENCES

There are multiple and far-reaching consequences of illicit trade in cigarettes. This includes annual revenue loss of over Rs. 24 billion to the Government of Pakistan. This reduced domestic revenue generation makes Pakistan more dependent upon foreign aid and loans. Availability of tax-evaded and cheaper cigarettes increases the accessibility and affordability of tobacco products thus undermining the public health agenda. Despite public health driven increased regulatory and fiscal burden, the smoking incidence remains virtually unchanged in Pakistan. During 2008 and 2013 the smoking incidence in Pakistan only reduced by 0.2 percentage points, because the volume has shifted from the tax-paid segment to the illicit segment. During this period, the tax-paid segment volume declined by 10.1% and the illicit segment

volume grew by 24.8%. Moreover, the lax compliance environment creates a perception of a soft-state which negatively impacts the foreign direct investment potential. The criminalization of legal trade itself has socio-economic consequences. Proceeds from illegal tobacco are a means of amassing great wealth for criminal groups to finance other organized crime activities, including drugs, human and arms trafficking, as well as terrorism. Last but not least, illicit trade undermines the legitimate and compliant cigarette sector which faces a non-level playing field. That is why tax-paid segment having 76.3% market share contributes 99.3% of the total annual tax revenue from the cigarette industry, whereas those who have the remaining 23.7% market share (illicit segment) contribute only 0.7% of the total revenue.

EXTENSIVE REGULATIONS WITHOUT ENFORCEMENT

Over the years, the Government of Pakistan has put in place a robust regulatory regime intended to curtail illicit trade in cigarettes. Over 25 Acts of Parliament, Presidential Ordinances and Statutory Rules prescribe strict laws regulating virtually every step of the cigarette industry supply chain. These include laws and rules regulating crop buying, procurement and use of raw

materials, manufacturing, transportation and distribution, and finally import and retailing of tobacco products. Despite this comprehensive regulatory framework, illicit segment occupies almost a quarter share of the overall cigarette market in Pakistan. This clearly shows that lax enforcement of fiscal and regulatory laws is the real hurdle in curtailing this.

HOLISTIC APPROACH NEEDED

There is a need to execute a comprehensive and holistic strategy to tackle illicit trade in cigarettes. Multiple laws already exist and if enforced rigorously can bring down the incidence of the illicit segment and help the Government in raising more revenue. Measures that can assist in enforcement include establishment of a single, dedicated task force headed by a Federal Minister, district level mobile enforcement units, expanding capacity of customs, and joint capacity building workshop for law enforcement agency officials. Mass media campaigns on

print, electronic and social media can be used to increase awareness about illicit trade. Illicit Free City Campaign, along with Citizen Journalism, can also be launched as pilot projects. Re-calibration of cigarette taxation policy to make it more balanced can help in reducing consumers switching to cheaper tax-evaded substitutes. Summary trials for on-spot penalties for illicit traders can increase risk of penalties. Harmonization of fiscal and regulatory laws with neighbours can reduce inflow of illicit cigarettes into Pakistan.



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RESEARCH METHODOLOGY

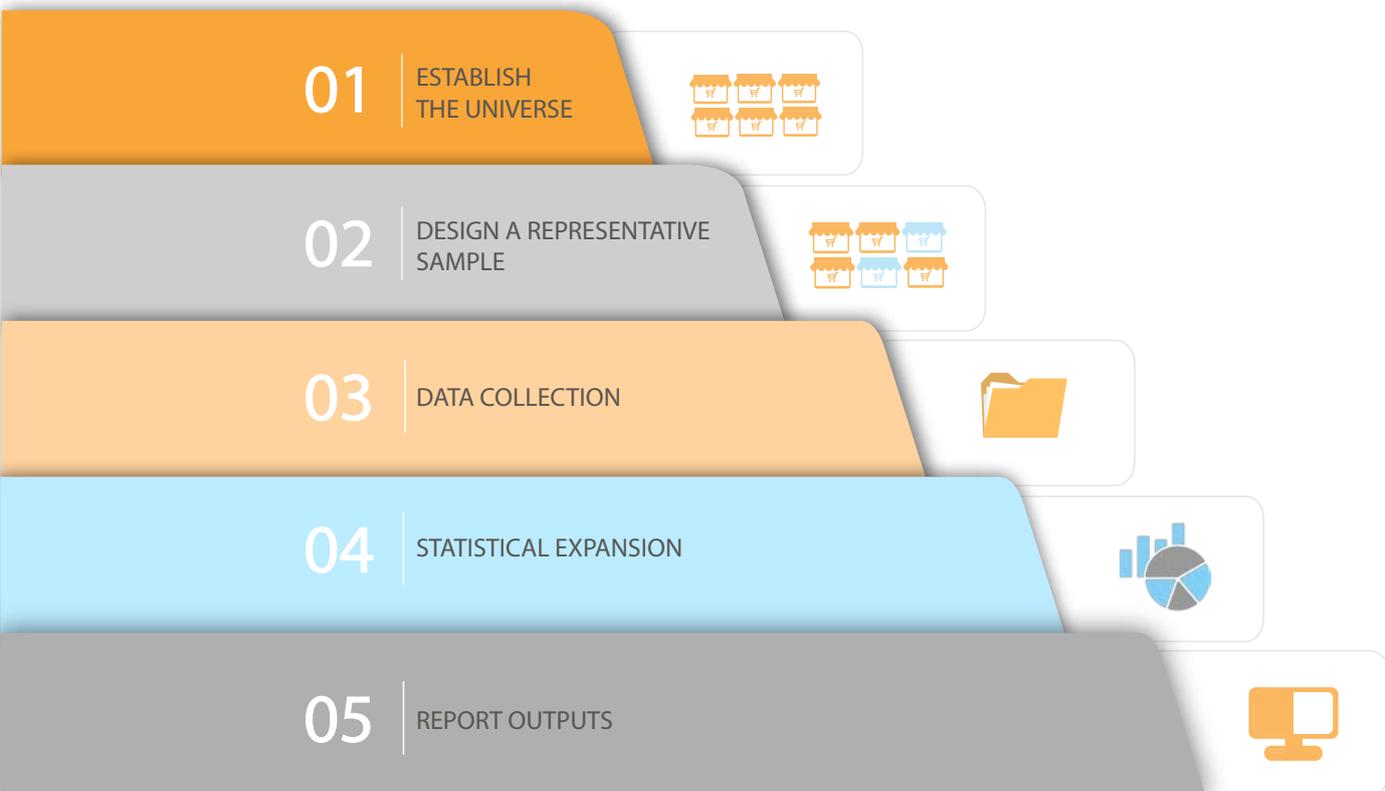
RESEARCH
METHODOLOGY

The methodology used in this Report for the measurement of size, trends, and dynamics of illicit trade in cigarettes in Pakistan is Retail Audit. In this methodology sales and market trends, based on information gathered from the retail outlets all over the country, are tracked over a period of time. Data collected by this process is much more credible and representative because Nielsen draws up retail outlets sample on the basis of a comprehensive nationwide Retail Census. The wide coverage and representative nature of this retail outlets sample ensures a comprehensive overview of consumer product markets and market trends. The resulting data contains information on sales, market shares, distribution and pricing. Using this Retail Audit methodology, this Report estimates the sales volumes, the market share, and the retail prices of the illicit cigarette segment in Pakistan.¹

RETAIL AUDIT: HOW DOES IT WORK?

The Retail Audit methodology functions on the basis of a panel of outlets drawn from the overall retail universe which is established through a nation-wide retail census. The key steps in this methodology include:

Figure 3.1: Retail Audit Methodology



1. Nielsen regularly conducts similar research in around 100 countries which is used by a variety of business for purposes of planning and reporting. These include Samsung, Proctor & Gamble, Unilever, Coca-Cola, and Telenor.

1. Establishing the Universe

There are over 600,000 retail outlets selling cigarettes in Pakistan. These outlets are of various nature including general stores, high-end stores, kiriyana stores, paan shops, hawkers, corner stores, petro-marts, hotels, restaurants, and cafes. After defining the geographic areas and store types, information is collected for conducting a Retail Census. Out of the entire retail universe, a panel of 8000 outlets is selected for the purpose of Retail Audit. These panel outlets exhibit certain characteristics, such as, sales to the final consumer, sales of packaged and branded goods, sales of a wide assortment of fast moving consumer goods, consumers having free access to enter the outlet, and the outlet having a fixed location.



2. Designing a Representative Sample

The sample of 8000 panel outlets is further divided into smaller groups like general stores, high-end stores, kiriyana stores, paan shops, hawkers, corner stores, petrol shops, hotels, restaurants and cafes. These groups exhibit similar characteristics such as geography, size, and type. The outlets within each group are selected so that they most closely represent the whole group. Moreover, it is ensured that the composition of the panel outlets resembles that of the entire retail universe in terms of turnover and volume, i.e., the weightage of each group of outlets relative to the entire retail universe is factored in.



3. Data Collection

Over 200 Nielsen auditors visit each panel outlet every week and record stock, purchases, and retail price. This is based on information provided by the retailer and also through physical inspection of sales records and stocks, wherever possible.



4. Statistical Expansion

This sample is then expanded to represent its universe, taking into account a projection factor which is a ratio of the sample's size relative to the universe. Projection factor ensures that, as accurately as possible, the proper weight is attached to the data collected.



5. Reporting Outputs

Nielsen provides all this data through interactive and easy to use software, allowing its client to undertake analysis as and when required. The data is organized into four dimensions: Market, Product, Fact and Period.

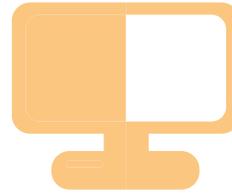
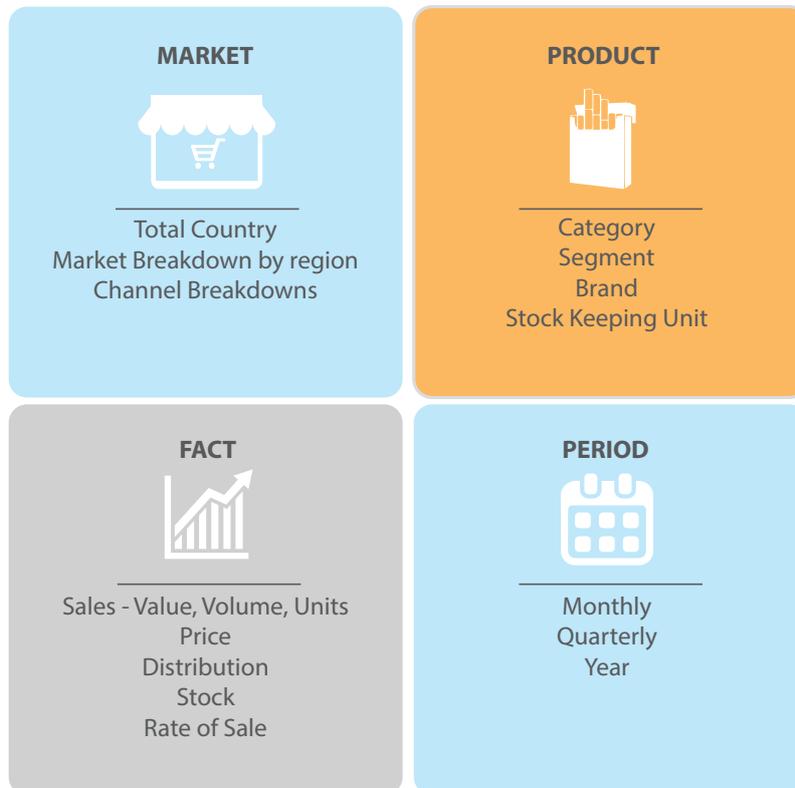


Figure 3.2: Retail Audit Data Matrix



EARLIER PUBLISHED RESEARCHES

This is not the first research to be published on illicit trade in cigarettes in Pakistan. A number of reports on this issue have already been published by credible research agencies of global repute. Each of those earlier reports used a variety of methodologies to measure the size, trends, and dynamics of illicit trade in cigarettes in Pakistan. Euromonitor International (2012) based its research on data from secondary sources, including in-house database of Euromonitor on cigarette products and macro-economic indices, websites of leading industry associations, business and

trade press.¹ International Tax and Investment Center (ITIC) and Oxford Economics (2014) based its research on Empty Packet Surveys, consumer research and the Retail Audit.² KPMG UK (2015) based its research on Retail Audit.³ That is why the estimates of illicit trade in this report (The Challenge of Illicit Trade in Cigarettes: Impact and Solutions for Pakistan, 2015) and those in the KPMG UK (2015) are quite analogous. A brief overview of some of the researches published on the issue is as follows:

Figure 3.3: Overview of Researches

Research Agency	Share of Illicit in Overall Market (%)	Annual Volume Of Illicit Sales (Billion Sticks)	Local Tax-Evaded Share of Illicit (%)	Smuggled Share of Illicit (%)	Counterfeit Share of Illicit (%)	Government Revenue Loss (Rs. Billion)
Euromonitor International	26.7	23.5	84.5	12	3.5	18.5
ITIC & Oxford Economics	22.8	18.8	81.6	18.4	-	26.2
KPMG UK	22	18.3	84.5	12	3.5	20.9
Nielsen	23.7	19.5	89	11	-	24.6

OTHER MEASUREMENT METHODOLOGIES

Mystery Shopping

Globally, other methodologies are also used to quantify the incidence of illicit cigarettes. One such methodology is Mystery Shopping, where the surveyors pose as consumers to estimate sales at retail outlets. The Mystery Shopping methodology is not used in Pakistan because retailers may only sell illicit cigarettes to repeat

customers and familiar faces to avoid risk of being exposed and hence penalized. In such circumstances, new and unfamiliar faces in the surveying team (mystery shoppers) may not be able to gather the correct market information which would undermine the accuracy of the data collected.

1. Euromonitor International (2012): Illicit Trade in Cigarettes: The Impact on Pakistan.
 2. ITIC & Oxford Economics (2014): Asia 14: Illicit Tobacco Indicator 2013.
 3. KPMG UK (2015): A Review of Cigarette Taxation in Pakistan.

Empty Packets Survey

Another methodology used to quantify the incidence of illicit cigarettes is through Empty Packets Survey. In this process discarded (empty) cigarette packets are collected from various places in the country to extrapolate and determine the size of the illicit cigarette segment. This methodology works better in those countries which suffer from sale of smuggled cigarette packets. The reason is simple. Such smuggled cigarette packets can be identified through multiple violations (wrong health warnings, wrong printed prices, etc.). The discarded packets gathered in this process can be easily sorted into domestic and smuggled lots. This information can then be used to determine the size of illicit segment.

In the case of Pakistan this Empty Packets Survey methodology may not deliver accurate market data. Pakistan has unique circumstances because it is not smuggled but local tax-evaded brands that are pre-dominant in the illicit segment.

It is, however, not possible to determine whether due taxes and duties have been paid

or not by gathering discarded cigarette packets as all the local cigarette brands anyway have the correct tax-paid price printed on them. In reality, however, the local tax-evaded cigarette brands are sold at prices much lower than the price printed on the packets.

In Pakistan's circumstances, the discarded packets gathered in this process cannot, therefore, be easily sorted into domestic tax-paid and domestic tax-evaded. Hence, this methodology cannot be used to determine the size of illicit segment.

Furthermore, Pakistan lacks proper waste disposal system. The condition of discarded (empty) packets gathered for the survey would be so poor as to make it difficult even to properly identify the brand name printed on packets. It would thus be a challenge to use packets in such condition for the purposes of any research and calculations.

Consumer Surveys

Consumer surveys provide a response based view of the population and track respondent consumption behaviors and purchase patterns. Consumer surveys are a system of obtaining responses, usually through one-on-one interviews, to a specific set of questions from smokers. From these responses data on the average daily consumption is collected which is further used to estimate total consumption of the market and the share of non-duty paid packets. One limitation of this methodology,

however, is that it requires respondents to accurately recall and report the brands they consume, in the absence of which, there would be under-reporting of illicit consumption. Moreover, the sample size of the study should be representative of the total market in terms of age, gender and geographical diversity; a requirement not always easily met through this methodology as there might be exclusion of those demographics that are not part of the survey.

The cover features a blue-toned background with a stylized globe on the left side. The globe is overlaid with a network of white lines and glowing nodes, suggesting global connectivity. A grey banner with a slight 3D effect is positioned horizontally across the middle. Two diagonal stripes, one orange and one light blue, run from the top right towards the bottom left. The text 'GLOBAL OVERVIEW' is centered in the banner and also appears in large, light grey letters at the bottom right.

GLOBAL OVERVIEW

GLOBAL
OVERVIEW

Illicit trade in cigarettes is any practice prohibited by law and which relates to production, shipment, receipt, possession, distribution, sale or purchase of cigarettes including any practice or conduct intended to facilitate such activity.¹ Illicit cigarettes primarily exist in three forms:

1. Smuggled

The unlawful movement of cigarettes (genuine or counterfeit) from one tax jurisdiction to another without the payment of applicable taxes or in breach of laws prohibiting its import or export. This includes Illicit Whites that are cigarettes specifically manufactured for export purposes but are instead smuggled out through informal distribution channels, and are one of the fastest growing illicit segments in the world.

2. Counterfeit

Illegal manufacturing in which cigarettes bear a trademark without the owner's consent. These are sold with the intent of being passed off as genuine. Illegally manufactured products can be sold in the source country or smuggled into another country. Excise tax is rarely, if ever, paid on counterfeit cigarettes.

3. Local Tax Evasion (LTE)

Cigarettes manufactured for consumption in the same jurisdiction, which are not declared to tax authorities. These cigarettes are sold without paying tax and may be manufactured in approved factories or illegal covert operations.

Illicit trade of cigarettes is a global phenomenon and all countries, be they developed,

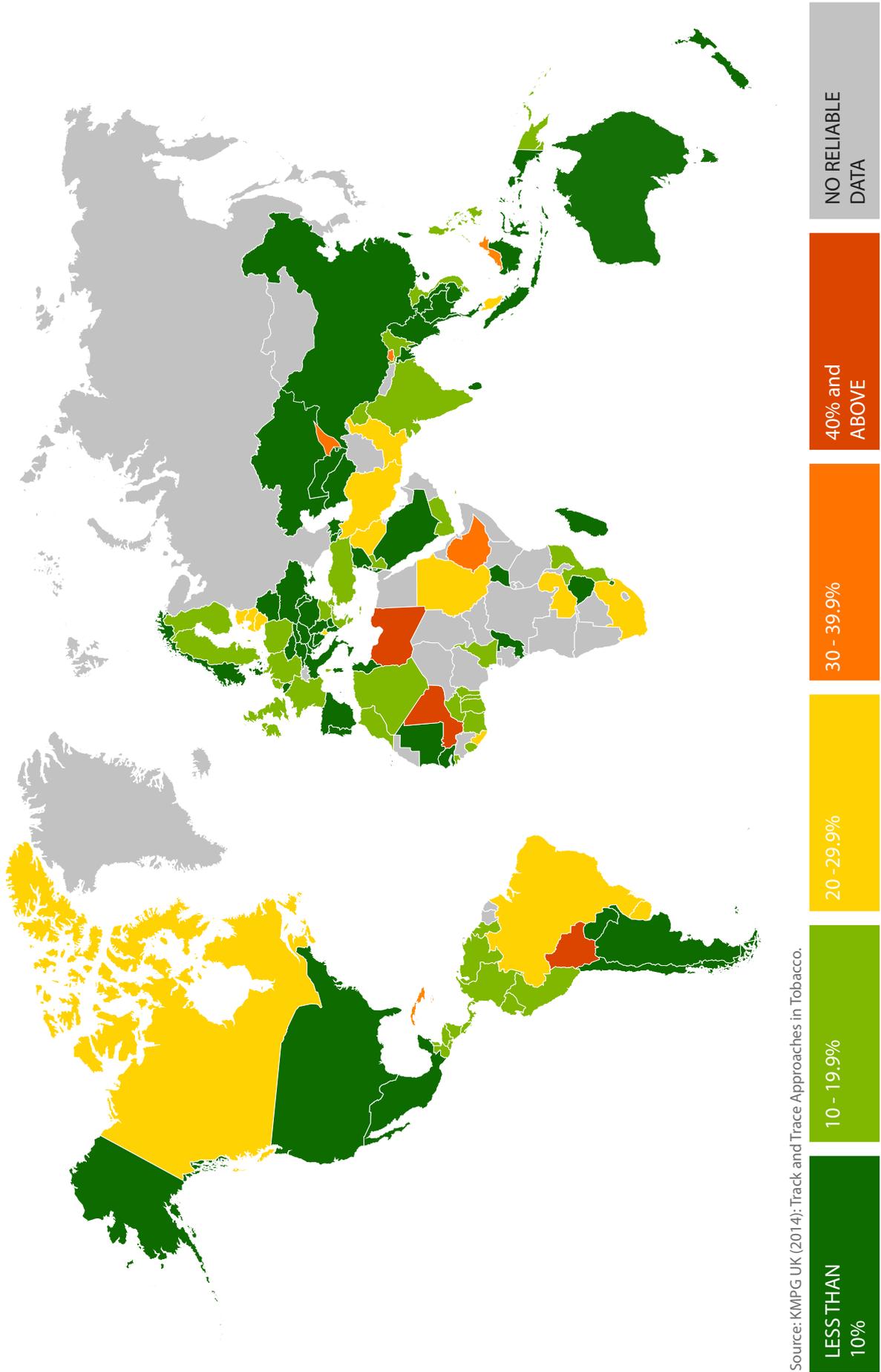
developing or in transition, suffer its negative consequences. According to Interpol, it would be hard to find a more ideal candidate for "illicit trade than cigarettes. The product is small, lightweight and profitable for illicit trade because the sale price is many times the cost of manufacture, mostly due to high levels of local tax in most countries".² According to World Health Organization estimate, 1 in every 10 cigarettes and tobacco products consumed globally is illicit,³ costing governments worldwide US\$31 billion each year in unpaid tobacco taxes.⁴ The European Commission estimates that illicit trade in cigarettes costs the EU and the Member states over €10 Billion annually in lost taxes and customs revenues.⁵

Tax evasion allows selling of these illicit brands on very low prices, thus increasing the accessibility and affordability of tobacco products and undermining the tobacco control policies. Research in the Iranian capital, Tehran, and in southern Thailand has shown that youth are more likely than older people to smoke smuggled cigarettes.⁶ Proceeds from illegal tobacco are a means of amassing great wealth for criminal groups to finance other organized crime activities, including drugs, human and arms trafficking, as well as terrorism.⁷ Illicit trade in tobacco products has disproportionate economic and social implications on developing countries and countries with economies in transition.



1. Article 1 (a) of the World Health Organization's Framework Convention on Tobacco Control (2003).
2. Interpol (2014): Against Organized Crime, Trafficking and Counterfeiting Casebook: (www.interpol.int)
3. World Health Organization (2015): Illegal Trade Of Tobacco Products: What You Should Know To Stop It.
4. <http://www.who.int>
5. <http://www.who.int>
6. World Health Organization (2015): Illegal Trade Of Tobacco Products: What You Should Know To Stop It.
7. <http://www.who.int/International>

Figure 4.1 Share of Illicit Cigarette Consumption by Country (% of Total Market)



Some countries are mainly a source of the illicit product (both for domestic consumption and for export), while others are used as transit routes, and destination countries are where consumption occurs. In many cases a country may fall in more than one of these categories.

1. Source

Cutting off illicit trade at source is in theory the most effective means of tackling the problem. It is, however, also the most difficult to achieve. According to the World Customs Organization, the highest amount of illicit cigarette seized originated from Asia (21% of global seizures), followed by the United Arab Emirates (9%).⁸

2. Transit

Transit points tend to be some of the largest and busiest ports in the world. Illicit trade shipments are very often deliberately transited via several ports in order to make detection more difficult. During transit process the documentation is changed and goods can be transhipped into other vessels.

3. Destination

Illicit tobacco products are available in both the high income and in the low income countries. Some common characteristics of final destination markets include stringent taxation regimes leading to high retail prices relative to consumer affordability, low law enforcement focus due to other priorities or general lack of capacity and resources, an inadequate legal regime with low likelihood of being caught and punished, and lastly, a culture of accepting illicit product or a lack of knowledge that the product is illicit.



2012 PROTOCOL TO ELIMINATE ILLICIT TRADE IN TOBACCO PRODUCTS

All countries in the world, in one form or the other, suffer from the problem of illicit trade in cigarettes. In response to this international issue, in November 2012 the global community negotiated and adopted the Protocol to Eliminate Illicit Trade in Tobacco Products, the first protocol by the World Health Organization's (WHO) Framework Convention on Tobacco Control (FCTC). The Protocol is based on Article 15 of the FCTC, which refers to the threats posed by the illicit trade and measures countries have to take to prevent it.

The 2012 Protocol is an international treaty with the objective of eliminating all forms of illicit trade in tobacco products through a package of measures to be taken by countries acting in cooperation with each other: it is a global solution to a global problem.⁹ As of May 2015, seven countries have ratified the Protocol, whereas 33 more are needed for it to become an international law.¹⁰

8. Tax and Investment Centre (2011): Illicit Trade in Tobacco Products and How to Tackle It.

9. <http://www.who.int/fctc/protocol/about/en/>

10. World Health Organization (2015): Illegal Trade Of Tobacco Products: What You Should Know To Stop It.



PAKISTAN OVERVIEW



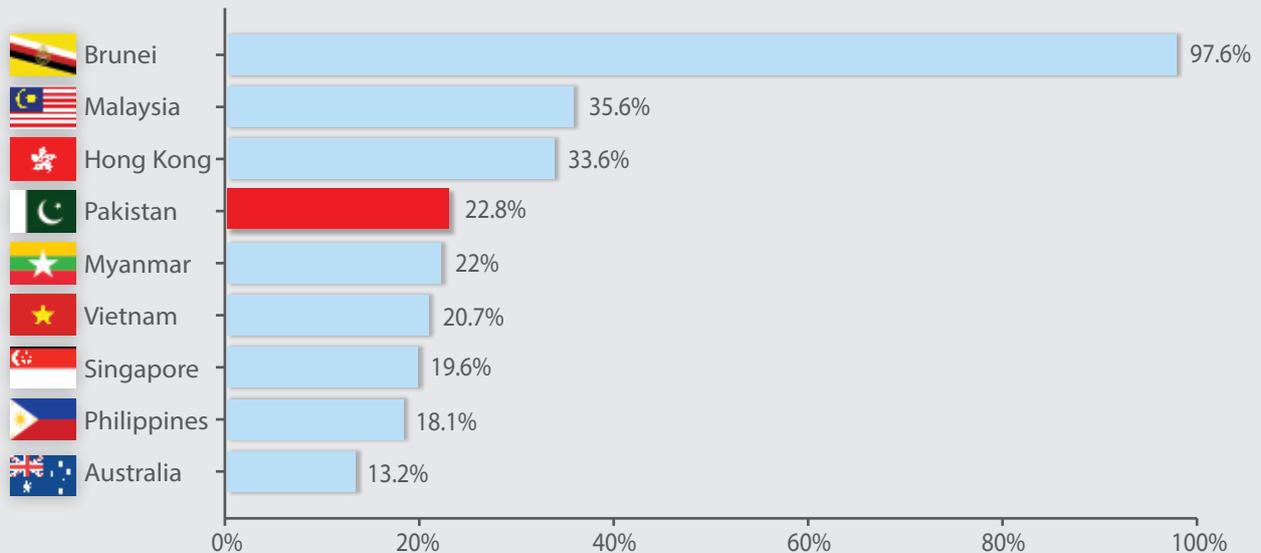
PAKISTAN
OVERVIEW

PAKISTAN RANKING: 4TH IN ASIA

Pakistan has one of the highest incidences of illicit cigarettes in Asia. According to an estimate, in 2013 more than 18 billion illicit cigarettes were consumed in Pakistan, making

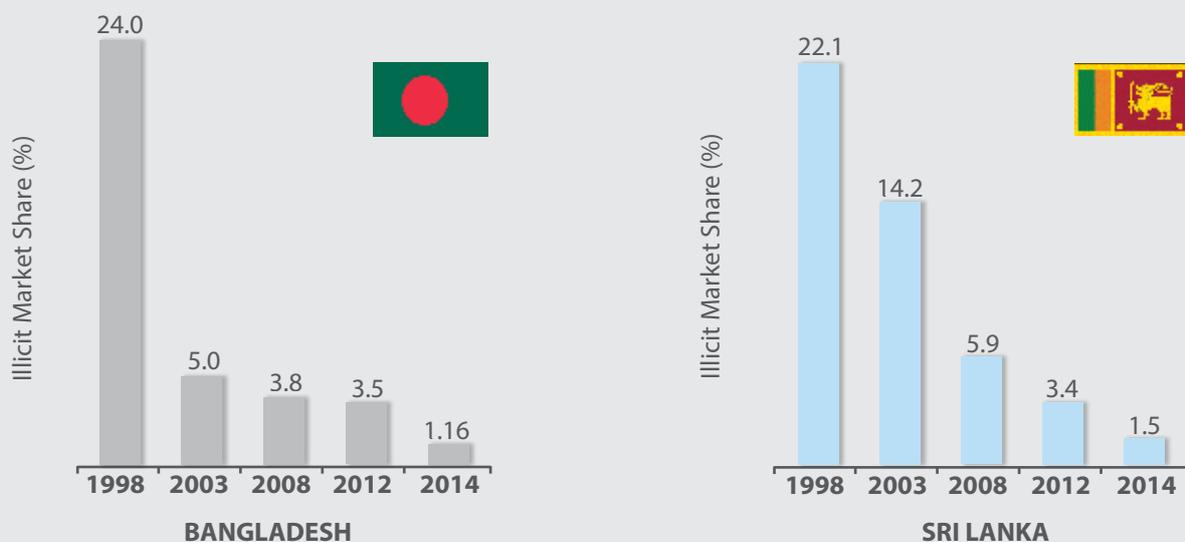
it the 4th highest in ranking in Asia on the basis of share of illicit cigarette consumption in the country (refer to Figure 5.1 below for details).¹

Figure 5.1: Share of Illicit Cigarette Consumption (% of Total Market: 2013)²



This high prevalence of illicit trade in cigarettes in Pakistan is in sharp contrast to Bangladesh and Sri Lanka, where the illicit trade has drastically declined over the years due to strict enforcement of laws (refer to Figure 5.2 below for further details).

Figure 5.2: Illicit Trade in South Asia³



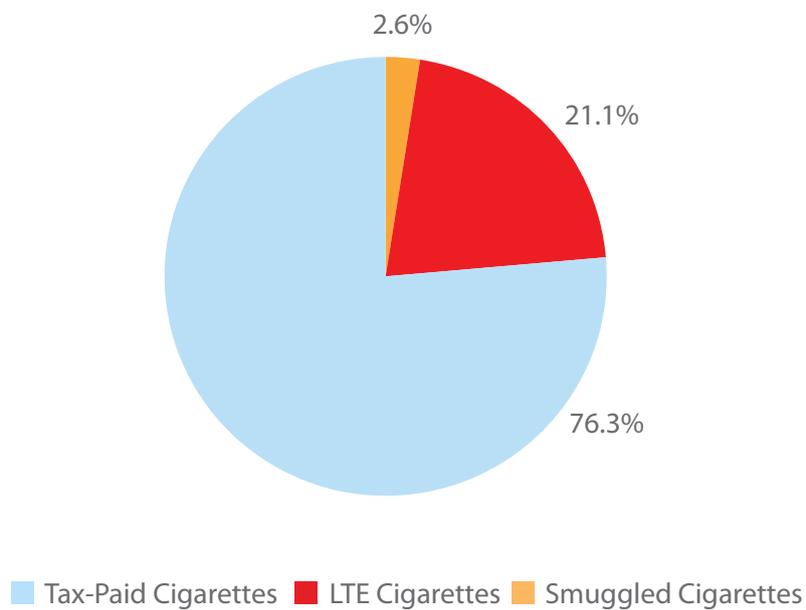
1. ITIC & Oxford Economics (2014): Asia 14: Illicit Tobacco Indicator 2013 by the International Tax and Investment Center (ITIC) and Oxford Economics.
2. ITIC & Oxford Economics (2014): Asia 14: Illicit Tobacco Indicator 2013 by the International Tax and Investment Center (ITIC) and Oxford Economics.
3. Industry Data.

NEARLY 1 OUT OF EVERY 4 CIGARETTES IS ILLICIT

Approx. 1 out of every 4 cigarettes consumed in Pakistan is illicit. In 2014, more than 82 billion cigarettes were consumed in Pakistan.⁴ Out of this total, an alarming 23.7% of the cigarettes

(19.5 billion) were illicit, comprising of local tax-evaded and smuggled.⁵ It means that on average more than 1.6 billion illicit cigarettes are consumed in Pakistan every month.

Figure 5.3: Composition of Cigarette Consumption in Pakistan (2014)



ILLICIT CIGARETTES
sold in Pakistan every month

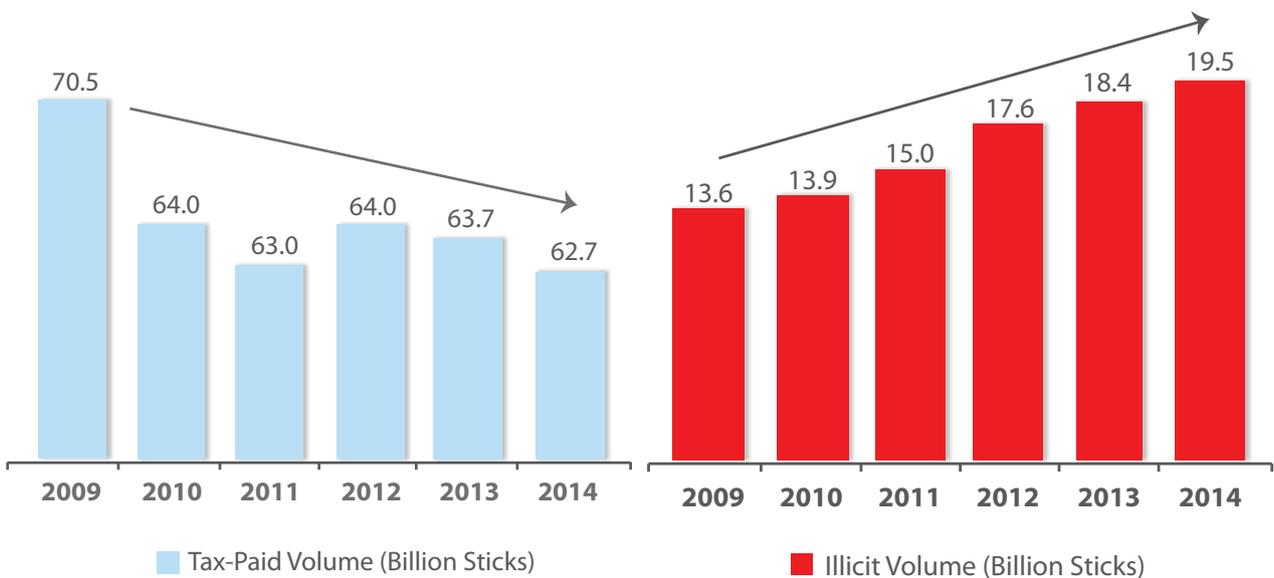
4. For tax-compliant segment it is based on actual shipped volume and for illicit segment it is based on retail audit methodology.
5. Retail Audit does not capture counterfeit cigarettes. As per other published researches, the counterfeit incidence in Pakistan is small. Refer to Page 25 for further details.

ANNUALLY 1 BILLION CIGARETTES ADDED TO ILLICIT SEGMENT

With increasing regulatory and fiscal burden on the tax-paid segment, more and more consumers are switching to the illicit segment every year. This increasing burden is fuelling growth in the share and the volume of illicit cigarettes in Pakistan. During the last six years' period, the illicit segment has grown by 43.5% and the tax-paid cigarette volume has

declined by 11%. On average approximately one billion cigarettes are added to the illicit segment every year in Pakistan (refer to Figure 5.4 below for details). In 2014 the total illicit volume increased to 19.5 billion cigarettes, due to which the Government suffered loss of more than Rs. 24 billion (refer to Annexure 1 for detailed calculations).

Figure 5.4: Growth in Illicit and Decline in Tax-Paid Segment in Pakistan

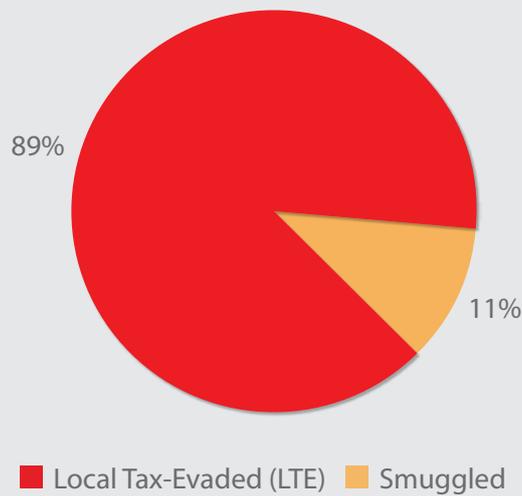


89% ILLICIT SEGMENT IS LOCAL TAX-EVADED

The total consumption of illicit cigarettes in Pakistan is primarily split between local tax-evaded (LTE) and smuggled cigarettes, with LTE cigarettes accounting for 89% of the total illicit segment in Pakistan.



Figure 5.5: Types of Illicit Cigarettes in Pakistan (2014)⁶



21.1% OF ALL CIGARETTES ARE LOCAL TAX-EVADED (LTE)

In 2014, 21.1% of the overall cigarettes consumed in Pakistan were local tax-evaded (LTE), which means that 17.3 billion LTE cigarettes were sold.⁷



6. Retail Audit does not capture counterfeit cigarettes. As per other published researches, the counterfeit incidence in Pakistan is small. Refer to page 25 for further details.

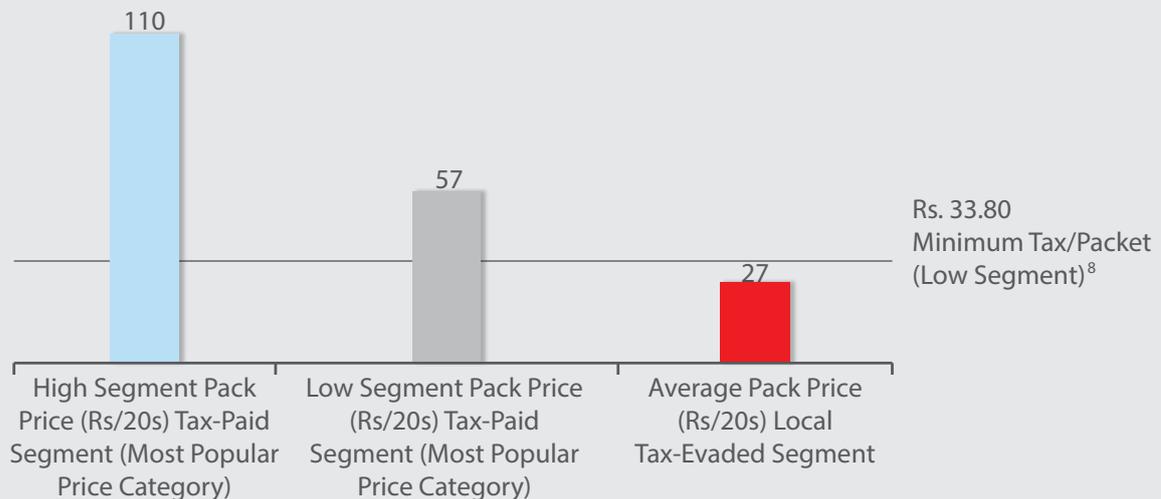
7. For tax-compliant segment it is based on actual shipped volume and for illicit segment it is based on retail audit methodology.

SELLING BELOW MINIMUM TAX PAYABLE PER PACKET

Selling a packet of cigarettes below the minimum applicable tax is itself clear evidence of tax evasion. Figure 5.6 below shows that the average selling price of LTE brands in Pakistan is Rs. 27 per packet, which is far below the minimum tax per packet of Rs. 33.80.⁸ On the other hand, most of the tax-paid brands are priced at Rs 57. Thus tax-paid brands face serious unfair competition from LTE brands

that sell at prices which are less than half of the tax-paid segment. Tax evasion provides pricing freedom to these LTE brands and allows them to sell at significantly lower prices as compared to tax-paid brands. This price gap between the two segments, which is increasing every year, is fuelling the growth of LTE cigarettes in Pakistan.⁹

Figure 5.6: LTE Cigarettes Sell Below The Minimum Tax Payable⁸



8. This includes excise duty and sales tax payable per packet. This is calculated on the basis of duty payable in lower tier or slab. In the upper tier or slab, higher taxes and duties are applicable. The minimum tax payable in the higher tier is more than Rs. 76 per packet.
9. All the prices mentioned in this Report are for a packet of 20 cigarettes. According to law packet of cigarettes that have less than 20 cigarettes cannot be sold in Pakistan

MORE THAN 2 BILLION SMUGGLED CIGARETTES ARE CONSUMED

In 2014, more than 2 billion cigarettes were smuggled into and consumed in Pakistan. This is equal to 11% of the overall illicit segment and 2.6% of the overall cigarette consumption in

the country.¹⁰ These smuggled brands can be easily identified because of multiple packaging and labelling violations, which include:

Figure 5.7: Identifying a Smuggled Cigarette Packet



10. For tax-compliant segment it is based on actual shipped volume and for illicit segment it is based on retail audit methodology.

INCIDENCE OF COUNTERFEIT CIGARETTES¹¹

Pakistan currently has low incidence of counterfeit cigarettes due to the interplay of various factors including lack of supply incentives, minimal market demand and higher risks discouraging supply.

a) Lack of Supply Incentive

Manufacturing LTE cigarettes is a cheaper and more lucrative tax-evasion opportunity than manufacturing costlier counterfeit brands. Manufacturers of LTE cigarettes need not manufacture counterfeit cigarettes which would anyway cost them more in order to copy the quality of the original brand. Instead they manufacture and supply their own tax-evaded, low priced brands. In this way they sell large volume of cheaper brands owned by them instead of selling lesser volumes of more costly counterfeit versions.

b) Minimal Market Demand

There are high chances of consumer rejection of counterfeit versions based on differences in various identifiable product characteristics. It is due to this fear of detection by consumers that counterfeit cigarettes are restricted to retail outlets with low repeat sale incidence, like bus stands and railway stations. In such outlets the chances of a consumer returning to complain about a counterfeit version are very low.

c) Higher Risk

In addition to tax-evasion, counterfeit manufacturers would be risking direct conflict with the owners of the intellectual property, i.e., the original manufacturer. Manufacturers of LTE cigarettes clearly understand that the risk of prosecution and penalties is far higher when they are in conflict with the private owners of original brands. Hence, the risk of penalties being enforced is higher in case of counterfeit manufacturing.



COUNTERFEIT CAN INCREASE

Enforcement of laws to protect intellectual property rights in Pakistan, however, remains a challenge (may see Page 59 for further details). Current incidence of counterfeit cigarettes in Pakistan is low not due to lack of capacity but because manufacturing of LTE cigarettes is cheaper and more lucrative. Whenever manufacturers of LTE cigarettes face stringent fiscal enforcement, they conveniently switch to counterfeit manufacturing. Sometime back the Government of Pakistan was informed by a trading partner that one of the manufacturers of LTE cigarettes in Pakistan was 'exporting' huge quantities of counterfeit cigarettes to that country. Hence, manufacturers of LTE cigarettes can easily resort to counterfeit manufacturing, whether it is of cigarettes or of tax stamps.

11. Retail Audit does not capture counterfeit cigarettes. As per other published researches, the counterfeit incidence in Pakistan is small.

CAUSES OF ILLICIT TRADE



CAUSES
OF ILLICIT TRADE

This high prevalence of illicit trade in cigarettes is driven by a multitude of demand and supply factors. With increased regulatory and fiscal burden on the tax-paid segment, more consumers search for ways to ease burden on their wallets by looking for cheap tax-evaded cigarette brands. Consumers search for substitute cigarette packets that do not carry large pictorial health warnings. Macro-economic factors including rates of employment, income, and inflation also impact

affordability of cigarettes and hence the level of illicit trade. Pricing and regulatory differential with neighbouring Afghanistan also plays a key role in continuing inflow of smuggled cigarettes into Pakistan. High profit margin that retailers make by selling illicit products also drives the growth of such tax-evaded products. Above all, lax enforcement of fiscal and regulatory laws is the key factor that influences the incidence of illicit trade in Pakistan.

WARNING

STOP SALE OF ILLEGAL/SMUGGLED CIGARETTES

	DEALING IN ILLICIT CIGARETTES IS A CRIME. PENALTIES INCLUDE:	
	RAID, FIR, CHALLAN	
	5 YEARS BEHIND BARS	
	0800-77377 REPORT any illegal cigarette retailers, wholesalers, sale points, godowns, storage facilities etc.	
	PKR 50,000 FINE & FINE EQUAL TO 500% OF UNPAID DUTIES & TAXES	
	CONFISCATION OF ALL SUCH CIGARETTES	
		

For further details please contact:

DIRECTORATE OF INTELLIGENCE & INVESTIGATION (Inland Revenue), Islamabad.
GOVERNMENT OF PAKISTAN
 House # 110-H, Luqman Hakeem Road, G-6/3, Islamabad
 Phone: 051-9203399, Mobile: 0321-5003060, Fax: 051-9218136

REASONS FOR LAX ENFORCEMENT

The jurisprudence is clear: it is not the quantum but the certainty of punishment that deters crime. Those involved in the business of illicit trade in cigarettes in Pakistan (whether manufacturers of LTE cigarettes or smugglers) know that certainty of punishment is not high. Raids and seizures by law enforcement agencies are rare. Formal prosecution, conviction and sentencing of the culprits are rarer still. It is this lax enforcement environment that creates opportunities and incentives for criminals to engage in and continue with illicit trade. Without drastically increasing risk of penalties, the current compliance environment in fact incentivizes the culprits to continue with their nefarious activities unabated and undeterred. Key reasons for such lax law enforcement environment, both for LTE and smuggled cigarettes, include:

a) Low Priority

Pakistan is plagued with many serious public law and order problems. In the midst of such gigantic issues, curtailment of illicit trade in cigarettes is often put on the back-burner by the relevant law enforcement agencies. Inadequate awareness among

the law enforcement officials about the far reaching consequences of such illicit trade on government revenues, national security, and even public health, further contributes to low prioritisation of this problem.

b) Capacity Constraints

Law enforcement agencies have weak infrastructure and lack the necessary resources to effectively deal with an issue of this magnitude. Many of the field officials may not

be well-trained to examine the relevant fiscal documents and follow all the legal procedures necessary for effective enforcement of laws related to illicit trade.

c) Lack of Coordination

At present multiple law enforcement agencies have jurisdiction over laws pertaining to illicit trade in cigarettes (refer to Figure 6.1 for list of all the relevant agencies). Due to lack of coordination amongst these agencies there is hardly any concerted effort to deal with this issue. In fact, due to inter-agency rivalry this

sometimes results in shifting of burden and blame thereby hindering effective concerted action. Lastly, lack of harmonization and concerted enforcement of fiscal and regulatory laws with the region of Azad Jammu and Kashmir further adds to the complexity of the issue.¹

1. Many units manufacturing LTE cigarettes are located in the region of Azad Jammu and Kashmir (AJK). While AJK Government has already adopted fiscal laws of Pakistan, the enforcement of such fiscal laws remains a challenge in the AJK region also. Hence, the AJK region continues to be a notable source of supply of LTE cigarettes currently being sold in Pakistan.

Figure 6.1: Law Enforcement Agencies in Pakistan and Their Jurisdiction

LAW ENFORCEMENT AGENCIES	JURISDICTION
Pakistan Customs	Smuggled
Inland Revenue Service	Counterfeit and Local Tax-Evaded
Police (Pakistan and AJK)	Smuggled and Counterfeit
Federal Investigation Agency	Counterfeit
Pakistan Coast Guard	Smuggled
Pakistan Maritime Security Agency	Smuggled
Pakistan Rangers	Smuggled and Counterfeit
North West Frontier Constabulary	Smuggled and Counterfeit
Intellectual Property Organization	Counterfeit
Excise and Taxation Department (Pakistan & AJK)	Smuggled and Local Tax-Evaded
Pakistan Tobacco Board	Local Tax-Evaded



REASONS FOR HIGH LTE PREVALENCE

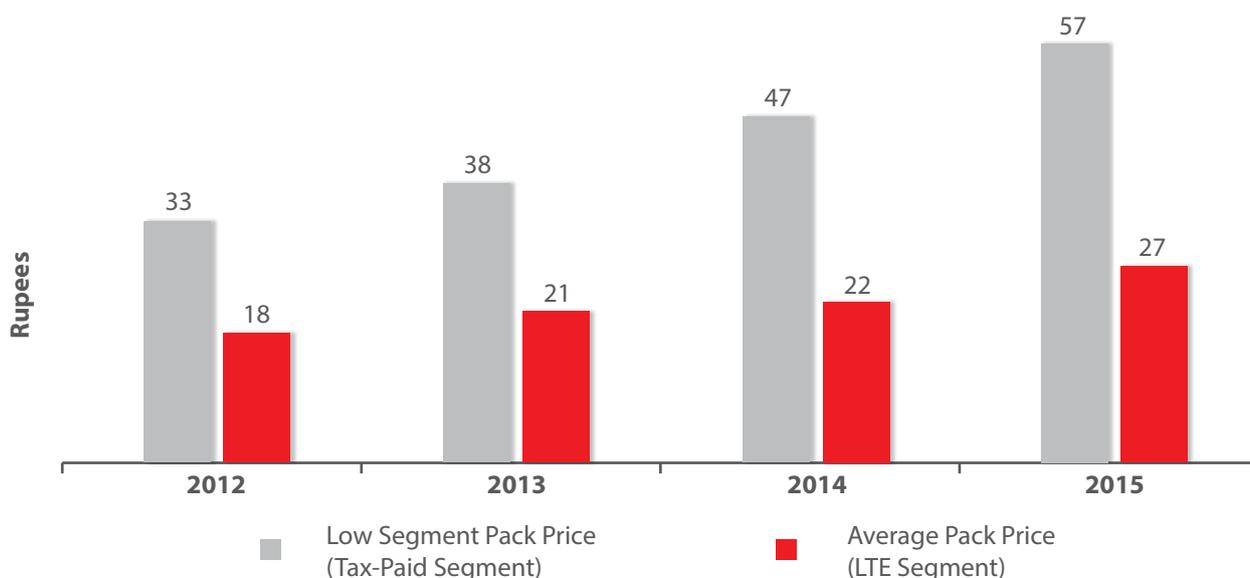
Key reasons for high incidence of LTE cigarettes include tax driven price differential between tax-paid and the tax-evaded brands. Moreover, due to macroeconomic factors tax-paid cigarettes have become more expensive relative to consumer incomes creating further pressure on consumer wallet which makes consumers opt for cheaper tax-evaded brands.

1. Tax Driven Price Differential: 100% Increase in 4 Years

Tax-paid brands face serious unfair competition from LTE brands that sell at prices which are less than half of the tax-paid segment. This is pulling the price sensitive consumers, especially the youth, towards the illicit segment. In the last 4 years this differential between prices of tax-paid and LTE cigarettes has increased from Rs. 15 to Rs. 30 (refer to Figure 6.2 below for details).² This price differential between the two segments, which is increasing every year, is fuelling the growth of LTE cigarettes in Pakistan. And this price differential is

being driven by enhanced cigarette taxation. Between 2008 and 2013, all the increase in price of tax-paid brands was actually driven by the enhancement of cigarette taxes.³ Evidently, due to tax-evasion, any increase in cigarette taxes does not impact the prices of LTE brands and they are able to maintain lower prices. On the other hand, tax-paid cigarettes continue to experience tax-led price increases. Due to these tax led price increases, more and more consumers are switching to far cheaper tax-evaded alternative of LTE cigarettes.

Figure 6.2: Increasing Price Differential Between Tax-Paid and Illicit Cigarettes



2. Data for years 2012, 2013 and 2014 is from KPMG UK (2015) research 'A Review of Cigarette Taxation in Pakistan'. Data about year 2015 has been added by Nielsen.

3. KPMG UK (2015): A Review of Cigarette Taxation in Pakistan: The report finds that between 2008 and 2013 total cigarette taxes on the weighted average priced brand increased by Rs. 6.2 in real terms. Over the same period, the pre-tax price of cigarettes fell by Rs. 0.8. As a result, the average pack price increased from Rs. 35.6 to Rs. 41.0, in real terms, with taxes responsible for all of the retail price increase. The evidence is clear that this trend continued even after 2013.

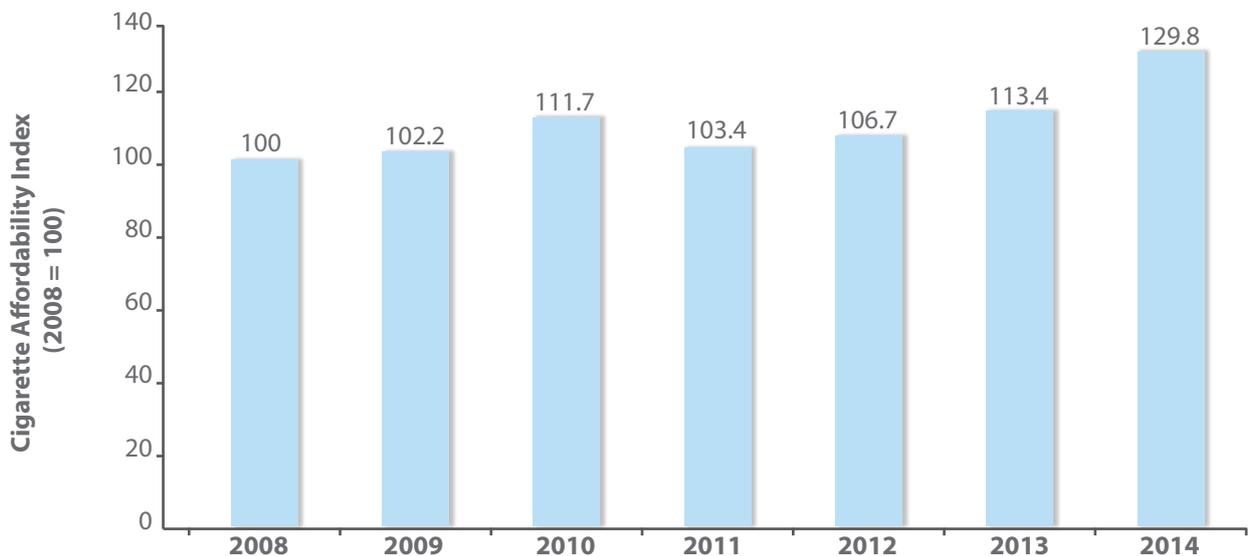
2. Cigarettes Becoming More Expensive

The prices of tax-paid segment brands have increased at a much faster rate than household incomes in the country. Between 2008 and 2014, household incomes grew by only 1.5% while, prices of tax-paid cigarettes increased at an average annual rate of 16%. The combined effect of slow growth in household incomes and increasing prices of tax-paid segment, made tax-paid cigarettes 30% more expensive, relative to incomes, in 2014 compared to 2008 (refer to figure 6.3 for details).⁴

Quite naturally, consumers substituted more expensive tax-paid cigarettes with cheaper tax-evaded alternatives which are

abundantly available throughout the country, to the detriment of government tax revenues as well as the tax paying industry. Thus, macro-economic factors including rates of employment, income, and inflation also impact affordability of cigarettes and hence the level of illicit trade in Pakistan.

Figure 6.3: Index of the price of tax-paid cigarettes relative to average household income between 2008 and 2014 (2008 = 100)⁴



4. KPMG UK (2015): A Review of Cigarette Taxation in Pakistan.

REASONS FOR SMUGGLED CIGARETTES

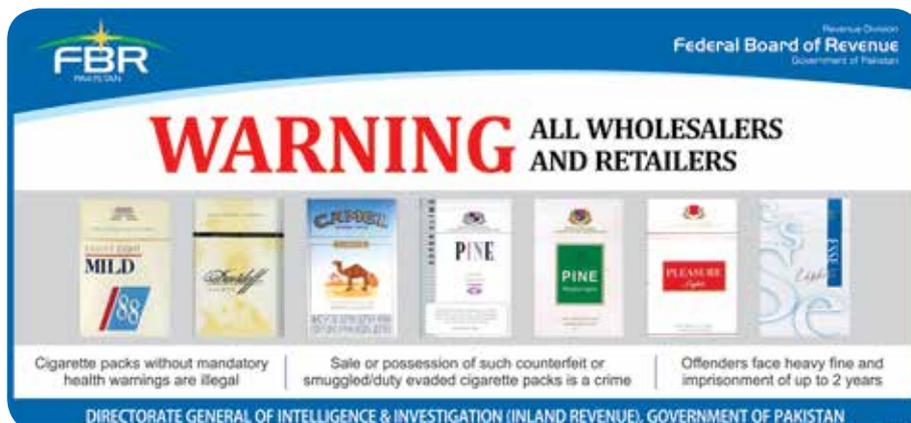
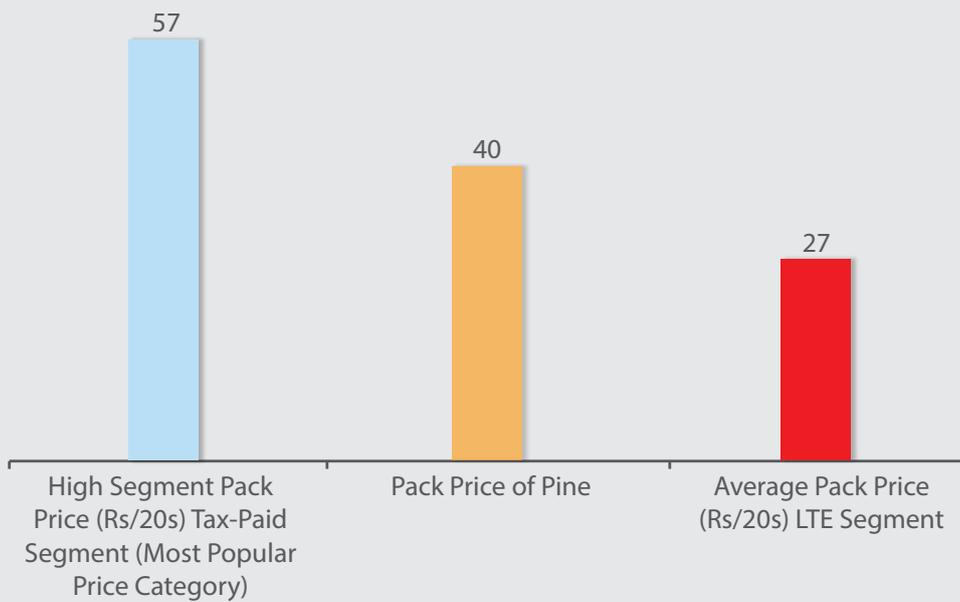
Key reasons for the widespread availability of smuggled cigarettes in Pakistan include demand factors like cheaper prices and no health warnings, and supply factors like fiscal and regulatory differential with Afghanistan, challenging border with Afghanistan, and higher profit margins for retailers.

1. Cheaper Prices

Most smuggled cigarettes are sold at very low prices as multiple duties and taxes are evaded. Nearly 50% of the cigarettes smuggled into Pakistan are of a South Korean brand called Pine currently being sold at a price of Rs. 40 per

packet, whereas most of the tax-paid brands in the low segment are priced at Rs 57. This price differential with tax-paid brands is the key driver of demand for such smuggled cigarettes.

Figure 6.4: Smuggled Cigarettes Selling at Lower Prices than Tax-Paid Cigarettes

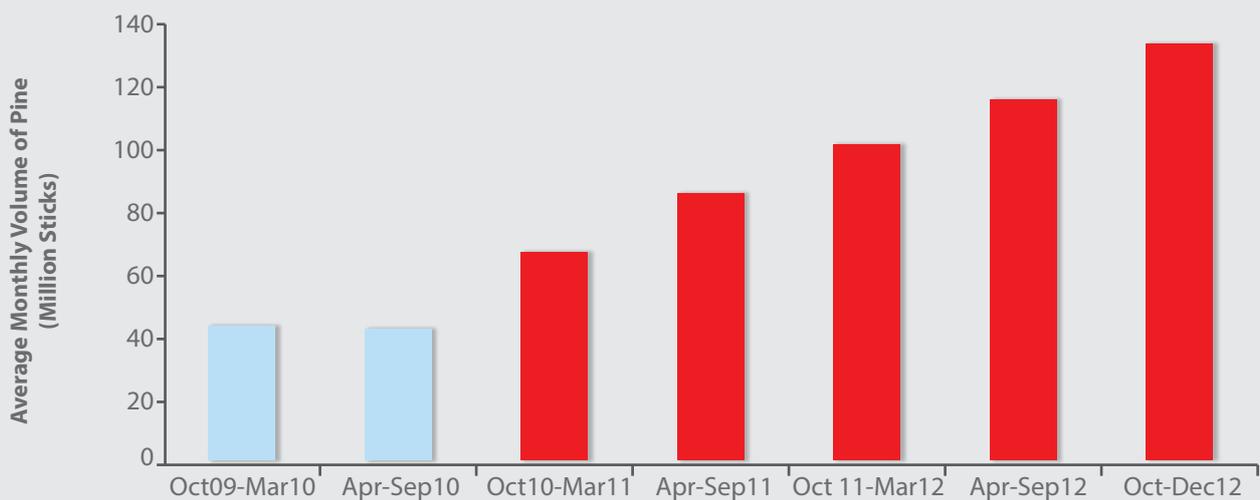


2. Packets without Health Warnings

Foreign cigarette brands which are not legally imported (and are smuggled) generally carry no health warning. In September 2010 the size of the health warning on cigarette packets in Pakistan increased from 30% textual to 40% pictorial.⁵ Soon after that sales of cigarette packets without health warning showed an increasing trend. This spurred growth in inflow of smuggled non-compliant cigarette packets, such as Pine from South Korea.



Figure 6.5: Growth in Sales of Pine After Implementation of Pictorial Health Warning



PINE: CASE STUDY

Pine is a smuggled brand that carries no health warning at all (neither textual nor pictorial). Within two years after the September 2010 change in health warning law, the sale of Pine grew by more than 240% as more and more consumers switched to this brand. Pine was not only much cheaper than tax-paid brands but also 'cleaner' than local tax-paid packets which complied with the 40% pictorial health warning law. It can be safely assumed that during this two year period, increasing the severity of the health warnings drove the consumers towards the easily available smuggled alternatives that carried no such warning.

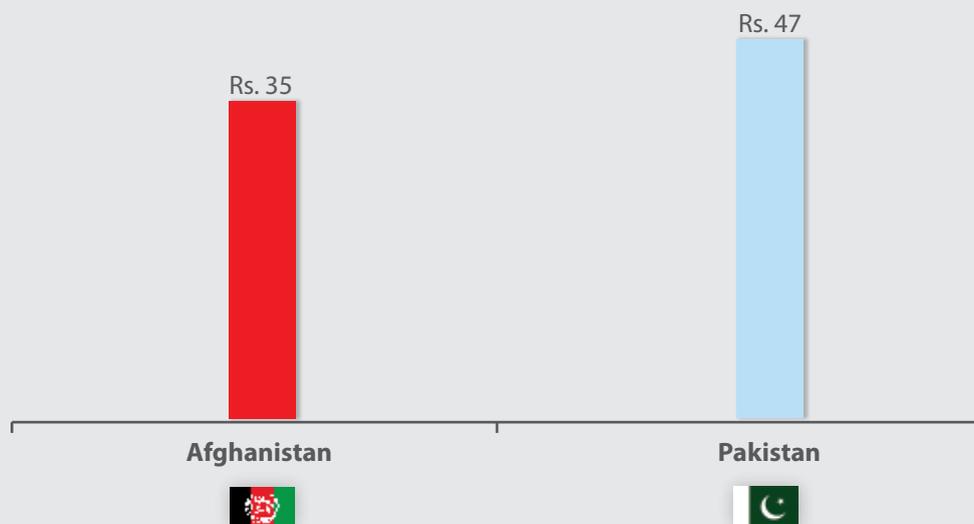
5. The Cigarettes (Printing of Warning) Ordinance, 1979 (LXXIII of 1979) as amended by The Cigarettes (Printing of Warning) (Amendment) Ordinance, 1980 (XL of 1980) and further amended by The Cigarette (Printing of Warning) (Amendment) Ordinance, 2002.

3. Regulatory Differential & Arbitrage

It is well established that differences in regulatory and fiscal policies between neighbouring countries create incentives for product substitution, cross-border shopping and bootlegging. The same holds true for Pakistan and Afghanistan. Regulatory and fiscal differential results in inflow of smuggled cigarettes from Afghanistan into Pakistan. First, Pakistan's law mandates printing of 40% pictorial health warning on all cigarette packets consumed in Pakistan, whether locally manufactured or imported. The law

in Afghanistan, however, prescribes no such requirement.⁶ Secondly, disparity between fiscal policies of both countries leading to price differentials creates arbitrage opportunities for smugglers. For example, in 2014 the price of most popular cigarette brand in Afghanistan was Rs. 35 as compared to Rs. 47 in Pakistan,⁷ creating incentive to sell in Pakistan to take advantage of higher pricing. All this spurred growth in the inflow of non-compliant cigarette packets from Afghanistan into Pakistan.

Figure 6.6: Cigarette Price (20/Packet) Differential Between Pakistan and Afghanistan for Most Popular Price Category⁷



AZAD JAMMU & KASHMIR: LACK OF HARMONISATION

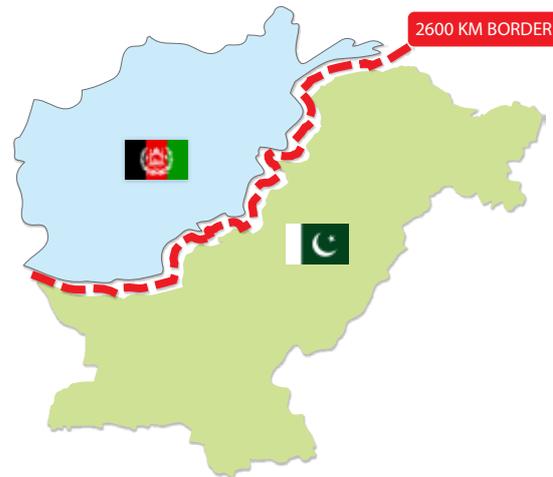
Many units manufacturing LTE cigarette are located in the region of Azad Jammu and Kashmir (AJK). Currently, there is a lack of harmonization of laws between Pakistan and the AJK region. For example, AJK Government does not require printing of pictorial health warnings, whereas Pakistan law mandates printing of 40% pictorial health warning on all cigarette packets consumed in Pakistan, whether locally manufactured or imported. As the regulatory burden in Pakistan continues to increase, manufacturers in AJK may soon start to realize that such regulatory differential provides an opportunity of arbitrage. This may increase inflow of non-compliant cigarette packets from the AJK region into Pakistan.

6. Cigarette Package Health Warning, International Status Report (Canada, September 2014).

7. WHO Report on the Global Tobacco Epidemic, 2015; Raising taxes on Tobacco.

4. Border Control Challenges

Pakistan shares a long mountainous border with Afghanistan. The terrain itself is so challenging that it is not easy for customs and other law enforcement agencies to have effective border controls. This facilitates smuggling into Pakistan which is not just restricted to inflow of cigarettes. Many other products, including tires, tiles, cloth and tea, worth billions are smuggled annually across this border.⁸



5. Higher Rewards for Smuggled Brands

Tax avoidance on smuggled brands allows illegal traders to reap huge profits and thus offer significantly higher trade margins. With higher margins (sometimes 8 times higher than those of tax-paid brands), smuggled brands are a highly attractive and extremely rewarding business opportunity for retailers. Retailers are

thus willing to engage in this illicit business as the rewards (higher margins) outweigh the risks (penal action for selling smuggled products). High margins thus incentivize retailers to push smuggled cigarettes to consumers. This spurs the growth of the illicit segment.

Figure 6.7: Higher Margins for Retailers⁹

Cigarette Type	Profit Margin
Tax-Paid Packet	Rs. 1 – 3
Smuggled Packet	Rs. 6 – 16

8. <http://www.customstoday.com.pk>

9. Industry Data.

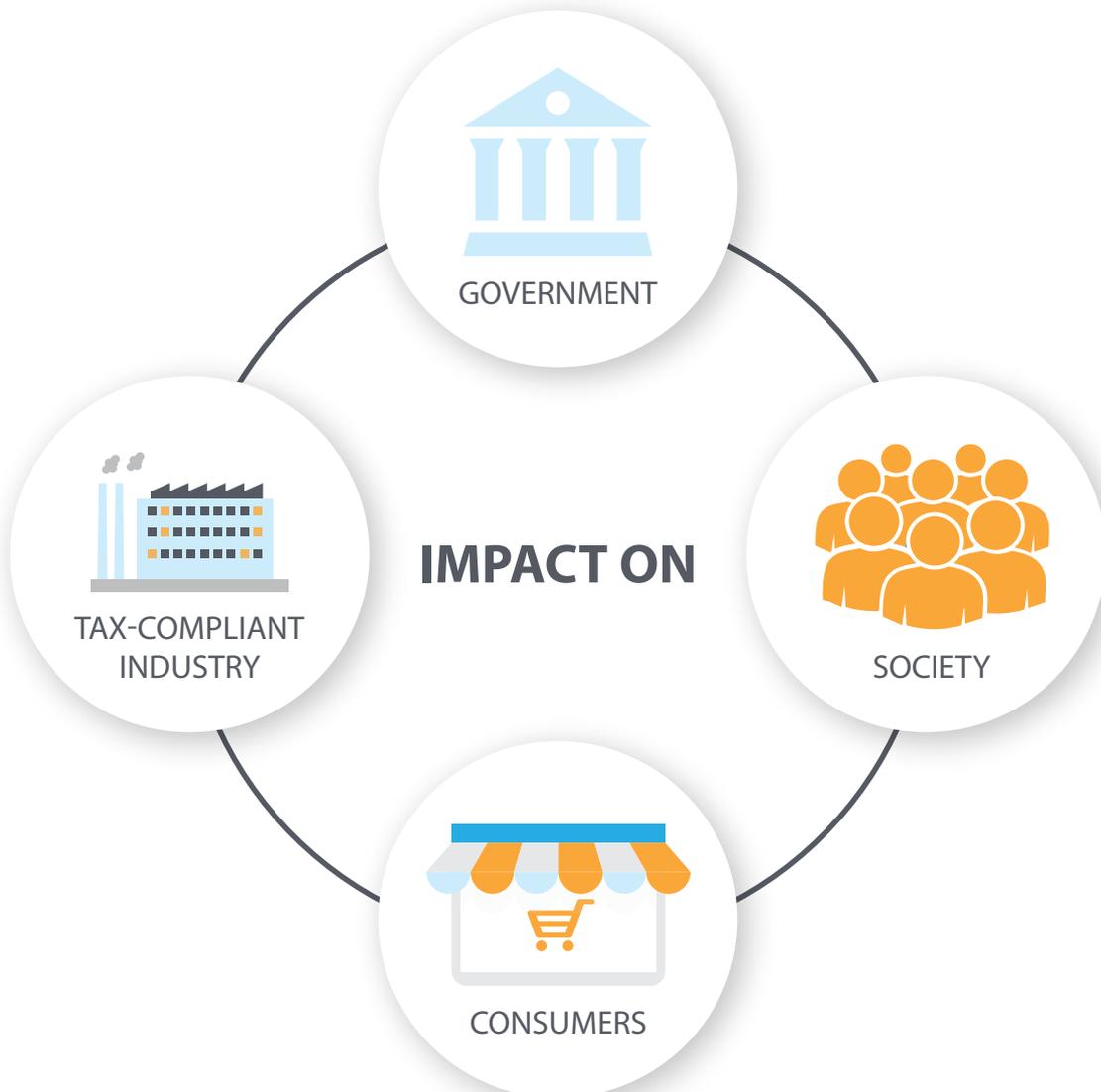


CONSEQUENCES OF ILLICIT TRADE



CONSEQUENCES
OF ILLICIT TRADE

There are multiple and far-reaching negative consequences of illicit trade in cigarettes. This includes reduced domestic revenue generation by the Government which makes Pakistan more dependent upon foreign aid and loans. Availability of tax-evaded and cheaper cigarettes increases the accessibility and affordability of tobacco products thus undermining the public health agenda. The lax compliance environment creates a perception of a soft-state which negatively impacts the foreign direct investment potential. The criminalization of legal trade itself has socio-economic consequences. Proceeds from illegal tobacco trade are a means of amassing great wealth for criminal groups to finance other organized crime activities, including drugs, human and arms trafficking, as well as terrorism.¹ Last but not least, illicit trade undermines the legitimate and compliant cigarette sector which faces a non-level playing field.



1. <http://www.who.int>

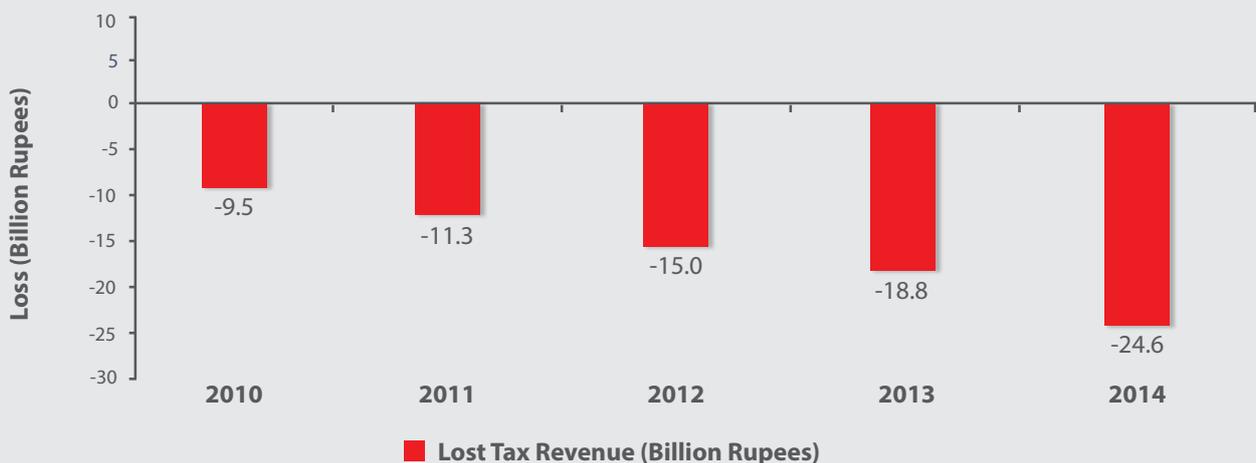
IMPACT ON GOVERNMENT

a. Revenue Loss Due to Volume Loss

Illicit trade in cigarettes adversely affects tax generation by the Government of Pakistan. Annual tax increases make tax-paid cigarettes more expensive as compared to illicit cigarettes which continue to offer lower prices due to tax evasion. Price sensitive consumers opt to down-trade to these cheap tax-evaded alternatives. This results in decreased sales of tax-paid cigarettes and increased sales of illicit brands. Due to illicit segment the Government

of Pakistan lost more than Rs. 24 billion in taxes during fiscal year 2013-14 (refer to Figure 7.1 below for details). This was equal to 26% of the total tax collected by the Government from the cigarette industry during that year. The loss in revenue continues to increase with the increase in illicit segment. During 2010 and 2014, the total revenue loss due to illicit segment was more than Rs. 79 billion (refer to Annexure 1 for detailed calculations).

Figure 7.1: Government Revenue Loss Increasing



GOV. REVENUE LOST
in Pakistan due to illicit trade in cigarettes (2010-2014)



LOST ANNUALLY
due to illicit trade in Pakistan

b. Revenue Loss Due to Pricing

Availability of cheaper and tax-evaded alternatives generates constant pressure on tax-paid segment against increasing its prices in Pakistan. In the absence of this unfair competition from the illicit segment, the tax-paid segment would evidently have far greater ability to increase its prices, yielding higher tax revenues for the Government. As the illicit segment hampers the pricing ability of the tax-paid segment, the Government suffers revenue loss, as revenue is also a function of pricing.²

c. Continued Dependence on Foreign Aid

Pakistan's tax-to-GDP ratio hovers at around 9%³ and the budget deficit in the fiscal year 2014-15 was around 4.9%.⁴ Tax evasion by the illicit cigarette segment undermines efforts of the Government to increase its tax-to-GDP ratio, lower its budget deficit, and increase its economic and financial autonomy. Unable to generate domestic revenues to fulfill its public sector development agenda, the Government is forced to seek foreign aid and loans. While the foreign loans help to finance development projects, the attached terms and conditions limit the Government's power to devise and implement autonomous economic policies.

Some donors may even raise the question of the moral hazard involved in seeking such assistance which comes from taxes generated from citizens and business in foreign countries, when the Government of Pakistan is unable to generate domestic revenues by plugging local tax evasion through curtailing illicit trade.



SRI LANKA: CASE STUDY

Sri Lanka provides a good example of how low levels of illicit trade positively impact government revenues (refer to Annexure 2 for further details on the issue). Due to low level of illicit segment (<1.5%), the prices of tax-paid cigarettes are much higher in Sri Lanka. As a result of these higher prices, the Government of Sri Lanka generates much higher revenues from a much smaller volume of cigarettes sold in that country. In 2014, the volume of cigarettes sold in Pakistan (82.2 billion) was nearly 24 times more than the volume in Sri Lanka (3.5 billion), whereas the revenue collected by the Government of Pakistan (US\$ 1,000 million) was only 2 times higher than in Sri Lanka (US\$ 550 million). Hence, the higher illicit trade incidence in Pakistan negatively impacts pricing ability of the tax-paid segment which in turn has a negative impact on government revenues.



ILLICIT SEGMENT

= Rs. 1 Billion Additional Government Revenue

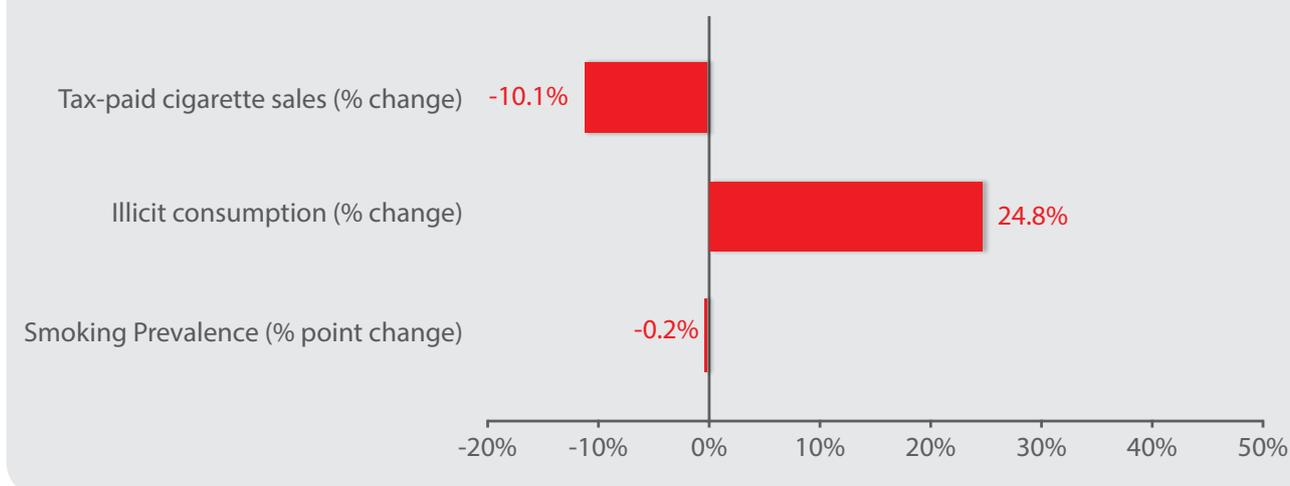
- Most components of the supply chain of illicit trade in cigarettes are undocumented and hence escape the tax net. This includes transporters, distributors, wholesalers and retailers, involved in illicit trade in cigarettes. Thus the actual revenue loss to the Government is even higher than the calculations made herein, as the current calculations are based solely on evasion of excise duty and sales tax by manufacturers of LTE cigarettes.
- Bi-Annual Review, Federal Board of Revenue (2014).
- IMF Program Note – Pakistan (2015): <http://www.imf.org/external/np/country/notes/pakistan.htm>

d. Public Health Agenda Undermined

The Government of Pakistan has, over the years, introduced multiple laws to reduce incidence of smoking in the country. These are in line with the country's commitment to the World Health Organization's Framework Convention for Tobacco Control (FCTC).⁵ As the regulatory burden on tax-paid segment increases, more and more consumers are purchasing illicit substitutes that are either cheaper (due to tax-evasion) or are non-compliant (due to lack of health warnings), which consequently fuels growth of the illicit sector and undermines the public health agenda. Easy availability of

non-compliant alternatives provided by illicit cigarettes undermines the intended objective of the regulations, i.e., reducing incidence of smoking. Product substitution from compliant to non-compliant (illicit) segment means that smoking incidence does not decrease (failure to meet intended objective), whereas multiple unintended consequences in the form of tax evasion, increased consumption, easier youth access, etc. follow. It is due to this growth of illicit sector that between 2008 and 2013 smoking incidence in Pakistan only reduced by 0.2 percentage points.

Figure 7.2: Change in Total Cigarette Consumption and Smoking Prevalence in Pakistan Between 2008 and 2013⁶



e. Investment Climate Undermined

High prevalence of illicit trade is detrimental to foreign investor confidence. It creates market distortions by way of unfair competition and a non-level playing field for a tax-compliant investor. Effective governance is crucial for gaining investors' trust. The lax compliance environment, exhibited by high levels of

illicit trade, creates perception of a soft-state which negatively impacts the foreign direct investment potential. The adverse impact of illicit cigarette trade is thus not limited to the tobacco industry alone but also has a negative bearing on the investment climate in the country.

5. Some of these regulations include: levying excise duties and other taxes to increase prices of cigarettes, printing of health warnings on each cigarette packet consumed in Pakistan (whether locally manufactured or imported), a virtual ban on tobacco products promotion and advertisement, and ban on sale to underage consumers.

6. KPMG UK (2015): A Review of Cigarette Taxation in Pakistan.

IMPACT ON SOCIETY

a. Funding Organized Crime

Proceeds from illegal tobacco are a means of amassing great wealth for criminal groups to finance other organized crime activities, including drugs, human and arms trafficking, as well as terrorism.⁷ In the World Health Organization's Protocol to Eliminate Illicit Trade in Tobacco Products (November, 2012), it is recognized that illicit trade "undermines the economies of Parties and adversely affects their stability and security". The said Protocol also recognizes "that illicit trade in tobacco products generates financial profits that are used to fund transnational criminal activity, which interfere with Government objectives."⁸ In 2009, the

International Consortium of Investigative Journalists (ICIJ) issued an investigative report on illicit trade in cigarettes in Pakistan stating that militant groups increasingly relied on proceeds from illicit cigarette production and smuggling.⁹ The fact that illicit trade in cigarettes is a source of funding for organized crime is further corroborated in a recent report by Interpol. According to the said 2014 Interpol report, "Because illicit cigarettes are a high-profit, low-risk product, organized crime is deeply involved...and it has also been a useful way for terror groups to raise cash."¹⁰

b. Growth of Informal Economy

Increase in illicit trade in cigarettes is also responsible for the growth of a parallel informal economy. It supports criminalization in the form of tax-evaded manufacturing with a chain of back-up alternative manufacturing units, undeclared warehousing, under-invoiced distribution and inflow of smuggled products. This parallel illicit supply chain operates under

the protection of organized criminal syndicates that perpetuate this low risk, high-reward informal economy across the country. The growth and expansion of this illicit and informal sector creates wider macro-economic issues in Pakistan by transferring resources from the formal to the informal economy, promoting a culture of tax avoidance and criminal behavior.

c. Livelihoods Transferred Abroad

Increasing inflow of smuggled cigarettes has its own displacement impact on local livelihoods in Pakistan. Economic activity (income, employment and investment) generated through the local cigarette industry is transferred and lost to countries of origin of smuggled products, further perpetuating underdevelopment in Pakistan. As the sale

of locally manufactured tax-paid cigarettes declines and the quantum of cigarettes smuggled into Pakistan increases, economic activity from Pakistan is being transferred abroad. Increased sale of smuggled cigarettes may actually be subsidizing the countries of origin of smuggled products at the cost of Pakistan's economy.

7. <http://www.who.int>

8. World Health Organization (2012): Protocol to Eliminate Illicit Trade in Tobacco Products.

9. <http://www.icij.org/project/tobacco-underground>

10. Interpol (2014): Against Organized Crime, Trafficking and Counterfeiting Casebook (www.interpol.int)

IMPACT ON CONSUMERS

Low Quality Products

Illicit cigarettes do not comply with minimum quality standards and may contain dangerous substances. In a study conducted by Centre for Regulatory Effectiveness in Washington, counterfeit cigarettes were found to contain excessively high levels of toxic metals, tar, nicotine and carbon monoxide as compared to genuine cigarettes. Moreover, miscellaneous

contaminants such as “rat droppings, camel dung, sawdust and tobacco beetles” as well as “sand and other packaging materials such as bits of plastic” were also sometimes detected in such counterfeit cigarettes.¹¹ Thus illicit cigarettes undermine public health agenda in multiple ways.

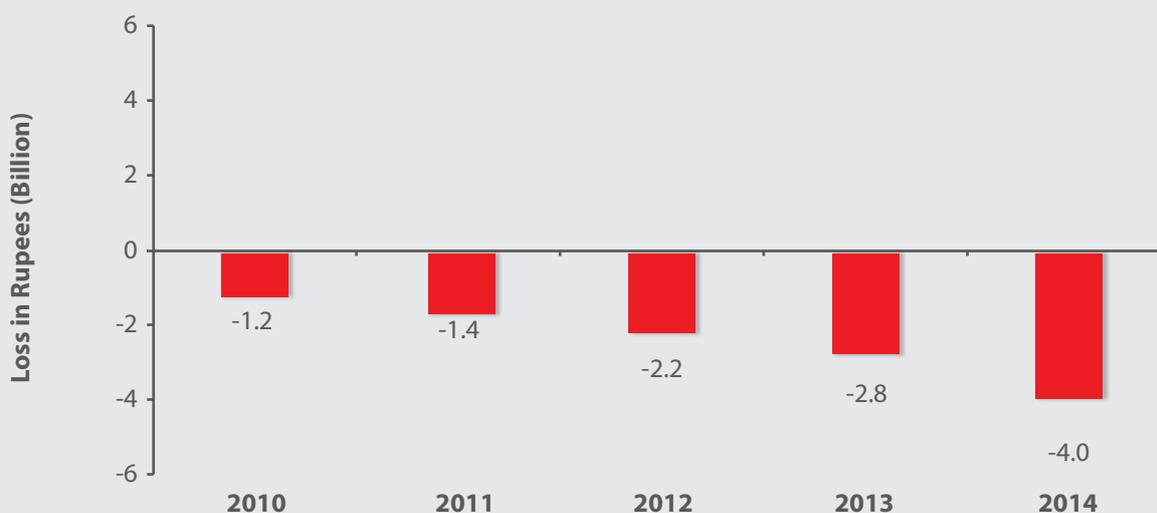
IMPACT ON TAX-COMPLIANT CIGARETTE MANUFACTURERS

a. Non-Level Playing Field

The tax-compliant segment of the cigarette industry faces unfair competition in marketplace, whether it is in regulatory or in pricing matters. It is not possible to have fair competition with the illicit segment which sells at prices that are even below the minimum tax payable per packet or which violates the health warning and multiple other regulations. Due

to these reasons the sales of tax-paid segment are declining which is resulting in substantial loss to the tax-paid segment, in addition to the multiple other consequences for the Government, the public and the consumers. According to an estimate, in the year 2014 the tax-paid segment suffered a loss of around Rs. 4 billion due to lost sales.

Figure 7.3: Losses to Tax-Compliant Industry Due to Illicit Trade



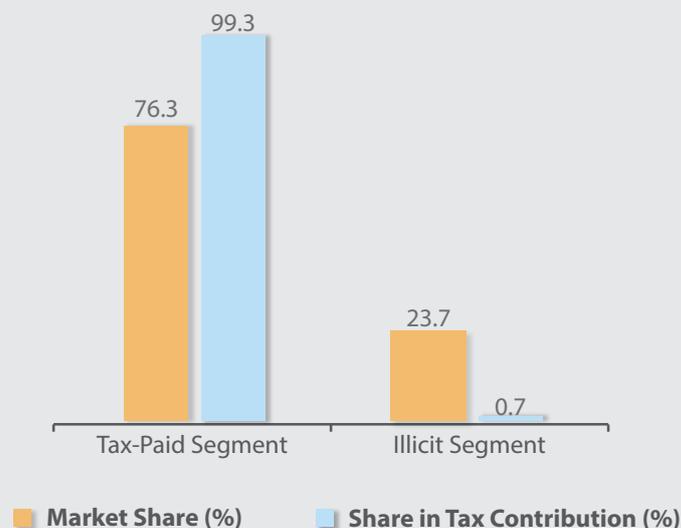
11. Center for Regulatory Effectiveness, Washington, D.C., USA (2011): The Countervailing Effects Of Counterfeit Cigarettes. May also refer to: Counterfeit Cigarette Information Sheet by HM Revenue & Customs available at: <http://www.thecre.com/ccsf/?p=93>.

b. Increased Tax Burden

Due to tax evasion by the illicit manufacturers and smugglers, the fiscal burden on the tax-compliant segment has significantly increased. The tax-compliant segment is expected to pay higher taxes to compensate for the revenue loss caused by the illicit segment. That is why two of the industry players having 76.3% market share (tax-paid segment) contribute 99.3% of the total annual tax revenue from the cigarette industry, whereas those who have the remaining 23.7% market share (illicit segment) contribute only 0.7% of the said revenue.



Figure 7.4: Illicit Segment Pays Less than 1% of Taxes¹²



12. Source: Federal Board of Revenue (for share in Tax Contribution data); Nielsen Retail Audit (for Market Share data).



ILLICIT SUPPLY CHAIN

ILLICIT
SUPPLY CHAIN

SUPPLY CHAIN MAPPING

One of the basic pre-requisites for tackling illicit trade in cigarettes is to understand its supply chain, both inside and outside Pakistan. This understanding requires clear and credible information on the origins of supply, the raw materials procurement sources, manufacturing facilities, transportation routes, including storage and warehousing facilities. A supply chain map of illicit trade would assist the regulators in devising necessary legal framework to control the problem. It would also help the law enforcement agencies to decide their points of intervention to control, and ultimately eliminate, illicit trade in cigarettes in Pakistan.

LOCAL TAX-EVADED (LTE) CIGARETTES

Manufacturing and distribution of Local Tax-Evaded cigarettes in Pakistan is not some covert operation but this supply chain is well established across the country and is operating seamlessly. Procurement of raw material is being done - manufacturing facilities exist and raw material is being converted to cigarettes; and finally storage and distribution system

is operational and the illicit products are reaching the consumers all over the country, all in broad day light. The under-declaration of raw materials, including tobacco crop, cigarette paper and filter rods, helps in under-declaration of volume of cigarettes manufactured that ultimately assists in evasion of excise duties on cigarettes (final taxable product).



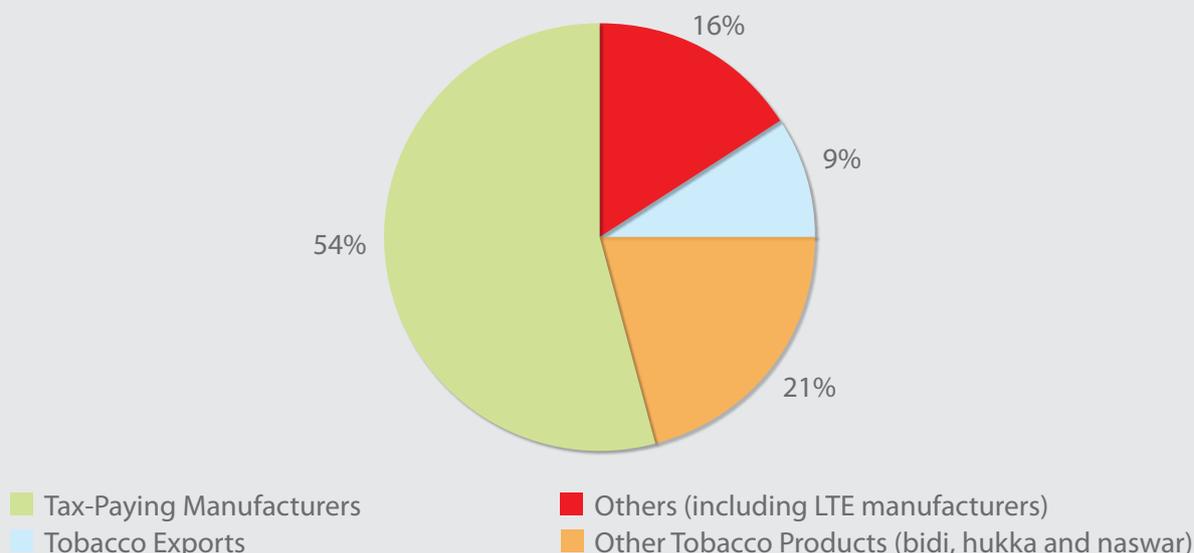
RAW MATERIALS PROCUREMENT

a. Tobacco Crop

16% of the tobacco crop produced annually in Pakistan is purchased by manufacturers of LTE cigarettes (refer to Figure 8.1 below for details). The average annual tobacco crop production in Pakistan for the last 5 years was around 117 million kilograms (refer to Annexure 3).¹ This means around 18 million kilograms of tobacco crop is annually purchased by manufacturers of LTE cigarettes, although the same is not

declared by them in order to avoid the tax net.² One kilogram of tobacco crop is used for manufacturing approx. 1,000 cigarettes. These 18 million kilograms of tobacco crop is thus enough for manufacturing 17.3 billion cigarettes annually, which was the sales volume of LTE cigarettes in 2014. Local tobacco crop is thus easily available for use by manufacturers of LTE cigarettes in Pakistan.

Figure 8.1: Share in Tobacco Crop Utilisation in Pakistan³



b. Cigarette Paper

Cigarette paper, a key raw material required for manufacturing cigarettes, is not manufactured locally. To avoid declaration of total quantity of cigarette paper used, and consequently, to avoid payment of applicable taxes, manufacturers of LTE cigarettes may instead either use smuggled cigarette paper or purchase imported cigarette paper through unregistered entities. This serves two purposes. First, under-declaration helps in

evasion of import duties levied on imported products (raw material). Secondly, the lower the declared quantity of cigarette paper used, the lower is the declared volume of cigarettes manufactured. Hence, under-declaration of raw materials helps in under-declaration of volume of cigarettes manufactured that ultimately assists in evasion of excise duties on cigarettes (final taxable product).⁴

1. <http://www.ptb.gov.pk/sites/default/files/14%20Production.pdf> (Pakistan Tobacco Board)

2. The manufacturers of LTE cigarettes may take two steps to avoid the tax net. First, is under-declaration of their tobacco crop requirement and their crop purchase volume. Secondly, instead of buying the crop directly, intermediary buyers are deployed to purchase the tobacco crop on their behalf. This under-declaration of tobacco crop (raw material) purchased later helps manufacturers of LTE cigarettes in under-declaration of volume of cigarettes (final taxable product) manufactured by them.

3. Nielsen (2014): Economics of Tobacco Crop: An Assessment of Contribution and Impact in Pakistan.

4. Cigarette paper comes in rolls called bobbins. Each roll is 6000 meters. If imported legally, cigarette paper is subject to tariff of 20% on CI&F value. On average 61 metres of cigarette paper is used to manufacture 1000 cigarettes. Hence, one bobbin can be used to manufacture a little less than 100,000 cigarettes.

MANUFACTURING & OPERATIONS



a. Green Leaf Threshing (GLT)

Green leaf threshing (GLT) is a critical process in the manufacturing of cigarettes.⁵ GLT process is itself fully mechanised and industrial in scope.⁶ Most manufacturers of LTE cigarettes in Pakistan do not have this industrial process in-house and instead procure the threshed tobacco from independent GLT plants operating in Pakistan.⁷ To evade the tax liabilities, these GLT plants, however, may not fully declare the actual quantities of tobacco threshed by them nor furnish details of their customers of threshed tobacco.⁸ This possible under-declaration of quantities of threshed tobacco (raw material) or sale to un-registered persons / establishments could later help manufacturers of LTE cigarettes in under-declaration of volume of cigarettes (final taxable product) manufactured by them, which ultimately helps in tax evasion.

b. Filter Rod Manufacturing

Just like green leaf threshing, filter rod manufacturing is also an in-house industrial process. Manufacturers of LTE cigarettes, however, do not make filter rods in-house and instead procure these from independent filter rod making units. Tax authorities, a few years ago, conducted an audit of these units and found that the actual quantities of filter rods manufactured were not being declared nor did these units furnish details of their buyers.⁹ This under-declaration of quantities of filter rods (key component) could later help manufacturers of LTE cigarettes in under-declaration of volume of cigarettes (final taxable product) manufactured by them, which ultimately helps in tax evasion.

5. GLT process involves separating the stem from the lamina, threshing of raw tobacco, and ensuring uniform moisture levels. This converts raw tobacco into un-manufactured (threshed) tobacco, i.e., tobacco which is ready for use in cigarette manufacturing.
6. Globally GLT is an in-house process to ensure integrated supply chain management, saving costs, and ensuring proper quality controls.
7. According to publicly available evidence, there are 6 stand-alone GLT plants operating in Pakistan. The rest of the GLT plants are in-house manufacturing facilities.
8. One kilogram of un-manufactured (threshed) tobacco is used to manufacture approx. 1,250 cigarettes.
9. Acetate tow is a synthetic material which is used to manufacture filter-rods for cigarettes. Just like cigarette paper, acetate tow is not manufactured in Pakistan and has to be imported. During the said audit by tax authorities it was also found that these units were importing acetate tow by mis-declaring it as textile related raw material. This was done for two reasons. First, it was done to claim tax benefits reserved for textiles related raw material and thus evade import duties levied on acetate tow itself. Secondly, it assisted them in under-declaring their final production volume in order to evade payment of excise duty levied on each filter-rod.

c. Cigarette Manufacturing Units

LTE cigarettes are manufactured in around 50 or so factories, most of which are located in the Province of Khyber Pakhtunkhwa and in the region of Azad Jammu and Kashmir.¹⁰ These LTE manufacturing units are not covert operations. Most of these units are formally registered with the Pakistan Tobacco Board for the purpose of crop purchasing and with the Federal Board of Revenue for the purposes of sales tax payments. Taking advantage of the lax enforcement of fiscal and regulatory requirements, these units are able to avoid their full tax liabilities by under-declaring the volumes of cigarettes manufactured. Hence, they escape the tax net of the Pakistan Tobacco Board and the Federal Board of Revenue. This segment, having more than 21% share in the overall cigarette market, in fact pays less than 1% of the total tax collected annually by the Government from the cigarette sector in Pakistan.¹¹



d. Transportation

Once manufactured, LTE cigarettes are then shipped from the cigarette factories either to the distributors or to the company owned warehouses. It is difficult to monitor and verify whether the same sales-cum-transport invoice is not being used for multiple transport vehicles. This would help manufacturers of LTE cigarettes to under-declare the total volume of cigarettes manufactured and thereby evade the total taxes due.¹²



10. Euromonitor International (2012): Illicit Trade in Cigarettes: Impact on Pakistan.
 11. Nielsen (2013): Tobacco Industry in Pakistan: Economic Contribution and Challenges.
 12. For example, when the same invoice is used for, say 20, different consignments, then in effect, only 1/20th of the volume of cigarettes shipped is actually being declared on the books, (assuming of course that in this example all the consignments are of the same size). This under-declaration will consequently reduce the actual tax liability by 1/20th.

e. Distribution

A well-established distribution network of LTE cigarettes exists across the country. From distributors, cigarettes go to wholesalers and retailers and then finally reach the consumers. The major markets in Pakistan where LTE cigarettes are stored, traded and later

distributed to adjoining areas are given in Figure 8.2 below. As is evident, these are not covert operations but operate openly throughout the country with little apprehension of being penalised by the law.

Figure 8.2: Illicit Cigarettes: Major Markets in Pakistan



SMUGGLED CIGARETTES

The supply chain of cigarettes smuggled into Pakistan is well-established. Most of these come into Pakistan from Afghanistan. Just like many other products, in case of cigarettes also, Afghanistan is basically a transit market. It is neither the origin nor the destination market for smuggled cigarettes. It is not an origin market because there is no cigarette manufacturing unit in Afghanistan. It is also not a destination market for three reasons. First, the size of the cigarette market in Afghanistan is even less than 1/10th of the size of cigarette market in Pakistan. Because of its low volume

it is far less attractive than Pakistan market. Secondly, cigarette prices in Afghanistan are lower than in Pakistan, creating incentive to sell in Pakistan to take advantage of higher pricing. Third, regulatory differential between the two countries provides smugglers with arbitrage opportunities which incentivizes cross-border trafficking. Once these cigarettes enter Pakistan, a seamless network of transportation and distribution exists across the country to make them available to consumers, all in broad day light.

a. Smuggling Into Afghanistan

There are reportedly two key routes for cigarettes smuggled into Afghanistan. First one is the 1700 kilometers air route from Dubai (United Arab Emirates) to Kabul (Afghanistan).

Second one is the 1400 kilometers land route from Bandar Abbas port (Iran) to Herat (Afghanistan) onwards to Kandahar (Afghanistan).

Figure 8.3: Smuggling Routes into Afghanistan¹³



13. Framework Convention Alliance and Healthbridge (2010): Tracing Illicit Tobacco Trade in South Asia.

b. From Afghanistan Into Pakistan

The two key routes used for such smuggling operations are:

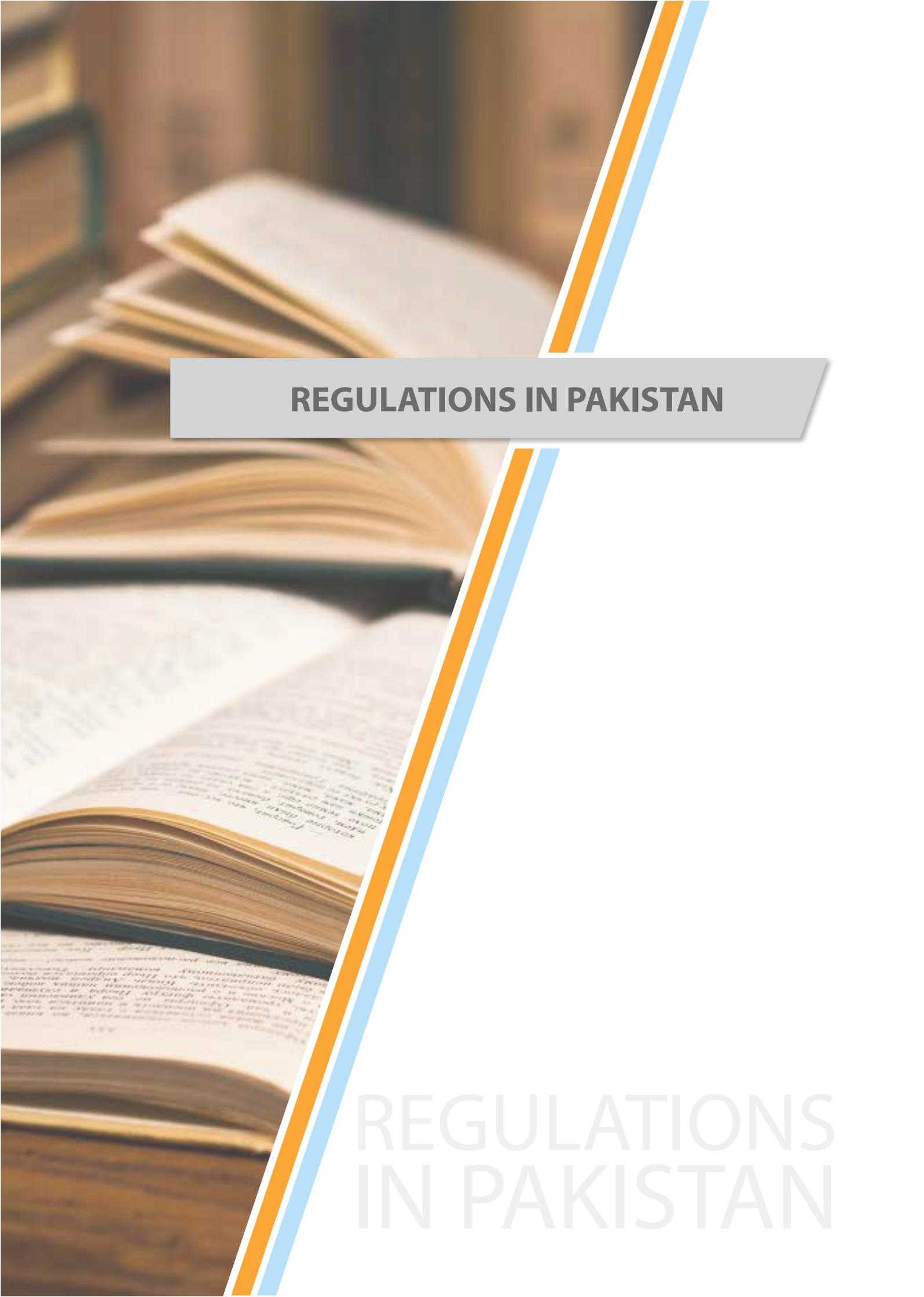
Torkham Route: Cigarettes are smuggled from Kabul (Afghanistan) into Torkham (Pakistan) from where they are initially taken to warehouses located in Khyber Agency and Peshawar (Pakistan). From here they are dispatched either to Rawalpindi or to Lahore using mid-sized cargo vehicles.

Distribution inside Pakistan: Once inside Pakistan smuggled cigarettes find their way to every major wholesale market in the country and from there onwards to retailers. These smuggled cigarettes are openly displayed and sold in retail outlets with little apprehension of being penalised by the law.

Chamman Route: Cigarettes are smuggled from Kandahar (Afghanistan) into Chamman (Pakistan) from where they are initially taken to warehouses located in Quetta. From there the smuggled cigarettes are dispatched in regular quantities through cargo vehicles to Karachi and other intended destinations.

Figure 8.4: Smuggling Routes from Afghanistan into Pakistan





REGULATIONS IN PAKISTAN

REGULATIONS
IN PAKISTAN

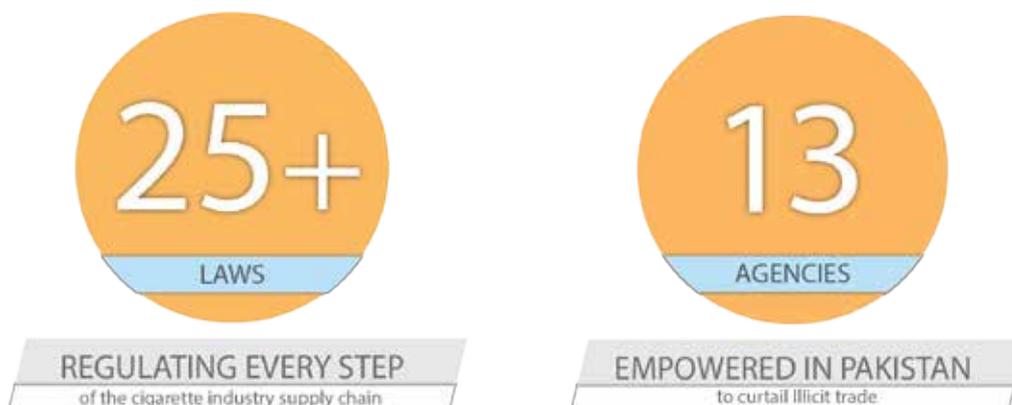
EXTENSIVE REGULATIONS WITHOUT ENFORCEMENT

Over the years, the Government of Pakistan has put in place a robust regulatory regime intended to curtail illicit trade in cigarettes. Over 25 Acts of Parliament, Presidential Ordinances and Statutory Rules prescribe strict laws regulating virtually every step of the cigarette industry supply chain (refer to page 54 and 55 for list of all such laws). These include laws and rules regulating crop buying, procurement and use of raw materials, manufacturing, transportation and distribution, and finally import and retailing of tobacco products (refer to Annexure 4 for details of multiple penalties already prescribed by law). Despite this comprehensive regulatory framework, illicit segment has 23.7% of the overall cigarette market, with 89% of this illicit segment being LTE cigarettes. It clearly shows that lax enforcement of fiscal and regulatory laws is the real hurdle in curtailing this.

PAKISTAN TOBACCO BOARD LAWS¹

The law binds all cigarette manufacturers to indicate to Pakistan Tobacco Board (PTB), by the 1st of October of each year, their requirements of tobacco crop for the next year.² PTB also levies a cess on un-manufactured (threshed) tobacco used for manufacturing of cigarettes.³ If these laws are strictly enforced, PTB officials and the tax authorities can determine the total volume of tobacco crop (raw material) procured and used by each cigarette manufacturer. One kilogram of tobacco crop is used for manufacturing approx. 1,000 cigarettes.

Similarly, one kilogram of un-manufactured (threshed) tobacco is used for manufacturing approx. 1,250 cigarettes. Based on the quantity of tobacco used it is easy to calculate the total cigarette volume (final taxable product) and consequently the taxes and duties owed by each cigarette manufacturing company. Enforcement of these laws can help curtail tax evasion by manufacturers of LTE cigarettes (through proper determination of raw material used by them).



1. These include the Pakistan Tobacco Board Ordinance 1968 (Ordinance No. I of 1968) and Martial Law Order 487 issued in 1985 by the then North-West Frontier Province (now Province of Khyber Pakhtunkhawa) Government and consequential rules and orders issued thereunder that govern tobacco crop, its procurement, marketing and pricing.
2. Rule 3 of Tobacco Marketing Control Rules, 1993 issued under Martial Law Order 487 of 1985.
3. Under Section 9 of the Pakistan Tobacco Board Ordinance 1968 (Ordinance No. I of 1968).

REGULATORY FRAMEWORK

- Martial Law Order No. 487
- Pakistan Tobacco Board Ordinance, 1968



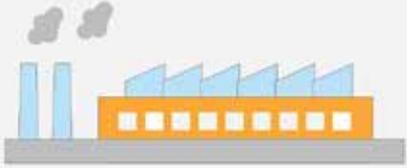
Tobacco Crop

- Federal Excise Rules, 2005



Green Leaf Threshing

- Federal Excise Act, 2005
- Federal Excise Rules, 2005
- Pakistan Penal Code, 1860
- Copyright Ordinance, 1962
- Trademark Ordinance, 2001
- Cigarettes (Printing of Warning) Ordinance, 1979
- Prohibition of Smoking and Protection of Non-smokers Health Ordinance, 2002

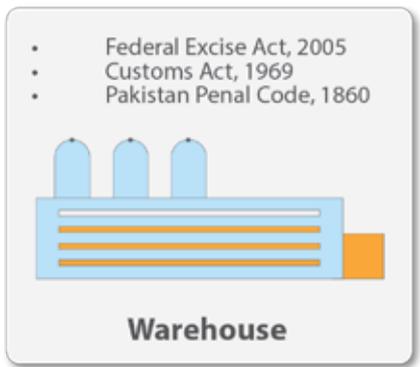
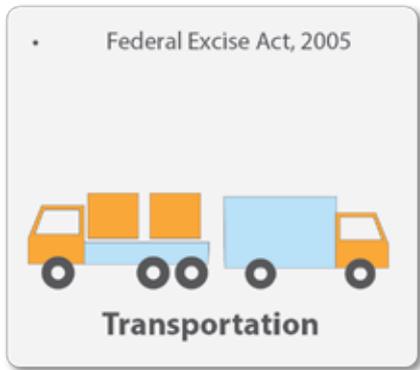


Manufacturing

- Import Policy Order, 2013
- Customs Act, 1969



Import of Raw Materials



CUSTOMS LAW (RAW MATERIAL AND CIGARETTES)⁴

Raw materials required for cigarette manufacturing, including acetate tow (for filter rod making) and cigarette paper, are imported. As per law taxes and duties are required to be paid at the port of entry for such imported raw materials. Moreover, the Import Policy Order 2013 directs that cigarette paper can only be imported by cigarette manufacturers registered with the Federal Board of Revenue.⁵ Cigarettes that are imported also require to be cleared from the port of entry after payment of requisite

taxes and duties. Customs authorities have the power to seize and confiscate all smuggled products, whether raw materials or cigarettes, at any stage. Enforcement of these laws can help curtail tax evasion by manufacturers of LTE cigarettes through full payment of duties on imported raw materials and also through proper determination of cigarette volumes (final taxable product) manufactured by them. This can also help prevent inflow of smuggled cigarettes into Pakistan.



FILTER ROD MONITORING LAWS

The law mandates that manufacturers of filter rods can only sell filter rods to a person registered under the Sales Tax Act.⁶ The law also levies an adjustable excise duty on each filter rod sold by them.⁷ Both these laws are put in place to allow authorities to determine the quantities of filter rods (key component) sold to manufacturers of LTE cigarettes. One filter rod is used for manufacturing approx. 6 cigarettes. Based on the number of filter

rods sold it is easy to calculate the total cigarette volume (final taxable product) and consequently the taxes and duties owed by each cigarette manufacturing company. Enforcement of these laws can help curtail tax evasion by manufacturers of LTE cigarettes through proper determination of cigarette volumes (final taxable product) manufactured by them.

4. This includes the Pakistan Customs Act, 1969 and consequential rules and regulation issued by the Federal Board of Revenue, from time to time, to levy and collect import duties.
5. Import Policy Order 2013 issued under Section 3 of Imports & Exports Act 1950.
6. S.R.O 61 (I) 2010 dated 4th Feb 2010 issued under Section 8(6) the Sales Tax Act, 1990.
7. Section 6 of Finance Act 2015 levies an adjustable excise duty of Rs. 0.75/filter rod.

FEDERAL EXCISE LAWS

The Federal Excise Act 2005 and Rules thereunder not only lay down a comprehensive regulatory framework for excise collection on cigarettes but also empower officials to enforce these laws across the supply chain.⁸

a. Green Leaf Threshing (GLT) Rules⁹

The law requires all tobacco Green Leaf Threshing (GLT) units that sell un-manufactured (threshed) tobacco to cigarette manufacturers to issue a tax invoice. The law also requires them to deduct adjustable excise duty of Rs. 10 per kilogram of un-manufactured (threshed) tobacco sold by them.¹⁰ GLT units are also required to file a monthly return declaring their sales. If these laws are strictly enforced, tax authorities can easily determine the total volume of un-manufactured tobacco (threshed raw material) used by each cigarette manufacturer.

One kilogram of un-manufactured (threshed) crop is used for manufacturing approx. 1,250 cigarettes. Based on the quantity of tobacco used it is easy to calculate the total cigarette volume (final taxable product) and consequently the taxes and duties owed by each cigarette manufacturing company. Enforcement of this law can help curtail tax evasion by manufacturers of LTE cigarettes (through proper determination of raw material used by them).

b. Printing Retail Price on Packets

The law mandates printing of retail price on each cigarette packet.¹¹ Manufacturers of LTE cigarettes do print the retail price on their cigarette packets but it is no more than a mere formality as the actual price of these brands at the retail outlets is far lower than even the minimum tax payable on each cigarette packets.¹² Active monitoring of the retail prices of LTE brands, combined with monitoring of raw material used to determine the actual

volume of cigarettes (final taxable product) manufactured, can help the tax authorities determine the taxes and duties owed by each cigarette manufacturing company. Enforcement of this law can help curtail tax evasion by manufacturers of LTE cigarettes (through proper determination of taxes due). It can also prevent tax evasion by smuggled cigarettes, as smuggled cigarettes do not carry any retail price on the packet.

c. Sales-Cum-Transport Invoice

The law mandates all vehicles transporting cigarettes from the factory to the warehouse or the distributor to carry a 'prescribed sales cum transport' invoice.¹³ Tax authorities have powers to stop and search any transport vehicle

and verify tax documents. Implementation of this law can help curtail tax evasion by manufacturers of LTE cigarettes (through proper determination of taxes due).

8. The Federal Excise Act 2005 empowers Federal Excise Officers to enter, search and investigate any premises where excisable goods are manufactured. It also confers upon them the right to seize and confiscate non-duty paid goods. Other enforcement powers conferred upon officers include audits, mandated reconciliation requirements and posting of officials on the manufacturing premises for monitoring under Section 40-B of the Sales Tax Act. Chapter VI of the Federal Excise Rules 2005 specifically pertains to cigarettes and grants special powers to tax authorities to curtail illicit trade in cigarettes.

9. Rule 81-86 of Excise Rules of 2005.

10. Section 3, Table 1, Serial Number 7 of First Schedule of Federal Excise Act of 2005.

11. This is prescribed under Section 12(4) of the Federal Excise Act 2005. It also mandates printing of requisite health warning and name of manufacturer on each cigarette packet. Manufacturers of LTE cigarettes print the requisite health warning and the name of manufacturer on each cigarette packet.

12. Selling a packet of cigarettes below the minimum applicable tax is itself clear evidence of tax evasion. Most LTE brands sell at around Rs. 27 per packet which is far below even the minimum tax per packet of Rs. 33.8. This includes excise duty and sales tax payable per packet.

13. SRO 217 (1) 2010 dated 31st March 2010 issued under Federal Excise Act 2005.

HEALTH WARNING LAWS¹⁴

The law mandates that no one can manufacture or sell (or even possess) cigarette packets, whether locally manufactured or imported, without the government-mandated health warning printed on them. In 2014, more than 2 billion cigarettes were smuggled into and consumed in Pakistan.¹⁵ These smuggled cigarette packets do not comply with the health warning regulations. It is a key regulation to distinguish a smuggled from a locally manufactured and/or legally imported cigarette packet. Enforcement of this law can help curtail tax evasion by preventing inflow of smuggled cigarettes and also sale of such tax-evaded and smuggled cigarettes at retail outlets.



Aim: Level Playing Field

PROMOTION AND ADVERTISEMENT RESTRICTION LAWS

The Government of Pakistan has, over the years, introduced multiple laws to reduce smoking incidence in the country. These are in line with the country's commitment to the World Health Organization's Framework Convention for Tobacco Control (FCTC). One of the regulations issued under the Prohibition of Smoking and

Protection of Non-Smokers Health Ordinance 2002 prescribes a virtual ban on tobacco products promotion and advertisement in Pakistan.¹⁶ Enforcement of these laws can help curtail violations by the illicit segment that undermines the public health agenda of the Government.¹⁷

14. The Cigarettes (Printing of Warning) Ordinance, 1979 (LXXIII of 1979) as amended by The Cigarettes (Printing of Warning) (Amendment) Ordinance, 1980 (XL of 1980) and further amended by The Cigarette (Printing of Warning) (Amendment) Ordinance, 2002.

15. For tax-compliant segment it is based on actual shipped volume and for illicit segment it is based on retail audit methodology.

16. Regulations issued under Section 7 of the Prohibition of Smoking and Protection of Non-smokers Health Ordinance 2002.

17. These violations include open consumer promotions, even advertisement and promotion through billboards and celebrity endorsements.

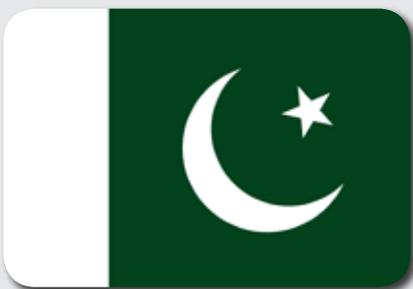
ANTI-COUNTERFEITING LAWS¹⁸

There are a number of laws to protect intellectual property rights in Pakistan. The enforcement of these laws, however, remains a challenge. In fact, in 2015, the United States Trade Representative (USTR) placed Pakistan on its Priority Watch List with regards to breach of Intellectual Property

Rights (IPR).¹⁹ Enforcement of IPR laws can help curtail regulatory violations by the counterfeit manufacturers. Lax enforcement undermines not only the cigarette sector but also the overall investment climate in the country.

AFGHAN TRANSIT TRADE AGREEMENT

Afghan Transit Trade Agreement is a bilateral trade agreement between Pakistan and Afghanistan, under which goods are transported to land-locked Afghanistan after unloading them at the ports of Pakistan. It is, however, prohibited to bring cigarettes for transit to Afghanistan, either by sea, land or air.²⁰ The rationale behind this prohibition is the high incidence of 'transit' cigarettes ending up in Pakistan without payment of import duties. Effective monitoring and enforcement of this law by the Customs authorities can help curb this inflow of smuggled cigarettes through this source.



18. These include The Trademark Ordinance 2001, The Copyright Ordinance 1962, and the Pakistan Penal Code.

19. Special 301 Report, Office of the United States Trade Representative (2014).

20. SRO 151 (I)/2004 issued under Section 3(1) of the Imports and Export (Control) Act 1950.



PROPOSED SOLUTIONS

PROPOSED
SOLUTIONS

There is a need to devise and execute a comprehensive and holistic strategy to tackle illicit trade in cigarettes. Multiple laws already exist and if enforced rigorously can bring down the incidence of the illicit segment and help the Government raise more revenue (refer to Chapter 9 for details). Measures that can assist in enforcement include establishment of a single, dedicated task force headed by a Federal Minister, district level mobile enforcement units, expanding capacity of customs, and joint capacity building workshop for law enforcement agency officials. Mass media

campaigns on print, electronic and social media can be used to increase awareness about illicit trade. Illicit Free City Campaign, along with Citizen Journalism, can also be launched as pilot projects in 10 districts. Re-calibration of cigarette taxation policy to make it more balanced can also help in reducing consumers switching to cheaper tax-evaded substitutes. Summary trials for on-spot penalties can increase risk of punishment. Harmonization of fiscal and regulatory laws with neighbours can reduce inflow of illicit cigarettes into Pakistan.



MEASURES TO ASSIST ENFORCEMENT

a. Establish a Dedicated Task Force

A single senior-level task force, headed either by the Minister for Finance or the Minister for Interior, comprising representatives from all the relevant law enforcement agencies can help (refer to Figure 6.1 for list of all such agencies). This task force will bring the political will, focus and coordination necessary for concerted

action by the multiple law enforcement agencies against illicit trade in cigarettes. This would allow for a more coordinated approach towards the issue as better and more frequent communication can identify overlaps and gaps otherwise left unchecked.

b. District Mobile Enforcement Units

Well managed, mobile enforcement units have the ability to ensure timely response and effective action against culprits. By bringing the Provincial Governments on board, the creation of such District-level mobile enforcement units will improve the responsiveness of law

enforcement agencies which would make illicit trade in cigarettes more risky and change the risk-reward balance for culprits. These District-level units can consist of local police and revenue officers for on-spot penalties.

c. Expand Customs Capacity

Porous borders are a boon for all illegal traders. Improved border control reduces the opportunities of inflow and available entry points for smuggled cigarettes. Check-posts on key smuggling routes from Afghanistan, with necessary equipment and capacity, can

also help control the inflow of illicit products. These check-posts can also be multi-agency to enable concerted action by the multiple law enforcement agencies working on border control.

d. Capacity Building Workshops

There is a need for joint training and capacity-building of multiple law enforcement agency officials. This will serve two purposes. First, it will help in better coordination between field formation officers who are responsible for on-ground enforcement action. Secondly, training of on-ground law enforcement officials on

how to review the relevant fiscal documents and follow all the legal procedures necessary can help address the enforcement gaps. These capacity building workshops can include all the law enforcement agencies, prosecutors and the judiciary to ensure seamless administration of justice.

MASS AWARENESS AND EDUCATION

a. Mass Media Campaign

Mass awareness campaigns through electronic, print and social media can be useful in ensuring that all stakeholders, including consumers, fully understand the consequences of indulging in illicit trade, and more importantly, how to differentiate illicit cigarettes from legitimate ones. Placing a focus on the adverse impact

of the illicit trade on the economy, society and consumer can deter most law-abiding citizens. Radio, television and even mobile phone networks can be used effectively to spread this awareness against the illicit segment across all sections of the society.

b. Illicit Free City Campaign

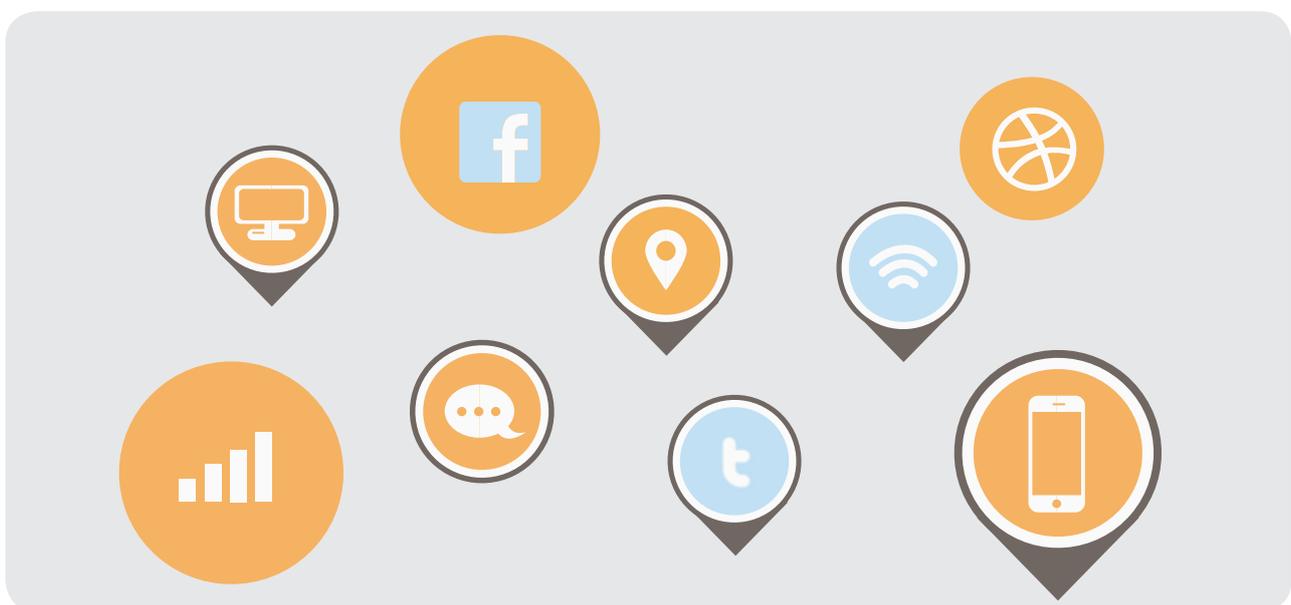
The Government can partner with civil society to launch campaigns that would free cities from illicit cigarettes through awareness and outreach. This initiative can be phased with pilot projects starting from 10 cities exhibiting highest incidence of illicit cigarettes for example Karachi, Lahore, Faisalabad and Islamabad.

These are high visibility metropolitan cities with high exposure to media surround sound. Consumers, wholesalers and retailers can be persuaded by government and civil society members through road-shows and focus-group dialogues to stop indulging in illicit trade in cigarettes.

c. Citizen Journalism

Civic activism can be harnessed in the fight against illicit trade. A citizen journalism initiative to expose retail outlets selling illicit brands by sharing pictures of such outlets on social media and with the relevant authorities

can be launched. This could be part of the Illicit Free City Campaign, in the 10 pilot cities, where citizens are most likely to engage in social media initiatives like this.



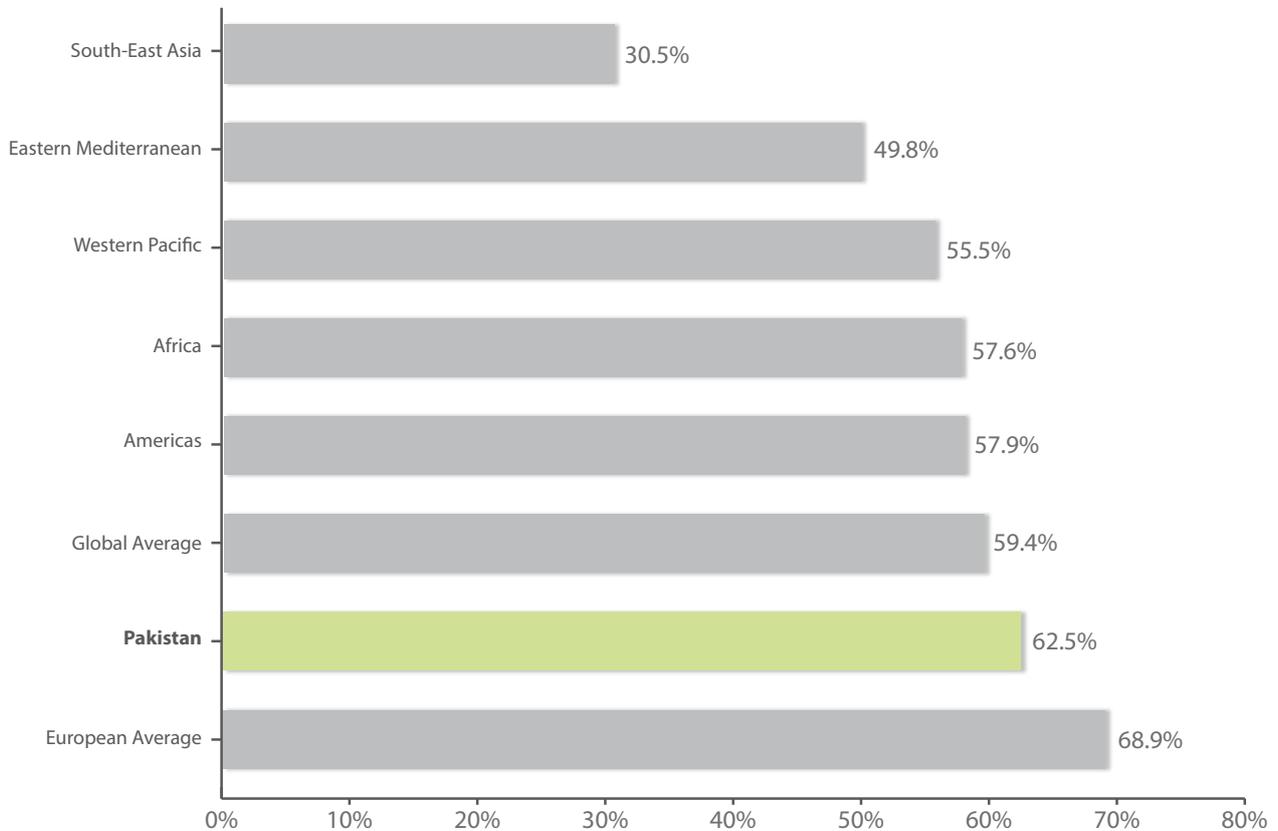
NEW REGULATORY MEASURES

a. Re-Calibrating Taxation Policy

Tax-driven price increases are fuelling growth of illicit segment as more and more price sensitive consumers in Pakistan are switching to tax-evaded cheaper substitutes. High tax rates with lax enforcement of fiscal laws and low purchasing power of the consumers merely boost the illicit segment. The total tax incidence on cigarettes in Pakistan is 62.5% of the retail price which is higher than the global average and is higher than in every region of

the world with the exception of the European Member States (refer to Figure 10.1 below). Hence, cigarette taxation policy needs to be re-calibrated to take into account multiple factors, including public health agenda, maximizing national revenues, consumer purchasing power, consumer behaviour, magnitude of illicit segment, fiscal policies of neighbouring countries, and above all fiscal compliance environment.

Figure 10.1: Tax Incidence of Cigarettes in Pakistan Higher than Global Average¹



1. KPMG UK (2015) : Review Of Cigarette Taxation In Pakistan.

b. Summary Trials

To ensure on-spot penalties for non-compliance, the process of disposal of criminal cases needs to be reviewed to provide for summary disposal of cases by officials who are with the mobile enforcement units at the district level. A streamlined process of

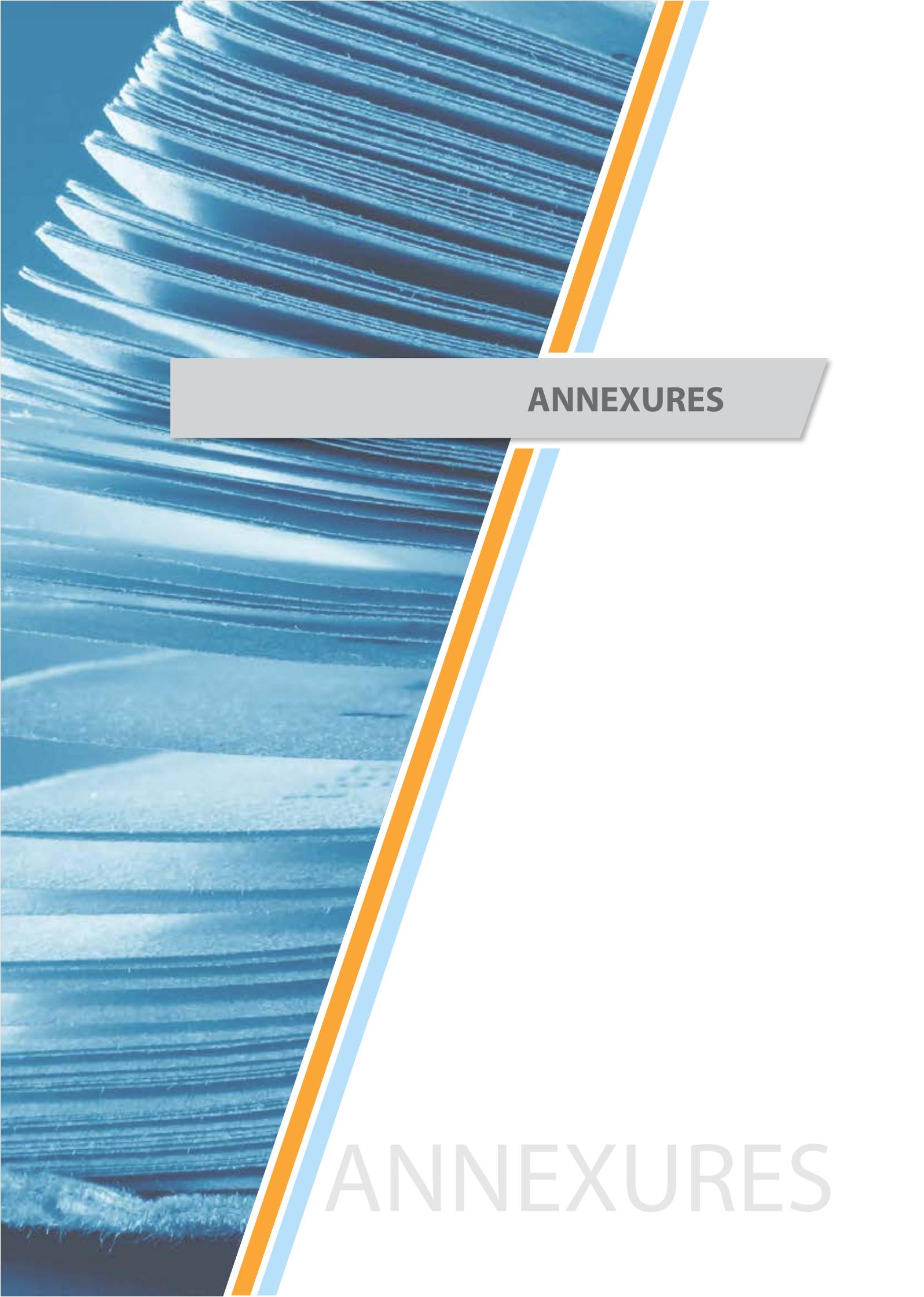
raids, spot checks and summary trials, all in one go, would result in higher efficiency and efficacy of the system. This will increase the risk of penalties and thus deter culprits from indulging in illicit trade.

c. Harmonizing of Laws

Regulatory and fiscal differentials with neighbouring countries, especially with Afghanistan and the region of Azad Jammu and Kashmir, also results in inflow of illicit cigarettes into Pakistan. The Government can

put in place a process of harmonisation of laws with these neighbours to reduce the fiscal and regulatory differentials and thus decrease arbitrage opportunities. This can reduce the inflow of illicit cigarettes into Pakistan.



The image features a stack of papers on the left side, with a blue and orange diagonal graphic element running across the page. A grey banner with the word "ANNEXURES" is positioned in the upper right quadrant.

ANNEXURES

ANNEXURES

ANNEXURE 1

GOVERNMENT REVENUE LOSS CALCULATION

	2010	2011	2012	2013	2014
Total Illicit Cigarette Consumption (Billion Sticks)	13.8	14.9	17.6	18.3	19.5
Average Low Segment Tax (Rs./Stick)	0.69	0.76	0.85	1.02	1.26
Lost Tax Revenues (Billion Rs.)	9.5	11.3	15.0	18.8	24.6
Total Tax Revenues Actually Paid (Billion Rs.)	59.8	64.3	71.7	81.6	96.1
Revenue Lost as a % of Total Tax Revenues Collected by Government	16%	18%	21%	23%	26%



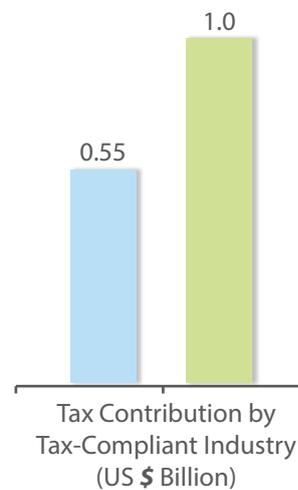
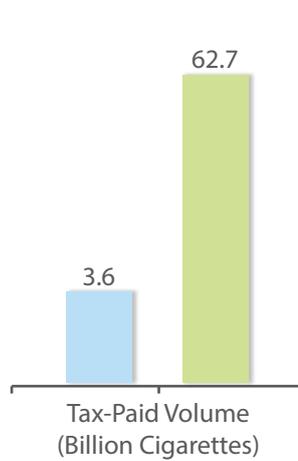
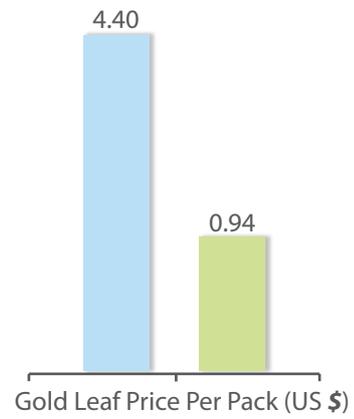
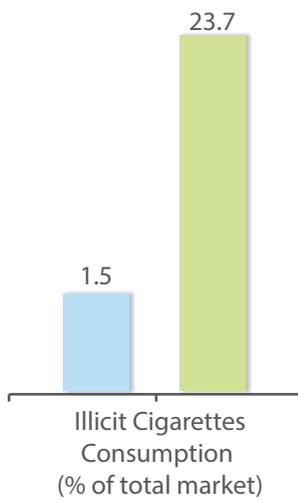
ANNEXURE 2

SRI LANKA: CASE STUDY

SRI LANKA



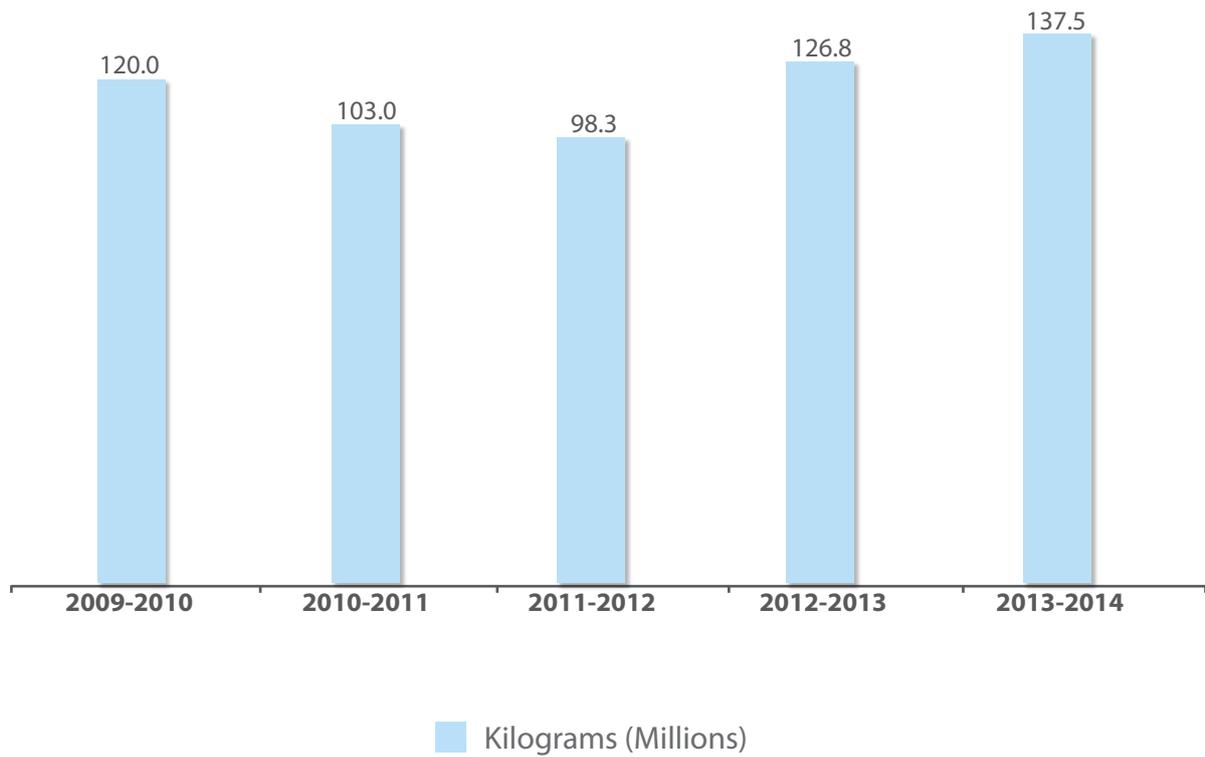
PAKISTAN



Source: Industry data (for 2014).

ANNEXURE 3

PRODUCTION OF TOBACCO CROP IN PAKISTAN

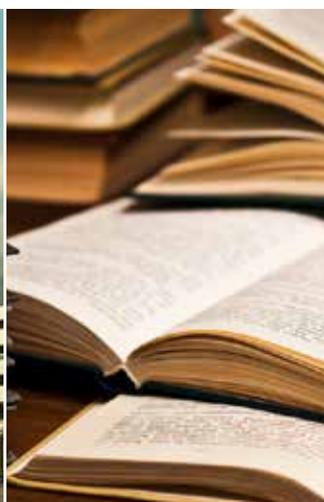


Source: Pakistan Tobacco Board, Ministry of Commerce, Government of Pakistan.

ANNEXURE 4

SUMMARY OF PENALTIES APPLICABLE IN CASE OF ILLICIT TRADE IN CIGARETTES

Law	Fine (upto)	Imprisonment (upto)	Seizure
Customs Act, 1969	10 times the value	14 years	Goods
Pakistan Penal Code, 1860	Not Excessive	7 years	Cigarettes
Federal Excise Act, 2005	500 % ad valorem 5 times of duty evaded 10 times the value of machinery	5 years	Cigarettes Machinery Conveyance
Copyrights Ordinance, 1962	Rs. 100,000	3 years	Cigarettes
Trademark Ordinance, 2001	Rs. 50,000	2 years	Cigarettes
Cigarette (Printing of Warning) Ordinance, 1979	Rs. 10,000	2 years	Cigarettes
Prohibition of Smoking and Protection of Non-Smokers Health Ordinance, 2002	Rs. 100,000	3 months	



- Martial Law Order No. 487
- Pakistan Tobacco Board Ordinance, 1968



Tobacco Crop

- Federal Excise Rules, 2005



Green Leaf Threshing

- Import Policy Order, 2013
- Customs Act, 1969



Import of Raw Materials

- Federal Excise Act, 2005
- Federal Excise Rules, 2005
- Pakistan Penal Code, 1860
- Copyright Ordinance, 1962
- Trademark Ordinance, 2001
- Cigarettes (Printing of Warning) Ordinance, 1979
- Prohibition of Smoking and Protection of Non-smokers Health Ordinance, 2002



Manufacturing

- Federal Excise Act, 2005



Transportation

- Federal Excise Act, 2005
- Customs Act, 1969
- Pakistan Penal Code, 1860



Warehouse

- Customs Act, 1969
- Federal Excise Act, 2005
- Cigarette (Printing of Warning) Ordinance, 1979
- Pakistan Penal Code, 1860



Retail

- Federal Excise Act, 2005
- Federal Excise Rules, 2005
- Cigarette (Printing of Warning) Ordinance, 1979
- Customs Act, 1969
- Customs Act Rules, 1969
- Import Policy Order, 2013
- Prohibition of Smoking and Protection of Non-smokers Health Ordinance, 2002
- Import and Export Control Act, 1950
- Pakistan Rangers Ordinance, 1959
- North-West Frontier Constabulary Act, 1915



Import of Cigarette Packets