



## Large Cigarette Tax Hikes, Illicit Producers, and Organized Crime: Lessons from Pakistan

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With the stated aim of increasing revenue and discouraging smoking, Pakistan raised tobacco duties over the past five years. The result empowered illicit actors, with a flourishing of illicit production and smuggling of cigarettes. Revenue rose initially, only to fall back as untaxed products proliferated. While organized crime and local production interests were the big winners, smoking rates have remained largely unchanged. Pakistan's authorities have tried to resolve the problem through better enforcement and lowering of duties for certain products, but overall the lesson learned is that rapid duty increases have significant negative effects that are difficult to reverse when illegal supply cannot be controlled.

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Public health announcements, public area smoking bans, cigarette pack warnings, advertising and sponsorship restrictions, and enforcement of rules against selling to minors are all touted as ways to lower smoking rates (WHO 2015). But probably the most effective method to lower demand is to increase the price of the product. While addicted smokers may continue their habit, they may reduce consumption, and the less addicted may lower consumption and perhaps even quit. Some may switch to new vaping or heat-not-burn products that are safer (RCP 2016). Additionally, revenue authorities can raise significant funds from excise duties on tobacco, so the policy has many adherents (Harvard University Institute for the Study of Smoking Behavior and Policy 1985).

Many countries have increased cigarette excise duties to both raise revenue and lower smoking levels (Parliament of the Commonwealth of Australia, House of Representatives 2016; WHO 2015).

Reduced smoking has undoubted public health benefits, and taxing products lowers demand. Coupled with public health education, tax hikes in Western nations have slowed new smoker uptake and lowered smoking among those who do not quit (Bader, Boisclair, and Ferrence 2011). This success was due to slowly raising taxes (often 3 to 5 percent real annual increases) over decades to their current level, at which a majority of the retail price is often tax (Orzechowski and Walker 2014).

Western nations had the resources and existing institutions to address the negative incentives that excise taxes create. Excise taxes encourage those who would avoid those taxes, from producers and smugglers to retailers and smokers themselves. Effective police and customs in wealthy nations can limit the negative effects, but even so, smuggling remains a problem (State of New York 2014).

Pakistan provides an interesting example of this process. It can show whether rapid tax hikes lower

smoking rates or whether smokers predominantly switch to illicit products if illicit supply cannot be controlled. If the latter is the case, then criminals benefit, the treasury loses, and smokers may well be hurt if illicit products are more harmful.

## Pakistan

The cigarette market in Pakistan has grown steadily over the past decade, in line with population growth and increasing income levels. Currently, the roughly 209 million people in Pakistan smoke about 82 billion cigarettes every year (Cevik 2016). Cigarettes are available everywhere from roadside kiosks and convenience stores to gas stations and hotels. It appears to be a classic example of a country that could benefit from stricter smoking rules, and, hence, it is the target of both local and international health activists. Pakistan has been a signatory to the World Health Organization (WHO) Framework Convention on Tobacco Control (FCTC) since November 2004 (WHO 2017b). Efforts against smoking were not much in evidence before this time, and in a limited way since.

While Pakistan has not enacted many anti-smoking policies, it did seriously start efforts to raise excise duties and sales tax duties and hence prices with the stated aim of driving down demand for cigarettes (MoNHSRC 2016). Excise taxes were annually raised by far more than inflation for the past five years, without controlling illicit production and trade. By 2017, the local price of the most popular brands was about 75 Pakistan rupees (PR) (roughly 68 US cents), of which approximately half was excise duties. Meanwhile, the local price of products that evaded tax was under 25 PR.

The largest shares of the market are taken by the Pakistan Tobacco Company (a subsidiary of British American Tobacco) and Philip Morris Pakistan Limited, which pay all taxes and duties on products. If one goes by tax revenue on products in 2011, these two companies provide about 98 percent of the market (Burki et al. 2013). But as the authors providing these data acknowledge:

There are a number of other smaller domestic cigarette companies operating in Pakistan, including Saleem Cigarette Industries Pvt Ltd., Universal Tobacco Company Ltd., Souvenir

Tobacco Company Ltd., Barah Tobacco Company, Alfridi Tobacco, and Tatara Tobacco. Reported production by these companies has been well below potential production and at least some have been found to be evading taxes by underreporting production and/or producing counterfeit cigarettes (Burki et al. 2013, 16).

The reality is that these local producers that evade duties have been present for decades. Local tobacco experts say they have provided 20 percent of the local market by volume for much of the past few decades. Burki et al. (2013) say that legitimate cigarettes provide 98 percent of the revenue, but they report:

In Pakistan, illicit trade in cigarettes is problematic, with untaxed cigarettes accounting for about one-third of overall cigarette consumption in 2011. Several factors contribute to illicit trade in Pakistan, most notably the long and porous border with Afghanistan, poor monitoring and the resulting underreporting of production, the lack of regional partnerships aimed at curbing illicit trade in tobacco products and internal corruption. These factors suggest that cigarette tax increase of the magnitude described above would likely lead to increased tax avoidance and evasion that would reduce, but not eliminate, the public health and revenue impact of tobacco tax increases (Burki et al. 2013, 42).

Whatever the precise market share, these manufacturers may pay some local employment and corporation taxes, but they evade excise duties on their products—known as duty not paid (DNP) cigarettes.

DNP cigarettes are made predominantly in the Khyber Pakhtunkhwa (KPK) province (Khan 2014). KPK is the northernmost of the four provinces of Pakistan. It borders Afghanistan and the Federally Administered Tribal Areas (FATA). DNP cigarettes made in KPK are consumed all over the country but especially in the poorest areas of central Punjab, where smokers are most price sensitive.

Table 1 shows that as tax rates rose, tax revenue initially increased, topping \$1.1 billion in 2016. But in 2017 it fell to only \$800 million, roughly what it

**Table 1. Fiscal and Market Cigarette Data**

	FY Excise Tax Raises <sup>1</sup>	Inflation Rate July YoY	Excise Tax Revenue FY Rs. Million (USD)	Tax (Sales and Excise) Revenue FY Rs. Million (USD)	Market Share of Illicit Cigarettes (Oxford Economics)	Market Share of Illicit Cigarettes <sup>2</sup>
2013	25.36%	8.3%	62,010.3 (\$624m)	76,545.3 (\$770m)	23%	22%
2014	23.30%	7.9%	72,088.8 (\$731m)	89,760.8 (\$910m)	25%	23%
2015	21.66%	1.8%	82,459.0 (\$810m)	103,440.0 (\$1.02bn)	31%	26%
2016	16.21%	4.1%	90,900.0 (\$868m)	114,700.0 (\$1.10bn)	44%	29%
2017	8.87% <sup>3</sup>	2.9%	66,300.0 (\$632m)	83,900.0 (\$800m)		39%
Now						34%

Source: Government of Pakistan, Finance Act of 2012; Government of Pakistan, Finance Act of 2013; Government of Pakistan, Finance Act of 2014; S.R.O. 481(I)/2015; S.R.O. 473(I)/2016; S.R.O. 407(I)/2017; State Bank of Pakistan (2013); State Bank of Pakistan (2014); State Bank of Pakistan (2015); State Bank of Pakistan (2016); State Bank of Pakistan (2017); FBR (2014–15); FBR (2015–16); Government of Pakistan Ministry of Finance (2016–17); Government of Pakistan Ministry of Finance (2015–16); and Oxford Economics (2017).<sup>4</sup>

was back in 2013 when rapid tax hikes began (Sial 2017).

Over the same period, the smoking rate barely altered. At most it has declined by one billion sticks (from 82 billion to 81 billion) in the past five years, although precise measurement is hard given the scope of the illicit market (Proprietary Nielsen Audit Data 2018).

### So What Has Happened?

Legal producers, both domestic and international, noted that sales in Pakistan were falling. The illicit market—both domestically produced cigarettes that evade tax and illegally imported cigarettes—grew, slowly at first and then rapidly in 2016. According to Nielsen data, tobacco industry estimates, and

other knowledgeable experts with whom I spoke, the illicit market has probably doubled by volume since 2012, reaching a high of about 41 percent of the market in the summer of 2017 (Proprietary Nielsen Audit Data 2018; Retail Insight Network 2017).

There is also anecdotal evidence supporting the expansion of the illicit market. For example, Omar Lodhra sells cigarettes from his mobile kiosk in Karachi, and by the summer of 2017 the main products he sold were local DNP cigarettes (Lodhra 2018).

Most of this increase came from domestically produced cigarettes, but illicit imports rose too. Illicit imports are primarily illicit whites—those made legally (often in free trade zones) but then smuggled illegally into myriad countries (Ross et al. 2015). These products are the most difficult to interdict, since production locations are entirely

<sup>1</sup> Increase is in lowest tier of excise tax scheme unless otherwise noted.

<sup>2</sup> Estimates are from Nielsen audit data, some of which are publicly available. See, for example, Baloch (2015). Additional support for Nielsen data was provided by industry sources.

<sup>3</sup> In fiscal year (FY) 2017, Pakistan implemented a third tier to the excise tax on cigarettes. Increase is based on middle tier for FY 2017.

<sup>4</sup> Table 1 draws data mainly from government sources, but the data on the size of the illicit market has different estimates. My best estimate of illicit rates over the past five years draws from multiple sources including Nielsen audit data, industry estimates, and personal communications with nonindustry experts. I also include Oxford Economics' generally higher estimates through 2016.



Source: Author.

According to Lodhra, the illicit white market has changed slightly. The main products in 2012 came from South Korea, and the bestselling brand was Pine, made by Korea Tobacco & Ginseng Corporation (KT&G) (see picture) (Lee et al. 2017). While these products are still the biggest sellers, Dubai's products from the Jebel Ali free trade zone, notably the Milano brand (see picture), have proliferated. To reiterate, KT&G and the Dubai producers are legal manufacturers, but they do not seem to track where their products are consumed. The major tobacco companies have agreements in place with the EU to monitor where their products are sold to prevent the type of diversion and smuggling seen in Pakistan (Bate 2016).

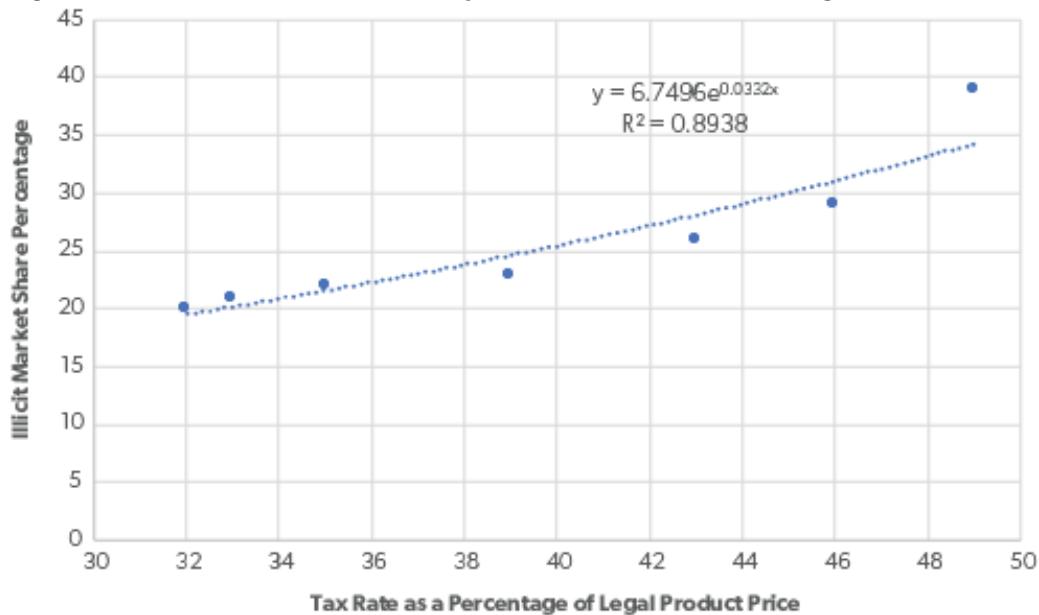
legal, and the jurisdictions where production is undertaken have no interest in preventing export. From speaking with local tobacco experts and sellers such as Lodhra, I estimate that by mid-2017 perhaps 10 percent of the Pakistan market was illicit whites.

Not everyone agrees that illicit rates are so high. Accurate measurement is difficult and contestable (Junaidi 2018a). But what is clear is that, as rates rose, revenue increased, as did illicit market share, and revenue eventually fell back as illicit products continued to flourish.

As Figure 1 shows, the link between excise duty as a percentage of the legal product price (x-axis) and the market share for illicit products (y-axis) is extremely strong (R-squared of 0.89). This is obviously just a correlation, and numerous variables should be taken into account when modeling causes of illicit product expansion. But it does suggest that tax hikes affect illicit products.

Illicit trade is bad for legitimate producers, Pakistan's treasury, and individual health. The illicit products are usually far higher in tar and more injurious

**Figure 1. The Link Between Excise Duty and Demand for Untaxed Cigarettes, 2011-17**



Source: Author's calculations based on Table 1 and industry estimates.

to health when burnt (Center for Regulatory Effectiveness 2011). However, the production quality on a few of the products, including Milano, are often equal to the best brands.

Facing a loss of revenue, a potential worsening of health, and a strengthening of organized crime, the Pakistan government responded admirably with numerous successful enforcement efforts against local illegal producers. More than 1.6 billion DNP cigarette sticks were seized across Pakistan from over a dozen raids on factories (*Nation* 2018). Eight factories have been closed and some production equipment confiscated. But in the vast majority of cases, DNP producers complained about the actions (they do, after all, employ a lot of people and pay some local taxes, so they have some political weight), closed their own plants voluntarily, and moved the production location.

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The vast inhospitable border area means it is hard to prevent any form of illicit trafficking, especially easily movable, high-value products such as cigarettes.

Producers are quite mobile and recently moved most of their operations to the more lawless areas of Kashmir and the FATA border area with Afghanistan, making eradication of illegal manufacturing impossible (Rizvi 2018). The Federal Board of Revenue (FBR), which coordinated the actions against illegal producers (with assistance from the police), has no jurisdiction in Kashmir and FATA. And as one local expert put it, it is a constitutional nightmare for the federal government to interdict any production in such areas.

In addition to enforcement actions, the federal government also instituted a minimum cigarette pack price of 48 PR in June 2017, which meant that

all retailers could be prosecuted if they sold them at below that price (Miraj 2017). In practice, however, it probably just provided another opportunity for low-level officials to extort small bribes from retailers. Lodhra told me that paying bribes to police is an occupational hazard. He usually gets away with one or two small payoffs a month, but occasionally, if there is a crackdown, as occurred in the summer of 2017, then the frequent extortion can make his business unprofitable (Lodhra 2018).

Unfortunately, smuggling is rife, and illicit products are slipping into the country at increasing rates, often through Afghanistan (Oxford Economics 2017). The vast inhospitable border area means it is hard to prevent any form of illicit trafficking, especially easily movable, high-value products such as cigarettes. There is also smuggling from Iran—often petroleum but also tires, electronics, and anything else that smugglers can make money on, including cigarettes (Yusufzai 2007). Dubai seems to be the source of an increasing amount of these legally produced but illegally smuggled cigarettes (Nielsen 2015). Since the products are legally made, the UAE seems to have little interest in interdicting the traffic.

Terrorist organizations benefit by either owning production or, more often, extracting their own tax on allowing production or allowing products to move through territory they control (US Department of State 2015). As a result, the US has a foreign policy interest in combating illicit cigarettes. The US is in the best place to pressure the UAE to prevent the illegal export of cigarettes to Pakistan. It can do this directly, but it can also do this through multilateral bodies, of which it is the largest funder (WHO 2017a). For example, the WHO should see its Illicit Trade Protocol (ITP) (under the FCTC) come into force in the fall of 2018. The aim of the ITP is to halt the kind of trade that is proliferating between UAE and Pakistan (WHO 2013).

The WHO generally seems more interested in going after legal producers, those that are losing market shares in Pakistan.<sup>5</sup> WHO health specialists,

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<sup>5</sup> Subsection 1.6 of the Guidelines for Implementation of Article 6 of the WHO FCTC is called “Tobacco tax policies should be protected from vested interests.” It states, “The development, implementation and enforcement of tobacco tax and price policies as part of public health policies should be protected from commercial and other vested interests of the tobacco industry, including tactics of using the issue of smuggling in hindering implementation of tax and price policies, as required under Article 5.3 of the WHO FCTC and consistent with the guidelines for its implementation as well as from any other actual and potential conflicts of interests.” FCTC focuses on the historic actions of legal industry rather than the current threat of illicit whites and DNP producers.

and more generally health practitioners, have good reason to distrust big tobacco, given its decades of lying about nicotine's addictive nature and the dangers of cigarettes in general, but at least the large tobacco companies pay their taxes and comply with international law. The WHO perversely may see the drop of smoking by up to one billion sticks in Pakistan as vindication of its overall convention, and it may do little if anything about the UAE-Pakistan situation.

The US is not a signatory to the FCTC, but it still provides the most funding for the WHO. The US should pressure the WHO to actually do what its protocol claims to want to achieve. After all, WHO policy is based on US policies (and those of other leading OECD nations), and the aims are at least rhetorically the same (US Department of State 2015).

Fewer smokers is a valuable public health goal, but not at all costs. If more people smoke illicit cigarettes, the impact on health for those people will worsen. And providing more revenue for those outside legal trade creates wider problems.

The US administration and business interests have been advising Pakistan on best practices. And in the summer of 2017, Pakistan brought in a new tier of lower duties for local production (*Business Recorder* 2017). The aim was to encourage some of the illicit producers to become legitimate and start paying cigarette duty. Given that such corporations pay bribes to officials and run the risk of product seizures, such a strategy may work in the future, but probably not if excise taxes rise rapidly again, making the profits from illegality too tempting.

More successfully, the authorities also allowed some of the premium brands to register in the lower tariff band—in effect halving the excise duty for many products (making them as cheap as they were in 2012) (Junaidi 2018b). Local experts estimate that the illicit rate is down to 34 percent (from a 40 percent high in the summer of 2017).<sup>6</sup> So, in effect, the overall excise rate fell, but the top rate actually increased in line with inflation. This shift allowed the Pakistani authorities to claim that a reduction in illicit trade had occurred, while the headline rate of duty was similar—in other words, it was a sleight of hand to make the case that their duty hikes had not failed.

According to FBR figures, since the new policy was enacted in the summer of 2017, revenue has risen by roughly 20 percent, with a near doubling of legitimate products sold in the new middle-tier tax bracket (Butt and Mustafa 2018). In other words, with legal products sold at lower prices due to lower excise duties, smokers buy the legal ones. Overall, there is no noticeable change in smoking rates.

## Discussion

Given the likely illicit market proliferation after massive excise duty hikes and little control of illicit production, what is the explanation for such a policy? The most obvious is desire for revenue by senior officials and blind faith (backed up by WHO rhetoric) that excise hikes would not lead to a spike in illicit activity. Burki et al. (2013) provide the strongest defense for this approach. Their model suggests only benefits from the policy. While acknowledging that maybe a third of the market is illicit, they then do not account for this market in their projections.

Blind faith in a policy is one explanation, but other reasons are possible. After all, illicit producers benefit, even as government revenue falls. Following the work of Bruce Yandle, one wonders if some kind of “Bootleggers and Baptists” coalition is occurring. Were illicit cigarette producers siding and even financially supporting efforts to raise revenues from legal producers?

Off the record, some legal manufacturers and wholesalers certainly think this might have occurred. Perhaps more persuasively, one of the most powerful families in KPK includes a son who is the former provincial health minister and whose father (a senator) runs tobacco companies (Noorani 2016). The provincial health minister pushed for the legislation on health grounds, and the family business probably increased its revenue (Zain 2016).

One or two powerful families likely could not have driven the entire policy, but they had domestic and international health allies, notably FCTC (Burki et al. 2013). Furthermore, given that domestic and international health advocates widely assume that legal volumes would only decline slightly as duties rose quickly (resulting in higher revenues),

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<sup>6</sup> Nielsen audit data suggest that, as of February 2018, the illicit rate is down to 33 percent.

it was a relatively easy sell to a government short of funds.

And initially it did look like a success. Revenues rose, and illicit trade took time to get going. Once illicit packs were selling for over 25 rupees, the illicit sector seemed to invest more in production and especially distribution. Such a lag should have been anticipated, but naive policymakers may at least explain why the policy was continued for several years.

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With the government largely abandoning operating in certain geographical areas, criminals and terrorists become de facto law.

More importantly, Pakistan has corruption at the highest levels of government, which means the naive could be easily co-opted by the corrupt (Transparency International 2018). The result was the manifestly dangerous practice of major excise duty hikes in the face of a likely illicit activity spike.

With the government largely abandoning operating in certain geographical areas, criminals and terrorists become de facto law (US House Committee on Homeland Security Subcommittee on Oversight Investigations and Management 2012).<sup>7</sup> A policy set in Islamabad directly benefited these organizations at the expense, ironically, of Islamabad's control. Any honest local politicians are driven out, killed, or corrupted. The powerless locals become totally disillusioned with Islamabad, and some directly benefit by working for illegal operations. In the parlance of the security expert, the terror-crime nexus creates grievances and then exploits them.

If DNP producers and illicit white smugglers sold an additional 10 to 13 billion sticks a year (which seems likely), that would equate to an increase in revenue of at least \$2 billion. No doubt heroin traders make more, but illicit cigarettes are far more easily traded and less aggressively tracked and prevented than the narcotics trade.

As Vanessa Neumann shows in her book *Blood Profits*, most terrorist groups and criminal organizations smuggle cigarettes (Neumann 2017). Pablo Escobar did it before making more money in cocaine, and all sides (Assad, ISIS, and those fighting both) are doing so in Syria. By hiking excise duties, the government played into their hands.

While Pakistan is a signatory to the FCTC, it has not yet signed the ITP (WHO 2018). Its policy of increasing excise taxes in 2017, while creating far lower duty categories to effectively lower rates, is the type of sleight of hand that politicians can defend. It allows the policymakers in Pakistan (and WHO officials in Geneva) to say that the recent rise in illicit trade has been reversed, while also saying that they have continued to raise the main excise duty rates. But to be fair to political leaders in Islamabad, they did act decisively to address the burgeoning illicit market, probably against the wishes of the Geneva health elite.

Nevertheless, the wrong lessons may be learned from Pakistan. Its policy appears a failure, its reversal a slightly better situation than mid-2017. One of the reasons for this is the sticky nature of certain product demand. When people switch to a cheaper product, some may switch back to the original when the relative cheapness of the illicit product declines, but some may decide to stay with the illicit if they like it enough. Also, the illicit business may have bribed, threatened, or otherwise increased market share that they may not lose entirely with the tax policy change.

## Conclusions

The rapid rise in cigarette excise duties in Pakistan lowered demand for legal products and increased demand for illegal DNP cigarettes. From a health standpoint, the impact of these changes is marginal. Overall smoking rates may have fallen slightly, but more people are smoking more deadly products too.

From a fiscal standpoint, the situation is almost entirely bad. Rates have had, in effect, to be reduced because of the flourishing illicit market. Now the

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<sup>7</sup> And it is hard to discern the difference between many illegal operators in the region. Criminal or terror orientated, they often seem the same. As expert testimony to a congressional committee concluded of their interactions: they frequent “the same shady bars, the same seedy hotels and the same sweaty brothels. . . . They are most assuredly talking business and sharing lessons learned” (Braun 2012).

revenue raised is less than before the rapid raises began five years ago, and the illicit demand rate is higher too.

From a security standpoint, it is also bad news. Illicit operators now have more control than they did before, and smuggling routes (useful for terrorists, their funders, and other bad actors) are strengthened.

It is not possible to know what will happen in other locations that try the Pakistan approach, especially given the lawless locations of Kashmir and FATA, which make illicit production inevitable. But

one would think that the results in Pakistan should prompt nations to think twice about rapidly increasing excise duties.

Right now the primary beneficiaries of Pakistan's experiment with rapid excise tax hikes are local manufacturers, organized crime, and other bad actors, as well as the illicit white makers in Dubai, Korea, and elsewhere. Compared with five years ago, an additional 10 to 13 billion cigarettes smoked in Pakistan are made or traded by folks not paying tax, who may well be oppressing people and causing widespread terror—a disastrous policy outcome.

## About the Author

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