Finance Act 2024:
Implications of Cigarette Tax Policy

Social Policy and
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INTRODUCTION

Even though the Government of Pakistan was under tremendous pressure to increase taxes in various sectors to generate additional revenue for financing the fiscal deficit in the fiscal year 2024-25, it surprisingly spared the cigarette industry from any tax hike. The Finance Act 2024 passed by the National Assembly on June 28, 2024 remained silent on enhancing the rate of Federal Excise Duty (FED) on cigarettes.

Nevertheless, the Act included two provisions: one modifying the Federal Excise Duty (FED) price tiers and another aimed at strengthening tax administration to combat illegal trade. The latter provision states: "*If any retailer is found selling cigarette packs without affixing, or affixing counterfeited, tax stamps, banderoles, stickers, labels or barcodes, notwithstanding any other provision of this Act, the retail outlet of such person shall be liable to be sealed in the manner as may be prescribed.*"[1]

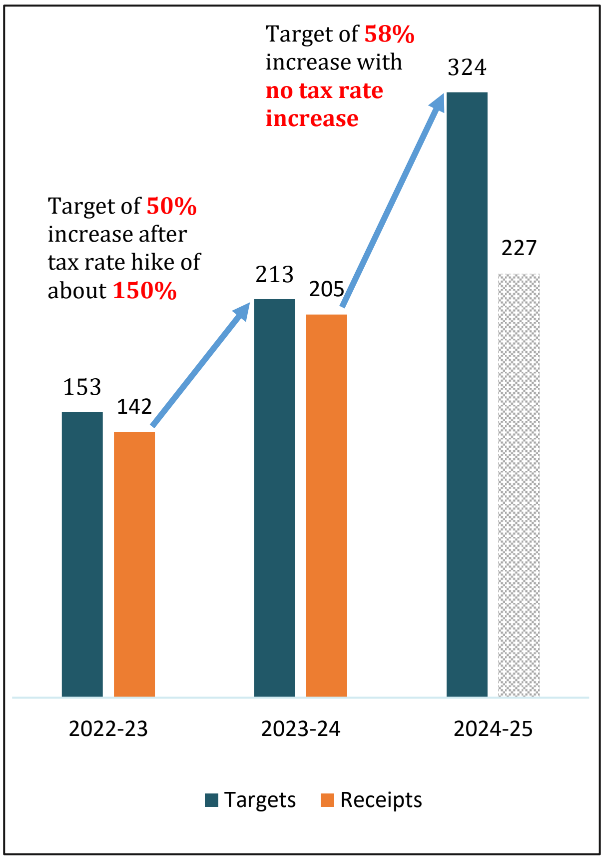
Whereas implementing the provision related to tax administration will take some time as the rules of business will have to be formulated and approved by the concerned authorities, the legislation on modifying the FED price threshold came into effect on July 1, 2024. Therefore, this policy brief focuses on the implications of the change in the price tiers. In addition, the feasibility of tax revenue targets is also discussed.

AN OVERAMBITIOUS REVENUE TARGET

The government has set a FED revenue collection target of Rs 324 billion for 2024-25, which is 58 percent higher than the revenue of Rs 205 billion collected during 2023-24, as per the revised estimates of the Finance Division.[2] Setting such an ambitious revenue target in the absence of any tax increase raises serious concerns about its achievability. Notably, the budgeted FED revenue for 2023-24 was 50 percent higher than the previous year's collection after an increase of about 150 percent in tax rates. Depending solely on improvements in tax administration to meet this ambitious revenue goal is likely an unrealistic approach. The estimates, based on SPDC's cigarette tax simulation model, suggest a shortfall of over Rs 100 billion (Figure 1).

Figure 1: FED revenue targets and receipts

Rs in billion



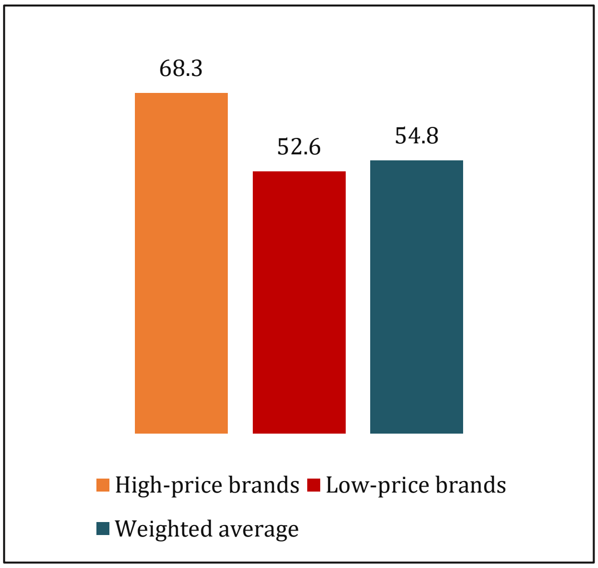
Source: Explanatory Memorandum on Federal Receipts 2024-25, Finance Division, Government of Pakistan.
Note: Receipts for 2024-25 are estimated by SPDC's cigarette tax simulation model.

FED SHARE IN THE RETAIL PRICE

Currently the average FED share in the consumer price of cigarettes is estimated to be 54.8 percent, which remains significantly lower than the widely-accepted benchmark of 70 percent. The tax share in high-priced brands is higher (68.3 percent) than the low-priced or economy brands (52.6). If cigarette prices are increased by the industry, the tax share in retail price will further decline.

Figure 2: Excise tax share in retail price

(%)



Source: Estimates based on data of printed prices collected through survey of smokers.

CHANGE IN FED PRICE TIERS

For the application of FED rates in Pakistan, cigarettes are categorized by price tiers: high-priced (Tier 1) and low-priced (Tier 2). As shown in Figure 3, in 2023-24, the tax rate on cigarettes is Rs 16,500 per thousand cigarettes (or Rs 330 per 20-stick pack) if the printed retail price (excluding GST) exceeds Rs 9,000 per thousand cigarettes (or Rs 180 per 20-stick pack). The FED rate applicable on Tier 2 is Rs 5,050 per thousand cigarettes (or Rs 101 per pack). Through the Finance Act 2024, the government has increased the price tier limit to Rs 12,500 per thousand cigarettes (or Rs 250 per pack). As mentioned earlier, the tax rates have remained unchanged. This change has also altered the level of the minimum price, which is set at 60 percent of the threshold. Thus, the minimum price of a 20-stck pack (excluding GST) has increased from Rs 108 to Rs 150 per pack.

Figure 3: Change in FED price tiers

2023-24		2024-25	
Tier/Price*	FED Rate*	Tier/Price*	FED Rate*
> Rs 9,000	Rs 16,500	≤ Rs 12,500	Rs 16,500
≤ Rs 9,000	Rs 5,050	≤ Rs 12,500	Rs 5,050

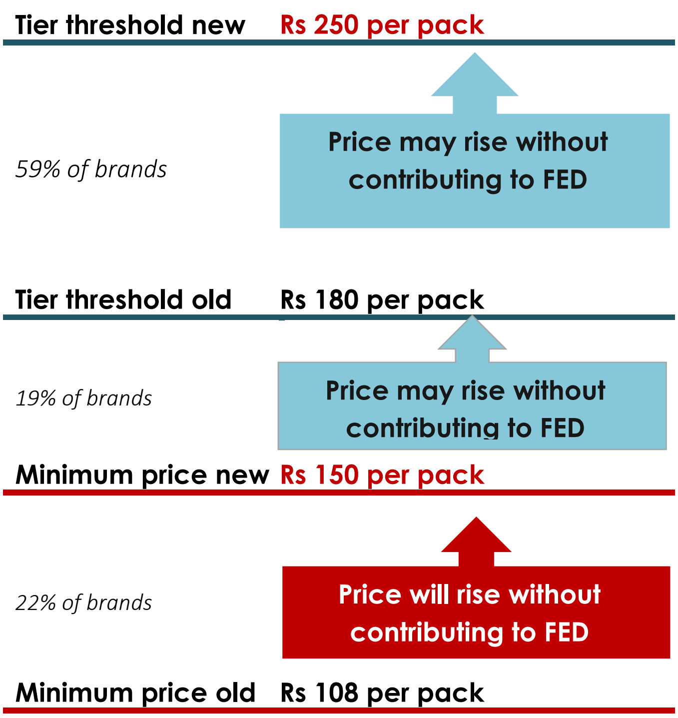
* Rs per thousand sticks, excluding sales tax.
Source: Finance Bill 2024

Unfortunately, the change in price tier is expected to provide some relief to the cigarette companies, particularly those producing economy brands, as it would allow them to increase prices without contributing to excise tax revenues.

Cigarette companies have a history of over-shifting the tax increase to consumers through price hikes. For instance, in 2022-23, the total tax on economy brands increased by Rs 89 per pack, but the consumer price surged by Rs 131. Actually, prices of the most popular economy brands were set at the maximum threshold, making it challenging for the companies to increase them any further. They may now choose to increase prices without moving to the higher tax tier. This price increase will have a minimal impact on GST revenue but no effect on FED revenue.

To explain the likelihood of price increases, we have divided the economy brands into three price categories (based on the data of SPDC's survey of smokers conducted in 2023-24). As shown in Figure 4, the majority of the brands (59 percent of the economy brands) fall in the category of having a price (excluding GST) at the edge of the previous threshold (Rs 180). Companies can choose to increase their prices to Rs 250 while remaining within the tier. Similarly, the prices of the brands whose current prices are close to the new minimum price (Rs 150) can also be raised. The prices of several brands (with a total share of 22 percent) are between Rs 108 (old minimum price) and Rs140, which is below the new minimum price. The firms will have to increase the prices of these brands to at least Rs 150 per pack. Again, there will be no gain in terms of FED revenue with these significant price increases.

Figure 4: Price categories of economy brands



CONCLUSION

The FED revenue target set by the government for 2024-25 seems unrealistically high and unlikely to be achieved without a tax increase. The recent changes in price tiers and minimum prices, without accompanying tax hikes, will likely benefit the cigarette industry. To address this, the government should consider adopting a two-pronged strategy of increasing the FED rate and developing necessary regulations to implement the provisions in the Finance Act aimed at combating the illegal cigarette trade. Also, it is important to note that the primary goal of tobacco control policies is not solely to generate revenue, but rather to achieve broader public health and social objectives. Accordingly, the government should leverage higher cigarette taxes as a potent instrument to discourage tobacco use and advance public health goals.

[1] Finance Act 2024, Government of Pakistan, p. 138.
[2] Explanatory Memorandum on Federal Receipts 2024-25, Finance Division, Government of Pakistan.

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