

# **Report on Tax Evasion in 5 Sectors of Pakistan**

## **An IPSOS Study**

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**GAME CHANGERS**



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## Introduction

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Pakistan, a country with the world’s fifth-largest population, significantly lags behind in infrastructure and human development. Pakistan’s ranking on UNDP’s Human Development Index has been deteriorating over the past decade, sliding down further from 152 to 154 out of 189 countries in 2020.<sup>1</sup>

There is a large chunk of population that does not have access to necessities like health, education, and basic infrastructure, leaving a huge potential and vacuum for interventions. The fiscal deficit for the previous financial year stood at 8.1% of the GDP i.e., PKR3.37 trillion.<sup>2</sup> Fiscal deficit for the first eight months of current financial year is 3.5% of GDP, whereas it stood at 3.7% for the same period last year.<sup>3</sup> This massive deficit is hampering the country’s ability to find extra cash to fund initiatives that can lead to human development.

There are several issues that have paved the way for this large deficit, but tax evasion is one of the biggest reasons of this huge revenue shortfall. Tax evasion not only affects the overall development of the country, it also leads to inflation as the burden is passed on to the public to minimize the deficit. Prime Minister Imran Khan while addressing the cabinet on March 16, 2021 said: “tax evasion causes loss of billions of rupees to national exchequer forcing the government to rely on indirect taxes which leads to price hike.”

The answer to this is already in the government’s own playbook i.e. increasing the tax receipts not by imposing new taxes but by enforcing tax regimes that helps in reducing evasion. The issue of tax evasion takes more limelight when we analyse Pakistan’s revenue streams. 76% of Pakistan’s total budget is

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<sup>1</sup> <http://hdr.undp.org/sites/default/files/hdr2020.pdf>

<sup>2</sup> [http://www.finance.gov.pk/fiscal/July\\_June\\_2019\\_20.pdf](http://www.finance.gov.pk/fiscal/July_June_2019_20.pdf)

<sup>3</sup> <https://www.dawn.com/news/1620770>

dependent on tax collections which emphasizes Pakistan's dependence on tax receipts.<sup>4</sup>

This paper aims to study the overall tax evasion in the country and will go deep into five sectors that, if diagnosed correctly, can significantly increase tax revenues. Tax evasion has far reaching implications in so far that it not only has fiscal repercussions but also negatively affects the investment climate and perception of the country. This report will also assess the opportunity lost due to the tax evasion that happens in these sectors. Any part of this report can be used or cited with a clear reference to Ipsos.

## Tax evasion and case studies of different sectors

To assess tax evasion, it is important to first ascertain the size of informal economy. The report aims to estimate the extent by engaging different official channels. When contacted, the Ministry of Planning, Development & Reforms shared that the shadow economy in Pakistan is estimated to be around 40% of the GDP and tax evasion as percentage of GDP stands at 6% of the GDP.

This massive leakage is due to several sectors in Pakistan's economy that have been depleting revenues that could potentially turnaround the fortunes of the country. Some of the sectors with considerable tax evasion that will be analysed in this research document are:

1. Tea
2. Tobacco
3. Tyres & Auto lubricants
4. Pharmaceutical
5. Real Estate

### Tea

Tea is a very popular low-cost drink in Pakistan. The country is one of the largest tea drinking and importing countries across the world. Comparing January 2020's figures with January 2021, one can see an increase of 28% of tea import in Pakistan which establishes the fact that it is a growing consumption commodity in Pakistan. In the first two months of 2021, Pakistan imported around 39 million kilograms of tea.<sup>5</sup> In 2020, Pakistan imported 250.8 million kilograms of tea.

As most of the country's needs are met via imports, it leaves a lot of room for tax evasion and illegal trade. While the law enforcement agencies have increased their vigilance on important trade points, the illegal traders are still able to evade taxes.

A Federation of Pakistan Chambers of Commerce & Industry (FPCCI) Standing Committee official associated with tea import industry requesting anonymity disclosed that 55%-60% of the tea demand in Pakistan is managed by large scale importers and the rest 40%-45% is managed by small traders. These

*PKR35 billion is the annual loss to national exchequer due to tax evasion in tea industry.*

<sup>4</sup> [http://www.finance.gov.pk/budget/Budget\\_in\\_Brief\\_2020\\_21\\_English.pdf](http://www.finance.gov.pk/budget/Budget_in_Brief_2020_21_English.pdf)

<sup>5</sup> Pakistan Tea Import Statistics – Pakistan Tea Industry

small traders are able to sell loose/unbranded/unpackaged tea which eventually contributes to massive tax evasion.

Half of the total consumption in Pakistan is loose tea.<sup>6</sup> This trend is more rampant in rural areas where there is no or very less tax enforcement. Khyber Pakhtunkhwa and Baluchistan are the places where the masses in large numbers prefer loose tea over branded tea because it is cheaper (no taxes). Also, the country has seen a mushroom growth of *Chai Dhaabas* (tea stalls) across the country and almost all of them use unpackaged loose tea which according to them is imported from Afghanistan.<sup>7</sup> But Pakistan does not export any tea from Afghanistan. At least not on paper. In fact, Afghanistan uses Pakistan as a trade corridor for its tea imports via the Afghanistan-Pakistan Transit Trade Agreement (APTTA) 2010.

The APTTA<sup>8</sup> was enacted to facilitate Afghanistan for its trade needs but over the years, the smugglers have been able to misuse the agreement. The imports for Afghanistan land in Pakistan and as such there is no tax or duty levied. Most of the tea imported under APTTA for Pakistan either doesn't make it to Afghanistan or due to the porous border it gets smuggled into Pakistani market avoiding all taxes and duties.

Loose tea, apart from hurting the national exchequer, is also leading to health hazards in the country as it is smuggled without any safety protocols. Furthermore, multiple reports of tea vendors adding colours to loose tea have been reported. These artificial colours are hazardous to health of the general public.

According to a tea importer who is a member of the Pakistan Chambers of Commerce and Industry (FPCCI)<sup>9</sup> and based on the existing information, the estimated tax evasion in the sector is between PKR30-35 billion (2019-20 estimates) which is a substantial amount.

### Illicit Cigarettes

As per several reports, illicit trade in cigarettes comprises close to 40% of the total cigarette market. This fact can be corroborated by the Prime Minister Imran Khan, who in a recent cabinet meeting had expressed his displeasure over the vast amounts of tax evasion in the country. On the 16th of March this year, the Prime Minister made a statement during a cabinet meeting that "98% of the tax in the tobacco industry is paid by two companies (60% share in the tobacco industry), while there is no collection of tax on the remaining 40%."<sup>10</sup>

*Tax evasion due to illegal tobacco trade is PKR80 billion annually.*

This statement of the country's Chief Executive, and that too not just the first time, speaks volumes of the problem of tax evasion within the cigarette sector. This tax evasion is carried out through the illegal trade

<sup>6</sup> Competition Assessment of the Tea Industry in Pakistan, CCP, 2019.

<sup>7</sup> <https://profit.pakistantoday.com.pk/2016/11/14/the-grey-economy-of-our-black-tea/>

<sup>8</sup> <https://www.commerce.gov.pk/wp-content/uploads/pdf/APTTA.pdf>

<sup>9</sup> Telephonic interview. The official spoke on the condition of anonymity.

<sup>10</sup> Prime Minister's address to federal cabinet - [https://youtu.be/ifAd\\_1Ujv6U?t=120](https://youtu.be/ifAd_1Ujv6U?t=120) (timecode 2:00)

of tobacco and has three main strands, each having its own estimation of losses to national exchequer and additional violations of several other laws in the country. Briefly explaining each below:

i. Local Duty-Not-Paid cigarettes

Local Duty-Not-Paid cigarettes is the most significant in terms of tax evasion within the three strands and has the majority share within illicit (>90%). These cigarette brands violate the minimum price and minimum tax per pack laws as well as openly flout tobacco advertising and promotion regulations.

Government of Pakistan has over the years introduced heavy taxes to discourage cigarette smoking. While this measure has not really been effective in reducing the smoking incidence, it has incentivized tax evasion from the local illicit sector. Given high incidence of tax on the product, tax evasion presents a lucrative financial incentive. As pointed out by the Prime Minister himself, apart from two big tobacco companies in Pakistan, companies responsible for 40% tobacco consumption in the country pay almost no tax whatsoever. As a result, their sale price of a cigarette pack is less than half compared to the cigarette packs that are complying with all the regulations.

The mandated minimum price of a cigarette pack as per law is PKR 62.76 which includes a minimum tax of PKR 42.12. There are more than 200 local tax-evading brands that are selling nation-wide below PKR 42.12. This tax evasion makes smoking affordable in the country and has enabled the illegal cigarette industry to thrive.

Under section 19(2)(d) of the Federal Excise Act 2005, it is an offence to sell cigarettes below the retail price (Plus Tax) printed on the pack. "A person who sells cigarettes in retail at a price lower than the retail price plus the amount of sales tax as printed thereon, shall be guilty of an offence and for every such offence shall be liable to fine which may extend to twenty thousand rupees". Reportedly, not a single person has been fined to date.

ii. Smuggling

Smuggled cigarette brands enter the country through illegal channels while evading the requisite taxes. These cigarette packs do not comply with the local mandated health warnings comprising of the pictorial health warning (60% of the packet) and printing of prohibition of sale to under-18 years old on the packet. The presence of smuggled cigarette brands in the country is a testament to weak border control and enforcement in the country since these brands are selling openly in most shops.

The local regulation also mandates that name of the manufacturer and retail price are mentioned on the pack, but smuggled cigarette brands violate most of these regulations. It is alarming to note that there are several brands selling in the country without the mandated 60% pictorial health warning, whereas the law clearly states that it is illegal to even possess packs that do not bear these warnings printed on them.

### iii. Counterfeit cigarettes

Counterfeit cigarettes can be defined as essentially fake cigarette brands that are manufactured in the local market by illicit manufacturers thereby violating trademark and copyright laws in addition to not paying the requisite taxes. Although a relatively smaller proportion within the three illicit cigarette strands, counterfeiting is very common in Pakistan and has the potential to grow within the illicit cigarette sector. As several media reports on TV and in print have indicated, counterfeiting within the illicit cigarette sector has become a cause of concern in the last few years unless dealt with effectively.

An FBR official currently working on Track and Trace system revealed in a background interview that the current estimates of tax evasion in tobacco industry are understated. Factoring in aforementioned, our estimates for the current year (2021) suggests, the tax evasion in tobacco industry will be between PKR75-80 billion.<sup>11</sup>

### Tyres and Auto Lubricants

Tyres is another industry that has a huge potential for tax revenue but has widespread tax evasion primarily due to tax evasion and counterfeiting by local dealers and retailers.

Tyres industry is directly connected to the automotive industry in Pakistan and has witnessed a sharp increase over the years. According to Ministry of Finance, Pakistan had around 4 million vehicles on the road in 2000.<sup>12</sup> Ten years later, this number had almost tripled to 11 million vehicles. In 2018, the total number of registered vehicles in the country was 23.5 million.<sup>13</sup>

The more the vehicles, the more the demand for tyres and most of that demand is met through imports. According to the local industry, 65% of the demand of tyres in the market is met by illegal/smuggled tyres. Annually, Pakistan uses approximately 10 million tyres out of which 20% are locally manufactured, 15% are imported and remaining 65% are smuggled.<sup>14</sup>

In 2018, the loss to national exchequer was PKR30 billion in taxes. According to industry estimates, by the start of 2020 this amount has exceeded PKR50 billion. Only the tyre trade under Afghanistan-Pakistan Transit Trade Agreement (APTTA) has seen an increase of 205%.<sup>15</sup> Trade under this agreement is meant for providing an avenue for Afghanistan to use Pakistan as a conduit for their imports but due to weak enforcement, the law gets abused.

In several raids by customs officials, they have noticed that some dealers hide 4-5 tyres in one tyre and by that practice they pay duty on one tyre against import of five/six causing massive losses to national

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<sup>11</sup> The Economics of Illicit Cigarettes in Pakistan. Oxford Economics UK (May 2020)

<sup>12</sup> [http://www.finance.gov.pk/survey/chapter\\_10/14\\_Transport.pdf](http://www.finance.gov.pk/survey/chapter_10/14_Transport.pdf)

<sup>13</sup> [https://profit.pakistantoday.com.pk/2019/06/16/registered-vehicles-in-pakistan-increased-by-9-6-in-2018/#:~:text=ISLAMABAD%3A%20The%20registered%20vehicles%20in,Bureau%20of%20Statistics%20\(PBS\).](https://profit.pakistantoday.com.pk/2019/06/16/registered-vehicles-in-pakistan-increased-by-9-6-in-2018/#:~:text=ISLAMABAD%3A%20The%20registered%20vehicles%20in,Bureau%20of%20Statistics%20(PBS).)

<sup>14</sup> <https://www.thenews.com.pk/print/828122-govt-loses-billions-on-tyre-import>

<sup>15</sup> <https://www.thenews.com.pk/print/654088-regulatory-duty-removal-urged>

exchequer. The customs department in the past has confiscated large amounts of tyre shipments that used this method to evade tax.<sup>16</sup>

Auto lubricants is another industry intertwined with the tyres industry in terms of usage. Like the tyres, auto-lubricants is also a source of loss to the Government of Pakistan due to tax evasion.

Auto lubricants industry's network has three tiers in Pakistan i.e. importers, processors, and dealers/distributors/retailers network. According to industry insiders, around 95% of wholesalers / retailers / unauthorized distributors are not documented.

*Tax evasion in tyres and auto-lubricants industry is estimated at PKR90 billion.*

Annually, Pakistan consumes 400 million litres of lubricants. Half of this oil (200 million litres) is reused as reclaimed oil and according to an industry expert, 60% (120 million litres) goes into the undocumented economy resulting in massive losses to national exchequer.<sup>17</sup> Total value of lubricants industry is estimated to be PKR120 billion and one third of it is reclaimed oil where government has no tax income. The estimated loss to national exchequer in the lubricants sector stands at PKR40 billion.

Reclaimed oil is cheap but substandard and many consumers prefer reclaimed oil. The reclaimed oil does not just result in losses to the national exchequer, it also poses significant risk to the automobiles it is used in. The oil that is reclaimed and reprocessed is adulterated, low quality, and does not comply with industry standards. The vehicles that use this oil are prone to engine troubles. A study done by the Government of the Punjab in 2018 to assess the reasons behind smog attributed the air pollution to "adulterated fuel" in the province.<sup>18</sup>

## Pharmaceuticals

Pakistan has witnessed a sharp increase in the usage of medicinal drugs over the years. Pakistan Pharmaceutical Manufacturers' Association (PPMA) says there were 304 pharmaceutical firms operating in Pakistan but according to Drug Regulatory Authority of Pakistan (DRAP), this number has more than doubled to 650 in a span of 20 years.

International research organization IQVIA Institute for Data Science puts Pakistan in "pharmerging" category. This category is used to countries that have a significant growth potential. IQVIA forecasts that Pakistan's medicine spending will grow at 12% from 2019-2023 and this

*Loss to national kitty due to illegal trade in pharmaceutical industry is estimate at PKR45 billion.*

<sup>16</sup> <https://www.youtube.com/watch?v=VIMYjt7rkSs>

<sup>17</sup> Telephonic interview – Mian Zahid Hussain, former chairperson All Pakistan Lubricants Manufacturers Association. 31 March 2021

<sup>18</sup> <https://epd.punjab.gov.pk/system/files/Smog%20commission%20report.pdf>

trend is against other countries that will see a growth of 5-8% in the same time period.<sup>19</sup>

Pakistan's pharmaceutical industry in 2017 was valued at PKR490 billion<sup>20</sup>. Factoring in the average annual growth rate of the past five years, the industry in 2021 is estimated to touch PKR650 billion and this does not include the significant investments made in the sector during the COVID-19 pandemic.

Counterfeit drugs in Pakistan is also a critical issue. The Lahore fake medicine crisis in January 2011 was an evident manifestation of this problem. Within a period of three weeks, more than 100 locals lost their lives while an additional 250 developed complications after a counterfeit heart medicine was administered to 40,000 cardiac patients.<sup>21</sup> According to a study done in 2019, around 4% of the total market demand is being met with counterfeit medicine.<sup>22</sup>

Smuggled medicines are also another major issue that is causing losses to national exchequer. 2% of the total market demand is deemed to be met through illegal means.<sup>23</sup>

Combining the volume of smuggled and counterfeit drugs, the amount comes to PKR45 billion<sup>24</sup> clearly indicating a major avenue of losses for the national exchequer.

## Real Estate

Real estate transactions are of rather complex nature in Pakistan, leaving significant room for tax evasion. There are two main reasons that can be attributed to tax evasion in the real estate sector i.e., under-invoicing and cash transactions.

Under-invoicing is a practice that is being applied in many economic sectors. The real estate sector, in particular, has been a beneficiary of this practice. Parties involved in a transaction deliberately understate the value of the estate to avoid paying taxes. According to an industry expert, the estate is valued 60-70% less than the market value in the sale/purchase deed.

For instance, valuation table of land was adopted in the province of Punjab almost three decades ago, and greatly streamlined through legislation/rule making under the Stamp Act 1899, specially section 27-A, and the Punjab Stamp (Valuation Tables in the respect of Urban Land) Rules 1999, as amendment in 2010, extending it to all immovable property in Punjab without differentiation of urban or rural but surprisingly in the Islamabad Capital Territory, wherein land is most expensive, this very essential framework was never adopted till 2020. Thus, resulting in tax evasion of billions of rupees since establishment of the Capital Territory and Islamabad district. This absence of legal framework is also one of the root causes of corruption in land revenue administration and lack of transparency in land transactions.

In 2019, Federal Board of Revenue issued a valuation table for immovable properties situated in different sectors and approved housing societies/colonies of Islamabad. This was a commendable step and enhanced revenue from real estate in old developed sectors and few new societies. For localities, areas

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<sup>19</sup> The Global Use of Medicine in 2019 and Outlook to 2023 – Forecasts and Areas to Watch. Jan 2019. IQVIA Institute for Human Data Science

<sup>20</sup> Pakistan's Pharmaceuticals Industry, 2017. PRIME Institute.

<sup>21</sup> <https://www.bbc.com/news/world-asia-16742832>

<sup>22</sup> Ascertain the Market Demand of Goods Prone to Smuggling – Establishing the Volume of Smuggling. 2<sup>nd</sup> Edition. H2 Consulting

<sup>23</sup> Ibid.

<sup>24</sup> 6% of the total market demand.



and revenue estates not covered by the above-mentioned SRO of the FBR, District Collector Islamabad has been empowered to notify an evaluation table under section 27-A of the Stamp Act, 1899. However, the above table has been twice revised downwards due to property mafia and property dealers' pressures.

The revenue administration of ICT for purposes of value determination of land in Islamabad, is still using the archaic method of classification of land which is immaterial and irrelevant in present times as it cannot be linked to the agricultural productivity of land, or classification of land. To avoid tax evasion, the land value has to be ascertained by its real estate value, potentiality and location, within five Zones of ICT, under the ICT Zoning Regulation, 1992 and with reference to proximity to the major roads, and most importantly "Land Use" as permitted by different regulations of Capital Development Authority, particularly Islamabad Residential Sectors Zoning (Building Control) Regulation, 2020. According to one report, the actual market rate compared to the DC rate is 5 to 10 times higher and compared to FBR rate, it is 2 to 4 times higher.<sup>25</sup>

*Tax evasion in realty sector is estimated to be around PKR60 billion.*

Cash transactions are also another important avenue of tax evasion. Agents prefer use of hard cash instead of banking channels to make payments which leads to parking of black money as well as tax evasion.

Senior journalist and expert in economic affairs Mehtab Haider shared that the federal government, in 2016/17, carried out an exercise to align the FBR rates with provincial DC rates and as a result some of the taxes at the federal level have been withdrawn.<sup>26</sup> Capital Value Tax (CVT) at the federal level has been withdrawn and modifications have been introduced in Capital Gains Tax (CGT) regime which has led to an increase in tax collection but structural issues related to under-invoicing and sale-purchase of plot files on cash are still there.

Shahid Hussain Asad, a prominent tax expert and a former Member of the Federal Board of Revenue, says, "So far the documentation in real estate is not satisfactory."<sup>27</sup>

Real estate is a sector that does not just witness massive tax evasion but is also a sector where the tax evaded/black money gets parked. A senior serving officer of Inland Revenue Service requesting anonymity stated that so far there has not been a study on the total volume of tax evasion in the country primarily due to unavailability of data. However, he stated that the estimated tax evasion that is often quoted in FBR echelons in the property sector is PKR80-90 billion.<sup>28</sup>FBR's tax collection from the realty sector in 2019-20 was around PKR25billion which leaves a shortfall of PKR55-65 billion.

<sup>25</sup> <https://www.thenews.com.pk/print/481932-property-valuation-rates-market-rates-to-be-equal>

<sup>26</sup> Telephonic Interview. 14 April, 2021

<sup>27</sup> Telephonic Interview. 14 April, 2021

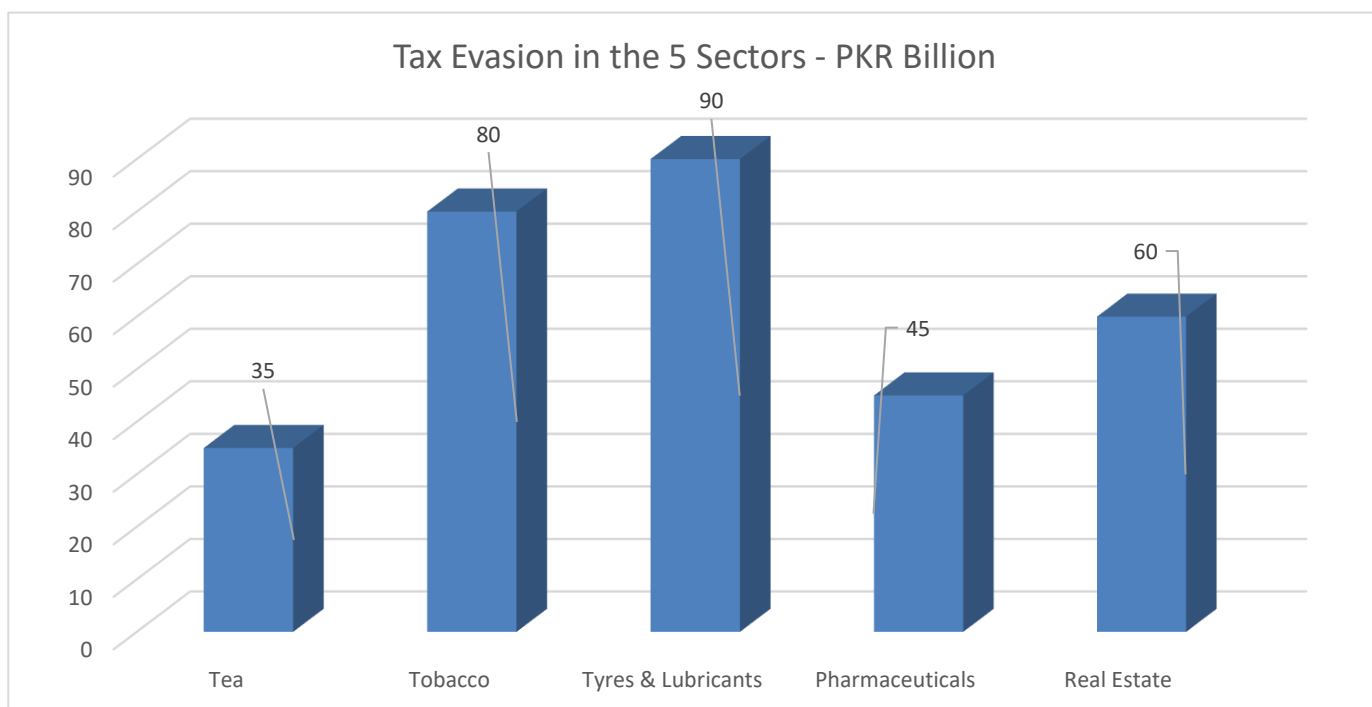
<sup>28</sup> In-person Interview. 13 April, 2021

## Implications/Opportunity loss

The whole purpose of this report is to assess the extent of the loss to national exchequer due to tax evasion and illegal trade and to identify the opportunity loss accordingly. In the start of this paper, we had stated that pulling the leakages in just these five sectors can generate enough revenue to finance social and infrastructure development projects essential towards much needed socioeconomic development.

The total estimated annual tax evasion in the sectors mentioned above is PKR310 billion.

### Tax evasion by sector



### **What can the Government of Pakistan do with this amount?**

- ❖ With this amount, Government of Pakistan can cover approximately **80% of the total national development program** (PKR418 billion) of all the federal ministries for the year 2020-21.<sup>29</sup>
- ❖ If this tax evasion is plugged, the federal government can **increase the size of federal education budget by almost four times**.<sup>30</sup>
- ❖ The scope and budget of federal government's premier social welfare program **Ehsaas can be increased by 60%**.<sup>31</sup>
- ❖ Federal government can easily build the **Mohmand Dam** (total cost: PKR309 billion) with this amount
- ❖ Pakistan can provide **clean drinking water to 80% of its total population**. This massive tax evasion amount translates to 156,500 water filtration plants, which means out of the total 400

<sup>29</sup> [https://www.pc.gov.pk/uploads/archives/PSDP\\_2020-21.pdf](https://www.pc.gov.pk/uploads/archives/PSDP_2020-21.pdf)

<sup>30</sup> Fed. education budget 2020-21: PKR83.3 billion. [http://www.finance.gov.pk/budget/Budget\\_in\\_Brief\\_2020\\_21\\_English.pdf](http://www.finance.gov.pk/budget/Budget_in_Brief_2020_21_English.pdf).

<sup>31</sup> Ehsaas 2021 budget: PKR 208 billion. [http://www.finance.gov.pk/budget/budget\\_speech\\_english\\_2020\\_21.pdf](http://www.finance.gov.pk/budget/budget_speech_english_2020_21.pdf)

tehsils in Pakistan each Tehsil will get almost 391 plants.<sup>32</sup> In total these water filtration plants can generate more than billion litres of water per day.

- ❖ Construction of more than **625 kilometres of motorways** is possible with this amount.<sup>33</sup> Other than this, if this tax evasion amount is used then **all the remaining and new motorway projects** of the government can be built which can decrease the travel time and improve intercity connectivity.
- ❖ The Government can easily finance the flagship **Naya Pakistan Housing project** with this money for the current year. This money can help in provision of 67,000 housing units for the poor in Islamabad alone. This year the government is building 20,000 units for PKR 100 billion.<sup>34</sup>

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<sup>32</sup> One filtration plant cost PKR 2 million and Pakistan has more than 400 Tehsils. One filtration plant caters to 35,000 population.

<sup>33</sup> According to ADB, per kilometre cost is PKR496 million.

<sup>34</sup> <https://www.geo.tv/latest/276841-pm-imran-inaugurates>