Competition Commission of Pakistan
Government of Pakistan

POLICY NOTE

***In Re:* THE IMPOSITION OF 'CAPACITY TAX' ON THE BEVERAGE INDUSTRY**

1. The Competition Commission of Pakistan (the "Commission") established under the Competition Act, 2010 (the "Act") took notice of various news items reporting the concerns raised by the beverage industry on the imposition of Federal Excise Duty (FED) and Sales Tax, vide notification SRO No. 649(I)/2013 dated 9th July, 2013 (the "SRO"), on production/installed capacity instead of actual sales (the "Capacity Tax"). Fixed amount of Capacity Tax per filling valve or spout imposed on different categories of manufacturers under the SRO is as follows:

S. No.	Category of manufacturer	Rate per filling valve
1	Factories having foreign or mix of foreign and local origin filling machines.	PKR 4,700,000
2	Factories exclusively having local origin filling machines	PKR 3,760,000
3	Factories having filling valves less than 40	PKR 1,175,000

2. Levy, based on the installed capacity, results in imposition of a fixed tax on manufacturing units with varying levels of actual production thereby discriminating and shifting the tax burden on to small manufacturers. In addition, this results in a number of competition concerns, such as (i) entry barrier; (ii) exit barrier; (iii) discriminatory treatment resulting in decrease in number of market-players, thereby reducing choice and increase in price.

3. The Commission's mandate includes ensuring free competition in all spheres of commercial and economic activity and to enhance economic efficiency. Section 29 of the Act stipulates that the Commission shall promote competition by, *inter alia*, reviewing policy frameworks for fostering competition and making suitable recommendation, to the Federal Government or Provincial Governments, to any law that affects competition in Pakistan.

I. Industry Overview

4. Aerated water is a solution of carbonic acid in water, and this term is frequently applied to carbonated drinks. Currently, there are approximately twelve manufacturers in the country producing and competing in the market of aerated drinks which are subject to the Capacity Tax. Filling valves are the basis for determination of production capacity of the industry for the purpose of Capacity Tax. Presently, two-third installed filling valves are

being used by two international brands, while the remaining valves are used by small local manufacturer and many of them are not functional anymore after the imposition of Capacity Tax.

5. In Pakistan, the beverage industry has gone through a period of rapid change and development. Until the 1990s, the local beverage competitors occupied upto 40% market share, while the rest was enjoyed by international brands. In 1990, all machines were made locally and were similar in their structure, but now imported modern technologies are imbedded in the industry. Machines of different origins and models have different ways of working and complexities to determine output. Some machines have very advanced valves which fill quicker than other valves, as the latest technology claims to increase bottle speed by up to fifty *per cent.*

6. **History (should not) repeat itself**. In 1991, Capacity Tax was introduced in the beverage industry, which was later withdrawn in 1994. However, Capacity Tax became a major reason for bankruptcy and closing down of many local competitors. Around fifteen local beverage plants in different parts of country stopped working since Capacity Tax was imposed in 1991. Today, competition in the beverage industry is confined to a few cities. There are a few local beverage plants functioning in Lahore, Multan, Lala Musa and other areas, and it is not viable for them to reach out and market their products all over Pakistan.

II. Problems with the Calculation of Capacity Tax

7. A review of the industry reveals that the capacity of valves cannot be quantified in one simple figure for all machines. Older machines producing 04 bottles per minute cannot be clubbed with machines with hi-tech turbo fillers producing 09 bottles per minute. Similarly, a plant working with one shift will be taxed at the same rate as a plant working with two or three shifts. In addition, the supply of electricity and gas being short and not available throughout the day makes the calculation of tax on capacity basis erroneous.

8. The demand of beverages in Pakistan is cyclical in nature and depends on the weather. Soft drinks are more in demand in summer than in winter; thus, imposing the same tax throughout the year is not without problems.

III. Competition Concerns

9. **Discriminatory treatment**: Capacity Tax results in gains for large scale manufacturers, who constitute a major share in the market, use high speed fillers and produce at higher rate of capacity utilization (up to 80-100 per cent, as large manufacturers outsource their production). On the other hand, a small manufacturer who has less demand in the market and is producing less than half of its production capacity will also have to pay the same fixed rate of tax. Therefore, a fixed rate of tax would reduce the tax burden of large manufacturers and shift it onto small manufacturers. This imbalance of tax imposition is anticompetitive, as it puts small competitors at a cost disadvantage, resulting unfair competition, and eventually squeezing small competitors out of the market.

10. Furthermore, the division of manufacturers into different categories also seems to be unreasonable, as the tax slab jumps from PKR1.17 million to PKR3.7 million if number of valves goes up from 39 to 40. The raise in tax from 39 valves to 40 valves is exponential and would only encourage slashing capacity to 39 valves.

11. **Barriers to entry and exit**: The Capacity Tax regime creates barriers to entry and exit. Under the given tax slabs, a potential competitor will be reluctant to install a large capacity, as this results in a higher incidence of tax in the earlier years of the usage of the machinery, when it is typically utilized below full capacity. Even otherwise, it would be difficult for any new competitor to compete with the large manufacturers who have a stronghold in the market and take the benefit of cost advantage under the Capacity Tax. Not only this, even if any existing manufacturer intends to expand its productivity, tax slabs given in the SRO will curtail machinery investment. The current situation is unlikely to yield higher revenue to the government. Moreover, the Capacity Tax regime makes the exit from the market also difficult. All those manufacturers who are not able to compete will have no buyer in the markets for their plants/machinery.

12. **Reduced choices; higher prices:** Once the small manufacturers are driven out of the market, competition will be reduced, and the consumers will be left with limited choices. Also, low profile brands having a small market share help in creating a healthy competition in favor of the consumer. These brands cannot sell at the same price as the high profile brands, but they do compel a high profile brand to maintain a proportionate price, otherwise it would start losing market share.

IV. Recommendation

13. Capacity Tax is a regressive way of revenue collection and gives unfair and unnecessary competitive cost advantage to those manufacturers who have high rate of capacity utilization over those who have less demand in market and are not able to fully utilize their installed capacity. Such a discriminatory tax regime stifles the competition in the beverage industry, and as a result, small local manufacturers will be forced to close down because they will no longer be able to compete in a tax environment that overwhelmingly favors large manufacturers. This is against the nation's professed aim of building and growing businesses and encouraging investment.

14. For the reasons documented above:

    a. It is recommended that the Notification SRO No. 649(I)/2013 dated 9th July, 2013 should be withdrawn with immediate effect to eliminate the above mentioned discriminatory treatment and create a level playing field for all the competitors in the beverage industry.

Islamabad, the 2nd of September, 2013.