Response by the Research Unit on the Economics of Excisable Products (REEP) to the National Treasury's discussion document on the taxation of electronic nicotine and non-nicotine delivery systems

1. In December 2021 the National Treasury published a discussion document on the taxation of electronic nicotine and non-nicotine delivery systems. This discussion document follows commitments made by the Minister of Finance in budget speeches in 2019 and 2020 to tax these products (par. 1.4). We would like to congratulate the National Treasury on an excellent document.

2. The Research Unit on the Economics of Excisable Products (REEP) is based in the School of Economics at the University of Cape Town. Our aim is to support public health by conducting independent and rigorous research, especially in the area of tobacco control and alcohol policy. We are financially supported by international donors, including the Bill & Melinda Gates Foundation, Cancer Research UK, and the International Development Research Centre. We have not, and will not, accept any funding from the tobacco, e-cigarette, and alcohol industries. We have strong relations with the World Health Organization (WHO), and host the Knowledge Hub on Tobacco Taxation and Illicit Trade on behalf of the Secretariat of the WHO Framework Convention on Tobacco Control. REEP currently employs seven researchers and two postdoctoral fellows. Between them, REEP has more than 60 years' research experience in the economics of tobacco and alcohol control, and has published more than 100 articles in national and international economics and public health journals. For more information on the unit, please visit www.reep.uct.ac.za.

3. Currently electronic nicotine and non-nicotine delivery systems (ENDS/ENNDS) are not subject to an excise tax in South Africa. Taxing ENDS/ENNDS follows a tradition of taxing products that have undesirable health consequences. Policy options for the taxation of ENDS/ENNDS are outlined in the 2021 WHO Technical Manual on Tobacco Tax Policy and Administration.

4. In the discussion document on the taxation of electronic nicotine and non-nicotine delivery systems, it is proposed that a specific excise tax be levied on both the non-nicotine and nicotine solutions using the 40% incidence rule applied to combustible tobacco products. It is also indicated that there is scope to levy an *ad valorem* excise tax on the device. Below we discuss the technicalities of the proposed tax, first in terms of the excise tax structure and secondly in terms of the proposed excise tax rate.

Excise tax structure

(i) Specific taxation of e-liquids

5. South Africa's current excise taxes on tobacco, alcohol, and sugar-sweetened beverages have two desirable characteristics: (1) they are administratively easy to implement and (2) in the case of beer, spirits and sugar-sweetened beverages, by focusing on the component that causes the harm (i.e., alcohol in beer and spirits and sugar in sugar-sweetened beverages) they create incentives to the producers to reduce the harm-causing components. These two issues are discussed in the following six paragraphs.

6. The fact that excise taxes on tobacco, alcohol and sugar-sweetened beverages are levied as specific taxes makes it administratively easier than if the excise tax had been levied as an *ad valorem* tax. There is ample evidence to show that the public health consequences of a uniform specific tax are superior to those of an *ad valorem* tax (WHO, 2021). The National Treasury's recommendation that the country should adopt a *specific* excise regime for the taxation of ENDS/ENNDS (par. 7.5) aligns with established excise tax regimes on tobacco, alcohol, and sugar-sweetened beverages.

7. A specific excise tax on E-liquid would result in a greater percentage increase in the price of cheaper products than in the price of more expensive products. While this tax system is likely to be strongly opposed by the ENDS/ENNDS industry, especially those that are producing the cheaper products, a specific excise tax has better health outcomes than an *ad valorem* tax. The reason for this is that younger people are likely to purchase cheaper E-liquids, the prices of which are more affected by the excise tax.

8. The discussion document proposes that both the volume of the liquid and the nicotine content be taxed. At an intuitive level this makes sense, because both the E-liquid (irrespective of whether it contains nicotine or not) and nicotine are harmful. From our reading of the discussion document, it seems that National Treasury wants to place a relatively greater weight on the nicotine content than on the E-liquid in setting the tax. Our concern is with the practicality of taxing the nicotine content. Based on informal discussions with officials from the National Department of Health, there is insufficient capacity to test these E-liquids in appropriately accredited laboratories

9. The discussion document indicates that South Africa should follow the Latvian model of taxing both the E-liquid volume and the nicotine content. However, after four and a half years, Latvia has abandoned the tax on the nicotine content as of January 2021. The fact that a highly developed country has simplified their tax system suggests that South Africa should adopt a simpler, rather than a more complicated, system.

10. If a tax is imposed on nicotine, it could result in an awkward situation in which the vaping industry could ask why quitting aids, such a nicotine replacement therapies, are not taxed because they also contain nicotine.

11. Furthermore, if the aim of the tax is to prevent youth from taking up ENDS/ENNDS, a tax on nicotine content may be misdirected. Youths are attracted to ENDS/ENNDS primarily because of the *flavours*, rather than the nicotine. On the other hand, cigarette smokers who would

want to use ENDS as a harm-reduction or quitting strategy are more likely to purchase ENDS with a high nicotine content. We do not want to discourage such people to switch.

12. We appreciate that taxing ENDS/ENNDS is complex because the product is complex and is still rapidly evolving. There are many more factors to consider with ENDS/ENNDS than with regular cigarettes, as has been pointed out in detail in sections 2 and 6 of the discussion document. We urge National Treasury to adopt a feasible, implementable, and simple tax regime. We acknowledge that National Treasury have tried to keep the taxation regime as simple as possible, but we believe that they can make the system even simpler by only taxing the E-liquid quantity, rather than both the E-liquid quantity and the quantity of nicotine.

13. To avoid the situation of the industry trying to avoid the tax on E-liquid by increasing the nicotine concentration, we propose that South Africa follows the EU example and limits the nicotine concentration to 20 mg/ml. While the enforcement of this limitation will require some laboratory capacity, it will not require as much capacity as testing all E-liquids for the quantity of nicotine, as is currently proposed in the discussion document.

14. Should the option of limiting the nicotine content in E-liquid prove to be unenforceable or undesirable for whatever reason, we propose that E-liquid based on nicotine salt be taxed as a higher rate than E-liquid based on free base nicotine. The nicotine concentration in nicotine salt (typically 40-50 mg/ml) is much higher than the concentration in free base liquid (typically less than 18 mg/ml).

(ii) Ad valorem taxation of devices

15. The discussion document indicates that "government could also consider including electronic cigarette devices in the *ad valorem* schedules" (par. 7.7). Given the large differences in price between the devices, it seems a sensible strategy to tax devices with an *ad valorem* tax, rather than a specific tax. Furthermore, this proposal is made within the context of an already-existing legal and administrative framework for levying an *ad valorem* excise tax on products that are considered luxuries or non-essential. The proposal to tax ENDS and ENNDS devices with an *ad valorem* tax aligns exactly with the recommendations in the WHO's tax manual (WHO, 2021: 74). The WHO indicates that the easiest type of *ad valorem* tax would be based on the declared retail price, rather than on an earlier stage in the value chain (WHO, 2021: 74).

Excise tax rate

16. The WHO Tax Manual of 2021 (p. 80) indicates that "ENDS/ENNDS products must be regulated and taxed in a manner that discourages uptake by youth and non-users".

17. The proposed level of the excise tax will be strongly opposed by the ENDS/ENNDS industry, whatever that level might be. We would like to comment about this issue in some detail. The first thing we note from the discussion document is the very large differences between countries in the level of the excise tax on E-liquids. The lowest excise tax, from our reading of the discussion document, is in Latvia, where E-liquid was taxed at 0.01 euro (R0.19) per millilitre and the nicotine at 0.005 euro (R0.10) per milligram (par. 6.7). The base of the excise tax was changed in January 2021 to 0.12 euro (R2.28) per millilitre of E-liquid, and in January 2022to 0.16 euro (R3.04) per millilitre. The highest excise tax on E-liquid seems to be in South

Korea, where, after the changes of 2020, the "tobacco consumption tax" is R18.28 per millilitre (par. 6.3). Together with other taxes and levies, the total tax burden, after the proposed changes of 2020, is around R52 per millilitre of E-liquid (see par 6.3). This is more than 17 times the rate in Latvia.

18. The discussion document notes that the excise tax on E-cigarettes in Kenya substantially exceeds the tax rate imposed on conventional cigarettes (par. 6.6). Rather than banning ENDS/ENNDS (which may have been its preferred strategy), it seems that the Kenyan government has decided to tax them so heavily as to make them out of reach for all but the very richest people.

19. It is clear from the discussion document that the National Treasury does not want to tax ENDS/ENNDS into oblivion, but instead wants to create a situation where ENDS/ENNDS and combustible cigarettes are treated equitably and even-handedly. The fact that the first option refers to the 40% excise tax benchmark (par. 7.13) indicates this. In the executive summary, National Treasury notes that "it is proposed that a 40% incidence guideline be used…". We believe that this is a sensible approach for finding a baseline excise tax. The National Department of Health is trying to regulate ENDS/ENNDS like tobacco products in the updated Bill. For consistency, it also makes sense for Treasury to tax ENDS/ENNDS like tobacco products.

20. Once the baseline is established, National Treasury should, each year, increase the excise tax on ENDS/ENNDS by the inflation rate, plus a pre-announced additional percentage, to prevent the industry from effectively setting the value of the excise tax, and to ensure that ENDS/ENNDS become less affordable over time. For many years (specifically between 1994 and 2010) the level of the excise tax on combustible cigarettes was set by the tobacco industry, as National Treasury passively set the excise tax so as to maintain the pre-announced threshold tax percentage. The cigarette industry's pricing strategy supported tobacco-control efforts at the time, because the above-inflation price increases resulted in above-inflation excise tax increases. However, it is not good policy to place control of the excise tax in the hands of the industry. Since 2010, when competitive pressures in the tobacco industry have resulted in lower-than-inflation increases in the retail price of cigarettes, National Treasury has increased the excise tax by at least the inflation rate. The combination of below-inflation increases in the retail price, and inflation-linked or slightly above-inflation increases in the excise tax, increased the tax burden on cigarettes to above the targeted level. We believe that National Treasury's excise tax decisions should be delinked from the industry's pricing decisions. It is already happening in practice. It should become official policy.

21. For the past number of years, countries like the UK and Australia annually increase the excise tax on tobacco products by the sum of the inflation rate and a pre-announced multi-year additional percentage. Through this multi-year approach, the tax authorities increase the predictability of the tax increases. This is likely to encourage smokers to quit, since they can assume that their habit is becoming increasingly expensive over time. We urge National Treasury to move away from the 40% tax incidence model and officially adopt a policy of multi-year preannounced increases in the excise tax on both tobacco products and ENDS/ENNDS.

In conclusion

22. We would like to congratulate National Treasury on an excellent document that prioritises public health above the financial interests of the ENDS/ENNDS industry. The proposed excise tax structure is well-considered, although we believe that it can be simplified further by taxing only the volume of the E-liquid, rather than both the volume of the liquid and the nicotine content. Once the baselines for ENDS/ENNDS excise taxes have been established, subsequent annual increases should be delinked from the pricing strategy of the industries. To some extent this has been happening with cigarette taxes since 2010, but National Treasury should make this official policy for all tobacco and ENDS/ENNDS products.

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