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14 November 2019

The Honourable Yunus Ismail Carrim
Chairperson: Select Committee on Finance
National Council of Provinces

Re: Comments on Rates and Monetary Amounts and Amendment of Revenue Laws Bill [B17-2019] (Rates Bill)

Dear Honourable Yunus Carrim,

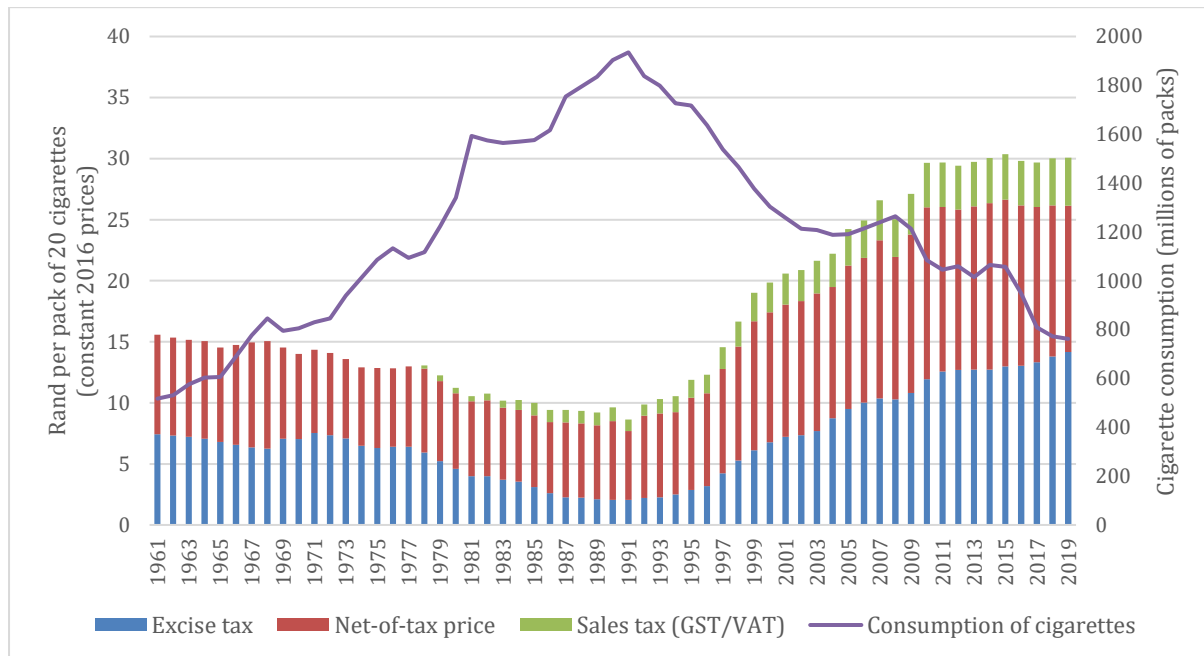
I appreciate the opportunity to comment on the Rates Bill. I am the Director of the Research Unit on the Economics of Excisable Products (REEP), which is a research unit at the School of Economics at the University of Cape Town. REEP's research focuses on the economic aspects related to excisable products. Our website can be found at www.tobaccoecon.uct.ac.za. Our motto is "Supporting public health through rigorous and objective research". Since our research focus to date has primarily been on tobacco, I am submitting comments on the item "Increases of the excise duties on alcohol and tobacco", focusing only on tobacco. My submission consists of two sections: (1) tobacco excise taxes reduce consumption, thereby improving public health, and (2) the limited link between excise taxes and illicit trade.

1. Tobacco excise taxes reduce consumption, thereby improving public health

An increase in tobacco taxation typically increases the retail price of tobacco. Global evidence shows that an increase in retail price decreases the demand for tobacco. In low- and middle-income countries, a 10% increase in the price of tobacco results in a 4–8% decrease in consumption.¹ This finding is also true for South Africa.² Decreases in tobacco consumption have positive health consequences for smokers and those around them. There is consensus among health economists and the tobacco control community that the *single* most effective policy to reduce the demand for cigarettes is to raise excise taxes.¹

South Africa's historical data shows that excise taxes are effective at reducing consumption. The inverse relationship between cigarette consumption and the real price of cigarettes is shown in Figure 1. As the excise tax (and retail price) increased from the 1990s, cigarette consumption decreased. At its peak in 1991, South Africans consumed almost 1.9 billion packs annually, which decreased to about 1 billion packs in 2016.³ Tobacco taxation (and the associated increase in the net-of-tax price controlled by the tobacco industry) was the main driver of the decrease in consumption.⁴

Figure 1: Cigarette consumption and cigarette prices: 1961-2016



Source: Van Walbeek C. South Africa time series data for cigarettes: 1960 – 2017. [dataset]: Version1.0. Cape Town: Economics of Tobacco Control Project [producer], 2018. Cape Town: DataFirst [distributor], 2018, 2018.

From the early 1990s to 2010, the tobacco industry, which was dominated by the multinationals at the time, increased the retail prices by substantially more than the tax increase.⁵ The excise tax component is shown as the blue bars and the net-of-tax price component is shown as the red bars in Figure 1. Higher profit margins compensated the industry for the reduction in sales due to higher tax. From 1994 to 2010, real (inflation-adjusted) tax increased by 377%, while the industry increased its net-of-tax price by 173%.⁵ The increase in the excise tax and the net-of-tax price increased both tax revenue and the industry's profits, despite lower sales quantities.

Between 1994 and 1997 the government increased the excise tax substantially to attain a 50% total tax burden on cigarettes. This target was announced in 1994, and in 1997 the Minister of Finance announced that the target was reached. Between 1998 and 2010 the tobacco industry's pricing strategy was responsible for the rapid excise tax increases. The mechanism was as follows: the government set the excise tax such that the sum of the excise tax and VAT comprised 50% of the retail price of the average retail price (after 2003 this was increased to 52%). Each year the government passively increased the excise tax to maintain this 50% (52%) tax burden. Because the tobacco industry was increasing the retail price so rapidly, the government would substantially increase the excise tax in the subsequent year in order to maintain the tax burden.



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The industry increased the retail price, but typically by much more than the increase in the excise tax. This increase in the retail price then triggered another large increase in the excise tax in the subsequent year. The result was a ratchet effect of increasing net-of-tax prices, increasing retail prices, and increasing taxes. In effect, the tobacco industry set the amount of excise tax levied by the government. At the time this strategy was very profitable for the multinationals that dominated the tobacco industry, but it created strong incentives for small players to enter the market. This started happening after the turn of the century, and became particularly pronounced after 2010.

Since 2010, the competitors to the multinationals have introduced many low-priced cigarettes to the market. As a result, the range of cigarette prices has become much wider, and on average, nominal cigarette prices after 2010 have increased by less than the inflation rate.³ While official cigarette consumption (excise tax paid) has decreased (purple line in Figure 1) since 2008, the number of cigarettes sold in the illicit market (not captured in official consumption) has increased.

In February 2019, the excise tax on a pack of 20 cigarettes was set at R16.66. This was expected to increase the real excise tax on cigarettes by about 3%. As a percentage of the retail price, the current excise tax on the most popular cigarette price category is around 43%. This is much lower than the World Health Organization's recommendation that the excise tax on cigarettes be set at a minimum of 70% of retail price.⁶ South Africa therefore has much room to increase excise taxes.

2. The limited link between excise taxes and illicit trade

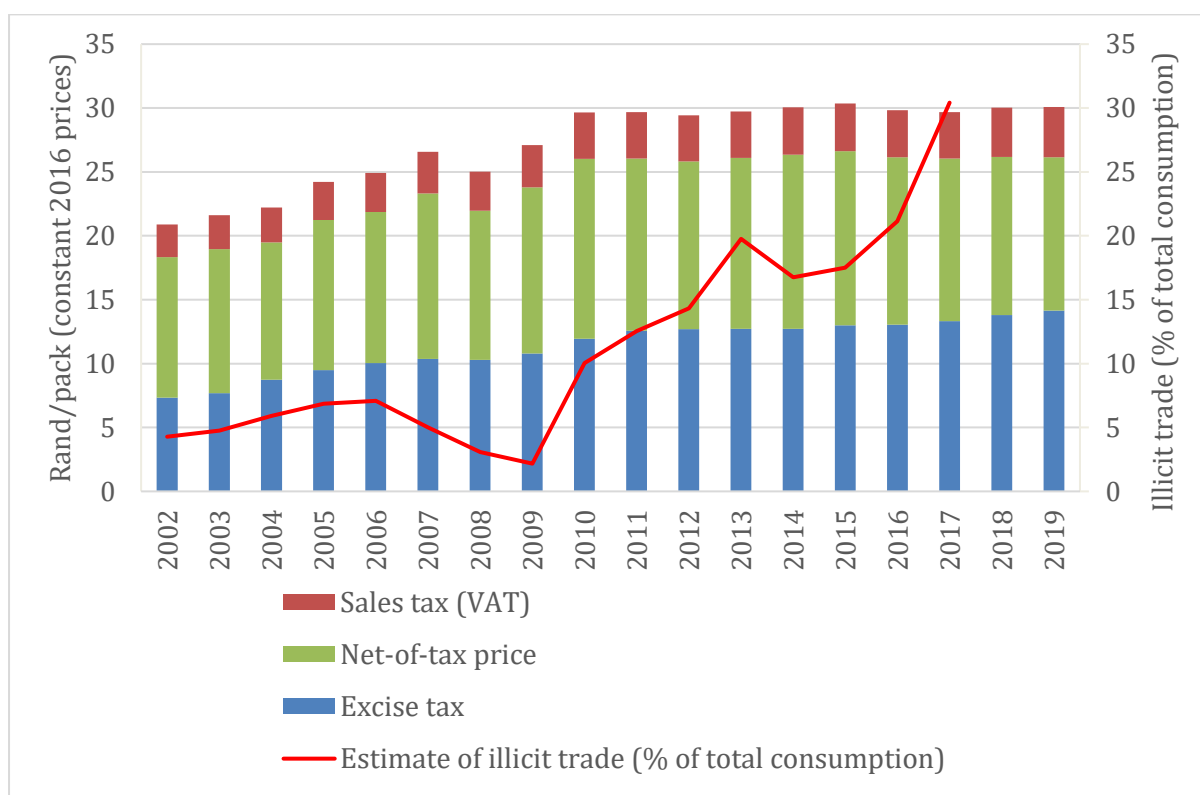
The presence of illicit trade can undermine the effectiveness of tax increases as both a public health and a fiscal measure, because it introduces cheaper alternatives to legal, full-priced cigarettes.

In 2019, together with my colleagues, I published a paper that assessed trends in the size of the illicit cigarette market in South Africa from 2002 to 2017 using gap analysis.⁷ Tax-paid cigarette sales were compared with consumption estimates from two nationally representative surveys: the All Media and Products Survey (AMPS) and the National Income Dynamics Study (NIDS). We found that since 2009, illicit trade has increased sharply. We estimated that illicit trade was between 30% and 35% of the total market in 2017. The acceleration in the growth of the illicit market since 2015 corresponds with the now well-known turbulent time at the SARS, when many of the enforcement functions were greatly reduced.

While the illicit cigarette trade in South Africa is a serious problem, its presence should not be used to undermine tobacco control policy, because the underlying cause is weak

tax administration, not the tax level. The real increases in excise taxes since 2010 have been modest. Figure 2 shows that the rapid increase in the size of the illicit market since 2015 occurred in a period when the real excise tax on cigarettes remained largely unchanged.⁷ In contrast, there is no evidence that the illicit market grew when the excise tax was growing rapidly (1995–2009). The tobacco industry’s argument that increases in the excise tax cause an increase in illicit trade, while sounding intuitively appealing, has no empirical support in South Africa.

Figure 2: Cigarette prices and illicit trade



Source: Price data from Van Walbeek C. South Africa time series data for cigarettes: 1960 – 2017. [dataset]: Version1.0. Cape Town: Economics of Tobacco Control Project [producer], 2018. Cape Town: DataFirst [distributor], 2018, 2018. Illicit trade estimates from Vellios N, Ross H, van Walbeek C. The illicit trade of cigarettes in South Africa: 2002 - 2017. Tobacco Control 2019

The tobacco industry, and the multinationals in particular, is raising alarm bells about the high level of tax, and how this is stimulating the illicit trade in tobacco. The fact of the matter is that the multinationals were responsible for the high levels of excise tax in the first place. To now blame the government for the high taxes, and to ask for a moratorium on further excise tax increases, is disingenuous.



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Cigarette supply chain controls in South Africa need to be drastically improved. A Track and Trace system would ensure that all products manufactured in the country are accounted for. For this reason it is encouraging to see that SARS has issued a call for tenders to implement a Track and Trace system for tobacco products. Tighter enforcement would further deter retailers from selling illicit cigarettes. These measures can be implemented at the same time as excise tax increases.

As economists with a particular interest in public health, we therefore encourage the Treasury to substantially increase the excise tax on tobacco products. While we acknowledge that there is a substantial illicit trade problem, we urge Treasury to not buy the self-interested argument of the tobacco industry, but to place the health of the population above the financial interests of an industry that has caused untold harm to hundreds of thousands of people in this country.

If you would like any further information, or if you have any questions, please contact me on 021 650 4689 or cornelis.vanwalbeek@uct.ac.za.

Kind regards

A handwritten signature in black ink, appearing to read 'C. van Walbeek'.

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