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RESPONSE AND COMMENTS TO THE 2019 BUDGET DRAFT TAX BILLS

Treasury proposal

Schedule II (Section 4) amendment of part 2a of schedule no. 1 to Customs and Excise Act of 1964, prepared foodstuffs; beverages, spirits and vinegar; tobacco

BATSA analysis of category 2402.2 to 2403.99 including 3824.99 and linked Treasury proposals

Summary of argument:

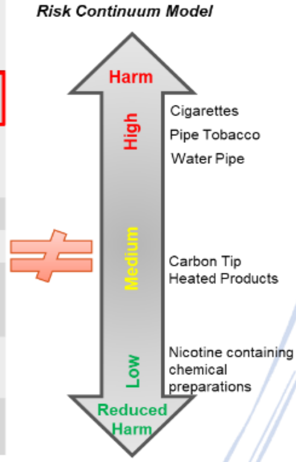
The current Tobacco Fiscal Framework and the tobacco category revenue contribution is unbalanced and not delivering the full revenue potential. Following the macro economic trends, Cigarette consumers of tax paid products are going to be over stretched, whilst consumers of duty non paid cigarettes are able to afford price movements on the bottom of the (illicit) market, as displayed in the last IPSOS study, published in July 2019.
As a result, excise collections are plateauing and are no longer able to deliver expected revenue targets, whilst the growth of illicit continues unabated. The under-representation of other tobacco products in revenue collections, represents a leakage in the fiscal framework, with only duty paid cigarettes accounting for tobacco excise revenue.

Analysis

The current fiscal framework for the tobacco category reveals cigarettes carry the highest excise rate within tobacco products category. Pipe tobacco (a semi-finished tobacco product) and water pipe tobacco, which carry similar harm as cigarettes are given a reprieve, indexing 21% of cigarettes excise rate. Tobacco Heated Products, one of the fastest growing categories globally and projected to equal 1 billion sticks by 2025, is not taxed at all despite being a tobacco product and sitting at a medium risk rating in the Risk Continuum Model. These policy anomalies have created an imbalance in excise collections, and do not answer the internalization of tobacco harm effectively.

Current Excise Framework on Tobacco Products

	Tariff Code	Category description	Current excise/kg	Current index to to cigs.	Commentary
1.	2402.2	Cigarettes containing tobacco	1,041.25	100%	Currently under performing due to a large illicit market
2.	2403.19.10	Pipe tobacco in immediate packings of a content of less than 5kg	215.52	21%	Tarif description includes: - Cigarette tobacco - Roll your own - Classic pipe tobacco
	2403.19.20	Other pipe Tobacco	215.52	21%	
	2403.19.30	Cigarette tobacco	374.58	36%	
3.	24.03.11	Water pipe tobacco	215.52	21%	Shisha aka Hubbly Bubbly
4.	24.03.91	Other manufactured tobacco and manufactured tobacco substitute	-	0%	Tobacco Heated Products and Carbon Tip Heated Products
5.	3824.99.99	(Other: Other)	-	-	All other types of nicotine delivery products unclassified

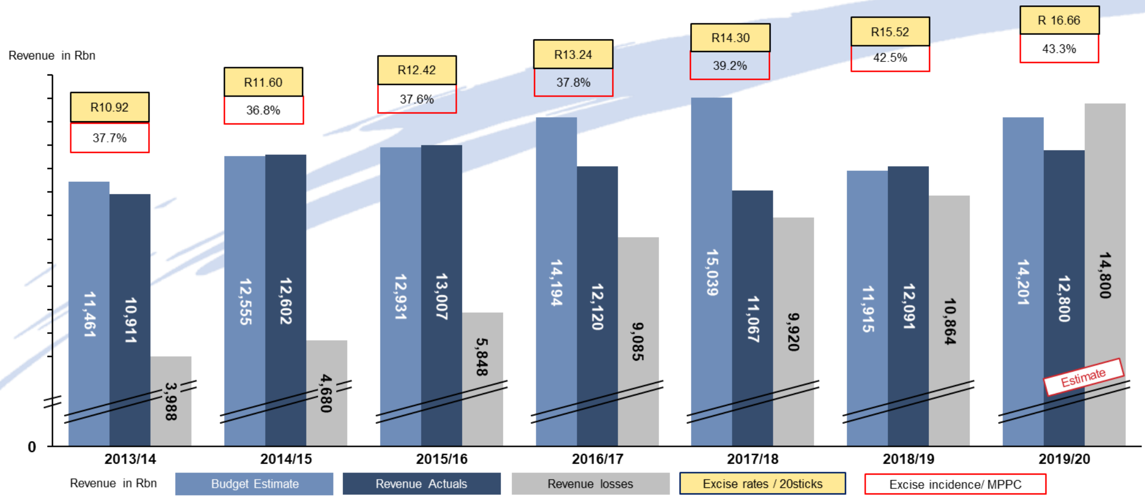


As displayed, the current excise framework is unbalanced, and can no longer deliver revenues as expected without a policy review that internalizes harm and captures the revenue opportunity from the non-cigarette tobacco subcategories.

<u>In the past, Treasury has missed revenue targets by over proportional excise increases which has resulted in bigger space for illicit trade growth</u>

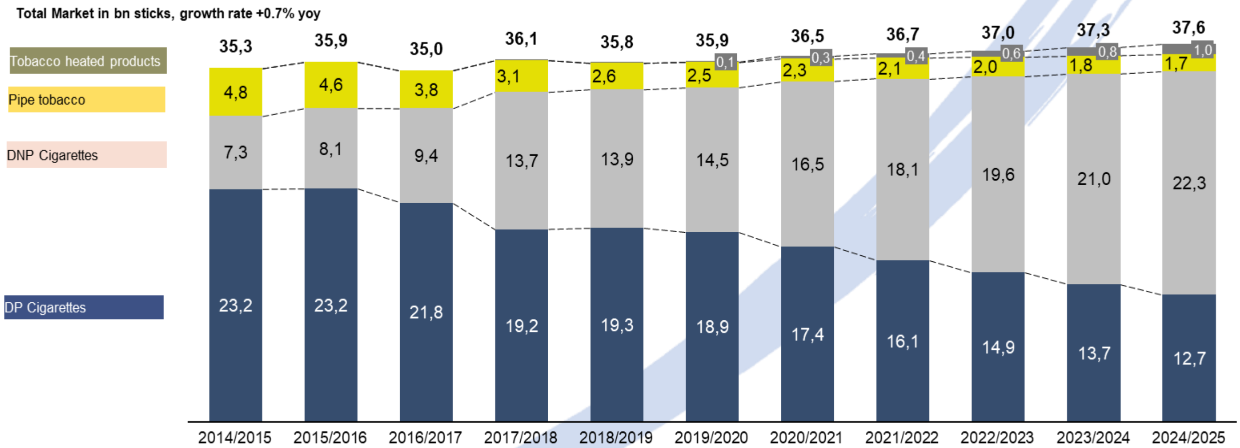
National Treasury forecasts for local cigarette revenue collection has continuously missed targets, the exception being fiscal year 2018/2019 when duty paid manufacturers did not pass on excise to assist consumer affordability. However, the growth in illicit continues to supersede the revenue that has been captured in 2018/2019, as estimates for 2019 /2020 show a growth in revenue opportunity cost lost to illicit from lack of enforcement action. The main driver of the revenue lies in the increase in the cost base of duty paying product as a result of excise increases above the target incidence of 40%, currently sitting at 43.3%, and the overestimation of the market dynamics.

6.2% CAGR excise increase drives revenue loss of 24% CAGR



If the current situation continues where the excise framework remains unbalanced, excise increases are roughly 8% per year, and enforcement action against illicit remains limited, it is our forecast that the illicit market will outgrow the legal market, within 5 years. In this scenario the government fiscus would be heavily impacted, as revenues meant to boost the fiscus collection leak out the fiscal net.

5 year forecast with current scenarios carried forward



BATSA's recommendations

It is our view and recommendation that fiscal, enforcement and administrative interventions are needed to return the tobacco category back to a state where it can deliver long term value for the fiscus. This can be done through improved administration and enforcement to prevent fiscal leakages in the value chain and to reduce the supply of duty not paid tobacco. Supporting these activities, are fiscal interventions, that seek to broaden the tax base, whilst allowing consumers of duty non paid product an opportunity to return to the consumption of duty paying products, thereby growing the excise revenues from a stretched cigarette category.

In this recommendation, less harmful tobacco products are given subcategory role, and excise rate that reflects the harm associated with the product. As these categories are new in the tobacco category, affording consumers options to migrate to these new products as harm reduced products must outweigh the need to tax them on the same level as cigarettes. Using the Risk Continuum Model, as a guiding tool for excise structuring, Tobacco Heated Products for example, must carry an excise rate equivalent to their harm, and the premium price position they currently occupy. On the other hand, nicotine containing chemical preparations have 95% less harm health effects and should be encouraged as a substitute product to cigarettes.

Fiscal Framework Recommendations

- Tariff code 2402.2 Cigarette Containing Tobacco:
  An excise freeze (R833/1000 sticks) on cigarettes for 3 years is needed to allow consumers to afford legal cigarettes (assumption- the duty paid market becomes bigger than 23 billion sticks and sensitive inflation-based increase can materialize – recovering 1 billion sticks from the duty non paid market equals R833mn revenue increase).

- Tariff Code 2405.19.10 Piped Tobacco:
  Increased excise on piped tobacco to R1041.25/KG (Current Cigarette rate of R833 converted with 0.8g tobacco/Stick = **100% of excise incidence of cigarettes). Currently 21% index.**

- Tariff code 24.03.91 Other reconstituted/substituted tobacco:
  Introduce **R416.50/1000 tobacco sticks** (**50% excise incidence to Cigarettes) on tobacco heated products. Currently no excise.**

- Tariff Code 3824.99.99 Other-Other:
  Introduction of **14c per ml for nicotine containing chemical preparations. Not classified or taxed.**

These interventions will shift illicit consumption into legal consumption and provide scope for future tax rate adjustments.

Enforcement and administrative framework

We are recommending short-term (quick wins), medium-term and long-term enforcement interventions to ensure sustainable revenue collections and to safeguard long terms revenue objectives.

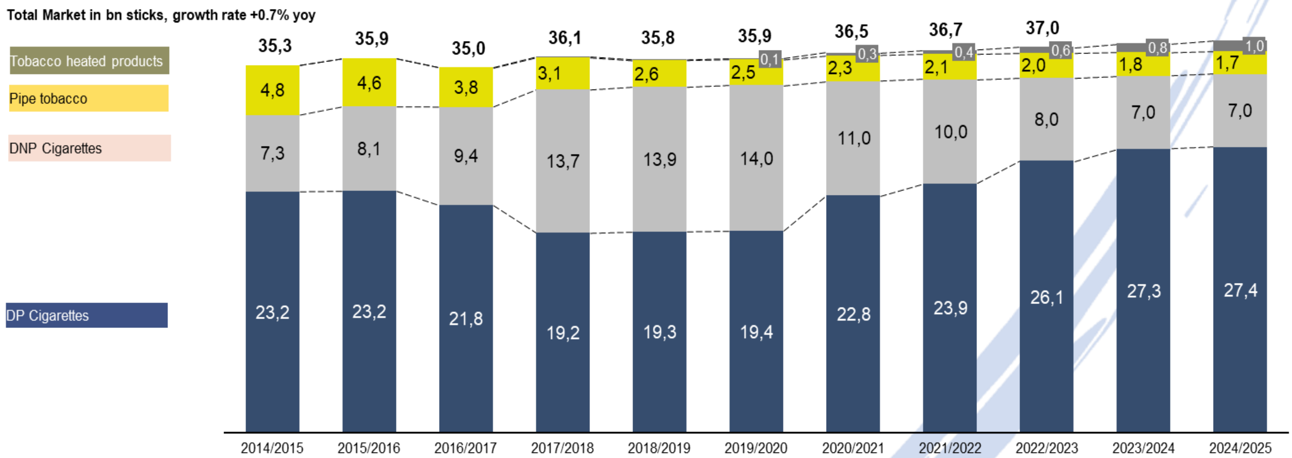
Interventions	Short-term (6months)	Medium-term (1-2years)	Long-term (+3years)
Strengthen Factory Controls	Volume production verification (production counters) + customs presence 24/7 + external CCTV control	Digital Tax verification and creating data storage cababilities	Track & Traceability to the first economic partner
Wholesale Enforcement	Consistent checks on sales below MCT price point.		
Retail Enforcement	Implement a concept of suspected retail price < R24/pack		
Strengthen Border Controls		Define fix entry/exit points for all tobacco related products + power of destruction set in excise act	
End to End Goods Reconciliation		Step 1: For all tobacco related raw material and finished goods	Step 2: Implement Blockchain as a holistic solution.
Forensic laboratory	Supports product enforcement, identification and prosecution for Counterfeit or DNP		
Enforcement Training	Strengthen capabilities of seizures and prosecution		

With enforcement a critical lever in tobacco category administration, an opportunity such as 1 Billion sticks recaptured from illicit trade can immediately return R833 million to the fiscus.

The implementation of production counters mechanism will immediately help to solve the local production leakages, give total production transparency and is the key to deliver revenue targets together with a balanced fiscal framework.

Should the recommendations be implemented, it is our forecast that the fiscus would immediately start seeing short to medium term benefits, as illustrated by our 5-year projection. In this scenario, excise increases remain flat for a short period of time, the excise framework is balanced and accounts for the harm effects of the non-cigarette tobacco sub categories, and enforcement efforts are implemented in phases, with production counters and SARS officials in factories co-authorizing the sales of goods out of the factory, and CCTV camera's installed in factories, that are manned offsite at the SARS offices for immediate implementation in the 2019/2020 fiscal year.

BATSA's 5 Year revenue forecast by implementing the fiscal and administrative framework recommendation



Conclusion

We therefore make this submission to the TALAB process in respect to comments on the Schedule II (Section 4) amendment of part 2a of schedule no. 1 to customs and excise act, 1964 prepared foodstuffs; beverages, spirits and vinegar; tobacco.

We welcome an opportunity to engage further on the details of the proposals and look forward to continued public private consultations and partnership to address fiscal leakages, and policy anomalies that have no effect in bringing revenue back to the state.