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Hon. J Maswanganyi, MP
Chairperson: Standing Committee on Finance (National Assembly)
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TRANSMITTED ELECTRONICALLY

Dear Sir

COMMENTS TO THE DRAFT RATES, MONETARY AMOUNTS & AMENDMENT OF REVENUES BILL, 2021 AND OTHER RELATED MATTERS

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1. INTRODUCTION

Thank you for the opportunity to provide comments on the Draft Rates, Monetary Amounts & Amendment Bill 2021 ("Draft Rates Bill") and other related matters outlined in the 2021/22 National Budget ("Budget Statement").

The Draft Rates Bill proposes to increase the excise rate on cigarettes by 8% in the context of a forecast inflation rate of only 4.9% for 2021. Further, the excise hike has placed the excise incidence on the cigarette's Most Popular Price Category ("MPPC") at 45% compared to a targeted incidence of 40% as per the National Treasury's excise policy.[1] The total tax incidence on the MPPC now sits at a significant rate 58% against the background of falling consumer affordability.

We respectfully submit that the excise increase is unsustainable and detrimental to the continued survival of the already distressed legal cigarette industry in South Africa. Further, we think that the excise increase is non-compliant to the extent to which it exceeds Government's own excise policy on tobacco products, being -the higher of 40% excise incidence on the MPPC or projected consumer price inflation.

We detail our submissions below.

1.1 Excise Increase is unsustainable

1.1.1 <u>The Excise change did not take into account the impact of the five months cigarette ban</u>

It is apparent that in setting the excise rate, the Honourable Minister of Finance did not fully take into account or at all, the impact of the unprecedented five months ban on cigarette trading in the prior year, which extensively destabilised South Africa's cigarette industry.

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[1] National Treasury uses Peter Stuyvesant as the anchor brand in the calculation of the MPPC- which we have used here. However, argue that due to changes in market dynamics the MPPC now sits at R22 and would need to be reviewed.

The extra ordinary five months ban on the sale of tobacco products and vaping products significantly transformed our industry in a historic fashion. According to an independent study by the Research Unit on the Economics of Excisable Products (University of Cape Town), the duty not paid ("DNP") cigarettes market grew by an unprecedented 104% during the lockdown period. The study concludes that the most popular brand in the legal duty paid ("DP") segment, namely Peter Stuyvesant, plummeted by over 54%. With respect to the 2020/21 financial year, National Treasury collected ZAR 7.58 billion from cigarette taxation which is 52% down from the budgeted figure of ZAR 14.46 billion. What is more concerning is that the five months ban allowed the development of strong and sophisticated local and transborder criminal networks of illicit players. The market has been unsurprisingly taken over by criminal syndicates right before our eyes. The Commissioner of SARS Mr Kieswetter rightly pointed out at the 2020 Tax Indaba in September 2020 that:

> "Criminal networks of tobacco smugglers that were created following the Government's temporary ban on tobacco sales are now embedded in the supply chain and it will take us years to reverse the impact."

The relationship between high taxes and the growth of the illicit cigarette market is well documented. This excise increase of 8%, in the context of record weak consumer demand currently persisting in the market will definitely result in a further growth in the DNP cigarette market, during this financial year.

It's important for Government to use excise policy to suppress the growth of the illicit market, by closing the gap between DNP and DP cigarette prices, through gradual excise increases typically in line with inflation. This allows the recapture of illicit volumes into the legal market and the meeting of public health objectives (which include the reduction of consumption from both the legal and illegal market).

1.1.2 State of the DNP Market

BATSA commissioned Ipsos to conduct a representative Retail and Wholesale price research measuring the cheapest prices in the market in order to understand the gap between Duty Paid products and Duty Not Paid products. The findings of the initial research were published in 8th March 2021.[2] We have attached a copy of the Ipsos Report as **Annexure A**. The research findings show the immensity of the illicit cigarette challenge in South Africa. Based on the study, 41% of the cigarettes sold in South Africa are below the minimum collectable tax, that is to say excise and VAT payable of the pack of cigarettes. Further, 64% of the cigarettes sold in South Africa are below the economically viable retail price. The economically viable retail price takes into account, the direct costs and the lowest possible margins required to bring a pack of cigarettes into the market. The lowest economically viable price point for a pack of cigarettes sold in South Africa currently sits at R26.55 for a pack. Accordingly, the DNP markets now constitutes 64% of the entire cigarette market. This makes South Africa's DNP cigarette market share the largest globally.

Another recent independent study by the National Income Dynamics Study-CRAM also established the rapid growth of the DNP market post the ban and concluded that:

> A larger and more entrenched illicit tobacco sector as a result of the ban is a source of concern. Even before the sales ban, the illicit trade in cigarettes was a problem. […] Within this context, the sales ban undid many of the positive developments of 2019. It entrenched distribution channels for illicit cigarettes, especially in the informal retail outlets. To undo the damage will be difficult."[3]

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[2] Ipsos, *Cigarette Retail and Wholesale Price Research*, IPSOS (March 2021)

[3] National Income Dynamics Study -Corona Virus Rapid Mobile Survey, *Market Impact of the Covid 19 National Cigarette Sales ban in South Africa* (February 2021) at 19.

It is clear that the Inter-Agency Working Group enforcement activities referred to in the Budget Statement, has not impacted on the illicit cigarette economy at all. On the contrary, the state of the illicit cigarettes industry has worsened in the past months. It therefore follows that further excessive excise increases of above inflation, will only worsen the growth of the DNP market at the expense of the legal market.

Experts have pointed out the unworkability of Treasury excise strategy, premised on taking huge excise increases in the context of an illicit ridden market:

> However, for many years more and more SA smokers have responded to high legal tobacco prices by switching to illicit brands. Since illicit cigarette manufacturers evade paying excise duties, these brands are considerably cheaper, even when sold at substantial margins. By the start of last year, before the onset of the pandemic, illicit cigarette sales made up between a third (according to the University of Cape Town) and half (according to manufacturers) of all cigarette sales in SA. So, intertwined have the legal and illicit markets become that the price of a cigarette is now far less important to smokers than the price difference between legal and illicit cigarettes. The larger this price difference, the more consumers are willing to switch to illicit brands.[4]

1.1.4 Change in the MPPC

It is important to note that the market dynamics have significantly changed since the excise policy which targets 40% of the MPPC was established in 2015. In 2015, Peter Stuyvesant was the anchor brand in the MPPC, with a resale price of R 30 per 20s. According to an Ipsos Market Analysis the MPPC now sits at the low value for money segment, with the anchor brand retailing for circ. R 22.70 ("Revised MPPC"). It's only logical therefore for National Treasury to determine the appropriate tax increases based on this Revised MPPC.

Now based on the proposed excise rate, excise alone will constitute 85% of the MPPC against an excise policy of 40% of the MPPC. The total tax incidence on the Revised MPPC is 99% – and makes South Africa by far the leading country in the world in terms of total tax incidence on cigarettes! This position is clearly unsustainable and unreasonable.

1.1.5 Price and Price Elasticity of Cigarettes in a COVID context

The COVID 19 pandemic has resulted in an unprecedented global recession.[5] The IMF forecasts a loss of global output of more than USD 28 trillion between 2020-25.[6] Equally, in 2020, the South African economy saw a deep contraction and it is estimated that recovery will be moderate. In view of the fact that most direct taxes are procyclical, that is to say revenues from taxes fall during recession, governments seeking to increase public funds may be tempted to increase excise duties on products such as tobacco which is exactly what National Treasury has done. Because taxes are levied on products with an inelastic demand – so goes the conventional wisdom. Raising them will always result in higher taxes and lower consumption levels.

In a recent paper, global consulting firm FTI has raised alarm about this conventional thinking which we believe entirely applies in the context of the South African economy:

> There are, however, some very good reasons to question the 'conventional wisdom' and for fiscal authorities to consider carefully the reasons why higher excise duties may not always result in higher government revenues:

[4] https://www.businesslive.co.za/bd/opinion/2021-02-18-hiking-cigarette-taxes-will-only-strengthen-illicit-trade/
[5] International Monetary Fund, 'The Great Lockdown: Worst Economic Downturn Since the Great Depression', 14 April 2020.
[6] The Guardian, 'IMF estimates global Covid cost at $28tn in lost output', 13 October 2020

(a) the long-held belief that cigarette demand is always 'inelastic' to price increases is not, in fact, accurate and – in an increasing number of countries, even before the advent of the current pandemic – higher tax rates can have a more than proportionate effect on sales volumes and result in lower tax revenues;

(b) lower incomes and higher unemployment arising from the COVID-19 crisis may make it more difficult for certain consumers, especially in lower income groups, to absorb tax and price increases – certainly now, and possibly permanently – which must be considered by fiscal policy makers in the coming months; and,

(c) the supply of illicit tobacco products and consumers acceptance of them may have changed in certain countries, which could make it more difficult to predict the effect of tax increases on the future growth – or not – of illicit cigarettes.[7]

This observation applies in its entirety to the South African context.

1.2 Excise Policy on Cigarettes

It's common cause that the consistent application of Government policy is an important tenet of good governance and legitimate regulation in a democratic society like ours. The foregoing also allows legal businesses to properly arrange their affairs, guided by Government policy statements. Notwithstanding, in the past four years, cigarette excise has been aggressively set outside Government's own cigarette excise policy parameters of: *the higher of 40% excise incidence on the MPPC or forecast inflation*, ("Excise Policy") as illustrated below[8].

Year	2018/19	2019/20	2020/21	2021/22
Inflation SARB	4%	4%	3.80%	4.20%
Excise incidence on MPPC	42.50%	43.30%	43.50%	45%
Excise increase	**8.50%**	**7.30%**	**4.40%**	**8%**

In the Budget Statement, the Honourable Minister of Finance acknowledged this as follows:

> "Taxes on alcohol and tobacco are guided by a policy framework ***that targets excise burden. [….] Excise duties have been increasing above inflation in the most recent years, resulting in higher tax incidence.*** Government will increase excise duties on alcohol [and tobacco] by 8 per cent for 2021/22. ***The excise incidence will further move above the guidelines for each category.*** [9]

It's important to note that the Excise Policy was communicated to all stakeholders including investors in the tobacco sector, thereby creating a legitimate expectation that Government will always abide by its own policy pronouncements. It is our respectful view that this clear disregard of the cigarette excise policy, violates Government's commitment to fair administrative treatment of investors, as provided under the Protection of Investment Act and the Constitution.[10] It has

[7] FTI Consulting "The Relationship between Price and the Price Elasticity of demand for Cigarettes- Revisiting the Evidence in the Wake of the COVID 19 Crisis", (2021)

[8] National Treasury uses Peter Stuyvesant as the anchor brand in the calculation of the MPPC- which we have used here. However, argue that due to changes in market dynamics the MPPC now sits at R22.

[9] 2021/22 *Budget Review Document* at 50. Emphasis added.

[10] Section 6(1) of the **Promotion of Investment Act 2015,** provides that "[T]he government must ensure administrative, legislative and judicial processes do not operate **in a manner that is arbitrary** or that denies

been stated that under the fair administrative treatment standard, Government is generally expected to implement changes to policies in good faith and in a manner that is not arbitrary, following due process. It is common cause that the Excise Policy is still in place and National Treasury only intends to review the policy during this current financial year. It is therefore improper for Government to openly ignore its own Excise Policy for four consecutive excise review periods.

2. PROPOSAL TO REVIEW THE CIGARETTE EXCISE POLICY

In the Budget Statement, the Minister advised of Government's intention to revise the cigarette excise policy with a view to increase the target excise incidence on the MPPC. The Minister explained that the main justification for the revision of the excise policy is to reduce consumption of cigarettes nationally.

Recent market studies plainly show that at least two out of every three cigarettes sold in South Africa are duty not paid cigarettes.[11] DNP cigarettes are sold for as little as R6 per 20s pack against an average price of R42 per 20s pack for legal cigarettes.

Against this background, it is clear that a review of the excise policy which will affect less than 36% of the true market will do little in terms of meeting Government's public health goal of reducing consumption. In fact, the inverse is exact in this case- an increase in excise, which only affects the legal market which is now 36% on the entire market, will further expand the gap between duty not paid cigarettes and duty paid cigarettes, further decreasing the size of the legal market.

The priority for Government at this juncture should be focused on putting in place an effective customs and excise administration and enforcement system for the tobacco industry. By SARS' own admission this will take a few years. It is our considered view that only after an effective excise collection system- which evidently collects full excise from all manufactures and importers has been put in place, should the existing excise policy can thereafter be relooked. It is common cause that in order for Government to achieve its objectives, it must follow these logical steps.

In our view, an effective customs and excise administration system for the tobacco industry must include the following aspects:

(a) the immediate enforcement of the SARS Productions Counter Rules by all local manufacturers. Production counters allow SARS to reconcile local production volume with excise payments and export declarations;

(b) end to end frequent and comprehensive audits of all manufacturers,

(c) stricter border control and enforcement;

(d) ratification of the WHO FCTC Illicit Trade Protocol and implementation of an independent track and trace system consistent with the FCTC Illicit Trade Protocol and Guidelines

(e) implementation and full enforcement of a Minimum Retail Sales Price of R28 for 20 sticks.

In the interim, we strongly urge Government to apply the existing cigarette excise policy, that is to say set future excise increases at the higher of the excise incidence of 40% on the MPPC or forecast inflation. The foregoing is in keeping with the rule of law, promotes regulatory certainty and allows the legal industry to recover volumes lost to the DNP market.

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administrative and procedural justice to investors in respect of their investments as provided for in the Constitution and applicable legislation" Section 33 of the constitution secure the right to administrative justice and fairness."

[11] Ipsos (note 3)

We trust that National Treasury will, at the appropriate time, subject future excise policy reviews to public hearing processes in terms of its customary practice and South African law. BATSA remains available to engage with the National Treasury and other stakeholders on such important matters.

3. OTHER REVENUE GENERATING MEASURES – PIPE TOBACCO PRODUCTS

In terms of toxicant continuum concept, pipe tobacco has an elevated toxicant profile compared to cigarettes. Ironically, the excise rate on pipe tobacco is only **21%** of the excise paid on factory manufactured cigarettes.[12] The excise incidence on the weighted average price of pipe tobacco is as little as 29% compared to an excise incidence of 45% on the MPPC of factory manufactured cigarettes. This explains why despite an excise increase of 8% on pipe tobacco in the 2021 Rates Bill, the pipe tobacco category, the popular price point in this category increased by more than 14%. Contrary to the National Treasury's position on this category, there is sufficient room to increase the price further according to the toxicant continuum argument without impacting sales in the significant way.[13]

It can also be argued that this favourable excise treatment of the pipe tobacco category amounts to unfair and discriminatory treatment of "like or similar" products, in violation of the national treatment principle -as enshrined in many treaties to which South Africa is party to. Clearly, this position poses a legal challenge for Government in the future.

The excise treatment of pipe tobacco relative to cigarettes, in Australia, Canada and New Zealand provides some instructive insights for South Africa. In these jurisdictions, excise on pipe tobacco is equal or more than the excise levied on factory manufactured cigarettes.

Accordingly, we recommend that excise on pipe tobacco under tariff item 104.35.02 and 104.35.03 in Schedule (Part 1) of the Customs & Excise Act, 1964 which currently sits at ZAR 250.22/kg, be increased to <u>at least</u> 75% of the excise rate of cigarette excise that is ZAR 880/kg. Government revenues are expected to grow by at least ZAR 1 billion per annum as a result of this change. The foregoing is in line with best practice and ensures equality and fairness in the tax treatment of tobacco products in South Africa.

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[12] Based on the concept of harm reduction, McNeill and Munafo "Reducing harm from tobacco use" *Journal of Psychopharmacy,* 27 (1) 13-18 introduced the idea of risk continuum of tobacco and nicotine products. Nicotine products are the less risky on the spectrum, that's why products such as nicotine replacement therapies are regulated differently.

[13] In National Treasury's response to the Parliamentary Standing Committee on Finance on 13 October 2020, *Draft Response Document on the 2020 Draft Rates and Monetary Amounts and Amendment of Revenue Laws Bill, 2020 Draft Taxation Laws Amendment Bill and 2020 Draft Tax Administration Laws Amendment Bill*, page 11, National Treasury stated that: "Response**: Not accepted.** The tobacco excise policy uses the targeted incidence guideline approach. It should be noted that although tobacco products in South Africa are taxed per weight and/or volume, they are not taxed at a uniform weight or volume. The reasons for the divergence in excise duty rates per category include the application of the benchmark guideline of 40% of the retail selling price of the most popular brand within each product category (i.e. excise tax incidence) and the disproportionate pricing of tobacco products concerned. Also, cigarettes make up a larger proportion of the tobacco market." This observation is incorrect – the excise rate on the pipe tobacco is only 29% of the MPPC (of the pipe tobacco products) versus 40% of that category. Granted that the volumes in this category are smaller than cigarettes – it is however the second largest category by volume in the total tobacco products category.

We kindly request participation and opportunity to present our submission to the Committee during the forthcoming virtual meeting with yourselves scheduled for 31 August 2021 to discuss these issues in greater detail.

We trust you will find the above in order.

For and on Behalf of **British American Tobacco South Africa**

Johnny Moloto
GENERAL MANAGER

- **ANNEXURE A –** IPSOS CIGARETTE RETAIL AND WHOLESALE PRICE RESEARCH (MARCH 2021)

- **ANNEXURE B –** FTI -PRICE AND PRICE ELASTICITY REPORT