Case Studies in Illicit Tobacco Trade: South Africa

Background

An often-heard argument from the tobacco industry is that an increase in the tobacco excise tax will stimulate illicit trade in cigarettes. The experience of South Africa, presented in this case study, does not support this argument.

South Africa was one of the first middle-income countries to use excise tax increases as a tobacco control tool. Between 1994 and 2004 the real (inflation-adjusted) excise tax increased at an average rate of 13% per year. The tax increases, together with large increases in the net-of-tax price, pushed up the real retail price by an average of 8% per year. Per capita consumption of cigarettes decreased at more than 5% per year, and smoking prevalence among adults fell from 31% to 24%. Between 1994 and 2004 real government revenue from tobacco taxes increased at an average rate of 9% per year. At the same time, there was no evidence that illicit trade was a real problem. See Figure 1.

Since 2010, however, there has been a partial reversal of those gains, in part because from 2010 to 2019, the real excise tax increased by less than 2% per year, but primarily due to an increase in illicit trade from an estimated 10% in 2010 to more than 30% in 2017. The rapid rise in illicit trade, especially since 2015, cannot be ascribed to the increases in the excise tax, but is closely associated with two factors: tobacco industry efforts to thwart taxation and enforcement measures; and large-scale corruption in many government institutions, including South Africa’s revenue authority.

The role of the tobacco industry

Historically, the cigarette market in South Africa was dominated by Rembrandt Tobacco Company (the South African subsidiary of Rothmans International), which merged with British American Tobacco in 1999. Since the early 1990s the multinational tobacco companies were increasing the real retail price of cigarettes by substantially more than the increase in the excise tax; this pricing strategy is called over-shifting the excise tax. See Figure 1. This pricing strategy was very profitable for the tobacco industry, because they were able to substantially increase revenue, despite selling fewer cigarettes.

In 2010 the cigarette market in South Africa changed fundamentally. The profits earned by the tobacco industry attracted small domestic producers to the market, which competed with the established multinationals on price. Many of these new entrants did not pay the required excise tax. They typically sold their product in the informal markets, where government oversight was limited. The resulting price war eroded the
pricing power of the established multinationals. It was also bad for public health, as large volumes of very cheap cigarettes flooded the market.

Instead of acknowledging that their desire for profits created this proliferation of new entrants, the tobacco multinationals typically blamed “high excise taxes” for the rapid increase in illicit trade. For example, the Tobacco Institute of Southern Africa (TISA), the industry alliance of the tobacco multinationals, created a narrative in 2006 which focused on the “fact” that illicit trade in South Africa was high and rising. Initially the industry claimed that 20% of the market was illicit, but by 2011 it had increased this estimate to 25% and by 2012 to 30%. There was no evidence to support these claims, but nevertheless the industry pushed the narrative strongly in the media. In order to sustain the narrative that the illicit trade problem was becoming worse each year, they would occasionally recalibrate historical “estimates” downward.

A 2012 working paper co-authored by a prominent pro-industry economist estimated that the illicit market could be as high as 50% of the total market. The methodology was fraudulently flawed. They estimated the illicit market as the difference between aggregate consumption, which was derived from a well-respected consumer survey and the tax-paid quantity of cigarettes. To obtain aggregate cigarette consumption, the authors subdivided the smoking population into light smokers (1-5 cigarettes a day), medium smokers (6-10 cigarettes a day) and heavy smokers (11 or more cigarettes a day), and assumed that they smoked an average of 3, 8, and 55 cigarettes a day, respectively. The 55 cigarettes smoked daily by heavy smokers was obtained as the average of 11 and 99, the highest number that respondents could enter on the questionnaire. The latter assumption, hidden in a footnote, drove the whole analysis. There was no reason to make this assumption, as respondents were asked how...
many cigarettes they smoked daily, and these numbers were available to the researchers. Despite the obvious flaw in the study, the industry used this study to confuse government officials about the size of the illicit market and to make their own estimate of 25-30% look reasonable.

In 2011 TISA created the Illicit Tobacco Task Team. The Task Team comprised of officials of the South African Police Service Crime Intelligence and the Detective branch, the Directorate of Priority Crime Investigations, and the State Security Agency. The ostensible aim of this group was to partner the “legal” tobacco industry with government law enforcement agencies to curb illicit trade. Importantly, the South African Revenue Service (SARS) was not a member of the Task Team. It turns out that TISA used the Task Team primarily as a tool to harass their competitors and to harass and side-line SARS. The Illicit Tobacco Task Team quietly closed down at the end of 2014 following various revelations of their tactics and of their officials being implicated in questionable conduct.

Institutional challenges at the South African Revenue Service (SARS)

After the democratic transition in 1994, SARS transformed itself into a world-class revenue collection service and set up specialised units, whose primary aim was to target tax evaders. Even before 2010, SARS shut down some tobacco companies on account of tax evasion. The spike in illicit trade in 2010 made the issue even more urgent. In 2013 SARS launched Project Honey Badger, a codename for a multi-pronged collaboration of a number of specialised units in SARS, focusing on the illicit trade in tobacco. Before long, a number of tobacco companies were being investigated for tax evasion and fraud. However, before these tobacco companies could be prosecuted, developments in the country and SARS torpedoed these investigations. Project Honey Badger often ran into conflict with the Illicit Tobacco Task Team, when the SARS team exposed some of their and TISA members’ private security agents’ involvement in illegal conduct. In response, the Illicit Tobacco Task Team attempted to discredit SARS officials. In some cases they succeeded.

The Zuma presidency (2009 - 2018) was characterised by large-scale corruption. Many state institutions were compromised when people loyal to President Zuma were appointed to strategic positions. They ensured that the President and his inner circle could loot government coffers without fear of prosecution.

In September 2014 the president appointed Tom Moyane as the commissioner of SARS. The president needed a loyal supporter to head SARS, to protect him and his associates from investigations into their tax affairs. Within a few months of taking office, acting on what proved to be false newspaper reports, Moyane fired the senior management team, shut down most of the specialised investigative units, suspended large numbers of employees, and many more resigned as a result. Project Honey Badger also ended abruptly.

In 2015 Moyane closed the Large Business Centre, which had been instrumental in ensuring better tax compliance by large businesses and wealthy individuals. While tax evasion became widespread across economic sectors post-2015, it was particularly acute in the cigarette industry. Moyane even ordered the SARS monitors at the various tobacco factories to be withdrawn and terminated the weekly inspections. Real excise tax revenue fell by 22% and legal consumption fell by 27% between 2015 and 2018, and the illicit market increased from 17% in 2014 to more than 30% in 2017.

A new dawn?

In February 2018 Cyril Ramaphosa succeeded Jacob Zuma as South Africa’s president. He suspended Moyane in March 2018 and appointed Judge Robert Nugent to investigate the governance and management failures at SARS. The Nugent Commission was particularly scathing about the tobacco industry and how they had actively undermined SARS investigators to do their work. The Commission concluded that the Illicit Tobacco Task Team was found to
“never to have investigated the illicit tobacco trade, but investigated instead investigators of the trade”. Nugent recommended that Moyane be fired, which happened in November 2018.

Since 2017 several books, newspaper articles and judicial commissions have exposed the depth of corruption that ravaged the country under the Zuma presidency. The spotlight has regularly fallen on the tobacco industry, exposing inappropriate or dubious relationships with well-connected political leaders or their family members.

In June 2019 SARS issued a comprehensive call for tenders to implement a Track and Trace system for tobacco products. The aim of a Track and Trace system is to allow an independent party (in South Africa’s case, SARS or a delegated authority) to hold the manufacturer accountable regarding the movements of its products. The tracking function is aimed at ensuring that the product reaches its intended destination and is not diverted (possibly into the illicit market) along the distribution chain. The tracing function allows a person to retrospectively trace the route from its current location, back to the point of manufacture. The call document indicated that bidders may not have any direct or indirect interest in the tobacco industry. For undisclosed reasons, the deadline for the tender has been extended a number of times. Once the Track and Trace system is fully implemented, it is expected to substantially reduce some of the most egregious forms of illicit trade.

Lessons learned

1. The growth in illicit trade in South Africa is not explained by an increase in the excise tax. Between 2010 and 2018, when illicit trade grew very rapidly, the excise tax increased by less than 2% per year in real terms. In contrast, in the previous 16 years, the excise tax increased by 10% per year in real terms, while the illicit market remained at insignificant levels.

2. An effective tax administration is crucial in ensuring that the taxes are collected. If the tax revenue authority is undermined or compromised, the tobacco industry can do as they please.

3. The multinational tobacco companies positioned themselves as the victims of illicit trade and successfully created a partnership with government law enforcement agencies to “fight illicit trade”. They used this partnership to fight the local competitors and to deflect attention from their own wrongdoing.

References


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