

TISA ILLICIT TOBACCO TRADE FACT SHEET / POSITION PAPER (2019)

Illicit Tobacco Trade in South Africa

Cigarettes are one of the world's biggest illicitly traded consumer products. This is due to the high profit / low risk nature of the illicit trade. The World Health Organisation (WHO) has estimated that approximately 600 billion counterfeit and contraband cigarettes are sold annually, accounting for more than 10% of global cigarette sales.

South Africa suffers from one of the highest illicit tobacco rates globally. In 2018, the country became the first in the world in which an illicit brand became the most sold variant in the market.

In 2018 the internationally renowned research house, IPSOS, released the findings of a comprehensive survey and measurement of the illicit tobacco economy in South Africa. The Ipsos study is the most robust scientific analysis of the multi-billion-rand illegal cigarette market ever carried out in South Africa. It has been peer-reviewed and independently validated. The latest Ipsos results, published on 27 November 2018, show that:

- Illegal cigarettes selling at an average price of R10 and as little as R5 per pack are available for sale in more than 100,000 shops all across South Africa. Individual sticks are selling at an average of 50 cents a stick and growing market share. These prices are well below the minimum collectable tax (MCT – 2018/2019 tax year) of R17.85 per pack of 20 owed to SARS.
- National sales of illicit cigarettes constitute 33.1% of the entire market and growing rapidly.
- Nationally, sales of illicit cigarettes in the informal sector constitute 42% of the market.
- The report also found that just one manufacturer's products, Gold Leaf Tobacco Company (GLTC), account for 73% of the illegal cigarette trade in the country. This is despite GLTC's cigarettes being made in a local factory officially registered by SARS.

Under-declaration and tax evasion is the biggest problem

The vast majority of illegal cigarettes sold in South Africa can be classified as tax-evaded or 'Duty Not Paid' because these products are sold well below the minimum collectible tax that is calculated as follows:

- While most of these products comply with legal packaging requirements (i.e. carry health warning and other requirements), they are sold at a price below R19.16 (The excise duty alone on a pack of 20s is R16.66 for the 2019/20 tax year. If 15% VAT of R2.50 is added onto the excise duty of R16.66, the minimum collectable tax or 'MCT' = R19.16).

Any product sold on the market priced below R19.16 should, therefore, be deemed illicit and prompt further investigation. Indeed, it could be alleged that such product is the result

of rogue legal manufacturers failing to properly declare their production volumes (and thus tax payments) to government.

Source of illegal tobacco

Historically, illicit, non-duty paid cigarettes were smuggled over land and sea into SA from various countries i.e. Dubai, China, Botswana, Swaziland, Lesotho, Namibia and Zimbabwe. While sporadic entry of product from foreign countries still occurs, the vast majority of illicit cigarettes today are produced by a number of manufacturers registered with SARS within the borders of South Africa.

The impact of illegal tobacco

In terms of impact on the fiscus, more than R32 billion in tax revenue has been lost to the illicit cigarette trade between 2010 and 2017. This conservative loss is purely based on excise and VAT and does not take into consideration any associated taxes payable, such as company or personal taxes that could have also been evaded. In 2018 alone, it is estimated that at least a further R8 billion was lost to the fiscus due to tobacco tax evasion, which could have been used to fund much-needed infrastructure and services in South Africa.

Jobs and the legal tobacco value chain are negatively impacted

Legal cigarettes are manufactured using local and imported tobacco leaf, for consumption in South Africa and for export to 22 other markets within Africa and the Middle East. Legal cigarettes are also imported as finished product from other countries using various sources of tobacco leaf.

Tobacco plants are grown, harvested and cured by farmers, the leaf is then processed by a green leaf threshing factory, packed according to specification and sold to tobacco product manufacturers. Tobacco manufacturers then manufacture cut rag and cigarettes and distribute the finished product to wholesalers, retailers and for export.

Farming

Flue-cured, dark-air cured and sun-cured Virginia tobaccos are produced in South Africa. Tobacco is produced in the Eastern Cape, Limpopo, Mpumalanga, the North-West Province and the Western Cape. There are currently some 180 commercial tobacco farmers in South Africa, whom cumulatively produce over 15 000 tons of tobacco leaf in South Africa. These farmers support 8 000 to 10 000 farm workers on their farms. It is estimated that these farm workers sustain the livelihoods of some 32 000 – 35 000 dependants; many of these families rely solely on wage income from working on tobacco farms.

The tobacco farming value chain includes a further 155 emerging tobacco farmers who produce tobacco and food crops in deep rural areas in South Africa, supporting their families and communities.

Tobacco Processing

Limpopo Tobacco Processors (LTP) is the only tobacco processor in South Africa and it is based in the North West Province. LTP employs 70 permanent staff and 320 seasonal staff.

Illicit trade has resulted in a decline in tobacco leaf demand, LTP has seen a 15% order reduction for the 2017 to 2019 crop years.

The negative impact of illicit trade on the tobacco value chain, especially those which are semi-skilled and that are based in rural areas where employment opportunities are scarce, is of serious concern.

Employment in the tobacco sector

From a transformation perspective, over 80% of individuals employed by the legal tobacco sector were previously disadvantaged individuals, of which 65% are African. Of all legal tobacco players, previously disadvantaged individuals constitute:

- 98% of informal workers;
- 95% of semi- and unskilled workers;
- 79% of skilled workers; and
- 44% of highly skilled workers.

The legal tobacco players have therefore a critical role in providing sustainable work conditions to this part of the labour force.

Funds organised crime

According to Interpol findings¹, illicit trade funds organised crime: Serious organised crime groups are at the epicentre of the illicit tobacco trade. Proceeds from illicit tobacco are used to fund drug smuggling, human trafficking and other serious crimes, blighting the safety of local communities in South Africa and supporting regional organised crime networks.

Undermines the government's health agenda

- Increases in youth access: Illicit cigarettes are more affordable and therefore accessible to those under the age of 18, undermining public health objectives.
- Almost all of illicit cigarettes are available in the market for well below the MCT, which severely compromises the government's health agenda to reduce consumption through excise driven price increases.
- The government's health agenda is further compromised where products do not comply with regulatory requirements, for example, the products exceeding the maximum tar and nicotine levels and non-compliance with Reduced Ignition Propensity regulations.

¹ Against Organised Crime: Interpol Trafficking and Counterfeiting Casebook 2014, pages 30 to 42

Robust law enforcement and tougher penalties are key to tackling illicit trade

Success in combating illicit tobacco trade requires a comprehensive approach by the private and public sectors in order to tackle both supply and demand. Such an approach should include measures that address policy, enforcement, cross-border intelligence sharing, research, technology for volume verification and tracking/tracing, public awareness, as well as avoidance of extreme tobacco regulations.

The manufacture and distribution of illegal tobacco can be addressed through the following measures:

- **Digital volume verification:** It is proposed that a digital tax verification code is applied to cigarette packs, that would enable government to verify where and when the cigarette pack was made (production volumes) and if the correct excise has been paid to the government. Only government-approved manufacturers and their licensed equipment can generate and apply codes and manufacture legal products. In addition, the tax verification code has the ability to be verified via SMS or by scanning the code with an appropriate mobile phone App. This would allow law enforcement agencies an immediate verification and the lack of the code would immediately identify the product as illegal.

The above is in stark contrast to the current system, whereby SARS issues the diamond excise stamp to registered manufacturers to print / emboss on cigarette packs locally and also abroad in relation to cigarette imports into South Africa. The system has been in place since the 1970's. SARS has little control over the use and abuse of the diamond stamp impression; it is easily counterfeitable and there is no way to verify whether the necessary taxes have been paid on a pack of cigarettes on the basis that it is carrying the stamp impression.

The DTV technology should also have the capability of authenticating products to detect counterfeiting and ensuring brands belong to their rightful owners.

- The introduction of an effective Track and Trace system provided it addresses the realities of illicit trade in the SA market and that a reasonable time frame is afforded for implementation. In the short term, given that most illicit cigarettes sales in SA currently are locally manufactured, duty-not-paid cigarettes, digital volume verification is the most effective and most urgent measure to implement.
- Introduction of adequate supply chain control measures by the suppliers of key inputs used to manufacture tobacco products, including tobacco leaf, cut rag, cigarette paper and filter tow.
- Robust and sustained investigations and prosecutions of instances where tobacco products are sold below the Minimum Collectable Tax level (i.e. below R19.16) – seizure of criminal assets after prosecution being an essential ingredient.

- Improved co-operation and information sharing between government departments and agencies involved with investigations into the illicit tobacco trade, including by introducing and/or strengthening administrative and criminal penalties on illegal manufacturers, importers and distributors.
- Regular engagement with legitimate manufacturers to share best practice about how to address threats related to national and international flows of illegal tobacco products. Public /Private Partnerships are widely recognised as best practice.
- The legitimate tobacco industry is part of the solution not the problem.

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