Submission to

The Framework Convention on Tobacco Control

Submitted by

The Economics of Tobacco Control in South Africa Project

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Background

(a) The scope of activities or mandate of the organization
The Economics of Tobacco Control in South Africa (ETCSA) Project was initiated in 1996 to investigate the economic, as opposed to the epidemiological or social, impacts of tobacco use and tobacco control. The Project aims to provide policymakers with information regarding the likely impact of tobacco control policies on aspects such as tobacco consumption, excise taxes, retail prices, government revenue, employment and smuggling.

(b) Funding
Phase I of the project was completed in 1998. It was funded by the International Tobacco Initiative (ITI), the predecessor to Research for International Tobacco Control (RITC), an international secretariat housed at the International Development Research Centre (IDRC), Ottawa, Canada. Phase II was initiated in March 2000 and aims to build on the analysis of Phase I. The project is funded by RITC and the World Bank and is housed in the Applied Fiscal Research Centre of the University of Cape Town.

(c) The organization’s interest in the FCTC process
The presentation presented here draws on the conclusions from both phases of the ETCSA project. The aim of the submission is to highlight some of the main findings and to indicate the relevance thereof to other developing countries. Given that South Africa has some experience of implementing a tobacco control policy, it is hoped that the lessons learned will be of interest to other developing countries.

The economics of tobacco control in South Africa

(a) Introduction
The public health impact of tobacco consumption is well known: tobacco kills one in two of its regular users; worldwide, the annual number of tobacco-related deaths is expected to increase from between 3 and 4 million in 1998 to 10 million in 2030; 500 million smokers currently alive are expected to die from a tobacco-related disease.

South Africa is not immune to the scourge of tobacco. It is estimated that tobacco-related disease causes 25 000 deaths in this country annually. Given that the country is a middle-income country with a high degree of income inequality, poverty is widespread. Smoking is particularly prevalent amongst the lower income groups. Their addiction forces them to spend a large proportion of their money on tobacco products, rather than on other necessities.

It is estimated that up to 75 per cent of adult smokers in South Africa regret that they ever started smoking. Despite the industry’s arguments that it does not target children in its advertising, the fact is that most smokers started smoking while in their teens or early twenties.

(b) Tobacco control in South Africa
Until the early 1990s South Africa did not have any tobacco control policies in place. Despite strong lobbying for tobacco control measures by the health sector, the government did not respond to their pleas. Since 1970 the real price of cigarettes had been allowed to decrease by more than 40 per cent, mainly as the result of a 70 per cent decrease in the real excise rate, resulting in significantly increased per capita cigarette consumption.

The first steps towards a tobacco control policy were taken in 1993 when the Tobacco Products Control Act was passed. This Act introduced warning messages on cigarette packs and advertising material, and prohibited smoking on public transport.
The first democratically elected government took office in 1994, and had a much stronger public health focus than its predecessor. As a result, the public health consequences of tobacco were placed in the spotlight. Based on public health reasons, the Minister of Finance announced in 1994 that the government intended to raise the excise tax on cigarettes from the existing level of 20 per cent to 50 per cent of the retail price. This increase has been phased in over a number of years.

After much wrangling with the industry, the Tobacco Products Control Amendment Act was passed in 1999. The main elements of this legislation are:

- to prohibit smoking in the workplace and public places;
- to prohibit tobacco advertising and the promotion of tobacco products through sponsored events;
- to ensure that all tobacco products be sold in packages and to ensure that nobody under the age of 16 buys tobacco products;
- to prohibit the free distribution of tobacco products; and
- to reduce the maximum yields of tar, nicotine and other constituents in cigarettes.

Once the regulations to the Act are promulgated, South Africa’s tobacco control policies will be comparable to those of most developed countries.

The following lessons can be drawn from the South African experience:

1. If the government has the political will to implement a comprehensive tobacco control policy, this can be done in a relatively short period of time. Although circumstances in developing countries differ from those in developed countries, developing countries are in the fortunate position that they do not have to learn through trial and error, but can draw from the tobacco control experience of numerous developed and a number of developing countries.

2. In South Africa the political will originated in the Ministry of Health. A strong minister, backed by numerous anti-smoking groups from various disciplines, is necessary to overcome the opposition of the industry and related groups.

3. Although not a precondition, a change of government creates an ideal opportunity to implement a tobacco control policy, since the new government has a “clean slate” and is not bound by the policies of the previous government.

4. The industry will oppose tobacco control legislation. South African legislation was decried as “the most draconian in the world”. This is meaningless rhetoric; South Africa’s tobacco control legislation is no more severe than that of countries like Australia, Canada, Singapore and Thailand. The industry made other invalid claims to argue against stronger tobacco control. Industry arguments need to be weighted against the facts.

(c) Prices and consumption

In South Africa, as in all countries, tobacco consumption is price sensitive. The average price elasticity of demand is estimated at between –0.6 and –0.8. The 60 per cent increase in per capita cigarette consumption between 1970 and 1991 is explained largely by a 40 per cent decrease in the real price. During this period the excise tax decreased from 50 per cent to 20 per cent of the retail price, because the increases in the excise tax did not keep pace with the inflation rate.

Since 1991 the real retail price of cigarettes started increasing. Initially this was caused by increases in the producer (i.e. the net-of-tax) price, but since 1994 they were driven mainly by real excise increases. The cigarette manufacturing industry’s reaction to the excise increases is interesting. Whereas traditional economic theory suggests that the industry would reduce the real producer price, or, in the extreme, keep it constant, the industry, in an attempt to maintain its profitability, used the excise increases as an opportunity to increase the producer price. Thus the real retail price increased by more than the increase in the real excise rate.
Between 1994 and 1999 the real excise rate increased by 160 per cent and the real retail price doubled. Despite income-induced increases in the demand for cigarettes – the income elasticity is estimated at about 1.0 - aggregate cigarette consumption decreased by more than 20 per cent during this period.

Further lessons which can be drawn from the South African experience, are the following:

5. *If the excise tax is a specific tax (i.e. levied as an amount per 10 or 20 cigarettes), the tax has to be adjusted regularly in order to prevent it from being eroded by inflation.*

6. *Increases in the real price of cigarettes have an immediate and measurable impact on cigarette consumption. In South Africa a 10 per cent increase in real cigarette prices reduces consumption by between 6 and 8 per cent.*

7. *In order to protect their profit margins, the cigarette manufacturing industry is tempted to increase the real retail price of tobacco products by more than the increase in the real excise tax. Thus an increase in excise taxes has a “multiplier effect” on the retail price, which, in turn, has beneficial tobacco control consequences.*

(d) **Excise tax and government revenue**

Tobacco excise taxes currently comprise about 1.5 per cent of total government revenue, down from 4.4 per cent in 1970 and 2.4 per cent in 1980, but more than the 1.1 per cent in 1990.

As a result of the large decreases in the real excise tax during the 1970s and 1980s, real government revenue from cigarette excise tax decreased by 45 per cent between the mid-1970s and 1990. The fact that the real excise rate was allowed to decrease in the way it did suggests that the government accepted the industry’s argument that increases in the real excise rate would reduce tobacco consumption to such an extent that government revenue would decline.

The falsity of the industry’s argument is vividly borne out by subsequent events. Between 1993 and 1999 the real excise tax increased by 160 per cent, while government revenue more than doubled. On average, each 10 per cent increase in the excise tax increased government revenue by 6.4 per cent during this period.

When it became clear that excise-induced price increases did not decrease cigarette consumption to the extent that government revenue would fall, the industry subsequently used the threat of increased smuggling as a rationale for decreasing, or at least not increasing, the real excise tax on cigarettes. While accurate data on smuggling are, by their nature, extremely difficult to obtain, it seems improbable that cigarette smuggling is out of control, as has been argued by the industry. Smuggling is estimated to have increased from about 2 per cent of sales to no more than 7 per cent. The greatest part of the past six years’ decrease in official sales is a result of the large price increases, not smuggling.

The following lessons can be drawn from the South African experience:

8. *An increase in the real excise rate increases real government revenue, given that the demand for tobacco products is relatively price elastic.*

9. *The industry will typically argue that an increase in the real excise rate will either (1) reduce consumption to the extent that total government revenue will fall, or (2) increase smuggling to the extent that government revenue from official sales will fall. The first argument, given cigarettes’ relatively inelastic demand and comparatively low price in developing countries, is spurious. The second argument may have more substance, but smuggling and corruption would have to be very rife for a tax increase to reduce government revenue. Furthermore, as has been pointed out by other studies, smuggling is not curtailed by reducing the excise taxes, but rather by better enforcement.*

(e) **Employment effects**

A typical comment by the tobacco industry is that despite the detrimental public health consequences, tobacco is good for the economic health of the country, in that it is a major provider of employment and a source of government revenue.
According to the now-defunct Tobacco Board about 34 500 people were employed in the tobacco industry in South Africa in 1996. Since the industry has an incentive to overstate its employment role, this figure should at best be interpreted as an upper limit. Since 1996 employment in the tobacco industry has decreased as a result of (1) decreased local demand, and (2) a move towards more capital intensive, rather than labour intensive production processes. This suggests that the tobacco industry currently employs less than 0.3 per cent of the economically active population of South Africa.

The industry’s misleading claim that tobacco control policies will destroy many jobs is usually made within a partial context. If the industry were to disappear overnight, people would direct their expenditures to other goods and services. The increased demand for these other goods and services would stimulate the demand for labour in these sectors, and compensate for tobacco-related job losses. Depending on the relative labour intensity of tobacco and other sectors, there could easily be net job gains if tobacco consumption falls. Using a social accounting (input-output) matrix, it is possible to determine the likely employment implications of expenditure switching. Using this approach, the analysis shows that, if people in South Africa were to switch their expenditures from tobacco to the typical “basket” of non-tobacco goods and services, total employment would increase substantially.

However, despite the fact that a reduction in tobacco use has beneficial economic consequences, in that more employment opportunities are created in other sectors, there are detrimental political consequences. Many of the tobacco-sector job losses are identifiable, while the larger number of new non-tobacco jobs, spread throughout the economy, are not so readily identified and thus not ascribed to the employment generating impact of smokers switching their expenditure to other goods and services.

The following lessons can be drawn from the South African experience:

10. The employment potential of the tobacco growing and cigarette manufacturing industries is not large in countries that are either self-sufficient or net importers of tobacco.

11. Should tobacco consumption decrease, people will spend their money on other goods and services, which, in turn, will stimulate employment in these industries. Using input-output matrices it has been shown that total employment in South Africa will increase if people switch their expenditure from tobacco products to alternative goods and services.

(f) Smuggling in Southern Africa

Compared to other developing, and even some developed countries, cigarette smuggling in South Africa is not rampant; the contraband market share is estimated at between 5 and 7 per cent.

As is the case in other countries, there is some evidence suggesting industry involvement in cigarette smuggling in Southern Africa. In a 1997 court case, South African based Rembrandt and US-based Philip Morris accused each other of promoting cigarette smuggling in South Africa.

As pointed out previously, the industry tries to use the smuggling argument to dissuade the government from increasing the excise tax. Evidence from South Africa indicates that cigarette consumption did not decrease by more than expected, given the large excise and retail price increases of the past six years. The ETCSA Project is of the opinion that the tax increases have not had a significant impact on smuggling.

The following lessons can be drawn from the South African experience:

12. The industry will argue that an excise increase will result in increased cigarette smuggling. In South Africa the evidence does not support this argument. Policymakers should not be unnecessarily intimidated by such threats. However, despite the fact that the smuggling threat should not be over-emphasised, countries should be vigilant against unlawful activities.

13. There is growing evidence, from South Africa and elsewhere, that the industry is involved in cigarette smuggling.