

Southern Africa Labour and Development Research Unit



Are the tobacco industry's claims about illicit trade
credible? The case of South Africa

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Are the tobacco industry's claims about illicit trade credible? The case of South Africa

Corné van Walbeek and Lerato Shai

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Abstract

Background The tobacco industry claims that illicit cigarette trade in South Africa is high and rising. This is often used as an argument not to increase the tobacco excise tax.

Objectives To determine how the industry's estimates of the size of the illicit market have changed over time.

Methods Published media articles on illicit trade were obtained from South African Press Cuttings, and published and unpublished articles and statements were sourced from the internet.

Results 419 relevant articles and media statements were found. Of these, 80 emphasised the industry's perspective, 40 emanated primarily from the tobacco control community, and 299 reported on action taken against illicit activity.

For each for the years between 2006 and early 2011, the Tobacco Institute of Southern Africa reported that South Africa's illicit market share was 20%, increasing to 25% in late 2011 and to 30% in 2012. In a 2012 presentation to Treasury the illicit market share in 2008 was shown as 7.9%, compared to claims in 2008 that the illicit market share was 20%. There was a large spike in reported seizures of illicit cigarettes in 2010 and 2011, but a 60% decrease in 2012.

Conclusions The tobacco industry has adjusted previous estimates of the illicit trade share downwards in order to create the impression that illicit trade is high and rising. If previous estimates by the tobacco industry were incorrect by their own admission, the credibility of current estimates should be questioned, especially by government officials.

Keywords: Illicit trade, cigarettes, South Africa, industry rhetoric
JEL-Classification: H26

What this paper adds:

The threat of an increase in the illicit trade of cigarettes is often used by the tobacco industry as an argument against an increase in the excise tax by the government. The tobacco industry has an incentive to exaggerate the size of the illicit market. This paper considers the industry's estimates of the illicit market, as published in the media, in a country that has experienced large excise tax increases over the past 20 years. The industry has adjusted previous estimates downwards in order to create the impression that the current illicit market is not only large, but has been growing rapidly. Policy makers should be aware of this tactic and should not believe the industry's estimates, because it is in the industry's interest to deceive.

INTRODUCTION

Cigarette consumption in South Africa has fallen sharply since the early 1990s as a result of a deliberate tobacco control policy based on, amongst other things, large increases in the excise tax. The international literature indicates that increasing the excise tax is the single most effective tobacco control measure.¹ Since 1993 the real (i.e. inflation-adjusted) excise tax on cigarettes increased by nearly 500% per pack. This increase, together with substantial increases in the real net-of-tax price, resulted in a tripling in the real retail price of cigarettes over the past 20 years.

Not surprisingly, the South African tobacco industry strongly opposed the tax increases, arguing that increased taxes would encourage cigarette smuggling and other illicit activity, with detrimental consequences (e.g. revenue loss and fuelling of organised crime). This line of argument is common throughout the world.^{2 3} While the tobacco industry acknowledges that the solution to illicit trade is multi-faceted, high and increasing excise taxes are held to be the catalyst of the illicit trade problem. From the industry's perspective the solution is clear: reduce, or, at the minimum, do not increase the excise tax on tobacco products.

This paper aims to investigate and evaluate the claims of the industry concerning the size of the illicit trade market in South Africa. We conclude that there are substantial anomalies in their estimates. The industry has revised their historical estimates of the illicit market downwards, admitting that their previous estimates were incorrect. This type of reasoning casts doubt on the credibility of the current estimates of the illicit market. If the tobacco industry's historic estimates of the size of the illicit market were wrong, why would the current estimates be credible?

METHOD

Data was obtained from a variety of sources: (1) South African Press Cuttings, (2) online newspaper articles, (3) online press releases by British American Tobacco South Africa (BATSA) and the Tobacco Institute of Southern Africa (TISA), and (4) presentations to the authors and the Treasury by BATSA and TISA.

South African Press Cuttings is a media monitoring company that provides press cuttings to clients. The National Council Against Smoking (NCAS) subscribes to all press cuttings (newspaper and magazine articles) on smoking and tobacco. We performed a manual review of articles published between 1990 and 2011, using the key words "cigarettes" or "tobacco" and "tax" or "illicit trade" or "smuggling".

We performed an internet search of online South African newspaper articles for the period 2010 to 2012. The key words were "cigarette", "tobacco", "tax", "counterfeit cigarettes", "smuggling", "illegal trade", "illicit", "TISA", "BAT" and "fake cigarettes".

Ignoring duplicate newspaper articles, a total of 419 articles were found. These were subsequently divided into three main categories: (1) those that emphasised the tobacco industry's perspective and their estimates of illicit trade (n=80), (2) those that emanated from the tobacco control community, especially the NCAS (n=40) and (3) those that reported on action taken against tobacco smugglers and other illicit traders (e.g. arrests, confiscations, trials and verdicts) (n=299).

A search of TISA's and BATSA's websites (www.tobaccosa.co.za and www.batsa.co.za) for media statements released between January 2011 and February 2013 yielded 28 media statements which mentioned the illicit tobacco market. Of these, 11 were published and thus covered above, while 17 were not published. BATSA has also launched a website that informs the public about illegal

cigarettes, e.g. how to identify illegal cigarettes, “facts” about illegal cigarettes, a radio campaign and a database of media articles pertaining to illegal cigarettes (www.stopillegalcigarettes.co.za).

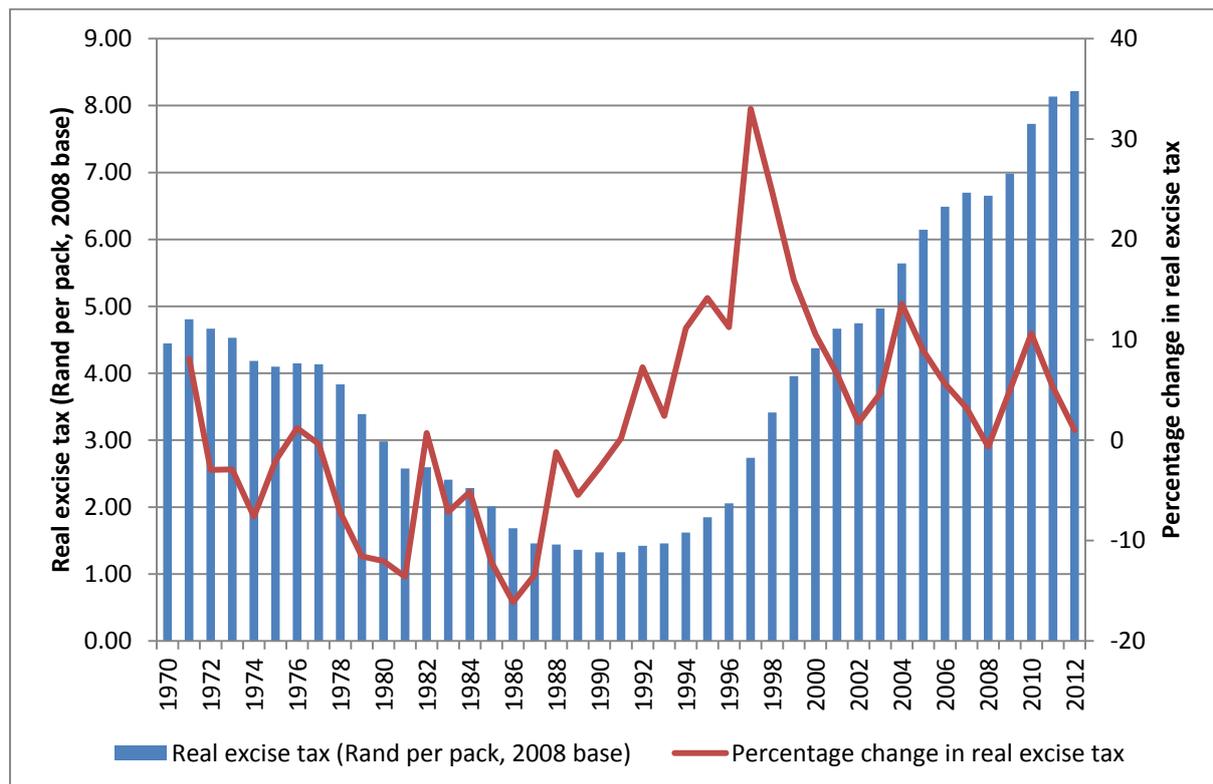
References to monetary amounts are in South African rand. Where relevant, they are converted to US currency at the average exchange rate of the year in question.

RESULTS

Between 1990 and 1993 there were no reports in local newspapers about the illicit trade in cigarettes in South Africa. There was no strong incentive to smuggle cigarettes. Real (i.e. inflation-adjusted) excise taxes were low, having decreased by more than 70% between 1970 and 1990 (figure 1). Real cigarette prices were at historical lows in the early 1990s (Van Walbeek, 2005). Modest increases in the real excise tax in 1992 and 1993 did not spawn media reports linking this excise tax increase to increased illicit activity.

In May 1994 the first democratically elected government came to power, and in June 1994 the government announced that it intended to raise the excise tax from 20% of the retail price to 50%, to be phased in over a number of years. The industry voiced its disappointment, warning that excise tax increases would result in increased smuggling and other illicit activities.⁴

Figure 1: Real excise tax on cigarettes in South Africa, 1970 to 2013



Source: National Treasury Budget Review⁵ and South African Reserve Bank⁶

The excise tax in South Africa (levied as a specific tax) was increased in each year after 1994. Other than in 2008, all excise tax increases exceeded the inflation rate and, in the 1990s, substantially so. The press published the tobacco industry’s reaction to the excise tax increases in 16 of the 19 years after 1994. The tobacco industry lamented the increase in 13 of these 16 years. The most common argument used against the excise tax increase was that it would lead to more illicit trade (n=14). The

industry also raised the following arguments: an increase in the excise tax may decrease government revenue (n=4); lead to a loss of jobs in the industry (n=2); is unfair to a legal product (n=2); and may not result in a decrease in consumption (n=1).

In five of the six previous years (2007-2012) the real excise tax increase was below 5% and the modest increase was generally welcomed by the tobacco industry as “reasonable”. For example, in 2009 the industry commented that *“the response by government in not increasing the rate shows their continued commitment in addressing the on-going problem of illicit trade in tobacco products”*.⁷

(a) Estimates of the illicit cigarette market by the tobacco industry

Between 1994 and 2002 the tobacco industry regularly alleged that the excise tax increase would increase illicit trade, but they did not publish any estimates of the illicit market. The first estimate was published in 2003. In an article in *Sunday World*, BATSA was quoted as saying that counterfeit cigarettes comprised “much less” than 1% of the total market.⁸ Counterfeit is only one aspect of illicit trade. In 2004, BATSA estimated the illicit market at between 5% and 15% of the total market.⁹

The Tobacco Institute of Southern Africa (TISA), founded in 1991, claims to represent the common interests of the entire South African tobacco industry. Amongst others, its members include producer organisations, tobacco traders, non-cigarette tobacco manufacturers and local subsidiaries of three multinational cigarette producers (BAT, Japan Tobacco and Phillip Morris). TISA’s claim of representing the whole industry has recently been challenged by Fair-trade Independent Tobacco Association (FITA). FITA was founded in 2012 and represents the interests of eight small-scale manufacturers, who are trying to gain market share from the incumbents, primarily through very low pricing.

In 2006, TISA was restructured and made illicit trade its primary public relations focus.¹⁰ According to its website *“TISA has identified the escalation of illicit trade as the single biggest threat to the sustainability of the legal tobacco industry, eroding the market share of legitimate players and government revenue alike”*. Initially the focus was on smuggling only but subsequently the focus shifted to other kinds of illicit activity as well, e.g. counterfeit, illegal manufacturing and ghost exports (i.e. where cigarettes are declared for export, corrupt officials are bribed to stamp the documents to show that they were exported, and the cigarettes are sold in the local market).

Table 1 summarises media reports on the size of the illicit market, ascribed to either TISA or BATSA. The press typically reported the illicit market size in one or more of the following ways: (1) the percentage market share of illicit cigarettes, (2) the number of illicit cigarettes smoked per day or per annum and/or (3) the annual loss of tax revenue. To avoid distortions caused by misrepresented or misquoted numbers, median, rather than average numbers are presented in Table 1.

Table 1: Summary of estimates of the illicit cigarette market by the tobacco industry

Year	Millions of illegal cigarettes sold per day (median)	% market share of illegal cigarettes (median; range in parentheses)	Forgone tax revenues by government (median)	Number of TISA references	Number of BATSA references
2004		10 (5 – 15)		0	1
2006	2.5	20 (15 - 20)		5	0
2007	10	20 (20 - 20)	R1.4 bill. (\$200 mill.)	2	0
2008	10	20 (20 - 20)	R1.95 bill. (\$236 mill.)	3	0
2009	10	20 (20 - 20)	R2 bill. (\$237 mill.)	1	1
2010	15	22.5 (20 - 25)	R2 bill. (\$273 mill.)	3	3
2011	15	22.5 (20 - 25)	R2.75 bill. (\$379 mill.)	15	1
2012	19	25 (20 - 30)	R4 bill. (\$487 mill.)	10	3

Note: No media reports on illicit cigarette trade were published in 2005

In 2006, and for five subsequent years, TISA claimed that the illicit market was 20% of the total cigarette market, having grown from almost zero in the late 1990s. During the course of 2011 TISA claimed that the illicit market share had increased to 25% in 2011, and in late 2012 it claimed that it had increased to 30% in 2012. BATSA’s estimates were very similar, if not identical, to those of TISA.

Between 2007 and 2009 BATSA and TISA indicated that 10 million illegal cigarettes were sold every day. This number was increased to 15 million cigarettes per day in 2010 and 19 million cigarettes per day in 2012. For comparison, during this period about 65 million legal cigarettes were sold daily.

The industry’s estimates of forgone tax revenue show a generally increasing trend, from less than R1 billion (\$148 million) in 2006 to R2 billion (\$273 million) in 2010 and R4 billion (\$487 million) in 2012. The increase in forgone tax revenues reflects both inflationary increases (approximately 6% during this period) and the industry’s claim of a growing illicit market. To put the forgone tax revenue in context, in the 2012/13 financial year the government collected R11.7 billion (\$1.43 billion) from legal cigarette sales.

Media reports typically did not provide year-by-year numbers showing *how* the illicit market share has increased over time. A notable exception was an interview with a BATSA official by *Business Report* in December 2010.¹¹ The newspaper published BATSA estimates of the illicit market for 2008, 2009 and 2010.

Table 2: Illicit market share percentage according to TISA and BATSA

Year	TISA numbers	December 2010 article in <i>Business Report</i> (BATSA)	June 2012 presentation to National Treasury (BATSA)
	(1)	(2)	(3)
2008	20%	11.0%	7.9%
2009	20%	16.6%	10.4%
2010	20%	23.1%	21.0%
2011	25%	-	26.0%
2012	30%	-	27.8%*

* Subsequently updated to 30%

Source: (1) Numerous articles; (2) Own calculations based on *Business Report* article¹¹, (3) unpublished PowerPoint presentation to South Africa's National Treasury, June 2012.

According to these statistics, the illicit market share increased from 11% in 2008 to 23% in 2010. BATSA highlighted that the illicit trade in cigarettes was an increasingly pressing problem. However, this "trend analysis" directly undermines TISA's claims that in 2008 (and even as early as 2006) the illicit market comprised 20% of the total market.

In a presentation to officials at the Treasury in June 2012 (which was subsequently made available to the authors), BATSA indicated that the illicit market share increased from 7.9% in 2008 to 27.8% in the first half of 2012. See column (5) in Table 2. The estimates for 2008-2010 were substantially lower than the illicit trade estimates published in December 2010. The tobacco industry had again rewritten history to emphasise the rapidity with which the illicit market had increased.

(b) Responses by the tobacco control lobby

The National Council Against Smoking (NCAS) is the most vociferous anti-tobacco lobby group in South Africa. Through media statements and letters to the editor, the NCAS proactively sends out an anti-smoking public health message, and responds strongly to the industry's statements. The NCAS has been quoted in hundreds of media reports over the course of the past 20 years, mostly on the health effects of smoking, anti-tobacco legislation and responding to comments by the tobacco industry. Between 1994 and 2012 the NCAS commented about illicit trade in 7 published media reports and 4 letters to the editor.

Initially the NCAS argued that court cases in Europe and North America had revealed that the industry was complicit in illicit trade in those continents (n=6). For example, the NCAS argued that the tobacco industry was "*aiding and abetting smugglers in an effort to boost its turnover*".¹² The NCAS also argued that cheap illicit cigarettes benefit the local manufacturers, because they allow price sensitive smokers – the poor and the young – to switch to lower-priced brands when prices increase. Price sensitive smokers remain in the market and when conditions improve they can be induced to switch back to legal, premium brands.¹³ Contrary to the tobacco industry, the NCAS argued that the link between excise taxes and illicit trade was not strong. After 2003 the NCAS argued that the level of and the increase in the excise tax is largely determined by the industry itself. The tobacco industry sets the retail price, and the Treasury passively sets the excise tax to keep the total tax burden at a constant percentage of the retail price. The NCAS argued that the industry is hypocritical and disingenuous to be effectively setting the level of the excise tax, and then to claim that the higher excise tax is causing the increase in illicit trade.

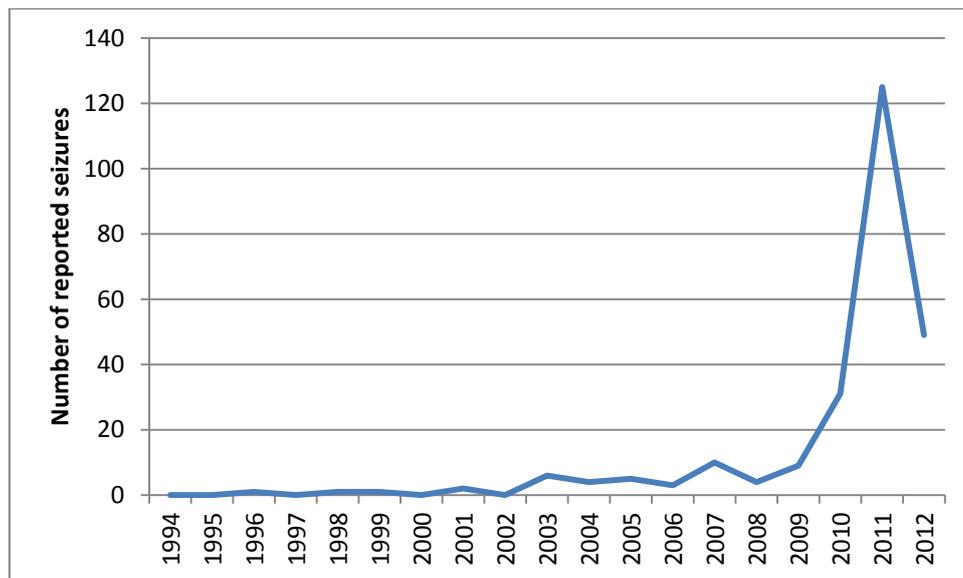
(c) Responses by government agencies

Government officials, especially from the South African Revenue Services (SARS), were quoted in 6 articles. They indicated that the illicit trade in cigarettes and goods like pharmaceuticals, textiles and alcohol was a large and increasing problem. Their focus was on the forgone tax revenue; typically the numbers were large. In 2005 SARS indicated that cigarette smuggling had cost the country R466 million (\$ 73 million) in lost revenue between 2002 and 2004.¹⁴ In December 2010 they estimated that the government had lost R1 billion (\$137 million) of revenue in 2010 to illegal cigarette trade. This number was about half the tobacco industry's estimate, yet still substantial.

(d) Reports on illicit trade in cigarettes

Since 1996 the media has reported arrests of tobacco smugglers and other illicit traders, confiscation of illicit tobacco product, and court cases related to these. Between 1996 and 2009 the media reports were infrequent (figure 2), but spiked in 2010 and especially 2011, after which they decreased sharply. The sharp increase in reporting of tobacco seizures in 2010 and 2011 can be interpreted in at least three ways: (1) a significant increase in illicit activity, (2) better policing and/or (3) more comprehensive reporting in the media.

Figure 2: Number of reports on seizures and other illicit activity in cigarettes, 1994-2012



With respect to (1), the tobacco industry claims that there has been a large increase in illicit trade, and independent research supports this view for 2010 (and to a lesser extent for 2011), but not in the other years.¹⁵

With respect to (2), TISA indicates on their website that it actively works with the South African Police Services (SAPS) and the South African Revenue Services to curb the illicit trade in tobacco product. In fact, SAPS have identified the illicit trade in cigarettes as a national priority crime, together with crimes like rhino poaching, truck hijacking and the bombing of automatic teller machines. The increased attention on curbing the illicit trade in cigarettes has apparently borne fruit, indicated by the increased numbers of reported arrests and verdicts in 2010 and 2011. The fact that

the reported number of seizures has decreased by 60% in 2012, despite the continuous attention that illicit cigarette trade receives in the media and its “national priority crime” status by the SAPS, suggests that there was a real decrease in the quantity of illicit trade in that year. This is congruent with a study that estimates the size of the illicit market by subtracting legal cigarettes from estimated total cigarettes sold.¹⁵

With respect to (3), it is in the industry’s interest to publicise arrests of illicit traders, because it supports their argument that illicit trade is a growing problem. Of the 28 news releases on the TISA website, 10 are about arrests and confiscations of illicit product. Of the 299 media reports that covered tobacco-related seizures, arrests and confiscations, TISA was quoted in 24, and invariably they emphasised the gravity of the illicit trade situation.

DISCUSSION

There is no doubt that an increase in illicit trade undermines the public health and fiscal benefits associated with an excise tax increase. However, even if illicit trade increases modestly, this may be an acceptable price to pay.¹⁶

Initially, arguments about illicit trade were vague and general and there was no “statistical evidence” to back up the claims. Since 2006 BATSA has used a large research organisation to perform regular surveys of retail outlets, with the specific aim of estimating the size of the illicit market. In the survey, buyers of cigarettes are approached as they leave the retail outlet and fieldworkers buy their product under the guise of “quality control”. More than 1500 outlets are included in the sample and more than 3000 packs are retrieved per survey. The survey is nationally representative, but the details of the sampling methodology and the subsequent outlet and volume weighting are proprietary. Illicit cigarettes are defined as those that are counterfeit, non-compliant (e.g. missing health warnings, quit line number, excise stamp and tar and nicotine ratings) or “suspicious price”. Cigarettes are classified as “suspicious price” cigarettes if the retail price is less than the sum of the excise tax, Value-added Tax, and a modest manufacturing cost and retail margin. In 2013 BATSA set the threshold for “suspicious price” cigarettes at R15.50 (\$1.55) per pack of 20. The retail price of popular price brands sold in supermarkets is about R30 (\$3.00) per pack.

BATSA indicates that the proportion of “suspicious price” cigarettes has increased, while the proportion of counterfeit and non-compliant cigarettes has decreased over time. In recent years a number of low-price cigarette manufacturers have entered the market, presumably aiming to capture a part of the lucrative market. Their industry body, FITA, claims that they are legitimate operators and pay the full excise tax, and that the incumbent (BAT), with the support of TISA, is using bullying tactics to destroy them.¹⁷ To the extent that the FITA-aligned small manufacturers are legitimate producers, a normal competitive conflict is presented as an illicit trade issue.

While BATSA’s research methodology seems broadly reasonable, the estimates of the size of the illicit market, especially in recent years, have a strong upward bias that has no reasonable explanation. For example, BAT claims that the illicit market share increased from 26% in 2011 to 30% in 2012. Legal cigarette sales, based on official tax revenue data, increased by 2.6% in the 2012 financial year.¹⁵ This would imply that aggregate cigarette consumption increased by nearly 7% in 2012. In a country with fairly strong tobacco control legislation, a history of decreasing smoking prevalence,^{18 19} stable real cigarette prices and modest economic growth (2.5%), this is simply not credible.

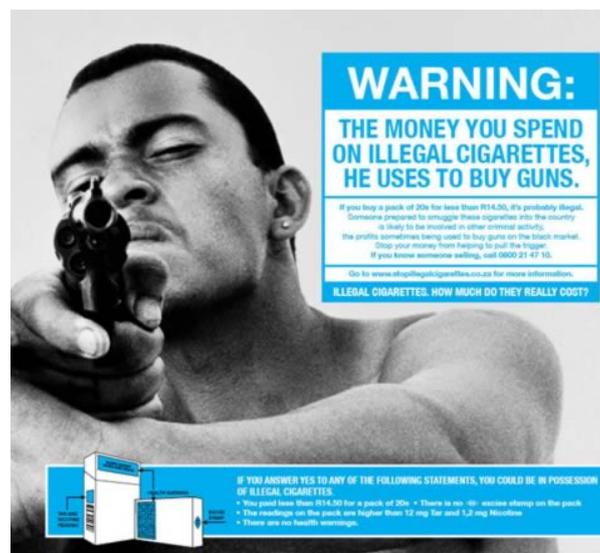
A decreasing illicit market is beneficial to the legal tobacco industry (especially if the decrease is in the number of counterfeit cigarettes), but it certainly harms their rhetoric. If illicit trade is under

control, this would allow the Treasury to increase the excise tax for both public health and fiscal reasons. It is not in the tobacco industry's interests to admit that there has been a reduction in illicit trade.

In a presentation to the authors, TISA indicated that the illicit market share was estimated at 21% in 2006, but dropped to 11% in 2007 and 8% in 2008, after which it increased to 10% in 2009, 21% in 2010, 26% in 2011 and 30% in 2012. The dramatic 2007 and 2008 decrease was ascribed to the closure of Mastermind Tobacco. This company was closed down in November 2006 by SARS because of tax evasion and the directors fled the country.²⁰ Not a single media statement by BATSA or TISA alluded to the decrease in illicit trade in this period.

In 2010 TISA and BATSA launched a national advertising campaign to alert the public to the link between illicit cigarettes and organised crime. Billboards showed an angry young man pointing a gun with the caption "Warning: The money you spend on illegal cigarettes, he uses to buy guns" (figure 3). Another advertisement stated: "Warning: Someone selling illegal cigarettes could also be selling drugs to your family". The public were urged to call a toll-free number if they had any information on illicit outlets. The industry placed posters in many retail outlets, which committed the retail outlet not to sell illegal cigarettes. The industry also ran similar commercials on radio.

Figure 3: Billboard advert



Source: Mahala website (<http://www.mahala.co.za/culture/death-and-taxes/>)

The campaign was short-lived. Eight members of the public complained to the Advertising Standards Authority (ASA) that the campaign was a deceptive way to advertise cigarettes.²¹ The complainants argued that BATSA used the campaign as a ploy to circumvent the law that prohibited the advertising of cigarettes in South Africa. By "discouraging" the purchase of illegal cigarettes, it was indirectly encouraging the purchase of legitimate cigarettes. The ASA did not rule on the legality of the advertisements but found that BATSA was unable to provide evidence linking the sale of illicit cigarettes to hijacking and drug activities. The ASA ordered BATSA to withdraw the campaign.

In a country with endemic crime (including organised crime) and high levels of poverty and inequality, the incentive to get involved in illicit activities is strong. Within this context the illicit trade in cigarettes should be taken seriously, and is indeed being taken seriously by government agencies and the legal tobacco industry. However, the tobacco industry has a very strong incentive to exaggerate the magnitude of the problem: they do not want the Treasury to increase the excise

tax. Within an international context, and relative to the benchmark proposed by the WHO (excise tax at least 70% of the retail price),²² South Africa's excise tax (at less than 40% of the retail price) is very low, and thus there is considerable scope to increase the excise tax.

The tobacco industry has a long history of deceit and misrepresentation.²³ By rewriting history about the magnitude of the illicit market, it has again shown itself an untrustworthy source of information. Government officials would do well to question the tobacco industry on any matter in which the tobacco industry has a stake.

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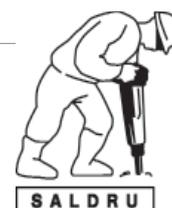
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southern africa labour and development research unit

The Southern Africa Labour and Development Research Unit (SALDRU) conducts research directed at improving the well-being of South Africa's poor. It was established in 1975. Over the next two decades the unit's research played a central role in documenting the human costs of apartheid. Key projects from this period included the Farm Labour Conference (1976), the Economics of Health Care Conference (1978), and the Second Carnegie Enquiry into Poverty and Development in South Africa (1983-86). At the urging of the African National Congress, from 1992-1994 SALDRU and the World Bank coordinated the Project for Statistics on Living Standards and Development (PSLSD). This project provide baseline data for the implementation of post-apartheid socio-economic policies through South Africa's first non-racial national sample survey.

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