

PHILIP MORRIS LIMITED (PML)
Supplementary Submission
***“Australia’s Future Tax System –
Consultation Paper”***

1 May 2009

Philip Morris Limited (PML) is pleased to respond to the *Australia's Future Tax System – Consultation Paper* and the related consultation questions regarding tobacco excise taxation.

Tobacco excise policy is an integral part of the Government's comprehensive tobacco control program. In Australia, fiscal measures, together with a range of other regulatory measures, including graphic health warnings and public smoking restrictions, have contributed to a decline in tobacco consumption¹.

Australia's current system optimises Government revenue and health objectives whilst not encouraging illicit trade. Since November 1999, Australia's bi-annual, inflation-adjusted excise tax increases have increased the excise tax rate by 35% and increased tobacco excise revenues by 18% while cigarette sales have declined by 18%². In part due to the excise system, the Recommended Retail Price (RRP) of *Peter Jackson 30's* has increased by 60% since 2000, significantly above the inflation rate³. The simplicity of the current tax system on tobacco makes it an efficient and sustainable policy instrument which can achieve both health and revenue objectives with minimum unintended and negative consequences.

In responding to the specific questions raised by the Consultation Paper, the following reiterates and expands upon the key points from our initial submission. These points, along with the associated facts and figures, were updated in PML's more recent Pre-Budget Submission 2009-10 (submitted 13 January 2009), which is attached in support of the response below.

<p style="text-align: center;">Any departure from Australia's proven tobacco excise taxation system requires deliberative and collaborative review</p>

The National Preventative Health Taskforce (NPHT), a committee established by the Federal Minister for Health and Ageing, is proposing a significant departure from the current practice of bi-annual, inflation-adjusted excise tax increases. In its Discussion Paper and accompanying Technical Paper on tobacco, the NPHT propose a series of tobacco excise taxation increases above the rate of inflation⁴. Consultation on those proposals closed on 2 January 2009, and the NPHT is scheduled to develop a National Preventative Health Strategy by June 2009.

Excise policy is quite rightly amongst those areas being considered by the 'root and branch' review and the *Australia's Future Tax System (AFTS) Consultation Paper* (the "Consultation Paper") recognises the conflicting views. It states, "The health sector supports increasing taxes on tobacco (by roughly one third – around \$0.075 per stick [or \$1.88 per 25's pack, before GST]) as an important means of reducing tobacco use and its associated health impacts"⁵. The Consultation Paper also puts the industry stakeholder view that "the current regime of tobacco taxation provides certainty for industry, consumers and governments,

¹ The Australian Institute of Health and Welfare's (AIHW) *2007 National Drug Strategy Household Survey* shows that this comprehensive approach is successful in achieving its objectives. The study noted that, in the period between 1991 and 2007, "daily tobacco smoking rates declined by more than 30% to the lowest levels seen over the 16-year period". In 2007, 16.6% of those 14 and over were daily smokers (Australian Institute of Health and Welfare, *2007 National Drug Strategy Household Survey, First Results*, Canberra, April 2008, p13). AIHW reporting also shows that youth smoking rates amongst teenagers aged 14 to 19 years halved between 2001 and 2007 (Australian Institute of Health and Welfare, *Making progress – the health, development and wellbeing of Australia's children and young people*, Canberra, September 2008, p33. The report defines "current smoker" as "persons who smoke daily, weekly, or less than weekly, but have not quit")

² The cigarette volume decline of 18% is from 1999 to 2007; whilst excise revenue and excise rate increases represent the period from 1999 to 2008

³ Further information available in Figure 2 of the attached Pre-Budget Submission, p4

⁴ National Preventative Health Taskforce, *Australia: The Healthiest Country by 2020*, Commonwealth of Australia, 2008 and Tobacco Working Group of the National Preventative Health Taskforce, *Technical Report No 2, Tobacco Control in Australia: Making Smoking History*, Commonwealth of Australia, 2008

⁵ *Australia's Future Tax System – Consultation Paper*, Commonwealth of Australia, December 2008, p226

while helping to control tobacco use and providing government with a significant and stable revenue stream”⁶.

More recently, the Heart Foundation pre-empted the NPHT *and* the AFTS reviews to call on the Federal Government to include an increase of “7.5c a cigarette – in the May Budget”⁷. The Federal Budget will be delivered in advance of the NPHT and AFTS review findings, which are scheduled for June and December 2009 respectively. In an address to the National Press Club, the Heart Foundation Chief Executive Officer stated that, “increasing tobacco tax is – quite frankly – a no brainer”⁸.

Professor of Economics Sijbren Cnossen recognises it is more complex than that. His seminal work, *Theory and Practice of Excise Taxation*, recognises the “difficulties in tailoring a tobacco tax regime in the context of multiple objectives and constraints”⁹. He describes “the question of what the right level and structure of tax should be” as “complex”¹⁰:

“For the economist, there are conceptual and empirical limits to excessively high levels of tobacco taxation ... As a single policy instrument, even with ideal excise tax administration, tobacco taxation cannot alone meet the multiple objectives of ‘social-welfare-maximising’ governments...”¹¹

As explained throughout this submission, Australia’s current system optimises the Government’s revenue and health objectives while helping to keep illicit trade under control. International experience shows that altering that existing balance could lead to significant unintended and negative consequences. A departure from this proven and effective system requires diligent deliberation by both health and fiscal experts and all considerations taken into account. The NPHT and AFTS ‘root and branch’ reviews provide such an opportunity.

<p style="text-align: center;">Consultation Question 11.1: Is it appropriate to use taxes on specific goods or services to influence individual consumption choices, and if so, what principles can be applied in designing the structure and rates of such taxes?</p>
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PML supports excise taxes as an appropriate part of the Government’s strategy to address both public health and revenue objectives in relation to tobacco products. We do not, however, support excessive taxes that are intended to make legal, tax-paid cigarettes unaffordable to adult consumers. Doing so would lead to unintended and negative consequences in the increase of illicit product.

Australia’s unit specific tobacco excise tax system and the current policy of bi-annual inflation-adjusted excise increases have proven to be successful and sustainable in increasing revenue for the Government while simultaneously contributing to the reduction in tobacco consumption. The incremental, predictable and inflation-based nature of the tax increases also guards against the risks associated with sharp and unpredictable increases in tobacco excise, such as the increase in consumer demand for cheaper and/or illicit tobacco products¹² experienced in the United Kingdom, Singapore and Canada¹³.

⁶ Ibid

⁷ Louis Andrews, “It’s death or taxes, says heart foundation boss,” *Canberra Times*, 16 April 2009, p5

⁸ Ibid

⁹ Sijbren Cnossen and Michael Smart, “Taxation of Tobacco,” in Sijbren Cnossen (Ed), *Theory and Practice of Excise Taxation: Smoking, Drinking, Gambling, Polluting, and Driving*, Oxford University Press, USA, 2005, p47

¹⁰ Ibid

¹¹ Ibid

¹² The illicit trade in tobacco products consists of the manufacture, transportation, distribution, purchase or sale of counterfeit tobacco products (*i.e.* not produced by, or with the authorization of, the trademark owner) or the diversion, export, distribution, purchase or sale of contraband cigarettes (*i.e.* genuine products that have been diverted from their intended market of destination and are being sold in another country in violation of applicable local tax, duty or other fiscal laws)

- In the United Kingdom, between 1997 and 2000, increases in the excise rate for machine-made cigarettes by inflation **plus 5%**, coupled with lower prices for loose tobacco for hand-rolling, led consumers to switch to cheaper cigarette brands; switch to hand-rolling tobacco; or switch to non-duty paid products. Excise tax revenue from tobacco products was foregone and tobacco consumption did not decline as anticipated.
- In Singapore, a 190% excise tax increase between 1999 and 2005 did not cause commensurate increases in Government revenue (with excise revenue actually declining in 2005); led consumers to switch to cheaper brands and likely did not result in anticipated declines in consumption; and saw increased demand for illicit tobacco products, with illicit cigarette seizures increasing significantly. The significant growth in illicit trade contributed to the Government's decision not to increase excise since 2005, as reflected in the quote below from Singapore's Finance Minister:

"I seriously considered raising tobacco duties, but have reluctantly decided against it because we are already seeing revenues declining, not because people are smoking less but because smuggling has gone up."¹⁴

- Canada, too, has seen tobacco taxes reach the levels where the price gap between illicit products and legal, tax-paid cigarettes is so large that any increases in excise taxes will be unlikely to reduce consumption or increase revenues.

For these reasons, PML supports the continued application of the current unit-specific tax rate in Australia, accompanied by twice annual inflation-adjusted excise tax increases on all tobacco products.

The current policy is based on the principle that tobacco excise tax should be evenly applied in an incremental and predictable way

The stick specific tax is ***applied evenly*** across all legal tobacco products, ensuring a level playing field. It does not discriminate against different brands or manufacturers. Product definitions clearly define the product category and the tax rate is consistently applied to cigarettes and loose tobacco¹⁵. That recognises that there is no safe cigarette, and all brands cause disease.

The current system is ***incremental*** by virtue of its twice yearly implementation, in line with the consumer price index. Sudden and steep increases in excise tax with the objective of making cigarette prices prohibitive are likely to lead to consumer down-trading to cheaper cigarettes and illicit products, neither of which advances public health or revenue objectives. As experiences from the UK, Singapore and Canada indicate, smokers can avoid the tax increase by moving to substitution products, such as cheaper and/or illicit products. Neither outcome yields a health benefit.

¹³ Further detail provided on pages 6 to 8 of PML's attached Pre-Budget submission 2009-10

¹⁴ *Singapore Budget Speech*, 17 February 2006, p16-17

¹⁵ The current excise rate for cigarettes less than 0.8 grams per stick is \$256.79 per thousand cigarettes. Excise for cigarettes greater than 0.8 grams per stick, cigars and loose tobacco for hand-rolling is \$321.00 per kilogram. Imported cigarettes do not pay import duties but are subject to the same excise tax as nationally produced cigarettes (Australian Taxation Office)

Many Australian adult smokers have already changed to lower priced brands as a result of the high cost of tobacco products: the share of market held by low-priced brands has increased from 1.68% in 2004; to 4.57% in 2007; and 6.18% in 2008¹⁶. There is no public health basis for a tax system that drives consumers to lower priced brands.

Although tobacco excise taxation makes up more than half the RRP of most packs, application of the current incremental, inflation-based system has not encouraged the proliferation of illicit tobacco experienced by other countries. The illicit trade, however, remains a threat to Australian Government revenue and public health. The Minister for Home Affairs recently reported that the tobacco and cigarette products seized by Customs in 2008 amounted to attempts at revenue evasion of more than \$55 million¹⁷. It is well recognised that illicit tobacco products evade taxes, but important to note that these products are not subject to the strict requirements implemented for the legal industry in Australia, including health warnings, restrictions on the use of descriptors and even the provision to government of annual ingredients lists.

The current system is *predictable*. Any plan to increase excise above inflation should incorporate an implementation period. No matter how high (or low) the excise increase, it takes at least 24 hours to implement: manufacturers compile new price lists; send the new price lists through the relevant channels to the retail trade; the retail trade then updates its systems; and, ultimately, sells the product to the consumer at a price that reflects the excise increase. If the goal of a sudden and steep excise increase is to make tobacco products more expensive for the consumer, then a proposal to increase tax without notice is less about reducing consumption than it is about hurting a legal industry. The tobacco industry already generates \$5.53 billion¹⁸ in tobacco excise taxes to Government each year.

Consultation Question 11.3

**What is the appropriate specific goal of taxing tobacco?
Is it necessary to change the structure or rate of tobacco taxes?**

As stated earlier, PML recognises fiscal policies are an integral part of a comprehensive tobacco regulation regime. Most governments aim to achieve multiple objectives with tobacco tax policy. Typical among their objectives are generating fiscal revenues, promoting local employment and addressing social and health considerations. There is widespread and growing recognition by governments and public health advocates that tobacco excise tax and related fiscal measures can be effective to reduce tobacco consumption.

The current tobacco excise system is effective and reflects best practice

Since November 1999, Australia's bi-annual, inflation-adjusted excise tax system has increased the excise tax rate by 35% and increased the Government's tobacco excise revenues by 18%, even while cigarette sales have declined by 18%¹⁹. The NPHT Technical Report itself establishes that the real costliness of cigarettes to consumers (as measured by the minutes worked per week in order to pay for a packet of cigarettes) has tripled in Australia over the last twenty-five years²⁰.

¹⁶ PwC Industry Exchange

¹⁷ Minister for Home Affairs, "Customs smokes out tobacco smugglers," *Media Release*, 24 December 2008

¹⁸ *Australian Government Budget 2008-09*, Budget Paper No. 1, Statement 5 – Revenue – Revenue estimates by revenue head, Table 6: Australian Government general government revenue

¹⁹ The cigarette volume decline of 18% is from 1999 to 2007; whilst excise revenue and excise rate increases represent the period from 1999 to 2008

²⁰ NPHT Technical Report, Figure 3, p2

The World Health Organisation (WHO) includes Australia's system as a best practice on its tobacco control website, and uses a document written by the author of the NPHT Technical Report to make its case²¹.

**There is no reason to change the current tax system and policy
of tax increases in line with inflation**

Since its formation in April 2008, the NPHT has made various proposals to increase tobacco excise taxation above inflation, ranging from a 10% increase of 2.5 cents per cigarette²² to a 29.5%²³ increase of 7.5 cents per cigarette. Subsequently, "once effective measures are in place to prevent revenue evasion,"²⁴ the NPHT Technical Report recommends using excise increases to ensure a minimum price of \$20 per packet and increasing tax in subsequent years by a minimum of 5% above the Consumer Price Index²⁵. Exactly such a policy led to significant problems in the UK.

Together with other tobacco control measures, the current tobacco excise taxation system is proven effective at reducing demand and increasing revenues, while at the same time minimising the consequences that are contrary to public health goals. It is recognised as best practice and should be maintained.

**Consultation Question 11.4:
If health and other social costs represent the principal rationale for
specific taxes on alcohol and tobacco, is any purpose served in retaining
duty free concessions for passenger importation of these items?**

We do not believe the Australian Government should abolish duty-free sales of tobacco products. Allowing international travelers to purchase duty free products is an established and expected practice, and is even recognised by international treaties. Most Australian duty-free sales occur within airports, which are among the most tightly controlled places in the world. Meaningful and effective regulation should continue to allow those passengers disembarking from flights in Australia to purchase a restricted amount of tobacco products.

A ban on the sale of duty free tobacco products in Australia would not stop those seeking to purchase duty free tobacco products from their country of departure; but it would impact the duty free businesses that operate here in Australia. The NPHT also suggests that "An effective policy to prevent the development of illicit trade ... would abolish duty free sales"²⁶. It provides *no* evidence to support that assertion.

The NPHT Technical Report recommends that the Government "actively participate in the negotiation of an effective protocol to the FCTC" and implement unspecified "effective measures to prevent revenue evasion" before significantly increasing tobacco excise tax²⁷. We agree. Further, we would support a requirement that all duty-free products be clearly marked as such. We agree with recommendations from leaders in the customs enforcement community who have called for the computerization of government systems controlling the

²¹ See WHO Tobacco Free Initiative, *Taxation: success stories and lessons learnt*, http://www.who.int/tobacco/training/success_stories/taxation/en/index.html, citing and linking to M Scollo and R Borland, "Taxation reform as a component of tobacco control policy in Australia"

²² Jessica Irvine and Yuko Narushima, "Call to increase tobacco tax," *Sydney Morning Herald*, 28 April 2008, <http://www.smh.com.au/news/national/call-to-up-tobacco-tax/2008/04/27/1209234655177.html> and "Rudd adviser urges tobacco tax hike," *The Australian*, 24 September 2008, <http://www.theaustralian.news.com.au/story/0,25197,23608712-5013871,00.html>

²³ This calculation is based on the excise rate as at publication of the NPHT Technical Report, October 2008

²⁴ NPHT Technical Report, p15

²⁵ Ibid

²⁶ Ibid

²⁷ Ibid

movement of duty-suspended goods to help such authorities monitor and track shipments, thus reducing the opportunities for the diversion of duty-suspended product into domestic commerce. We also support strict, consistent enforcement of the maximum allowances of duty-free tobacco products that an individual can purchase.

Conclusion

Australia's unit-specific tobacco excise tax rate, accompanied by twice annual inflation-adjusted excise tax increases on all tobacco products, should be maintained.

The current system is effective; it optimises the Government's revenue and health objectives while helping to keep illicit trade under control. The simplicity of the current tax system on tobacco makes it an **efficient** and **sustainable policy instrument** which can achieve both health and revenue objectives with minimum unintended and negative consequences. It is also recognised by the WHO as best practice.

It is based on the principle that tobacco excise tax should be **evenly applied** because all tobacco products cause disease. Tobacco excise tax should be **incremental**; international experience shows that sudden and steep increases trigger shifts to cheaper and/or illicit products, from which there is no health benefit.

Tobacco excise taxation is, and should remain, **predictable**; if the goal of a sudden and steep excise increase is to make tobacco products more expensive for adult consumers, then a proposal to increase excise tax without notice is less about reducing consumption than it is about hurting a legal industry.