The Treasury

Regulation Impact Statement

Tobacco Excise and Excise Equivalent Customs Duty: Staged increases and change from CPI to AWOTE

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POLICY OBJECTIVE

Context

1.1 In a joint media release by the Treasurer and the Assistant Treasurer on 6 November 2013 the Government announced that it would proceed with two tobacco excise measures that were announced but not enacted by the former government. These measures are:

- six-monthly indexing of tobacco excise and excise equivalent customs duty to average weekly ordinary time earnings (AWOTE) instead of to the consumer price index (CPI), commencing from 1 March 2014;[1]
  - dates of tobacco indexation would change to 1 March and 1 September each year (from 1 February and 1 August) to accommodate the later release of AWOTE data by the Australian Bureau of Statistics (ABS);
- increasing excise and excise equivalent customs duty on tobacco and tobacco related products under a staged process, with a 12.5 per cent increase on 1 December 2013 and further 12.5 per cent increases on 1 September 2014, 1 September 2015 and 1 September 2016.

1.2 The Government, when in opposition, made an election commitment (in a joint media release of 28 August 2013) that it would proceed with these measures if elected.

1.3 As a result of Gazette Notices published on 29 November 2013 by the Commissioner of Taxation (the Commissioner) and the Chief Executive Officer of Australian Customs and Border Protection Service (ACBPS) the first of the 12.5 per cent increases came into effect on 1 December 2013. The Australian Taxation Office (ATO) and ACPBS have been collecting duty at the new, higher rate since that date.

EXCISE TAXATION

1.4 Excise duty imposed under the *Excise Tariff Act 1921* is a tax on alcohol, tobacco, fuel and petroleum products (including gaseous fuels) produced or manufactured in Australia. Collectively, these products are referred to as excisable goods.

1.5 Imported goods, comparable to those subject to excise, attract customs duty at the same rate as the excise rate. Such duty is referred to as 'excise equivalent customs duty' and its application means that imports and locally-produced goods are taxed in an equivalent fashion.

1.6 Excisable alcohol includes beer, brandy, other spirits, liqueurs and other beverages such as ready-to-drink products, but not wine. Home-brewed beer (that is, beer produced for non-commercial purposes using non-commercial facilities and equipment) is exempt from excise duty. Wine is subject to the wine equalisation tax, not excise duty.

1 Historically, growth in AWOTE has exceeded growth in CPI because wages growth on average has been higher than inflation. Based on this experience, the excise increase that will occur on 1 March 2014 under AWOTE indexation should be around nine cents higher per packet of 25 cigarettes than under CPI indexation.

1.7 A per stick duty applies to all cigarettes with a tobacco content not exceeding 0.8 grams per cigarette. All other tobacco products (including cigarettes containing more than 0.8 grams of tobacco, loose tobacco and cigars) are taxed at a per kilogram rate equivalent to the rate effectively imposed on the tobacco content of cigarettes containing 0.8 grams of tobacco.

APRIL 2010 RATE INCREASE

1.8 The last (non-CPI) general increase in the excise rate for tobacco occurred on 29 April 2010, when the former Government increased the excise and excise equivalent customs duty applying to tobacco products by 25 per cent.

1.9 This measure was announced[2] along with a range of anti-smoking measures applying to tobacco products including:

- the introduction of plain packaging;
- updated and expanded graphic health warnings;
- extending existing restrictions on advertising to Australian internet advertising of products; and
- spending an additional $27.8 million on anti-smoking campaigns aimed at high need and hard to reach groups, including: pregnant women and their partners, people from culturally and linguistically diverse backgrounds, people living in socio-economically disadvantaged areas, people with mental illness and prisoners.

1.10 These measures were in line with the major recommendations of the National Preventative Health Taskforce, which was established in 2008 to develop the National Preventative Health Strategy (NPHS). The NPHS focussed initially on health problems arising from obesity and consumption of alcohol and tobacco. In its report *Australia: the healthiest country by 2020,*[3] released in September 2009, the Taskforce recommended a sequence of increases in tobacco excise on public health grounds. Specifically, it identified reducing the affordability of tobacco products as a key action area to reduce tobacco consumption and the prevalence of smoking by deterring young people from taking up smoking, encouraging smokers to quit, or at least reduce consumption. It recommended staged increases with the aim of increasing the price of a pack of 30 cigarettes to at least $20 (in 2008 dollar terms) within three years.

2 Prime Minister, Treasurer, Minister for Health, Anti-Smoking Action, Media Release, 29 April 2010.

3 Australia: the healthiest country by 2020 Technical Report 2 Tobacco control in Australia: making smoking history including addendum for October 2008 to June 2009, Commonwealth of Australia 2009.

GOVERNMENT COMMITMENTS TO REDUCE SMOKING RATES

1.11 In 2008, the Commonwealth and state and territory governments, meeting as the Council of Australian Governments (COAG), committed to reducing the adult daily smoking rate to 10 per cent of the population, and to halving the daily rate of smoking among Aboriginal and Torres Strait Islander people by 2018.[4] This commitment was affirmed in 2012.[5]

1.12 The National Tobacco Strategy (NTS) 2012-2018 is an overarching tobacco strategy that draws together a number of tobacco-related initiatives and policies. It takes into account the public consultation on the draft for consultation of the NTS 2012-2018, the review of the National Tobacco Strategy 2004-2009, key policy contexts for tobacco control, such as the COAG National Healthcare Agreement, the COAG National Partnership Agreement on Preventive Health, the Australian Government's response to the National Preventative Health Taskforce Report, state and territory tobacco strategies and policy frameworks, and recent Australian Government tobacco reform initiatives.

1.13 The NTS 2012-2018 sets out nine priority areas for action on tobacco control in Australia, including priority area 6 'Continue to reduce the affordability of tobacco', under which priority action 6.3.2 is to 'Continue to implement regular staged increases in tobacco excise as appropriate, to reduce demand for tobacco'.[6]

AUSTRALIA'S FUTURE TAX SYSTEM REVIEW

1.14 The December 2009 Report to the Treasurer on *Australia's Future Tax System* (AFTS) recommended that 'the existing regime for tobacco taxation in Australia should be retained, with the rates of tax substantially increased, depending on further evidence on the costs of harm from tobacco smoking' (Recommendation 73).[7]

1.15 The AFTS review noted the following about tobacco taxation:

> *While consumer sovereignty is an important principle in tax policy design, government intervention in the tobacco market is justified by the strongly addictive qualities of tobacco, its serious health impacts, its uptake by minors and the costs that smoking imposes on non-smokers.*
>
> *Tobacco taxes raise prices and reduce both smoking rates and smoking intensity. Australian retail prices for cigarettes are moderate by international standards and taxes constitute a relatively small share of the retail price.*
>
> *As Australia's tobacco taxes are low by international standards, it is feasible to increase them substantially.*

4 Council of Australian Governments. National Healthcare Agreement. 2012, Council of Australian Governments Canberra.

5 COAG Reform Council (2013). Healthcare 2011-12: Comparing performance across Australia, Report to the Council of Australian Governments, 30 April 2013. Available from: www.coagreformcouncil.gov.au.

6 Intergovernmental Committee on Drugs. 2012. National Tobacco Strategy 2012-2018. Commonwealth Of Australia: Canberra.

7 The final report of the Australia's Future Tax System Review (AFTS), 2011 Commonwealth of Australia 2011. Available from http://taxreview.treasury.gov.au/content/Content.aspx?doc+html/home.htm.

1.16 The AFTS review also recommended that tobacco excise should be indexed to a broad measure of wages rather than the CPI. This would maintain policy effectiveness by preventing excise falling as a proportion of wages (Recommendation 74).

WHO FRAMEWORK CONVENTION ON TOBACCO CONTROL

1.17 In 2003, Australia became a party to the World Health Organization (WHO) Framework Convention on Tobacco Control (FCTC), which supports the use of price and tax measures to discourage tobacco consumption. An increase in tobacco excise is consistent with Australia's obligations under this Convention, and represents a move towards international best practice in the pricing of tobacco products.

- Article 4(4) of the FCTC states that comprehensive multi-sectoral measures and responses to reduce consumption of all tobacco products are essential.
- Article 6 of the FCTC describes price and tax measures as 'an effective and important means' to reduce tobacco consumption and Article 7 recognises that non-price measures are also an effective and important means to reduce tobacco consumption.

1.18 In May 2013, the World Health Assembly endorsed the WHO Global Action Plan for the Prevention and Control of Non-communicable Diseases 2013-2020. The Global Action Plan provides Member States, international partners and WHO with options which will contribute to progress towards the nine global non-communicable diseases (NCD) targets, one of which is, 'a 30 per cent relative reduction in prevalence of current tobacco use in persons aged 15+ years.'[8]

IMPACT OF TAXATION ON TOBACCO CONSUMPTION

1.19 It is a widely held view among health professionals that higher tobacco taxes which lead to higher prices reduce tobacco use. Lower consumption, in turn, reduces the health and social costs associated with tobacco consumption.[9]

1.20 The WHO and the World Bank recognise that within any tobacco control regime, tax is one of the most effective instruments through its influence on price. Young people and poor people are particularly sensitive to price given the strong competing demands on their low incomes and the short exposure of the young to the addictive properties of tobacco.[10]

1.21 The US Surgeon General stated in the most recent report (2014) *The Health Consequences of Smoking — 50 Years of Progress* 'we know that increasing the cost of cigarettes is one of the most powerful interventions we can make to prevent to smoking and reduce prevalence'. [11]

8 WHO Global Action Plan for the Prevention and Control of Non-communicable Disease 2013-2020. Available from: http://www.who.int/nmh/events/ncd_action_plan/en/.

9 WHO Framework Convention on Tobacco Control Price and tax polices (in relation to Article 6 of the Convention) (Technical Report by WHO's Tobacco Free Initiative, 2010 FCTC/COP/4/11 15 August 2010, paragraphs 4–6.

10 WHO report on the global tobacco epidemic, 2009: implementing smoke-free environments. Geneva, World Health Organisation, 2009 and World Bank (1999) Curbing the Epidemic: Governments and the Economics of Tobacco Control (Washington: World Bank).

11 The Health Consequences of Smoking — 50 Years of Progress A Report of the Surgeon General Executive Summary US Department of Health and Human Services Executive Summary Message from Kathleen Seblius. Available at: http://www.surgeongeneral.gov/library/reports/50-years-of-progress/index.html.

1.22 The sensitivity of tobacco consumption to price is measured by tobacco price elasticities.[12] WHO studies have shown that a tax increase that increases tobacco prices by 10 per cent can lead to a decrease in tobacco consumption of about 4 per cent in high-income countries and by up to 8 per cent in low and middle income countries.[13]

1.23 There is a link between tobacco consumption and poverty. Lower income households are particularly vulnerable to the 'opportunity cost' of expenditure on tobacco products. Tobacco may replace food and other essential goods and services for the family. The health impact of tobacco consumption also puts additional pressure on family budgets and reduces the income-generating potential of family members.[14]

1.24 Opposition to tobacco excise increases has often focussed on the argument that tobacco taxation is 'regressive' i.e. it has a disproportionately greater impact on the economically disadvantaged. However, expert opinion in the field of price and taxation for tobacco control points to the opposite effect. Chaloupka *et al* make the following observations:

> *The regressivity of existing taxes, however, does not necessarily imply that tax increases are regressive as well. In many countries, tobacco use among the lowest income/SES populations is most responsive to price, while use among the highest income/SES populations is least responsive. Thus, a tax increase that raises tobacco product prices will lead to the largest declines in smoking among the lowest income persons, and the burden of tax increase will fall more heavily on higher income consumers whose smoking behaviour changes little in response to the tax increase.*[15]

1.25 In 1999, the World Bank review *Curbing the Epidemic: Governments and the Economics of Tobacco Control* concluded that, all else being equal, price rises of about 10 per cent would on average reduce tobacco consumption by about 4 per cent in developed countries. Further, the review stated that there is thought to be a strong correlation between sharp price increases and sharper declines in tobacco consumption, although there may be a time lag.[16]

1.26 The findings of the World Bank review are supported by a more recent review by the WHO[17], which states that a large and growing body of empirical literature, dominated by studies from the United States of America (USA) and to a lesser extent the United Kingdom (UK), has found that tobacco consumption decreases when the price of tobacco increases. The WHO review states that since the World Bank's publication *Curbing the Epidemic* the evidence suggests that, at least based on aggregate demand studies, the consensus price elasticity of around -0.4 is still valid for high income countries. However, the price elasticity estimates for high-income countries other than the USA and the UK are more dispersed.

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12 Price elasticity of demand is the proportionate reduction in consumption resulting from a 1 per cent increase in price. For example, a price elasticity of cigarette demand of -0.5 indicates that a 10 per cent increase in cigarette prices reduces overall cigarette consumption by 5 per cent.

13 Technical Report by WHO's Tobacco Free Initiative, 2010 paragraphs 4 to 6.

14 International Agency for Research on Cancer (2011). Chapter 7. Tax, price and tobacco use among the poor, in Effectiveness of tax and price policies for tobacco control, IARC: Lyon, France. Available from: http//www.iarc.fr/en/publications/list/handbooks/.

15 Chaloupka, F.J., A. Yurekli and Fong (2012). Tobacco taxes as a tobacco control strategy. Tobacco Control; 21:172-180.

16 Prabhat Jha, Chaloupka, Frank J The World Bank Curbing the Epidemic Governments and the Economics of Tobacco Control 1999 Washington DC, p. 6.

17 International Agency for Research on Cancer WHO IARC Handbooks of Cancer Prevention Tobacco Control Volume 14 Effectiveness of Tax and Price Policies for Tobacco Control 2011.

1.27 The WHO review also noted that many econometric studies from countries at all income levels find that smoking prevalence and intensity among young people decrease as cigarette price increases. The estimated overall price elasticity of demand for young people in most high income country studies ranges between -0.5 and -1.2. As noted previously, these high elasticities reflect the effects of generally low incomes of young people and their short exposure to the addictive properties of tobacco.

1.28 Additionally, there will be elasticity differences in the short term compared with the longer term. That is, a reduction in smoking prevalence due to current smokers quitting will have an immediate impact on smoking rates whereas a reduction in prevalence due to a lower take-up of smoking will have an impact over the longer term as it affects potential future smokers. Studies that measured responses to price changes in the short term tended to report lower elasticities than studies that reported long-run estimates (-0.40 compared with -0.44).[18]

1.29 A recent US National Bureau of Economic Research (NBER) study on tobacco taxes[19] has questioned the effectiveness of taxes in reducing cigarette consumption. The study claims that increases in cigarette taxes are associated with insignificant decreases in adults' consumption, and estimates that it will take a 100 per cent tax increase to decrease adult smoking by as much as 5 per cent.

1.30 However, it is important to note that this study looks at the effect on adult smokers, who are likely to have smoked for years and are addicted to tobacco, and hence, are highly price inelastic. It has not taken into account the effectiveness of tobacco excise increases in deterring take-up by non-smokers, or in reducing consumption among young people.

1.31 A Post-implementation Review of the impact of the April 2010 25 per cent excise increase compared consumption immediately prior to the increase with consumption two years later. It showed a decrease in consumption of licit tobacco by 11 per cent, using tobacco clearances data.[20]

18 Gallet C and List J. Cigarette demand: a meta-analysis of elasticities. Health Econ 2003; 12:821-35.

19 Callison, K and Kaestner, R (2012), Do higher tobacco taxes reduce adult smoking? New evidence of the effect of recent cigarette tax increases on adult smoking, National Bureau of Economic Research.

20 Post-implementation Review 25 per cent tobacco Excise Increase The Treasury February 2013 p. 16 Available on the website of the Office of Best Practice Regulation. http://ris.finance.gov.au/category/post-implementation-reviews p. 25.

INTERNATIONAL BEST PRACTICE

1.32 The WHO recommends that tobacco excise taxes account for at least 70 per cent of retail prices for tobacco products.[21] According to the 2013 WHO report on the global tobacco epidemic, excise tax as a percentage of the average price of a brand of 20 cigarettes in Australia was around 60 per cent.[22] This compares with New Zealand of around 61 per cent, France 64 per cent, Sweden 54 per cent.

1.33 For a pack of 25 Winfield cigarettes, increasing tobacco excise by a series of four 12.5 per cent increases along with biannual indexation by AWOTE is estimated to increase the excise rate per stick from $0.35731 prior to 1 December 2013 to $0.64035 by 1 December 2016. The combined impact of these increases is estimated to result in a tax to price ratio of around 67 per cent by 1 December 2016.

1.34 Although the ratio of tobacco taxes to price is often used to compare how different countries tax tobacco products, the use of this ratio should be treated with caution. This is because the ratio depends on the total retail price as well as the underlying tax rates. As tobacco product prices are not regulated and retailers are free to increase prices at any time, the tax-price ratio can fall even if tax rates do not change. Retail prices can increase significantly over time for various reasons including rising production and distribution costs, supply shortages or declining profit margins.

Problem

1.35 The scope of the problem of tobacco use in Australia can be defined by:

- rates of smoking;
- market failure which includes externalities of tobacco use (that is, health, economic and social costs);
- information failure which lead to higher rates of smoking; and
- the regulatory framework which requires consideration of the effectiveness of existing government regulation to combat tobacco use.

SMOKING PREVALENCE IN AUSTRALIA

1.36 Table 1.1 shows the daily rate of smoking of adults, 18 years or older.

TABLE 1.1: DAILY RATE OF SMOKING OF ADULTS

	1990	1995	2001	2004-05	2007-08	2011-12
TOTAL %*	27.7	25.1	22.3	21.3	19.1	16.3

*age-standardised

Source: ABS Surveys; ABS Australian Health Survey: Updated Results, 2011 12 (AHS): released 30 July 2013

21 World Health Organisation Technical Manual on Tobacco Tax Administration 2010 Reprinted 2011, available from: http://whqlibdoc.who.int/publications/2010/9789241563994_eng.pdf, p. 104.

22 World Health Organization (2013) WHO Report on the Global Tobacco Epidemic, 2013, Appendix IX available from: http://www.who.int/tobacco/global_report/2013/en/index.html, Table 9.1. This percentage was calculated prior to the 1 December 2013 increase in tobacco excise.

1.37 In 2011-12, 16.3 per cent of Australians aged 18 years and older smoked daily (age-standardised rate). The following table shows daily smoking rates for males and females aged 18 years and older between 2001 and 2011-12.

TABLE 1.2: DAILY SMOKING RATES OF ADULTS — MALES AND FEMALES

	2001*	2004-05*	2007-08*	2011-12*
MALES	27.2	26.2	23.0	18.3
FEMALES	21.2	20.3	19.0	12.6
ALL PERSONS %	22.3	21.3	19.1	16.3

*age-standardised to the 2001 Australian population

Source: for 2001, 2004-05 and 2007-08 — ABS, 4125.0 — Gender Indicators, Australia, July 2012. For 2011-12, ABS Australian Health Survey: Updated Results, 2011-12 (AHS) released 30 July 2013.

HEALTH IMPACTS

1.38 There are no safe levels of consumption of tobacco products. The harms from smoking are well documented.

1.39 Tobacco smoking continues to be the largest cause of preventable death and disease in Australia.[23] In 2003 it was responsible for 7.8 per cent of the total burden of disease and injury in Australia, with lung cancer, chronic obstructive pulmonary disease (COPD) and ischaemic heart disease, accounting for more than three-quarters of this burden. In Indigenous communities, this burden was even greater: smoking was responsible for 12.1 per cent of the total burden of disease and injury, and accounted for 20 per cent of deaths.[24]

1.40 The latest 2014 report by the US Surgeon General *The Health Consequences of Smoking — 50 Years of Progress* states:

> *Since the 1964 Surgeon General's report, cigarette smoking has been causally linked to diseases of nearly all organs of the body, to diminished health status, and to harm to the fetus.'*[25]

1.41 The report goes on to state:

> *A half century after the release of the first report, we continue to add to the long list of diseases cause by tobacco use and exposure to tobacco smoke. This report finds that active smoking is now causally associated with age-related macular degeneration, diabetes, colorectal cancer, liver cancer, adverse health outcomes in cancer patients and survivors, tuberculosis, erectile dysfunction, orofacial clefts in infants, ectopic pregnancy, rheumatoid arthritis, inflammation, and impaired immune function. In addition, exposure to secondhand smoke has now been causally associated with an increased risk for stroke.* [26]

23 Begg S, Vos T, Barker B, Stevenson C, Stanley L & Lopez A 2007. The burden of disease and injury in Australia 2003. Cat. No. PHE 82. Canberra: AIHW p. 5.

24 Begg S, Vos T, Barker B, Stevenson C, Stanley L & Lopez A 2007. The burden of disease and injury in Aboriginal and Torres Strait Islander peoples 2003 (School of Population Health, University of Queensland p. 55.

25 The report is available at: http://www.surgeongeneral.gov/library/reports/50-years-of-progress/index.html, Executive Summary, p.4, para 3.

26 Ibid. Preface.

1.42 A British study found that about half of long-term smokers died prematurely from cigarette smoking, and that the average number of years of life lost by long-term smokers was 10 years.[27] More recently (11 October 2013), the Sax Institute reported on findings from the 45 and Up Study that 'the first ever analysis of long-term Australian smoking data has found that two-thirds of deaths in current smokers can be directly attributed to smoking — much higher than international estimates of 50 per cent'.[28]

1.43 In calculating the value of the private mortality costs of smoking (for committed smokers over a lifetime, with a reference age of 24 years old) Viscusi and Hersch estimated that,

> *The economic value of the premature mortality due to smoking dwarfs the purchase price of cigarettes. The mortality cost per [cigarette] pack for men is $222 [US] in 2006 dollars. For women, the cost is much lower than that for men but is still large, with a cost per pack of $94 in 2006 dollars.*[29]

1.44 Smoking cessation is associated with the following health benefits:

- lowers the risk for lung and other types of cancer;
- reduces the risk for coronary heart disease, stroke, and peripheral vascular disease. Coronary heart disease risk is substantially reduced within 1 to 2 years of quitting;
- reduces respiratory symptoms, such as coughing, wheezing, and shortness of breath. The rate of decline in lung function is slower among people who quit smoking than among those who continue to smoke;
- reduces the risk of developing chronic obstructive pulmonary disease (COPD), one of the leading causes of death in the United States; and
- reduces the risk of infertility of women during their reproductive years. Women who stop smoking during pregnancy also reduce their risk of having a low birth weight baby.[30]

1.45 Compared with non-smokers (never smoked or ex-smokers), smokers are more likely to rate their health as being fair to poor, more likely to have asthma and more likely to suffer psychological distress. In Australia, tobacco smoking is a major risk factor for coronary heart disease, stroke, peripheral vascular disease, cancer and various other diseases and conditions.[31] Tobacco has been responsible for the greatest disease burden in Australia.[32]

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27 Doll R, Peto R, Boreham J and Sutherland I. 'Mortality in relation to smoking: 50 years' observations on male British doctors'. British Medical Journal, 2004. 328: 1519–33.

28 Sax Institute Media release. 2013. 'Even light smokers have double risk of early death, Australian-first research reveals'. Friday, 11 October 2013.

29 Viscusi WK and Hersch J. 2007. 'The mortality cost to smokers'. NBER Working Paper No 13599. National Bureau of Economic Research: Cambridge, MA. Available from: www.nber.org/papers/w13599.

30 U.S. Department of Health and Human Services (2010). How Tobacco Smoke Causes Disease: The Biology and Behavioural Basis for Smoking Attributable Disease. Fact Sheet. National Centre for Chronic Disease Prevention and Health Promotion, Office of Smoking and Health. Atlanta. Available from: http://www.cdc.gov/tobacco/data_statistics/fact_sheets/cessation/quitting/index.htm#benefits.

31 AIHW 2011 2010 National Drug Strategy Household Survey report 2011. Drug statistics series no. 25. Cat. No. PHE 145. Canberra: AIHW: p xii, p. 1.

32 Begg S, Vos T, Barker B, Stevenson C, Stanley L & Lopez A The burden of disease and injury in Australia 2003. PHE 82. Canberra: AIHW 2007.

1.46 Smoking remains a significant cause of poor health among newborn babies, and smoking is a major contributor to the poorer health outcomes for Indigenous babies.[33]

1.47 Secondhand (or passive) smoking also poses health risks, including children. Children exposed to secondhand tobacco smoke are 40 per cent more likely to suffer from asthma symptoms than children who are not exposed. An estimated 8 per cent of childhood asthma is Australia is attributable to passive smoking and is estimated to contribute to the symptoms of asthma in 46,500 Australian children a year. Other symptoms of passive smoking in children compared with their non-passive smoking peers include ear infections, shorter physical stature, more absences from school, reduced lung function, and more serious lung infections. [34]

SOCIAL AND ECONOMIC IMPACTS

1.48 Smoking has been reported to kill over 15,000 Australians each year.[35] Annually, over 750,000 hospital bed days are attributable to tobacco-related disease.[36]

1.49 The 2008 study by Collins and Lapsley, *The costs of tobacco, alcohol and illicit drug abuse to Australian Society in 2004/05*, is the most recent major study which seeks to quantify the social and economic costs of tobacco use in Australia.[37] The study estimates that the tangible and intangible social costs of tobacco use amounted to $31.5 billion in 2004-05,[38] which includes $5.7 billion attributed to absenteeism and a reduction in the workforce.[39]

1.50 Table 1.3 sets out the key components of the tangible and intangible social costs of smoking, (noting that tangible costs refers to the extra resources which would have been available if there had been no past or present abuse with intangible costs being costs that cannot be shifted, for example, in the case of loss of life, there is no mechanism by which this cost can be passed on to others).

TABLE 1.3: KEY COMPONENTS OF SOCIAL COSTS OF SMOKING

COMPONENT	$M
Net healthcare costs (gross costs minus savings from premature deaths	318.4
Total net labour costs (including lost production in the workplace and in the household)	8,009.1
Resources used in tobacco consumption	3,635.6
Value of loss of life from tobacco consumption[40]	19,459.7

From Tables 33 and 34 of the study

33 Wills R and Coory M. Effect of smoking among Indigenous and non-Indigenous mothers on preterm birth and full-term low birth weight. Medical Journal of Australia. 2008;189(9): pages. 490-494.

34 National Tobacco Strategy 1999-2002-03 Fact Sheet The dangers of passive smoking Department of Health and Ageing Available from: https://www.health.gov.au/internet/main/publishing.nsf/.../tobpass.pdf.

35 Begg S, Vos T, Barker B, Stevenson C, Stanley L & Lopez A 2007. The burden of disease and injury in Australia 2003. Cat. No. PHE 82. Canberra: AIHW p. 5.

36 Collins D and Lapsley H. 2008. The costs of tobacco, alcohol and illicit drug abuse to Australian Society in 2004/05. Commonwealth of Australia: Canberra. p. 40, Table 13.

37 ibid.

38 ibid. p. 65.

39 ibid. p. 59.

40 For explanation of valuation of life see page 15 of the study.

1.51 Of the tangible costs shown in Table 1.3, the government sector bore 8 per cent, while households and businesses bore 50 per cent and 42 per cent, respectively.[41] The study also includes the cost of secondhand (passive) smoking. It assumes that all smoking attributable symptoms suffered by people aged less than fifteen years reflect involuntary smoking.[42]

1.52 In their study, Collins and Lapsley adopt a 'demographic approach' rather than a 'human capital' approach taking the definition of the economic costs of drug abuse as:

> *The value of the net resources which in a given year are unavailable to the community for consumption or investment purposes as a result of the effects of past and present drug abuse, plus the intangible costs imposed by this abuse.* [43]

1.53 The demographic approach is based on the calculation of the size and structure of a hypothetical population in which no drug abuse has occurred.[44] The counterfactual scenario used by Collins and Lapsley is where there has been no abuse of tobacco for at least 40 years before 2004-05.[45] In the case of premature mortality, the actual and hypothetical outputs are compared to yield the production costs in the year of study of past and present substance abuse.[46] The average potential years of life lost for tobacco is 16.[47]

1.54 Collins and Lapsley break down the calculation of net healthcare costs of $318 million set out in Table 1.4 which is the gross costs of health care reduced by savings from premature death. These savings arise because, had the prematurely deceased been still alive, they would have been placing demands on healthcare resources, which have been avoided as a result of premature death.[48]

TABLE 1.4: HEALTHCARE COSTS AND SAVINGS FROM TOBACCO USE

	MEDICAL ($M)	HOSPITAL ($M)	NURSING HOMES ($M)	PHARMACEUTICALS ($M)	AMBULANCES ($M)	TOTAL ($M)
Gross cost	462.1	669.6	436.6	205.2	62.5	1,836.0
Savings from premature deaths	303.7	446.2	613.9	127.9	25.9	1,517.6
Net costs	158.4	223.4	(177.3)	77.3	36.6	318.4

1.55 Collins and Lapsley identify the costs of a premature loss of life also referred to in Table 1.3 as the loss of productive capacity and the psychological effects borne by user and others. Using the demographic approach the study estimates the value of the loss of one year's living, not the value of a lost life.[49] In 2004/05 prices this was calculated to be $53,267.[50]

41 ibid. p. 67.
42 ibid. p. 14.
43 ibid. p. 3.
44 ibid. p. 3.
45 ibid. p. 3.
46 ibid. p. 6.
47 ibid. p. 6.
48 ibid. p.50.
49 ibid. p.15.
50 ibid. p.16.

1.56 The Collins and Lapsley study is the latest and definitive research that the Australian Department of Health uses as the estimate of the social and economic (including healthcare) costs of tobacco use.

1.57 Collins and Lapsley take a conservative approach to the estimation of costs.[51] Susan Hurley notes:

> *Collins and Lapsley's estimates of the social costs of tobacco abuse are extremely conservative; the actual costs are likely to be much higher. Lack of data prevented Collins and Lapsley assigning values to many of the social costs known to be attributable to smoking. For example, the following are not included: the purchase of over-the-counter medicines, domiciliary care and allied health services.*[52]

1.58 Furthermore, the study did not cost reduced on-the-job productivity. However, a study published in 2006 estimated that between eight to 30 minutes per day are lost due to smoking. If five minutes are spent daily on smoking outside of normal break times, the employee is one per cent less productive.[53]

1.59 As noted above, Collins and Lapsley acknowledge that some of their cost estimates were almost certainly too low. For example, the cost of pharmaceutical products is based only on the highest volume drug categories on the PBS. The hospital cost estimates are based on average treatment costs for each condition and do not reflect the fact that health care costs for smokers are likely to be higher than for non-smokers.[54] For example, smoking up to the time of any surgery increases cardiac and pulmonary complications, impairs tissue healing and is associated with more infections, therefore increasing the average length of stay, staff workload and requirements for medicines.[55] [56] Costs associated with the management of birth complications for women in the United States who smoke during pregnancy exceed those of non-smokers by 66 per cent.[57] Costs for smokers having orthopaedic surgery can be up to 38 per cent higher than those of non-smokers due to infections resulting in prolonged hospital stay and double the re-admission rate.[58]

1.60 Tobacco-related health expenditure includes more than primary healthcare and hospital costs. It also includes expenditure on the prevention of tobacco use through strategies such as social

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51 ibid. p. xi.

52 Hurley, S. Chapter 17: The economics of tobacco control, in Scollo, MM and Winstanley, MH [editors]. Tobacco in Australia: Facts and issues. 4th ed. Melbourne: Cancer Council Victoria; 2012. Last updated November 2011. Available from: http://www.tobaccoinaustralia.org.au/downloads/chapters/Ch17_Economics.pdf.

53 Javitz HS, Zbikowski SM, Swan GE and Jack LM. Financial burden of tobacco use: an employer's perspective. Clinics in Occupational and Environmental Medicine. 2006;5(1):9–29, vii. Available from: http://www.ncbi.nlm.nih.gov/sites/entrez?cmd=Retrieve&db=PubMed&list_uids=16446251&dopt=Abstract.

54 Bertakis KD and Azari R. The influence of obesity, alcohol abuse, and smoking on utilization of health care services. Family Medicine. 2006;38(6):427-34. Available from: http://www.stfm.org/fmhub/fm2006/June/Klea427.pdf.

55 Peters MJ. Should smokers be refused surgery? British Medical Journal. 2007;334(7583):20. Available from: http://www.bmj.com/cgi/content/full/334/7583/20.

56 Theadom A and Cropley M. Effects of preoperative smoking cessation on the incidence and risk of intraoperative and postoperative complications in adult smokers: a systematic review. Tobacco Control. 2006;15(5):352–8. Available from: http://tc.bmjjournals.com/cgi/content/abstract/15/5/352.

57 Medical care expenditures attributable to cigarette smoking during pregnancy — United States, 1995. Morbidity and Mortality Weekly Report. 1997;46(44):1048-50. Available from: http://www.cdc.gov/mmwr/PDF/wk/mm4644.pdf.

58 Whitehouse JD, Friedman ND, Kirkland KB, Richardson WJ and Sexton DJ. The impact of surgical-site infections following orthopedic surgery at a community hospital and a university hospital: adverse quality of life, excess length of stay, and extra cost. Infection Control and Hospital Epidemiology. 2002;23(4):183-9. Available from: http://www.journals.uchicago.edu/ICHE/journal/issues/v23n4/4183/4183.text.html?erFrom=-2198106237673852801Guest.

marketing campaigns and Quitline. In 2008–09, Australian governments spent $55.6 million on these types of prevention programs.[59]

1.61 In terms of health care costs, studies show that smokers have higher health service usage and costs than non-smokers. A Western Australian study, based on data for 1978-94 in Busselton, showed that former smokers' hospitalisation utilisation rates and hospital bed-days were higher than for never smokers but lower than for smokers. There are also health care costs associated with exposure to second-hand smoke (or 'passive smoking') such as in the home. Due to limitations of Australian databases, this is the only Australian study.[60]

INFORMATION FAILURE

1.62 It is recognised internationally that many people are not fully informed about the health effects of smoking. As noted above, Australia is a party to the WHO FCTC. FCTC Guidelines for Article 11, Packaging and labelling of tobacco products, states 'Globally, many people are not fully aware of, misunderstand or underestimate the risks for morbidity and premature mortality due to tobacco use and exposure to tobacco smoke.'[61]

1.63 International studies report that while most smokers agree that smoking poses a health risk many have important gaps in their knowledge, are unable to recall specific health effects and tend to underestimate the magnitude of the risks.[62]

1.64 It is possible that even if some consumers had full information about the harms and costs of smoking (and excluding the influence of addiction on rational decision making), they might still choose to smoke. However, there are gaps in smokers' knowledge of the mechanisms the tobacco industry uses to influence the experience of smoking. For example, additives can be used to improve the flavour and aroma of cigarettes, and decrease the harshness of tobacco.[63,64] The combined effects of increased filtration and increased ventilation make the smoke more dilute so it tastes weaker or 'milder' and produces less harshness (the immediate burning/scratching sensations in the mouth and throat) and irritation (the lingering tingling sensations in the throat and chest).[65] This 'lighter' or 'milder' taste can support the smoker's perception that these cigarettes deliver less tar and nicotine, and by tasting less harsh, stimulate beliefs about diminished dangers to health.[66]

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59 Australian Institute of Health and Welfare. (2011) Public health expenditure in Australia 2008-09. Health and welfare expenditure series no. 43. Cat. no. HWE 48. Canberra: AIHW.

60 op. cit. Hurley, S. Chapter 17.

61 See Principles section of the WHO Guidelines for the implementation of Article 11 of the WHO FCTC Packaging and labelling of tobacco products. Full copy of the text can be found at http://www.who.int/fctc/guidelines/article_11.pdf.

62 Hammond, Fong, McNeill, Borland, Cummings. 2006 Effectiveness of cigarette warning labels in informing smokers about the risks of smoking: findings from the International Tobacco Control (ITC) Four Country Survey Tobacco Control 115 19-25. Available at http://tobaccocontrol.bmj.com/content/15/suppl_3/iii19.full.

63 Rabinoff M, Caskey N, Rissling A, Park C. Pharmacological and chemical effects of cigarette additives. Am J Public Health Nov 2007;97(11):1981–1991.

64 Tobacco Products Scientific Advisory Committee Menthol Cigarettes and Public Health: Review of the Scientific Evidence and Recommendations. A report to the US FDA, 2011. Available from http://www.fda.gov/downloads/AdvisoryCommittees/CommitteesMeetingMaterials/TobaccoProductsScientificAdvisoryCommittee/UCM269697.pdf.

65 King B, Borland R. The 'low tar' strategy and the changing construction of Australian cigarettes. Nicotine & Tobacco Research 2004;6(1):85–94. Available from http://www.informaworld.com/smpp/content~db=all?content=10.1080/14622200310001656907.

66 Kozlowski & O'Connor. Cigarette Filter Ventilation is a Defective Design Because of Misleading Taste, Bigger Puffs and Blocked Vents. Tobacco Control 2002:11(Suppl I):i 40-i50.

1.65 Findings from the International Tobacco Control Four Country Survey, which included Australian smokers, has reported significant knowledge gaps among adult smokers (age 18 years or older), regarding the health effects and the magnitude of risk associated with smoking .[67] For example, among the Australian smokers in the survey, 10 per cent did not believe smoking caused heart disease, 20 per cent did not believe smoking caused stroke and 30 per cent did not believe smoking caused lung cancer in non-smokers.

1.66 Studies also indicate that many smokers fail to personalise the risks, believing that their own risk is less than the risks faced by other smokers.[68] Studies have also shown that smokers know relatively little about the nature of illnesses caused by smoking or what it might be like to experience these illnesses.[69] For example, one study found that smokers underestimate lung cancer death rates, overestimate survival from lung cancer, and only a minority realise that emphysema is incurable.[70] Research has also found that some smokers believe myths about reducing their risk including that exercising or taking vitamins can reverse most of the effects of smoking.[71]

1.67 Studies have also documented that adults, and young smokers in particular, misunderstand addiction, fail to recognise the signs of addiction in themselves or others and believe that their personal risk of addiction is less than others.[72, 73] Young smokers also tend to believe they are unlikely to become addicted and that the health risks are only associated with long term use and are therefore irrelevant.[74]

1.68 Almost no one starts smoking after age 25. Nearly nine out of 10 smokers started smoking by age 18, and 99 per cent started by age 26 and progression from occasional to daily smoking almost always occurs by age 26.[75]

1.69 The evidence around the health effects of tobacco use also continues to grow each year. The National Preventative Health Taskforce acknowledged in 2009 that there was extensive new

67 ibid.

68 Weinstein, Marcus and Moser. 2005. Smoker's unrealistic optimism about their risk. Tobacco Control Vol 14, pp 55-59. Available at http://tobaccocontrol.bmj.com/content/14/1/55.full.pdf+html.

69 Weinstein, Slovic, Waters et al. 2004 Public understanding of the illnesses caused by cigarette smoking. Nicotine & Tobacco Research. 6(2) p349-355. AND Weinstein, Marcus and Moser. 2005. Smoker's unrealistic optimism about their risk. Tobacco Control Vol 14 pp 55-59. Available at http://tobaccocontrol.bmj.com/content/14/1/55.full.pdf+html.

70 Weinstein, Slovic, Waters et al. 2004 Public understanding of the illnesses caused by cigarette smoking. Nicotine & Tobacco Research. 6(2) pp 349-355.

71 Weinstein, Marcus and Moser. 2005. Smoker's unrealistic optimism about their risk. Tobacco Control Vol 14 p55-59. Available at http://tobaccocontrol.bmj.com/content/14/1/55.full.pdf+html.

72 Weinstein, Slovic & Gibson, 2003. Accuracy and optimism in smokers' beliefs about quitting. Nicotine & Tobacco Research. 6(Suppl 3) pp 375-380.

73 Eureka Strategic Research, 2005. Youth Tobacco Prevention Project. Australian Government Department of Health and Ageing available at http://www.health.gov.au/internet/main/publishing.nsf/Content/C0A3291951BC1115CA257BF0001D7925/$File/youth_research.pdf.

74 Eureka Strategic Research, 2005. Youth Tobacco Prevention Project. Australian Government Department of Health and Ageing available at http://www.health.gov.au/internet/main/publishing.nsf/Content/C0A3291951BC1115CA257BF0001D7925/$File/youth_research.pdf.

75 U.S. Department of Health and Human Services. Preventing Tobacco Use Among Youth and Young Adults: A Report of the Surgeon General. Atlanta, GA: U.S. Department of Health and Human Services, Centers for Disease Control and Prevention, National Center for Chronic Disease Prevention and Health Promotion, Office of Smoking and Health, 2012.

evidence about the health effects of smoking that Australian consumers had not yet been warned about.[76]

1.70 Given the multitude of anti-smoking campaigns to raise awareness of the health risks of tobacco, the perceived information deficiency may be explained by the addictive nature of smoking, rather than a lack of public awareness.

1.71 Most smokers regret starting smoking and have the desire to quit. A major international study of smokers, including Australian smokers, reports an 'overwhelming' high level of regret among adult smokers about starting to smoke, with nearly nine out of 10 agreeing with the statement 'If you had to do it over again, you would not have started smoking'.[77]

1.72 A survey, conducted annually from 2002 to 2009, reports that each year an average 72.8 per cent of Australian smokers are interested in quitting and plan to make a quit attempt either within the next month, within 6 months or at some point in the future.[78] Additionally, around 39 per cent of Australian smokers report making an actual quit attempt in the previous 12 months.[79]

1.73 Because of the highly addictive nature of tobacco, many attempted quits are unsuccessful. Typically, quitting should be viewed as a process with most smokers making multiple quit attempts before they succeed in quitting for good.[80] The number of quit attempts before success varies widely and studies use different methods to measure quit attempts. An average of 4.7 quit attempts before success has been reported in the past although a more recent study indicated that the average 40 year old smoker who started smoking in their teens may have made more than 20 attempts to quit.[81]

1.74 Data from the 2010 Australian National Drug Strategy Household Survey indicates that over a 12 month period 19.1 per cent of smokers aged 14 years and over had successfully given up smoking for more than a month while 29 per cent had unsuccessfully tried to quit.[82]

1.75 The 2010 US Surgeon General's report on how tobacco smoke causes disease notes that of those who try to quit, less than 5 per cent are successful at any one time.[83]

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76 National Preventative Health Taskforce. 2009. Australia: the healthiest country by 2020, National Preventative Health Strategy — the roadmap for action 30 June 2009. Commonwealth of Australia: Canberra.

77 Fong, Hammond, Laux et al, 2004 The near universal experience of regret among smokers in four countries: Findings from the International Tobacco Control Policy Evaluation Survey. Nicotine & Tobacco Research. Vol 6 (Suppl 3) p341-351. Available at http://ntr.oxfordjournals.org/content/6/Suppl_3/S341.abstract.

78 Cooper, Borland & Yong. 2011 Australian smokers increasingly use help to quit, but number of attempts remains stable: Findings from the International Tobacco Control Study 2002-2009. Australian & NZ Journal of Public Health. Vol 35 no 4 p 368-376 available at http://onlinelibrary.wiley.com/doi/10.1111/j.1753-6405.2011.00733.x/pdf.

79 Cooper, Borland & Yong. 2011 Australian smokers increasingly use help to quit, but number of attempts remains stable: Findings from the International Tobacco Control Study 2002-2009. Australian & NZ Journal of Public Health. Vol 35 no 4, pp368-376 available at http://onlinelibrary.wiley.com/doi/10.1111/j.1753-6405.2011.00733.x/pdf.

80 US Surgeon General. 2010. How Tobacco smoke causes disease: The biology and behavioural bases for smoking-attributable disease. A report of the Surgeon General. US Department of Health and Human Services, p171.

81 Borland, Partos, Yong et al, 2011. How much unsuccessful quitting activity is going on among adult smokers? Data from the International Tobacco Control Four Country cohort survey. Addiction. Vol 107, pp673-682.

82 Australian Institute of Health and Welfare. 2011. 2010 National Drug Strategy Household Survey Report. Drug statistics series no. 25. Cat no PHE145. Canberra: AIHW. p. 4. Available at http://www.aihw.gov.au/publication-detail/?id=32212254712.

83 US Surgeon General. 2010. How Tobacco smoke causes disease: The biology and behavioural bases for smoking-attributable disease. A report of the Surgeon General. US Department of Health and Human Services, p.105.

1.76 There is evidence from the International Tobacco Control Four Country Survey (USA, UK, Canada, Australia) of a strong relationship between people's intentions to quit smoking and the number of quit attempts. Given the highly addictive nature of tobacco, it usually takes smokers multiple quit attempts before they can successfully quit smoking (as outlined above). A significant relationship was observed between the participants' intentions to quit at Wave 1 and remaining quit at Wave 2 of the Survey. The difficulty of quitting and the link to quit attempts are important considerations for designing and implementing tobacco control policies and interventions as part of a multi-strategy regulatory framework, of which excise on tobacco is a key component. This is in line with the comprehensive approach to tobacco control under the WHO FCTC.[84]

EFFECTIVENESS OF CURRENT REGULATORY REGIME

1.77 Australia has a long history of tobacco control measures, and currently has a comprehensive set of tobacco control strategies in place at the national level and in every state and territory.

1.78 Multi-pronged approaches that are population wide in reach have proved to be the most successful public health responses to the prevalence of preventable risk factors (for example, tobacco use) for chronic diseases. Based on historical experience, smoking rates do not decline without major and comprehensive policy intervention to successfully change community-wide behaviour to 'non-smoking'. These tobacco control strategies include addressing tobacco use and withdrawal, secondhand (passive) smoking, tobacco advertising, taxation and pricing, sales restrictions, public education, and smoke-free premises and environments (for example, enclosed and public places).[85]

1.79 As outlined above, the last (non-CPI) general increase in the excise rate for tobacco occurred on 29 April 2010, when the former Government increased the excise and excise equivalent customs duty applying to tobacco products by 25 per cent.

1.80 Prior to this increase, the previous (non-CPI) general increase in the excise rate for tobacco occurred in the 1995-96 May Budget, which increased the excise rate by 10 per cent.

1.81 In addition to taxation measures, at the national level, other recent comprehensive tobacco control initiatives include the following:

- investment in anti-smoking social marketing campaigns;
- listing of nicotine replacement therapies on the PBS, which subsidises access for lower-income Australians and people with a prescription from their GP, and extended listings for the smoking cessation support drugs bupropion (available in two brands) and varenicline (Champix®);
- investment in support for Aboriginal and Torres Strait Islander communities to reduce smoking rates, including:

84 World Health Organization. 2008. MPOWER: A policy package to reverse the tobacco epidemic http://www.who.int/tobacco/mpower/mpower_report_six_policies_2008.pdf.

85 Gruszin, S, Hetzel D and Glover J. Advocacy and action in public health: lessons from Australia over the 20th century. Canberra: Australian National Preventive Health Agency, pp 118-120.

  - the $14.5 million Indigenous Tobacco Control Initiative, which funded 18 innovative tobacco control projects in a mix of urban, rural and remote Indigenous communities; and
  - $100.6 million Tackling Smoking and $35.6 million Healthy Lifestyle measures under the COAG Closing the Gap in Indigenous Health Outcomes National Partnership Agreement to support Regional Tackling Smoking and Healthy Lifestyle Teams in 57 regions;

- legislation to restrict Australian internet advertising of tobacco products, from 6 September 2012, bringing restrictions on tobacco advertising on the internet into line with other points of sale;
- legislation to mandate the plain packaging of tobacco products – from 1 December 2012 all tobacco products sold in Australia are required to appear in a drab, dark brown colour with a matt finish. Tobacco industry logos, brand imagery, colours and promotional text other than brand and product names must be in a standard colour, position, font style and size;
- regulations to update and expand the graphic health warnings appearing on tobacco products, in line with tobacco plain packaging requirements;
- a reduction in the duty-free allowance for tobacco products from 250 cigarettes or 250g of cigars or tobacco products to 50 cigarettes or 50g of cigars or tobacco products per person, from 1 September 2012;
- introduction of a maximum penalty of ten years' imprisonment for tobacco smuggling offences, from 6 November 2012; and
- four staged increases in excise and excise equivalent customs duty on tobacco and tobacco-related products: the first 12.5 per cent increase commenced on 1 December 2013 and further 12.5 per cent increases will occur on 1 September 2014, 1 September 2015 and 1 September 2016. These increases are in addition to the change to bi-annual indexation of tobacco products (from CPI to AWOTE), which will take effect from 1 March 2014. (These excise measures are the subject of this RIS.)

1.82 These measures are in addition to a number of long-standing tobacco control initiatives including:

- minimum age restrictions on the purchase of tobacco products;
- comprehensive advertising bans under the *Tobacco Advertising Prohibition Act 1992*;
- retail display bans;
- bans on smoking in offices, bars, restaurants and other indoor public spaces, and increasingly outdoor places where children may be exposed to environmental tobacco smoke;
- extensive and continuing public education campaigns on the dangers of smoking;
- PBS subsidies for smoking cessation supports; and
- Quitlines and other smoking cessation support services in each state and territory to help people quit.

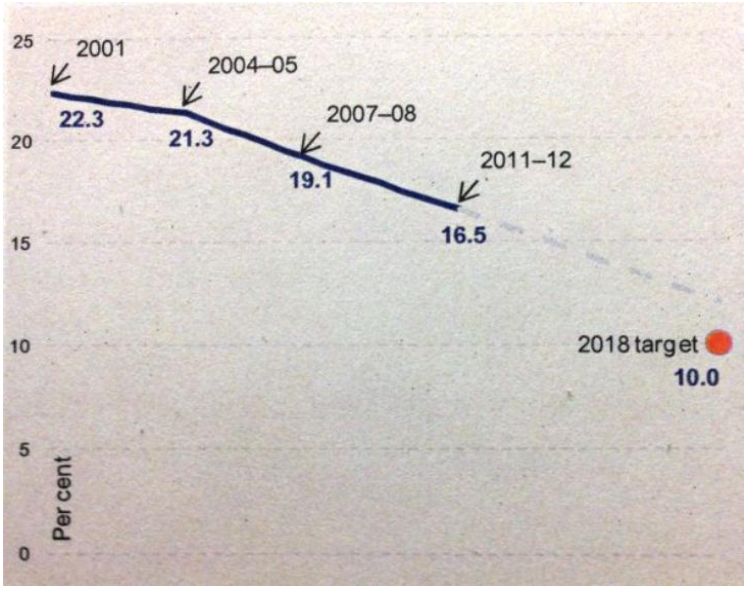
1.83 As shown in Tables 1.1 and 1.2 above, Australia has made significant gains in reducing smoking prevalence over many years. However, Australian smoking rates are still too high. As noted

in paragraph 1.11, COAG committed to the following performance benchmark: 'By 2018, reduce the national smoking rate to 10 per cent of the population, and halve the Indigenous smoking rate, over the 2009 baseline'. Progress against this benchmark is measured by reference to the adult daily smoking rate.

1.84 Despite Australia's comprehensive efforts on tobacco control, the COAG Reform Council's most recent report states that while good progress has been made in reducing smoking rates over the last decade Australia's smoking rate may need to fall more quickly than it has since 2004-05 (when it was 21.3 per cent) in order to meet the target of 10 per cent by 2018.

1.85 Figure 1.1 below shows smoking rates dropping but they need to fall faster to meet the 10 per cent target.

FIGURE 1.1: DECLINE IN SMOKING RATES



Source: ABS, presented as Figure 4.2 in the COAG Reform Council Report (2013).

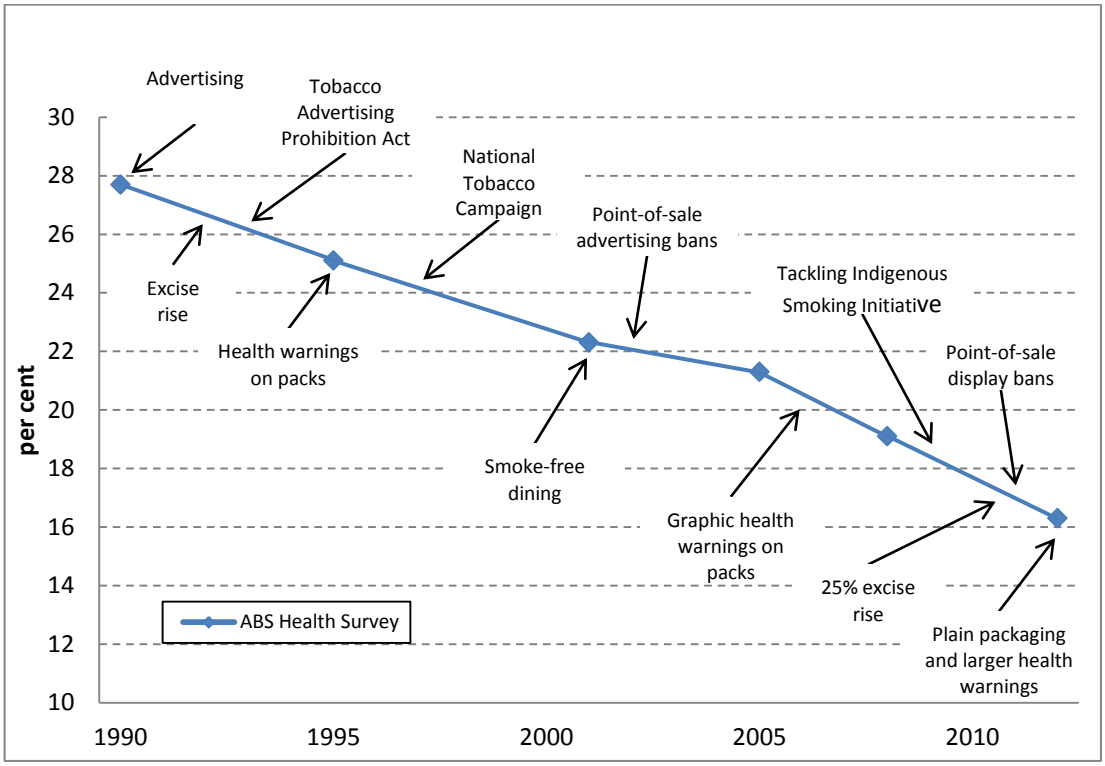
Note: The ABS Australian Health Survey 2011-12 Updated Results released on 30 July 2013 (after the COAG Reform Council report was published) revised the age-standardised rate for daily smoking among people aged 18 year or older to 16.3 per cent.

1.86 In 2009 it was projected that based on patterns of uptake and quitting, prevalence of daily smoking would still be over 14 per cent in 2020 and that smoking cessation rates would need to double for Australian smoking prevalence to reach a policy target of 10 per cent by 2020.[86]

1.87 Figure 1.2 below shows daily smoking rates among Australians 18 years and older and some of the key policy interventions, 1990 to 2011-12.

86 Gartner CE, Barendregt J and Hall W. Predicting the future prevalence of cigarette smoking in Australia: how low can we go and by when? Tobacco Control 2009; 18: pp183-189.

FIGURE 1.2: DAILY SMOKING RATES AND POLICY INTERVENTIONS



Source: ABS National Health Surveys 1989-90, 1995, 2001, 2004-05 and 2007-08, and ABS Australian Health Survey, Updated Results, 2011-12.

1.88 Given the health, community and economic costs associated with tobacco consumption, any action that can be taken to reduce the consumption and prevalence of tobacco in Australia, including actions of Government, should be considered.

1.89 As outlined above, it is well recognised that price and tax measures are one of the most effective instruments to reduce tobacco consumption.[87] Tobacco control measures interact synergistically as a suite of measures, to help bring down smoking rates and keep them down over a sustained period of time.

1.90 It is difficult to separately quantify the dollar value of individual measures within the comprehensive package of measures.[88] A study prepared by the consultancy firm Applied Economics for the then Department of Health and Ageing estimated that over a 30 year period (from 1970), government investment of $176 million in public health programs to reduce tobacco consumption returned a net benefit of about $8.4 billion, and averted 17,400 premature deaths. Benefits attributed to tobacco control public health programs (including national mass media campaigns, health warnings on cigarette packets, regulations restricting the promotion of cigarettes as well as the conditions under which the cigarette products might be consumed, and changes in taxes, which contributed to a 154 per cent increase in the price of tobacco products) were estimated at a total of

87 Australian Government. Preventative Health Taskforce. 2009. Australia: the healthiest country by 2020. Technical Report No. 2. Tobacco control in Australia: making smoking history. Canberra: Commonwealth of Australia.

88 Department of Health and Ageing. 2003. Returns on investment in public health: An epidemiological and economic analysis prepared for the Department of Health and Ageing by Applied Economics, p. 22. Available at: http://www.health.gov.au/internet/main/publishing.nsf/Content/8E28958A40B64604CA257BF0001A4CCF/$File/roi_eea.pdf).

$12.3 billion, comprising longevity gains (approximately $9.6 billion), improved health status gains ($2.2 billion) and lower health care costs ($0.5 billion). [89]

1.91 New research conducted by the NSW Cancer Institute and reported in the *Medical Journal of Australia*[90] is evidence of immediate and actual behaviour change following the introduction of tobacco plain packaging, demonstrating that people are taking action to obtain support to quit smoking. The report states:

> *There has been a sustained increase in calls to the Quitline after the introduction of tobacco plain packaging. This increase is not attributable to anti-tobacco advertising activity, cigarette price increases nor to other identifiable causes. This is an important incremental step in comprehensive tobacco control.*

1.92 Also, as noted in the Post-implementation Review for the 25 per cent tobacco excise increase that took effect from 29 April 2010, the increase exceeded the objective of cutting licit tobacco consumption by around 6 per cent as indicated by the decline in tobacco clearances.

Objective

1.93 The two measures will meet the Government's election commitment to proceed with the two tobacco excise and excise equivalent customs duty measures as announced by the former Government.

1.94 The broader objective is to reduce tobacco consumption in Australia. Excise taxation is at the centre of Australia's tobacco control policy. Compared to other taxes, excise can be applied selectively to pursue non-revenue objectives like the problems of smoking outlined above.

Implementation options

1.95 The Government has committed to implementing the change in indexation for tobacco excise and excise equivalent customs duty to AWOTE instead of CPI and increasing excise and excise equivalent customs duty on tobacco and tobacco-related products under a staged process.

1.96 Consequently, alternative options to the commitment are not required to be examined.

89 As cited in Gruszin, S, Hetzel D and Glover J. Advocacy and action in public health: lessons from Australia over the 20th century. Canberra: Australian National Preventive Health Agency, pp127-128.

90 Jane M Young, Ingrid Stacey, Timothy A Dobbins, Sally Dunlop, Anita L Dessaix and David C Currow (2014). Association between tobacco plain packing and Quitline calls: a population-based, interrupted time-series analysis. MJA 2014;200:29-32 doi:10.10.5694/maja13.11070 Available at: https://www.mja.com.au/journal/2014/200/1/association-between-tobacco-plain-packaging-and-quitline-calls-population-based.

Assessment of impacts

ANALYSIS OF COSTS/BENEFITS

COSTS

1.97 The costs of the two measures, which will result in an increase in tobacco prices for consumers are:

- a reduction in real incomes for those continuing to smoke at the same rate or take up smoking (see Impact Group Identification);
- a loss of any benefits to consumers from smoking;
- possible increased compliance costs for various stakeholders in the industry including licenced tobacco manufacturers, distributors and retailers (see Impact Group Identification);
- increased administrative costs for the ATO and ACBPS (see Impact Group Identification); and
- a shift to illicit tobacco and other unregulated products.

LOSS OF BENEFITS FROM SMOKING

1.98 There are possible benefits from smoking but these benefits are extremely small. That is, consumption of tobacco appears to provide some protective effect from Parkinson's disease in males and females and endometrial cancer in females.[91]

1.99 If, as a result of the price rises, smokers quit or reduce their smoking or not take up smoking, these benefits will be lost.

SHIFT TO ILLICIT TOBACCO AND OTHER UNREGULATED PRODUCTS

1.100 The ACBPS is responsible for collecting customs duty and also for detecting illicit tobacco at the Australian border and for administering related penalties. Imported tobacco is considered to be illicit or illegal if it is not declared at the border and does not have the appropriate duty paid.

1.101 The ACBPS does not differentiate between counterfeit (fake) and contraband (or smuggled) tobacco, as tobacco smuggling offences under the *Customs Act 1901* are primarily concerned with the evasion of excise equivalent customs duty, rather than copyright or trademark infringements.

1.102 Australia has a strong legislative and regulatory framework to control illicit trade in tobacco products. The maximum penalty for tobacco smuggling, including conveying or possessing smuggled tobacco products, is now 10 years imprisonment in addition to pecuniary penalties of up to five times the amount of duty evaded.

91 Collins and Lapsley, op. cit, p. 4

1.103 The ATO and the ACBPS do not formally estimate the size of the amount of excise or excise equivalent customs duty forgone through the sale of illicit tobacco consumed in Australia. They instead focus on a risk-based intelligence-led approach to focus on high risk areas of non-compliance.

1.104 The tobacco industry's estimates of the size of the illicit market are not considered to be accurate. A KPMG report prepared for the tobacco industry (British American Tobacco Australia, Philip Morris Ltd and Imperial Tobacco Australia Ltd) and released on 4 November 2013, claims that during 2012-2013, consumption of illicit tobacco grew from 11.8 per cent to 13.3 per cent of total tobacco consumption in Australia. The report claims that this represents a loss of $1 billion in excise revenue.

1.105 Like previous illicit trade reports commissioned by the tobacco industry, the KPMG report appears to substantially exaggerate the size of the illicit tobacco market in Australia and the consequent loss of excise and duty revenue. According to Australia's National Drug Strategy Household Survey conducted in 2010, only 1.5 per cent of smokers use illicit tobacco half the time or more.[92]

1.106 The Cancer Council Victoria's published detailed critique of the KPMG report[93], highlights multiple flaws in the surveys used to obtain the data underpinning the report, and the analyses used by KPMG.

1.107 While increases to excise and excise equivalent rates have the potential to increase the illicit trade in tobacco, ACBPS detection data does not support the premise that the total volume or value of tobacco smuggled increased significantly following previous excise rate increases. However, ACBPS detection data does indicate that previous excise increases have led to increased detections of small scale personal illicit tobacco imports through the international mail and by international travellers.

1.108 The table below provides information on average monthly detections of illicit tobacco and cigarettes in the sea cargo stream for recent financial years. Sea cargo detections are responsible for 95-99 per cent of the volume and value of illicit tobacco detected by the ACBPS. The equivalent tobacco weight in this table is calculated by combining tobacco and cigarette weights, and assumes a cigarette stick contains 0.8g of tobacco. This table shows that, except for a decrease in 2008-09, the total weight of tobacco detected by the ACBPS has remained relatively constant since 2007-08.

92 AIHW 2011 2010 National Drug Strategy Household Survey report 2011. Drug statistics series no. 25. Cat. No. PHE 145. Canberra: AIHW.

93 Available at: http://www.cancervic.org.au/downloads/mini_sites/Plain-facts/analysis-kpmg-llp-report-illicit-tobacco-aust-2013.pdf.

TABLE 1.5: ACBPS DETECTION OF ILLICIT TOBACCO

YEAR	NO. OF DETECTIONS	TOBACCO (TONNES)	CIGARETTES (MILLIONS OF STICKS)	DUTY EVADED ($ MILLION)	EQUIVALENT TOBACCO WEIGHT (TONNES)
2007-08	58	287	107	114	373
2008-09	33	180	50	70	220
2009-10	42	311	68	120	365
2010-11	55	258	82	135	324
2011-12	45	177	141	125	289
2012-13	76	183	200	151	343
2013-14 (YTD UNTIL 31 DEC 13)	51	112	96	85	189

1.109 Following the significant excise increase in April 2010, the total volume and value of illicit tobacco detected by the ACBPS decreased. In the nine months prior to the increase (July 2009 — March 2010), ACBPS detected an average of 39 tonnes of illicit tobacco per month in sea cargo. In the 15 months after the increase (April 2010-June 2011), an average of 24 tonnes of illicit tobacco per month was detected in sea cargo.

1.110 However, there is evidence of a correlation between previous excise increases and increased detections of small scale personal illicit tobacco imports through the international mail and by international travellers. These imports are primarily opportunistic in nature and do not appear to be associated with organised crime. While the small quantities involved do not significantly increase the overall volume or value of illicit tobacco detected, there are moderate additional workload and resourcing impacts for the ACBPS around processing the increased number of small scale imports.

1.111 A comprehensive approach to the ongoing risk associated with increasing volumes of smaller scale imports could include regulatory changes to the importation of tobacco products. This could be as far reaching as a complete ban on the importation of tobacco by unlicensed individuals, which has been introduced in other countries.

1.112 The Australian Government does not consider that tobacco plain packaging led to an increase in the illicit trade in tobacco products. Tobacco plain packaging is unlikely to be a significant factor in facilitating the activity of counterfeiters as the *Tobacco Plain Packaging Act 2011* provides for tobacco companies to use certain anti-counterfeiting techniques, including alphanumeric codes, on packaging on a voluntary basis.

1.113 The WHO FCTC Protocol to Eliminate the Illicit Trade in Tobacco Products[94] was adopted by the fifth session of the Conference of the Parties, in Seoul, Republic of Korea on 12 November 2012. The Protocol was open for Parties to the FCTC to become signatories until 9 January 2014 (New York time). As at 10 January 2014 (Australian time), 54 countries have signed and one country, Nicaragua, has acceded to the Protocol.

1.114 Australia has commenced work on the domestic processes (including a regulation impact statement) that precede a decision on whether to accede to the Protocol.

94 The Protocol can be accessed at: http://www.who.int/fctc/protocol/illicit_trade/en/.

BENEFITS

BENEFITS FOR INDIVIDUALS AND SOCIETY

1.115 As outlined above, there are significant overall negative health, social and economic impacts for individuals, their families and society from tobacco usage. The benefits associated with anti-smoking measures should reduce these impacts.

1.116 However, these benefits are reduced because of changes in smoker behaviour. A survey conducted in November 2010 (Victorian Smoking and Health Survey) to assess smokers' reported changes in smoking habits following the 25 per cent increase in tobacco excise in April 2010 indicates a range of behaviour change. It reported as follows:

> *Of all smokers surveyed (recent quitters were not asked such questions), 45 per cent reported that they had changed their smoking behaviour in response to the price increase, either by trying to quit (28 per cent) or by smoking fewer cigarettes (34 per cent). Younger smokers were most likely to report that they tried to quit as a result of the price increase (37 per cent tried to quit, compared with 27 per cent of mid-aged and 23 per cent of older smokers). Approximately half of smokers from the low socio-economic status (SES) group who were still smoking reported trying to change their behaviour compared with 45 per cent of mid-SES and 37 per cent of high-SES smokers (p=0.04). In 2010, 48 per cent of smokers had changed their purchasing behaviour in at least one way following the price increase. More than 20 per cent had looked for a cheaper source for their regular brand, while 15 per cent switched to a cheaper brand or bought in bulk. Small proportions reported having bought loose tobacco since the price increase — 9 per cent had bought roll-your-own tobacco, and 3 per cent reported that they had purchased unbranded tobacco. Only 18 per cent of smokers changed their purchasing behaviour without attempting to change their smoking behavior (sic) ....*[95]

1.117 The survey data shows that about two-thirds of the smokers (62 per cent) surveyed said they had changed their smoking behaviour, with younger respondents (37 per cent) and low SES smokers (about half) more likely to have done so. Less than one in five (18 per cent) of the smokers surveyed only changed the types of tobacco products purchased without also trying to quit or cut down.

1.118 While some smokers may choose to switch to cheaper cigarettes to avoid paying more for their tobacco products, many smokers who would consider switching to cheaper brands (or 'down trading') are likely to have already done so in response to the increased availability of 'value' brands by tobacco companies. Some smokers may also switch to lower priced cigarettes or cut down on the amount of cigarettes they consume as an intermediate stage before choosing to quit altogether.

95 Scollo, M. Chapter 13, The pricing and taxation of tobacco products in Australia, in Scollo, MM and Winstanley, MH [editors]. Tobacco in Australia: Facts and issues. 4th edn. Melbourne: Cancer Council Victoria; 2012. Available from: http://www.tobaccoinaustralia.org.au/chapter-13-taxation.

1.119 As noted, many smokers indicated that they were smoking fewer cigarettes as a result of the tobacco excise increase applying from 29 April 2010. The Royal Australian College of General Practitioners Supporting Smoking Cessation: a guide to health professionals (the Guide) states:

> *Research has shown that smoking reduction by 50 per cent significantly reduces the risk of lung cancer in heavy smokers (15 or more cigarettes each day). But studies have not shown a decrease of fatal or non-fatal myocardial infarction, hospitalisation for COPD or all cause mortality compared with heavy smokers who do not change smoking habits.*[96]

1.120 Individual behavioural responses to the 29 April 2010 25 per cent excise increase indicate why a comprehensive and sustained approach to tobacco control and smoking cessation is required.

REVENUE

1.121 The revenue from these two measures is estimated to be $6,540 million, including $560 million in goods and services tax payments to the states and territories over the forward estimates period.

Impact group identification

DIFFERENT SOCIO-ECONOMIC GROUPS

1.122 The tobacco excise increase will increase tobacco prices for consumers.

1.123 Table 1.6 below shows the estimated impact of the staged excise increases and AWOTE on cigarette prices and additional tax paid (including GST) over time, using an example of a pack of 25 Winfield cigarettes with a retail price of $21.00 as of January 2014, which is inclusive of the 1 December 2013 excise increase.[97]

TABLE 1.6: ADDITIONAL TAX PAID AS A RESULT OF EXCISE INCREASE

DATE	RETAIL PRICE PER PACK AFTER EXCISE INCREASE	INCREASE IN TOTAL TAX AS A RESULT OF EXCISE INCREASE
1 SEPTEMBER 2014	$22.86	$1.86
1 SEPTEMBER 2015	$25.02	$4.02
1 SEPTEMBER 2016	$27.56	$6.56

96 Royal Australian College of General Practitioners. 2011. Supporting smoking cessation: a guide to health professionals. Melbourne: RACGP. Available from: http://www.racgp.org.au/your-practice/guidelines/smoking-cessation/.

97 Note that this is an example only, and the retail price varies between retailers. The figures in Table 1.6 indicate the amount of additional tax that will apply to a 25-pack of Winfield cigarettes in September 2014, 2015 and 2016, compared to the amount of tax that currently applies as of January 2014. The estimates in Table 1.6 also rely on no future changes to the current tax-exclusive price of a packet of Winfield Cigarettes. Although this is not a likely assumption, it is necessary for the benefit of this analysis. The estimated additional tax paid each year until 2016 does not take into account likely rises in cigarettes prices beyond the excise increases, which would further increase the GST payable and thus the total amount of tax paid.

1.124 As an indication of the excise increase's impact across the socio-economic spectrum, Table 1.7 below, derived from the 2010 National Drug Strategy Household Survey[98] shows smoking rates across socio-economic status groups.

TABLE 1.7: INCIDENCE OF SMOKING ACROSS SOCIO-ECONOMIC STATUS GROUPS

SOCIO-ECONOMIC RATING	SMOKERS (PER CENT)
1 (lowest)	24.5
2	20.7
3	17.7
4	16.3
5 (highest)	12.5

1.125 This table indicates that smoking among people from low socio-economic groups is much higher than in the general population.

1.126 Other studies or surveys show that:

- in 2008, 47 per cent of Aboriginal and Torres Strait Islander people aged 15 years and over were daily smokers;[99]
  - the latest data are from the Aboriginal and Torres Strait Islander Health Survey: First Results, 2012-13, released on 27 November 2013.[100] These preliminary results are based on a sample size of 9,300 Indigenous Australians but the final results, due to be published in June 2014, will be of the full Indigenous sample of around 12,300;
  - the report shows that 41 per cent of Indigenous Australians aged 15 years and over and 43.8 per cent aged 18 years and over smoked daily;
- in 2011, 35.8 per cent of all teenage mothers reported smoking;[101]
- in 2007, around 32 per cent of people with mental illness smoked cigarettes and this increased to 73 per cent for people with psychotic conditions such as schizophrenia;[102] and
- in 2010, 27.6 per cent of unemployed people were smokers.[103]

1.127 Smoking rates among the most disadvantaged groups are extremely high.[104] In 2007, children living in households in the most disadvantaged areas in Australia were more than

98 Australian Institute of Health and Welfare (2011). 2010 National Drug Strategy Household survey report. Drug statistics series no. 25. Cat No. PHE 145. Canberra: AIHW.
99 2008 National Aboriginal and Torres Strait Islander Social Survey Cat. no. 4714.0 Australian Bureau of Statistics 2009.
100 ABS, Aboriginal and Torres Strait Islander Health Survey: First Results, 2012-13 — Australia, released 27 November 2013. Table 10.3 Health Risk Factors. (NT: non age standardised ata has been used).
101 Zeki R, Hilder L & Sullivan EA (2013). Australia's mothers and babies 2011. Perinatal statistics series no. 28. Cat. No. PER 59. Canberra: AIHW National Perinatal Epidemiology and Statistics Unit.
102 ABS (2008) National Survey of Mental Health and Wellbeing — Summary of Results 2007, 4326.0.
103 AIHW 2011 2010 National Drug Strategy Household Survey report 2011. Drug statistics series no 25. Cat no. PHE 145. Canberra AIHW.
104 AIHW 2011 2010 National Drug Strategy Household Survey report 2011. Drug statistics series no. 25. Cat. No. PHE 145. Canberra: AIHW.

three times more likely to be exposed to tobacco smoke in the home compared with those living in more advantaged areas.[105] People experiencing socio-economic disadvantage and Aboriginal and Torres Strait Islander people represent higher proportions of the population in remote and very remote areas compared with metropolitan areas.[106]

1.128 There is a link between tobacco consumption and poverty. Lower income households are particularly vulnerable to the 'opportunity cost' of expenditure on tobacco products. Tobacco may replace food and other essential goods and services for the family. The health impact of tobacco consumption also puts pressure on family budgets and reduces the income-generating potential of family members.[107]

1.129 As noted in paragraph 1.24 above, opposition to tobacco excise increases has often focussed on the argument that tobacco taxation is 'regressive' that is, it has a disproportionately greater impact on the socio-economically disadvantaged. However, expert opinion in the field of price and taxation for tobacco control points to opposite effect.

1.130 According to the Cancer Council of Victoria, for those low income people who do not give up smoking and do not cut down, it is true that the price of purchasing their regular pack of cigarettes would be greater following an excise increase. However, the effects of an excise increase would be offset by consumers cutting down on the number of cigarettes smoked. A recent cohort study of Victorian smokers showed that while consumption among light smokers did not decline, heavy smokers reduced consumption substantially after the April 2010 price rise. Further, the numbers of smokers experiencing financial stress did not change significantly following the tax increase.[108]

1.131 A similar argument applies to Aboriginal and Torres Strait Islanders, who are more than twice as likely to be daily smokers as non-Indigenous people.

1.132 As the Cancer Council of Victoria has noted, failing to increase taxes on tobacco products does not ensure that smokers will pay less for cigarettes. As occurs in many countries,[109] tobacco companies in Australia have consistently 'over-shifted' tax increases to consumers, that is, charged consumers higher prices than required by tax increases, thereby benefiting from the increase of revenue while consumers blame the government's tax increase for the price rise.

1.133 Increasing tobacco taxes, in combination with investment in other tobacco control measures, will contribute to improving the situation of low-income people.

1.134 Staged introduction of excise increases will give smokers several chances to quit prior to the transition to higher prices at each stage.

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105 AIHW 2009 A picture of Australia's children 2009, Canberra.

106 Australian Institute of Health and Welfare (2011). 2010 National Drug Strategy Household survey report. Drug statistics series no. 25. Cat. No. PHE 145. Canberra: AIHW.

107 International Agency for Research on Cancer, Chapter 7. Tax, price and tobacco use among the poor, in Effectiveness of tax and price policies for tobacco control 2011, IARC: Lyon, France. Available from: http://www.iarc.fr/en/publications/list/handbooks/.

108 Scollo, M., et al., Impact in Victoria of the April 2010 25 per cent increase in excise on tobacco products in Australia. Short-term effects on prevalence, reported quitting and, reported consumption, real cost, and price-minimising strategies, 2012, Centre for Behavioural Research in Cancer, Cancer Council Victoria: Melbourne, Australia.

109 International Agency for Research on Cancer, Chapter 3. Tobacco industry pricing, price-related marketing and lobbying, in Effectiveness of tax and price policies for tobacco control2011, IARC: Lyon, France. Available from: http://www.iarc.fr/en/publications/list/handbooks/.

1.135 In addition to the incentive of price increases, a range of initiatives are available to help people quit smoking including Quitline and smoking cessation support services in each State and Territory. Subsidised smoking cessation aids including nicotine replacement therapy (for example, nicotine patches and medicines to assist with quitting smoking) have been available on the subsidised PBS since February 2011.

ELECTRONIC CIGARETTES

1.136 Smokers may attempt to reduce the impact of increases in the price of tobacco by seeking out other comparatively cheaper nicotine delivery systems. An emerging product worldwide is electronic cigarettes (or electronic nicotine delivery systems — ENDS).[110]

1.137 However, e-cigarettes containing nicotine are prohibited from retail sale in Australia through state and territory legislation. Some states and territories (eg, Western Australia, South Australia) also have regulations that apply to the sale of e-cigarette devices without nicotine.

1.138 However, therapeutic preparations (eg, TGA-evaluated nicotine replacement therapies) for therapeutic purposes (such as assistance to quit smoking), are schedule 4 'Prescription only' medicine. These products are rigorously assessed for efficacy and safety and, therefore, approved by the Therapeutic Goods Administration for use as aids in withdrawal from smoking.

LICENCED TOBACCO MANUFACTURERS/WHOLESALERS

THE AUSTRALIAN TOBACCO MARKET

1.139 In 2012, KPMG noted that the total legal market for cigarettes in Australia was for 17 billion sticks, while the loose tobacco market accounted for 1.8 million kilos of tobacco[111].

1.140 Trends in volumes of products traded in the Australian legal tobacco market are shown below in Table 1.8.

110 Electronic cigarettes are devices for making mists for inhalation that usually simulate the act of cigarette smoking and are sometimes marketed as a tobacco replacement. Australian health authorities are concerned about the use of electronic cigarettes in Australia because of a lack of evidence on their safety and efficacy. The impact of wide scale use of these devices on tobacco use is not known, and the outcome in the community could be harmful.

111 KPMG LLP Strategy Group London (2013). Illicit Tobacco in Australia: 2013 Half Year Report (London: KPMG) p. 11.

TABLE 1.8: LEGAL TOBACCO MARKET, AUSTRALIA 2000-2013 (MILLIONS OF KG)

	CIGARETTES	LOOSE TOBACCO	TOTAL
2000	17.6	1.3	18.8
2001	16.5	1.3	17.8
2002	16.7	1.5	18.2
2003	17.0	1.5	18.5
2004	16.8	1.5	18.3
2005	16.3	1.6	17.9
2006	15.9	1.5	17.5
2007	16.0	1.6	17.6
2008	15.9	1.6	17.5
2009	15.9	1.7	17.6
2010	14.6	1.8	16.4
2011	13.9	1.8	15.7
2012	13.5	1.8	15.3
2013	13.3	1.8	15.1

Source: KPMG LLP Strategy Group London (2013). *Illicit Tobacco in Australia: 2013 Half Year Report* (London: KPMG) p. 11.

1.141 While KPMG noted that there has been a 2.2 per cent annual rate of decline in manufactured cigarette volumes over the last 12 years, tobacco volumes for loose tobacco volumes over the same period have experienced an annual rate of increase of 3.0 per cent[112]. This has clearly resulted in a change in the mix of tobacco products towards more loose tobacco, but the fall in the weight of tobacco in the cigarette market could have resulted from a fall in the average amount of tobacco in each cigarette.

1.142 There are three major tobacco companies operating in Australia; British American Tobacco (Australasia Holdings) Pty Ltd (British American Tobacco), Philip Morris Limited (Philip Morris) and Imperial Tobacco Australia Limited (Imperial Tobacco). Philip Morris and British American Tobacco have Australian manufacturing and distribution operations while Imperial Tobacco, which formerly contracted with British American Tobacco to supply some of its products and relied on imports for other products[113] now imports all of these products from its New Zealand factory[114] and is now a distributor or wholesaler of tobacco products.

1.143 In the period January to May 2013, citing Nielsen Australia's BAT Tobacco Industry Database, KPMG noted that the cigarette market is divided into three broad price categories — high, medium and low price. In terms of cigarettes, the market shares of each category were 15 per cent, 48 per cent and 36 per cent respectively.

112 (KPMG LLP Strategy Group London (2013). Illicit Tobacco in Australia: 2013 Half Year Report (London: KPMG) p. 10.

113 IBISWorld Smoked out: Rising health concerns and excise taxes affect industry revenue IBISWorld Industry Report C1220 Cigarette and Tobacco Product Manufacturing in Australia July 2013 p.5.

114 Cleo Fraser (2012) 'New Zealand boosts Australian tobacco exports', The Australian, Web Edition of 6 August 2012, and consulted on 21/1/2014.

1.144 The market shares of manufacturers have been reported for British American Tobacco as 66.6 per cent and Philip Morris as 33.4 percent.[115] KPMG has reported the legal tobacco market shares in Tables 1.9 and 1.10 below and referenced the data to Euromonitor's report *Tobacco in Australia August 2012*.

TABLE 1.9: AUSTRALIAN LEGAL TOBACCO MARKET — PERCENTAGE MARKET SHARES

	CIGARETTES
BRITISH AMERICAN TOBACCO	45
PHILIP MORRIS INTERNATIONAL	35
IMPERIAL TOBACCO	19
OTHERS	1

Source: KPMG LLP Strategy Group London (2013). *Illicit Tobacco in Australia: 2013 Half Year Report* (London: KPMG) p.11.

TABLE 1.10: AUSTRALIAN LEGAL LOOSE TOBACCO MARKET — PERCENTAGE MARKET SHARES

	LOOSE TOBACCO
BRITISH AMERICAN TOBACCO	29
IMPERIAL TOBACCO	62
OTHERS	9

Source: KPMG *ibid.* p. 11

1.145 The major market for the tobacco manufacturers is tobacco product wholesalers, which purchase tobacco products from manufacturers or import these products from overseas. The independent wholesale market is declining as manufacturers increasingly sell directly to retail customers.[116]

1.146 Tobacco manufacturers have been affected by falling demand over the past five years because of increasing health concerns, anti-smoking campaigns, increasing regulations and higher excise taxation. Australian Industry revenue after excise is expected to decline at an annualised 0.2 per cent over the five years to 2013-14, to total $1.8 billion in that year.[117] It is further forecast to decrease at a compound annual rate of 3.4 per cent over the five years to 2018-19 to reach $1.5 billion.[118]

1.147 However, profit margins of manufacturers are expected to increase as manufactures shift their resources towards low-cost manufacturing activities, such as unpackaged tobacco.[119]

115 IBISWorld Industry Report C1220 op. cit. pp.22.23.
116 IBISWorld Industry Report C1220 op. cit., p.4.
117 IBISWorld Industry Report C1220 op. cit., p.4.5.
118 IBISWorld Industry Report C1220 op. cit., p.4.
119 IBISWorld Industry Report C1220 op. cit., p7.

1.148 The tobacco wholesaling sector has been declining at an annualised 1.9 per cent over the past five years, to reach $2.2 billion in 2013-14.[120] In 2013 there were around 46 tobacco wholesalers in Australia with British American Tobacco, Philip Morris and Imperial Tobacco accounting for more than 60 per cent of industry revenue. [121]

IMPACT ON COMPLIANCE COSTS

1.149 Tobacco companies are well accustomed to excise and excise equivalent duty rate changes as these rates have increased biannually in line with CPI indexation. The main compliance cost of these increases is adjusting prices, which has previously been reported as taking two to three days.[122] These price changes occur with bi-annual indexation of tobacco excise and excise equivalent customs duty. There was an additional price increase as a result of the first staged increase as from 1 December 2013.

1.150 Tobacco companies reported difficulties resulting from the 25 per cent increase in tobacco excise in April 2010. This was because of the short notice given and the flow-on impact on companies. However, in relation to the recent measures, tobacco companies have been provided with a significant lead time before the increases take effect, especially for those which occur in later years. The increases also take effect on the same day as bi-annual indexation (except the 1 December 2013 increase), which minimises costs for the tobacco companies.

1.151 The long lead time provided for adjustment also means that there should be no difficulty in terms of excise payments. As a result of the 25 per cent excise increase in April 2010, orders that had left the bonded warehouse before the announcement but did not arrive until after the announcement required a change of price list during transportation. Difficulties of this nature should not arise because of the long lead times.

QUOTAS

1.152 A further cost may arise to businesses because of tobacco quotas. Quotas may be imposed to protect government revenue from anticipatory behaviour and stockpiling of product prior to the new rate taking effect. The quotas have the effect of setting the amount of tobacco products that could be released into home consumption at the excise and excise equivalent customs duty rates prior to the rate rise taking effect. The quota system is administered by the ATO.

1.153 Where quotas are imposed, the amounts are determined by reference to the expected levels of product that would be released into the market place if there were no anticipation of rate increase present. The ATO administers quotas in a manner to provide sufficient amounts for suppliers to continue supplying product at normalised levels at the current rate of duty. The quotas allow an uplift factor to adjust for seasonal variations and known individual circumstances. However, there is also provision for entities that have quotas imposed to have their individual circumstances reviewed and quota amounts adjusted.

1.154 The declared period for the tobacco quotas for the first staged increase on 1 December 2013 commenced on 3 October 2013 and ended on 30 November 2013. The ATO will decide whether quotas will be imposed for the next three staged increases.

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120 IBISWorld Going up in smoke: Demand suffers due to government reforms and health consciousness IBISWorld Industry Report F3606b Tobacco Product Wholesaling in Australia August 2013 p.5.

121 IBISWorld Industry Report F3606b ibid, p.5,6.

122 Post-implementation Review: 25 per cent tobacco excise increase op. cit. p.25.

1.155 While the quotas are in operation, the allocation of tobacco products to specific retailers is a business decision for tobacco manufacturers, importers and distributors upon which the quotas have been imposed. The imposition of a quota does not prohibit the release of tobacco products for sale to retailers above the quota amounts. Quotas do no more than effectively limit what can be entered into the Australian market at the current rate of duty. However, if a manufacturer importer or distributor exceeds their quota limit they would in effect have to pay duty at the rate applicable from the date of the staged increase on that excess amount.

1.156 The quota system may impose some additional costs on manufacturers, and distributors as these businesses will have to monitor their sales to ensure that they operate within the quota or otherwise pay a higher rate of duty on the excess over the quota limit. The costs of either of these two options are not expected to be significant.

CHANGING BUSINESS STRATEGIES TO RESPOND TO PRICE RISES

1.157 Tobacco companies in Australia have the potential to 'over-shift' tax increases to consumers by charging consumers higher prices than required by tax increases, thereby benefiting from the increase of revenue. By increasing tobacco prices above that required by the excise increases and bi-annual indexation, tobacco companies have been able to counteract some of the impact of a decline in total tobacco consumption on their revenue and profit.

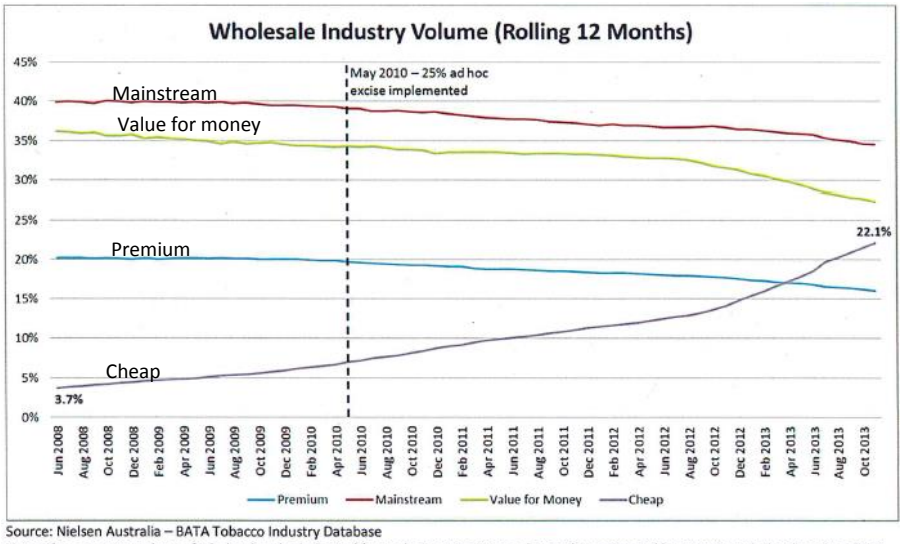
1.158 Profit margins for tobacco manufacturers have been increasing as manufacturers increase their production prices at the same time as excise increases, engage in wholesale bypass and consumers demonstrate a greater preference for unpackaged tobacco, which costs less to produce.[123]

1.159 As part of consultation on the Post-implementation Review for the 25 per cent tobacco excise increase from 29 April 2010, tobacco companies submitted that the 25 per cent increase encouraged adult smokers to move from their current product to cheaper brands and 'roll-your-own' (RYO). One tobacco company claimed that the market share of low cost brands had increased from 24.9 per cent in 2010, to 31.0 per cent in 2012. Another company submitted the total retail sales of cheap cigarettes had increased from virtually nothing in 2007 to comprise around 9 per cent of the total market for cigarettes in 2011.

1.160 Table 1.6 below shows the composition of the Australian cigarette market. Particularly noteworthy is the increasing share comprised by "cheap" cigarettes.

123 IBISWorld Industry Report C1220 Cigarette and Tobacco Product Manufacturing in Australia July 2013 op. cit. p.5.

FIGURE 1.3: COMPOSITION OF THE AUSTRALIAN RETAIL CIGARETTE MARKET



Source: Nielsen Australia – BATA Tobacco Industry Database
Note: The percentage share of wholesale sales indicated for each cigarette type each month is estimated by summing wholesales sales of that particular type of cigarette over the preceding 12 months, divided by total wholesale sales of cigarettes over that 12 month period.

1.161 One tobacco company advised that the price gap between the recommended retail price of a well-known premium price brand and the equivalent price brand in a leading low-cost brand is 18.8 per cent. Price differentials for the same sized pack range from $2.90 to $6.05.

1.162 One of the companies submitted that the increase in quantity of cheap cigarettes consumed was an unintended effect of the 25 per cent tobacco increase. That is, increases in tobacco excise or excise equivalent duties had unintentionally encouraged smokers to 'down trade' to smoking cheap cigarettes, rather than reducing the total number of cigarettes they consume.

1.163 The same tobacco company submitted the excise increase had the effect of unintentionally altering the relative competitive positions of cigarette suppliers in the markets for not only their products, but also in the markets for their inputs of raw materials and factors of production (that is land, labour and capital). The company argued that this, in turn, reduced the effectiveness of excise and excise equivalent duties as a means of reducing cigarette consumption.

1.164 The tobacco companies reported that the 25 per cent increase had also driven a consumer shift from cigarettes to RYO tobacco. In 2010, one tobacco company saw a 3.2 per cent increase in the RYO segment over the course of the year. The upward trend was more evident in the second half of 2010, where the average increase between July and December was 4.2 per cent. Although the trend did not continue in 2011, the volume gained in 2010 was retained within RYO and the segment was flat compared with 2010.

1.165 Tobacco companies submitted that there was no public health benefit in a policy which encourages adult smokers to move from their current product to a cheaper and / or illicit or unregulated product.

1.166 It is expected that further excise increases will create an increase in cheaper brands and RYO. This shift combined with any consequent decline in tobacco consumption may affect business decision-making of the tobacco companies. It may require them to adapt their strategies to try to capture market share of an increasingly competitive market, for example, by increasing their range of

products at various price points.[124] Further, as highlighted above by the Victorian Smoking and Health Survey, strategies aimed at encouraging consumers to 'switch' to an alternative product have not been overly successful to date (see paragraphs 1.116-1.117 above).

1.167 However, the staged tobacco excise increases and change of the indexation from CPI to AWOTE are not likely to create any significant distortion in business decision-making of the tobacco companies in addition to the range of anti-smoking measures that are already in force.

A SHIFT TO ILLICIT AND UNREGULATED PRODUCTS

1.168 As part of consultation to the Post-implementation Review for the 25 per cent tobacco excise increase from 29 April 2010, tobacco companies submitted that the excise increase in 2010 also contributed to an increase in the illicit tobacco trade.

1.169 As outlined above, while increases to excise and excise equivalent rates have the potential to increase the illicit trade in tobacco, ACBP detection data does not support the premise that tobacco smuggling increased following previous excise rate increases.

RETAILERS

1.170 Tobacco product wholesalers are the major purchasers of tobacco products from manufacturers. These wholesalers distribute products to retailers such as supermarkets, grocery stores, convenience stores, service stations and tobacco stores. Supermarkets are estimated to account for the largest share of industry revenue making up 41 per cent of revenue in 2013-14 with convenience stores contributing an estimated 26 per cent of revenue and tobacconists 18 per cent.[125] As noted above, tobacco product manufacturers are increasingly selling their products directly to some retail outlets lowering demand from wholesalers in 2013-14.[126]

1.171 Retailers do not pay excise but will incur the cost of changing their displayed prices for tobacco products, but as all staged increases other than the 1 December 2013 increase occur at the same time as bi-annual indexation, the compliance costs are expected to be limited. Retailers are accustomed to changing their prices when price lists from wholesalers and tobacco manufacturers' change and it is expected that there will be no incremental costs to retailers arising from the staged increases.

1.172 Retailers may suffer from declining sales. However, daily smoking rates in Australia have been declining gradually for the last few decades. Any further decrease in tobacco consumption that occurs as a result of the staged increases will occur in this context. The impact of a further decrease in tobacco consumption is difficult to quantify and will vary considerably depending on the size of the retailer, their reliance on income from tobacco products and their product mix. The significant lead time before the commencement of most of the staged increases provides retailers with an opportunity to adapt their business if required.

1.173 There will be no additional compliance costs arising for retailers from the imposition of quotas. However, if their suppliers choose to withhold supplies of tobacco products rather than pay duty on the excess over the quota limit, there is a potential restriction on supply that may have an

124 IBISWorld Industry Report C1220 Cigarette and Tobacco Product Manufacturing in Australia July 2013 op. cit.. p.8.
125 IBISWorld Going up in smoke: Demand suffers due to government reforms and health consciousness IBISWorld Industry Report F3606b Tobacco Product Wholesaling in Australia August 2013 p13,14.
126 ibid. p.5.

opportunity cost attached to it through an imbalance between supply availability and customer demand.

IMPORTERS

1.174 Importers are required to pay excise equivalent customs duties. The ACBPS advises of the changes in rates by way of the publication of an Australian Customs and Border Protection Notice and advice on the ACBPS website via the ICS message facility for customs brokers and agents. Importers will need to change their price lists and make adjustments to their computer systems. It is expected that compliance costs of these changes will be minimal with any additional costs arising only from the 1 December 2013 increase as it was additional to bi-annual indexation increases.

DUTY FREE SHOPS / PROVIDORES

1.175 There are a number of duty free shops / providores in Australia that are required to pay duty on tobacco in certain circumstances, for example when goods are not exported. These businesses are informed of excise increases by the ATO and, apart from being aware of the changes, are not expected to experience additional compliance costs resulting from the 1 December 2013 excise increase.

Business Cost Calculator

1.176 Table 1.10 below sets out the estimated additional compliance costs for business arising from the changes in the indexation factor from CPI to AWOTE and the four staged increases. As outlined above, the only entities that may incur increased compliance costs are the three major tobacco companies, British American Tobacco, Philip Morris and Imperial Tobacco.

TABLE 1.11: REGULATORY BURDEN AND COST OFFSET (RBCO) ESTIMATE

AVERAGE ANNUAL COMPLIANCE COSTS (FROM BUSINESS AS USUAL)				
COSTS	**BUSINESS**	**COMMUNITY ORGANISATIONS**	**INDIVIDUALS**	**TOTAL COST**
Total by Sector	$2,119.5	$	$	$2,119.5
COST OFFSET	**BUSINESS**	**COMMUNITY ORGANISATIONS**	**INDIVIDUALS**	**TOTAL BY SOURCE**
Agency	$2,119.5	$	$	$2,119.5
Within portfolio	$	$	$	$
Outside portfolio	$	$	$	$
Total by Sector	$2,119.5	$	$	$2,119.5
Proposal is cost neutral? ☑ **Yes** ☐ No				
Proposal is deregulatory ☐ Yes ☑ **No**				
Balance of cost offsets (<u>$127,749,637.08</u>)				

1.177 The costs in the above table have been calculated on the assumption that two of the major tobacco companies incur transitional costs for extra administration required as a result of four staged increases with three of the companies incurring additional administrative costs as a result of quotas being imposed during this period.

- One company stated positively that there are additional compliance costs in managing price rises; another company stated there are no additional costs; and the third company did not respond to this consultation issue so it assumed that additional costs are incurred.
- One company indicated positively that the imposition of quotas resulted in increased administrative costs while the other two companies did not respond so it is assumed that these companies incur additional costs from the administration of quotas.

1.178 The compliance costs resulting from price increases are based on 30 additional hours of labour for technicians/clerical/administrative staff assuming average earnings of $33.20 per hour and five additional hours for management assuming average earnings of $41.60 per hour. For quotas, the costs of administering quotas are based on 10 hours of labour for clerical/administrative staff assuming average earnings of $30.40 per hour and 10 additional hours for management assuming average earnings of $41.60 per hour. A 16 per cent loading is added to take account of costs such as superannuation. The costs are calculated over a 10 year period.

1.179 The regulatory costs are transitional, that is, the calculated compliance costs take into account the additional hours required for the four staged increases occurring on 1 December 2013, 1 September 2014, 1 September 2015 and 1 September 2016 where price rises are above normal because of the 12.5 per cent price increase and AWOTE indexation. It is assumed that there are no on-going compliance costs after the last staged increase on 1 September 2016 after which prices increases revert to bi-annual indexation. It assumes that quotas will not be applied after the last staged increase on 1 September 2016.

1.180 A regulatory offset has been identified from within the Treasury portfolio. This offset relates to the Future of Financial Advice (FOFA) reforms.

ADMINISTRATIVE IMPACTS

1.181 The ATO and the ACBPS incurred one-off administrative costs as a result of the measures. The costs arose as a result of the 1 December 2013 increase, which is outside the bi-annual indexation of tobacco excise. The increase involved a change to ATO systems and communications material as a result of the increase and notifying manufacturers / duty-free shops / providores of the increase. The ACBPS also had to change their systems and notify importers of the changes to excise equivalent rates.

1.182 These costs are minimal as ATO and ACBPS systems already make changes to excise rates as a result of the bi-annual increases. The staged increases are one-off with excise increases reverting to bi-annual increases after the final staged increase is made in December 2016.

1.183 The ATO incurs some additional cost in its administration of quotas. However, these are minimal and arise from monitoring market behaviours, determining whether quotas should be imposed, preparation of quota orders, settling variation requests and recovering additional revenues where applicable.

OPTIONS-STAGE RIS

1.184 The agency has fully complied with the options-stage RIS:

- ☑ Does the options-stage RIS include a minimum of three elements — the problem, objective and options? **Yes**
- ☑ Does the options-stage RIS include at least three options (including a regulatory option, a non-regulatory or light-handed regulatory option, and a do-nothing option)? **Yes**
- ☑ Has the options-stage RIS been certified at the secretary or deputy secretary level and provided to the OBPR before consideration by the decision-maker? **Yes**
- ☑ Has the options-stage RIS been published following the public announcement of an initial decision to regulate? **Yes**

CONSULTATION

1.185 Following the announcement of the tobacco excise increases, the tobacco excise measures, in particular, the staged increases received strong support from the health sector. The tobacco industry raised concerns about substitution with illegal tobacco and cheaper legal products, while many smokers, as anticipated, demonstrated resistance to the price increases.

1.186 A broader consultation was undertaken with a wider range of stakeholders than was undertaken as part of the NPHS and NTS which is summarised below.

1.187 Consultation was also undertaken with the tobacco industry and retailers in relation to the change of the indexation factor from the CPI to AWOTE and the four staged increases, the results of which are also summarised below.

Consultation under the NPHS

1.188 As outlined in paragraph 1.10 above, the NPHS was developed by the National Preventative Health Taskforce (Taskforce) and released in September 2009. The Taskforce recommended a sequence of increases in tobacco excise on public health grounds with the aim of increasing the price of cigarettes to $20 within three years.

1.189 The development of the NPHS took into account extensive consultations from October 2008 to February 2009 with the public, professional and consumer groups, and other interested stakeholders. Feedback on the proposed excise increases indicated overall support for the increases, particularly if they were complemented by a range of tobacco control initiatives, including programs targeted towards smokers from lower socio-economic backgrounds.

1.190 The feedback also suggested that the revenue raised from tobacco excise should be re-directed towards other tobacco control initiatives such as smoking cessation programs, tobacco control prevention and research activities.

1.191 The Taskforce also received over 400 submissions from interested individuals and organisations following the release of its discussion paper — *Australia: the healthiest country by 2020*, in October 2008. The range of stakeholders who provided submissions included the tobacco industry, tobacco retailers, smokers, non-smokers, tobacco control advocates, researchers, and health consumer advocates. The submissions received, combined with the consultations conducted, were considered by the Taskforce and informed the development of the NPHS, which was provided to the former Government on 30 June 2009.

Consultation conducted during the development of the NTS 2012-2018

1.192 The draft for consultation of the National Tobacco Strategy (NTS) 2012-2018 was developed by the Intergovernmental Committee on Drugs Standing Committee on Tobacco (Standing Committee). As noted in paragraph 1.13, the draft for consultation included the priority action area, '6.2 Continue to reduce the affordability of tobacco'.

1.193 At the 27 April 2012 meeting of the Standing Council on Health, all Health Ministers approved the public release of the draft for consultation of the NTS 2012-2018.

1.194 Public consultation on the draft for consultation of the NTS 2012-2018 was conducted during June 2012 and included a national call for written submissions, consultations with non-government stakeholders with expertise in tobacco control, and consultations with Aboriginal and Torres Strait Islander stakeholders with an interest in tobacco control.

1.195 Written submissions were received from academics, government organisations, non-government organisations, Aboriginal and Torres Strait Islander organisations, pharmaceutical and insurance organisations, retail and hotel organisations, smokers and non-smokers, and the tobacco industry and associated groups.

1.196 Feedback received on the draft for consultation of NTS 2012-2018, in relation to priority action area 6.2, indicated that:

- the majority of stakeholders were supportive of further proposed tobacco excise increases;
- many stakeholders agreed that further tobacco excise increases are the most reliable way to accelerate declines in national smoking rates, notwithstanding the importance of a range of tobacco initiatives to support specific population subgroups;
- some stakeholders opposed further proposed excise increases. These stakeholders suggested that further tobacco excise increases would increase the demand for cheaper tobacco alternatives and illicit tobacco.

1.197 The Standing Committee considered the views of stakeholders obtained during the public consultation on the draft for consultation prior to revising and finalising NTS 2012-2018. The final NTS 2012-2018, endorsed by all Health Ministers on 9 November 2012, includes the priority action area, '6.3 Continue to reduce the affordability of tobacco products.'

1.198 The consultation processes for the NPHS and the NTS 2012-2018 provided substantial opportunity for stakeholders to provide input on the issue of tobacco excise increases. Conducting additional consultation on the new tobacco excise increases is unlikely to reveal additional views and would consequently be an inefficient use of public resources.

1.199 In addition, stakeholders, including the tobacco industry and smokers, have been aware that the former Government announced the four staged tobacco excise increases and that the new Government adopted this position publicly during the 2013 election. This has allowed stakeholders three months lead time to express any concerns and views to the Government and their political representatives, and to plan for the excise increases.

Consultation with licenced tobacco companies / distributors

1.200 Tobacco companies opposed the tobacco excise increases with their main concern being that the excise increases would result in a significant increase in the market for illegal products.

GROWTH IN ILLICIT TOBACCO

1.201 Tobacco companies submitted that tobacco excise increases would lead to a shift to illicit tobacco.

1.202 The companies stated that following the 25 per cent increase in tobacco excise tax on 30 April 2010, there was a marked consumer shift to cheaper products or illicit products. However,

impacts abated to some degree with the return to twice-yearly, CPI-linked tobacco excise tax increases in 2011-12. The tobacco companies anticipate that further increases will again result in a growth in the illicit tobacco trade.

- One company claimed that the latest tobacco excise increases will see illicit trade grow annually by 1.85 per cent, from 13.3 per cent (see KPMG report below) to 20.7 per cent by 2017 as a consequence of the four staged increases.

1.203 Referring to historical trends, tobacco companies referred to reports commissioned by the tobacco industry.

- The report by Roy Morgan Research and Deloitte[127] indicated a rise in illicit tobacco to 15.9 per cent as a result of the 25 per cent increase in April 2010 but this declined to 10.5 per cent in 2011 after a period of relative pricing stability and seizures by Australian authorities.
- The report by KPMG[128] whose methodological approach[129] showed a significant increase in illicit tobacco consumption in 2010 following the 25 per cent increase (from 9.1 percent in 2009 to 12.8 per cent in 2010) followed by a levelling off or decline in 2011 and 2012. The report found that in the twelve months to the end of June 2013, the level of illicit consumption, represented $1.0 billion in foregone revenue for the Government with consumption growing from 11.8 per cent to 13.3 per cent of total consumption.

1.204 Tobacco companies submitted that ACBPS data supports their claims of an increasing trend to illicit tobacco. ACBPS annual reports show an increase in detections from 42 in 2009-10 to 55 in 2010-11 but a decline to previous levels in 2011-12 with the number of detections of illegal tobacco entering Australia in 2013 at its highest in seven years at 76 with the number of cigarettes seized and the potential duty being evaded at record highs. [130] This occurred despite ACBPS staff reductions and with less than 5 per cent of all sea cargo containers being inspected or scanned in 2013.[131] [132]

1.205 A tobacco company submitted that ACBPS annual reports support that there was a marked increase in the amount of illegal tobacco and cigarettes detected following from the 25 per cent increase in tobacco excise in April 2010 and this could be attributed in part to the excise increase. [133] [134] It also noted an ACBPS Report that tobacco detections have increased between 2007 and 2013, with tobacco seized doubling over the period.[135]

127 Deloitte, Illicit trade of tobacco in Australia, February 2010, 2011,2012.

128 Illicit Tobacco in Australia — 2013 Half Year Report, KPMG LLP October 2013.

129 KPMG report uses a wide range of data (including Nielsen, Euromonitor, Datamonitor, Exchange of Sales) and methods of validation (including Roy Morgan Research consumer survey, empty pack survey, rolling papers sales data, ACBPS seizures data and internal company intelligence data).

130 ACPBS Annual Reports 2009-10 to 2012-13.

131 http://www.liberal.org.au/latest-news/2013/06/22labour%E2%80%99s-attack-customs-makes-it-vulnerable-organised-crime.

132 http://www.customs.gov.au/aboutus/annualreports/2013/p2c.html.

133 ACBPS 2009-10 to 2012-13 Annual Report.

134 Chris Johnson, Canberra Times, Tuesday 2 November 2010 p 3.

135 ACBPS Intelligence and Targeting Division, Border Targeting, Illicit Cigarette and Tobacco Detection Summary January to June 2013 p 3.

1.206 A tobacco company submitted that the announcement by the Trident Taskforce[136] of the closure of one of the biggest organised illicit tobacco importation syndicates in the country's history demonstrates that tobacco smuggling is a significant problem. In commenting on changes to penalties for individuals and businesses involved in selling illicit tobacco, tobacco companies noted that the Victorian Premier, Denis Napthine acknowledged that higher taxes tempt people to use illegal tobacco.[137]

1.207 A tobacco company noted that ACBPS annual reports indicate that Task Forces Polaris, Yelverton and Trident had been responsible for the seizure of 249 tonnes of illicit tobacco and 92 million cigarettes for the year up to May 2013, preventing the evasion of approximately $140 million in tax revenue from those seizures alone.[138]

1.208 The tobacco company noted that 'seizure statistics cannot do more than represent a percentage of the illicit goods smuggled into a country…'.[139] It stated that ACBPS only searches a proportion of containers that arrive in Australia with reports suggesting fewer than 1 per cent of shipping containers being inspected by ACBPS.[140] The company also noted media and other reports of bribery and corruption within Commonwealth agencies that included offences related to imports of border controlled precursors.

1.209 In its analysis, the tobacco company estimated that the illicit tobacco trade will increase to almost 21 per cent by 2017 as a result of the four successive 12.5 per cent excise increases. The growth in this trade will represent approximately $2 billion in lost revenue by 2017 to the Government and profit to organised crime groups. The $5.3 billion revenue target will not be met, only delivering an additional $1.42 billion over 4 years.

- The company submitted that there is an optimal rate of excise which once exceeded, will result in a decrease in government revenue. It submitted that under an analysis the optimum scenario is a one-off 12.5 per cent excise increase followed by AWOTE increases.

1.210 The company provided examples of other countries such as Malaysia, Ireland, Singapore and Sweden where excise rates have been frozen and even reduced as a result of smokers' reactions to substantial excise increases. These countries experienced reduced revenue as a result of reduced licit consumption because of diversion of demand to the illicit tobacco market.

1.211 The tobacco company noted that Australia has significantly higher cigarette prices than surrounding markets in Asia.[141] This large price variation necessarily creates an incentive and opportunity for those involved in illicit trade.

1.212 The company also noted that recent seizures of illicit cigarettes in Australia demonstrate how the Singapore Port and Free Trade Zones are abused in order to facilitate the smuggling of

136 Media Release, 'Trident Taskforce shuts down multi-million dollar tobacco importation syndicate', Australian Federal Police, 24 October 2013 — http://www.afp.gov.au/media-centre/news/afp/2013/october/media-release-trident-taskforce-shuts-down-multi-million-dollar-tobacco-importation-syndicate.aspx.

137 Radio interview, 3AW Melbourne, hosted by Neil Mitchell, 16 January 2014.

138 http://www.customs.gov.au/webdata/resources/files/ACBPSAnnualReport2012-13.pdf.

139 International Tax and Investment Center (ITIC), The Illicit Trade in Tobacco Products and How to Tackle It 2nd edition, p.9.

140 http://www.smh.com.au/national/unchecked-cargo-stirs-fears-20111231-1pg9z.html.

141 KPMG, Illicit Tobacco in Australia, 2013 Half Year Report, October 2013.

cigarettes.[142] Cigarettes brought into the Port of Singapore from other countries are stored in a Licenced Warehouse where they are prepared for export. In order to avoid detection upon arrival in Australia, the cigarettes are shipped under false or mis-declared Bills of Lading that are only required to be submitted once the vessel containing the cigarettes has departed Singapore. This makes identification of the true nature of the cargo of illicit cigarettes and the intended destination extremely difficult.

1.213 The tobacco company also noted that counterfeit and other forms of illegal tobacco products are not part of the legal supply chain. As a result, counterfeit producers and retailers are not accountable for the product they sell, who they sell it to, or to the Governments for taxes that should be paid.

1.214 Furthermore, it referred to a report by the Centre for Public Integrity which states 'Tests reveal that counterfeit cigarettes carry a bevy of products that could further shorten even a heavy smoker's life: metals such as cadmium, pesticides, arsenic, rat poison and human faeces.'[143]

CONSUMERS WILL MOVE TO CHEAPER /ILLICIT PRODUCTS

1.215 Tobacco companies submitted that the tobacco excise increases will result in a shift by consumers to cheaper products including illicit tobacco, which will go against Government public health objectives.

1.216 One tobacco company submitted that this may unfairly impact on lower-income groups. One tobacco company noted that research commissioned by ASH in the UK found that one in four low income smokers buy illicit tobacco compared to one in eight of the most affluent. Low income smokers are more likely to be tempted by cheaper prices, and access to illicit tobacco undermines efforts to quit smoking, exacerbating health inequalities.[144]

1.217 The tobacco company also noted the November 2011 Roy Morgan Research Tobacco Usage Study which identified that a key reason for the purchasing decisions of illicit tobacco by consumers was price. Currently the price of illicit products sits at least 30-50 per cent below the lowest end of the legal market. The company provided examples of overseas markets which demonstrate the role that an affordable legal duty-paid product can have as a buffer to cheap illicit cigarettes (Hungary and Germany). The tobacco company noted that once consumers have a regular source of supply of illicit tobacco products it becomes extremely difficult to get them to return to purchasing legal tax-paid products.[145]

1.218 One tobacco company stated that its sales data following the April 2010 25 per cent excise increase supports that further excise increases could create an increase in sales of cheaper brands and RYO tobacco. The share of market held by low-priced brands increased from 13.2 per cent in 2009 to 42.4 per cent in 2013.

142 ITIC, 2nd edition op cit.
143 The Centre for Public Integrity "Tobacco Underground" by Marina Walker Guevara (19 October 2008).
144 ASH factsheet on illicit trade (http://ash.org.uk/files/documents/ASH 122.pdf.
145 ITIC, 2nd edition, op. cit.

1.219 The excessive excise tax increase in 2010 accelerated this growth in the consumption of low cost and super low cost brands to 24.9 per cent in 2010, 28.9 per cent in 2011 and 31.1 per cent in 2012.[146]

1.220 The tobacco company advised that as at 1 December 2013, there was a 20.7 per cent price gap between the RRP of Marlboro 25's (premium priced brand) and the RRP of an equivalent pack size in a leading low-cost brand, JPS which amounts to a $4.30 price gap per pack.[147]

1.221 The 2010 25 per cent excise increase also accelerated a consumer shift from cigarettes to roll your own RYO tobacco. In 2010 there was a 3.2 per cent increase in the RYO segment over the course of the year. The upward trend in the RYO segment was particularly evident in the second half of 2010, where the average increase between July and December was 4.2 per cent. Although the trend did not continue in 2011, the volume gained during 2010 was retained within RYO and the segment was flat versus during 2010. RYO now accounts for 14.2 per cent of the overall legal market.

1.222 The tobacco company expects that each 12.5 per cent excise increase will further accelerate the consumer shift to lower-priced cigarette brands and segments, legal and illegal.

PRICE INCREASES

1.223 One tobacco company stated although the time to adjust final prices takes two to three days, additional complexities mean a greater time lag between when excise rates are changed and when final prices are locked in at a retail level. Therefore, the main compliance cost with excise price changes is not adjusting the prices themselves, but rather the process leading to final prices.

1.224 Once excise changes are enacted, manufacturers go through a process of determining their own prices for all products. This process involves a period of between a few days to several weeks where manufacturers adjust their prices several times to ensure their products are competitively priced. This process is more pronounced when the excise increases are of higher magnitudes.

1.225 However, because of retailer deadlines (and the time it takes for changes to be made via complex retailer pricing systems), this can lead to retailers holding retail prices down and passing the differential costs of the new excise rate on to manufacturers (which can be significant) until all manufacturer prices are finalised.

1.226 Consequently, larger excise increases will mean more intensive activity (adjusting prices) and the risk of exposure to retailer penalties from these adjustments. This may result in significant costs to tobacco companies to comply with these new excise changes in a competitive environment.

1.227 The tobacco company submitted that there is no benefit to be gained from significant lead times to the 12.5 staged increases and the change to AWOTE indexation. This is because there is no consistent increase in AWOTE levels, nor can they be reliably forecasted. As a general practice, CPI in the past has only been released 1 week prior to an excise increase and it expects AWOTE to be similar in its timing. Accordingly the long lead time gives no certainty to manufacturers in relation to pricing.

1.228 Another tobacco company stated that it is well practiced at administering the twice-yearly, CPI-linked excise increases. It is well placed to issue and implement new price lists and it has a sense

146 Infoview Industry Exchange.
147 ibid.

of the rate of increase of the CPI on 1 February and 1 August and have up to five working days' notice on the actual rate of CPI before it is implemented. The shift to AWOTE indexation implemented on 1 March and 1 September is not expected to negatively impact this.

QUOTAS

1.229 One tobacco company submitted that there are more than minimal costs to ensure that they operate within quotas. That is, manufacturers must restrict volume to customers to operate within the quota limits resulting in potential loss sales. In addition, significant management time is required to manage distribution, demand, forecasting and equitably manage the supply of stock between retailers over this period.

1.230 If the manufacturer adopts the option of paying duty on the excess over the duty, because no retailer wants to be disadvantaged if manufacturers run out of stock under the quota, retailers may engage in speculative buying at the same time that manufacturers are looking to avoid exceeding the quota.

1.231 Speculative behaviour from retailers (and resulting impacts on manufacturer stock levels and associated costs) is likely to be even greater than current levels because of the forward notice of the significant but not finally quantified excise increases.

1.232 Other companies did not comment on the compliance costs associated with the administration of quotas.

CHANGING BUSINESS STRATEGIES TO RESPOND TO PRICE INCREASES

1.233 One tobacco company stated that it strongly believes that the significant increases in tobacco excise will have a significant effect on business decision-making by the industry.

1.234 The company notified that the cheap segment has grown more than five times from 3.7 per cent of the market in June 2008 to be 22.1 per cent of the total legal cigarette market in October 2013. It has overtaken the premium segment and at this rate will shortly become the second largest segment, where four years ago it was a distant fourth.[148]

1.235 Not only has the volume in this segment grown over time, but there have been a number of new products launched into the Cheap segment since the ad hoc excise (for example, Just Smokes and Bonds Street) while others have been repositioned in price to compete in this segment (for example, Brandon has now become part of the JPS brand).

1.236 It is therefore clear that industry business strategies have been impacted in the past by excise increases, and going on these trends, will continue to be impacted further by the future excise increases. This will result in a greater amount of cheaper products being available to consumers.

1.237 By way of example, the tobacco company anticipates a significant increase in the price of a packet of Winfield 25s (the most popular brand in the market, that is, by around 52 per cent between August 2013 and December 2016 which does not include any price increase levied by manufacturers, wholesalers or retailers as a result of increased cost of sales. This increase will impact on consumer behaviour, meaning that tobacco businesses may adjust towards the cheap segment of the market.

148 Source: Neilson Australia — BATA Tobacco Industry Database.

INFLATION

1.238 One tobacco company was concerned with the contribution of the staged increases on inflationary pressures. It stated that the first 12.5 percent implemented on 1 December has already contributed to inflationary pressures.

1.239 The CPI rose 0.8 per cent in the December quarter with tobacco price rises listed among the most significant price rises.

1.240 The ABS stated in a media release that 'tobacco prices rose primarily due to the effects of the federal excise tax increase from 1 December 2013 and a flow on effect from the indexed rise in the excise in August.'[149] This was also supported by a separate forecast, the TD Securities – Melbourne Institute Inflation Gauge was referred to by Ivan Colhoun, Chief Economist at ANZ who said the 1 December tobacco excise increase had contributed to the unusual rise in the Gauge's inflation forecast.[150] [151]

1.241 The April 2010 25 per cent excise increase was also a key contributor to inflationary pressure, but abated alongside the Government's return to the practice of twice-yearly, CPI-linked tobacco excise tax increases in 2011 and 2012.[152]

1.242 The tobacco company stated that previous CPI-linked tobacco excise tax increases had neutralised the inflationary pressure but increases above inflation, naturally, increase the national inflation rate and this will likely be the case for each of the next three scheduled 12.5 per cent excise increases, as well as the move to index tobacco excise to AWOTE.

1.243 The tobacco company referred to a paper by Professor Sinclair Davidson, Professor of Institutional Economics at RMIT University which considered the interaction between tobacco excise and the CPI. The paper states the interaction is not trivial and imposes higher prices and costs on all Australians whether they consume tobacco or not. It also results in higher welfare expenditure in the order of $2.4 billion over four years just to maintain the real value of welfare spending.[153]

1.244 The tobacco company responded to suggestions that the inflationary impact of tobacco increases be tackled by removing tobacco from the CPI. It submitted that this would be misleading to consumers and voters who would by impacted by the tax increase and turn the CPI into a political instrument.

Consultation with retailers

1.245 Consultation took place with two major retailers (Coles and Woolworths) and industry associations representing retailers including the Alliance of Australian Retailers Pty Ltd (and its

149 Media Release, 'ABS CPI December quarter rises 0.8%, Australian Bureau of Statistics, 22 January 2014.
150 TD Securities Press Release, 'TS Securities — Melbourne Institute Monthly Inflation Gauge December 2013, '20 January 2014.
151 'Afternoon Live, ABC News 24, 20 January 2014.
152 Refer to ABS webpage for more information: http://www.abs.gov.au/AISSTATS/abs@nsf/second+level+view?ReadForm&prodno=6401.0&viewtitle=Consumer%20Price%20Index,%20Australia~Jun%202011~Previous~27/07/2011&&tabname=Past%20Future%20Issues&prodno=6401.0&issue=Jun%202011&num=&view=&.
153 'The Inflationary Impact of Tobacco Excise', Professor Sinclair Davidson, RMIT University, September 2013 http://catallaxyfiles.com/files/2013/09/The-inflatonary-Impact-of-Tobacco-Excise.pdf.

member associations comprising Australian Newsagents' Federation Ltd, National Independent Retailers Association and the Service Station Association Pty Ltd), the Australasian Association of Convenience Stores Limited and the Australian Retailers Association.

LARGE RETAILERS

1.246 Large retailers have advised that they do not anticipate any additional compliance costs as a result of the price rises and that the lead time has been sufficient to prepare the business and to advise the customer base of the changes.

1.247 For quotas, the retailers did not advise of additional compliance costs but one major retailer recommended that the quota system operate on a like to like, year on year basis. This will give a more accurate indication of stock levels and enable retailers to operate more in line with their set quotas.

OTHER RETAILERS

1.248 One industry association strongly opposed the four staged 12.5 per cent excise increases because of the unfair impact on small retailers and because the measures have not been proven to improve public health but only exacerbate the increasing trade in illegal tobacco and shift business to large supermarkets which have greater pricing flexibility.

1.249 The association submitted that small businesses are already under increasing pressure in the current economic environment and they are also having to deal with excessive tobacco regulation. It raised the same issues with the shift to illegal tobacco as provided by the tobacco companies further stating that tobacco is an important category for many small businesses who are already facing pressures from larger chains. The shift to large retailers or to the illegal black market will further damage corner shops and service station convenience stores, as well as jobs and income for thousands of Australian families.

1.250 The association submitted that the tobacco excise increases will also act as a factor for an increase in the theft of tobacco products. Since the last tobacco excise increase in April 2010, small retailers reported an increase in robberies, theft and damages to premises.

1.251 The association further submitted that the 2010 25 per cent tobacco excise increase had a considerable impact on small business; the illegal trade increased significantly and there was a shift in business away from small retailers to the larger chains with greater pricing flexibility.

1.252 One retail association stated that the excise increases have affected business decision-making for the retail industry. This has been reflected by the launching of several new brands in the 'cheap' segment as well as brands being price repositioned into this segment.

1.253 The association further added that the two measures will continue to create significant distortion in business decision-making as these additional increases to already high tobacco prices will have a compounding effect on retail prices for consumers and retailers.

1.254 Another retail association raised the following additional concerns with the tobacco price increases:

- greater taxes push up the prices which impact retailers' stockholding costs and potentially insurance costs;

- higher costs impact on and unfairly target consumers who choose to smoke and buy their products legally;
- higher tobacco taxes could force smokers to reduce consumption of other goods to maintain the same level of cigarette consumption which may impact diverse retailers;
- severe sales reductions could affect retailer viability causing stores to close and losses of employment placing more strain on social security;
- retailers, particularly small businesses, catering to lower socio economic customers may be unfairly disadvantaged as these customers may seek cheaper alternatives such as illegal tobacco or they may switch to buying from supermarkets instead; and
- price discounting for tobacco may be necessary by retailers to maintain sales volumes, but their profitability may be adversely impacted.

CONCLUSION AND RECOMMENDED OPTION

1.255 The implementation of the tobacco measures will meet the Government's commitment given both before and after the 2013 election to implement the two tobacco excise measures announced by the former Government.

1.256 The measures will result in transitional compliance costs for major tobacco companies which result from making adjustments to prices and administering quotas that result from the four staged increases.

1.257 The two measures progress:

- the recommendations of the National Preventative Health Strategy Report which recommended the staged increases with the aim of increasing the price of a pack of cigarettes to $20 within three years;
- the commitment by Commonwealth and state and territory governments to reduce the adult daily smoking rate to 10 per cent of the population, and halving the rate of smoking among Aboriginal and Torres Strait Islander people by 2018; and
- priority area 6 of the National Tobacco Strategy 2012-18 to 'continue to implement regular staged increases in tobacco excise as appropriate, to reduce demand for tobacco'.

IMPLEMENTATION AND REVIEW

1.258 Changes to the rates of excise and excise equivalent customs duty and indexation method for the rates of duty can be achieved through amendments to the *Excise Tariff Act 1921* and the *Customs Tariff Act 1995*.

1.259 To allow the ATO and ACBPS to begin collecting the additional duty on and from 1 December 2013, the increases were initiated using excise and customs tariff proposals.

1.260 The tariff proposals were published by way of Gazette Notices on 29 November 2013. The tariff proposals were tabled in the House of Representatives on 10 December 2013, that is, within the required seven sitting days of the Gazette Notice being published.