

Australia's illegal tobacco market

Counting the cost of Australia's black market

February 2010



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Glossary

Term	Definition
ABS	Australian Bureau of Statistics
ACBPS	Australian Customs and Border Protection Service
AFP	Australian Federal Police
ANAO	Australian National Audit Office
AQIS	Australian Quarantine and Inspection Service
ATO	Australian Tax Office
BATA	British American Tobacco Australia
FCTC	Framework Convention on Tobacco Control
GST	Goods and Services Tax
PIN	Penalty Infringement Notice
PML	Phillip Morris Limited
RYO	Legal roll-your-own pouch tobacco
TMC	Tailor made cigarettes
WHO	World Health Organisation

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Executive summary

Illegal tobacco remains a problem for Government and the wider community

Illegal tobacco consumption equivalent to 12.3% of cigarettes consumed in Australia

The illegal tobacco market continues to represent a large problem for government, retailers and the tobacco industry with the volume of illegal tobacco consumed equivalent to 12.3% of tobacco consumption in Australia, based on modelling results.

Following the cessation of legal domestic tobacco production there has been decreased availability and access to unbranded tobacco in Australia, which has seen the number of consumers who regularly purchase unbranded tobacco dip from 6% in 2007 to 2% of smokers today (based on the results of a survey of tobacco users).

However, there has also been a partial shift away from unbranded tobacco to counterfeit and contraband tobacco products, and the volume of illegal tobacco purchased per occasion and the frequency of purchase also appears to have risen.

\$642 million in Commonwealth Government taxation revenue lost due to illegal tobacco use

As a result, the total illegal tobacco market has grown, with an estimated 2.3 million kilograms of illegal tobacco consumed annually. This is up from 1.8 million kilograms, which was the estimated market size in 2007.¹ With the recent increase in taxation rates, this represents a taxation revenue loss for the Commonwealth Government of \$624 million (excluding GST).

The illegal tobacco market is a problem for Australia and internationally in many respects. In terms of adverse health impacts, the Department of Health and Ageing (DoHA) identifies that illegal tobacco presents serious health risks in addition to those of smoking legal tobacco.² This is due to the fact that illegal tobacco typically contains a number of contaminants and is not subject to quality control standards that legal tobacco production adheres to. Press reports in the United States and Canada are also pointing to a nexus between illegal tobacco and organised crime where it is believed that some organised crime syndicates are using the trafficking of illegal cigarettes as a way to fund their organisations because the potential profit margin is so large.³

The change in the types of illegal tobacco products being used in Australia represents a new challenge in combating illegal tobacco trade. Greater focus now needs to be on the international environment, particularly countries from which illegal tobacco is being sourced, and the smuggling of illegal tobacco into Australia.

¹ PricewaterhouseCoopers 2007, *Illegal Tobacco Trade: Costing Australia Millions*.

² Department of Health and Ageing website 2007, *Fact Sheet: The facts about 'chop-chop' tobacco*, www.health.gov.au

³ For instance, see <http://www.ticklethewire.com/2009/04/16/illegal-cigarettes-and-organized-crime-more/>, <http://www.tillsonburgnews.com/ArticleDisplay.aspx?archive=true&e=2079074>, <http://www.nationalpost.com/scripts/story.html?id=2277961>.

Need to remain vigilant in addressing sources of illegal supply

Consumers are sourcing illegal tobacco from multiple suppliers, and products are coming from Australia as well as overseas

Despite the positive illegal tobacco control measures currently in place, access to illegal tobacco products remains a problem. Survey results show that the points of sale of illegal tobacco are abundant enough for most consumers to have multiple suppliers. Only 29% of illegal tobacco users purchase their unbranded tobacco from only one supplier. Over 50% purchase illegal tobacco products from two to four different suppliers, and 20% purchase from a larger number of suppliers.

Most unbranded tobacco continues to be purchased from a tobacconist (39%) or at local markets (17%). Unbranded tobacco users believe that their illegal tobacco is sourced mainly from Australia, or otherwise it is believed to be sourced from China, India or Holland.

Illegal tobacco smokers remain price sensitive, and for those that are aware of it, more are using it

Price remains a key driver of decisions to use illegal tobacco products

Illegal tobacco users are typically more price sensitive than smokers of legal tobacco products, which has been confirmed in the latest survey results. The key findings on illegal tobacco demand include the following:

- The awareness of illegal tobacco continues to be high at 50% of smokers. Of those that are aware of illegal tobacco, half actually purchase it, which is up from around a third of those that actually purchased it in 2007.
- The proportion of consumers purchasing unbranded tobacco has fallen from 16% to 13% of smokers, but new information on purchases of counterfeit and contraband tobacco products more than makes up for this (purchased by 8% of smokers) and total consumption has grown.
- Unbranded tobacco users are predominately male and over 45 years of age (similar to the population of legal tobacco smokers). They also tend to smoke cheaper tobacco products in general, showing a strong preference for mainstream or value brands of legal tobacco. This shift to preferences for cheaper legal brands has increased since 2007.
- Users of counterfeit and contraband illegal tobacco products are younger, and tend to prefer more premium brands of legal tobacco products. This suggests that they use illegal products as a way of affording higher end products.
- Smokers of unbranded tobacco are long time users - 48% of unbranded tobacco users have been purchasing illegal tobacco for more than 9 years.
- Most common reason for using illegal tobacco is cheaper prices, followed by perceptions of 'healthier products'. The 'cheapness' of illegal tobacco was the key reason for 77% of purchases of unbranded tobacco, but only 52% of purchases of counterfeit and

contraband cigarettes with many users not realising at the time that they were purchasing illegal products.

- Information from smokers that ceased purchasing unbranded tobacco in the last 12 months cited mainly poor quality as well as reduced availability and access as reasons for no longer purchasing unbranded tobacco.

Estimated size of the illegal tobacco market

Estimates of the size of the illegal tobacco market range from 347,000 kilos to 2.3 million kilos in 2008/09

Estimates on the size of Australia's illegal tobacco market, using four specific models, range from 347,000 kilos to 2.3 million of illegal tobacco in Australia 2008-09.

Using the consumption model, it is estimated that there was a \$624 million excise revenue loss in 2008-09 due to illegal tobacco

Estimates using the consumption model, which is based on the usage patterns of illegal tobacco consumers total 2.3 million kilos of illegal tobacco in 2008/09, representing a \$624 million excise revenue loss (excluding GST) to the Commonwealth Government, a 39% increase in the estimated excise loss from 2007. However, it is important to consider that \$95.8 million of this increase is due to the identification of counterfeit and contraband tobacco products.

In comparison, using a smuggled tobacco model, the total quantity of illegal tobacco is estimated at 264,061 kilos (based on seized smuggled tobacco only). This level of illegal tobacco is equal to a \$96.3 million excise revenue loss (excluding GST).

Positive evidence of a recent crackdown on illegal tobacco supply but still more to do

Tobacco control measures can have the unintended consequence of increasing illegal tobacco demand

Since the cessation of legal domestic tobacco production in 2007, increases in regulatory control, particularly through increased monitoring and seizing of illegal tobacco products have had some impact on reducing the size of the illegal tobacco market.

However, unbranded loose leaf tobacco has now given way to higher quantities of illegally imported tobacco products such as contraband and counterfeit cigarettes. Coupled with higher excise duties, the illegal tobacco market is seen as a lucrative way to avoid paying taxes, which represent about 68% of the cost of tobacco products.

Illegal tobacco control must remain vigilant, given that measures to reduce legal tobacco use may unintentionally result in greater illegal tobacco trade. For instance, regulatory options that have been canvassed in the public domain include:

- increasing the price of legal cigarettes;
- banning the display of tobacco products at retail outlets; and
- introducing generic packaging.

Overall, there is a risk that these new tobacco control measures could result in increased consumption of illegal tobacco. For instance:

When asked what their response to a 10% increase of the price of manufactured cigarettes would be, 16% of surveyed tobacco users (legal and illegal) responded that they would increase purchases of illegal

New illegal tobacco control measures must reflect the changing nature of the illegal tobacco problem in Australia

tobacco. Of those that would increase purchases, half (50%) of the respondents identified they would shift more than half of all purchases to illegal tobacco.

In addition, 13% of respondents stated that they would increase their purchases of illegal tobacco if tobacco displays for manufactured cigarettes were removed from the point of service. Of those that would increase purchases, almost half (46%) identified they would shift more than half of all purchases to illegal tobacco.

This report has highlighted the changing nature of the illegal tobacco problem. This should be reflected in future regulatory options to decrease the incentive for people to purchase, smuggle, or produce illegal tobacco products, such as:

- Further enhancements to monitoring and detection; and
- Increased penalties for using or smuggling illegal tobacco.

1 Background

The Australian tobacco industry makes a significant contribution to the economy in terms of government revenue, retail sales and employment. In 2007/08, the Australian tobacco market generated total revenues of \$9.3 billion, representing a contribution of \$3.6 billion (0.4%) to Australia's GDP. Of this, \$5.62 billion was collected in excise revenue directed to government (excluding imported products / customs duty).

The illegal tobacco market represents a large problem for government, retailers and the tobacco industry with the total volume of illegal tobacco consumed equivalent to 12.8% of tobacco consumption in Australia.

Following the cessation of legal domestic tobacco production there has been decreased availability and access to unbranded tobacco. As a result, there has been a shift away from unbranded tobacco to counterfeit and contraband cigarettes.

This represents a new challenge in combating illegal tobacco trade. Greater focus now needs to be on the international environment, particularly countries from which illegal tobacco is being sourced, and the smuggling of this illegal tobacco into Australia.

The use of illegal tobacco results in foregone government revenue, adverse public health impacts, and is believed to have links with other unlawful activity.

Scope of study

This study is an independent report, commissioned by BATA, which identifies the scale and scope of the illegal tobacco market in Australia and highlights the characteristics and purchasing behaviours of illegal tobacco users.

This report has been produced by PricewaterhouseCoopers and draws on independent primary research undertaken for this study through a survey of legal and illegal tobacco users undertaken by Roy Morgan.

This study is an updated version of *Illegal tobacco trade: Costing Australians millions* report, which was also commissioned by BATA and independently produced by PricewaterhouseCoopers in July 2007.

Legal domestic tobacco production

Legal domestic tobacco production has ceased in Australia. Prior to 2007, around 4 million kilograms of tobacco was produced domestically, which had continually declined from a production peak of 17.2 million kilograms in 1970. This cessation of domestic tobacco production was, for the most part, due to three key drivers:

- international price competition;
- successive reductions in the protective tariff on Australian leaf during the 1990s; and

- declining tobacco consumption in the Australian population.

To smooth the transition from domestic tobacco production for Australian farmers, the Australian Government provided financial assistance to former tobacco growers. For instance:

- In 2004, former tobacco growers in Northern Queensland received Government assistance following the cancellation of their growing licences by the Australian Tax Office (ATO);
- In 2006, BATA notified growers in Victoria that it would not be purchasing tobacco after 2009.⁴ This provided tobacco growers with three years to smooth the transition from farming tobacco to agricultural products. The Federal Government has since provided in excess of \$16.8 million in assistance to former Victorian tobacco growers.

Although illegal tobacco trade has long been prevalent in the Australian tobacco market, since the cessation of legal domestic tobacco production, illegal tobacco is increasingly being sourced from China, Vietnam, Syria, Philippines, Indonesia, Brazil and the United Arab Emirates.⁵

Tobacco excise

A variety of taxes are applied to cigarettes and other tobacco products internationally. Virtually all countries apply excise duties as an amount payable per cigarette stick. Tobacco taxes are favoured by governments because of their relatively high level of acceptance amongst voters and because of their low administrative costs relative to the income they generate.

In Australia, taxes comprise on average 68% of the total cost of cigarettes. This percentage is lower than the majority of OECD countries. For example, taxes make up 80% of the cost of cigarettes in France, 78% of the costs in the United Kingdom and 76% of the cost in Canada.⁶

However, it is important to note that although the tax component may be low in Australia that other countries, the absolute price of cigarettes is often higher. In fact analysis of the relative international price of cigarettes shows that prices in Australia are significantly higher than elsewhere. Recent research by Citi, which uses the local price of the McDonald's hamburger as the base unit, found that a packet of Marlboro in Australia costs three times the local price of a Big Mac, which was the highest of all countries that sell Big Mac's and are used in the 'Big Mac index'.⁷

⁴ ABC Rural Victoria, *Federal Government offers tobacco growers exit package 2006*, accessed on 20 September 2009, at <http://www.abc.net.au/rural/vic/content/2006/s1774133.htm>

⁵ Cancer Council Victoria, accessed on 25 September 2009, at: www.tobaccoinaustralia.org.au

⁶ Mackay, Eriksen and Shafey, *The Tobacco Atlas*, 2006, World Bank classification of income status of nations. Available from: www.tobaccoinaustralia.org.au

⁷ Citi Research 2009, 'Where there's smoking there's Citi research', Sydney Morning Herald, 10 September 2009, www.smh.com.au/business/where-theres-smoking-theres-citi-research-20090909-fho4.html

In Australia, the current 'per stick' excise (excluding GST) as at 28 August 2009 is

- \$0.25833 per stick (not exceeding 0.8 grams tobacco content); and
- \$322.93 per kg of tobacco (loose leaf tobacco, RYO and cigars).⁸

In 2008, the Australian tobacco market generated total revenues of \$9.3 billion, representing a contribution of \$3.6 billion (0.4%) to Australia's GDP. In 2008/09 \$5.62 billion was collected in excise revenues of tobacco products, representing 2% of Australia's taxation revenue.^{9,10}

Relative to other taxes, the excise on tobacco, alcohol and petroleum accounted for approximately 10% of total federal revenue collected by the ATO in 2007/08.¹¹

Tobacco tax creates incentives to supply illegal tobacco

The avoidance of taxation is a key driver of illegal tobacco sales. Unbranded loose tobacco is sold for 30% of the price of legal tobacco at approximately \$8 per 50 grams¹² (wholesale price), compared to an average retail price of \$27 per 50 grams for branded tobacco.

Table 1 shows that unbranded tobacco in a cigarette tube costs approximately \$0.22 compared to \$0.40 for a legal RYO cigarette - a cost difference of \$0.18 per cigarette. This is despite the fact that tubes generally use more grams of tobacco than RYO cigarettes, and that tubes are nearly double the price of papers. These results show a 48% increase in the price of a legal RYO cigarette and a 16% increase in the price of an unbranded tobacco cigarette.

⁸ Australian Taxation Office, *Excise Tariff Working Pages*, Schedule 28 August 2009, accessed on 24 September 2009, at <http://law.ato.gov.au/atolaw/view.htm?docid=PAC/BL030002/1>

⁹ Commonwealth 2009/10 Budget Paper No.1, Statement 5: Revenue, Table 10, pg 29

¹⁰ Reserve Bank of Australia, *Gross Domestic Product -- G10*, June 2009, accessed on 20th September 2009, at: www.rba.gov.au/Statistics/AlphaListing/alpha_listing_g.html

¹¹ Australian Taxation Office, *Compliance Program 2009/10*, pg 4.

¹² Calculated based on Roy Morgan survey research 2009

Table 1: Cost of unbranded tobacco versus legal cigarettes

Cost analysis	Legal RYO cigarette	Unbranded tobacco in a tube
<i>Assume total number of cigarettes is equal to:</i>	40	40
Total number of grams of legal/illegal tobacco per cigarette	0.70	1.25
Total number of grams of legal/illegal tobacco for 40 cigarettes	28	50
Cost of 50g tobacco pouch (\$)	\$27.39	\$7.84
Proportionate cost of tobacco for 40 cigarettes (\$)	15.34	7.84
Cost of 50 papers/tubes (\$)	0.60	1.16
Proportionate cost of papers/tubes for 40 cigarettes (\$)	0.48	0.93
Total cost for 40 cigarettes	\$15.82	\$8.77
Cost per cigarette	\$0.40	\$0.22

Illegal tobacco overview

There are three different forms of illegal tobacco available in Australia – unbranded tobacco, counterfeit cigarettes and contraband cigarettes. Each of these illegal forms of tobacco is defined below.

Unbranded tobacco more commonly known as ‘chop chop’ is generally sold in cheap packaging (i.e. clear plastic bags) as loose leaf tobacco in half-kilogram and one-kilogram lots and carries no health warnings or other labelling. The name chop chop is derived from the fact that this tobacco is often produced in amateur conditions and roughly cut into fine strips.¹³ It is consumed in the same way as legal RYO pouch tobacco or via empty cigarette tubes. Tubes can be purchased from some tobacco retailers and supermarkets. When used in conjunction with a tubing machine (a small inserting device, available from tobacconists) many unbranded tobacco users are making a product that looks like tailor made cigarettes (TMCs) but avoiding tobacco tax, which makes them a fraction of the TMC packet price.

Counterfeit cigarettes often known as ‘fake smuggled cigarettes’, are generally cigarettes manufactured overseas illegally and smuggled into Australia for illegal sale. These cigarettes labelled with fake branding pose health risks to consumers as production facilities are unregulated and do not have to adhere to the strict production standards which licensed manufacturers follow. Of those counterfeit cigarettes seized by customs in the first half of 2009, the illegal tobacco production was sourced from China, the Philippines, Vietnam and Syria.

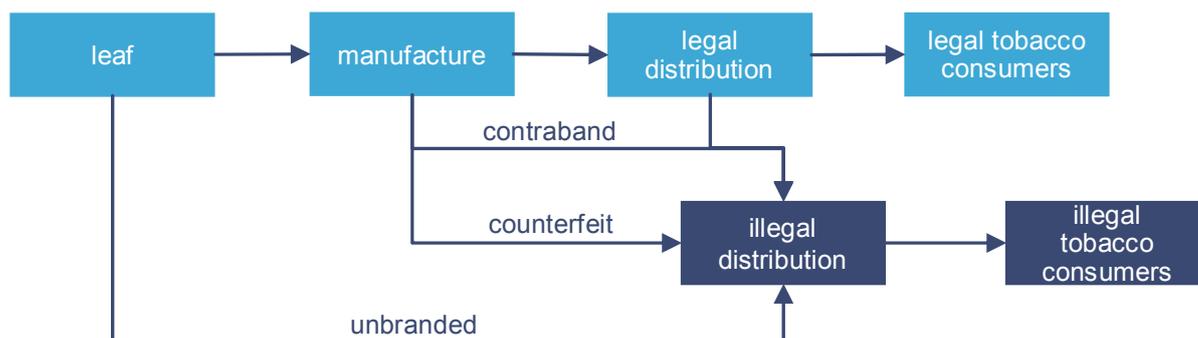
Contraband cigarettes are legitimate branded cigarettes, but the excise duty has been evaded. These cigarettes may be purchased in shops and tobacconists without the knowledge of the consumer. They can also be traded on the illegal market at a price much lower than that of an equivalent legal pack. One example of contraband cigarettes are packets

¹³ Bittoun, R. 2004, *The Medical Consequences of Smoking “Chop-Chop Tobacco”*, Prepared for the Commonwealth Department of Health and Ageing, p. 3.

purchased or somehow acquired duty free and then on-sold at a lower price.

Figure 1 illustrates the legal tobacco supply chain, showing the three types of illegal tobacco – unbranded, counterfeit and contraband - that at different stages of the supply chain divert from legal supply to the illicit market.

Figure 1: Legal and illegal tobacco supply chain



Imports of illegal tobacco are often large in scale. For instance, in January 2009, customs intercepted an attempt to import 10 million cigarettes from the Philippines in a sea cargo container at the Container Examination Facility in Sydney.¹⁴ Another arrest of two men in 2009 represented Australia's largest single seizure of undeclared molasses tobacco. In total, 1,562 cartons of molasses tobacco with a weight of 11,600 kilograms were found which represents an attempt to evade more than \$4 million of government revenue.

A global issue

Illegal tobacco is not only a problem in Australia, but elsewhere in the developed world. For example, the illegal tobacco market in Canada is a growing problem. Of the cigarettes smoked in the province of Ontario, reports have estimated that between 32%¹⁵ and 40%¹⁶ of cigarettes were illegal in 2007, according to the published survey commissioned by Imperial Tobacco Canada and 'Physicians for a Smoke-Free Canada' respectively. Figures for 2008, by Imperial Tobacco Canada indicate that the share of purchased illegal cigarettes in Ontario has increased to almost half the entire tobacco trade. The 'Physicians for a Smoke-Free Canada' provided a Canada-wide estimate of 27% of total cigarettes sales that were contraband in 2007 which indicates that some provinces

¹⁴ Australian Customs and Border Protection Service Media Release, *Customs continues crackdown on cigarette smuggling*, 8 January 2009.

¹⁵ Imperial Tobacco Canada, *Illicit Usage of Cigarettes in Canada – 2008 Study GfK Research Dynamics: Summary of Results*, accessed on 9th September 2009.

¹⁶ Physicians for a Smoke-Free Canada, *Estimating the volume of Contraband Sales of Tobacco in Canada*, December 2008, p.8, accessed on 9th September 2009, at: http://www.smoke-free.ca/pdf_1/estimatesofcontraband-2008.pdf

(such as Ontario and Quebec) have a higher incidence of illegal tobacco trade than others.

The tobacco regulation in Canada includes; the prohibition of tobacco advertising; mandated cigarette packet pictorial health warnings on both the front and back; smoking bans in indoor public places, workplaces and restaurants (slight variations between provinces), and the minimum age set between 18 and 19 years old depending on the province.

Recently the province of Saskatchewan was the first to implement legal tobacco retail display bans in 2005, with all other Canadian provinces following suit.¹⁷ This has posed additional concern over the link between increased regulation of legal tobacco, such as retail display bans and increased usage of illegal tobacco, particularly contraband products. Further, in Saskatchewan, since the introduction of retail display banks, smoking rates have increased to 25 per cent, with some areas of the province experiencing smoking rates of over 35%, the highest smoking rate in Canada (2006 results).¹⁸

It must be noted however, that the illegal tobacco market in Canada is different to Australia as the majority of illegal cigarettes are moving illegally off native reserves, causing it to be a culturally-sensitive issue for Canada's government and law-enforcement agencies.

Impacts of illegal tobacco

There are four key impacts of illegal tobacco use in Australia that affect governments, retailers and the tobacco industry:

- changing trends in the type of illegal tobacco consumed with some shift from the purchase of illegal unbranded tobacco ('chop chop') to the purchase of counterfeit and contraband tobacco products, which require a shift in focus to better control illegal tobacco supply and distribution;
- foregone government revenue;
- adverse public health effects; and
- links with other unlawful activities.

Each of these key impacts of illegal tobacco use are discussed below.

Changing trends

Following the cessation of legal domestic tobacco production there has been decreased availability and access to unbranded tobacco. As a result, there has been a shift away from unbranded tobacco to counterfeit and contraband cigarettes. This represents a new challenge in combating illegal tobacco trade. Greater focus now needs to be on the

¹⁷ Banning the Display of Tobacco Products, accessed at: <http://www.productdisplayban.com/Pages/Section1/Canada/TobaccoLegislation.htm>

¹⁸ The Lung Association Saskatchewan, accessed at: http://www.sk.lung.ca/content.cfm?edit_realword=xtra0298

international environment, particularly countries from which illegal tobacco is being sourced, and the smuggling of this illegal tobacco into Australia.

Foregone government revenue

The tobacco industry is a dynamic industry that represents a large source of taxation revenues. The cost to Government of illegal tobacco trade is substantial, and continues to climb as tobacco tax rates increase and the total volume of illegal tobacco rises. With approximately 2.3 million kilos of illegal tobacco estimated to have been used in 2009 (see Section 1), this represents a taxation revenue loss (including GST) of \$624 million. This is up from the estimated \$450 million in lost government revenue estimated in 2007.

The issue of lost taxation revenue becomes more significant as tobacco excise becomes a greater proportion of total excise, which as shown in Table 2, has grown from 11.8% in 1999/00 to 24.2% in 2005/06, with a slight decline of 1.3% over the past three years. If tax rates rise further as part of a preventative health initiative, the total expected revenue lost would rise further still.

Table 2: Tobacco excise growth trend

Year	Tobacco excise collected (\$m)	Tobacco excise as a % of total excise	% change
1999-2000	1,659	11.8%	
2000-01	4,637	24.4%	179.51%
2001-02	4,841	24.7%	4.40%
2002-03	5,212	25.1%	7.66%
2003-04	5,240	24.9%	0.54%
2004-05	5,293	24.1%	1.01%
2005-06	5,296	24.2%	0.06%
2006-07	5,382	23.6%	1.62%
2007-08	5,631	23.9%	4.63%
2008-09(f)	5,620	22.9%	-0.20%

Source: Commonwealth Budget Papers 2000/01 -2009/10, No. 1, Statement 5: Revenue.
Note: The collected tobacco excise excludes customs duty and GST.

Public health effects

Another major cost of illegal tobacco use is the negative impact on public health. The Department of Health and Ageing identifies that illegal tobacco presents serious health risks in addition to those of smoking legal tobacco.¹⁹ This is due to the fact that illegal tobacco typically contains a number of contaminants and is not subject to quality control standards that legal tobacco production adheres to. Further, illegal tobacco does not display health warnings as legal tobacco does.

¹⁹ Department of Health and Ageing website 2007, *Fact Sheet: The facts about 'chop-chop' tobacco*, www.health.gov.au

Illegal tobacco can be manipulated by producers and sellers to increase weight and therefore profits, grown using techniques that may elevate the concentration of heavy metals and other toxic substances.²⁰ Illegal tobacco, in particular loose leaf unbranded tobacco frequently has straw, twigs or grass clippings added to the tobacco leaf to bulk up the weight for sale. There have also been reports of dampening the illegal tobacco to also increase its weight. This practice can increase the prevalence of mould spores which could enter the lungs, and also increases the presence of fungal contamination. Some products are also fumigated with chlorine bleach, which puts users at risk of inhaling chlorine gas.²¹

A recent nation-wide study found that current and lifetime users of illegal tobacco report 'significantly worse mental and physical health' relative to smokers of legal tobacco.²²

Also, for price sensitive smokers, illegal tobacco may present an alternative to quitting.

Links with other unlawful activity

The illegal tobacco trade poses significant costs to the community as a result of its links to organised crime. The smuggling of tobacco has been linked with other serious criminal activity. On the basis of Australian Taxation Office research, the ANAO observed that smuggling organisers were 'actively involved in other forms of criminality such as drugs, money laundering, identity fraud and car rebirthing as well as tobacco smuggling'.²³

Press reports in the United States and Canada in particular are also pointing to a nexus between illegal tobacco and organised crime where it is believed that some organised crime syndicates are using the trafficking of illegal cigarettes as a way to fund their organisations because the potential profit margin is so large. For example, profit margins in the United States are known to be seven times the value of the illegal goods.²⁴

²⁰ Pappas, R., Polzin, G., Watson, C., & Ashley, D., 2007, 'Cadmium, lead, and thallium in smoke particulate from counterfeit cigarettes compared to authentic US brands', *Food and Chemical Toxicology Journal*, Volume 45, pp 202-209.

²¹ Smoking Research Unit, Department of Psychological Medicine, University of Sydney NSW 2003

²² Aitken, C., Fry, T., Farrell, L., & Pellegrini, B., 2009, 'Smokers of illicit tobacco report significantly worse health than other smokers', *Nicotine & Tobacco Research*, Volume 11, No. 8 9 August 2009), pp. 996-1001.

²³ ANAO 2006, *Administration of Petroleum and Tobacco Excise Collections: Follow-up Audit*, Australian Tax Office, p. 15.

²⁴ For instance, see <http://www.ticklethewire.com/2009/04/16/illegal-cigarettes-and-organized-crime-more/>, <http://www.tillsonburgnews.com/ArticleDisplay.aspx?archive=true&e=2079074>, <http://www.nationalpost.com/scripts/story.html?id=2277961>.

Structure of this report

The remainder of this report is structured as follows:

- **Section 3** provides information on the supply of illegal tobacco;
- **Section 4** provides a profile of legal and illegal tobacco users;
- **Section 5** provides an estimation of the size of the illegal tobacco market in Australia using a number of different models; and
- **Section 6** provides information on the current regulation of the tobacco market in Australia and provides an assessment of proposed regulatory options and their impact on the illegal tobacco market.

2 Supply of illegal tobacco

The incentives to supply illegal tobacco products continue to drive its availability in Australia with the survey of illegal tobacco users showing that:

- Most unbranded tobacco is purchased from a tobacconist (39%) or at local markets (17%);
- Smokers often purchase illegal tobacco from two, three or four different suppliers; and
- Unbranded tobacco users believe that their illegal tobacco is sourced mainly from Australia, but also from China, India or Holland.

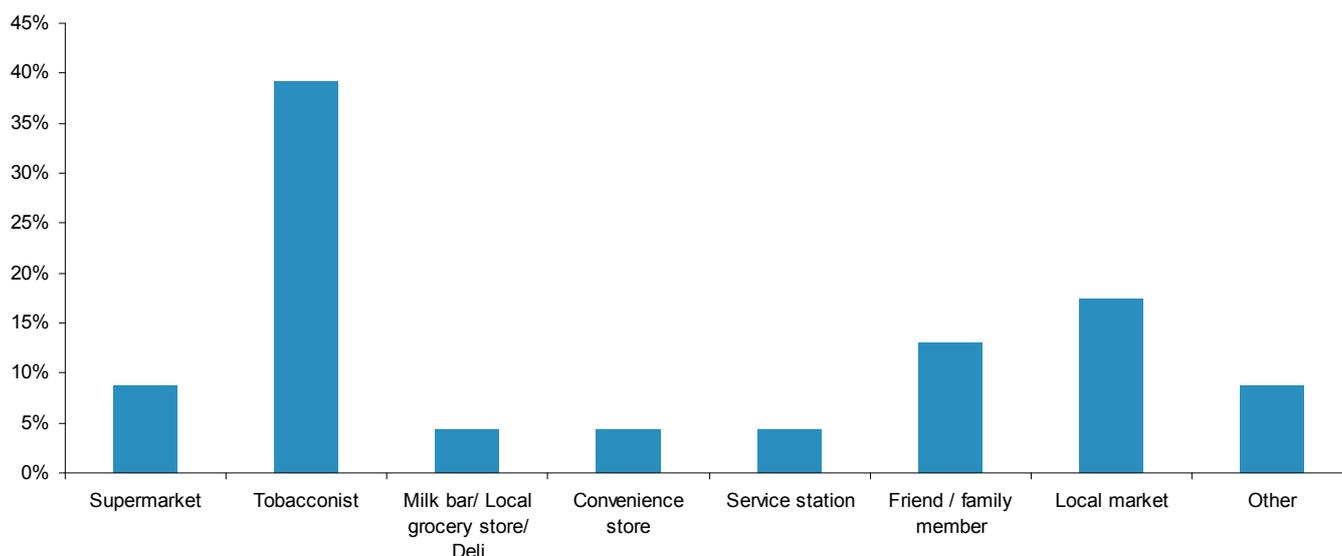
Supply of illegal tobacco

Illegal tobacco is sourced from a number of different distribution outlets. Some of these distribution outlets include:

- tobacconists;
- supermarkets;
- milk bars;
- convenience stores;
- local markets; and
- family and friends.

39% of unbranded tobacco was purchased from a tobacconist and 17% was purchased at local markets

Of all unbranded tobacco smokers surveyed, the most common outlet to purchase unbranded tobacco was from a tobacconist (39%) followed by local markets (17%) (see Figure 2). The category of 'other' includes gift shops and overseas.

Figure 2: Tobacconists and market stalls continue to be the major distribution outlets for illegal tobacco products

Smokers often purchase illegal tobacco from two, three or four different suppliers

The points of sale of illegal tobacco are abundant enough for most consumers to have multiple suppliers. Survey results show that only 29% of illegal tobacco users purchase their unbranded tobacco from one supplier. Over 50% purchased their unbranded tobacco from two to four different suppliers, and 20% purchase from a larger number of suppliers (see Table 3). The data does not specify how frequent an unbranded tobacco smoker uses a particular supplier or if their purchase is simply a one-off purchase.

Table 3: More than 70% of users obtain illegal tobacco from more than 1 source

Number of suppliers	Response %
1	29%
2	24%
3	14%
4	14%
5	5%
10	5%
≥ 11	10%

Most unbranded tobacco users believe that illegal tobacco comes from Australia, although known origins include China, India and Holland.

While most unbranded tobacco users are unaware of the origin of the illegal tobacco they purchase (65% of unbranded tobacco users), of those that did know, more than half (57%) believed that it came from Australia. However, this appears an 'assumed' response given the cessation of legal domestic production of tobacco in Australia. Also, given the expected market size and known cross border seizures, international sources are likely to be more prevalent than believed. International sources that were identified in the survey include China, India and Holland.

3 Profile of legal and illegal tobacco users

Illegal tobacco users are typically more price sensitive than smokers of legal tobacco products, which has been confirmed in the latest survey results. The key findings on illegal tobacco demand include the following:

- The awareness of illegal tobacco continues to be high at 50% of smokers. Of those that are aware of illegal tobacco, half actually purchase it, which is up from around a third of those that actually purchased it in 2007.
- The proportion of consumers purchasing unbranded tobacco has fallen from 16% to 13% of smokers, but new information on purchases of counterfeit and contraband tobacco products more than makes up for this (purchased by 8% of smokers) and total consumption has grown.
- Unbranded tobacco users are predominately male and over 45 years of age (similar to the population of legal tobacco smokers).
- Smokers of unbranded tobacco tend to smoke cheaper tobacco products in general, showing a strong preference for mainstream or value brands of legal tobacco. This shift to preferences for cheaper legal brands has increased since 2007.
- Users of counterfeit and contraband illegal tobacco products are younger, and tend to prefer more premium brands of legal tobacco products. This suggests that they use illegal products as a way of affording higher end products.
- Smokers of unbranded tobacco are long time users - 48% of unbranded tobacco users have been purchasing illegal tobacco for more than 9 years.
- Most common reason for using illegal tobacco is cheaper prices, followed by perceptions of 'healthier products'. The 'cheapness' of illegal tobacco was the key reason for 77% of purchases of unbranded tobacco, but only 52% of purchases of counterfeit and contraband cigarettes with many users not realising at the time that they were purchasing illegal products.
- Information from smokers that ceased purchasing unbranded tobacco in the last 12 months sited mainly poor quality as well as reduced availability and access as reasons for no longer purchasing unbranded tobacco.

Characteristics of legal tobacco users

Legal users of tobacco are typically male, over 45 years old, work full-time, earn a low to middle income and mainly smoke manufactured cigarettes

Based on the results of the survey of illegal tobacco users a picture of the typical legal and illegal tobacco user can be formed.

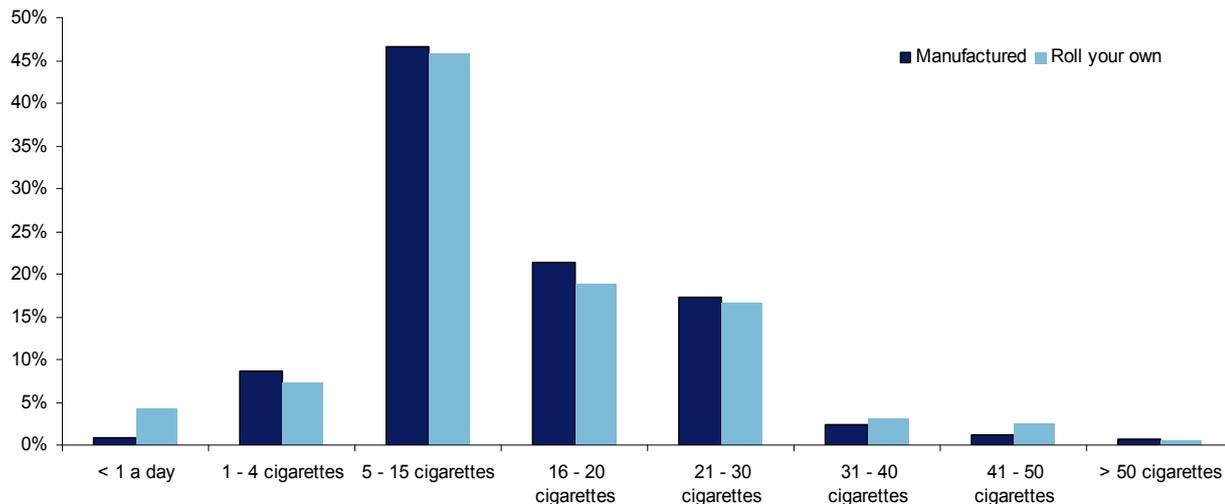
The average *legal* tobacco user is:

- over 45 years old (60% of total respondents);
- more likely to be male (53% of total respondents);
- works in either a blue or white collar industry and is likely to be working full-time (79% of total respondents work full-time); and
- earns a low to middle income (37% of total respondents earn between \$30,000 and \$60,000 per annum).

The majority (80%) of surveyed legal tobacco smokers consume manufactured cigarettes compared to 17% who consume Roll Your Own (RYO) tobacco and 3% who consume pipes and/or cigars.

Figure 3 below shows that the typical legal smoker consumes between 5 and 15 cigarettes a day.

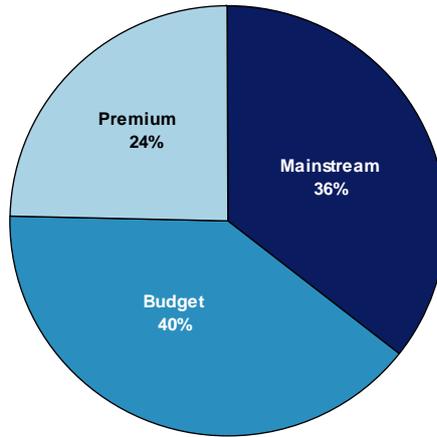
Figure 3: The typical legal smoker consumers between 5 and 15 cigarettes a day



40% of legal tobacco smokers regularly purchase value brand tobacco

Of those legal tobacco smokers surveyed, 24% regularly purchased premium brands of tobacco (Benson & Hedges and Dunhill were the most commonly identified brands). The largest share of legal tobacco smokers (40%) regularly purchased value brand tobacco (Longbeach and Horizon brands) and 36% regularly purchased mainstream tobacco brands (Peter Jackson and Winfield brands) (see Figure 4).

Figure 4: Most legal tobacco users purchase budget 'value' brand or mainstream brand tobacco



50% of legal tobacco smokers are aware of unbranded tobacco and 25% consume it (an increase on 2007 results)

Awareness of illegal tobacco products remains high

According to the survey, 50% of legal tobacco users are aware of illegal tobacco products – a result that is unchanged from the 2007 survey (see Figure 5, below). A quarter (25%) of survey respondents reported they purchase unbranded tobacco, which is higher than the 2007 results when 16% of total legal tobacco users, or 32% of those that are aware of it, actually purchased it.

Figure 5: In 2009, 50% of legal tobacco users were aware of unbranded tobacco and 25% reported they had previously purchased it



Characteristics of illegal tobacco users

Survey respondents were asked about their illegal tobacco consumption, depending on if they had previously purchased unbranded tobacco,

counterfeit cigarettes, or contraband cigarettes. Questions on counterfeit and contraband tobacco products are new to the 2009 survey. These results are discussed below by illegal tobacco category.

Unbranded tobacco

13% of legal tobacco users surveyed had previously purchased unbranded tobacco - a decrease from 16% in 2007

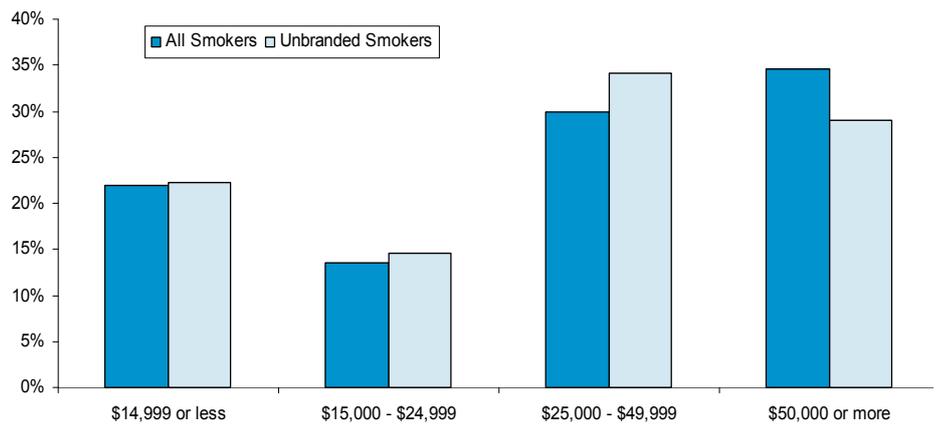
Of all surveyed legal tobacco smokers, 13% identified that they had previously purchased unbranded tobacco, this shows a decrease in the magnitude of people purchasing unbranded tobacco – in 2007, 16% of surveyed tobacco users has previously purchased unbranded tobacco.

Of all unbranded tobacco smokers surveyed, two-thirds were male compared to an almost even gender split for legal tobacco, consistent with 2007 results. The majority of unbranded smokers in 2009 reported that they are 45 years or older (60%).

Unbranded tobacco users tend to have lower incomes than smokers of legal products

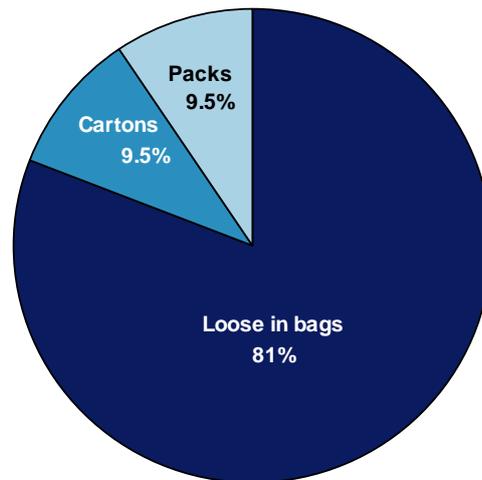
Compared to smokers of legal tobacco products, there are also significantly less illegal tobacco smokers that earn more than \$50,000 (see Figure 6). However, the income differential between unbranded tobacco smokers and all smokers has decreased compared to the 2007 results.

Figure 6: Over 70% of unbranded tobacco users earn less than \$50,000



The most common form of unbranded tobacco purchased is loose tobacco in bags (81%, see Figure 7).

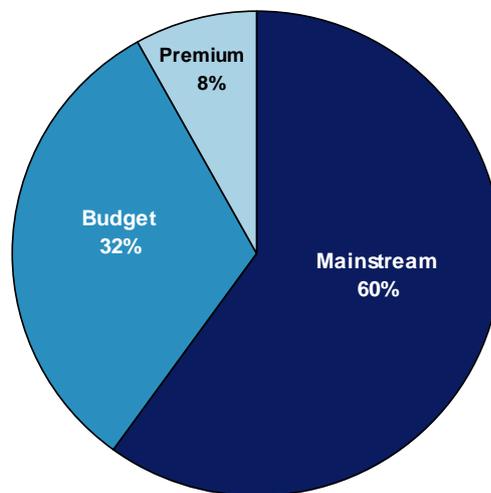
Figure 7: Unbranded tobacco is predominantly purchase loose in bags



Smokers of unbranded tobacco have a strong preference for mainstream or value branded legal tobacco

Further, when compared to all smokers, smokers of unbranded tobacco have a stronger preference for mainstream or value branded legal tobacco than for premium brands (92%, see Figure 8). The preference for cheaper legal cigarette brands has increased compared to the 2007 survey result where 80% of unbranded smokers preferred mainstream and value legal brands.

Figure 8: 92% of legal tobacco purchased by unbranded tobacco users is for non-premium products



48% of unbranded tobacco users have been purchasing illegal tobacco for more than 9 years

There is also a high proportion of long time users of unbranded tobacco with almost half of all unbranded tobacco users surveyed having been purchasing illegal tobacco for over 9 years, with only 10% of respondents commencing purchases of illegal tobacco in the last 12 months (see Table 4).

Table 4: 48% of unbranded tobacco users have been purchasing illegal tobacco products for more than 9 years

Length of time	% of unbranded smokers
Less than one year	10%
1 -3 years	19%
4 – 6 years	14%
6 – 8 years	10%
9 – 11 years	24%
More than 11 years	24%

77% of unbranded tobacco users purchased illegal tobacco because it was cheaper than legal tobacco

Unbranded tobacco users identified two key reasons for why they choose to purchase illegal tobacco. The most commonly identified reason for purchasing unbranded tobacco was because it was cheaper (77% of total responses). The next most common reason for purchasing unbranded tobacco was positive perceptions of taste and that unbranded tobacco was less of a health risk. For instance, one survey respondent commented:

'It is cheaper, doesn't have many chemicals, I don't know if that is true but I think so'

Those smokers that ceased purchasing unbranded tobacco in the last 12 months cited quality, availability and access as reasons for not purchasing unbranded tobacco

However, since the 2007 illegal tobacco survey, previous smokers of unbranded tobacco, whom no longer purchase illegal tobacco, gave a number of reasons for ceasing their illegal purchasing behaviour. The majority of unbranded tobacco users stated that the lower quality of unbranded tobacco was the main reason they ceased purchasing illegal tobacco. This was followed by availability and access to unbranded tobacco. The rising price of unbranded tobacco accounted for only 7% of respondents who ceased purchasing illegal tobacco (See Table 5). Some survey respondents commented:

*'The contact I had is gone'
'I just did not have the time to roll it, it was inconvenient for me'
'It is now risky buying chop chop because it can be mouldy or wet and has a taste of being soaked in something like water or alcohol'
'It was harsh on the throat. I developed a bad cough worse than smoking normal cigarettes''*

Table 5: 40% of unbranded tobacco smokers stopped purchasing it because the quality was not as good as legal tobacco

Reason	% of previous unbranded tobacco users
Unbranded tobacco quality isn't as good as legal tobacco	40%
Unbranded was not available	26%
Unbranded was harder to get	21%
Unbranded was not cheap enough compared to legal tobacco products	7%
I was worried that I may get into trouble	7%

Counterfeit and contraband cigarettes

Counterfeit and contraband smokers generally have a younger age demographic than unbranded tobacco and legal tobacco smokers

8% of legal tobacco users had purchased counterfeit of contraband cigarettes in the past 12 months

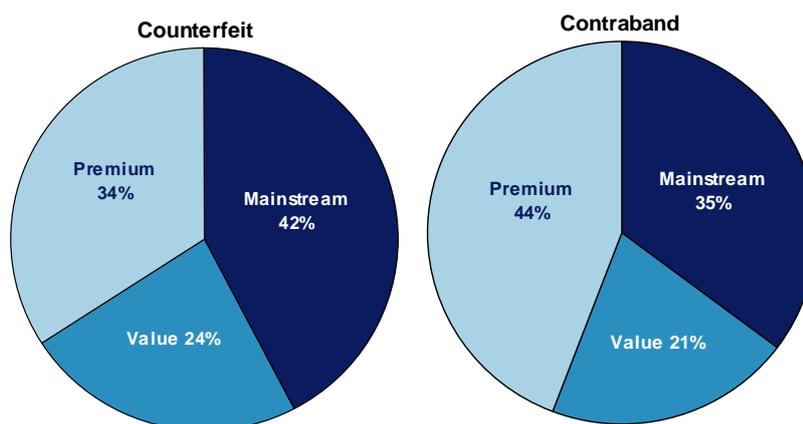
Premium and mainstream brands were preferred by counterfeit and contraband users

Similar to unbranded tobacco smokers, the majority of counterfeit and contraband cigarette smokers surveyed were male (78% and 83% respectively). A large number of counterfeit smokers were 21-39 years (56%, and 49% for contraband smokers), a generally younger age demographic than legal smokers and unbranded tobacco smokers.

Of all legal smokers surveyed, 4% had purchased counterfeit cigarettes and 4% had purchased contraband cigarettes in the last 12 months. Approximately half of the smokers that purchased either counterfeit or contraband cigarettes also purchased the other illegal form of tobacco. This suggests a degree of substitution between these two forms of illegal cigarettes.

Premium and mainstream brands were preferred by counterfeit and contraband consumers (34% and 44% of illegal users respectively), representing a low-cost way of smoking cigarettes brands that may otherwise be higher than consumers' willingness to pay (see Figure 9).

Figure 9: Premium and mainstream brands were preferred by counterfeit and contraband consumers



52% of respondents identified price as the main reason they purchased contraband or counterfeit cigarettes

Smokers of counterfeit and contraband tobacco products identified three key reasons for why they choose to purchase illegal tobacco. For contraband cigarettes, more than half of the surveyed users identified price as the main reason they purchased contraband cigarettes. This was followed by 28% who were unaware they had purchased contraband cigarettes at the time (34% for counterfeit cigarettes). In addition, 8% purchased the contraband cigarettes as they were available or offered to them (10% for counterfeit cigarettes). Some survey respondents commented:

'They were cheaper and I thought they were the real deal'

'It was cheaper in price and the tobacconist offered it to me'

'I wasn't aware it was contraband, they were mixed with manufactured ones'

Of all illegal tobacco users (unbranded, counterfeit and contraband), almost 90% stated that they would prefer to purchase duty paid tobacco rather than not smoke if illegal tobacco became unavailable.

4 Size of the illegal tobacco market

Four approaches have been used to provide a range of estimates on the size of Australia's illegal tobacco market, with estimates ranging from 264,000 kilos to 2.3 million of illegal tobacco in Australia 2008-09. Estimates for the four models include:

- the consumption model, which is based on the usage patterns of illegal tobacco consumers. Using this model provides an estimate of 2.3 million kilos of illegal tobacco in 2008/09, representing a \$624.0 million excise revenue loss (excluding GST) to the Commonwealth Government, a 39% increase in the estimated excise loss from 2007; and
- the smuggled tobacco model, which examines illegal tobacco seizures and estimates the total quantity of illegal tobacco of 264,061 kilos (based on seized smuggled tobacco only). This level of illegal tobacco is equal to a \$96.3 million excise revenue loss (excluding GST).

Given the illicit nature of the product, and its many forms, estimating the size of the illegal tobacco market should reflect demand and supply side aspects to the market. Two approaches have been used to provide a range of estimates on the size of Australia's illegal tobacco market:

- the consumption model - which builds up a profile of the market based on the usage patterns of illegal tobacco consumers; and
- the smuggled tobacco model – which examines illegal tobacco seizures;

It is difficult to estimate the size of the illegal tobacco market with absolute certainty, as purchases are not recorded or comprehensively monitored. A further challenge is the changing nature of the illegal tobacco market and trends in the use of 'chop chop' versus those in counterfeit and contraband cigarettes.

In the past, the size of the illegal tobacco market has been estimated by examining domestically grown tobacco crop yields that are diverted from legal manufacturing. This method has become less relevant since the cessation of legal tobacco growing in Australia. Focusing only on illegal tobacco seizures by Customs will underestimate the volume of illegal tobacco as it does not capture illegal tobacco that is not imported and/or is not detected. It is also difficult to estimate with certainty the probable volume imported based only on detection and seizure rates of illegal tobacco products, when discoveries are often co-located with other illegal products that are the primary focus of investigation.

Our preferred methodology for estimating market size is based on the purchasing patterns and behaviour of illegal tobacco users, based on a customised survey of smokers (the 'consumption model'). This is the only methodology that captures purchases and use of all types of illegal tobacco, irrespective of its form, type, or country of origin.

The challenge in estimating total market size stems from the approach used to pro-rata the surveyed usage rates to the total smoking

population. In this regard, other methods of calculating market size serve as a useful reference point to ensure that the estimates from the consumption model remain 'reasonable'.

Table 6 summarises the high level results using the two models:

- the consumption model estimates a total quantity of illegal tobacco of 2,348,000 kilos, with 15% of illegal tobacco drawn from counterfeit and contraband products and the remainder drawn from unbranded tobacco consumption. This level of illegal tobacco represents a \$624.0 million excise revenue loss (excluding GST) to the Commonwealth Government, a 39% increase in the estimated excise loss from 2007. However, it must be considered that \$95.8 million of the excise loss increase is due to the identification of illegal counterfeit and contraband products; and
- the smuggled tobacco model estimates the total quantity of illegal tobacco of 264,061 kilos (based on seized smuggled tobacco only). This level of illegal tobacco is equal to a \$96.3 million excise revenue loss (excluding GST).

Table 6: Estimates of the illegal tobacco market in Australia

Source	Excise revenue loss for Commonwealth Government (\$M)	Quantity of illegal tobacco ('000 kg)
Consumption model	\$624.0	2,348
Smuggled tobacco model	\$96.3	264

Consumption model

This model estimates the size of the market based on a Roy Morgan survey of the purchasing patterns, behaviour and drivers of illegal tobacco users. This research represents the most up to date and comprehensive assessment of illegal tobacco users in Australia.

The consumption model is based on an examination of the quantified purchasing patterns of illegal tobacco users in Australia. Based on the survey results the total market volume of the three types of illegal tobacco is 2.3 million kilograms. This estimate is derived by estimating the quantity and frequency of illegal tobacco by type purchased by consumers in the survey, and extrapolating to the national smoking population.

Table 7 shows the volumes and purchasing patterns separated into the three different types of illegal tobacco; unbranded tobacco, counterfeit and contraband cigarettes. The total market size estimate of 2.3 million kilograms represents an increase of 520,000 kilograms from the 2007 results of 1.8 million kilograms. The key reasons behind this growth are:

- The survey now includes counterfeit and contraband tobacco (not included in 2007), which represents 229,000 kilos (44% of the difference); and
- The purchasing behaviour of unbranded tobacco users has changed – a small number of users (a 9% decrease from 2007) purchase more unbranded tobacco (a 10% increase from 2007), more frequently (20% increase from 2007).

Table 7: Consumption model

Detail	Unbranded	% change from 2007	Counterfeit	Contraband
Quantity of illegal tobacco purchased per occasion (g) [1]	403	10%	243	350
Frequency of illegal tobacco purchase per annum [2]	11	20%	3	3
Quantity of illegal tobacco purchased per annum (g) [3]	4181	27%	830	1,389
Number illegal tobacco users in Australia ('000) [4]	507	-9%	160	160
Illegal tobacco users as % of Australian tobacco users	13%	-19%	4%	4%
Quantity of illegal tobacco used in Australia ('000 kg) [5]	2,119	16%	133	228

Notes:

[1] Based on Roy Morgan survey data: weighted average of grams purchased per number of consumers, weighted to reflect composition of loose versus stick purchased in the survey sample.

[2] Based on Roy Morgan survey data: weighted average frequency of purchases (frequency of purchase weighted by number of consumers)

[3] Based on [1] & [2] combined to an annual quantity

[4] Based on extrapolating [5] to [6]

[5] Based on [3] and [4]

Analysis of illegal tobacco consumers in Australia shows that the majority of illegal tobacco trade is conducted on the east coast of Australia. Unbranded tobacco purchases were highest in Victoria than any other state, possibly indicating the continued demand for loose tobacco following the cessation of legal domestic legal tobacco production. NSW had the highest number of consumers of counterfeit and contraband cigarettes in Australia at 39% and 46% respectively (See Table 8).

Table 8: Illegal tobacco consumers across Australian states

State	Unbranded tobacco users	Counterfeit tobacco users	Contraband tobacco users
NSW	32%	39%	46%
VIC	36%	29%	34%
QLD	22%	15%	12%
WA	5%	12%	5%
SA	6%	2%	2%
Total	100%	100%	100%

Note: Unbranded tobacco average volume purchased calculation is based on grams per average purchase, counterfeit and contraband cigarettes calculation is based on the most recent purchase.

Smuggled tobacco model

The size of the smuggled tobacco market can be estimated by examining the quantities of tobacco discovered in random inspections, assessing the probability of illegal tobacco discoveries as the number of inspections increases and extrapolation to wider container imports. In addition, the channelling of resources to 'high risk' containers means that it is likely that the number of illegal discoveries will decline as the number of inspected containers increases.

The total size of the illegally smuggled tobacco market has been estimated by applying volume of tobacco seized to the proportion of total containers estimated to conceal illegal tobacco, making an allowance for the declining rate of discoveries. This model assumes that the current ACBPS risk profiling and targeting arrangement approximate a level at which seizures (outputs) are maximised for the given level of inspection resources (inputs).

In terms of actual tobacco seizures, in 2008/09 Customs seized 169 tonnes of illegal tobacco leaf and 50 million cigarette sticks through the sea cargo stream. Another 12 tonnes of smuggled molasses tobacco was detected at the border. The potential revenue evaded from these illicit importations was approximately \$70.5 million. In total, the smuggled model estimates the total quantity of illegal tobacco of 264,061 kilos (based on seized smuggled tobacco only). This level of illegal tobacco is equal to a \$96.3 million excise revenue loss. The smuggled model estimates a lower result compared to the consumption model because it is based on the number of reported seizures of illegal tobacco, where as the consumption model is based on the purchasing behaviour of illegal tobacco survey respondents.

Alternative methods

An alternative method of estimating the size of the illegal tobacco market is based on the volume of cigarette tubes and papers imported into Australia which are not used in conjunction with legal tobacco. However, this model is based on data for which the quality can be variable and can lead to highly sensitive results that need to be interpreted with caution. Another estimation of the size of the illegal tobacco market was provided by the ATO in the Australian National Audit Office (ANAO) report²⁵. This report was last published in 2006 and estimated the size of the illegal tobacco market at 347,000 kgs in 2004/05.

²⁵ ANAO, 2006, *Administration of Petroleum and Tobacco Excise Collections: Follow-up Audit*, Australian Tax Office

5 Regulation of the tobacco market

Since the cessation of legal domestic tobacco production in 2007, increases in regulatory control, particularly through increased monitoring and seizing of illegal tobacco products have had some impact on reducing the size of the illegal tobacco market.

However, unbranded loose leaf tobacco has now given way to higher quantities of illegally imported tobacco products such as contraband and counterfeit cigarettes. Coupled with higher excise duties, the illegal tobacco market is seen as a lucrative way to avoid paying taxes, which represent about 68% of the cost of tobacco products.

Greater regulatory control that curbs incentives to purchase illegal tobacco in all of its forms is required to effectively combat the future illegal tobacco market in Australia.

In addition to the current regulatory controls in place, a number of proposed regulatory options have been canvassed in the public domain, including:

- Increasing the price of legal cigarettes;
- Banning the display of tobacco products at retail outlets; and
- Introducing generic packaging.

Overall, there is a risk that these new tobacco control measures could result in increased consumption of illegal tobacco. For instance:

- When asked what their response to a 10% increase of the price of manufactured cigarettes would be, 16% of surveyed tobacco users (legal and illegal) responded that they would increase purchases of illegal tobacco. Of those that would increase purchases, half (50%) of the respondents identified they would shift more than half of all purchases to illegal tobacco.
- 13% of respondents stated that they would increase their purchases of illegal tobacco if tobacco displays for manufactured cigarettes were removed from the point of service. Of those that would increase purchases, almost half (46%) identified they would shift more than half of all purchases to illegal tobacco.

There are some significant elements of regulatory control that could be drawn on as part of future regulatory options to decrease the incentive for people to purchase or smuggle/produce illegal tobacco products, such as:

- Further enhancements to monitoring and detection; and
- Increased penalties for using or smuggling illegal tobacco.

Current regulatory controls

The regulation of the Australia tobacco market includes regulatory policies, tobacco excise taxes, and seizing illegal tobacco as it enters the country.

Regulation

Developments in the regulation of tobacco products in Australia have evolved over the past three decades, in line with regulation in other developed countries. Figure 10, highlights the key events in the regulation of tobacco in Australia since the mid 1980's.

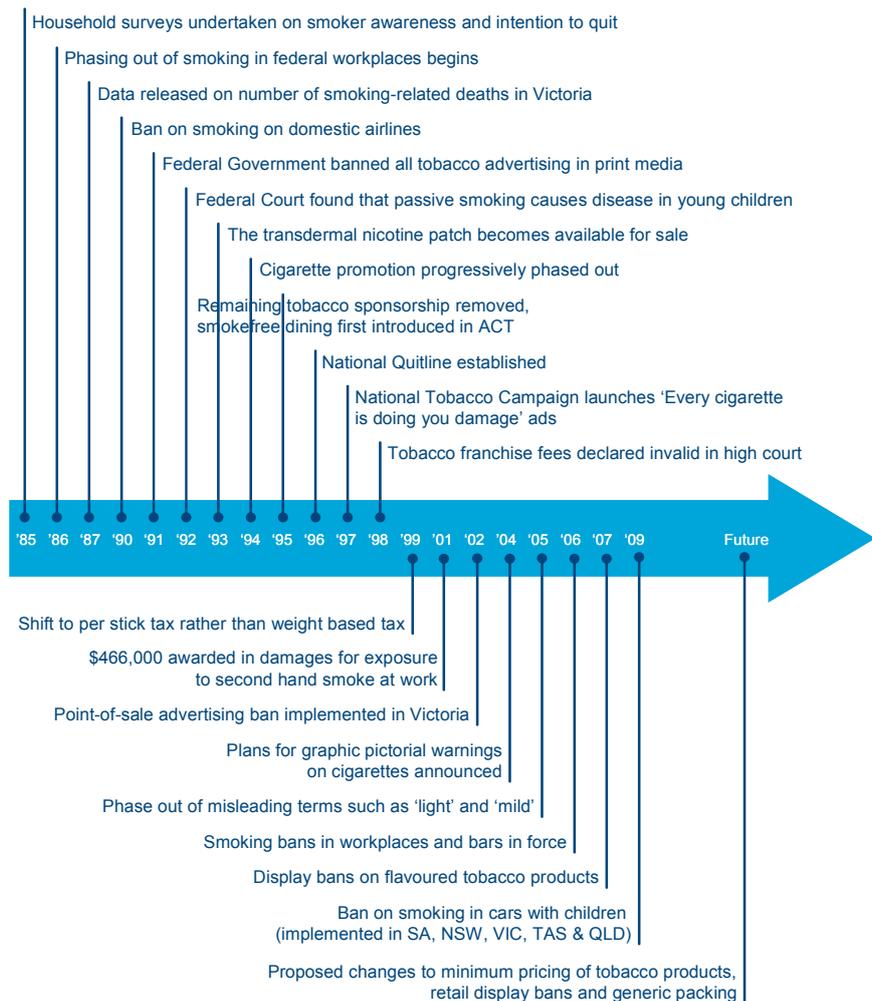
A key regulatory change came in 1999. Prior to November 1999, excise duty was levied according to the weight of the manufactured tobacco product. In the case of cigarettes the duty was applied to the total weight of the cigarette (including paper and filter, but not packaging), and for loose tobacco, the duty was applied to the weight of the tobacco (without packaging).

In August 1998, the Government announced its decision to modify regulations to introduce a 'per stick' tobacco excise system to replace the weight based system. The new regulations were introduced on 1 November 1999 which led to a rise in cigarette prices. A further price rise occurred with the introduction of the GST on 1 July 2000.

The outcome of these changes to the taxation of tobacco led to a rise in price of high volume, low weight cigarettes, while the price of premium brand cigarettes price remained relatively constant.²⁶

²⁶ Department of Health and Ageing, *Tobacco – Current tobacco excise arrangements*, accessed on 25 September 2009, at www.health.gov.au/internet/main/publishing.nsf/Content/health-pubhlth-strateg-drugs-tobacco-taxation.htm

Figure 10: Tobacco Regulation Timeline, Australia, 1985 – 2009



Over the last four years, regulation has taken the form of smoking bans. All Australian states & territories have increased legislation to reduce public exposure to second hand smoke. This has included:

- *A ban on smoking in hotels, nightclubs, and restaurants* (with some exceptions in gaming areas for NSW, QLD and VIC). Smoking is still currently allowed in NT hotels; and
- *A ban on smoking in cars with children under the age of 18* (16 in some states). The regulation has now been agreed and implemented in SA, NSW, VIC, TAS and QLD, (while WA and ACT are in the process of considering legislative proposals). In NSW, this ban is enforced through an on-the-spot fine of \$250.

Since the release of BATA's 2007 report on the illegal tobacco market, a number of the recommendations have been progressed as part of the future regulation of the Australian tobacco market. For example:

- bans on future growing licenses have been put into place;
- an increase in the surveillance of potential growing sites has been engaged to increase seizures of illegal tobacco; and

- there is work towards a government advertising campaign to highlight the adverse health impacts of using unbranded tobacco.

However, greater regulatory control that curbs incentives to purchase illegal tobacco in all of its forms is required to effectively combat the future illegal tobacco market in Australia.

Seizures of illegal tobacco

The Australian Tax Office and the Australian Customs and Border Protection Service are the key government organisations that monitor the tobacco market, seize illegal tobacco that enters (or is entering) Australia and take part in the regulation of tobacco products.

Australian Taxation Office (ATO)

The ATO is responsible for the collection and administration of tobacco excise duties. Excise duties are levied on certain excisable goods manufactured or produced in Australia, such as petroleum, tobacco, most alcohol, and crude oil. The estimated \$5.62 billion tobacco excise collected in 2008/09 comprises almost 23% of total excise tax collected by the ATO. Under the principle of self-assessment, the calculation of excise duty is the responsibility of the manufacturer or dealer in excisable goods. The excise is payable to the ATO when the product leaves the manufacturer's bonded warehouses.

The ATO is also responsible for administering and monitoring licenses necessary to:

- manufacture tobacco;
- deal in tobacco; or
- store and freight tobacco with permission to sell duty-free.

In July 2009, the ATO seized an illegal tobacco crop worth \$1.2 million dollars in excise duty, in a raid of two properties in the Southern Highlands, NSW. Approximately 9 tonnes of stripped tobacco plants and 4 tonnes of tobacco leaf were seized during the raid of the hothouses.²⁷ The seizure is the largest of locally grown tobacco since the closure of the legal domestic tobacco growing industry in Australia.

Australian Customs and Border Protection Service (ACBPS)

ACBPS is responsible for administering and collecting customs tariffs on imported tobacco. It plays a key role in detecting and administering penalties for smuggled tobacco products. Smuggling involves the illegal transportation, distribution and sale of large consignments of cigarettes and other tobacco products that avoid all taxes. ACBPS does not differentiate between contraband tobacco products and imported illegal tobacco as both types of imports have illegally evaded customs tariffs.

²⁷ Herald Sun, *Australian Tax Office seizes illegal tobacco*, 17 July 2009, accessed on 25 September 2009, at <www.heraldsun.com.au/news/breaking-news/australian-tax-office-seizes-illegal-tobacco/story-e6frf7jx-1225751473191>

In 2007/08, the ACBPS prevented approximately \$70 million in duty evasion by seizing more than 50 million illegal cigarettes and 180 tonnes of loose tobacco at the Australian border.²⁸ The number of individual seizures almost tripled from 21 in 2006/07 to 58 in 2007/08 financial year.²⁹

Proposed regulatory options

Further to current regulatory controls, a number of measures have been proposed by government, community groups and the Preventative Health Taskforce to combat the future illegal tobacco market, including:

- *An increase in the average price of a packet of 30 cigarettes to \$20 (in 2008 \$ terms) within three years.*³⁰ This has been recommended by the Australian Government's Preventative Health Taskforce in the *National Preventative Health Strategy*. This recommendation also applies to RYO and other tobacco products;
- *A ban on the display of tobacco products at retail outlets.* This has currently been implemented in NSW and Tasmania but not addressed in other states and territories. From 1 July 2009 in NSW, retailers will have to gradually remove tobacco products from public display. Retailers that employ more than 50 people have six months to store all tobacco products out of sight, and other retailers have twelve months. From 1 February 2011, a complete display ban will be imposed in Tasmania (with exceptions for tobacconists);
- *The introduction of generic packaging for tobacco products* as proposed by the global Framework Convention on Tobacco Control (FCTC) and supported by the WHO's Conference of the Parties,³¹
- *Bans on smoking in any public place* where the public, particularly children, are likely to be exposed. The Government's Preventative Health Taskforce is currently proposing further legislation for both indoor and outdoor areas in restaurants and hotels, near building entrances and air-conditioning intake points; and
- *Regulation to prevent smoking in movies* this possible control is likely to be addressed in the longer-term. The regulation options currently proposed are to either change the classification rules, so that movies with smoking receive an adult classification and warning of smoking scenes or alternatively mandating 'counter-ads' before any film with smoking.

²⁸ Australian Customs and Border Protection Service, *CEO Review, Annual Report 2008/09*, 9 November 2009, pg 5.

²⁹ Australian Customs and Border Protection Service Media Release, *Customs targets drug and tobacco smugglers – Annual Report 2007/08*, 30 October 2008.

³⁰ Commonwealth Government, Preventative Health Taskforce, 2009, *Australia: The Healthiest Country by 2020 – Roadmaps for Action*, chapter 3, pg. 176.

³¹ Freeman, B., Chapman, S., and Rimmer, M., *The Case for the Plain Packaging of Tobacco Products*, 2009, University of Sydney, School of Public Health, pg. 7.

Assessment of regulatory options

The expected impact of new tobacco control measures represents a potential shift towards increased consumption of illegal tobacco.

Analysis of changes in smoking prevalence has found that the cost of cigarettes has the most impact of all the proposed regulatory options outlined above, and that the effect of price was greatest among those on lowest income.

A study published in the *American Journal of Preventative Medicine*, based on Australia data found that a \$1AUD increase in the price of cigarettes caused a decline of 2.6%, 0.3%, and 0.2% in the prevalence of smoking among low, medium, and high-income groups respectively.³² The study concluded that increasing the price of cigarettes may provide a means of reducing social disparities in smoking. Further, a 2008 study commissioned by BATA and undertaken by PricewaterhouseCoopers on tobacco taxes and prices estimated an average price elasticity of 0.39% resulting in a decrease in demand.

However, this increase in price may also have an impact of the use of illegal tobacco. When asked what their response to a 10% increase of the price of manufactured cigarettes would be, 16% of surveyed tobacco users (legal and illegal) responded that they would increase purchases of illegal tobacco. Of those that would increase purchases, half (50%) of the respondents identified they would shift more than half of all purchases to illegal tobacco. Further, a large number of surveyed illegal smokers identified price as a major reason for changing their purchase behaviour towards illegal tobacco products (see section 4).

Further, survey respondents (legal and illegal) were asked if tobacco displays for manufactured cigarettes were removed from the point of service what the impact would be on their purchasing behaviour. 13% identified that they would increase their purchases of illegal tobacco. Of those that would increase purchases, almost half (46%) identified they would shift more than half of all purchases to illegal tobacco.

In addition, generic packaging regulations may lead to an increase in access to counterfeit and contraband cigarettes. Removing branding from packages would make the process of producing counterfeit cigarettes easier.

Considering these future regulatory options, a number of impacts could be considered in greater detail to further control the shift to illegal tobacco products, including further enhancements to monitoring and detection of illegal products and increased penalties for illegal tobacco activity

³² Siahpush, M., Wakefield, M., Spittal, M., Durkin, S., & Scollo, M., 2009, 'Taxation reduces social disparities in adult smoking prevalence', *American Journal of Preventive Medicine*, 36, pp. 285-291.

Further enhancements to monitoring and detection

The seizure of illegal tobacco and crops falls under the jurisdiction of Australian Customs and Border Protection Service, the Australian Taxation Office, the Australian Federal Police (AFP) and the Australian Quarantine and Inspection Service (AQIS) as described in section 1.

The methods of detection at airports and ports include x-ray inspections, physical examinations and collation of intelligence from international agencies. The ATO uses methods such as aerial surveillance, ground verification techniques to identify tobacco growing and cultivation, as well as the collection of intelligence from other agencies and the public. Further enhancements have been made by the ACBPS to their risk profiling methodology to effectively target illegal tobacco smuggling.

Despite the merits of this enforcement regime and recent increases in the monitoring and detection of illegal tobacco, the risk of detection and prosecution is low, which acts as an inadequate deterrent to illegal tobacco supply. In 2008/09, only 5% of imported containers were targeted for inspection by the ACBPS. In addition, of those containers that were inspected between 2001/02 and 2005/06, only 1 in every 4,983 contained illegal tobacco. This shows that risk assessment processes for identifying containers for inspection do not target illegal tobacco and discoveries are coincidental in the search for more serious illegal goods and substances.

Increased penalties for illegal tobacco activity

There are a range of penalties for supplying illegal tobacco, which reduce the payoff for illegal supply, but only if implemented in a frequent, consistent way that discourages illegal trade. Under criminal law, penalties for the importation of illegal tobacco are imprisonment of up to 10 years and/or a fine. The maximum penalty for the importation of illegal tobacco under civil law is a fine of up to five times the amount of duty evaded.

The frequency of prosecutions and penalties has increased slightly. For example, in 2008-09, two major penalties were imposed on tobacco smuggling, resulting in over \$13 million and \$11.4 million in fines, penalties and reparation orders. The number of excise revenue fraud cases adopted for prosecution by ACBPS exceeded the projected target for 2008-09.³³ These harsher penalties and an increased probability of prosecution may deter potential smugglers from taking the risk of tobacco smuggling in the future and further action of this nature should be considered as part of future regulatory options.

³³ Australian Customs and Border Protection Service, *Annual Report 2008/09*, pg 91.

Appendices

Appendix A

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Appendix A Bibliography

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