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RE: 2019-20 PRE-BUDGET SUBMISSION

INTRODUCTION

Imperial Tobacco Australia Limited (ITA) welcomes the opportunity to participate in the Australian Government's 2019-20 Pre-Budget Submission process.

Imperial Tobacco Australia (ITA) is an Australian-based wholly owned subsidiary of Imperial Brands, the world's fourth largest international tobacco company.

ITA entered the Australian market in September 1999 at the request of the ACCC to ensure that competition was maintained following the global merger between British American Tobacco ("BAT") and Rothmans International.

For the 2017/18 year, ITA delivered approximately $3.5 billion to the Federal Treasury through excise duties on tobacco products (excluding GST). We employ approximately 310 people in Australia and make further contributions to government through corporate taxation, employment taxes and other revenues of approximately $18 million annually.

In totality, the tobacco industry contributes approximately $12 billion to the Federal Treasury through excise duty.

This submission will address the duty drawback process, tobacco excise and the illicit tobacco market.

The black market for illicit tobacco has become an established and significant segment of the tobacco market in Australia. At 15% of consumption[1], the illicit market represents approximately one in every seven cigarettes and $1.91 billion dollars in lost revenue to the Government.

It is necessary to highlight that the illicit tobacco trade is intimately linked to excise.

Australia is a high tax environment for tobacco products. Excise increases result in higher prices, driving down trading and, ultimately, movement of consumers to the illicit market. These large excise increases also fuel the black market by making it even more lucrative for organised criminals to smuggle illegal tobacco into Australia.

The duty drawback scheme is an unnecessary regulatory red tape burden which could easily be amended and carries demonstrable benefits for government, Australian businesses, the environment and the Australian public.

DUTY DRAWBACK

The tobacco industry is a significant excise and duty contributor. ITA contributes an annual excise and duty liability of approximately $3.5 billion.

We pay duty on tobacco products that have been imported into Australia.

Like the majority of fast moving consumer goods operations, we have some unsaleable stock that is periodically returned from retailers. It may be a discontinued line, past the used by date, have minor carton damage or packaging issues.

We absorb the business cost of the lost product, but in order to claim a refund on duty paid on unsaleable stock, we (and other manufacturers who import tobacco products) must re-export that tobacco back to the various points of manufacture.

[1] KPMG "Illicit Tobacco in Australia" 2017 Full Year Report, 20 April 2018

That is, duty paid stock cannot be destroyed locally and a duty refund be obtained following the destruction.

Since approximately June 2012, 100% of product distributed in Australia by ITA is imported. We source our products from a number of factories located in various parts of the globe including Europe, Asia, Turkey and (primarily) New Zealand.

Whilst there are associated costs to the business, there are also wider social and economic costs; significant extra transport requirements (trucks on roads, containers on ships), additional movement of plant material across borders and import/export administrative burdens.

Environmental impact

Re-export requirements in these instances involve entirely unnecessary additional transport, which naturally involves additional use of fuels and increased emissions. Aside from the environmental impact of transport from Australia to country of origin, ITA product must be moved from across Australia back to facilities in Sydney. The additional heavy vehicle movements associated with this are entirely unnecessary and could be eliminated with the allowance of local destructions.

Impact to ITA

In this past financial year alone, ITA was forced to re-export 13 shipping containers with an excise refund value of $25.1 million. The additional compliance costs, or costs to our business for this re-exportation process is approximately $50,000, but this is an unnecessary business cost which is the consequence of a complex, burdensome and redundant process.

Successful trial

The regulatory amendment set out in *the Customs Amendment Regulation* 2012 (No. 8) allowed for duty paid stock to be destroyed locally and a subsequent Duty Drawback refund. This was an interim measure which came into effect on 9 November 2012, until 30 April 2013. This trial was undertaken to assist with the implementation of plain packaging and the high volume of stock destruction as a result. It was extremely successful and praised by all stakeholders (including government officials), proving that the process can be easily implemented.

History

In May 2007, following a public review, the Howard Government announced its intentions to rectify the matter. The reform was to have the effect that all excise and excise-equivalent imported goods could be destroyed with the prior approval of the relevant administering authority, and would not be required to be re-exported to the point of manufacture[2].

The measure was to have effect from the later of 1 January 2008, or the date of Royal Assent. Unfortunately, this legislation did not take effect as it was not dealt with prior to an election.

In September 2017, correspondence with the then Minister for Immigration and Border Protection, The Hon. Peter Dutton MP, noted that "Treasury has policy responsibility for the taxation of excise-equivalent goods, including tobacco. The Department will work with Treasury, the Australian Taxation Office and other relevant stakeholders to reduce red tape on business as part of ongoing reform measures…"

Senate Select Committee on Red Tape (*Effect of red tape on tobacco retail)* Final Report, December 2018

The 2018 Senate Select Committee on Red Tape (Effect of red tape on tobacco retail) Final Report recommends:

Effect of red tape on tobacco retail, Recommendation 3

2.65 The committee recommends that the Department of Immigration and

Border Protection provide an explanation to justify the requirement for re-exportation of tobacco products on which drawback is claimed, failing which the requirement should be eliminated in a timely fashion.

[2]http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2007/045.htm&pageID=003&min=pcd&Year=&DocType=0

ITA notes that the dissenting reports by Labor Senators to Red Tape Inquiry Reports do not include any opposition to the recommendation that the requirement for re-exportation of tobacco products on which drawback is claimed be removed.

The operation of the duty drawback system is an example of unnecessary and economically inefficient taxation regulation. We ask that local destruction of stock and drawback of duty be implemented permanently

EXCISE AND THE ILLICIT TOBACCO MARKET

"The potential for smuggling tobacco can limit increases in tobacco tax rates. When setting tax rates, consider the risk of smuggling, the purchasing power of local consumers, tax rates in neighbouring markets, and the ability and effectiveness of the tax authorities to enforce compliance."[3]

Excise is a key growth driver for the trade in illegal tobacco. Tobacco taxation policy necessarily requires a balanced approach with consideration given not only to public health objectives, but also revenue optimisation and avoiding the emergence, or encouraging the growth, of illicit trade.

The illicit tobacco trade is a serious, and complex, problem. The World Health Organisation recognises that "[F]rom many angles, the illicit trade of tobacco products is a major global concern, including health, legal and economic, governance and corruption. The illicit tobacco market may account for as much as one in every ten cigarettes globally."[4]

Australia is not immune. Indeed, in Australia, illicit trade currently sits at 15% of total consumption, representing approximately $1.91 billion dollars in foregone excise to the Government, with lost revenue instead funding organised crime. [5]

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[3] Yurekli, A., World Bank Economics of Tobacco Toolkit, "Tool 4: Design and Administer Tobacco Taxes, What is the Right Tax Rate? / Evaluate the Impact of Tobacco Excise Rates", page 18. http://siteresources.worldbank.org/INTETC/Resources/375990-1113490055569/Taxes.pdf

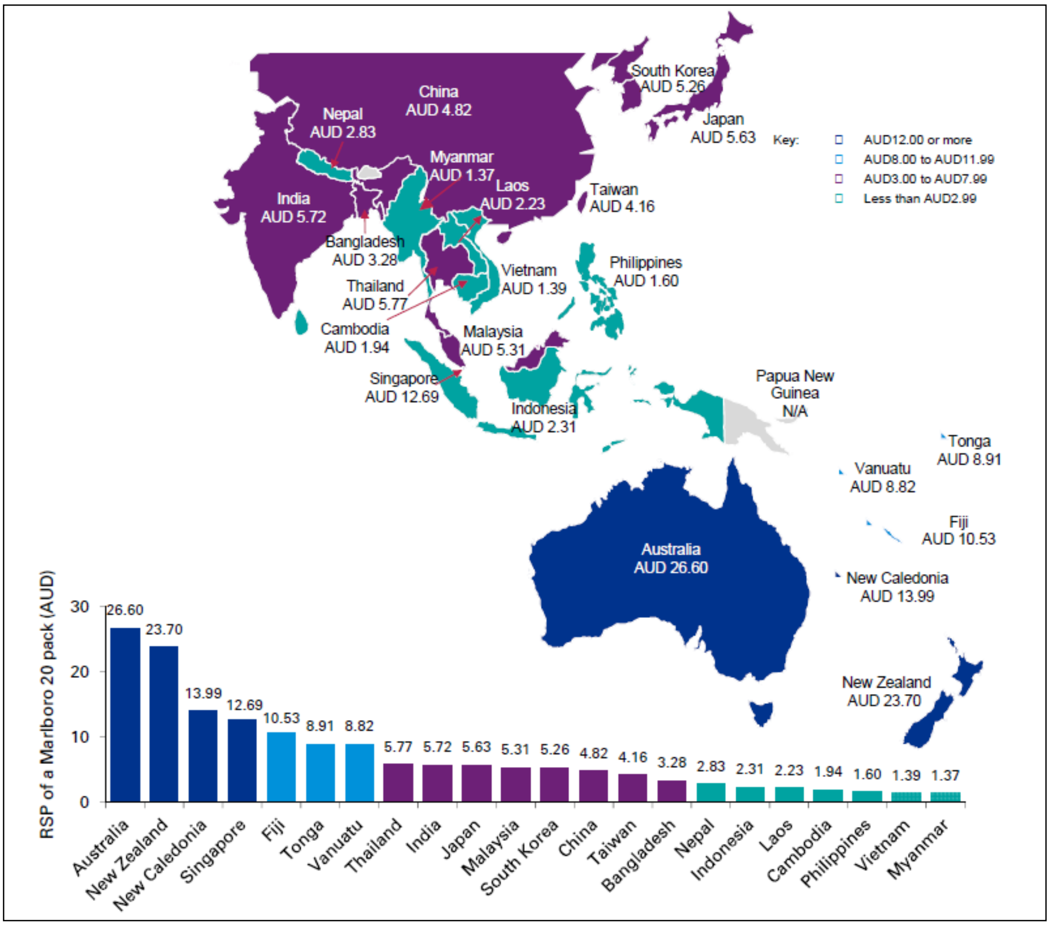
[4] http://www.who.int/campaigns/no-tobacco-day/2015/event/en/

[5] KPMG "Illicit Tobacco in Australia" 2017 Full Year Report, 20 April 2018

Australia is a high tax environment for tobacco products, made even more so by the cumulative effect of the successive annual 12.5% excise increases running from 2013-2020 and initiated by a one off 25% excise increase in 2010. Such excise increases are resulting in exorbitantly high prices, ultimately encouraging the movement of consumers out of the legal market and into the illicit market.

These large excise increases also fuel the black market by making it even more lucrative for organised criminals to smuggle illegal tobacco into Australia. With the exception of New Zealand, Australian prices are over 90% higher than any other markets within the Asia Pacific region. A pack of 20 cigarettes is up to 11 times more expensive in Australia than Indonesia, for example *(See Figure 1 below)*.[6] These high profit margins can provide an attractive and valuable source of income for organised crime.

Figure 1. Regional Tobacco Prices



[6] KPMG “Illicit Tobacco in Australia” 2017 Full Year Report, 20 April 2018

International Experience

International experience – such as from Ireland, the EU accession countries, Malaysia, Turkey and Singapore – show that the implementation of steep tax increases has led to a sharp rise in illicit trade in tobacco products, which damages the long-term tax base and undermines public health objectives.

Ireland

In June 2014, Ireland's then Finance Minister Michael Noonan acknowledged the relationship between excise and illicit trade. When questioned about increasing the tax on cigarettes, Mr Noonan said:

"In economic terms the demand for Irish duty paid cigarettes has moved to become much more elastic in nature. This implies an increase in price will lead to a proportionately larger decrease in consumption of Irish duty paid cigarettes resulting in an overall decrease in cigarette excise receipts…Some people will reduce their smoking levels, others will simply substitute their consumption to non-Irish duty paid cigarettes. These can be either illicit or legally brought into the country".[7]

Malaysia

Malaysia increased excise duty on cigarettes by 430% between 2002 and 2010. The increase in the price of legal cigarettes prompted consumers to switch to illicit sources of supply. In 2002, Malaysian smokers consumed 19.5 billion legal cigarettes. By 2010, this had declined 31% to 13.5 billion. The decline in legal sales was mainly driven by the surge in consumption of illegal cigarettes, which reached 8.8 billion in 2010. [8]

As a result, the illicit market share rose from 21% in 2002 to 39% in 2010. Acknowledging the massive illicit trade problem and the impact of excessive cigarette taxation, the Government decided to freeze excise in its 2012 budget. The

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[7] S. Rogers, "Noonan: No gain from further tobacco price rise" *The Irish Examiner*, 17 June 2014

[8] "The Illicit Trade in Tobacco Products and How to Tackle It (second ed.) International Tax and Investment Center, p 21

Malaysian Prime Minister made the following statement on 8 October 2011, the day after the budget announcement:

"We can't increase the price of cigarettes sharply when the use of illegal cigarettes has reached 40%. This level is too high. If there is a sharp rise in the price of cigarettes, the percentage of those who smoke illegal cigarettes will continue to rise."[9]

As excise increases continue to drive the price of legitimate tobacco products up, the demand for illicit tobacco will similarly see a continued increase as consumers seek more affordable alternatives. Those criminals involved in the illicit tobacco market do not pay taxes, and therefore illicit tobacco will always be quite significantly cheaper.

The demand for tobacco products is better met by well governed, tax-paying and responsible businesses that will work in partnership with stakeholders, rather than criminals who operate in the illicit market.

ITA submits that the size and scope of the problem, and the direct causal link between excessive taxation and the illicit tobacco trade warrants a stabilisation of the excise environment, and return to AWOTE only increases.

RECOMMENDATION

We ask that local destruction of stock and drawback of duty be implemented permanently.

The May 2018 Federal Budget handed down a number of measures to address illicit tobacco, including the abolishment of bonded warehouses and the movement of the taxing point for excise to the border. We are aware that the Government is currently working towards finalising these measures by 1 July 2019. ITA submits that this presents an opportune time to streamline the duty drawback process and remove what is a redundant and inefficient taxation regulation.

[9] The illicit trade in tobacco products and how to tackle it, International Tax and Investment Center, Second Edition, Elizabeth Allen 2013

The measure is not new – only the permanence is. The regulatory amendment set out in the *Customs Amendment Regulation* 2012 (No. 8) allowed an interim Duty Drawback refund, which came into effect on 9 November 2012. It permitted imported stock to be destroyed locally until 30 April 2013. This measure was implemented to deal with the high level of stock destruction occasioned by the implementation of plain packaging.

The process was extremely effective and praised by government officials and the industry.

We submit that making the process permanently available is a relatively straightforward task, carries demonstrable benefits for government, Australian businesses, the environment and the Australian public. ITA understands that there is no political opposition to the proposed change.

Excise is a key driver of the illicit tobacco trade. Excessive excise increases are the stimulus to encourage both the supply and demand side of this problem. Stabilisation of the excise environment, and return to AWOTE only excise increases, should be considered.

We would be pleased to discuss any aspect of this submission in more detail.