

CENTRE FOR TAX SYSTEM INTEGRITY



Public wealth, public health, and
private stealth: Australia's black
market in cigarettes

Gilbert Geis, Sophie Cartwright and Jodie Houston



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**PUBLIC WEALTH, PUBLIC HEALTH,
AND PRIVATE STEALTH:
AUSTRALIA'S BLACK MARKET IN
CIGARETTES**

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This series of working papers is designed to bring the research of the Centre for Tax System Integrity to as wide an audience as possible and to promote discussion among researchers, academics and practitioners both nationally and internationally on taxation compliance.

The working papers are selected with three criteria in mind: (1) to share knowledge, experience and preliminary findings from research projects; (2) to provide an outlet for policy focused research and discussion papers; and (3) to give ready access to previews of papers destined for publication in academic journals, edited collections, or research monographs.

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Abstract

Taxes on tobacco provide a significant income for the Australian government – \$5.1 billion in 2001. At the same time, health officials are making strenuous efforts to reduce smoking, particularly among teenagers. Some economists suggest that raising taxes on tobacco will produce more revenue while at the same time lowering smoking rates, particularly among youths who have less discretionary spending power than adults. But a by-product of excise tax in Australia has been the emerging market in ‘chop-chop,’ tobacco diverted from legal channels by growers who receive considerably higher prices for a part of their yield than they can obtain from legal manufacturers. The article details this situation and suggests that only bold solutions may be able to reduce tensions in tax policies, smoking rates and the ‘chop-chop’ black market.

Public wealth, public health, and private stealth: Australia's black market in cigarettes

Gilbert Geis¹, Sophie Cartwright and Jodie Houston

Introduction

Australia's tobacco industry in worldwide terms is extremely small – some two tenths of one per cent of the globe's total tobacco production – in a market dominated by China, Brazil, India and the United States. Australia today has about 300 licensed tobacco growers, a number that has been shrinking steadily. In contrast, countries such as Brazil and Canada, comparable in size to Australia, report in the vicinity of 30 000 tobacco growers each. The specific dynamics of the Australian tobacco industry provides an interesting and well defined context in which to understand the interaction of regulation, collection of tax revenue and the rise of the illicit tobacco trade. In the first section of the paper we briefly outline the regulatory changes that have taken place, particularly over the last decade. We then examine the current arrangements for the regions that farm tobacco in Australia, documenting the concerns growers have for the future of tobacco in Australia and the offhand treatment of farmers who feel caught at the mercy of the manufacturers and the government. Finally, this article considers the rise of the illicit tobacco market and examines the temptations and the problems illegal tobacco is causing.

The current arrangement for the control and taxation of tobacco in Australia is a relatively recent development so that as yet there are few tested tactics for dealing effectively with the emergent black market. Tobacco has been grown in Australia since the establishment of the penal colony (Walker, 1984; Winstanley, Woodward & Walker, 1995). Cigarettes first were manufactured in 1887 and became preferred over pipes and cigars. The tobacco industry prospered as the twentieth century unfolded, with an all time high of 1317 growers before the Great Depression of the 1930s. Regulation largely was left to the industry itself, though in 1936 the Local Leaf Content Scheme mandated Commonwealth support for growers. By 1997, this subsidy program decreed that manufacturers include

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50 per cent of domestic product in their cigarettes. On their own, the manufacturers raised this figure to 57 per cent.

Tobacco was taxed by the states and the territories by means of business franchise fees. In August 1997, however, the High Court in *Ha v. New South Wales* ruled by a 4-3 margin that such fees were an excise duty and that under Section 50 of the Constitution the Commonwealth is granted the exclusive power to collect excise taxes. The court decision noted 'the size of the business fee clearly exceeded the cost of implementation' (*Ha and Another v. New South Wales*, 1997, p. 471). Had one judge in the majority joined the dissenters, arrangements for the tobacco trade in Australia would have remained under the control of the states. Instead, oversight became a federal responsibility.

Before the *Ha* decision, state governments had provided funds to restructure the tobacco industry. In 1994, for instance, Victoria allocated \$3 million for growers who voluntarily agreed to leave the industry, and in the same year the entire New South Wales tobacco growing enterprise was dismantled by a similar approach. This development occurred in concert with the abolition of the tariff on imported leaf (Australian Taxation Office 2002a, p. 7).

There always has been a certain low level of tax-evasive dealing in cigarettes. When state franchises were in force, this tended to involve cross-border forays of shoppers who legally stocked up on cigarettes that cost less in the countries or states they were visiting than at home, and there were smugglers who did the same thing, dealing in much larger amounts (see van Fossen, 2002, p. 223 for an illustration of smuggling via Norfolk Island). During the Second World War, an extensive black market came into existence when cigarette supplies were severely limited (Thompson, 2002).

Tobacco growing today

The Australian practice of licensing growers is believed to exist nowhere else in the world. The exceedingly small number of growers (about 300) makes this approach feasible; Australia produces only about two-tenths of one per cent of the world's tobacco. In

countries such as Brazil and Canada, which are not much different in size from Australia, there are about 30 000 tobacco farmers.

From the viewpoint of those licensed tobacco growers at work in Australia today, the country's domestic industry is in dire financial straits, a judgment not sensibly open to dispute. The growers are now almost exclusively congregated in two sites – Mareeba and the neighbouring Dimbula and Muchiba regions in Northern Queensland and Myrtleford, including the surrounding valleys in North-east Victoria. The growers' plight is the result of an ever-decreasing interest in the purchase of their crop by Philip Morris and the British American Tobacco Australia (BAT), the country's two major cigarette manufacturers. Table 1 indicates the dramatic dip in the demand for North Queensland tobacco. In 2002, BAT withdrew from the North Queensland market, a move dictated in large measure by economic factors. In 2002, when BAT purchased 12 000 bales in North Queensland and Philip Morris bought 10 000, this constituted only about fifty per cent of what growers customarily had and could produce. For one thing, Myrtleford possesses the only threshing machine² in Australia. This facility moved there from Melbourne in 1995, adding significantly to the transportation costs for Queensland-grown tobacco, or, as those in the trade put it, imposing 'a tyranny of distance.'

² It is here that the stem is separated from the lamina of the tobacco leaf and the lamina is dried to an even moisture content that seeks to provide optimum ageing conditions during the storage period. The acquisition of the threshing plant from Philip Morris was a striking coup for the Myrtleford area growers.

Table 1: Bales of tobacco purchases by manufacturers in North Queensland

Year	Number of Bales	Year	Number of Bales
1983	68 639	1994	59 136
1984	65 006	1995	N/A
1985	65 002	1996	85 212
1986	66 328	1997	50 542
1987	68 585	1998	45 421
1988	69 929	1999	32 950
1989	69 537	2000	27 736
1990	70 045	2001	31 128
1991	72 201	2002	22 000
1992	72 931	2003	est. 10 000
1993	69 031	-	-

Source: Stadhans & Gibbs (2002)

Both BAT and Philip Morris indicated that they have not altogether given up on domestically-produced Australian tobacco, largely because the country has a relatively stable economy and political structure. Otherwise, they long since would have moved to sites such as Indonesia, where labour is much cheaper. Last year, illustratively, BAT opened a processing plant in China, a country with 310 million smokers who consume one-third of the world's cigarette production. But Indonesia, as we have seen, has been targeted by terrorists, and China only recently signed a treaty that allowed inroads to be made into the government's monopoly grip on the nation's cigarette industry, an industry that provides ten per cent of the country's tax revenues.

The current situation has taken a considerable emotional and financial toll on Australian tobacco growers, many of whom are second and third-generation descendants of immigrant families – primarily Italians and Albanians – that cultivated tobacco when the crop first became prominent in Australia in the 1850s. Some tobacco growers have tried to break their economic fall by turning to other crops, or beginning supplementary agricultural pursuits, but they have had a notable lack of success with such endeavours. In Northern Queensland, mangoes and avocados and lychees quickly ran up against an oversupplied market. The tea tree oil business prospered briefly with the product advertised to deal with sensitive skin conditions, but in the end left North Queensland farmers with storage tanks

full of a product whose price dropped dramatically because of over-supply. This occurred – after tax shelter promoters signed up some 40 000 customers in tax avoidance schemes (including tea tree investments).

Despite the growers' misfortunes, the Australian health authorities undoubtedly are not unhappy about what appears to be strong signs of the demise of domestic tobacco cultivation. The thoroughly-documented health ravages produced by cigarette smoking could be further attacked, even if only symbolically, by a program eliminating the domestic growing of tobacco and only reluctantly, in the name of freedom of choice and free trade, allowing cigarettes to be imported into Australia.

There are other matters that bear upon the future of Australian tobacco. For one thing, the Australian government in 2001 took in \$5.1 billion in revenue from taxes imposed on the tobacco. The seventy per cent tax impost in Australia accords with the rate in place throughout most of the world. European Union legislation requires that cigarette taxes be at least seventy per cent (Merriman, no date, p. 34).

The cigarette tax impacts most heavily on lower income people, and it can consume a significant portion of their living expenses. This matter seems worth more attentive political consideration. Cnossen (1977, p. 47) points out, following a survey of excise taxes throughout the world, that 'it appears that the tobacco excise is repressive almost everywhere.' But the same author notes that this situation could be remedied if lower-grade cigarettes were produced and consumer prices were adjusted to accord to the nature of the product. In Indonesia, for instance, a lower rate is (or at that time was) imposed on indigenous black tobacco and clove primarily used by lower-income workers. In India, biri cigarettes are taxed at a much lower rate than American imports, and in the Philippines the excise rate for a pack of cheaper cigarettes was about one-third that for the expensive imports (Cnossen, 1977, p. 50). Of course, selectively reducing taxes to make some cigarettes more affordable conflicts with policies that seek to reduce smoking, a practice disproportionately found in persons with lower incomes. But nonetheless such policies seem preferable because they are fair and not favourable to the haves at the expense of the have-nots.

The Australian practice of licensing growers is believed to exist nowhere else in the world. Australian growers sell their tobacco crop to the two manufacturers: recent prices were about \$600 a bale; the average grower produces about 400 bales a year. The manufacturer is then taxed \$26 000 for each bale it buys. On top of that there is a ten per cent Goods and Services impost. It does not take a mathematical Nobelist to appreciate that the gap between what the grower receives for tobacco and what the government realises is stunningly large. The numbers are these: A grower gets about \$7 for a kilo of tobacco; the tax authorities harvest \$287 for each kilo. Were the tax to be evaded and the product sold directly to consumers, the growers' profit would increase dramatically. Growers themselves, as far as we know, have not taken this illegal path, but middlemen have emerged to purchase tobacco bales for the illicit market. There is a great deal of talk evidence regarding the involvement of mafia-type groups in the chop-chop trade (Australian Taxation Office, 2002b, pp. 4, 15; Baxter & Wilson, 2001, pp. 45, 49, 52), but David Gray (2002), the director of intelligence at the National Crime Authority (now Australian Crime Commission), told us that his agency's investigation of the chop-chop market concluded that it was not a sophisticated operation and that it 'didn't seem to meet the threshold level to justify National Crime Authority involvement.' That does not necessarily mean, Gray added, that there might not be some kind of organised crime activity in the chop-chop business.

Chop-chop middlemen pay about \$3000 to \$4000 for a bale of tobacco. Pressures have been increasing for growers to deal with chop-chop purchasers because of the diminishing legal outlet for their product, particularly in North Queensland where growers are experiencing a serious decline in their income standard. They commonly describe their situation as 'desperate' and getting worse. 'To encourage your children to take over the farm and grow tobacco,' said one farmer wryly, 'would be a form of child abuse.' Another, asked about his view of the future, said that he felt as if he were 'behind a dog's balls.' We remain uncertain exactly what he meant, but understand that it was not a desirable location. Chop-chop underground transactions impact on the morale of honest growers. They are well aware of most of the transgressors, but they also are strongly united in upholding a code that insists that one not dob on those who choose a different solution to a common problem.

Danny Latit

The growers' plight was well expressed by Danny Latit, who works a tobacco farm with his brother Shahan. Danny sees the future as 'scary'. 'They ought to shut the industry down,' he says, 'and that would get rid of the chop-chop. Anybody growing tobacco would be doing it illegally'. He has no argument with diverse proposals to revive--perhaps resurrect is a better word--the tobacco industry, but he believes that they are utopian dreams. 'They're slowly choking the growers.' By 'they' he means the manufacturers and the government.

'We've lived an honest, decent life,' Danny says, 'and the chop-chop buyers roll up and offer us \$4000 for a bale that we can sell legally for only \$660'. He says that sometimes the chop-chop merchants now call from public pay phones. He tells them all the same thing: 'For you, the risk is small. You probably won't get caught and if you do, the penalty will be light. For me it means the revocation of my license to grow tobacco and the end of the main source of my livelihood.'

Danny is a trained mechanic, but the farm is where he wants to be, though he appreciates that he probably is in a no-win situation. Growers, even as members of co-operatives, are so few in number that they possess no political clout, and no sensible politician is going to publicly support a product as tainted as tobacco. 'Marijuana growers are better off than we are under the law,' Danny says. He also repeats a theme that is virtually a creed today among Queensland growers. 'Chop-chop used to be sold out of greed; now it has become a matter of need.' Young tobacco producing families are said to be saddled with large mortgages and growing families that they cannot support under current marketing conditions. Nor will the banks make loans for repairs or new equipment when the future of the industry is in doubt. 'I'm not doing anything illegal,' Danny says, 'yet I am made to feel that I am doing something dirty.' Another grower put the point more forcefully: 'They make me feel like a murderer,' he said.

Remzi Mulla

Remzi Mulla, white-haired, gregarious, articulate, and deeply devoted to the cause of tobacco growers in North Queensland, speaks for the beleaguered growers as head of the local co-operative.

Remzi's father came to Australia from Albania in 1927, on his own at the age of nineteen. He had left Europe for political and economic reasons. Twelve years later, he brought his wife and son to Australia. Remzi studied pharmacy, but in 1960, spurred by government subsidies, he and his brother started to cultivate tobacco – and for some time prospered. He believes that there remains hope for tobacco growing today if the following steps are taken:

- (1) Let the manufacturers defer their tax payments, now required weekly, to a monthly basis, which would allow them to pay higher prices to growers;
- (2) Eliminate the twice-a-year increases of the excise tax for tobacco that are based on the Consumer Price Index;
- (3) Beef up the enforcement effort to make chop-chop dealing truly dangerous for those who engage in it; and
- (4) Require buyers to purchase 40 000 bales of tobacco from North Queensland growers.

Remzi in his interview with us then veered off to a threat that if growers do not get a better deal they will unite and not pay their rates. We suggested that such a revolt seemed unlikely to lead to constructive results. He shrugged: 'We just can't lie down,' he said.

Another option that Remzi is pushing is a buy-out by the government of the tobacco growers or at least those who can no longer sell sufficient product to sustain themselves. In 2000, the North Queensland growers, in collaboration with those in Victoria, thought that they had the outline of a successful buy-out package. But Victorian growers withdrew from the coalition when their own growing future became more assured. What is needed today for North Queensland, Remzi says, is an 'agri-politician,' someone who will fight for North Queensland's tobacco growers.

Chop-chop

The term 'chop-chop' apparently came into use when Chinese immigrants, escaping from bleak mining jobs, briefly came to dominate the tobacco fields in the mid-nineteenth century before they were driven from the growing areas by prejudice that fuelled violent mob actions against them. Chop-chop tobacco typically is a roll-your-own smoke (or a 'rollie' in light-hearted linguistic Australian) and is sold throughout the country in petrol stations, convenience stores, over the Internet, and at many other outlets. It is usually merchandised in plastic bags, though it can sometimes be marketed in packages of tailor-made cigarettes. It generally is sold in bulk size of half-kilogram or one kilogram weight. Purchasers often presume that chop-chop is 'purer' than what they regard as adulterated and hazardous legal cigarettes, but what they neglect to consider is that what they buy is a product of particularly uncertain quality and composition.

The amount of revenue lost because of the chop-chop market has been rather promiscuously guesstimated by a number of sources. The figures offered range between \$90 million and \$600 million annually: manufacturers' estimates tend toward the higher amounts.

Only a few surveys have made a stab at the number of persons who use chop-chop. The Department of Housing and Ageing, focusing on respondents who were twenty or older, places the Australian smoking population at twenty per cent of that age cohort. One and one half per cent of the regular smokers (defined as those who have at least one cigarette a week) said that they used chop-chop daily. This comes to about 20 persons out of 1500 adult smokers. Only 0.4 per cent reported using chop-chop some days, while eight per cent said that chop-chop crosses their lips 'only occasionally' (Scollo, Freeman, Icasino & Wakefield, in press).

A national survey of almost 27 000 persons 14 years and older found 19 per cent responding yes to the somewhat ambiguous question: 'Have you ever come across unbranded loose tobacco (also called chop-chop) sold in plain bags or rolled in unbranded cigarettes?' Within this group, 41 per cent responded affirmatively to the question: 'Have

you ever smoked it?’ We do not learn how often they have done so. Young persons (age 14-19) reported smoking chop-chop less than their elders (29 per cent compared to 71 per cent) and males more than females (47 per cent to 33 per cent) (Australian Institute of Health & Welfare, 2002).

In terms of street prices, chop-chop retailed in 2001 for \$45 to \$60 a kilogram, while more recent reports escalate that figure to \$80 to \$100 for each kilogram. This compares to \$320 a kilogram for legal roll-your-own tobacco. The chop-chop price rise may indicate a lesser availability of the product, though it could reflect a rising demand or a greater risk of selling it.

Various tactics suggest themselves to try to combat the chop-chop trade. The Taxation Office has inaugurated a Global Positioning System that seeks to measure the amount of growing area and thereby to calculate the output that any given farmer can expect to harvest. Subtractions are made for likely losses during cultivation, but the approach has flaws. Most notably, growers can plant tobacco seeds closer together and beat the government’s estimate of their yield.

Beyond that, an increase in field investigators very likely would make an indent in the chop-chop business. So too would a system of rewards for information on illegal transactions as well as sting operations that attempt to buy part of a grower’s crop for the chop-chop market. Both a policy of rewards for information on illicit dealings and sting operations should make those involved or contemplating being involved in black market transactions a good deal more wary. Random roadblocks after tobacco has been harvested also ought to snare some trucks and vans transporting tobacco diverted from legal channels.

Criminalising chop-chop use

The best approach to this topic may be by way of posing a hypothetical. Suppose that we had the scientific information that we now possess in regard to the consequences of personal use of various drugs, such as opiates, alcohol, marijuana, and cigarettes. Suppose

too that we had no laws whatsoever on the books concerning the sale or possession of these items. And suppose, finally, that you are in a position to enact legislation on these matters. What would be the nature of the laws that you would favour? All matters considered, should a criminal penalty – presumably a relatively benign one, if any criminal penalty can be regarded as benign – be mandated for the use of any of these drugs, including cigarettes and chop-chop?

Historically, there have been times and places where any trade in tobacco was outlawed. In 1652, the English parliament prohibited the growing of tobacco. It empowered anyone to ‘grub, cut up, destroy, and utterly consume such tobaccos.’ In some eastern countries at this time torture and death was the fate of cigarette smokers (Corina, 1975, pp. 38-39). There also have been times and places when the smoking of tobacco was virtually made mandatory. Tobacco was used by the Mayans for religious festivals as early as the first century. Jean Nicot, immortalised in the term ‘nicotine’, brought tobacco to France in 1556 from his post as ambassador to Portugal; physicians used it for medicinal purposes (Braithwaite & Drahos, 2000, pp. 394-395). In 1665, students at Eton were required to smoke daily to protect themselves against the great plague, ‘under penalty of a housemaster’s whip for non-compliance’ (Corina, 1975, p. 49).

There are few persuasive arguments regarding free traffic in the opiates; better ones perhaps could support legal cocaine; while the pros and cons concerning legally-available alcoholic beverages often seem to turn not on the issue of harm but on questions of the social and political feasibility of a prohibitive policy.

How about marijuana and cigarettes and chop-chop? The options are to criminalise or, conversely, to make legal all three or any one or two of the trio. There appears to be no dispute that cigarette smoking is more dangerous to health than marijuana (Mack & Joy, 2001; Zimmer, Morgan & Nadelmann, 1997). Nonetheless, whether a political entity ought to interdict self-destructive behaviour is not a question with an unquestionable answer. For some, such actions, to use a phrase highlighted in the Wolfenden Report (Great Britain, 1957) on homosexuality and prostitution, are ‘not the law’s business’. For others, it is apparent that no adequate society would allow the marketing of foods that make people

seriously ill or products that are too easily flammable; therefore, it is argued, any product whose ill effects outweigh benefits ought to be banned.

A difficulty is that a governing principle that might justify banning both cigarette smoking and marijuana use is not readily generalisable. If the aim is to reduce behaviours that are obviously and importantly related to poor health outcomes then dealing similarly with many other matters, such as overeating, offers a significant challenge. Do we concentrate on behaviours that seem easier to contend with or does the extent of the harm dictate our response? These are complicated issues that are key to public policy in regard to cigarettes and the chop-chop market. They rarely are addressed head-on, if at all.

Conclusion

In the halcyon days of the Australian tobacco industry, political office holders routinely appeared at the auctions and market festivities in the growing areas, proud to associate with an important source of income and employment in their constituency. Today, tobacco growing is a tainted enterprise, and its practitioners have been left unattended, their fate at the mercy of the harsh realities of an unsympathetic marketplace. Our strong recommendation would be that the government buy out the remaining growers with a subsidy that would decently allow them to abandon the cultivation of tobacco and to bankroll entry into a different enterprise.

This should eliminate the chop-chop market derived from domestically-produced leaf. It would return enforcement to Customs where the focus would be on the smuggling of untaxed tobacco. The wisdom of those who have studied the struggle against smuggling is that it is manageable if adequate resources are committed to combating it. They maintain that empirical research has shown, contrary to what commonsense might assume, that cigarette smuggling is most prevalent in countries with low excise tax, and they offer the advice that raising excise taxes (no ceiling is stipulated) will not only generate additional government income but also reduce smoking rates (Merriman, Yrelki & Chaloupka, 2000, p. 365; Joosens & Raw, 2000). Spain is often used as an example: it is said that although cigarettes in Spain were almost the cheapest for any European Union country, smuggled

cigarettes accounted for fifteen per cent of the market. But enforcement pressures reduced that rate to five per cent in half a dozen years. This and other case studies have led the World Bank to conclude: 'Smuggling is a serious problem, but even where it occurs at high rates, tax increases bring greater revenues and reduce [cigarette] consumption. Therefore, rather than forgoing tax increases, the appropriate response to smuggling is to crack down on criminal activity' (Action on Smoking and Health, 2000, p. 18). The reduction in smoking is said to be most pronounced among younger persons (Chaloupka, Tei-Wei Hu, Warner & Ayda, 2000, p. 237), though there is some dispute about this view (Wasserman, Manning, Newhouse & Winkler, 1991, pp. 60-61).

We do not want to leave the World Bank conclusion unchallenged. It seems to us fairly obvious that if there is very little money to be made from smuggling rather fewer people would attempt it, and that, all other things being equal, the greater the profit the stronger the appeal. Second, the win-win position of the World Bank and other economists fails to factor in the costs of more effective enforcement, which may outweigh the advantage of a higher excise tax rate. As Flexner (1996, p. 1) has noted:

The compact, lightweight nature of cigarettes makes it an ideal product for both cross-border purchases and large-scale interstate smuggling. Thus the disincentive to consume tobacco products posed by higher taxes can be largely mitigated by changes in purchasing patterns. The incentive to engage [in smuggling] clearly increases as the tax differentials between states rise.

A case in point occurred in England in 1856, when a drafting error inadvertently cut the tobacco tariff by one-quarter. This reduced smuggling to such an extent that the revenue from the tobacco tax actually increased (Bartlett, 1994, p. 2).

Smuggling obviously should be dealt with as effectively as possible, but it seems to us that the most efficient use of resources in realm of cigarette smoking lies in campaigns to convince people that it is not in their best interests to begin or to continue ingesting tobacco.

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