PHILIP MORRIS
ASIA LIMITED

May 30, 2009

The Honorable Members of the Bills Committee on Dutiable Commodities (Amendment) Bill 2009,

On behalf of Philip Morris Asia Limited, which currently has close to 50% of the cigarette market in Hong Kong, I am writing to express our concerns on how the 50% tobacco tax increase introduced on February 25th 2009 has brought and will most likely continue to bring about negative unintended consequences, including:

- Fueling an already burgeoning illicit trade; and
- Not meeting intended public health goals.

<u>Illicit trade in Hong Kong</u>

On April 2nd, in a debate at the Legislative Council, the Secretary for Financial Services & Treasury Professor KC Chan remarked that there was no sign of an increase in the sale of illicit cigarettes since the recent 50% tax increase. Unfortunately, our data for Hong Kong and several media reports suggest a different story. This is also consistent with our international experience in other markets such as Singapore, the United Kingdom and Malaysia where excessive tax increases have resulted in a growth in illicit trade.

In a survey which we conducted two weeks after the tax increase, the incidence of duty-unpaid *Marlboro* cigarettes increased to 45.5% from 35.9% at the end of 2008. These similar surveys involved collecting and analysing 1,500 discarded *Marlboro* packs from various locations in Hong Kong. This increase in duty-unpaid may mark the potential beginning of a reversal in a trend that has seen the incidence of duty-unpaid *Marlboro* cigarettes decline from a high of 68.9% in recent years. As a follow-up, we will continue to monitor the illicit trade situation closely.

The local media has also widely reported an increasingly large number of illicit cigarette seizures by the Hong Kong Customs & Excise Department and the presence of new illicit operation channels selling cigarettes across Hong Kong. Philip Morris Asia Limited appreciates Customs efforts to strengthen the enforcement against illicit cigarettes, however, based on our international experience and what we are starting to see here in Hong Kong, we have serious concerns on the potential growth in illicit trade.

The Hong Kong Government has also shared this concern and in recent years several cautionary remarks were made by different high level Government officials. Most recently, Financial Secretary John Tsang openly stated in a radio interview in 2008 that:

"*We need to take a more balanced approach. We already have a high tax there, if we raised it at this time, it would increase the smuggling. We need to look at all different aspects. Tax is just one* *aspect. It is now about 80 cents per cigarette. We could raise it further. But there are other things we can do better*."

Overseas experience

Based on our experience, excessive and sudden tax increases can cause unintended negative consequences as mentioned above. In Singapore, between 2000 and 2005, the tobacco tax increased by 152% while seizures of illicit cigarettes rose by 457%. This prompted the Finance Minister to acknowledge the illicit trade problem in his Budget Speech in 2006 and has prevented him from increasing the excise tax further on cigarettes. Despite the efforts of the Singapore authorities, the illicit trade issue developed slowly and consistently over time, and still remains a major issue today.

In Malaysia, a 13% tax increase between 2005 and 2006 was matched by a 106% increase in seizures.

The United Kingdom had a similar experience in the late 1990s, prompting the Chancellor of the Exchequer in 2001 to forego any tax increase above the rate of inflation. In fact, the Department of Health in the United Kingdom recently recognized that when considering tax policy, one has to take into account that *"significantly increasing the levels of tax on tobacco could increase the smuggled share of the tobacco market." 1**[1]***

Down trading

From our experience in countries similar to Hong Kong, we have seen that a sharp tax increase is often followed by adult smokers turning to, or down-trading, to cheaper cigarette brands.

In Singapore, cigarette excise tax was increased by 40% from 2000 to 2002 and the retail price of mainstream priced brands increased by 19%. During this period of heightened tax and price increases, 15 new low-priced brands were launched. Following several successive tax increases between 2002 and 2005, the market share of low-priced brands surged to 46.4% in mid-2005 from less than 0.1% in January 2000. Brands with the lowest retail price grew the fastest, and in the past two years, almost all new brands launched in Singapore have been in the low price segment.

From a public health perspective, low-priced brands carry the same health consequences as mainstream-priced brands. This fact was reiterated by the United Kingdom's Chief Medical Officer in 2004 when he talked about low-price brands after significant tax increases from 1997 to 2004. He stated:

1[1] United Kingdom Department of Health, Consultation on the Future of Tobacco Control, 31 May 2008, pg 23. See: http://www.dh.gov.uk/en/Publicationsandstatistics/Publications/PublicationsPolicyAndGuidance/DH_085114

1[2] United Kingdom Department of Health, Annual Report of the Chief Medical Officer 2004 on the State of Public Health: Tobacco and Borders - Death Made Cheaper, p. 18.

> *"The duty-paid market in the UK has also seen a real change since 1997. As price has increased, a new market in ultra-low and low/economy-price cigarettes has expanded. The ultra-low price share of the cigarette market increased from 15% in 1997 to 35% in 2004; the low-price share rose from 15% to 22%. Rather than quitting in the face of price rises, smokers had an alternative route to maintain their addiction without paying more. They could also trade down to hand-rolling tobacco. This expansion in ultra-low/economy-price brands again dents the health impact made by price rises."2* ***[2]***

As confirmed by recognized public health authorities, there is no public health benefit to an excise increase which leads adult smokers to choose cheaper brands.

Conclusion

We believe that the Government's objective of reducing consumption by making all cigarettes less affordable may be seriously undermined by an excessive tax increase that leads to a surge in illicit trade. At the same time, public health goals may not be achieved in the most efficient manner as smokers will most likely down-trade or switch to illicit or cheaper cigarettes. This has already been witnessed in other countries which applied excessively large tax increases such as Singapore and the United Kingdom.

As a company participating in the legitimate trade in cigarettes, we encourage the Hong Kong Government to consider measures that could minimize the unintended negative consequences described above. As an alternative, the 50% tax increase could be spread over a number of years to allow the Government achieve the similar tax and price levels without generating unintended consequences such as illicit trade. Such an approach of raising cigarette prices through moderate and regular tax increases has proved successful for countries that are globally recognized as leading examples of tobacco control: Australia and New Zealand. To date, those jurisdictions have avoided major issues with illicit trade and Hong Kong may want to consider adopting a similar approach.

We respectfully request the members of the Legislative Council factor in illicit trade when discussing the Government's fiscal policies related to cigarettes.

Sincerely

Tammy Chan
General Manager
Hong Kong, Macau and Taiwan