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DEREGULATION OF THE VICTORIAN TOBACCO INDUSTRY

by
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Abstract

The tobacco growing industry was one of the most regulated and protected in Australia. The regulation and protection were manifested in a stabilisation scheme which supported by complementary commonwealth and state legislation, provided a local content scheme, concessional tariffs for manufacturers and price setting arrangements. Commonwealth legislation established the Australian Tobacco Marketing Advisory Committee, which recommended national quota and national average prices. State legislation established state marketing boards with vesting powers and the power to administer state and grower quotas. In the early 1990's changing community attitudes to smoking, reduced opportunities to smoke, technological change and sharp increases in state and commonwealth tobacco taxes reduced demand for tobacco products and created a severe downturn in the tobacco growing regions of Myrtleford, in Victoria and Mareeba in North Queensland. This paper discusses the quota retirement scheme and regulatory reform policies implemented by the Victorian Government to offset the regional impacts and speed up the adjustment process in the tobacco industry.

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1. Introduction

The paper discusses the issues associated with a serious adjustment problem in the Victorian tobacco growing industry and the processes and action undertaken by growers and the Government of Victoria to address these problems.

Section two provides background information on the industry and the nature of the industry stabilisation schemes which dominated the industry for some thirty years. Section three addresses the adjustment pressures which began to build on the industry in the late 1980's. Pressures including, the increased scrutiny of regulated markets, the impact of changing attitudes to smoking and tax increases which substantially reduced the demand for tobacco products.

In section four an account is given of the events leading up to intervention by the Victorian Government, the provision of a tobacco quota retirement scheme and deregulation of the industry. In the concluding sections the outcome of these events and the impact of these actions on the rest of the Australian industry is also discussed.

2. The Tobacco Industry and Regulation

In 1993 some 600 growers produced the Australian tobacco crop of about 12 million kilogram with a farm gate value of some $80 million. The bulk of the crop is grown on the Atherton Tableland around Mareeba (60 per cent) and the Myrtleford region of the Victorian north-east (37 per cent) with the remainder grown in northern NSW and south-east Queensland

Prior to World War 2 most of the crop was air dried and used for cut tobacco but in the post war period there was a shift to "tailor-made" cigarettes and flue-cured tobacco. During the 1950's the shift to manufactured cigarettes and associated economies of scale lead to a reduction in the number of buyers and eventually to the three current manufacturers, Philip Morris, Rothmans and W D and H O Wills.

The principle form of Commonwealth support was through the Local Leaf Content Scheme (LLCS) first introduced in 1936. This arrangement continued till the 1960's. The LLCS reflected the assistance policies of the day - a response to volatility in farm gate prices. The protection initially provided was modest but remained the mechanism for greater increases in protection in later years.

During the 1950's production expanded rapidly. To match this rapid growth governments responded by increasing the statutory requirement under the LLCS from 7.5 per cent in 1955 to 28.5 per cent by 1960. Despite this, some 2,000 tonnes from the 1961 crop was left unsold.

These factors lead to representation from growers and manufacturers to commonwealth and state ministers for the establishment of a Tobacco Industry Stabilisation Plan (TISP). The first interim TISP came into operation in the 1965 selling season.

It is worth noting that constitutionally, powers to control production lie with the states, while tariff settings are, of course, a commonwealth responsibility. Thus in order to implement a national TISP that involved supply controls, statutory usage and a tariff there was a requirement for separate, though complementary state and commonwealth legislation.

Commonwealth legislation, the *Tobacco Marketing Act 1965*, established the Australian Tobacco Board (ATB) which is now known as the Australian Tobacco Marketing Advisory Committee (ATMAC). Complementary state legislation (in Victoria the *Tobacco Leaf Stabilisation Act 1966)* conferred marketing powers to the commonwealth. This allowed the ATB to set a national tobacco quota initially based on a 50 per cent Percentage Leaf Usage Requirement and a commensurate concessional tariff on imports. In 1977 and in subsequent TISP's the manufacturers voluntarily agreed to 57 per cent local content.

At the state level, additional legislation was passed to establish Tobacco Leaf Marketing Boards. These Boards were responsible for selling leaf on growers' behalf and administration of the state and growers' quotas. Growers were allocated a "basic quota" based on delivery in previous seasons. All tobacco grown in the state was vested in the state board. In Victoria, an omnibus piece of legislation (the *Marketing of Primary Products Act 1958*) provided legislative support to a number of statutory agricultural marketing authorities. This was used as a vehicle to establish the Victorian Tobacco Leaf Marketing Board (VTLMB).

The ATB was made up of representatives of the three state boards, the three manufacturers, the three state governments and the commonwealth. The essential elements of the first industry plan were, an aggregate marketing quota, administered prices and manufacturer's stock-holding requirement for domestic consumption. These features changed little over a series of plans in the next 20 years despite recommendations for reform from several Industries Assistance Commission (IAC) and it's successor the Industry Commission (IC) inquiries into the industry. Needless to say the tobacco growing industry became one the most regulated and protected in the agricultural sector.

3. Adjustment Pressures

The major adjustment mechanism in the industry was the sale and transfer of quota. Quotas were transferable within state boundaries and there were provisions within state legislation for the transfer of quotas interstate. However, in the first decades of TISPs growers were able to fully supply quota and with domestic prices related to "cost of production", adjustment was minimal and generally occurred within state boundaries. Between 1970 and 1980 the total number of quota holders nationally fell from 1303 to 1176. Between 1980 and 1993 this number was almost halved to 608 growers. Pressures were mounting on the industry as the socio-economic climate in which the industry had operated for a number of years began to change rapidly. There are three key changes which have had a significant impact on the tobacco industry in Australia. These are discussed in the following sections of this paper.

3.1 Tobacco Industry Stabilisation Plan 1989-1995

The reforms of the Australian economy during the 1980's - the floating of the exchange rate, the deregulation of the banking system and reduced protection to Australian industry made it inevitable that the tobacco industry would also be required to face significant changes. Indeed, the IAC Report of 1987 recommended the dismantling of the TISP on 1 October 1993. In November 1988 the Commonwealth Government announced that :

- the marketing quotas and administered pricing would end on 1 July 1993, but the LLCS would continue till 1 October 1995.

- that the ATB would become the Australian Tobacco Marketing Advisory Committee (ATMAC) and that ATMAC would be responsible for developing a more market oriented industry

ATMAC attempted to address the latter through two mechanisms.

Changes to the Price-Grade Schedule - The national average price was set each year by ATMAC and was based on cost of production surveys with little reference to international prices. Grade prices were based on a complex formula using weighted average prices for some 80 grades of tobacco using a seven year running average to establish grade fallouts each year. This grade price schedule had a flat profile with price differentials between the most desirable grades and lower grades providing little incentive to improve quality.

ATMAC seriously addressed this issue and between 1989 and 1994 a series of adjustments were made to grade schedules and grade prices were brought more into line with international relativities. On efficiency grounds this action was long overdue. For some growers, particularly those who could not match the new production requirements, these changes had serious implications.

Changes to Marketing Arrangements - The second step taken by ATMAC was to initiate and develop the application to the Trade Practices Commission (TPC) by the "Australian Tobacco Leaf Corporation" (ATLC). In essence ATLC was to represent both the manufacturers and the grower bodies and the arrangements for which authorisation were sought in effect mirrored existing arrangements. In its determination in July 1992, the Commission denied authorisation on the grounds that the anti competitive effects of the proposed scheme outweighed the public benefits of the proposed arrangements. The result was disappointing, not because of the outcome but because industry, particularly some elements of the growing interests, failed to appreciate the new environment in which the industry now operated. A modified application more in tune with the need to wind back protection but with less anti competitive elements may have been more successful, at least in the short run.

One other element of the final TISP was a requirement that manufacturers' stocks of domestic leaf should be no more than 10 months supply at the conclusion of the Plan. The need for stocks was related to the lumpy nature of supply (sales tended to be clustered in the middle months of the year). However, in the past stocks had blown out to as much as 16 months supply which created further problems in fixing national quota. Unfortunately, this was to occur again.

3.2 Change in Community Attitudes to Smoking

The effects of smoking on human health are well documented. Through the late 1970's health organisations promoted non-smoking, however, during the 1980's and 1990's governments have become actively involved in supporting these programs (eg the Quit program in Victoria). More recently, bans on smoking in the work place and in many public and private buildings have been adopted by both public and private sector. There are no estimates of the impact of these actions on the overall level of cigarette consumption. However, the reduction in smoking on health grounds and reduced opportunities to smoke, are likely to have some impact on total consumption.

3.3 Tobacco Taxation

Tobacco, like alcohol and petroleum products, has historically attracted very high levels of taxation because of inelastic demand. The total revenue raised from commonwealth excise and state tobacco licence fees raise in the order of $3.5 billion per year. The growth in these taxes have increased rapidly in recent years. The reasons for this are two-fold. First, as a measure to reduce consumption (price increase) and second as a revenue measure. The states particularly, have had difficulty finding new sources of revenue as budget options tighten. Cigarettes, and the changes of community attitudes towards smoking have provided a perfect solution. High taxes on tobacco products is generally accepted by the community (the non-smokers at least) as one acceptable measure to reduce smoking and raise revenue.

States' revenue through state licensing fees (ranging from 75 per cent - 100 per cent of the wholesale price) has increased dramatically in recent years from $916 million in 1990-91 to $1,971 million 1993-94. In the past, commonwealth excise has been linked to CPI increases, however, in August 1994 the Commonwealth Government announced a further 15% increase in excise over and above CPI to be spread over the following 18 months. The states will receive further wind fall gains through these excise increases. For example, the Victoria will receive an additional $16 million in 1995 as a result of these increases through the impact they will have on the wholesale price on which the Victorian tax is based.

There has been a further side effect of increased tobacco taxes on reduced demand for tobacco. Australian tobacco excise is based on weight rather than ad-valorem. Further, excise is levied on the fabricated product. It has been suggested therefore, that Australia has the lightest cigarettes in the world. Less tobacco, lightest paper, lightest filter and lightest cork. One company[1] indicated that in 1992 the industry used 20 per cent less tobacco than 20 years ago but at the same time cigarette sales had increased by 30%. This was accentuated further with the recent introduction of cheaper, (relatively) lighter 40's and 50's packs of cigarettes.

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[1] Submission to the Industry Commission by W D and H O Wills. IC report on The Tobacco Growing and Manufacturing Industries. Appendix N p 6

4. The Crisis of 1993

The combined effects of a reduction in the number of smokers, reduced opportunities to smoke, increased taxes and lighter cigarettes resulted in a sharp decline in demand for tobacco. This, along with the failure of ATMAC to reduce the national quota sufficiently in 1992 and 1993, saw manufacturers' stocks rise to unacceptable levels to 14.3 months supply. In order to meet the statutory requirement of 10 months manufacturers' supply ATMAC foreshadowed, in March 1993, a national quota of 8.1 million kilograms in 1994, a 40 per cent reduction in grower's delivery entitlement (while a grower's basic quota remained constant delivery entitlement was subject to changes in the national quota). If the trend continued a further reductions in delivery entitlements would be necessary in 1995, the final year of TISP.

The rapid reduction in selling entitlements in a short period caused consternation in the industry. While in the previous ten years quota transfers had allowed many growers to leave the industry with a significant cash return from quota sales, the imminent demise of TISP meant that quota had little or no value. All growers were faced with similar production cuts regardless of the efficiency of the individual and there appeared to be no mechanisms which could speed up adjustment without a serious regional impact. However, mounting pressure from growers for some form of Government initiated mechanisms for speeding up adjustment were emerging.

4.1 Industry Submission for a Quota Buy-Out

In July 1993 the Tobacco Growers of Victoria put a submission to the Treasurer seeking assistance from the Victorian Government to rapidly restructure the Victorian industry. The submission from industry sought a one-off $6 million grant to retire production quota. The major aim of the grower proposal was for a substantial reduction in the number of growers in the industry. The proposal was predicated on an internal re-allocation of the Victorian quota. The rationale for this scheme was to allow some growers to capitalise their quota in order to retire from the industry or to re-invest in other farm activity and for remaining growers, a substantial increase in delivery entitlements for the final year of TISP thus placing them in a more sound position to face a competitive market post 1995.

In justifying this approach, growers argued that sharp increases in state taxes and changes to health policies were largely responsible for the decline in the demand for tobacco leaf. Growers also argued that the rapid downturn coupled with the concentration of the industry in the Myrtleford region would have a serious economic impact on the region. Indeed, it is estimated that the gross income from the tobacco industry would decline from some $30 million to some $18 in a 12 month period.

A counter argument would indicate that for some 30 years tobacco growers had been extracting excessive economic rents from the industry as a result of legislative arrangements; that the industry had sufficient notice that the TISP would conclude in 1995 and despite changes in government policies the industry should have been further advanced towards deregulation and been in a better position to accommodate change. From a government viewpoint, funding quota buy-outs could create politically difficult precedents.

4.2 Government Response

Between the period of the growers application and the Victorian Government's response, considerable discussion took place between industry leaders and the Department of Agriculture. Not only about the immediate problem but also about the future direction and structure of the industry.

In December 1993, in a joint statement, the Minister for Agriculture, the Deputy Premier and the Treasurer announced a restructuring package for the tobacco industry. The announcement encompassed a $3 million grant to finance quota retirement and notice of the Victorian Government's intention to repeal existing statutory marketing arrangements by the middle of 1994. In general the Government accepted the grower's rationale for assistance. The Government's offer was to remove 1.5 million kg of Victorian quota by offering $2/kg for the basic quota of those growers who wished to leave the industry. Advice to the Government suggested that the removal of 1.5 million kg would be sufficient to stabilise the industry for remaining growers and that a price of $2/kg for quota would be sufficient to achieve this.

The announcement clearly recognised the need for assisted adjustment which would lead to a significant restructuring of the industry in terms of the number, size and structure of farms. While the funds provided were half that requested the industry was generally pleased with the outcome. In accepting deregulation, industry leaders quickly recognised that by establishing a commercial operation to replace the VTLMB they would be well placed when the industry was deregulated nationally.

For the Victorian Government there was, therefore, an opportunity to tie structural adjustment in the grower sector to deregulation, an important plank in the Government's agenda. In this context, the Government flagged the repeal of all state tobacco marketing legislation and transfer the assets of the VTLMB to a new commercial entity to be established by Victorian growers for the marketing of their tobacco. The Government recognised that with the cessation of Commonwealth Government involvement in the management of Australian production of tobacco at expiry of TISP in 1995 there would be no further role for a state statutory body. Early and well managed adjustment and deregulation of the Victorian industry could better position the Victorian industry, albeit in a diminishing but national free market trading environment.

Without the rapid movement of grower entitlement from the inefficient to the efficient growers, almost all growers and the industry would languish under low per farm levels of tobacco production and sales. The retirement of quota would enable current growing entitlement to be redistributed. This rapid restructuring in the industry would help currently efficient but economically non-viable (because of inadequate growing entitlement) tobacco growers to survive, particularly in a deregulated market where price would be more closely aligned with quality and world prices.

The solution to the crisis in the industry was a pragmatic one and while "buying" quota may be an anathema to some, the alternative was a slow haemorrhaging of the industry and the economy of the region to the extent that significantly greater expenditure on welfare payments and other government transfers may have been required/initiated in the long run than the $3 million outlaid.

4.3 Management of Quota Retirement

Given the need to ensure a high level of accountability for the management and disbursement of funds under the early quota retirement scheme the Rural Finance Corporation (RFC) of Victoria, which had expertise in managing rural adjustment of this kind, was considered the appropriate body to administer the quota retirement scheme.

The development of the detail operational criteria for the scheme (including eligibility criteria) was the subject of a working group comprising RFC, Department of Agriculture, the VTLMB and industry leaders. Final operational detail of scheme was subject to Treasurer's and Minister for Agriculture's approval. There was no compulsion for any grower to take up the offer. However, in the event of the number of applications exceeding the funds available, some order of precedence needed to be established. This discretion was left with the RFC but clearly, if the process were to be effective and equitable, some guidelines were necessary. Generally the growers targeted were: those who produced lower grade tobacco leaf (and received lower average prices), had smaller quota holdings, had a smaller farm size, had lower productivity and were at or nearing retirement age.

4.4 Timing and Conditions for Retirement of Quota

The Victorian Government set a tight timetable in order to finalise the retirement of quota before the commencement of the 1993-94 season. Details of the scheme were published in January and growers were given till the end of March to indicate their interest, with the buy-out to be finalised by June 30. Independent financial (subsidised by the commonwealth) advice was provided to assist growers in decide on their future in the industry. At the same time the legislative processes were set in place to repeal all state tobacco legislation and to transfer the assets of the VTLMB to a grower body. Meanwhile those growers intending to stay in the industry formed a co-operative - the Tobacco Co-operative of Victoria (TCV), to which the Board's assets were finally transferred.

The question of ownership of the VTLMB assets, amounting to some $3 million (the tobacco warehouse), had been addressed in early discussion with growers. The legislation under which the Board was created appeared to indicate that in the event of the demise of the Board, assets reverted to growers and as there had been no government contributions or guarantees in creating capital this was the option chosen.

In order to ensure growers did not re-enter the industry after deregulation, those accepting the Government's offer were required to give an undertaking not to re-enter the industry for a 5 year period. Indeed, in order to give some teeth to this undertaking the RFC held a mortgage over the properties concerned. In addition the sale or retirement of quota would remove the entitlement of the grower to any claim on the VTLMB assets.

The quota retirement plan did conclude on 30 June 1994 and all payments to growers were finalised by September 30. Some 68 growers accepted the Government's offer which effectively matched the target of removing 1.5 million kg of Victorian quota and absorbing the $3 million leaving about 130 to continue in the industry.

The Tobacco Industry (Deregulation) Act 1994 passed through the Victorian Parliament in

May 1994 and was proclaimed on 30 September 1994. The 130 growers who held quota on that day received shares in the TCV in proportion to the basic quota they held.

5. Conclusion

The deregulation or restructuring of the Victorian tobacco industry was an exercise in change which those who work in the public sector policy area often face. There are seldom perfect solutions. Solutions have elements of economics, politics and pragmatism. Final decisions are not made in a vacuum and many would argue that they are not all good decisions. In this case there was certainly public debate and internal debate both within the public sector and within industry about such issues as adjustment mechanisms, equity and precedent. On balance, the outcome satisfied the agenda of most parties involved although at a cost to the taxpayers of Victoria.

From the Government's point of view a difficult regional adjustment problem was overcome. While the quota buy-out did not guarantee the future of the industry, it gave additional capital to those leaving the industry to facilitate adjustment and for those remaining in the industry, a more viable future. At the same time the deregulation of the industry provided the environment for more efficient allocation of resources in the region. In a political sense the initiative was sufficient to satisfy and indeed impress the electorate. Again, the concentration of the industry in the region was a factor in influencing the Government's decision.

There has been no exit survey of those leaving the industry. Nevertheless, it is know that 65% of this group produced tobacco in the bottom 50 percentile in terms of the price/grade schedule and had small quota and farm size. Of those who sought advice about accepting the Government's offer, 59% gave age and 19% ill health as a consideration for leaving the industry. Many growers believed the $2/kg offer was too low and there were also concerns about the mortgage provisions designed to prevent these growers re-entering the industry. However, implementation proceeded with few difficulties. As further assistance to this group, the Government amended local government planning restrictions which allowed those wishing to retire from farming to excise the family home from the property and sell remaining farm land.

Those who elected to stay in the industry benefit from becoming shareholders in the assets of the new co-operative. A share-holding which represented about 60 cents for every kilogram of quota held. As well, these growers will benefit from an increased entitlement to sell (from 60% in 1994 to 90% in 1995) On the down side, this group faces the uncertainty of the free market beyond 1995 and the inevitability that taxes on the product they produce are likely to increase. Nevertheless, there is an a general view that even though prices may fall, tobacco growing will remain profitable. Again, this group has some entrepreneurial flair, most growers have a reasonably sized land base, have diversified into a range of alternative crops (nuts, grapes, vegetables and cattle) and the land is fertile and has irrigation water rights. This is not say that further adjustment will be unnecessary. But manageable adjustment not requiring government assistance.

The legislation passed through the parliament supported by all parties and the opposition. There was recognition that the community as a whole benefited from higher taxes on tobacco products and active policies to discourage smoking but there was also recognition that tobacco farmers were seriously disadvantaged by these policies. In general it was considered that $3 million was not a significant amount to overcome a serious industry and regional problem.

Perhaps a final comment from the IC is an appropriate conclusion. While not recommending quota buy-outs per se, the commissioners said. "The Victorian quota retirement scheme has acted as a useful circuit-breaker in that it has injected a degree of certainty into the local community and has provided growers remaining in the industry with an improved prospect for survival in the immediate future"[2].

Postscript

These events did not occur in a vacuum. Growers in other states perceiving the action taking place in Victoria mounted pressure on their own governments for similar assistance. The Industry Commission in its report in June 1994 recommended a tariff of 20% phasing down to 5% in 2002. This received a poor response from manufacturers who under the current arrangements paid nominal tariff. In addition, and under the Uruguay Round negotiations Australia was obliged to provide greater access to imported tobacco than the industry had anticipated.

The Queensland Government was reluctant to provide funding to it's growers. In 1989, after first introducing tobacco licensing fees, it had provided the industry with $10 million as a "compensation " package and to improve farm viability. With some justification it was reluctant to provide further funding. In June 1994 the NSW Government provided funding to the small group of growers in that state as a compensation measure. Even though there was no quota buy out scheme as such, growers who left the industry voluntarily did receive a higher payment. The manufacturers for their part encouraged grower representatives to consider commercial contractual arrangements rather than rely on government protection through increased tariff.

In mid 1994 an impasse was reached. It appeared that the Commonwealth Government would not intervene, that the TISP would wind up, that there would be a free market nationally, a deregulated industry in Victoria, a regulated industry in Queensland, perhaps no industry in NSW and perhaps a short term phased out tariff. To complicate things further there were real concerns that any marketing arrangements in this environment may contravene the Trade Practices Act. There was however, a suggestion that a special tobacco tax to assist adjustment in the industry may be an option.

Finally, in October 1994, the manufacturers came up with a proposal which finally satisfied the growers, the State Governments, the Commonwealth and indeed any concerns of the TPC. The manufacturers offered to provide $10.8 million to assist industry adjustment. Effectively, and building on the Victorian initiative, the removal of a third of the quota/growers from the industry with the monies to be distributed between states' growers according to state quota relativities. This offer to be matched by state governments (in the case of Victoria and NSW this was already the case). The market would be deregulated on 1 January 1995 with a zero

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[2] Industry Commission report on The Tobacco Growing and Manufacturing Industries. Chapter 8. p. 133

tariff and growers and manufacturers to negotiate separate medium to long term contracts between grower bodies and individual manufacturers for the supply of Australian tobacco. The only stipulation was that all governments agree not to raise any additional taxes for the specific tobacco industry adjustment.

This arrangement came into effect on 1 January 1995. While the credit for this rapid resolution of an extremely complex and difficult situation should be shared with some dynamic individuals in both industry and government the catalyst was the initial move by the tobacco growers and the Government of Victoria.

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