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To: Minister of Finance

## **AIDE MEMOIRE: EXCLUDING THE IMPACT OF THE TOBACCO EXCISE INCREASE FROM CPI ADJUSTMENTS**

This aide memoire provides further advice on excluding the impact of the tobacco excise increase from CPI adjustments for New Zealand Superannuation (NZS), the Veterans' Pension, benefits, Working for Families tax credits and other payments that are adjusted according to changes in the CPI. It also addresses the impact of such a change on the independence of the Government Statistician, as was discussed during Cabinet's consideration of the Budget 2010 Tax Package on 12 April 2010.

Recommendations are attached for you to table at Cabinet to agree the exclusion.

### ***Background***

Cabinet has agreed increase in the real rate of tobacco excise by 33% through three compounding 10% steps on 1 May 2010 (or as soon as possible); 1 Jan 2011 and 1 Jan 2012. This is in addition to a 14% increase in excise on loose tobacco from 1 May 2010 (or as soon as possible). These increases are on top of automatic CPI-based increases on 1 January each year.

When fully implemented, this will increase the retail price of manufactured cigarettes by an estimated 28%, and this will in turn lift the CPI by an estimated 0.6% over the next 2½ years (tobacco is weighted at 2.15% of the goods and services in the CPI "basket").

Under existing legislation, NZ Superannuation and Veterans pensions increase automatically each 1 April by the movement in the CPI (all groups index) in the previous year. The Income Tax Act provides for similar automatic indexation of Working for Families Tax Credits whenever cumulative increases in the CPI reach 5% since the last adjustment. Annual CPI-based increases have been routinely applied to other main benefits in the past, and the Future Focus Bill currently before the House of Representatives proposes to make such adjustments automatic in future.

Treasury estimates that the increased cost of CPI-based indexation of NZ Superannuation and main benefits following the increase in tobacco excise rates will reach \$40 million per year by 2012.

Cabinet directed officials to report back on the desirability of excluding the price impact of tobacco excise increases from the CPI to SOC by 30 September 2010, or to Budget Ministers in time for the Budget (CAB MIN (10) 12/11 recommendation 13.2 refers).

### ***Decisions Required Now***

For the full revenue from increased tobacco excise to be recognised and counted in the budget tax package, a Cabinet decision is required now to exclude tobacco prices from CPI-based adjustments to entitlements in each of the next 3 years. Otherwise, the forecast tobacco excise revenue must be offset by the costs of indexing these

entitlements. This is estimated to be \$5 million in 2010/11; \$20 million in 2011/12; and \$40 million in 2012/13 and outyears.

Implementation will require legislation that can take effect before the annual adjustments to apply from 1 April 2011 are determined. For NZ Super, Veterans pensions and Tax Credits, this can be included in Budget night legislation. For other benefits that are the subject of the Future Focus Bill currently before the House, an alternative approach is needed – either a Supplementary Order Paper, or introducing separate amending legislation after the passage of the Future Focus bill. The fiscal risk that this legislation cannot be enacted will be reflected in the Fiscal Risks reported with the 2010 Budget.

Further work will include technical decisions on the exact design of the amended CPI-based adjustment, and some specific decisions on the scope of this change (for example, whether it is to apply to student allowances and/or to a variety of small benefit entitlements), and legislative drafting.

### ***Rationale for excluding tobacco price increases from CPI-based adjustments to entitlements***

The purpose of these step changes in tobacco excise is to raise tobacco prices and discourage consumption. While tobacco prices do mechanically affect the CPI, there is no reason in principle to adjust superannuation, benefits and working for families tax credit rates to compensate for this. Non-smokers don't need to be compensated (as they don't face this cost), and smokers should not be compensated as that would contradict the intent the policy.

CPI-based indexation offers a simple, transparent and consistent approach to making cost of living adjustments for superannuation, benefits and tax credits. These advantages should not be forgone unless there are strong and exceptional reasons for doing so (for example, routine annual increases in alcohol and tobacco excise rates to maintain their real value, are not excluded from the CPI-based adjustments to increase NZ Super and benefits).

In the Treasury's view, the current increase in tobacco excise (by 33%-51%) is an exceptional case that justifies a one-off and time limited change to the way annual increases are calculated:

- First, the cost of increasing all entitlements by an additional 0.6% over 3 years is large and permanent – and would substantially offset the revenue gained from higher excise rates (revenue which will fall as smoking rates decline, if the policy is successful);
- Second, tobacco products are unique in the basket of goods covered by the CPI in being both addictive and extremely harmful – this is a one-off change, not intended as a precedent for further ad-hoc changes to indexation policy.
- Third, this temporary and one-off change to the basis for calculating entitlement adjustments can be readily explained and justified to the public.

### ***The proposal has no impact on the Government Statistician's independence or the official CPI***

The CPI is produced by Statistics New Zealand through a transparent independent technical process. The proposed changes do not affect this. Instead, they amend

legislation that refers to the CPI measure by limiting which components of the CPI are applied in calculating changes to NZ Super, the Veterans' Pension, benefits and Working for Families tax credits.

The Treasury and Statistics New Zealand agree that changing the calculation of increases in entitlements derived from the CPI does not impact on the statutory independence or perceived independence of the Government Statistician, or on the calculation of the Consumer Price Index itself.

The headline measure - the all groups CPI - would continue to be released and made available under the legislative requirements of the Statistics Act and to meet the principles and protocols of official statistics. The proposal is not to change how the CPI is calculated, but to exclude the tobacco component of the CPI when calculating annual adjustments to entitlements. There are technical issues to be worked through concerning index weights, and whether a separate sub-series needs to be calculated and published. But these issues do not change the way the CPI itself is measured.

For transparency, the exclusion will be announced and explained as part of the communications around the excise and the tax package. Communications will also note that there has been no change in the calculation of the headline CPI measure or in the independence of the Government Statistician.

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**Recommendations to table at Cabinet on 19 April 2010:**

It is recommended that Cabinet:

1. **Note** that Cabinet has agreed to increase the excise and excise-equivalent duties on all tobacco products [CAB Min (10) 12/10];
2. **Note** that on 12 April 2010, Cabinet directed the Treasury, in consultation with the Inland Revenue Department, the Ministry of Social Development, the Ministry of Health, and Statistics New Zealand, to assess the desirability of excluding the price impact of tobacco excise increases from the CPI and report back to SOC by 30 September 2010, or to Budget Ministers in time for amendments to be included in Budget night legislation if requested by Budget Ministers [CAB Min (10) 12/11];
3. **Agree** that Budget legislation to implement the Government's tax reform package include amendments to the New Zealand Superannuation and Retirement Income Act 2001, the Income Tax Act 2007, the War Pensions Act 1954 and other relevant Acts to exclude tobacco products from the Consumers Price Index measures applied to adjust New Zealand Superannuation, Veterans' Pension and Working For Families tax credit entitlements in 2011, 2012 and 2013.
4. **Agree** that a corresponding amendment to exclude tobacco products from inflation adjustment calculations will need to be made to the Social Assistance (Future Focus) Bill which is currently before the Social Services Select Committee.
5. **Note** that if recommendations 3 and 4 above are not agreed the fiscal cost of the Budget tax package will increase by the following amount:

	\$m increase/(decrease)			
	2010/11	2011/12	2012/13	2013/14 & Outyears
Not removing CPI flow through*	5.000	20.000	40.000	40.000

\*all figures rounded to nearest \$5m.

6. **Note** that if recommendations 3 and 4 above are agreed this will not compromise the independence of the Government Statistician or the official measure of inflation.
7. **Direct** the Treasury, in consultation with the Ministry of Social Development, inland Revenue Department, Statistics New Zealand, the Parliamentary Counsel Office and other relevant agencies, to prepare draft legislation to give effect to recommendation 3 above, provide further advice on options for implementation of recommendation 4 above, and on any subsequent implementation issues.