

Treasury Report: Revised Estimate of Savings from Excluding Tobacco Prices from CPI-Based Adjustments to NZ Superannuation, Benefits and Family Tax Credits

Date:	27 April 2010	Report No:	T2010/713
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Action Sought

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Minister of Finance (Hon Bill English)	<p>Note that the savings from excluding tobacco price rises from CPI-based adjustments to entitlements as agreed by Cabinet are significantly higher than earlier estimated.</p> <p>Note that the Government's intention to exclude tobacco price increases from indexation of entitlements is included in communications material for the tobacco excise Bill to be introduced to the House tomorrow, Wednesday 28 April 2010.</p>	Wednesday 28 April 2010.

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
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Minister of Finance's Office Actions (if required)

None.

Enclosure: No

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Executive Summary

Revised costings based on final BEFU forecasts show that savings of \$432 million over four years will result from excluding tobacco price increases from the CPI-based indexation of benefits, NZ Superannuation, and WFF Family Tax Credits as agreed by Cabinet.

This is significantly higher than the estimate of \$104 million provided in the March 2010 Cabinet papers on the tobacco excise increase. The difference is mainly due final BEFU CPI forecasts showing that including tobacco prices would trigger the indexation of Family Tax credit rates a year earlier on 1 April 2011, and correcting an error in calculating CPI impacts.

This revised costing does not change the net fiscal impact of the Budget tax package, which assumes this policy change and has been forecast using a CPI track for entitlements that excludes tobacco prices. However, there is now a larger fiscal risk, should the necessary legislation not be passed to implement this policy change.

Recommended Action

We recommend that you:

- a **note** that the BEFU forecasts assume tobacco price increases will be excluded from CPI-based adjustments to NZ Superannuation, benefits and WFF tax credits over the next three years as agreed by Cabinet [CAB Min (10) 13/24 refers];
- b **note** the revised estimate of savings from implementing this policy change, based on final Budget forecasts, is \$432 million over four years - significantly higher than the \$104 million estimate provided in Cabinet papers on the tobacco excise increase;
- c **note** that the four-year total cost of *not* excluding tobacco prices from indexation of entitlements will be included in communications supporting the bill to increase tobacco excise, due to be introduced in the House of Representatives tomorrow, Wednesday 28 April 2010;
- d **note** that detailed costings will not be released until Budget day (as this could compromise Budget secrecy of forecasts), but these details will be available to support communication of the required legislative amendments in Budget night tax legislation; and

- e **note** that this revised costing does not alter the costings for the Budget tax package, which assumes this policy change, but the fiscal risk of not passing the necessary legislation is now larger.

John MacCormick
**Senior Analyst, Health
for Secretary to the Treasury**

Hon Bill English
Minister of Finance

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Purpose of Report

1. A Bill to increase tobacco excise is due to be introduced to the House of Representatives under urgency tomorrow, Wednesday 28 April 2010.
2. This note provides revised estimates of the savings that will result from excluding tobacco price increases from annual CPI-based adjustments to NZ Superannuation and benefit rates, and Working for Families tax credit rates and thresholds over the next three years as recently agreed by Cabinet [CAB Min (10) 13/24 refers] .
3. This information is provided to support you in briefing Cabinet and parliamentary colleagues on the justification and significance of the proposed legislative amendments to exclude tobacco price increases from CPI-based adjustments.

Analysis

4. The revised costings are based on final Budget CPI forecasts and forecast expenditure on these entitlements following Budget 2010 decisions. At \$432 million over four years, the savings from this policy change (and the potential cost if it is not implemented) is significantly higher than the estimate of \$104 million provided in the March 2010 Cabinet papers on the Tobacco Excise increase. The change is due mainly to:
 - tobacco price increases triggering earlier indexation of family tax credit rates given the revised BEFU CPI forecast track;
 - a higher CPI impact for tobacco prices in the final BEFU forecast, and correcting an error in the calculation of quarterly CPI impacts from the three step increases in tobacco excise and tobacco prices; and
 - other minor changes such as including Student Allowances with the benefits subject to the change in indexation.

Summary of Revised Costings

\$ million	2009/10	2010/11	2011/12	2012/13	2013/14	4 Year total
Increase in tobacco excise revenue (unchanged)	14	130	184	205	191	724
Potential cost if indexation of entitlements includes CPI impact of tobacco prices						
– NZ Superannuation and Benefits	-	(8)	(46)	(79)	(99)	(233)
– WFF Family Tax Credits	-	(41)	(127)	(16)	(15)	(199)
Total	-	(49)	(173)	(95)	(114)	(432)

CPI impact is higher than noted in the Tobacco Excise Cabinet paper

- The cumulative impact of higher tobacco prices on CPI inflation over three years is estimated to be 0.8%.
- The Cabinet paper on tobacco excise increases presented the following table of estimated increases in CPI inflation for the agreed option:

	2010	2011	2012	2013
<i>Increase in forecast CPI track (year to 30 September)</i>	+0.11%	+0.23%	+0.09%	+0.01%

- These figures were incorrect, due to an error in calculating annual index changes from the re-phased, three step increase in tobacco excise and prices. In addition, the estimated CPI impact of tobacco prices was increased in the BEFU forecast compared to the preliminary BEFU CPI track. The corrected estimates for the impact of tobacco excise on CPI (December quarters) are:

	2010	2011	2012	2013
<i>Increase in BEFU forecast CPI track due to tobacco prices (year to 31 December)</i>	0.3%	0.2%	0.3%	0.0%

Tobacco price and tobacco excise revenue estimates are unchanged

- The Cabinet papers on tobacco excise estimated that retail tobacco prices (incl GST at 12.5%) would increase by 140% of the dollar increase in excise. Excise revenue is estimated to increase by \$724 million over the forecast period.

\$ million	2009/10	2010/11	2011/12	2012/13	2013/14	4 Year total
Increase in excise revenue	14	130	184	205	191	724

- These estimates are unchanged. They remain subject to a high level of uncertainty. Retail price changes will depend on the pricing and margin strategies adopted by tobacco manufacturers, distributors and retailers in response to an increase in excise that is unprecedented in recent history. The demand response has been modelled as a 5% drop in demand for each 10% increase in price, but the timing and extent of demand responses in this case are also much more uncertain than for smaller annual CPI adjustments to excise rates.

Potential flow-on costs for indexation of NZ Superannuation and benefits are higher

- The estimated cost of *not* excluding tobacco price increases from the CPI-based measure used to adjust rates of NZ Superannuation, Veterans Pensions and other main benefits is significantly higher than the estimate provided in the tobacco excise Cabinet papers. These costings are net of income tax recouped on the increased payments.

Flow-on cost for indexation of NZ Superannuation and benefits

\$ million	2010/11	2011/12	2012/13	2013/14	4 Year total
Estimate in tobacco excise Cabinet paper [EGI (10) 55]	4	22	37	41	104
Corrected Estimate (using BEFU forecasts) net of tax	8	46	79	99	233
Change in estimated cost	+4	+24	+42	+58	+129

11. The increase in flow-on costs results from applying the corrected CPI impact noted above, and including flow-on costs to some entitlements not counted in the earlier estimate, including Student Allowances.

Including tobacco price rises would trigger early indexation of WFF Family Tax Credits

12. A critical issue in costing the impact of tobacco price increases in CPI-based adjustments to entitlements is whether the adjustment of Working for Families Family Tax Credit rates is triggered sooner than forecast. This adjustment is made on 1 April following any September in which cumulative CPI growth since the last adjustment hits 5%.
13. As the tobacco excise proposal has developed, other policy decisions impacting on CPI forecasts have also been made and CPI forecasts have been revised:
- In early March, we advised that a one-off 33% increase in excise *would* trigger earlier indexation of family tax credit rates (in 2011 and 2014, rather than 2012 and 2015) at a cost of \$146 million over four years, compared to the DEFU forecast track; and
 - The paper considered by EGI on 31 March noted that based on preliminary BEFU forecasts, three sequential 10% increases in tobacco excise *would not* trigger earlier indexation of family tax credit rates. The paper therefore did not quantify a cost for WFF indexation, but noted:
“There is a small risk that the first 10% step increase in excise... could be the trigger that brings forward indexation of family tax credits by a year to April 2011 at a cost of approximately \$150 million over 4 years, but preliminary 2010 Budget Economic and Fiscal Update (BEFU) forecasts indicate this will not be the case, and the impact on family tax credit costs will be substantially lower than this.”
14. Based on the final BEFU CPI forecast track (incorporating the tax package and all other budget policy changes), our revised estimate shows the CPI impact of tobacco price increases *would now* again trigger an earlier indexation of family tax credit rates in April 2011, at a cost over 4 years of \$199 million. The cost is largely a one-off timing change. A second increase would still be required in April 2012 due to other drivers of inflation in the year to September 2011.

\$ million	2010/11	2011/12	2012/13	2013/14	4 Year total
Tobacco excise Cabinet paper [EGI (10) 55]	unquantified				
Increased cost of Family Tax Credit indexation if tobacco price impact on CPI is included	41	127	16	15	199

	1-Apr-11	1-Apr-12	1-Apr-13	1-Apr-14
Difference in WFF indexation if tobacco price rises are included (compared to BEFU)	5.3%	-5.0%	0.0%	0.0%

Risks

15. We are working with Inland Revenue, the Ministry of Social Development and Parliamentary Counsel to include in the budget tax bill the amendments required to exclude tobacco price increases from indexation of NZ Superannuation, Veterans Pensions and WFF Family Tax Credits. We are working with the Ministry of Social Development to prepare a Supplementary Order Paper to amend clauses in the Future Focus Bill that provide for annual indexation of main benefits.

Communications Points

16. The following key messages will be included in the communications material supporting announcement of the increase in tobacco excise:
 - The Government has decided that for the next three years, the effect of tobacco price changes will be excluded from the CPI-based annual adjustment of NZ Superannuation, Veterans Pensions, Working for Families Family Tax Credits, and main benefits.
 - Treasury estimates that tobacco price increases following this Bill will add a cumulative 0.8% to the CPI over the next three years. If this flows through to the annual CPI-based adjustments to New Zealand Superannuation, Veterans Pensions, Working for Families Family Tax Credits, it would cost taxpayers approximately \$430 million over the next four years.
 - It makes no sense to increase Superannuation, benefits and family tax credits paid to smokers to compensate for Government actions to increase tobacco prices and discourage smoking. It also makes no sense to compensate non-smokers receiving these entitlements for tobacco price increases that don't affect their cost of living. The cost of increasing NZ Superannuation, benefit and tax credit rates would be permanent and compounding into the future, while the additional tobacco excise revenue will decline as tobacco consumption falls.
 - This change will require minor amendments to existing legislation governing NZ Superannuation, Veterans Pensions and WFF Family Tax Credits. Amendments will also be needed to the Future Focus Bill currently being considered by Select Committee, as this Bill provides for automatic CPI-based indexation of other benefits. This change will be temporary, for three years. It is a one-off measure, reflecting the scale of these step changes in tobacco excise, and the high cost of not making this change.
 - The Government continues to believe that a simple, transparent and consistent approach to annual indexation of NZ Superannuation and Benefits is desirable. Following these changes, the Government will continue to adjust entitlements annually to reflect changes in the cost of living as measured by the CPI.