

# Regulatory Impact Statement: Increases in Tobacco Excise

## Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by The Treasury.

It provides an analysis of options to reduce smoking prevalence by:

- further increasing tobacco excise, and
- continuing to exclude tobacco from consumer price index (CPI) adjustments to welfare payments.

The analysis considers different options and their impact on smoking prevalence, consumer expenditure, government revenue, equity, growth, efficiency and industry.

Key assumptions in the analysis include:

- the price elasticity of demand for tobacco products is constant at -0.5 (thus, a 10% increase in the price of tobacco leads to a 5% decrease in consumption of tobacco)
- the tobacco price elasticity of daily smoking prevalence is -0.25 (thus, a 10% increase in the price of tobacco leads to a 2.5% decrease in smoking prevalence, measured in terms of the number of people who have smoked more than 100 cigarettes in their lifetime and currently smoke at least once a day), and
- the weight of the cigarettes and tobacco subgroup in the CPI is 2.3%.

The analysis does not consider other policy tools to reduce smoking prevalence. New Zealand's tobacco control programme comprises a range of complimentary interventions that work together to reduce the harms caused by smoking. The Ministry of Health continues to evaluate best practice evidence and ensure that funded tobacco control interventions are providing value for money and are fit for purpose.

Key gaps and uncertainties in the analysis include:

- whether recent increases in tobacco excise in New Zealand have made the tax less regressive
- the impact of smoking on lifetime earnings, and
- the impact of excluding tobacco from CPI adjustments on smoking prevalence.

Increases in tobacco excise would require amendments to the Customs and Excise Act 1996. Tobacco manufacturers and retailers would need to familiarise themselves with the increases and make changes to price notices. Continuing to exclude tobacco from CPI adjustments to welfare payments would require amendments to various social policy Acts and regulations.

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## Executive summary

Smoking is the leading health risk in New Zealand and the leading cause of preventable early death. Smoking prevalence across the population as a whole stood at 15% in 2014/15 – although it was considerably higher among Māori and Pasifika.

The Government is committed to reducing the burden of death and disease caused by smoking. It has adopted the ‘Smokefree’ goal of reducing levels of smoking prevalence to minimal levels – widely interpreted to mean less than 5% within all demographic groups – by 2025.

Raising the price of tobacco through tax increases is internationally recognised as one of the most effective ways to reduce smoking prevalence. Since 2010, the Government has increased tobacco excise by at least CPI+10% each year. The Government has also excluded tobacco from CPI adjustments to welfare payments, so that increases in tobacco excise, and subsequent increases in the price of tobacco, do not flow through to CPI adjustments to these welfare payments.

The recent series of increases in tobacco excise has come to an end. With no change, tobacco excise will remain at its current level. Should this happen, it is unlikely the Smokefree 2025 goal will be achieved. Furthermore, the legislative provision excluding tobacco from CPI adjustments to welfare payments will expire shortly. As it stands, any future above-CPI increases in tobacco excise will flow through to CPI adjustments to these welfare payments.

The analysis below considers options to reduce smoking prevalence by:

- further increasing tobacco excise, and
- continuing to exclude tobacco from CPI adjustments to welfare payments.

The analysis finds that four successive annual increases in tobacco excise of CPI+10% from January 2017 onwards would reduce smoking prevalence to 12% by 2025. Similar increases of CPI+15% would reduce smoking prevalence to 11.4% by 2025. In the absence of other policy changes, increases in tobacco excise significantly higher than CPI+15% would likely be needed to achieve the Smokefree 2025 goal.

The analysis finds that tobacco excise is a regressive tax, but that increases in tobacco excise may make it less regressive. Nevertheless, the burden of increases would weigh heaviest on low-income groups who continue to smoke.

Continuing to exclude tobacco from CPI adjustments to welfare payments would help reinforce the objective behind increases in tobacco excise: to reduce smoking prevalence by reducing the affordability of tobacco products. However, the precise impact on levels of smoking prevalence is unknown.

Increases in tobacco excise would require amendments to the Customs and Excise Act 1996. Extending the exclusion of tobacco from CPI adjustments to welfare payments would require amendments to various social policy Acts and regulations.

## Status quo and problem definition

Smoking is the leading health risk in New Zealand, accounting for 9% of health losses from all causes.<sup>1</sup> It is also the leading cause of preventable early death, with 4,500-5,000 New Zealanders dying each year from smoking or exposure to second-hand smoke.<sup>2</sup> Smoking is the leading cause of cancer death and is a major cause of heart attacks, strokes, emphysema, bronchitis, asthma and a range of other conditions.<sup>3</sup>

Smoking prevalence across the population as a whole has fallen gradually in recent years, from 18.3% in 2006/07 to 15% in 2014/15.<sup>4</sup> Prevalence is higher among Māori and Pasifika than the population as a whole, at 35.5% and 22.4% respectively in 2014/15.<sup>5</sup>

In 2011, in response to the recommendations of the Māori Affairs Select Committee's *Inquiry into the Tobacco Industry and Consequences of Tobacco Use for Māori*, the Government adopted the Smokefree 2025 goal of "reducing smoking prevalence and tobacco availability to minimal levels, thereby making New Zealand essentially a smokefree nation by 2025".<sup>6</sup> Although the Government has not defined "minimal levels", stakeholders have widely interpreted it to mean a smoking prevalence of less than 5% within all demographic groups.<sup>7</sup>

The Government has implemented a range of policies to reduce smoking prevalence, including:

- funding a wide range of smoking cessation services
- prohibiting the point-of-sale display of tobacco products, and
- increasing fines for the sale of tobacco products to minors.

In addition, the Government implemented two series of annual increases in tobacco excise by at least CPI+10%: for three years beginning in 2010; and then for another four years beginning in 2013.

Raising the price of tobacco through excise increases is internationally recognised as one of the most effective ways to reduce smoking prevalence.<sup>8</sup> However, the most recent series of annual increases in tobacco excise has come to an end, with the final increase taking place in January 2016. No further increases are scheduled. With no further action, tobacco excise rates will remain at current levels. Should this happen, it is unlikely the Smokefree 2025 goal will be achieved.

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<sup>1</sup> *Health Loss in New Zealand: A report from the New Zealand Burden of Diseases, Injuries and Risk Factors Study, 2006–2016*, Ministry of Health, 2013.

<sup>2</sup> *Tobacco Use in New Zealand : Key findings from the 2009 New Zealand Tobacco Use Survey*, Ministry of Health, 2010.

<sup>3</sup> *Government Response to the Report of the Maori Affairs Committee on its Inquiry into the tobacco industry in Aotearoa and the consequences of tobacco use for Maori (Interim Response)*, Parliament, 2011.

<sup>4</sup> *Annual Update of Key Results 2014/15: New Zealand Health Survey*, Ministry of Health, 2015.

<sup>5</sup> *ibid.*

<sup>6</sup> *Government Response to the Report of the Māori Affairs Committee on its Inquiry into the tobacco industry in Aotearoa and the consequences of tobacco use for Māori*, Parliament, 2011.

<sup>7</sup> See, for example, 'What does Smokefree New Zealand 2025 mean?', [smokefree.org.nz/smokefree-2025](http://smokefree.org.nz/smokefree-2025)

<sup>8</sup> See, for example, 'Tobacco Control Program', [worldbank.org/en/topic/health/brief/tobacco](http://worldbank.org/en/topic/health/brief/tobacco)

In 2012, the Finance and Expenditure Committee recommended the Government implement further increases in tobacco excise after 2016 if achievement of the Smokefree 2025 goal is in doubt.<sup>9</sup>

In 2014, the Health Committee recommended the Government continue with its planned increases in tobacco excise up to 2016, and consider increasing the scale of increases. The Government accepted this recommendation and said it may consider further increases.<sup>10</sup>

Since 2010, increases in tobacco excise have been accompanied by the exclusion of tobacco from CPI adjustments to the following welfare payments:

- Jobseeker Support
- Youth Payment and Young Parent Payment
- Supported Living Payment
- Sole Parent Support
- Orphans and Unsupported Childs Benefit
- Foster Care Allowances
- Working for Families Family Tax Credit
- New Zealand Superannuation
- Veterans' Pension
- Student Allowances

This was done so that increases in tobacco excise, and subsequent increases in the price of tobacco products, did not flow through to CPI adjustments to these welfare payments. This reinforces the objective behind increases in tobacco excise: to reduce smoking prevalence by reducing the affordability of tobacco products.

The legislation that provides for these welfare payments to be indexed to CPI-excluding-tobacco is time-limited. As it stands, indexation adjustments from 2018 onwards will be based on CPI-*including*-tobacco. This will incorporate the price effects of any above-CPI increases in tobacco excise from 2017 onwards. The indexation adjustments to these welfare payments would therefore be higher than if they were based on CPI-excluding-tobacco.

## Objectives

This analysis assesses options to reduce smoking prevalence, and help achieve the Government's goal of making New Zealand essentially a 'Smokefree' nation by 2025, by:

- further increasing tobacco excise, and
- continuing to exclude tobacco from CPI adjustments to welfare payments.

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<sup>9</sup> *Customs and Excise (Tobacco Products—Budget Measures) Amendment Bill (22-1)*, Finance and Expenditure Committee, 2012

<sup>10</sup> *Government Response to Report of the Health Committee on Inquiry into improving child health outcomes and preventing child abuse with a focus from preconception until three years of age*, Parliament, 2014

These are not the only policy tools to reduce smoking prevalence. New Zealand has a comprehensive tobacco control programme that is in line with international best practice, as outlined in the World Health Organization's Framework Convention on Tobacco Control. The programme comprises a range of evidence-based measures, including strong legislation, health promotion and mass media campaigns and services to help smokers quit. Raising the price of tobacco through increases to tobacco excise is a central part of the programme but works in synergy with the other measures. The Ministry of Health continues to evaluate best practice evidence and ensure that funded tobacco control interventions are providing value for money and are fit for purpose.

## Options and impact analysis

### Increasing tobacco excise

#### *Options*

Like other excises, tobacco excise is usually increased each year by at least the growth in CPI, in order to maintain its value in real terms. Real terms increases in tobacco excise are typically made by increasing rates by a given number of percentage points above CPI – for example, in recent years tobacco excise has been increased each year by CPI+10%.

Annual increases in tobacco excise are customarily announced in advance and implemented on 1 January each year. On occasion, additional increases have been announced at short notice and implemented on dates other than 1 January, such as on the day of the Budget. The announcement of increases in advance allows planners of smoking cessation campaigns to plan their campaigns to coincide with the increases. However, it also allows tobacco companies to accelerate the clearance of tobacco product past the point of excise before the increase is implemented, so that more product is taxed at the lower, pre-increase rate.

An increase in tobacco excise may be a one-off, or may be part of a series of successive increases. The announcement of a series of successive increases provides more certainty over the direction of future tobacco prices than the announcement of a one-off increase.

The analysis below considers the impact of no further increases in tobacco excise (option 1), as well as three options for implementing four successive annual increases of:

- CPI+10% each year (option 2)
- CPI+12.5% each year (option 3), and
- CPI+15% each year (option 4).

These increases would be announced in advance and implemented from 1 January 2017 onwards.

#### *Impact on smoking prevalence and tobacco expenditure*

Table 1 below shows the estimated impact of the options in terms of:

- smoking prevalence across the population as a whole
- additional weekly expenditure for a half-a-pack-a-day smoker who continues to smoke the same amount, and

- annual savings for an identical smoker who quits.<sup>11</sup>

Table 1	Smoking prevalence		Weekly additional expenditure	Annual saving
	2020	2025	2020	2020
Option 1: no increases	14.4%	13.7%	\$0	\$0
Option 2: CPI+10%	12.7%	12.0%	\$35	\$5,770
Option 3: CPI+12.5%	12.3%	11.7%	\$46	\$6,310
Option 4: CPI+15%	12.0%	11.4%	\$57	\$6,890

The key assumptions made to derive these impacts are:

- smoking prevalence falls by 1% each year with no increase in tobacco excise (this results in a fall from one year to the next of, for example, 14.9% to 14.8%)
- the tobacco price elasticity of daily smoking prevalence is -0.25 (thus, a 10% increase in price leads to a 2.5% decrease in smoking prevalence)
- the final market-weighted price of tobacco products rises by the same percentage as the increase in excise.

Table 1 shows that annual increases of CPI+15% are insufficient to achieve a smoking prevalence of 5% across the population as a whole by 2025. In the absence of other policy changes, increases in tobacco excise significantly higher than CPI+15% would likely be needed to achieve the Smokefree 2025 goal.

#### Impact on revenue

Table 2 below shows the estimated impact of the three options on government revenue.

Table 2	Revenue gain (\$m)				
	2016/17	2017/18	2018/19	2019/20	2020/21
Option 1: no increases	0	0	0	0	0
Option 2: CPI+10%	+5	+70	+139	+211	+280
Option 3: CPI+12.5%	+3	+85	+169	+258	+344
Option 4: CPI+15%	0	+99	+197	+302	+406

The key assumptions made to derive these impacts are:

- price elasticity of demand for tobacco products is -0.5 (thus, a 10% increase in price leads to a 5% decrease in consumption)<sup>12</sup>
- the majority of revenue is collected between July and December each year (hence why the majority of revenue from a 1 January 2017 increase falls into 2017/18)

<sup>11</sup> Smoking prevalence estimates for 2025 assume no further excise increases after 2020.

<sup>12</sup> Treasury uses an elasticity of -0.5, following reviews of a number of New Zealand and overseas studies that estimate the effect of tobacco price increases on tobacco consumption. See, for example, *Tobacco taxes as a tobacco control strategy*, Chaloupka et al, 2011

- tobacco companies accelerate the clearance of a few months' worth of tobacco product past the point of excise before an increase occurs on 1 January each year, and
- there is no impact on GST revenue, as increased spending on tobacco products is offset by decreased consumption of other items subject to GST.

### *Impact on equity*

Tobacco excise is a regressive tax, as smoking prevalence is generally higher among low-income groups. However, increases in tobacco excise may make it less regressive. This is because low-income smokers are likely to be more price-sensitive than high-income smokers. They are therefore likely to reduce their consumption of tobacco by a greater amount in response to an increase in tobacco excise. This would result in a greater proportion of the incidence of excise falling onto high-income groups, making the tax less regressive. Modelling results from studies in the USA and Turkey provide some evidence of this effect.<sup>13</sup>

Smokers who quit in response to an increase in tobacco excise gain large financial benefits as a result of the savings they make from no longer purchasing tobacco products. Table 1 shows that those who quit would save nearly \$6,000 a year by 2020 under option 1. Potential smokers who are deterred from smoking as a result of an increase in tobacco excise would avoid costs of the same magnitude. The additional savings/avoided costs from quitting/not taking up smoking would be of most benefit to low-income groups.

Smokers who do not reduce their consumption following an increase in tobacco excise may respond by borrowing more, saving less, switching to cheaper tobacco brands or substituting consumption away from other goods. The additional costs of continuing to smoke would weigh heaviest on low-income groups.

### *Impact on growth*

Non-smokers and ex-smokers have longer working lives than smokers.<sup>14</sup> They are also more productive, largely due to reduced absenteeism.<sup>15</sup> Increases in tobacco excise may therefore help raise lifetime earnings.

### *Impact on efficiency*

One of the main rationales for taxing tobacco is to address the external costs of smoking, such as the public health costs of treating smoking-related illnesses and the impacts of passive smoking. As they do not bear the external costs, smokers may consume more than is desirable from society's point of view. Taxes on tobacco can help shift consumption towards the socially desirable level. At this level, revenue from taxes on tobacco will broadly match the external costs of smoking. If revenue is below external costs, tax increases can be justified. If revenue exceeds costs, tax decreases can be justified.

It is difficult to define and measure the external costs of smoking, and therefore to know the optimal level of revenue. However, a 2007 study commissioned by tobacco control groups said "[i]t appears certain that smokers contribute considerably more in taxes than the net

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<sup>13</sup> *Response by Adults to Increases in Cigarette Prices by Sociodemographic Characteristics*, Farrelly et al, 2001; *Who pays the most cigarette tax in Turkey*, Önder & Yürekli, 2014.

<sup>14</sup> *The Effects of Increasing Tobacco Taxation: A Cost Benefit and Public Finances Analysis*, Reed, 2010

<sup>15</sup> *ibid.*

‘economic costs’ to the rest of the community caused by their smoking”.<sup>16</sup> Since then, revenues from taxes on tobacco have increased in real terms. Over the same period, the external costs of smoking are likely to have fallen, as consumption has declined. This suggests the current level of revenue from taxes on tobacco may be higher than external costs, and therefore that, at least from an external costs perspective, no further increases in tobacco excise are justified.

*Impact on industry*

Increases in tobacco excise would impose minor compliance costs on tobacco manufacturers and retailers, due to the need to familiarise themselves with the increases and make changes to price notices. Existing systems for excise compliance mean there is little if any other compliance cost to industry – though there may be increased security risks for tobacco retailers due to an increase in the attractiveness of tobacco products to criminals.

All parties in the tobacco supply chain would experience a fall in sales if increases in tobacco excise have their intended effect of reducing demand for tobacco.

*Impact on illicit trade*

Increases in tobacco excise would be likely to increase incentives for trade in illicit tobacco products. However, New Zealand’s geographic isolation, border control systems and climate mean the risks of large-scale smuggling and illicit domestic manufacturing are relatively low.

**Excluding tobacco from CPI adjustments to welfare payments**

The analysis below considers the impact of continuing to exclude tobacco from CPI adjustments to welfare payments (option 5).

*Impact on revenue*

Table 3 below provides an estimate of the difference between the fiscal costs of adjusting welfare payments by CPI-including-tobacco and CPI-excluding tobacco, based on four successive annual increases in tobacco excise of CPI+10% from January 2017 onwards (option 2 above).

Table 3	\$m				
	2015/16	2016/17	2017/18	2018/19	2019/20
Option 5	0	0	15	78	141

We have taken a conservative view that continuing to adjust payments by CPI-excluding tobacco would not count as a saving against the government’s operating allowance. Instead, it would count as the avoidance of a cost – that of higher welfare payments caused by an increase in tobacco prices following an increase in tobacco excise.

The key assumptions made to derive these impacts are:

- the weight of the cigarettes and subgroup in the CPI is 2.3%

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<sup>16</sup> Report on Tobacco Taxation in New Zealand Volume 1 Main Report, O’Dea and Thomson, 2007

- the difference between CPI-excluding-tobacco and CPI-including-tobacco is 0.27 percentage points.

### *Other impacts*

Continuing to exclude tobacco from CPI adjustments to welfare payments is likely to reduce smoking prevalence, though the impact may be marginal. It would mean that welfare payments would not be as high as they otherwise would be. Non-smokers would not be compensated for the increase in the price of a product they do not consume. Smokers also would not be compensated, which is the policy intention.

## Consultation

The Ministry of Health and New Zealand Customs Service were consulted in preparing this Regulatory Impact Statement. No further consultation was undertaken due to Budget sensitivity.

## Conclusions

Table 4 below summarises the options analysed above.

<i>Table 4</i>	<b>Impact</b>		
	<i>Smoking prevalence in 2025</i>	<i>Annual saving to quitter in 2020</i>	<i>Revenue from 2016/17 to 2020/21</i>
Option 1: no increases	Reduce to 13.7%	\$0	\$0
Option 2: CPI+10%	Reduce to 12%	\$5,770	+\$705m
Option 3: CPI+12.5%	Reduce to 11.7%	\$6,310	+\$859m
Option 4: CPI+15%	Reduce to 11.4%	\$6,890	+\$1,004m
Option 5: CPI-ex. tobacco	Small reduction	n/a	Small avoided cost

Treasury recommends four further annual increases of CPI+10% from 1 January 2017 (option 2). While increases of this magnitude would not, on their own, achieve the Smokefree 2025 goal, we believe they strike an appropriate balance between the drive to make further reductions in smoking with the recognition that ultimately some smokers will not cut back.

In addition, Treasury recommends extending the indexation of welfare payments by CPI-excluding-tobacco (option 5). This would bolster the public health rationale for increases in tobacco excise.

## Implementation plan

Increasing tobacco excise rates would require amendments to the Customs and Excise Act 1996. Customs would need to update its computer systems and brief its staff prior to an increase.

Extending the indexation of welfare payments by CPI-excluding-tobacco would require amendments to the following:

- Social Security Act 1964
- Children, Young Persons, and Their Families Act 1989
- Income Tax Act 2007
- New Zealand Superannuation and Retirement Income Act 2001
- Veterans Support Act 2014
- Student Allowance Regulations 1998

## Monitoring, evaluation and review

The New Zealand Health Survey will continue to track smoking prevalence on an annual basis. The results would be monitored to assess whether smoking prevalence is falling in line with expectations following increases in excise.

Tobacco consumption (the amount smoked per capita) is also monitored through annual tobacco returns that are legally required to be submitted by tobacco manufacturers and importers (who sell in New Zealand) to the Ministry of Health. The tobacco returns enable the Ministry of Health to analyse the total amount of tobacco released for sale in New Zealand and compare tobacco sales to previous years.