

# The Treasury

## Budget 2016 Information Release

### Release Document July 2016

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[40]	Not in scope	

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**Budget Report:** Increasing tobacco excise

<b>Date:</b>	5 February 2016	<b>Report No:</b>	T2016/14
		<b>File Number:</b>	SH-13

**Action Sought**

	<b>Action Sought</b>	<b>Deadline</b>
Minister of Finance (Hon Bill English)	<b>Agree</b> to the recommendations	Tuesday 9 February 2014
Associate Minister of Finance (Hon Steven Joyce)	<b>Agree</b> to the recommendations	Tuesday 9 February 2014
Associate Minister of Finance (Hon Paula Bennett)	<b>Agree</b> to the recommendations	Tuesday 9 February 2014

**Contact for Telephone Discussion (if required)**

<b>Name</b>	<b>Position</b>	<b>Telephone</b>		<b>1st Contact</b>
Matt Cowan	Senior Analyst, Tax Strategy	04 917 6137 (wk)	[23] (mob)	✓
Suzy Morrissey	Team Leader, Tax Strategy	04 917 6292 (wk)	[23] (mob)	

**Actions for the Minister of Finance's Office Staff**

**Return** the signed report to Treasury.

**Refer** a copy of the report to Minister of Health Hon Dr Jonathan Coleman, Associate Minister of Health Hon Peseta Sam Lotu-liga and Minister of Customs Hon Nicky Wagner.

Note any feedback on the quality of the report

**Enclosure:** No

# Budget Report: Increasing tobacco excise

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## Executive Summary

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The Ministry of Health is proposing that Budget announce increases in tobacco excise to drive further reductions in smoking. This report provides Treasury advice on this issue.

The Government has adopted the *Smokefree* goal of reducing smoking prevalence to minimal levels by 2025. As part of its strategy to reduce smoking, the Government increased tobacco excise by CPI+10% each January from 2010 to 2016. No further increases are scheduled. With no further action, tobacco excise rates will remain at current levels. Should this happen, it is almost certain the *Smokefree* goal will be missed.

Increasing tobacco excise by CPI+10% for a further four years from 1 January 2017 onwards would raise the following:

	Revenue gain (\$m)				
	2016/17	2017/18	2018/19	2019/20	2020/21
CPI+10% each Jan	+5	+70	+139	+211	+280

An additional Budget night increase could be made in combination with annual increases. However, even a Budget night increase of CPI+10% followed by four annual increases of CPI+15% would be insufficient to achieve the *Smokefree* goal. Other policies would need to be pursued in tandem.

Although tobacco excise is regressive, *increases* in tobacco excise may be progressive. This is because low-income groups are more price-sensitive than high-income groups, so they reduce their consumption by a greater amount following an increase in price. Low-income smokers who cut back in response to an increase in excise may see large financial benefits as a result of the savings they make from purchasing fewer tobacco products. However, some low-income smokers will not cut back, and may respond by substituting consumption away from other goods and towards tobacco.

Increases in tobacco excise rates require amendments to the Customs and Excise Act 1996. A Budget night increase would require Budget night legislation. Annual increases could go through the normal Parliamentary procedure.

Treasury recommends four further annual increases of CPI+10% from 1 January 2017, with no additional increase on Budget night. While increases of this magnitude would not, on their own, achieve the *Smokefree* goal, we believe they balance the need to drive further reductions in smoking with the recognition that ultimately some smokers will not cut back.

In addition to increasing rates, supplementary options include [33] and extending the current practice of indexing welfare payments by a measure of CPI that excludes the price of tobacco products.

## Recommended Action

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We recommend that you:

- a **note** the content of this report
- b **note** Treasury's preference is for:
- four annual increases of CPI+10% from 1 January 2017
  - no additional increase on Budget night
  - [33]
  - of welfare payments by CPI-excluding-tobacco
- c **note** our understanding is that the Ministry of Health's preference is for:
- four annual increases of CPI+12.5% from 1 January 2017, and
  - an additional increase on Budget night
- d **agree** to discuss this issue at the Fiscal Issues meeting on 10 February 2016, and

*Agree/disagree.*  
Hon Bill English

*Agree/disagree.*  
Hon Steven Joyce

*Agree/disagree.*  
Hon Paula Bennett

- e **refer** a copy of this report to:
- Minister of Health Hon Dr Jonathan Coleman
  - Associate Minister of Health Hon Peseta Sam Lotu-liga, and
  - Minister of Customs Hon Nicky Wagner.

*Referred/not referred.*  
Minister of Finance

Matt Cowan  
**Senior Analyst, Tax Strategy**

Hon Bill English  
**Minister of Finance**

Hon Steven Joyce  
**Associate Minister of  
Finance**

Hon Paula Bennett  
**Associate Minister of  
Finance**

## Budget Report: Increasing tobacco excise

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### Purpose of Report

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1. The Ministry of Health is proposing that Budget announce increases in tobacco excise to drive further reductions in smoking. This report provides Treasury advice on this issue.

### Context

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2. 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 New Zealanders dying each year from smoking or exposure to second-hand smoke. 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.
3. 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>2</sup> Prevalence is higher among Māori and Pasifika than the population as a whole, at 35.5% and 22.4% respectively in 2014/15.
4. The Government has 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”. Although the Government has not defined “minimal levels”, stakeholders have interpreted it to mean a smoking prevalence of 5% within all demographic groups.
5. 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
  - increasing fines for the sale of tobacco products to minors, and
  - increasing tobacco excise by CPI+10% each January since 2010.

### Issue

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6. The recent series of increases in tobacco excise has come to an end, with the final increase taking place on 1 January 2016. No further increases are scheduled. With no further action, tobacco excise rates will remain at current levels. Should this happen, it is almost certain the *Smokefree 2025* goal will be missed.
7. 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.

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1 Health losses are defined here in terms of years of life lost due to early death or time spent in less than full health.

2 Smoking prevalence is defined here 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.

8. 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.
9. Further increases are supported by a broad range of health organisations and professionals. For example, ASPIRE 2025, a coalition of tobacco research groups, has called for increases of 20% for at least four years. Conversely, the Taxpayers' Union, a tax lobby group, has called for a moratorium on further increases pending reviews of the impact of previous increases on the black market, and of the benefits of lifting the ban on the sale of e-cigarettes.

## Background to tobacco excise

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10. Tobacco excise has three rates:
  - \$605.90 per 1,000 cigarettes, for standard factory-made cigarettes
  - \$863.40 per kilogramme of tobacco, for loose tobacco (this rate is equivalent to the rate for standard factory-made cigarettes on a \$ per cigarette basis), and
  - \$757.35 per kilogramme of tobacco, for other tobacco products (e.g. cigars).
11. GST is charged on the excise-inclusive price of tobacco products.
12. The highest selling budget brand of cigarettes currently sells packs of twenty for \$21.60. Of this, tobacco excise accounts for \$12.12 (56%) and GST for \$2.81 (13%).
13. Tobacco excise currently raises \$1.5 billion per year (2% of total tax revenue). With CPI-only increases, revenue from tobacco excise is forecast to fall in nominal terms from 2017 onwards as consumption of tobacco products declines.

## Rationale for tobacco excise

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14. There are two main rationales for taxes on smoking such as tobacco excise:
  - Addressing the external costs of smoking, and
  - Discouraging smoking for public health reasons.

### **Addressing the external costs of smoking**

15. The costs of smoking can be categorised into two groups: those borne by smokers themselves ("internal costs"), such as the costs of purchasing cigarettes and the negative health effects suffered by the individual; and those borne by others ("external costs"), 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.
16. Taxes on smoking can help shift consumption towards the socially desirable level. At this level, revenue from taxes on smoking 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.

17. 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 ‘economic costs’ to the rest of the community caused by their smoking”.<sup>3</sup> Since then, revenues from taxes on smoking 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 smoking may be higher than external costs, and therefore that, at least from an external costs perspective, no further increases in tobacco excise are justified.

### **Discouraging smoking for public health reasons**

18. Smoking is an addictive, destructive and harmful habit. Reduced levels of smoking can bring significant benefits in terms of improved health, increased life expectancy, improved quality of life and financial savings.
19. Taxes on smoking can help reduce levels of smoking by discouraging consumption. Raising the price of tobacco through excise increases is internationally recognised as one of the most effective ways to reduce smoking prevalence – in particular, by deterring uptake by potential smokers. Evidence suggests that a 10% increase in the price of tobacco products will, in general, reduce demand by around 5% in the long term. Young people and low-income groups will generally reduce smoking in response to price changes by more than older people or high-income groups.
20. There is no ‘optimal’ level of tax on smoking from a public health perspective. However, key considerations include: the extent to which smoking should be discouraged through tax increases as opposed to other policy tools; the extent to which higher levels of tax might push smokers towards illicit tobacco products; and the fact that some people will not respond to tax increases and will continue to smoke.

### **Options**

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21. This section explores some of the options for increasing tobacco excise through annual increases and an additional increase on Budget night. Successive annual increases send a repeated set of messages to smokers. Also, announcing the dates of these increases in advance means that smoking cessation campaigns can be planned to coincide with the increases. An additional Budget night increase could be made in combination with annual increases to raise tobacco prices further.

### **Annual increases**

22. Table 1 shows indicative impacts of four successive annual increases from 1 January 2017 onwards of:
- CPI+10%
  - CPI+12.5%, and
  - CPI+15%.
23. These impacts are shown in terms of:
- smoking prevalence across the population as a whole

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3 *Report on Tobacco Taxation in New Zealand Volume 1 Main Report*, O’Dea and Thomson, November 2007

- 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>4</sup>

<i>Table 1</i>	<b>Smoking prevalence</b>		<b>Weekly additional expenditure</b>	<b>Annual saving</b>
	2020	2025	2020	2020
CPI+10% each Jan	12.7%	12.0%	\$35	\$5,770
CPI+12.5% each Jan	12.3%	11.7%	\$46	\$6,310
CPI+15% each Jan	12.0%	11.4%	\$57	\$6,890

24. As the table shows, even annual increases of CPI+15% are insufficient to achieve a smoking prevalence of 5% across the population as a whole.
25. Table 2 shows the revenue gain for the above increases.

<i>Table 2</i>	<b>Revenue gain (\$m)</b>				
	2016/17	2017/18	2018/19	2019/20	2020/21
CPI+10% each Jan	+5	+70	+139	+211	+280
CPI+12.5% each Jan	+3	+85	+169	+258	+344
CPI+15% each Jan	0	+99	+197	+302	+406

26. The modelling assumes 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. The modelling also assumes that tobacco companies shift a few months' worth of product past the point of taxation before an increase occurs in January. As a result, these products are taxed at the pre-increase rate instead of the post-increase rate. The larger the increase, the greater the incentive to shift – hence why the revenue gain in 2016/17 is lower for a CPI+15% than for a CPI+10% increase.

### **Additional Budget night increase**

27. Table 3 shows indicative impacts of Budget night increases of CPI+5% and CPI+10% combined with annual increases of CPI+10% and CPI+15%.

<i>Table 3</i>	<b>Smoking prevalence</b>		<b>Weekly additional expenditure</b>	<b>Annual saving</b>
	2020	2025	2020	2020
CPI+5% Budget 16 CPI+10% each Jan	12.5%	11.9%	\$41	\$6,060
CPI+5% Budget 16 CPI+15% each Jan	11.9%	11.3%	\$63	\$7,240
CPI+10% Budget 16 CPI+10% each Jan	12.3%	11.7%	\$46	\$6,350
CPI+10% Budget 16 CPI+15% each Jan	11.7%	11.1%	\$70	\$7,580

<sup>4</sup> Smoking prevalence estimates for 2025 assume no further excise increases after 2020.

- 28. These options entail increases of up to CPI+25% within the space of twelve months (CPI+10% at Budget 2016 plus CPI+15% in January 2017). Although large, such increases would not be unprecedented – excise on some tobacco products was increased by 100% in the 1958 Budget.
- 29. However, even the increases in table 3 would be insufficient to achieve the *Smokefree 2025* goal. Other policies would need to be pursued in tandem.
- 30. Table 4 shows the revenue gain for these increases.

Table 4	Revenue gain (\$m)					
	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
CPI+5% Budget 16 CPI+10% each Jan	+197	-171	+107	+177	+250	+321
CPI+5% Budget 16 CPI+15% each Jan	+197	-176	+135	+236	+342	+449
CPI+10% Budget 16 CPI+10% each Jan	+194	-150	+138	+210	+284	+357
CPI+10% Budget 16 CPI+15% each Jan	+194	-156	+167	+269	+378	+487

- 31. The modelling assumes that tobacco companies find out about Budget night increases in advance, and shift a few months’ worth of product past the point of taxation before the increase occurs. As a result, these products are all taxed in 2015/16 instead of some being taxed in 2015/16 and some in 2016/17. This is the reason for the revenue loss in 2016/17.

**Other impacts**

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**Equity**

- 32. Tobacco excise is a regressive tax, as levels of smoking prevalence are highest among low-income groups. However, *increases* in tobacco excise may be progressive. This is because low-income groups are more price-sensitive than high-income groups. For a given increase in price, low-income groups reduce their consumption by a greater amount. This shifts a greater proportion of the tax incidence onto high-income groups.
- 33. Low-income smokers who quit, and potential smokers who are deterred from smoking, would see large financial benefits as a result of the savings they make from not purchasing tobacco products. Currently, those who quit save around \$4,000 a year on average.<sup>5</sup>
- 34. Nevertheless, some low-income smokers will not reduce their consumption following an increase in excise. These smokers may respond by switching to cheaper tobacco brands or substituting consumption away from other goods and towards tobacco.

**Growth**

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

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5 Based on 11 cigarettes per day at \$1 per stick.

## Risks

36. Increasing tobacco excise is 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. Nevertheless, there may be increased security risks for tobacco retailers due to an increase in the attractiveness of tobacco products to criminals.

## Supplementary options

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37. This section explores some minor options that could be implemented alongside those set out above.

[33]

## Indexation of welfare payments

42. In recent years, benefits, pensions and student allowances have been indexed by a measure of CPI that excludes the price of tobacco products. This ensures that increases in tobacco excise do not flow through to CPI increases in these payments. This provision is time-limited and is due to expire in 2018, but it could be extended to reflect increases in tobacco excise from 2018 onwards.

## Implementation

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### Legislation

43. Increases in tobacco excise rates would require amendments to the Customs and Excise Act 1996. A Budget night increase would require Budget night legislation. Annual increases could go through the normal Parliamentary procedure. These increases would be legislated one year at a time, based on the relevant CPI [33] update published each year.

44. Extending the indexation of welfare payments by CPI-excluding-tobacco would require amendments to the New Zealand Superannuation and Retirement Income Act 2001 and the Social Security Act 1964.

### Administration

45. Prior to any increase in tobacco excise, Customs would need to update its computer systems and brief its staff. A Budget night increase would require a balance between:
- the need to make these changes in sufficient time before the increase to ensure a smooth implementation, and
  - the need to restrict prior knowledge of the increase to a limited pool of people for Budget security reasons.
46. Annual increases would have no material implementation consequences for Customs, although any increase in low-level smuggling could present resource implications.

### Treasury comment

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47. Treasury recommends four further annual increases of CPI+10% from 1 January 2017, with no additional increase on Budget night – i.e., an extension of the increases seen in recent years. While increases of this magnitude would not, on their own, achieve the *Smokefree 2025* goal, we believe they strike an appropriate balance between the need to drive further reductions in smoking with the recognition that ultimately some smokers will not cut back.
48. In addition, Treasury recommends [33] and extending the indexation of welfare payments by CPI-excluding-tobacco. These changes would bolster the public health rationale for increases in tobacco excise.
49. Our understanding is that the Ministry of Health's preference is for four annual increases of CPI+12.5%, and an additional increase on Budget night.