

Regulatory Impact Statement

Customs and Excise Act Review: Changes to Tobacco Excise

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by New Zealand Customs Service (Customs). It provides an analysis of options to reduce the domestic illicit supply of roll-your-own tobacco. It does not consider the effectiveness of excise as a demand management tool to reduce smoking. That question is outside the scope of the Customs and Excise Act Review.

Our analysis assumes that:

- as the legal price of tobacco rises, smokers who are addicted will continue smoking and some will seek cheaper, illicit tobacco.
- locally grown roll-your-own tobacco will continue to be a source of illicit tobacco if no action is taken;
- legislative changes will only be complied with if they are widely perceived to be reasonable.

There are no reliable estimates of home-grown tobacco in New Zealand. In lieu, this regulatory impact statement uses rough estimates of the size of illicit markets published in "Out of the Shadows" a 2010 report by Ernst and Young and commissioned by British American Tobacco. Ernst and Young's report was criticised by NZIER in its 2010 "Review of Ernst and Young's Report on New Zealand's Illicit Tobacco Market"; the NZIER report was commissioned by ASH New Zealand.

However, NZIER considered Ernst and Young's estimates of illicit unreported tobacco consumption to be based on sensible consideration of sources although assumptions were not fully identified and there was no sensitivity analysis. NZIER also agreed that some price-driven switching between legal and illicit supplies of roll-your-own tobacco was likely.

As the assumptions are reasonable and the costs of the proposals minimal, decision-makers should be able to rely on this analysis.

Signed by Michael Papesch on 15 September 2015

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15 September 2015

Executive summary

1. The illicit supply of locally grown, roll-your-own tobacco is not currently a major problem in New Zealand. It is estimated that 8% of such tobacco consumed is illicitly supplied¹. However, the demand for illicit tobacco can be expected to increase as levels of excise continue to rise. The illicit supply of tobacco reduces Crown revenue and undermines the Government's policy of reducing smoking through increased prices.
2. The main risks are from:
 - the abuse of the personal allowance whereby, in certain circumstances, people can grow and manufacture up to 15kg tobacco a year for their own use. This is much higher than the average consumption of roll-your-own smokers with the risk that the residual tobacco could be illicitly supplied to other smokers; and
 - the definition of manufacture which allows the unregulated sale of excise-free tobacco which is cured and dried but not cut.
3. It is proposed to reduce these risks by reducing the personal use allowance to 5 kg per year and by including curing and drying in the definition of manufacture.
4. These proposals will not affect most people who legitimately grow and manufacture tobacco for their own use. The proposed allowance of 5kg a year equates to 19 - 34 cigarettes a day. A smoker who consumes more than 30 cigarettes a day is considered to be a heavy smoker. The average roll-your-own smoker consumes 14.
5. As the amount of tobacco in a roll-your-own cigarette varies, it is not possible to set a limit based on the number of cigarettes or to directly link the weight limit for the personal use allowance (for roll-your-own tobacco) to a number of cigarettes.

Status quo and problem definition

The tobacco excise regime

6. The New Zealand market for tobacco products is supplied by three major companies and a fourth very much smaller one. Only one of the major companies manufactures tobacco products in New Zealand, using imported tobacco.

¹ Ernst and Young, (2010). Out of the Shadows, p.1. Other references are also to this report unless otherwise stated.

7. Excise duty is imposed on the manufacture² of tobacco and excise-equivalent duty on imports. The term excise is used here for both excise and excise-equivalent duty.
8. Excise is applied to manufactured tobacco to:
 - lower demand and consequently reduce the resulting personal and social harms; and
 - address the negative financial externalities from smoking, such as costs to the public health system;
 - raise revenue; \$1,506 million of tobacco excise was collected in 2014/15 and the value of tobacco excise is growing:
9. To ensure that excise is paid, the Customs and Excise Act requires:
 - the manufacture of tobacco to occur within a licenced, customs-controlled, manufacturing area (LMA).
 - licensees to keep records of the manufacture, movement, storage and loss of tobacco on which excise has still to be paid and to self-assess due revenue; excise returns and businesses are subject to audit by Customs.
 - payment of excise, through monthly returns, when manufactured tobacco leaves the LMA for the domestic market.
10. The excise regime is aimed at commercial manufacture and import. The Act permits anyone over 18 to grow and manufacture for personal use up to 15kg of tobacco (dried weight) per year. A 2010 report estimated that 5% of the roll-your-own tobacco consumed in New Zealand was home grown³.
11. Growing tobacco is technically not illegal. The tobacco grown cannot be manufactured other than for personal use or by a licensed manufacturer. The latter is unlikely now and in the future as the tobacco companies have advised that New Zealand grown tobacco has historically been of poor quality⁴.

² **manufacture**, in relation to goods specified in the Excise and Excise-equivalent Duties Table, means,—
(a) if the goods are tobacco, the process of cutting, pressing, grinding, crushing, or rubbing raw or leaf tobacco, or otherwise preparing raw or leaf tobacco or manufactured or partially manufactured tobacco, and of making cigarettes whether from duty-paid or from non-duty-paid tobacco, and of putting up for use or consumption scraps, waste, chippings, stems, or deposits of tobacco resulting from processing tobacco;

manufactured tobacco means tobacco that has been manufactured or prepared for smoking or any other purpose

³ P.14.

⁴ It has been suggested by some growers that tobacco could be grown for other purposes such as composting. Tobacco is not an obvious choice of plant for this.

Enforcement in New Zealand

12. Customs monitors the illicit supply of locally grown tobacco in co-operation with the New Zealand Police. Customs also co-operates with the tobacco companies who monitor domestic sales with a view to detecting anomalies and changing patterns in consumption⁵. Customs also uses on intelligence garnered from word-of-mouth, internet sales and information Police receive through their general crime prevention activities. If illicit tobacco is identified, Customs can seize the tobacco and may also prosecute.

Australia

13. New Zealand's regulation of tobacco differs from Australia's. Australia does not have a personal use allowance and tobacco can only be grown under an excise licence. There are currently no such licences and the Australian Tax Office (ATO) website warns that they are rarely granted. It notes that the licence holder would have to be a fit and proper person. Other considerations in granting a licence could include: whether there is a market for the tobacco, an applicant's financial resources, the physical security applying to the premises and the electronic record-keeping system in use. The tobacco could not be moved without ATO permission and tax officers would have a right of access to the premises at all times.

The problem

14. Revenue leakage directly reduces Crown revenue; the excise forgone on 15 kg of roll-your-own tobacco is \$12,951 a year⁶. Illicit supply also reduces Crown revenue by diverting purchase away from excise-paid tobacco. Both revenue leakage and illicit supply undermine the effectiveness of excise in reducing demand for tobacco and thus reducing personal and social harms.
15. The New Zealand tobacco market is supplied by three large companies, and a very much smaller one. Only one of the major companies manufactures in New Zealand using only imported tobacco. As:
 - excise is paid when finished tobacco products cross the border;
 - there are no commercial tobacco farms in New Zealand; and
 - the excise regime strictly controls domestic manufacture;

the likelihood of illicit supply and revenue leakage from the commercial sector is low and can be cost-effectively managed.

⁵ The companies hire investigators and periodically undertake analysis of the illicit market.

⁶ The current rate of excise on roll-your-own tobacco is \$863.40c per kg.

The illicit supply and sale of tobacco in New Zealand

16. A 2010 report estimated that 8% of roll-your-own tobacco consumed in New Zealand was thought to be illicit⁷.
17. The table below indicates the comparative scale of the illicit supply in New Zealand and the revenue forgone in 2009⁸. GST is included as it is also forgone when tobacco is supplied illicitly:

Taxes collected on tobacco	Value \$ million
Tobacco excise and GST collected (GST excl.)	1,300
Excise and GST forgone on illicit roll-your-own tobacco	32-39
Excise and GST forgone on illicitly imported tailor made cigarettes	7-11

18. The illicit supply of tobacco is currently small scale with 81% of people smoking illicit tobacco doing so once a month or less⁹. The majority of users (69%) typically purchase it from friends, family and acquaintances¹⁰. Nonetheless, there are believed to be a small number of syndicates growing large volumes of tobacco¹¹.
19. However, there are factors suggesting that the illicit supply of roll-your-own tobacco could grow¹²:
- Tobacco excise increased 40% between April 2010 and May 2012, followed by increases of over 10% in the last three years. Another increase of over 10% will occur in 2016¹³;
 - consumption of home grown tobacco is driven by the price, as home-grown tobacco is considered poorer quality;
 - unmet demand, 1 in 10 smokers of illicit tobacco surveyed had wanted to obtain illicit tobacco but couldn't;
 - end users and consumers believed, quite strongly, that the volume of illicit tobacco would grow dramatically;
20. There is a risk that a growing market for illicit tobacco will lead to the involvement of organised crime.

⁷ P.15

⁸ Pp1 and 3

⁹ Colmar Brunton Survey cited in NZIER report, p.5.

¹⁰ Colmar Brunton cited in Ernst and Young p28

¹¹ P. 15

¹² Pp28 and 10

¹³ www.beehive.govt.nz/release/tobacco-excise-rise-part-wider-programme

The current legislation facilitates illicit supply

21. The current personal use allowance of 15kg equates to 58-103 cigarettes a day. Someone consuming more than 30 cigarettes a day would be considered a heavy smoker¹⁴. Average consumption by roll-your-own smokers is estimated at about 14 cigarettes a day¹⁵. 15kg is therefore more than a “reasonable amount” for personal use, and a personal use allowance of this amount provides the potential for a minority of non-compliant growers to illicitly supply other smokers.
22. Aggravating the situation, the definition of manufacture allows the sale of cured but not cut tobacco prior to manufacture, including in commercial amounts. Such sales are legal but outside of the excise regime.
23. As the growing and manufacture of tobacco under the personal use allowance is not regulated we cannot estimate the amount of tobacco that could be grown for the illicit market under the cover of the personal use allowance. In any case such a calculation would be misleading as there is no reason to think that most people growing and manufacturing under the personal use allowance are doing so at the maximum quantities permitted, or are supplying the illicit market.

Objectives

24. There are two key objectives:
 - to cost-effectively diminish the illicit supply of tobacco
 - while enabling individuals to grow and manufacture a reasonable amount of tobacco for their personal use
25. Achieving these objectives would:
 - recognise that smoking is not illegal
 - enable Customs to collect all excise due, contributing to Crown revenue and discouraging harmful tobacco smoking
 - avoid normalising non-compliance
 - avoid an opportunity for organised crime.
26. In order for an option to be sustainable it will need to be efficient; with so many growers this will require voluntary compliance by growers and consumers. This in turn will depend on the excise regime being perceived as reasonable and acceptable.

¹⁴ Based on the Ministry of Health’s New Zealand Tobacco Use Survey, smokers are categorised as follows: light smoker 1-15 cigarettes per day, moderate smoker 16 – 30 cigarettes a day, and heavy smoker more than 30 cigarettes a day

27. It follows that the two criteria for judging the options are: efficiency and also effectiveness which is reliant on public acceptance. The options will be successful if over time, the illicit supply of tobacco diminishes and enforcement of tobacco excise does not divert Customs' resources from other government priorities.
28. Consideration of the effectiveness of excise as a demand management tool to reduce smoking is outside the scope of the Customs and Excise Act Review.

Options and impact analysis

29. In addition to the status quo, Customs considered a range of other options to reduce the risk of revenue leakage and growth in illicit supply of tobacco.

Reducing the personal use allowance

30. Reducing the personal use allowance to 5 kg a year would equate to 19 - 34 cigarettes a day, approximating a moderate smoker. This would allow people to legitimately grow and manufacture a reasonable amount of tobacco for their own personal use. This allowance is therefore likely to be viewed as reasonable and be complied with. Voluntary compliance avoids the risk of further developing the illicit market or involving organised crime.
31. This option would however, reduce the extent to which people supplying the illicit market could hide behind the personal use allowance.

Changing the definition of manufacture

32. The current definition of manufacture does not refer to drying and curing. This could potentially undermine the tobacco excise regime and the personal allowance, which is measured in the lesser, dry weight of tobacco.
33. The Ministry of Health advises that people only dry tobacco to smoke it and that the manufacturing process should be defined as beginning with the drying process and as including curing. Curing¹⁶ is a significant step in tobacco processing. Once cured, tobacco can be cut and used in self-rolled cigarettes. The definition also needs to refer to drying as cigars can be produced by drying alone.
34. Including drying and curing in the definition of manufacture means that anyone growing tobacco that is dried or cured would need to be licensed by Customs and pay excise on the tobacco, unless the quantity was small enough to fit within the personal use allowance. This would end unregulated commercial drying and curing, outside of people's personal allowance.

¹⁵ Ministry of Health 2015

¹⁶ Curing of tobacco leaf involves a drying process to control the temperature and moisture content to produce tobacco fit for smoking. It is commonly done by "flue-curing" the leaf in a kiln.

35. This option would not impact people lawfully growing and manufacturing tobacco under the personal use allowance. However, it could assist enforcement activities as it would make it illegal to be in possession of more dried or cured tobacco than equates to the personal allowance. This would close a legislative loop-hole and help stop unlicensed and illegal manufacture for supply.

Licensing tobacco growers

36. One option is to licence all people who grow tobacco for their own use. Licences could be limited to fit and proper people, excluding those whose background suggests they would be more likely to supply the illicit market. This would not be an efficient option, however. Applicants would incur the inconvenience of applying and could possibly face an application fee. Customs would incur the administrative cost of processing licences and checking that applicants were fit and proper. Administering a licensing regime would divert Customs' resources away from other government priorities.
37. There are a multitude of individuals who grow tobacco for their own use. Customs lacks the information or resources to enforce a licensing regime on these growers and would rely heavily on voluntary compliance. This is likely to be low. Individuals growing tobacco for their own use can be expected to consider licensing unreasonable, an intrusion into private life with high compliance costs
38. Licensing private growers could also bring the tobacco excise regime into general disrepute. To the extent the regime is discredited in the eyes of the public, more people may be willing to source tobacco illicitly, normalising non-compliance with the law.

Licensing the growing of tobacco

39. The activity of growing tobacco could be licensed as in Australia. Growers would have to report volumes of tobacco and its movement to Customs, giving Customs control over the tobacco prior to manufacture. This would prevent its supply to other than a LMA.
40. However, so long as New Zealand has a personal use allowance this option would involve either subjecting people growing for personal use to the full excise regime or setting a limit on the amount of tobacco that could be grown without a licence. Either would be problematic:
- Licensing the growing of tobacco for personal use would not only involve licensing the grower but also impose onerous requirements for security, book-keeping and regular submission of information to Customs. This would not be efficient and would bring the regime into disrepute. This option would have the effect of removing the personal use allowance.
 - Theoretically licensing could be required for larger-scale growers only. However, following the Australian model, no licences would be granted to

larger-scale growers as there would be no legal market for the tobacco. There would also be practical problems setting the limit on the amount of tobacco that could be grown without a licence.

Removing the personal use allowance

41. Some countries do not have a personal allowance. Removing the ability for New Zealanders to grow and manufacture enough tobacco for their own use:
- would be contrary to the objective of allowing people to grow and manufacture a reasonable amount of tobacco for their own use
 - is likely to be seen as unreasonable by individual growers and a portion of the public, bringing the tobacco excise regime into disrepute and
 - some growing would continue illicitly, normalising non-compliance.

Reducing the personal use allowance

42. Reducing the personal allowance to 5 kg a year would equate to 19 - 34 cigarettes a day, approximating a moderate smoker. This would allow people to legitimately grow and manufacture a reasonable amount of tobacco for their own use. It would reduce the situation where people can legally grow and manufacture more than they use, with the intention of using the surplus for illicit supply.
43. As this option provides for reasonable personal use, it is likely to be complied with. Voluntary compliance avoids the risk of further developing the illicit market or involving organised crime.

Comparison of options

44. The table below summarises the analysis of options:

Key: ✓✓ meets the criterion, ✓x partially meets the criterion, xx does not meet the criterion

	Effectiveness and public acceptance	Efficiency
Status quo	xx Only 8% of the roll-your-own market is thought to be supplied illicitly but this percentage could increase in response to rises in excise.	✓✓ The personal allowance enables people to supply their own needs without being subject to an excise regime, reducing cost for the consumer and Customs.
5 kg personal allowance	✓✓ A 5kg personal allowance would enable moderate smokers to grow a reasonable amount of tobacco for their own use. They could no longer legally grow more than they need with the intent of illicit supply	✓✓ The personal allowance enables people to supply their own needs without being subject to an excise regime, reducing cost for the consumer and Customs.

Licence all growers	xx In theory this option could exclude people more likely to supply the illicit market from legally growing tobacco but voluntary compliance could be low..	xx Applying a licensing regime to a multitude of small scale growers would be costly for them and Customs.
Licensing the growing of tobacco	xx This option would allow Customs to control all growing of tobacco, theoretically preventing illicit supply... Compliance costs mean that this option would effectively end the personal use allowance	xx Applying an excise regime to a multitude of small scale growers would be costly
No personal allowance	xx This option would make manufacture outside of customs-controlled LMA illegal. It would also stop the growing and manufacturing of tobacco for personal use.	xx Actively preventing individuals from growing tobacco for their own use would be extremely costly.
Amend definition of manufacture	✓✓ This option would help enforcement as people would have no legal right to hold more dried or cured tobacco than provided for in the personal use allowance.	✓✓ This option would not incur additional enforcement costs.

Consultation

45. A Discussion Paper on the Review of the Customs and Excise Act was open for submissions from March to May 2015. Three submissions were received from the major companies involved in import and manufacture. Officials also met with them. No submissions were received from people growing their own tobacco for personal use.
46. One of the major companies supported the status quo, another sought the removal of the personal use allowance and the licensing of commercial growing of tobacco. In lieu of such licensing; that submission supported the expansion of the definition of manufacture.
47. Customs also established a Senior Officials Advisory Group which met regularly during the review and consulted on the issues and recommendations in this paper.
48. The Ministry of Health support the proposals to reduce the personal allowance and expand the definition of "manufacture". Inland Revenue was also consulted.

Conclusions and recommendations

49. Reducing the the personal use allowance and including drying and curing tobacco in the definition of manufacture would not stop the illicit supply of locally grown roll-your-own-tobacco. However, they would assist in enforcement by making it more transparent when people are illicitly growing or manufacturing tobacco for supply.

These options would not prevent people from growing and manufacturing a reasonable amount of tobacco for their own personal use.

50. It would not be effective or sustainable to licence the growers, or growing, of tobacco nor to completely remove the personal exemption. Neither option would have sufficient public acceptance to be viable.

Implementation plan

51. Both proposals will require legislative change. A Customs Bill is on the Legislation Programme to give effect to the Review of the Customs and Excise Act.
52. If these proposals are accepted Customs will directly notify known growers and publicise the changes widely.
53. The proposals have been designed to minimise compliance costs and encourage voluntary compliance, thereby minimising enforcement requirements.

Monitoring, evaluation and review

54. Customs monitors illicit tobacco in co-operation with the New Zealand Police and the tobacco companies. The Ministry of Health's Smoke-free Enforcement Officers would also report any cases of the sale of unlabelled (and therefore locally grown) tobacco to Customs. Customs will evaluate the effectiveness of the lowered personal use allowance and expanded definition of manufacture against changes in the volume of illicit supply of tobacco.

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