

# Regulatory Impact Statement

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## Excise on Tobacco: Proposed Changes

### EXECUTIVE SUMMARY

Due to changes in the amount of tobacco in manufactured cigarettes, loose tobacco (roll-your-own) is effectively taxed 14 percent lower than manufactured tobacco products. This has resulted in an unintended price difference between the two products. There is no policy rationale for the difference, which has resulted in an increase in the proportion of smokers who use loose tobacco. Tax on the two types of tobacco was last equalised in 1995.

In addition, the decline in tobacco consumption has stalled and smoking prevalence is declining slowly. The current tobacco control programme of regulation, health education, cessation and taxation is holding rates steady, but is not achieving the declines necessary for sustainable health gains and reductions in tobacco-related costs to society and the economy. Evidence shows that increasing the price of tobacco products is the single most effective means of reducing smoking prevalence and tobacco consumption, and averting tobacco related deaths and illnesses.

The policies proposed below address both issues by equalising the taxation of loose and manufactured tobacco products, and then in addition, increasing the price of *all* tobacco products through an increase in excise (the first since 2000). The policies will impact on Maori, Pacific and low income groups as the impact is regressive; however these groups are the most price sensitive with regard to tobacco and have the most potential to benefit in terms of health and financial gains associated with reducing or quitting smoking. Price increases are also proven to be effective in preventing uptake of smoking by young people.

### ADEQUACY STATEMENT

Treasury's Regulatory Impact Analysis Team has reviewed this Regulatory Impact Statement and considers that the level of analysis presented is not commensurate with the significance of the proposals, which represent a significant increase of 33 per cent on manufactured cigarettes and 51 per cent on loose tobacco as a proportion of the price.

Information gaps include:

- The problem of equalisation is based on an assumed consumer switch from manufactured to loose tobacco due to an excise differential arising from changes to tobacco content in manufactured cigarettes. As this change does not trickle through in observed prices, it is not clear consumers are aware of the change in tobacco content (and be a reason for any behavioural changes) or that consumers readily switch between the two types of tobacco products;
- On equalisation, no alternative options have been considered. For example, the excise could be changed to directly link to tobacco content instead of product packaging;
- The problem of setting the rate of the excise, it is not clear that the rate will be set at the level that achieves the highest net benefit to society;

- Alternative options to using excise have not been subjected to an appraisal. Other options may include: utilise levers within the existing tobacco control programme (including cessation services, education and smoking prohibitions); other regulatory options; other tax levers; or commercialising less harmful substitutes (e.g., electronic cigarettes, chewing tobacco and nicotine patches); and
- Compliance costs on manufacturers of tobacco products have not been quantified by magnitude or monetised.”

## **STATUS QUO AND PROBLEM**

### ***Status quo***

The Government currently uses four primary approaches to reduce tobacco-related harm:

- health education services, including media campaigns;
- cessation services such as subsidised nicotine replacement and cessation counselling and support;
- regulatory measures, for example banning sales of tobacco to minors and banning smoking in bars and pubs; and
- taxation, including CPI adjustments and periodic increases to raise the price of tobacco.

Approximately 70 percent of the total cost of tobacco products is tax levied by Government, resulting in current revenue of \$1125 million per annum (GST inclusive), about 30 percent of which comes from sales of loose (roll your own) tobacco.

### ***The problem***

At present, about 21 percent of New Zealanders over 15 years of age are smokers. Tobacco use results in between 4,500 and 5,000 deaths a year, and is the single largest cause or preventable death and chronic illness in this country. The lifespan of those smokers who die early from smoking is, on average, reduced by 15 years. Smoking prevalence and consumption is higher among Maori, young people and people with lower socio-economic status. Those communities bear a disproportionate burden of smoking-related illness and death.

The social costs of smoking have been estimated at 62,800 life years lost to tobacco-related premature deaths, and 19,000 quality adjusted life-years lost to tobacco-related illness<sup>1</sup>. A 2007 estimate put the cost of smoking to the health system at \$300 to \$350 million per annum; however current work within the Ministry of Health suggests that figure may be as high as \$1 to \$1.6 billion per annum<sup>2</sup>.

This proposal deals with two specific aspects of the problem of tobacco control in New Zealand:

- An artificial distinction between the price of loose and manufactured tobacco products; and
- A plateau in the reduction of tobacco consumption and a slow decline in smoking prevalence

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<sup>1</sup> O'Dea D, Thomson G (2007) *Tobacco Taxation in New Zealand*.  
<http://intranet.wnmeds.ac.nz/academic/dph/research/heppru/research/tobacco.html>

<sup>2</sup> Please note that this analysis is work in progress and methodological issues are currently being addressed.

### *Artificial distinction between taxes on loose tobacco and manufactured tobacco products*

There is currently an artificial distinction in the price between loose tobacco and manufactured cigarettes. The amount of tobacco per manufactured cigarette has declined from 0.8 grams per cigarette in 1995 to 0.7 grams today, resulting in an effective 14 percent difference in taxation and making loose tobacco cheaper per cigarette. The taxation of loose and manufactured tobacco products was last equalised in 1995; since then the proportion of smokers using loose tobacco has increased from 28 percent to 50 percent today.

Users of loose tobacco tend to be younger, of lower socio-economic status and be Maori or Pacific peoples. These groups are the most sensitive to price of tobacco products, hence their greater use of loose tobacco. This is especially evident among young people: 61 percent of smokers aged 15-19 years report smoking roll-your-owns.

The current situation undermines the Government's health target for *Better help for smokers to quit*, as smokers who might otherwise be encouraged to quit due to price increases since have instead shifted to roll-your-owns.

### *A plateau in the reduction of tobacco consumption and smoking prevalence*

There are a number of approaches that make up a comprehensive tobacco control programme, including health education, regulation, cessation and taxation. All are currently in use in New Zealand; however the current mix of services is not resulting in significant change in tobacco consumption or smoking prevalence.

Prevalence of smoking and tobacco consumption have declined in New Zealand over the last 50 years; however those declines slowed significantly since 1990 and, in the case of consumption, have stalled since 2003. The "business as usual scenario" indicates minimal change in smoking prevalence, consumption and tobacco-related deaths<sup>3</sup>. Based on the current rates of decline in smoking prevalence, it would take at least 350 years for prevalence to reach zero<sup>4</sup>. The status quo would see tobacco-related costs remain static at best.

## **OBJECTIVES**

There are two objectives:

- Equalise the taxation of loose tobacco and manufactured tobacco products by removing the artificial price distinction between loose and manufactured tobacco products.
- Achieve a significant and sustainable reduction in tobacco-related deaths and illnesses though reducing tobacco consumption and smoking.

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<sup>3</sup> Ministry of Health modelling estimated that over the period 2011 to 2031, the smoking prevalence rate would drop by 1.3 from 22.3 in 2011 to 21.0 in 2031; consumption would drop by 6 percent and tobacco attributable mortality by 0.7 percent.

<sup>4</sup> This calculation assumes that the current average reduction in prevalence stays static at 0.65% per year.. However, is a forecast reduction in the rate of decline: between 2011 and 2021 it was 0.7% and between 2021 and 2031 it was 0.6%. If the rate of decline continues to lessen, then zero prevalence will never be reached.

## **1. Equalise the taxation of loose tobacco and manufactured tobacco products to remove the artificial price distinction**

*Alternative option: Lower the tax on manufactured products to equalise with loose tobacco*

This option would achieve the aim of equalising the taxing of both products. There is an argument that this would be a more transparent approach than increasing the tax on loose tobacco, given that the focus on alignment is to correct an unintentional outcome rather than a policy decision, and due to the fact there is no apparent difference in the health impacts of loose and manufactured tobacco.

The risk associated with this option is that, if implemented without a subsequent across the board increase in tobacco tax, this approach could contribute to an increase in consumption of tobacco and the prevalence of smoking by lowering the price of manufactured tobacco products. This would undermine the Government's expenditure on other tobacco control programmes and would send contrary messages to the industry and the public about pricing of tobacco products in New Zealand. It would not achieve the aim of contributing to health gains as it would reduce price barriers to tobacco smoking. This is of particular importance for young and low income smokers who are the most price-sensitive<sup>5</sup>

If implemented with an across-the-board increase in tax to achieve the desired health impacts, both types of tobacco would need to be subject to a greater increase in tax to increase the price of tobacco to a point where the health outcomes are significant and sustained. In either scenario, the public would see a significant increase in the price of loose tobacco relative to the increase in manufactured tobacco.

### ***Preferred option***

*The preferred option is to:*

- *Raise the tax on loose tobacco by 14 percent to bring it into line with the tax on manufactured tobacco products.*

This option would meet the first objective removing the price differential between loose and manufactured cigarettes.

### **Benefits**

This option meets the objective of equalising the price of loose tobacco with that of manufactured tobacco products, removing the unintended price difference. The estimated price increase would be from \$21.00 to \$24.00 per 30 gram pouch of loose tobacco. This does not include retail margin increases which may be imposed on top of the increased tax.

Based on the data that show 50 percent of smokers use loose tobacco, the Ministry of Health estimates that (in isolation) a 14 percent increase in tax on loose tobacco will result in:

- A 7 percent decline in consumption of loose tobacco

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<sup>5</sup> Wilson N (2007). *Review of the evidence for major population-level tobacco control interventions*. Ministry of Health. Accessible at: [http://www.moh.govt.nz/moh.nsf/pagesmh/6142/\\$File/review-evidence-major-population-level-tobacco-control-interventions.pdf](http://www.moh.govt.nz/moh.nsf/pagesmh/6142/$File/review-evidence-major-population-level-tobacco-control-interventions.pdf)

- A 3.5 percent decline in overall tobacco consumption
- A 2.8 percent decline in smoking prevalence, equating to approximately 10,000 fewer smokers
- An estimated revenue increase of \$30 million per annum<sup>6</sup>

Health benefits would result from reduced consumption and smoking prevalence, particularly among the price sensitive groups of youth, low income groups and Maori and Pacific peoples. These groups have the highest smoking prevalence and in the case of Maori and Pacific peoples, suffer a disproportionate burden of tobacco-related disease. The lowering of tobacco consumption and smoking in young people will result in comparatively greater health benefits and lower costs to society in the long term as the risk of tobacco-related death and illness increases with the number of years that a person continues to smoke.

*The costs, risks, impact on regulation; implementation and review and consultation discussions for this proposal are the same as those for proposal 2 (below) and are included in that discussion.*

***Achieve a significant and sustainable reduction in tobacco-related deaths and illnesses though reducing tobacco consumption and smoking.***

A comprehensive tobacco control programme requires several component parts: education to ensure that the population is aware of the risks of tobacco use, and where to get help to quit; regulation to control the supply of tobacco; cessation services to support those who wish to quit; and taxation to implement price as a barrier to tobacco use. All four of these approaches are in use in New Zealand at present, although the problem shows that the interventions are holding steady rather than reducing tobacco consumption and smoking prevalence.

There are measures for dealing with the various negative impacts of tobacco use. New Zealand experience indicates that interventions need to be specific to be effective. For example, the Smoke-free Environments Amendment Act 2003 used regulatory mechanisms to ban smoking in pubs and clubs to reduce the health impacts of passive or second-hand smoking. This ban resulted in a significant increase to the number of calls to Quitline but does not appear to have had any impact on tobacco consumption or smoking prevalence<sup>7</sup>.

Cessation services are essential: it is not appropriate to incentivise people to undertake withdrawal from an addictive substance without providing support for them. Cessation services are highly effective in New Zealand and overseas; however they are most effective when combined with measures which strongly encourage quitting. The most effective means of encouraging people to quit is to raise the price of tobacco. Evidence demonstrates that price increases are the single most effective measure to reduce tobacco consumption<sup>8</sup>. International evidence shows that price increases through increased taxation also improves the effectiveness

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<sup>6</sup> This calculation (from Treasury) takes into account of the estimated number who will quit smoking and those who reduce consumption.

<sup>7</sup> Ministry of Health (2006) *After the smoke has cleared: evaluation of the impact of a new smokefree law*. Wellington, Ministry of Health.

<sup>8</sup> Wilson N, Thomson G (2005). *Tobacco tax as a health protecting policy: a brief review of the New Zealand evidence*. NZMJ vol 188 no. 1213 accessed at: <http://www.nzma.org.nz/journal/118-1213/1403/>

of the investment in other tobacco control programmes of the type currently provided by the New Zealand Government, such as health education campaigns and cessation support services<sup>9</sup>. Price increases also result in the most rapid impact on tobacco consumption and smoking prevalence, realising the most social and economic benefits in the shortest time<sup>10 11</sup>.

This proposal considers three options for increasing tax excise to achieve the objective of lowering tobacco-related harm through a price mechanism.

The options presented assume equalised taxation of loose and manufactured tobacco products; however it should be noted that the proposals are not mutually exclusive. It is reasonable to assume that smokers would continue to favour loose tobacco if taxation was not equalised, thus reducing the number of smokers likely to quit or reduce consumption as a result of price increases. The preservation of an artificial price differential would not meet the objectives of this proposal.

Based on this assumption, the options are set out in table 1, with the relative impacts of these options, assuming the following other changes in other components of the tobacco control programme.

Table 1: estimated impact of options for increased excise on tobacco products

Option†	Reduction in current smoking prevalence (%)*		Reduction in tobacco consumption (%)		Reduction in tobacco-related deaths per annum		Total revenue increase ‡	
	2021	2031	2021	2031	2021	2031	Excl. rise on RYO	Incl. rise on RYO
Option 1: Increase tax on all tobacco products 10 %	2	4	3.5	6	90-100	150-175	+\$66m	+\$95m
Option 2: increase tax all tobacco products by 20%	4	8	7	12	180-200	300-350	+\$126m	+\$154m
Option 3: increase tax all tobacco products by 33.3%	6.5	13	11.5	20	300-375	500-575	+\$193m	\$218m

\* A 1 percent drop in prevalence equates to approximately 30,000 fewer smokers.

† The model does not include the proposed 14 percent increase in tax on loose tobacco.

‡ These estimates are adjusted for price elasticity of demand of -0.50; price elasticity of prevalence of -0.20; and price elasticity of consumption of -0.30.

<sup>9</sup> Centers for Disease Control (2007) *Best Practice for Comprehensive Tobacco Control Programs*. CDC: Atlanta.

Accessible at:

[http://www.cdc.gov/tobacco/tobacco\\_control\\_programs/stateandcommunity/best\\_practices/pdfs/2007/BestPractices\\_Complete.pdf](http://www.cdc.gov/tobacco/tobacco_control_programs/stateandcommunity/best_practices/pdfs/2007/BestPractices_Complete.pdf)

<sup>10</sup> World Health Organization Report on the Global Tobacco Epidemic (2008) *The MPOWER Package*. Accessible at: [http://www.who.int/tobacco/mpower/gtcr\\_download/en/index.html](http://www.who.int/tobacco/mpower/gtcr_download/en/index.html)

<sup>11</sup> World Bank (1999) *Curbing the Epidemic: government and the economics of tobacco control*. World Bank: Washington DC. Accessible at: <http://www1.worldbank.org/tobacco/reports.htm>

### ***Alternative options***

Options 1 and 2 were considered against the objective of reducing tobacco-related harm by increasing the price of tobacco products, using a price barrier set at different points.

Evidence demonstrates that the higher the price increase, the more significant and long-lasting the effect on tobacco consumption and smoking prevalence, as a price increase is the most effective barrier to the purchase and use of tobacco. This is shown by the estimated impact of the options on smoking and tobacco consumption.

Both options would contribute to a reduction in both tobacco consumption and smoking prevalence. The magnitude of the impact necessarily increases with the raising of the tax and therefore the price of tobacco. There is a risk that these options may not be sufficient to kick start a decline in tobacco consumption and smoking prevalence that would result in significant, long term health, social and economic gains.

Price increases are also an effective barrier to smoking initiation among young people<sup>12</sup>. Options 1 and 2 would be less effective in preventing uptake.

Options 1 and 2 carry risks associated with the regressive nature of tobacco taxation, an impact exacerbated by the addictive nature of tobacco products. Any increased price barrier to purchasing tobacco may also limit the choice of people to use a legal product, and their enjoyment of it. However, the addictive nature of the product compromises a person's ability to choose to smoke, and to spend money on tobacco.

Options 1 and 2 would have a lower financial impact on low income people; however those options would be less effective in reducing the impacts of tobacco-related harm among the groups who already bear a disproportionate burden of chronic disease and financial impact from expenditure on an addictive product. Options 1 and 2 provide fewer incentives for people to use the available cessation counselling and support services, and as a result do not promote the most efficient and effective use of the tobacco control programme as a whole. Option 1, in particular, is expected to result in marginal changes.

Reductions in the costs to the health sector are difficult to quantify; however it is reasonable to assume that option 2 would result in greater savings than option 1.

### ***Preferred option***

The preferred option is option 3: increase the tax on all tobacco products by 33.3 percent.

This proposal assumes that the preferred option would be carried out in conjunction with the preferred option for equalising the tax on loose and manufactured tobacco. Please note that the following discussions relate to both proposals.

### **Benefits**

Table 1 demonstrates the estimated impact on smoking prevalence, tobacco consumption, reduction in tobacco-related deaths and government revenue resulting from this proposal.

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<sup>12</sup> Wilson N (2007) op.cit.

These comprise the most tangible benefits of the proposal, and demonstrate the scale of positive impacts relative to options 1 and 2.

This policy would achieve the objective of a significant and sustainable impact on tobacco-related harm, as there is strong evidence that the higher the price rise, the greater the immediate impact on prevalence and consumption, and the greater the long-term health, economic and societal benefits. Option 3 offers the best support for achieving the Government's health target "Better help for smokers to quit" by promoting the use of cessation services.

A 33.3 percent increase would bring the total tax proportion of the price to tobacco to around 93.5 percent. This would put New Zealand at the leading edge of tax as a proportion of tobacco price, but in line with tobacco taxation trends in Europe and the United Kingdom, and Canada<sup>13</sup>. The Australian Preventative Health Taskforce Report has recently recommended a similar increase in taxation, to be implemented over the three year period.

### Risks

There is a risk of backlash from smokers and industry, particularly if the perception that the objective of the excise increase is to increase revenue. The proposal would be supported by a communications plan that explains the clear health gain rationale for the proposal, and ensuring that cessation services are well publicised, readily available and accessible.

The proposal includes a significant increase in excise: 47.3 percent for loose tobacco and 33.3 percent for all other tobacco products. Such an increase may limit Government's options with regard to other taxation changes, in particular options such as increasing GST, which are also regressive in nature. There is a risk that this proposal would create a barrier to other tax options that would result in a greater fiscal benefit to Government.

The New Zealand Customs Service has noted that large-scale tobacco smuggling, while rare, is likely to be exacerbated by a price increase. Customs also notes that it is likely to see an increase in small scale offences such as travellers attempting to bring in one or two packages of cigarettes in excess of their duty free allowance. There is also the potential for more people to manufacture tobacco for their own use and potentially for sale<sup>14</sup>, resulting in non-payment of excise and potential undermining (albeit on a small scale) of the objective of reducing tobacco consumption. An amendment to the Customs and Excise Act (effective from 24 September 2009) significantly increases the fines and introduced a prison term for illicit manufacture, import, sale and possession (e.g. backyard tobacco manufacturing), and defrauding Customs of revenue. These measures may help minimise this problem, although the likely nature and impact of these risks is difficult to quantify and would be included in the monitoring process.

### Costs

There will be no cost to Government as the proposals would both be implemented within baselines. This includes absorption of increased demand on cessation services and subsidised nicotine replacement.

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<sup>13</sup> American Cancer Society (2007) The Tobacco Atlas (3<sup>rd</sup> Edition) accessible at: [http://www.cancer.org/docroot/AA/content/AA\\_2\\_5\\_9x\\_Tobacco\\_Atlas\\_3rd\\_Ed.asp?sitearea=&level=](http://www.cancer.org/docroot/AA/content/AA_2_5_9x_Tobacco_Atlas_3rd_Ed.asp?sitearea=&level=)

<sup>14</sup> Individuals are currently able to grow up to 15 kilograms of tobacco a year for their own use. On-selling is prohibited.



Both proposals will involve financial costs to individual smokers. The average smoker smokes approximately 12 cigarettes a day, at a cost of \$2,190 per annum. A 33.3 percent increase in tax would result in an increased expenditure of \$730 per annum for a smoker who did not alter his or her behaviour, to a total of \$2,920 (excluding any retain margin). This equates to approximately 2.7 percent of an average annual income.

Evidence shows that at a population level, “tobacco taxation is likely to be achieving far more benefit than harm in the general population and in socio-economically deprived populations.”<sup>15</sup>, particularly when they have access to cessation services, as would be the case in this instance. However, for some smokers, the enjoyment of smoking and/or an inability to quit due to the addictive nature of tobacco will mean that they are unable or unwilling to avoid the additional costs imposed by the proposal. As there is no ‘safe dose’ of tobacco, any benefits derived from smoking are in fact a financial and health cost. The costs of tobacco are particularly severe on lower income groups and young people. Price increases act as a deterrent for initiation and a strong incentive to quit among people who have the most to gain from reducing or eliminating tobacco use. This allows them to choose to reallocate their income. Evidence shows that productivity and wage-earning capacity increase when tobacco use drops<sup>16</sup>.

The greater impact on lower income groups will be mitigated by the more effective operation of the other tobacco control services, in particular cessation services and preventing young people from taking up smoking.

The proposals would involve some costs to retailers and manufacturers related to the need to change price notices in retail outlets. The costs would be mitigated by introducing both changes at the same time. In terms of impact on competition and impact of costs across the industry, it should be noted that the only domestic producer of tobacco products is Imperial, which has about 17 percent of the local market. Imperial’s split of loose versus manufactured products is approximately the same as British American Tobacco, New Zealand’s major tobacco company.

#### Stock of regulation

Both preferred options amend but do not add to the existing stock of regulation.

#### Implementation and review

Both preferred options will be given effect through changes to legislation. These changes would occur through Amendment Acts as the proposals would not be suitable for a change via Order in Council.

The Customs Service has advised that necessary changes to the Customs systems to accommodate both excise increases would be relatively straightforward. Customs has reported that such changes generally require a couple of months’ advance notice and planning.

The impact of both increases would be monitored by the Ministry of Health, with involvement of the Customs Service.

As noted above, the proposals are expected to have an immediate impact on smoking prevalence and tobacco consumption. The impacts on health status and any reduction in costs

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<sup>15</sup> Wilson N, Thomson G, Blakely T (2004). *How much downside? Quantifying the relative harm from tobacco taxation*. Journal of Epidemiology and Community Health 58:451-454.

<sup>16</sup> WHO MPOWER report, op. Cit.

to the health system will take longer to track and will be the subject of ongoing research by the Ministry and academic institutes.

*Consultation*

These proposals were discussed with the New Zealand Customs Service, The Treasury, and Te Puni Kōkiri. Advice received from the NZ Customs Service and The Treasury was incorporated where appropriate.