



Associate Minister of Health, Hon Casey Costello

Cabinet material: reducing excise duty from heated tobacco products

23 July 2024

These documents have been proactively released by the Ministry of Health on behalf of the Associate Minister of Health, Hon Casey Costello.

Title of Cabinet papers:

- Reducing excise duty from heated tobacco products [*N.B. both the May and June papers have the same title*]

Titles of minutes:

- Heated Tobacco Products: Update (CAB-24-MIN-0172)
- Reducing Excise Duty from Heated Tobacco Products (CAB-24-MIN-0204)



Cabinet

Minute of Decision

This document contains information for the New Zealand Cabinet. It must be treated in confidence and handled in accordance with any security classification, or other endorsement. The information can only be released, including under the Official Information Act 1982, by persons with the appropriate authority.

Heated Tobacco Products: Update

Portfolio Associate Health (Hon Casey Costello)

On 20 May 2024, Cabinet:

- 1 **noted** that the Coalition Agreement between the National Party and New Zealand First specifies that the parties will repeal amendments to the Smokefree Environments and Regulated Products Act 1990 and regulations before March 2024, to:
 - 1.1 remove requirements for denicotisation;
 - 1.2 remove the reduction in retail outlets and the generation ban;
 - 1.3 amend vaping product requirements and taxing smoked products only;
- 2 **noted** that, as part of Budget 2024, Cabinet has agreed to create a tagged contingency of \$216.094 million operating to manage the fiscal implications of further decisions to be taken on options to change the tobacco excise applied to heated tobacco products [CAB-24-MIN-0148.38, Initiative 16085];
- 3 **noted** that the funds in contingency are reflective of joint Ministry of Health and Treasury work to estimate the revenue foregone if 50 percent of tobacco excise duties were removed from heated tobacco products;
- 4 **noted** that the fiscal implications associated with this initiative reflect a 1 July 2024 start date;
- 5 **noted** that the likely pathway to implement the changes is through a two-step Order in Council process that would:
 - 5.1 temporarily suspend and reduce the tobacco excise duty and excise-equivalent duty rates for heated tobacco products until 1 January 2025;
 - 5.2 permanently maintain the reduction of excise duty and excise-equivalent duty rates for heated tobacco products from 1 January 2025 onwards;
 - 5.3 amend the Tariff to better classify heated tobacco products;

- 6 **invited** the Associate Minister of Health (Hon Casey Costello) to report back to Cabinet after the Budget moratorium to seek final approval, including on:
 - 6.1 the level of excise to be applied to heated tobacco products, relative to current levels;
 - 6.2 the implementation date of any change to excise duty on heated tobacco products;
 - 6.3 the drawdown of the tagged contingency funding referred to in paragraph 2 above;
- 7 **invited** the Associate Minister of Health (Hon Casey Costello) to report back to Cabinet within 12 months of any implementation, supporting Cabinet consideration of whether this initiative is having the desired impact;
- 8 **invited** the Minister of Customs to issue drafting instructions to the New Zealand Customs Service to give effect to the above paragraphs, subject to final Cabinet decisions referred to in paragraph 6 above.

Diana Hawker
for Secretary of the Cabinet

PROACTIVELY RELEASED

BUDGET SENSITIVE

Office of the Associate Minister of Health

Cabinet

Reducing excise duty from heated tobacco products

Proposal

1. This paper updates Cabinet on policy considerations to reduce the excise duty applied to heated tobacco products¹ (HTPs). This paper invites Cabinet to discuss the level of excise applied to HTPs, relative to current levels, as well as the implementation date of any change to excise duty on HTPs.
2. It also seeks Cabinet's agreement to authorise joint Ministers (the Minister of Finance and Associate Minister of Health) to jointly finalise or revise outstanding decisions related to heated tobacco excise changes, alongside drawdown of the associated tagged contingency, after conclusion of the Budget 2024 Moratorium on 30 May 2024.

Relation to government priorities

3. The Coalition Agreement between New Zealand First and National commits to "taxing smoked products only".
4. The Government is committed to reducing smoking rates and achieving the Smokefree 2025 goal of less than 5% of New Zealanders smoking daily.

Executive Summary

5. On Monday 29 April 2024, as part of its consideration of the Budget 2024 paper, Cabinet agreed to set aside \$216.094 million operating in contingency, to enable further decisions to be taken on options to change the rate of tobacco excise duty applied to HTPs [CAB-24-MIN-0148 refers].
6. In this paper, I provide Cabinet an update on policy considerations to reduce excise duty applied to HTPs. This paper also invites Cabinet to discuss the level of excise applied to HTPs, relative to current levels, as well as the implementation date of any change to excise duty on HTPs.

Background

7. Progressing the Coalition Agreement commitments is an important part of this Government providing people with practical tools and support to help them quit

¹ The Smokefree Environments and Regulated Products Act 1990 defines a heated tobacco product as *a smokeless tobacco product that has a device that uses or facilitates the use of heat to aerosolise nicotine from tobacco leaf directly*. HTPs do not include any products which burn or combust the tobacco. Shisha, or water pipe tobacco, is not included in the definition of HTPs.

smoking, and to maintain the progress being made in reducing smoking rates. This includes people being able to access less harmful products than cigarettes, such as HTPs, which are already in the market and provide an alternative to vaping that may be appealing to long-term smokers as a tool towards transitioning away from tobacco use completely.

8. We've seen a significant decline in daily smoking rates in recent years and the 2023 New Zealand Health Survey results show that we are well on our way to achieving the Smokefree 2025 goal. 6.8% of New Zealanders are smoking daily, down from 8.6% the previous year and 16.4% in 2011/12. Vaping has been a significant contributing factor to this.
9. To achieve the Smokefree 2025 goal of less than 5 percent of daily smokers for all population groups, we need to try different approaches to help people quit smoking, especially for those most addicted. Discussions with some smokers indicate that while smoking is expensive, vaping is not an appropriate tool for them. Stop smoking service providers have also told me that the more options people have to transition away from tobacco use, the better.
10. I will be reporting back to Cabinet later this year with options for the introduction of alternative products to support quitting smoking that are not currently available in New Zealand, for example, snus and nicotine pouches. The report back will also include advice on a risk proportionate regulatory regime to protect non-smokers from the harms of any new products made available to support smokers to quit.
11. On Monday 29 April 2024, as part of its consideration of the Budget 2024 paper, Cabinet agreed to set aside \$216.094 million operating in contingency, to enable further decisions to be taken on options to change the rate of tobacco excise duty applied to HTPs [CAB-24-MIN-0148 refers]. The funds in contingency are reflective of joint Ministry of Health and Treasury work to estimate the revenue foregone if 50% of tobacco excise duties were removed from HTPs.

Tax smoked tobacco products only

12. The Smokefree 2025 goal is to reduce smoking rates to below 5% across all population groups.
13. To support this objective, the Coalition Agreement between New Zealand First and National commits to "taxing smoked products only" "before March 2024". I would like to invite Cabinet's discussion on the level of excise applied to HTPs, relative to current levels.
14. The current excise duty on imports of smokeless tobacco products, including HTPs, is relatively small but rising rapidly, from \$3,622,463 in 2022, to \$5,970,938 in 2023.
15. If excise on HTPs were reduced, the Crown would forgo a portion of this revenue stream. For those people who smoke that switch to HTPs, the duty that they would otherwise have paid on smoked tobacco would also be

foregone. Duty paid by importers/manufacturers of HTPs would also be reduced.

16. The duty rates are set out in the Excise and Excise-equivalent Duties Table (EEDT). Duty would continue to be payable on other non-smoked tobacco products at the full rate.

Health impacts of HTPs and their use as a transitional tool

17. In general, heated products are considered less harmful than smoked products due to the lack of products of combustion in the inhaled vapour. Given their relative recency to the market, there is not yet clear evidence that HTPs are significantly less harmful than cigarettes. However, the US Food and Drug Administration (FDA) has authorised limited HTP products from one company to be marketed as modified risk tobacco products. This means that these products can be marketed with claims that a person who uses regular cigarettes and fully switches to the products can reduce their exposure to harmful chemicals.
18. Vaping is less harmful than smoked tobacco and has been a key factor in recent drops in New Zealand's smoking rates. However, vaping is not always suitable for long-term addicted smokers, and HTPs provide a different option that could support smokers to transition away from tobacco use over time.
19. Our current smoking rates suggest about 285,000 New Zealanders are daily smokers, many of whom are likely long-term smokers. Encouraging this group of smokers to quit requires an approach that provides alternatives to cigarettes that may not be tobacco-free themselves but serve as a means-to-an-end to transition away from tobacco use entirely. Preliminary modelling from the Ministry of Health suggests that around 7,200 smokers over the next two years could switch to HTPs. It is important to note that these 7,200 smokers would not have otherwise begun transitioning away from tobacco use.
20. Reducing the excise duty on HTPs may increase their appeal to smokers who have not found switching to vaping successful, as removal of the excise duty will likely make these products cheaper than they are currently. As we have seen with vaping, we will need to be vigilant about monitoring the potential uptake of HTPs by non-smokers, including youth, as a result of lower prices. However, widespread knowledge of the harms related to tobacco use and the likelihood that HTPs will be more expensive than vaping means that youth and non-smoker uptake of HTPs will likely be minimal.
21. The relative recency of HTPs to the market means that there is limited research around their use as a cessation or transitional tool. However, on balance, feedback from smokers and stop smoking services about providing smokers with more choice to transition away from smoked tobacco suggests that this action will support New Zealand to achieve its smokefree ambitions.
22. If these proposals are progressed, a review of the impact of the excise reduction will be conducted 12 months post-implementation to better understand whether the uptake of HTPs has been as pronounced as predicted

by modelling, and whether smokers and stop smoking providers believe that HTPs have provided a viable tool towards smokers eventually becoming tobacco free. The review will also provide us with an opportunity to identify whether HTPs are being taken up by non-smokers, particularly youth, so that we can respond quickly if needed. These insights will also help inform future decisions on the introduction of other products and the appropriate excise regime to be applied across a range of products.

Implementation

An Order in Council would need to be made under Schedule 3 of the Customs Act

23. Excise duty is a tax imposed on domestically manufactured tobacco, fuel, and alcohol. When these goods are imported, this is referred to as excise-equivalent duty. The rates for both domestic manufacture and importation are set out in the EEDT. The current EEDT is administered under Schedule 3 of the Customs Act.
24. Schedule 3 of the Customs Act provides limited Order in Council making powers to amend the rates of duty in the EEDT:
 - 24.1 clause 20 permits the suspension and reduction of a rate of duty;
 - 24.2 clause 21 allows for changes to the rate of duty for tobacco products, but increases are limited by a formula that ties any increase to changes in the Consumers Price Index. The power in clause 21 can only be exercised in relation to tobacco products once a year, on 1 January.
25. If there were to be a change to excise duty on HTPs, one option would be that this decision is enduring but that the amended rate is reviewed after 12 months to allow for consideration of whether the initiative has had the desired impact (as outlined in paragraph 24).
26. If progressed, I would propose a temporary reduction of the relevant duty rates via an Order in Council made under clause 20 of Schedule 3 to the Customs Act, coming into force on 1 July 2024. A further Order in Council would then need to be made under clause 21 of Schedule 3 of the Customs Act to come into effect on 1 January 2025 to implement the change permanently.
27. Given excise and excise-equivalent duties are a tax, if this or any successive Government intended to reinstate the excise and excise-equivalent duty rates for these products to be in line with other tobacco products after 1 January 2025, primary legislation would be required.

An amendment to the Tariff would also be required

28. The Tariff classifies all imported goods, including any goods subject to excise-equivalent duty. Tobacco products are classified under chapter 24 of the Tariff.
29. Currently, HTPs are not separately identified within a broader category of products containing reconstituted tobacco in chapter 24 of the Tariff. If progressed, for the reduction in duty to be implemented specifically in relation

to HTPs, a new tariff classification would need to be created in chapter 24 to separately identify these products.

30. This change could be made by Order in Council under the Tariff Act 1988. This Order would also need to come into effect by 1 July 2024 to align with a temporary reduction (if progressed). Other products containing tobacco in this chapter would continue to be charged at the higher rate. Creating a new classification would also have the benefit of improving data on the use of HTPs in New Zealand.

Waiver of the 28-day rule would be required

31. If progressed, and with a 1 July commencement date, I would intend to seek a waiver of the 28-day rule to enable the Order in Council made under clause 20 of the Customs Act, and the Order made under the Tariff Act 1988 to come into force by 1 July 2024. The Order proposed under clause 21 of the Customs Act would be brought back to Cabinet in November 2024.

The reduced rate may change market behaviours

32. Customs has identified that, if any change to excise duty is progressed, there may be issues that need clarification by the regulator of tobacco products (the Ministry of Health) to ensure the reduced excise rate only applies to the correct items. Currently, there is no incentive for manufacturers or importers to “mis-declare” products containing tobacco, as they have the same duty rates. The lower rate on these products may encourage some people to mis-declare other products in this category to lower their liability for duty charged.
33. Customs also advises that it is likely that existing products may be developed or adjusted to fit into this category. The Ministry of Health will work with Customs on how to deal with mis-declared items and changes to products in the market. Customs may also need to undertake additional assurance and investigations to ensure the regime is operating correctly.
34. Other existing legislative requirements continue to apply to the import, manufacture, and sale of HTPs.

Cost-of-living implications

35. The average person who smokes is estimated to spend between \$5,200 - \$7,800 on tobacco products per year (based on an average of 9.6 cigarettes per day). For many households, this is likely to account for a significant proportion of their discretionary income.
36. Because this product currently has a monopoly market in New Zealand, the extent to which a reduction in excise duty on HTPs would be passed on to consumers via lower retail prices is unclear. A higher pass-through rate, defined as the change in retail price as a percent of the change in a tax, is likely to encourage greater substitution from cigarettes but will not affect the tax revenue lost on sales of HTPs. One international study found that HTP prices increased by 31 cents for each one dollar increase in HTP taxes. However, I

am advised by my officials that a 100 per cent pass-through rate, as applied in the analysis that estimated the revenue foregone if 50% of tobacco excise duties were removed (which the funds in contingency are reflective of), is the most reasonable assumption at this time. This is because of different responses to tax increases and decreases, the incentive for HTP manufacturers to lower their prices to attract consumers away from cigarettes and establish their presence in New Zealand's tobacco market, and the potential for competition from new entrants.

37. To the extent that a reduction in tax is passed through to consumers in lower prices, a reduction in excise duty on HTPs is aligned to the Government priority to address the rising cost of living. If changes to excise duty on HTPs were progressed, this may also increase the relative price of smoked tobacco compared to HTPs to encourage people who smoke to switch to HTPs.

Financial Implications

38. There are no direct financial implications arising from this paper.
39. As part of its consideration of the Budget 2024 paper [CAB-24-MIN-0148 refers], Cabinet agreed to create a tagged contingency which set aside \$216.094 million operating funding to manage the fiscal implications of further decisions to be taken on options to change the tobacco excise applied to HTPs. The funds in contingency are reflective of joint Ministry of Health and Treasury work to estimate the revenue foregone if 50% of tobacco excise duties were removed from HTPs.
40. This estimated foregone Crown revenue is officials' best estimate, in the time available, of the fiscal impact of a 50% reduction in excise on HTPs, informed by the limited data and research available. It involves several assumptions and considerable uncertainty.
41. The fiscal impact of removing excise duty on HTPs on total tobacco excise duty revenue is modelled by scaling tobacco consumption attributable to HTPs in the four years following their introduction in Japan (2016-2019), by the current demand for all tobacco in New Zealand and the assumed price change in domestic HTPs after removing excise duty. The consequent difference in the demand for total tobacco was then input into Treasury's existing Custom and Excise model to estimate the dollar impact of this proposal.
42. The estimated fiscal impact accounts for both the reduced tax revenue on HTPs and the estimated increase in substitution from cigarettes to HTPs due the lower expected price of HTPs under the proposed change. However, the comparison to Japan has some significant limitations given the different regulatory contexts (noting that Japan has no legalised vaping).

Legislative Implications

43. If changes to the excise duty applied to HTPs were progressed, amendments to the Tariff and the Excise and Excise-Equivalent Duties Table would be needed to bring the changes into effect. These would be done via Orders in Council.

Impact Analysis

44. Cabinet's impact analysis requirements apply to the proposal to discuss the level of the excise duty applied to heated tobacco products, but there is no accompanying Regulatory Impact Statement, and the Ministry for Regulation has not exempted the proposal from the impact analysis requirements. Therefore, it does not meet Cabinet's requirements for regulatory proposals.
45. The Ministry for Regulation and Ministry of Health have agreed that a post-implementation review will be undertaken after 12 months.

Population Implications

46. Some population groups have higher rates of smoking, therefore, the harm from tobacco affects these groups disproportionately (both in terms of direct health impact and the indirect impact that smoking can have on household disposable incomes). Groups with higher rates of smoking include Māori and low-income earners.
47. If the excise applied to HTPs were reduced, this would increase the relative price of smoked tobacco compared to HTPs (assuming the reduction in excise duty is passed on to consumers). This may encourage people who smoke to switch to HTPs.

Human Rights

48. The proposals in this paper are not inconsistent with the New Zealand Bill of Rights Act 1990 and Human Rights Act 1993.

Use of external Resources

49. No contractors have been involved in developing this paper.

Consultation

50. The following agencies were consulted on the development of this paper: the Treasury and New Zealand Customs Service. The Department of the Prime Minister and Cabinet has been informed.

Communications

51. My office will work with officials to ensure timely communications as required.

Proactive Release

52. I intend to proactively release this Cabinet paper in whole within 30 business days of decisions joint Ministers' subsequent decisions (subject to redactions on standard withholding grounds, such as maintaining legal privilege).

Recommendations

The Associate Minister of Health recommends that Cabinet:

- 1 **Note** that the Coalition Agreement between the National Party and New Zealand First specifies that the parties will repeal amendments to the Smokefree Environments and Regulated Products Act 1990 and regulations before March 2024, removing requirements for denicotisation, removing the reduction in retail outlets and the generation ban, while also amending vaping product requirements and taxing smoked products only;
- 2 **Note** that as part of its consideration of the Budget 2024 paper [CAB-24-MIN-0148 refers], Cabinet agreed to create a tagged contingency, which set aside \$216.094 million operating funding to manage the fiscal implications of further decisions to be taken on options to change the tobacco excise applied to heated tobacco products (refer to Annex D, Initiative No: 16085, titled 'Proposals to Change Excise Treatment of Heated Tobacco Products initiative');
- 3 **Note** that the funds in contingency are reflective of joint Ministry of Health and Treasury work to estimate the revenue foregone if 50% of tobacco excise duties were removed from heated tobacco products;
- 4 **Authorise** the Minister of Finance and Associate Minister of Health to jointly draw down the tagged operating contingency funding in recommendation 2 above after the Budget Moratorium expires on 30 May 2024;
- 5 **Discuss** the preference of Cabinet for the level of excise applied to heated tobacco products, relative to current levels;
- 6 **Note** that the fiscal implications associated with this initiative reflect a 1 July 2024 start date;
- 7 **Discuss** the preference of Cabinet for the implementation date of any change to excise duty on heated tobacco products;
- 8 **Note** that the likely pathway to implement changes is through a two-step Order in Council process that would:
 - 8.1 temporarily suspend and reduce the tobacco excise duty and excise-equivalent duty rates for heated tobacco products until 1 January 2025;
 - 8.2 permanently maintain the reduction of excise duty and excise-equivalent duty rates for heated tobacco products from 1 January 2025 onwards;
 - 8.3 amend the Tariff to better classify heated tobacco products.
- 9 **Authorise** the Minister of Finance and Associate Minister of Health to jointly finalise outstanding decisions related to heated tobacco excise changes, including the outstanding issues in recommendations 5-8 above, alongside drawdown of the associated tagged contingency after conclusion of the Budget 2024 Moratorium on 30 May 2024;

- 10 **Agree** that the Associate Minister of Health report back to Cabinet within 12 months of any implementation, supporting Cabinet consideration of whether this initiative is having the desired impact;

Drafting instructions

- 11 **Invite** the Minister of Customs to issue drafting instructions to the New Zealand Customs Service (who draft these Orders) to give effect to recommendations 5, 7 and 8, subject to final decisions jointly taken by the Minister of Finance and Associate Minister of Health.

Authorised for lodgement

Hon Casey Costello

Associate Minister of Health

PROACTIVELY RELEASED



Cabinet

Minute of Decision

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Reducing Excise Duty from Heated Tobacco Products

Portfolio Associate Health (Hon Casey Costello)

On 10 June 2024, Cabinet:

- 1 **noted** that, as part of Budget 2024, Cabinet agreed to set aside contingency funding to manage the fiscal implications of further decisions to be taken on options to change the tobacco excise applied to heated tobacco products [CAB-24-MIN-0148.38, Initiative 16085];
- 2 **noted** that the fiscal implications associated with the above initiative reflect a 1 July 2024 start date;
- 3 **agreed** to reduce the level of excise applied to heated tobacco products by 50 percent, relative to current levels;
- 4 **agreed** that the changes to excise duty on heated tobacco products will come into effect on 1 July 2024;
- 5 **agreed** to draw down on the contingency referred to in paragraph 1 above;
- 6 **approved** the following changes to provide for the decision in paragraph 3 above, with a corresponding impact on the operating balance and net debt:

	\$m - increase/(decrease)				
	2023/24	2024/25	2025/26	2026/27	2027/28 & Outyears
Operating Balance Impact*	-	(11.295)	(44.715)	(75.999)	(84.085)
Net Core Crown Debt Impact Only	-	-	-	-	-
No Impact	-	-	-	-	-
Total	-	(11.295)	(44.715)	(75.999)	(84.085)

* Unless non-cash, will also impact net core Crown debt.

	\$m - increase/(decrease)				
Vote Customs	2023/24	2024/25	2025/26	2026/27	2027/28 & Outyears
Minister of Customs					
Tax Revenue:					
Tobacco excise	-	(11.295)	(44.715)	(75.999)	(84.085)
Total Revenue	-	(11.295)	(44.715)	(75.999)	(84.085)
Total Operating	-	11.295	44.715	75.999	84.085

- 7 **noted** that, following the adjustments referred to above, the tagged contingency described in paragraph 1 above is now exhausted and therefore closed;
- 8 **noted** that the changes agreed in paragraphs 3 and 4 above will be made through a two-step Order in Council process that would:
- 8.1 temporarily suspend and reduce the tobacco excise duty and excise-equivalent duty rates for heated tobacco products until 1 January 2025;
 - 8.2 permanently maintain the reduction of excise duty and excise-equivalent duty rates for heated tobacco products from 1 January 2025 onwards;
 - 8.3 amend the Tariff to better classify heated tobacco products;
- 9 **invited** the Associate Minister of Health (Hon Casey Costello) to report back to Cabinet within 12 months of any implementation, supporting Cabinet consideration of whether this initiative is having the desired impact;

Legislative implications

- 10 **invited** the Minister of Customs to issue drafting instructions to the New Zealand Customs Service to give effect to the above paragraphs;
- 11 **noted** that draft Orders in Council are expected to be submitted to the Cabinet Legislation Committee on 20 June 2024, seeking authorisation to submit the Orders to the Executive Council on 24 June 2024;
- 12 **noted** that the Minister of Customs intends to seek a waiver of the 28-day rule to enable the changes to come into force on 1 July 2024.

Rachel Hayward
Secretary of the Cabinet

BUDGET SENSITIVE

Office of the Associate Minister of Health

Cabinet

Reducing excise duty from heated tobacco products

Proposal

1. This paper seeks Cabinet's approval to reduce the level of excise to be applied to heated tobacco products (HTPs) by 50 percent on 1 July 2024.

Relation to government priorities

2. The Government is committed to reducing smoking rates and achieving the Smokefree 2025 goal of less than 5 percent of New Zealanders smoking daily.

Background

3. The Smokefree 2025 goal is to reduce smoking rates to below 5 percent across all population groups. To support this objective, smokers need to be provided with a range of lower cost, reduced harm options that will help them transition away from tobacco use.
4. The current revenue from excise duty on imports of smokeless tobacco products, including HTPs, is relatively small but rising rapidly, from \$3.622 million in 2022, to \$5.971 million in 2023.
5. Reducing the excise duty on HTPs may increase their appeal to smokers who have not found switching to vaping successful, as reducing the excise duty will likely make these products cheaper than they are currently.
6. On Monday 29 April 2024 [CAB-24-MIN-0148 refers], as part of its consideration of the Budget 2024 paper, Cabinet agreed to set aside \$216.094 million operating funding in contingency to allow for any changes to the rates of tobacco excise to be applied to HTPs.
7. Cabinet subsequently [CAB-24-MIN-0172 refers] invited me to report back to Cabinet after the Budget moratorium to seek final approval on:
 - 7.1 the level of excise to be applied to HTPs, relative to current levels
 - 7.2 the implementation date of any changes to excise duty on HTPs
 - 7.3 the drawdown of the tagged contingency funding referred to in paragraph 6.

Health impacts of HTPs and their use as a transitional tool

8. In general, heated products are considered less harmful than smoked products due to the lack of products of combustion in the inhaled vapour. Given their relative recency to the market, there is not yet clear evidence that HTPs are significantly less harmful than cigarettes. However, the US Food and Drug Administration (FDA) has authorised limited HTP products from one company to be marketed as modified risk tobacco products. This means that these products can be marketed with claims that a person who uses regular cigarettes and fully switches to the products can reduce their exposure to harmful chemicals.
9. Our current smoking rates suggest about 285,000 New Zealanders are daily smokers, many of whom are likely long-term smokers. Encouraging this group of smokers to quit requires an approach that provides alternatives to cigarettes that may not be tobacco-free themselves but serve as a means-to-an-end to transition away from tobacco use entirely. Preliminary modelling from the Ministry of Health suggests that around 7,200 smokers over the next two years could switch to HTPs. It is important to note that these 7,200 smokers would not have otherwise begun transitioning away from tobacco use.
10. Reducing the excise duty on HTPs may increase their appeal to smokers who have not found switching to vaping successful, as removal of the excise duty will likely make these products cheaper than they are currently. As we have seen with vaping, we will need to be vigilant about monitoring the potential uptake of HTPs by non-smokers, including youth, as a result of lower prices. However, widespread knowledge of the harms related to tobacco use and the likelihood that HTPs will be more expensive than vaping means that youth and non-smoker uptake of HTPs will likely be minimal.
11. The relative recency of HTPs to the market means that there is limited research around their use as a cessation or transitional tool. However, on balance, feedback from smokers and stop smoking services about providing smokers with more choice to transition away from smoked tobacco suggests that this action will support New Zealand to achieve its smokefree ambitions.
12. If these proposals are progressed, a review of the impact of the excise reduction will be conducted 12 months post-implementation to better understand whether the uptake of HTPs has been as pronounced as predicted by modelling, and whether smokers and stop smoking providers believe that HTPs have provided a viable tool towards smokers eventually becoming tobacco free. The review will also provide us with an opportunity to identify whether HTPs are being taken up by non-smokers, particularly youth, so that we can respond quickly if needed. These insights will also help inform future decisions on the introduction of other products and the appropriate excise regime to be applied across a range of products.

Proposed excise level

13. Given that this is a novel proposal, with some uncertainty about its intended impacts, I propose that the excise that is applied to HTPs is not fully removed but is reduced by half.
14. I will report back to Cabinet within 12 months of the changes coming into effect to support Cabinet's consideration of whether this initiative is having the desired effect of contributing to the Smokefree 2025 goal.
15. The review will provide insights on whether the uptake of HTPs has been as pronounced as predicted by modelling, and whether smokers and stop smoking providers believe that HTPs have provided a viable tool towards smokers eventually becoming tobacco free.
16. The review will also provide us with an opportunity to identify whether HTPs are being taken up by non-smokers, particularly youth, so that we can respond quickly if needed. These insights will also help inform future decisions on the introduction of other products and the appropriate excise regime to be applied across a range of products.

Implementation date

17. To change the excise applied to HTPs, Orders in Council would need to be made under Schedule 3 of the Customs and Excise Act 2018 (the Customs Act).
18. In addition, an amendment to the Tariff would also be required to separately classify HTPs, since they are currently grouped within a broader category of products containing reconstituted tobacco.
19. I propose that the changes come into force on 1 July 2024. This aligns with other proposed amendments to the Excise and Excise Equivalent Duties Table that are intended to take effect from this date.
20. Given excise and excise-equivalent duties are a tax, if this or any successive Government intended to reinstate the excise and excise-equivalent duty rates for these products to be in line with other tobacco products after 1 January 2025, primary legislation would be required.

Drawdown of the tagged contingency funding

21. I seek Cabinet's approval to draw down on the tagged contingency to give effect to this policy decision.

Waiver of the 28-day rule would be required

22. The Minister of Customs intends to seek a waiver of the 28-day rule to enable the changes to come into force on 1 July 2024.

Cost-of-living Implications

23. The average person who smokes is estimated to spend between \$5,200 - \$7,800 on tobacco products per year (based on an average of 9.6 cigarettes

per day). For many households, this is likely to account for a significant proportion of their discretionary income.

24. Because this product currently has a monopoly market in New Zealand, the extent to which a reduction in excise duty on HTPs would be passed on to consumers via lower retail prices is unclear. A higher pass-through rate, defined as the change in retail price as a percent of the change in a tax, is likely to encourage greater substitution from cigarettes but will not affect the tax revenue lost on sales of HTPs.
25. One international study found that HTP prices increased by 31 cents for each one dollar increase in HTP taxes. However, I am advised by my officials that a 100% pass-through rate, as applied in the analysis that estimated the revenue foregone if 50% of tobacco excise duties were removed (which the funds in contingency are reflective of), is the most reasonable assumption at this time.
26. This is because of different responses to tax increases and decreases, the incentive for HTP manufacturers to lower their prices to attract consumers away from cigarettes and establish their presence in New Zealand's tobacco market, and the potential for competition from new entrants.
27. To the extent that a reduction in tax is passed through to consumers in lower prices, a reduction in excise duty on HTPs is aligned to the Government priority to address the rising cost of living. If changes to excise duty on HTPs were progressed, this may also increase the relative price of smoked tobacco compared to HTPs to encourage people who smoke to switch to HTPs.

Financial Implications

28. As part of its consideration of the Budget 2024 paper [CAB-24-MIN-0148 refers], Cabinet agreed to create a tagged contingency which set aside \$216.094 million operating funding to manage the fiscal implications of further decisions to be taken on options to change the tobacco excise applied to HTPs. The funds in contingency are reflective of joint Ministry of Health and Treasury work to estimate the revenue foregone if 50% of tobacco excise duties were removed from HTPs.
29. This estimated foregone Crown revenue is officials' best estimate, in the time available, of the fiscal impact of a 50% reduction in excise on HTPs, informed by the limited data and research available. It involves several assumptions and considerable uncertainty.
30. Japan was the only country to be found with comprehensive real-world information about uptake of HTPs. The fiscal impact of removing excise duty on HTPs on total tobacco excise duty revenue is modelled by scaling tobacco consumption attributable to HTPs in the four years following their introduction in Japan (2016-2019), by the current demand for all tobacco in New Zealand and the assumed price change in domestic HTPs after removing excise duty. The consequent difference in the demand for total tobacco was then input into Treasury's existing Customs and Excise model to estimate the dollar impact of this proposal.

31. The estimated fiscal impact accounts for both the reduced tax revenue on HTPs and the estimated increase in substitution from cigarettes to HTPs due to the lower expected price of HTPs under the proposed change. However, the comparison to Japan has some significant limitations given the different regulatory contexts (noting that Japan has no legalised vaping).

Legislative Implications

32. Amendments to the Tariff and the Excise and Excise-Equivalent Duties Table are needed to bring the changes into effect. These would be done via Orders in Council.

Impact Analysis

33. Cabinet's impact analysis requirements apply to the proposal to discuss the level of the excise duty applied to HTPs, but there is no accompanying Regulatory Impact Statement, and the Ministry for Regulation has not exempted the proposal from the impact analysis requirements. Therefore, it does not meet Cabinet's requirements for regulatory proposals.
34. The Ministry for Regulation and Ministry of Health have agreed that a post-implementation review will be undertaken after 12 months.

Population Implications

35. Some population groups have higher rates of smoking, therefore, the harm from tobacco affects these groups disproportionately (both in terms of direct health impact and the indirect impact that smoking can have on household disposable incomes). Groups with higher rates of smoking include Māori and low-income earners.
36. If the excise applied to HTPs were reduced, this would increase the relative price of smoked tobacco compared to HTPs (assuming the reduction in excise duty is passed on to consumers). This may encourage people who smoke to switch to HTPs.

Human Rights

37. The proposals in this paper are not inconsistent with the New Zealand Bill of Rights Act 1990 and Human Rights Act 1993.

Use of external Resources

38. No contractors have been involved in developing this paper.

Consultation

39. The following agencies were consulted on the development of this paper: the Treasury and New Zealand Customs Service. The Department of the Prime Minister and Cabinet has been informed.

Communications

40. My office will work with officials to ensure timely communications as required.

Proactive Release

41. I intend to proactively release this Cabinet paper within 30 business days of decisions (subject to redactions on standard withholding grounds, such as maintaining legal privilege).

Recommendations

The Associate Minister of Health recommends that Cabinet:

- 1 **Note** that as part of its consideration of the Budget 2024 paper [CAB-24-MIN-0148 refers], Cabinet agreed to create a tagged contingency, which set aside \$216.094 million operating funding to manage the fiscal implications of further decisions to be taken on options to change the tobacco excise applied to heated tobacco products (refer to Annex D, Initiative No: 16085, titled 'Proposals to Change Excise Treatment of Heated Tobacco Products initiative').
- 2 **Note** that the fiscal implications associated with this initiative reflect a 1 July 2024 start date.
- 3 **Agree** to reduce the level of excise applied to heated tobacco products by 50 percent, relative to current levels.
- 4 **Agree** that the changes to excise duty on heated tobacco products should come into effect on 1 July 2024.
- 5 **Agree** to draw down on the contingency referenced in recommendation 1 above.
- 6 **Approve** the following changes to provide for the decision in recommendation 3 above, with a corresponding impact on the operating balance and net debt:

	\$m - increase/(decrease)				
	2023/24	2024/25	2025/26	2026/27	2027/28 & Outyears
Operating Balance Impact*	-	(11.295)	(44.715)	(75.999)	(84.085)
Net Core Crown Debt Impact Only	-	-	-	-	-
No Impact	-	-	-	-	-
Total	-	(11.295)	(44.715)	(75.999)	(84.085)

* Unless non-cash, will also impact net core Crown debt.

B U D G E T S E N S I T I V E

Vote Customs Minister of Customs	\$m - increase/(decrease)				
	2023/24	2024/25	2025/26	2026/27	2027/28 & Outyears
Tax Revenue:					
Tobacco excise	-	(11.295)	(44.715)	(75.999)	(84.085)
Total Revenue	-	(11.295)	(44.715)	(75.999)	(84.085)
Total Operating	-	11.295	44.715	75.999	84.085

- 7 **Note** that, following the adjustments detailed in recommendation 3 above, the tagged contingency described in recommendation 1 above is now exhausted and therefore closed.
- 8 **Note** that changes will be made through a two-step Order in Council process that would:
- 8.1 temporarily suspend and reduce the tobacco excise duty and excise-equivalent duty rates for heated tobacco products until 1 January 2025
 - 8.2 permanently maintain the reduction of excise duty and excise-equivalent duty rates for heated tobacco products from 1 January 2025 onwards
 - 8.3 amend the Tariff to better classify heated tobacco products.
- 9 **Note** that the Associate Minister of Health will report back to Cabinet within 12 months of any implementation, supporting Cabinet consideration of whether this initiative is having the desired impact.

Drafting instructions

- 10 **Invite** the Minister of Customs to issue drafting instructions to the New Zealand Customs Service (who draft these Orders) to give effect to recommendations 3 and 4, using the approach noted in recommendation 6.
- 11 **Note** that that draft Orders in Council will be submitted to LEG on 20 June 2024, seeking authorisation to submit to the Executive Council on 24 June 2024.
- 12 **Note** that the Minister of Customs will need to seek a waiver of the 28-day rule to enable the changes to come into force on 1 July 2024.

Authorised for lodgement

Hon Casey Costello

Associate Minister of Health