The Excise Duty on Spirits

. . . the Case for Another Drop

A Report prepared for

The Scotch Whisky Association

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"The producers, importers and retailers of alcoholic drinks in the UK join in condemning the consequences for UK jobs and international competitiveness from past Government policy of high taxation of alcoholic drinks. High taxation depresses home sales, encourages cross-border shopping to the detriment of the UK revenue and the domestic industry, encourages fraud and other crime, and sends the wrong signals to our export markets. Duties on alcoholic drinks in the UK are too high and should be reduced".

Joint statement by :

The Brewers and Licensed Retailers Association

The Gin and Vodka Association

The National Association of Cider Makers

The Scotch Whisky Association

The Wine and Spirit Association of Great Britain and Northern Ireland

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THE TAX MUDDLE

The Chancellor's 1998 Budget decision to freeze the excise duty on spirits was a welcome recognition of the heavy discrimination faced by Scotch, and the need for corrective action.

Alcoholic drinks are taxed because they contain alcohol. The UK excise tax structure does not reflect this simple fact: it is a jungle of anomalies, whose basis lies in historical precedent rather than in logic.

As a result, spirits consumers who account for 18% of all alcoholic drinks bear 28% of the excise tax burden amongst drinkers.

THE DOMESTIC MARKET

1998 is proving to be one of the worst years in recent memory, with Scotch Whisky clearances down so far by 7%. Since 1990, the market has weakened by 25%. For the Exchequer, the spirits revenue position mirrors the decline in the market.

Tax discrimination against spirits has served to exacerbate the declining share of consumer expenditure on spirits. At the same time, wine consumption in the UK is continuing to grow rapidly: over the last five years, revenue receipts from wine have increased year by year at an average rate of just under 7%.

Cross-border activity in alcoholic drinks, encouraged by high UK rates, adds to the problem, and is currently estimated by C&E to be sucking some £460m out of the UK Treasury's coffers. Trade research indicates the loss to the UK to be much greater.

Market changes are complex and not all tax driven. Nevertheless, the tax on spirits is high and discriminatory. Since some 80% of *all* Scotch in the UK is sold through the retail trade, the shelf price is crucial. The high incidence of tax means that the Chancellor - rather than producers or retailers - is the principal determinant of price.

TAXATION POLICY

The Government is committed to fair and efficient taxation: drinks tax policy is neither. It discriminates against spirits, with no evidence to suggest that these are predominantly consumed by the better off. And it defies efficiency by burdening the more price sensitive category with the highest tax rate.

EXECUTIVE SUMMARY

Pragmatism indicates that the Treasury is unlikely to enhance spirits tax receipts without reducing spirits tax levels. Indeed, recent econometric research commissioned by the industry suggests that the price elasticity of spirits lies in the region of minus 2.18, which implies that tax *cuts* will be revenue enhancing.

EXPORT IMPLICATIONS

The implications for the valuable export trade in Scotch are clear. UK tax policy tells overseas governments that discrimination is acceptable: in ten of its top 20 markets there is tax discrimination against Scotch to protect domestic spirits; in all but one, Scotch is taxed more heavily than wine.

This has spilled over into the EU - which accounts for 40% of Scotch exports. Completion of the so-called Single Market ushered in a discriminatory *minimum* rates structure, with a high minimum rate on spirits, whilst wine benefits from a zero rate. The UK cannot fight EU discrimination with credibility, whilst its own structure is discriminatory.

GENERAL PRINCIPLES

The Scotch Whisky industry believes that the core principles of taxation embraced by the Government - that it should be fair and efficient - mean that the UK system is ripe for overhaul.

It calls for progressive reductions of the rate applied to Scotch (and other spirits) until discrimination is eliminated, so that the UK tax structure and thus the home potential for Scotch is improved, and the effort to eliminate tax trade barriers abroad is underpinned.

SOLUTIONS FOR THE 1999 BUDGET

The industry therefore asks the Government to *acknowledge* the exceptionally difficult current market conditions - themselves fuelled by an exceptional tax regime - and to *initiate* a series of progressive tax cuts leading eventually to equal tax treatment of *all* alcoholic drinks.

The industry urges that a start be made in the 1999 Budget by going further with a cut in the duty on spirits than the 4% which is the maximum delivered by any previous government.

SECTION 1

THE TAX MUDDLE

Where We Are

The foundation of any efficient tax system is that it should be transparent and comprehensible. In the case of alcoholic drinks, they are taxed because they contain alcohol. Yet the UK excise duty structure for alcoholic drinks discriminates against spirits, and is anything but comprehensible and transparent: it is a jungle of regulations quite divorced from any set of rational principles.

At present, we have

- spirits duty levied per litre of pure alcohol
- beer duty based upon volume
- cider and perry rates which vary between *high* strength and *low* strength
- wine charged at a rate per hectolitre, but at differing rates for *light, medium, heavy* and *sparkling* wines
- entirely different structures for *intermediate* and *mixed* drinks.

Significantly different rates of duty, *per degree of alcohol content*, are applied to different alcoholic drinks, with substantial variations in tax *as a percentage* of the retail price of beverage categories. The system is clearly not 'transparent', and many of those responsible for administering it have little idea of why different tax rates apply to different drinks.

How We Got Here

The rationale behind many of the decisions which created these anomalies, and the resultant discrimination in the system, is shrouded in history, reaching back to pre-war Budgets and 19th century Chancellors of the Exchequer. From time to time there have been marginal adjustments to this structure, but there has been no *review* of the underlying principles. As a result, spirits face discrimination with the highest rate of duty. Figure 1.1 shows typical measures of alcoholic drinks, all containing the same amount of alcohol, but all attracting very different levels of taxation.

THE TAX MUDDLE

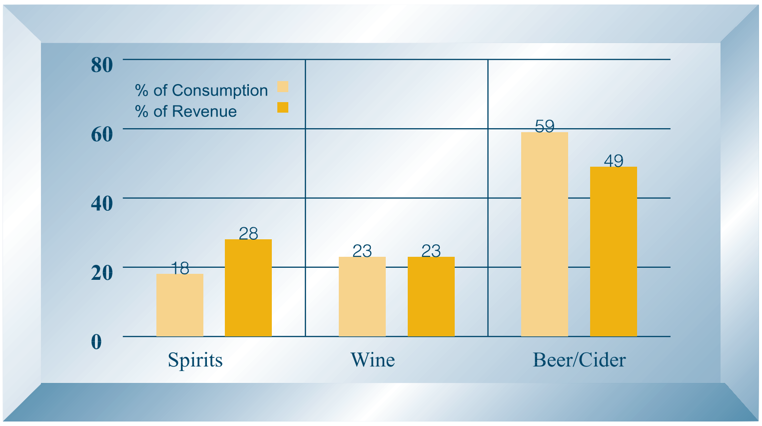
Figure 1.1

Duty in Standard Measures with same Alcohol Content

As a result of the above, spirits consumers, who account for 18% of all alcoholic drinks consumed in UK, bear 28% of the excise tax burden (Figure 1.2). Inevitably, this discrimination depresses spirits' share of the domestic market for alcoholic drinks.

Figure 1.2

Consumption and Revenue Share, 1997



The current system is thus inflexible, out-dated, and illogical, as well as discriminatory. Further, it does not meet the Chancellor's own stated principles of transparency, efficiency and fairness.

SECTION 2

THE DOMESTIC MARKET

1998 is proving to be one of the worst years in recent memory for the domestic market.

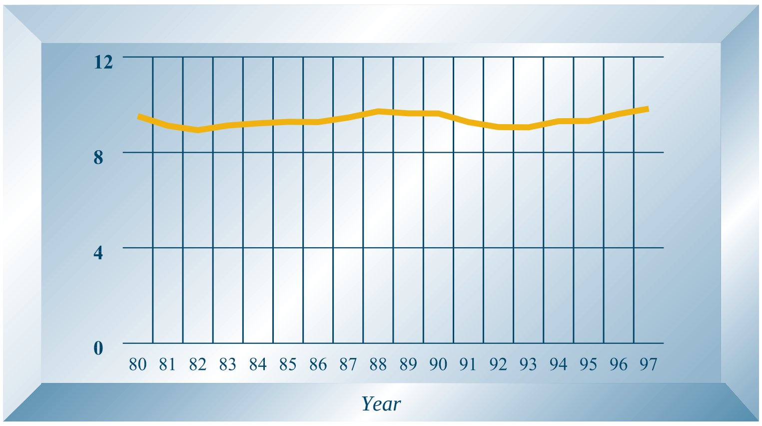
- In the first nine months of 1998, Scotch Whisky clearances are down 7% on the same period in 1997.
- Clearances for the 12-months to September 1998 are down 5.6% on the previous 12-month period.
- Since 1990, annual clearances of Scotch Whisky have declined by 25%.

The above is against a background in which:

- the UK market for alcoholic drinks, with its high incidence of tax, is highly competitive;
- per capita consumption of alcoholic drinks is static (see Figure 2.1);
- increased travel has introduced consumers to a wider range of drinks.

Figure 2.1

*Per Capita Alcohol Consumption (LPA per head) **



* at 100% alcohol by beverage type

For the Exchequer, the revenue position mirrors the decline in the market. All the indications are that, within the current tax system, the contribution of spirits to revenue receipts is no longer buoyant and is declining:

Year	*Spirits Revenues*	*% of alcohol revenues*
1994/5	£1776m	32%
1995/6	£1653m	29%
1996/7	£1593m	28%
1997/8	£1546m	27%

THE DOMESTIC MARKET

At the same time, wine consumption in the UK (and across Northern Europe) is growing rapidly. Its UK growth is amply demonstrated by the fact that, over the last five years, revenue receipts from wine have consistently increased year by year at an average rate of just under 7%. Wine's share of total alcohol excise revenues increased by 23% over the same period.

Clearly, a variety of factors contribute to changing customer tastes and preferences. Taxation policy is crucial amongst them. Tax discrimination against spirits has served to exacerbate the declining share of consumer expenditure on spirits.

Most nations have devised tax systems which favour domestically produced alcoholic drinks. For example, the wine-producing nations of the EU discriminate heavily in favour of wines, which additionally provides support for grape growers. By contrast, the UK tax structure disadvantages a major UK industry - spirits - which is also a major export earner, of strategic importance to the UK. This disadvantages UK cereal growers also.

Cross-Border Activity

Revenue receipts from spirits (and other alcoholic drinks) are being further eroded by the growth of cross-border trading, both legal and illegal, a phenomenon directly linked to the high level of UK excise duties. HM C&E have regularly revised upwards their estimates of revenue foregone from the purchase of alcoholic drinks across the Channel. Their latest estimates for losses from legal purchases have risen to a hefty £240m (1997), and from smuggled goods stand at £220m (1997). Revenue losses from spirits alone, arising from cross-border activity, are estimated at £75m. Trade research indicates the loss to the UK to be much greater.

These wounds are self-inflicted: it may well be no mere coincidence that, in the period since the increase in spirits duty in January 1998, domestic sales of Scotch have *fallen* by around 4 million bottles, while sales in France have *increased* by around 4 million bottles. Sales to other EU member states do *not* show anything approaching this rate of increase. It is hard to resist the conclusion that much of the additional sales in France reflects cross-border activity, reducing tax revenues and employment in the UK.

THE DOMESTIC MARKET

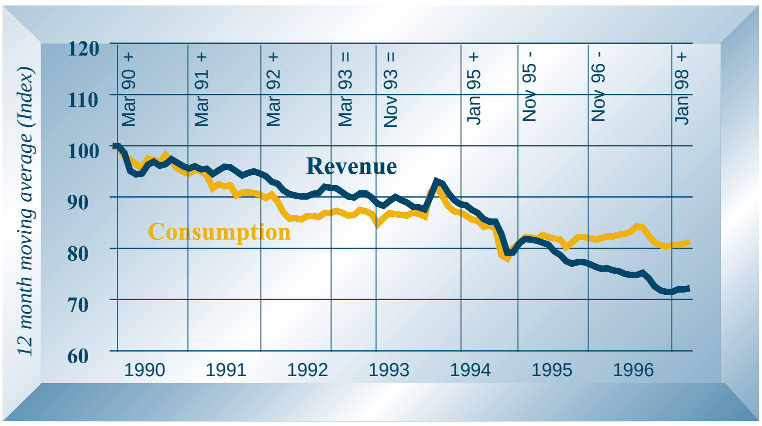
Whilst the 1997/8 Alcohol & Tobacco Fraud Review sought to analyse the problem, the remedies suggested focus upon deterrence and detection, with scant regard for the single most important factor energising this trade: high levels of differential taxation in the UK, as compared with our closest EU neighbours. Without immediate downward adjustment of spirits duty, cross-border activity will continue to grow.

Market changes are complex and are not all tax driven. Nevertheless, the fundamental issue remains that the tax imposed on spirits is high in absolute terms, and discriminatory compared with other drinks.

At home, some 80% of all Scotch is sold through the retail trade. In these circumstances, the shelf price is crucial. With the tax on a typical bottle of Scotch Whisky accounting for more than 60 per cent of the retail price, it is ultimately the Chancellor, rather than the producers or the retailers, who remains the main determinant of the retail price. The results of this are clear for all to see in the decline both of the home market for Scotch Whisky and other spirits, and of revenue receipts since 1990 (Figure 2.2). With figures expressed in constant prices, the decrease turns out to be even greater for revenue receipts than it is for the consumption of spirits.

Figure 2.2

Spirits Consumption and Revenue (1990 Constant Prices)



TAXATION POLICY - PRINCIPLES and PRAGMATISM

Principles

The New Labour Government is committed to fair and efficient taxation for the UK. It has recognised that methods of taxation send clear signals about the economic activities which governments believe should be encouraged (or discouraged). It has also acknowledged that the implications of tax policy for the UK's international competitive position should be considered within its own taxation framework.

Currently, the signals emanating from UK tax structures for alcoholic drinks are negative, given the high discriminatory rates applied to spirits. The level of discrimination against spirits has no justification on grounds of fairness, efficiency or behavioural considerations.

The Government's principles of taxation, if applied as a guide to policy in the case of competing goods, would indicate a strong case for equal treatment across the spectrum, unless it can be demonstrated that one particular set of these competing goods should be treated differently - on grounds of fairness, efficiency, or for behavioural reasons.

Duty & VAT

Different categories of alcoholic drinks are clearly competing goods within the UK domestic market. The taxation of alcoholic drinks is based upon the fact that they contain alcohol. The taxation has two elements: excise duty and VAT.

VAT raises no issues of *principle* because it is applied at a flat rate across *all* alcoholic drinks. However, as VAT is applied to the duty paid price, Scotch attracts a higher *effective* rate because it faces higher excise duty.

Excise duty is a different matter. *All* alcoholic drinks attract duty based upon their alcohol content. But the *rate* of duty varies significantly between categories. For competing goods, discrimination is inappropriate and there is a strong case for equal tax treatment across the spectrum, unless it can be demonstrated that one particular set of these competing goods should be treated differently on grounds of fairness, efficiency or for behavioural reasons.

Fairness

There is no universally accepted definition of fairness. But it is reasonable to suggest that the tax burden should be *lighter* for those goods and services which are more important to those on lower incomes, and *heavier* for those goods and services which are more important to those on higher incomes, a principle which underpins the zero VAT rating of food.

SECTION 3

TAXATION POLICY - PRINCIPLES and PRAGMATISM

The discriminatory tax treatment of Scotch Whisky (and other spirits) does not match this concept of fairness. Figure 3.1 shows that the share of income spent on spirits falls as income rises. There is no substance therefore to the perception of Scotch Whisky, or indeed of spirits generally, as "*the rich man's drink*". Yet spirits carry the top levels of duty (and therefore of consequential VAT).

Figure 3.1

Alcohol Expenditure as a % of Total Household Income, 1996-97

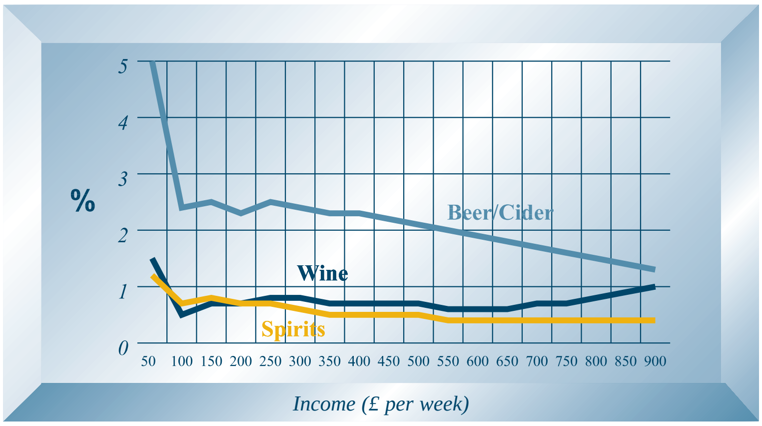
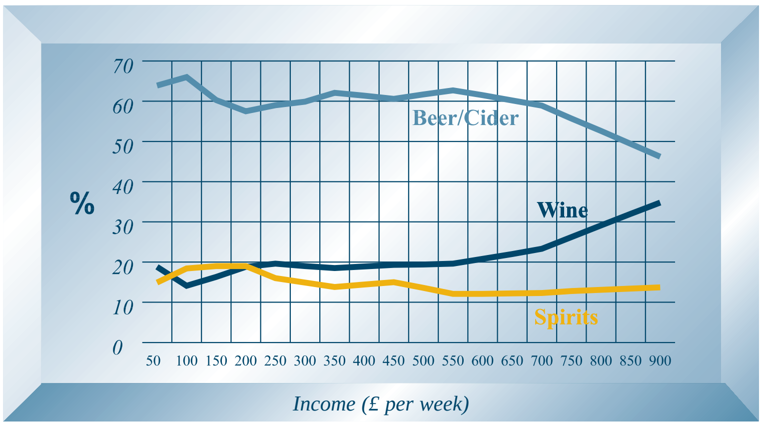


Figure 3.2 looks at this issue from a different but related angle. It demonstrates that the share of total alcohol expenditure on wines increases as family income increases, while the share accounted for by other alcoholic drinks reduces.

Figure 3.2

Beverage Category Share (%) of Alcohol Expenditure, 1996-97



To justify the discriminatory taxation of spirits on fairness grounds, it would be necessary to demonstrate that the consumption of Scotch (and other spirits) is particularly associated with higher income groups. There is no credible evidence to this effect.

TAXATION POLICY - PRINCIPLES and PRAGMATISM

Efficiency

As with the concept of fairness, there is no universal view of what constitutes efficiency. In the case of tax collection, however, it has to do with the costs of collection, and the impact of taxation upon the market provision of goods and services. Collection costs do not vary significantly across different categories of alcoholic drinks. But the impact on the market is more complex.

Efficiency requires that the post-tax pattern of production and consumption should be as close as possible to the pattern which would prevail with no taxes, that is, the tax impact should be 'neutral'.

As far as the market shares of alcoholic drinks are concerned, in order to achieve this, the most price sensitive product should bear the lowest tax rate, and the least price sensitive, the highest. Current Customs and Excise demand equations show the most price sensitive drink - spirits - with the highest price elasticity of demand of minus 1.07. Yet, spirits bear the highest rate of duty. This applies *a fortiori* if, as we believe, HM C&E has underestimated the real price elasticity of demand for spirits.

There is, in short, *no* case for a higher rate on spirits.

Behavioural Considerations

There are no reasons on grounds of health or behavioural considerations for taxing one alcoholic drink more heavily than another.

The Department of Health's Sensible Drinking Message noted the beneficial effects of the moderate consumption of alcoholic drinks. More recently, the Minister for Public Health, Tessa Jowell, in the context of the Government's plans for a National Alcohol Misuse Strategy, clearly articulated the Government's recognition that any health problems had to do with the *misuse* of alcohol and not the *consumption* of alcoholic drinks per se. The Government had no intention of attempting to influence the behaviour of the vast majority of sensible drinkers.

The Sensible Drinking Message draws no distinction between different categories of alcoholic drinks and establishes no case for treating different alcoholic drinks differently for tax purposes. It supports the approach of tackling problems associated with inappropriate drinking by targeting measures at the potential "misuser", irrespective of the form in which the alcoholic drinks are being consumed.

TAXATION POLICY - PRINCIPLES and PRAGMATISM

The vast majority of those who regularly take a drink fall into the category of sensible drinkers, who derive enjoyment and social benefits from consuming alcoholic drinks. The generally accepted view is that it is the *amount* of alcohol consumed and not the *form* in which it is taken which is important. There is no evidence that penal taxation serves to discourage inappropriate drinking.

Given the Government's recognition that there is no health or behavioural consideration to justify differences between different categories of alcoholic drinks, a duty structure which does not discriminate between different categories of alcoholic drinks would reflect Government policy in this area.

Pragmatism

The Treasury is unlikely to secure enhanced revenue receipts over the long term - with less distortion of consumer demand - without reducing the level of tax levied on spirits, and moving progressively towards equality of tax treatment across different categories of alcoholic drinks.

The pattern of revenue receipts from spirits, when aligned with movements in spirits excise duty rates, amply demonstrates (see Figure 2.2 above) how the law of diminishing returns is in play in the context of spirits rates. Where rates have stood still or fallen in recent years, consumption has improved and revenues have shown signs of recovery. Given the poor state of the UK market, there is little room for sustaining better revenue returns by raising rates. On the contrary, a progressive series of decreases is required to stimulate the home market - the industry's priority - and at the same time to stem the long-term haemorrhage of revenue returns for the Treasury.

In fact, HM C&E is currently reviewing its demand equations for alcoholic drinks, which may well be in need of amendment. Recent UK studies have suggested that the demand for spirits may be more price sensitive than current official estimates would suggest. Certainly, the impact of the last three increases in spirits duty suggests this may be so. In its latest (1997) Green Budget, The Institute for Fiscal Studies argues:

> *"For spirits . . . demand seems to be more price responsive and taxes make up a large part of the final price. This makes the argument that cutting tax rates will yield an overall increase in duties much more plausible in the case of spirits than for beer and wine"*

TAXATION POLICY - PRINCIPLES and PRAGMATISM

The industry has also sought independent advice on this central issue, and commissioned the French consultancy, *Bossard*, to provide econometric evidence on the price elasticity of demand for spirits in the UK.

Their modelling was based on auditable public information, and produced a robust estimate of spirits elasticity lying at minus 2.18. The work aligns closely with the findings of an earlier Bossard study, produced for the European Commission in 1994, on competition in the market for alcoholic drinks, which found an elasticity estimate of minus 2.2.

The new econometric work also established that:

- 90% of UK duty changes *are* passed on to customers in the retail price. Hence, duty changes will impact upon sales and revenue receipts.
- there is 99% confidence that the *true* value of the spirits elasticity lies in the range of minus 2.04 to minus 2.32, compared with the current official estimate of minus 1.07.
- price elasticities of demand within the above range mean that any *reduction* in the excise duty on spirits will be revenue enhancing, and any *increase* can be expected to *reduce* revenue receipts.

In short, the new Bossard study is consistent with experience and other recent studies which show that a spirits excise rate increase can be expected to reduce revenues, and a cut to improve them. Their modelling of sectoral volumes against prices will capture all relevant effects, including cross-border shopping, smuggling and duty free purchases. Full details of the research have been passed to HM C&E which we hope will be of assistance in the current review of demand equations and elasticities.

The fact is that UK excise duty structures are also at variance with the Government's aim to promote international competitiveness through the tax system: they send the wrong signals to crucial export markets that discrimination against Scotch Whisky (and other spirits) is acceptable; and they encourage cross-border trading, with all the losses outlined above which this entails.

The Treasury has advanced no justifications for the current tax structure, on the grounds of fairness, efficiency, behavioural considerations or pragmatism. Insofar as there has been any justification, it has been on the basis of retaining flexibility, ". . . so as to accommodate changing market conditions".

Market conditions for spirits have become progressively less favourable in the UK, with continuing poor demand for spirits. It is hard to conclude, therefore, that this flexibility has been applied.

SECTION 4

EXPORT IMPLICATIONS

Scotch is the flagship product of Scotland, a global product with an unrivalled reputation for quality and consistency, a standard setter others seek to match. It is one of the UK's top five export earners:

- Exported to more than 200 markets world-wide
- Exports account for 90% of sales
- Exports in 1997 earned £2.4 billion
- Export sales per employee are higher than for any other UK industry (Figure 4.1)
- The trade balance for Scotch (and other spirits) ensures a positive trade balance on the drinks import/export account (Figure 4.2)

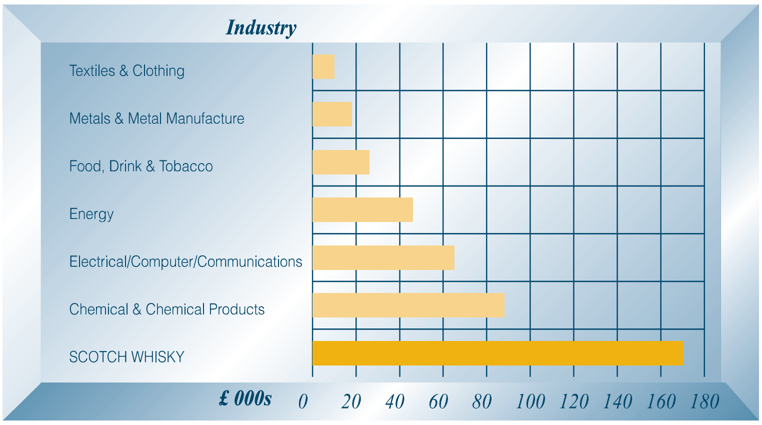


Figure 4.1

UK Export Earnings per Employee, 1996 (£000s)

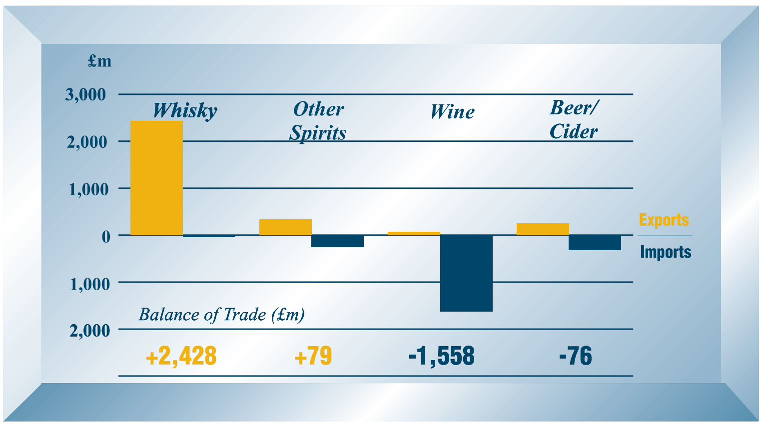


Figure 4.2

Trade in Alcoholic Drinks, 1997 (all figures in £m)

EXPORT IMPLICATIONS

The interests of Scotch Whisky and of UK plc are interwoven. But the ability of Scotch Whisky further to develop its export potential is seriously hampered by tax discrimination in many overseas markets:

- Ten of the top 20 discriminate against Scotch in favour of domestic spirits
- All but one tax Scotch more heavily than wine
- Fourteen give beer preferential treatment over Scotch

Figure 4.3

Discrimination Against Scotch Whisky : Top 20 Markets

Market	Share of Scotch Exports (%)	Scotch v Other Spirits	Scotch v Wine	Scotch v Beer
USA	12.4		●	●
France	11.2	●	●	●
Spain	9.4		●	●
Japan	4.1	●	●	●
Germany	3.9		●	●
S Korea	3.6	●	●	
Thailand	3.4	●	●	
Greece	3.1	●	●	●
S Africa	2.6		●	
Australia	2.5	●	●	●
Venezuela	2.5	●	●	●
Brazil	2.1	●	●	●
Italy	2.0		●	●
Portugal	1.9		●	●
Paraguay	1.8		●	
Netherlands	1.5		●	●
Uruguay	1.5	●	●	●
Bel-Lux	1.4		●	●
Aruba	1.3		●	
Taiwan	0.6	●		

● = Discrimination Occurs

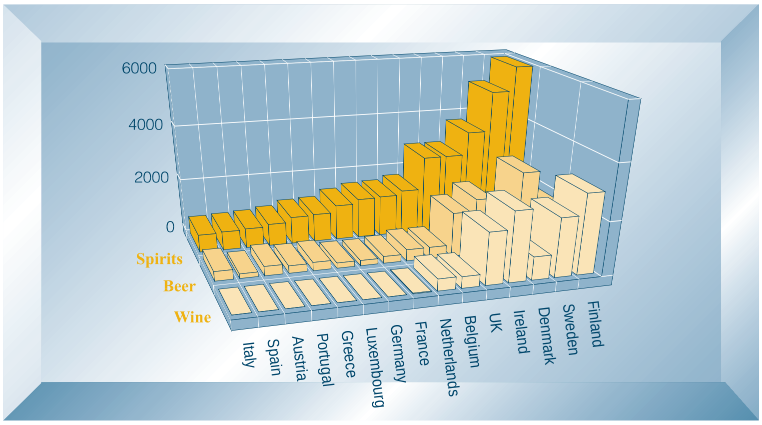
Europe remains a vital market for Scotch, accounting for some 40% of exports. Yet the industry's efforts to secure movement towards genuine tax harmonisation and a recognisable single market for alcoholic drinks are frustrated by the UK's own structure.

The tax discrimination faced by Scotch (and other spirits) in the UK is mirrored across the EU. All fifteen Member States tax spirits more heavily than other drinks. Seven out of the fifteen - wine producers above all - levy *no* tax on wine, and an eighth virtually no tax.

EXPORT IMPLICATIONS

Figure 4.4

Excise Duty Rates in the EU: March 1998 [ECU/HLPA (000s)]



Current *minimum* excise rates were agreed in 1992 and *require* that minimum rates for spirits should be greater than those for competing categories. The Minimum Rates Directive effectively enshrines discrimination in law.

To make matters worse, in July 1999 the industry loses a valuable £136m market for its products with the abolition of duty free shopping for travellers within the EU. Abolition is predicated upon the creation of the Single Market, in which duty free would be an anomaly. However, there is no Single Market for alcoholic drinks: there are fifteen different tax regimes, all of which discriminate against Scotch Whisky and other spirits.

The rest of the EU is now the most important market for Scotch Whisky. As in other parts of the world, Scotch faces *institutionalised* discrimination there in the form of higher indirect taxes. The irony is that the UK Government has provided major support and direct assistance in reducing discrimination against Scotch Whisky in major export markets - notably Japan and Taiwan. Yet Scotch faces increased discrimination in the "national" market of the EU.

The Scotch Whisky industry is convinced that this state of affairs is directly connected with the anomalies in the UK domestic tax structure for alcoholic drinks. The world-wide penetration of Scotch Whisky means that the UK Government has a major national interest in ensuring fair tax treatment overseas. It cannot safely achieve this whilst practising discrimination at home.

SECTION 5

GENERAL PRINCIPLES

This paper sets out above how the core principles of taxation support the industry's long term aim of securing equal tax treatment for Scotch Whisky (and other spirits) with other alcoholic drinks, with a single rate levied according to their alcohol content.

A first priority is to reduce the current level of tax discrimination against spirits. The industry believes that its fundamental arguments are accepted in principle by the Government and it acknowledges the duty freeze delivered in the 1998 Budget.

The industry now looks for further advances, through progressive reductions of the discriminatory tax levied on Scotch Whisky, as a means of:

- improving the tax structure for alcoholic drinks in the UK and thus the prospects for Scotch Whisky (and other spirits) in their home market
- supporting the collective effort to eliminate tax trade barriers overseas and thus the prospects for increased success in export markets
- improving the prospects for UK plc and for revenue receipts in the UK

SECTION 6

SOLUTIONS FOR THE 1999 BUDGET

The industry asks the Government to recognise that the exceptionally difficult domestic market conditions which it faces are themselves fuelled by an exceptional tax regime, one which penalises a major UK export earner and strategic Scottish-based UK manufacturing industry, at the same time as hindering the Government's own case when battling for equal tax treatment abroad.

A progressive move towards the elimination of discrimination at home will meet the industry's long-term objective of *a tax structure for alcohol*, under which *all* drinks bear a single rate of duty, levied per degree of alcohol content.

The Scotch Whisky industry does not seek, and never has sought, favourable treatment. It believes nevertheless that it has a compelling case for clear and continued movement towards equal tax treatment.

It therefore asks the Government to:

- demonstrate its recognition of the industry's case, and take *progressive* steps which reduce tax discrimination against spirits

- make an immediate move in the 1999 Budget, by going further with a cut in the duty on spirits than the 4% which is the maximum delivered by any previous government

- consider more fundamental reform of the overall excise tax structure, and the implementation of a process to review its many anomalies. The long-term rationale of the industry's case remains the principle of applying duty at the *same* rate per degree of alcohol content to *all* alcoholic drink categories.