

Letter to Lisbon

The Case for Lower Excise Duties on Alcohol & Tobacco

by
Keith Boyfield

The high duties which have been imposed upon the imposed upon the importation of many different sorts of foreign goods, in order to discourage their consumption in Great Britain, have in many cases served only to encourage smuggling; and in all cases have reduced the revenue of the customs to what more moderate duties would have afforded.

Adam Smith, *Wealth of Nations*, Book V, Chapter II, Part II, Article IV.

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Contents

| | |
|---|-----------|
| Introduction | 4 |
| A Single European Market? | 4 |
| The Quest for Harmonisation | 6 |
| The Minimalist Approach | 6 |
| Tobacco Products | 8 |
| Cross-Border Shopping | 11 |
| Tobacco Products | 12 |
| Handrolling Tobacco | 13 |
| Mail Order Schemes | 14 |
| UK Government Budget Policy | 17 |
| The Dupuit/Laffer Curve | 18 |
| What is at Risk? | 20 |
| An Unsustainable Policy | 20 |
| Tobacco Products | 21 |
| Issues to be considered by the Lisbon Conference | 23 |
| The Lisbon Conference | 24 |
| Tax Strategies on the Market | 24 |
| Excise Duties & Revenue | 25 |
| Excise Taxes & the Treaty | 27 |
| Unsettled Questions | 27 |
| Conclusions | 29 |
| Internal Market issues | 29 |
| UK Excise Duty Policies on Alcohol & Tobacco Products | 30 |
| Recommendations | 30 |
| Taxation of Tobacco Products in the UK | 31 |
| Notes | 33 |

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1. Introduction

This paper has been prepared as a follow up study to our earlier report, *Too Much To Swallow*, which put the case for lower excise duties on alcohol. The purpose of this report is to address the issues on the agenda at the European Commission's conference on fiscal policy and the harmonisation of excise duties, in Lisbon on November 13-15th 1995.

We have extended the scope of this paper to include tobacco products as well as alcoholic drinks. The Lisbon conference, organised by DG XXI of the European Commission, will provide a forum for discussion on the taxation of both these products along with the taxation of mineral oils.

A Single European Market?

The founding fathers of the Community sought to establish a single European market in goods and services where there were no important differences in national taxation. Thus, Article 99 of the Treaty of Rome states:

"The Council (of Ministers) shall, acting unanimously on a proposal from the Commission after consulting the European Parliament, adopt provisions for the harmonisation of legislation concerning turnover taxes, excise duties and other forms of indirect taxation to the extent that such harmonisation is necessary to ensure the establishment and functioning of the internal market".

The proper functioning of the Internal Market, so its proponents argue, hinges on two important elements, namely the orderly control of the movement of exciseable goods throughout the European Union, and the harmonisation of taxation.

But the vexed issue of tax harmonisation has been one of the most intractable problems facing the European Commission in its attempts to reach the goal of a single European market. As noted in our previous study *Too Much To Swallow*, few issues arouse such strong feelings as the excise duties applied to alcohol and tobacco. Indeed, the Commission has pointed out that "it is probably fair to say that each member state would wish that other member states should adjust their rates to bring them in line with its

own national rates".¹

The objective of a single European market in alcoholic drinks and tobacco products is clearly still a long way off. Within the European Union there are myriad examples of major price differentials on the same or similar products. The price disparities are particularly marked in the case of bottles of spirits: on a recent research visit to Italy the author of this paper was able to purchase several bottles of spirits at less than half the retail price charged in the United Kingdom! But there are also very significant differences on beer too. Thus, a lively trade has sprung up, in which people from the United Kingdom hire vans to load up with cheap beer in the Channel ports of France and Belgium, allegedly for personal consumption, but all too often for resale. The Brewers and Licensed Retailers Association has shown this trade to be very significant.

Figure 1 summarises the receipt the author was given on a visit to the Co-op supermarket in Campi Bisenzio, Tuscany on Tuesday, 26th September 1995, and compares prices with those commonly found in the UK. Just one cursory look at these huge differentials in retail prices is enough to show that the objective of a single European market in spirits could hardly be more distant. Note, too, that the Gordon's gin sold in Italy is of a higher strength than that sold in the UK. The distillers have reduced the alcoholic strength in Britain in order to attract less excise duty and VAT!

Figure 1: Price Comparison of Spirits between Britain and Italy

| | Italian price | UK price |
|----------------------------------|----------------------|-------------------------|
| Johnnie Walker 70cl Red Label | £5.52 | £14.49 |
| Glenfiddich 8 year old 70 cl | £10.36 | £19.49 |
| Gordon's Gin | £4.98 (40% proof) | £10.79 (37.5% proof) |

£1 = 2,500 lire

Note: Italian prices charged on Tuesday, 26 September, Co-op supermarkets, Tuscany
UK prices based on current list prices quoted by Victoria Wines and Oddbins.

Turning to tobacco products, there are similar wide disparities in the prices charged. However, in the case of handrolling tobacco these disparities are even easier for people to take advantage of, since the product is light and compact. ***Colossal price disparities exist between neighbouring Member States, most notably between the UK and Belgium. Consequently, the incentive for both***

legitimate and illegitimate cross-border shopping is immense. For example, UK consumers who decide to buy 5 kilos of handrolling tobacco in Belgium would pay only £200 whereas in Britain the retail price for the same quantity of tobacco is over £700!

These examples demonstrate that the single internal market is still very much an unrealised ambition, at least as far as alcohol and tobacco products are concerned. Why is this the case? To answer this question, we first of all need to review the background behind the moves towards the creation of a single European market.

The Quest For Harmonisation

The European Community was established with the aim of removing barriers to trade and increasing competition, thereby delivering substantial benefits to all consumers in each Member State, who now collectively number over 340 million. Thus, one of the key goals of the founding founders of the Community was the realisation of the idea of an open trading market with no notable distortions caused by national taxation policies. Nevertheless, very little was achieved in terms of harmonisation of excise duties prior to the mid 1980s. The aims set out in Article 99 of the Treaty of Rome remained an aspiration, not a realistic policy goal.

Things began to change when Lord Cockfield was appointed a Vice President of the Commission in 1985. Cockfield, a former Inland Revenue official who had also run Boots the Chemists, realised that a positive lead was needed if the Community was ever to stand a chance of achieving the creation of a single internal market in alcohol and tobacco goods.

After a wide ranging review Cockfield arranged for a series of White Papers to be published, setting out the Commission's strategy for the completion of the Internal Market. The guiding principle behind these documents was harmonisation through uniformity at rates producing the same Community-wide revenue yield.

However, member states were not yet willing to surrender sovereignty on the way in which they levied excise duties; they therefore rejected Cockfield's proposals. The Commission tried again with a reworked strategy aimed at the removal of fiscal barriers to trade, including controls over the movement of exciseable goods (Directive 92/12) and on the harmonisation of excise taxes. This policy involved the establishment of target rates of taxation with provision for convergence over time. Yet, once again, the Council of Ministers rejected this approach due to strong opposition against the idea of Member States surrendering any significant national sovereignty in the area of fiscal policy.

The Minimalist Approach

But after five years of protracted negotiations, the Council of Finance Ministers (Ecofin) agreed what was intended to be a partial move in the direction of a single Internal Market for alcohol, tobacco and petroleum products. Thus, at a mammoth horse-trading session of Ecofin in July 1992, a system of minimum excise duties for alcoholic drinks and tobacco products was adopted by all EU Member States. However, this new regime was a political 'fix', based on a rate system consisting of minimum rates with certain agreed derogations. Mainly as a result of German pressure, Member States agreed that no minimum excise rates should apply to wine.

Consequently, as things presently stand, seven out of the fifteen Member States do not tax wine at all!

Commenting on this stitched-up deal, Dr Barry Bracewell-Milnes observes that this agreement was the "outcome of a power struggle, in which the principal vested interests were appeased or at least not seriously affronted. It was not informed by any economic principle".² None the less, this political 'fix' soon began to unravel. It has become abundantly clear that one cannot seek to achieve a single Internal Market in the foreseeable future merely by imposing minimum rates of duty. Indeed, the system of minima actually serves to institutionalise existing discrepancies in the taxation of different types of alcohol.

Thus, despite all the efforts by the European Commission to move towards a single Internal Market in alcoholic drinks, very wide disparities in prices remain across the European Union. These disparities are mainly attributable to the widely differing tax regimes maintained in each Member State. Figure 2 sets out the excise duty rates which are applied to the three main categories of alcoholic drinks in each EU country. This table reveals the gross inconsistencies in the way in which wine, beer and spirits are taxed. For example, the table shows that *seven countries choose not to levy excise duties on wine but have no hesitation in taxing its direct competitor, beer*.³ Indeed, under the EU minima rules adopted by Ecofin in July 1992, beer *must* be taxed at a minimum rate of 187 ECU per hectolitre of pure alcohol.

The two Scandinavian countries which have just joined the EU — Finland and Sweden — levy excise duties on wine (which, of course, they do *not* produce) at a huge rate of 2,744 ECU per hectolitre of pure alcohol (HLPA) and 2,611 ECU per HLP respectively! The other two countries which levy high rates of duty are the Republic of Ireland, where excise duties are only just below Scandinavian levels, and the UK, where excise duty rates are 1,543 ECU per HLP, compared with 31 ECU per HLP in France!

Figure 2: EU Member States' Tax Rates, 2 October 1995

| Excise Tax ECU Per HPLA* | Wine | Beer | Spirits | Ex |
|-----------------------------|------|------|---------|----|
| Austria | Nil | 362 | 755 | |
| Belgium | 346 | 381 | 1641 | |
| Denmark | 817 | 883 | 3980 | |
| Finland | 2744 | 3018 | 5327 | |
| France | 31 | 193 | 1398 | |
| Germany | Nil | 205 | 1355 | |
| Greece | Nil | 196 | 548 | |
| Eire | 2408 | 1927 | 2688 | |
| Italy | Nil | 321 | 503 | |
| Lux | Nil | 207 | 1085 | |
| Netherlands | 464 | 445 | 1573 | |
| Portugal | Nil | 280 | 711 | |
| Spain | Nil | 162 | 541 | |
| Sweden | 2611 | 2554 | 5196 | |
| UK | 1543 | 1306 | 2487 | |

* **Note:** HPLA = Hectolitre Per Pure Alcohol

The disparities in the taxation of beer are similarly vast. The new Scandinavian entrants to the Community levy penal rates of tax, with the Republic of Ireland again following closely behind in the league table. The yawning gulf in the rates of excise duties applied to beer have led to considerable problems centring on cross-border shopping between two sets of neighbouring Member States, namely Denmark and Germany, where German duty rates are less than a quarter of those charged in Denmark; and France and Britain, where the French duty rates are less than a sixth of those levied in the UK.

As detailed in *Too Much To Swallow* the tax treatment of spirits varies considerably throughout the European Union. Figure 2 shows that the new Scandinavian Member States levy duties at over ten times the rate charged in Italy! And, as we have seen, the tax differences on spirits between Britain and Italy make prices roughly twice as high in the former as in the latter. The same differentials — a doubling of price — apply between the UK and Spain, Greece and Portugal.

The excise duties charged on alcohol in general in Scandinavian countries are astronomically high in comparison with those charged in the Club Med countries. As a reliable guide, one can argue that the nearer one gets to the Arctic Circle, the keener governments are on making life difficult for consumers of alcohol, particularly spirits. However, such policies tend to be self defeating: puritanical zeal merely encourages people to evade penal rates of taxation by distilling their own raw alcohol, albeit with all the associated health risks involved, or through smuggling, a practice which on all accounts is flourishing among the Scandinavian countries which border

Russia.

Instead of creating a genuine single market for alcoholic drinks, the minimum rates adopted by Ecofin as from 1 January 1993 have served to institutionalise price distortions between spirits, beers and wines. What is more, since the so called completion of the single European market in January 1993, nine EU countries have widened discrimination against spirits as compared with wine, and eight as compared with beer, and subsequently there have been five further movements in the spirits rates occasioned by the relationship between the local currency and the ECU.

Thus, one must conclude that the EU system of minimum rates undermines attempts to create a single Internal Market. It also works against the principle of equivalency, i.e. an excise duty system which is based on taxing alcoholic drinks according to the units of alcohol which they contain. If such a system was to be adopted in all the Member States, as recommended in ***Too Much To Swallow***, tax distortions across the drinks market would be minimised and the current discrimination in favour of wine would be eliminated.

Tobacco Products

Meanwhile, in the case of tobacco, there had been widespread concern in the negotiations leading up to the adoption of EU minima that the removal of frontier controls might encourage a tidal wave of cross-border shopping, since consumers — if they acted rationally — could be expected to take advantage of the fact that tax rates differed so markedly between neighbouring Member States. Accordingly, the Council of Ministers agreed a minimum excise formula aimed at curbing potential problems associated with cross-border shopping. The outcome was a Directive (92/79) which required Member States to levy a minimum excise tax of 57 per cent on the retail price of the most popular price category of cigarettes (known commonly by the acronym MPPC).

This Directive has proved to be a disastrous failure. In many 'Club Med' countries, the domestic tobacco industry has been run — until very recently — as a state-owned monopoly, and as such represented an important source of government revenue.⁴ In order to protect these domestic monopolies, national governments in their tax structures have tended to discriminate in favour of lower priced home-produced brands. Southern European countries achieve this policy objective through levying modest specific excise duties and relying on ***ad valorem*** duties which tend to favour the lower-priced domestic product.⁵

Figure 3: Tax Structures on Cigarettes within the European Union, 1 July 1995

| Country | Tax Rates as Proportion of Retail Price | | | Excise Incidence | Total Tax Yield ECU/'000 |
|----------|---|--------------------------|----------------------|------------------|--------------------------|
| | VAT | <i>Ad Valorem</i> Excise | Total Proportion Tax | | |
| Denmark | 20.00% | 21.22% | 41.22% | 63.1% | 165.78 |
| Finland | 18.03% | 50.00% | 68.03% | 57.5% | 130.80 |
| Ireland | 17.36% | 16.82% | 34.18% | 58.6% | 127.10 |
| UK | 14.89% | 20.00% | 34.89% | 62.1% | 124.98 |
| Sweden** | 20.00% | 0 | 20.00% | 49.2% | 107.85 |
| Germany | 13.04% | 24.80% | 37.84% | 57.3% | 96.52 |
| France | 16.30% | 54.95% | 71.25% | 58.7% | 94.90 |
| Belgium | 17.01% | 50.00% | 67.01% | 57.4% | 93.39 |
| Austria | 16.67% | 41.00% | 57.67% | 57.0% | 81.64 |
| Holland | 14.89% | 21.05% | 35.94% | 57.0% | 77.96 |
| L'bourg | 10.71% | 54.50% | 65.21% | 57.9% | 62.44 |
| Greece | 15.25% | 53.86% | 69.11% | 57.4%* | 59.98 |
| Portugal | 14.53% | 56.00% | 70.53% | 66.6% | 56.73 |
| Italy | 15.97% | 53.35% | 69.32% | 56.8%* | 54.71 |
| Spain | 15.25% | 50.00% | 65.25% | 56.4%* | 27.51 |

* for excise incidence purposes the European Commission also employs nominal rates for these three countries, based on data established on 1 January each year based on sales in the previous calendar year, which nudges the percentage figure over the 57 per cent minima.

** Sweden has been granted a derogation on excise incidence until 31 December 1998.

Figure 3 above demonstrates that ***the 57 per cent minimum formula does nothing to promote convergence***. Note that there is no correlation between the total tax yield per thousand cigarettes sold and the excise incidence in each of the fifteen Member States. Hence, one finds that in Portugal, where the excise incidence is 66.6 per cent on the most popular price category of cigarette, the total tax yield on a thousand cigarettes is a mere 56.73 ECU — just over a third of the tax yield raised in Denmark where the excise incidence is 63.1 per cent!

This problem is probably most clearly demonstrated in the case of Spain where the nominal excise incidence is 57.3 per cent and yet the total tax yield is only 27.51 ECU — a fifth of the yield raised in Finland which has a similar rate of excise incidence, bordering on the EU minimum.

Moreover, the Directive is also having the effect of forcing those countries which impose high excise duties on cigarettes, such as the Netherlands and Sweden, to raise their taxes even further. The Directive has therefore proved to be highly counter-productive — it does nothing at all to assist in the creation of a single Internal Market; indeed, it has the effect of widening existing disparities! But then it was hastily conceived and ill thought

through.

This minimum formula is manifestly a nonsense, and does nothing by way of achieving the aims of a single European market where excise taxes are in close approximation. ***In short, minimum excise rates in the case of cigarettes are a discredited irrelevancy: they should be abolished.***

2. Cross-Border Shopping

The clearest signal that the current EU tax regime is not achieving its declared aims is the huge boom in cross-border shopping. ***The disparities in retail prices attributable to different national tax policies have led a stampede of consumers travelling long distances in order to take advantage of lower excise taxes.*** This is particularly noticeable in Northern European countries such as the UK, Sweden and Denmark where alcohol and tobacco have traditionally been taxed very heavily.

A growing body of evidence suggests that cross-border shopping is placing tremendous pressures on those countries which levy comparatively high excise duties on alcohol and tobacco. In some ways this development is to be welcomed: tax competition between Member States is one of the most effective ways of encouraging positive steps towards harmonisation. European Commission officials obviously appreciated this fact when they argued the case for the removal of frontier barriers between those countries which have elected to join the EU, knowing full well that abolition would lead to a massive surge in cross-border shopping if tax rates were markedly different. Tax competition exerts a strong downward pressure on tax rates because Member States such as the UK with high excise taxes suffer an erosion of the tax base.

The precise impact attributable to the cross-border shopping epidemic is a matter of considerable controversy here in the UK. However, Valerie Strachan, the head of HM Customs & Excise, has just conceded in evidence to the Parliamentary Treasury and Civil Service Select Committee ***that the official estimate of the loss to the Treasury in foregone excise duty and VAT revenues on alcoholic drinks personally imported into the UK amounted to £220 million in the year to June 1995, while the loss on tobacco excise and VAT revenues as a result of the boom in cross-border shopping was calculated to be around £150 million.***

Nonetheless, these estimates would appear to underestimate the true loss to the Treasury. The third annual survey on cross border shopping published by the Wine & Spirits Association (WSA) in October 1995 estimated that cross-border shopping is now costing the Treasury £453 million a year in lost taxes on wine and spirits alone! This is a dramatic increase on the loss estimated for 1993 which totalled £274 million.

It appears that more people than ever before are seeking to circumvent the high excise taxes levied in the UK. As *The European* newspaper recently pointed out in its coverage of the WSA survey, "Cars returning to Britain this year from countries such as France, the Netherlands, Belgium and Spain were found to be carrying 50 per cent more bottles of wine and three times as many bottles of spirits as in 1993".⁶ This evidence would appear to confirm the view that the flow of (low) duty-paid imports and smuggled goods has accelerated greatly since the rules governing personal imports were revised in January 1993.

Buying beer, wine and spirits in France and importing it personally into the UK has become a highly lucrative business. Within the last couple of years more than thirty supermarkets and cash and carry outlets have opened in the Calais area, specifically geared to the cross-Channel drinks trade. Among them are major British retailers such as Tesco, Sainsbury and Victoria Wine, a subsidiary of the drinks giant, Allied Domecq. It has also made millionaires of such individuals as Dave West, the owner of Eastenders, which turns over £15.5 million a year. It comes as no surprise to learn that Mr West's operation is the biggest beer retail outlet in France!

The cross-border trade in beer is having a devastating effect on our own UK brewers, publicans and off-licence trade. Prior to the relaxation of frontier controls in January 1993, duty-paid imports from France were around 440,000 pints per day. Two years later the Brewers & Licensed Retailers Association estimated that imports had almost tripled to over 1,100,000 pints a day. This is the equivalent of 4 per cent of the British beer market or 16.5 per cent of the take-home trade. Put another way, it is the equivalent of the total sales of all the pubs in Kent and Sussex!

By increasing the burden of excise duties on alcoholic drinks, the Government is danger of jeopardising its total revenue take from this source. *The brewers estimate that the lost retail revenue from duty-paid imports on beer alone totalled £406 million in 1994.* And in the first five months of 1995 the amount of spirits released from bond for sale to UK consumers fell by 15 per cent compared with the corresponding period in 1994 and Treasury revenues have declined by £62.3 million. But, the full implications of the across-the-board increase of 4 per cent in the duty on alcoholic drinks will only be known after the pre-Christmas shopping season, when many people stock up on their supplies of beers, wines and spirits.

Tobacco Products

Turning to tobacco, the Tobacco Manufacturers Association (TMA) has given some examples of just how profitable cross-border shopping can prove. Anyone making a one-day cross-Channel shopping trip and buying their permitted duty-paid allowances can save up to £140 on tobacco products.

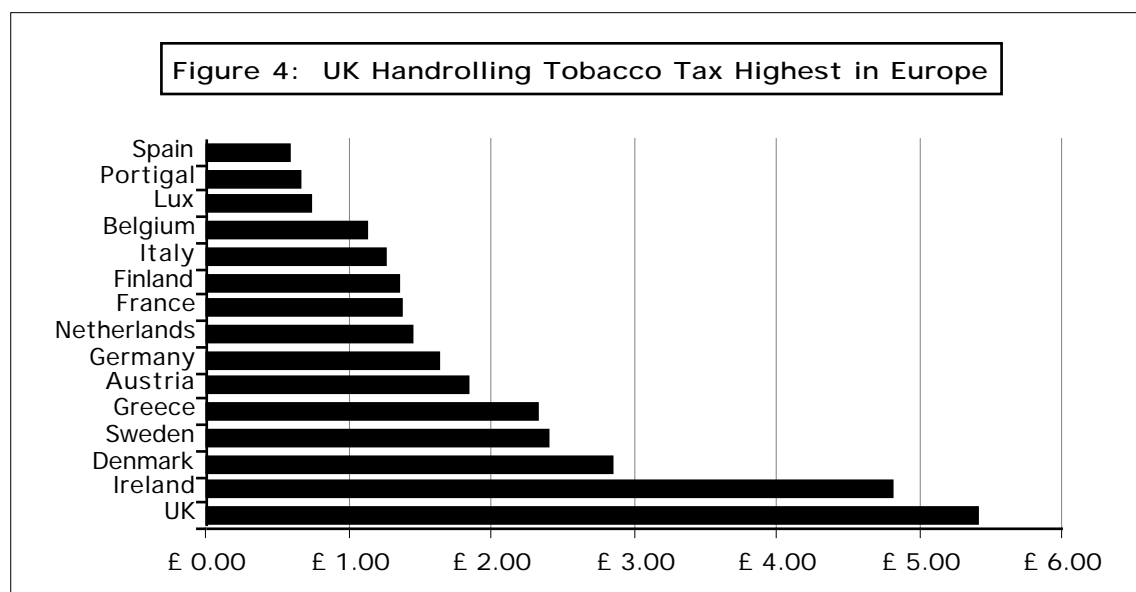
The organised van trade in legal and illegal personal imports (ie. those

intended for resale) has had a profound effect on UK brewers and retailers. Nevertheless, the TMA points out that for those in the illegal trade, a mere three 5 kg cases of handrolling tobacco, taking up around 2 per cent of the space of a small van, will yield twice the profit of a van fully loaded with beer. "For an outlay of just over £600 a smuggler can realise about £1,200 on the UK black market even selling at about half UK recommended prices".

In its latest evidence to the Parliamentary Treasury & Civil Service select committee *the TMA estimate that the retail sales losses attributable to illegal as well as legal imports of tobacco amounts to £750 million*, significantly up on its revised total of £550 million for 1994. It is calculated that £205 million of these losses are accounted for by cigarettes but the vast bulk of this total is represented by handrolling tobacco — the preferred commodity favoured by bootleggers.

Handrolling Tobacco

The tax levied on handrolling tobacco in the UK is far higher than anywhere else in the European Union. As Figure 4 demonstrates, the tax burden is three times higher in Britain than in France, Benelux or Germany.

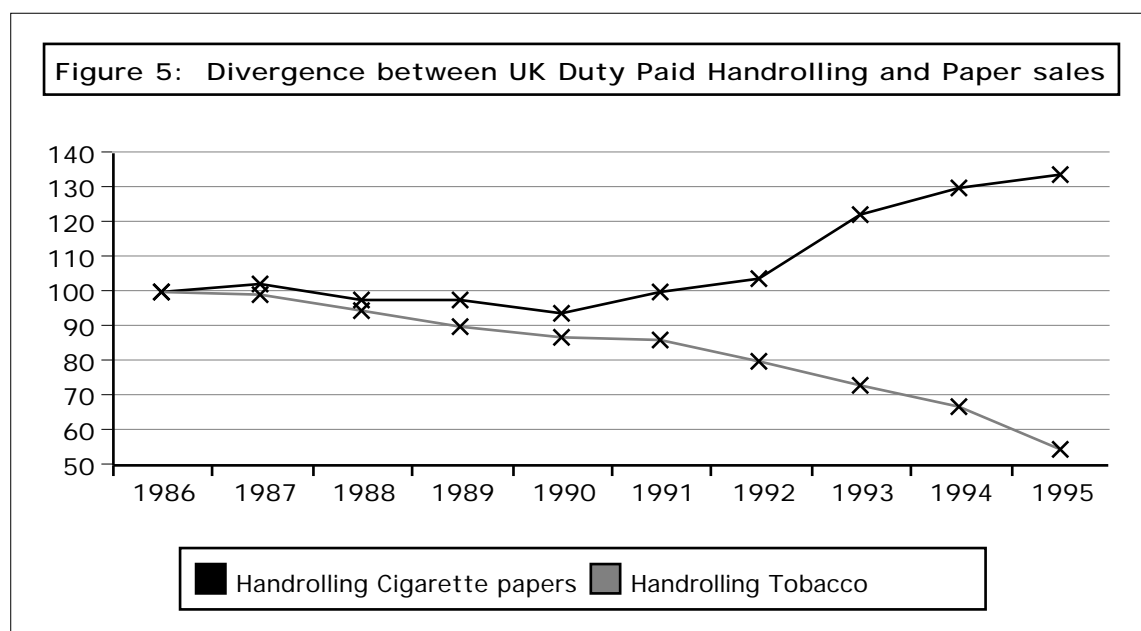


Source: Industry Figures.

These huge differences in taxation rates help to explain the disorder which has gripped the UK market in handrolling tobacco. *It is now reliably estimated that more than half the handrolling tobacco smoked in Britain is sourced — illegally — from cross-border trading!* A highly sophisticated distribution network has grown up in the last few years supplying handrolling tobacco throughout the UK. And this network is particularly strong in the regions, such as the urban conurbations in the North East and North West of England.

The gross disparities in tax on handrolling tobacco between the UK and Belgium explains why Drum is Britain's UK's third most popular brand of tobacco for handrolled cigarettes, enjoyed by 12 per cent of consumers, though it is not officially for sale in the UK! Similarly, Samson, a brand with less than 2 per cent of the UK market, is claimed to be smoked regularly by 11 per cent of consumers!

The situation with regard to handrolling tobacco has obviously reached a crisis point: UK duty-paid sales and excise revenues have plummeted since 1991/92. We have the bizarre situation whereby sales of handrolling cigarette papers have soared by 30 per cent since 1986 while duty-paid handrolling tobacco sales have tumbled by 37 per cent. And this trend is accelerating as Figure 5 below shows.



Source: Industry Figures.

For some, the temptations for illegal resale are overwhelming. No wonder then that although the UK handrolling market in 1994 amounted to 3,050 tonnes, the actual market, judged on paper sales, was more like 6000 tonnes — nearly double the legitimate duty-paid domestic sales!

A recent nationwide survey commissioned by the Tobacco Alliance, a lobbying group of independent shops, revealed that one in three tobacconists have been offered smuggled tobacco products for resale. Nearly two-thirds of the 1,370 tobacconists interviewed said they knew of illegal tobacco sales in their areas — mostly in pubs, clubs and car boot sales. The Tobacco Alliance reckon that the government is losing £1.6 billion in excise duties and VAT.

Mail Order Schemes

Another sign of consumers seeking to circumvent high tobacco taxes is the remarkable rise in the number of mail order schemes offering to supply smokers with cigarettes from low-tax EU countries. One such scheme which has hit many a newspaper headline is an ingenious mail order service devised by two former students of Exeter University — John 'BJ' Cunningham and Sten Bertelsen. These two young entrepreneurs set up a company — the Enlightened Tobacco Company — and a direct import subsidiary, dubbed 'The Man in Black', which operated as an agent importing cigarettes for customers. Those smokers who took advantage of this scheme only paid the tax in Luxembourg, which is around £1.04 on a packet of twenty, compared to £2.11 in the UK. The 'Man in Black' was thus able to import major cigarette brands from low-duty Luxembourg and sell them at discounts of up to 40 per cent on their normal retail price. It comes as no surprise to discover that the company soon had 60,000 customers placing orders. Bertelsen and Cunningham maintain that this is perfectly legal under EU single-market rules, which permit unlimited imports for personal use.

HM Customs & Excise disagreed with this interpretation of the law and started confiscating orders. But Bertelsen and Cunningham were not deterred; they took the government to court in May 1995. They were unsuccessful in this legal challenge, at least initially. The High Court found that their operation was illegal because the legislation requires consumers to transport their goods personally. The judge, Mr Justice Popplewell, nevertheless said that both sides of the argument were "persuasive and based on reason", and he gave leave for an appeal on the grounds that the case raised issues of public importance.

In August 1995 the Appeal Court referred the Enlightened Tobacco Company's case against HM Customs & Excise to the European Court of Justice (ECJ) in Luxembourg. In the meantime, it upheld Justice Popplewell's injunction banning the Enlightened Tobacco Company from mail order sales of imported cigarettes pending the ECJ ruling. This scheme, together with a number of others, is now seen as a test of Single Market practice. If the Enlightened Tobacco Company wins in Luxembourg, the UK and other high-tax countries would stand to lose large tax revenues on exciseable goods such as cigarettes and beer.

If the European Court of Justice upholds the right of consumers to import cigarettes from low-duty countries it would open up a deep fissure in existing UK tax policy, jeopardising the £6.5 billion which the government receives from excise duties and VAT on cigarettes. As if the threat from legitimate and bootleg cross-border shopping was not bad enough, such a development would put Britain's entire manufacturing, wholesaling and retailing sectors in peril unless the UK government adjusted its excise duties downwards to harmonise with the rates levied by our continental neighbours.

The lesson to be drawn from these examples of consumers seeking to circumvent high excise duties is that ***high-taxing national governments such the UK will be forced, before long, to review their excise duty policies in order to bring them more into line with the EU average.*** The British government would like other Member States to raise their excise duty rates so as to approximate with those levied in the UK. This might be a convenient solution for Treasury officials, but it is hardly in the interest of European consumers. Fortunately, there is little chance of it happening for exactly that reason. And the Commission, in considering the impact of cross-border shopping, has pointed out to the Council of Ministers that "This is essentially a matter for high taxing Member States to tackle, through reducing their national rates and/or improving controls".⁷

If the UK government does nothing, it is in danger of risking a further damaging deterioration in its tax base as more and more consumers go in for legitimate cross-border shopping, or, as in the case of handrolling tobacco, resort to the rapidly developing bootleg market.

3. UK Government Budget Policy

The boom in cross-border shopping is beginning to act as a catalyst for reform as more and more taxpayers question the way in which the British government levies excise duties on alcohol and tobacco. The message also appears to be getting through to the Chancellor. In his original 1994 Budget Kenneth Clarke admitted: "One of the most widely publicised other effects of the Single Market has been the increase in legitimate cross-border shopping in alcohol and tobacco, and in smuggling. Both of these have inevitably meant some loss of duty to the Exchequer, pressures on the British drinks industry and some damage to British business. No Chancellor can remain unmoved in the face of this".

He told MPs that "This year, I have once again listened to the concerns of the industries and I propose no increase in the duties on beer, table wines and spirits. This will mean that the proportion of the cost of an alcoholic drinks represented by tax in this country will continue to fall."⁸

But the Budget of 29 November 1994 ended in a débâclé on 6 December when MPs rejected the Government's proposals to apply VAT at the standard rate on domestic heating bills. This placed the Chancellor in a dilemma: he needed to replace the lost tax revenues he had previously anticipated raising from an extension of VAT, and he needed to do so in a hurry. In a rushed policy move, the Chancellor, guided by his Treasury officials, resorted to that old stand-by, a hike in excise duties.

Unfortunately, this rushed reaction by the Chancellor exacerbated a problem which the Government had previously had the good sense to acknowledge. The across-the-board increase of 4 per cent on alcoholic drinks further widened the disparity between the level of alcohol tax on wine and on spirits, which were already subject to very high taxes compared with the rate imposed on wine.

The across-the-board percentage increase therefore had the effect of increasing the absolute disparity. This negated the UK Government's policy of working with other EU countries to reduce the disparities; and once again it discriminated against UK-produced drinks such as beer and whisky, as compared to wine, which is mostly imported.

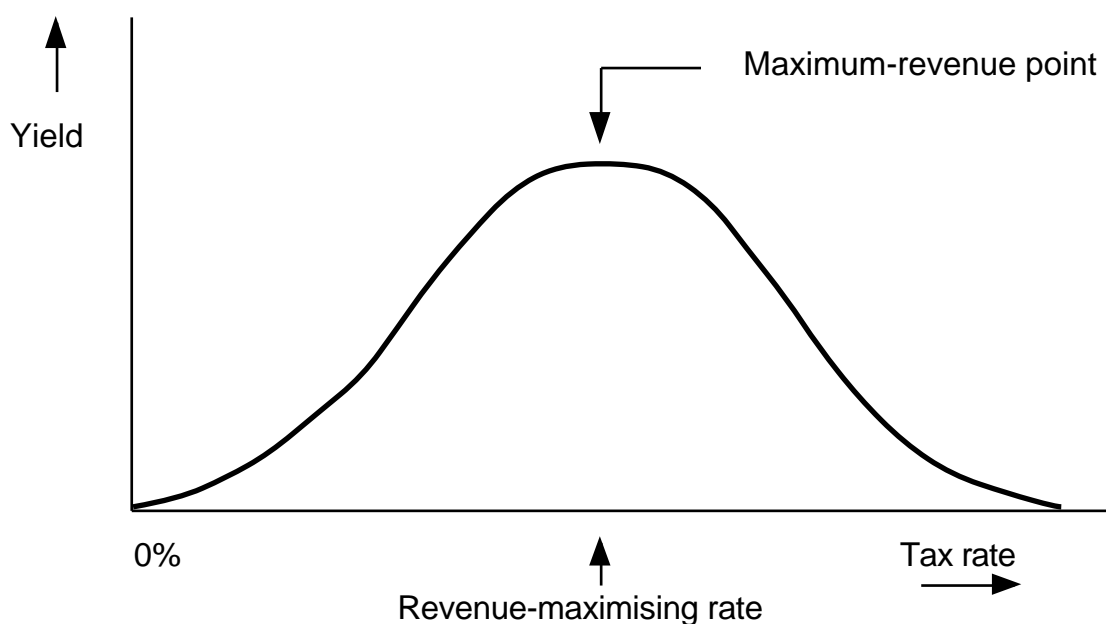
The November 1994 budget increased taxes on cigarettes by 10 pence per

packet. Then, in the Mini-Budget of December 1995, a further 6 pence was slapped on a packet of twenty in the Chancellor's bid to replace the shortfall in taxation receipts caused by the lost parliamentary vote on VAT increases. ***The Chancellor now faces a serious threat to total revenues by over-taxing tobacco products, due to the new freedom which smokers enjoy to import personal supplies of cigarettes, handrolling tobacco and cigars when they visit other Member States of the EU.*** As we have seen, an increasing number of consumers are also making use of the illegal bootleg market in tobacco. More and more of them are switching from cigarettes to handrolling tobacco and there is a real danger that many more smokers will be tempted to buy cigarettes from bootleg suppliers. Thus higher rates of duty may well bring falling returns to the Exchequer.

The Dupuit/Laffer Curve

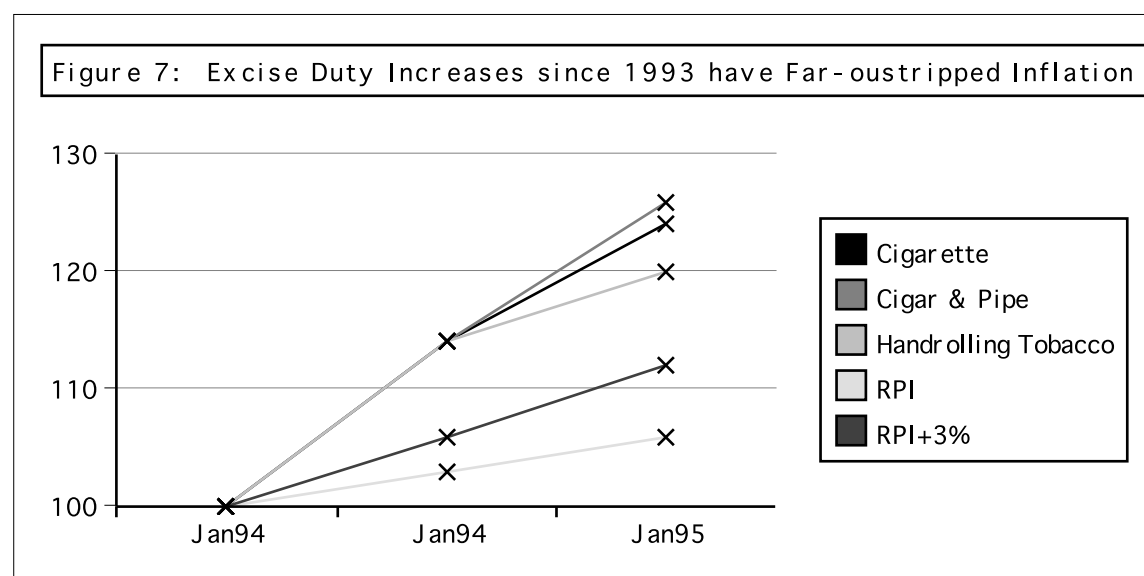
The principle in question here can be illustrated by reference to the Dupuit/Laffer curve. As pointed out in our last study ***Too Much To Swallow*** the critique of high rates of excise duties begins with the Dupuit curve or, as it is more commonly known in the USA, the Laffer curve.

As Figure 6 demonstrates the familiar "supply side" argument, namely that tax revenues will fall if governments raise their rates above a certain point. For any excise tax, we can chart different tax rates against the revenue which they bring in for HM Customs & Excise.



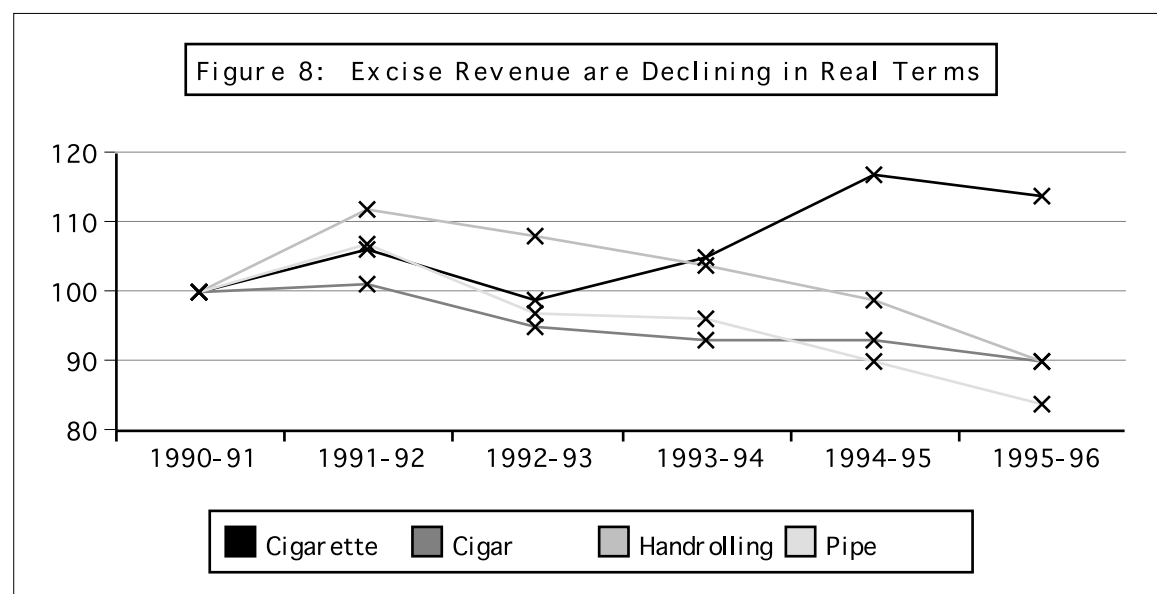
Obviously the revenue yield starts at zero when the tax is nil, but then rises to a maximum and falls to zero when the rate of tax become prohibitive. The

high point of the curve is the "bliss point" as far as the tax authorities are concerned. If the actual rate is anywhere above it, as is likely in the case of handrolling tobacco, then the yield would be increased by a cut in the rate.



Source: Industry Figures.

It can be seen from Figure 7 that tobacco duties on cigarettes, cigars and pipe tobacco have increased by 24 per cent or more since January 1993. As we have noted, there is now clear evidence that there is considerable consumer resistance to such spiralling prices. Demand is no longer so robustly inelastic. Indeed, over the last three years the total tax yield collected by government on cigars, handrolling and pipe tobacco has declined in real terms, see Figure 8.



Source: Industry Figures.

One is forced to conclude that it is becoming increasingly difficult and costly for governments to realise revenue projections by the perennial increase of excise duties on drinks and tobacco products. It is no longer such an effective means of raising tax!

4. What is at Risk?

An Unsustainable Policy

High-taxing EU Member States such as Britain are currently confronted by a difficult dilemma with regard to excise duty policy. They can seek to exert their rights as sovereign nations and formulate their own fiscal policies, including VAT and excise rates. However, the virtual abolition of frontier controls coupled with smuggling has created a major threat which effectively constrains the ability of national governments to apply excise duties which significantly differ from neighbouring Member States.

One obvious truth emerges from this development: *countries which levy high excise duties on tobacco and alcohol, like the UK, will not be able to sustain such a policy for long, because such a regime will wreak serious damage to their tax base. Consumers will simply shop elsewhere, or buy from people who have done so.*

A good case history which illustrates how this inevitable process unfolds is the example of Denmark. In 1991 and 1992 the Danish government was forced to cut excise duties on beer and wine by a total of 48 per cent because of the massive explosion in cross-border shopping with Germany, where duty rates were considerably lower. It is worth highlighting the fact that these large reductions in duties occurred long after the problem had been identified and after a significant loss in tax revenue. As in the case of Sweden in 1992 and Canada in 1994 the eventual reductions in excise rates which are forced on governments as a result of the impact of cross-border trading have had to be very high to staunch the leak. Indeed, they are typically in the range of 20 to 40 per cent.

Britain offers a striking example of the chaos which high excise duties create. The UK's taxation policy on alcohol has created a mass of anomalies and has proved to be a wholly counter-productive tax regime. The system is becoming more and more discredited as:

- consumers *refuse to pay grossly excessive excise duties*, particularly those on spirits;
- consumers look instead to buy alcohol duty-free, or duty-paid in other EU countries;

- we witness *a massive boom in cross-border shopping*, particularly across the English Channel;
- *cut-price ferry tickets* have encouraged the growth in 'bootlegged' imports;
- the relaxation of trading barriers has had the effect of *exporting jobs in the off-licence sector* to the other side of the English Channel;
- a recent econometric study by Oxford Economic Forecasting shows that for all reasonable price elasticities *at least 80 per cent of personal beer imports are substituting for UK sales*;
- the Henley Centre calculates that *as a result of lost beer sales, more than 10,000 full time equivalent jobs have been lost in the UK*,⁹
- taken together, this had led to a *considerable shortfall in revenues* for the Exchequer with more people claiming state unemployment benefit and other welfare payments;
- *UK beer production has slipped by nearly a fifth*, from 41.2 million barrels in 1979 to 34.85 million barrels in 1993;¹⁰
- *production of Scotch whisky has fallen every year* throughout the 1990s; total production amounted to 4,158,700 hectolitres in 1980, but in 1993 this total had declined to 3,562,500 hectolitres.

In the UK, cross-border shopping must now be recognised as an accepted part of consumer behaviour and it will continue to grow in popularity as long as substantial tax advantages persist. Furthermore, current excise rates act as a direct economic incentive not just to shopping in other countries, but to smuggling from them.

Tobacco Products

With regard to tobacco products, the potential threat to the government's tax base of around £9 billion on cigarettes, cigars and handrolling and pipe tobacco is just as alarming. Tobacco generates more excise revenue for the government than all the alcoholic drinks categories combined. Indeed, tobacco, in the form of cigarettes, is the most heavily taxed of all exciseable goods — duty and VAT account for 76 per cent of the sale price of a packet of cigarettes. In the calendar year 1994 HM Customs & Excise received £7,927 million in excise duty from tobacco products, equivalent to 25 per cent of total excise duty revenue.

Tobacco manufacturing and processing makes a very important contribution to the UK economy:

- the industry ***employs nearly 10,000 people directly*** in the manufacture of tobacco products;
- almost 29,000 people are employed in producing various goods and services used by tobacco manufacturers;
- a further 89,000 jobs in retailing — about 4 per cent of all retail employment — depend upon the sale of tobacco products;
- people whose jobs are dependent on tobacco products paid £450 million in income tax and national insurance contributions in 1994;¹¹
- tobacco manufacturers paid £247 million in corporation tax in 1994;
- consumers spent over £11 billion on tobacco products in 1994;
- ***excise duties and VAT on tobacco products raised around £8.9 billion in 1994 — equivalent to 5 pence on income tax!***

In Britain, current taxation rates on tobacco, which are the third highest in the EU after Denmark and Finland, put both jobs and tax revenue at risk. It is estimated that cross-border trading is leading to a tax loss of up to £600 million a year and the loss of as many as 3,200 jobs.¹²

One of the key aspects of this problem is that Ministers and Treasury officials need to see a dramatic reduction in excise revenues before they are stirred into action. This perception is vividly illustrated by the speech given by John Cope, David Heathcoat-Amory's predecessor as Paymaster General, at a conference held to discuss the repercussions of the cross-Channel shopping boom. "For us the starting point," Mr Cope observed, "and to a large degree the measuring stick, has to be the one absolutely hard statistic available to the government — excise duty receipts, which in turn are directly related to the volume of UK duty-paid sales". However, such an ingrained Whitehall view does not appreciate the fact that by the time the official revenue yield statistics show a sustained loss in revenue it will be too late for many businesses and their employees operating in the UK manufacturing, wholesale and retail sectors. By then the jobs will already have been lost!

Policymakers would do better to remember the section on taxes upon consumable commodities in *The Wealth of Nations* where Adam Smith warns that "High taxes, sometimes by diminishing the consumption of the taxed commodities, and sometimes by encouraging smuggling, frequently afford a smaller revenue to government than what might be drawn from moderate taxes".¹³

5. Issues to be considered by the Lisbon Conference

Excise duties have long been an important component of the tax policies of Member States within the European Union. Traditionally, excise duties were considered ideal taxes. They were cheap and easy to administer and were applied to a relatively narrow range of products which were judged to be price inelastic; that is to say, people will continue to buy the products whatever the price charged.

However, this conventional wisdom exposed as a nonsense by the relaxation of EU frontier controls. Only physically-enforced border controls can maintain a high excise duty regime, but for all intents and purposes these controls have been swept away since January 1993. With their abolition one essential truth has been confirmed: consumers will always seek to avoid paying tax if possible.

Lord Cockfield, in a seminar focusing on the cross-Channel beer trade, emphasised that "When it was established in 1957, the founders of the Community realised if you were going to have what was then called the Common Market, and what we now called the Single Market, it was absolutely essential that you harmonise the indirect taxation, absolutely essential".¹⁴ And he stressed that "without it you could not get the freedom of movement of goods".¹⁵

Recalling the difficulty of achieving that aim during his term as a EU Commissioner, Lord Cockfield said, "I came away from the concept of harmonisation and introduced the concept of approximation. This is critically important because the concept was that you brought these very divergent rates of duty, whether it was the VAT or the excises, sufficiently close that you did not get serious distortions of trade, and you could then leave it to the forces of the market or Adam Smith's 'hidden hand' to iron out any minor difficulties which existed".¹⁶

We are a long way off from approximation, but the 'hidden hand' is having its effect throughout the EU as consumers take advantage of the relaxation in border controls. As people travel more frequently, spurred on by the attractive tax incentives, shopping in other Member States is developing into a normal part of everyday life. Thus, consumers are beginning to shop around in Europe as though it really is one market, albeit with widely differing prices on each stall.

The Lisbon Conference

The Lisbon conference organised by DG XXI of the European Commission at the instigation of the new Commissioner, Mario Monti, was called to find some answers to the problems associated with establishing an Internal Market in exciseable goods within the European Union. It focuses on three main issues, namely:

- the functioning of the Internal Market;
- excise duties as revenue earners;
- the role of excises in wider Treaty objectives.

In its briefing document for the conference DG XXI distinguished between two concepts of the Internal Market — the 'minimalist' and 'maximalist' approaches. Adherents of the former approach believe that by permitting the free movement of goods across Member States' borders one will gradually eradicate significant differences in taxation rates, thus creating a single market. In time, this is surely a correct analysis. However, Peter Wilmott, the recently sacked Director General of DG XXI has observed that *without the essential input from politicians, tax harmonisation could be at least 20 years away*.¹⁷

Tax Strategies and the Market

The Commission's briefing paper for the Lisbon conference asks: "What, under either approach, should be the role of tax approximation in the creation of optimal market conditions?"

Our answer to this question is that *tax approximation is a welcome move if high-taxing Member States are persuaded to lower their rates into line with the broad band of rates levied by EU countries*. However, there may be a temptation, reinforced by the recent enlargement of the EU which brought in the high-taxing Scandinavian countries, to raise excise duties across the Community towards the rates one finds in Sweden, Denmark or, for that matter, the UK! If this were to happen, the EU, acting as a tax cartel, would inflict unprecedented harm on the alcoholic drinks and tobacco industries of Europe. It would do considerable damage to consumer welfare *and* jeopardise revenue yields, since higher duties will serve as a strong incentive to smuggle goods from outside the EU or to brew and distil one's own hootch.

As the Commission notes, "under the 'maximalist' approach the present state of affairs is seen as an interim step on the way to a more integrated market".¹⁸ But, as the briefing document points out, "much work needs to be done before such a market is achieved".¹⁹

The Lisbon conference perhaps marks the start of that work, providing a valuable opportunity for all interested parties to discuss the merits of a single Internal Market and how it might be achieved. No doubt, certain Member States and some interested pressure groups (for example, the health lobby) will resist any proposals which seek to lower the existing high levels of duty which are to be found in the UK, the Republic of Ireland and the Scandinavian countries. ***Any such moves to penalise consumers in the rest of Europe through the introduction of higher excise taxes should be strongly resisted.***

There is no benefit to be derived from adopting a maximalist approach which substantially raises the average rate of excise duty within the EU. It would be far preferable to maintain a minimalist approach which, although it may not deliver harmonised taxation rates in the short term, at least provides consumers with the opportunity to purchase goods in Member States with lower tax regimes. Such a policy puts downward pressure on those EU countries which levy excessively high excise duties, bringing the 'hidden hand' into the fight for harmonisation.

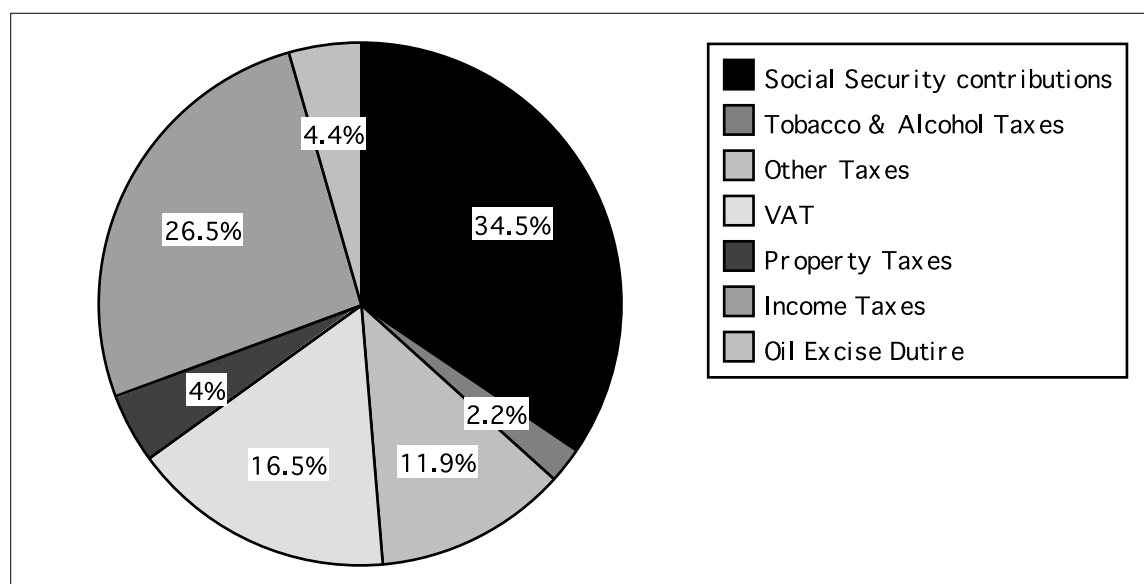
Proponents of the minimalist approach argue that a system of minimum duty rates is necessary to achieve the goal of tax harmonisation. In reality, one suspects that the introduction of EU-wide statutory minimum rates of duty on such items as spirits was the ***quid pro quo*** for the ***de facto*** removal of frontier controls. However, as we have seen, this minimum rate policy was introduced in an erratic fashion that simply panders to national interests and differences: on wine the effective minimum rate is zero, and while on spirits the 'Club Med' countries were obliged to charge a higher minimum level than hitherto, the rate was not set very high because it was felt that there would be a limited amount of cross-border trading between, say, Italy and the UK. And with regard to cigarettes, we have seen that the minimum excise rate system (i.e. 57 per cent excise incidence on the MPPC) is entirely discredited and works, in practice, against the goal of convergence.

We should remove the statutory minimum rates system, which has created a myriad of competitive distortions within the tobacco markets for beer, spirits and tobacco. And, one must remember, there is no minimum rate for wine! So why bother with statutory minimum rates at all? ***The only justification for statutory minimum rates is that some high-taxing Member States may fear a total erosion of their tax base on alcohol and tobacco products if other countries are allowed to attract away from their customers with the lure of lower rates.*** But then why does this argument not apply to the European market for wine?

Excise Duties and Revenues

This brings us to the second main issue to be discussed in Lisbon, excise

duties as revenue earners. Excise duties are a very old form of tax which have historically been levied to raise revenue in a simple manner, requiring a minimum amount of administration. In a nutshell, a limited number of producers were required to pay tax on an easily identifiable quantity of goods which were fairly price-inelastic. As pointed out at the beginning of this chapter, excise duties have therefore been considered ideal taxes. However, in an overall public finance context, it needs to be recognised that their total contribution is relatively minor. They are certainly no bottomless purse for free-spending governments. The OECD calculate that within the EU in the calendar year 1992 excise duties on alcoholic drinks and tobacco accounted for 2.2 per cent of total EU tax revenues. This contribution was dwarfed by social security contributions which accounted for 34.4 per cent of total tax revenues and income tax receipts which accounted for 26.4 per cent of all EU tax revenues.



Source: OECD Revenue Statistics, 1992 data.

What must be firmly resisted is the suggestion in the briefing paper issued by DG XXI that increasing excise yields, "through both rate increases and enlargement of the tax base", might be a method of reducing statutory charges on labour. This is one of the themes running through the European Commission's White Paper on ***Growth, Competitiveness & Employment***. But this policy approach fails to appreciate that the problems associated with high statutory charges on the cost of labour, as set out in the Social Chapter of the Maastricht Treaty, are a self-inflicted burden imposed by certain Member States, most notably France, on their own economies.

Inevitably, such policies will need to be reviewed as EU Member States come under increasing competitive pressure from newly industrialised economies such as the "Pacific Tigers" where there are no such onerous burdens on employers. ***The answer to the problem of international***

competitiveness is to reduce the statutory disincentives on employment; it makes no sense to merely shift such unnecessary burdens on to the backs of EU consumers of tobacco and alcohol products. This simply substitutes one form of competitive distortion for another.

In this context the briefing paper produced by DG XXI for the Lisbon conference raises the question of whether the Community has a role or interest in helping Member States to use excises as a means of raising revenue? The answer must be an emphatic no!

Excise Taxes and the Treaty

Thirdly, the Commission refers to the role of excises in wider Treaty of Rome objectives. This covers such issues as the complementary benefits which lower consumption levels, influenced by excise duties, might offer. In this regard, Commission officials are considering the demands on national health services, environmental damage, and transport infrastructure which stem from the consumption of alcohol, tobacco and fuel.

Many of these issues are more concerned with the question of excise duties on petroleum products and the role of motor vehicles in modern industrialized society than they are to do with the tax treatment of alcohol and tobacco. Suffice to say, however, that on the evidence available in the UK, ***excise duties and VAT generate far more in the way of revenue than the demands placed on the state by those who abuse these products*** or develop health problems as a result of consumption.

Unsettled Questions

On harmonisation of excise duties three main trends can be identified:

- the Council of Ministers has shown little enthusiasm for challenging the principle of ***Member State sovereignty over fiscal policy*** — subsidiarity still rules when it comes to tax policy;
- the Council of Ministers has ***shied away from defining the extent to which harmonisation would be necessary*** to ensure the functioning of the Internal Market;
- the Council of Ministers has been ***unable to agree on a consistent strategy*** as to how harmonisation would be achieved if found to be necessary.

Peter Wilmott, the Director-General of DG XXI recently sacked for his apparent enthusiasm for harmonising VAT collection throughout Europe,²⁰

consistently argued that the idea of tax harmonisation has always been essential to the smooth working of the single market. He has made it clear that the Commission is prepared to take up the fight with regard to excise duties in its efforts to create a single Internal Market. "The system is not working", he concedes, "The single market has not yet delivered the level playing field it was supposed to".²¹

Significantly, Wilmott believes that only if tax changes are decided by qualified majority voting, and not, as at present, by unanimous vote, will agreement ultimately be possible. "The biggest problem is to get politicians to sign up to a long term process and stick to it" he observes. "Excise is too important to ignore".

But the issue of fiscal sovereignty is of such pre-eminent importance that no agreement is likely to be sealed before the inter-governmental conference in 1996 when the issue of majority voting will be discussed. Even so, if more decisions are taken by qualified majority voting in the Council of Ministers, the larger EU member states such as the UK, Germany and France will want to ensure that voting reflects the size of national populations. Not surprisingly, small countries such as Sweden, Finland and Denmark oppose such a move. And this is a crucial point, since these are precisely the countries which tend to impose excessively high excise duties on alcohol and tobacco.

6. Conclusions

Internal Market issues

Turning first to Internal Market issues this study concludes:

- ***Tax approximation is a welcome move if Member States imposing high excise duties can be persuaded to lower their rates substantially*** so as to move into line with the broad band of rates levied by EU countries.
- A 'maximalist' approach to the harmonisation of the Internal Market would produce no overall benefit in consumer welfare if it were to lead to a substantial increase in the average rate of excise duty within the EU. It would be far more preferable to maintain a minimalist approach which, although not delivering harmonised taxation rates in the short term, at least provides consumers with the opportunity to purchase goods in Member States with lower tax regimes; such a policy also has the great advantage of putting downward pressure on those EU countries which levy excessively high excise duties.
- There may be a case for ***removing statutory minimum*** rates because the existing minima create a myriad of competitive distortions within the markets for beer, spirits and tobacco.
- ***What must be firmly resisted is any proposal which seeks to increase revenue yields from excise duties*** through rate increases and enlargement of the tax base ***in order to compensate for a reduction in statutory charges on labour***. Such a policy fails to recognise that the problems associated with high statutory charges on the cost of labour, as set out in the Social Chapter of the Maastricht Treaty, are a self-inflicted burden imposed by certain Member States, most notably France, on their own economies.
- The European Union has no role or justifiable interest in helping Member States to use excise duties as a means of raising revenue.
- The issue of fiscal sovereignty is of such pre-eminent importance that no agreement is likely to be sealed before the inter-governmental conference in 1996 when the issue of majority voting will be discussed.

UK Excise Duty Policies on Alcohol & Tobacco Products

The UK government has adopted a doubly misguided policy with regard to the taxation of alcohol. Firstly, it is seeking to persuade other EU Member States to **raise** their excise duties in order to defend the UK Exchequer's tax base from the damaging effects of cross-border shopping. This attempt at spreading the agony is fortunately unlikely to win much support, but if it did the first party to suffer would be our own domestic drinks industry which sells over half the spirits consumed across the European Union. Our valuable Mediterranean markets would be the first to suffer from such a compulsory hike in minimum excise duty rates.

The second reason why such a strategy is misguided is that the UK government appears to display no support, as yet, for the goal of equivalency which would introduce for the first time an element of logic and fairness into tax policy on alcohol. Through its policy of maintaining excessively high rates of excise duty on spirits, the UK is sending out all the **wrong** signals to our EU partners. What hope is there in persuading our partners to drop excessive duties on spirits when we ourselves continue to tax them to the hilt?

Recommendations

In seeking to harmonise excise duties throughout the EU, *the UK government will need to accept the likelihood that duties will be required to be lowered here in Britain.* This is fundamental to any progress towards the long term goal of a single European market in alcoholic beverages which offers so much potential to our own domestic drinks industry. If the UK government is unwilling to contemplate such a move, harmonisation will remain a chimera.

Furthermore, the absolute differentials between the excise duty on spirits and other alcoholic drinks has been greater in the UK than for most other Member States. Consequently, there may be a temptation on beer and/or wine producing Member States to raise spirit duties in order to provide additional protection for their own domestic products.

Following on from these conclusions, this study recommends that a five-point strategy be adopted by the Government for the reform of the UK system of excise duties on alcohol:

- 1] The concept of equivalency should be adopted as the new basis for levying duties on alcohol. Thus, alcohol will be taxed in accordance with a given rate of duty per unit of alcohol. This reform would minimise distortions within the market caused by our present

inequitable regime.

- 2] It is recognised that the adoption of such a tax strategy will require a transitional period of change before it can be fully implemented. Since beer and wine already attract a relatively high rate of duty in this country, compared with the majority of our EU partners, it is recommended that excise duties on spirits are gradually reduced to the same rate as beer. This will require excise duties on spirits to be almost halved to bring them into line with the duty charged on other types of alcoholic drinks.
- 3] In order to achieve this goal, it is recommended that a five-year plan be adopted, whereby excise duties on spirits are reduced by 10 per cent a year. This will give drinks manufacturers time to adjust to the new excise duty regime. Such a gradual change-over will also allow the Government to identify the relationship between falling taxes and increased demand for spirits, and how this increased economic activity feeds through to other sectors of the economy.
- 4] By announcing such a bold five-year tax plan for alcohol, this government — and any successive governments — will send a clear signal to our EU partners in favour of reducing high excise duties on spirits. This will promote the principle of tax neutrality between different alcoholic drinks and between alcoholic drinks and other consumer goods and services.
- 5] Over the same five-year time period, excise duties on beer and wine should be frozen with the aim of reducing the real rates of duty as it applies to these drink categories. This can be achieved most simply through not revalorising the rates of duty to compensate for the effects of inflation, albeit current government policy seeks to limit inflation below a maximum ceiling of 4 per cent per annum.

Taxation of Tobacco Products in the UK

In proposing the upward convergence of tax differentials, but then regularly widening the gap at every budget, *the UK government has adopted an unrealistic policy which almost certainly aggravates our European neighbours.* Moreover, unless action is taken to reduce the wide differentials in the taxation of tobacco products between the UK and our near continental neighbours, the duty revenue will continue to accrue to those Member States such as Belgium which adopt a relatively low excise duty on tobacco.

Since there is very little likelihood that the 15 Member States will be able to agree a strategy to harmonise excise taxes in the short term, *it is up to the UK government to tackle the worst symptoms of our present tax regime,* which is characterised by its lack of economic logic.

The excise structure for cigarettes is quite complicated. EU Directives require all Member States to set a tax on cigarettes comprising three components: two proportional elements — *ad valorem* excise duty and VAT and one specific tax by unit. In Britain, the excise duty on cigarettes consists of a specific excise duty per thousand cigarettes and an *ad valorem* duty calculated on the recommended retail selling price.

With the exception of 1987 and 1989, taxation on cigarettes has been increased annually with every budget for the last fifteen years. Every increase has been at a rate well above the retail price index — in fact, ***real taxes on cigarettes have risen by almost 100 per cent between 1980 and 1993.*** The Government's commitment since 1993 to increase tobacco duty by an average of at least 3 per cent a year in real terms has already been fulfilled and no increase in this next Budget is required to meet this target.

Moreover, the economic evidence tends to suggest that ***as tax rates on tobacco have been rising at an increasing rate, revenues have started to level off.*** The yearly trends in real tax revenue generated by cigarette sales is subject to large annual variations (see Figure X) but the overall trend indicates that tax revenues have not only clearly levelled off, but may have started to decline. London Economics, a prominent firm of consultants, has concluded from the available evidence that "this may indicate that the maximum point of the Laffer curve is being approached".²² In other words, tobacco duty increases can no longer be guaranteed to generate an increase in the overall excise 'take'.

Accordingly, ***there would appear to be a strong argument in favour of freezing (or reducing) excise duty rates this year*** so as not to exacerbate further the problems associated with cross-border trading. A freeze or reduction would signal to other Member States that the UK was aware of the dangers of jeopardising revenue yields from tobacco and that it was in favour of making a positive move towards the ideal of tax harmonisation.

With regard to handrolling tobacco, there is clearly an urgent problem which needs to be addressed by the Chancellor. As things stand, it would seem that ***more than half the handrolling tobacco consumed in the UK is supplied largely illegally from overseas sources*** and hence no UK duty has been paid! A major reduction in the level of taxation on handrolling tobacco is therefore required if an orderly market is to be restored in this country and we are to arrest the harm which is being inflicted on tobacconists and other retailers.

Finally, if we are to achieve any progress toward harmonisation in the taxation of cigarettes and other tobacco products, then the UK government, along with other high-taxing countries, must accept that duty rates will need to be lowered.

Notes

- ¹ Article 4 review, the European Commission Com (95) 285 final, 13 September 1995.
- ² Dr Barry Bracewell-Milnes, *A Disorderly House*, Adam Smith Institute, page 22.
- ³ A fact recently confirmed by the Bossard study, commissioned by the European Commission, see *Competition between Different Categories of Alcoholic Drinks*, a report for the European Commission DG XXI, Bossard Consultants, Paris, June 1994.
- ⁴ SEITA, the French state monopoly, was privatised in February 1995; AAMS, the state tobacco monopoly which retains a particularly strong grip on the Italian domestic market, is scheduled for privatisation; Tabacalera, the Spanish state monopolist, was partially privatised in 1986 — the state still holds a 52.4 per cent stake; Tabaqueira, the Portugese state tobacco monopoly which until 1990 commanded a 99 per cent share of the market, is due to be privatised next year.
- ⁵ Under the Ecofin deal, which came into force in January 1993, the specific excise duty element on cigarettes must continue to represent between 5 and 55 per cent of the total tax burden.
- ⁶ Issue 12 October 1995.
- ⁷ COM (95) 285 FINAL. See *The Wealth of Nations*, Book V, Chapter II, Part II, Article IV: "When the diminution of the revenue is the effect of the encouragement given by smuggling, it may perhaps be reduced in two ways: either by the temptation to smugle, or by increasing the difficulty of smuggling."
- ⁸ See *The Budget Statement*, 29 November, page 30, issued by HM Treasury.
- ⁹ Brewers & Licensed Retailers Association, memorandum to HM Treasury, June 1995, page 14.
- ¹⁰ HM Customs & Excise; see *Drinks Pocket Handbook* 1995, NTC Publications, page 47.
- ¹¹ *The Economic Significance of the UK Tobacco Industry*, 1995, Peida.
- ¹² *Ibid.*
- ¹³ *The Wealth of Nations*, volume 2, Liberty Classics Edition, page 884.
- ¹⁴ Speeches from the Cross Channel Beer Trading Seminar, 14 June 1994, Canadean Ltd.
- ¹⁵ *Ibid.*
- ¹⁶ *Ibid.*
- ¹⁷ *The European*, 15 June 1995.
- ¹⁸ Excise Conference 1995, Directorate General XXI Customs & Indirect Taxation.
- ¹⁹ *Ibid.*
- ²⁰ See *Financial Times*, 27 October 1995.
- ²¹ See *The European*, 15 June 1995.
- ²² *Who Pays Tobacco Tax?*, London Economics, July 1995, page 15.