Distilled Spirits Industry Council of Australia Inc.

Tax Forum Submission 2011

September 2011

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Who is DSICA?

The Distilled Spirits Industry Council of Australia Inc (DSICA) is the peak body representing the interests of distilled spirit manufacturers and importers in Australia. DSICA was formed in 1982, and the current member companies are:

- Bacardi Lion Pty Ltd;
- Beam Global Australia Pty Ltd;
- Brown-Forman Australia;
- Bundaberg Distilling Company Pty Ltd;
- Diageo Australia Limited;
- Mast-Jägermeister AG;
- Moët Hennessy Australia Pty Ltd;
- Rémy Cointreau International Pte Ltd;
- Suntory (Australia) Pty Ltd; and
- William Grant & Sons International Ltd.

DSICA's goals are:

- to create an informed political and social environment that recognises the benefits of moderate alcohol intake and to provide opportunities for balanced community discussion on alcohol issues; and
- to ensure public alcohol policies are soundly and objectively formed, that they include alcohol industry input, that they are based on the latest national and international scientific research and that they do not unfairly disadvantage the spirits sector.

DSICA members are committed to:

- responsible marketing and promotion of distilled spirits;
- supporting social programs aimed at reducing the harm associated with the excessive or inappropriate consumption of alcohol;
- supporting the current quasi-regulatory regime for alcohol advertising; and
- making a significant contribution to Australian industry through primary production, manufacturing, distribution and sales activities.

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Executive summary

The Australian alcohol tax system

- The Henry Review recommended that all alcohol beverages should be taxed on a volumetric basis, which, over time, should converge to a single rate, with a low-alcohol threshold introduced for all products. The rate of alcohol tax should be based on evidence of the net marginal spillover cost of alcohol. **DSICA strongly supports this recommendation.**
- There are a number of incremental reforms which can assist in transitioning to a single volumetric rate for all alcohol beverages and removing the anomalies in the existing tax structure. These reforms and DSICA's recommendations are outlined below.

Reform of cider taxation

- DSICA recommends that the taxation of cider products be amended from the current Wine Equalisation Tax (WET) arrangement to a volumetric tax at the same rate as Ready-to-Drink (RTD) alcohol products.

Reform of the wine taxation regime

- DSICA recommends that the Government note that the 'wine glut' is likely to end within the next 12 to 24 months. The Government should commence considering alcohol taxation reform options to ensure that they can be implemented in a timely manner following the end of the wine glut.
- DSICA recommends that the Government make all necessary legislative amendments to the *A New Tax System (Wine Equalisation Tax) Act 1999* (Cth) (the WET Act) (and Wine Producer Rebate provisions) as a matter of urgency to reduce ongoing distortions within the wine market, with a view to eventually phasing out the Wine Producer Rebate altogether. Treasury Wine Estates and Pernod Ricard, two of Australia's largest winemakers also support the abolition of the Wine Producer Rebate.
- DSICA recommends that the Government pursue wine taxation reform using the four-step process outlined in this submission as a transition to achieving the long-term goal of a fully volumetric taxation regime for all alcohol beverages. DSICA notes that Treasury Wine Estates and Pernod Ricard also support the introduction of a volumetric taxation regime for wine.
- DSICA strongly opposes the introduction of a minimum floor price on all alcohol beverages. Instead, DSICA notes that the introduction of a volumetric wine tax regime would effectively set the minimum (floor) price of alcohol in Australia.

Removal of the five per cent ad valorem customs duty on imported spirits and Ready-to-Drink products

- DSICA recommends that the Government immediately remove the five per cent tariff on imported spirits and RTDs in order to remove structural complexity from the current alcohol taxation regime.

Tax equivalence for low- and mid-strength Ready-to-Drink alcohol products with beer of similar alcohol content

- DSICA recommends that the Government introduce taxation equivalence between low- and mid-strength packaged RTDs and packaged beer of similar alcohol content by applying the same volumetric rates as well as applying the 1.15 per cent alcohol by volume (abv) excise-free threshold.

Freezing of automatic indexation of the spirits and Ready-to-Drink product excise duty rate

- DSICA recommends that the Government commit to freeze automatic (statutory) indexation of the spirits and RTD excise duty rate as a means of facilitating the transition to a single volumetric rate for all alcohol products, as recommended by the Henry Review.

1 The Australian alcohol taxation system

1.1 Introduction

This section provides an overview of the Australian alcohol taxation system and the current anomalies and distortions that prevent achieving desired revenue, and health and social policy outcomes.

1.2 Alcohol taxation in Australia

Revenue authorities around the world apply two main methods in taxing alcohol products:

- tax on the basis of the volume of alcohol in the beverage (a 'volumetric', or specific rate method); and
- tax on the basis of the value of the product (an 'ad valorem' method).

Australia uses a combination of both methods, depending on the beverage type.

Volumetric systems are usually described as 'excise' duties – that is, taxes which are selective in the product they cover and involve quantification of the product in determining the liability. In the case of alcohol, the quantification is in 'litres of pure alcohol', which is usually abbreviated to either LPA, or lals. Australia applies a volumetric excise duty to beer, spirits and RTDs.

Ad valorem taxes can take various forms. Broad-based general purpose taxes such as the Goods and Services Tax (GST) are usually ad valorem taxes, but in some cases, ad valorem taxes are selectively applied. This is the case with the WET in Australia, which is levied on wine, grape wine products and cider.

Architecture of Australia's tax system

The Australian Government levies tax on alcohol beverages which are more than 1.15 per cent abv. The exact tax arrangements applicable depend on the type of alcohol beverage.

Beer

Beer is subject to seven different volumetric excise rates, depending on whether the product is brewed for commercial or non-commercial purposes, the alcohol content of the beer and the size of the container.

There are three 'tiers' of taxation that apply to commercial beer products according to alcohol content, being, low-, mid- and full-strength. Low-strength packaged beer qualifies for a lower rate of excise. The exception to this is that mid-strength packaged beer pays the same headline rate as full-strength packaged beer.

In addition, beer products qualify for an excise-free threshold of 1.15 per cent abv. This means that excise is not payable on the first 1.15 per cent abv of a beer product. The effect of the threshold is to lower the 'effective rate' of excise on low and mid-strength beer compared with full-strength beer.

Draught beer – that is, beer which is sold 'on tap' – pays a lower rate of excise duty than the equivalent packaged beer. To qualify for the 'draught beer' rates of excise, the beer must be sold in a container exceeding 48 litres in volume – for example, a keg.

Beer produced for non-commercial purposes also benefits from a concessional excise duty rate.

Wine

Wine, grape wine products and cider are taxed on an ad valorem basis under the WET.

WET is payable by manufacturers, wholesalers and importers of wine, grape wine products and cider as defined. It is collected under the WET Act which is administered by the Australian Taxation Office (ATO).

The WET rate is currently 29 per cent and is applied to the wholesale sales value of the product. WET is levied on the last wholesale sale (or equivalent) of a product.

Wine Producer Rebate

A special Wine Producer Rebate was introduced by the Australian Government effective from 1 October 2004. The rebate sought to address the inherent bias created by the WET system in favour of large producers. The maximum rebate amount was increased on 1 July 2006 and now effectively provides an exemption from WET for a producer's first $1.7 million of domestic wholesale sales. This has the effect of removing WET liability for the wine sales of the large majority of small/medium producers.

The Henry Review identified that around half of all wine producers are unprofitable. It further commented that the Wine Producer Rebate may be acting to prevent proper market responses by discouraging mergers.[1]

Pernod Ricard and Treasury Wine Estates (two of Australia's largest winemakers) have now called for the abolition of the Wine Producer Rebate, believing that its abolition is in the best interests of the wine industry.

Spirits

All spirits (including RTDs) are taxed at a single volumetric rate, with the exception of brandy. Brandy pays a lower rate of excise, an anomaly which dates back to a policy of providing a taxation concession to the local grape growing industry.

Prior to the tax increase on RTDs in April 2008, RTDs were subject to excise duty at similar rates as packaged beer. The rationale for this approach was that RTDs and beer were products of similar alcohol content, marketed in similar ways (i.e. bottles and cans) to a similar demographic (that is, primarily males 24 years and above).

Spirits and RTDs do not qualify for the 1.15 per cent abv excise-free threshold available to beer, despite spirits and RTDs being subject to a much higher rate of volumetric taxation.

Australia's current alcohol tax arrangements are summarised in Figure 1 below.

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[1] Commonwealth of Australia, *Australia's Future Tax System – Report to the Treasurer, Part Two – Detailed Analysis,* 2010, p. 438.

Figure 1: Taxation of alcohol in Australia

TAXATION OF ALCOHOL IN AUSTRALIA

DSICA

Product category	Beer	Spirits (incl. RTDs)	Wine	Cider
Excise duty (Locally produced goods)	✓	✓		
Customs duty – ad valorem (Imported goods only)		✓	✓	
Customs duty – excise equivalent (volumetric) (Imported goods only)	✓	✓		
WET			✓	✓
GST	✓	✓	✓	✓

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Source: DSICA Pre-Budget Submission, 2011-12

1.3 Weaknesses in the current Australian alcohol tax structure

The current alcohol taxation system fails to adequately satisfy key criteria of a good tax system. This was confirmed in the Henry Review.[2]

Furthermore, the system does not assist in achieving good health outcomes and it also distorts the alcohol beverage marketplace by unduly influencing decision making regarding product manufacture and consumption.

The problems of the current taxation regime are demonstrated by:

- a mix of ad valorem (wine, grape wine products and cider) and volumetric taxation rates (beer, spirits and RTDs);
- a system of ten different rates – only some of which are inflation-indexed;
- automatic bi-annual indexation of spirits, RTD and beer excise rates, which results in growing disparities in the relativities with wine prices, which are not subject to similar increases;
- some products (i.e. spirits) have import duty at ad valorem rates indiscriminately applied based on their country of origin; and
- rebates and tax free thresholds are available to some products (e.g. wine and beer) and not to others.

DSICA analysed the many shortcomings of the current alcohol tax system in its submissions to the Henry Review.

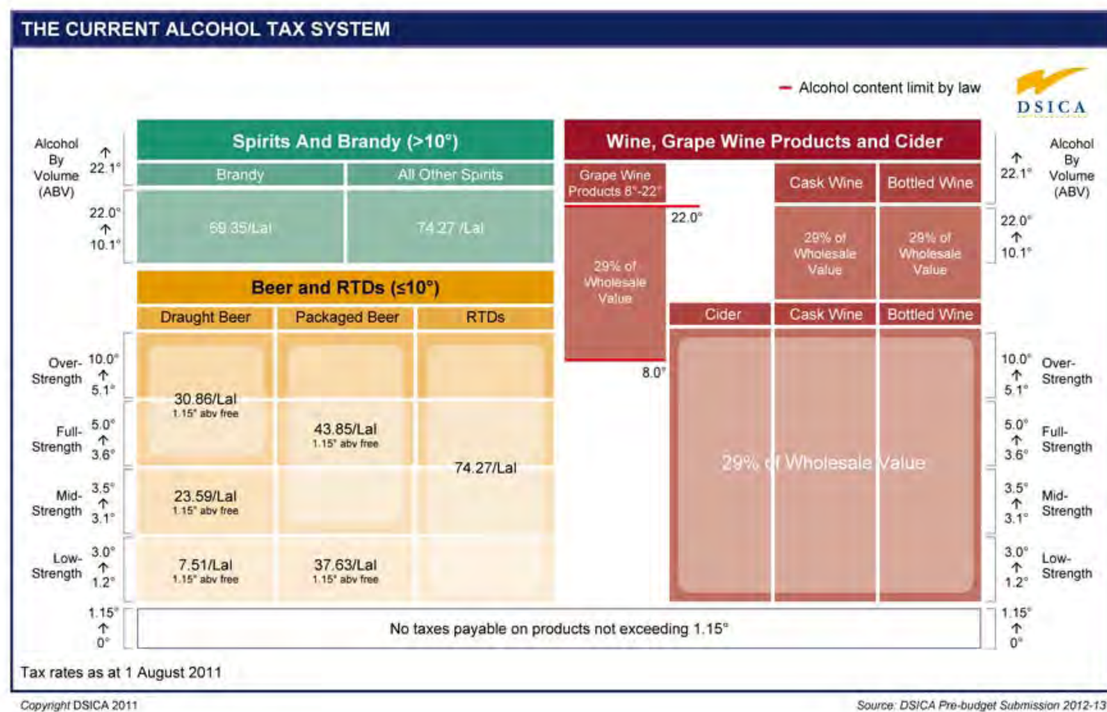
[2] Commonwealth of Australia, *Australia's Future Tax System – Report to the Treasurer, Part Two – Detailed Analysis*, 2010, p. 431.

Conceptual framework of Australia's alcohol tax system

DSICA has developed a graphical representation tool to illustrate the current taxation regime for alcohol in Australia (Figure 2). The purpose of the graphic is:

- to demonstrate the current complexities and anomalies that exist, particularly in relation to differing tax treatments that apply to products that are substitutable;
- to identify opportunities for incremental tax changes to remove unsustainable concessions; and
- to act as a framework to assist in the development of alternative models for alcohol taxation reform.

Figure 2: Australia's alcohol tax system



Key features of Figure 2 are:

- different beverage categories are listed horizontally across the page, with products levied the ad valorem WET coloured red;
- abv content is listed along the left-hand side vertical axis of the graphic;
- there is a deliberate delineation in the graphic at 10 per cent abv, as this tends to be the upper limit on 'lower-strength' beverages such as beer and spirit-based RTDs, while most wine, liqueur and spirits products are above this level. The exception to this is the red (ad valorem) category for wine-based products, which dips slightly below 10 per cent as some products (e.g. cider) contain lower alcohol contents, that are similar to the alcohol content of beer and RTDs;
- we note that 10 per cent abv is also a key reference point in the excise and customs legislation. It also separates Tax Base 1 from Tax Base 2 in Treasury's Tax Expenditure Statement analysis;

- the placement of the grape wine product category (in red) also reflects the definitional requirement in the WET Act that grape wine products must be between 8 and 22 per cent abv;
- different beverages are then listed in the category boxes in the graphic. Current taxation rates are indicated, as well as whether a particular beverage qualifies for the 1.15 per cent abv excise-free threshold;
- abv levels below five per cent are designated to reflect the different excise rates that currently apply to low-, mid- and full-strength beer, but not to wine-based products or spirit-based products; and
- draught beer is separated as a category as it is subject to different excise rates compared with packaged beer.

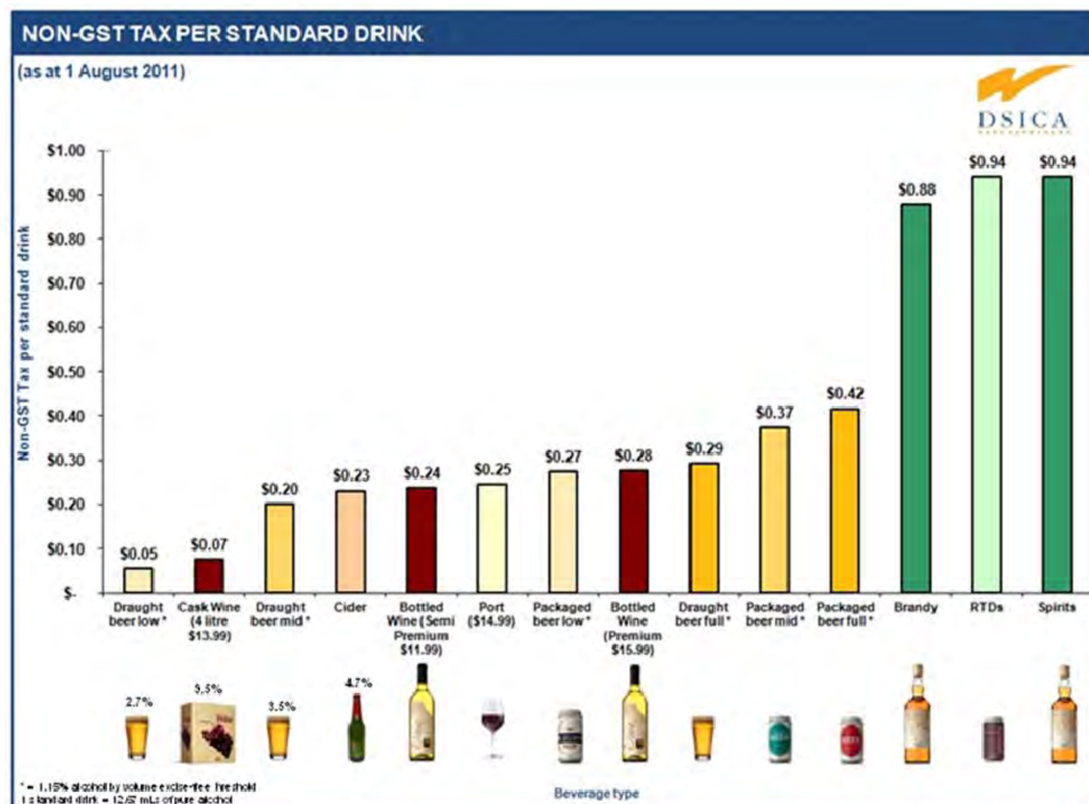
This graphic shows both the current taxation regime (including its anomalies and complexities) and provides a framework to consider possible tax changes and tax reform options.

1.4 Non-GST (alcohol) taxes per standard drink

Using the concept of a standard drink allows for a uniform comparison of the incidence of taxation on products of differing alcohol strength and retail price, shown in Figure 3. The graphic highlights some of the issues and complexities inherent in the current tax system.

DSICA believes that consumers have an increasing appreciation of the need for taxation equity when tax incidence can be compared on a 'per standard drink' basis.

Figure 3: Non-GST tax per standard drink as at 1 August 2011



The inconsistency in the tax treatment of particular beverages becomes particularly clear when one considers that:

- cask wine (typically abv of 11 to 13 per cent) pays only seven cents per standard drink;
- full-strength RTDs (less than half the abv of most cask wines) pay 94 cents per standard drink (13 times that paid by cask wine); and
- full-strength packaged beer (at about the same abv as full-strength RTDs) only pays 42 cents per standard drink, less than half that paid by RTDs of equivalent alcohol content.

1.5 The ideal alcohol taxation system

The Henry Review outlined a recommendation pertaining to the design of an ideal alcohol taxation system as follows:

> **Recommendation 71:**
>
> All alcoholic beverages should be taxed on a volumetric basis, which, over time, should converge to a single rate, with a low-alcohol threshold introduced for all products. The rate of alcohol tax should be based on evidence of the net marginal spillover cost of alcohol.

Taken from Australia's Future Tax System – Report to the Treasurer, Part Two – Detailed Analysis, 2010, p. 442

DSICA strongly supports this recommendation. DSICA also notes that the use of a single volumetric rate for all alcohol products should be supported as it:

- does not distort production and consumption decisions with no coherent policy justification;
- facilitates desired health and social policy objectives as it enables consumers to make responsible consumption decisions based on the alcohol content of product (cf higher-strength products which may enjoy a cheaper retail price due to favourable taxation structures [e.g. cask wine]); and
- better addresses social harm arising from risky and high-risk alcohol consumption through closer targeting of social costs (as facilitated through the introduction of a single volumetric rate based on evidence of the net marginal spillover cost of alcohol).

1.6 Reform of the Australian alcohol taxation system

DSICA acknowledges that reform to a single volumetric rate is a long-term goal. However, in the interim there are a number of incremental reforms which can be undertaken to assist in reforming the anomalies and distortions prevalent in the existing taxation regime. These reforms are as follows:

- taxation of cider products as RTDs, rather than under the WET;
- reform of the WET from an ad valorem tax to a volumetric tax; and
- tightening of the Wine Producer Rebate to include anti-avoidance provisions.

The additional revenue gained through these reforms could be used to fund other alcohol tax related reforms including:

- removal of the five per cent ad valorem customs tariff on imported spirits and RTDs; and
- tax equivalence for low- and mid-strength RTD products.

Each of these considerations is addressed in turn.

2 Reform of cider taxation

2.1 Introduction

This chapter demonstrates how the tax paid on cider is far lower than that paid by other alcohol beverages of similar alcohol content, and how reform of cider taxation from the ad valorem WET to a volumetric excise rate equivalent to that applied to RTDs would result in significant revenue gains to Government.

2.2 A brief history of cider taxation in Australia

Since the introduction of the GST in July 2000, cider (and perry) have been subject to a 29 per cent ad valorem tax (i.e. the WET).

The original design of the Howard Government's *A New Tax System* policy (ANTS) intended cider and perry to be subject to the same taxation treatment as RTD products (i.e. volumetric excise duty). However, there were significant changes between the original ANTS policy design and the final tax structure adopted; the most significant of which was the exclusion of basic food products from the Goods and Services Tax (GST). Other changes included the introduction of concessional tax rates for draught beer, and the decision to tax cider on the same basis as wine products (under the ad valorem WET) rather than under the excise system which applies to beer and RTD products.

This tax treatment gives cider products a significant price advantage over other alcohol beverages with similar alcohol content which compete in the same alcohol market segment, namely full-strength beer and RTDs. In particular, the April 2008 excise taxation increase on RTD products greatly increased the disparity between the tax paid by RTD and cider products.

2.3 The current taxation disparity

The use of the ad valorem WET as the taxation regime for cider products creates significant disparities between the effective taxation rates applied to cider and its main competitors – RTDs and beer.

At present, a popular full-strength cider product pays approximately 23 cents in tax per standard drink. This is much lower than the 42 cents per standard drink paid by full-strength packaged beer or the 94 cents per standard drink paid by spirit-based RTDs.

As cider products are taxed under the WET, the taxation rate has the benefit of not being subject to indexation. Conversely, excisable goods (RTDs and beer) are subject to biannual Consumer Price Index (CPI)-based indexation increases. This means that the gap between the effective taxation rates for RTDs and cider widens whenever cider production costs are not increasing at the rate of increase in general consumer prices.

Furthermore, smaller boutique cider producers may also effectively pay no WET at all as they may be entitled to the Wine Producer Rebate. Any cider producer with less than $1.7 million in total annual sales effectively pays no WET, creating a further discriminatory advantage that is not available to small RTD producers.

2.4 The Australian cider market

The Australian cider market grew by 25 per cent in 2009-10.

The Australian cider market is growing rapidly. AC Nielsen data indicates that in 2009-10 approximately 3.2 million nine-litre cases of cider were consumed (i.e. 1.5 million litres of pure alcohol). Furthermore, the volume of cider sold in Australia grew by more than 25 per cent in this period and it now accounts for almost one per cent of total alcohol beverages consumed (when measured in litres of pure alcohol). Based on these figures, the amount of WET collected from these cider sales was approximately $31 million in 2009-10.

The latest DSICA analysis estimates that in 2011-12:

- the quantity of cider consumed in Australia will be 2.4 million litres of pure alcohol; and
- the WET revenue collected from sales of this quantity of cider will be $53 million.

2.5 Cider revenue gains under a volumetric tax

If cider products are taxed at the equivalent volumetric rate as RTDs, additional revenue of $89 million per annum could be gained.

Using the estimated volume of 2.4 million lals of cider in 2011-12, if cider were taxed at the same rate as RTDs and *assuming total alcohol sales volumes remained constant*, the amount of excise collected would be **an additional $89 million** compared with the estimated WET collection of $53 million.

This assumes that:

- cider sales would decrease by one-third in response to a tax increase (as was the case with RTDs following the April 2008 tax increase); and
- the reduction in cider consumption would result in an equivalent increase in the number of lals of other products being consumed (e.g. packaged beer). The April 2008 RTD tax increase showed that a tax increase on one product does not generally decrease the *total* amount of alcohol consumed; it merely results in consumers shifting their consumption from one type of alcohol beverage to another, resulting in increased revenue from sales of other beverages.

A full breakdown of the forecast additional revenue from the reform of cider taxation for the 2011-12 to 2014-15 period is provided in Figure 4 below.

Figure 4: Forecast additional revenue from taxation of cider at the RTD excise rate

($m)	2011-12	2012-13	2013-14	2014-15	2011-12 to 2014-15
Taxation of Cider at RTD excise rate	89	95	101	105	389

The anticipated revenue acquired from the reform of cider taxation can be used to fund other alcohol tax related reforms including:

- tax equivalence between low- and mid-strength RTDs with beer products of equivalent alcohol strength *(estimated cost of $3 million per annum)*; and
- immediate removal of the five per cent ad valorem customs duty on imported spirits and RTDs *(estimated cost of $16 million per annum)*.

This would help remove distortions in the current system and move towards an alcohol tax system that is closer to the vision outlined in the Henry Review.

Recommendations

That the taxation of cider products be amended from the current WET arrangement to a volumetric tax at the same rate as RTDs.

That the additional revenue acquired through the reform of cider taxation be used to fund other alcohol tax related reforms.

3 Reform of the wine taxation regime

3.1 Introduction

Wine in Australia is currently taxed at a rate of 29 per cent of its wholesale sales value through the WET. This ad valorem tax was introduced in conjunction with the GST to maintain a tax treatment for wine roughly consistent with the previous wholesale sales tax regime.

Because wine is taxed on a value basis, wines with the same alcohol content can be subject to different levels of taxation. The cheaper the wine, the less it is taxed. This has been the subject of considerable media attention, which has focused on the abuse of low-price cask (and low-price cleanskin bottled) wine, particularly in indigenous communities.[3] It is noted that cask wine pays a minimal tax of seven cents per standard drink, while wine produced by small winemakers pays no effective tax. Furthermore, the taxation of wine on a value basis creates incentives for the production of low-value, high-volume products which have contributed to the current 'wine glut' and oversupply of Australian-produced wine.

The need for reform of the WET to a volumetric taxation system is gaining momentum. In particular:

- health lobby groups have noted that WET reform is the first step to be pursued in reform of the Australian alcohol taxation system;[4]
- media releases from The Greens demonstrate support for WET reform;[5] and
- Pernod Ricard and Treasury Wine Estates (two of Australia's largest winemakers) have now called for the introduction of a volumetric tax system for wine products. Pernod Ricard has noted that the introduction of a volumetric tax system will *'support sustainable value growth of the industry and…incentivise the production of premium products'*.[6]

The Government has reiterated that it will not pursue reform of the Australian alcohol taxation system 'in the middle of a wine glut and where there is an industry restructure underway'.[7] However, DSICA analysis of the Australian wine market indicates that not only are existing WET arrangements contributing to the 'wine glut', but the Australian wine market is likely to return to an 'in-balance position' in the next 12 to 24 months. As such, this chapter discusses the following issues:

- the purported 'wine glut' and evidence indicating that the wine market is returning to an 'in-balance' position;
- proposed tightening of Wine Producer Rebate legislation to remove current 'rorting' of the system; and
- DSICA's proposal for transitioning to a volumetric wine tax regime.

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[3] The Australian, *Alcohol floor 'a hit on elderly and poor'*, 9 June 2011.
[4] Alcohol Education and Rehabilitation Foundation, *Media Release: AER Foundation calls for urgent reform on the Wine Equalisation Tax*, 6 September 2011.
[5] Senator Dr Richard Di Natale (Greens Senator for Victoria), *Media Release: Greens back report on alcohol tax reform*, 6 September 2011; Senator Dr Richard Di Natale (Greens Senator for Victoria), *Media Release: No excuse not to debate alcohol reform now: Greens*, 26 September 2011.
[6] Premium Wine Brands (Pernod Ricard), *Premium Wine Brands' Submission to the Federal Government Tax Forum – October 2011*, p. 1. See also Treasury Wine Estates, *Submission prepared by Treasury Wine Estates Ltd for the Federal Tax Forum – Tax Reform for a Sustainable Australian Wine Industry*, September 2011, p. 4.
[7] The Hon Kevin Rudd MP and the Hon Wayne Swan MP, *Media Release: Stronger, Fairer, Simpler: A Tax Plan for Our Future*, 2 May 2010.

3.2 End of the 'wine glut'

The recently-released *Tax Forum Discussion Paper – Tax Reform: Next Steps for Australia* indicates that the Government has committed not to change alcohol tax in the middle of a wine glut and where there is an industry restructure underway.[8] This is despite the fact that two existing anomalies in the Australian alcohol taxation system – the WET and the Wine Producer Rebate are actually contributing to the purported wine glut.

Notwithstanding this, DSICA believes that the wine glut is likely to end in the next 12 to 24 months. This has been confirmed by Mr David Dearie, Chief Executive Officer of Treasury Wine Estates, another of Australia's largest wine producers who is recently reported as saying that:

> *'the Australian wine sector is 12 to 24 months away from supply and demand being in balance',*[9] and *'the wine market is in balance globally but the local market is in oversupply, and could remain so for up to two years'.*[10]

There are two relevant measures used to determine whether the supply and demand of wine is 'in-balance':

- **demand versus production** (measure one); and
- **the stock to sales ratio** (measure two).

DSICA's analysis of each of these measures indicates that the wine glut is likely to end in the next 12 to 24 months, therefore **now is the time for the Government to consider reform to the alcohol taxation system.**

Causes of the wine glut

The WET and Wine Producer Rebate are systemic anomalies in the Australian alcohol taxation system which are contributing to the 'wine glut'.

The wine glut has been raised as a hurdle to pursuing reform of the WET and Wine Producer Rebate. However, the current 'wine glut' has been exacerbated by the operation of the existing WET and Wine Producer Rebate.[11] As the WET encourages producers to produce wine on the basis of low value, high volume as opposed to value and the Wine Producer Rebate supports the continuance of small otherwise unprofitable wineries the following problems have arisen:

- the introduction of unsustainably low grape prices in Australia, which is threatening continued grape supply from all grape growers rather than only those who have uneconomic business structures;
- damage to the Australian wine brand resulting in considerable discounting of Australian wine products in domestic and export markets due to:
  - ⇨ poor-quality products entering the market due to a focus on the volume of wine sales rather than the development of high-value, quality products; and

[8] Australian Government, *Tax Forum Discussion Paper – Tax Reform: Next Steps for Australia*, July 2011.
[9] The Australian, *Dollar drags on Treasury earnings,* 23 August 2011.
[10] Australian Financial Review, *Asia to get a bigger taste of Grange*, 23 August 2011.
[11] See also Premium Wine Brands (Pernod Ricard), *Premium Wine Brands' Submission to the Federal Government Tax Forum – October 2011*, p. 4; The Allen Consulting Group, *Alcohol Taxation Reform – Starting with the Wine Equalisation Tax*, p. 13 and Senator Dr Richard Di Natale (Greens Senator for Victoria), *Media Release: No excuse not to debate alcohol reform now: Greens*, 26 September 2011.

⇨ the emergence of cheap cleanskin and cask wine products produced using cheap excess wine, some of which dominate sectors of the wine market.[12]

As such, the key design features of the existing wine taxation system are contributing to the current 'wine glut' and require reform. These considerations are discussed in greater detail in Sections 3.3 and 3.4.

Measure one: demand versus production

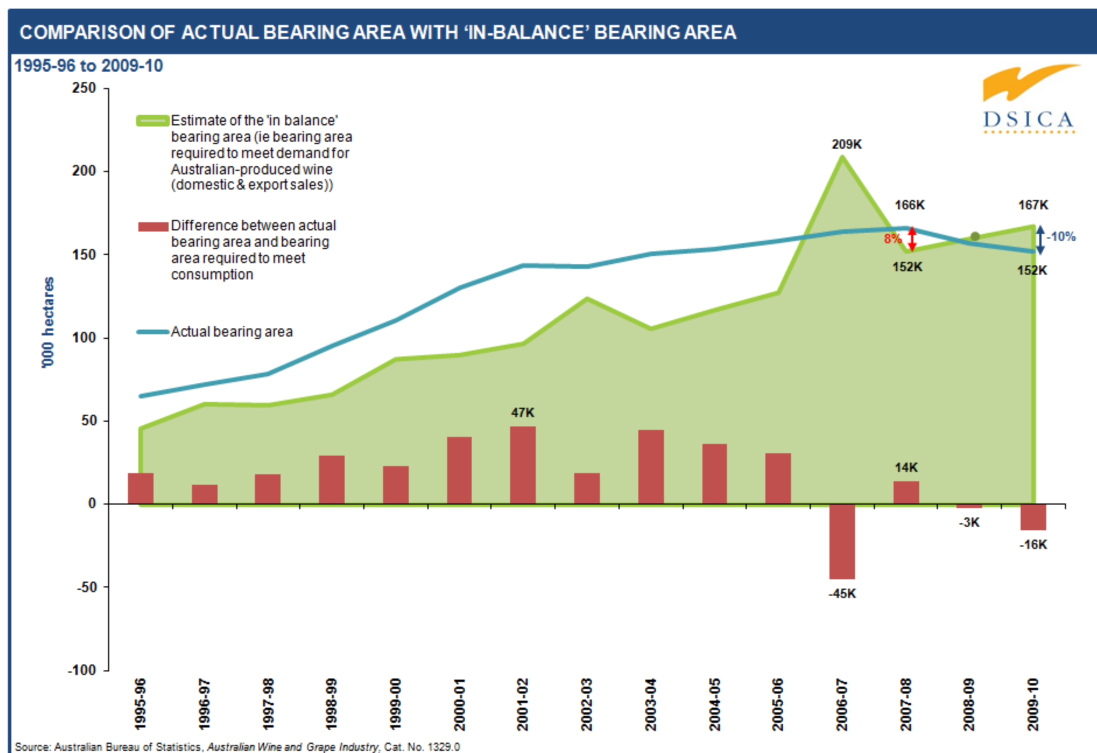
Analysis of demand versus production figures indicates that the Australian wine industry is moving to an 'in-balance' position between the supply and demand of wine.

The demand versus production measure compares the bearing area required to meet the demand for Australian wine (both domestic sales and exports) against the actual bearing area of Australian vines. DSICA's assessment of the demand versus production measure for the period 1995-96 to 2009-10 indicates that:

- in three of the last four years, the ideal 'in-balance' bearing area has exceeded the actual bearing area; and
- the wine industry is moving to an 'in-balance' position between the supply and demand of wine. While there were eight per cent surplus bearing vines in 2007-08, in 2008-09 and 2009-10 there was a deficit of bearing vines of two per cent and 10 per cent respectively.

These findings are outlined in Figure 5 below.

Figure 5: Comparison of actual bearing area with 'in-balance' bearing area, 1995-96 to 2009-10



These findings indicate that the Australian wine industry is moving to an 'in-balance' position between the supply and demand of wine.

[12] Premium Wine Brands (Pernod Ricard), *Premium Wine Brands' Submission to the Federal Government Tax Forum – October 2011*, p. 3.

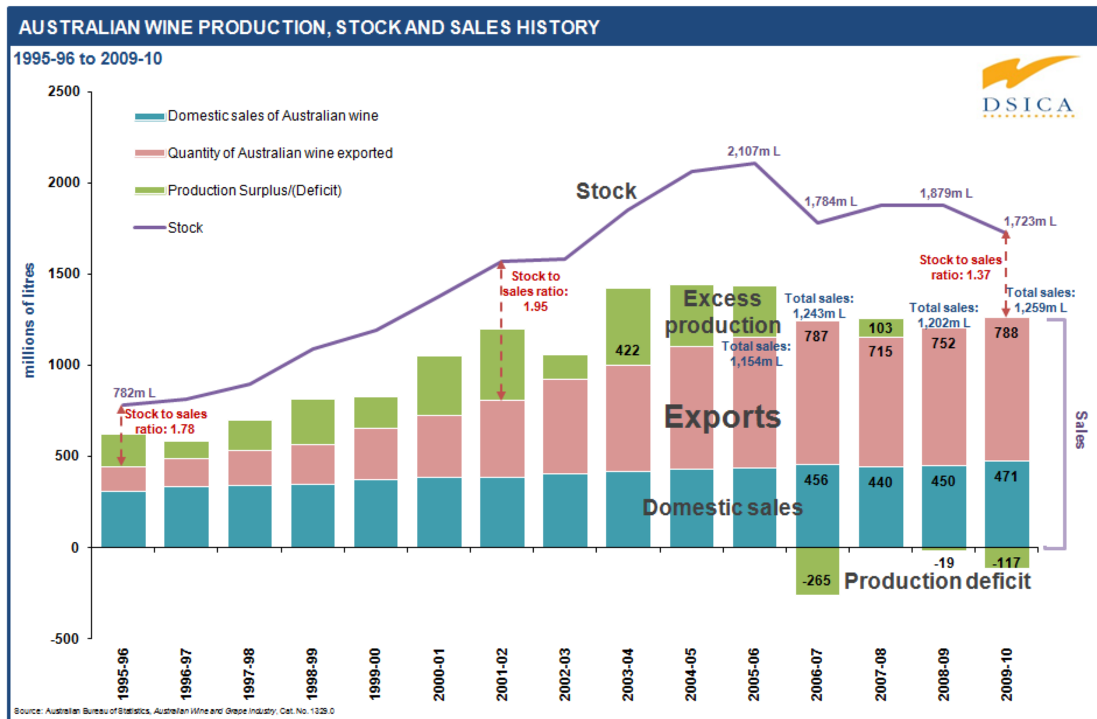
Measure two: stock to sales ratio

Analysis of stock to sales ratio figures indicates that the stock to sales ratio is tending below the desired level of 1.67.

The stock to sales ratio measurement considers the volume of total stock beverage wine (i.e. inventory) against the total sales of Australian wine (both domestic sales and exports). The Senate Rural and Regional Affairs and Transport Reference Committee Inquiry into *The operation of the wine-making industry* (the Inquiry) noted that the stock to sales ratio is the main indicator of the supply/demand balance.[13] In its submission to the Inquiry, the Department of Agriculture, Forestry and Fisheries noted that the comfort range (which indicates a balance between supply and demand) varies according to the nature of the stock (principally in relation to quality and red-versus-white holdings). However, a stock to sales ratio of 1.67 (i.e. 1.67 years of sales in stock) is considered a desirable level across all wine holdings in the current operating environment.[14]

DSICA's analysis of Australian wine production and sales history indicates that the wine glut is coming to an end. While production has exceeded combined domestic and export sales demand in 12 of the last 15 years, there have been production deficits in three of the last four years, as demonstrated by Figure 6 below.

Figure 6: Australian wine production, stock and sales history, 1995-96 to 2009-10

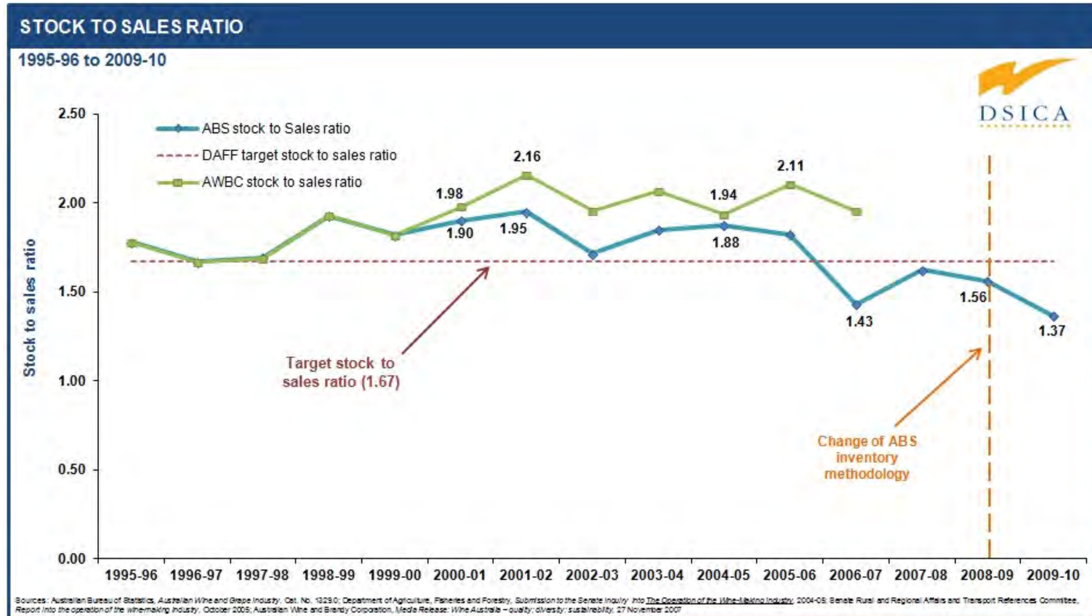


These findings are further supported by an analysis of historical stock to sales ratios which indicates that from 2006-07 onwards, the stock to sales ratio (which is calculated using ABS data) has consistently remained under the desired level of 1.67 (see Figure 7). If there is a continued reduction in actual bearing area hectares (as the trends in Figure 6 suggest),

[13] Senate Rural and Regional Affairs and Transport References Committee, *The operation of the wine-making industry*, October 2005, [2.13].
[14] Department of Agriculture, Fisheries and Forestry, *Submission to the Senate Inquiry into the Operation of the Wine-Making Industry*, 2004-05, 5.

inventory levels will fall further below the target stock to sales ratio over the coming years. This is demonstrated in Figure 7 below.

Figure 7: Stock to sales ratio history, 1995-96 to 2009-10



Conclusion

The foregoing analysis of demand versus production levels and historical stock to sales ratios indicates that the Australian wine market is moving towards an 'in-balance' position, and, based on current trends, the wine glut is expected to end in the next 12 to 24 months. **Given this, now is the time for the Government to consider reform to the alcohol taxation system in order to implement reforms which coincide with the end of the wine glut.**

Recommendation

That the Government note that the 'wine glut' is likely to end within the next 12 to 24 months and therefore commence considering alcohol taxation reform options to ensure that they can be implemented in a timely manner following the end of the wine glut.

3.3 Tightening of the Wine Producer Rebate

This section outlines the problems that have arisen from the introduction of the Wine Producer Rebate which has attempted to address the bias in favour of large producers created by the ad valorem nature of the WET, namely:

- the support it provides for small, otherwise uneconomic wineries, which contributes to Australia's purported 'wine glut';
- the fact that it operates as a disincentive against mergers of small wineries; and
- issues of tax avoidance and 'double-dipping' due to inadequate definitions of wine 'producer' and 'manufacturer'.

Operation of the Wine Producer Rebate

The Wine Producer Rebate supports small, otherwise uneconomic wineries and prevents the merging of small wineries, creating market distortions and reflects contradictory policies.

As wine is taxed under the ad valorem WET (i.e. on a value basis), wines with the same alcohol content can be subject to different levels of taxation. The cheaper the wine, the less it is taxed. Therefore, a value-based tax favours cheaper wines that tend to have lower profit margins, and are often made by large producers.

The Wine Producer Rebate was originally introduced in 2004 in an attempt to address the bias in favour of larger producers created by the ad valorem nature of the WET. The rebate of up to $500,000 per year means that the first $1.7 million of domestic wholesale wine sales per producer are effectively exempt from WET.

However, the Wine Producer Rebate does not provide an efficient solution to this problem because it creates biases of its own in favour of smaller producers. Small producers effectively pay no net WET, but the rebate reduces only a proportion of the WET paid by larger producers. As a result, two similar bottles of wine – one from a large producer, one from a small producer – pay different amounts of tax. Thus, while the Wine Producer Rebate does provide tax assistance to smaller producers, at the same time, it does not allow wines to compete on an equal footing.

The Wine Producer Rebate encourages small-scale production and supports some small, otherwise uneconomic wineries, contributing further to the current oversupply of wine. The wine industry has conducted a study which found that, in 20 of the 50 wine producing regions studied, more than half the production is uneconomic, while in ten regions 70 per cent or more is uneconomic.[15] This consideration is noted by Pernod Ricard which has stated that *'existing tax arrangements are distorting market forces by … incentivising the production and sale of cheaper wines, contrary to the industry endorsed strategy of value building through premium, branded products'*.[16]

Moreover, the rebate also provides an incentive against mergers between small wineries, which may prevent producers being able to take advantage of economies of scale. This means that resources such as land, water and capital are not being used efficiently. By supporting uneconomic wineries, the current arrangements are likely to increase the costs of production for wineries which are efficient. This also serves to exacerbate the problem of excess production that recently affected the wine industry in Australia.

Wine industry restructure

In November 2009, the national wine industry organisations launched a *Wine Restructuring Action Agenda* (the Action Agenda) aimed at confronting the issues of grape and wine oversupply. The *Action Agenda* identified that at least 20 per cent of bearing vines were surplus to requirements, and that the problem was not restricted to specific regions, varieties or price points.[17]

The Rudd Government's May 2010 decision not to commence implementation of the Henry Review recommendations on alcohol taxation was clearly influenced by the Action Agenda.[18]

In December 2010, the national wine industry organisations made a second statement on the progress being made to address the oversupply situation. One of the key conclusions was that:

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[15] The Australian, *Storm clouds threatening wine industry's blue sky,*19 November 2009.
[16] Premium Wine Brands (Pernod Ricard), *Premium Wine Brands' Submission to the Federal Government Tax Forum – October 2011,* p. 1.
[17] Winemakers' Federation of Australia, Wine Grape Growers' Australia, the Australian Wine and Brandy Corporation and the Grape and Wine Research and Development Corporation, *Wine industry must confront the reality of oversupply* (Statement to Industry), November 2009.
[18] The Hon Kevin Rudd MP and the Hon Wayne Swan MP, *Media Release: Stronger, Fairer, Simpler: A Tax Plan for Our Future,* 2 May 2010.

> *'The process of adjustment is not proceeding at a sufficient pace. A combination of unrealistic expectations, non-commercial motives and short-term opportunism continues to motivate many operators to resist change.'*[19]

The statement identifies a number of factors contributing to the oversupply: total supply, domestic demand, and export demand. Of these, total supply is the one over which the wine industry has most control.

In terms of oversupply in particular, the statement identifies the Wine Producer Rebate as one of the contributing factors which is *'shielding otherwise unprofitable businesses'.*[20]

The Henry Review identified that around half of all wine producers are unprofitable. It further commented that the Wine Producer Rebate may be acting to prevent proper market responses by discouraging mergers.[21] This is also noted by Pernod Ricard and Treasury Wine Estates, which note that:

> *'The WET rebate is inhibiting industry restructuring as it subsidies producers who would otherwise not be able to compete in the market and restricts consolidation in the industry',*[22]*;* and
>
> *'it is a 'damaging subsidy (which) is preventing consolidation and sustaining uneconomic production at a time when the industry urgently needs to retire excess supply and rebuild value'.*[23]

In light of all of the above, it is DSICA's view that the most elegant solution to remove the biases in the market created by the WET system would be to abolish the WET altogether and replace it with a volumetric tax as recommended by the Henry Review. Such a change would also eliminate the need for the Wine Producer Rebate, thus simultaneously removing the biases created by the rebate scheme and all of the problems of tax avoidance and double-dipping created by its very existence (see below). This position is again supported by Pernod Ricard which notes that *'tax reform would end these distortions and allow normal market forces to address the structural oversupply issues'*,[24] and Treasury Wine Estates which has stated that while the Wine producer Rebate is *'well intentioned, (it) is a failed policy and must be abolished'.*[25]

However, for the immediate term, DSICA supports legislative amendments to prevent ongoing Wine Producer Rebate abuse and evaluate reform options to reduce market distortions' which is discussed in greater detail below.[26]

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[19] Winemakers' Federation of Australia, Wine Grape Growers' Australia and the Australian Wine and Brandy Corporation, *Wine sector must continue to focus on transition* (Statement to Industry), 6 December 2010.
[20] Ibid.
[21] Commonwealth of Australia, *Australia's Future Tax System – Report to the Treasurer, Part Two – Detailed Analysis,* 2010, p. 438.
[22] Premium Wine Brands (Pernod Ricard), *Premium Wine Brands' Submission to the Federal Government Tax Forum – October 2011,* p. 4.
[23] Treasury Wine Estates, *Submission prepared by Treasury Wine Estates Ltd for the Federal Tax Forum – Tax Reform for a Sustainable Australian Wine Industry,* September 2011, p. 2.
[24] Ibid, p. 1.
[25] Treasury Wine Estates, *Submission prepared by Treasury Wine Estates Ltd for the Federal Tax Forum – Tax Reform for a Sustainable Australian Wine Industry,* September 2011, p. 6.
[26] Winemakers' Federation of Australia, Wine Grape Growers' Australia and the Australian Wine and Brandy Corporation, *Wine sector must continue to focus on transition* (Statement to Industry), 6 December 2010.

Urgent need for legislative amendments to Wine Equalisation Tax producer rebate provisions

Cost savings of $52 million per year could be realised if Wine Producer Rebate anti-avoidance amendments are introduced.

The Winemakers' Federation of Australia (WFA) has previously suggested in its 2010-11 Pre-Budget Submission that the Government should amend the definitions of wine 'producer' and 'manufacturing' in order to address problems of tax avoidance and double-dipping created by the Wine Producer Rebate. In that submission, the WFA estimated that making such changes to the legislation would save the Government approximately $50 million per annum in 2010-11.[27]

A year has passed since then, and the Australian National Audit Office (ANAO) has now concluded that there is an urgent need for *'more comprehensive changes to the definition of a "wine producer" to … address other practices that potentially provide inappropriate access to the rebate'*.[28]

This was one of the key conclusions of the ANAO when it released the results of its review of the ATO's administration of the WET on 14 December 2010.[29]

The ANAO reviewed, amongst other things, the ATO's actions in improving compliance with the Wine Producer Rebate provisions. The ANAO observed that *'it is sometimes appropriate to resolve wine tax technical issues through requesting legislative amendments rather than administrative arrangements'*.[30]

The ANAO recommended that *'the Tax Office advises Treasury on options to clarify the definition of a wine producer for the purposes of the producer rebate'* in order to *'resolve unintended outcomes regarding access to the wine tax producer rebate'*.[31] The ATO agreed with the ANAO's Recommendation,[32] as did Pernod Ricard which noted that:

> *'We recognise … the Government's desire to protect small vineyards offering a broader benefit, particularly in terms of tourism and employment, and should our proposal to abolish the WET rebate not be supported, we would propose reform of the rebate to limit its operation to the sale of packaged wine by producers direct to consumers. This would enable policy objectives to be pursued without the existing unintended consequences.'*[33]

DSICA strongly supports the ANAO's Recommendation and recommends that all necessary legislative amendments to the WET Act and Wine Producer Rebate provisions should be introduced as a matter of urgency to reduce ongoing distortions within the wine market.

Figure 8 below outlines the expected budget savings for the periods 2011-12 to 2014-15 if the necessary anti-avoidance provisions were introduced.

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[27] Winemakers' Federation of Australia, *Pre-Budget Submission 2010-11*, 2009.
[28] Australian National Audit Office, *Administration of the Wine Equalisation Tax – Audit Report No. 20, 2010-11 Performance Audit*, 2010, p. 67.
[29] Ibid.
[30] Ibid, p. 65.
[31] Ibid, p. 14.
[32] Ibid, p. 67.
[33] Premium Wine Brands (Pernod Ricard), *Premium Wine Brands' Submission to the Federal Government Tax Forum – October 2011*, p. 4.

Figure 8: Anticipated review from tightening of the Wine Producer Rebate scheme

($m)	2011-12	2012-13	2013-14	2014-15	2011-12 to 2014-15
Tighten Wine Producer Rebate scheme	52	56	58	60	227

DSICA notes that the estimated revenue impact of $50 million per annum in 2010-11 is approximately one-quarter of the value of benefits currently delivered to wine producers under the rebate scheme. This confirms that the Wine Producer Rebate is currently poorly targeted and supports DSICA's more fundamental point that the Wine Producer Rebate scheme is flawed and should be removed entirely. Should the Government take the bolder step of removing the Wine Producer Rebate altogether, revenue savings of around $200 million per annum would be available.

In the lead-up to the federal election on 21 August 2010, the Coalition suggested that the savings from the tightening of the Wine Producer Rebate scheme should be committed to extending the Export Market Development Grant scheme.[34] However, DSICA believes that any savings from Wine Producer Rebate reform should instead be used to fund other alcohol tax related reforms including:

- tax equivalence between low- and mid-strength RTDs with beer products of equivalent alcohol strength **(estimated cost of $3 million per annum)**; and
- immediate removal of the five per cent ad valorem customs duty on imported spirits and RTDs **(estimated cost of $16 million per annum).**

Recommendations

That the Government make all necessary legislative amendments to the *A New Tax System (Wine Equalisation Tax) Act 1999* (Cth) (and Wine Producer Rebate provisions) as a matter of urgency to reduce ongoing distortions within the wine market, with a view to eventually phasing out the Wine Producer Rebate altogether.

That the additional revenue acquired through tightening of the Wine Producer Rebate be used to fund other alcohol tax related reforms.

3.4 Reform of the Wine Equalisation Tax to a volumetric regime

The foregoing analysis indicates that the operation of the existing WET regime and Wine Producer Rebate are structural anomalies in the Australian alcohol taxation system which are key factors contributing to the purported 'wine glut'. As noted by The Allen Consulting Group:

> *'It is highly likely that the current taxation regime for wine is contributing to the very "wine glut" being used by the Government to justify delaying reform and Government assistance is necessary to help the industry adapt. The twin reasons for reform are therefore inseparable'.*[35]

Reform of the WET to a volumetric taxation regime is gaining considerable support. In particular:

- peak health lobby groups including the **Alcohol Education and Rehabilitation Foundation (AERF)** have indicated that *'the current tax arrangement doesn't make economic sense, it doesn't make sense for the health of Australians, and it doesn't make sense for the wine*

[34] Liberal Party of Australia, *The Coalition's plan for real action to support Australian Exporters*, 2010.
[35] The Allen Consulting Group, *Alcohol Taxation Reform – Starting with the Wine Equalisation Tax*, August 2011, p. 13.

industry'.[36] The AERF-commissioned report *Alcohol Taxation Reform – Starting with the Wine Equalisation Tax* provides three wine taxation reform scenarios, each of which replace the WET with a volumetric tax;[37]

- **The Greens** have demonstrated support for WET reform, noting that *'alcohol tax reform should be debated at the October Tax Forum'*, and *'the Wine Equalisation Tax is value-based, which creates a perverse incentive to produce cheap wine rather than high-quality product'*;[38]
- **Pernod Ricard** has stated that it *'supports the reform of the wine tax system in Australia so that wine is taxed by alcohol content (i.e. a volumetric tax), with the tax rate set to reflect a revenue-neutral approach'*;[39] and
- **Treasury Wine Estates** has stated that *'wine should be taxed on a volumetric, revenue neutral basis'*, and *'a simple three-tiered structure based on alcohol content bands by volume would be most appropriate for wine'*.[40]

DSICA has developed a proposal for wine taxation reform which is designed to operate as a *transition step* in achieving the long-term aim of a single volumetric excise rate applying to all alcohol beverages. This proposal aims to facilitate an increase in the tax (and price) of cask (and low-price cleanskin bottled) wine, while preserving many of the existing features of the WET. This proposal comprises a four-step approach as follows:

- **retain the WET:** retain the WET as the legal structure for wine taxation, rather than moving wine tax into the excise system;
- **taxation tiers:** introduce several taxation tiers, based upon wholesale sales price points (or other criteria to be developed), equivalent to the economy, semi-premium and premium wine categories;
- **volumetric rate for economy wine:** introduce different taxation rates within those tiers, including a volumetric rate for the economy tier; and
- **accelerated indexation:** introduce an accelerated indexation factor for the volumetric rate in the economy tier which would allow convergence to a common rate with the semi-premium tier over a phase-in period.

Each of these steps is described in greater detail below.

Step one – retain the existing Wine Equalisation Tax as the taxing system

The proposal would involve retention of the existing WET system legal infrastructure (rather than moving wine taxation into the excise system). This would minimise administrative disruption for wine producers and also minimise any compliance changes otherwise required under the excise system. It is proposed that:

- administration of wine taxation should continue under the WET Act; and
- wine products should continue to be taxed at the last wholesale sales point, as is current practice under the WET.

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[36] Alcohol Education and Rehabilitation Foundation, *Media Release: AER Foundation calls for urgent reform on the Wine Equalisation Tax*, 6 September 2011.
[37] The Allen Consulting Group, *Alcohol Taxation Reform – Starting with the Wine Equalisation Tax*, August 2011, 16-22.
[38] Senator Dr Richard Di Natale (Greens Senator for Victoria), *Media Release: Greens back report on alcohol tax reform*, 6 September 2011.
[39] Premium Wine Brands (Pernod Ricard), *Premium Wine Brands' Submission to the Federal Government Tax Forum – October 2011*, p. 4.
[40] Treasury Wine Estates, *Submission prepared by Treasury Wine Estates Ltd for the Federal Tax Forum – Tax Reform for a Sustainable Australian Wine Industry*, September 2011, p. 2.

The objectives of this approach are to 'neutralise' the traditional resistance that is expected from winemakers regarding a potential move into the excise system. In particular, it will remove the need for winemakers to obtain excise licences or to implement bonded warehouses. In addition, this would also allow the Wine Producer Rebate to be retained, possibly in an amended form, to continue to support legitimate small winemakers.

DSICA notes that this approach to amend existing WET legislation (rather than moving wine taxation into the excise system) is supported by Pernod Ricard.[41]

Step two – introduce taxation tiers (possibly defined by wholesale sales price points)

The wine industry has traditionally opposed the concept of a single volumetric wine tax as a 'flat earth' approach that could not take account of the various categories within the wine market. DSICA's proposal addresses this concern by introducing several taxing tiers (or taxing bands), which would be set for the commonly recognised categories of wine products. These taxing bands could be defined by wholesale sales price (or some other criteria to be developed).

This would allow three (or more) taxing bands with different (escalating) volumetric rates being set for each band. These bands could be based on the commonly recognised categories: economy (i.e. cask wine), semi-premium and premium wine products. An initial outline of the conceptual framework is outlined in Figure 9 below.

Figure 9: Illustrative wholesale sales price bands and equivalent volumetric excise taxation rates

Price band reference	Proposed wholesale sales price band	Volumetric rate reference
Band 1 or B_1	Economy products	R_1
Band 2 or B_2	Semi-premium products	R_2
Band 3 or B_3	Premium products	R_3

DSICA notes that Treasury Wine Estates supports a three-tiered volumetric wine taxation structure, however rather than defining the respective brands by wholesale sales price (as DSICA has proposed), it encourages the use of bands on the basis of alcohol content.[42] In its submission to the Tax Forum, Treasury Wine Estates notes that this approach is preferable as it would obviate the need for testing of each batch and the application of potentially multiple tax rates.[43] DSICA notes that the wholesale sales price banding approach it proposes may be refined and refer to some other criteria to be developed, rather than wholesale sales price points. DSICA would welcome the opportunity to work with the Government and wine industry representatives to identify the most appropriate criteria by which to define the proposed bands.

Step three – identify the volumetric taxation rate applicable to each band

This stage involves identification of the volumetric taxation rate for each of the three bands (B_1, B_2 and B_3). The rates would ideally be on a per litre of alcohol basis (i.e. not per litre, as in Europe).

[41] Premium Wine Brands (Pernod Ricard), *Premium Wine Brands' Submission to the Federal Government Tax Forum – October 2011*, p. 4.
[42] Treasury Wine Estates, *Submission prepared by Treasury Wine Estates Ltd for the Federal Tax Forum – Tax Reform for a Sustainable Australian Wine Industry*, September 2011, p. 4.
[43] Ibid.

For present purposes, these volumetric rates will be noted as R_1, R_2 and R. The rates for the bands could be selected/adjusted to achieve varying political, social, industry or other objectives.

Economy band (B_1)

A volumetric rate would be introduced for the economy band. The setting of this rate (R_1) would effectively set the minimum price of alcohol in Australia.

The volumetric rate for the economy band could be initially set at a level that resulted in no immediate change in cask wine prices. This is similar to Costing Option 1, developed by the Federal Treasury team supporting the Henry Tax Review.[44] Under that Option, the commencing volumetric wine tax rate was $7/lal and it required a 15-year transition period. This band would be subject to accelerated indexation (discussed in greater detail in step four below).

Semi-premium band (B_2)

The products falling within price band B_2 (i.e. semi-premium products) would be subject to a volumetric rate (R_2) which would be subject to twice-yearly indexation in accordance with CPI movements (as is current practice with excisable alcohol products – beer, spirits and RTDs).

Premium band (B_3)

The rate in the premium products band (B_3) could be set to minimise price falls of expensive super-premium bottled wine. This could counter one oft-cited argument against a shift to a volumetric wine tax, which is that '*Grange* will fall in price under a volumetric wine tax'.

Transition options for the tax rate in the premium band include:

- retain the existing ad valorem rate of 29 per cent (for a period); or
- select a proposed volumetric rate (R_3) which would ensure no price change for a target premium bottle of wine of a selected retail price. The rate would then become subject to twice-yearly indexation in accordance with CPI.

Step four – accelerate the indexation factor applied to the economy band

In order to increase the tax paid by products in the economy band (B_1), an accelerated indexation factor would be applied to the volumetric rate selected for this band. This would allow for convergence to a common rate with the semi-premium tier over a phase-in period. The use of accelerated indexation draws on a key feature outlined by the Henry Review team in its Costing Minute which used accelerated indexation to achieve convergence of volumetric rates at different starting positions.

As the most significant tax differential is seen in the economy (i.e. economy/cask wine products) market, the primary aim of this proposal is to increase the tax paid by this market segment. Hence, it is proposed that the indexation factor applied to rate R_1 for this price band (B_1) could be *accelerated* to have the effect of increasing the effective minimum floor price (for low-value wine) over time.

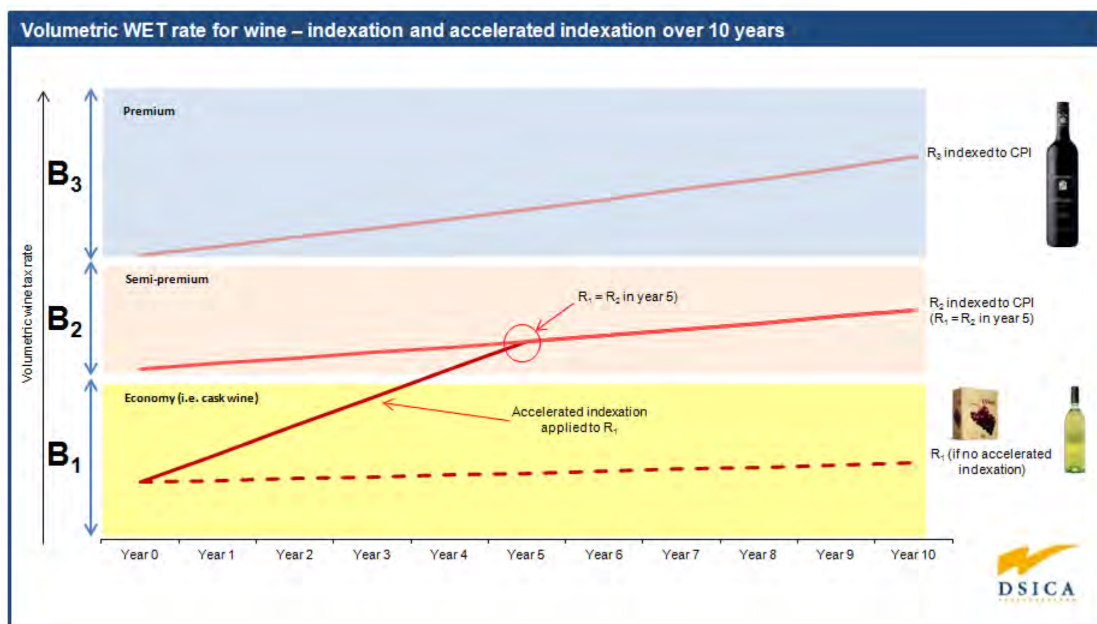
[44] Treasury, *Costing Minute: AFTS Proposal – Alcohol Tax Reform*, 2010.

Concept overview

The operation of the concept and the four stages described is outlined in Figure 10 below. It is pertinent to note the following:

- in order to reduce the taxation distortions between cheaper wine products (i.e. those in B_1), the indexation factor applied to the volumetric excise rate for these products (R_1) could be accelerated. The acceleration factor could be defined by a known variable such as growth in Gross Domestic Product;[45]
- due to the accelerated indexation factor applying to R_1, it is inevitable that R_1 will eventually converge with R_2. At this point of convergence, the accelerated indexation will cease to apply to R_1, and this rate will be subject to normal indexation on the basis of the CPI;
- the acceleration of the R_1 rate is demonstrated by the bold maroon line. To simplify the analysis, the graphic demonstrates rates R_1 and R_2 converging at year five. This timeframe could be changed to accommodate preferred transitional arrangements; and
- later convergence to a single volumetric wine rate could then be designed.

Figure 10: Volumetric WET rate for wine – indexation and accelerated indexation over 10 years



Advantages of this reform proposal

DSICA's volumetric wine taxation reform proposal has a number of advantages, namely:

- maintenance of the WET structure, which minimises winemaker resistance in moving to an excise regime and avoids the introduction of complex administrative requirements (e.g. bonded warehouses) that may be difficult for small winemakers to implement;
- allows for retention of the Wine Producer Rebate (if desired), providing assistance for legitimate small wine producers;
- use of a transition period and accelerated indexation which allows for a gradual increase in the tax rate applying to products in the economy band and prevents any 'price shocks';

[45] Note that at present, Gross Domestic Product is growing at a faster rate than the Consumer Price Index.

- use of multiple taxation tiers which account for the different segments of the wine market;
- use of a volumetric tax which helps facilitate health and social policy objectives, promoting responsible consumption decisions; and
- use of a volumetric tax (as opposed to an ad valorem regime), which removes existing incentives in the tax system for the production of low-value wine. This allows the Australian wine industry to focus on is stated strategy of enhancing and developing the premium wine market segment and assists in ending the 'wine glut'.

Recommendations

That the Government undertake economic modelling to identify the appropriate wholesale sales price points (or other criteria) to separate the proposed economy, semi-premium and premium product price bands.

That the Government undertake economic modelling to identify the appropriate equivalent volumetric taxation rates for the proposed economy, semi-premium and premium product price bands.

That the Government pursue wine taxation reform using the four-step process devised by DSICA as a transition step to achieving the long-term goal of a fully volumetric taxation regime for all alcohol beverages.

3.5 Introduction of a minimum floor price

DSICA strongly opposes the introduction of a minimum floor price on alcohol products.

DSICA acknowledges that there is a current policy and media focus on minimum floor pricing on alcohol products. In particular, the Australian National Preventative Health Agency (ANPHA) has been tasked with the development of a minimum floor price concept and comments have been made indicating that the concept of a minimum floor price is likely to be discussed at the October 2011 Tax Forum.

DSICA strongly opposes the introduction of a minimum floor price as:

- there is a lack of economic evidence confirming the effectiveness of minimum floor pricing in reducing risky and high-risk drinking behaviours;
- it adopts a 'one size fits all' approach, disproportionately affecting responsible consumers and those of lower socio-economic backgrounds in order to discourage the behaviour of a (limited) few;
- it operates as a blunt, population-wide instrument which does not target at-risk drinkers; and
- studies demonstrate that while heavier drinkers tend to consume cheaper and stronger alcohol products than the average consumer, they are the least responsive group to changes in the price of alcohol products.[46]

DSICA favours the introduction of a rationalised alcohol tax system based on a volumetric tax across all alcohol products. In effect, this would provide a minimum floor price on alcohol without incurring costs to retailers to implement the scheme or limiting consumer choice.

DSICA notes that its wine taxation reform proposal outlined above, which facilitates the introduction of tiered volumetric taxation for wine products, would alleviate concerns

[46] Centre for Economics and Business Research, *Review of Minimum Alcohol Pricing: Alcohol etc. (Scotland) Bill 2009*, 2009.

regarding very low-value wine products and purported abuse of cask and cleanskin wine products. In particular, this reform proposal would:

- remove the significant tax concessions afforded under the WET system to cheap, low quality wine products (relative to other types of alcohol beverages); and
- remove the incentive for producers to make cheap, low quality wines (such as cask wine) as these products would no longer be taxed on the basis of their wholesale price under the ad valorem WET.

4 Removal of the five per cent ad valorem customs duty on imported spirits and Ready-to-Drink products

4.1 Introduction

This chapter outlines DSICA's reasons for seeking removal of the five per cent ad valorem customs duty applied to imported spirits and RTDs, namely:

- it is an inefficient, discriminatory and distortionary method of taxation for which there is no justifiable taxation or health policy rationale;
- there is no longer any sector of the domestic spirits industry in Australia which needs protection from imported spirits and RTDs;
- collection of the five per cent ad valorem duty imposes a significant administrative burden on the industry; and
- the duty has no effect other than causing Australian consumers to pay higher prices for imported spirits and RTDs than they otherwise should.

4.2 Operation of the duty

Imported spirits and RTDs are currently subject to a five per cent ad valorem customs duty ('the duty') where imported from countries other than countries with which Australia has a preferential trade agreement. In addition to this 'protective' customs duty, a volumetric excise-equivalent customs duty of $74.27 per litre of alcohol (lal) applies to imported spirits and RTD products, whilst domestically produced spirits and RTDs are subject to an excise duty of $74.27 per lal only.[47] This volumetric component ensures equivalent taxation treatment of all spirits and RTD products consumed in Australia (whether imported or locally produced).

The duty applies on a customs value basis, and thus applies unequally to spirits with the same alcohol content and as such it is an inefficient, discriminatory and distortionary method of taxation.

4.3 Spirits import statistics (2009-2010)

A review of whisk(e)y import figures reveals significant discrimination between products imported from the United States, and those from other countries of origin.

Whisk(e)y products imported from Scotland, Ireland, Japan and Canada represent approximately 45 per cent of all whisk(e)y and bourbon products imported into Australia, with Scotch Whisky products comprising some 41 per cent. Meanwhile, 55 per cent of the imported whisk(e)y category originates from the United States of America (i.e. bourbon products) (see Figure 11).

[47] Note that there is a concessional rate of $69.35 per lpa applying to brandy products.

Figure 11: Summary of imports of whisk(e)y and bourbon products into Australia by country of origin, 2009-10

Country of origin	Imports (000s 9L cases)	Percentage of total imports
Scotland (i.e. Scotch Whisky)	1,794,000	41%
Ireland, Japan and Canada (i.e. Whiskey)	177,000	4%
United States of America (i.e. Bourbon)	2,440,000	55% (no customs duty)
Total	**4,411,000**	**100%**

Source: Liquor Merchants Association of Australia (LMAA) database as at 23 May 2011 and DSICA; bulk spirits imported for manufacture of beverages not exceeding 10 per cent abv are assumed to be imported at 80 per cent abv

As a result of the *Australia-United States Free Trade Agreement*, 45 per cent of whisk(e)y products are subject to a five per cent customs duty discrimination, while **55 per cent of these products** (i.e. bourbon imported from the United States) are **free** from this duty.

4.4 DSICA's policy position on imported spirit tariffs

DSICA seeks immediate removal of the five per cent ad valorem customs duty on *all* spirits and RTDs imported into Australia.

The Henry Review proposed the immediate removal of this tariff on imported spirits, RTDs and wine in order to remove structural complexity from the current system.[48] **DSICA strongly supports this recommendation.**

The Productivity Commission report *Bilateral and Regional Trade Agreements* also noted that unilateral reform (such as the removal of this tariff) is the most direct means of reducing Australia's trade and investment barriers.[49] Immediate removal of the five per cent ad valorem customs duty would be a perfect example of such a unilateral reform.

In addition to the duty anomaly which favours US-sourced spirits, DSICA has advocated total removal of the five per cent ad valorem customs duty on the following grounds:

- **Little/no domestic spirits significant production:** with the exception of rum and other limited producers, there is no domestic spirits industry which Australia needs to protect from overseas competition.
- **Administrative costs:** there are significant administrative costs to business of paying the five per cent ad valorem component, especially in the case of bulk imported spirits used in the manufacture of RTD beverages in Australia. Payment of the five per cent customs tariff on the bulk RTD spirit is made to the Australian Customs and Border Protection Service. At the appropriate time, after manufacture of the RTDs, payment of the volumetric duty component (as excise duty) is made to the ATO. Dealing with, and making duty payments to two separate agencies creates significant administrative issues for producers. The abolition of the five per cent customs tariff would significantly simplify the administrative burdens imposed on DSICA members.
- **Increased retail prices for consumers:** the customs tariff is generally 'absorbed' into a product's cost base which is used as a basis for determining wholesale, and ultimately,

[48] Commonwealth of Australia 2010, *Australia's Future Tax System – Report to the Treasurer, Part 2 – Detailed Analysis*, Australian Government, Canberra, p 443.
[49] Productivity Commission, *Productivity Commission Research Report: Bilateral and Regional Trade Agreements*, 2010.

retail prices. Accordingly, margins and GST are calculated on the 'duty inclusive' price paid by an importer. This import cost 'flow through' effect magnifies the impact of the duty component in the final retail price paid by the Australian consumer.

4.5 Australian Government trade policy statement

DSICA draws attention to the Government's recently stated principle of unilateralism in trade policy in advocating the removal of the five per cent ad valorem customs duty on all full-strength spirits and RTDs imported into Australia.

Australia's trade policy is currently driven by ongoing productivity-focused domestic reform coupled with the negotiation of improved access for exporters to overseas markets. The Government's trade policy statement is framed around the principle that trade policy is an indivisible part of overall economic reform and is facilitated by unilateralism, non-discrimination, separation and transparency.

> Under this principle, *'adopting a bargaining-chip approach of refusing to liberalise at home unless other countries offer trade barrier reductions as a quid pro quo only damages the home country's long-term prosperity. Using domestic reform as a bargaining chip in negotiations is akin to an athlete refusing to get fit for an event unless and until other competitors also agree to get fit'.*[50]

Removal of the five per cent ad valorem customs duty would be an example of unilateral reform which removes discrimination in the current customs tariff regime.

4.6 Cost of removing the duty

Based on information contained in the detailed Henry Review Costing Minute, DSICA estimates the cost to revenue of immediate removal of the five per cent ad valorem customs duty would be approximately $16 million in 2011-12.[51] This cost could be funded from reforms suggested earlier, including tightening of the Wine Producer Rebate and the taxation of cider products as RTDs.

Recommendation

That the Government immediately remove the five per cent tariff on imported spirits and RTDs in order to remove structural complexity from the current alcohol taxation regime.

[50] Department of Foreign Affairs and Trade, *Gillard Government Trade Policy Statement: Trading our way to more jobs and prosperity*, April 2011.
[51] Treasury, *Costing Minute: AFTS Proposal – Alcohol Tax Reform*, 2010.

5 Tax equivalence for low- and mid-strength Ready-to-Drink alcohol products

5.1 Introduction

At present, all RTD products are taxed at a single volumetric rate ($74.27/lal), while beer products are taxed in bands according to alcohol content and receive a 1.15 per cent abv excise-free threshold. This inequitable system fails to support health and social policy objectives and creates distortions in the alcohol market.

This chapter outlines the reasons for introducing tax equivalence for low- and mid-strength RTD products and the estimated cost to revenue of this taxation change.

5.2 Operation and effects of the Ready-to-Drink excise rate

There is a significant difference in the excise taxation paid by low- and mid-strength RTDs when compared to that paid by low- and mid-strength beer products.

The current excise rates applied to beer products account for the different bands (i.e. low-, mid- and full-strength) of alcohol strength seen in this market segment, while RTD products are subject to a single excise rate regardless of product strength. In addition, beer products are subject to a 1.15 per cent excise- free threshold, while RTD products are not.

In practice, these anomalies result in significant differences paid by RTD and packaged beer products as follows:

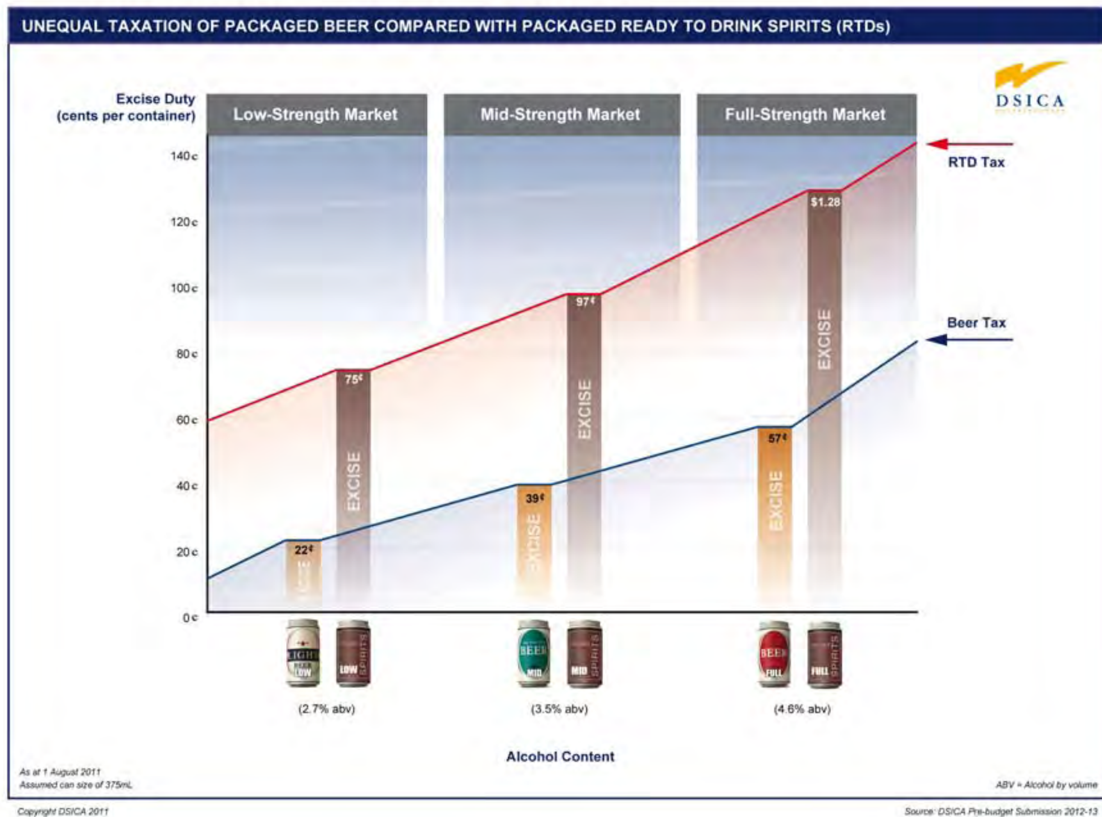
- the amount of excise duty payable on a mid-strength RTD can (97 cents) is almost twice as much as the amount of excise duty payable on a full-strength can of beer (57 cents);
- the amount of excise duty payable on a low-strength RTD can (75 cents) is approximately one-third more than a full-strength can of beer.

These flaws are a direct result of the fact that low- and mid-strength RTDs receive neither:

- the benefit of the 1.15 per cent abv excise-free threshold granted to packaged beer of similar alcohol strength; nor
- the concessional excise rates granted to low-strength packaged beer.

This is illustrated in Figure 12.

Figure 12: Unequal taxation of packaged beer compared with packaged RTDs



The volumes of mid-strength RTDs are very small at present, and there are no low-strength RTDs that DSICA is aware of. Examples of mid-strength RTDs include *Bundaberg Rum and Cola Mid* (3.5 per cent abv) and *Jim Beam and Cola* (3.5 per cent abv). The lack of tax equivalence with mid-strength beer continues to prevent these products gaining any market share of significance. The absence from the market of low- and mid-strength RTDs is a glaring anomaly and suggests a loss of consumer welfare is being caused by the differential tax treatment between beer and RTDs.

5.3 Reform to achieve health and social policy objectives

Submissions from both public health advocates and producers to the Henry Review process generally supported lower rates of tax on lower strength alcohol products. However, there is presently no incentive for RTD manufacturers to develop lower alcohol pre-mixed spirit-based products, with all RTDs being taxed at the same volumetric rate as full-strength bottled spirits and lacking an excise-free threshold.

DSICA considers that there is a sound policy case for providing complete tax equivalence between low- and mid-strength RTDs and low- and mid-strength packaged beer. This would result in the 1.15 per cent abv excise-free threshold also applying to low- and mid-strength RTDs and is consistent with the findings of the Henry Review.

The Henry Review stated that *'low-alcohol products can be considered as having a social benefit to the extent that they substitute for higher strength alcohol products that impose greater spillover costs on the community'*, going so far as to characterise extremely low alcohol

products as *'harmless'*.[52] The Henry Review also rejected submissions that sought to argue that RTDs caused more harm compared with other alcohol beverages, and therefore should be taxed higher.[53]

The Henry Review also recommended that the 1.15 per cent abv excise-free threshold currently applying to beer should be extended to all beverages.[54] Furthermore, the Preventative Health Taskforce report also recognised that lower taxation rates for lower alcohol beverages are a desirable feature of a tiered volumetric alcohol tax system.[55]

5.4 Cost of facilitating tax equivalence

DSICA notes that the estimated cost to revenue of this recommendation is $3 million per annum. This cost could be funded from reforms suggested earlier, including tightening of the Wine Producer Rebate and the taxation of cider products as RTDs.

Recommendation

That the Government should introduce taxation equivalence between low- and mid-strength packaged RTDs and packaged beer of similar alcohol content by applying the same volumetric rates as well as also applying the 1.15 per cent abv excise-free threshold.

[52] Commonwealth of Australia, *Australia's Future Tax System – Report to the Treasurer, Part Two – Detailed Analysis,* 2010, p. 436.
[53] Ibid, p. 435.
[54] Ibid, p. 440.
[55] Preventative Health taskforce, *Australia: The Healthiest Country by 2020, National Preventative Health Strategy – The Roadmap for Action,* 2009, p. 254.

6 Freezing of automatic indexation of the spirits and Ready-to-Drink product excise duty rate

6.1 Introduction

This chapter demonstrates how the bi-annual indexation of spirit and RTD excise duty rates is having a discriminatory and distortionary effect on these products when compared to beverages taxed under the WET. This chapter also examines how the freezing of indexation of spirits and RTD excise duty rates can assist in transitioning to a single volumetric excise rate for all alcohol products.

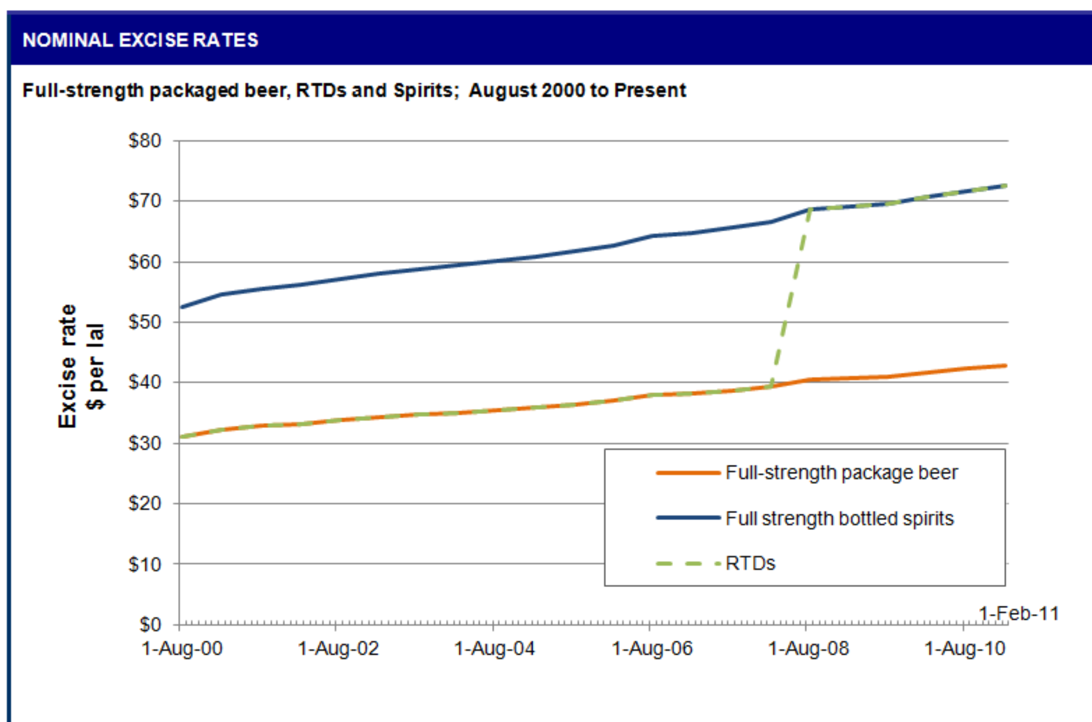
6.2 Indexation of excise rates for spirits and Ready-to-Drink products

The use of indexation has resulted in substantial increases in the excise rate applying to spirit and RTD products.

Since 1984, excise rates for certain excisable goods including spirits and RTDs have been subject to automatic six-monthly indexation on 1 February and 1 August. This practice continued with the introduction of the GST on 1 July 2000. The indexation factor applied is determined in accordance with the CPI change from the previous 1 July to 30 December and 1 January to 30 June periods (respectively). For example, the indexation rate applied on 1 August 2011 was calculated in accordance with the CPI change over the period 1 January 2011 to 30 June 2011.

Since 1 July 2000, the excise rate applying to spirits products has increase from $51.58 per lal to $74.27 per lal – an increase of 44 per cent over some 11 years. This is outlined in Figure 13 below.

Figure 13: Increase in excise duty rates applying to full-strength packaged beer, Ready-to-Drink products and spirits (1 August 2000 to 1 February 2011)



6.3 Different treatment of wine products

The use of indexation has a distortionary impact and limits the ability for spirits and RTDs to compete with products taxed under the WET.

As wine and wine products (e.g. cider, port) are taxed under the ad valorem WET regime (taxed at 29 per cent of the product's wholesale sales price), they are not subject to statutory indexation. This creates a substantial (and increasing) gap in the price and tax burden difference between wine products compared to spirits and RTDs.

The recently released report *The Australian wine tax regime – assessing industry claims* by The Australia Institute provides an analysis of ABS consumer price data which outlines how wine prices have changed in Australia over the past three decades, and contrasts this against overall movements in consumer prices. This research indicates that:

- from 1980 to 2000, wine prices changed roughly in accordance with other consumer prices;
- from 2000 onwards (the period which corresponds with the introduction of the WET), wine prices began to lag behind other CPI items; and
- by June 2011, wine prices were some 16 per cent below where they would have been had previous price trends persisted beyond 2000.[56]

This analysis highlights the distortionary and discriminatory impact of the application of automatic indexation on spirits and RTDs excise duty rates when compared with wine products. As spirits and RTD excise duty rates are subject to automatic indexation, the retail price difference between these products and wine products increases with each indexation period. This results in a growing price and tax burden differential between wine products and spirits and RTDs.

This growing price and tax gap is particularly noted in the cider and RTD markets. As cider products are taxed under the WET, they have the benefit of not being subject to statutory indexation, while one of the main competitors to the cider market, RTDs, are subject to bi-annual indexation. As a result, the gap between the effective taxation rates for RTDs and cider widen whenever cider production costs are not increasing at the rate of increase in general consumer prices. This reduces the ability of RTD producers to maintain their competitiveness both against cider producers and within the broader alcohol beverage market.

6.4 Freezing of indexation

DSICA supports the freezing of indexation of spirits and RTD excise duty rates as a means to transition to a wholly volumetric alcohol taxation regime.

DSICA notes that in transitioning to a wholly volumetric tax regime for all alcohol products, as recommended by the Henry Review, a freeze on bi-annual indexation of the highest excise duty rates can be used as a method to achieve gradual convergence of all excise rates. This analysis has been undertaken by the Henry Review panel in formulating their final recommendations. In undertaking this analysis, the Treasury analysed the revenue impacts of replacing *'current excises on beer and spirits, and Wine Equalisation Tax, with a common alcohol tax based on alcohol content, set by reference to the net social costs of alcohol consumption and taxation, with a low-alcohol threshold for all products'*.[57]

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[56] The Australia Institute, *The Australian wine tax regime – Assessing industry claims*, September 2011, p. 8.
[57] The Treasury, *Costing Minute: AFTS Proposal – Alcohol Tax Reform*, November 2010, p. 1.

Treasury analysis indicated that rates could converge via the current indexation arrangements for the volumetric excise currently applying to spirits, RTDs and beer in the following manner:

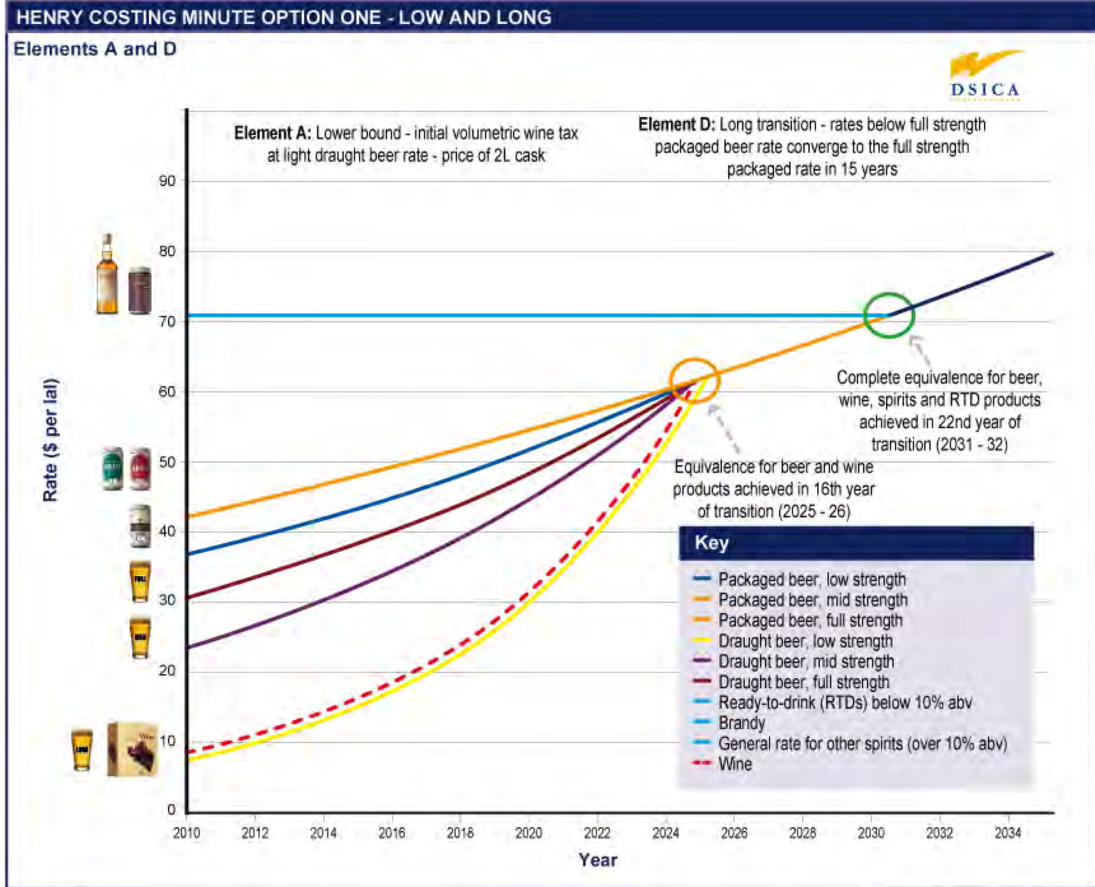
- bi-annual indexation increases of the full-strength packaged beer excise rate in line with movements in the CPI would continue;
- bi-annual indexation increases of all excise rates below the full-strength packaged beer excise rate would be increased so that they would converge with the full-strength packaged beer excise rate within a certain number of years (NB this includes the new volumetric rate for wine); and
- indexation increases of the spirits excise rate would be suspended/frozen until such time as the full-strength packaged beer excise rate is equivalent to the spirits excise rate. Using Treasury's assumption of 2.5 per cent per annum inflation, the spirits excise rate would be suspended/frozen for approximately 21 years.[58]

An example of the Treasury methodology is outlined in Figure 14 below. Key features of this graphic are as follows:

- **step 1:** automatic indexation of the spirits excise duty rate is suspended/frozen and after 15 years, all wine and beer products will be taxed at a single rate (equivalent to the full-strength packaged beer rate);
- **step 2:** the full-strength packaged beer rate converges to the spirits rate; and
- **step 3:** indexation of the final converged rate recommences on a bi-annual basis, including for spirits and RTDs.[59]

[58] Ibid.
[59] Ibid.

Figure 14: Henry Review transition to a single volumetric excise duty rate for all alcohol products option one (low and long)



Recommendation

That the Government commit to freeze automatic (statutory) indexation of the spirits and RTD excise duty rate as a means of facilitating the transition to a single volumetric rate for all alcohol products, as recommended by the Henry Review.

7 Conclusion

DSICA strongly supports the calls by Treasury Wine Estates and Pernod Ricard for the introduction of a volumetric wine tax, and immediate amendments to overcome the systemic abuse of the WET Producer Rebate. The likely end of the wine glut in 12 to 24 months means that it is now time for the Government to take action in reforming Australia's wine taxation regime. This action will remove the need to introduce any retail-based minimum alcohol floor price mechanism

These reforms, and an increase in the taxation of cider at the RTD taxation rate, would allow funding for the removal of the five per cent ad valorem customs duty on imported spirits and RTDs, as well as the introduction of taxation equivalence for low- and mid-strength RTDs with packaged beer of similar alcohol content.

DSICA also recommends that the Government commit to freeze automatic (statutory) indexation of the spirits and RTD excise duty rate as a means of facilitating the transition to a single volumetric rate for all alcohol products, as recommended by the Henry Review.