

PO-CH/NL/0503

Part A

Part A.

**CONFIDENTIAL**

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Begins : 15/12/88 .  
Ends : 31/10/89 .

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PO CH | NL | 0503 .  
Pt.A.

Chancellor's (Lawson) papers:  
Taxation of the Drinks Industry  
Following the Opening of European  
Community Frontiers.

DD'S : 25 Years

*[Signature]*  
28/2/96.

PO CH | NL | 0503  
Pt.A.



→ J. J. J. J.  
of 20/12

UNITED DISTILLERS GROUP

LANDMARK HOUSE HAMMERSMITH BRIDGE ROAD  
HAMMERSMITH LONDON W6 9DP  
TELEPHONE 01-846 8040 TELEX 923484 FACSIMILE 01-741 4542

of 4/11

15th December, 1988.

The Rt. Hon. Nigel Lawson, MP.,  
Chancellor of the Exchequer,  
H.M. Treasury,  
Parliament Street,  
London SW1P 3AG.

CH/EXCHEQUER	
REC.	16 DEC 1988
ACTION	EST
COPIES TO	

✓ 16/12

Dear Chancellor,

It was a pleasure to have the opportunity to meet you at the lunch at Laurence Prust earlier this week and, at least, to raise with you some of the issues important to our industry in the context of '1992'.

First and foremost we see the creation of a Single Market of 320 million consumers in Europe as a major opportunity for us to expand our business. Britain has three of the top four spirits companies in the world: a unique position which no other sector of British industry enjoys. An enlarged 'home' market would enable us to rationalise distribution and help us compete internationally and thereby expand Scotch whisky exports to the rest of the world.

Scotch whisky has a substantial market share in every Member State of the European Community. However, our stiffest challenge is the displacement of established domestic beverages which are, or have until recently been, protected from import competition by discriminatory taxation. The removal of internal frontiers and residual discrimination in favour of domestic spirits, will enable Scotch whisky to compete more effectively against these products.

However, the Single Internal Market will not be a reality for the Scotch whisky industry without the removal of all internal frontier controls and the harmonisation of excise duties. The retention of residual frontier controls, even along Benelux lines, would substantially inhibit these opportunities by reinforcing and facilitating the retention of discrete national markets.

The current differences between rates of excise duties across internal frontiers could not be sustained in the absence of frontier controls. Indeed residual controls along Benelux lines could not sustain them; at least 60% of spirits currently sold in Luxembourg are consumed in neighbouring "high tax" Member States. Furthermore, we have been unable to identify any restrictions which would prevent "cross-border" trafficking without undermining the Single Internal Market for the alcoholic drinks industry or adding substantially to our costs.

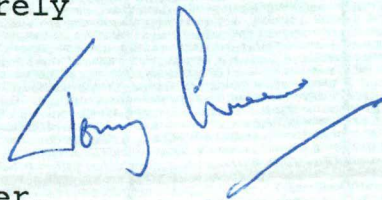
I know that you are well aware of the discriminatory tax treatment of spirits compared with other alcoholic beverages, particularly wine and beer. We are extremely grateful for the positive steps that you have taken as Chancellor to improve this situation in the U.K.

In Europe, there are far greater differences between taxation of alcoholic beverages than in the U.K. For example, in seven Member States, wine is not taxed at all. Given the importance of the U.K. spirits industry to the British economy it is essential that U.K. spirits producers are not disadvantaged against our European competitors. It is essential that competition between all alcoholic beverages is recognised, and in the absence of a neutral system of taxation, that competition is distorted as little as possible.

The only neutral system for the taxation of alcoholic beverages would be equal taxation per unit of alcohol. We recognise the difficulty of achieving this in a single step, consequently we support a "two-tier" structure in which all beverages are taxed according to their alcoholic strength, albeit at different rates, as an interim solution.

I should mention that we were fortunate to be able to discuss this subject, including the "two-tier" structure, with the Economic Secretary to the Treasury when he recently lunched with us at our Group Headquarters.

Yours sincerely



A. A. Greener.

Chy  
not seen in draft.  
note behind.

mpaw.

CONFIDENTIAL

*Handwritten initials/signature*

*(on bf?)*

FROM: R G MICHIE  
DATE: 20 December 1988

PS/CHANCELLOR

cc PS/CST  
PS/FST  
PS/PMG  
PS/EST  
Mr Scholar  
Mr Culpin  
Mr Gilhooly

PS/Customs  
Mr P R H Allen  
Mr Kent )  
Mr Stark ) Customs  
Mr Savins )

LETTER FROM UNITED DISTILLERS GROUP (UDG) DATED 15 DECEMBER

We agreed that the above letter would be best treated as a Budget representation. I attach a draft reply in the standard form but have added a few lines to cover UDC's assertion that the Chancellor is "well aware of the discriminatory treatment of spirits compared with other alcoholic beverages" (page 2 para 2 of UDC's letter). You will recall that the Chancellor covered this same point in his recent reply to the Scotch Whisky Association.

*Handwritten signature: R. George Michie*

R G MICHIE

ENC

CONFIDENTIAL

DRAFT

A A Greener Esq  
United Distillers Group  
Landmark House  
Hammersmith Bridge Road  
Hammersmith  
London W6 9DP

*Please type  
for signature*

Thank you for your letter of 15 December. ~~[on behalf of the  
United Distillers Group.]~~

As you know, our approach to the removal of fiscal frontier controls does not involve the approximation or harmonisation of indirect tax rates. Nevertheless, I note what you say in that context.

I can assure you also that your representations on the rates and structure of excise duty will be carefully considered in the run-up to the Budget. I hope you will understand that it would be inappropriate for me to comment in any detail at this stage, but there is one point which I would like to clarify.

In your letter you argue that all drinks should be taxed on a per degree of alcohol basis, and say that I am "well aware of the discriminatory tax treatment of spirits compared with other alcoholic beverages, particularly wine and beer". Whilst I accept that relative alcoholic strength is one factor which must be considered when setting the level of excise duties, I do not accept that it should be the sole determining factor.

**CONFIDENTIAL**

Each year, in setting the levels of excise duty, I have to strike a careful balance between a wide range of factors. To do as you suggest would very much upset this balanced approach, and severely constrain my room for fiscal manoeuvre. The existing duty stem<sup>ys</sup> allows the opportunity to take account of changes in the economic conditions affecting each of the drinks industries, and as you were good enough to acknowledge in your letter, this approach has greatly benefited the spirits industry in recent years.

I too enjoyed our recent meeting at the lunch at Lawrence Prust, and it was most interesting to hear your views at first hand.

**NIGEL LAWSON**





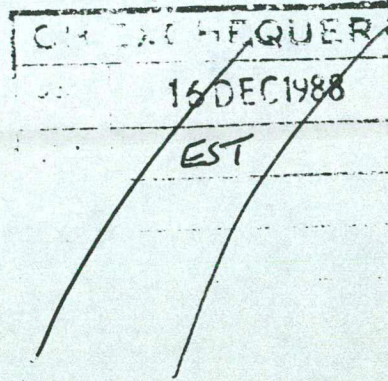
UNITED DISTILLERS GROUP

LANDMARK HOUSE HAMMERSMITH BRIDGE ROAD  
HAMMERSMITH LONDON W6 9DP  
TELEPHONE 01-846 8040 TELEX 923484 FACSIMILE 01-741 4542

ECONOMIC SECRETARY	
REC'D	19 DEC 1988
MR MICHIE	
PS/CHX B/ST B/ST B/A	
MR SCHORR MR GUNN	
MR GUNN	
MR KENT GHE MR STARK	
MR SAVINS GHE B/GHE	

15th December, 1988.

The Rt. Hon. Nigel Lawson, MP.,  
Chancellor of the Exchequer,  
H.M. Treasury,  
Parliament Street,  
London SW1P 3AG.



Dear Chancellor,

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First and foremost we see the creation of a Single Market of 320 million consumers in Europe as a major opportunity for us to expand our business. Britain has three of the top four spirits companies in the world: a unique position which no other sector of British industry enjoys. An enlarged 'home' market would enable us to rationalise distribution and help us compete internationally and thereby expand Scotch whisky exports to the rest of the world.

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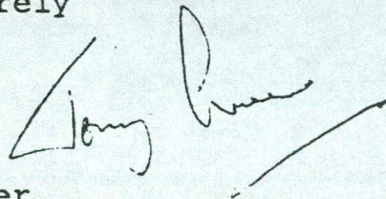
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I should mention that we were fortunate to be able to discuss this subject, including the "two-tier" structure, with the Economic Secretary to the Treasury when he recently lunched with us at our Group Headquarters.

Yours sincerely



A. A. Greener.



Treasury Chambers, Parliament Street, SW1P 3AG  
01-270 3000

22 December 1988

A A Greener Esq  
United Distillers Group  
Landmark House  
Hammersmith Bridge Road  
Hammersmith  
LONDON W6 9DP

A handwritten signature in dark ink, appearing to read 'A A Greener'.

Thank you for your letter of 15 December.

As you know, our approach to the removal of fiscal frontier controls does not involve the approximation or harmonisation of indirect tax rates. Nevertheless, I note what you say in that context.

I can assure you also that your representations on the rates and structure of excise duty will be carefully considered in the run-up to the Budget. I hope you will understand that it would be inappropriate for me to comment in any detail at this stage, but there is one point which I would like to clarify.

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conditions affecting each of the drinks industries and, as you were good enough to acknowledge in your letter, this approach has greatly benefited the spirits industry in recent years.

I too enjoyed our recent meeting at the lunch at Lawrence Prust, and it was most interesting to hear your views at first hand.

A handwritten signature in black ink, appearing to read "Nigel Lawson".

NIGEL LAWSON



UNITED DISTILLERS GROUP

LANDMARK HOUSE HAMMERSMITH BRIDGE ROAD  
HAMMERSMITH LONDON W6 9DP  
TELEPHONE 01-846 8040 TELEX 923484 FACSIMILE 01-741 4542

~~Handwritten scribble~~ *py*

3rd February, 1989.

The Rt. Hon. Nigel Lawson, MP  
Chancellor of the Exchequer  
H.M. Treasury,  
Parliament Street,  
London SW1P 3AG

✓  
6/2

CH/EXCHEQUER	
REC.	06 FEB 1989
ACTION	EST
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Dear Chancellor,

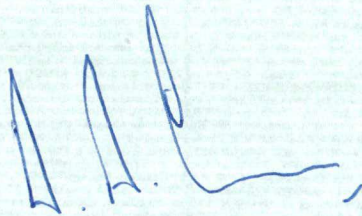
Thank you for your letter of 22nd December 1988. I am grateful to you for having taken the trouble to write at such length.

Perhaps I could take up two matters which you raised. First, in your letter you comment that the relative alcoholic strength of different beverages should not be the sole determinant of relative rates of Excise Duty on those beverages. Yet, in reality in the market place, all alcoholic drinks are in competition, each with the others: to give favourable treatment to certain categories of beverage distorts that competition. As was recognised by the CPRS Review, no distinction, on grounds of health or otherwise, can be drawn between the different categories of alcoholic beverage such as to justify this interference with the market. In our view, excise duties should be neutral in their impact on competition and consumer choice.

You also comment that the existing duty system permits you to "take account of changes in the economic conditions affecting each of the drinks industries". This implies that the current tax differential between beer and wine on the one hand and spirits on the other exists either to protect the former or to penalise the latter - an approach which is surprising in that it favours imported wine as against domestic spirits. I find it difficult to justify objectively any such approach.

We readily acknowledge that the standstill in excise duties on spirits has greatly benefited the spirits industry in recent years. However, a partial removal of the historical discrimination against spirits cannot be seen as unduly favourable treatment of spirits. We therefore hope that you will feel able in the forthcoming Budget to reduce further the tax discrimination against spirits and to move towards the competitively neutral system of equal taxation per degree of alcohol for all alcoholic beverages.

Yours sincerely,

A handwritten signature in blue ink, consisting of three distinct, tall, narrow vertical strokes followed by a horizontal line that tapers to the right.

A. A. Greener.



cc PS/Chief Secretary  
PS/Financial Secretary  
PS/Paymaster General  
PS/Economic Secretary  
Mr Scholar  
Mr Culpin  
Mr Gilhooly  
Mr Michie

PS/C&E



CH/EXCHEQUER	
REC.	22 FEB 1989
ACTION	EST
COPIES TO	

SCOTTISH OFFICE  
WHITEHALL, LONDON SW1A 2AU

✓  
22/2

Jonathan Taylor Esq  
Private Secretary to the  
Chancellor of the Exchequer  
HM Treasury  
Parliament Street  
LONDON  
SW1P 3HE

21 February 1989

**TAXATION OF THE DRINKS INDUSTRY**

My Secretary of State recently lunched with the Chairman and Senior Directors of International Distillers and Vintners Ltd. Two main points they put to him at that lunch were, firstly, their case for an additional period of deferment of excise duty and secondly their anxieties about excise duty harmonisation.

I thought you should see the attached paper which IDV have subsequently sent to us. In doing so they stress that the original concession has substantially eroded and that with the present state of Government revenues, this represents an ideal opportunity to "restore some equity to the situation". IDV also offer to assist in any way possible to find a way forward on excise duty harmonisation.

Mr Rifkind would be grateful if the Chancellor would take note of these views.

Yours sincerely,

**DAVID CRAWLEY**  
Private Secretary

Enc



1. INTRODUCTION

Excise duty is, in effect, a consumer tax. In applying the duty the Chancellor expects that it will be fully reflected in retail prices to consumers. To facilitate collection on alcoholic drinks, however, the tax is charged not at the moment of purchase by the consumer, but an average of four weeks after withdrawal from bond. There is an interval of, on average, a further eight weeks between payment of the tax by the trader and his customers. The trader is, therefore, effectively borrowing to finance the cost of tax collection.

This is an ongoing commitment, representing a financial burden on the industry which could be avoided, or substantially alleviated by the Government by further deferment of the collection date. This would involve a delay in revenue collected in the year in which the change was made,\* but would add nothing to the administrative costs of revenue collection.

This principle was accepted by the Government in 1983, when a 28 day period of grace on the payment of excise duty on wines and spirits, after withdrawal from bonded warehouses, was introduced.

The change acknowledged the basic issue that traders should not be asked to finance the cost of tax collection.

2. ADDITIONAL TAXATION BURDENS

Almost immediately following the introduction of the 28 day duty deferment period, other legislative changes were introduced, which left the trade substantially worse off.

2.1 Stock Relief

The concession on stock relief, introduced to alleviate problems caused by high inflation on stock values, was withdrawn at a stroke in March 1984, in tandem with a progressive reduction in Corporation Tax.

Because of the need to hold maturing stocks the impact on the Scotch Whisky sector is very serious, with an estimated thirteen year period before the cumulative benefits of the lower taxation rates will outweigh the additional costs of financing stocks in the transitional period. As a result Scotch Whisky and any other long maturing wine or spirit, given the inflation factor and current legislation, will in perpetuity be paying a higher effective rate of corporation tax.

(\*Parliamentary answer by Mr B.Hayhoe - Hansard 30th April 1985 Column 96)

2.2 Loss of tolerances

Through the withdrawal of tolerances on the declaration of spirit strengths and liquid retention in April 1983, the trade had, for example, on spirits to bear an additional ½% on the duty payable. This was equivalent to losing 60% of the duty deferment benefit on a bottle of spirits.

2.3 Loss of Postponed Accounting for VAT

In the 1984 Budget, postponed accounting for VAT (PAS) was abolished. The loss of PAS brought forward the payment of VAT by an average six and a half weeks on imported goods and home produced items which had been subject to a supply under bond. In the case of imported wines and spirits a significant element of the additional cost was the VAT charge on the duty element, not the imported value.

2.4 Net effect of the tax changes

The effect of each of these changes varied between the different sectors of our trade but weighed more heavily on the smaller company. Additional financial burdens on smaller companies will reduce the vital job creating role which these can fulfil. As an illustration, however, the impact this year on one company with interests in each of the sectors is estimated to be:-

<u>CREDIT</u>	<u>£M p.a.</u>
4 weeks Duty Deferment (granted February 1983)	+ 1.7
<u>LESS</u>	
- Loss of tolerances	- 0.9
- Loss of Postponed Accounting	- 0.3
- Stock Relief ( net impact of Finance Act 1984)	- 2.7
	<hr/>
Current Gross Loss	- 3.9
	<hr/>
Net Loss	- 2.2
	<hr/>

As can be seen, this company is now substantially worse off than before the original 28 day duty deferment period was granted.

### 3. REDRESSING THE BALANCE

We strongly request that an immediate concession of an additional 28 days deferment be granted on duty deferment for the following reasons:-

#### 3.1 Costs to the Trader of financing tax collection

Despite the concession granted in February 1983, the trade is still left to finance two thirds of the period between clearance from bond and cash collection, and therefore has to pay interest on money borrowed to pay a consumer tax.

#### 3.2 EC comparisons

The EC Commission proposals on "Alcoholic Beverage Tax Harmonisation" imply the need to bring duty deferment periods into line to enable the free movement of excisable goods between bonded warehouses in different EC countries. The treatment currently afforded to the UK wine and spirit companies compares very unfavourably with that of our EC competitors. Duty deferment periods in Europe are:-

	WINES	SPIRITS
Belgium	2 - 6 months	4 months
Luxembourg	2 - 6 months	2-6 months
Denmark	65 days	45 days
France	2 months	2 months
West Germany	Still wines/not taxed. Aromatic/liqueur wines 3 months Sparkling wine 40 days	3 months
United Kingdom	1 month	1 month

Increasingly wines and spirits brands are facing worldwide competition. A strong home market is essential as a base from which to build export.

The duty deferment accorded to European competitors is, therefore, relevant to the ability of UK companies to compete in worldwide markets.

Given that the Scotch Whisky industry alone will have export earnings of £1 billion this year, and Gin will contribute a further £90M it is also a concern to both the balance of payments and UK jobs.

An extension of duty deferment now would also be a significant step towards a freer market within the EC.

### 3.3 Impact of taxation changes

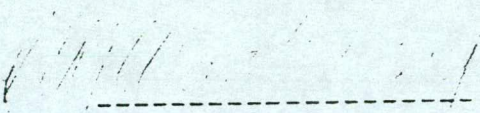
Our trade has been hard hit by general taxation changes; Scotch Whisky and other maturing products on stock relief, imported wines and spirits by the loss of PAS. Duty deferment provides a vehicle to give selective assistance to this industry without creating wider taxation precedents.

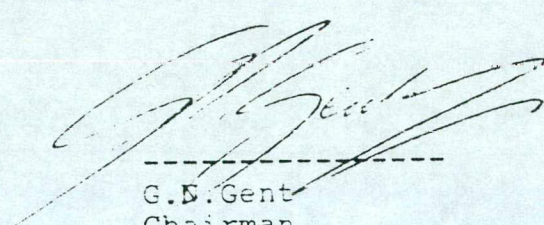
The effect, on our sample company, of granting an additional twenty eight days deferment would be still to leave that Company substantially worse off than in February 1983 when the original 28 day duty deferment period was introduced.

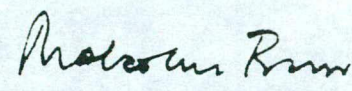
#### 4. CONCLUSION

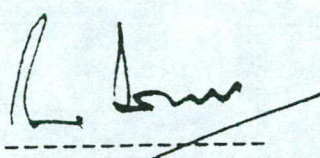
The following associations submit that there is now an overwhelming case to grant an immediate four week additional period of duty deferment. This will mean that:-

- (a) the trade will not be asked to finance more than an average one month of the cost of duty collection; and
- (b) although still being worse off than the position intended in February 1983, this move would leave the trade with a stronger home base and therefore better placed to build vital exports.
- (c) EC harmonisation will be facilitated.

  
-----  
J.A.R. Macphail, C.B.E.  
Chairman  
Scotch Whisky Association

  
-----  
G.E. Gent  
Chairman  
Wine & Spirit Association  
of Gt. Britain and N. Ireland

  
-----  
R.M.J. Burr  
Chairman  
The Gin Rectifiers  
and Distillers  
Association

  
-----  
R.N. Bowes, M.W.  
Chairman  
Vodka Trade Association

October 1986

INTERNATIONAL DISTILLERS AND VINTNERS LIMITED

NET EFFECT OF TAX CHANGES

Update February 1989

In the duty deferment paper dated October 1986 an example of the financial impact of various legislative changes on one company was shown. This paper updates that example.

CREDIT		<u>£M p.a.</u>
4 weeks' Duty Deferment (granted (granted February 1983)		+ 2.3
LESS		
- Loss of tolerances	- 1.0	
- Loss of postponed accounting	- 0.6	
- Stock Relief (Net impact of Finance Act 1984)	- 2.7	
	<hr/>	
Current Gross Loss		- 4.3
		<hr/>
Net Loss		- 2.0
		<hr/>

The conclusion drawn in 1986 remains valid, namely that this company is now substantially worse off than before the original duty deferment period was granted.

*Earlier letter, p. 1*

FROM: K SEDGWICK  
DATE: 21 February 1989

MR TAYLOR

cc Mr Michie

*Ch / Content for me to write as proposed? Ok  
21 22/2*

**FURTHER LETTER FROM THE UNITED DISTILLERS GROUP (UDG)**

The UDG wrote to the Chancellor on 3 February in reply to the Chancellor's letter of 22 December. I attach a reply for your signature.



K SEDGWICK  
FP Division



SCOTTISH OFFICE  
CH/EXCHEQUE- WHITEHALL, LONDON SW1A 2AU

REC.	22 FEB 1989
ACTION	EST
COPIES TO	

22/2

ECONOMIC SECRETARY	
REC'D	23 FEB 1989
ACTION	Mr Kent.
COPIES TO	PS/CHX, PS/CST 2 PS/FST, PS/PMB, Mr Culpin, Mr Gilkwood, Mr Michie, Mr Call

Jonathan Taylor Esq  
Private Secretary to the  
Chancellor of the Exchequer  
HM Treasury  
Parliament Street  
LONDON  
SW1P 3HE

21 February 1989

Mr Jefferson-Smith  
Mr Wilmott  
Mr Stark  
PS/C+E.

*New Jonathan,*

*[Handwritten signature]*

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*Yours sincerely,*  
*[Signature]*

**DAVID CRAWLEY**  
Private Secretary

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This principle was accepted by the Government in 1983, when a 28 day period of grace on the payment of excise duty on wines and spirits, after withdrawal from bonded warehouses, was introduced.

The change acknowledged the basic issue that traders should not be asked to finance the cost of tax collection.

2. ADDITIONAL TAXATION BURDENS

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(\*Parliamentary answer by Mr B.Hayhoe - Hansard 30th April 1985 Column 96)



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Through the withdrawal of tolerances on the declaration of spirit strengths and liquid retention in April 1983, the trade had, for example, on spirits to bear an additional ¼% on the duty payable. This was equivalent to losing 60% of the duty deferment benefit on a bottle of spirits.

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<u>CREDIT</u>	<u>£M p.a.</u>
4 weeks Duty Deferment (granted February 1983)	+ 1.7
<u>LESS</u>	
- Loss of tolerances	- 0.9
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	<hr/>
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Despite the concession granted in February 1983, the trade is still left to finance two thirds of the period between clearance from bond and cash collection, and therefore has to pay interest on money borrowed to pay a consumer tax.

#### 3.2 EC comparisons

The EC Commission proposals on "Alcoholic Beverage Tax Harmonisation" imply the need to bring duty deferment periods into line to enable the free movement of excisable goods between bonded warehouses in different EC countries. The treatment currently afforded to the UK wine and spirit companies compares very unfavourably with that of our EC competitors. Duty deferment periods in Europe are:-

	WINES	SPIRITS
Belgium	2 - 6 months	4 months
Luxembourg	2 - 6 months	2-6 months
Denmark	65 days	45 days
France	2 months	2 months
West Germany	Still wines/not taxed. Aromatic/liqueur wines 3 months Sparkling wine 40 days	3 months
United Kingdom	1 month	1 month

Increasingly wines and spirits brands are facing worldwide competition. A strong home market is essential as a base from which to build export.

The duty deferment accorded to European competitors is, therefore, relevant to the ability of UK companies to compete in worldwide markets.

Given that the Scotch Whisky industry alone will have export earnings of £1 billion this year, and Gin will contribute a further £90M it is also a concern to both the balance of payments and UK jobs.

An extension of duty deferment now would also be a significant step towards a freer market within the EC.

### 3.3 Impact of taxation changes

Our trade has been hard hit by general taxation changes; Scotch Whisky and other maturing products on stock relief, imported wines and spirits by the loss of PAS. Duty deferment provides a vehicle to give selective assistance to this industry without creating wider taxation precedents.

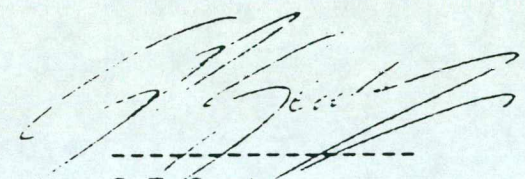
The effect, on our sample company, of granting an additional twenty eight days deferment would be still to leave that Company substantially worse off than in February 1983 when the original 28 day duty deferment period was introduced.

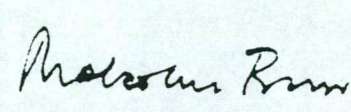
### 4. CONCLUSION

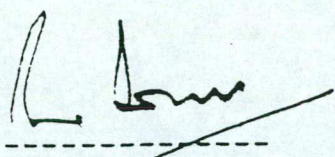
The following associations submit that there is now an overwhelming case to grant an immediate four week additional period of duty deferment. This will mean that:-

- (a) the trade will not be asked to finance more than an average one month of the cost of duty collection; and
- (b) although still being worse off than the position intended in February 1983, this move would leave the trade with a stronger home base and therefore better placed to build vital exports.
- (c) EC harmonisation will be facilitated.

-----  
J.A.R. Macphail, C.B.E.  
Chairman  
Scotch Whisky Association

  
-----  
G.E. Gent  
Chairman  
Wine & Spirit Association  
of Gt. Britain and N. Ireland

  
-----  
R.M.J. Burr  
Chairman  
The Gin Rectifiers  
and Distillers  
Association

  
-----  
R.N. Bowes, M.W.  
Chairman  
Vodka Trade Association

October 1986

INTERNATIONAL DISTILLERS AND VINTNERS LIMITED

NET EFFECT OF TAX CHANGES

Update February 1989

In the duty deferment paper dated October 1986 an example of the financial impact of various legislative changes on one company was shown. This paper updates that example.

CREDIT		<u>£M p.a.</u>
4 weeks' Duty Deferment (granted (granted February 1983)		+ 2.3
LESS		
- Loss of tolerances	- 1.0	
- Loss of postponed accounting	- 0.6	
- Stock Relief (Net impact of Finance Act 1984)	- 2.7	
	<hr/>	
Current Gross Loss		- 4.3
		<hr/>
Net Loss		- 2.0
		<hr/>

The conclusion drawn in 1986 remains valid, namely that this company is now substantially worse off than before the original duty deferment period was granted.



Treasury Chambers, Parliament Street, SW1P 3AG  
01-270 3000

23 February 1989

A A Greener Esq  
United Distillers Group  
Landmark House  
Hammersmith Bridge Road  
Hammersmith  
LONDON W6 9DP

*Dear Mr Greener*

Thank you for your further letter of 3 February to the Chancellor of the Exchequer on behalf of the United Distillers Group.

I can assure you that the further points you make will be carefully considered in the run-up to the Budget. However, I hope you will understand that it would be inappropriate for me to comment further at this stage.

*Yours sincerely*  
*J M G Taylor*

J M G TAYLOR  
Private Secretary



py

Johnathon

In connection with the launch of the new Customs cutter tomorrow at Portsmouth.

I attach copies of i) EST's speech ii) press notice and iii) a list to take when he speaks to the local press.

Nigel

24/2

24/2/89.

ADDRESS BY MR PETER LILLEY, MP, ECONOMIC SECRETARY.

There is no doubt that international drugs traffickers are targeting the United Kingdom and Europe as a potentially lucrative market. The drugs threat - especially to the young - is growing. It is extremely serious and <sup>can</sup> affect us all, whether we are parents, employers or politicians.

The Government is determined to beat drugs traffickers - to track them down, to seize their ill-gotten profits and to ensure that they receive proper punishment in the courts.

A new Act of Parliament has given judges the power to strip convicted drugs smugglers of their assets and severe prison sentences are now awarded by the courts for drugs offences.

The United Kingdom has also signed agreements with foreign governments to co-operate in investigating and prosecuting drugs crimes internationally and we are investing in new equipment and technology to ~~to~~ beat drugs smuggling and to detect hidden drugs.

This vessel, for example, is part of a seven million pound programme to enhance the maritime capability of Her Majesty's Customs and Excise against seaborne drugs traffickers.

However, all this would be of little value if it were not for those people responsible for combating drugs traffickers day in and day out. We are fortunate that, in our front line of defence against drugs, are the officers of Her Majesty's Customs and Excise.

Last year they seized illegal drugs with a record street value of one hundred and eighty-five million pounds.

It was very much a team effort, involving uniformed officers at ports and airports, plain-clothes specialist investigators, intelligence officers stationed in foreign countries and the men and women of the Marine Branch.

All of them are Civil Servants - a fact which surprises many who still have a stereotyped view of Government service. The Marine Branch, for example, is manned by volunteers from the Department who spend three months a year away from their normal jobs and their families to tackle drugs smugglers at sea. They display the highest standards of seamanship and put to sea in all weathers to protect our society.

Last year they were particularly successful. In the closing months of 1988 Marine Branch officers arrested several ships and yachts and seized 16 tonnes of cannabis, worth fifty million pounds.

I am very pleased, as the Government minister responsible for customs and excise matters, to have this opportunity of paying tribute to their professionalism and dedication.

DRAFT PRESS NOTICE

SECOND NEW FAST PATROL BOAT FOR HM CUSTOMS AND EXCISE

A new anti-drugs smuggling fast patrol boat, built for HM Customs and Excise, was named at a ceremony at Portsmouth on Saturday, 25 February, by Mrs Gail Lilley, wife of the Economic Secretary to HM Treasury, Mr. Peter Lilley, MP, the Government minister responsible for customs and excise matters.

Her Majesty's Customs Cutter Valiant is the second of three new 26-metre Protector-class vessels built by FBM Marine Ltd at Cowes, Isle of Wight, for the Department.

HM Customs and Excise maintains a flotilla of seven vessels for coastal and deep water anti-smuggling work. In addition, about 60 smaller craft are in use for harbour and inshore work. The new Protector-class vessels, HMCC's Vigilant, Valiant and Venturous, are replacing existing vessels. The first of the class was commissioned into service in December last year and the third will be enter service in April this year.

They are powered by two 1,500 b.h.p. diesel engines driving twin propellers, which give a maximum speed in excess of 25 knots. A smaller diesel engine powers a separate water jet, which enables the boats to work at very slow speeds for long periods during covert surveillance operations.

The most modern surveillance radars and communications equipment is fitted to give the Customs crews a technological advantage over well equipped smugglers that are encountered in drugs trafficking operations. Individual cabins for the crews and a high degree of crew comfort enable the vessels to operate extended patrols in deep water and in rough weather. X

Saturday's naming ceremony was held at the HMS Nelson Gunwharf site at Portsmouth, where the Marine Branch of HM Customs and Excise has its headquarters. The ceremony was attended by many Customs and Excise cutter crew members and their families.

The Valiant was handed over by Mr Jack Barr, Managing Director of FBM Marine Ltd and accepted into service by Mrs Valerie Strachan, Deputy Chairman of HM Customs and Excise.

During the ceremony Mr Lilley said: "There is no doubt that international drugs traffickers are targeting the United Kingdom and Europe as a potentially lucrative market. The drugs threat - especially to the young - is growing.

"The Government is determined to beat drugs traffickers - to track them down, to seize their ill-gotten profits and ensure they receive proper punishment in the courts.



"A new act of Parliament has given judges the power to strip convicted drugs smugglers of their assets and severe prison sentences are now being awarded by the courts for drugs offences.

"The United Kingdom has also signed agreements with foreign governments to co-operate in investigating and prosecuting drugs crimes internationally and we are investing in new equipment and technology to beat drugs smuggling and to detect hidden drugs.

"This vessel, for example, is part of a seven million pound programme to enhance the maritime capability of HM Customs and Excise against seaborne drugs traffickers."

Mr. Lilley also paid tribute to the Customs and Excise cutter crews and to the Department, which last year seized illegal drugs with a street value of £185 millions.

"We are fortunate to have them in our front line of defence against drugs. The Marine Branch of Customs and Excise is manned by volunteers from the Department who spend three months a year away from their normal jobs and their families to tackle drugs smugglers at sea. They display the highest standards of seamanship and put to sea in all weathers to protect our society."

END

## NAMING CEREMONY HMCC VALIANT - MEDIA INTERVIEWS

### POINTS TO MAKE

Last year HM Customs and Excise seized a record £185<sup>million</sup> of illegal drugs - an increase of almost 60 per cent by street value on the previous year.

The Marine Branch was particularly successful. In the closing months of the year the cutters arrested several yachts and ships (now the property of the Crown) and seized more than 16 tonnes of cannabis.

The traditional method of smuggling by sea is still a major threat. With the 12 mile limit HM C&E have to patrol 64,000 square sea miles.

The drugs threat affects all of us - parents, employers and politicians. It is an international problem.

The Government is determined to protect society from the menace of drugs and to beat drugs traffickers. It has taken initiatives in the following areas.-

**LEGAL:** The Drugs Trafficking Offences Act is proving very effective in helping to track drugs smugglers and dealers and in enabling the courts to strip them of their ill-gotten assets.

Courts are imposing severe sentences and parole for drugs traffickers has been limited severely.

**ENFORCEMENT:** Customs and Police manpower and resources have been enhanced.-

\* (Including efficiency savings) 450 extra posts for Customs are being allocated in the current financial year. These will be deployed in control and detection work. Further increases in staff to combat drugs are planned to 1991.

\* £13 million is being provided for Customs for the provision of drugs detection equipment and research and development.

\* £7 million is being provided to enhance the Customs maritime capability. (The new boats are part of this programme).

\* £7 million is being provided to enhance the Customs criminal intelligence computer.

\* By the end of the current financial year the number of Customs drug dog teams will have been increased from 40 to 56.

\* A National Drugs Co-ordinator has been appointed.

\* All police forces in England and Wales now have specialist drugs squads and regional crime squads have their own drugs wings and the numbers of officers working on drugs cases have been increased.

PREVENTION: A campaign of education, particularly aimed at the young, has been undertaken.-

\* A massive advertising campaign has been undertaken

\* The DES is providing £6.7 millions to provide teaching staff to co-ordinate preventive action in schools

#### TREATMENT AND REHABILITATION

\* The DHSS has provided £17.5 million for the funding of a range of projects and services for drugs misusers.

(See also attached draft speech).



H.M. CUSTOMS AND EXCISE  
 NEW KING'S BEAM HOUSE, 22 UPPER GROUND  
 LONDON SE1 9PJ  
 01-620 1313

*Plse type final*

*Ch. Content for me to write my  
 proposed? (I have amended  
 slightly the C+E draft, which  
 seemed rather incongruous).*

FROM: P B KENT  
 REVENUE DUTIES DIVISION B

DATE: 24 February 1989

PS/CHANCELLOR OF THE EXCHEQUER

*27/2*

*OK*

**TAXATION OF THE DRINKS INDUSTRY**

To his note of 21 February, David Crawley attached a paper on duty deferment by the various Trade Associations involved with wines and spirits. This paper was sent to the Secretary of State for Scotland following a lunch with one of the main wines and spirits traders, International Distillers and Vintners Ltd. (IDV). This issue has been raised on previous occasions by IDV and the Trade Associations concerned with both the Economic Secretary and Customs officials and is well known to the Chancellor. In view of this, if any reply is called for, we suggest a simple acknowledgement along the following lines:

"Thank you for your note of 21 February on drinks taxation. ~~The Chancellor is aware of the views of the trade on excise duty deferment. Nevertheless, he is grateful to the Secretary of State for Scotland for drawing his attention to the paper on the subject submitted by International Distillers and Vintners Ltd, the contents of which have been noted.~~

*The Chancellor is*

*duty deferment*

*PBC*

P B KENT

Circulation: PS/Economic Secretary  
 Mr Michie  
 Mr Call

CPS  
 Mr Jefferson Smith  
 Mr Wilmot  
 Mr Stark,

cc PS/EST  
Mr Michie  
Mr Call  
PS/C+E  
Mr Jefferson  
-Smith  
Mr Wilmott  
Mr Stork  
Mr Kent.



Treasury Chambers, Parliament Street, SW1P 3AG  
01-270 3000

28 February 1989

David Crawley Esq  
Private Secretary to the  
Secretary of State for Scotland  
Scottish Office  
Whitehall  
LONDON  
SW1

*Dear David*

**TAXATION OF THE DRINKS INDUSTRY**

Thank you for your note of 21 February on drinks taxation. The Chancellor is grateful to your Secretary of State for drawing his attention to the paper on duty deferment submitted by International Distillers and Vintners Ltd.

*Yours ever  
J.M.G. Taylor*

J M G TAYLOR  
Private Secretary

H.M. CUSTOMS AND EXCISE  
DEPARTMENTAL PLANNING UNIT  
NEW KING'S BEAM HOUSE, 22 UPPER GROUND  
LONDON SG1 9PJ  
01-620 1313

*PRH*

FROM: P R H ALLEN

DATE: 21 MARCH 1989

ECONOMIC SECRETARY

**INSTITUTE FOR FISCAL STUDIES: ALCOHOL CONSUMPTION & TAXATION**

1. You may already be aware of the Institute for Fiscal Studies' (IFS) recent publication entitled 'Alcohol consumption and taxation' A copy is attached for information. The study examines the economics of alcohol consumption and taxation - paying particular attention to the social costs of alcohol and the effects of the tax system on consumption. Its empirical analysis is based on the Simulation Programme for Indirect Taxes (known by its unlovely acronym as SPIT) in the development of which our economists have been closely involved and which we part funded.

2. The report - while independent - was largely financed by groups concerned with alcohol abuse, such as Alcohol Concern and the Health Education Authority. In common with other IFS studies, some of the report's conclusions look sound in terms of economic theory. However, they may not accord with the practicalities of setting duties in today's market for alcoholic drinks. The study's main policy recommendation is that all alcoholic drinks should be taxed in direct proportion to their alcoholic strength. The study

---

cc	Chancellor	)	CPS	)
	Mr Scholar	)	Mr Jefferson Smith	)
	Mr Culpin	)	Mr Wilmott	)
	Mr Michie	)	Mr Kent	)without attachment
	Mr Call	)	Mr Vernon	)
			Mr Knox	)
			Mr French	)
			Mr Oxenford	)

therefore lends independent support to the spirits industry's long held preference for a uniform duty rate per degree of alcohol. The IFS's preferred method of implementing the recommendation is to raise the duty on beer and wine steadily to bring it into line with the duty on spirits in a way that limits the growth of alcohol consumption. This departs from the general presumption that the nominal level of duties should be updated to maintain their real value over time.

3. We are preparing a detailed analysis of the report and its recommendations with the aim of letting you have our considered views on its findings in good time for further Finance Bill discussions. Our initial reaction is to be sceptical about some of the conclusions.

RA.

P R H ALLEN



**FROM:** S M A JAMES  
**DATE:** 22 March 1989

**MR ALLEN - C&E**

**cc:** PS/Chancellor  
Mr Scholar  
Mr Culpin  
Mr Gilhooly  
Mr Michie  
Mr Call

PS/C&E  
Mr Jefferson-Smith - C&E  
Mr Wilmott - C&E  
Mr Kent - C&E

**INSTITUTE FOR FISCAL STUDIES : ALCOHOL CONSUMPTION AND TAXATION**

The Economic Secretary was grateful for your minute of 21 March. He looks forward to receiving your detailed analysis of the report and its recommendations. He is sure that this will be quoted in Finance Bill Committee.

A handwritten signature in cursive script, appearing to read "S M A James".

**S M A JAMES**  
**PRIVATE SECRETARY**





P Jefferson Smith  
Deputy Chairman

*Thanks.  
If we want to follow  
this course, we X,  
what we have done in  
the 1989 Budget, with what  
impact of RPI effects on  
comp. with strength  
administration?*

Board Room  
H M Customs and Excise  
New King's Beam House  
22 Upper Ground  
London SE1 9PJ  
Telephone: 01-382 5011

FROM: P JEFFERSON SMITH  
DATE: 15 MAY 1989

CHANCELLOR

**INSTITUTE FOR FISCAL STUDIES: REPORT ON ALCOHOL CONSUMPTION AND TAXATION.**

*BT, actually*

In his minute to you of 21 March, Mr Allen promised to let you have a detailed analysis of the recommendations of this IFS Report.

2. We have now considered the study in some depth. As Mr Allen reported, the principal recommendation is that all drinks should be taxed in direct proportion to their alcoholic strength (save for one or two exceptions such as very low alcohol drinks which do not cause any harm). Other recommendations address the actual level at which duties on alcoholic drinks should be pitched - consistent with the main proposal - to minimise disruption in the drinks industry.

3. A brief summary of the report and our analysis of it are attached.

---

<u>Distribution:</u>	Economic Secretary	CPS
	Sir P Middleton	Mr Wilmott
	Mr Byatt	Mr Allen
	Mr Scholar	Mr Kent
	Mr Culpin	Mr Vernon
	Mr Gilhooly	Mr Knox
	Mr Matthews	Ms French
	Mr Michie	Mr Oxenford
	Mrs Chaplin	Mr Stark
	Mr Call	Mr Palnoch

4. The nub of the report is that it looks for a rational basis for taxation of alcohol, and concludes that this must be the capacity for alcohol as such to do harm - hence the proposal to phase in a structure related across the board to alcoholic strength. It would be wrong to scoff at this: but it seems to me to fail to recognise the extent that our taxes are the product of historical development. The changes required to get to the Report's preferred structure would have to be phased in and would in any event be disruptive. The present duties are far from perfect - in particular the beer duty could do with a radical overhaul - but the existing technique of piecemeal change is more flexible and familiar. If you would like further work done on the proposals in this Report we would be happy to do so. But in that event, it would be helpful to have a short discussion to set the policy parameters.

Ph 5

P JEFFERSON SMITH

## General background to the reports analysis

1. The opening chapters of the report are largely devoted to providing a historical and institutional background of alcohol consumption. Some interesting facts emerge:

(i) levels of alcohol intake rose in the post war years and have broadly stabilized since the 1970s. They are still well below those of 150 years ago.

(ii) over the past decade or so wine drinking has grown, spirits drinking has stagnated and beer drinking has declined. These trends are, not surprisingly, associated with relative movements in real price.

(iii) shares of consumers' expenditure allocated to alcohol remained steady at 7-7 1/2 per cent between 1971 and 1986.

(iv) the UK is twenty third in a league table of per capita alcohol consumption by OECD and East European countries.

2. The report focuses on the taxation of alcohol. By translating\* the existing structure into duty per unit of alcohol, it alleges that there is substantial tax discrimination against spirits.

3. The report suggests that this structure has evolved in an ad hoc way. It identifies major influences as being the necessity to raise revenues; the need to curb heavy spirits drinking in the 18th century and 19th century; and the need to maintain tax rates in real terms. Other contributory factors include the reduction in wine duty in 1984 to comply with a European Court ruling and the real reduction in spirits duty to compensate for the abolition of Corporation Tax stock relief in 1984.

\* Because beer duty is charged in relation to original gravity not alcohol content, this is necessarily a matter of approximation.

## The report's proposal

4. Believing that the current ad hoc structure to be irrational the report attempts to establish a better one. It accepts that revenue raising, income distribution concerns, industry policy and the macro economic background are important factors in the decision to tax alcohol. But, it claims, the only reason for taxing alcohol at a different level from other goods is its capacity to do harm. The report does not attempt to establish what that level of taxation should be - that would require an estimate of the social costs of alcohol consumption and such estimates are notoriously difficult to make. Rather, the more modest goal is to establish an economically sound relative structure of taxes between different alcoholic drinks.

5. After surveying the available empirical evidence on the social costs of alcohol the report concluded that it is the quantity of alcohol taken that does the damage rather than how it is taken - whether consumed in the form of beer, wine or spirits. The report then takes a short step to its central policy prescription that "the obvious form of taxation is a specific tax charged at a single rate on the alcohol content of all forms of drinks".

### Economic effects of the proposal

6. The authors use a newly-developed tool called the Simulation Program for Indirect Taxation (SPIT) to assess the empirical consequences of adopting this proposal. Four scenarios are analysed - levelling down the duty rate on spirits to that on beer and wine; levelling the latter up; setting a uniform duty rate that leaves total alcohol consumption unchanged; and setting a uniform rate that leaves revenue unchanged.

7. All four show large changes in the pattern of alcohol consumption. In three of them spirits consumption would rise by 40 - 150 percent. The results were not to the authors liking and they finally recommended that the beer and wine duties be gradually levelled up to that of spirits, with revalorisation, over a period of five years. With consumers expenditure rising by an assumed 2 per cent a year, this scenario left total alcohol

consumption broadly unchanged with less dramatic changes in consumption of beer, wines and spirits.

#### Our assessment of the report

8. First we would challenge the assumption that alcohol should be taxed, primarily, to prevent harm. Health aspects are important, but it would involve a major policy switch for them to be regarded as the primary influence on the level of the excise duties. Revenue raising is at present the most important consideration and maintaining the current flexible duty structure allows taxes to be tailored to budgetary and other requirements. Moreover, once a unitary system as proposed was established it would be difficult to break.

9. The key proposition behind the report's advocacy of unitary taxation is that it is immaterial how alcohol is consumed - in particular alcohol consumed in the form of spirits is assumed to be no more harmful than that taken in less concentrated forms. We believe this to be unproven. The studies quoted in the report are few in number and do not seem especially authoritative. Indeed the authors themselves seem uneasy with the proposition and call for more work on this aspect. Indeed, they appear to accept the need to curb excessive spirits drinking.

10. It is not clear what level of spirits consumption the authors consider excessive. The various scenarios developed from their central proposal suggest spirits consumption could rise dramatically, depending on how the proposal was implemented, to levels not seen since the 19th century. Even the preferred approach, of phasing up of beer and wine duties to that of spirits over five years yields a rise of some 20 per cent in spirits consumption.

11. Furthermore, we have concerns with the methodology used to analyse the effects of proposals. Customs and the Treasury jointly funded the development of this methodology (SPIT) by members of the IFS. It has also been used widely in other IFS exercises. We believe it is a useful piece of work that could, potentially,

assist us with the costing of budget measures and forecasting indirect tax receipts. However we firmly believe it needs further development - which we are currently addressing - before it can be used in analysing scenarios such as these. The study itself acknowledges deficiencies in the methodology.

12. This adds to our scepticism. It is not possible to gauge accurately, within the current state of the art, the major effects on revenue and consumption of adopting unitary taxation - whatever the form. Resulting patterns of alcohol consumption could therefore present new and unknown social problems and bring about a major upheaval in the drinks industry. By contrast we know the existing level and structure of alcohol consumption. Problems of alcohol abuse can therefore be addressed on a relatively stable basis.



FROM: J M G TAYLOR

DATE: 16 May 1989

*Handwritten:* 23/5  
26/5

MR JEFFERSON SMITH - C&E

cc PS/Economic Secretary  
Sir P Middleton  
Mr Byatt  
Mr Scholar  
Mr Culpin  
Mr Gilhooly  
Mr Matthews  
Mr Michie  
Mrs Chaplin  
Mr Call

*Jonathan*  
*Mr Allen has put a draft up to*  
*Mr Jefferson Smith. So we should*  
*see something in next couple of days*  
*Tom 23/5*

*Handwritten signature/initials*

3913-5013

Mr Unwin - C&E  
Mr Wilmott - C&E  
Mr P R H Allen - C&E

**INSTITUTE FOR FISCAL STUDIES:  
REPORT ON ALCOHOL CONSUMPTION AND TAXATION**

The Chancellor was grateful for your note of 15 May.

2. He notes that the IFS recommendation is that beer and wine duties should be gradually levelled up to that of spirits, with revalorisation, over a period of five years. He would be grateful to know what we would have done in the 1989 Budget, with what price, revenue and RPI effects as compared with straight revalorisation, if we were to have followed this course. I should be most grateful for advice.

*Handwritten initials*

J M G TAYLOR



P Jefferson Smith  
Deputy Chairman

Board Room  
H M Customs and Excise  
New King's Beam House  
22 Upper Ground  
London SE1 9PJ  
Telephone: 01-382 5011

*Charles  
Institute*

FROM: P JEFFERSON SMITH  
DATE: 24 MAY 1989

CHANCELLOR

**INSTITUTE FOR FISCAL STUDIES: REPORT ON ALCOHOL CONSUMPTION AND TAXATION**

You asked what would we have done in the 1989 budget compared with revalorisation - and with what price, revenue and RPI effects - had we followed the IFS recommendation to level up the duty on beer and wine gradually to that of spirits over five years on top of revalorisation. (Mr J M G Taylor's note of 16 May refers.)

2. The required changes in the 1989-90 budget in the excise duty (without consequential VAT) on a typical item would have been:

	Revalorisation	IFS proposal
Beer (pint)	1.3p	4p
Table Wine (bottle)	4.9p	15p
Spirits (bottle)	32p	32p

Circulation: Economic Secretary  
Sir P Middleton  
Mr Byatt  
Mr Scholar  
Mr Culpin  
Mr Gilhooly  
Mr Matthews  
Mr Michie  
Mrs Chaplin  
Mr Call

CPS  
Mr Wilmott  
Mr Allen  
Mr Kent  
Mr Vernon  
Mr Knox  
Ms French  
Mr Oxenford  
Mr Stark  
Mr Palnoch



3. Assuming that these changes in duty plus associated VAT were reflected fully in higher prices, the **increases in typical prices in 1989-90** would be:

	Revalorisation	IFS proposal
Beer (pint)	1 1/2p	4 1/2p
Table Wine (bottle)	5 1/2p	17p
Spirits (bottle)	37p	37p

4. The **increases in revenue** resulting from the Budget changes would be:

	Changes from a non-indexed base			
	1989-90		1990-91	
	Revalorisation	IFS proposal	Revalorisation	IFS* proposal
Beer	145	440	275	885
Wine	45	135	90	275
Spirits	75	75	140	140
<b>Total</b>	<b>265</b>	<b>650</b>	<b>505</b>	<b>1300</b>

\* Assuming the second stage of the levelling process was introduced in the 1990 budget.

5. The **estimated impact on the RPI of revalorisation of alcohol duties in the 1989 budget is 0.16 per cent.** That of adopting the **IFS proposal would be 0.41 per cent.**

*ph 5*

P JEFFERSON SMITH



FROM: J M G TAYLOR

DATE: 25 May 1989

A handwritten signature in ink, appearing to be "JMG".

MR JEFFERSON SMITH - C&E

cc PS/Economic Secretary  
Sir P Middleton  
Mr Byatt  
Mr Scholar  
Mr Culpin  
Mr Gilhooly  
Mr Matthews  
Mr Michie  
Mrs Chaplin  
Mr Call

Mr Unwin C&E  
Mr Wilmott C&E  
Mr P R H Allen C&E

**INSTITUTE FOR FISCAL STUDIES: REPORT ON ALCOHOL CONSUMPTION AND TAXATION**

The Chancellor was grateful for your note of 24 May, which he found most interesting.

Handwritten initials, possibly "JMG", in ink.

J M G TAYLOR

# UNITED DISTILLERS

The Spirits Company of Guinness PLC

mp

31st October 1989

Miss M P Wallace  
Her Majesty's Treasury  
Parliament Street  
London SW1P 3AG

*I see you have been forwarded  
with one of these, too.*

*I have returned mine out via HCU*

Dear Miss Wallace

Many British travellers already unknowingly benefit from cheaper European travel, thanks to "duty free" sales on ferries, at airports, and on charter flights. If they are one of the thirty million UK purchasers of "duty free" products, then they doubly benefit from bargain prices on a wide range of goods.

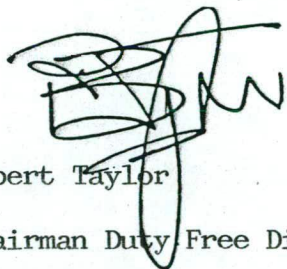
You are probably also aware that thousands of jobs are directly created by the UK "duty free" industry, which is the largest in Europe; and that regional airports and ferries use "duty free" profits to improve their service to travellers.

However, whilst we in the industry fully support the creation of a single European market, many members of the public are not only unaware of the threat posed to the future of "duty-free" sales, but also of the simple opportunity of maintaining "duty free" within the single market.

I am sending you a printed copy of a speech I made earlier this year in Paris on this subject. It is an issue that is increasingly being raised as people realise the likely impact of its abolition.

If I or my colleagues in the "duty free" industry can help you with any further information, then we would be very happy to.

Yours sincerely,



Robert Taylor

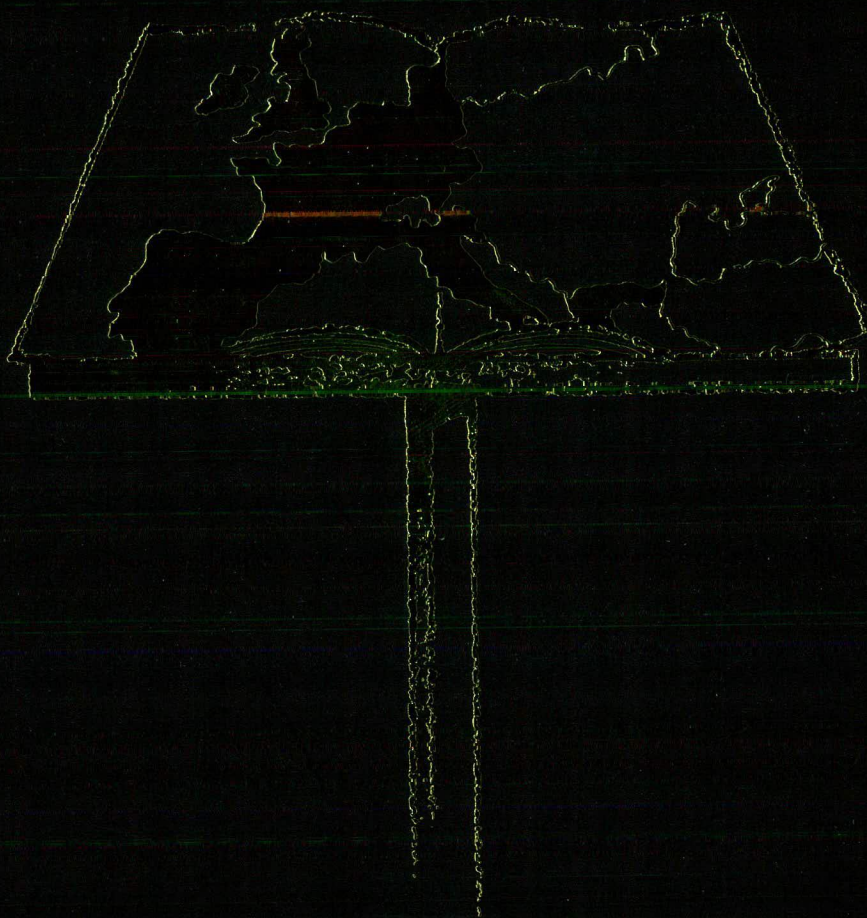
Chairman Duty Free Division

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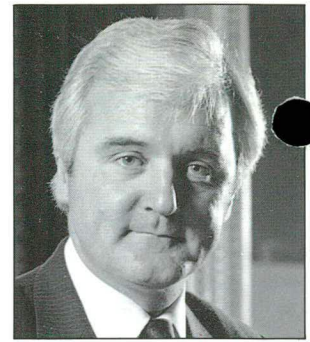


THE FUTURE OF THE  
DUTY FREE SPIRITS BUSINESS,  
POST 1992

## Introduction

This document looks at the Duty Free spirits market in the EEC: its size, its structure and its future, very much with 1992 in mind.

The text is drawn from a speech delivered in Paris earlier this year by Robert Taylor, Chairman of United Distillers Worldwide Duty Free Division, when he addressed the International Duty Free Confederation.

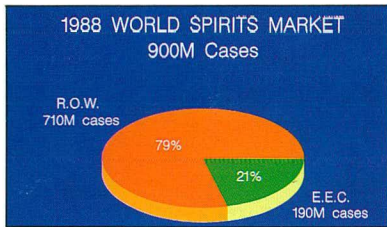


Robert Taylor

## Background

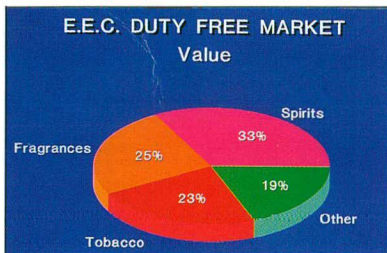
To begin with let us put the market and the perceived 'threat' of 1992 into context.

The world spirits market (both Domestic and Duty Free) has been estimated at some 900 million cases. That figure excludes 800 million cases of East European and cheap local spirits. Out of this 900 million case market, 190 million cases (21%) are sold in the EEC.



Compared, however, to the worldwide Duty Free market the EEC almost doubles in significance. In fact the EEC represents nearly 40% of an 18 million case market.

Spirits are the largest EEC Duty Free category by value, accounting for a third of all business.

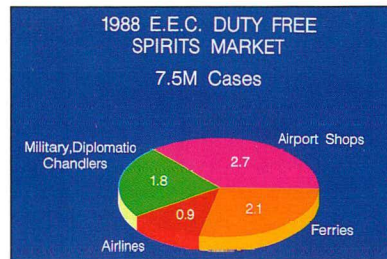


And as an industry, key European countries dominate the world spirits market in a way which is unique: of the ten largest companies in the world in

terms of sales, six are European.

## Market Overview

The EEC Duty Free market is quite diverse; but, for the purposes of this document, the market is broken down into the key trading sectors, of which Airport Shops and Ferries are clearly dominant.



The differences between Duty Free and Domestic markets, in terms of consumer behaviour and structure, will be dealt with later. For the moment let us look at how the two types of market compare in terms of spirits sold.

The differences are much as you would expect. Far more of the high value-added categories are sold in Duty Free. Particularly Scotch Whisky and Cognac. And even within Scotch and Cognacs there is greater sales emphasis at the top end, particularly with Malt and Deluxe Scotch, VSOP and XO Cognac.



As a result, the retail value of the average case of spirits in Duty Free is very much greater than in domestic markets. At retail level it is nearly double; while in terms of value to the trade – that is from manufacturer through to retail, which takes out the Duty element – it is worth four times as much.



Yet the customer is still getting a bargain; and it is the customer (in this case the traveller) who drives the market. The more travellers, the more customers, the bigger the market.

It is important to note that the growth in travellers in the EEC has been significant. Indeed the number of international travellers in the EEC countries grew by nearly 25% between 1981 and 1986.

And the proportion of international travellers in the EEC who come from other EEC countries (i.e. intra-EEC travellers) is overwhelming, some 85%; and that proportion has remained fairly constant throughout the 80's, and looks like staying that way, despite variants such as the increase in high-spend Japanese travellers.

## Towards a Forecast for the Future

To make a forecast, particularly in a market notoriously short of data, we have to make certain assumptions.

Although we know the various influences on travel growth by sector and region (such as the channel tunnel, the increased cost of safety measures, leading to increased airfares, the changing trends in destination and volume for charter holidays), for the purpose of this document let us take an overall passenger growth rate in the EEC of 5% per year.

Then there is the trend, seen in both domestic and Duty Free markets, towards higher quality, higher-price spirits goods; which will continue to be fuelled by a steady increase in European prosperity. So we are seeing a rate of value growth, say at around 8%, that will exceed volume growth.



The demand for quality will grow

In order to provide a base forecast, let us make a third (hypothetical) assumption: that there will be no significant change in how the industry operates, and little change in the rules, structure and allowances under which it operates today.

Finally, let us assume that Military, Diplomatic and Chandling volume will also see little change.

Based on those four assumptions, we arrive at a market in 1992 of about 9 million cases, worth about one and a half billion US dollars (which equates to about 1.5 billion ECU).

## 1992 – The Ill-informed Pessimist's View

We now have to ask what would be the effect of the removal of the Duty Free facility from travellers within the EEC.

Let us therefore play the role of the ill-informed pessimist.

As previously mentioned, many Duty Free statistics are uncertain, as the industry has yet to get its data base sensibly together. However, let us examine the worst possible picture of potential 1992 losses – a picture, painted usually by those with little knowledge of the industry, who are, in the main, only interested in sensationalising issues of this type.

Without going into a detailed analysis of spend by spirit type, nationality and destination, let us simply assume that the proportion of spirits business lost would be equal to the proportion of total passenger travel within the EEC.

For example, since 55% of European airtravel is within the EEC, let us assume that this proportion of business would be affected. And that this would be a minimum as most spirits business is done on charter lines, which in turn are mostly between EEC countries.

Ferry business intra-EEC would suffer even more: it might disappear completely.

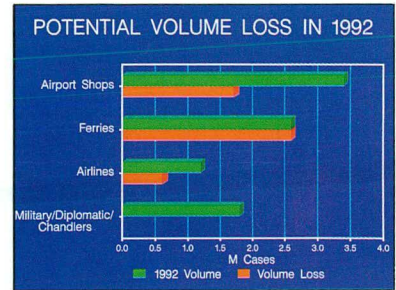
On the other hand, even the worst pessimist acknowledges that Military, Diplomatic and Chandling business will largely remain un-affected. There may be a marginal decline in Military business, due to glasnost. Diplomatic business will largely remain small but valuable. Chandling will see a slight decline reflecting the worldwide decrease in merchant shipping. And Cruise Ship business will simply remain small.

Compare 1988 (where we can see the picture of how the spirits business broke down by volume and trade sector) with projections for 1992, based on the assumptions described earlier, and you will see a pattern of growth across the first three trade sectors.



Now let us contrast this with the rough sort of loss-assumption that our ill-informed pessimist might make.

This would produce a downside of nearly 2 million cases in Airport Shops; 2½ million cases in Ferries; and over 600k cases from Airlines.



We can make similar comparisons in terms of value. Based again on our first set of assumptions, the picture looks pretty good, with growth in all sectors, once again due to the trend towards higher quality added-value products.

Our Pessimistic Friend's Guide to Duty Free, however, gives us losses of more than \$300 million in Airport Shops, nearly \$400 million on Ferries and over \$100 million in the Airline business.

Our pessimist would have a field day. One can imagine the headlines talking of 5 million lost cases of spirits sales; of outlets losing 70% of sales and ceasing to trade, including those in EFTA countries like Scandinavia, Austria and Switzerland; and of increased fares reducing passenger travel and spirits sales further suffering.



The ill-informed pessimist's view

It is unlikely that even 15% of Duty Free volume would be recouped domestically, but even assuming it were all recouped, the headlines might still talk of over \$500m lost turnover.

The truth, however, about all these pessimistic scenarios is that, if they did come about, no one would gain.

Duty Free makes such a major contribution to all new cross-channel ferries and provides most charter airline profit. It played a major part in the refurbishment of Heathrow's Terminal 3 as well as probably footing the bill for Terminal 4.

Who can therefore believe that the small amount of Government revenue from extra domestic purchases will justify the traumas of change, job loss, and increased travel costs?

There's been enough gloom and doom written about this and its potential negative effect on EEC Duty Free. The nightmare of bureaucratic tidiness triumphing over common sense does not bear thinking about. Our industry must protect itself from the unthinkable.

## The Potential of the International Traveller's Market Lies in Understanding the Consumer



1992 is a very real threat which the Industry cannot ignore. At the same time, we should be working as responsible and farsighted marketers to develop the International Traveller's Market with the most important factor in mind – the consumer.

If that potential is to be realised, the first essential is to gain a better understanding of the consumer. In our business it's tempting to base assumptions about his needs on our knowledge of how he behaves in his domestic environment.

Most of the spirits industry, however, recognises that such a course is downright dangerous: first because it is simply wrong; secondly, because it leads to missed opportunities.

The fact is, it is only by understanding the particular nature of the Duty Free spirits customer that we have come to realise the worldwide Duty Free profit potential.

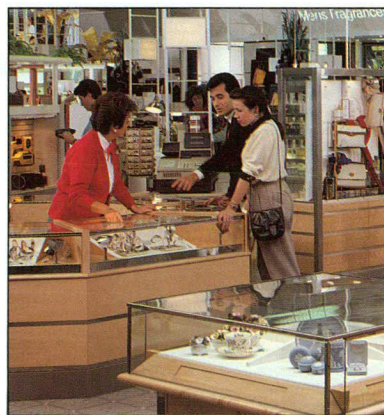
That is why United Distillers alone is spending nearly a million pounds per annum researching the International Traveller. It is therefore very clear to us at United Distillers that the 1992 problems identified require strategic rather than short term tactical solutions.

## Different Motivations for Purchase in the Travel Environment

Let us start by looking at why people buy spirits Duty Free.

Some of the reasons are pretty obvious; the first being **ECONOMY**, whether it's getting our usual brand cheaper, or trading up to a brand we cannot usually afford. This motivation – based on a rational, practical and totally understandable sense of economy – is the one most vulnerable to the potential EEC legislation.

Another major buying impetus comes from the desire for **GIFTS** – gifts for business colleagues, family, friends, and indeed even for ourselves.



Gift purchase is a leading factor for international travellers

Thirdly, there's what you might call the **SOUVENIR MOTIVATION**: a need for products and brands to enhance our image as knowledgeable, travelled people. We call this 'social badging'.

Then there is the **QUALITY PERCEPTION**. Many people believe that Duty Free shops invariably offer good quality products, often better than in the High Street. And there are no downmarket/own label perceptions to cause confusion.

Additionally there's **TIME-PASSING**: travellers use Duty Free outlets as places to pass time, while waiting for the plane, boat or train. If the environment is right, they're likely to make impulse purchases – and this is a significant factor in our business.



Browsing travellers are likely to make purchases in the right environment

Finally, there's **EXPERIMENTATION**: the opportunity to try a brand not found in the home market. And currently United Distillers is enjoying great success with its new range of Classic Malts, mainly by utilising this marketing approach.

## The Traveller is Different

However – while recognising the importance of all these factors, we must also understand the psychology of the traveller, and examine the inner needs and motivations which make his behaviour different.

He is as different as the *environment* in which he travels. As soon as he passes through passport control to leave his own country, he begins to operate on an entirely different value-system.

His environment changes: not only in the process of travelling – which is likely to be very different from his normal daily experience – but in what he finds at his destination.

To a great extent as a result of these differences, his *emotional state* changes, giving rise to feelings which frequently conflict. Feelings of boredom, and loneliness combine with uncertainty, inadequacy and fear of the unknown. This induces a need for, amongst other things, reassurance and status.

In short, this is not your average trip down the High Street on a Saturday morning to do the weekly shopping.

This however, by no means the end of the story. On top of these changes in environment and emotional state, a third factor to be considered is *nationality*. This will dictate the strength of his or her motivation to buy Duty Free spirits, especially when such a purchase replaces a domestic one.

To an American abroad, the Duty Free price differentials for alcohol will seem low, and may reduce his motivation to purchase in Duty Free markets. At the other end of the scale, however, the Japanese traveller's motivation will be high; his Duty Free allowance is large, the differential against domestic prices is great; and he has a strong cultural obligation to bring gifts home from abroad. In a similar way, each European country will have its own particular degree of motivation.



The Japanese traveller's purchase motivation is high

To these three factors we must add a fourth – *social class*. This too has a marked effect on what travellers seek when shopping in Duty Free. Up-market travellers opt for products which reflect a sophisticated, international lifestyle, while down-market travellers tend to seek products to fit their local image.

Industry research, however, shows that demographics alone are inadequate for the task of segmenting the market. Depending on his reason for travel, the same person will behave in very different ways. His reactions to *business*, as against *leisure*, travel are a case in point.

The Business Traveller wants products that enhance status, individuality and respect; indeed he will often reject anything he believes will not help achieve this. The Leisure Traveller, by contrast, wants goods and services to enhance the glamour, excitement and pleasure of the trip.

The Business Traveller is often alone, whereas the Leisure Traveller will tend to be with family or friends. This again brings about differences in behaviour – differences we need to recognise.

The Business Traveller flies Schedule, and usually Club or First Class; the Leisure Traveller goes by Charter or Economy. How right of British Airways therefore to segment their Duty Free onboard sales into separate ranges for First, Club and Economy Class.

Common to all International Travellers is the readiness to spend more freely: the businessman, perhaps because he's using company money; the holidaymaker, because he's usually drawing on a special fund of 'spending money', quite unlike his normal budget. Even the frequent traveller – for whom Duty Free is a more common and unexciting experience – will still see an advantage in that it can often offer him the chance to buy gifts without crowds and hassle. Meanwhile the Leisure Traveller will be tempted by any purchase which will make the occasion a more valuable experience.

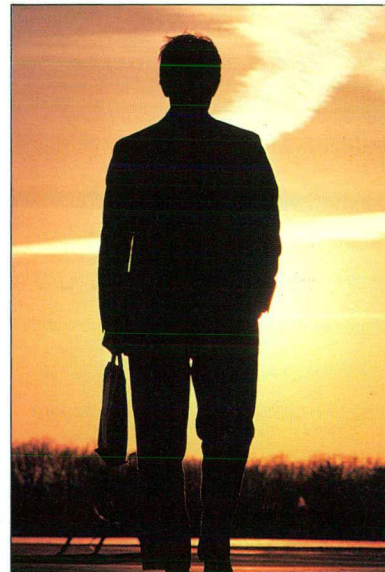
Probably the greatest potential, however, lies in a category of purchase which we call 'emotional browsing'. The customer finds himself shopping in a stylish atmosphere; he sees highly prestigious products on offer, many of them not available in domestic markets; packaging and presentation is beautiful, high quality, seductive.



'Emotional Browsing'

All in all, the situation is perfect for thinking about gifts, for self-indulgence and for impulse-purchase. Price is important here, but outweighed by the elements of quality and style.

So what can we deduce from all this? First, and foremost, there is vast scope for getting to know the traveller better, and then tailoring products and services to his needs. This opportunity exists *quite regardless* of any potential legislative change.



It is important to get to know the traveller

For example, just as the consumer behaves in very different ways depending on the circumstances of his travel, so will an outlet have different requirements at different times – and that means not only the time of year, month and day, but by hour also. Witness the high-spending Japanese tourist, for example, who often justifies a special and expensive Japanese-speaking, merchandising focus to match their arrival at a certain hour.

## A Massive Opportunity

We must recognise and cater for the differences created by the travel environment. There is a massive opportunity, worldwide, to enhance the traveller's personal status, and cater for his need for indulgence and even in some cases fantasy; and to do so through offering the right brands, with the right service, and in the right environment.

Recently there has been an increased focus on marketing strategies which concentrate on the crucially important market of the consumer as an International Traveller, rather than just on the trade function of distributing domestic brands into a place where they are then sold more cheaply.



In the business of selling spirits to the International Traveller, we see the range of opportunity and have, as a company, targeted our strategies accordingly – sometimes for obvious reasons, sometimes less so. To start with, the concept of using retail outlets in the travel environment as a 'shop window' for domestic markets is not new. If Duty Free between EEC countries does disappear, this strategy may well be increasingly adopted, since the loss of this shop window could certainly hurt domestic markets.

A further familiar area is that of presenting our brands in *variant formats* aimed exclusively at the International Traveller. The Duty Free industry needs high ticket, high yield products, and there is ample potential for such speciality giftpacks particularly when linked to well-known international brands.



The Duty Free Industry needs high ticket, high yield products

It's a strategy that has been used at United Distillers, launching products like Johnnie Walker Oldest, the Classic Malts range and Royal Lochnagar uniquely into Duty Free. And their success has been outstanding.



Consider the example of the Classic Malts launch. In UK airports, malt whisky is now the largest and fastest growth sector in the Scotch whisky market; so much so that the relaunched Terminal Three Duty Free shop at Heathrow has its own Malt Whisky Shop, accounting for nearly half the space available for all Scotch. The Classic

Malts launch was based on the premise of consumer trial across the range of six brands and it has been an outstanding success. It gives the travelling consumer most of the key factors which he is looking for – exclusivity, interest, status and quality. The range has immediately achieved a leading share of malt sales in key retail outlets.



Lagavulin: one of the 6 Classic Malts

Another successful type of line extension is the *Giftpack* which gives added-value convenience. Products like these, carefully researched and targeted, will continue to offer consumers the style, status and cachet they associate with international travel. And they will continue to do so whatever happens in relation to EEC legislation.



The style and status of Giftpacks, aimed exclusively at the International Traveller

For those spirits companies with an armoury of first-rate international brand names there are widespread opportunities for *Trade Mark Diversification* in the International Traveller market. These cover sectors directly related to the spirits industry, and those less obviously linked to spirits. Diversification is no new idea. Indeed there is a graveyard full of Trademark Diversification projects that did not make it. The warning is there, and the raising of such projects to true international status can be long and expensive.

But it can lead to phenomenal success, and there is a vast range of products and services being marketed in this way. Coca Cola, Dunhill, Jaguar, Marlboro, Porsche, Gucci – these are just a few of those who made it. Last year, for example, Coke had a turnover of half a billion dollars in the US alone, in only its second year of licensing clothes.

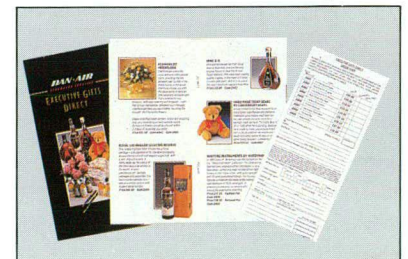


Dunhill's diversification success

A fashionable variation on this theme is the idea of forming *partnerships*, or joint-ventures, with complementary businesses in a growing market. This can offer cost-savings and leverage.

At the same time, the spirits industry must look at new ways to merchandise its products, particularly if, in the face of EEC tax harmonisation, airport retailers start to limit their activity.

One possibility is *Direct Marketing*, which is already moderately well developed in the Americas and in the Asia Pacific region. It allows relatively easy and direct access to large numbers of international travellers. Catalogues, mailers, airline video, seat-back shopping, telephone sales... in a captive market all these methods have potential for effective consumer marketing.



Direct Marketing offers significant potential

*Airport Retailing* is in itself always an option for liquor companies. The strength of our brand names, the portfolio of products and services available to each of us, makes the creation of luxurious international shopping outlets more than a possibility; shopping associated with prestige, fashion and style – the 'emotional shopping' referred to earlier – all under one roof. Given the travelling consumer pressure on airport authorities and concessionaires to upgrade the 'travel experience', and given the pressure to find a replacement for their high margins on Duty Free merchandise, franchise-deals and joint-ventures with manufacturers may be a route for some retailers to take.

Finally, far from our mainstream business, but by no means far from our experience in understanding international travellers, the industry is also considering the *marketing of services* to our target audience. Information-hungry, far from home and very much in need of convenient systems to help them, the traveller is looking for efficient business, financial or travel services. Working with experts in these fields, the development of such services is a very real possibility.

These are just a few of the options open to the spirits industry. But, whatever routes individual companies take, we as an industry have to plan. And, more importantly, we have to act.

## **Action Needed Now**

We have to demonstrate that Duty Free is compatible with a single internal market. In fact there is a very strong case for retaining Duty Free post-1992, though it might be in a modified form that is properly consistent with EEC policy.

If the Single Internal Market is aimed at creating a better way of life for its 320 million members, it is fair to ask why it should unnecessarily remove, for the sake of administrative tidiness, benefits which those members already enjoy. For, let's be clear, the benefits of Duty Free apply today to the very large and growing numbers of the public who travel – not just a privileged few, as might have been the case twenty years ago.

Nor let us forget that, in the final analysis, that public is also the electorate of Europe. That public will not thank a political bureaucracy that unreasonably removes travellers' benefits and thus brings discontent to their notice.



*Euro MP's cannot ignore the voters*

There are ways of getting round the problem. Once the barriers are down, for example, there is no reason why boarding passes should not be used as self-regulatory allowance-passes for Duty Free purchases. This is the sort of area where retailer and manufacturer must work together. This is where the industry's current lethargy and inertia must be jettisoned.



*Systems such as vendor control should be seriously considered*

It is not beyond the wit of our industry to devise a convenient and foolproof system such as vendor control; and, if that were achieved, other benefits would naturally follow, such as avoiding the massive cost of reorganising airport terminals.

If it cost £80m to revamp Heathrow Terminal 3, and £200m to build Terminal 4, then surely hundreds of millions would be needed to reorganise every international EEC airport.

Additionally, given that Duty Free is traditionally the main source of finance for such building changes, where does that money come from? A massive increase in landing charges? That would be more than unpopular.



*A rise in landing charges would be unpopular with many groups of people*

An approach such as vendor control would offer a sensible compromise – a compromise which does not have to conflict with the very real and important need of an emerging, unified Single European market.

To define the Duty Free concept, we need above all a well-unified approach from all parts of Europe. The emergence in the last year or so of the international Duty Free Confederation is important and encouraging, aiming, as it does, to pursue the battle on behalf of all European countries.

If Duty Free in Europe is bureaucratically abolished, then no-one should underestimate the painful impact it could have on the world's Duty Free industry. Vast numbers of people could lose benefits; jobs could go in many parts of Europe; and a lot of travellers could have to pay a lot more money for the privilege of conformity.

That is why the approach to this whole issue must be unified and consistent.

Most Trade Sources indicate that abolition of Duty Free is by no means a corollary of the single internal market. As an industry, there appear no possible benefits from it – not to consumers, not to industry, not to governments. And we believe we can demonstrate this to the authorities cogently enough to retain Duty Free.

Whatever happens, what the threat of 1992 has achieved is to show the spirits industry what a massive opportunity is open to it. We have been forced to see, 1992 or no 1992, that there are many ways to increase and focus on our sales to the International Traveller. Which gives the industry cause for strong and realistic optimism for the future.

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