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Alcohol taxation reform: considerations and options

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Executive summary

- Economic efficiency, equity, and enforceability and compliance are the general principles that guide taxation policy.
- Inconsistencies exist in the current alcohol taxation regime when viewed against these principles. For example, the excise on low-strength draught beer is about one fifth that on low-strength packaged beer, while the tax on cask wine is only a fraction of that on mid-strength beer even though wine has higher alcohol content. The amount of wine equalisation tax (WET) is unrelated to alcohol content. These differences seem unrelated to policy objectives.
- In practice, alcohol taxation entails trade-offs among different considerations such as the need to raise revenue, the effects on consumer behaviour, and the ease of administration. However, scope exists for considerable improvement in alcohol taxation.
- Reform options based on the general taxation principles include broadening the tax base, eliminating preferential treatment of certain beverages and producers, applying a single excise rate, structuring excise so that rates rise as alcohol content increases, and abolishing the WET and replacing it with excise.
- Taxing alcoholic beverages on the basis of alcohol content, combined with a graduated taxation rate, whereby the tax rate is higher the higher the alcohol content of the beverage, would represent a considerable improvement on the current alcohol taxation regime. The evidence indicates that combining a graduated tax based on alcohol content with an increase in the overall tax take would reduce the very considerable social costs of excessive alcohol consumption.

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Introduction

The harmful health and other effects of excessive alcohol consumption have long been of concern. The recent debate over the taxation of alcopops was a manifestation of that concern. Successive governments have introduced programs to counter alcohol-related harms. For example, on 10 March 2008, the Rudd Government announced a national binge drinking strategy.[1]

How alcohol should be taxed is part of the on-going debate on how to address excessive alcohol consumption and associated harms. The final report of the Preventative Health Taskforce, for example, contained multiple proposals aimed at discouraging harmful drinking including a proposal to reform alcohol taxation.[2] Health experts have advocated taxes on alcoholic drinks, based on their alcohol content, regardless of the type of product (beer, wine, spirits and so on).

This raises the question of the factors that have to be considered when designing alcohol taxation. This paper examines these factors and discusses reform options based on three general principles that guide taxation policy. While there are many alcoholic beverages, for simplicity, this Paper covers only the main products: beer, wine and spirits. Further, it deals only with excise and the wine equalisation tax (WET) and assumes that under reform, there would be no change to the goods and services tax (GST). The reason for this assumption is that the government has excluded the GST from the scope of the national taxation review being conducted by the Secretary of the Treasury, Dr Ken Henry. The Paper recognises, however, that the GST interacts with excise and the wine equalisation tax.

Why is alcohol taxed?

Historically, the main reason for taxing alcohol was to raise revenue. Revenue from the taxation of alcohol in 2008–09 is estimated at $6 132 million. This consists of $3 781 million from excise and the WET, $1 202 million from the GST, and $1 149 in customs duty on beer spirits and ready-to-drinks.[3]

Taxation is also a way of changing consumer behaviour. This is especially appropriate in the context of market failure such as externalities (discussed below) which means that price

1. K Rudd (Prime Minister), *National binge drinking strategy*, media release, 10 March 2008, viewed 30 September 2009, http://www.pm.gov.au/node/5902

2. Preventative Health Taskforce, *Australia: the healthiest country by 2020 – national preventative health strategy – the road map for action*, Department of Health and Ageing, Canberra, 2009, pp. 253–255, viewed 30 September 2009, http://www.yourhealth.gov.au/internet/yourhealth/publishing.nsf/Content/nphs-report-roadmap

3. Sources: excise and the WET: Australian Government, *Consolidated Financial Statements 2008–09*; GST: estimate by the Statistics Section, Parliamentary Library; customs duty: estimate by the Distilled Spirits Industry Council of Australia Inc., personal communication.

signals will not generate efficient solutions. In particular, taxing alcohol is a means of reducing excessive consumption and associated social costs.

How is alcohol taxed?

Alcohol is subject to three taxes. Excise is levied on a litre of alcohol basis as contained in the beverage. The alcohol content of beverages, by volume, ranges from about 2.7 per cent for light beer to about 40 per cent for spirits.[4] The first 1.15 per cent of alcohol in beer is excise-free (see Box). There is no excise-free threshold for other beverages whose alcohol content does not exceed 10 per cent by volume. Excise rates are indexed in February and August each year in accordance with changes in the consumer price index to maintain their 'real' values.

Box: Effect of the 1.15 per cent threshold on beer

The effect of the threshold is to increase the amount of excise by a higher proportion than the proportionate increase in alcohol content. For example, assume that a 375 millilitre can of beer has an alcohol content of 6.15 per cent. The taxable alcoholic content is 5 per cent (6.15 less 1.15 per cent). The taxable volume of alcohol is 5 per cent of 375 millilitres (equals 0.01875 litres). The amount of excise is this volume multiplied by the excise rate ($41.06 per litre of alcohol), which equals 77 cents. If, on the other hand, the alcohol content were 4.9 per cent, the amount of excise would be 58 cents. The 26 per cent increase in the alcohol content (from 4.9 to 6.15 per cent) increases the amount of excise by 33 per cent (from 58 to 77 cents).

There are also two value-based (ad valorem) taxes: the WET and the GST. The WET applies to 'assessable dealings' in wine. These include wholesale sales and untaxed retail sales.[5] The WET rate is 29 per cent. The WET was introduced when the GST was implemented to fill the difference between the former 41 per cent wholesale sales tax on wine and the GST.[6] The GST is applied after excise or the WET is applied. Beer, spirits and pre-mixed beverages ('alcopops') are subject to excise and GST. Wine is subject to the WET and GST.

Excise rates

Table 1 shows excise rates as at 28 August 2009.

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4. Department of Heath and Ageing (DoHA)website, Standard drink guide, DoHA website, viewed 30 September 2009, http://www.alcohol.gov.au/internet/alcohol/publishing.nsf/content/E9E12B0E00E94FD5CA25718E0081F1DC/$File/std0409.pdf

5. Australian Taxation Office (ATO), 'Wine equalisation tax', ATO website, viewed 30 September 2009, http://www.ato.gov.au/businesses/pathway.asp?pc=001/003/097

6. P Costello, *Tax reform. Not a new tax, a new tax system*, Commonwealth of Australia, Canberra, August 1998, p. 23, viewed 30 September 2009, http://www.treasury.gov.au/documents/167/PDF/Whitepaper.pdf

Table 1: Excise rates, per litre of alcohol, beer and spirits ($)

Beer (per litre of alcohol over 1.15%)	
Draught beer low strength	7.03
Draught beer mid strength	22.09
Draught beer high strength	28.91
Other beer low strength	35.24
Other beer mid strength	41.06
Other beer high strength	41.06
Non-commercial low strength	2.47
Non-commercial mid and high strength	2.87
Other beverages not exceeding 10% of alcohol content	69.57
Potable spirits	
Brandy	64.96
Other spirits exceeding 10% alcohol content	69.57
Notes: rates applying from 28 August 2009. Beer strength definitions by volume of alcohol: low: not exceeding 3%; medium: exceeding 3% but not exceeding 3.5%; high: exceeding 3.5%.	

Source: Australian Taxation Office, 'Excise tariff working pages'.[7]

Table 1 shows that excise rates vary substantially. The variability in rates reflects a range of historical factors including the need to raise revenue, the desire to reduce the social costs of alcohol consumption, political compromises, and industry protection.[8] The need to increase revenue is reflected, for example, in the indexation of excise rates and discretionary rate increases, while the desire to reduce the social costs of excessive alcohol consumption lay behind the excise differential between low strength and higher strength beer.[9]

Taxation principles

The design of taxes is based on three main principles: economic efficiency, equity, and enforceability and compliance:

7. Australian Taxation Office (ATO), 'Excise tariff working pages', ATO website, viewed 30 September 2009, http://law.ato.gov.au/atolaw/print.htm?DocID=PAC%2FBL030002%2F1&PiT=99991231235958&Life=10010101000001-99991231235959

8. For a history of excise changes, see D James, *'Beer and cigs up!': a recent history of excise in Australia*, Background paper, no. 5, 1995–96, Department of the Parliamentary Library, Canberra, 1996, viewed 30 September 2009, http://www.aph.gov.au/library/pubs/bp/1995-96/96bp05.htm.

9. R Webb, *Excise taxation: developments since the mid-1990s*, Research brief, no. 15, 2005–06, Parliamentary Library, Canberra, 2006, viewed 30 September 2009, http://www.aph.gov.au/library/pubs/rb/2005-06/06rb15.pdf

> *First*, so long as taxation affects incentives it may alter economic behaviour of consumers, producers or workers in ways that reduce economic efficiency. These effects should be taken into account when the costs and benefits of public expenditure to be funded are being assessed. *Second*, the distribution of taxation's impact across the population raises issues of equity, or fairness, which must be given substantial weight even if it entails costs in terms of economic efficiency. *Third*, the practical enforceability of tax rules and the costs arising from compliance are important considerations, the more so since these are both affected by, and have implications for, the efficiency and public perceptions of the fairness of tax systems … the key challenge for tax policy is to strike the best possible balance among these issues.[10]

Economic efficiency

An aspect of the economic efficiency principle is neutrality:

> … the tax system should be as neutral as possible, i.e. minimise discrimination in favour of or against any particular economic choices … improvements in efficiency can be achieved by: (i) broadening tax bases by eliminating exemptions and special regimes; (ii) flattening rates structures; and (iii) integrating or aligning different rate structures to avoid arbitrage opportunities.[11]

But, as noted below, there are circumstances where efficiency is not served by adherence to these principles, that is, other considerations may modify the application of the neutrality principle.

Price elasticity

One consideration is the responsiveness of the volume of a good consumed to a change in its price.[12] In economic jargon, this is called 'own price elasticity'. Demand for a good is said to be price 'inelastic' if a one per cent change in its price results in a less than one per cent change in the quantity consumed. When demand is inelastic, a rise in the tax rate increases government revenue even though consumption falls. Hence:

> Governments may find scope for levering the revenue-raising potential of tax systems by taxing some items more heavily than others. For example, under some circumstances it can be efficient to tax most heavily those items that are comparatively price-inelastic.[13]

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10. P van den Noord and C Heady, *Surveillance of tax policies: a synthesis of findings in economic surveys*, OECD Economics Department Working Papers, No. 303, July 2001, p. 16, viewed 30 September 2009, http://www.oecd.org/dataoecd/30/18/2399416.pdf

11. ibid.

12. The following discussion ignores substitution among different products, for example, wine for beer.

13. P van den Noord and C Heady, op. cit.

On the other hand, demand is said to be price 'elastic' when a one per cent change in price results in a more than one per cent change in quantity consumed. When demand is elastic, an increase in the tax rate reduces revenue as consumption falls. One study found that spirits are twice as price-sensitive as wine and beer.[14]

Externalities

A second reason for modifying the neutrality principle is to correct for market failure.[15] Externalities are a form of market failure. Externalities—also called external costs and external benefits—arise when one party imposes on, or provides to others, costs or benefits that are not captured in market transactions. For example, trucks impose 'negative' externalities such as noise and air pollution on residents living near highways but the users of the truck services do not compensate residents for loss of amenity. Hence:

> It may be desirable to use the tax system to enhance welfare by correcting market failure. This may involve taxing "bads", such as alcohol, tobacco and polluting substances such as fossil fuels. Where demand for such goods is inelastic there may be revenue benefits which allow distorting taxes elsewhere to be lowered.[16]

In the case of alcohol, negative externalities take many forms such as alcohol-related car accidents, violence (including street violence, intimate partner violence and child abuse and neglect) and lost production. These externalities are additional to the negative health consequences which have a social as well as private cost. As discussed below, the aim of reducing negative externalities suggests a graduated taxation whereby the amount of tax is higher the higher the alcohol content of the beverage, and where the total tax take is at least equal to the value of the negative externalities.

The remainder of this paper examines the extent to which the three principles are applied, in practice, to alcohol taxation in Australia.

Inconsistencies in the current regime

Inconsistencies exist in the current alcohol taxation regime when viewed against the three principles. For example, the concessional treatment of draught beer violates the neutrality

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14. Preventative Health Taskforce, *Australia: the healthiest country by 2020*. See particularly Technical report no. 3, 'Preventing alcohol-related harm in Australia: a window of opportunity' including addendum for October 2008 to June 2009, Canberra, 2009, p. 23, viewed 30 September 2009, http://www.preventativehealth.org.au/internet/preventativehealth/publishing.nsf/Content/national-preventative-health-strategy-1lp

15. The existence of market failure is, in itself, not a reason for government intervention because intervention has costs as well as benefits.

16. P van den Noord and C Heady, op. cit.

principle. For a given beer strength (for example, medium strength) the excise rates favour draught over packaged beer—shown as 'other' beer in Table 1—with the rates on the former between 25 per cent and 80 per cent less than those on the latter. The rate disparity is most marked in the case of low-strength beer, with the rate on draught beer ($7.03) per litre of alcohol about one-fifth that on packaged beer ($35.24). The value of the concessional treatment of draught beer is substantial, with the estimated revenue forgone in 2009–10 at $165 million.[17] The concessional treatment of draught beer favours pubs and clubs. A person who drinks the same beer from bottles or cans pays more excise. It is not obvious why pubs and clubs should be favoured in this way.

A feature of current alcohol taxation is that in some instances, higher alcohol content beverages attract higher rates of tax per litre of alcohol. Excise on spirits, for example, is higher than on beer. This feature makes sense when considered from a negative externalities perspective. However, this principle is not applied consistently. The excise on mid-strength and high-strength packaged beer, for example, is the same ($41.06 per litre) per litre of alcohol. Another example is cask wine and beer:

> The tax on typical cask wine is only $0.05 **per standard drink** compared to $0.32 per **standard drink** of mid-strength beer, despite the vastly different alcohol volumes in these products: 12.5% alcohol by volume (ABV) compared to 3.0% ABV respectively …[18] (Author's bolding).

A third example of an inconsistency is the excise treatment of beer, and of other alcoholic beverages whose alcohol content does not exceed 10 per cent. Currently, the first 1.15 per cent of alcohol in beer is excise-free. However, this exemption does not apply to other alcoholic beverages whose alcohol content does not exceed 10 per cent.

Wine is taxed through the wine equalisation tax (WET), which is a value tax. This means that the amount of WET varies with wholesale value and not alcohol content: the higher the wholesale value, the higher the amount of WET. Hence two bottles of wine may each have the same alcohol content but incur different amounts of WET and therefore different effective taxation rates, per litre of alcohol. This is anomalous for two reasons. Firstly, in relation to discouraging excessive alcohol consumption, one would expect the bottle of wine with the higher alcohol content to incur more tax. Secondly, binge drinking which is responsible for much of the alcohol-related harm is more associated with cheap rather than more expensive products. Logic would suggest a higher tax on cheaper products, which is the reverse of what occurs with the WET.

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17. Treasury, *Taxation Expenditures Statement 2008*, Commonwealth of Australia, Canberra, 2009, p. 20, viewed 30 September 2009, http://www.treasury.gov.au/documents/1465/PDF/TES_2008_Combined.pdf

18. Preventative Health Taskforce, *Australia: the healthiest country by 2020*, op. cit.

Reform options

There are several options for reform based on the principles described above. The following examines some of these options.

Tax base

As noted, economic efficiency can be improved by broadening the tax base. The base could be broadened by taxing all alcohol in beverages. Under a policy that taxes all alcohol, the first 1.15 per cent alcohol in beer would be taxed. Alternatively, the 1.15 per cent—or similar—exemption could be applied to all alcoholic beverages. However, this would narrow the tax base.

The efficiency principle implies that there should be no preferential treatment and, where it exists, that it should be justified. Table 1 shows that brandy is treated preferentially with a lower rate of excise than other spirits. Preferential treatment of brandy was introduced to assist the wine industry to develop. The wine industry has obviously long since developed. Hence the preferential treatment of brandy can no longer be justified on industry assistance grounds.

A neutral tax base would not discriminate among producers. However, small beer and wine producers receive preferential excise treatment. Microbreweries producing less than 30 000 litres of beer annually can claim a concession in the form of a rebate of excise paid (the rebate must not exceed the lesser of $10 000 or 60 per cent of the excise payable).[19] In the case of wine, eligible wine producers can claim a rebate of the first $500 000 of WET paid annually. The estimated cost of the WET rebate in 2009–10 is $260 million.[20] If under reform, the WET were retained but the rebate abolished, the WET rate would fall. But, as discussed elsewhere, there are strong arguments for increasing the total tax take from alcoholic beverages including wine.

Single excise rate

Table 1 shows that excise rates per litre of alcohol vary considerably. Based on the principle that taxes should minimise discrimination in favour of or against any particular economic choice, an option is to apply a single rate of excise to all alcoholic beverages in what is termed a 'volumetric' system. A single rate would have the advantage of simplifying administration and compliance. Further, a single rate would dispense with the need to distinguish between different forms of product (beer, wine, spirits and so on) and their alcohol strengths.

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19. Australian Taxation Office (ATO), 'Excise and beer manufacture', ATO website, viewed 30 September 2009, http://www.ato.gov.au/businesses/content.asp?doc=/content/00180139.htm&page=28&H28

20. Treasury, op. cit.

There are several objections to a single excise rate. One is that a single rate does not take sufficient account of negative externalities because a single rate would encourage consumption of high-alcohol content beverages. Table 2 shows that a consequence of applying a single, revenue-neutral rate to all alcoholic beverages (including wine) is that, in general, the amount of excise on high-alcohol content beverages would fall and that on low-alcohol content beverages would rise. Excise on spirits (including 'alcopops') and brandy, in particular, would fall considerably. This would be counter-productive from a public health perspective, because high alcohol content beverages are heavily implicated in harmful drinking. It is quicker and easier to drink to excess when consuming high alcohol drinks. A single excise rate would run counter to the goals of reducing risky drinking, especially among young people.

Table 2: Estimated changes in excise under a single rate ($ per litre of alcohol) assuming no change in total tax take

	Average excise rate 2007–08	Estimated uniform excise rate	Change
Beer:			
Draught low strength	6.73	22.57	15.84
Draught mid strength	21.14	22.57	1.43
Draught high strength	27.66	22.57	-5.09
Other low strength	33.72	22.57	-11.15
Other mid strength	39.29	22.57	-16.72
Other high strength	39.29	22.57	-16.72
Spirits	66.57	22.57	-44.00
Brandy	62.15	22.57	-39.58
Note: based on 2007-08 data			

Source: estimate by Economics, and Statistics and Mapping sections, Parliamentary Library.

Externalities

As noted, a reason for modifying the neutrality principle is to correct for externalities. The evidence indicates that increasing alcohol taxes can reduce consumption, and that lower alcohol consumption reduces negative externalities:

> A recent systematic review of 112 studies examined the relationship between alcohol tax or price levels and alcohol sales or self-reported drinking. The review concluded that alcohol price and tax increase are related inversely to drinking levels; in other words, policies that raise the price of alcoholic beverages are an effective means of reducing alcohol consumption. In addition, studies have shown that price increase reduce problems due to alcohol …[21]

21. Preventative Health Taskforce, *Australia: the healthiest country by 2020*, op. cit.

A study by Collins and Lapsley using 2004–05 data found that the social costs of alcohol abuse in Australia amounted to more than $15 billion[22] although this figure has been contested.[23] Total alcohol tax revenue in 2008–09 was about $6 132 billion, which is less than the estimated $15 billion in social costs (which approximate the external costs of alcohol consumption).[24]

Scaled rates

As noted, a principle underlying current alcohol taxation—albeit a principle that is not applied consistently—is the higher the alcohol content, the higher the tax rate. This principle reflects evidence that consumption of high alcohol content beverages results in the largest social costs. The Preventative Health Taskforce concluded that a scaled rate structure of excise, where the scale is based on the percentage alcohol content, offers the best prospect for reducing negative externalities:

> … a 'tiered' volumetric system is recommended by the Taskforce. This system would be inclusive of stepped increases in tax rates that provide economic incentives for the production and consumption of lower strength alcohol products, and disincentives for the production and consumption of the highest-risk alcohol products. In this way, taxation would reflect the negative externalities attributable to certain products.[25]

Categorising beverages by alcohol content and not by type of beverage would have the advantage of dispensing with the multiple definitions of different types of beverage that now clutter the excise (and customs) tariff. In other words, it would no longer be necessary to define beer, cider, whisky and so on. Categorising beverages by alcohol content would also eliminate the incentive for producers to try to get around the current definitions.

Equity

The principle of vertical equity holds that people on high incomes should pay a higher proportion of their incomes in tax than those on low incomes. Income tax is the usual

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22. DJ Collins and HM Lapsley, *The costs of tobacco, alcohol and illicit drug abuse to Australian society on 2004/05*, report prepared for the Department of Health and Ageing, Canberra, 2008, p. xi, viewed 30 September 2009, http://www.nationaldrugstrategy.gov.au/internet/drugstrategy/publishing.nsf/content/34F55AF632F67B70CA2573F60005D42B/$File/mono64.pdf

23. In a report prepared for the National Alcohol Beverage Industry Council, Access Economics criticised the methodologies that Collins and Lapsley used. Access Economics concluded that the overall cost of alcohol abuse was at least 18 per cent (about $1.7 billion) lower than the Collins and Lapsley estimate.

24. It can be noted that to the extent that alcohol consumption is associated with benefits, these are primarily captured by the individual consumer and are thus irrelevant to this argument.

25. Preventative Health Taskforce, *Australia: the healthiest country by 2020*, p. 255.

example of a so-called 'progressive' tax that seeks to reduce vertical inequality by taxing high incomes at higher rates than low incomes. Conversely, a 'regressive' tax is one where the lower the income, the higher the proportion of income that is paid as tax. Alcohol taxation tends to be regressive:

> Studies consistently show that lower socio-economic groups and people with limited disposable income (young people, Indigenous groups and heavy drinkers) are more directly impacted by the price of alcohol products. Higher income drinkers tend to drink more expensive alcohol, and while price may lead them to reduce their consumption marginally, they are also able to alter drinking preferences to cheaper alternatives. [26]

A factor that needs to be considered when examining equity effects is the type of tax. Excise is sometimes referred to as a 'specific' tax, that is, it is levied on the basis of the volume, weight, or strength of the good (for example, dollars per litre of alcohol). A feature of excise is that it is a larger proportion of the price of a cheap good than of an expensive good. Excise therefore increases the relative price of a cheap good. The reverse is true of a value tax. Given that harms related to alcohol abuse are concentrated among low income groups, excise might be more effective in curbing abuse than a value tax such as the WET.

While higher alcohol taxes would lower consumption and hence social costs, non-problem drinkers might incur a loss of well-being through increased prices. On the other hand, all would benefit from the reduction in external costs, (such as reduced levels of violence). The net situation would vary across the community depending on the level of harms currently being experienced as well as proposed change to the tax structure. Nonetheless, there is at some point, a trade-off between lower social costs and lower social benefits for non-problem drinkers.

Enforceability and compliance

The taxation of alcohol could be simplified if there were only one tax (other than the GST). One option is to abolish the WET and substitute excise on wine. As noted, the GST and the WET are both value-based taxes. The norm in the Organisation for Economic Co-operation and Development (OECD) countries is to impose excise and a value added tax on alcoholic beverages (the GST is a value added tax by another name).[27] Australia seems to be the only OECD country with two value-based taxes on alcoholic beverages. Abolishing the WET would have several advantages: administration would be simplified, and it would facilitate the removal of some anomalies, notably, the variation in the rate per litre of alcohol described above.

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26. Preventative Health Taskforce, *Australia: the healthiest country by 2020*. Technical report no. 3, op. cit. See also R Webb, op. cit.

27. Organisation for Economic Co-operation and Development, *Consumption tax trends 2008. VAT/GST and excise rates. trends, and administration issues*, OECD, Paris, 2008, pp. 74–86, viewed 30 September 2009, http://dpl/Ejournals/OECD_ConsumptionTaxTrends/2008.pdf

Conclusions

While general principles guide the development of taxation arrangements, in practice, taxation arrangements inevitably entail trade-offs among the principles. Alcohol taxation is no different in this respect. When designing taxes, factors that have to be taken into account when taxing alcohol include the need to raise revenue, the effects on consumer behaviour, equity, efficiency (including the need to address externalities), enforceability and ease of administration. That said, it is clear that scope exists to improve the taxation of alcohol. In particular, taxing alcoholic beverages solely on the basis of their alcohol content—irrespective of what the product is—and having graduated taxation whereby the amount of tax is higher the higher the alcohol content of the beverage, would be improvements. Taxing wine in the same way as other alcoholic beverages, that is, via excise rather than the WET is a logical part of that reform. It can also be noted that if support for a particular industry or type of business is considered in the community interest, it is important that the reasons are clearly enunciated and that ways are found to offer the support in ways that do not undermine the efficiency objectives.