EXPLANATORY MEMORANDUM TO

THE DUTY STAMPS (AMENDMENT OF PARAGRAPH 1(3) OF SCHEDULE 2A TO THE ALCOHOLIC LIQUOR DUTIES ACT 1979) ORDER 2006

2006 No. 144

1. This explanatory memorandum has been prepared by the Treasury and is laid before the House of Commons by Command of Her Majesty.

This memorandum contains information for the Select Committee on Statutory Instruments.

2. Description

2.1 This instrument amends paragraph 1(3) of Schedule 2A to the Alcoholic Liquor Duties Act 1979(c.4) in order to limit the alcoholic liquors that are required to bear duty stamps to spirits of a strength of 30% alcohol by volume or more and also wine, and made-wine of 30% alcohol by volume or more. It comes into force on 1 February 2006.

3. Matters of special interest to the Select Committee on Statutory Instruments

3.1 This is the first exercise of the power to make an order provided by paragraph 2 of Schedule 2A to the Alcoholic Liquor Duties Act 1979.

4. Legislative Background

4.1 This instrument forms part of a package of measures being introduced by the Government to counter spirits fraud following a public commitment made in Budget 2004.

4.2 Section 4(2) of the Finance Act 2004 (c.12) inserted a new Schedule 2A into the Alcoholic Liquor Duties Act 1979 (c.4). That Schedule contains powers to make regulations to implement a duty stamps scheme. Those powers are to be exercised in the Duty Stamps Regulations 2006, which will come into force on 22 February 2006 and which will be covered by a separate explanatory memorandum.

4.3 Paragraph 1(3) of Schedule 2A to the Alcoholic Liquor Duties Act 1979 provides that the Schedule applies to all spirits and to wine and made-wine of a strength exceeding 22%. This Order amends paragraph 1(3) to provide that the Schedule will now apply to spirits of a strength of 30% or more and wine or made-wine of a strength of 30% or more.

4.4 Schedule 2A to the Alcoholic Liquor Duties Act 1979, as amended by this instrument, will be brought into effect on 1 February 2006 by the Finance Act 2004 (Duty Stamps)(Appointed Day) Order 2006. That Order is not subject to any Parliamentary procedure.

5. Extent

5.1 This instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

The Financial Secretary to the Treasury, Mr John Healey MP, has made the following statement regarding Human Rights:

In my view the provisions of the Duty Stamps (Amendment of paragraph 1(3) of Schedule 2A to the Alcoholic Liquor Duties Act 1979) Order 2006 are compatible with the Convention rights

7. Policy background

7.1 Schedule 2A to the Alcoholic Liquor Duties Act 1979 provides for the introduction of a duty stamps scheme for spirits, wine and made-wine.

7.2 A duty stamps scheme, as a method of combating spirits fraud, was first considered in 2001 but was put on hold in favour of closer working with the UK spirits industry. The need to revisit that decision became apparent when revenue losses due to spirits fraud were estimated by HM Customs and Excise (as it then was) to be in the region of £600m for the year 2001/02. It was decided, following further consultation with the UK alcohol industry on alternative regulatory and voluntary measures, that duty stamps were the only way to strike at the heart of the problem as it provided a visible differentiation between licit and illicit product at the retail end of the supply chain.

7.3 A duty stamps scheme would therefore make fraud easier to detect, reduce the opportunities for outward diversion fraud (where goods purporting to be exported are clandestinely moved onto the UK home market without the payment of UK excise duty) - as stamped product would not be able to be exported - and would drive up the cost of fraud, thereby reducing the profits to be made by the fraudster.

7.4 Customs subsequently revised their spirits fraud estimates downwards to £450m for 2001/02 and produced a new estimate of £250m for the year 2002/03. Ministers considered that these estimates still represented a significantly high level of fraud to merit a duty stamps scheme, though detail of the scheme was developed in proportion to the size of the problem, and in such a way that industry compliance costs were minimised as far as possible.

7.5 Customs therefore explored a number of ways to fulfil the commitment given by Government at the outset to implement the duty stamps scheme in such a way that compliance costs to the legitimate industry were minimised. One of the areas for consideration was how products with a low risk of fraud could be excluded from the scope of the scheme. After close consultation with industry, it was concluded that the best way to do this would be to create an alcohol by volume (abv) cut off point, below which duty stamps would not be required.

7.6 Schedule 2A provides that all spirits in containers of 35cl and over which are intended to be sold by retail are subject to the measure. In addition, the Schedule applies to wine or made-wine of a strength exceeding 22%. This instrument amends paragraph 1(3) of Schedule 2A to provide that the Schedule will only apply to spirits of a strength of 30% or more and wine and made wine of a strength of 30% or more. It effectively introduces a "de-minimis" limit for all products below which the Schedule will not apply, stripping out products which were previously within the scope of the scheme.

7.7 The products most at risk from fraud are brown or white spirits with a strength of between 37.5% and 40%. As part of the consultation process on the new scheme the trade argued that an abv cut-off point of around 35% would be appropriate. This argument was rejected for two reasons. First, if a 35% cut off was adopted, there is a possibility that products could be re-formulated in order to avoid the duty stamping requirement. For example, producers of product with a strength of 37% could start producing liquor with a strength of 34.5% without significantly altering the character of the product. This type of reformulation would also reduce revenue yield.

7.8 Second, imposing an abv cut-off of 35% could lead to new products at the cheaper end of the market emerging that were just under the abv threshold. Such products would potentially be at risk from fraud but would not be required to bear a duty stamp. A 30% cut off reduces this risk as the strength of any new product would be so much lower than that of product required to bear a stamp that they would not represent a significant competitive threat.

7.9 A 30% abv limit has therefore been introduced on the basis that there is no substantial evidence of fraud in products below that strength and the risk of re-formulation is kept to a minimum, so maintaining the integrity of the duty stamp as an anti-fraud measure.

8. Impact

8.1 A Regulatory Impact Assessment reflecting the duty stamps scheme that was envisaged before further consultation with the spirits industry is attached to this memorandum. This was published alongside Finance Bill 2004, which contained the primary legislation that enables the introduction of duty stamps. The Regulatory Impact Assessment now includes a new appendix which takes account of the recent changes to the duty stamps scheme. The consequential revisions to the scheme's compliance costs are £6 million set-up (down from £23 million) and £4 million per annum ongoing (down from £54 million).

8.2 The impact on the public sector is accounted for as part of a three year allocation totalling £36million for HMRC to implement the enhanced alcohol strategy.

9. Contact

Ruth Ryan at Her Majesty's Commissioners for Revenue and Customs, Tel: 0161 827 0337 or e-mail: ruth.ryan1@hmrc.gsi.gov.uk, can answer any queries regarding the instrument.

EXCISE: Tackling Spirits Fraud

Regulatory Impact Assessment

8 April 2004

HM Customs and Excise

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Executive summary

For the last 3 years the Government has been actively considering the most effective and appropriate response to the problem of spirits diversion fraud. During that time it has held two formal consultations with the alcohol industry to examine, first, the introduction of tax stamps and, second, a range of regulatory proposals designed to restrict the sale and movement of duty-suspended alcohol.

Following the tax stamps consultation in 2001-02, the Government concluded that, although tax stamps were an effective response to spirits fraud, the compliance costs of tax stamps for the legitimate spirits industry would be disproportionate to the benefits at that time, particularly if alternative means of making progress to those objectives could be pursued. It therefore decided, in the 2002 Budget, not to proceed with the introduction of tax stamps at that time. Instead, a range of other measures were adopted, based on enhanced co-operation between Customs and the spirits industry.

Following the second consultation, on regulatory options, in 2003, the Government concluded that, while some of the measures would have a positive impact in helping to counter alcohol fraud across all sectors of the industry in the short to medium term, the most significant proposals - to radically reduce the movement and sales of alcohol in duty suspension - would not deliver an anti-fraud benefit that was proportionate to their compliance cost to the industry.

In the meantime, according to Customs' estimates, the level of spirits fraud in the UK continued to rise. In December 2003, Customs estimated that the fraud had cost the Exchequer £600 million in 2001-02 and was on an upward trend. In the 2003 Pre-Budget Report, the Chancellor therefore announced that he would legislate for tax stamps in the 2004 Finance Bill unless the industry put forward an equally effective alternative. The Government cautiously estimates that the anti-fraud impact of tax stamps will be £160 million during their first year of introduction.

Following subsequent intensive discussions with Ministers and Customs and Treasury officials, the alcohol industry, through the Joint Alcohol and Tobacco Consultation Group (JATCG), submitted a package of proposals which it estimated would deliver an anti-fraud impact in excess of that of tax stamps. The industry also considered that the benefits of its package would accrue earlier and be more enduring than those of tax stamps.

In the light of the Government's proposals and the alternatives put forward by the industry, this Regulatory Impact Assessment evaluates the two options – and a third "do nothing" option – against the following criteria: benefits; costs; equity and fairness; impact on small firms; and impact on competition.

<u>Benefits</u>

The "do nothing" option, by definition, delivers no anti-fraud benefits.

The Government considers that tax stamps remain the most effective response to the serious problem of spirits diversion fraud. Only tax stamps provide the clear benefit for consumers and retailers of visible differentiation between legitimate and illicit spirits, which is key to both deterring and detecting diversion fraud. The compliance costs to the legitimate industry of tax stamps are significant. However, through a carefully targeted series of offsetting measures that it announced at the time of the 2004 Budget, the Government believes these costs can be minimised.

The Government estimates that the industry's package of alternative proposals will, at best, have an anti-fraud impact that is less than half that of tax stamps. As a whole, the package contains a number of inherent weaknesses: it leaves the door open for displacement to other types of fraud, most notably inward diversion; it stands to be undermined by a complicit party; and it does not address the issue of identification - the ability for consumers, retailers and Customs officers to distinguish readily between legitimate and illicit product.

Costs

The compliance costs estimated provisionally by the industry are based on a series of working assumptions set out by Customs in January 2004. Although these are significant, the Government has indicated that it will seek to minimise them through a number of targeted offsetting measures, including: Customs paying for the printing and distribution of stamps; seeking to ensure that tax stamps do not have to be paid for up-front; the creation of a £3 million fund for capital grants to smaller firms; and a spirits duty freeze for the remainder of this Parliament. Compliance costs may also be affected by the final, detailed design of the tax stamps scheme; the Government is committed to discussing these details with the spirits industry and to reducing final compliance costs wherever possible.

Although the industry did not provide any quantified estimate of the compliance costs of its package of alternative proposals, the Government accepts that the costs to the trade would be less than for tax stamps.

Equity and fairness

This assessment concludes that there are no significant issues of equity and fairness raised by any of the options. The wide scope of both tax stamps and the industry package of alternative measures will ensure that businesses are treated even-handedly.

Impact on small firms

The Government believes that both tax stamps and the industry alternatives are likely to generate comparatively higher compliance costs for smaller firms. For example, small firms may have more difficulty in raising the necessary finance to fund purchases of tax-stamping machinery or up-front payment for tax stamps. Similarly, the new registration and notification requirements in the industry package would impact disproportionately on smaller firms, as would any requirement for investment in bar coding technology.

The Government paid particular attention to the situation of small firms in proposing its package of offsetting measures. In particular, its £3 million fund for capital grants will be focused on small firms and the commitment to seek to ensure that stamps do not have to be paid for up-front should reduce additional finance, which small firms could least afford.

Impact on competition

Notwithstanding the points made above about equity, fairness and the impact on small firms, this assessment concludes that tax stamps are unlikely to have a significant detrimental effect on competition in the legitimate spirits industry. Furthermore, the Government believes that any adverse impact of tax stamps on competition will be minimised by the package of offsetting measures that it announced in the 2004 Budget. However, to the extent that they help transfer market share back to legitimate suppliers, tax stamps could, in fact, help these to compete more fairly and effectively on price.

Conclusion

Taking into account all of the above factors, the Government concludes that tax stamps remain the most effective and proportionate response to the serious problem of spirits diversion fraud.

Purpose and intended effect of measure

Objective

Those people who abuse the tax system undermine the principle that everyone should pay their fair share and attack both the stability of the public finances and the Government's ability to deliver world-class public services. There are other reasons why it is vital to tackle tax abuse:

- it is clear that serious and organised criminal groups are responsible for a substantial proportion of tax abuse, often using the proceeds to fund their other criminal activities;

- citizens and businesses paying their fair share have a right to expect others to do so and the Government to crack down on those that do not; and

- fraud, including spirits fraud, has a serious and real impact on the public. Every pound of revenue that is lost through fraudulent activity is a pound that is not available to be spent on public services for the benefit of society as a whole.

The Government is determined to make inroads into the losses from spirits fraud as part of a broader strategy to tackle fraud across the alcohol sector. Clear outcome targets need to be set and a range of operational responses developed which apply proportionate, directed pressure at all levels of the problem. A specific fraud-reduction target for spirits will be announced alongside the outcome of the 2004 Spending Review. However, the Government expects the strategy to yield, at minimum, additional revenue of £175 million[1] in 2006-07 against a baseline estimate of £600 million fraud losses in 2001-02.

[1] £160 million from tax stamps plus £15 million from the regulatory changes announced in the 2003 Pre-Budget Report.

Background

In the Pre-Budget Report of December 2003 the Chancellor announced the introduction of an enhanced strategy to combat alcohol fraud. The strategy aims to deliver a substantial reduction in the illicit share of the spirits market. This announcement was in response to the evidence that fraud in the spirits sector was increasing despite the work that the industry and Customs were undertaking, and followed several years of discussion and working with the industry on tackling fraud. The strategy is based on new regulatory controls to be introduced from 2004 and tax stamps for spirits to be introduced in early 2006 unless an effective alternative was put forward by the industry.

In June 2000, the Paymaster General and the Chairman of Customs commissioned an independent investigation, headed by John Roques, an ex-senior partner of Deloitte and Touche, to look into Customs' handling of a series of excise diversion frauds which occurred between 1993 and 2000. Mr Roques made a total of 65 recommendations designed to strengthen the excise holding and movement systems, improve controls on investigations and establish clearer lines of accountability for revenue issues at senior levels within Customs. The Government, in its response, accepted 63 of those recommendations and 55 have now been implemented.

Tackling Indirect Tax Fraud, published by the Government in November 2001, set out very clearly the Government's commitment to tackling fraud. This Government has established a strategic approach to tackling fraud, assessing, for the first time, the size and nature of the problems, setting clear objectives and targets for tackling those problems, identifying the operational responses required to achieve those targets, and monitoring the delivery of results. The experience of the Government's *Tackling Tobacco Smuggling* Strategy has demonstrated the effectiveness of this approach. To tackle spirits fraud, and in particular the problems of inward diversion, Customs had at that time already introduced a number of measures, including:

- the creation of a specialist team to check and 'discredit' the paperwork covering the movement of duty-suspended goods in freight consignments;
- the implementation of a tougher HGV seizure policy, targeting those hauliers who failed to carry out simple checks to ensure that they were not caught up in fraud; and
- the redeployment of an additional 146 assurance officers to strengthen the excise holding and movement system.

The Government believed, however, that further action would be necessary and announced a consultation on the costs, benefits and practicalities of introducing a tax stamps system for spirits. This was consistent with a recommendation in the Roques' report "to introduce tax stamps for spirits and associated sanctions, to protect both excise revenue and the UK's whisky production industry" and followed feasibility research undertaken by Customs with spirits producers on the whole range of fiscal markings for spirits, including tax stamps. The consultation established that tax stamps would have the major advantage of allowing enforcement staff, the trade and the public alike to distinguish between legitimate and illicit spirits at the point of retail sale and so would have significant anti-fraud benefits. The consultation also confirmed that their introduction would have compliance costs for the industry. In Budget 2002 the Government, therefore, announced that it had decided not to proceed with tax stamps at that time but that Customs would work with the industry to tackle fraud and to explore alternative means of making progress in reducing the illicit market share, further detail is contained in Appendix D.

In November 2002 the Government published *Protecting Indirect Tax Revenues*, in which it set out the progress made so far, including the joint working between Customs and the spirits industry through the Joint Spirits Fraud Task Force (JSFTF), and noted that there had been some success. It announced that Customs would build on the initial progress, exploring what further support the industry could provide and what new steps, including regulatory measures, might be taken to keep pace with the changing tactics of the fraudsters, and continue to clamp down on alcohol fraud.

The Government examined a range of options for reducing the opportunities available to commit fraud through the framework for holding and moving alcohol in duty suspension. Customs conducted an initial, informal consultation with key trade associations on several outline regulatory proposals and received a range of useful information and feedback which was used to inform the further development of the measures on which the Government formally consulted between July and October 2003.

Responses to the consultation suggested that, while some of the measures would be accepted by the industry and have a small further impact in reducing fraud, the most significant proposals - to radically reduce the movement and sales of alcohol in duty suspension - would not deliver an anti-fraud benefit that was proportionate to its compliance cost to the industry.

At the same time, Customs' estimates of spirits fraud, published in *Measuring and Tackling Indirect Tax Losses* alongside the 2003 Pre-Budget Report, showed that around £600 million of revenue was lost through spirits fraud in 2001-02. Customs also reviewed their estimates for previous years in the light of new data and these revised estimates showed a clearly rising trend to that year. The Government regarded such continued high levels of losses as unacceptable, especially in light of its success in tackling fraud losses in the other main indirect tax regimes, with the growing trend in tobacco and oils fraud decisively reversed and indications of a decline in VAT missing trader fraud.

While welcoming the co-operative approach which the industry had shown with Customs, the Government had been unable to identify alternative means to tax stamps that would deliver the substantial reduction in spirits fraud which is required. This led to the announcement on tax stamps in the Pre-Budget Report in December 2003.

The Economic Secretary to the Treasury, John Healey MP, and Customs and Treasury officials have been involved in extensive discussions with the industry since the Chancellor's announcement in the Pre-Budget Report. This document seeks to summarise and assess the benefits and costs of the options available to tackle spirits fraud.

Risk assessment

The EU-wide excise holding and movements system has, since its inception in 1993, operated under constant threat from diversion and other types of fraud. Fraud and smuggling affects a range of alcohol products including beer and wine. However, today, estimated revenue losses are overwhelmingly caused by spirits fraud.

<u>Evolving fraud and Customs' Response</u>

Outward Diversion

The first fraud to emerge as a major threat to the Single Market system was outward diversion – probably the simplest and most cost-effective method for the fraudster. Criminals posing as legitimate traders would buy goods in duty suspension, and ask warehousekeepers to release the goods for export to another Member State. The warehousekeeper would prepare the paperwork to the owner's destination, and release the goods in good faith. The owner would then divert the goods directly on to the UK market, often breaking down the lorry-load within a few miles of the warehouse gates and distributing the goods to cash and carry stores, off-licences, pubs or simply to individuals who would sell the product on street corners or at car-boot sales. Rarely was the paperwork returned as required, and as warehousekeepers and

Customs alike sought to implement the new EU system, these missing documents often went undetected and unreported.

Customs reacted to the emerging trend, and managed to reduce outward diversion drastically by the late 1990s through, for example, the introduction of import/export verification officers to target duty-unpaid goods and trace them back to their originating warehouse.

Inward Diversion

However, many fraudsters were undeterred and switched their fraudulent activity to inward diversion, whereby product legitimately leaves a production or storage facility in another EU Member State, is imported into the UK, and then is diverted onto the retail market without payment of excise duty. This is more expensive for the fraudster, reducing their profit margins, as they must establish a trading base in another Member State and fund the transport costs of moving the product to the UK. However, it is also more difficult to detect, as the product is not usually expected in the UK and so can disappear without Customs or any legitimate warehousekeeper being aware that it is in the country. Moreover, UK Customs has no control over the registration procedures by which criminals may obtain the veneer of legitimacy from other Member States' fiscal authorities. If the consignment is stopped en route, it is accompanied by correct documentation and appears to be legitimate. If Customs show an interest, the consignment is delivered to the warehouse shown on the documentation and sold through the legitimate market. The fraudster would lose his profit on that load, but would avoid any penalty.

Customs have become more adept at detecting in-bound loads purporting to be legitimately destined for approved UK warehouses. Many consignments, and the vehicles which carried them, have been seized. This action has cut into the profit margins of the fraudsters, making this type of fraud less attractive. As a result, outward diversion has re-emerged as a threat to the revenue base, with fraudsters introducing many clever and innovative ways to deceive not only UK Customs and the legitimate warehousekeeper, but also the fiscal authorities in other Member States. Customs' current view is that inward and outward diversion are of a comparable scale.

Fraudsters may also hide their activities within long supply chains, or behind multiple movements and sales of the goods. These make it very difficult for Customs to trace the origins of the goods, and to identify the those who are the guiding minds behind the frauds. The company at the end of the chain is sacrificed if the fraud is discovered, while the other fraudulent companies hidden within the chain continue to operate. Even where the same names occur many times within supply chains it is difficult, if not impossible, for Customs to gather enough evidence against these people to prove they are involved in fraud.

Transport and Sale of Illicit products

The one thing that is a constant in any diversion fraud is that the driver of the vehicle carrying the goods must be prepared to deliver the goods to premises other than those shown on the accompanying documentation. Unless the transporter provides the movement guarantee, the only sanction that may be open to Customs is to assess them jointly and severally for any duty that becomes due on the goods with the person under whose guarantee the goods were moved (usually the warehousekeeper from whose premises the goods were dispatched).

In some instances, suspicions may be raised on the part of the driver, or the company concerned, that the goods are not to be legitimately delivered. For example if they pick up goods from a warehouse in Glasgow and the paperwork says that the destination is in France, but they are told to deliver it to Manchester, they may suspect that the product is not legitimate. However, they could simply be informed, and believe, that the circumstances of the delivery have genuinely changed, or be asked to exchange loads with another driver at a motorway service station. Whether or not they are complicit in the fraud, there is no provision in the EU legislation governing the excise holding and movement system that allows Customs to restrict the transporter's access to duty-suspended goods in the future.

Although some illicit product is sold through unlicensed outlets, or directly from car boot sales or private homes, the biggest profits for the fraudsters are to be had if the product can be sold at, or close to, normal retail prices. Some wholesalers or retailers innocently buy these goods from other traders; others are aware that these are illicit goods and they seek to hide their involvement with forged paperwork. As the retailers were not involved in diverting the goods from duty suspension (only in buying them further down the line), they have no liability for the evaded duty.

The scale of the illicit market

There is an inherent difficulty in establishing the scale of illicit markets. Customs adopt gap analysis for estimating spirits fraud. This involves establishing total UK spirits consumption and deducting legitimate spirits sales. The balance represents the illicit market.

Customs' Estimates

The underlying data on spirits consumption used by Customs is derived in part from surveys carried out on household expenditure and consumption by the Office for National Statistics (ONS) and the Department of the Environment, Food and Rural Affairs (DEFRA) - on-licence consumption from the Family Expenditure Survey (FES) and off-licence consumption from the National Food Survey (NFS)[2]. The raw data is smoothed in order to reveal the underlying trends. Household surveys are typically characterised by under-reporting. In order to overcome this, Customs assume that in 1992 there was minimal smuggling and cross-border shopping and that overall consumption in that year was equal to UK duty-paid consumption and legitimate duty-free purchases[3]. This assumption was informed by the expert opinion of those involved with assuring the alcohol regime at the

[2] Since 2001/2 FES and NFS have been combined into EFS (Expenditure and Food Survey) but ONS and DEFRA are still responsible for publishing the FES and NFS equivalent data respectively.
[3] Intra-EU duty free purchases are included. Intra-EU duty-free was abolished in June 1999.

time. It is also consistent with the view that it was the formation of the single market at the end of 1992 which created many of the opportunities for alcohol fraud.

Using this methodology, Customs estimate that in 2001-02 – the latest year for which figures are available - £600 million was lost to spirits fraud and that spirit fraud levels were rising. This implies that in 2001-02, 16% of the spirits market was illicit with almost one in six bottles of spirits consumed in the UK over that period not having borne UK duty.

Industry Estimates

However, whilst accepting that there is a problem with fraud in the spirits industry the Scotch Whisky Association (SWA), representing the UK alcohol industry through the JATCG, estimated that the level of spirits fraud was reducing, and that the revenue loss was between £100-£150 million in the period 2001-02. This estimate was based on the Omnibus Survey carried out by the ONS.

Findings of the National Audit Office

With such a wide variation in figures, the National Audit Office (NAO) were asked by the Public Accounts Committee in January 2004 to review the methodologies, data sources, and rationale for the adjustments adopted by Customs and the SWA. The Economic Secretary to the Treasury welcomed this review and committed Treasury and Customs officials to giving the NAO their full cooperation in pursuing the work. The NAO concluded, based on statistical advice from the London School of Economics, that the tax gap methodology adopted by both parties in calculating the total level of spirits consumption and deducing from this the known level of legitimate duty-paid spirits was similar[4]. The differences between the fraud estimates arose mainly from the different survey data that was used to estimate spirits consumption and adjustments made to reflect under-reporting in such surveys.

The NAO concluded that both methods of calculation were statistically viable and that, using the gap analysis technique, Customs' figure should more properly be said to be in the range of £330 - £1,080 million for 2001-02, and the SWA figure in the range of £10-£260 million. On 8 March further uncertainty was created when the ONS informed the NAO that it had discovered an error in their analysis of the General Household Survey for the period 1992 to 1996 and as a result the NAO is only able to say with certainty that the SWA fraud estimate of £100-150 million based on data from the ONS' Omnibus Survey will itself 'have a wide confidence interval'.

Furthermore the NAO commented that, given the contrasting results of the General Household and Expenditure and Food Surveys, neither survey estimate could be accepted as unequivocally reliable and great care would be needed in determining what reliance is placed on the results currently available. ONS will be taking forward,

[4] For the purposes of their review, and with the agreement of the SWA, the NAO reperformed analysis work using data from the General Household Survey (GHS). This was undertaken because the Omnibus Survey, used by SWA, only provided data from 1997 onwards, while the GHS has data from 1992-93.

with Customs and the SWA, further work to explain why there are such different estimates for consumption and therefore spirits fraud.

The case for change

While disagreeing over the precise level of fraud within the spirits market, all parties acknowledge that it is unacceptable and damaging to the industry, the consumer and the taxpayer alike. The Government is, therefore, concerned that, unlike with cigarettes, neither the consumer nor the honest trader has any consistent means of distinguishing between duty-paid and non-duty-paid product.

The risks presented by fraudulent activity are not only financial. The impact on society of spirits fraud is significant. Any revenue lost to fraud is revenue that could have been spent on public services that are essential and important to all UK citizens, such as education and health. Furthermore, those involved in fraud are often major criminal organisations. The criminality associated with alcohol fraud was highlighted with the discovery earlier this year of firearms at the premises of a haulier suspected of being involved in diversion fraud.

The vulnerability of the alcohol, and particularly the spirits duty-suspended movement system to fraud results from the confluence of, essentially, two factors:

- firstly, the fact that large consignments of high-value, low-volume product are being moved under duty suspension and sold repeatedly and across national borders without any tax being paid or any guarantee that it will be. A container-load of vodka can be worth over £100,000 in evaded duty alone; and

- secondly, the lack of any remotely practical means for consumers, retailers, or Customs to identify illicit product. Duty-paid and illicit spirits can sit side-by-side on a shop shelf and nobody would be able to tell the difference.

Put together, these factors make spirits fraud a low-risk, high-reward occupation, and one that the Government believes requires firm action to tackle it.

Options

Since the problem of spirits fraud was first considered, many options and measures have been suggested and assessed. Since the Pre-Budget Report in 2003, the field has been narrowed to two alternatives. These are a package of measures put forward by the industry, via the JATCG, and a tax stamp scheme. For the sake of completeness and comparison, a third option, to do nothing, has also been considered.

Option 1: Do nothing

The Government has been demonstrating, since 1997, its commitment to the fight against alcohol fraud, and the need to apply increased resources to reinforce Customs' efforts. Customs have worked closely with the industry, employing new methods of assurance, investigation and detection of fraud, and gathering of intelligence.

This option proposes that the Government continues with existing procedures and efforts to tackle spirits fraud and implements nothing more.

Option 2: The spirit industry's alternative package of measures

While announcing the Government's proposal to introduce tax stamps on the basis that exploration of alternative routes had been exhausted, in the 2003 Pre-Budget Report, the Chancellor offered the industry a further opportunity to suggest an effective alternative to tax stamps in the run-up to Budget 2004. The announcement at the time of the Pre-Budget Report stated:

> "In order for any alternative proposal to be acceptable, it must deliver a reduction in spirits fraud comparable to that which would be delivered by tax stamps, and to the same timescale".

The spirits industry, under the auspices of the JATCG, presented a package of alternative measures to tax stamps to the Government on 5 March 2004.

The industry package, comprising 17 proposals, seeks to bring together a wide range of measures, which construct a series of hurdles for fraudsters to overcome, deterring or preventing their illegal activities. The industry consider that, taken as a package, the proposals provide a workable alternative to tax stamps, would have an earlier impact on fraud and would have a greater and more enduring effectiveness, whilst imposing a manageable compliance cost on the industry. The industry believe that, whilst Proposals 1 to 12 will have a relatively early impact on fraud, the remainder of the proposals may require a longer period of evaluation and development and so may be seen as less immediate in their impact. The industry's proposals are described and assessed in detail in Appendix A.

Option 3: A tax stamp scheme

Under this measure, retail containers of spirits would, subject to certain exceptions, be required to bear a duty stamp indicating that UK duty has been paid. Retail containers of wine or made-wine with an alcohol by volume (abv) over 22% would also be subject to the same requirements. A tax stamp would be affixed to a qualifying retail container at any point in the production and supply chain before it is released onto the UK market.

The Government acknowledges that there would be a certain compliance burden to the industry and various offsetting measures have been formulated to alleviate these costs. Details of both the compliance and offsetting issues are provided in later sections.

Costs and benefits

BUSINESS SECTORS AFFECTED

All three options to tackle spirits fraud will affect the following business sectors:

- producers;
- bottlers;
- warehousekeepers;
- importers;
- distributors;
- wholesalers (including cash and carry);
- retailers (both on and off-trade);
- consumers; and
- ancillary businesses in the supply chain (such as suppliers of tax stamp printers and suppliers of machinery and of security equipment).

In general all spirits products retailed in the UK will be affected, regardless of their country of origin.

Option 1: Do nothing

This option effectively replicates the status quo, albeit with the minor regulatory measures announced in the Pre-Budget Report, and will not impact on sectors to any greater or lesser extent than currently.

Individual impact assessments will be produced, as appropriate, for each of the regulatory measures alongside the draft regulations.

Option 2: The spirit industry's alternative package of measures

Table 1: The impact on business sectors of Option 2

Business sector	Impact
Overall	The industry states that, in the time available, it has not been able to make a reliable estimate of compliance costs. There are a number of areas where the industry has quantified the impact, but these are in a minority. Where compliance costs are estimated, the industry describes them as minimal or neutral. The industry has stressed that the alternative measures could be implemented more quickly than tax stamps. As such any impact on either fraud or compliance costs will take effect sooner.
Producers	The Government believes that costs may, for example, arise from greater use of bar-coding technology, and also from changes to invoicing systems to record details of duty payment. Neither cost has been quantified to date.
Small producers	As for producers. The industry have not identified any major differences between firms of different size, although the level of technology available to individual firms will affect the impact and affordability of some measures.
Bottlers	As for producers. Invoicing systems may need to be changed if duty payment details are changed, but these costs have not been quantified.
Warehousekeepers	A number of measures will increase costs for warehousekeepers. The provision of information about expected arrivals, the accreditation of warehouse staff and the notification of cash transactions are examples. The industry state that the costs will not be significant at a global level.
Wholesalers	The industry have not identified any significant compliance costs for businesses in this sector. The registering and licensing of alcohol suppliers and retailers may have a minor effect.
Retailers	The industry have not identified any significant compliance costs for businesses in this sector. The industry have not identified any significant compliance costs for businesses in this sector and they do not expect the retail prices rises associated with tax stamps to occur.
Consumers	The industry have not identified any significant impact on consumers. There may be some indirect effects on health and consumer behaviour if fraud and counterfeit sales are reduced.
Ancillary businesses in the supply chain	The industry have not identified any significant impact on other businesses in the supply chain.

Option 3: A tax stamp scheme

Table 2: The impact on business sectors of Option 3

Business sector	Impact
Producers	Producer costs are shown in the Table 6 for Option 3. Although these costs fall initially on producers, the Government believes that they will be passed on as far as possible. The majority of these total costs will fall on larger firms: the top 9 producers account for the top 71% of the UK spirits market by volume. Although many large firms already apply tax stamps for non-UK markets, the need for extra capacity and new machinery remains. There will also be costs related to increased security requirements for holding high values of tax stamps. A small number of producers have stated that they would have difficulty raising finance and could cease trading as a result, though the Government considers that offsetting measures, particularly in respect of cashflow costs, will significantly mitigate this risk.
Small producers	Small firms account for around 6.7% of total clearances of spirits onto the UK market but 11.9% of total compliance cost. On this basis, the costs are disproportionate, at least in the absence of any suitable offsetting measures. However, the Government believes that the offsetting measures proposed will mitigate this effect.
Importers	As shown in the Table 6 for Option 3, importers expect to incur costs of around £4m. These costs are expected to fall disproportionately on small businesses.
Warehousekeepers	An expected move to more just-in-time production means that warehousekeepers expect to lose up to £7.5m of business a year, depending on the impact of offsetting measures.
Wholesalers	Cash and Carry groups have estimated an increased financial exposure for them of approximately £3m, caused by expected changes in business practice. In particular, they expect to close facilities storing duty-suspended spirits and buy from suppliers on a just-in-time basis.
Retailers	The industry has indicated that they will recover, by raising prices, any costs that are passed to them. They have suggested an increased risk of cross-border shopping as a result, though any loss in Government revenue would be outweighed by the reduction in fraud. The effect of higher prices will be most marked at the "cheapest on display" end of the market where margins are tightest. The cost of a tax stamp, however, is fixed and does not vary with the quality or design of the product. Any reduction in sales resulting from tax stamps is expected to be minimal, and more than offset by the reduction in illicit sales and counterfeit production. Airport retailers say they would cease to sell UK duty-paid spirits in export shops if strip stamps were required for sales to passengers on intra-UK or intra-EU journeys. Registered mobile operators, such as the cross-channel ferry operators, have highlighted the practical difficulties that tax stamps can cause them. Their concern is that unless a solution can be agreed, tax stamps would have to be removed on leaving UK territory. Customs are aware of these issues and are considering the best way of addressing them.

Business sector	Impact
Consumers	It is likely that the costs of tax stamps will be passed onto consumers as noted above. The Government estimates that the compliance costs, not including offsetting measures, equate to around 13p per bottle on an

	ongoing basis (slightly more if set-up costs are included). Adding VAT to this pushes the figure to around 15p. The industry themselves have suggested rises of as much as 50p per bottle, caused by the complex nature of the supply chain, but it is unclear, given the apparent competitiveness and efficiency of the industry, that this would be so. Certainly the impact will vary between firms, but nonetheless the Government has made allowance for a potentially significant impact on retail prices in proposing a package of measures to help offset these costs. A 10p rise in price would, the industry believes, lead to a fall in sales of around 0.8%, with other rises having a pro-rata effect. The industry points out that such a reduction in sales would have a consequent negative impact on Government revenue.
Ancillary businesses in the supply chain	Machine manufacturers, tax stamp printers and suppliers of production materials will all benefit indirectly from the introduction of tax stamps. For obvious reasons, this is not taken as an argument in favour of tax stamps, but simply as an observation about the impact of the scheme. Any gain to such businesses is a cost to other stakeholders by definition.
Employees	The industry estimates that the security requirements of tax stamps will place a strain on employee relations (with consequent, but unquantifiable, costs) as companies holding valuable tax stamps might be forced to place employees under closer surveillance.

Assumptions

General assumptions (applicable to all options)

The Government has assumed that EU legislation concerning the holding and movement of duty-suspended alcohol remains largely unchanged. For assessments to be made as to the impact of the various options on specific businesses, the Government has assumed that a small enterprise is one that has a spirits output of fewer than 100,000 cases per annum.

Specific assumptions

Option 1: Do nothing

The Government has assumed that Customs' operational resources targeted at alcohol assurance remain at existing levels, so the measures in place can be maintained. It must also be assumed that the spirits producers would sign and comply with the Memoranda of Understanding that have been developed under the auspices of the JSFTF.

Option 2: The spirits industry's alternative package of measures

Assessing the likely impact of the industry's package in reducing fraud is far from straightforward and it should be noted that the industry did not place a revenue impact estimate on their package of measures in their submission to Government. In contrast to tax stamps, the industry's package will affect fraud through a number of different mechanisms, but will, the Government estimates, also leave considerable scope for illicit activity to be displaced to other forms of fraud and smuggling.

Customs took the approach of convening a group of operational experts to determine what types of fraud the different measures proposed by the industry might impact on, the extent to which they might impact, and how much of the fraud so prevented might be displaced into other types of fraud. This approach is similar to the approach to assessing the revenue impact of tax stamps. Although each proposal was considered individually, its impact was assessed against the background of all the other proposals, and against Customs' existing and planned activity to tackle spirits fraud.

The Government's assessment of the industry's package of alternative measures takes as its starting point the same level of fraud – i.e. a revenue loss of £600 million and an illicit market share of 16% - as is used in the analysis which generates an estimate of £160 million as the impact of tax stamps. Customs' estimates of the impact of the industry's proposals were measured against the assumptions set out in their submission – i.e. they were based on the industry's assumptions of how they themselves saw each proposal working.

Likely impacts were classified as "Low", "Low/Medium", "Medium", "Medium/High", or "High" – where each classification corresponded to a potential impact on fraud. The impact on fraud of each of these classifications used as its baseline the impact of tax stamps, which is expected to be "high". This is illustrated in the table below.

Table 3: The impact on fraud of Option 2

Direct impact on fraud	**Lower**	**Upper**
Low	0%	1%
Low/Medium	1%	20%
Medium	20%	30%
Medium/High	30%	40%
High	40%	100%

Similarly, the risk of fraud displacement associated with the measures was characterised as "Low, "Medium", or "High", corresponding to the extent to which fraud stopped would be displaced to other channels.

Table 4: The risk of fraud displacement of Option 2

Displacement Potential	Lower displacement **(Used in producing the upper end of the final revenue estimates)**	**Upper displacement (Used in producing the lower end of the final revenue estimates)**
Low	0%	10%
Medium	10%	50%
High	50%	100%

The analysis was carried out in the anticipated conditions of 2006, in order to be consistent with the analysis for tax stamps. It is assumed that the baseline level of fraud will amount to 490,000 hectolitres of illicit spirits.

Final revenue impacts were assessed by making an assumption regarding the amount of illicit product which would be replaced by tax-paid product. Customs assumed that 80% of fraud prevented would give rise to duty-paid sales – consistent with our assumption that 80% of illicit alcohol is sold through licensed retailers.

The overall level of fraud was also broken down between various modes, drawing on Customs' operational and intelligence expertise. The impact on fraud was then assessed by summing the potential impacts of the individual measures as assessed under the criteria above.

In addition to these assumptions, in order to make a valid assessment of the industry's measures, Customs has assumed that the entire industry would comply with each and every undertaking (e.g. Memoranda of Understanding) and that there are no unexpected legal barriers to implementing the industry's proposals. As for option one, it is assumed that Customs would be sufficiently resourced, including funds to implement required IT systems.

Option 3: A tax stamps scheme

Customs issued three information papers to the JATCG in January 2004 on the proposed 'Strip Stamp Regime', 'Compliance Costs', and 'Possible Measures to help Offset and Mitigate Compliance Costs'. These included some 'guidelines' to assist the industry in assessing the compliance costs of tax stamps, making it clear that, although a number of options would be considered, the working assumptions to be used were that:

- the purchase price of the stamp will be an amount equivalent to all of the duty payable on the amount of goods in the retail container plus the unit cost of the stamp;
- the stamp will take the form of a paper strip stamp affixed to the liquor container across the opening or over the stopper;
- the cost of delivery by secure means will be included in the price of the stamp;

- all spirits in a container of 35cl and over will be caught by the proposal. Spirit-based Ready-to-Drink products (RTDs - e.g. ‘alcopop’- type drinks) will be exempted;

- wine and made-wine over 22% abv in a container of 35cl and over will be included; and

- existing deferment arrangements will apply, even if the cost of the stamp has to be paid up-front.

All these assumptions were used to estimate gross compliance costs. The actual net costs will be reduced substantially by the offsetting measures detailed in the costs section.

It has been assumed that no more than 20% of illicit spirit sales are hawked and also, as with the first option, that Customs has sufficient resources to implement and police a tax stamp scheme.

Benefits

Option 1: Do nothing

The benefits of a ‘Do Nothing’ option are that the degree of legislative work that would have to be done (over and above that already required to implement the regulatory measures announced in the Pre-Budget Report) would be nil and the costs to industry of maintaining the status quo would be essentially nil. Furthermore, there would be no compliance costs involved as the industry would not be required to do anything they do not already do. However, it is likely that without action, spirits fraud would remain at, or grow beyond, its current significant levels.

Option 2: The spirits industry’s alternative package of measures

There are inherent difficulties in assessing the impact of a large number of different measures. For example, there is scope for “double counting” of benefits, given that some measures will impact in different ways on the same type of fraud, though no specific account has been taken of that in assessing the benefits of the industry package. The industry believes its alternative package of measures will deliver a significant impact on fraud, alongside a less burdensome compliance process, and can be put in place sooner than a tax stamps solution and will have a greater and more enduring effect. The package as a whole is designed to act as a risk-based approach to tackling spirits fraud by constructing a series of hurdles for any potential fraudster to overcome. The industry believes that all of the hurdles will hinder their activity, and may deter or prevent the fraud altogether.

Fraud

The industry believes that the combination of proposals gives this option a multi-faceted and flexible approach to tackling fraud. **However**, assessing the impact on fraud for the purpose of comparison with tax stamps is difficult, because unlike tax stamps, none of the proposals, either individually or as a package, removes one of the pillars on which most diversion fraud is built – the ability to deceive honest traders and consumers that product is duty-paid when it is not – or reduces significantly either the incentive or the opportunity to infiltrate the supply chain and commit diversion fraud.

While a number of the industry’s alternative measures could be useful in tightening control of the movement and supply of duty-suspended alcohol, the package as a whole falls short of the anti-fraud and revenue benefits that the Government expects from the implementation of tax stamps. This is chiefly because:

- the measures are open to circumvention by fraudsters;
- the measures are susceptible to being undermined by a complicit party;

- unlike tax stamps, which are a visible indicator to the retail customer that spirits have borne UK duty, the measures would impact at earlier stages in the supply chain and provide no visible means of differentiating between legitimate and illicit spirits; and

- also in contrast to tax stamps, in many cases the proposed measures serve to tackle only parts of the illicit spirits market, and, therefore, face greater scope for displacement of fraud to other means (most notably inward diversion).

Furthermore, the proposed system of risk-based notification, which is a key element of the package, would be voluntary and based in part on subjective risk assessment, with the impact depending on the good will and commitment of each individual business. The proposals for tighter control by the industry on the use of their financial guarantee already broadly reflects Customs' established policy on the use of financial guarantees, and any impact could be diluted by the industry’s suggestion of certain exclusions and exceptions from their application of the measure.

The Government’s assessment of the fraud impact of the 17 measures shows that at most three (proposals 1, 7 and 9) would have a medium impact on fraud (defined as 20%-30% reduction in fraud), the remaining 14 measures having either no effect, or low impact (defined as 0%-1% reduction in fraud). Of the three medium-impact proposals, two (1 and 7) show a high risk (50%-100%) of displacement of the ‘stopped’ fraud to other channels. The Government’s detailed assessments of each of the proposals are shown in Appendix A.

Revenue

The Government estimates the revenue impact of the industry’s package to be in the range of £25 million to £115 million. The extremes of the range are generated by the multiplied effects of using, respectively, lower boundary and upper boundary estimates for the fraud and displacement effects described previously, applied to each proposal. Thus, the extremes of the range represent respectively unnecessarily pessimistic and unreasonably optimistic views of the likely overall impact. A plausible estimate of the impact of the package is £70 million per year. However, this number is by necessity subjective, and a more cautious estimate, consistent with the level of caution in the tax stamps estimate, would suggest a figure towards the lower end of the range, particularly as the assessment assumes near complete industry compliance with what would, in reality, be partly voluntary measures.

Trade

The alternative package of measures would present relatively lower compliance burdens on legitimate trade. Their proposals are procedural or regulatory, and, while there may be some implications such as increased risk analysis and notification requirements, there would not be the cost of the installation or upgrade of equipment that would come with tax stamps.

Society

The impact on society of spirits frauds is significant, as would be any benefits reaped from tackling such activity. The estimated £600 million lost to the Exchequer through spirits fraud in 2001- 02 leaves fewer resources to spend on public services. The £70 million that Customs estimate that the industry's package of measures could produce would be a net social benefit.

Option 3: A tax stamps scheme

Tax stamps offer many benefits in tackling fraud. It will be significantly easier to identify those selling illicit product following the introduction of tax stamps. Tax stamps will mean that retailers and the public will know that they are purchasing illicit product and will be conscious of the potential risks associated with the purchase and consumption of illicit product.

Fraud

Whilst tax stamps will not completely eradicate diversion fraud, they will remove much of the profit and the incentive for fraud. Diversion of unstamped product will still present a degree of risk. However, the task of detecting inward diversion may be easier, as products bearing a legitimate stamp will not be a risk.

While Customs' intelligence suggests that fraud trends can change quickly (e.g. in response to Customs' operational activity), their analysis suggests that inward and outward diversion are currently of a comparable scale. If tax stamps are affixed to imported product prior to importation into the UK (bearing in mind that this would not be a legal requirement), there will be an impact on inward diversion. Tax stamps will also make the wholesale and retail sale of unstamped, diverted product more difficult, which will impact on both inward and outward diversion. The Government's estimate of the revenue yield does not include any impact from tax stamps at the frontier, so that the estimate of fraud prevented is cautious.

Operational experience suggests that around 80% of illicit spirits are supplied through the licensed retail (on- and off-trade) sector and 20% by "hawking" through unlicensed premises. Customs also assess that, in line with the balance of spirits sales between the on- and off-trade, within the licensed retail sector, the large majority of illicit spirits are sold through the off-trade.

Tax stamps will make sales of illicit alcohol through the licensed retail sector more difficult because the risk of detection will be significantly increased, as will consumer awareness of the licit or illicit nature of the product they are buying. The Government believes that tax stamps will prevent 70% of illicit sales through retail outlets. The impact upon hawking is likely to be smaller because consumers already know that the product they are buying is illicit. Tax stamps are assumed, therefore, to stop only 5% of illicit sales made through hawking. To add an additional element of caution to the assessment, the Government has also assumed that 20% of the reduced volumes in the retail sector will be displaced into hawking.

Anti-counterfeiting

The Government is aware of the risk of counterfeiting of tax stamps. In order to minimise the risk, it will employ the latest in security printing technology to ensure that the UK tax stamp is at the leading edge of document security. Provision will also be made for the design of tax stamps to be varied periodically, if necessary, in order to pre-empt potential counterfeiters.

Revenue

The Government estimates that, based on a spirits fraud estimate of £600 million, the introduction of tax stamps will have a revenue impact of £160million in the first year of implementation. It should be noted that, although compliance will be economically and logistically more burdensome than the other two options, the fraud impact of tax stamps is much higher. Customs would aim to effectively target their assurance efforts, and the scope for increased assessments for evaded duty will result directly in an increase in revenue saved.

Trade

The scheme as a whole will serve to have a disruptive effect on fraudulent activity. Making life more difficult for fraudsters will be of significant benefit to the legitimate industry, reducing the risk of the alcohol market being swamped with illicit goods and maintaining, and potentially even increasing, the market for legitimate product. From a brand-protection point of view, producers have reported concern that their brands are being counterfeited. Whilst there remains the risk that genuine stamps may find their way onto counterfeit product, the introduction of tax stamps may contribute to consumers identifying genuine product with greater confidence.

Society

As mentioned above, society is detrimentally impacted by spirits fraud. Tax stamps provide a way for this impact to be reduced. For example, the implementation of tax stamps would give consumers, many of whom are currently unwittingly buying illicit goods, the ability to directly combat organised criminal gangs, who run much of the smuggling and diversion, by being able to identify illicit, non-UK-duty-paid product. The £160 million of revenue Customs believes would be produced as a minimum with the implementation of tax stamps would thus be available for allocation to more worthwhile causes and is a significant net social benefit.

Costs

The compliance costs discussed in this section are gross figures. The Government is, however, committed to minimising the compliance cost impact on the legitimate industry and, to achieve this, the compliance costs discussed in this section will be mitigated by a range of offsetting measures. As such the figures in this section overstate significantly the true, net impact.

Option 1: Do nothing

The ‘Do Nothing’ option clearly represents a lower direct cost to business than the other two options. However, the industry and society are already being damaged by fraud. Failure to take effective action to counter fraud will ultimately cause further damage to both, as fraudsters continue to undercut legitimate businesses and consumer confidence in the alcohol industry is undermined.

This could potentially have an impact throughout the supply chain to the consumer. If fraud levels remain high, or even increase (as is expected to be the case with a ‘Do Nothing’ approach), more revenue will be lost, revenue that could be spent in essential areas such as education, health, the environment, or crime-fighting initiatives. Legitimate businesses will also feel an impact if fraud remains unchallenged. Turnovers would be reduced, margins would become tighter, and consumer confidence may be compromised.

As the Government’s objective is to reduce the level of fraud to benefit the spirits industry, the consumer and the taxpayer, it is imperative that we continue to seek out new ways of improving our control of the holding and movement system.

There are measures that could be taken in addition to the current regulatory framework that would not involve any legislative change, such as co-regulation between Customs and the spirits industry, post-market exclusion measures and increased assurance protocols. These would present limited fraud and revenue benefits and these would present compliance costs to legitimate businesses.

Option 2: The spirits industry’s alternative package of measures

Although the industry did not provide any quantified estimate of the compliance costs of its package of alternative proposals, Customs accepts that the costs to the trade would be less than for tax stamps.

Option 3: A tax stamps scheme

The Government recognises that the introduction of tax stamps will place a compliance cost on legitimate businesses. Customs and Treasury officials have held detailed discussions with the industry on the scale and nature of these costs. Based on provisional information provided by the JATCG in February 2004, in response to guidelines and working assumptions for a tax stamp scheme provided by Customs (outlined above), the gross costs – as agreed with the industry - are estimated to be as shown in table 5.

Although these are significant, the Government has indicated that it will seek to minimise them through a number of targeted offsetting measures, including: Customs paying for the printing and distribution of stamps; seeking to ensure that tax stamps do not have to be paid for up-front; the creation of a £3 million fund for capital grants to smaller firms; and a spirits duty freeze for the remainder of this Parliament. Compliance costs may also be affected by the final, detailed design of the tax stamps scheme; the Government is committed to discussing these details with the spirits industry and to reducing final compliance costs wherever possible.

Table 5: Gross costs of Option 3

	Total £m	**Industry average £/case (8.4 litres)**	**Industry average £/bottle (70cl)**
One-off costs	**23.2**	**£0.66**	**£0.06**
Ongoing costs	**53.9**	**£1.54**	**£0.13**

N.B. The costs per case figures are industry averages and measure just the total cost divided by the number of cases. The actual cost feeding through to retail prices may be different. A case typically contains a dozen 70cl bottles or equivalent.

These figures can be further broken down for the whole industry as follows:

Table 6: Breakdown of gross costs of Option 3

Capital costs (one-off)	**£m**
New machinery	15.4
Factory redesign	1.8
Other	5.9
Total capital costs	**23.2**
Ongoing costs	**£m**
Producers’ costs	16.5
Finance costs	23.8
Non-finance costs	7.0
Importers’ costs	4.0
Warehousing costs	2.6
Total ongoing costs	53.9

These figures can also be broken down by small, medium and large firms as shown in Table 7 below. Except where stated, these numbers refer to costs initially incurred by spirits producers. Clearly there are many other stakeholders such as retailers and consumers, who will be affected and who may end up meeting the compliance costs, but the producers are likely to be affected first.

There is considerable variation in costs between individual firms and, because of this, an assessment of the impact on a “typical business” is not available. However, the likely impact on different business sectors and on different sizes of firm can be assessed.

Table 7: Breakdown of gross costs for Option 3 by firm size

(Figures all £millions)	Large firm	Medium firm	Small firm	Total
No. of firms:	9	15	c. 160	
Annual volume (cases):	>1m	100k – 1m	≤100k	
Capital costs (one-off)				
> new machinery	12.8	2.2	0.4	15.4
> factory redesign	1.3	0.5	0.0	1.8
> other	4.1	1.5	0.3	5.9
Total capital costs	**18.2**	**4.2**	**0.7**	**23.2**
Ongoing costs				
> producers' costs	13.0	2.4	1.1	16.5
> finance costs	20.6	3.1	0.1	23.8
> non-finance costs	3.4	3.4	0.2	7.0
> importers' costs	0.0	0.0	4.0	4.0
> warehousing costs	0.0	1.1	1.5	2.6
Total ongoing costs	**37.0**	**10.0**	**6.9**	**53.9**
Capital cost per case	£0.73	£0.75	£0.16	£0.66
Ongoing cost per case	£1.48	£1.78	£1.56	£1.54
Capital cost per bottle	£0.06	£0.06	£0.01	£0.06
Ongoing cost per bottle	£0.12	£0.15	£0.13	£0.13

<u>Offsetting measures</u>

The Government is aware of the compliance costs a tax stamp scheme will impart on the legitimate industry and has taken steps to alleviate the financial burden with a number of offsetting measures. The Government has said that it will:

- **seek to implement the scheme without requiring upfront payment for stamps – preventing increased cash flow costs and ensuring the industry continues to benefit fully from the facilitation offered by duty suspension and deferment;**
- **set aside a £3million fund for assistance with capital investment, targeted at the smallest firms, to offset upfront costs;**
- **bear the full production and distribution costs associated with tax stamps;** and
- to help absorb any costs passed through into prices, **freeze spirits duty for the remainder of this Parliament**.

The Government will also further examine likely security costs, and any scope for reducing these, as part of detailed implementation discussions.

Value of offsetting measures

The compliance costs estimated provisionally by the industry are based on a series of working assumptions set out by Customs in January 2004. Although these are significant, the

Government has indicated that it will seek to minimise them through a number of targeted offsetting measures, including: Customs paying for the printing and distribution of stamps; seeking to ensure that tax stamps do not have to be paid for up-front; the creation of a £3 million fund for capital grants to smaller firms; and a spirits duty freeze for the remainder of this Parliament. Compliance costs may also be affected by the final, detailed design of the tax stamps scheme; the Government is committed to discussing these details with the spirits industry and to reducing final compliance costs wherever possible. Provisional assessments of the impact of the offsetting measures across the industry as a whole are:

Table 8: Impact of offsetting measures

Offsetting measure	Effect on compliance costs
Seek to implement tax stamps without requiring upfront payment.	Cashflow costs, which account for around 40% of total ongoing compliance costs, will be reduced significantly. The benefit will depend on the detail, with an upper limit of £23.8 million p.a.
Customs will bear the production and associated distribution costs of tax stamps.	The estimated benefit is 1p per stamp for production, plus distribution costs. This equates to around £5m-£10m p.a., depending on the complexity of the distribution network.
A fund will be set aside to assist small firms with capital compliance costs.	The fund will be £3m.
Spirits duty will be frozen for the duration of this Parliament.	The tax on a bottle of spirits will be 36p lower in real terms than in 2003-04, assuming a 2-year freeze. This is more than the total compliance costs of tax stamps, although the benefit would be spread across all sectors of the industry, not just those incurring costs.
Security costs will be reviewed with a view to minimising them.	The impact here has yet to be quantified.

The total benefit of all these measures is estimated to reduce compliance costs by up to £35 million, not including the duty freeze.

Equity and fairness

Tax stamps are a necessary response to the growing problem of spirits fraud and are the clear means of addressing the underlying problem and making a real impact by heightening the visibility of fraudulent product by imposing marking requirements on legitimate products. The Government has balanced its consideration of the burden on industry with the need for a highly visible stamp.

The Government has been careful to strike a balance between those costs imposed on the industry and the expected benefits, as well as the need to provide a scheme that is legal and can be applied equally to domestically produced and imported goods.

Option 1: Do nothing

This option will, by its nature, impact all those involved in the alcohol industry. Furthermore, Customs believe that if nothing is done, then alcohol fraud will increase, which will impact negatively on all parties, with very little benefit gained from the Option per se.

Option 2: The spirits industry's alternative package of measures

The industry consider that their alternative package of measures is a more proportionate response to the problem of spirits fraud, and focuses on targeting fraudulent activities rather than those of the legitimate trade.

However, the measures would in practice apply across the spirits industry and would impact on all those dealing legitimately in spirits (producers, warehousekeepers, owners, transporters, retailers and wholesalers), to varying degrees according to the size of the business. In particular, there would be a need for more robust risk analysis, further registration requirements and new notification requirements. While these might not impact on any one sector within the alcohol industry more than another, there may be issues in respect of the impact on small, medium or large businesses within those sectors, the latter of which will potentially find it easier and more affordable to adopt some of the measures than a small business would.

In particular, the extended use of bar coding is probably an option open to larger businesses but less so to smaller ones. The technology itself may be less expensive than it once was, but there would also be research and development costs to consider. There would also be costs relating to the accreditation of warehousekeepers, registration of owners and transporters, notification from warehousekeepers of expected arrivals, licensing of suppliers and retailers and increased record keeping requirements for endorsing invoices with duty payment details. These would all add to business compliance costs, which are likely to be proportionately higher for small businesses.

It should be pointed out that, as many of the components of the package are based on voluntary Memoranda of Understanding, there would, in practice, be no legal obligation for businesses to comply with them. But the effect on those enterprises who might not have the finance or other resources to implement elements of the package would also need to be considered - in terms of whether it would be likely to impact on their ability to compete for legitimate business with their larger competitors, and whether it might have the undesirable effect of attracting fraudsters to their services.

Looking at issues of equity and fairness from a social angle, any reduction in spirits fraud would have a positive effect on producers, wholesalers, retailers and consumers of spirits. However, as the alternative package of proposals does not distinguish between licit and illicit product, it provides no safeguard to retailers that the product they are selling is genuine, nor to the consumers who are purchasing it at, or close to, normal retail prices.

Option 3: A tax stamp scheme

The Government acknowledges that there will be costs for the legitimate industry to comply with a tax stamp scheme, and that this cost may compare unfavourably with the compliance costs for Option 2. However, the Government intends that the package of offsetting measures described above will help reduce these costs significantly. Furthermore, tax stamps are expected to produce an additional £160 million in 2006-07, meaning that the net social benefit of tax stamps is significant and, in the Government's view, clearly justifies the costs.

Small firms' impact test

Customs have used the industry's own definition of a small business, namely a firm that has a spirits output of fewer than 100,000 cases per annum. Around 160 producers are believed to meet this criterion, though the majority are some way below the 100,000 ceiling. The figure of 160 is tentative, as information about this sector of the market is limited.

Option 1: Do nothing

This option effectively sustains the status quo in the current spirits market.

Option 2: The spirits industry's alternative package of measures

The industry did not provide a breakdown of the impact of their alternative package on small businesses. However, it is clear that a number of the voluntary measures being proposed will have a larger impact on smaller firms who may, for example, not have the money to invest in the extended use of bar coding or be able to easily comply with the further registration and new notification requirements.

Option 3: A tax stamps scheme

The industry provided information on the impact of a tax stamp regime on smaller firms. However, this information does not take account of the Government's offset measures so cannot be analysed in isolation. Based on industry data, small firms will have a disproportionate share of the ongoing costs (6.7% of the business and 11.9% of the cost). They suggest that those that have unusual, 'boutique' or quality items will have to adjust their prices upward to cover the cost, and those who sell low ticket items feel they may simply exit the business and allow overseas suppliers to take that part of the market.

The industry has concerns that small producers would have difficulty raising any increased financing required; and that small producers could not afford new tax stamping machinery and so would suffer reduced efficiency from having to apply tax stamps manually. Small importers would need to endure the high cost of rework and so would miss out on just-in-time supply. They also believe that there would be higher expected production costs because of the need to reduce stock holding.

The Government considers that the package of offsetting measures will minimise the potential burdens imposed upon small businesses. In particular, the Government intends to pay for the printing and distribution of the tax stamps, which will significantly ease the financial burden upon smaller firms, and to introduce a system of payments for stamps that minimises up-front costs. Additionally, the provision of capital grants and a continuing duty freeze will make the upgrade or acquisition of machinery less burdensome.

The Government has asked Customs to work closely with the Small Business Service of the DTI on the detailed implementation of the tax stamps scheme.

Competition assessment

Following the Government White Paper *Opportunity for all in a world of change*, the Government is committed to taking into account the potential effects on competition of any new regulation that it introduces.

Option 1: Do nothing

This option effectively sustains the status quo in the current broad based spirits market. Currently, the largest three firms have less than 50% of the total spirits market occupying between 10-15% each. Although the market is innovative, it is not characterised by rapid technological change.

The impact on competition will be minimal, although the legitimate industry may continue to lose market share to illicit sales and fraud, which will continue to distort the market.

In terms of the supply chain, the effects of fraud are most likely to distort competition at the retail end, particularly amongst the "cheapest-on-display" sector.

Option 2: The spirits industry's alternative package of measures

The Government again considers that the impact on competition will be minimal. As compliance costs of this option are lower than for tax stamps, the chances of extra costs affecting competitiveness are reduced. Accordingly, the industry has not identified any direct competition issues, anywhere along the supply chain.

Any reduction in fraud will restrict the competitive distortion caused by illicit sales, though our assessment is that this benefit would be less for option 2 than for option 3.

Option 3: A tax stamp scheme

The industry has highlighted the compliance costs of the tax stamp scheme and the impact that it will have on firms. However, their assessment does not take into account the package of offsetting measures proposed by the Government and therefore this information alone could lead to a distorted picture of the impact on competition.

It is clear that some (generally larger) firms are better placed to apply tax stamps as they already apply tax stamps for their export markets. The industry have indicated that smaller firms will experience greater difficulty than larger businesses although they have not quantified the extent of any competitive distortion.

Although compliance costs will vary between firms, the Government believes that tax stamps alone would not lead to higher set-up costs for new entrants compared to established firms, since all firms will be required to abide by the same requirements. This applies to both set-up and ongoing costs. For new firms, the additional cost of producing spirits with tax stamps is a very small percentage of the total set-up costs of a new business and so should not act as a significant barrier to entry when competing with established firms who have already acquired the equipment.

In considering the different stages of the supply chain, tax stamps may have some impact on price and/or profit margins. Although the Government believes that offsetting measures will minimise the average effect and hence price rises, increases for certain products, or in certain sectors, are likely. In particular because the cost of tax stamps is independent of the product itself, some products (notably at the cheaper end of the market), may be disproportionately affected. The industry has also argued that the spirits market is strongly competitive and therefore price-setting power may already be very limited.

The Government is considering setting an abv threshold below which tax stamps will not be required to be applied, to reflect the fact that lower strength products do not, in general, present the same fraud problems. Evidently, there is some scope for this affecting competition at the margin, as some products would be subject to compliance costs and others would not. However, the Government is committed to setting any such threshold in close consultation with the spirits industry. In this way, it hopes that any adverse competition effects can be avoided or minimised. Similarly, there is potentially scope for displacement of purchases from spirits to other products, such as wine, which will not be required to carry tax stamps and which, to some extent, are in competition with spirits. This will be a particular risk if tax stamps result in retail price increases for spirits. However, as stated earlier, the Government believes that its proposed package of offsetting measures will minimise the risk of retail price increases.

The spirits industry has also suggested that, because of the longer supply chains involved, importers and foreign producers will suffer a competitive disadvantage, largely as a result of the greater cashflow disadvantage that they would suffer from having to pay for tax stamps up-front. However, the Government has announced that it will seek to introduce tax stamps without a requirement for payment up-front and believes that this will remove, or mitigate, any specific disadvantage for importers and foreign producers.

In principle, it is the competitive environment that determines how much profit each part of the supply chain extracts from a transaction and the Government believes that this environment will not be significantly altered by tax stamps. That would suggest that producers will be able to pass a reasonable portion of costs onto retailers and consumers, rather than taking a hit on margins. The Government would also expect a significant proportion of the costs incurred by importers and distributors to be passed on in the same way.

The pricing power of the major players, such as the supermarkets, is very real – particularly in the short-term. However, if prices are affected, the Government believes that the underlying competitive situation will tend to re-exert itself over time and subsequent price changes will tend to see producer margins creeping back to where they would have been without stamps. The Government would expect any effect on the relative profitability of different parts of the supply chain to be temporary, with underlying market forces dictating prices in the long-term.

In addition to price there may be other impacts on consumers, for example in the form of reduced choice if certain products are withdrawn from the UK market. However, the Government believes that its proposed package of offsetting measures will minimise such impacts.

On the positive side, tax stamps do offer a significant benefit because of the greater reduction in fraud expected than with the other two options. The industry have confirmed the damage that illicit sales can do to legitimate businesses, their ability to compete on price, and to small businesses in the retail sector. The Government believes that tax stamps will help transfer market share back to legitimate suppliers. The unfair distortion to competition posed by fraud will thus be restricted.

In conclusion, tax stamps clearly present some competition issues for the spirits sector. However, because of the benefits of its proposed package of offsetting measures, and the fact that tax stamps will apply to all spirits, the Government considers that tax stamps are unlikely to have a significant detrimental effect on competition in the legitimate spirits industry.

Enforcement and sanctions

Option 1: Do nothing

Existing powers and regulatory controls would be used. Clearly this is proving inadequate to tackle the current level of spirits fraud.

Option 2: The spirits industry's alternative package of measures

A number of the alternatives proposed by the industry would necessarily work on the basis a voluntary code of conduct (MoU) between Customs and the industry, since the *vires* do not exist at EU level to legislate for such provisions. Those proposals that do not require regulatory change would be enforced through existing powers under Customs' legislation. As many of the measures effectively rely on self-regulation, there is a risk that parts of the industry will be disadvantaged if others choose not to comply with the code. There would be no action that the Government could take to ensure equity of adherence to the code.

Option 3: A tax stamps scheme

It is not proposed that new offences will be introduced to assess for duty although new sanctions will be required to ensure the robustness of the tax stamp scheme. The offence provisions will be set out in primary legislation and, except for permitted cases under existing legislation (e.g. for legitimate purchases free of UK duty), it is proposed that it will be an offence of strict liability (criminal) to be in possession of, transport, display, sell, or offer for sale, or otherwise deal in unstamped retail containers that are required to bear a duty stamp. The penalty will be that retail containers that are the subject of the offence will be liable to forfeiture and, in addition, a fine up to Level 5 on the standard scale (currently £5,000) may be imposed.

It will also be a strict liability offence (again, criminal) to allow premises to be used for the sale of liquor in, or from, un-stamped retail containers that should bear a tax stamp. The penalties will be as above and in addition the courts will have the power to make an order prohibiting the use of the premises for the sale of alcoholic liquor for up to six months.

In addition to criminal offences, there will be civil penalties for altering a tax stamp after it has been issued, affixing a 'wrong' (i.e. not appropriate to that bottle-size or abv), altered or forged stamp to a container or covering the stamp. In these cases there will be a discretionary fixed penalty of £250 per container or stamp. In addition, duty stamps that have been altered and containers bearing incorrect or obscured stamps will be liable to forfeiture.

Counterfeiting of stamps will be a criminal offence and will be dealt with under existing legislation,[5] as the stamps will be a document issued by the Commissioners of Customs and Excise for an assigned purpose. Current sanctions are, for cases on conviction on indictment, a penalty of any amount, or up to 2 years in prison, or both.

Customs will enforce the tax stamps regime through a programme of visits to wholesale and retail outlets, both in the on- and off-trades, based on risk assessment. The implementation of tax stamps will be accompanied by a Government publicity campaign aimed at spirits consumers, those involved in the supply of spirits in the UK and the wider public. The public will be encouraged to report any instances of offences relating to tax stamps, and this information will play a part in directing Customs' enforcement activity.

[5] s168 Customs & Excise Management Act 1979

Consultations

In late 2001 Customs held a formal consultation on the Roques Report's recommendation that tax stamps be introduced for spirits. Following the consultation, the Government concluded that, whilst the anti-fraud benefits of tax stamps were clear, the industry compliance costs were, at that time, disproportionate to those benefits. The Government, therefore, decided not to proceed with tax stamps while it considered further alternatives.

From July to October 2003 Customs held a formal consultation on a range of regulatory proposals aimed at reducing opportunities for fraud in the alcohol holding and movement system. Following the consultation, the Government concluded that, while some of the measures would have a positive impact in helping to counter alcohol fraud across all sectors of the industry in the short to medium term, the most significant proposals - to radically reduce the movement and sales of alcohol in duty suspension - would not deliver an anti-fraud benefit that was proportionate to its compliance cost to the industry.

Following the announcement in the Pre-Budget Report on 10 December 2003 that the Government planned to legislate to introduce tax stamps unless the industry could propose an equally effective alternative, the Economic Secretary to the Treasury, John Healey MP, and Customs and Treasury officials have held extensive discussions with representatives of spirits producers and importers, warehousekeepers and retailers. Those discussions have focused on all aspects of a possible tax stamps regime, as well as examining in depth a package of alternative measures being developed by the industry.

The Economic Secretary, Treasury and Customs officials also visited a range of businesses in the sector (particularly UK spirits producers). These visits provided much useful information, in particular on: the trade's alternative package of measures; the quality and quantity of tax stamping machinery in place; possible changes to premises and working practices as a result of tax stamps; estimated effects on the efficiency of bottling lines; and counterfeiting and security concerns.

A full list of meetings held since the Pre-Budget Report is at Appendix B.

<u>Other countries</u>

Following the Pre-Budget Report, Customs launched a consultation exercise with the forty EU Member States and third countries that operate a tax stamps scheme, have considered doing so, or have withdrawn a tax stamps scheme. Customs received information from over 20 countries and have held follow-up discussions with a number of these.

It is apparent from this exercise that countries have used strip stamps for a variety of purposes, including quality control and origin authentication, as well as for fiscal reasons. While a number of countries have encountered counterfeiting, the level of sophistication of stamps in those countries has often been relatively low and countries reported positive effects when anti-counterfeiting features were added to stamps.

All countries operating a tax stamp scheme reported that their scheme was considered effective.

A full list of countries with whom Customs has consulted is included in Appendix C.

Alcohol bottling and labelling industry, security printers and anti-counterfeiting

Since the Pre-Budget Report, Customs have also held discussions with manufacturers of bottling and labelling machinery, as well as with the security printing industry and anti-counterfeiting experts.

Through contacts with the security printing industry and anti-counterfeiting experts, Customs have been able to gather helpful information on a wide range of security and anti-counterfeiting technologies and associated costs. The information received will be used as a basis for further discussions with the alcohol industry and to inform the procurement exercise that will lead to the appointment of a contractor to manufacture and distribute tax stamps.

Customs' discussions with manufacturers of labelling and bottling machinery provided information on the quality and costs of machinery currently available and on lead times for delivery of new, and upgrading of existing, machinery.

Other Government Departments

Since the initial consultations, Customs have welcomed input from many Government Departments, including DEFRA, DTI, and the Scottish Executive, as well as the Scottish Parliament.

Monitoring and review

As is the case for all new legislation and policies, Customs will monitor and periodically review the tax stamps scheme in the period following implementation. The alcohol industry will also have regular opportunities to comment on the legislation, its implementation, enforcement and effectiveness through established channels such as the JATCG or JSFTF.

According to now established practice, Customs will continue to publish updated estimates of the scale of spirits fraud annually at the time of the Pre-Budget Report. In the years following implementation of tax stamps, these estimates will be additionally informed by tax stamp data which will be used to record and monitor levels of spirits being legitimately bottled and labelled for release onto the UK market.

Conclusions

In the light of the Government's proposal and the alternatives put forward by the industry, this Regulatory Impact Assessment evaluated the two options – and a third "do nothing" option – against the following criteria: benefits; costs; equity and fairness; impact on small firms; and impact on competition.

Benefits

The "do nothing" option, by definition, delivers no anti-fraud benefits and was therefore discounted from further consideration.

The Government considers that tax stamps remain the most effective response to the serious problem of spirits diversion fraud. Only tax stamps provide the clear benefit of visible differentiation between legitimate and illicit spirits at the retail level, which is key to both deterring and detecting diversion fraud. The compliance costs to the legitimate industry of tax stamps are significant. However, through a carefully-targeted series of offsetting measures that the Government announced at the time of the 2004 Budget, these costs can be minimised.

The Government estimates that the industry's package of alternative proposals will, at best, have an anti-fraud impact that is less than half that of tax stamps. As a whole, the package contains a number of inherent weakness: it leaves the door open for displacement to other types of fraud, most notably inward diversion; it stands to be undermined by a complicit party; and it does not address the issue of identification - the ability for consumers, retailers and Customs officers to distinguish readily between legitimate and illicit product.

Costs

The compliance costs estimated provisionally by the industry are based on a series of working assumptions set out by Customs in January 2004. Although these are significant, the Government has indicated that it will seek to minimise them through a number of targeted offsetting measures, including: Customs paying for the printing and distribution of stamps; seeking to ensure that tax stamps do not have to be paid for up-front; the creation of a £3 million fund for capital grants to smaller firms; and a spirits duty freeze for the remainder of this Parliament. Compliance costs may also be affected by the final, detailed design of the tax stamps scheme; the Government is committed to discussing these details with the spirits industry and to reducing final compliance costs wherever possible.

Although the industry did not provide any quantified estimate of the compliance costs of its package of alternative proposals, Customs accept that the costs would be less than for tax stamps.

Equity and fairness

This assessment concludes that there are no significant issues of equity and fairness raised by any of the options. The wide scope of both tax stamps and the industry package of alternative measures will ensure that businesses are treated even-handedly.

Impact on small firms

Both tax stamps and the industry alternatives are likely to generate comparatively higher compliance costs for smaller firms. For example, small firms may have more difficulty in raising the necessary finance to fund purchases of tax-stamping machinery or up-front payment for tax stamps. Similarly, the new registration and notification requirements in the industry package would impact disproportionately on smaller firms, as would any requirement for investment in bar coding technology.

The Government paid particular attention to the situation of small firms in drawing up its package of offsetting measures. In particular, its £3 million fund for capital grants will be focused on small firms and the commitment to seek to ensure that stamps do not have to be paid for up-front should reduce additional finance, which small firms could least afford.

Impact on competition

Notwithstanding the points made above about equity, fairness and the impact on small firms, this assessment concludes that any adverse impact of tax stamps on competition will be minimised by the package of offsetting measures that the Government announced in the 2004 Budget.

Taking into account all of the above factors, this assessment concludes that tax stamps remains the most effective and proportionate response to the serious problem of spirits diversion fraud.

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MINISTERIAL DECLARATION

I have read the regulatory impact assessment and I am satisfied that the benefits justify the costs.

Signed

Date 06 April 2004

John Healey MP
HM Treasury

APPENDIX A: the SPIRIT INDUSTRY's ALTERNATIVE package of measures

The industry, via the JATCG, has proposed the following measures as an alternative to tax stamps. There is a brief overview of each Proposal followed by Customs' assessment of the measure. An overall assessment of the package, and a quantification of the anti-fraud assessments is included in the main body of this Regulatory Impact Assessment.

Proposal 1 - Risk-based notification of movements and transactions

Summary

- Notification to Customs of all high-risk/abnormal transactions.
- For basic 'notifiable' transactions, the presumption would be that businesses were acting responsibly in terms of carrying out their own checks. Customs would be notified, but intervention or restriction would be the exception, not the norm.
- For 'highest threshold of risk transactions', Customs would be able to apply additional monitoring/controls/restrictions in proportion to the risk assessment.
- Implementation to be taken forward in tandem with development of Memoranda of Understanding.

Customs' Assessment

Customs agree that this proposal would help them focus their assurance activities on high-risk consignments and could help tackle outward diversion, depending on how far in advance of despatch of the goods they would be notified. Ideally, this would need to be at least one working day before, but certainly no later than the time of despatch.

However, there is considerable potential for displacement to inward diversion, whereby fraudsters would export and re-import UK product, or source from overseas producers and suppliers. The measure is also unlikely to identify fraudsters already operating without suspicion within the warehousing system. There is also a high risk that loads would continue to move around warehouses in the UK until a weak link in the system is found.

In addition to this, as is the case with a number of the proposals, as the notification would be voluntary (through Memoranda of Understanding with trade associations involved in the spirits industry or through bi-lateral MoUs with those businesses that are not members) and based in parts on subjective risk assessment, the impact would very much depend on the goodwill and commitment of each individual trader involved. This is in comparison to tax stamps, or other regulatory measures, where compliance is mandatory and enforced through legislation.

Customs' assessment of anti-fraud impact of Proposal 1:
Direct impact on fraud – Medium
Potential for displacement to other types of fraud - High

Proposal 2 - Guarantees

Summary

- Tighter control by the industry on the use of their financial guarantees required for the intra-EU movement of goods, to be adopted as part of MoU arrangements.
- Traders generally to limit provision of their guarantee to movements in which they continue to have a financial interest in the goods.
- Third-party warehousekeepers to operate a basic policy that they do not provide movement guarantees (with relaxations where they are in no doubt as to the bona fides of the owner concerned, e.g. deliveries by owners to major supermarkets).

Customs' Assessment

Customs consider that this proposal is little more than publicising existing policy on the use of financial guarantees that they have regularly discussed with, and publicised to, the industry. The matter has been a regular agenda item at JATCG meetings prior to the alcohol strategy and Customs' policy on the use of movement guarantees, and the implications of allowing them to be used, has been well publicised to the industry in Excise News on two separate occasions.

To reinforce these messages even further, the Government committed in PBR 2003 to examining the scope for a registration scheme for those providing guarantees for holding and movement of alcohol in duty suspension. While this might not necessarily be the form any change to the guarantee system takes, this is a clear signal that the Government are already seeking ways to strengthen the guarantee system, regardless of the introduction of tax stamps. The assertion that this measure could be valued as part of a package of alternatives to tax stamps is therefore questionable.

In addition to this, the industry are referring to potential subjective exclusions and exceptions from the application of the measure, which Customs feel would dilute the anti-fraud benefits of the proposal further. Customs consider there to be a considerable risk of displacement to inward diversion – the UK (HM Customs or the trade) has no influence over whose guarantee is used for an inward movement. The assumption behind the industry's suggestion is that by restricting the use of their guarantees, fraudsters will not be able to move (and thus divert) duty-suspended alcohol, as fraudsters will not be able to get a guarantee of their own. However, fraudsters can, and will continue to, get banks and other financial institutions to underwrite guarantee applications - often using a "clean" front-man or business to do so.

Again, as with Proposal 1, as the measure would be voluntary (as part of an MoU agreement) Customs would have no enforcement powers for non-compliance.

Customs' assessment of anti-fraud impact of Proposal 2:
Direct impact on fraud – Low
Potential for displacement to other types of fraud - High

Proposal 3 - Registration of owners moving goods

Summary

- Extension of current regulatory system for warehousekeepers and owners of warehoused goods (known as WOWGR) to include owners of goods moving in duty suspension in the UK.
- Registration requirement to be applied to inward and outward duty-suspended movements, with provision for duty representatives to be appointed for overseas owners.
- Warehousekeepers would need to be in possession of the relevant WOWGR certificates before the goods are released from/received into a warehouse.

Customs' Assessment

It is already the case that warehousekeepers cannot hold goods on behalf of an owner in a warehouse unless that owner is registered (subject to certain exceptions, which Customs are already addressing through the changes to WOWGR announced at PBR 2003). This means that warehousekeepers should already hold the owner's registration certificate when despatching goods in duty suspension. In addition to this, Customs already ask for, and check details of, the WOWGR registration of the owner to whose account the goods are to be received at the intended warehouse of destination when challenging inward movements.

The proposal for registration of owners moving goods was first put forward as one of the Alcohol and Tobacco Fraud Review recommendations in 1998. The outcome was the implementation of WOWGR in 1999. Due to legal difficulties with the full proposal, these regulations only cover the owners of goods in warehouse rather than owners of goods in transit. Our legal advice is that those difficulties still stand – that there is currently no margin in EU law to introduce the type of scheme proposed.

Customs also consider that, were such a scheme to be introduced, its effectiveness would be reduced by goods being bought or sold whilst outside the UK. Neither would it do anything to address the existing difficulties in tracking and tracing movements of goods all along the supply chain.

Customs' assessment of anti-fraud impact of Proposal 3:
Direct impact on fraud – Low
Potential for displacement to other types of fraud - High

Proposal 4 - Use of trend analysis information

Summary

- Improved use and analysis of W1 warehouse returns (submitted by spirits producers and 3rd party warehousekeepers operating tax warehouses) in order for Customs to spot trends in sales, ownership, exports, etc. and use for risk-analysis purposes.

Customs' Assessment

The improved use and analysis of W1 returns would help to provide a better understanding of the dynamics of the duty suspension system and is something that Customs are developing, regardless of tax stamps, in order to improve intelligence, trend analysis and targeting of assurance activity. Customs expect to have a new alcohol intelligence coordination team in place in April 2004 to undertake this precise function. Ongoing and improved use of trend analysis information is something that that will be addressed as part of a wider Excise modernisation and e-business programme. However, there are limitations to proposal this as a direct anti-fraud measure, as the information provided on the W1 is largely historical.

Customs' assessment of anti-fraud impact of Proposal 4:
Direct impact on fraud – No additional impact (as action already planned)
Potential for displacement to other types of fraud – Not applicable

Proposal 5 - Introduction of a new machine to uniquely process movement documents

Summary

- Assessment and possible adoption of a system reportedly in operation in France for uniquely-stamping movement documents to help counter inward and outward diversion frauds in advance of the electronic EU-wide Excise Movement and Control System (EMCS).
- In addition, Customs to consider:
  - asking for all movement documents to be sent to them for the necessary checking of stamped documents to take place; and
  - requiring Copy 3 AADs[6] to be returned to other Member States through them.

Customs' Assessment

Preliminary research undertaken by Customs has indicated that the system is only used in France for Registered Mobile Operators (such as the ferry operators). Customs await further information from French Fiscal Authorities.

Customs understand that the machine merely provides a more sophisticated stamp of receipt by the consignee warehousekeeper. It is not clear how a unique serial number will assure the consignor warehousekeeper that the goods were properly received – unless he was otherwise aware of what the number should be.

Customs' assessment of anti-fraud impact of Proposal 5:
Direct impact on fraud – Expected to be low
Potential for displacement to other types of fraud - Low

Proposal 6 - Registration and control of transporters

[6] (AAD) The document that must accompany goods moving between tax warehouses in the European Union.

Summary

- Customs to introduce a requirement for transporters of duty-suspended spirits to be registered before being allowed to carry duty-suspended goods.
- In the interim, and possibly as a fall-back position, producers and warehousekeepers to put into place a code of best practice to heighten awareness and improve the control of transporters, endeavouring to ensure the wider and more consistent distribution of the Customs leaflet for transporters of excise goods.
- To also set out guidelines to be followed by warehousekeepers despatching goods in duty suspension to enable them to identify risk factors that may warrant drawing particular assignments to the attention of Customs. These would be notified to Customs under the remit of Proposal 1, and incorporated within MoUs where possible.

Customs' Assessment

Improved control of the risks inherent in the movement of duty-suspended alcohol (not just spirits) is already being progressed through Customs' work on the "recognised transporters' scheme" (Regulatory Option 7) announced at PBR 2003. Under this scheme, Customs will keep a list of transporters and hauliers who have a good compliance history with Customs and have not been the transporter or haulier for any duty-suspended movements of alcohol that have not reached their destination.

Customs' legal advice is that a fuller compulsory registration system is unlikely to be able to be devised in a way that would not, in practice, favour UK-based transporters, and would therefore be ultra-vires EU law.

A code of best practice as an interim measure, while useful, again falls under the remit of the voluntary MoUs. The transporters leaflet was first published in November 2002 so the impact of attempting to distribute it more widely is likely to have a negligible additional impact on fraud.

Customs' assessment of anti-fraud impact of Proposal 6:
Direct impact on fraud – Low
Potential for displacement to other types of fraud – Low

Proposal 7 - Placing Customs officers in 'high-risk' warehouses

Summary

- A proposal for a system of 'invigilation' at warehouses known to be utilised by owners regarded as "high risk".

Customs' Assessment

Previous 'saturation' exercises, where Customs have spent considerable periods of time at a high-risk warehouse, have been deemed successful in disrupting and frustrating frauds. But while a system of 'invigilation' would, in all likelihood, provide a moderate impact on outward diversion, and potentially a knock-on effect on inward diversion, there remains a high risk of displacement to other forms of fraud, including the misuse of other regimes (notably Registered Excise Dealers and Shippers) and smuggling.

We also need to be mindful when evaluating the effect of the proposal that fraud rarely takes place in the warehouse (although we accept that the presence of officers in warehouses deters high-risk consignments from moving in and out).

Customs currently deploy their resources on the basis of risk assessment and their operational activity is continually being refined and developed. The deterrent and preventive impact of this form of assurance is clear as high-risk owners avoid the particular warehouses and move their operations to other warehouses. Customs will continue to use ‘saturation exercises’ where and when they believe it is appropriate to do so.

Customs’ assessment of anti-fraud impact of Proposal 7:
Direct impact on fraud – Medium
Potential for displacement to other types of fraud - High

Proposal 8 - Greater use by Customs of Administrative Accompanying Document (AAD) copy 4

Summary

- Customs to consider whether they should require submission of copy 4 of the Accompanying Administrative Document (AAD)[7] to obtain information about despatching warehouses and about trends in brands being imported.
- Could be linked to the possible introduction of a requirement for traders to send copy 3 to Customs in line with the procedures outlined in Option 5 (AAD machine).
- Customs to consider Information to be submitted on a risk basis given likely volumes.

Customs’ Assessment

The benefits of this measure are questionable, given that in practice, only the copy 4 for goods that have been received into a warehouse would be submitted, and so would only allow Customs to monitor trends in the legitimate sector. It would fail to track the copy 4s relating to diverted/duplicate loads (i.e. where there is multiple use of the same AAD).

In any case, in order to properly build up a picture of all spirits being imported into the UK to inform its risk assessment and help target assurance activity, Customs would require copies of all AADs to be submitted, rather than on a risk basis. This would have obvious and considerable resource implications, for both Customs and businesses, and the viability of the measure as an interim source of information in advance of EMCS is therefore questionable.

[7] (AAD) The document that must accompany goods moving between tax warehouses in the European Union.

It is also the case that brand information is not mandatory and, therefore, is not necessarily detailed on the AAD. While it may be useful to provide a means of identification of trends in brands of imported product, it may be that this information is best obtained through amendments to the W1, which provides global information of receipts into stock, rather than through the AAD system.

Customs' assessment of anti-fraud impact of Proposal 8:
Direct impact on fraud – Low
Potential for displacement to other types of fraud - Low

Proposal 9 - Warehousekeepers to provide information about expected arrivals

Summary

- Fraudsters often book storage space in warehouses to provide cover for themselves if an inward-bound load intended for diversion is intercepted by Customs on arrival in the UK.
- Warehousekeepers are offering to provide information on booked arrivals that fall within parameters to be agreed with Customs, under the remit of Memoranda of Understanding.
- Warehousekeepers will advise of repeated failure of booked consignments to reach the warehouse.

Customs' Assessment

Customs consider that this measure does have merits - provided that it would deliver comprehensive real-time information on expected arrivals (with no exceptions), cancelled loads, consignments, which have failed to arrive, and unexpected and rejected arrivals.

It has the potential to speed up the discreditation process (benefiting both Customs and the legitimate trade) and to play a part in deterring inward diversion, possibly allowing, depending on the level of information provided, Customs' frontier staff to spot duplicate loads, and to track and target imports considered high-risk.

However, key to its value as an effective anti-fraud tool is how the measure would be implemented. As a voluntary part of a MoU, its effectiveness will rely on a trader's good will and commitment. The effect of the Proposal could also be lessened by the application of risk parameters to reduce numbers of notifiable movements.

Customs' assessment of anti-fraud impact of Proposal 9:
Direct impact on fraud – Medium
Potential for displacement to other types of fraud – Low

Proposal 10 - Notification of cash transactions

Summary

- Legitimate business to take action under new regulations governing money laundering, if asked to accept large sums of cash in payment for goods.
- Trade to notify Customs, possibly under the MoUs being developed, of transactions falling within certain "risk parameters" so that "unusual" transactions could be the object of closer scrutiny.
- Any unusual method of payment for warehouse services, such as cash, could also be advised to Customs as a potential fraud indicator to be used in their risk assessment.

Customs' Assessment

As presented by the industry, this proposal appears to give Customs little beyond Proposal 1 (risk based notification of movements and transactions). The measure is also vulnerable in that the industry proposes that the MoU may cover this and, other than for requirements under the money laundering regulatory provisions, is therefore, voluntary and reliant on industry cooperation.

Implementation of Option 3 of the regulatory proposals, which was announced at PBR 2003 would, on the other hand, make mandatory notification of cash or advance payments above specified limits (proposed as £5,000 for goods and £2,000 for services) and so allow sanctions in the event of non-compliance.

Customs do, however, acknowledge the link between Regulatory Option 3 and the money laundering provisions and committed in PBR 2003 to exploring how any potential for duplication of information could be avoided.

Customs' assessment of anti-fraud impact of Proposal 10:
Direct impact on fraud – Not applicable (already scored under Proposal 1)

Potential for displacement to other types of fraud – Not applicable

Proposal 11 - Registering or licensing of alcohol suppliers and retailers

Summary

- A registration scheme, operated by Customs, for those wholesalers not already covered by the Licensing Act 2003 with wholesalers 'confirming' their status as licensed operators through, perhaps, provision of their licence number on their invoices (as with a VAT registration number).
- Changes to the Licensing Act to give Customs the status of a "responsible authority" to revoke or request a review of a licence and to include dealing in illicit goods in the list of offences.

Customs' Assessment

A separate registration for duty purposes could enhance the regulation of businesses dealing in alcohol in the UK, improving Customs' ability to identify and control this part of the supply chain through approval scrutiny and assurance activity, and allowing effective sanctions to be applied where they detect offences/irregularities.

However, wholesalers dealing in alcohol will be registered for VAT purposes, and as such are already subject to regulatory control by Customs. Enhanced control of these businesses through the VAT assurance programme will be explored as part of Customs' whole-trade approach to risk and assurance. Moreover, while a licensing system for duty purposes might allow Customs to eliminate some fraudsters, others will inevitably succeed in getting re-licensed under the cover of a new business or 'clean' front-man.

Customs have already identified provisions in the Licensing Act 2003, which they believe require amendment to reflect developments since the law was drafted and to take account of the introduction of tax stamps in 2006. They will be exploring these further in discussions with the Department for Culture, Media and Sport and making recommendations to Ministers for change.

Customs' assessment of anti-fraud impact of Proposal 11:
Direct impact on fraud – Low
Potential for displacement to other types of fraud - Low

Proposal 12 - Extended use of bar coding technology to improve traceability

Summary

- Customs to make more use of modern technology.
- Proposal based on international work currently underway to develop a track and trace system using sophisticated bar coding language.
- Customs to progress towards the use of the European Article Number bar coding standards.
- Will provide a method of capturing data at individual transport unit levels, enabling the tracking and tracing of individual pallets and/or cases.
- Could be used to capture additional information on the product, including its duty status, if required.

Customs' Assessment

Customs consider that this proposal has long-term benefits in improved tracking and tracing, and has already commissioned preliminary work to explore the extent to which it may assist in improving compliance across VAT, excise and international trade. However the potential benefits are not likely to be widely realised until well beyond 2006.

Until technology can guarantee to identify the whole supply chain (producer to retailer), tracking and tracing is of only limited benefit to Customs' anti-fraud work. Currently, at best, only the first customer in the supply chain can be identified. Emerging technologies such as Radio Frequency Identification may, in time, offer the ability to track legitimate supply chains throughout their length (producer to retailer and everyone between) but only for those parties using the technology – which is unlikely to include the fraudsters (who have been known to deliberately remove or obliterate marks and numbers to prevent tracking and tracing).

Customs' assessment of anti-fraud impact of Proposal 12:
Direct impact on fraud – Low
Potential for displacement to other types of fraud - Medium

Proposal 13 - Endorsing invoices with duty payment details

Summary

- Customs to consider requiring those dealing in spirits to endorse details of duty payment on sales invoices in order to trace goods back through the supply chain to the source at which duty was paid.
- Could be tied in with Proposal 11 (licensing).

Customs' Assessment

Customs have identified no immediate legal barrier to implementing this proposal and consider that, in theory, it could allow for more effective, quicker identification of non-duty paid products.

But in practice, it is likely that fraudsters would falsify invoices and make sure they 'disappeared' before Customs tracked the supply chain back to the point of duty payment.

Any measure along these lines would also need invoices to show marks and numbers of products subject to the transaction, to prevent suppliers holding a single duty-paid invoice to cover a much larger stock, to have a more significant anti-fraud impact.

Customs assessment of anti-fraud impact of Proposal 13:
Direct impact on fraud – Low
Potential for displacement to other types of fraud - Low

Proposal 14 - Improved intra-EU mutual assistance arrangements

Summary

- The industry consider that proposals published in January 2004 by the European Commission to strengthen the effectiveness of the intra-EU mutual assistance provisions to combat excise duty fraud will further improve the efficiency of anti-fraud initiatives.

Customs' Assessment

Work is already underway, outside the remit of the alcohol strategy, to bring existing mutual assistance activities throughout Member States into a single legal instrument. Changes are due to be implemented in January 2005.

Mutual assistance between Member States is accepted good practice and Customs hope that improved arrangements will mean that the time taken to gain an awareness of ongoing fraud may be reduced as a result of the proposals. However, the mutual assistance arrangements will still remain reliant on the priorities and actions of other Member States and will continue to have a long response time in many instances. They also tend to be "after the event", therefore offering little "real-time" protection against fraud.

In any event, it is difficult to attribute an additional anti-fraud benefit to this proposal as part of a package of alternatives to tax stamps, as the initiative is already in progress, and will be taken forward regardless of the implementation of tax stamps.

Customs' assessment of anti-fraud impact of Proposal 14:
Direct impact on fraud – No additional impact as action is already planned
Potential for displacement to other types of fraud – Not applicable

Proposal 15 - Excise Warehouse Approval Project

Summary

- A current Customs initiative is for the adoption of a standardised approach to authorising, approving and controlling warehouses.
- The industry consider that the increased awareness of a warehousekeeper's obligations that should come from this exercise, coupled with a consistent use of conditions and requirements, will themselves lead to a reduction in opportunities for fraud.

Customs' Assessment

This is a project currently being undertaken by Customs to improve the standard and consistency of approval documentation and was set up in response to Customs' own internal reviews of approvals.

While a more consistent approach to excise warehouse approvals may bring some anti-fraud benefits, this is very much "business as usual" for Customs, planned and accounted for as part of ongoing operational work, regardless of tax stamps or any other part of the alcohol strategy. For this reason, the suggestion is again not considered to be a viable 'alternative' to tax stamps.

Customs' assessment of anti-fraud impact of Proposal 15:
Direct impact on fraud – No additional impact, action already planned
Potential for displacement to other types of fraud – Not applicable

Proposal 16 - The accreditation of excise warehousekeepers

Summary

- Proposal for a 'standards' system, similar to practices already adopted by other Government Departments responsible for 'policing' activities – e.g. Department of Transport requiring hauliers and bus operators to have at least one member of management who holds a Certificate of Professional Competence before they are granted an Operator's Licence.
- Would require significant development, including with external examining bodies, and a partnership approach with Customs.
- Would begin at a future date, for new applicants for excise warehousing authorisation.
- Trade consider that this would lead to a substantial improvement in warehousekeepers' understanding of, and compliance with, official requirements to the benefit of all parties.

Customs' Assessment

Customs consider that while this proposal may have some benefits in the longer term (probably post-2006) in terms of promoting best practice and fraud awareness, it is largely cosmetic as a direct anti-fraud tool. Depending on the criteria for accreditation, they consider that the measure would probably have more of an impact on compliance in terms of record keeping and a reduction in civil penalties for minor infringements, than a significant shift away from fraudulent activity.

Moreover, Customs' legal advice confirms that an accreditation requirement could not be applied to existing warehousekeepers - only for new authorisations - and so the potential anti-fraud impact of the measure would be considerably be reduced. In practice, it is also likely that a fraudulent warehousekeeper will be able to gain accreditation just like his legitimate competitors.

Customs' assessment of anti-fraud impact of Proposal 16:
Direct impact on fraud – Low
Potential for displacement to other types of fraud – High

Proposal 17 - The role of the JSFTF, the new JWFTF and Memoranda of Understanding

Summary

- The development of Memoranda of Understanding between trade associations and Customs underpins a large number of proposals in the industry's package of alternatives to tax stamps.
- MoUs will contain very specific guidelines on a wide range of activities designed to contribute to the anti-fraud efforts, and will be living documents which can develop and change to meet changing business practices and methods employed by fraudsters.
- Spirits producers have already been developing such an approach in partnership with Customs, and the proposal is that other trade associations will set up similar agreements with Customs.
- Industry also proposes to carry on the work of the Joints Spirits Fraud Task Force (JSFTF) for spirits producers and expand the concept to include a similar task force for warehousekeepers (JWFTF).

Customs' Assessment

As the concept of MoUs was already being developed in the context of the JSFTF, Customs acknowledge that a collaborative approach to tackling alcohol fraud has benefits in defining and promoting best practice. However, these benefits are not of the magnitude of tax stamps. Experience has shown that co-operative working with the industry is not enough, by itself, to tackle the problem of alcohol fraud. Much would depend on the agreement of the risk parameters within the MoUs, the speed and ease with which such parameters could be changed (re-negotiated) to reflect changes in fraud trends. When viewed as a measure for tackling fraud outright, the fact that the MoUs are voluntary, reduces any potential anti-fraud impact.

The JSFTF has provided a useful forum for discussion with spirits producers and importers, and Customs and the warehousekeepers' trade representatives have started discussions on the creation of a parallel forum for 3rd party warehousekeepers. It is hoped that these initiatives will continue.

However, this proposal taken as a whole appears to offer very little over and above the industry's Proposal 1.

Customs' assessment of anti-fraud impact of Proposal 17: Direct impact on fraud – Low (largely covered by Proposal 1) Potential for displacement to other types of fraud – Not applicable

Appendix B: MeetingS held BETWEEN THE ECONOMIC SECRETARY TO THE TREASURY, CUSTOMS AND TREASURY OFFICIALS, AND spirits industry and interested parties since Pre-Budget report 2003

Date	Attendees
10/12/2003	EST met the All-Party Parliamentary Scotch Whisky Group
11/12/2003	Scotch Whisky Association (SWA) HMC&E
16/12/2003	SWA Economic Secretary to the Treasury (EST) HMC&E
16/12/2003	Gin & Vodka Association (GVA) EST HMC&E
16/12/2003	Wine & Spirits Association (WSA) EST HMC&E
17/12/2003	SWA HMC&E
22/12/2003	SWA HMC&E
06/01/2004	SWA HMC&E
08/01/2004	SWA HM Treasury (HMT)
08/01/2004	GVA HMC&E
09/01/2004	Bacardi-Martini HMC&E
12/01/2004	JATCG HMT HMC&E
14/01/2004	SWA GVA HMT HMC&E
15/01/2004	SWA (UK Distilling Industry C&E Committee) HMC&E
21/01/2004	SWA GVA WSA HMT HMC&E
21/01/2004	*JATCG* HMT HMC&E
22/01/2004	Diageo Plc EST HMT HMC&E
23/01/2004	*JATCG* HMC&E
28/01/2004	SWA United Kingdom Warehousing Association (UKWA) Bonded Warehousekeepers Association (BWA) HMC&E
02/02/2004	GVA

	WSA SWA HMT HMC&E
02/02/2004	JATCG HMT HMC&E
03/02/2004	All-Party Parliamentary Scottish Whisky Group EST
05/02/2004	WSA Tesco Allied Distillers Somerfield Matthew Clark HMT
10/02/2004	JATCG EST HMT HMC&E
13/02/2004	Maxxium UK HMC&E
17/02/2004	Thames Distillers GVA HMT
19/02/2004	UKWA BWA HMC&E
20/02/2004	JATCG HMC&E
23/02/2004	EST John McFall, MP Dumbarton HMT Morrison Bowmore Distillers Auchentoshan Distillery Whyte and MacKay WM Grant & Sons Broxburn Bottlers Glenmorangie Plc Edrington Group Diageo GB SWA Allied Distillers
23/02/2004	Diageo plc HMC&E
23/02/2004	*Ian MacLeod & Co.* HMC&E
24/02/2004	UKWA HMC&E
26/02/2004	JATCG (sub-group) HMCE HMT
26/02/2004	JATCG (sub-group) HMC&E
27/02/2004	WSA and small importers representatives HMC&E
01/03/2004	Full JATCG HMC&E HMT
01/03/2004	Penderyn Single Malt Whisky HMC&E
01/03/2004	Greenalls HMCE

02/03/2004	Whyte & MacKay HMC&E
03/03/2004	SWA EST HMT HMC&E
03/03/2004	Speyside Distillers HMC&E
03/03/2004	The Edrington Group HMC&E
04/03/2004	Kingsland Wine and Spirits HMC&E
09/03/2004	Angus Robertson (MP) Gordon & MacPhail (Distillers) EST
10/03/2004	EST met the All-Party Parliamentary Scotch Whisky Group

Appendix C: Other countries consulted

- Albania
- Belarus
- Belgium
- Bolivia
- Brazil
- Bulgaria
- Czech Republic
- Denmark
- Egypt
- Estonia
- Germany
- Greece
- Hungary
- Italy
- Japan
- Kazakhstan
- Kyrgyzstan
- Latvia
- Lithuania
- Macedonia
- Morocco
- Norway
- Philippines
- Poland
- Portugal
- Spain
- Thailand
- Uruguay
- USA
- Vietnam

APPENDIX D: SUMMARY OF PREVIOUS CONSULTATIONs ON THE INTRODUCTION OF TAX STAMPS

The Roques' Report recommended that Customs move as quickly as possible to introduce tax stamps for spirits, and associated sanctions, to protect both excise revenues and the UK's whisky production. In response, the Government announced that Customs was undertaking feasibility research on the range of fiscal marking for spirits, from tax stamps to label marks (as had recently been introduced for tobacco). In August 2001 Customs opened discussions with the main spirits and warehousekeeper trade associations to elicit their help in establishing, *inter alia*, the compliance costs of introducing a fiscal mark, both in the form of a tax stamp and as a label mark.

Through its research, Customs noted that different marks can be more effective against different kinds of fraud, and the nature of the industry is also an important consideration. Tobacco is a fairly homogenous product (e.g. smaller number of retail package sizes than alcohol), produced by a handful of mainly domestic manufacturers for the UK market who generally know in advance (because of the need to apply language-specific health warnings) which specific markets they are producing for. Also, the arrangements governing the duty-suspended movement of tobacco are very restricted - in broad terms, from the production premises, it is not allowed to move anywhere other than directly onto the UK market or to export, so opportunities for fraudulent diversion are limited. All of these factors affect the judgement of the kind of fiscal mark that would be effective. Customs concluded, therefore, that a label mark would not be effective in tackling spirits fraud and that further consultation should focus on a tax stamp scheme. Tax stamps would provide three key benefits: (i) squeezing a fraudster's profit by, for example, reducing the price that can be charged for illicit product; (ii) easing the identification of illicit product; and (iii) provide new sanctions and easier application of them.

The informal discussions produced a range of important information and views from a number of key stakeholders. It informed a formal consultation on tax stamps, announced at the time of the Pre-Budget Report in November 2001 and launched on 11 December 2001. The purpose of this formal consultation, which ran until 5 March 2002, was to outline how a tax stamps system might work in practice, what its impact would be and who would be affected. It was also designed to seek specific information and views on a series of questions contained in the Consultation Document, *Tax Stamping of Spirits*, as well as general comments on the proposal as a whole. This formal consultation enabled a wider audience, particularly businesses in the wholesale and retail sectors who had not previously been consulted, to offer views and contained a series of questions specifically targeted at these sectors.

Over the course of the consultation process Customs received input from numerous stakeholders from all sectors, including: 17 different trade associations; 21 producers; 10 representatives of the retail and wholesale sectors; 10 responses from warehousekeepers, bottlers, and importers; and several replies from other interested parties, such as packaging, intelligence, Government, and legal specialists. Ministers and officials also attended several meetings with various stakeholders in the spirits, security printing, and machine manufacturing industries.

<u>UK producers and importers of spirits</u> were opposed to tax stamps primarily due to the negative impact they would have on cash-flow costs and production efficiency, particularly with regard to smaller bottling plants. They also had concerns that the introduction of tax stamps in the UK would undermine their efforts to seek abolition of tax stamps in foreign markets.

Large wholesalers and retailers, able to buy and store spirits in duty-suspension, opposed tax stamps, mainly because of potential loss of cash-flow advantage through having to buy stamped spirits at prices inclusive of an amount paid up-front for the stamps.

Smaller wholesalers and retailers offered no consensus view. Some said that they would welcome tax stamps, provided that they were allowed a reasonable period of time to clear the shelves of unstamped stock. Those that opposed the concept were concerned that the scheme would impose additional costs upon them.

Excise warehousekeepers involved in trading duty-suspended spirits were concerned about the implications on cashflow and potential loss of business.

The ferry and airline industries voiced their concerns about the practical difficulties stamps would cause in operating the arrangements put in place following the abolition of duty-free sales on intra-EU journeys.

It was clear from the consultation process that the introduction of tax stamps would have a real impact on the productivity and compliance costs of the spirits industry which – if passed on in full – could have a significant impact on retail prices for spirits. In Budget 2002, the Government announced, therefore, its decision not to proceed with tax stamps at that time, considering those costs disproportionate to the benefit of tax stamps, if alternative means of making progress against spirits fraud could be pursued.

Instead, it said that Customs would work with the spirits industry on a joint strategy to identify, trace and track illicit consignments of spirits, increasing their exchange of information and, hopefully, making fraud easier to detect through the development of product testing kits and enhanced barcode data. The Government also announced additional funding for Customs to enable them to step up the volume of intelligence-based checks on inward freight consignments of duty-suspended spirits (making full use of the national network of x-ray scanners), increase disruption of the criminal gangs engaged in spirits fraud, and strengthen their controls on UK excise warehouses.

Appendix E: Index of published documents

Ref No.	Title/Website Address	Date of Publication
1	**Tackling Indirect Tax Fraud** **http://www.hm-treasury.gov.uk/media/933B7/Fraud%20Complete.pdf**	November 2001
2	**Tackling Tobacco Smuggling** **http://www.hm-treasury.gov.uk/media/BAA80/433.pdf**	March 2000
3	**Protecting Indirect Tax Revenues** **http://www.hm-treasury.gov.uk/media/835C3/adprotect02-173kb.pdf**	November 2002
4	**Measuring and Tackling Indirect Tax Losses** **http://www.hmce.gov.uk/forms/budgetnotices/pbr-2003/meas-ind-tax-loss-03.pdf**	December 2003
5	**Opportunity for all in a world of change** **http://www.dti.gov.uk/opportunityforall/pages/contents.html**	February 2001
6	**The collection of excise duties in HM Customs and Excise – Report by Mr John Roques and the response by Her Majesty's Government to the recommendations in the report** **http://www.hmce.gov.uk/about/reports/roques.pdf**	July 2001
7	**Tax Stamping of Spirits – Consultation Document** **http://www.hmce.gov.uk/business/consultations/alcoholtaxstamps.pdf**	December 2001

APPENDIX TO REGULATORY IMPACT ASSESSMENT FOR TACKLING SPIRITS FRAUD

Introduction

1.1 This is an appendix to the Regulatory Impact Assessment "EXCISE: Tackling Spirits Fraud", published on 8th April 2004[8]. It updates on the arrangements for implementation of the recommended measure contained within that assessment (a duty stamps scheme for spirits) to take account of changes to the scheme which have arisen out of further consultation with the spirits industry and the Government's commitment to minimise the compliance burden on the industry.

Background

2.1 The original Regulatory Impact Assessment set out and assessed the case for tackling the problem of spirits fraud through the introduction of a scheme which would require retail containers of spirits to bear a duty stamp to indicate that UK duty had been paid. Much of that original Regulatory Impact Assessment remains unchanged and therefore does not require updating in this appendix.

2.2 Customs estimated, in their report "Measuring and Tackling Indirect Tax Losses" published in December 2003, that spirits fraud had cost the Exchequer £600 million in 2001-02 and was on an upward trend. Having considered a number of alternative options and after lengthy discussions with the industry, the Government concluded that duty stamps were the most effective response to the problem. Primary legislation for the scheme was introduced in Finance Bill 2004, with a commitment to bring the scheme into effect in 2006.

2.3 At that time, whilst concluding that duty stamps were necessary to combat spirits fraud, the Government recognised the significant compliance burden on the legitimate industry that would arise from implementing the scheme. It therefore made the commitment that the final scheme would be designed to minimise compliance costs as far as possible. In particular, the Government said that it would explore the possibility of Customs funding the printing and distribution of stamps and that it would seek to ensure that there would be no up-front payment for stamps. The Government also announced a spirits duty freeze and a £3million capital grants fund to help smaller businesses to meet capital costs incurred as a result of the proposed scheme.

2.4 In the 2004 edition of "Measuring and Tackling Indirect Tax Losses", Customs' spirits fraud estimate was revised downwards from £600 million to £450 million for 2001-02 and a new estimate of £250 million was published for 2002-03. While this estimate was considerably lower than the figures previously published, the Government stated that the revenue loss remained significant and unacceptable and confirmed plans to introduce duty stamps in 2006 as part of a comprehensive alcohol strategy, while reaffirming its commitment to minimising compliance costs. (In the 2005 edition of "Measuring and Tackling Indirect Tax Losses", spirits fraud is estimated at £250 million for 2003-04.)

2.5 HM Revenue and Customs (HMRC) have continued to work closely with the industry since Budget 2004 to ensure that this objective is achieved. The result is secondary legislation which imposes far less costly compliance burdens than originally envisaged.

2.6 This Appendix to the existing Regulatory Impact Assessment therefore updates the details of the scheme and re-evaluates its compliance costs.

<u>Reducing the compliance costs of duty stamps</u>

[8] www.hmrc.gov.uk/practitioners. (Can be found under Reference documents, RIAs under Library listing for VAT, Customs & Excise).

The Original Duty Stamps Model

Table 1: Original Option 1 Costs (£ Millions[10])			
	Large Firms	**SMEs[11]**	**Total**
Annual Volume (cases)	> 1m	< 1m	
Capital Costs (one-off)			
New machinery	12.8	2.6	15.4
Factory redesign	1.3	0.5	1.8
Other	4.1	1.8	5.9
TOTAL CAPITAL COSTS	**18.2**	**4.9**	**23.1**
Ongoing costs			
Producers' costs	13	3.5	16.5
Finance costs	20.6	3.2	23.8
Non-finance costs	3.4	3.6	7
Importers' costs	0	4	4
Warehousing costs	0	2.6	2.6
TOTAL ONGOING COSTS	**37**	**16.9**	**53.9**
Capital cost per case	£0.73	£0.49	£0.66
Ongoing cost per case	£1.48	£1.69	£1.54
Capital cost per bottle	£0.06	£0.04	£0.06
Ongoing cost per bottle	£0.12	£0.14	£0.13

3.1 The original proposal was for a traditional strip stamp scheme – a paper strip affixed to the retail container across the opening or over the stopper of the bottle. The stamps would be "purchased" in advance at a price equivalent to the duty payable on the product in the retail container plus the unit cost of the stamp. In the event of an irregularity, liability for the duty associated with the stamps would rest with the person who acquired them (usually the producer or the brand owner). The scheme would apply to all spirits products and all wine/made-wine products with an alcoholic strength of more than 22%.

3.2 Compliance costs for this scheme were estimated at £23m for first year capital costs and £54m for ongoing costs each year.[9] A high proportion of the capital costs related to the initial outlay for strip stamp application machinery, and a large part of the ongoing costs arose from the cash flow cost of providing a payment equivalent to the duty in advance of the actual duty point.

3.3 The details of full costs of the original scheme are set out in table 1 below (reproduced from original RIA):

[9] These figures were subsequently revised downwards to £20m and £44m as a result of introducing an abv threshold of 30%. See paragraph 4.1(a)

[10] The aggregates costs here were revised down from the £54m published in RIA by compliance cost estimates from JATCG, 7 October 2004 to £51m but as the costs on the individual items are not affected significantly the breakdowns here are not amended.

[11] "SMEs"are Small and Medium Size enterprises producing less than 1 million cases per year.

Customs Proposal - A Label Stamp Scheme, With Up-Front Payment For Stamps Or Provision Of Financial Security

3.4 Customs listened to the industry's concerns and accepted that allowing stamps to be incorporated into bottle labels would significantly reduce capital costs, as existing labelling machinery could be utilised. They therefore proposed that a label stamp alternative could be offered. However, the acquirer (usually the producer or brand owner) of the duty stamps would still have to secure that acquisition with a form of financial security and would remain liable for ensuring that duty was accounted for on that stamp when it passed the duty point.

Industry Proposal - A Label Stamp Scheme, With Liability For The Stamps Being Passed Down Through The Supply Chain

3.5 Industry were content with the label stamp proposal, but remained concerned at the cash flow implications that resulted from liability for the amount equivalent to the duty resting with the producer. They proposed that liability for the stamp should rest not with the producer, but instead be passed through the supply chain as ownership of the goods changed hands, using a system of "electronic handshakes". Liability for the stamps would then remain with whomever in the supply chain was last recorded as holding the product in the event that it went missing or was diverted. The system would be regulated by means of a Customs IT system, which would allow Customs to monitor the entire duty suspended supply chain.

Analysis of industry proposal

3.6 The Government thought that the industry suggestion had a promising basis, but only if some safeguards could be built into the "electronic handshake" system. These included that transactions on the electronic system be "authorised" before liability could be passed on. In order to strengthen the proposal, the possibility that the liability for the stamps could be passed back to the previous supplier in the event of a liable trader going missing in the supply chain was also explored. But Government considered that any system where liability was passed-on could only work if it was supported by an effective "track and trace" system where all consignments of stamped product were assigned a unique reference number so that they could be identified at every stage in the supply chain. However, these enhancements to the industry's proposal would have significantly increased compliance costs

The Final Scheme

3.7 The Government finally proposed that the label stamp scheme be adopted, along with making available a freestanding, self-adhesive format of the stamp which could be used by those traders who were unable to or did not wish to use the label stamp (such as those that only used small quantities of stamps or who used them infrequently.)

3.8 While the idea of attaching some sort of financial liability to the duty stamp remained preferable, Treasury Ministers accepted that the compliance costs of the various alternatives explored were disproportionate to the benefits that would be achieved. They therefore agreed to forego this element of the scheme and instead to adopt a more flexible system, where producers could incorporate stamps into labels without being held accountable for any duty liability relating to the production and usage of those stamps. As a result, the degree of assurance that resulted from the financial liability attached to the stamps would have to be addressed, as far as possible, by other elements in the design of the scheme. This is covered in more detail in the risks and benefits section.

3.9 The decision to take forward this scheme was announced in PBR 2004 and confirmed in Budget 2005 and it is the impact of this proposed scheme that this document now evaluates.

Risks and Benefits

Summary Of How The Final Scheme Is Different From Original Proposal

4.1 The following points summarise the key working assumptions used to assess the compliance costs of the initial scheme and how these have now changed in the final scheme in order to reduce industry compliance costs.

(a) Under the original scheme, all spirits in containers of 35cl and over would have been subject to the measure, with the exception of spirits based "ready to drink" products (e.g. alcopops). In addition, wine or made-wine of a strength exceeding 22% would have fallen within the duty stamping requirements. The new legislation now increases the strength threshold from 22% to 30% for all spirits, wine and made wines - effectively introducing a "de minimis" limit for all products. This excludes a large number of products which were previously caught within the duty stamping requirements, but where there was no significant evidence of fraud. The result is that only products with an alcohol by volume of 30% or more sold in retail containers of 35cl or more will now be required to bear a duty stamp.

(b) The stamp was going to take the form of a paper strip stamp affixed to the container across the opening or over the stopper. This would have involved many businesses incurring new machinery costs. The current scheme now provides for stamps to be incorporated into bottle labels, so drastically reducing compliance costs as it removes the need for new stamping machinery and allows existing labelling procedures to be used. An alternative "freestanding" self-adhesive option will also be made available to offer further flexibility for those businesses who are either unable to, or do not wish to, incorporate stamps into labels.

(c) The stamps would have been "purchased" up front, with the purchase price of each stamp being an amount equivalent to all of the duty payable on the goods in the retail container plus the unit cost of the stamp. This clearly had adverse consequences on trade cash flow as in practice this would have had a similar effect to bringing the duty point forward. There is now no such "advance purchase" requirement (there will be no cost associated with obtaining the stamp from HMRC at all) therefore avoiding this adverse impact on cash flow.

Anti-fraud impact of final duty stamps scheme

4.2 The final scheme will have a lower impact on fraud than the original scheme, whose impact was estimated at some £160m per year by 2007/08. The principal cause of this is that duty will no longer be secured in advance by making an equivalent charge for the stamp.

4.3 Duty stamps are nevertheless central to HMRC's alcohol strategy, which aims to reduce spirits fraud by half by 2008. The most obvious benefit of the scheme is that any product not bearing a stamp will be clearly identifiable as illicit. However, duty stamps will also have a number of other benefits. Not least of these is the significant impact that stamps will have on outward diversion (the illicit diversion of products, purportedly bound for export, onto the UK market) as exporting stamped product will be illegal. In response, it is likely that fraudsters will focus more on inward diversion, to which HMRC will now be able to dedicate more resources, and which is, in any case, easier to detect.

4.4 In order to bolster the effectiveness of duty stamps as an anti-fraud tool, the scheme will control access to stamps as strictly as is consistent with EC law. For example, as far as possible, it only offers duty stamps registration to traders who are already known to HMRC for excise duty purposes. In addition, label stamps may only be incorporated into branded labels, which will make counterfeiting of stamps less attractive. Importantly, the scheme will impose stricter controls over the freestanding stamp, which is the more susceptible of the two formats to misuse. Access to these stamps is more restricted and there are more comprehensive record-keeping requirements.

Industry Compliance Costs of Final Duty Stamps Scheme

4.7 HMRC now estimates the compliance costs of the final duty stamps scheme at £6m in the first year, and £4m per year in ongoing costs (rounded). This is based on information supplied by the Joint Alcohol and Tobacco Consultative Group (JATCG), following a survey of affected companies. The full details are set out in table 2 below:

Table 2: Current Estimate of Costs £ Millions[12]			
	Large Firms	**SME**	**Total**
Annual volume (cases):	> 1m	< 1m	
Capital costs (one-off)			
Label Redesign	1.1	1.00	2.1
New machinery	0.9	0.9	1.8
Factory redesign	0.1	0.8	0.9
Other	0.1	0.7	0.8
TOTAL CAPITAL COSTS	**2.2**	**3.4**[13]	**5.6**
Ongoing costs			
Extra labour for application	0.2	0.4	0.6
Extra labour for rework c/s	0.4	0.8	1.2
Extra security	0.1	0.1	0.1
Extra administration	0.3	0.3	0.6
Extra label costs	0.7	0.1	0.8
Extra warehousing	0.0	0.4	0.5
Other	0.1	0.0	0.1
TOTAL ONGOING COSTS	**1.8**	**2.1**	**3.9**
Capital cost per case	£0.08	£0.54	£0.17
Ongoing cost per case	£0.07	£0.33	£0.12
Capital cost per bottle	£0.01	£0.05	£0.01
Ongoing cost per bottle	£0.01	£0.03	£0.01

Impact on trade sectors

5.1 The impact of the final duty stamps scheme will fall on the same trade sectors identified and detailed in the original RIA, but to a much lesser extent given the reduction in compliance costs detailed above, the effect of which should be felt throughout the supply chain. The capital costs which fall on small producers and importers remain higher than those on larger business, since they are the most likely to use the self-adhesive version of the duty stamp rather than the label stamp.

5.2 Looking at the aggregate level, overall industry costs have been reduced by nearly 90% across the board, save for the capital costs of SMEs, where costs have fallen by 31%.

5.3 On a per unit basis, costs are cut by a similar amount, with the ongoing cost per case falling by £1.41 for large firms to 7p and £1.36 for small firms to 33p. However, the capital costs per case for SMEs actually rise

[12] These figures are based on the JATCG Duty Stamp survey dated July 2005
[13] These figures are calculated on the basis that the aggregate figure is the average survey figure scaled up on a per company basis as opposed to a per case basis (which leads to a lower estimate of £1.85 million). The per company calculation leads to a higher estimate since it assumes that capital costs incurred per company will be the same regardless of output. The per case assumption assumes that capital costs are related entirely to output. Given the nature of the capital costs involved, the former is considered to be a more realistic estimate of the likely value but there is some uncertainty as to the exact number of firms in this category which introduces a potential margin for error.

by 5p despite the fact that the aggregate capital costs have fallen. This is because the number of cases produced by this sector has actually fallen, with the effect that there are fewer cases to bear the cost burden.

5.4 However, despite this, the costs to SMEs do still fall considerably in comparison to the scheme originally proposed, and the offsetting measures covered later in this appendix will further mitigate some of these costs.

5.5 It is acknowledged that costs will be incurred by companies (including some of the large supermarkets) who need to remove or void stamps from duty stamped stock which they subsequently decide to export. These costs will mainly arise through businesses needing to amend their stock keeping procedures and supply chain management, so that goods for export are sourced from unstamped stock, which, in practice, is likely to lead to an increase in numbers of stock-keeping units. Both Government and industry recognise that, while this effect is undesirable, the requirement to void stamps prior to export is integral to any duty stamps scheme and there is little scope for further reducing costs in this area without significantly undermining the objectives of the scheme. Without this requirement, product bearing duty stamps, supposedly bound for export, would continue to be diverted onto the UK market. The scheme does provide for stock to remain unstamped right up until the duty point, so there is no requirement to stamp bottles while their final destination is unknown. If businesses still wish to re-work and export stamped product, however, the scheme offers further flexibility by providing a choice of how stamps may be voided.

5.6 Other than the considerations highlighted above, the final duty stamps scheme should not present any competition issues over and above those which were discussed in the original RIA, and in some respects will reduce those previously identified. For example, larger businesses, that already apply tax stamps over the stoppers of bottles for export markets, would have been better placed than smaller businesses had the UK introduced this type of stamp. Adopting stamps incorporated into labels and the alternative freestanding stamp has removed this potential competitive distortion.

Offsetting measures

6.1 At the time that duty stamps were announced in Budget 2004, the Government committed a £3m fund to assist small businesses with the capital expenditure they would incur in preparing for the scheme. However the scheme now being implemented is very different from the one envisaged at that time and the estimated capital costs have now been reduced from £23m to some £6m. The capital grants fund nevertheless remains available to small businesses.

6.2 For the purposes of this assessment, it is reasonable to assume that some of the compliance costs relating to capital expenditure that are incurred by small businesses in preparing for implementation of the duty stamps scheme may be further reduced through allocations from the capital grants fund.

Further consultation

7.1 The full consultation process for duty stamps is set out in the original RIA. Since that document was published, the draft regulations have been developed in close consultation with the industry via a series of meetings through the Joint Alcohol and Tobacco Consultation Group and sub-groups of it. The draft regulations were then with the industry for a further period of six weeks for comment and the majority of comments made were taken on board.

7.2 The draft regulations then underwent a three-month period of scrutiny by the European Commission and other Member States under the Technical Standards and Specifications Directive (Directive 98/34/EC). They were also notified under the obligations in the WTO Agreement on Technical Barriers to Trade. France submitted a detailed opinion that caused the scrutiny period to be extended by a further three months. France was concerned about the imposition of record keeping requirements on overseas businesses by the UK, and about burdens on small producers who might be required to register despite only exporting small quantities of product to the UK. HMRC officials met French officials in November 2005 and addressed their concerns, explaining that spirits producers may avoid the need to register and maintain records, for example by arranging for others in the supply chain to register and affix duty stamps to their products. The European Commission have indicated that they believe the UK duty stamps scheme is a proportionate response to fraud and that the UK legislation is consistent with the Treaty and the relevant Excise Directives.

Implementation of scheme

8.1 Three pieces of secondary legislation will bring the duty stamps scheme into effect. This update to the Regulatory Impact Assessment is published ahead of these instruments being laid:

1. A Treasury Order will amend the primary legislation so that only products with an alcohol by volume of 30% or more will fall within the scope of the scheme.

2. The Duty Stamps Regulations will cover the detailed requirements of the scheme.

3. A Treasury Order will apply the amended primary legislation to alcoholic liquor falling within the scope of the scheme from the date specified in the Order. In effect, this will introduce the duty stamp scheme from early 2006.

8.2 However, business will have almost a year before they will become subject to the full requirements of the scheme. Only goods which pass a duty point on or after 1 October 2006 will be required to bear a duty stamp and the criminal offences for holding or transporting unstamped product will not come into effect until 1 January 2007.

Conclusion

9.1 Comparison between the initial proposals and the final scheme shows that the final scheme has substantially reduced capital costs from £23m to £6m. Instead of incurring large capital expenditure on the new strip stamping machinery required for the original scheme, only minor initial expenditure on label redesign for label stamps and minimal capital costs for freestanding stamps is now incurred.

9.2 Ongoing costs are reduced even more substantially from £54m to £4m, given that the finance and production costs of the original scheme are virtually eradicated.

9.3 The final duty stamps scheme produces a considerable reduction in aggregate and unit costs that is spread fairly evenly amongst large and small business in terms of aggregate and per unit costs. The only exception is the smaller reduction in capital costs for SMEs. But even here the reduction is substantial compared with the costs attached to the initial scheme and not significantly below the reduction that has occurred in other areas.

Comments

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