Tax White Paper

Submission by Wine Grape Growers Australia (WGGA)

May 2015

Contents

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1. About Wine Grape Growers Australia

Wine Grape Growers Australia (WGGA) is the national voice for Australian winegrape growers. Membership is open to all growers – both independent[1] growers and winemaker growers. It is an incorporated association that is accountable to its members through a representative Executive Committee.

There are roughly 6,200 winegrape growers in Australia and WGGA can count around 3,250 of these as having a direct involvement in the organisation. The organization is funded by voluntary levies in South Australia and by project funding from regional associations or by voluntary subscriptions in other parts of Australia.

In close collaboration with the other national bodies, WGGA gives growers a national voice on key policy issues. These include biosecurity, vine health, and improving market access for winegrapes. On market access, we take an active role in negotiating maximum residue limits in key markets for Phosphorous Acid applications in the vineyard, promoting the industry's Code of Conduct and improving commercial practices between growers and wine companies.

Key functions include:

- Provide a national grower voice in conversations with industry and the Commonwealth government.
- Enact national wine sector biosecurity arrangements to protect Australia's vineyards from pest and disease threats.
- Improve market opportunities for winegrapes through initiatives such as negotiating Maximum Residues Limits for phosphorous acid in key markets.
- Facilitate better trading terms with wine companies including a Code of Conduct.
- Deliver information and resources to assist growers' businesses.

2. Scope of this submission

This submission focuses entirely on the wine taxes. Specifically, it relates in the first instance to the merits of an ad valorem versus volumetric basis to wine taxes and secondly, the Producer Rebate, which is more commonly referred to the as the 'WET rebate'.

[1] Growers of winegrapes who sell to wine processors and who don't make wine themselves from the grapes.

3. Preamble

The Australian wine sector is a valuable contributor to the Australian economy in terms of jobs, exports, regional development and tax contributions.

The grape and wine industry, compared with other alcohol industries, is distinctive in its production, financing, economic contribution, export orientation, regional footprint, linkages to other lifestyle industries, consumption, social impact and environmental credentials. This is expanded on further below.

4. Grape and wine in context: economic dimensions of the sector

Production

Grape and wine production has less flexibility and higher risk than most other industries

- Vineyards are permanent plantings with three to five year lead times for income generation, a similar timeframe to respond to changes in market preferences (varieties), and significant fixed costs.
- Inflexibility is heightened by the limited scope to vary alcohol levels or substitute grape colour and types with changes in taste.
- Low capital efficiency of grape processors due to sub-optimal utilisation of winery processing capacity as a result of one, seasonal vintage per year.

Financial structure

The financial structure of wine production is predisposed, over a medium time horizon, to a lower return on capital compared to most industries including other alcohol beverage production industries. This is due to

- capital intensive, long-life assets,
- high working capital requirements, and
- high inventory levels with slow stock turn.

Economic contribution

Grape and wine production supports an estimated 30,000 jobs that are key to regional economies because of their location and local value creation

- The high degree of value adding in Australia is to a regionally-differentiated agricultural product.
- Around 60 regional economies have a substantial or significant dependency on the grape growing and wine.

Export orientation

Australian wine is internationally competitive across all wine grades and generates $2 billion in annual export revenues.

- Around 60% of Australian wine production by volume is exported.
- Australian wine is a valuable brand ambassador for a sophisticated Australian lifestyle.
- Australian wine is advanced in its technological expertise.

Regional footprint

The wine sector's contribution to regional economies is more transformational than most other rural industries due to numerous factors.

- A high degree of local value adding
    - Wine production is characterised by a high degree of local processing that is anchored to winegrape growing regions and with the level of processing extending high into the value chain.
- Creation of a critical mass of infrastructure and business services.
    - Local food processing and hospitality businesses create a critical mass of infrastructure, skills and suppliers that is necessary to support them.
- Connection of Australian regional economies directly to specific international markets.
    - Marketing of wine involves wine producer visits from export markets as well as inbound visits by trade and media personnel from those markets.
- Business leadership.
    - The grape and wine industry, for the regions in which they operate, are an important source of high-profile, well-educated and dynamic business leaders.
- Skills base
    - Wine businesses employ a high level technical, financial, marketing and management skills and thereby add to the diversity and to the professional expertise in a region's skills base.
- Tourism attractions and infrastructure.
    - The grape and wine sector creates marketing assets for regions. It creates or contributes to a regional image; it creates visitor experiences that constitute a destination attraction; it generates media publicity; and by sponsoring high value trade visitors it enables investment in tourism accommodation and hospitality infrastructure."

Source: WFA Submission to AFTS Review (Henry Tax Review), May 2009, page 15

Linkages with other lifestyle industries

Vineyards and wine processing facilities create the amenity and experiences that become tourism destinations and attract visitation.

- Wine is the catalyst to bundling a combination of experiences from the food, arts and entertainment industries to create tourism products and experiences.
- Wine, due to its complementarity with food, can also generate a critical mass of demand for local artisan food producers.

Consumption

Wine is consumed by a different demographic, in different places and in a different context from other alcohol beverages.

- Wine is predominantly consumed by an older age group.
- Wine consumption occurs overwhelmingly with food accompaniment.
- There is an aspirational motivation for wine purchases which weakens the link between alcohol and price.
- The most frequent place of wine consumption is at home or in food service venues.

- Most cask wine is consumed at lower serving quantities per drinking occasion than bottled wine, reflecting its convenience and ability to control portions without spoilage.

Social impact

Wine consumption generates lower social costs than other alcohol forms.

- Wine is consumed with food in by far the majority of drinking occasions.
- Wine is not the predominant beverage of choice for youth binge drinking.

Environmental credentials

Grape growing and wine rely on international markets that are more sensitive than locally, to environmental stewardship - due to the social responsibility agendas of powerful supermarket gatekeepers in those locations.

- Grape and wine production has high water use efficiency relative to most other agriculture or agriculturally-based production.
- Grower and winemaker membership of environmental management programs such as Entwine and other environmental programs are targeting improved environmental outcomes.
- Regions are championing environmental performance initiatives.
- There is a growing shift in favour of organic growing principles in Australian grape growing.

5. Wine and taxation

5.1 Volumetric vs ad valorem taxation

Wine sales attract a specific tax, the Wine Equalisation Tax (WET), in addition to the general goods and services tax (GST). The WET, like most taxes including the GST, is a value based tax and hence, is progressive in its impact on consumers. As such, it is socio-economically equitable and is a growth tax for Government revenue in a growing economy.

The Henry Review of taxation in 2010 recommended a volumetric tax on all alcoholic beverages including wine. It was argued that a volumetric tax, with an appropriate setting, would raise the price of cheap wine, effectively introducing a floor price on wine, and hence reduce the 'spill over costs' associated with alcohol abuse.

However, in contrast to an ad valorem tax, a volumetric tax regime, levied on the volume of alcohol, is fixed per unit of alcohol content and in order to keep pace with inflation, requires administrative adjustments that are both costly to government and disruptive to private markets.

Position1: WGGA is opposed to any increase in the rate of tax on wine

Wine already pays its share of tax

- Focusing on the WET only, understates the overall tax take from the grape and wine industry. A total reckoning of the tax contribution from wine will include the large number of wine producers in Australia who pay payroll and property taxes. This may

mean that wine tax is not dissimilar from that paid on the more consolidated beer and spirits industries.
- Wine in Australia is highly taxed relative to other wine producing countries with which we compete.
- Wine consumption generates much lower social costs than other forms of alcohol. Lower tax returns are therefore required to cover the cost of spill over effects compared to beer and spirit abuse.

Position 2: WGGA is opposed to changing the existing ad valorem basis to wine tax to a volumetric basis

Changing to a volumetric tax would have significant adverse impacts on the industry

A change to a volumetric tax basis would disadvantage producers, regional communities and grape growers, cause substantial grape and wine business disruption, result in unpredictable outcomes for industry viability and development and finally, impede the industry's restructuring and recovery efforts.

- The substantial increase in the price of low priced wine that would result from a volumetric-based tax at the beer rate, would lead to large reductions in wine sales by volume. Depending on modelling assumptions and the time period under consideration, the reduction could be as much as 34%. Such a reduction would translate into the displacement of 360,000 tonnes of grapes (20% of current production), equivalent to the loss of 29,000 hectares of vineyard and direct and indirect job losses, estimated at 12,000, mostly in regional communities.
- Reduced grape demand would impact most heavily on the grape growing regions of Murray Darling-Swan Hill, the South Australian Riverland and Riverina which represent the most cost-efficient wine production regions in Australia and the source of wine to the largest segment of the wine market – popular premium wine.
- The implied reduction in wine processing throughput would mean increased unit costs for wine producers and reduced export competitiveness.
- Reduced sales volumes would exacerbate grape and wine oversupply in the short term leading to widespread business disruption.
    - Excess growing and processing capacity would result in downward pressure on asset values with the disruptive effects on the market compounded by limited alternative use for these assets.
    - Excess wine accessing export markets through necessity, will damage Australian wine reputation and have adverse effects on Australian export prices.

An ad valorem tax (ie the WET) is the most appropriate tax structure for wine

- It is progressive in common with other consumer taxes and is well suited to a product which covers a wide price range, from a few dollars to hundreds of dollars.
- The WET avoids the administrative costs and inflexibility of a volumetric tax that would have to cope with a wide range of wine alcohol levels and thousands of geographically dispersed production facilities.

- It is a tax that is responsive to market conditions and industry fortunes, thereby providing a growth tax for Government and an appropriate tax for producers who experience structurally lower returns on investment at the same time as volatility in demand and sales price.

Position 3: A volumetric basis to wine tax cannot be justified on the grounds of reducing the cost of alcohol abuse

- A volumetric basis to wine tax would reduce wine consumption but it is questionable how much this would improve public health outcomes by reducing the harm attributable to abusive consumption of wine.
  - A consumption profile for wine, of an older demographic and food accompaniment, suggests that wine is less implicated in abusive consumption than other forms of alcohol.
  - Wine is not the drink of choice for risky youth consumption through binge drinking.
  - Lifting the price of one type of alcohol is more likely to lead to a switch to the next available substitute rather than a reduction in consumption.
- Claims that "wine is cheaper than water" are misleading, as they are based on comparing expensive luxury branded water with the lowest cost wine. A more valid comparison would be a comparison of basic spring water (10 litre cask) with a 5 litre cask of inexpensive wine. In this case wine is at least six times more expensive than water.[2] Major retailer market power and promotions are the drivers of cheap wine rather than wine producers. Despite this, wine producers would bear the largest burden of the shift to a volumetric tax through the decline in sales.
- Responsible wine consumers, representing the majority of wine consumers, would be punished as a consequence of increased wine prices.
- A volumetric tax on wine would be regressive and discriminate against older and generally poorer consumers who would be most affected by the price increase, whereas consumers of luxury wines (generally wealthier) would make gains through price reductions.
- Many adverse social impacts of alcohol consumption derive from the *context* of consumption rather than price.
  - Late night inner city violence is an example of a social cost that is attributable to licencing provisions and access rather than price. Moreover, it is believed that wine is under-represented in these circumstances
- Circumstantial evidence that low price is not the primary determinant of wine choice is provided by the falling sales trend for wine casks – which are the primary target of wine consumption with health impacts in certain sections of the community.
  - Although acknowledged to be the cheapest source of alcohol, wine cask sales volumes have been in decline for more than a decade. This evidence calls into question the assumption that price per unit of alcohol is the primary factor in alcohol purchase decisions.

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[2] Calculated at 10 litres @ $3.50 for a cask of spring water compared to 5 litres of cask wine @ $10 each in a three cask multibuy. This results in wine costing $2 per litre whereas the water costs 35 cents per litre.

- The primary driver of price for cask wine is the economics of its packaging format rather than the alcohol content. A tax on alcohol content, for the purpose of raising price, is therefore mis-targetted and would establish distortions throughout the wine market.

- Tax increases can be an ineffective mechanism for influencing consumer behaviour if the tax increase is not fully passed on in the retail price. This has been the case in the UK for several years where excise tax increases have been largely borne by producers through reduced margins.[3]
- An across-the-board reduction in wine consumption does not translate into an equivalent reduction in harmful consumption because there is evidence that risky drinkers are less sensitive to price than moderate drinkers
- Access Economics estimates that alcohol tax revenue is already higher than the total social costs of alcohol abuse.[4]

WGGA maintains that the role of government is to ensure that public health policies on alcohol are based on evidence that is specific to wine's contribution to social costs; that intervention measures are targetted to the problem beverage and drinker segment/s as well as the circumstances in which the social cost is generated. Finally, interventions must be warranted on the basis of cost-benefit evaluation.

WGGA acknowledges that risky and abusive wine consumption does occur and is committed to working with Government to develop evidence based solutions to this problem in line with its view of the foregoing criteria for intervention.

5.2 The Producer Rebate ('WET rebate')

Unintended consequences of the WET rebate in a changing operating environment

The original justification for the WET rebate - to support small regionally based producers – is an important objective but it is not sufficient, given the industry conditions that have emerged since the rebate was established.

The conditions that have emerged since the installation of the rebate, means that the original policy objective for the rebate is poorly targeted and includes other parties beyond the original target group of cellar-door outlets. These include non-regionally based, non-wine producing (virtual) wineries, large wineries and offshore producers (New Zealand for wine sales in Australia).

Compared to when the WET rebate was originally introduced, wine oversupply and growing retail power mean that wine producers are willing to trade away the rebate, through lower

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[3] The UK Wine and Spirit Trade Association, www. wsta.uk/taxation

[4] Access Economics, Collins and Lapsley report review: avoidable costs, 23rd December 2008. Although it is not spelled out, the revenue estimation (summarised in the final table of the report's Executive Summary) shows that taxation raised from alcohol abuse exceeds its cost to Government, so it is budget positive and abusers pay their way by some $1.4 billion (2004-05 prices) per annum. Alcohol taxes thus more than pay for the social costs of alcohol abuse, by a considerable margin, each year. Moreover, taxation of alcohol increased from $3.37 billion in 1998-99 to $5.11 billion in 2004-05, a 52% increase (8.6% per annum), greatly exceeding population or consumption growth." Page12.

on-sell prices, meaning retailers and consumers derive the benefit of the rebate through lower retail prices.

In a further flow-on effect, lower profitability for wine producers means fewer winegrapes are purchased from independent winegrape growers who might choose to survive by converting under contract, their unsold grapes into wine, and then selling the wine directly to retailers for marketing as retailer-owned-brands. This further strengthens the position of major retailers.

Independent growers surviving this way, have the added incentive to do so because the rebate can also be accessed. But in any event, they too may be willing to trade away the rebate, through lower selling prices, in the face of the greater negotiating power of retailers.

The sum result of these effects is lower winegrape prices for independent growers generally – many of whom are not able to offset these lower prices with rebate receipts. WGGA estimates suggest that around 92% of Australia's independent growers (roughly 4,000 grower businesses), who account for around half of the independently grown tonnes of winegrapes, are affected this way.

On the other hand, roughly 400 independent growers of larger size are more likely to be able to finance the conversion of their grapes into wine and to bear the market risk of selling this wine, and therefore gain access to the rebate. These larger growers account for the other half of independently grown winegrapes.

WET rebates cause damage to the grape and wine industry by amplifying the market power of retailers

Major retailers are the central player in the unintended consequences of WET rebates in the current operating environment. While major retailers are an emerging dynamic in food and beverage marketing, and this trend cannot be denied, their growing market power through consolidation erodes competition. As demonstrated in the foregoing passages, this growing market power requires careful monitoring and containment to ensure it is not excessive. This work is the role of government.

Position 4: WGGA supports removal of eligibility for the WET rebate from bulk and unbranded wine sales

WGGA supports the removal of eligibility for the WET rebate from bulk and unbranded wine sales. Doing so, removes the incentive for direct sale of wine to major retailers for retailer-owned-brands. Hence, the measure curbs to some extent, the market power of retailers to operate in the market in a manner that drives down winegrape prices.

Evidence is needed on the effects of WET rebate reform for better industry outcomes

In theory, this policy will yield higher winegrape prices for by far the larger number of independent winegrape growers (92%). Desirably, there would be evidence to support this – but this evidence doesn't exist. In the absence of evidence to support the theory, WGGA is willing to test empirically, the proposition that removing eligibility for the WET rebate from bulk and unbranded wine, will result in higher winegrape prices.

There are nevertheless downsides to the WGGA policy of WET rebate reform for the winegrape growing community.

1. The potential exists for a portion of the 50% of independently grown grape tonnages, which can access the rebate through sales of bulk and unbranded wine to retailer-owned-brands (which would be de-incentivised by the removal of eligibility), to now flood back into the pool of winegrapes seeking a home in wine company-owned brands. The result of this will be lower prices from the wine companies. Without evidence and the ability to quantify these effects, it is not possible to determine if the sum result will be for the potential rise in winegrape price rises by removing eligibility of bulk and unbranded wine, to be eroded or even completely annulled, or worse, by the increased competition in attempted sales to wine companies.
2. Some 400 independent growers, responsible for around 50% of independently grown winegrapes, who had the opportunity to remodel their businesses on the back of the rebate, would now have this facility removed and will be disadvantaged.

Hence, WGGA has a number of concerns about WET rebate reform.

- Some legitimate grower and wine businesses will undoubtedly be worse off – particularly growers who have adopted new business models (to survive) by value adding to their production by moving into the wine business.
- There could be adverse unintended consequences from the reform and there is no evidence available to predict what this impact could be.
- The operation of the rebate, even according to industry's own estimates, is not the major causal factor in the structural problems currently facing the industry.

Position 5: WGGA seeks government assurances in regard to the implementation of WET rebate reforms

Therefore, WGGA seeks a commitment from government that:

- modelling be done as part of the preparation of the Treasury paper on the WET rebate, on the likely impact of the proposed changes to the rebate,
- a portion of the savings from reduced rebate payments will be directed to initiatives to support growers who are adversely affected by the changes.

6. A broader view of reform

WGGA is committed to partnering with other industry organisations and government to restore the profitability and growth of the Australian grape and wine industry.

This will target industry restructuring initiatives such as:

- Better alignment of the grape and wine supply chain to market opportunity.
  - Objective grape specification and measurement protocols.
  - Transparency in the linkage between market requirements and grape specification.
  - Market intelligence on new markets that enables more structured supply projections.

- Faster take up by growers of technologies and business models that improve efficiency and/or reduce variance from planned specification.
- A national vineyard database.
- Benchmarking best practice for technical and financial performance of vineyards.

Government has an important role to play in:

- Reducing red and green tape that imposes unwarranted costs, particularly for agrichemicals.
- Facilitating market access and supporting market development of Asian markets and other emerging wine markets.
- Increasing structural adjustment support for the wine sector, which like all manufacturing industry, is seriously impacted by the competitiveness disadvantage of the high Australian dollar.
- Maintaining the status quo in relation to the ad valorem basis to wine tax.

Stability of Government policy settings is especially important for grape and wine investment due to long lead times for revenue generation and the long life of vineyard assets. Moreover, uncertainty about retention of the existing ad valorem basis to wine tax is anticipated to place downward pressure on winegrape prices as wine producers will be inclined to hedge against the major financial disruption that would be expected by a change to a volumetric basis.

For Government, the benefit from a revitalised, profitable and growing grape and wine industry would be the increased tax revenue that would accrue from a growing and more profitable industry.

Lawrie Stanford
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Wine Grape Growers Australia
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