



House of Commons
Scottish Affairs Committee

**Response by the
Government to the
Third Report (Session
2003–04) on The
Proposed Whisky Strip
Stamp**

**Second Special Report of
Session 2003–04**

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The Scottish Affairs Committee

The Scottish Affairs Committee is appointed by the House of Commons to examine the expenditure, administration, and policy of the Scotland Office (including (i) relations with the Scottish Parliament and (ii) administration and expenditure of the office of the Advocate General for Scotland (but excluding individual cases and advice given within government by the Advocate General)).

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Committee staff

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1 Second Special Report

1. The Scottish Affairs Committee published its Third Report¹ of Session 2003-04 on 26 April 2004. On 22 June 2004 we received a memorandum from HM Treasury which contained a response to the Report. The memorandum is published as Appendix 1 to this Report.

1 Third Report from the Scottish Affairs Committee, Session 2003-04, *The Proposed Whisky Strip Stamp*, HC (2003-04) 419

Appendix 1

On 26 April 2004, the Scottish Affairs Committee published its Third Report of Session 2003-04 on *The Proposed Whisky Strip Stamp*. In this response, the Government has identified what it considers to be the Committee's main points.

Fraud

“We wish to put it on record that we support fully the Government’s and the industry’s attempts to tackle spirits fraud. However...the Government appears to be reacting in response to what is an unconfirmed level of fraud, with the possibility of major implications for the industry. In addition...we are convinced neither that strip stamps would be the best way to tackle such fraud, nor that the Government has exhausted all possible alternatives. Under such circumstances, the Committee urges the Government to reconsider Clause 4 of and Schedule 1 to the Finance Bill. (Para 42)”

The Government is grateful for the Committee’s support in its attempts, in conjunction with the industry, to tackle fraud. The Government accepts that where there is fraud there will always be uncertainty about its scale, but does not accept that this is an argument for taking no action to combat criminals.

For the last three years the Government has been actively considering with the alcohol industry the most effective and appropriate response to the problem of spirits diversion fraud. During that time, Customs has held two public consultations: first, from late 2001 to early 2002, on tax stamps; and second, in summer 2003, on a range of regulatory options designed to restrict the sale and movement of duty-suspended alcohol. These formal processes were interspersed with ongoing informal consultations and discussions.

During this period, Customs implemented a range of other measures, including enhanced cooperation with the spirits industry. The Government also provided additional funding for Customs to enable the department to step up the volume of intelligence-based checks on inward freight consignments of duty-suspended spirits, increase disruption of the criminal gangs engaged in spirits fraud, and strengthen their control of UK excise warehouses. In the meantime, according to Customs’ estimates, the level of spirits fraud continued to rise, costing £600 million in 2001-02.

What was effectively a “last chance” for the industry or Customs to come up with an equally effective alternative to duty stamps was provided in the period between the Pre-Budget Report 2003 and Budget 2004. As the Regulatory Impact Assessment (RIA) makes clear, there were further, very intensive discussions with the industry in the first months of 2004. The announcement on duty stamps in the Pre-Budget Report 2003, confirmed in Budget 2004, was, therefore, part of a long process of detailed discussion and examination of alternatives by the Government and with the alcohol industry. That process established that, in the absence of effective alternatives, duty stamps for spirits are necessary if the Government is to tackle fraud in the spirits market effectively – as it continues to do in the other main indirect tax regimes.

The Government recognises the impact that duty stamps will have for the industry. These were discussed in detail during pre-Budget discussions with the industry through the Joint Alcohol and Tobacco Consultation Group and are reflected in the RIA. The Government has, however, addressed measures to help alleviate compliance costs to the key areas of concern:

- to help offset any overall impact on retail prices, the Chancellor has frozen spirits duty for the remainder of this Parliament;
- subject to further discussions with the industry, the Government intends to target the benefits of the funds that have been made available for assistance with capital costs towards smaller firms; and
- in the discussions that are now under way on payment arrangements for tax stamps, officials are working with the industry to identify options that take account of the financing constraints that face smaller firms in particular.

“...The Government and the trade have come up with wildly different estimates. This uncertainty as to the level of fraud was highlighted by the publication on 11 March 2004 of a report from the National Audit Office (NAO), Estimating the level of Spirits Fraud... (Para 11)”

“Because of the uncertainty over the level of spirits fraud, the Chairman of the Committee wrote on the NAO report’s publication to the Chancellor of the Exchequer on 11 March, urging caution... (Para 13)”

“We regret to say that we did not receive a reply from the Chancellor giving his reaction to the Chairman’s letter... (Para 14)”

The Government recognises the differences between the estimates from the Scotch Whisky Association (SWA) and Customs and welcomes the further research by the Office for National Statistics (ONS) to help address these differences. As recognised by the Committee, the NAO also confirm that both the SWA and Customs’ methods for producing their estimates are statistically reasonable.

Customs are continuously improving their measurement of tax fraud, including spirits. The department is working with the ONS, as recommended in the NAO memorandum to the PAC. Customs will also continue to use operational evidence to back up their estimates.

The Government notes the Committee’s comments concerning the letter from the Committee Chairman of 11 March to the Chancellor of the Exchequer.² As Minister responsible for Customs and Excise matters, John Healey, Economic Secretary to the Treasury, replied to Irene Adams on 12 March.³ A copy of Mr. Healey’s reply was placed in the Library of the House at the time. It was unfortunate that the original response did not reach the Committee Chairman. This only came to light on publication of the report. The

2 *ibid*, Ev pp 62-63

3 See Appendix 2

Government was grateful for the Committee Chairman's kind acknowledgement at the press conference launching the report that the response had indeed been sent.

“We accept the general truth as advanced by the Economic Secretary. But it has become something of a cliché that “doing nothing is not an option”. We do not necessarily agree that every recognised form of criminal fraud requires an instant response. Caution should not be confused with inertia... (Para 15)”

The introduction of tax stamps was a recommendation of a report by John Roques, who was commissioned in June 2000 by the Paymaster General and the Chairman of Customs to carry out an independent investigation into Customs' handling of excise diversion fraud. Following a formal consultation on that recommendation in late 2001, the Government decided in Budget 2002 that it would be inappropriate to introduce tax stamps before alternative courses of action had been fully explored. In 2003, when the Government decided following further exploration – and new fraud figures – that tax stamps were a proportionate and necessary response, it did not immediately proceed to introduce duty stamps. Rather, Customs consulted and explored alternatives as described above in the response to Point 1.

Duty stamps, therefore, represent a fully-considered response, based on several years' work and consultation, and are viewed as a timely and effective solution to the very real and, on the Government's estimates, growing spirits fraud problem in the UK.

Industry Approach

“We appreciate that the industry have made good efforts to put forward constructive proposals and this, in turn, has been accepted by the Government. However, the industry had been aware of the growing concern of HM Customs and Excise for some time, and it would have been helpful if the industry had responded quicker, and had been prepared to accept binding regulations, rather than rely on a code of voluntary agreements. Evidence from the Scotch Whisky Association did, we believe, illustrate a certain lack of urgency on the industry's part... (Para 27)”

The Government notes, and echoes, the Committee's acknowledgment of the efforts of the industry to develop alternatives to a duty stamp scheme and their ongoing commitment to help tackle alcohol fraud.

On Alternatives

“Mr Healey gave no indication as to the sort of proposals the industry could make that would pass muster. (Para 32)”

As the Economic Secretary stated in his response to Mr Hamilton in his oral evidence to the Committee (Q360), the Chancellor of the Exchequer announced in the Pre-Budget Report in December 2003 that the Government invited the trade to put forward alternatives and indicated that, to “pass muster” (Committee's terminology), these alternatives would need to be as effective in tackling spirits fraud as duty stamps. Officials expanded on this in working papers provided to, and discussions with, the industry through the JATCG. i.e. at least £160 million additional revenue a year from 2006-07,

against a fraud estimate of £600 million. The effectiveness of the trade's alternative proposals was assessed on the same basis as duty stamps.

“We do not know how exhaustive the Government’s consideration of all these options has been, but its responses are disappointingly negative and unimaginative. For example, Proposal 12, Extended use of bar-coding technology to enhance traceability, could have been considered in Parallel with a recent EC Regulation which, with effect from 1 January 2005, will mean that all food sold within the EU will need a barcode to ensure, inter alia, the traceability of food (including alcohol). Although we understand that the rationale behind this Regulation was to trace genetically modified product, we consider that there is the possibility of utilising modern technology to trace a bottle of spirits from distillery to shelf in the same way. We accept that it may be a few years before this particular technology is available, but during our discussions in Washington we were advised of some interesting developments in combating tobacco fraud in California. (Para 30)”

Following the Pre-Budget Report, officials met regularly with the industry to discuss the proposals they were developing as an alternative to duty stamps and tried to help the industry make these more robust and fit-for-purpose. Officials were open about the weaknesses they identified in the package: that it left the door open for displacement to other types of fraud, most notably inward diversion; that it stood to be undermined by a complicit party; and that it did not address the key issue of visibility – the ability for retailers, consumers and Customs’ officers to distinguish readily between legitimate and illicit product.

The Government believes its assessment of the industry’s package of measures has been objective and fair, using a similar methodology to that used for assessing the revenue impact of duty stamps. Against a fraud loss of £600 million, duty stamps will deliver at least £160 million, whereas the industry’s alternative proposals would deliver less than half that, £70 million at best.

The Government considered the industry’s proposal to use bar-coding technology as an alternative to duty stamps, but, as the industry (and the Committee) recognise, this is not yet sufficiently advanced to track every bottle at every stage of the supply chain from bottling line to retailer as would be necessary to effectively tackle spirits diversion fraud. Bar coding at present merely allows the point of manufacture to be traced.

Emerging technologies such as radio frequency identification (RFID) may offer the ability to track legitimate supply chains throughout their length (producer to retailer and everyone between), albeit 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). However, the ability to easily and consistently achieve this level of traceability is still many years ahead.

Customs are aware of research being undertaken in the US, particularly California, into the use of 2D barcodes and encryption within tobacco packaging. Both these technologies are among the wide range of security features the Government is considering to develop a duty stamp design that is both secure and fit-for-purpose.

The Government recognises the need in the long term to continually assess the potential of new technologies, as they develop, to supplement Customs' ability to tackle alcohol fraud.

Tax Stamps

“...We have been told that there are four main flaws to the stamps. Firstly, a bottling plant needs a particular, and very expensive, type of machinery to put the stamps on the bottles. We heard of one example of the damage that could be caused to a community by the introduction of strip stamps when we visited Bushmills. The distillery employs 130 people from a village of some 1,000. Of those 130, only 30 were employed on distillation. The remaining 100 employees work in the bottling plant. Should strip stamps be introduced, Bushmills' current machinery would not be able to fix the stamps on the bottles, so new machines would be necessary. (Para 17)”

In recognition of the additional costs some firms may face, the Government has set aside a fund of £3million for assistance with aspects of the capital costs involved in establishing the capacity to administer duty stamps. The Government is discussing in detail with the industry how best to use this. For example, it may be targeted at the smallest firms to help offset upfront compliance costs. This fund is just one of a package of offsetting measures to minimise the compliance burden of a duty stamp scheme.

For those that may require additional machinery, Customs' research indicates that a range of applicator equipment is available at a range of prices, from £5,000 for the simplest, stand-alone strip stamp applicator, up to £600,000 for the top-of-the-range, all-in-one, multi-label applicator machine.

Customs' research also indicates that many, particularly the larger, producers already have stamp-applicator machinery on most of their bottling lines, as tax stamps are required for many export markets. In these cases, new machinery may not be required.

“The second flaw with strip stamps is their physical nature. During our visit to the United States, it was put to us that a thin, sticky label stuck over the top of a bottle was a nineteenth century solution to a twenty-first century problem. We agree... (Para 20)”

The Government is aware that tax stamps have been around since the mid- to late-nineteenth century, being first regularly applied to cigar boxes during the American Civil War. However, when considering a design for its stamp, the Government will have at its disposal the very latest, cutting-edge, twenty-first century security printing technology. This will include advanced inks, papers, adhesives, and hidden security features and will give the stamp an appearance and functionality unimaginable in the nineteenth century.

It is also important to recognise that today stamps are used on alcohol products in over forty countries around the world and are generally regarded as efficient and effective tools, not only in the facilitation and control of revenue collection but, also, in tackling fraud.

It is, of course, relevant to note that not all duty stamps that are used are “a thin, sticky label stuck over the top of the bottle”. For example, some countries use a frangible, vinyl-substrate label on the side of the bottle; others use a hologram disc – each have their

advantages and disadvantages. The Government is exploring all the options for the UK duty stamp.

“The third problem is that the strip stamps would be easy to counterfeit. The memorandum from the Scotch Whisky Association (SWA) told of what had happened in one Eastern European country: “A recent example was the Ukraine’s decision to reformulate its tax stamps system on 1 January 2004 in an effort to defeat widespread fraud of existing stamps. Within three weeks, we understand the Ukrainian police had reported the seizure of 66,000 bottles of illicit spirits each marked with forgeries of the newly introduced state of the art hologram seals. (Para 21)”

“...If forgers have no difficulty in reproducing passports, then counterfeiting a label about 12cms long and 2cms wide should not pose too many problems... (Para 23)”

Customs’ officials have held discussions with anti-counterfeiting technology specialists and several members of the security printing industry. Anti-counterfeiting technology has improved considerably in recent years and is continuing to progress. A number of security requirements have been identified and Customs will look to take into account all the technologies available in considering the final stamp design.

The Government is aware of the skill and resource of the determined counterfeiter and is very mindful not to underestimate this. However, the Government is confident that the combination of security features that will be included in any putative duty stamp design will render any counterfeiting challenge extremely burdensome.

The Government also notes the comments made by Mr Samuel of Gavin Watson concerning gangs in China and the fact that holographic machinery is ubiquitously available and holograms can be bought “off the peg”. The Government accepts that equipment can be bought to produce holograms. However, the level of complexity within the most advanced holograms, now termed more correctly as optically variable devices (OVDs), is far in excess of what a counterfeiter could produce easily or quickly. Custom’s officials have consulted with OVD specialists and have been reassured that some of the most advanced features and techniques are practically irreproducible.

It is also important to stress that the robustness of the duty stamp is not purely dependent on the presence of an OVD. The OVD must look, and perform (in terms of images, movements, colour changes and hidden features) totally as intended in order to be verified as genuine. The Government will look to provide educative media, possibly even basic decoders for retailers, in order to allow retailers and consumers to know what to look for in a genuine stamp. Coupled with a combination of other overt, covert and forensic features, the duty stamp will present any fraudster with a number of very high barriers to overcome in order to produce a successful counterfeit.

The Government notes the Committee’s point concerning passports. Customs’ officials have visited security printers involved in producing UK passports and have consulted with many other security printing experts. The Government understands from these consultations that accurately reproducing a UK passport is, in fact, exceptionally burdensome and difficult, due to the combination of the many security features within the design. As indicated above, whilst it may be possible for skilled counterfeiters to produce

representations of such documents as passports and duty stamps relatively easily, it is the accuracy and quality of these copies that is of greatest importance and relevance, and a sub-standard copy that does not contain all the relevant security features should, therefore, be easily detected.

“The final problem was set out in the SWA’s written submission; legitimate stamps could actually exacerbate the problem of fraud by making counterfeit spirits appear genuine... (Para 24)”

The Government believes it is very unlikely that counterfeit spirits will have genuine UK duty stamps applied to them. Fraudsters look to maximise their profit by buying or producing spirits for the minimum amount possible and then selling them on to the legitimate market at, or near to, duty-paid prices.

Customs’ operational experience is that counterfeit spirits in the UK are invariably also non-duty paid. Paying duty would remove the largest part of a fraudster’s potential profit. Thus, suppliers of counterfeit products would be most unlikely to pay for, and affix, genuine UK duty stamps to their product.

Furthermore, the supply of duty stamps will be very carefully controlled. Those producing counterfeit spirits are very unlikely to want to attract attention by requisitioning stamps from a legitimate source. Moreover, obtaining enough genuine stamps through illegitimate sources is likely to be prohibitively burdensome and high in risk.

“The Government has set great store by retailers and consumers being able to tell whether the whisky being sold to them is legitimate... (Para 35)”

“We fear that the Government may be missing the point. An individual who buys a bottle of spirit from a large retailer, such as a supermarket or a branch of an off-licence chain, will reasonably expect the content of that bottle to be genuine, and that all relevant duties and taxes had been paid on it. But, if that same person were to buy a bottle of spirit from a boot sale or from “someone they met down the pub”, it is a fair chance that the purchaser would have some suspicion that the spirit had been stolen, smuggled or was fake. (Para 36)”

“In the same vein, if the proprietor of a corner shop or an off-licence buys spirit from “a white van man” who turns up at the proprietor’s backdoor with a few cases in the back of his vehicle, it is a very different proposition to buying goods from a reputable distributor or wholesaler. We consider that many people buying spirits under such circumstances must suspect that they are buying illicit goods. The fact that the bottle of spirit being offered for sale does not have a strip stamp will not, we suggest, deter most of them. (Para 37)”

“What, we believe, would deter people from buying and selling illicit spirits is the prospect of detection and prosecution. When the Economic Secretary appeared before us, we raised with him the possibility of using section 170A of the Customs and Excise Management Act to recover civil penalties from those convicted of offences involving non-duty paid goods or, if necessary, changing the law to facilitate the prosecution of such individuals... (Para 38)”

The Government accepts that some retailers knowingly buy illicit spirits, and that Customs are sometimes able, albeit not without considerable difficulty, to find evidence that they have done so. In such cases Customs will apply one or more of a range of sanctions, both civil and criminal, which are available to them. But fraudsters can infiltrate an, apparently legitimate, supply chain at any point, and then both retailers and consumers are duped into buying illicit products. Many smaller retailers, for example, buy their stock from cash-and-carrys. If that product is non-duty paid, those retailers, and their customers, are oblivious to what they are buying.

With duty stamps, those fraudsters intent on criminal activity may try to source illicit products but the profitability of their actions will be much reduced, as, unlike now, it will be apparent that goods are illicit. Duty stamps will, for the first time, allow retailers, consumers and Customs to distinguish quickly and easily between duty-paid and non-duty-paid product. A fraudulent retailer who wants to continue selling illicit product will have to consider the greatly increased risk of being detected and sell it ‘under the counter’ to consumers who will now know what they are buying and be prepared to pay a much-reduced price for it, consequently reducing the fraudster’s potential profits. 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. 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 Government believe that these measures will greatly decrease the criminals’ opportunity and outlets for passing on illicit product.

However, if similar offences were proposed without a duty stamp regime in place, then proving that a particular bottle of spirits was illicit remains exceedingly difficult, as there would be no visible means of verification. This would prove wholly unfair, as without the means to readily identify licit and illicit products, a retailer could not readily claim due diligence.

Businesses supplying the retail spirits sector, certainly the independent retail sector, which is most at risk, will rarely have been responsible for paying the duty, so seeking out positive evidence of duty payment is very difficult. Within a tax stamp regime, this becomes simply verifying the presence or absence of a genuine tax stamp.

“Should the Government insist that the public needs some kind of visual indication that duty has been paid on a bottle of spirits, we believe that it would be far less disruptive to the industry for a tax stamp to be incorporated into the front or the back label of a bottle. We accept that there would still be extra security costs for the industry, as the labels themselves would be worth £5.48 per each 70cl bottle, and the duty would still need to be paid “upfront”, but there would not be the potential extra cost of having to buy new bottling machines – which...could cost in excess of £1million. (Para 41)”

The Government has said it will consider all options for a duty stamp, including that of a label mark. Customs’ officials are continuing to examine fully the benefits and costs of all alternatives in discussion with the industry.

The Government has also said it is seeking to implement tax stamps without requiring upfront payment for stamps in order to prevent increased cash flow costs and ensure that

the industry continues to benefit fully from the facilitation offered by duty suspension and deferment. Realising this ambition is not straightforward, but work is ongoing with the industry on how this might be achieved.

USA

“During our discussions in Washington we were advised that, since tax stamps on spirits were abolished in the early 1980s, the United States operated a closed supply chain. Everyone in that chain, producer or importer, wholesaler and retailer, were licensed in the “three-tier system” of distribution... (Para 33)”

“Such a system seems to work well in the US and, we assume, provided the model for the industry’s Proposal 11, Registration or licensing of alcohol dealers and retailers. Although Customs do seem to have, at least, taken notice of this Proposal, it is only in the context of strip stamps actually being introduced, not as a measure in its own right. We consider that the introduction into the UK of a licensing regime along the lines of the American system certainly merits more thorough consideration by Customs, although we do appreciate that the European Single Market would preclude an exact Parallel being introduced into the UK, in particular, and the EU as a whole. (Para 34)”

The Government explored a proposal, put forward by the industry, under which all parts of the distribution chain from producer or importer right through to those selling spirits to final consumers would be licensed or registered. The Government acknowledged that a separate licensing system for duty purposes could be useful, improving Customs’ ability to identify and control this part of the distribution chain through licensing scrutiny and assurance activity, and allowing effective sanctions to be applied where they detect offences or irregularities.

However, in practice, all parts of the legitimate supply chain in the UK are already regulated, either under the duty or VAT regimes, or under liquor licensing provisions, and, in some cases, under both. Moreover, while a licensing system might enable Customs to eliminate some fraudsters, others may inevitably succeed in getting re-licensed under cover of a new business or a ‘clean’ frontman.

The USA’s system governing the sale and movement of excise goods is also far less liberal than the UK or EU systems. In the USA, duty is paid early in the process – essentially at ‘the factory gate’ – rather than being deferred, as has been the case in the UK since the early 1800s in line with a system first proposed by Robert Walpole some years earlier to move the tax burden on merchants closer to the point of consumption and away from production or importation.

The Government consulted last year on measures to radically tighten up the duty suspension arrangements in the UK: firstly to limit the numbers of movements in duty suspension, thereby reducing the opportunities for alcohol to be diverted; and secondly to limit the number of times that alcohol products could be sold while in warehouse, to prevent fraudsters hiding their connection with the goods in complex and artificially-long supply chains.

Both options were unanimously and firmly rejected by the industry mainly on the grounds of proportionality, cost, and fair-trading. The Government, having examined the industry responses carefully and reviewed the estimated anti-fraud impact in the light of information during the consultation period, agreed. With an anti-fraud impact of around £5million per year, the measures would not deliver the level of reduction in fraud the Government is seeking, and which will be delivered by duty stamps.

HM Treasury

22 June 2004

Appendix 2

Letter from John Healey MP, Economic Secretary, HM Treasury to the Chairman of the Committee

SPIRITS FRAUD

Thank you for your letter of 11 March to Gordon Brown about tax stamps.

I welcome your statement that your Committee, the Government and the spirits industry are united in supporting the need to tackle spirits fraud. We are clamping down successfully against criminal attacks in other regimes such as tobacco, oils and VAT, and must do so on spirits.

As you know from your own involvement, Treasury ministers and officials from both Treasury and Customs have had very extensive and thorough discussions with the spirits industry over the last 2-3 years on the most effective ways to tackle spirits fraud. Gordon's announcement in the Pre-Budget Report was made against the background both of Customs' latest fraud estimates and of the fact that it became clear that the options for reducing fraud on which we consulted over the summer would not in fact be effective.

The challenge of spirits fraud remains. I have welcomed the NAO's report and am considering its findings carefully. Of course where there is fraud there will always be uncertainty about its scale. As the NAO recognises, measuring illegal activity is inherently difficult. But this is not an argument for doing no analysis, still less an argument for taking no action to combat criminals.

All aspects of this issue, including the new package of alternative measures put forward by the industry since the PBR and the NAO's findings, are being thoroughly reviewed and evaluated in the run-up to next week's Budget. You have kindly invited me to give oral evidence to you Committee after the Budget and I look forward to that hearing.

I note you have made a copy of your letter available to Members in the House of Commons Library, and will make this reply available similarly.

12 March 2004