

SUBMISSION TO THE TREASURY SUB-COMMITTEE

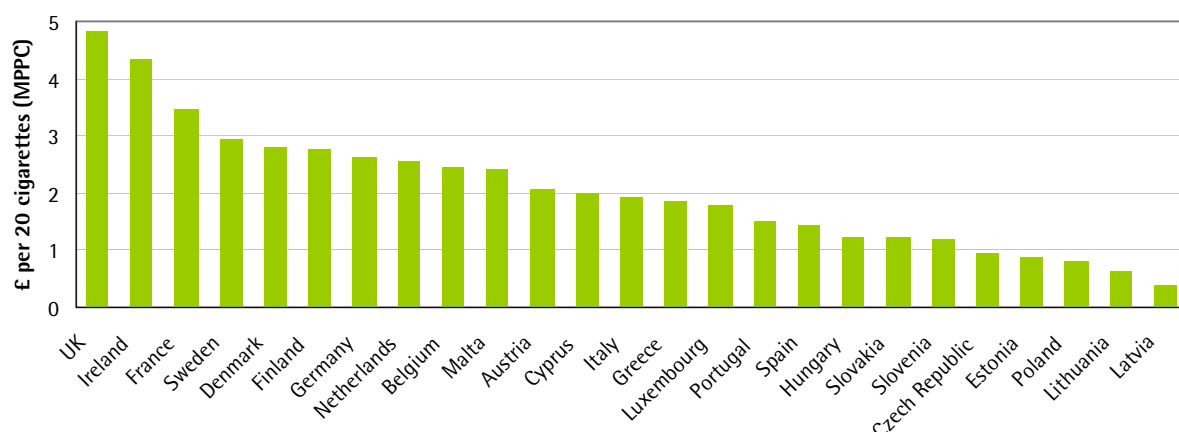
EXCISE DUTY FRAUD

This submission from the Tobacco Manufacturers' Association (TMA) represents the views of its principal member companies¹ who are responsible for the collection of £8 billion in excise duties each year. The growth in smuggling and crossborder shopping of tobacco products seen in the UK since the early 1990s is of great concern to us and has had a detrimental effect on the profitability of operations in the UK. Since 1993 sales of UK duty paid cigarettes have fallen by almost 40% and the value of the market has fallen by 30% in real terms. This has also had serious ramifications for thousands of retailers across the country.

THE CAUSE & SCALE OF THE PROBLEM

The UK experiences a high level of tobacco smuggling and crossborder shopping – amongst the highest in Western Europe. In 2002/3 HM Customs & Excise (HMC&E) estimated that 18% of cigarettes and 51% of handrolling tobacco (HRT) consumed in the UK was smuggled with crossborder shopping accounting for a further 9% and 18% respectively². Smokers are tempted to buy this product because of its low price compared to that in the legitimate UK duty paid (UKDP) market. Illegal tobacco sellers are typically charging £2.50 for 20 cigarettes and £5 for 50g of HRT, which represent savings of over £2.00 and £4.50 respectively against the cost of the price in the legitimate UK retail market. Chart 1 shows the typical price of 20 cigarettes in each of the EU Member States and shows how much those who travel abroad themselves can save through crossborder shopping.

Chart 1: Price of 20 Cigarettes Across the EU - October 2004



Source: TMA based on price, tax and exchange rate information available on 1 October 2004

¹ British American Tobacco, Gallaher Ltd & Imperial Tobacco Ltd.

² HM Customs & Excise. Annual Report and Accounts 2002/3: 94th Report of the Commissioners of Her Majesty's Customs & Excise. HMC&E, 2003

As well as providing huge savings for the smoker, the fact that there are around 13 million cigarette and HRT smokers in the UK means that there is a potentially large and lucrative market for criminals seeking to exploit the demand for products that consumers see as a bargain.

It is obvious that HMC&E face a mammoth task in identifying and halting the volumes of tobacco being smuggled into the UK via freight, cross-Channel and air routes. In 2003 UK residents made over 61.4 million visits abroad, 45 million of these were to other EU Member States - an increase of over 70% since 1993³. In 2002 there were over 14.9 million freight movements through UK ports, an increase of over 56% since 1993⁴. The recent growth in cheap flights provides further opportunities for low price tobacco to enter the UK, legally or illegally.

Although HMC&E seized 1.9 billion cigarettes and 258 tonnes of HRT in 2002/3 they estimate that 13.5 billion cigarettes and 4,500 tonnes of HRT were smuggled into the UK, representing a seizure rate of 12% and 6% respectively. The loss of revenue to the Treasury from tobacco smuggling in this period was estimated to be £3 billion and since the first estimates of revenue loss from smuggling were made by HMC&E in 1996, over £15 billion has been lost.

NON-UK DUTY PAID, SMUGGLED, BOOTLEGGED OR CROSSBORDER SHOPPED?

HMC&E claim that, based on their seizure data, the majority of smuggled product comes from outside the EU. However, we believe that HMC&E underestimate the scale of cross-Channel smuggling or 'bootlegging'⁵ and also legal crossborder shopping. This is due to its seizure policy being weighted towards extra-EU container traffic and so tending to uncover large volumes (2-8 million) of cigarettes at a time. Determining the extent of bootlegging is more difficult as HMC&E must differentiate between UK citizens exercising their right to buy tobacco for personal consumption and the bootlegger. Exchanges over the past two years between the UK Government and the European Commission have shown that enforcing this distinction is hard and therefore measuring it is that much more difficult.

The Government has sent out confusing signals about crossborder shopping. The change made to the UK's Minimum Indicative Levels (MILs) in October 2002⁶, which saw the allowances for cigarettes increase from 800 to 3,200 and for HRT increase from 1kg to 3kg, can only have helped further encourage crossborder shopping. While the decision in April 2004⁷ to apply restrictions on the allowances available for travellers to some of the low tax/low price countries that were joining the EU in May 2004 demonstrates that there is concern about the possibility of further growth in crossborder shopping and bootlegging.

Although it is correct for HMC&E to concentrate on the illegal importation of tobacco into the UK, we believe that the level of legitimate crossborder shopping is also having serious consequences for the Government's revenue and consumption objectives. In 2002/3 HMC&E estimate that 7 billion cigarettes and around 1,600 tonnes of HRT were legally brought into the UK, representing a revenue loss to the UK of £1.4 billion. The first estimate of revenue loss as a result of crossborder shopping was made in 1995 and was put at £50 million, since then almost £4.5 billion has been lost.

³ Transport Travel and Tourism: Overseas Travel and Tourism. Office for National Statistics, 2004

⁴ Transport Statistics Great Britain. Department for Transport, 2004

⁵ The illegal sale in the UK of tobacco goods that have been bought, duty paid, in another EU Member State.

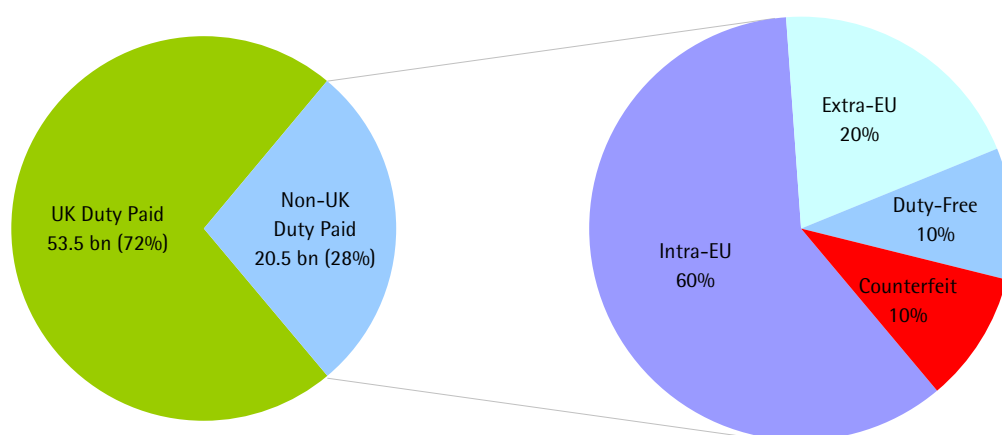
⁶ New Rights and Controls: The Next Stage in the Strategy to Combat Excise Smuggling and Protect Cross-Channel Shoppers. HMC&E Press Release, 29 October 2002

⁷ Tobacco Restrictions for Travellers Returning From Some New EU Member States. HMC&E Press Release, 1 April 2004

The TMA's estimate (see Chart 2) for the total volume of the market that evades UK duty through all forms of smuggling and crossborder shopping does not differ markedly from HMC&E's. For 2003 we estimated a level of non-UK duty paid (NUKDP) for cigarettes and HRT of 28% and 72% respectively, which is comparable to HMC&E's estimate for 2002/3 of 27% and 69%. Unlike HMC&E we are not able to determine how much of this NUKDP volume is smuggled.

Our analysis, which is based on the analysis of cigarette packs found in regular large-scale pack collections and face-to-face consumer interviews, does not provide us with any insight as to whether they are legal or illegal imports. However, we are able to determine the product's intended country of sale and whether it is genuine or counterfeit. Counterfeit cigarettes are a recent development in the UK and although small in volume - we estimate around 2 billion cigarettes out of the total UK consumption of 74 billion in 2003 were counterfeit - it is a growing problem.

Chart 2: TMA Estimate of UK Cigarette Consumption in 2003



Source: TMA

The high volume of Intra-EU product found in our surveys leads us to believe that the level of crossborder shopping and bootlegging is higher than HMC&E believe. We believe that the majority of the 7,200 tonnes of non-UK duty paid HRT that we estimate was consumed in the UK in 2003 - 72% of total HRT consumption - originates from other EU Member States.

HMC&E'S STRATEGY

Since 2001, when the measures outlined in the *Tackling Tobacco Smuggling (TTS)* strategy document started to come on stream, HMC&E appear to have halted the growth in the level of smuggling. This is very much welcomed by the TMA. When HMC&E release data showing their estimates for 2003/4 around the time of the forthcoming Pre-Budget Report, we hope to see the level of smuggling fall - for the first time - below the level reported at the beginning of the strategy.

However, it must be stressed that this strategy has been implemented during a period of fiscal restraint. It is no coincidence that cigarette smuggling took off in the UK following a prolonged period of above inflation tobacco duty increases and only levelled off when these ceased.

Two of the key markers for measuring the success of the *TTS* strategy - an increase in the price of cigarettes on the black market and the volume of product seized - show that HMC&E are not achieving the success they hoped for. With the introduction of scanners and the increase in manpower, HMC&E aimed to seize 5 billion cigarettes in 2002/3 but instead they seized 1.9 billion,

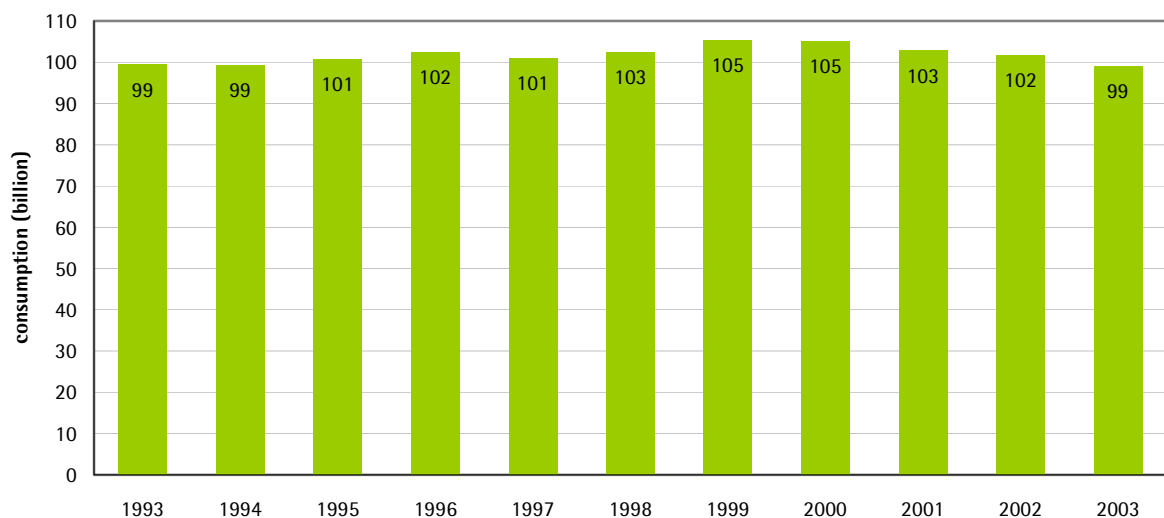
still an enormous amount, but less than that seized in previous years. Part of the reason for this 'failure' may be that the volumes found in seizures are now lower as smugglers instead dispatch a greater number of smaller loads thus minimising their chances of losing the whole volume. Ideally we would like HMC&E to be able to scan each and every one of the freight movements into the UK, but this is clearly impossible. However, more scanners and manpower would enable HMC&E to increase their detection rate and serve as a further deterrent.

The TTS strategy has also had little effect on the price charged for cigarettes on the black market. This remains, on average, £2.50 per pack of 20 and has remained largely unchanged over the last 5 years.

We believe that all this demonstrates that the drive against tobacco smuggling using enforcement measures alone is approaching its end. The long-term target to reduce cigarette smuggling to no more than 13% by 2007/8⁸ would still represent a high and unacceptable level of criminality. In addition there is no specific target to reduce HRT smuggling, nor is there any suggestion as to what level of crossborder shopping the Government is willing to accept.

As well as the targets to reduce smuggling and safeguard revenue the Government is committed to reducing tobacco consumption and smoking prevalence. While UKDP consumption has fallen the large volume of NUKDP product consumed in the UK has seen no change in overall tobacco consumption (see Chart 3) or smoking prevalence in the last 10 years. Indeed one of the Office for National Statistics' most recent statements⁹ on the smoking habits of adults in Great Britain was headlined "Cigarette Smoking: Stable now for a decade."

Chart 3: TMA Estimate of Total UK Tobacco Consumption 1993 - 2003



Source: TMA. Graph shows cigarette and cigarette equivalent of HRT consumption

TMA ACTION

The growth in smuggling and crossborder shopping has adversely affected the UK operations of our member companies. The UK duty paid cigarette market is 40% smaller than it was 10 years' ago while the value of this market is 30% lower in real terms; this has had a 'knock-on' effect on the retail network. Surveys conducted by the Tobacco Alliance have shown that many retailers have cuts

⁸ 2004 Spending Review. July 2004. New Public Spending Plans 2005 – 2008. HM Treasury, July 2004

⁹ Office for National Statistics Webpage 18 March 2004 (http://www.statistics.gov.uk/ci/nugget_print.asp?ID=866)

jobs as a result of falling sales caused by the high level of NUKDP consumption and many have been forced to close.

The long-standing level of co-operation between the TMA, our member companies and HMC&E to combat smuggling has recently been 'formalised' through a series of Memoranda of Understanding¹⁰. The TMA's member companies have themselves continued to take effective steps to reduce the supply of genuine product that may become available to smugglers. The success of these measures has been noted by HMC&E who, based on the increasing volume of counterfeit product found in their seizures, report that smugglers have turned to counterfeit product to satisfy consumer demand. In response TMA member companies have invested significant resources into initiatives with customs' authorities around the world to identify likely sources of counterfeit production and close them down. We welcome HMC&E's intention to develop a specific policy to deal with counterfeit cigarettes in the UK and we look forward to its implementation.

THE SOLUTION

We believe that despite the enforcement policies of HMC&E and the measure of success that *TTS* has delivered, the UK's high level of NUKDP tobacco consumption will continue unless the fundamental reason for this unacceptable situation - the high level of UK tobacco tax - is addressed.

The TMA believe that the level of smuggling, bootlegging and crossborder shopping can be reduced through two complementary measures. The first is for HMC&E to be provided with increased resources, both scanners and manpower, to tackle large-scale container smuggling. The second, and in our view most important, is to realign the level of UK tobacco taxes to eliminate the incentives for bootlegging and crossborder shopping. We do not believe that the necessary tax cuts would see any significant change in the level of overall tobacco consumption or in the Treasury's revenue take, they would simply move the majority of NUKDP consumption back to the UKDP sector.

When we met with the Economic Secretary to the Treasury (EST) in February 2004 we made the following recommendations to address the problem of tobacco smuggling and crossborder shopping:

- Return UK price differentials with Europe to mid-1990 levels - this would require tax reductions of £1 for 20 cigarettes and £4 for 50g HRT
- Limit personal imports of cigarettes from the new EU Member States to 200 cigarettes

To address the continuing problems of tobacco smuggling and crossborder shopping we make the same recommendation regarding tax reductions to the Committee as we made to the EST. We also recommend that the restrictions applied to the 'new' EU Member States be renewed when the Government reconsiders them in Spring 2005.

TMA

8 November 2004

¹⁰ HMC&E Press Releases 23 April 2002, 30 October 2002 & 14 July 2003