House of Commons

Treasury Committee

Excise Duty Fraud: Government Response to the Committee's Fourth Report of Session 2004–05 (HC 126)

Second Special Report of Session 2005–06

Ordered by The House of Commons to be printed 14 July 2005

HC 360
Published on 19 July 2005
by authority of the House of Commons
London: The Stationery Office Limited
£0.00

The Treasury Committee

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Second Special Report

On 15 March 2005, our predecessor Committee published its Fifth Report of Session 2004–05, Excise Duty Fraud, as House of Commons paper No. 126. We have now received a response from the Government (dated 17 June 2005) which is appended below.

APPENDIX

Government response

Recommendation 1.

Excise duty fraud grew significantly during the 1990s partly as a result of the opportunities provided to criminals by the introduction of the single market and of the large increases in international trade and passenger movements. We note Customs' acknowledgement that they did not initially react with sufficient speed to these developments. We are concerned that Customs failed to recognise and react to the effect that these events, which were predictable, would have on the level of smuggling and fraud. But we welcome the more strategic response which has subsequently been put in place.

The Government notes the Committee's concerns. The wider backdrop to the growth in excise fraud was the introduction of the Single Market but other factors played their part, most notably the reducing investment in Customs and the introduction of the tobacco duty rate escalator. Between 1990 and 1997 there were reductions of over 3,500 Customs staff and in the same timeframe the tobacco duty rate escalator ensured there were occasions when cigarette prices increased dramatically in short periods of time. For example, in 1995 there were two increases with a combined effect of over 12%.

In 1997, the Government cancelled a previously planned further reduction of 300 staff and subsequently, in 2000, as part of the Tackling Tobacco Smuggling strategy, provided HM Revenue & Customs with an extra £209 million to fund almost 1000 additional HM RC officers and a national fleet of x-ray scanners. This marked the start of a fundamental change in the Department's approach to tackling fraud by moving from a tactical approach to one based on well researched operational strategies delivering unambiguous outcomes, including additional funding for HM RC to tackle oils and alcohol fraud.

The Government has also set HM RC challenging year on year targets under its Public Service Agreement (PSA) to reduce the illicit market share of smuggled cigarettes. The target for 2007-08 is to reduce the illicit market share to 13%.

Recommendation 2.

While the differential in excise duty rates between the UK and other countries may be a significant factor in the level of legitimate cross-border shopping, most smuggling and fraud involves products on which little or no duty has been paid. Customs accepted that there was a relationship between rates of duty and the level of fraud. We would welcome a published study of this relationship.

The Government agrees that most smuggling and fraud involves product on which little or no duty has been paid, with large scale commercial smuggling continuing to account for the vast majority of seizures. In 2003-04, 76% of all cigarette seizures were commercial consignments intercepted either overseas or at UK seaports. As HM Revenue & Customs continues to successfully restrict the availability to smugglers of genuine product, so those smugglers are increasingly looking to counterfeit sources for their contraband. In 2003-04 54% of seized cigarettes were counterfeit, compared to 15% in 2001-02. These counterfeit cigarettes are manufactured in illegal factories in China, the Far East, Russia and Eastern Europe and then smuggled into the EU. Spirits fraud involves the illegal diversion of alcohol on which no duty has been paid, irrespective of the country of origin. Oils fraud involves the misuse in the road fuels sector of domestically sourced fuels that carry a significantly lower rate of duty for off road uses such as heating. This is also a significant part of the problem in Northern Ireland, but the land boundary here means that there is also smuggling of both rebated fuels and road fuels from the Republic of Ireland.

In relation to tobacco, analysts at HM Revenue & Customs and academics at the London School of Economics have recently developed a new theoretical model of this market, which aims to capture its modern complexities. The model has been published as a Government Economics Service paper titled 'The Demand for Tobacco Products in the UK', and is available on the HMRC website at www.hmrc.gov.uk.

Recommendation 3.

We support the approach now adopted by Customs that efforts to tackle fraud must be based on an accurate assessment of the size and nature of the problem. We acknowledge that estimating the level of excise duty fraud is difficult. Although useful progress has been made, we are concerned that losses from smuggling and fraud are currently estimated to be some £3,750 million a year, and therefore remain at an unacceptable level.

The Government welcomes the Committee's support. HM Revenue & Customs are in the forefront of the European Union in measuring excise evasion, and have been producing estimates of the amounts evaded from excise duties for several years; we first published a complete set of estimates of losses in tobacco, spirits and oils in November 2001 (for 1999-2000). The strategic approach adopted by HMRC has seen the volume of cigarettes smuggled cut by a third, oils fraud down by a quarter and spirits fraud substantially reduced.

Despite this success, the Government has set challenging targets to reduce smuggling and fraud further, so that by April 2008 the illicit market share for cigarettes is no more than 13%, the illicit market share for spirits has been reduced to at least half, and the illicit market share for oils in England, Scotland and Wales is no more than 2%.

Recommendation 4.

Customs and the tobacco industry broadly agree on the scale of cigarette smuggling, that it peaked in 2001 at around 21% of the market, and that it is now declining. Customs' strategy for tackling tobacco smuggling appears to be having an effect on illicit cigarettes, but with revenue losses running at £1,900 million a year, there is still a long way to go.

Through their *Tackling Tobacco Smuggling* strategy, announced in March 2000, HM Revenue & Customs have succeeded first in halting the previous rapid growth in cigarette smuggling and then reducing the market share for illicit cigarettes to its current level of 15 per cent. In the past four years more than 9 billion cigarettes have been seized and over 259 gangs involved in large scale smuggling broken up. Furthermore, the total number of cigarettes smuggled into the UK each year has been reduced by over 5 billion sticks, which represents a reduction of over one third.

Although tobacco smuggling is now being contained, the Government agrees that there is still much work to do. That is why the target set by the *Tackling Tobacco Smuggling* strategy has been extended to reduce the illicit market to 13% by 2007-08.

Recommendation 5.

The fact that only 3 out of every 10 packets of hand rolling tobacco consumed in the UK are duty paid is a matter of very serious concern. The illicit market share for hand rolling tobacco has been above 50% of the market for each year since estimates have been available, and is now rising. In our view this indicates that the level of smuggling in this area is extraordinarily high. We note that the Treasury and Customs are considering what action to take to provide a fresh focus on hand rolling tobacco in their strategy for tackling tobacco smuggling. Effective action is urgently required.

The Government agrees that the illicit market share for hand rolling tobacco (HRT) is cause for concern. The respective markets for cigarettes and HRT are evolving differently with the proportion of smokers who smoke HRT having increased against a backdrop of decreasing overall consumption. Analysis undertaken by HM Revenue & Customs has identified that the proportion of smokers who smoke HRT has more than doubled from 10% in 1992-93 to 22% in 2002-03. The respective illicit markets are also fundamentally different with the majority of illicit HRT being sourced, duty paid, in the EU.

As the Chancellor announced in the Budget, the Government is considering further action to tackle the smuggling of hand-rolling tobacco with a view to announcing a package of further measures later in 2005.

Recommendation 6.

Customs have signed memoranda of understanding with the major UK tobacco manufacturers designed to reinforce co-operation in tackling tobacco smuggling into the UK. We expect tobacco manufacturers to co-operate fully with Customs to ensure that their products do not get into the hands of smugglers. We note the views of both Customs and the UK manufacturers that the current arrangements are working well and that this is evidenced by a reduction in the amount of genuine UK-manufactured cigarettes in the illicit market.

The Government welcomes the Committee's recognition of the impact of the work undertaken with the tobacco manufacturers. HM Revenue & Customs expect this co-operation to continue and are looking to enhance the existing Memoranda of Understanding to ensure greater control of legitimate supply chains and introduce further measures to address the problem of counterfeit.

Recommendation 7.

The memoranda of understanding between Customs and the UK manufacturers predate the EU agreement with Philip Morris. However, answers we received to questions asking what difference the memoranda had made to what was being done before did not leave us with an impression of a radical change in the practices of the major UK tobacco companies. We recommend that Customs review the provisions of each memorandum in the light of the commitments contained in the EU agreement with Philip Morris with a view to reinforcing the existing arrangements where necessary.

The Government agrees with this recommendation. HM Revenue & Customs are reviewing the provisions of the memoranda of understanding they have and aim to conclude any revised arrangements this year. HM Revenue & Customs work with the Tobacco Manufacturers has seen the incidence of UK manufactured cigarettes being smuggled back into the UK fall markedly from about 75% of large seizures in 2000-01 to 28% in 2003-04.

Recommendation 8.

We are concerned to note, particularly in view of the claimed success of the memoranda of understanding with UK manufacturers, that Customs have not sought a similar agreement with Philip Morris. The UK could have signed, and still can sign, the EU agreement with Philip Morris with the prospect of receiving payments from the company when their tobacco products are seized as contraband. Had this been done, payments would have been due to the UK for smuggled Philip Morris cigarettes in 2003–04. Whether it would be better for the UK to sign the EU agreement or to seek a separate memorandum of understanding with Philip Morris depends upon the arrangements that can be negotiated with the company. But doing nothing is unacceptable. We expect Customs to take this matter forward as a matter of urgency.

HM Revenue & Customs will reconsider the need for a specific memorandum of understanding (MoU) with Philip Morris International (PMI) in light of the other MoU reviews that are currently underway. HMRC do not currently have an MoU with PMI as their products have very little significance in the illicit UK tobacco market. In 2003-04 less than four in every 100 cigarettes seized were genuine PMI product; Customs estimate that the supplementary payments to the UK in 2003/2004 for smuggled PMI cigarettes would have been well under £1 million. In the same year PMI branded cigarettes equated to 3.5% of total UK seizures compared with 2.6% in 2002-03. Indications for 2004-05 are that the proportion of genuine PMI product seized has fallen below 2002-03 levels.

On the basis of market share alone, it is questionable whether there are sufficient benefits to warrant co-signing the PMI Agreement with the EU. Not only does PMI product make up a tiny share of the illicit market in the UK but their deal with the EU is inferior in some respects to the agreements HMRC currently have in place with the other tobacco manufacturers. For example, the tracking and tracing provisions to identify a first customer are only applicable to master cases (10,000 sticks), whereas both Imperial and Gallaher are able to trace the first customer from a single pack of 20 sticks. Nor does the EU-PMI deal cover the intra-EU illicit cigarette trade.

Recommendation 9.

Counterfeit cigarettes are a significant and growing problem in the UK that threaten both revenues and public health. We note Customs' efforts and those of the industry to tackle this issue which, to be successful, depend on co-operation with enforcement agencies overseas to identify contraband destined for the UK and to cut off the supply of counterfeit cigarettes at source, the illegal factories where they are made.

The Government agrees with this conclusion. Following the introduction of the Tobacco Strategy, HM Revenue & Customs have been increasingly active abroad, employing 15 Fiscal Liaison Officers (FLOs), who are permanently based overseas, within a network covering 44 countries. In 2003-04, this overseas network intercepted more smuggled cigarettes before they reached the UK than were seized at UK seaports.

HMRC have increased the resources invested in the Fiscal Liaison Officer (FLO) network, and will continue to review these resources ensuring they remain appropriate to target the levels of perceived risk.

Recommendation 10.

We were surprised to learn during our visit to China, the largest source of counterfeit cigarettes destined for the UK, that there was only one UK Customs officer, based in Hong Kong, to cover the whole country. We were also surprised to discover that until our visit there had been no meetings between UK Customs and the State Tobacco Monopoly Administration, the agency charged with tackling cigarette counterfeiting in China. We recommend that Customs review the resources they are devoting to intelligence gathering and co-operation with enforcement agencies overseas and the location of the officers concerned and consider placing officers within China.

The Government agrees with this recommendation. In 2001-02 counterfeit cigarettes were a relatively small problem in the UK with HM Revenue & Customs estimating that 15% of large seizures were counterfeit. This proportion has grown steadily, so that in 2003-04 counterfeit cigarettes had grown to 54% of all seizures. HMRC believe that the primary sources of counterfeit cigarettes are currently China, the Far East, Russia and Eastern Europe.

In view of this growth in counterfeit cigarettes, HMRC, having reviewed the resources devoted to liaison work in China, appointed an additional officer from April 2005 and are currently seeking to fill a further post which will increase the complement in the region to three. It is likely that these officers will continue to be based in Hong Kong which is conveniently situated for the main export locations of counterfeit cigarettes, and liaison with Chinese Customs, at the maritime ports in Fujian, Guangdong, Zhejiang and Shanghai Provinces.

HMRC aim to address the supply of counterfeit product from China by working through the most appropriate channels to achieve this. HMRC are party to the existing Inter Governmental Multi-Agency MoU which allows them to co-operate with the Chinese law enforcement authorities in combating criminal activity. China Customs, who come partly under the Ministry of Public Security are included in this, whereas the State Tobacco Monopoly Administration (STMA) are not. Furthermore, the focus of the STMA is on inland activity—dismantling factories and packing houses etc, and UK Customs cannot assist them in this as they have no intelligence on this activity.

The work HMRC has undertaken with the Chinese authorities has resulted in some notable successes. For example, in 2004 more than 23 million counterfeit cigarettes have been seized in China in joint operations between UK and China Customs. The relationship HMRC have with the Chinese authorities is productive and they continue to work to improve it.

Recommendation 11.

We recognise that estimating the level of spirits revenue evaded through fraud and smuggling is difficult. But confidence in Customs' estimates of spirits fraud is undermined by a number of factors. The figures are disputed by the industry, whose alternative estimate, showing fraud to be much lower, is equally valid statistically. The level of uncertainty attached to Customs' estimates is such that their latest figure for fraud, of £250 million a year, falls statistically within a range of minus £150 million to plus £650 million. And if the methodology used for estimating spirits fraud is applied to beer, it produces a result that suggests more tax is collected than beer is consumed.

Recommendation 12.

Given these factors, we conclude that specific estimates for spirits fraud can only be viewed with caution. We look to the review being undertaken by the Office for National Statistics to result in more accurate estimates being produced. We expect this to be completed and published promptly.

The Government partially accepts the committee's conclusion and has always acknowledged that there is an inherent level of uncertainty in the published spirits fraud estimate. However, the Government is satisfied that the current estimate – for 2002-03 is reasonable and notes that HM Revenue & Customs operational evidence suggests that spirits fraud is a significant problem. For example, that year HMRC seizures prevented over 100,000 bottles of illicit spirits finding their way onto retail shelves every month (1.3 million bottles seized in the year) and they successfully prosecuted 55 people for alcohol fraud offences, in doing so disrupting 24 criminal gangs involved in the supply of non-duty paid alcohol.

The Government welcomes the Office for National Statistics decision to review consumption data sources and awaits their report with interest.

Recommendation 13.

Excise duty receipts on beer, wine and other alcohol products were some £5 billion in 2003–04, substantially more than the £2.4 billion collected on spirits. We note Customs' evidence that the level of fraud is much lower in this area, but it is of concern that there are no reliable estimates to support this view. We look to Customs to provide robust estimates of the level of fraud in all areas where significant revenue streams are at risk.

The Government accepts the Committee's concern. HM Revenue & Customs continue to explore alternative methods to measure the illicit beer and wine markets, however this is a technically demanding undertaking.

Tax gap estimates are based upon estimates of total consumption from survey data, which contain significant levels of statistical uncertainty. Results from spirits show that currently available datasets from the Office for National Statistics produce ranges in the estimate of around plus or minus ten percentage points for alcohol consumption. This makes it difficult to measure any fraud activity of less than 5 to 10 per cent, which is believed to be the case for wine and beer. Solving this and the statistical challenge of correcting for underreporting of consumption of these products relies on obtaining new, more accurate, estimates of total consumption.

Work in this area is ongoing and is a priority, but may require the commissioning of a specific survey, which will take some time to produce results. In the short term HM RC is developing a risk matrix for alcohol that will inform operational activity and future strategy development. It will be in use from the autumn 2005 and, coupled with operational results analysis, will enhance the department's capability to identify criminal activity and trends in fraud, including beer and wine.

Recommendation 14.

The Government is convinced that tax stamps on spirits bottles are required to tackle alcohol fraud. Following lengthy and detailed consultations with industry, which have resulted in a number of changes to the proposals to minimise compliance costs, a tax stamp scheme is to be implemented early in 2006–07. The decision to proceed with the scheme was made when losses were estimated to be some £600 million a year. But estimated losses have fallen, without a tax stamp regime being in place, to £250 million a year, a figure which on past experience could well be revised downwards.

Recommendation 15.

The decision to implement tax stamps should be based on accurate and up-to-date assessments of the level of fraud, and of compliance costs, in order to determine whether the expected benefits outweigh the costs. Customs' estimates of fraud contain a significant level of uncertainty, and the most recent figure is for the year 2002–03. We expect this estimate to be revised as new information is available, either from later figures, or as a result of the review being undertaken by the Office for National Statistics. But as the latest estimate of fraud (£250 million a year) is of a different order of magnitude from the estimated compliance costs (£7 million start-up costs and £5 million a year thereafter), we conclude that the latest proposals for tax stamps cannot be considered a disproportionate response to the problem.

The Government accepts the Committee's conclusion. Since the intention to introduce duty stamps for spirits was announced, the Government and HM Revenue & Customs have worked extensively, and very constructively with the industry to ensure the development of a scheme that will be effective in helping to reduce spirits fraud, but that also minimises and offsets the compliance costs to the legitimate trade.

Recommendation 16.

We received little evidence on oils fraud during our inquiry. Customs' estimates of the level of fraud do not appear to be a matter of dispute with the industry, but we are concerned that proper figures for Northern Ireland are not available.

HM Revenue & Customs do not have figures for the illicit market in Northern Ireland as we are unable to collect data on cross-border shopping. Unlike the major entry and exit points from Great Britain, traffic is not canalised when it crosses the Northern Ireland land boundary, instead it passes through one of around 300 crossing points. This means it is not possible to make reliable estimates of cross-border shopping or smuggling and therefore HM Revenue & Customs publishes a non-UK duty paid market share figure, which covers both fraud and legitimate cross-border shopping.

These estimates, published in the Pre-Budget Report in 2004, show that the revenue loss in the non-UK duty-paid market in Northern Ireland road fuel has reduced by 9% between 2000 and 2003. Moreover, the Industry have long used the deliveries of legitimate road fuel into Northern Ireland as a measure of the health of the market. Following five years of decline between 1996 and 2000, we have seen three years of successive increase in 2001, 2002 and 2003 as shown in the following table.

	Diesel	**Petrol**	**Total**	**+/-**
2000	190m litres	405 m litres	595 m litres	-13%
2001	205 m litres	430 m litres	635 m litres	+7%
2002	245 m litres	450 m litres	695 m litres	+9%
2003	290 m litres	450 m litres	740 m litres	+6%

Recommendation 17.

We note Customs' evidence that oil frauds in Great Britain are principally the result of rebated fuels fraud—the laundering, mixing and misuse of red diesel, kerosene, and oils used for industrial processes. We are concerned at the scale of fraud in this area, currently estimated to be some £850 million a year, and we are struck by the fact that there has been a consistent pattern of estimates for a given year being subsequently revised upward. We cannot consider Customs' strategy for tackling oils fraud to be working satisfactorily when losses continue at this level. We therefore recommend that this strategy and the resources devoted to tackling oils fraud be reviewed if there is not a significant improvement when the next figures are produced with the Pre-Budget Report 2005.

The latest estimates of diesel fraud show that it is reducing with the illicit market reduced from 8% at the end of 2000 to 6% at the end of 2003. Based on operational data HM Revenue & Customs expect to see a further reduction in the GB illicit diesel market when our estimates for 2004 are published. However, if the expected reduction in the illicit market in 2004 does not occur, then we accept the Committee's recommendation that it would be necessary to carry out a review of the UK Oils Strategy.

HM Treasury
17 June 2005