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COMPTROLLER AND
AUDITOR GENERAL

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HM Revenue & Customs

Progress in tackling tobacco smuggling

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National Audit Office

HM Revenue & Customs

Progress in tackling tobacco smuggling

Report by the Comptroller and Auditor General

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Audit Departments Act 1921

Amyas Morse
Comptroller and Auditor General
National Audit Office

4 June 2013

This report examines HMRC's progress in tackling tobacco smuggling since the introduction of its renewed strategy.

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Key facts

£9.9bn

duty collected in 2011-12
from sale of tobacco
products

£1.9bn

HMRC's estimate of
revenue loss due to
tobacco smuggling
in 2010-11

9%

HMRC's estimate of
the illicit market share
for cigarettes in 2010-11

38%

HMRC's estimate of
the illicit market share
for hand-rolling tobacco
in 2010-11

£69 million HMRC's expenditure on tackling tobacco smuggling in 2011-12

1.7 billion reported number of illegal cigarettes seized as a result of HMRC
and Border Force action in 2011-12

572 tonnes reported volume of hand-rolling tobacco seized as a result of HMRC
and Border Force action in 2011-12

£919 million reported revenue loss prevented due to HMRC and Border Force
action against the organised crime element of tobacco smuggling
in 2011-12

Summary

- 1** Section 2 of the Exchequer and Audit Departments Act 1921 requires the Comptroller and Auditor General (C&AG) to examine the accounts of HM Revenue & Customs (HMRC) to ascertain that adequate regulations and procedures have been framed to secure an effective check on the assessment, collection and allocation of revenue, and that these regulations and procedures are being duly carried out.
- 2** Tobacco duties generated £9.9 billion of revenue in 2011-12, but tobacco smuggling represents a significant risk to revenues. HMRC estimates that duty was not paid on some 9 per cent of cigarettes and 38 per cent of hand-rolling tobacco smoked in the UK in 2010-11, with associated revenue losses of around £1.2 billion and £0.66 billion respectively.
- 3** Tobacco smuggling undermines government initiatives to reduce the prevalence of smoking as it makes smoking more affordable. It can also be linked to organised criminal gangs involved in other crimes such as drug smuggling and people trafficking.
- 4** The Committee of Public Accounts reported on HMRC's progress in tackling tobacco fraud in 2003 and 2006.¹ The Committee's 2006 report noted that between 2000-01 and 2003-04 the market share in illicit cigarettes fell from 21 per cent to 16 per cent, and included a recommendation that HMRC consider whether further reductions could be achieved by devoting more resources to this area.
- 5** HMRC launched the latest iteration of its tobacco strategy in April 2011. This is a joint strategy with Border Force; HMRC has overall responsibility for delivery while Border Force is responsible for the seizure of illicit tobacco at the border. As part of the 2010 spending review, HMRC allocated an additional £25 million over four years to tackling tobacco fraud by organised criminal gangs. It expected this investment to achieve a benefit of £1.4 billion in terms of revenue loss prevented.
- 6** HMRC's approach before the latest iteration of its strategy contributed to a decline in the market share for illicit tobacco products between 2000-01 and 2010-11, from 21 per cent to 9 per cent for cigarettes, and from 61 per cent to 38 per cent for hand-rolling tobacco.
- 7** This report examines HMRC's progress in tackling tobacco smuggling since the introduction of its renewed strategy.

¹ Committee of Public Accounts, *Tobacco Smuggling*, Third Report of Session 2002-03, HC 143, January 2003. Committee of Public Accounts, *Customs & Excise Standard Report 2004-05*, Forty-eighth Report of Session 2005-06, HC 874, June 2006.

Key findings

Scope of the strategy

8 HMRC's strategy for tackling tobacco smuggling is logical and includes a range of complementary measures. It includes a wide range of initiatives to tackle different aspects of the problem, such as activity to detect and seize illicit goods, pursue criminal and civil sanctions, engage with tobacco manufacturers to reduce the availability of genuine products for fraud, and work with partner organisations within the UK to reduce demand for smuggled tobacco products (paragraphs 1.17, 1.18, 1.23 and 1.24).

9 HMRC's approach to deterring and disrupting the illicit market within the UK is not yet effectively integrated. HMRC is already taking action, including targeted local enforcement operations and a new project focus to building and sharing intelligence. However, it recognises that it needs better intelligence on distribution networks for illicit tobacco within the UK to help target its domestic enforcement activities. HMRC participates in regional partnerships to improve collaboration with other agencies such as the police, trading standards and health organisations. While existing partnerships have shown promising results, the approach has not yet been rolled out across the country due to funding constraints. There were 159 people convicted of tobacco fraud in 2012-13, but HMRC does not yet have a good understanding of the role of enforcement action in creating an effective deterrent (paragraphs 1.23 to 1.27, 2.30 and 2.38).

Progress in implementing the strategy

10 HMRC has made progress against its key operational objectives but performance fell short of internal targets in 2012-13. HMRC made progress against all of its key objectives over the first two years of its renewed strategy. It exceeded all but one of its internal targets in 2011-12 but failed to meet more stretching targets in 2012-13. HMRC has implemented a number of the key commitments made in its strategy, including reducing the minimum indicative levels for EU travellers, and supporting the development of an international protocol to combat tobacco smuggling (paragraphs 2.1, 2.20 and 2.47).

11 HMRC's focus on building overseas intelligence is yielding success. As part of the 2010 spending review, HMRC funded 11 overseas intelligence officers, bringing the total to 28. Overseas intelligence officers work with host countries to gather and exchange information on criminal activity including customs fraud. HMRC estimates that its intelligence officers worked with overseas authorities to seize goods equivalent to preventing a revenue loss of £658 million between 2011-12 and 2012-13 – 7.5 per cent above target. In total, the overseas intelligence officers facilitated the seizure of an estimated 1,270 million cigarettes and 56 tonnes of hand-rolling tobacco overseas in 2012-13, although there are limitations in the assurance of HMRC's reported performance on overseas seizures (paragraphs 2.3 and 2.8 to 2.18).

12 HMRC is unlikely to achieve its plan to prevent revenue loss of £1.4 billion from investment in new tobacco initiatives over the spending review period. Two of the five strands of HMRC's plans for reinvestment in tackling tobacco smuggling are on track (the expansion of overseas intelligence officers and the new approach to criminal investigation). However, the remaining three initiatives have been significantly delayed or cancelled, including one key initiative to tackle over-supply of genuine tobacco overseas, where the proposed approach was abandoned on legal grounds. HMRC achieved a benefit of £328 million by the end of 2012-13 from reinvesting £10.9 million in tackling tobacco smuggling – less than two-thirds of the original benefit expected at this point. The original plan to prevent revenue loss of £1.4 billion from new tobacco initiatives over the spending review period appears unachievable (paragraphs 2.2 to 2.4, 2.15 to 2.18, 2.26, 2.27 and 2.36).

13 HMRC's analysis shows a continuing problem of over-supply of genuine tobacco products to overseas markets despite the introduction of supply chain legislation in 2006. Under supply chain legislation passed in 2006, tobacco manufacturers have a legal obligation not to facilitate smuggling as far as is reasonably practicable. HMRC has worked with tobacco manufacturers since the introduction of the legislation to tackle specific concerns and to review their supply chain policies. Tobacco manufacturers' sales data shows supplies to high-risk markets have fallen since the introduction of the legislation, with a fall of 20 per cent between 2010 and 2012. HMRC remains concerned that supplies of certain brands to specific countries are considerably higher than legitimate local demand. HMRC's latest estimate, for 2011, is that the aggregate actual supply of some brands of hand-rolling tobacco to some countries exceeded legitimate demand by 240 per cent. HMRC has not applied the full range of sanctions available under supply chain legislation. It has issued only one warning letter and no penalties in this period as it considers it has had insufficient evidence that tobacco manufacturers are facilitating smuggling (paragraphs 2.19 to 2.25).

Evaluating performance

14 HMRC publishes detailed estimates of tax losses from tobacco smuggling. HMRC is one of the few tax authorities worldwide to publish tax gap estimates. It recognises that its estimates of the illicit market share for cigarettes and hand-rolling tobacco are subject to an 18-month time lag, meaning that the latest available data are for 2010-11. More up-to-date survey data have become available which will allow HMRC to generate more timely estimates and publish these from autumn 2013 onwards (paragraphs 1.6 to 1.12).

15 Inaccuracies in the reported impact of criminal investigations limit its usefulness as a performance measure. HMRC assesses the impact of criminal investigations by estimating the amount of revenue loss its actions have prevented. Amounts of revenue loss prevented count towards HMRC's measure of 'total revenue raised', a published performance indicator. We reviewed cases that covered 60 per cent of the £540 million impact HMRC reported it had achieved between April 2011 and October 2012 from criminal investigations into tobacco fraud. HMRC has chosen to assess impact at the first point of intervention rather than at the outcome of a case. This enables reported impact to be linked to activity within a particular year, as a case may take some years to come to trial. We found that this led to significant under-reporting because information that came to light later in the case was not reflected. In one case this meant recorded impact was potentially understated by £17 million. It also led to potential over-reporting because not all cases lead to arrests and convictions. In one case where there were no arrests HMRC claimed an £11 million impact equivalent to preventing the fraud for 12 months. We also found a lack of clarity over how calculations should be made, updated and recorded (paragraphs 2.31 to 2.35).

Overall conclusion

16 HMRC's renewed strategy for tackling tobacco smuggling, launched in April 2011, is logical and sets out a wide range of complementary measures to tackle the problem, but its approach to deterring and disrupting the distribution of illicit tobacco within the UK is not yet effectively integrated. HMRC's focus on building overseas intelligence is yielding success. HMRC exceeded internal operational targets in 2011-12 but fell short of more stretching targets in 2012-13 and has failed to capitalise on additional reinvestment funding made available under the 2010 spending review settlement. Two years on, HMRC also lacks a timely and comprehensive assessment of the impact of its strategy on the scale and nature of tobacco smuggling.

Recommendations

- a HMRC should develop its approach to tackling the trade in tobacco products within the UK.** HMRC should:
- assess the deterrent impact of enforcement action against people selling illicit tobacco; and
 - develop further its collaborative work with police, trading standards and other local bodies, building on successful regional initiatives.
- b HMRC should evaluate the options for improving its methodology for estimating tax losses from tobacco fraud.** HMRC recognises that it needs more accurate and up-to-date information on the scale of the illicit market. It should continue to explore options including involving other sources of expertise, such as academic input.

- c** **HMRC should improve the quality of its key performance information or disclose limitations in any public reporting.** HMRC should ensure teams take a more consistent and evidence-based approach to estimating the revenue loss prevented from criminal prosecutions and disclose the limitations in its approach in any public reporting. While it may not be feasible to impose independent checks on seizure volumes reported by overseas tax authorities, it should also disclose these limitations in any public reporting.
- d** **HMRC should ensure that projected benefits from key initiatives are fully tested before they are announced.** HMRC should take a more robust approach to challenging the feasibility of projects at an early stage, including seeking legal and technical advice where appropriate.
- e** **HMRC should establish why legislation has not yet resolved the problem of over-supply of tobacco overseas.** HMRC should establish what more it needs to do to resolve outstanding concerns. It should take a robust stance in its enforcement activities with tobacco manufacturers where it establishes clear evidence of over-supply to foreign markets.

Part One

HMRC's renewed strategy

This part of the report examines the evolution of HMRC's approach to tackling tobacco smuggling. Tobacco smuggling refers to tobacco products imported illegally to the UK. The illicit market refers to the trade in smuggled goods.

The nature of the threat

1.1 Tobacco smuggling is a significant threat to UK tax revenues. HMRC collected £9.9 billion in duty from the sale of tobacco products in 2011-12. It estimates that duty was not paid on around 9 per cent of cigarettes and around 38 per cent of the hand-rolling tobacco smoked in the UK in 2010-11, with associated revenue losses of approximately £1.2 billion and £0.66 billion respectively.

1.2 Illicit tobacco products also have public health implications because they make smoking more affordable and illicit tobacco products distributed through informal networks can be more accessible to children and young people. Counterfeit tobacco products are unregulated.

1.3 The potential profits from tobacco smuggling are substantial. The UK has one of the highest rates of tobacco duty in the world. **Figure 1** shows the difference in price of a pack of 20 premium cigarettes across Europe. A premium pack of cigarettes in the UK costs around £7.50, of which some £5.10 is duty and VAT. While a high rate of tax can provide an incentive for tobacco smuggling, there are other factors that contribute to levels of smuggling, such as the likelihood of being caught and the nature of punishments.²

1.4 The nature of the threat from tobacco smuggling has evolved since HMRC first published a strategy for tackling tobacco smuggling in 2000. There are four main types of smuggled tobacco products: genuine UK brands on which UK duty is not paid; genuine non-UK brands; brands produced mainly or solely for the illicit market (known as 'illicit whites'); and counterfeit versions of existing UK brands. In 2000, most large cigarette seizures consisted of genuine UK brands, but by 2012-13 most large seizures were of illicit whites. Some types of illicit white cigarettes are so popular in the UK that their 'brand' has become well-known, for example 'Jin Ling'. HMRC seized 47 million Jin Ling cigarettes in the UK in 2010-11 – a quarter of all seizures of illicit whites in that year.

² L. Joossens and M. Raw, 'Strategic directions and emerging issues in tobacco control: From cigarette smuggling to illicit tobacco trade', *Tobacco Control*, vol. 21, issue 2, March 2012, pp. 230-34, online: www.tobaccocontrol.bmj.com, downloaded on 30 July 2012.

Figure 1
Cigarette price differentials across Europe



- Less than £1.99
- £2.00 – £3.99
- £4.00 – £5.99
- More than £6.00
- No data available

NOTES

- 1 Premium cigarette prices (per 20) as at January 2013.
- 2 Figures obtained from www.illicitradereview.com/JTITradeReview2012.pdf, and converted to sterling on basis of average sterling-euro exchange rate in January 2013: £0.83 to €1.

Source: Tobacco Manufacturers' Association and National Audit Office analysis

1.5 Organised criminal gangs are heavily involved in tobacco smuggling. These gangs have the capacity to smuggle products in bulk and adapt smuggling routes in response to HMRC's interventions. The trade in illicit tobacco products also involves bootlegging: individuals or small groups who import small quantities of products, abusing cross-border shopping provisions. Illegal products are also manufactured in the UK, primarily counterfeit hand-rolling tobacco.

Tax losses from illicit tobacco

1.6 The nature of the illicit market means it is difficult to measure accurately the revenue losses from illicit tobacco, known as the tobacco tax gap. Transparent public data on illicit tobacco are limited and, in many countries, non-existent.³ In 2010, the Organisation for Economic Co-operation and Development found that, from a sample of 49 countries, 20 attempted to calculate their overall tax gap (of which the tobacco tax gap is a part) and, of these, 12 made their tax gap estimates public.⁴

1.7 HMRC publishes data on the tobacco tax gap and makes the methodology public. It estimates the gap from an assumption of total tobacco consumption minus legitimate consumption. Total consumption is estimated from Office for National Statistics survey data on smoking prevalence and personal daily consumption. HMRC recognises that this could be a significant underestimate of actual consumption and makes an adjustment of around 40 per cent for under-reporting. Legitimate consumption is estimated from HMRC data for tobacco sales, and assumptions about legal overseas shopping from other Office for National Statistics survey data.

1.8 Due to the uncertainty around the estimate, HMRC quotes a range for the tobacco tax gap. **Figure 2** shows HMRC's estimate of the illicit market share for cigarettes and hand-rolling tobacco. The downward trends suggest that the tax gap has fallen since 2000-01, from 21 per cent to 9 per cent for cigarettes and from 61 per cent to 38 per cent for hand-rolling tobacco. Over this time, cigarette consumption has fallen while that of hand-rolling tobacco has increased. Revenue losses in 2000-01 were estimated at £2.7 billion for cigarettes and £0.67 billion for hand-rolling tobacco. According to the latest data available (for 2010-11), HMRC estimated revenue losses to tobacco fraud were £1.2 billion for cigarettes and £0.66 billion for hand-rolling tobacco.

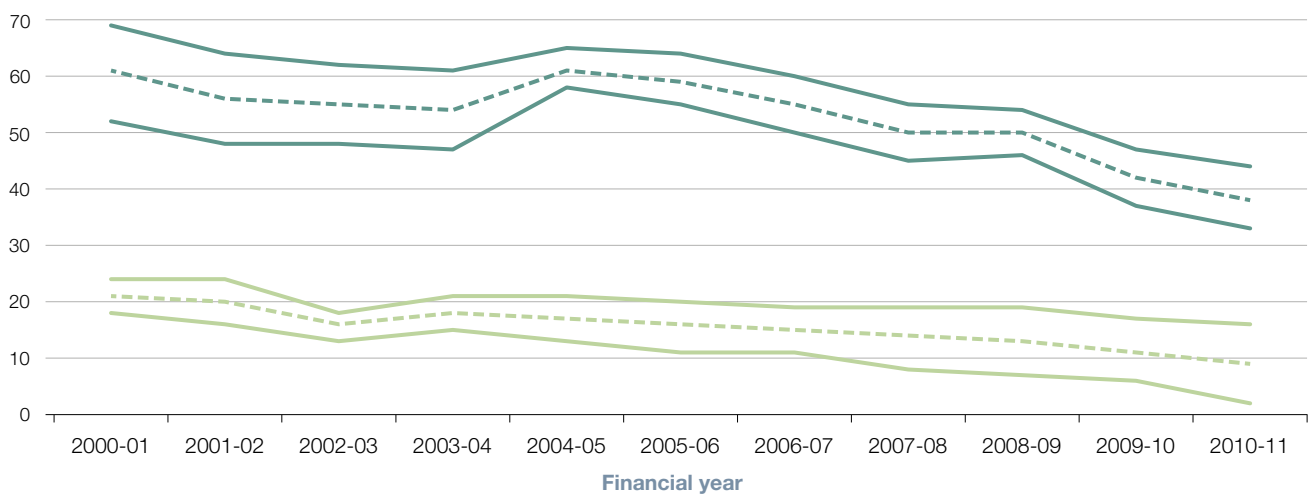
3 L. Joossens and M. Raw, 'Strategic directions and emerging issues in tobacco control: From cigarette smuggling to illicit tobacco trade', *Tobacco Control*, vol. 21, issue 2, March 2012, pp. 230-34, online: www.tobaccocontrol.bmj.com, downloaded on 30 July 2012.

4 Organisation for Economic Co-operation and Development, *Tax administration in OECD and selected non-OECD countries: comparative information series*, 2010, p. 92, online: www.oecd.org/tax/administration/CIS-2010.pdf

Figure 2

HMRC's estimates of the illicit market share for cigarettes and hand-rolling tobacco from 2000-01 to 2010-11

HMRC's estimates of the cigarette and hand-rolling tobacco tax gaps each show a clear downward trend since a strategic approach was adopted in 2000

Illicit market share (%)

- Hand-rolling tobacco range
- - - Hand-rolling tobacco midpoint
- Cigarette range
- - - Cigarette midpoint

NOTES

- 1 HMRC uses different assumptions to determine high and low estimates, and also quotes the midpoint between the two.
- 2 For cigarettes, the high estimate assumes that personal daily consumption is the same as in 1994-95; the low estimate assumes personal daily consumption has declined in line with the trend in reported consumption.
- 3 For hand-rolling tobacco, the estimate comprises different assumptions about the total consumption of dual smokers (those who declare smoking cigarettes and hand-rolling tobacco) and the estimate of legitimate consumption is varied by assumptions of overseas shopping.

Source: National Audit Office analysis of HM Revenue & Customs Measuring tax gaps reports

Other tax gap estimates

1.9 HMRC is not the only source of estimates of the tobacco tax gap, with industry and academic sources broadly supporting HMRC's tax gap analysis:

- KPMG conducts a survey across Europe, Project Star, to estimate counterfeit and contraband consumption on behalf of Philip Morris International. In 2011, this placed the UK 13th of 27 European Union (EU) nations. This same survey reported that the proportion of non-UK duty paid consumption in the UK was 12.7 per cent for cigarettes.
- Academic research in 2012⁵ suggested 9.2 per cent of packs in England were illicit – just above the average of 18 European countries.

1.10 Tobacco manufacturers estimate non-UK duty paid tobacco consumption. Industry figures include legitimate overseas shopping, which is excluded from HMRC's estimates of the tax gap. These estimates show a similar downward trend to HMRC's tax gap estimates between 2000 and 2011. The latest industry figures suggest that for cigarettes non-UK duty paid consumption increased from 17 per cent in 2011 to 21 per cent in 2012, while Project Star showed an increase from 12.7 per cent in 2011 to 19.2 per cent in 2012 (**Figure 3**). Similarly, industry estimates for hand-rolling tobacco show a steady reduction from 78 per cent in 2000 to 47 per cent in 2012 (**Figure 4** on page 16).

1.11 There are limitations in all methods for estimating the tobacco tax gap:

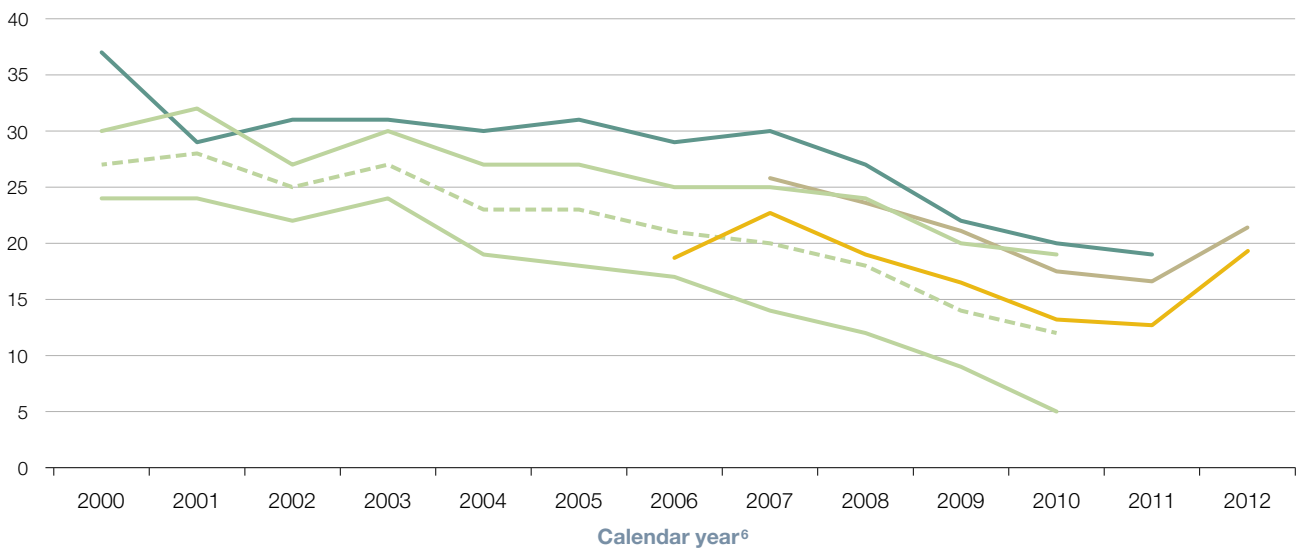
- HMRC has historically drawn on Office for National Statistics survey data, which are published around 15 months after the period the survey relates to. This has limited the timeliness of HMRC's tobacco tax gap estimates, and HMRC's estimates have been subject to an 18-month time lag, meaning that HMRC cannot yet assess whether its renewed strategy has had an impact on the size of the tax gap. Further, the range for HMRC's estimate of the cigarette tax gap has widened over the last decade (Figure 2). Its high estimate assumes that personal consumption of cigarettes is the same level as in 1994-95. Survey results show a decline in reported consumption over this period and HMRC's low estimate assumes under-reporting has not increased.
- The tobacco manufacturers' estimates of non-UK duty paid consumption are determined from a pack survey, typically the collection of discarded empty packs. This makes them more up-to-date than HMRC's estimate, and results are available in less than three months. However, pack collections are made in large towns, have a geographical bias against non-urban areas and exclude consumption within private premises. Pack surveys can give a breakdown of non-UK duty paid consumption, but do not estimate how much is from legitimate cross-border and duty free shopping, therefore will yield higher absolute values in comparison to HMRC's estimate of the cigarette tax gap.

⁵ L. Joossens, A. Lugo, C. La Vecchia, A. Gilmore, L. Clancy and S. Gallus, 'Illicit cigarettes and hand-rolled tobacco in 18 European countries: a cross-sectional survey', *Tobacco Control*, Online First, 10 December 2012, doi:10.1136/tobaccocontrol-2012-050644.

Figure 3

Comparison of HMRC and industry figures for non-UK duty paid market share for cigarettes from 2000 to 2012

Industry figures support the scale and downward trend of HMRC's market estimates for cigarettes since 2000. However, their latest and more timely figures show an increase

Non-UK duty paid market share (%)

- Tobacco Manufacturers' Association
- Industry figures
- HMRC range
- HMRC midpoint
- Project Star

NOTES

- 1 HMRC uses different assumptions to determine a high and low estimate, and also quotes the midpoint between the two. The high estimate assumes that personal daily consumption is the same as in 1994-95; the low estimate assumes personal daily consumption has declined in line with the trend in reported consumption.
- 2 Until 2011, the Tobacco Manufacturers' Association made empty pack collections around sports venues. Since 2007, the industry has made a more representative pack collection from different locations around large cities.
- 3 Since 2011, the industry has conducted its empty pack collection twice yearly. Figures for 2011 and 2012 are the average of survey results from quarter 2 and quarter 4.
- 4 Industry figures include both illicit and legitimate non-UK duty paid consumption, while HMRC's figures comprise the illicit market share and an estimate of legitimate cross-border shopping.
- 5 Project Star is a report from KPMG commissioned by Philip Morris International, based on empty pack surveys.
- 6 HMRC's tax gap figures are reported in financial years, whereas the industry reports on calendar years, e.g. figures for 2000-01 are shown in 2000.

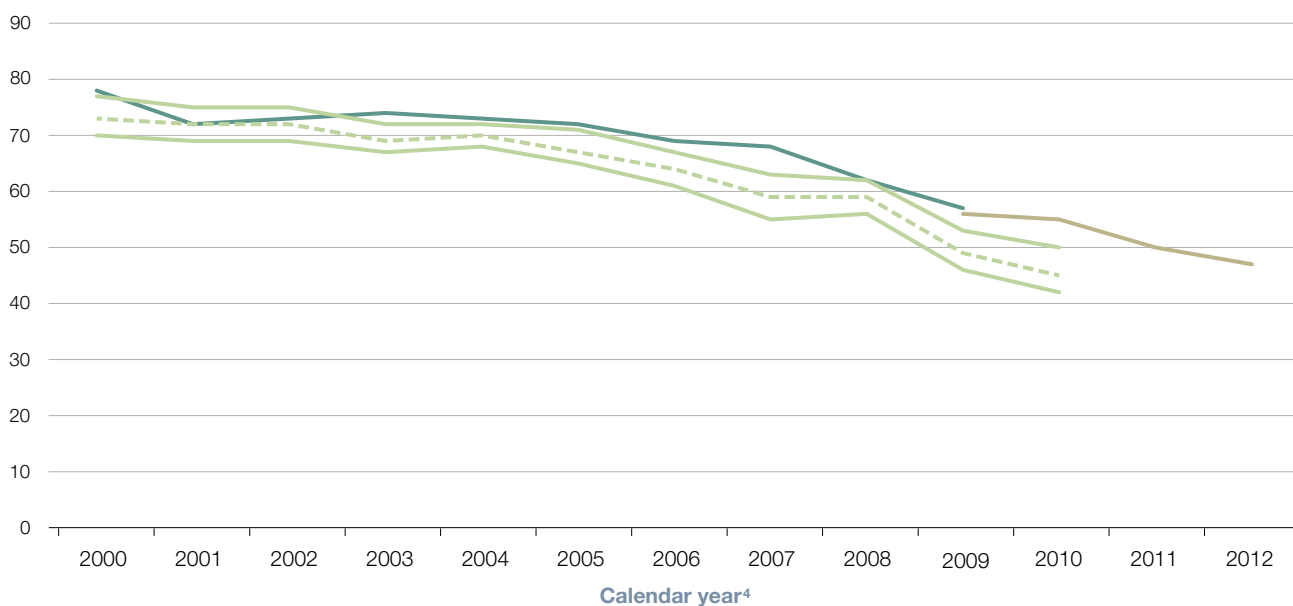
Source: National Audit Office analysis of HM Revenue & Customs Measuring tax gaps reports, Tobacco Manufacturers' Association, other industry figures and Project Star 2012 (www.pmi.com/eng/media_center/media_kit/Documents/Project_Star_2012_Final_Report.pdf)

Figure 4

Comparison of HMRC and industry figures for non-UK duty paid market share for hand-rolling tobacco from 2000 to 2012

Industry figures support the scale and downward trend of HMRC’s market estimates for hand-rolling tobacco since 2000

Non-UK duty paid market share (%)



- Tobacco Manufacturers' Association
- Industry figures
- HMRC range
- - - HMRC midpoint

NOTES

- 1 HMRC uses different assumptions to determine a high and low estimate, and also quotes the midpoint between the two. The overall estimate makes different assumptions about the total consumption of dual smokers (those who declare smoking cigarettes and hand-rolling tobacco) and the estimate of legitimate consumption is varied by assumptions of overseas shopping.
- 2 Until 2008, the Tobacco Manufacturers' Association collated industry assessments of non-UK duty paid consumption and shared these with HMRC. Since 2008, the industry has undertaken a pouch swap survey.
- 3 Industry figures include both illicit and legitimate non-UK duty paid consumption, while HMRC's figures comprise the illicit market share and an estimate of legitimate cross-border shopping.
- 4 HMRC's tax gap figures are reported in financial years, whereas the industry reports on calendar years, e.g. figures for 2000-01 are shown in 2000.

Source: National Audit Office analysis of HM Revenue & Customs Measuring tax gaps reports, Tobacco Manufacturer's Association and other industry figures

1.12 HMRC plans to improve its estimates of the tobacco tax gap by using more timely survey data. This should reduce the time lag to six months. It aims to reduce the range for cigarettes by reviewing the assumptions used to determine the high and low estimates. HMRC hopes to publish 2011-12 and 2012-13 tax gap estimates in the next *Measuring tax gaps* report, due in autumn 2013. This will include a revised time series, dating back to 2000, to avoid compromising the comparability of year-on-year data on the tobacco tax gap.

The evolution of HMRC's tobacco strategy

1.13 HMRC published its first strategy, *Tackling tobacco smuggling*, in 2000. It updated its tobacco strategy three times between 2006 and 2011, to respond to changes in the nature of tobacco smuggling and to provide a joined-up approach after the creation of the UK Border Force (**Figure 5** overleaf).

1.14 Since 2000, HMRC has worked with other government departments and tobacco industry representatives to make tobacco smuggling more difficult, increase the penalties for involvement in smuggling and educate the public about the dangers of smuggled tobacco products. In 2006, the government placed a legal responsibility on tobacco manufacturers to control their supply chain.

1.15 HMRC's approach contributed to the decline in the illicit market share for tobacco products between 2000 and 2011. HMRC recognises that the illicit market share is not a direct measure of operational performance, but it does serve as a long-term indicator of success. Several external factors affect smuggling levels, including price differentials across national borders (driven by different duty rates and exchange rates) and economic conditions. The impact of these factors on the size of the tax gap cannot easily be quantified.

HMRC's renewed strategy

1.16 HMRC and Border Force published a renewed strategy in April 2011 in response to changes in the threat from smuggling illicit cigarettes and hand-rolling tobacco. The strategy is a joint strategy; HMRC has overall responsibility for delivery while Border Force is responsible for the seizure of illicit tobacco at border entry points.

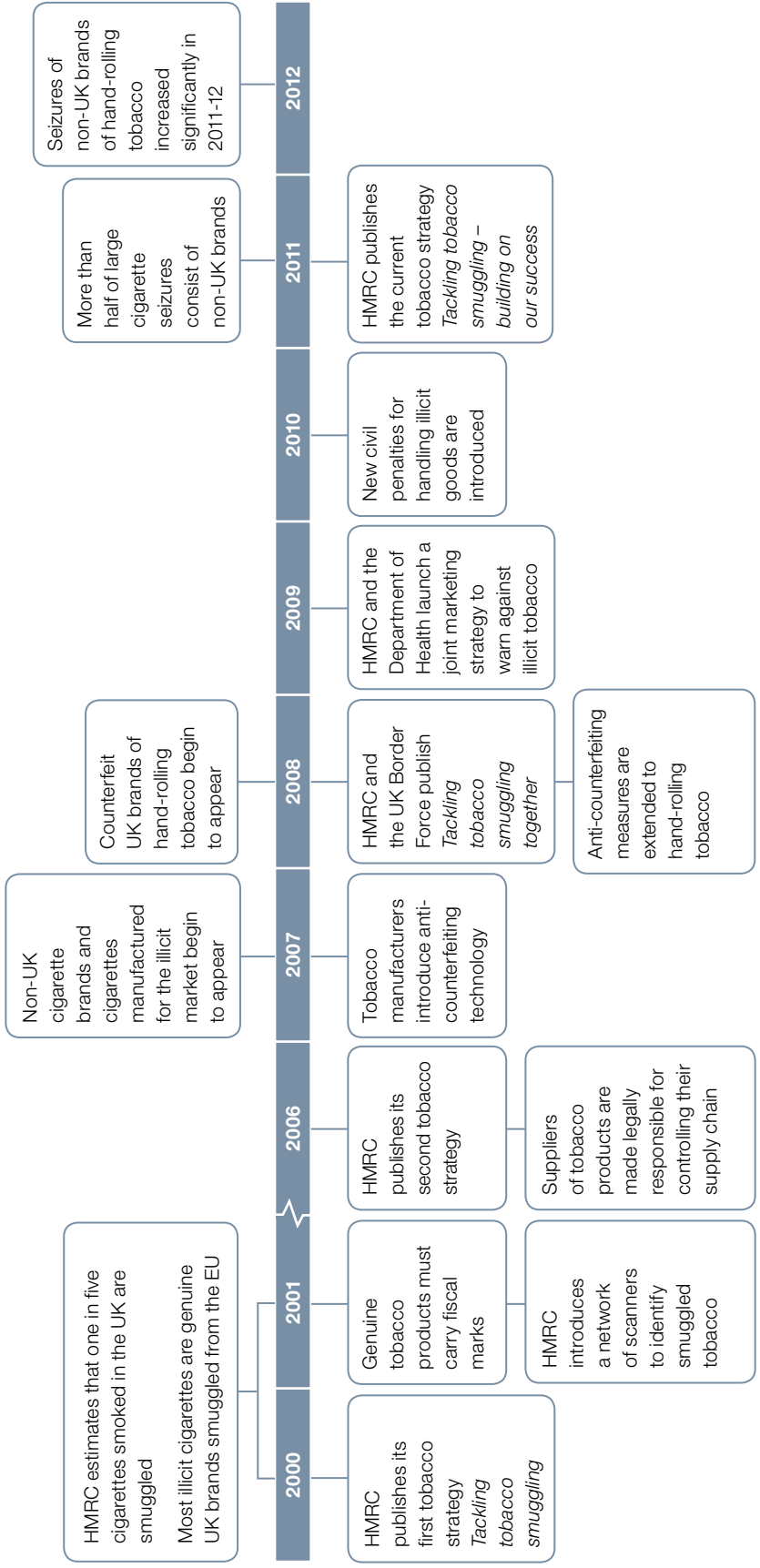
1.17 The renewed strategy has four main objectives:

- **Seizures:** to seize illicit tobacco overseas, at the border and within the UK in order to undermine the economics of the crime.
- **Supply:** to reduce the availability of genuine tobacco products for fraud.
- **Criminal investigations:** to disrupt the organised criminal gangs responsible for large-scale fraud.
- **Deterrents:** to deter and punish those involved in the fraud.

Figure 5

HMRC's response to tobacco smuggling has evolved in response to changes in the nature of the threat

The problem



Government and industry response

Source: National Audit Office

1.18 The tobacco strategy also includes measures to reduce demand for illicit tobacco products and promote cooperation between HMRC and overseas partners, international organisations and the tobacco industry.

1.19 The renewed strategy is a sensible evolution of approach rather than a radical shift in direction. HMRC did not stop any major initiatives with the introduction of its new strategy. The main changes were to expand activity in certain areas using reinvestment funding secured through HMRC's 2010 spending review. As part of its 2010 spending review settlement, HMRC secured agreement to reinvest £917 million of efficiency savings across its whole business between 2010-11 and 2014-15, on the basis that this would return £7 billion of additional revenue a year by March 2015. It allocated £25 million of this funding to projects directly related to tackling tobacco smuggling.

1.20 HMRC spent £69 million on delivering its tobacco strategy in 2011-12 compared with £66 million in 2010-11. Five per cent of the total funding used to deliver the tobacco strategy in 2011-12 (£3.2 million) came from HMRC's 2010 spending review settlement.

Figure 6 overleaf maps the projects planned under the spending review settlement against the objectives of the tobacco strategy.

1.21 Reinvestment initiatives to tackle tobacco smuggling form part of three broader projects. One of these projects aims to improve HMRC's approach to tackling organised criminal gangs responsible for large-scale fraud. Two further projects are designed to improve HMRC's approach to tackling lower-level 'mass market' evasion, one by increasing prosecutions for lower-level criminality and the other by initiatives including extending the use of civil penalties.

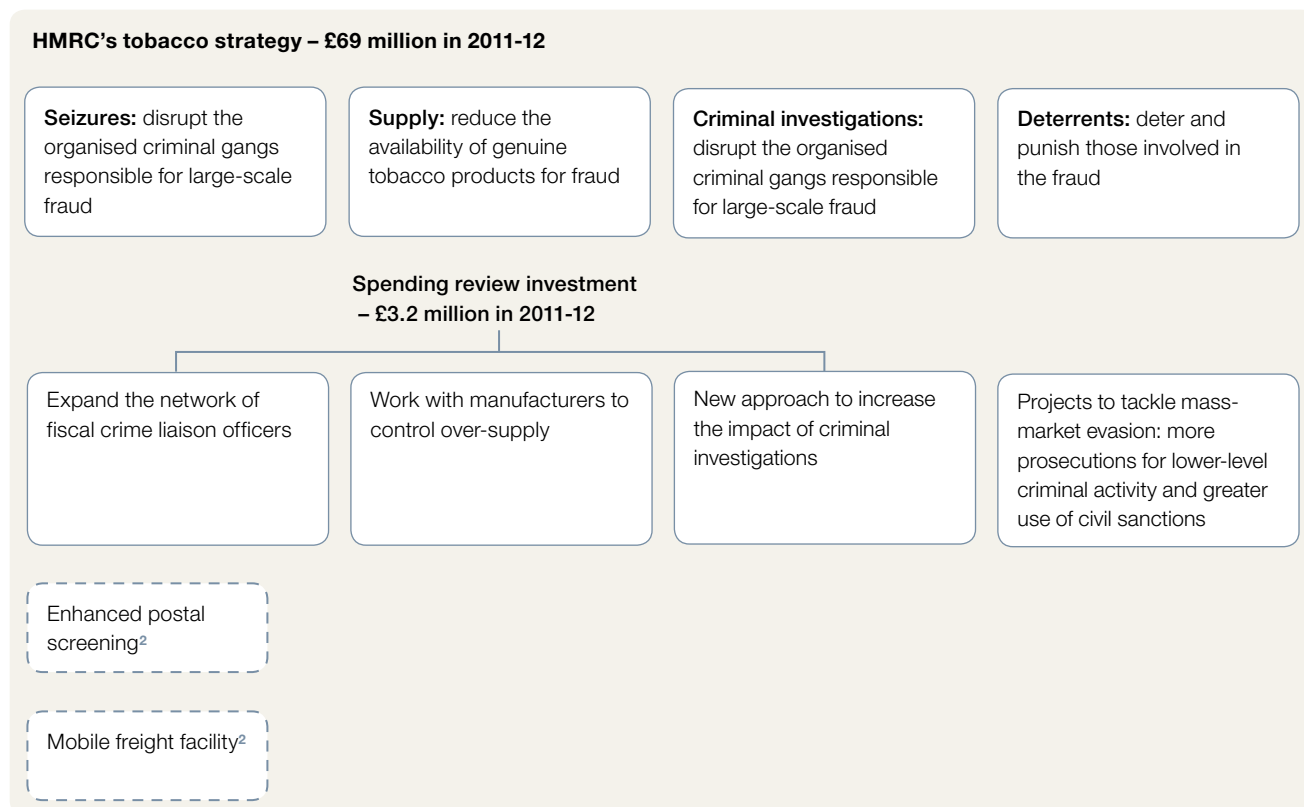
1.22 HMRC anticipated that the tobacco organised crime reinvestment projects would prevent the loss of £1.4 billion of revenue over the four years of the spending review period. It expected the supply chain control project to give a particularly high return on investment, preventing lost revenue of £465 million in total over the four years at a cost of £0.28 million; this represents a third of the £1.4 billion expected benefits for 1 per cent of the costs.

The coherence of HMRC's tobacco strategy

1.23 In developing its tobacco strategy, HMRC aims to create a sufficiently comprehensive set of interventions to ensure there are no easy routes for fraud, but also to target the bulk of its resources where it can have the most impact.

1.24 HMRC has developed its tobacco strategy sensibly in response to changes in the nature of the threat from tobacco smuggling. The latest strategy includes a wide range of complementary initiatives designed to tackle all aspects of the problem: overseas and in the UK, large- and small-scale fraud, supply and demand. HMRC made decisions about where to invest additional funding based on intelligence on emerging risks. HMRC devotes most resources to identifying and disrupting the organised criminal gangs that orchestrate large-scale fraud, with a particular focus on tackling the problem at source overseas. This is a sensible approach given that this is where HMRC has historically had the most impact.

Figure 6
HMRC's spending on its tobacco strategy in 2011-12



NOTES

- 1 HMRC spending on projects to increase prosecutions for lower-level criminal activity and increase the use of civil sanctions covers smuggling of all kinds, not just tobacco. HMRC does not monitor what proportion of this spending relates specifically to tobacco cases.
- 2 The enhanced postal screening and mobile freight initiatives form part of HMRC's plans for spending review investment but HMRC did not incur any costs on these initiatives in 2011-12.

Source: National Audit Office analysis of HM Revenue & Customs data

1.25 HMRC needs to maintain a balance between preventing illicit tobacco from entering the UK and deterring the sale of illicit tobacco products within the UK. Action against organised criminal gangs has a significant impact in terms of preventing lost revenue, but HMRC also recognises the importance of enforcement action within the UK to punish and deter offenders.

1.26 HMRC enforces a wide range of sanctions against those who handle illicit tobacco within the UK, for example by bringing prosecutions, imposing fines and referring offenders to licensing authorities. It has a strategy for engaging with the media to publicise successful action. HMRC is developing its approach to deterring and disrupting the illicit market in the UK in order to maximise the impact of this work:

- HMRC has worked with other agencies to establish joint action programmes to tackle the demand for, and supply of, illicit tobacco. These have shown promising results (see **Case example 1** on the Tackling Illicit Tobacco for Better Health programme).
- In 2012, HMRC introduced a new project-based approach to its compliance work on tobacco fraud. This brought together intelligence and investigation officers and other government agencies to tackle particular risks. This new approach should help develop and share intelligence and deliver greater impact. It also has the potential to provide a more qualitative assessment of performance.
- HMRC and Trading Standards signed a 'Closer Working' protocol in June 2011, which sets out the procedures for sharing information. The protocol facilitates access to information relevant to each partner's activities and reduces the risk of duplication of activities.

Case example 1

Tackling Illicit Tobacco for Better Health

Tackling Illicit Tobacco for Better Health is a pilot scheme launched in 2009 to improve the health of people in the North West, North East and Yorkshire and Humber by trying to reduce the supply of, and demand for, illegal sources of cigarettes and tobacco. Prior to the pilot programme, illegal tobacco was mainly the responsibility of HMRC, which focused mostly on supply. The new scheme has been the first large-scale attempt to cut public use of illicit tobacco using healthcare agencies as well as enforcement, social marketing campaigns and intelligence-gathering initiatives.

The UK Centre for Tobacco Control Studies assessed the impact of the programme. It concluded that the programme has had a measurable effect on the problem in the north of England. It found evidence that the illicit tobacco market was shrinking in the north of England, which was likely to be attributable to the programme, and that the programme increased awareness among consumers about the harmfulness of illicit tobacco to communities, increasing intelligence reported to the hotlines and shifting the social norms around the illicit tobacco trade. The UK Centre for Tobacco Control Studies also concluded that the scheme offers a blueprint for regional initiatives to reduce both the supply and demand for illicit tobacco and is an exemplar of partnership working.

1.27 HMRC's approach to tackling the problem within the UK is not yet effectively integrated:

- HMRC recognises that it needs better intelligence on the distribution networks used by organised criminal gangs in the UK and the way in which money is transferred along the supply chain.
- The regional partnership approach has not been rolled out across the country due to funding constraints.
- HMRC has not yet evaluated the impact of any of its projects.
- HMRC does not yet have a good understanding of the impact of criminal prosecutions and other sanctions for tobacco fraud in deterring fraudulent activity. HMRC has not set targets for numbers of prosecutions for tobacco fraud in cases of volume crime.

1.28 Part Two of this report assesses HMRC's performance in the first two years of its tobacco strategy, including its performance in delivering projects funded under the 2010 spending review settlement.

Part Two

Progress against key actions in the strategy

This part of the report examines HMRC's performance on each objective of the strategy. We have evaluated HMRC's progress against the key actions in the strategy by assessing the design of the various performance measures and reviewing performance against targets for each key performance indicator.

Summary of performance

2.1 HMRC met all but one of its key operational targets for tobacco in 2011-12 but did not meet any of its more stretching targets in 2012-13. It has nevertheless made progress over the first two years of the strategy against its four main objectives: to seize greater volumes of illicit tobacco to undermine the economics of the crime; to reduce the availability of genuine products for supply; to increase the impact of activities to target and disrupt the organised criminal gangs behind the fraud; and to punish and deter those involved with the fraud. In all cases key operational performance measures showed an improvement between 2010-11 and 2012-13 (**Figure 7** overleaf). HMRC spent £69 million in delivering its tobacco strategy in 2011-12 and estimates this prevented revenue loss of more than £919 million in that year.

2.2 HMRC's performance on some objectives has been affected by the delivery of projects funded through the 2010 spending review. Three of the five spending review projects intended to improve HMRC's approach to disrupting the involvement of organised criminal gangs in tobacco smuggling have been delayed or cancelled:

- Supply chain control – HMRC intended to make test purchases abroad to assess the effectiveness of UK manufacturer supply chain controls; however, this approach was later abandoned on legal grounds and the project is being re-scoped. HMRC expected this project to deliver £465 million of benefit over four years – one-third of the £1.4 billion that the spending review reinvestment to tackle the tobacco element of organised crime was expected to deliver (paragraphs 2.26 and 2.27).
- Enhanced postal screening facility – to fund a facility to allow Border Force to examine a greater volume of incoming post than at present without disrupting Royal Mail services. This is two years behind schedule and has yet to deliver any benefits (paragraph 2.17).
- Mobile freight facility – to provide a mobile unit to move between entry locations in the UK to enable Border Force to examine a greater number of mobile freight consignments. This has been cancelled (paragraph 2.18).

Figure 7
HMRC's reported performance against objectives

HMRC's reported performance against its targets since the introduction of the new strategy is mixed. Although HMRC met most of its objectives in 2011-12, none were met in 2012-13

Objective/Measure		2010-11		2011-12		2012-13		
		Achievement	Target	Achievement	Status	Target	Achievement	Status
Seizures: Seize greater volumes of illicit product to undermine the economics of the fraud	Cigarettes (millions)	1,727	1,700	1,732	●	1,928	1,858	●
	Hand-rolling tobacco (tonnes)	389	400	572	●	614	483	●
Supply: Reduce the availability of genuine tobacco products for fraud	Cigarettes (millions)	1,296	Less than 1,857	1,046	●	Less than 1,027	1,042	●
	Hand-rolling tobacco (tonnes)	3,427	Less than 3,306	2,789	●	Less than 2,455	2,743	●
Criminal investigations: Increase the impact of targeting and disrupting the criminal gangs behind the fraud	Revenue loss prevented (millions)	£281	No target	£313	n/a	£421	£378	●
Deterrents: Punish and deter those involved in the fraud	Assessments and penalties (millions)	n/a	£20	£8.2	●	£30	£17.7	●

NOTES

- 1 HMRC assesses performance against its supply objective in terms of the volume of sales of genuine product to high-risk countries. The targets set are therefore maximum desired volumes – HMRC's ambition is that sales volumes are less than the target figures.
- 2 HMRC measures its objectives for seizures, deterrents and criminal investigations on a financial year basis. Hence performance on these objectives for 2010-11, 2011-12 and for 2012-13 runs from April to March.
- 3 HMRC measures its objectives for supply on a calendar year basis. Hence performance on this objective for 2011-12 is from January 2011 to December 2011 and for 2012-13 is from January 2012 to December 2012.
- 4 The status compares 2012-13 performance against target. Green signifies performance has met or exceeded the target. Amber signifies performance is within 5 per cent of the target. Red signifies that performance is outside 5 per cent of the target.
- 5 For action against the organised crime element of tobacco smuggling in 2011-12, HMRC reports £919 million of revenue loss prevented, attributing £116 million to reinvestment and £803 million to business as usual. In 2012-13, HMRC reports £1,000 million of revenue loss prevented overall, attributing £213 million to reinvestment and £787 million to business as usual.

Source: National Audit Office analysis of HM Revenue & Customs performance data

2.3 Two of the projects designed to tackle organised crime that are funded through the 2010 spending review reinvestment have exceeded the benefits expected in the first two years:

- Fiscal crime liaison officer (FCLO) network expansion – additional funding enabled its extension to other high-risk locations by recruiting an additional five officers and funding six posts previously funded by the Department of Health (paragraph 2.16).
- Expansion of criminal investigation work – funding allowed recruitment of 101 additional staff (paragraph 2.36).

2.4 Overall, in the first two years of the 2010 spending review period HMRC has delivered 62 per cent (£328 million) of the expected benefits for the tobacco initiatives of its organised crime programme funded through the 2010 spending review. In 2011-12, HMRC spent £3.2 million on these initiatives and reported a benefit of £116 million (**Figure 8**).

Figure 8

Performance to date for tobacco initiatives of the organised crime programme planned under the 2010 spending review

Sums in £m		Expected			Achieved		
		2011-12	2012-13	Total	2011-12	2012-13 ^{2,3}	Total
Fiscal crime liaison officers expansion	Cost	1.7	2.9	4.6	1.6	2.9	4.6
	Benefit	80	134	214	83	143	226
Mobile freight facility	Cost	0.3	0.0	0.3	0.0	0.0	0.0
	Benefit	4	17	21	0	0	0
Postal scanning operation	Cost	0.2	0.1	0.3	0.0	0.2	0.2
	Benefit	11	20	31	0	0	0
Supply chain control	Cost	0.0	0.1	0.1	0.0	0.1	0.1
	Benefit	66	100	166	0	0	0
New approach	Cost	1.5	4.5	6.0	1.5	4.5	6.1
	Benefit	31	65	95	33	69	102
Total	Cost	3.7	7.6	11.3	3.2	7.7	10.9
	Benefit	192	335	527	116	213	328

NOTES

1 Totals may not sum due to rounding.

2 Benefits are measured in £ million of revenue loss prevented, and are as reported at the end of 2011-12 and 2012-13.

3 Costs are measured in £ million, and are as known at December 2012.

Source: National Audit Office analysis of HM Revenue & Customs performance data and expenditure figures

2.5 HMRC also allocated investment funding to tackle lower-level criminality – ‘mass market’ evasion. HMRC reports that the number of volume crime prosecutions is increasing. However, the application of civil penalties was delayed due to recruitment delays and legal considerations.

2.6 The following sections review HMRC’s performance against each of its four main tobacco strategy objectives in more detail. Each section includes:

- an **overview of HMRC action** to achieve the objective;
- an assessment of the quality and relevance of **performance measurement**; and
- an analysis of **performance**, including progress in implementing spending review projects.

2.7 The final section of the report reviews performance against the other aims of HMRC’s tobacco strategy: to decrease demand for illicit tobacco products and to promote cooperation between HMRC and overseas partners, international organisations and the tobacco industry.

Seizures

Overview of HMRC action

2.8 HMRC and Border Force aim to seize sufficient volumes of illicit product overseas, at the border and inland, to disrupt supplies, reduce profits and make illicit products more expensive. HMRC’s network of FCLOs are responsible for facilitating the overseas seizures of contraband cigarettes destined for the illicit UK market by sharing intelligence with overseas enforcement authorities. **Case example 2** shows an example of how FCLOs cooperated with a host authority to disrupt an organised crime group. Border Force is responsible for the detection and seizure of illicit tobacco products at the border. HMRC has criminal investigation staff responsible for seizing products within the UK.

Case example 2

Fiscal crime liaison officers

In 2012, a host authority, through cooperation with the fiscal crime liaison officers, seized 60 million ‘cheap white’ cigarettes in one of their biggest ever seizures. The fraud involved abuse of ‘T1 status’, where import duties on goods entering the EU are suspended, under guarantee, if their final destination is outside the EU. In reality, the goods were being diverted into illicit EU markets (the UK in particular) by an organised crime group, with the help of corrupt officials. The fiscal crime liaison officers gathered and exchanged intelligence with the host authority, which demonstrated fraud in the movements. This cooperation resulted in significant disruption to an organised crime group, through the seizure of the cigarettes by the host country, arrest and questioning of 11 members of the group, investigation of the group for tax evasion and the falsification of documents, and the seizure of 18 properties belonging to the group.

Performance measurement

2.9 HMRC uses the volume of products seized as a key performance indicator. Seizure volumes are not an absolute measure of success as the ease of detection will fluctuate with changes in the nature and scale of the illicit market. It is important for HMRC to set seizure targets to focus the activities of operational teams, although HMRC recognises that its activities are not the only factor influencing the volume of goods seized.

2.10 FCLOs report their performance in terms of the seized volume of tobacco products destined for the UK. HMRC has limited powers to carry out independent checks to verify seizure volumes, secured as a result of the activities of the FCLOs, reported by the foreign customs authorities. In August 2011, HMRC's internal audit team raised concerns about the inadequate quality of the evidence maintained to support the reported performance of FCLOs and recommended that minimum standards of evidence be introduced for recording and reporting seizures attributable to the FCLO network. HMRC has adopted this recommendation.

2.11 The seizures reported by HMRC and Border Force are drawn from estimates made at the point of seizure. Until September 2011, consignments of illicit tobacco products seized at the border and in the UK were physically counted. This provided assurance over the accuracy of the reported figures. Border Force is in concurrent negotiations with HMRC and warehouse contractors to re-introduce the physical counting of seizure consignments at the Queen's warehouses.

Performance

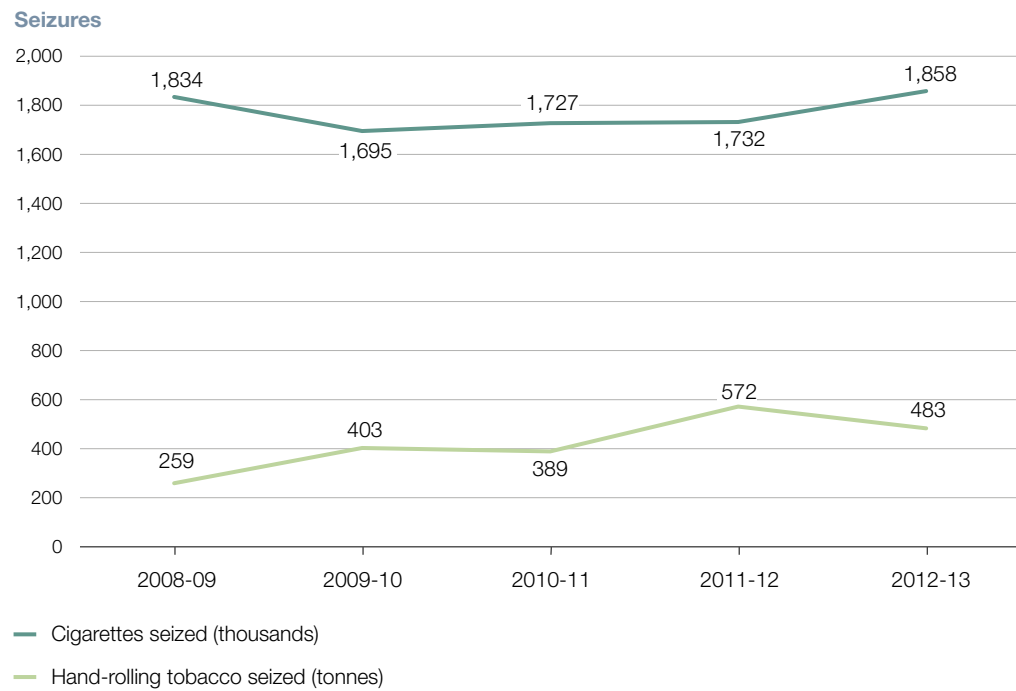
2.12 HMRC and Border Force's performance in terms of the volumes of cigarettes and hand-rolling tobacco seized over the period 2008-09 to 2012-13 is summarised in **Figure 9** overleaf. The volume of cigarettes seized annually has remained fairly constant year-on-year. During the same period, the illicit market has fallen, which indicates that the overall interdiction rate has increased. Hand-rolling tobacco seizures vary more year-on-year, with an overall increase in the period shown. HMRC exceeded its internal targets for total seizure volumes in 2011-12 but failed to meet its targets in 2012-13 for both cigarettes and hand-rolling tobacco.

2.13 HMRC's intelligence suggests that the high profit margins associated with the smuggling of 'illicit whites' result in organised criminal gangs being more resilient to seizures. Seizures may, therefore, no longer have as significant an impact on the economics of the fraud as when the main threat related to genuine products. However, seizure statistics can provide valuable information on the trends and the nature of the illicit trade.

2.14 HMRC estimates that its intelligence officers worked with overseas authorities to seize goods equivalent to preventing a revenue loss of £658 million between 2011-12 and 2012-13 – 7.5 per cent above target. Border Force tobacco seizures are significantly below target (**Figure 10** overleaf). However, as long as the overall seizure targets are met, the interdiction rates (that is, the volume of goods seized as a proportion of the total volume of illicit goods targeted at the UK) are not adversely affected.

Figure 9

Total cigarettes and hand-rolling tobacco seized over the period 2008-09 to 2012-13



Source: HM Revenue & Customs performance data

Figure 10

Total cigarettes and hand-rolling tobacco seized in 2012-13

	Cigarettes		Hand-rolling tobacco	
	Target (millions)	Achievement (millions)	Target (tonnes)	Achievement (tonnes)
Overseas	1,250	1,272	40	56
Border	558	488	524	360
Inland	120	98	50	68
Total	1,928	1,858	614	483

NOTE

1 Totals may not sum due to rounding.

Source: HM Revenue & Customs performance data

Progress in implementing spending review projects

2.15 HMRC expected three projects funded through the 2010 spending review to lead to increased seizures: expansion of the FCLO network, a mobile freight scanning facility and an enhanced postal screening facility.

2.16 HMRC reports that the reinvestment funding on FCLOs facilitated the seizure of illicit goods equivalent to revenue loss of £83 million in 2011-12 and £143 million in 2012-13 (Figure 8). Not all of this is additional impact above 2010-11 performance as it includes the impact of six existing FCLO posts previously funded by the Department of Health.

2.17 Border Force planned to reconfigure the current scanning operation to allow for additional scanning of incoming post to increase the rate of detection of illicit hand-rolling tobacco. However, this new configuration was two years late in coming into operation and has yet to deliver any benefits. Treasury ministers agreed reduced seizure targets for Border Force based on the re-configuration becoming operational on 1 November 2012. This was delayed further until March 2013, but the delivery target has not been reduced further.

2.18 The planned mobile freight facility was cancelled in early 2012-13, as a prototype scanner was never put into production. HMRC did not seek appropriate technical advice to gauge the feasibility of the project at an early stage.

Supply of genuine products

Overview of HMRC action

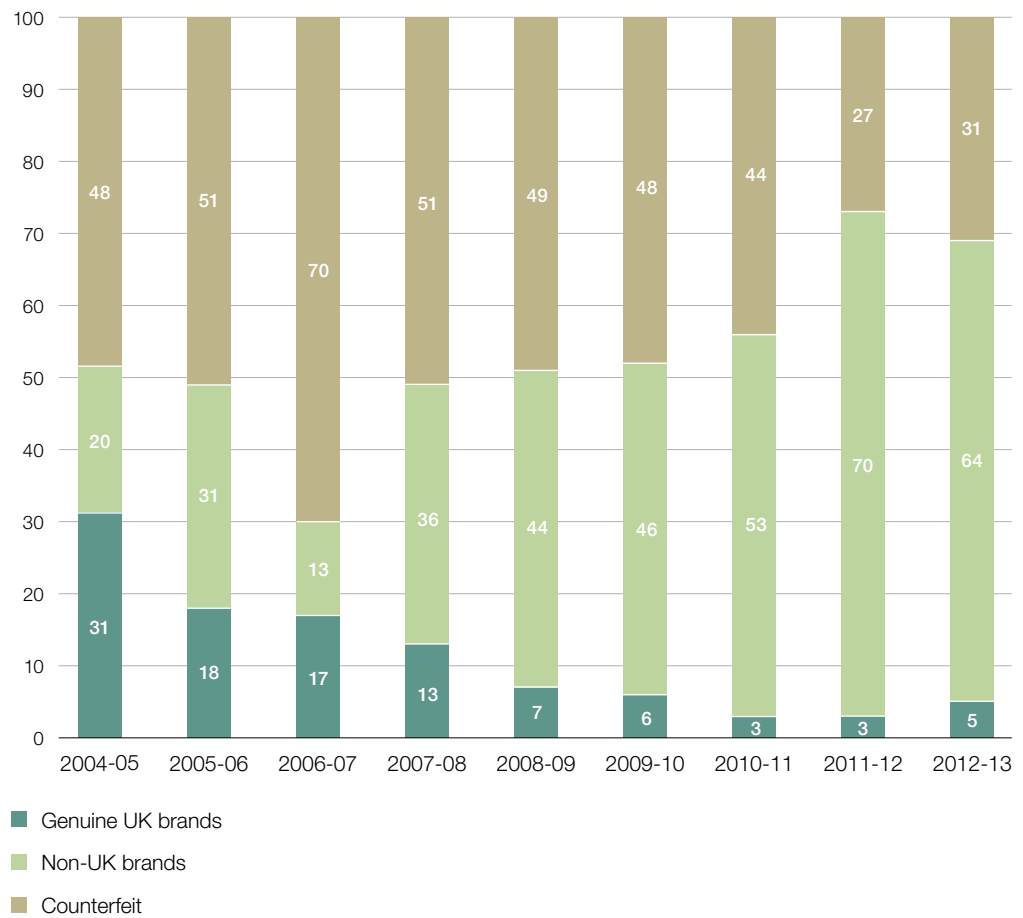
2.19 Historically, a significant proportion of the illicit market has comprised genuine products. For example, in 2004-05, 31 per cent of large seizures of cigarettes were genuine UK brands (see **Figure 11** overleaf).

2.20 In 2011, HMRC reduced the minimum indicative levels for tobacco and cigarettes brought into the UK from the European Union (EU), to align them with levels applied elsewhere in Europe and help prevent abuse of cross-border shopping provisions. HMRC and Border Force use the minimum indicative levels as a guide for determining whether imported goods are for a traveller's own use.

Figure 11
Composition of large seizures of cigarettes

The proportion of large seizures of cigarettes comprising genuine UK brands has fallen since 2004-05, but has increased most recently

Percentage



NOTES

- 1 Totals may not sum due to rounding.
- 2 A large seizure consisted of 250,000 cigarettes or more from 2004-05 to 2006-07 and 100,000 or more cigarettes thereafter.
- 3 Results are based on HMRC's sample testing of large seizures in the years concerned.

Source: HM Revenue & Customs and UK Border Force data

2.21 HMRC can, under the provisions of supply chain legislation introduced in 2006, impose penalties of up to £5 million on the tobacco manufacturers if there is sufficient evidence, following a six-month initial notice period, that a manufacturer has failed in their duty not to facilitate smuggling. All of the tobacco manufacturers are required to have a supply chain policy, which is a written statement of the controls they have put in place to ensure they comply with their legal duty not to facilitate smuggling so far as is reasonably practicable. By enforcing the supply chain legislation, HMRC aims to restrict the supply of genuine tobacco products falling into the hands of organised criminal gangs. **Case example 3** shows how the actions of HMRC prompted a tobacco manufacturer to address a weakness in its supply chain.

Performance measurement

2.22 The operational targets of the control of the supply chain objective of the strategy are expressed in terms of limiting supplies to high-risk markets. HMRC does not carry out independent checks on the sales figures provided by the tobacco manufacturers. In practical terms it would be difficult for HMRC to develop an independent measure of performance.

Performance

2.23 HMRC's analysis of a sample of large seizures indicates that smuggling of genuine product in bulk has fallen substantially since the introduction of the supply chain legislation. In 2004-05, 31 per cent of the sample of large seizures of smuggled cigarettes tested was genuine UK brands, decreasing to 3 per cent in the first year of the renewed strategy. Figures for 2012-13 show a year-on-year increase, as the proportion had increased to 5 per cent (Figure 11). For hand-rolling tobacco, UK brands decreased from 75 per cent of the sample of large seizures tested in 2007-08 to 8 per cent in 2011-12, but comprised 17 per cent of the sample of large seizures tested in 2012-13 (**Figure 12** overleaf). This follows the implementation of operational activity targeted at intercepting consignments of genuine smuggled tobacco products.

Case example 3

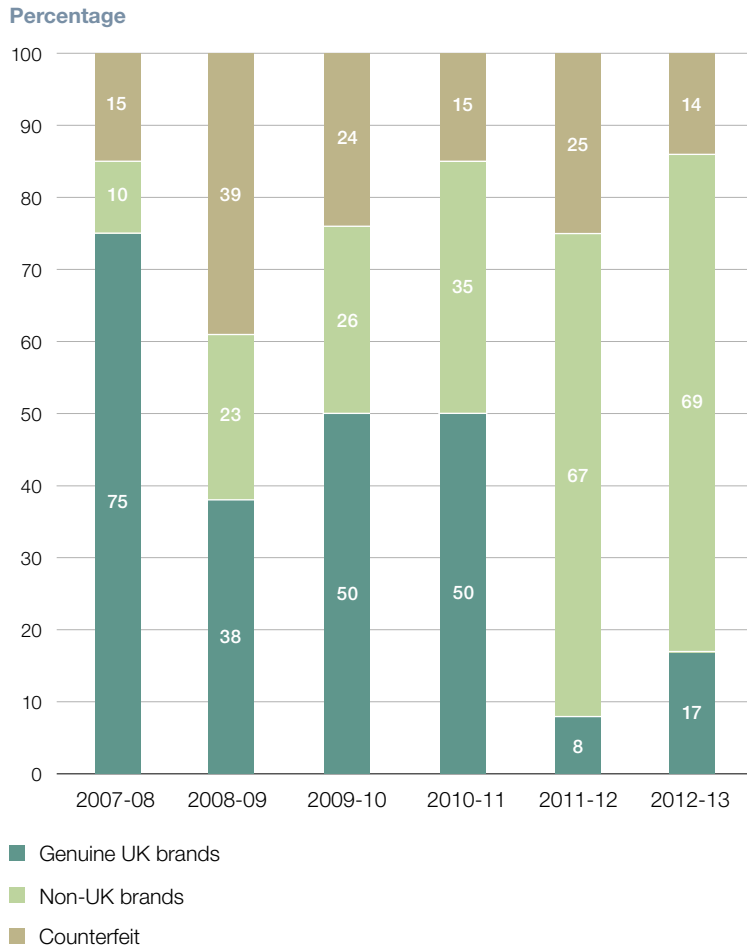
HMRC action prompted a tobacco manufacturer to improve its track and trace capabilities

Towards the end of 2012, HMRC requested information from a manufacturer on the supply of goods found within eight large seizures of its products and compared the manufacturer's response to each seizure to its policy on tracking the supply chain.

The manufacturer identified a breakdown in its tracking system at an overseas warehouse operated by a third party. As a result, it made short-term improvements to its systems and plans to implement a more comprehensive tracking system by June 2013, a year earlier than required by the relevant EU cooperation agreement. This represents a cost to the tobacco manufacturer but the new system will allow it to trace the supply chain of seized product and identify more accurately the point the product entered the illicit market. This should allow HMRC and the tobacco manufacturer to identify and address more specific weaknesses in the supply chain.

Figure 12
Composition of large seizures of hand-rolling tobacco

The proportion of large seizures of hand-rolling tobacco comprising genuine UK brands has fallen since 2007-08, but has increased most recently



NOTES

- 1 A large seizure consists of 50 kilogrammes or more of hand-rolling tobacco.
- 2 Results are based on HMRC's sample testing of large seizures in the years concerned.

Source: HM Revenue & Customs and UK Border Force data

2.24 Tobacco manufacturers' sales data show supplies of genuine product to high-risk markets fell by 20 per cent between 2010-11 and 2012-13. HMRC exceeded its 2011-12 targets but failed to meet its more stretching targets in 2012-13 (Figure 7 on page 24). Supply of genuine products to high-risk markets remains higher than HMRC's analysis of local demand, particularly for certain brands of hand-rolling tobacco, although manufacturers dispute this. For example, in its latest analysis HMRC estimates that the aggregate actual supply of some brands of hand-rolling tobacco to some countries exceeded legitimate demand by 240 per cent in 2011. HMRC has not undertaken any analysis of legitimate demand for cigarettes in export markets since 2010.

2.25 HMRC uses a series of interventions with tobacco manufacturers to discourage over-supply of products to other European nations. Since the introduction of the supply chain legislation, HMRC has not, however, fined any tobacco manufacturer and has issued only one letter of warning.

Progress in implementing spending review projects

2.26 HMRC has yet to realise any additional financial benefits from supply chain control activity from additional funding made available under its 2010 spending review settlement. We consider this to be a major concern since HMRC anticipated this would deliver £465 million in the four years to 31 March 2015 – one-third of the total projected reinvestment benefits from new tobacco initiatives.

2.27 A key component in HMRC's planned approach involved test purchasing from overseas retailers to support other intelligence that tobacco manufacturers were over-supplying tobacco product. However, subsequently the proposed approach was abandoned on legal grounds. The actions supporting the strand are currently being re-scoped and it appears unlikely that a new proposal can deliver the full £465 million expected initially from supply chain control initiatives.

Criminal investigations

Overview of HMRC action

2.28 Criminal investigations are a key part of HMRC's approach to tackling the organised criminal gangs behind large-scale tobacco smuggling. HMRC has legal powers to seize cash suspected of being the proceeds of crime and refer cases for prosecution. HMRC targets the cases that it believes will have the biggest impact, based on intelligence on organised criminal gangs. The aim is to make tobacco smuggling into the UK less attractive to organised criminal gangs. Factors such as profit margins, the ease and cost of operating in a country, the likelihood of being caught and the severity of the sentences play a key part in determining smuggling routes.⁶

Performance measurement

2.29 It is difficult to measure the impact of criminal investigations activity directly. As a proxy for direct measurement, HMRC assesses the impact of its criminal investigations activity to target organised crime in terms of revenue loss prevented. This is an estimate of the reduction in future losses of revenue as a consequence of a particular enforcement action. The measure has some limitations. In particular, it does not take into account the displacement effect whereby other criminal gangs benefit from reduced competition.

⁶ L. Joosens, F. J. Chaloupka, D. Merriman and A. Yurekli, 'Issues in the smuggling of tobacco products', in P. Jha and F. J. Chaloupka (eds), *Tobacco control in developing countries*, Oxford University Press, 2000.

Performance

2.30 In 2011-12, there were 52 convictions of people HMRC identified as key individuals in organised criminal gangs for tobacco fraud (**Figure 13**), and HMRC estimated that its criminal investigations into organised criminal activity prevented revenue loss of £313 million. In 2012-13, there were 37 convictions, and an estimated revenue loss prevented of £378 million against a target of £421 million. In each of these years there were also tobacco fraud convictions that HMRC identified as relating to lower-level criminality; these convictions fall under HMRC's objective on deterrence (paragraph 2.38).

2.31 We audited a sample of cases covering reported benefits for HMRC's criminal investigations into tobacco fraud between April 2011 and October 2012. We selected the three largest for each financial year for criminal investigations into organised crime and the three largest cases for each financial year for criminal investigations into lower-level criminality – 12 cases in total – which covered reported benefit of £323 million, or 60 per cent of the total £536 million benefit reported in that period.

2.32 HMRC's criminal investigation teams estimate revenue loss prevented at the point of first intervention (seizures or arrest). Teams estimate the scale of fraud disrupted and can claim a benefit equivalent to preventing up to 12 months of future fraudulent activity.

Figure 13
Organised crime cases involving tobacco

	2010-11	2011-12	2012-13
Revenue loss prevented (£m)	281	313	378
Arrests ²	n/a	78	59
Prosecutions	133	62	51
Convictions	78	52	37

NOTES

1 Arrests and prosecutions in one year may lead to convictions in another year.

2 Data for the number of arrests in 2010-11 is not available.

Source: HM Revenue & Customs performance data

2.33 Our review illustrates that this approach can lead to under- and over-reporting of benefits. Under-reporting can arise because initial estimates of the scale of the fraud disrupted tend to be conservative; additional evidence of fraud may be uncovered as cases progress to trial. For example, one case we reviewed assessed as an impact of £3.6 million at intervention would have been assessed as an impact of £20.9 million at trial. Over-reporting can arise because the outcome of an investigation is not reflected; not all cases progress to a successful prosecution. For example, in one non-organised crime case we reviewed, a team claimed an impact of £10.7 million equivalent to preventing fraud for 12 months following a seizure of illicit goods on which the duty payable was £300,000. No arrests have yet been made in this case and subsequent seizures nine months later showed the fraud was ongoing.

2.34 Any methodology for estimating impact from criminal investigations activity is likely to have limitations. Recording impact at outcome rather than at first point of intervention would be more accurate but would weaken the link between the activity and benefit reported within a particular year. It can take more than a year for a case to come to trial.

2.35 Nevertheless, our review found HMRC could improve the quality of performance data within the current approach and reduce the scope for both under- and over-reporting. We found that teams either did not have, or had not followed, guidance in the following areas:

- We found a lack of clarity over whether and how VAT and customs duty should be included in calculations of benefit.
- We also found a lack of clarity over the extent to which initial figures should be revisited at all: while some cases we reviewed had been updated to reflect revised counts of seized goods, others had not.
- Current guidance does not set out when an estimate should be extended over less than 12 months.
- Benefits calculations were not always recorded, though in all cases teams could reconstruct a calculation based on evidence in the case file.

Progress in implementing spending review projects

2.36 HMRC adopted a new approach to criminal investigations as part of the investment secured through the 2010 spending review. In 2011-12, HMRC experienced recruitment delays but reported that it exceeded its expectations of benefit, preventing £33 million of revenue losses. HMRC also exceeded expectations in 2012-13, reporting revenue loss prevented from additional investment in the new approach of £69 million (Figure 8 on page 25).

Deterrents: civil sanctions and volume crime

Overview of HMRC action

2.37 In addition to its work to tackle large-scale tobacco smuggling by organised criminal gangs, HMRC committed additional funding from its spending review settlement to tackle smaller-scale smuggling of tobacco and other illicit goods. It aimed to increase the number of prosecutions for lower-level criminal activity (known as volume crime) and the number of civil sanctions issued against businesses and individuals that fail to comply with the law. HMRC expects these measures to act as a punishment and as an effective and visible deterrent to potential future smugglers.

Performance measurement

2.38 HMRC's key performance measure for this objective is the value of civil assessments and penalties issued for which HMRC has set internal targets.

2.39 As a secondary measure, HMRC also monitors the revenue loss prevented from prosecutions. HMRC did not set a target for volume crime prosecutions for tobacco fraud. HMRC aims to secure 1,000 volume crime prosecutions across all regimes by 2014-15, but this target is not tobacco-specific. HMRC considers prosecutions in this area to be effective and visible deterrents to potential future smugglers. We would therefore expect HMRC to have an informed view of the level of prosecutions needed to create an effective deterrent.

Performance

2.40 Reported assessments and civil penalties were substantially below target in both 2011-12 and 2012-13. HMRC processed only 1 per cent of potential cases successfully in 2011-12. Performance has nevertheless been steadily improving with 28 per cent of potential cases processed successfully in 2012-13. A number of factors have contributed to the underperformance:

- **Recruitment delays and training requirements.** This is a new area of work for HMRC and in the first year teams and processes had to be established. Delays in recruiting staff and training requirements meant that teams were not operating at full capacity until April 2013.
- **Legal considerations.** Following a European Court of Justice judgment, HMRC ceased issuing penalties on all non-European Community referrals pending legal advice.

2.41 HMRC reports that the number and impact of volume crime prosecutions increased over the first two years of the strategy, with 104 convictions for tobacco fraud in 2011-12, and 122 convictions in 2012-13. HMRC reported that these convictions and associated criminal investigations prevented lost revenue of £53 million in 2011-12 and £119 million in 2012-13. The total number of convictions for tobacco fraud, including organised crime and volume crime cases, was 156 in 2011-12 and 159 in 2012-13. Our review of the revenue loss prevented from criminal investigations work found significant inaccuracies which limit its usefulness as a performance indicator (paragraphs 2.31 to 2.35).

Other objectives

Reducing demand for illicit products

2.42 HMRC aims to suppress consumer demand for illegal tobacco products by working with other agencies and with the industry. This includes organising or participating in coordinated regional and national marketing and multi-agency enforcement operations.

2.43 HMRC and the Department of Health developed a joint marketing strategy with the aim of raising awareness, increasing understanding of the issues and amplifying credible threats in relation to illicit tobacco. The three-year strategy was built around the Department of Health/HMRC budget available for 2009-10 marketing, which was £400,000. However, the budget for this work was withdrawn the following year.

2.44 HMRC and Trading Standards signed a 'Closer Working' protocol in June 2011 that set out the procedures for sharing information between HMRC and local council Trading Standards services. The protocol facilitates access to information relevant to each partner's activities and reduces the risk of duplication of activities.

Working with industry and overseas organisations

2.45 HMRC works closely with tobacco manufacturers within the framework of the supply chain legislation and cooperation agreements between manufacturers and the EU, and the exchange of intelligence enables a more effective targeting of HMRC's interventions. HMRC has set up a new anti-illicit tobacco joint working group with the UK tobacco manufacturers to improve the mechanism for information exchange to support work to tackle the illicit market.

2.46 HMRC also works in collaboration with European and international governments, mainly through the FCLO network, encouraging closer bilateral cooperation, gathering and exchanging information, liaising with other governments to initiate and service joint operations, and providing advice. HMRC is involved in the negotiations for an effective protocol for international regulation of tobacco production and distribution – the World Health Organization Framework Convention on Tobacco Control – which should result in the implementation of measures such as the tracking and tracing of all tobacco products in signatory countries.

Performance measurement

2.47 Reducing demand for illicit products and working with industry and international partners support the overall delivery of HMRC's strategic objectives. There are no key performance measures for these objectives. However, HMRC does monitor relevant media coverage, particularly coverage of prosecutions for tobacco fraud and large seizures.

Performance

2.48 We heard about good examples of sharing of intelligence gathered by tobacco manufacturers, from their UK and overseas networks, with HMRC. Tobacco manufacturers would welcome more feedback where intelligence they have provided has helped HMRC secure a prosecution or seizure, to better enable manufacturers to tackle tobacco smuggling in foreign jurisdictions. HMRC is exploring how to achieve this within legal constraints. HMRC is in the process of reviewing memoranda of understanding with the major tobacco manufacturers to ensure a robust framework of cooperation is in place to facilitate and promote joint working to tackle tobacco fraud.

2.49 The renewed strategy is weighted towards the supply side of the illicit tobacco trade with much less focus on the demand side. HMRC no longer has a budget for media campaigns targeted at tackling the demand for illicit tobacco but monitors media coverage.

Appendix One

Our audit approach

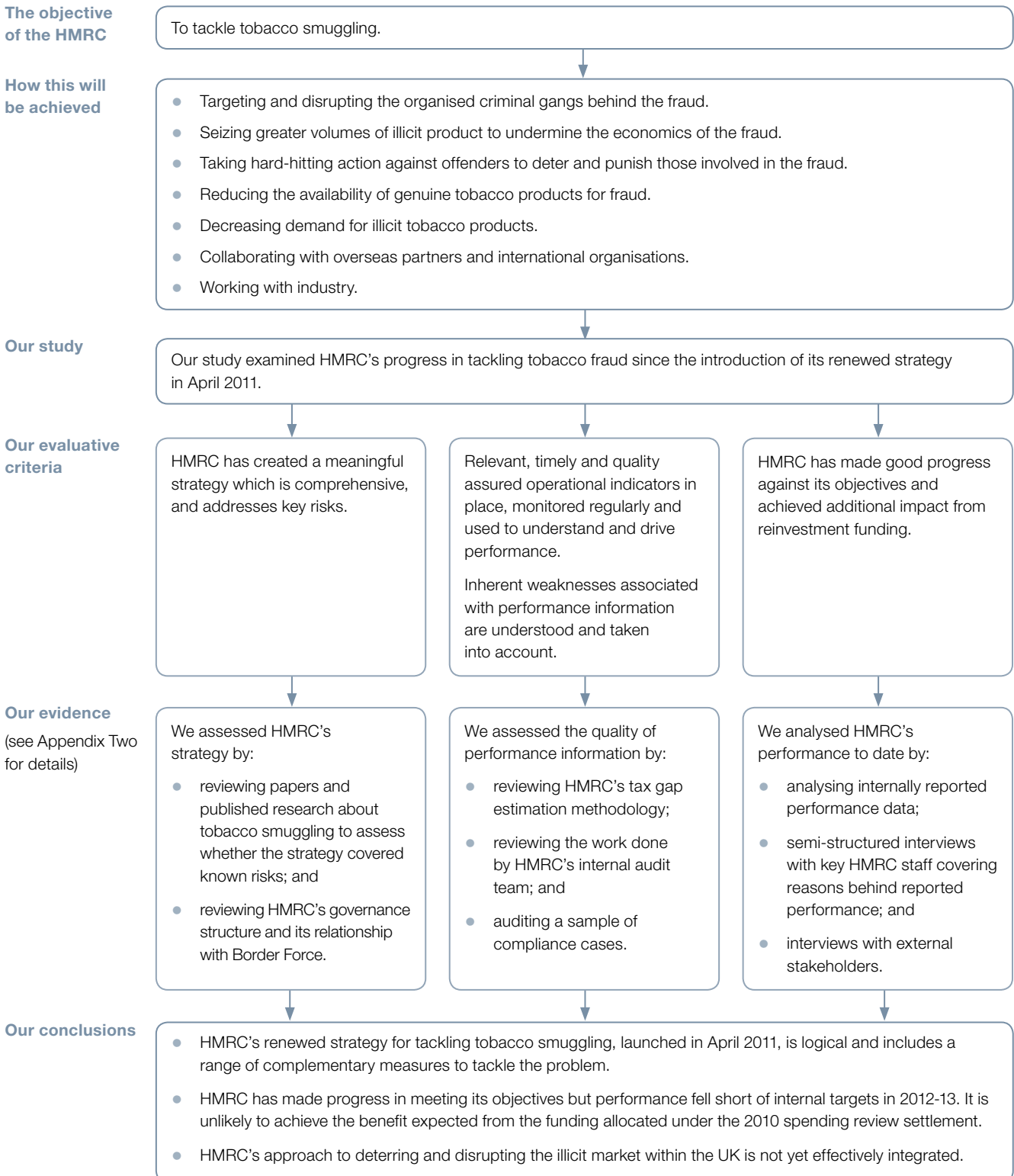
1 This study examined HMRC's progress in tackling tobacco smuggling since the introduction of its renewed strategy in April 2011. It was conducted under Section 2 of the Exchequer and Audit Departments Act 1921, which requires the Comptroller & Auditor General (C&AG) to examine the accounts of HM Revenue & Customs (HMRC) to ascertain that adequate regulations and procedures have been framed to secure an effective check on the assessment, collection and proper allocation of revenue, and that these regulations and procedures are being duly carried out.

2 We investigated:

- the comprehensiveness and responsiveness of the renewed strategy in response to the emerging threats;
- the quality of management information; and
- HMRC's performance in tackling tobacco smuggling.

3 Our audit approach is summarised in **Figure 14** overleaf. Our evidence base is described in Appendix Two.

Figure 14
Our audit approach



Appendix Two

Our evidence base

1 We reached our independent conclusions following our analysis of evidence collected between November 2012 and February 2013.

2 We applied an analytical framework with evaluative criteria, which considered whether HMRC's strategy has been appropriately developed and delivered, and where it has delivered the expected impact. Our audit approach is outlined in Appendix One.

3 We assessed whether HMRC had developed a comprehensive and risk-based strategy

- We reviewed HMRC's strategy and departmental papers, and published research about tobacco smuggling including:
 - previous versions of HMRC's strategy;
 - intelligence assessments; and
 - minutes of the meetings of the key delivery groups.
- We compared the strategy against known threats to check that it covered key risk areas.

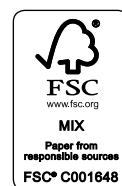
4 We reviewed the quality of HMRC's performance information

- We reviewed HMRC's work on the tobacco tax gap, which involved:
 - review of the methodology, referring to published documentation and interviews with analytical staff responsible for this work, and for ongoing work to improve tax gap estimates; and
 - collation and review of feedback from other stakeholders, including tobacco manufacturers and academics, for their view of HMRC's estimates and process, and comparison of HMRC's estimates with industry and academic figures.
- We reviewed the work carried out by HMRC's internal audit team in relation to the quality of reported management information.

- We visited criminal investigations offices across the country and audited a sample of cases to gain assurance over the reported revenue loss prevented figures. We selected the three largest cases for both organised crime and volume crime – six cases in total for the financial years 2011-12 and 2012-13 (April to October). Our testing provided us with coverage in terms of value over approximately 66 per cent and 38 per cent of organised crime and volume crime cases respectively.
- We audited a sample of assessments and penalties raised by HMRC's local compliance team to obtain assurance over the reported figures. We selected the three largest cases for each financial year: 2011-12 and 2012-13 (April to October).
- We interviewed staff at the central warehouse, one of the Queen's warehouses, to understand the control environment in relation to seized tobacco products.

5 We investigated HMRC's performance in meeting its overall strategy objectives and reinvestment targets

- We reviewed and analysed reported performance information, including tobacco strategy scorecards and 2010 spending review performance packs.
- We undertook semi-structured interviews with a range of key HMRC staff, including senior staff in criminal investigation, large business service, risk and intelligence service and excise, customs, stamps and money, and also with UK Border Force to elicit the reasons behind reported performance.
- We reviewed the additional investment made as part of the 2010 spending review settlement, to understand the rationale behind the measures and the expected costs and expected benefits.
- We reviewed the organised crime programme business case and supporting documents, including financial costings and benefits realisation plans.
- We held semi-structured interviews with tobacco manufacturers, Action on Smoking and Health and Luk Joossens, who has published academic papers on the illicit tobacco trade. These interviews captured views about the effectiveness of HMRC's interventions and how they could be improved.



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