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executive summary

Report by the Comptroller and Auditor General

- 1 Section 2 of the Exchequer and Audit Departments Act 1921 requires me to examine the accounts of HM Customs and Excise (the Department) to establish that adequate regulations and procedures have been framed to secure an effective check on the assessment, collection and proper allocation of revenue and to examine the correctness of sums brought to account. This report sets out the results of work carried out by the National Audit Office to fulfil these requirements.
- 2 During 2000-01 we examined both new and existing systems. These included VAT registration and assurance, the collection of tobacco duty including the fight against tobacco smuggling, and the introduction of procedures to support the new Climate Change Levy. We also reviewed a number of HM Customs and Excise computer installations and the management of the risks associated with their information technology infrastructure.
- 3 Since publishing its first anti-fraud strategy on tobacco smuggling in March 2000, Customs have made significant changes to their strategy and approach to tackling fraud. This has entailed moving from an essentially tactical approach, where success was defined in terms of outputs, such as increased numbers of seizures, to a strategic approach based on the achievement of outcomes which have a direct and measurable impact on the problem the Government is aiming to solve.

This approach has been based on six components:

- *Estimating the size of the problem*, measuring the size of illicit activity wherever possible
- *Analysing the problem*, establishing the nature and economics of the fraud through analysis of intelligence
- *Operational responses*, rooted in analysis of the nature of the fraud and the most effective means of tackling it
- *Establishing outcomes*, to achieve a clear and measurable outcome in terms of impact on the problem being tackled
- *Strengthening controls*
- *Monitoring and delivery*, through measuring outcomes.

As part of this work, in November 2001¹, the Government published details of its strategy for tackling indirect tax fraud. Customs have built on the first specific strategy on Tobacco Smuggling (March 2000), by publishing estimates of the levels of fraud for other indirect taxes, concerning alcohol, oils and part of the VAT system (Missing Trader Intra-community fraud). Customs are currently working on their strategies for tackling fraud in all the remaining indirect taxes.

¹ "Tackling Indirect Tax Fraud", November 2001, part of the Pre-Budget Report.

- 4 As a result of Customs' new approach, I can now take a better view of the adequacy of the regulations and procedures for ensuring an effective check on the assessment and collection of taxes. Customs' estimates to date suggest that a sum of between £6.4 billion - £7.3 billion (6.3 per cent -7.1 per cent of the tax collected in 2000-01) has not been collected as a result of fraud. In addition the Department have not yet completed their assessment of fraud in VAT, which is Customs' largest tax stream, representing 57 per cent of total receipts.
- 5 While I am satisfied that in most respects the Department's procedures and regulations were effective, the estimates of fraud suggest that there is more work to be done to ensure that the regulations and procedures are fully adequate to secure an effective check on the assessment, collection and proper allocation of revenue. I therefore welcome and support the steps they have and are taking to measure the stock of fraud, and to develop and implement counter-fraud strategies.
- 6 In parts 3 to 5, I look at the checking Customs perform on traders' returns, how VAT registration procedures can assist Customs to identify potential fraud and the way Customs are tackling fraud on tobacco duty. My main recommendations are aimed at helping Customs further develop their procedures for tackling fraud on VAT and tobacco duty.

VAT registration procedures

- 7 Customs have made an estimate of one aspect of VAT fraud, Missing Trader intra-community fraud and are working to produce estimates of the level of fraud in other areas. Customs can improve the way their VAT registration procedures identify potential fraud by:
 - Making the planned improvements to their LORDS computer system for registering traders as soon as possible to ensure that their records are as complete and accurate as possible;
 - Looking at whether legislative changes are needed to enable them to refuse applications to register where they have continuing concerns about an applicant and if so raise these at the European level;
 - Making more use of the intra- European Union enquiry systems already available to identify suspect traders, and co-operate more widely with European partners to benchmark performance, for example the number of applications refused;
 - Completing their work to estimate the losses to the revenue from all types of VAT fraud as soon as possible and develop a strategy to tackle them.

Tobacco duty

8 The early results recorded in Customs' Tackling Indirect Tax Fraud² are encouraging, and Customs have met their target for the first year of the Strategy. In 2000-01, Customs exceeded its seizure target of 2 billion cigarettes by 38 per cent, seizing 2770 million cigarettes; 1860 million in the UK and 910 million overseas in conjunction with local enforcement agencies. New scanner technology to detect smuggled goods has come into operation and I intend to review progress on the strategy when implementation is further forward. In the meantime, Customs can improve the way they tackle fraud by:

- building on the success of their publicity campaign about tobacco smuggling in increasing awareness of Customs' anti-smuggling work by making more information available nationally and more regularly about progress towards the achievement of Customs' targets for tobacco smuggling. This could reinforce their publicity campaigns and allow a more informed debate;
- building on their success in 2000-01 by making more effective use of their new scanner technology at ports, particularly by gathering good quality intelligence information to optimise performance;
- keeping under review the balance between prosecution and other measures in reducing overall smuggling.

2 "Tackling Indirect Tax Fraud", published in November 2001.

Part 1

Basis of the audit

Introduction

- 1.1 Section 2 (1) of the Exchequer and Audit Departments Act 1921 requires me to examine the accounts of Customs and Excise "to establish that adequate regulations and procedures have been framed to secure an effective check on the assessment, collection and proper allocation of revenue and to satisfy myself that any such regulations and procedures are being duly carried out". The legislation also requires me to examine the correctness of the sums brought to account and to report the results to the House of Commons.
- 1.2 This part of my report summarises the work I have done to discharge these obligations and my conclusions.

Audit approach and scope

- 1.3 Each year, the work I perform to fulfil the statutory requirement under Section 2 (1) of the 1921 Act includes:
 - the examination of internal controls;
 - reviews of quality assurance work including the work of Internal Audit and other checks carried out;
 - cyclical reviews of existing tax systems covering any significant changes and the evaluation of new systems. This year my examination has included VAT registration, tobacco duty, and preparations for the introduction of the Climate Change Levy;
 - reviews of computer installations and networks and specific information technology applications; and
 - test examinations of individual transactions and balances.
- 1.4 I also examine the economy, efficiency and effectiveness with which Customs and Excise have used their resources under Section 6 of the National Audit Act 1983. The results of these value-for-money examinations are published in separate reports to the House of Commons under Section 9 of that Act. Since my last report on systems and procedures (HC 25-XVI, 2000-01)

I have reported on Regulating Freight Imports from Outside the European Community (HC 131, 2000-2001) and Losses to the Revenue from Frauds on Alcohol Duty (HC 178, 2001-2002). I will shortly report on the Misuse and Smuggling of Hydrocarbon Oil.

- 1.5 My review of new Budget Assumptions and the cyclical review of those used in the past also involves coverage of the work of Customs and Excise and has included assumptions about the forecast VAT yield, the expected revenues from tobacco anti-smuggling measures and revenues from the Spend-to-Save programme (HC 959, 1999-2000).

Whole of Government Accounts

- 1.6 With the introduction of Whole of Government Accounts over the coming years, and with a Central Government Account due for 2002-03, the revenues reported under the Trust Statement will be reported on an accruals basis. I am already working with both Customs and Treasury on the form of account and the accounting policies to be applied.

Work carried out for 2000-01

- 1.7 My audit approach gives coverage of specific functions every year and cyclical coverage of tax revenue streams. Details of the functions reviewed in 2000-01 are provided in **Figure 1 overleaf**.
- 1.8 Information Technology is integral to the administration of indirect taxes. I perform specific IT reviews in support of the work outlined above. This year I also carried out a review of the VAT Registration System, and further details are included at Part 4.

1 National Audit Office examination of Customs & Excise tax systems 2000-01

Tax system	Aspects examined	Notes
General	<ul style="list-style-type: none"> ■ Examination of the Department's internal financial controls, including the development of governance arrangements and the evaluation of new systems. 	See Part 2
All taxes	<ul style="list-style-type: none"> ■ Review of systems and transactions at major and local accounting centres for all tax streams. ■ Review of systems and transactions for Landfill Tax Credit Scheme, Betting and Gaming Duty and Excise duty drawback, Beer Duty, Credibility Unit, Insolvency Unit, Large Payers Unit, Errors and Accounting Adjustments Branch, National Import Duty Adjustment Centre, National Investigation Service, Write-offs and remissions. ■ Review of Debt management. ■ Review of VAT Repayments. ■ Review of National Investigation Service case handing. 	See Part 3
VAT	<ul style="list-style-type: none"> ■ Review of VAT Registration policy and assurance systems. ■ Review of computer systems. ■ Review of measures to combat VAT fraud including intra-EU missing trader fraud. 	See Part 4
Tobacco	<ul style="list-style-type: none"> ■ Review of policy and assurance systems. ■ Review of computer systems. ■ Review of developments on anti fraud strategy. 	See Part 5
Wine, cider and perry	<ul style="list-style-type: none"> ■ Review of policy and assurance systems. ■ Review of computer systems. 	Management Letter
Climate Change Levy	<ul style="list-style-type: none"> ■ Review of implementation of new system. 	Management Letter
Regional and local offices	<ul style="list-style-type: none"> ■ Review of procedures and controls in North West England, West Midlands, Wales, Eastern England, South East England and London. Follow up visits to Northern England, Northern Ireland, and Southern England. High level reviews in Scotland, East Midlands, South West and London International. 	See Part 3

1.9 The main findings from my work are set out in the following parts of my report:

- Part 2: Developments in Internal Control;
- Part 3: Collecting the right revenue at the right time - checking traders' returns;
- Part 4: How VAT Registration helps Customs identify potential fraud;
- Part 5: Tobacco Duty.

Conclusions

1.10 No systems of tax collection can be completely effective. A key factor mitigating against this is fraud, involving non-payment of taxes and duties due.

1.11 As explained in paragraph 2.11 below, the Department has made significant changes in their strategy and approach to tackling fraud. As a result, they now have estimates for the level of fraud in tobacco, alcohol, hydrocarbon oils and one aspect of VAT - Missing Trader fraud. Customs are currently working on estimates for other VAT losses.

- 1.12 As a result of Customs' new approach, I can now take a better view of the adequacy of the regulations and procedures for ensuring an effective check on the assessment and collection of taxes. Customs' estimates to date suggest that a sum of between £6.4 billion - £7.3 billion (6.3 per cent -7.1 per cent of that collected) has not been collected as a result of fraud. In addition the Department have not yet completed their assessment of fraud in VAT, which is Customs' largest tax stream, representing 57 per cent of total receipts.
- 1.13 While I am satisfied that in most respects the Department's procedures and regulations were effective, the estimates of fraud suggest that there is more work to be done to ensure that the regulations and procedures are fully adequate to secure an effective check on the assessment, collection and proper allocation of revenue. I therefore welcome and support the steps they have and are taking to measure the stock of fraud, and to develop and implement counter-fraud strategies.
- 1.14 I propose to provide an unqualified opinion on the HM Customs and Excise Trust Statement for 2000-01. However my report on those accounts (under Section 2 (2) of the legislation) will record that while the receipts and payments relating to duties and taxes collected have been properly presented, I am concerned that in certain cases repayments may be made to the collaborators of missing traders in missing trader fraud, and that while the legal position remains unchanged these repayments cannot be prevented.
- 1.15 Customs and Excise also prepare Resource Accounts giving details of their administrative expenditure and resources used and I have provided a clear audit opinion on these.

Part 2

Developments in internal control

2.1 In this part of my report I examine:

- Developments in corporate governance, looking particularly at:
 - Governance;
 - Statements of internal financial control;
 - The role of the Audit Committee (**Figure 2** below)
- Review of the operation of Departmental Internal Audit;
- The impact of fraud;
- Management information.

2.3 For 2000-01, Customs and Excise have to make this statement in relation to all accounts that have to be laid before Parliament. This is the first year that Customs have widened the statement to cover the systems in place for the assessment, collection and allocation of revenues. The specific content of the Statement was still under consideration at the end of January 2002.

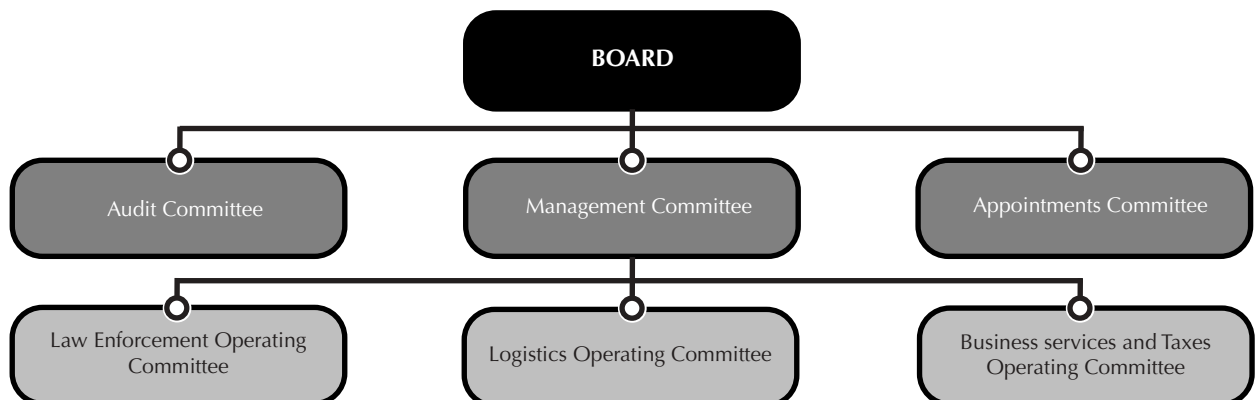
Statements of Internal Financial Control

2.2 In line with other central government departments, Customs and Excise have to produce a Statement on Systems of Internal Financial Control. The purpose is to confirm that the Accounting Officer has satisfied his responsibility to ensure that effective management systems, including financial monitoring and control systems, have been put in place. **Figure 3 overleaf** shows the hierarchy of internal controls.

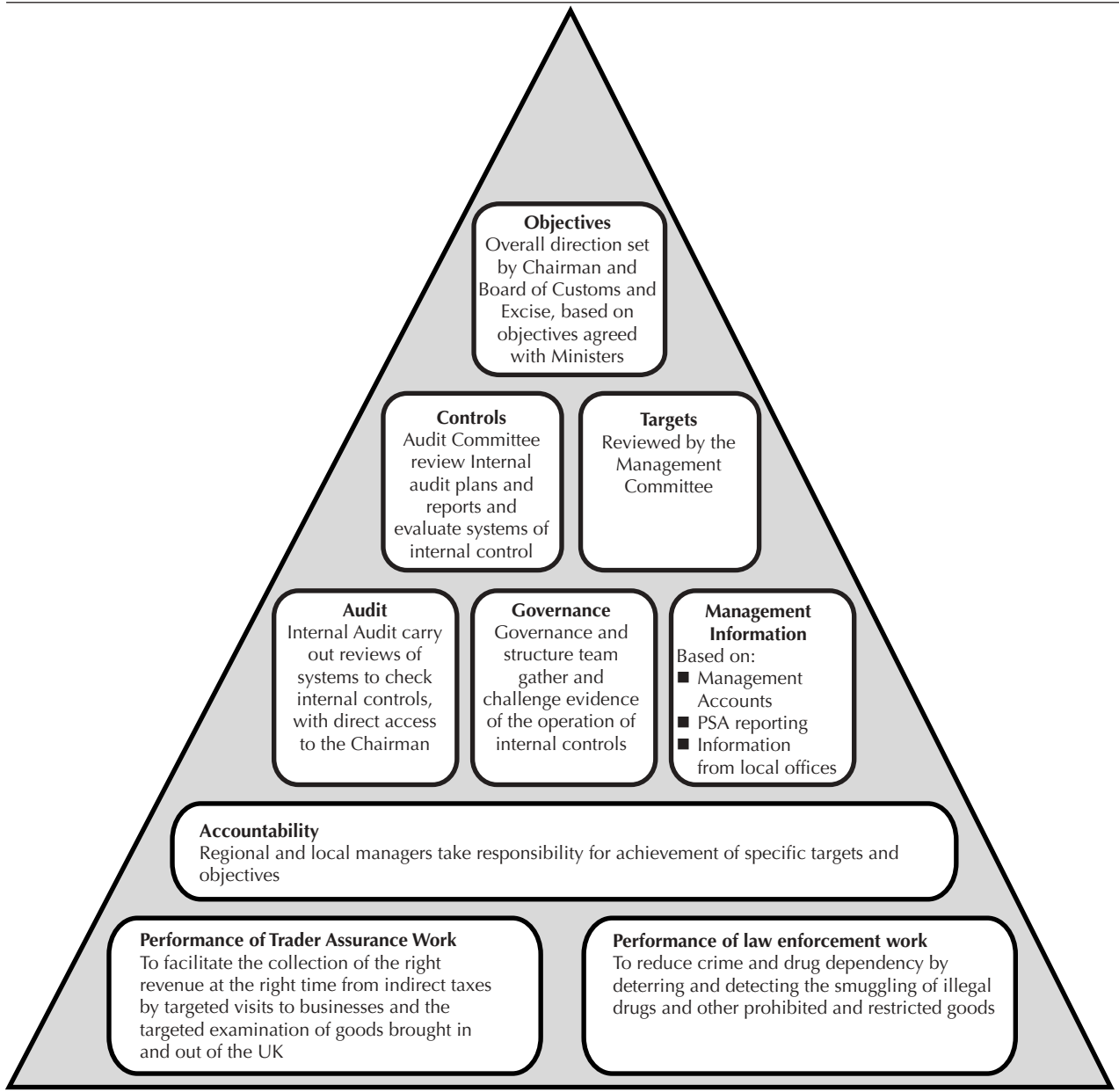
Wider Statement of Internal Control

2.4 In September 1999, the Turnbull Committee issued "Internal Control: Guidance for Directors on the Combined Code". The Treasury has decided that departments should adopt the Committee's recommendations on wider statements of internal control and report progress on this for the year 2001-2002. Customs and Excise expect to be in a position to give this wider assurance and are working to establish systems to ensure evidence to support such a statement can be provided by the Accounting Officer. For example, in Customs, this will extend the statement of internal financial controls (which covers revenue receipts on a cash basis) to cover internal controls on operations, finance and compliance with legislation.

2 HM Customs and Excise: governance, organisation and reporting chains



3 Customs and Excise internal control structure



2.5 In order to improve revenue controls, Customs plan to implement an integrated revenue accounting system, and to increase resources dedicated to verification of controls and the development of revenue control standards, policies and procedures. They also plan to implement a risk and issues control framework and introduce consolidated in-year reporting that will monitor outturn against expectation and match revenue receipts and losses to costs.

role as suggested by Treasury best practice, for example in extending the number of independent members and considering whether someone other than the Customs Chairman should Chair the committee. The National Audit Office attends the Committee.

2.7 During 2000-01 the Audit Committee have made good progress in developing their approach to risk management. There has been extensive work on the identification of risks posed to all aspects of the business. There is, however, ongoing work to further improve and extend risk management as part of the embedding process. An example of this is assessing the risks to revenue collection posed by slow or ineffective management of outstanding debt.

The Role of the Audit Committee

2.6 Customs' Audit Committee is formed by individuals from the Board and one of Customs' two non-executive directors. Customs are still developing the Committee's

Review of the operation of Departmental Internal Audit

2.8 As part of my audit I review the work and independence of Internal Audit. The Head of Internal Audit reports directly to the Principal Finance Officer and also has access directly to the Chairman and Board. Internal Audit provide a variety of reports, including an annual report on their own performance, and an assurance statement covering internal controls. The majority of staff are qualified or studying for Institute of Internal Audit qualifications at member and professional levels.

2.9 I have taken assurance from Internal Audit work in a number of areas, both for my audit of administrative expenditure and receipts and for my review of systems supporting taxation receipts and repayments. The range of Internal Audit investigations in 2000-01 is indicated below:

Tax/duty	Coverage
VAT	VAT Registration and De-Registration, visit selection and quality of audit assurance activity
International Trade	Authorisation of Inland Customs Traders
Customs duties	Common Agriculture Policy imports
Customs' administrative expenditure	Staff expenditure on travel and subsistence and on Regional Office systems
Accounting procedures	Recording of write-offs, remissions, losses and special payments

2.10 The Head of Internal Audit has provided a statement of assurance to the Accounting Officer on the effectiveness of the wider control framework. Specific Internal Audit reports noted poor levels of compliance with procedures in a number of key areas including some impact on the effectiveness of VAT assurance caused by continuing inconsistencies in operational management, generally poor levels of compliance with authorisation processes for Inland Customs Traders, and weaknesses in debt management particularly when write off action is proposed.

The impact of fraud

2.11 The Department has recently changed its approach to tackling fraud. This has entailed moving from an essentially tactical approach, where success was defined in terms of outputs, such as increased numbers of seizures, to a strategic approach based on the achievement of outcomes which have a direct and measurable impact on the problem the Government is aiming to solve. Customs new approach to tackling fraud has six key components (**Figure 4**).

4 Customs approach to tackling fraud

1. **Estimating the size of the problem.** Measuring the size of illicit activity is inherently difficult, but where possible, the Government has developed estimates for the size of fraud across a range of indirect taxes which it believes to be the most accurate available. These estimates are published routinely on an annual basis, and revised if significant new information emerges. However, the Government sees no value in publishing estimates which are not robust, and which would therefore give an inaccurate baseline against which to measure fraud trends, or the performance of anti-fraud strategies.
2. **Analysing the problem.** Establishing the nature and economics of the fraud through the analysis of intelligence, largely gathered during individual investigations, is crucial to the development of well-targeted anti-fraud strategies. The nature of the fraud and trends in its development need to be carefully understood before Customs can develop and deploy appropriate operational responses.
3. **Operational responses.** Customs' operational response to fraud is rooted in a careful analysis of the nature of the fraud, and the resulting assessment of the most efficient and effective means of tackling it. This can often involve a simultaneous strengthening of the enforcement effort to ensure maximum pressure at all different levels of the fraud network, from additional staff designed to improve front-line detection, to tougher penalties targeted at those involved in the supply chain.
4. **Establishing outcomes.** The Government's new strategic approach to tackling fraud is based on the establishment and delivery of ambitious outcomes, such as stopping and reversing the growth of a fraud. Each of Customs' anti-fraud strategies is designed to achieve a clear and measurable outcome in terms of its impact on the problem being tackled.
5. **Strengthening controls.** Fraud often flourishes by exploiting weaknesses in the control regime for a tax. Underpinning the operational response to each fraud is therefore an assessment of any changes required to strengthen the control regime and prevent its exploitation by fraudsters. This is essential if additional resources designed to tackle fraud are to be deployed effectively: increased numbers of staff will achieve little if there are fundamental weaknesses in the revenue control regime.
6. **Monitoring and delivery.** Customs' performance against their key outcomes is central to measuring the effectiveness of each anti-fraud strategy, and thereby to monitoring their delivery of the Government's high level objectives. However, Customs also set lower level operational output targets (for example, relating to the number of seizures or criminal gangs disrupted), which are important indicators of whether their performance is on track to deliver the key outcome. Once established, these outcomes and targets are monitored through Customs' Public Service Agreement and the supporting Service Delivery Agreement.

2.12 As part of this work, in November 2001³, the Government published details of its strategy for tackling indirect tax fraud. Customs have built on the first specific strategy on Tobacco Smuggling (March 2000), by publishing strategies for other indirect taxes, where the Government has so far made estimates of the levels of fraud, concerning alcohol, oils and part of the VAT system (Missing Trader Intra-community fraud). They have also produced estimates for the levels of fraud in these areas totaling between £6.4 billion and £7.3 billion (Figure 5). They are currently working on a wider strategy for tackling VAT fraud.

5 Customs estimates of fraud

	£ billion	Period (latest available figures)
Total cigarette smuggling plus cross-channel smuggling of hand rolling tobacco*	3.5	2000-01
Alcohol	0.75	1999-00
Hydrocarbon oils (GB Diesel)	0.45	2000
VAT missing trader fraud	1.7-2.6	2000-01

* Includes cross-channel smuggling of hand rolling tobacco - Customs are working on a full estimate for hand rolling tobacco.

Management Information

2.13 Customs acknowledged that the weakness in management information at both the strategic and operational levels is a key business risk. In March 2001 Customs announced that, as part of a number of initiatives, they would be designing and preparing a knowledge management infrastructure during 2001-02 to support their strategic decision-making. From November 2000 monthly Management Accounts

showing key performance information have been produced and considered by the Management Committee. In the early stages these were incomplete, however all key performance data is now included. Customs plan to further develop these accounts to meet the evolving needs of the Committee. The introduction of an integrated accounting package will improve management information at all levels and assist with earlier identification of, and reaction to, developing issues. With a large number of IT projects being developed the management of this process is complex and needs careful monitoring to ensure that the business critical systems are delivered on time.

2.14 I requested that Customs provide me with the reasons for an increase in outstanding debt to £1.4 billion, which at 31 March 2001 was 40 per cent higher than the position a year earlier. Customs have informed me that 60 per cent of this was due to the cumulative effect of: a £62 million rise in assessments being challenged by business, a £133 million rise in fraud related debts where recovery action has been suspended whilst investigations and prosecutions are finalised and £40 million more debt placed under civil recovery action through the courts. This increase represents a significant amount of revenue uncollected, and Customs need to monitor and actively manage progress on recovery where appropriate.

2.15 During 2000-01 no routine independent quality review of excise assurance work was carried out and Customs did not therefore know how well assurance teams were performing or where improvements could be made. Since April 2001, the new Excise Operations division have been collating regional statistics about assurance teams, covering: identification of additional liability from excise duty as a result of visits, average "hit rates" for visits and average time spent on visits; and breakdown of excise trader population by risk group. They assess whether priorities are being addressed, and the Department has told me that they are learning lessons from this activity. Customs are also now planning a review of Excise information systems.

Part 3

Collecting the right revenue at the right time: checking traders' returns

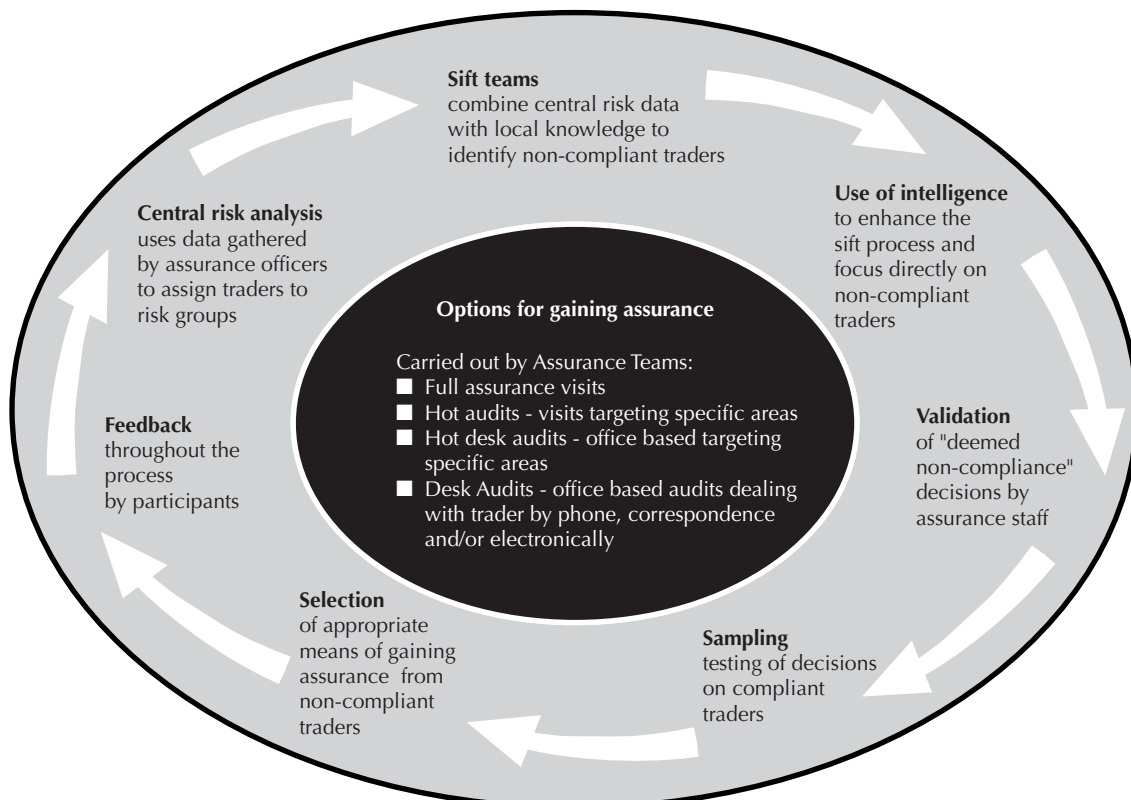
Background

3.1 Customs ensure they collect the correct amount of revenue from traders by checking the systems and accounts thought to present the greatest risk to the revenue of those traders. They identify these traders by reviewing factors such as the complexity of the business, the results of previous visits and payment history. Customs also take a random sample of traders, which is not related to risk, to monitor the systems and accounts of those traders thought to present the greatest threat to the revenue.

3.2 Using the information that Customs have on traders, staff in local offices work in "sift" teams to consider the most appropriate method of gaining assurance, either through a visit to the trader or office based enquiries. The cycle of coverage of a trader's activities is shown in **Figure 6**.

3.3 Following assurance checks, staff may make recommendations to traders for improvements and, if necessary, raise assessments if errors have been identified. To ensure that Customs' procedures are efficient and effective, national rules govern the conduct of audits and are contained in the Departmental Audit Standard guidance. Separate arrangements have been established for large taxpayers.

6 How Customs gain assurance from traders



Findings

- 3.4 Since 1997-98 my audit has identified some reduction in compliance by staff with the Departmental Audit Standard in assurance work, mainly for large traders. This was particularly in the area of planning, system testing and management review, and there was some lack of consistency in the preparation of files. There were also instances in which management review of large trader assurance work was not documented adequately. Although Customs does not believe that there is evidence of any direct impact on results, they should consider the need for further guidance and provision of specialised training for staff on the approach to this type of assurance work.
- 3.5 In terms of outputs, for 2000-01 Customs' VAT staff exceeded their target for net additional liability identified. My audit found that there was, however, potential for sift teams to make better use of the knowledge of assurance staff in identifying traders who represent the greatest risk. From April 2001 Customs have set up a network of regional risk managers to help ensure that this happens.
- 3.6 My audit noted that the overall number of trader visits has reduced. This reflects in part Customs' policy of improved risk assessment and consequent improvements in the targeting of assurance visits; and traders classified as high risk were effectively targeted. At some Excise and Inland Customs Advice Centres the provision of experienced officers for sift teams has affected the numbers deployed on assurance, with planned assurance visits not completed in some instances. Customs need to take care that, where traders do not receive planned visits, the increased risk of non-compliance does not undermine efficiencies gained from the effective use of sift teams.
- 3.7 Customs' organisation in the Regions has been subject to a number of changes over the course of the year to 31 March 2001. These include boundary changes to collections, reorganisation of support functions, changes and upgrades to IT systems, change to operating methods and new guidance. As with any major change process this has created risks that need to be managed.

- 3.8 I found, in a number of instances, a lack of emphasis on formal handover procedures and succession planning where work had moved between regions or been subject to other forms of reorganisation, and there was some effect on the quality of work. I also found a related problem with the transfer of some trader files, such as where Outturn reports, which summarise previous assurance activity and help to enable another officer to take over a new file, were sometimes not prepared for transfers. Although some effect on systems may be understandable at a time of change, for the future Customs should note that systematic handover procedures can help to ensure a seamless transition that minimises any reduction in quality.

Conclusions

- 3.9 Major change creates risks that need to be managed and Customs have had to face up to significant challenges as a result of the reorganisations that they have undergone in the past two years. There have been instances of shortcomings in their planning and handover procedures, and in compliance with the Departmental Audit Standard, that have led, in some cases, to a larger degree of transitional disruption to essential assurance work than might otherwise have been the case.
- 3.10 Customs should ensure that short-term imperatives do not detract too far, post-reorganisation, from the need for systematic planning and documentation - so as to avoid any damage to their performance in the longer term. Management influence and encouragement - coupled with focused training where appropriate - should help to ensure that this happens.

Part 4

How VAT registration helps Customs identify potential fraud

Introduction

4.1 This part of my report examines how Customs use the VAT registration system to identify fraud on VAT. Specifically, it looks at:

- The system for registering traders;
- Estimates of VAT missing trader fraud;
- How Customs prevent potential fraudsters from registering;
- Customs' approach to tackling those fraudsters who have successfully registered;
- Customs' developing strategy for tackling other VAT fraud risks.

4.2 I have previously reported on aspects of the VAT system (Figure 7). In 2002, I also plan to report to Parliament the results of a separate review of VAT Avoidance.

The system for registering traders

4.3 Traders are required to register for VAT if their turnover of 'taxable' goods and services exceeds £54,000 in the previous 12 months, or is expected to exceed this amount within the next 30 days alone. Where the value of taxable supplies is below the threshold, suppliers can still register voluntarily. Traders must deregister where they no longer make taxable supplies and can voluntarily deregister where their turnover falls below the threshold for deregistration, which is £52,000. At the end of March 2001, there were just over 1.6 million registered traders. In 2000-01, Customs registered 189,423 traders for VAT (1999-2000: 191,370) and de-registered 176,061 (1999-2000: 172,371).

4.4 From the date of registration, traders must account for VAT at the appropriate rate on all taxable supplies but can offset any VAT paid on purchases related to those supplies. The net amount of VAT due has to be remitted to Customs (or claimed back if more VAT has been paid on inputs than collected on sales) when the trader submits their VAT returns. These returns are usually submitted monthly or quarterly.

7 Previous reports on Customs' responsibilities for collecting and repaying VAT

Cost to Business of Complying with VAT Requirements (HC319, Session 1993-94) examined how far Customs have kept traders' costs to a minimum by simplifying regulations and procedures and providing better information and advice. It also looked at how far Customs have determined the nature, extent and incidence of VAT compliance costs, as a basis for targeting their simplification efforts.

Writing-Off VAT Arrears (HC 209, Session 1994-95) examined the significance of increases in the amounts written off and the circumstances under which Customs decide that certain arrears are irrecoverable.

Checking Claims for Repayment of VAT (HC 703, Session 1994-95) examined the effectiveness of Customs' examination of the credibility of claims for repayment and how effectively they targeted those repayment claims most at risk of being fraudulent or erroneous.

Checking Large-Traders' VAT Liability (HC 368, Session 1996-97) examined the identification of risks associated with large-traders and the consequent allocation of resources; the conduct of large-trader audit work and the measurement of performance.

Improving VAT Assurance (HC 15, Session 1999-00) examined Customs' performance in auditing the general trader population of around 1.6 million traders including the management of changes to working practices.

4.5 Traders register by completing a VAT registration form and sending it to one of the Customs registration units. During 2000-01 Customs started the process of consolidating their 39 registration units to 4 regional centres located at Carmarthen, Newry, Wolverhampton and Grimsby, completed in October 2001. These centres are responsible for carrying out checks on traders before registering and issuing them with a VAT number. The VAT number is unique to that trader and allows them to charge VAT on supplies and offset VAT on purchases. By 2005, Customs intend that traders will be allowed to register on line.

8 Taxable supplies

Taxable supplies are any supplies of goods and services that are not specifically listed in the VAT legislation as being exempt from VAT. Exempt goods and services do not attract VAT and include things such as insurance services, lotteries, education and most financial services.

Taxable supplies are divided into three categories:

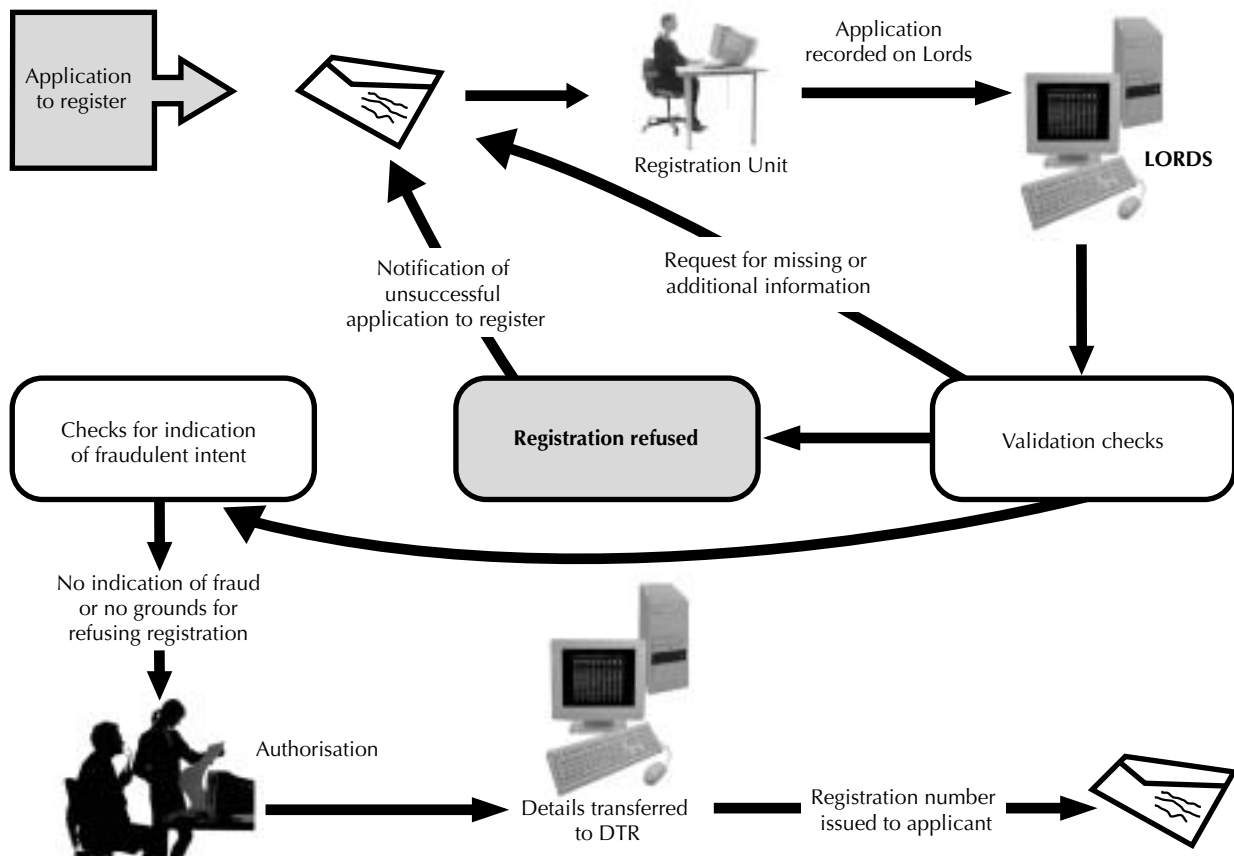
- **Zero rated supplies** where VAT is "charged" at 0 per cent. Examples of these include books, newspapers, public transport and supplies made between European Union Member States. The difference between zero-rated supplies and exempt supplies is that businesses which make zero-rated supplies are entitled to reclaim VAT paid on any related purchases, whereas those making exempt supplies are not.
- **Reduced-rate supplies** which attract VAT at 5%. This applies to domestic fuel and power and the installation of energy saving material.
- **Standard rate supplies** which attract VAT at 17.5%. This includes the supply of any goods and services not listed in the VAT legislation as being exempt from VAT, zero-rated or reduced-rate supplies.

4.6 To record and track applications from traders to register and deregister, Customs' VAT registration centres use a computer system called LORDS. Once cases have been input onto and processed on LORDS, the data is transferred onto another system - the Departmental Trader Register - which is a permanent record of each trader's VAT registration details (Figure 9).

4.7 Customs have been aware for some time that there are weaknesses in their computer systems including poor controls over the data input to LORDS which could affect the accuracy of the information held on traders. The system also has poor logical security and it cannot produce transaction logs, audit logs or print outs of access rights. The Departmental Trader Register was unavailable for periods of time between February and June 2001 owing to technical problems, and when available response times were poor. This prevented Registration Centres from gaining access to key information. Customs have informed me that since that time reliability has improved, although their statistics indicate that availability remains at less than 97 per cent during working hours.

4.8 Registration Centres are working within the limitations of current computer systems by undertaking manual checks. There is a risk, however that these checks may not be carried out properly during periods of peak workload. They are also an inefficient way of carrying out the work. Customs intend to replace LORDS with a system that will meet their changing demands, as part of their wider e-programme strategy. I have noted, however, that there has already been slippage in the original implementation timetable. The Department is also looking at improving access to the information on the Departmental Trader Register. Until the work on LORDS is complete, limited reliance can be placed on the Customs' computer systems to ensure that registrations and deregistrations are complete, accurate and processed within agreed time-scales.

9 How the VAT Registration system operates



Estimates of missing trader fraud

4.9 Customs' systems for registering traders can help them identify potential fraudsters. Customs became concerned about the growth in a particular type of fraud - VAT intra-community missing trader fraud - in 1999. This fraud is a systematic criminal attack on the VAT system and has been detected in many European Union Member States. The fraud involves fraudsters obtaining VAT registration to acquire goods VAT free from other Member States. They then sell on the goods at VAT inclusive prices and disappear without paying over the VAT paid by their customers. The fraud is usually carried out very quickly, with individual fraudsters managing to defraud VAT at the rate of up to £1 million a week. The fraudsters disappear by the time the tax authorities follow up the registration with their regular checking activities.

4.10 In September 2000, Customs introduced a strategy to tackle missing trader fraud. The VAT registration system is an important part of this strategy. Customs are also carrying out targeted investigations of the organised gangs perpetrating the frauds. They are continuing to develop and refine the strategy further in the light of experience and to ensure their response matches changes in the fraud. An example of a missing trader fraud case is set out in **Figure 10**.

4.11 In November 2001, Customs published estimates that showed losses to the Exchequer in 2000-01 from missing trader fraud were in the range £1.7 to £2.6 billion (1999-00: £1.5 to £2.3 billion) or around 3 to 4.5 per cent of the total amount collected from VAT (£58.6 billion). These are broadly in line with the estimates produced by the mobile phone and computer chip industries - those industries most affected by

10 A recent example of VAT missing trader fraud investigated by Customs

In one case a Glasgow man masterminded a VAT missing trader fraud from offices in Glasgow and West London. He perpetrated the fraud over a 4 month period using £38 million worth of computer components, which were purchased VAT free from other Member States. The goods were sold to legitimate companies in the UK with UK VAT charged on all transactions. The man charged and received a total of £4.6 million VAT from these unsuspecting companies, none of the money being paid to Customs.

An extensive surveillance operation by Customs' staff resulted in the Glasgow and London offices being searched for evidence of the fraud. The man deliberately destroyed all the accounting records in an attempt to conceal the extent of the fraud. However, the investigation also identified a "safe house" at which computer software was found. When interrogated this software showed Customs that the man had calculated the amount of VAT defrauded on a regular basis. In December 2000, he was sentenced to 4 years imprisonment after pleading guilty to stealing £4.6 million VAT. The case also resulted in Scotland's biggest ever confiscation order for over £400,000 of assets.

missing trader fraud - which suggest that the level of VAT evasion in their sectors is running at around £2 billion a year.

- 4.12 Customs' estimates of these losses from missing trader fraud have risen year on year. However, based on statistical and operational data they consider that there are early indications that this type of fraud may have peaked towards the end of calendar year 2000 and may have started to level off and decline. Recognising the serious threat posed to the revenue, as part of their strategy Customs redeployed 340 staff to tackle this type of VAT fraud during 2000-01. They aim to halve the losses from missing trader fraud by the end of 2003-04.
- 4.13 Customs are working on an estimate of, and developing strategies to tackle, other types of VAT losses including other forms of fraud (**Figure 11**).

11 The "tax gap" and VAT fraud

The assessment and collection of VAT is subject to a variety of threats and risks, including from the shadow economy, fraud, evasion, error and avoidance. Customs are currently preparing a full analysis of the theoretical VAT liability, which will also take into account amounts not collected due to differences between theoretical and actual liability. These include the impact of various schemes which have been designed to simplify aspects of the tax. Work is also underway to analyse amounts lost to error, avoidance and evasion. Customs are trying to calculate what they should be collecting in VAT and the amounts that are being lost from the different elements.

A number of fraud risks help to explain part of the gap. The main risks are:

- **Missing trader fraud within the European Community (intra-EU fraud), including:**
 - **"Carousel" fraud** - where the goods that have been sold on in the UK, then get sold through a series of transactions to another Member State, and the same goods then re-enter the UK.
 - **Acquisition fraud** - involves the fraudster obtaining a VAT registration number for the purpose of purchasing goods VAT-free from another EU Member State. The goods are then supplied on in the UK at a VAT inclusive price, often to legitimate traders. The fraudster then goes missing without paying the VAT to Customs.
- **Repayment frauds** - where fraudsters register for VAT, make false claims for repayments from Customs and then abscond, including:
 - **Multi-cell repayment fraud** - where fraudsters make several applications to register spurious companies, submit false repayment claims for each company and then disappear;
- **Suppression fraud** - where fraudsters with a primary legitimate trading activity perpetrate a fraud by understating a portion of their sales or by falsely inflating their claims to input tax to reduce their VAT liability.
- **Informal economy** - genuine businesses with a turnover above the VAT registration threshold that deliberately do not register for VAT.

4.14 In January 2002 Customs revised the application form to register (VAT Form 1) which requires traders to provide more information than previously. The information on the form will further help Customs to determine whether the traders are legitimate. On receipt of the application, Customs' registration staff carry out a number of checks on the applicant which include using risk criteria to identify potential fraudsters. The LORDS computer system also carries out automatic checks.

4.15 Customs' registration centres refer suspect cases to law enforcement staff who undertake further checks. These checks may result in Customs' staff carrying out pre-registration visits to traders to ensure that applications are bona fide. For the year to the end of August 2001, Customs' checks led to 1033 suspect registrations being refused or around half of one per cent of those applying to register (Figure 12).

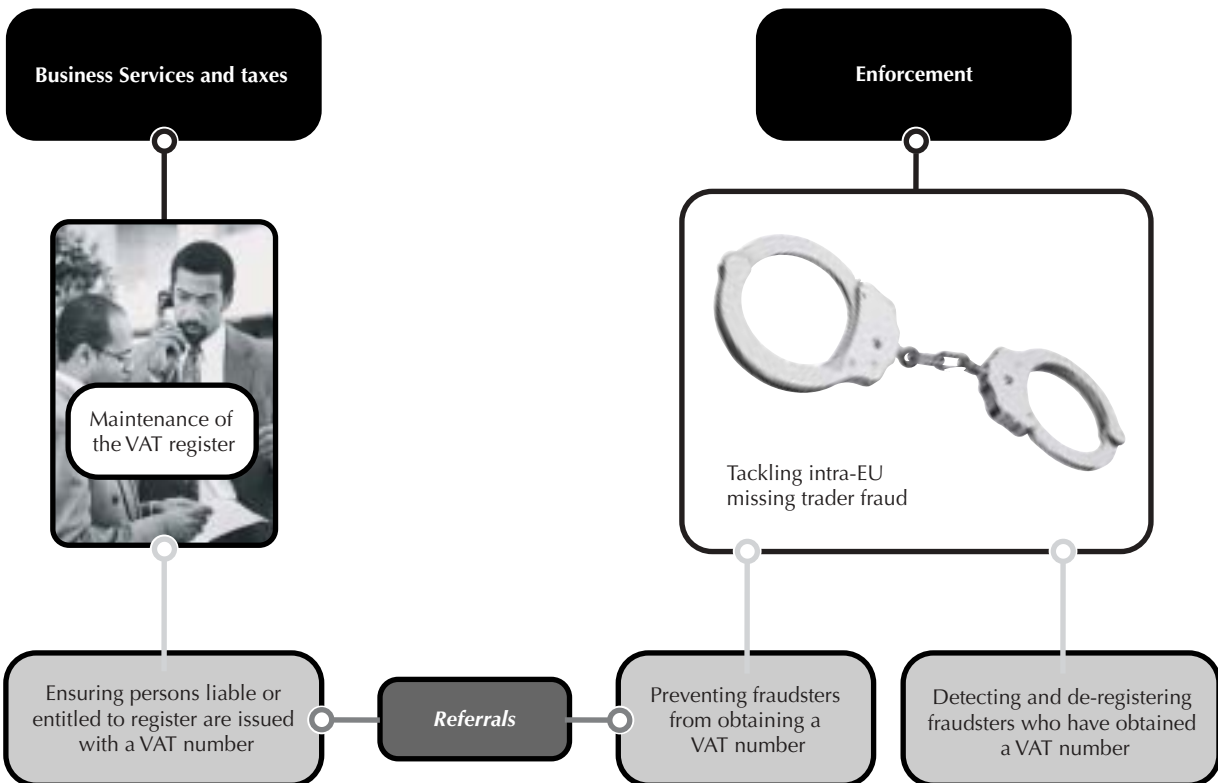
4.16 Customs' approach could mean that some legitimate applications are held up because of their initial suspicions but which further checks find are satisfactory. Customs approach should ensure that only a relatively small number are affected because they focus on the high-risk applications. As long as this is the case, Customs consider that their approach is acceptable because of the risks to the revenue if fraudsters successfully register.

4.17 There are cases where Customs register traders even where they have continuing concerns. This is because the trader may have provided all of the information requested by Customs and there does not appear to be strong enough grounds to refuse their application. In these cases Customs may apply conditions before registering the trader such as requiring the trader to provide financial security. For the year to the end of August 2001, Customs granted 2467 registrations where conditions were applied. An alternative would be for Customs to seek amendments to the European VAT Directives, in co-operation with other European Member States, to allow them to refuse applications in cases where they have continuing concerns.

Customs approach to tackling those fraudsters who have successfully registered

4.18 Customs pre-registration checks may not identify all potential fraudsters. For example fraudsters may register a bona fide business but after obtaining a registration number change their activities to commit VAT frauds. As part of their strategy, Customs are carrying out targeted investigations of the organised gangs perpetrating the frauds. To help them identify cases for targeted investigation Customs are:

12 The Registration system and the separation of Customs' core functions



- working with bona fide traders to obtain details of proposed new suppliers and purchasers of high risk commodities in which the frauds tend to take place. However, the elapsed time for Customs to examine cases fully can be considerable because of the number of traders in the supply chain;
- Working with the National Criminal Investigation Service (NCIS) to improve the provision of information which could help to detect fraudsters. NCIS provide tactical and strategic intelligence to Government Departments on serious and organised crime nationally and internationally;
- Improving co-operation with other European Member States by exchanging information on and investigating suspect cases.

4.19 Where Customs detect a trader who may be committing fraud they will take steps to disrupt their activities including de-registering them, freezing their bank accounts and/or seeking prosecutions. Between September 2000 and August 2001, Customs:

- identified and de-registered 350 missing traders;
- had issued assessments totalling £341 million (this amount will change as investigations continue). A debt management team has been introduced to follow up specifically on amounts owed from detected cases of missing trader fraud;
- secured injunctions to a value of £39 million to meet the VAT debts of missing traders; and
- reported for prosecution 18 missing trader fraud cases.

Conclusions

4.20 The early indications are that Customs' strategy for countering VAT missing trader fraud is having an impact. To ensure that the level of this particular type of fraud reduces further, Customs intend to continue developing and refining their strategy. This may involve using new

techniques to disrupt fraudsters, evaluating new legal and systems options for tackling this type of fraud and tightening further the current registration procedures.

4.21 From my examination I consider that Customs need to:

- Make the planned improvements to their LORDS computer system for registering traders as soon as possible, taking account of their other priorities. LORDS holds key information provided by traders at registration and provides essential data to Customs' other VAT computer systems;
- Monitor closely whether legitimate traders applying to register are not unduly inconvenienced by Customs further checks on applications;
- Look at whether legislative changes are needed to enable them to refuse applications to register where they have continuing concerns about an applicant and if so raise these at the European level;
- Make more use of the intra- European Union enquiry systems already available to identify suspect traders, and co-operate more widely with European partners to benchmark performance, for example the number of applications refused. This would help to indicate areas where Customs could take further action.

4.22 More widely, Customs recognise that they need to complete their work to estimate the losses to the revenue from all types of VAT fraud as soon as possible and develop a strategy to tackle them. There are lessons from their approach on missing trader fraud through the VAT registration system which could assist them in this work, such as seeking the right balance between the need to tighten controls which will prevent fraud, and facilitating trade. Customs also need to complete their work to explain the revenue lost to error, avoidance and evasion on VAT. The information will help them allocate their resources optimally between the various elements and to monitor and measure their performance in protecting the revenue.

Part 5

Tobacco Duty

5.1 In 2000-01 Customs collected £7.6 billion in tobacco duty, (up from £5.7 billion in 1999-00), approximately 7.5 per cent of the total revenue that they collected that year. In support of their health policy, successive governments have raised the duty on tobacco. The current rate of duty on cigarettes, as announced in the March 2001 budget, is 22 per cent of the retail price plus £92.25 per 1,000 cigarettes. A packet of 20 cigarettes costs (approximately) between £3.49 and £4.39 in the UK, amongst the highest prices in the European Union.

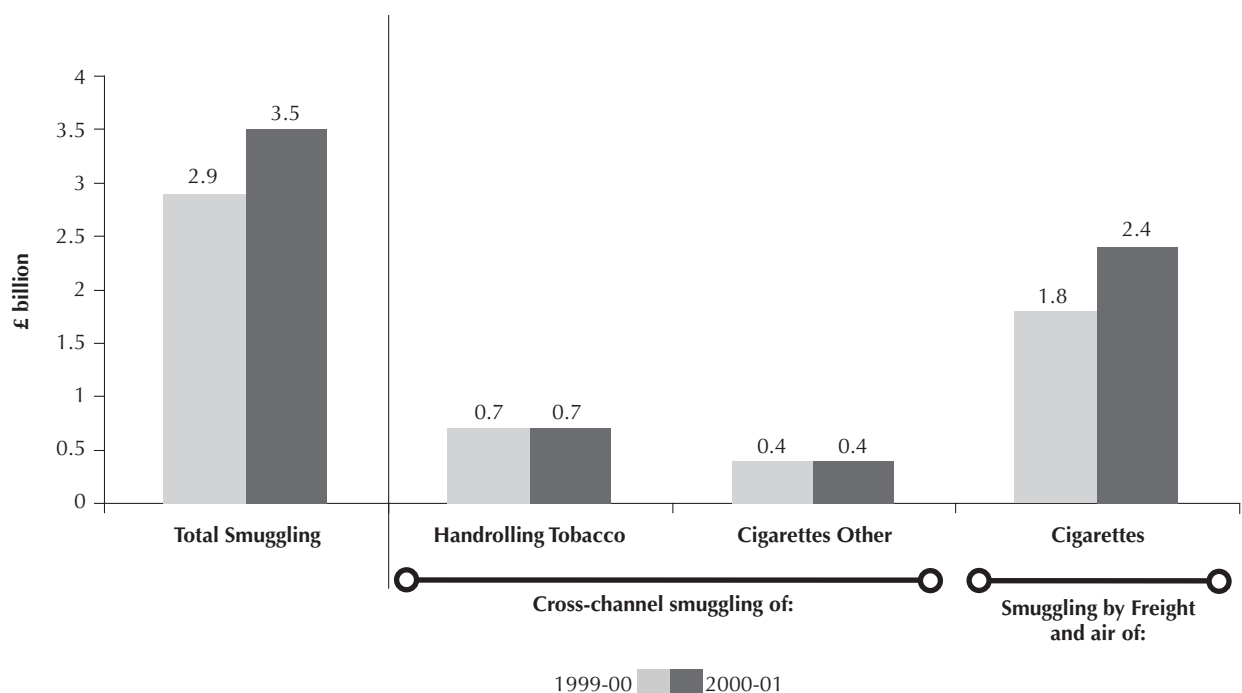
The threat to tobacco duty from smuggling

5.2 When the Single Market began in 1993, routine frontier controls between EU states were removed in order to facilitate the free movement of trade between member

states. At the same time, restrictions on the amounts of excise goods subject to duty that travellers returning from elsewhere in the EU could bring into the UK for their own use were removed. Since the mid 1990s a large market in smuggled cigarettes has developed in the United Kingdom. Customs estimate that 70-80 per cent of smuggled cigarettes are being transported into the country by freight - principally in deep-sea ship containers or "roll on roll off" ferries. Most of the remainder is being smuggled in light vehicles through the Channel ferry ports and the Channel Tunnel; the so-called "white van" trade.

5.3 Customs estimate that in 2000-01 just over 1 in 5 cigarettes smoked in the UK was smuggled (see Figure 13). Smuggling at these levels results in substantial revenue loss and Customs estimate that in 2000-01 tobacco smuggling cost the UK tax payer £3.5 billion as shown in **Figure 13** below.

13 Revenue lost (Excise and VAT) through smuggling of all tobacco in 1999-00 and 2000-01



4 Customs have not produced an assessment of the current level of total fraud and avoidance in handrolling tobacco (HRT). Until recently, HRT fraud was confined to cross-Channel smuggling and estimates of its magnitude were derived from survey evidence. However, there has recently been evidence of some HRT freight smuggling and Customs is currently investigating alternative methodologies in the light of this change.

Tackling tobacco smuggling

5.4 Customs published their strategy to tackle tobacco smuggling in March 2000, with the aim of putting smuggling into decline within 3 years. The Government committed £209 million in the March 2000 budget to slow the rate of growth, stabilise and then reduce illicit market penetration over three years⁵. Customs aim to achieve this by making smuggling less profitable and less attractive by increasing the chance of getting caught and increasing the penalties that are imposed on smugglers.

5.5 Customs aim to increase the chances of being caught by increasing the numbers of physical checks that are made. They have made more staff available for this work, both at the frontier and inland, and hope that this will result in high volume and frequent seizure of illicit tobacco. Specific actions taken under the strategy are shown below:

The range of options available against tobacco smuggling includes:

- Disruption along the supply chain involving a higher interception rate and a severe seizure policy;
- Improved intelligence to increase interception rates and target major inland distribution;
- Investigation geared to maximum disruption of supplies at import and key distribution points;
- Extra resources, both human and technological (x-ray scanners) to enhance the enforcement effort to make tobacco smuggling an economically unattractive proposition;
- Targeted measures to apply effective sanctions to those caught involved in inland distribution;
- Increased emphasis on asset confiscation to remove the economic rewards of smuggling;
- Financial investigation in all large-scale smuggling/distribution cases to ensure assets are identified and Confiscation Orders obtained;
- Better use of civil recovery and related economic penalties where retailers are caught using illicit supplies;
- Enhanced working with other UK agencies both domestically and abroad, notably the intelligence agencies, the police, the Inland Revenue and the Benefits Agency;
- The introduction of fiscal marks to identify UK duty paid products.

5.6 To measure delivery, key targets have been set by Customs and agreed with Ministers for each year up to 2003-2004. These are expressed in Customs' current Public Service Agreement as shown below:

Year	Target
By 2004-05	To reverse the current trend in tobacco smuggling so that by 2004-05 smuggled cigarettes represent no more than 18 per cent of the market.
2003-04	To limit the market share* taken by smuggled goods to no more than 20 per cent
2002-03	To limit the market share taken by smuggled goods to no more than 21 per cent
2001-02	To stabilise illicit market share at 22 per cent
2000-01	To slow growth and hold the smuggled share of cigarettes to 21 per cent (Outturn 21 per cent - provisional)

* Market share is defined as the percentage of the total amount of cigarettes consumed that is made up from smuggled cigarettes.

5.7 Against this background my examination covered:

- Assurance work on compliant tobacco traders;
- Customs' approach to increasing public awareness;
- The introduction of X-ray scanners at ports to detect high volume smuggling;
- Sanctions used against tobacco smugglers to deter smuggling, and
- The measurement of the level of smuggling.

Assurance work on Tobacco traders

5.8 Most Customs' assurance work relates to five major tobacco companies. My review found that Customs' systems and procedures were effective. The introduction of the National Business Manager for Tobacco Products Duty from 1 April 2001 is a significant development. This is part of the wider introduction of national business managers. They will take a holistic approach to whole trader revenue management for Large Business Assurance; provide an overview of specific business areas, such as the tobacco industry, and take responsibility for the direction of risk-based assurance work, including the allocation of resources to meet the overall business requirement.

Customs' approach to increasing public awareness

5.9 Under their Tackling Tobacco Smuggling strategy Customs embarked on a £7 million public awareness campaign. This was launched by the Paymaster General on 21 September 2000, and aimed at informing the public of what the law is and to persuade them to comply with it. £3 million of this budget was allocated for use in the first year.

Objectives of the campaign:

- Make the public aware that tobacco smuggling is a large scale criminal activity undertaken by serious and violent organised criminals;
- Highlight the new means that Customs has to fight tobacco smuggling;
- Ensure that criminals know that the risk of being caught has increased substantially;
- Explain the penalties that criminals face when they are caught; and
- Encourage the public to help Customs tackle tobacco smuggling.

Methods used have included:

- A series of adverts targeting specific audiences in national newspapers, trade magazines and billboards;
- Adverts in target locations, including pub beer mats and motorway washroom posters;
- Radio adverts; and
- Internet publicity, including links to Customs web site and 'Pop-up' messages warning potential purchasers that UK duties must be paid on all cigarettes.

Customs internet publicity campaign has recently been short-listed for a Marketing Award as well as a Campaign Advertising media award.

5.10 Customs recognise that changing the public's perception is a long-term process and this will not be achieved through a publicity campaign alone. Customs are using a market research company to help them assess the success of the campaign using a series of attitude surveys. Research carried out prior to the start of the campaign acts as a benchmark and the findings of research undertaken after each burst of publicity is measured against this.

5.11 Another indicator of the effectiveness of the campaign is the trend in calls to Customs Confidential, the hotline where members of the public can alert Customs to potential frauds. The 'hotline' number is published on each piece of media, and calls increased immediately after each burst of publicity.

The introduction of X-ray scanners at ports to detect high volume smuggling

5.12 The use of scanners is one of the range of actions being taken by Customs to halt the increase in, and then reduce, the incidence of tobacco smuggling. 2000-01 is the first year in which investment in this important technology has been made. Just 2,400 freight containers of cigarettes could supply the entire illicit market in cigarettes each year. Given that some 4 million containers pass through UK ports each year, Customs' use of a number of X-ray scanners is an important aid to assist with the detection of high volume cigarette smuggling in freight containers and roll-on-roll-off traffic. The main advantage of scanners is their ability to conduct more examinations and faster, increasing the number of incoming vehicles and containers that Customs can examine for illicit cigarettes and other goods.

5.13 Customs currently have twelve (five at the end of 2000-01) scanners in place (see Figure 14), the last two having being deployed in January 2002.

14 Network of X-ray scanners

There are 43 ports or approved points of entry in the UK (not including airports and railheads) and Customs used risk profiles in order to decide where to locate the scanners initially. This assessment was based on previous seizures made at each port and the throughput of traffic.

The introduction of scanners at ports has been staggered. The first scanner was deployed in November 2000. Scanners already purchased by Customs cost between £1.4 and £1.9 million each.

Customs expect to have in place their planned network of scanners by the end of 2002. All of these machines are classed as mobile.

5.14 Customs expected level of seizure for scanners during the first year was 50m cigarettes and they estimated that scanner operations could contribute over 2 billion cigarettes to total seizures during the first three years. In practice, due to a variety of reasons including delays with procurement, logistical arrangements, training and the staggered nature of their introduction, X-ray scanners did not reach the expected level, detecting around 13 million cigarettes during 2000-01.

Customs are having difficulty increasing scanner throughput

5.15 In 2001/02 Customs aim to scan 30,000 freight containers and 50,000 roll-on-roll-off vehicles at each of the main ports. However scanner teams are having difficulties increasing vehicle throughput to the levels that they need to meet their targets, despite starting to operate scanners continuously.

5.16 Customs rely heavily on the co-operation of port authorities and matters outside Customs' control, such as the number of port staff available to assist, can affect Customs' ability to meet their throughput targets. Customs have very limited space at some of the major ports in which they can hold containers and vehicles that they are waiting to scan. At some this can limit their scanning throughput, as they need to ensure that their activity does not block the exit channels and cause significant delays to other port users.

5.17 At freight container ports, in particular, Customs rely on port staff and port equipment to retrieve containers for scanning and then hold or return these as appropriate. The nature and size of these ports can result in delays when retrieving containers for examinations. Port authorities have had to change their working methods in order to accommodate scanners and retrieve the required number of containers each day. Nevertheless Customs still encounter logistical problems in this part of their operation.

Cigarette seizures at some ports with scanners have dropped dramatically

5.18 Customs' data on the overall levels of smuggling indicate that levels of illicit smuggling may have stabilised. At a number of ports where scanners have been introduced, overall seizure rates have dropped dramatically. At one freight container port the number seized during the last quarter of 2000-01, the period when the scanner was deployed, fell to 20 million cigarettes from 100 million cigarettes only 6 months earlier. This may indicate that scanners may have acted as a deterrent, and that smugglers are having to use

more complex, costly methods of smuggling (or have discontinued all together), or they have revised their routes and smuggling modes into the UK.

5.19 All of the twelve scanners currently used are mobile, but so far there has been limited movement between ports. In order to reduce the risk of smugglers moving elsewhere Customs are monitoring the risks regularly at each port using intelligence information from previous detections. As this model is further developed each port will be risk scored according to the volume and origin of their incoming traffic, in addition to any seizures that may have been made locally. Customs now have the capacity to scan at all the ports that pose a significant risk and will seek to move scanners to ports where risks may have changed over time.

X-ray scanners are forcing more intelligent methods of smuggling

5.20 As Customs' activities deter smuggling in large volumes loaded into containers and vehicles, smugglers are changing their approach. Cigarettes are being smuggled in smaller quantities, often concealed within other goods. Using scanners has helped Customs to detect these in some cases, however in others only a manual examination has been successful.

5.21 The Department recognises that training officers in the interpretation of x-ray images is key to the scanners success. The training programme has taken much longer than anticipated and Customs now monitor this to ensure efficiency. Customs are currently scanning all containers and vehicles suspected of smuggling in order to build a library of images that will assist officers with image interpretation.

Sanctions used against tobacco smugglers to deter smuggling

5.22 A range of sanctions has always been available to Customs to help ensure taxpayers comply with their obligations under the law. A key feature of the Tackling Tobacco Smuggling strategy is to improve the targeting of these against those who smuggle.

5.23 Customs consider that while prosecution remains an option for the most significant smuggling offences it is just one of a range of weapons in their armoury to disrupt smuggling and achieve the objective of putting it into decline. During 2000-01 prosecutions from cigarette smuggling decreased by around 19 per cent from the previous year.

5.24 In 2000-01 Customs adopted a policy of non-restoration, other than in exceptional circumstances, of private light goods vehicles (such as transit vans) used to smuggle, aimed at disrupting the flow of goods into the UK, and in particular striking at the profitability of smaller smuggling gangs. This policy has resulted in a substantial increase in the number of vehicles seized, almost doubling from 5,199 in 1999-00 to 10,219 in 2000-01. Since July 2001 Customs have adopted a similar policy on Heavy Goods Vehicles, seizing vehicles on first offences, where the amount of duty evaded exceeds £50,000 (approximately 300,000 cigarettes), and seizure on second offences where the duty evaded is less than £50,000.

5.25 Customs have also introduced financial penalties for tobacco smuggling involving asset seizures (to be determined by the courts). In 2000-01 they had a target to seize £15 million of assets, however the actual value of seized assets was only £8.34 million. Customs have a target of £16.5 million for 2001-02 and they need to make sure that this remains appropriate.

5.26 Since June 2001 all UK bought cigarettes and hand rolling tobacco released for sale in the UK must have a compulsory "UK DUTY PAID" pack mark on them, clearly indicating to both the retailer and the general public that they have borne UK duty. Possession, sale or permitting premises to be used for the sale of unmarked tobacco is now an absolute offence, except in the case of tobacco bought legitimately overseas for personal consumption, and offers all enforcement agencies a highly visible indication that UK duty has not been paid. Since July 2001, any retailer who sells unmarked tobacco products can face significantly tougher penalties, such as those shown below (**Figure 15**).

5.27 The introduction of Fiscal marks has also made it easier for other agencies to assist in tackling tobacco smuggling. Trading Standards Officers are now authorised to seize or detain unmarked products. They can also carry out separate actions for breaches of

trading standards legislation against the person from whom goods have been seized.

Measurement of tobacco smuggling

5.28 Customs calculate the level of tobacco fraud by measuring the difference between the supply of legitimate tobacco products in the UK and the estimated level of consumption. Customs use a variety of data including tobacco manufacturers' tax returns, the General Household Survey and the Omnibus Survey for tobacco consumption, data from the Tobacco Manufacturers Association, and the International Passenger Survey for cross-border shopping. The difference between UK duty paid supply and consumption represents the amount of tobacco that is consumed in the UK but has not borne any UK duty. Customs combine estimates of the volumes of legitimate cross-border shopping and duty paid (since July 1999) and conclude that the remainder of the products consumed in the UK are smuggled.

5.29 During 2000-01 Customs found methodological inconsistencies in the data used in their model to measure the level of market penetration. Customs have been refining the data and their methodology to estimate the level of market penetration and will continue to do so. In particular, Customs are reviewing the data used to calculate the prevalence of smoking in the UK and that used to calculate the level of legitimate cross-border shopping.

5.30 Customs' best assessment of the likely growth in market share accounted for by smuggled cigarettes for 2000-01, without any additional enforcement action, was 25 per cent. However, Customs pursued a target of holding the level of smuggled cigarettes to 21 per cent of the UK market, an anticipated revenue loss of £2.8 billion (Excise and VAT). Customs' provisional assessment of the market share for 2000-01 is that the 21 per cent illicit share was met (**Figure 16**). This measurement is subject to statistical error of ± 2 per cent.

15 Penalties available for selling unmarked tobacco products

Retailers found selling unmarked tobacco can face:

- Prohibition of tobacco sales for up to six months; and
- Fines of up to £5,000 for dealing in, or allowing premises to be used for dealing in unmarked tobacco.

Further sanctions available to Customs:

- Removal of National Lottery terminal if a person is convicted of a criminal offence;
- Objections to renewal of liquor licence; and
- Report to franchise-owner requesting action against franchisee.

Conclusions

5.32 Initial results from research into Customs publicity campaign about tobacco smuggling are encouraging with an increased awareness of Customs' anti-smuggling work. Research is due to be carried out again at the end of the publicity campaign and a full assessment made of its impact. Customs make extensive use of press and other public relations activities in order to highlight individual operations and seizures. While the results of seizures are regularly reported in the local press more information could be made available nationally and more regularly about progress towards the achievement of Customs' targets for tobacco smuggling. This could reinforce their publicity campaigns and allow a more informed debate on the issues involved.

5.31 Customs' achievements in 2000-01:

16 Showing the number of cigarettes smuggled in relation to those consumed

	1999-2000	2000-2001
Estimated UK consumption of cigarettes (number of sticks)*	80 billion	78 billion
Estimated consumption of UK duty paid cigarettes (number of sticks)*	63 billion	56 billion
Estimated number of cigarettes smuggled (number of sticks)*	14 billion	17 billion
Seizure Target	None	2 billion
Number of cigarettes seized	1.88 billion	2.77 billion
Tax per cigarette	£ 0.16	£ 0.17

* Provisional estimates - rounded to the nearest billion. Source - HM Customs and Excise.

5.33 In 2000-01, Customs exceeded its seizure target of 2 billion cigarettes by 38 per cent, seizing 2770 million cigarettes; 1860 million in the UK and 910 million overseas in conjunction with local enforcement agencies. However the number of cigarettes seized using the new scanner technology did not reach the expected level for 2000-01 by some 37 million sticks. While early results from 2001-02 indicate that seizures using scanners are increasing, particularly as more scanners come on line and staff become more familiar with the technology, performance from 2000-01 suggests that meeting the 2001/02 seizure target will be extremely challenging. Customs need to ensure that this new technology is fully utilised, particularly by gathering good quality intelligence information to optimise performance.

5.34 Customs have to consider the impact of their work on the wider operation of commercial port activities when deciding on the number of vehicles and containers they can examine through the use of scanners. There may be scope for Customs to improve the working areas at some ports, which would provide them with more operational flexibility.

5.35 As both Customs and port staff gain experience of using scanners, the delays and number of problems that both have experienced should diminish. Customs are monitoring performance of the scanners at all locations so that best practice can be disseminated quickly, problems overcome and a better understanding of the technical capabilities of scanners acquired. Customs are also

developing a library of intelligence that will enable them to make better judgements on which vehicles should be scanned and which should be examined manually.

5.36 Customs' disruption policy does not place a premium on the use of prosecution where Customs judge that other measures will be as or more effective in achieving the outcome of reduced overall smuggling. This approach needs continually to be carefully balanced to avoid on the one hand giving the impression that smuggling is a low risk activity with low penalties to some smugglers and on the other hand not wastefully devoting resource to unnecessary prosecutions at the expense of alternative activities more likely to reduce overall smuggling volumes.

5.37 The strategy's early results recorded in Customs *Tackling Indirect Tax Fraud*⁶ are encouraging, and, based on the provisional figures available, Customs have met their target for the first year of the Strategy. While it is clear that Customs are seizing increasing numbers of cigarettes, their overall aim is to halt the growth of market penetration by smugglers. When considering any refinement to their model for measuring the levels of tobacco smuggling, Customs need to consider the impact that this will have on their targets to ensure these are still relevant. There are indications that the introduction of heavier penalties (such as the confiscation of vehicles involved in tobacco smuggling) and fiscal marks, are having an effect and I will review progress on the strategy when implementation is further forward.

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31 January 2002

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