National Audit Office

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COMPTROLLER AND
AUDITOR GENERAL

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HM Revenue & Customs

Renewed Alcohol Strategy: A Progress Report

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National Audit Office

HM Revenue & Customs

Renewed Alcohol Strategy: A Progress Report

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Amyas Morse
Comptroller and
Auditor General

National Audit Office

20 January 2012

This report examines the Department's performance in implementing the revised strategy in its first year, as well as its progress in establishing accurate figures for the value of revenue lost through alcohol duty evasion.

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Contents

Summary 4

Part One
Introduction 9

Part Two
Progress on the key actions within the renewed Strategy 16

Part Three
Enforcement action to combat alcohol fraud 24

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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 (the Department) 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 they are being duly carried out.

2 Excise duties on alcohol generated £9.5 billion of revenue in 2010-11, but the Department's latest estimate of the tax gap indicates that up to a further £1.2 billion is lost each year due to duty evasion, principally fraud. The United Kingdom is one of the few countries to try to make such estimates, which are inherently difficult.

3 In October 2008, the Committee of Public Accounts considered the Department's progress in implementing its 2005 Strategy to tackle spirits duty evasion and Committee members have since raised concerns with the C&AG about the Department's efforts to tackle alcohol duty fraud. The Department launched its Renewed Alcohol Strategy in April 2009, with implementation from 1 April 2010.

4 This report examines the Department's performance in implementing the revised Strategy in its first year, as well as its progress in establishing accurate figures for the value of revenue lost through alcohol duty evasion.

Key findings

Measuring the tax gap for alcohol

5 **The Department's latest figures indicate that the tax gap for alcohol increased to £1.2 billion in 2009-10.** The Department published its latest estimate of the tax gap in September 2011, which indicated that the upper bound estimate of losses due to alcohol duty evasion had increased significantly, from £850 million in 2008-09 to £1.2 billion in 2009-10. This pre-dates the implementation of the Renewed Alcohol Strategy.

6 **The Department has yet to establish a reliable estimate of the tax gap for wine and has published only an upper estimate of the tax gap for beer.** It intends to publish a midpoint estimate for the beer duty tax gap early in 2012. Although an official statistic, the brewing industry contests the Department's estimates of the tax gap for beer (the upper estimate was 14 per cent of the total market for 2009-10), and believes that the true gap is likely to be significantly lower.

7 **The Department continues to seek indicators which will provide an earlier assessment of the impact of its intervention activities on the tax gap.** There is an unavoidable 18-month time lag in producing the tax gap estimates. The Department attempted to develop ‘proxy indicators’, which should give a more immediate assessment of the impact of its activities, but it was unable to obtain the necessary data. Instead, it has developed a methodology that gives an indication of the impact of its operational interventions on the tax gap estimate.

Creating a meaningful alcohol strategy

8 **The renewed strategy is a significant improvement on the Department’s 2005 alcohol strategy.** The Department’s previous alcohol strategy covered spirits duty only, whereas the renewed strategy is more comprehensive and covers the duty payable on wine and beer as well.

9 **The strategy includes some important elements but no explicit objective of increasing the Department’s use of criminal sanctions (prosecutions) from its low level.** The key actions within the strategy include interventions to implement legislative changes to make life tougher for criminals; to work with the alcohol industry to secure its supply chains; and to strengthen the Department’s operational response to criminal activity.

Delivering the key actions within the strategy

10 **The Department exceeded its key financial objective for the year.** The Department set a number of key performance outcomes for 2010-11 and achieved a number of these, including its principal financial target of delivering operational outputs of £390 million.

11 **The performance monitoring information used by the Department’s Alcohol Strategy Delivery Group (the Delivery Group) is of variable quality.** The Delivery Group is the forum where the Department determines the tactical adjustments necessary to deliver the Strategy. There is significant scope for improvement in the depth and quality of the management information provided to the Delivery Group. In particular, we found that £43 million out of £476 million reported as operational outputs of the Strategy were not defensible, because of poor quality assurance processes around reported results.

12 The Department's efforts to work with industry to secure alcohol supply chains have not reduced the volumes of beer moved duty-unpaid to the near continent and subsequently diverted back for illicit sale in the UK. Achieving a reduction in the volume of exported alcohol that is diverted back into the UK for illicit sale requires closer working with the alcohol industry, and this formed one of the key actions within the renewed Strategy. There was no evidence that the Department's efforts to work closer with the industry achieved tangible results in the period. There have, however, been discussions between the Department and key stakeholders in 2011 on the viability of fiscal marks (e.g. 'duty paid' stamps) for beer, as these have helped in countering spirits duty fraud.

13 The Department has implemented the Excise Movement Control System (EMCS) but has yet to exploit the full benefits of the system to tackle fraud. EMCS facilitates the electronic tracking of freight across the European Union, and holds valuable data on movements that can be analysed towards better targeting of interventions and investigations. The Department is not yet able to download the data within the system for detailed analysis by its Knowledge, Analysis and Intelligence units, and is also developing a risk capability to enable it to utilise the data fully.

14 The Department has recorded increased revenue from businesses participating in its new Registered Consignee scheme, but is as yet unable to say why the growth in revenues has occurred. The Department established its Registered Consignee scheme in April 2010 to tackle concerns in the previous arrangements for registered traders receiving duty suspended alcohol from other EU Member States. As the revenue received from businesses has increased since the new scheme was launched (£1,195 million during 2010-11), there is some evidence that the scheme is encouraging traders to pay more duty than under the previous regime. The Department is currently reviewing the reasons for the growth in receipts under the scheme.

15 The Department's financial securities scheme is not effective in protecting alcohol duty revenues. Under EU law, the scheme requires traders to provide financial guarantees on alcohol movements to cover risks inherent in the movement. The Department's consultation on the scheme determined there was no scope for it to help counter alcohol duty fraud. At present, the scheme recovers very little of the duty due on goods that are diverted, as the guarantees required by the Department are far lower than the value of duty that would be due (less than 16 per cent of the duties due on invoked guarantees were recovered in the three years up to 2010-11).

16 Repayments of alcohol duty through the drawback scheme on goods that have a higher risk of being diverted illicitly on to the UK market rose by 9 per cent in 2010-11. The Department refunds duties that have been paid on goods that are exported from the UK. This arrangement was previously facilitated through the Department's Warehousing for Export scheme. When closing this scheme from 1 June 2009, the Department expected that the level of duty drawback claims often associated with alcohol duty evasion would drop by 15 per cent during 2010-11. In the event, the value of claims from small and medium-sized traders, which include the higher risk movements, rose by 9 per cent (£6.8 million).

Enforcement action to combat alcohol fraud

17 The Department has not actively pursued an increase in criminal sanctions against fraudsters. In each of the four years to 2009-10, there were convictions in six cases or fewer for suspected alcohol duties fraud.

18 In the first year of the renewed strategy, the Department increased its use of civil sanctions considerably, especially its seizures of illicit alcohol. The Department is able to impose civil sanctions on individuals and businesses that fail to comply with the law, and considers this a more effective option in some instances than pursuing criminal sanctions. During 2010-11, the quantity of alcohol seizures increased by over 61 per cent, compared to 2009-10, to almost 10 million litres.

Overall conclusion

19 The Department has achieved some of its objectives in the first year of its Renewed Alcohol Strategy, including exceeding its financial target for operational outputs. The Department has not, however, achieved tangible success in working with industry stakeholders to disrupt the supply chain for alcohol diverted illicitly on to the UK market. There is insufficient quality, depth and analysis in the performance information used to inform delivery of the Strategy. Significant improvements are needed in these areas to ensure that the Renewed Alcohol Strategy reduces the increasing level of alcohol duties lost to fraud.

Recommendations

20 The Department has yet to establish a reliable estimate of the tax gap for wine and has published only an upper estimate of the tax gap for beer. It should therefore:

a devise and publish a tax gap estimate for wine as soon as possible; and

b work with the brewing industry to develop credible lower-bound and midpoint estimates of the beer tax gap.

21 The Department exceeded its key financial objective for the year but performance was overstated. The Department needs to improve the quality and depth of the financial and operational performance information provided to decision-makers to inform delivery of the strategy.

22 The Department's efforts to work with industry to secure alcohol supply chains have not reduced the volumes of beer moved duty-unpaid to the near continent and subsequently diverted back for illicit sale in the UK. It should therefore:

a take urgent steps to exploit the data within the Excise Movement Control System to better target its interventions; and

b introduce new measures to improve the effectiveness of its work with industry to reduce the volume of beer at risk of diversion into illicit markets.

23 The Department has recorded increased revenue from businesses participating in its new Registered Consignee scheme, but is as yet unable to say why the growth in revenues has occurred. The Department should conclude its review of the scheme as quickly as possible to gain a timely understanding of the factors for its success and of the residual risks to revenue.

24 The Department's financial securities scheme is not effective in protecting alcohol duty revenues. The Department should ensure that the guarantee scheme provides a greater measure of revenue protection for excise goods moved under duty suspension.

25 The Department has not actively pursued an increase in criminal sanctions against fraudsters. As criminal sanctions are an important deterrent to potential fraudsters, the Department's Strategy for tackling alcohol fraud should include an objective to increase the number and impact of criminal investigations and prosecutions.

Part One

Introduction

1.1 The Comptroller and Auditor General (C&AG) is appointed by Parliament as the external auditor of HM Revenue & Customs (the Department). Section 2 of the Exchequer and Audit Departments Act 1921 requires the C&AG to ascertain that adequate regulations and procedure have been framed to secure an effective check on the assessment, collection and proper allocation of revenue, and that they are duly being carried out.

1.2 Alcohol duties provide the Exchequer with revenue of over £9 billion each year. However, the Department estimates that fraud against alcohol duties may cost the Exchequer up to £1.2 billion per annum.[1] The fraud is carried out primarily by organised criminals who exploit weaknesses in the supply chains of alcohol producers, wholesalers and distributors to divert goods on to the UK market without paying the taxes that are due. The illicit importation of alcohol products into the UK without the payment of UK duty is the main element of the fraudulent activity.

1.3 This report presents the findings from our review of the Department's implementation of its renewed Strategy to tackle alcohol fraud, which came into effect from 1 April 2010. Our review covered the Department's performance against a range of key measures it set itself in implementing the renewed Strategy, and a review of the evidence underlying the financial benefits of £476 million recorded internally by the Department as outputs of its various operational interventions.

The initial Alcohol Strategy

1.4 Opportunities for excise fraud emerged effectively with the creation of the European Union (EU) single market on 1 January 1993. Until that time, the Department and customs authorities in other Member States had established tight control of excise goods to ensure duties were paid on the goods produced.

1 The estimated £1.2 billion of revenue lost through alcohol fraud is made up of the upper bound estimate of £440 million from spirits, and the provisional upper bound estimate of £800 million from beer (as identified in Measuring Tax Gaps – September 2011 (http://www.hmrc.gov.uk/stats/mtg-2011.pdf). The estimates for spirits and beer are official statistics which meet the code of practice for official statistics as published by the UK Statistics Authority.

1.5 Once the single market was established, businesses were legally free to move excise goods around the EU between registered warehouses on a duty suspended basis without routine customs checks at the borders. The duty due on goods dispatched for UK consumption becomes due once the goods are released from the warehouses, and goods destined for export can travel without any duty being paid. As excise duty rates on alcohol are far higher in the UK than on mainland Europe, perpetrators of fraud have exploited this new regime. The fraudsters move alcohol products to the EU with excise duties unpaid, store the goods in warehouses on the near continent, release the goods on to the EU market and then divert them back into the UK. Products are then sold on to retailers, wholesalers or other parties, without UK excise being paid.

1.6 In the past, the Department considered that, of all three forms of alcohol duty (wine, beer and spirits), spirits duty evasion presented the greatest revenue risk to the Exchequer. Therefore, the Department's *Tackling Alcohol Fraud Strategy* launched in 2005 focused on tackling spirits excise duty evasion.

1.7 In October 2008 the Public Accounts Committee considered the Comptroller & Auditor General's Report[2] on the Department's implementation of its 2005 Strategy. The Report recognised that the Department had made good progress in embedding measures underlying the Strategy. Since then, however, fraudsters have been targeting areas of lesser control, notably affecting duties due on beer and wine. Public Accounts Committee members have raised concerns with the C&AG about the Department's performance in countering these threats.

1.8 In April 2009, the Government announced that it was renewing its alcohol fraud strategy to tackle fraud across all three forms of alcohol duty. Implementation of the Department's renewed operational approach commenced from 1 April 2010.

The Renewed Alcohol Strategy

1.9 The Department's Renewed Alcohol Strategy is more comprehensive than its predecessor which was restricted to tackling spirits duty fraud. Its interventions now cut across alcohol duties. The new Strategy has three principal themes, and aims to:

- change the law to make life tougher for criminals and easier for legitimate businesses to compete;
- work with honest businesses to secure legitimate supply chains and so make it harder for criminals to obtain access to illicit alcohol; and
- strengthen the Department's operational response to alcohol fraud as part of a more centrally coordinated effort to detect, disrupt and dismantle organised criminal networks and supply chains.

2 *HM Revenue & Customs Accounts 2007-08*, HC 674, 2007-08.

1.10 Figure 1 below summarises the Department's progress at the end of the first year of its Renewed Alcohol Strategy.

Figure 1
Performance in the first year of the Renewed Alcohol Strategy

Theme	Key Actions	Key performance measures	Outcomes for 2010-11
Changing the law: to make life tougher for criminals and easier for honest businesses to compete	Implement legislative changes to: • reduce the opportunity for fraud; and • reduce the use of drawback (*duty refunds*) to source illicit alcohol.	• Successfully introduce legislative changes to withdraw 'warehousing for export (WFE)' as from June 2009 and impose conditions to pay duty up front for warehousing for dispatch in April 2010. • A 15 per cent reduction in the level of high risk drawback claims.	**Partially achieved.** The warehousing for export scheme was withdrawn as planned. However, drawback claims increased from £84.7 million in 2009-10 to £110.3 million in 2010-11, and the value of drawback claims most at risk increased from £74.7 million in 2009-10 to £81.5 million in 2010-11.
	Introduce allowable journey times for movements of goods under duty suspension to reduce opportunities for diversion of alcohol movements.	Implementation of the Excise Movement Control System (EMCS) to monitor journey times. (*As a first step towards introducing allowable journey times*).	**Partially achieved.** The three phases of the EMCS have been introduced but the system is being operated in a trade facilitation capacity and not as a counter-fraud tool. No allowable times have been introduced to date, and full use is not as yet being made of the data on EMCS in efforts to tackle fraud.
	Tighter system of regulations for Registered Excise Dealers and Shippers (REDS) scheme.	A target was set to remove high risk and/or dormant REDS traders.	**Partially achieved.** The REDS scheme has been replaced by a new scheme for Registered Consignees as from 1 April 2010, and the process required all traders to reapply for registration. The impact of this scheme is yet to be assessed by the Department.
Securing the supply chains	Working with businesses to develop practical measures that will drive out fraud and secure alcohol supply chains. Work with large brewers, wholesalers and hauliers to restrict the supply of popular brands of canned beer in duty suspense to the near continent subsequently fraudulently diverted to the UK with duty unpaid.	A reduction in the supply of duty suspended alcohol.	**Not achieved.** The benefits of the Department's efforts to secure the supply chains by working with businesses are not yet demonstrable, and the level of popular UK brands of canned beer supplied to the near continent in duty suspense remains unchanged.
Strengthening the Department's operational response	There is a wide range of key actions within this area, intended to disrupt criminal activity and thereby prevent revenue losses from fraud (*see Figure 6*).	A target was set to achieve operational outputs of £390 million in the first year of the strategy.	**Achieved.** Approximately £433 million of operational outputs was achieved in 2010-11 through a range of enforcement activities.

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

Measuring the impact of the Renewed Alcohol Strategy

1.11 Since the withdrawal of Public Service Agreements and Departmental Strategic Objectives in 2010, the Department no longer has a specific published target to meet in tackling alcohol fraud. Instead, the Renewed Alcohol Strategy contributes to the Department's strategic objective of reducing the aggregate level of revenue losses for VAT, excises, direct tax and National Insurance contributions.

1.12 To measure the scale of alcohol duties lost to the Exchequer, the Department estimates the amount of tax revenues due but not received in each year (the tax gap), and monitors the changes in these estimates year on year. Its first step in estimating the amount of revenue lost in each year is to estimate the share of the market for each form of alcoholic drink (spirits, beer and wine) that is serviced through illicit trade. The United Kingdom is one of the few countries to try to make such estimates, which are inherently difficult.

1.13 As the data required for the calculation of tax gap figures are only available about 18 months after the end of each financial period, they are of limited value in informing tactical decisions in implementing the Strategy. However, they provide an indication over time of the Department's progress in tackling alcohol duty fraud. The latest available tax gap estimates are for 2009-10 which is the year before the Renewed Alcohol Strategy was implemented. It is therefore too early to draw any conclusions about the impact that the Strategy has had on the tax gaps.

The Spirits Duty tax gap

1.14 The Department's 2005 Alcohol Strategy aimed to reduce the illicit market for spirits by at least half by the end of 2007-08, from the baseline figure of 12 per cent which was the Central Estimate recorded in 2003-04. This estimate of fraud reduced during the period, but the Department missed its target by two percentage points, as shown in **Figure 2**. It achieved the target in 2008-09, but the Central Estimate of the tax gap for 2009-10 indicates that the illicit share of the market for spirits has subsequently increased from 2 per cent to 3 per cent, with associated revenue losses of £130 million.

Figure 2
Spirits: Illicit market share and associated revenue losses

	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
Illicit market share							
Upper confidence interval (%)	17	9	11	14	14	8	11
Central estimate (%)	12	3	6	9	8	2	3
Lower confidence interval (%)	7	–	–	3	2	–	–
Associated revenue losses							
Upper confidence interval (£m)	–	350	430	550	550	310	440
Midpoint estimate (£m)	–	–	220	320	310	80	130
Lower confidence interval (£m)	–	–	–	90	70	–	–

Source: HM Revenue & Customs – Measuring Tax Gaps 2011. Revenue losses include spirits duties and VAT. Figures for 2009-10 are provisional

The Beer Duty tax gap

1.15 In September 2011, the Department published the tax gap estimates for beer (**Figure 3** overleaf). It estimated that the revenue losses from beer in 2009-10 could be as high as £800 million (equivalent to about 14 per cent of the total beer market). Although an official statistic, the brewing industry contests the Department's estimate, and believes the true gap is likely to be significantly lower based on its figures of sales that are exposed to the risk of duty fraud. The beer industry estimates that over 70 per cent of the beer sold in the off licence trade (by small to medium-sized retailers) would have to be illicit for the Department's upper estimate to be credible. However, the Department believes the lower estimates put forward by the brewers do not take account of illicit sales in other outlets such as the 'on-trade' (pubs, bars and other outlets licensed to serve alcohol) and by large retailers.

Figure 3
Beer: Illicit market share and associated revenue losses

	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
Illicit market share (upper estimate) (%)	9	8	13	12	10	14
Associated revenue losses (£m)	500	450	700	650	550	800

Source: HM Revenue & Customs – Measuring Tax Gaps 2011 (2004-05 figures are from Measuring Tax Gaps 2010). Revenue losses include beer duties and VAT

1.16 The Department is still developing central and lower bound estimates and is liaising with the brewing industry to construct a more robust estimate of the tax gap for beer. It expects to be able to publish a midpoint estimate early in 2012. In the meantime, it has acknowledged that the actual level of the tax gap will be lower than the published upper bound of 14 per cent.

The Wine Duty tax gap

1.17 Unlike beer and spirits, where the majority of the output is produced by UK-based brewers or suppliers, most wines consumed in the UK are produced overseas, which limits the amount of data the Department has to analyse the wine tax gap.

1.18 The Department also considers that using household survey data (which helps inform the fraud estimates for beer and spirits duties) provides unreliable estimates for both total wine consumption and the estimates of wine fraud. There are several factors that may influence this, such as:

- under-reporting of consumption and the conversion of consumer spending on wine into volumes of the product;
- significant changes in consumer tastes and consumption patterns that affect survey data;
- the complexities of dealing with three distinct categories of wine: still, sparkling and fortified; and
- significant corporate consumption not captured by the household surveys.

1.19 The Department is seeking a reliable estimate for total wine consumption. Until then, it is unable to derive a reliable estimate of the size of the wine market represented by illicit trade. In the meantime, the Department relies principally on information from intelligence and operational activities to indicate the extent of fraud against wine duties.

Managing the delivery of the Renewed Alcohol Strategy

1.20 The Department’s Alcohol Strategy Delivery Group (the Delivery Group) is responsible for delivering the tactical elements of the Strategy. The Delivery Group comprises representatives from several operational sections of the Department as well as a representative from the UK Border Agency (an executive agency of the Home Office). It monitors the delivery of the Strategy through monthly performance packs and oral updates received from the intervention teams working to deliver strands of the Strategy. For example, the Delivery Group reviews performance against targets for the seizure of illicit alcohol.

1.21 The performance information provided to the Delivery Group in 2010-11 to inform its decision-making could be more comprehensive. For example, the Department’s Large Business Service team provided information from the brewers on the volume of duty suspended movements of beer, but was unable to obtain the total volume of beer dispatched. Similarly, within its submission to the performance monitoring team for January 2011, the Department’s Inland Detection team provided information on the volume of its seizures, but not the information required on the value of individual seizures or the average time taken to respond to intelligence.

1.22 We also found scope for improvement in the Department’s use of its data. For example, an analysis of seized illicit products to determine trends, such as the country of production, would give the Department further clarity on the potential volume of illicit goods that were produced in the UK and dispatched to the near continent for subsequent inward diversion, compared with the volume of goods that were produced overseas. This would provide the Department with a stronger basis for its engagement with the UK alcohol industry (especially the producers and the hauliers) as there is currently a difference of views between the Department and industry stakeholders on the level of UK product that is dispatched overseas and then diverted inwards illicitly. However, the Department is of the view that routine analyses of the countries of origin of seized goods would not be of value.

1.23 In the first quarter of 2011-12 the Department has sought to widen the scope of the information required within the reporting packs provided to the Delivery Group.

1.24 As the data used in the calculation of tax gap estimates take about 18 months to establish, the Department has also tried to develop some interim ‘proxy indicators’ to provide a more immediate assessment of the impact of its interventions in reducing tax losses. An example of a proxy indicator is the relationship between the volumes of UK produced beer dispatched to the near continent and the beer tax gap. The Department’s efforts to develop these proxy indicators were unsuccessful as it was unable to obtain the necessary data. Instead, it has developed a methodology that gives an indication of the impact of its operational interventions on the tax gap estimate.

Part Two

Progress on the key actions within the renewed Strategy

Reform of the Excise drawback system

2.1 The alcohol duties drawback arrangements allow claimants to recover the duty paid on alcohol products purchased in the UK which are destined for consumption outside the country. The risks for the Department are that it repays alcohol duties on alcohol products (beer, spirits or wine) on which UK duty was never paid in the first place, and on alcohol products that do not leave the UK but are diverted on to the UK market without payment of UK duty. There is a further risk, whereby products on which duty has been repaid by the Department are exported, but are then placed in duty suspension on the near continent ready for diversion back into the UK for illicit sale.

2.2 Between 2006-07 and 2010-11, alcohol drawback claims paid by the Department rose by 83 per cent (from £60 million to over £110 million – see **Figure 4**). The largest percentage increase was for wine duties (due on wine, cider and perry), where drawback payments more than tripled from £14.24 million in 2006-07 to £48.45 million in 2010-11. Drawback payments made on beer also increased by over 50 per cent in the period.

2.3 Between 2009-10 and 2010-11 total drawback claims increased by £25.6 million (from £84.7 million to £110.3 million). Approximately £17 million of this increase is accounted for by claims made by large companies, including supermarkets, who received 26 per cent of the total drawback paid in 2010-11 (12 per cent in 2009-10). The increase in drawbacks by large companies is due to more supplies of alcohol being sourced from UK duty-paid stock rather than being dispatched in duty suspension, and also to adjustments for amounts under-claimed in previous years.

2.4 The Department's view is that the risks of drawback fraud and the use of drawbacks to source alcohol for subsequent diversion back into the UK sit mainly with the smaller companies, which received a total of £81.5 million of drawback payments in 2010-11 (£74.7 million in 2009-10). The Department attributes the majority of the increase of £6.8 million (9 per cent) in payments to this category of claimants to the year-on-year rise in alcohol duty rates, with the remainder due to ongoing demand from criminals for alcohol to be positioned on the near continent.

Figure 4
Alcohol drawback payments

Year	Beer (£m)	Spirits (£m)	Wine/Cider/Perry (£m)	All Alcohol (£m)
2006-07	36.8	8.9	14.2	59.9
2007-08	25.9	5.0	15.0	45.9
2008-09	54.6	5.0	13.8	73.4
2009-10	57.6	3.2	23.9	84.7
2010-11	56.7	5.1	48.5	110.3

Source: HM Revenue & Customs

2.5 Over the last five years, the Department has introduced a number of legislative changes aimed at preventing abuses of the drawback system, including the abolition of the 'Warehousing for Export' scheme with effect from 1 June 2009. The Department's aspiration was that the abolition of this scheme would reduce the amount of drawback claims by £20 million in 2009-10, and by £10 million in each subsequent year.

2.6 After the abolition of the scheme, the Department initially saw a drop in the overall number of drawback claims but this was short-lived because the number of claims under the alternative scheme (the Despatch scheme[3]) began to rise. To further counter this fraud, the UK Government secured provisions under a new Council Directive governing the movement of excise goods across the EU[4] to allow the Department to grant drawback only when the claimant provides evidence that the duty has been paid and collected in the receiving Member State. These provisions came into force on 1 April 2010 and allow the Department to request evidence from claimants that the alcohol products for which they are seeking repayment of duties have genuinely been released for consumption in the relevant EU Member State.

2.7 The Department has established that fraudsters who had previously exploited the Warehousing for Export scheme are able to circumvent controls within the Despatch scheme. This may in part be due to revenue authorities in some Member States adopting a more liberal interpretation of the new regime and allowing goods to re-enter duty suspension in their country. Some of the goods positioned in duty suspension on the near continent could then be ready for diversion back to the UK.

2.8 For these new arrangements to work effectively, the Department needs the cooperation of other Member States to help in controlling supply chains outside the UK. The Department is therefore working with tax and customs authorities in other Member States to achieve this cooperation.

3 The Despatch scheme allows drawback to be claimed when UK duty-paid excise goods have been despatched to another Member State subject to certain conditions being met, the main one being that the duty has been guaranteed, prior to despatch, in the Member State of destination.
4 Council Directive 2008/118/EC replaced Council Directive 92/12/EEC.

Reform of the Excise Financial Securities System

2.9 Excise goods may travel within or between Member States of the European Union in a state of duty suspension. In order to provide a measure of revenue protection, EU and national legislation requires that such movements are guaranteed by a financial security sufficient to cover the risks inherent in the movement, except in very specific, exceptional circumstances. In the event of an irregularity occurring, such as theft or diversion of all or part of the load, the financial security system identifies the person who provided the security as the person primarily liable to pay the duty whether or not they caused the irregularity. Should that person be unable to pay, the Department will call on the financial institution that provided the financial security to pay the duty due from the guaranteed amount.

2.10 In April 2009, the Department published a consultation document on reforming excise financial securities for the holding and movement of goods. This was prompted by evidence showing that the number of guarantees called upon was increasing significantly and, in more than half of the cases, the amount guaranteed was substantially less than the excise duties payable to the Department. In the 24 cases where guarantees were invoked in the three years up to 2010-11, the amount secured was sufficient to cover only £1.9 million of the £12 million of duties that were due. The majority of this shortfall was due to two cases involving fraud where the duty assessed as due was £8.5 million and the guarantees accepted by the Department were for £267,475.

2.11 The Department's view is that it is unrealistic to require commensurate guarantees for high value movements of alcohol, as this would impose an indefensible financial burden on compliant traders and conflict with the intention of facilitating trade. It also believes that any attempt to use the guarantees system to secure the duty lost through fraud would be vulnerable to legal challenge.

2.12 The Department's analysis of the responses to its consultation process identified little support for introducing changes to the financial securities system. It has concluded that the financial securities system has a minimal impact in countering excise fraud. Until enhancements are made to the current securities system, there remains a level of risk to revenues where traders do not maintain adequate guarantees for excise goods in duty suspension. The Department continues to explore possibilities but has yet to determine how it intends to ensure a greater measure of revenue protection.

Replacement of the Registered Excise Dealers and Shippers (REDS) scheme

2.13 Registered Excise Dealers and Shippers (REDS) were traders approved and registered by the Department to receive duty suspended alcohol acquired from other Member States. The traders were required to account for UK duty on receipt of the goods in the UK. In 2007, the Department carried out a review of the REDS scheme to obtain assurance over its proper operation. It found evidence of the system being abused, for example by businesses acting as 'hidden importers' and by fraudsters running duplicate alcohol loads under the same paperwork. The Department also found that there were a large number of REDS agents submitting nil returns (dormant traders) who should have been deregistered to avoid the risk of their details being stolen and used for fraudulent activities. In general, the Department concluded that REDS agents were not monitoring effectively the traders that were abusing the system.

2.14 Under EU legislation,[5] and with effect from 1 April 2010, the Department revised the REDS arrangements (see **Figure 5** overleaf). The revisions address one of the deficiencies exploited by fraudsters under the REDS regime as the notification system within the recently introduced Excise Movement Control System (EMCS) now ensures all Registered Consignees (previously REDS) are made aware of every consignment sent to them even before movements occur. In effect, where a load has been approved for movement by a Consignor outside the UK, the REDS agent on record as the Consignee or recipient within the UK is automatically notified, has to either accept that the proposed movement is as expected, or inform the Department of a fraudulent attempt to use his/her details. This addresses the risk that REDS agents collude with fraudsters to allow the use of their details for movements but subsequently deny being aware of movements that are found to have been diverted.

2.15 As part of the replacement of the REDS scheme the Department also established a new register for Registered Consignees which replaced the previous REDS register. This removed the risk associated with dormant traders' details being hijacked and used for fraudulent activities, as all traders had to reapply to participate in the new scheme. The Department's cash receipts from the REDS/Registered Consignees scheme increased from £823 million in 2007-08 to £1,195 million in 2010-11 representing a rise of 45 per cent over four years. Receipts from Registered Consignees now represent 13 per cent of total alcohol receipts.

2.16 We examined the year-on-year increases from 2007-08 to 2010-11 and noted that the receipts increased by 22 per cent in 2008-09, 5 per cent in 2009-10 and 13 per cent in 2010-11. We understand that much of the increase of 22 per cent in 2008-09 was due to the closure of a warehouse used by a large trader, forcing it to account for more of its alcohol duties through the REDS system.

5 EU Council Directive 2008/118/EC of 16 December 2008 concerning the general arrangements for excise duty, replacing Directive EC 92/12/EEC. The Government incorporated the new EU Directive into UK law through the Excise Goods (Holding, Movement and Duty Point) Regulations 2010 (Part 4).

Figure 5
Outline of the alcohol Duty Suspended system

Alcohol produced/distilled/brewed in UK or imported from non-EU countries

Excise duty is liable at this point unless held in duty suspended premises, or transferred to a duty suspended excise warehouse.

Imports (Acquisitions) from other EU Member States under duty suspension arrangements

These goods can only be received in the UK in one of the three ways below.

The Registered Consignee Scheme

This comprises registered traders who have been approved by the Department to receive duty suspended alcohol from other EU Member States, and must account for UK duty when goods are received.

The Temporary Registered Consignee Scheme

The Scheme comprises registered traders who have been approved by the Department to import duty suspended excise goods from other EU Member States on a consignment by consignment basis.

Duty Suspended excise warehouse

An excise warehouse is one that is approved by the Department for the storage of goods without the payment of excise duty. Owners of goods held in warehouses are legally required to be registered. Many alcohol products are deposited in such warehouses by the manufacturers themselves or by wholesalers to whom manufacturers may have sold in bulk. Goods can be bought and sold while held in the warehouse without incurring payment of duty. There are three main reasons for which goods can be removed from an excise warehouse:

- **Release for consumption in the UK** – Excise duty is payable at the point of release.
- **Transfer to another Duty Suspended warehouse** – Either in the UK or another EU Member State. Despatching warehouse keepers, owners or hauliers of the goods must provide a financial guarantee to cover such movements. Goods despatched between warehouses must have an electronic administrative document, which provides evidence of the warehouses acting as Consignor and Consignee for the goods, and enables real-time monitoring of when the goods reach their intended location.
- **Export to non-EU countries** – Excise duties are not paid on exports. Traders can reclaim excise duties, if already paid, under the excise drawback scheme.

Source: National Audit Office

2.17 We have sought explanations from the Department for the increase of 13 per cent in 2010-11. Our review to date indicates that the most likely explanation for the increase in REDS/Registered Consignees revenues may be that some consignments that would have been diverted and sold illicitly are no longer able to escape detection. This suggests there is an opportunistic element to inward diversion fraud, whereby some traders that were previously committing fraud are now paying the duties that are due.

2.18 In the light of the growing value of these receipts, the Department is currently undertaking a full assurance review of the new scheme. The assurance review should enable the Department to determine the reasons for the growth in REDS/Registered Consignees receipts, and may provide insights into how to further strengthen the controls within the current REDS/Registered Consignees regime.

Working with the industry to tackle fraud in the supply chain

2.19 The Department believes that the illicit market in alcohol in the UK is driven by strong demand for popular UK brands of bottled and canned beer. Therefore, the volume of alcohol available for fraudulent use in the UK is to a large extent within the control of producers and large buyers of duty suspended goods. This has prompted the Department to work closely with these legitimate large businesses to restrict the availability of alcohol for fraud by taking practical, preventative steps at early stages of the supply chains.

2.20 In presenting the Budget in 2011, the Government announced that it would be exploring potential legislative measures to tackle existing and emerging threats to alcohol duty receipts. There is clearly a need for industry-wide support for any measures that are introduced. The Department has started a period of informal consultation to identify possible options, and has established a working group with key beer industry stakeholders.

2.21 The Department has also maintained a regular dialogue with key industry stakeholders since the start of the implementation of the renewed Strategy, and a number of proposals on how the industry might contribute to the efforts to tackle alcohol fraud have been discussed. One of the options under consideration is the introduction of fiscal marks for beer, which might be as useful a tool in tackling fraud affecting beer duty as it has been for spirits duty.

2.22 The Department's efforts to explore the viability of fiscal marks for beer have been welcomed by a number of the key industry stakeholders, although brewers have expressed concerns about the practicality and the costs of measures that may involve each item of product to be sold in the UK being marked as duty paid. The Department plans to begin formal consultations on this proposal in early 2012. The planned consultation is subject to ministerial approval.

Strengthening the operational response to alcohol fraud

2.23 The Department set itself an operational outputs target of £390 million in the first year of the renewed strategy, and advised us that it had achieved £476 million. This figure was made up of revenue losses prevented, assessments raised for duty payable and the revenue value of seized alcohol. The target was to be met through several distinct interventions and **Figure 6** sets out these interventions as well as the results of our review of the outturn numbers presented by the Department for 2010-11.

2.24 Our audit of the evidence underpinning the amounts claimed established that the Department's claim of £476 million of operational outputs included overstatements of approximately £43 million.

2.25 Our work to confirm the Department's reported operational outputs identified several instances where the information provided for audit was incomplete and/or inaccurate. The same information was reported to the Alcohol Strategy Delivery Group, which suggests there is significant scope for improvement in the quality of the information being reported to the Delivery Group on the financial impacts achieved through the Department's interventions.

2.26 Our work to confirm the seizure figures presented above also identified significant gaps in the information held on the Department's electronic system for recording seizures (CENTAUR). For example, there were several instances where the amount of tax evaded or the method of concealment of the fraud was not recorded.

2.27 In addition, the CENTAUR system does not note the country of production of the goods seized. As noted earlier in our report, the Department is of the view that an analysis of seizures would not give clarity on the proportion of goods being diverted into the UK that were produced within the UK (and will have been exported under duty suspension or through the drawback scheme) versus the proportion that was produced overseas and therefore outside the scope of any work the Department could do with the UK industry.

Figure 6
Results of the National Audit Office's review of operational outputs

Intervention	Outputs claimed by the Department (£m)	Audit comments
Specialist Investigations – To tackle organised criminal gangs who infiltrate the alcohol supply chain.	267.7	Agreed. We have been able to confirm the figure to supporting documents.
Risk-based assurance – To target high risk registered warehouses, and remove approvals or apply sanctions as necessary.	93.0	In responding to audit queries around the figure of £93 million, the Department undertook further quality assurance procedures and determined that the figures submitted for audit were overstated by £10 million.
Seizures of illicit alcohol – at the border and inland by UK Border Agency and HM Revenue & Customs officers.	23.9	Agreed. We have been able to confirm the figure to supporting documents.
Integrated Intervention Teams – To undertake cross-tax investigations to tackle non-compliant wholesalers and related individuals.	59.5	We examined three cases with a total value of £26.6 million in detail. We found that £6.5 million (24 per cent) of the sample related to assessments made before the alcohol strategy commenced on 1 April 2010. The £59.5 million presented to audit was therefore overstated by at least £6.5 million, and possibly by as much as £14.5 million, based on an error rate of 24 per cent.
The Missing Trader Intra Community (MTIC) Fraud Drinks Project – This addresses fraudulent acquisition of illicit goods in alcohol supply chains, and targets wholesalers.	12.0	The £12 million scored is incorrect as the MTIC Fraud Drinks Project did not commence until 2011-12. We understand that the £12 million may represent an estimate of the defaulter assessments issued to missing traders in 2010-11. These are issued for the completeness of case records, and there is no expectation that missing traders will pay.
VAT – This addresses the VAT element of the other taxes evaded within the cases investigated by the Risk-based assurance team.	20.0	In responding to audit queries around the figure of £20 million, the Department undertook further quality assurance procedures and determined that the figure submitted for audit was overstated by £12.3 million. We examined the new balance of £7.7 million, and, of the sample tested, £2.4 million related to assessments that were raised in the 2011-12 financial year.
Total	**476.1**	**£433 million confirmed. Initial claim was overstated by £43 million.**

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

Part Three

Enforcement action to combat alcohol fraud

Criminal sanctions

3.1 The Department has the legal powers to carry out criminal investigations into suspected excise fraud. The Crown Prosecution Service is the national authority in England and Wales responsible for taking the results of the Department's investigations and determining the basis of any prosecution. Similarly, in Scotland and in Northern Ireland the roles of independent prosecutors are fulfilled by the Crown Office and the Northern Ireland Public Prosecution Service respectively.

3.2 The Department recognises that the number of prosecutions for alcohol duty fraud in the five years preceding the renewed Strategy was low (**Figure 7**).

Figure 7
Prosecutions cases involving alcohol

	2006-07	2007-08	2008-09	2009-10
Cases Referred – Cases	7	6	8	1
Complete Prosecutions – Cases[1]	7	3	8	12
Convictions – Cases[1]	6	3	6	5
Convictions – Defendants	15	4	12	16

NOTES

1 A case is regarded as completed when an outcome is given for all defendants involved (excludes absconders).

2 This table includes prosecutions where there is at least one charge relating to evasion of excise duty payable on alcohol.

3 The data for 2010-11 is not held in a comparable format due to changes in the CPS' database systems.

Source: Crown Prosecution Service (CPS)

3.3 The Department's Criminal Investigation Directorate adopted ten new cases involving suspected alcohol duty fraud in 2010-11. The Department has cited a number of factors to explain the relatively low number of investigations and prosecutions, including:

- a deliberate decision to focus on key targets within the alcohol landscape rather than a mass approach;
- the complexity of alcohol duty fraud, which is often facilitated by UK and EU-based large buyers of duty suspended goods, registered excise warehouse keepers and a multitude of UK and EU transporters;
- the limited availability of resources to conduct complex investigations to support prosecutions that have a strong probability of securing convictions;
- the need to prioritise investigations work to accommodate other commitments; and
- the need to balance the deployment of HMRC's resources against key threats across many tax regimes.

3.4 In view of these factors, the Department has not set any target for criminal sanctions against alcohol fraudsters in its Renewed Alcohol Strategy.

Civil sanctions

3.5 In addition to pursuing criminal investigations, the Department also has powers to impose civil sanctions on businesses and individuals that fail to comply with the law. These sanctions include: detention and seizure of goods; assessments for lost duties, removal of approvals and licences to trade in excise goods and civil penalties. In serious cases, the Department is able to impose asset freezing orders and initiate proceedings under the Proceeds of Crime Act 2002 and insolvency legislation.

3.6 The Department considers that, although criminal investigation remains its default position, this should be used only where the potential disclosure impact can reasonably be minimised. It therefore considers the application of civil sanctions (summarised in **Figure 8** overleaf) a cost-effective option, particularly where its main aim is to liquidate the assets of the companies or persons committing fraud.

Figure 8
Civil sanctions used by the Department to tackle alcohol fraud

	2006-07	2007-08	2008-09	2009-10	2010-11
Assessments raised (£m)	46	62	45	71	93[2]
Civil penalties issued (£)	23,000	77,000	70,826	67,423	56,286
Confiscation orders (£)	Nil	260,000	Nil	Nil	6,565,942
Number of vehicles seized	131	168	158	168	N/A[3]
Number of approvals revoked	31	15	23	34	38
Number of approvals amended	575	593	431	336	415
Number of Commissioners' Directions[1] imposed	21	31	288	284	164
Quantity of alcohol seized					
Spirits (litres)	384,078	557,909	368,354	704,430	1,144,500
Beer (litres)	1,915,173	4,763,006	5,780,117	3,823,352	6,530,178
Wine (litres)	303,048	1,128,117	1,304,518	1,620,174	2,270,247

NOTES
1 Commissioners' Directions are conditions imposed on any warehouse to meet any perceived risks.
2 The figure presented for audit was found to be overstated by approximately £10 million (see the outturn from Risk-based assurance activities in Figure 6).
3 Data on the number of vehicles seized is no longer available.
4 The table includes the outcome of all alcohol compliance activities undertaken by the UK Border Agency and HM Revenue & Customs.
5 Vehicle seizure figures are those associated with alcohol seizures in excess of 500 litres (i.e. commercial seizures).
6 Figures for the years before 2010-11 fall outside the period of the Renewed Alcohol Strategy, and are unaudited.

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

Future developments – the Excise Movement Control System

3.7 In the European Union internal market, all movements of excise goods under duty suspension arrangements are required to take place under cover of an Administrative Accompanying Document (AAD) and be covered by a financial guarantee. These are discharged only when the goods arrive at their destination. The EU introduced this system to enable monitoring of intra-community movements of excise goods, to require payment of duty in the Member State where they are released for consumption, while at the same time respecting the principle of free movement of goods within the EU.

3.8 In May 1998, the Council of the European Union[6] endorsed a recommendation sponsored by the European Commission and Member States to set up a computerised trader-to-trader link via the national tax and customs authorities, which has now become known as the Excise Movement Control System (EMCS).

3.9 EMCS is a computerised system for monitoring movements of excise goods under suspension of excise duty within the EU, i.e. goods for which no excise duties have yet been paid. It facilitates the electronic tracking of freight across the European Union, and holds valuable data on movements that can be analysed towards better targeting of interventions and investigations.

3.10 The system was implemented in three phases from 1 April 2010. The final phase was introduced on 1 January 2012 and allows Member States greater opportunities for real-time monitoring of the movement of goods for which excise duties have still to be paid. EMCS should also allow faster information exchange between authorities to help prevent and detect excise fraud.

3.11 We found that the Department is not yet able to download the data within the system for detailed analysis by its Knowledge, Analysis and Intelligence units. It is also developing a risk capability to enable it to utilise the data fully.

3.12 The EMCS system has removed the need for paper Administrative Accompanying Document (AAD) documents to accompany each movement of goods across borders, but there is no requirement for the electronic AAD accompanying each movement to be recorded at ports of entry. If this were required, it would prevent the AAD from being used for the purpose of running multiple loads under the same document (as is currently being done by fraudsters).

3.13 The potential benefits of the EMCS system as a tool to combat fraud will not be fully realised until Member States have implemented all of the non-mandatory counter-fraud functionalities within the system. Until then, the Department and other Member State tax and customs authorities will face continuing difficulties in monitoring the movements of alcohol between warehouses within the European Union.

6 The Council of Economic and Finance Ministers took this decision.

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