



National Audit Office

REPORT BY THE  
COMPTROLLER AND  
AUDITOR GENERAL

HC 226  
SESSION 2013-14

6 JUNE 2013

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HM Revenue & Customs

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# Progress in tackling tobacco smuggling

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## Key facts

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**£9.9bn**

duty collected in 2011-12  
from sale of tobacco  
products

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**£1.9bn**

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

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**9%**

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

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**38%**

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

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**£69 million**

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

**1.7 billion**

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

**572 tonnes**

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

**£919 million**

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

# Summary

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

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

## Key findings

### Scope of the strategy

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

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

### Progress in implementing the strategy

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

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

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

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

## Evaluating performance

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

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

## Overall conclusion

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

## Recommendations

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

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