

Protecting indirect tax revenues

November 2002



HM Customs and Excise



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FOREWORD BY JOHN HEALEY MP, ECONOMIC SECRETARY TO THE TREASURY

In this year's Pre-Budget Report, we have renewed our commitment to maintain the stability of the public finances, to continue building a stronger economy and a more inclusive society, and to make the sustainable investments necessary to create world-class public services.

If taxpayers are contributing their fair share towards those objectives, they have the right to expect that other taxpayers will do likewise, and that the Government will crack down hard on those who try to abuse or cheat the system and ensure a level playing field for legitimate businesses.

That is why, last year, we did something no government has done before. We published carefully calculated estimates of the losses caused by indirect tax fraud, we explained our strategic approach for tackling those losses, we set out our plans and targets, and we invited people to hold us to account on delivering them.

This paper sets out the latest estimates of those indirect tax fraud losses, and updates the progress we have made with new figures. The story it tells, particularly in relation to tobacco smuggling, demonstrates the strength and value of our approach.

At the start of 2000 it was estimated that the problem of tobacco smuggling would continue its rapid growth, and that – by the end of 2002 – one out of every three cigarettes smoked in the UK would be smuggled.

Instead, as a result of our *Tackling Tobacco Smuggling* strategy, we have in the past two years stopped the growth in cigarette smuggling altogether and reduced the revenue lost to Government through cross-Channel passenger smuggling of alcohol and tobacco by more than 80 per cent.

By doing so, we have not only saved more than 1.5 billion pounds for investment in our public services, we have also struck a significant blow against organised crime and protected the rights of honest shopkeepers throughout the country.

Building on this success, we announced last month the second stage of our strategy against cross-Channel smuggling with a new package of measures designed to be fair for honest shoppers, tough on criminal smugglers, and clear about the distinction between the two.

Having begun to apply our strategic approach successfully across the excise duty regimes, we are now ready to take another unprecedented and equally challenging step. We are launching a strategy to tackle the revenue shortfalls which – over the last decade or more – have become a standing feature of the VAT system.

Through this strategy, we will offer increased support to businesses who are prepared to play by the rules, but we will take tougher action against those who continue to abuse the VAT system through fraud, avoidance and non-compliance.

This strategy is designed to reduce VAT losses, produce additional VAT revenues and stop businesses that break or bend the tax law competing unfairly with those that abide by it. But equally importantly, it reinforces the principle that everyone must contribute their fair share to funding our public services, and it renews this Government's commitment to uphold that principle.



EXECUTIVE SUMMARY

- The Government is committed to tackling abuse of the tax system in order to protect the revenue required for investment in public services, to defend the competitiveness of legitimate businesses, and to protect society both from the serious and organised criminals behind fraud and from the debilitating impact of a culture where abuse and evasion of taxes is considered acceptable.
- *Tackling Indirect Tax Fraud*, published alongside the 2001 Pre-Budget Report, described the Government's strategic approach to tackling revenue losses, based on accurately assessing the size and nature of each problem, setting clear objectives and targets for tackling it, identifying the operational responses required to achieve those targets and monitoring the delivery of results.
- The impact of the *Tackling Tobacco Smuggling* strategy continues to show the effectiveness of that approach, with the illicit share of the cigarette market held at 21 per cent, against a target of 22 per cent for this stage of the strategy, and the revenue evaded through cross-Channel passenger smuggling of all types of tobacco and alcohol cut from £1.5 billion to £290 million in just two years.
- The Government has also continued to take action against oils and alcohol fraud, with the launch of a major strategy designed to tackle the misuse of rebated fuels, and the formation of a new Joint Spirits Fraud Task Force through which the spirits industry now provides direct support to front-line Customs officers to help them detect illicit and counterfeit spirits.
- This strategic approach will now be applied to the historical shortfall in VAT revenues resulting from fraud, avoidance and non-compliance. With this document, the Government launches a new strategy – supported by the deployment of 1,000 Customs staff to key problem areas – combining intensive programmes of support and help for businesses who want to abide by the rules with concerted action against those which seek to abuse the system.
- The strategy is designed to reduce the size of the shortfall and produce more than £2 billion per year of additional revenue by 2005-06. This is the Government's aim, but in line with its cautious approach to the public finances, and with the agreement of the National Audit Office (NAO), a lower estimate of the yield is being projected in the Pre-Budget Report public finance forecast.
- To accompany this paper, the Government has today placed in the House of Commons library a technical paper entitled *Measuring Indirect Tax Losses*, setting out the detailed methodology used to produce its estimates of VAT losses, and updating the methodologies used to measure excise fraud. Copies of *Measuring Indirect Tax Losses* can be obtained from the address at the front of this paper.

A FAIR TAX SYSTEM

THE GOVERNMENT'S TAX OBJECTIVES

1.1 On a platform of a stable economy and stability in the public finances, the Government was able in this year's Spending Review to make the sustainable increases in investment necessary to deliver world-class public services.

1.2 This stability requires a tax system which encourages work and saving, which supports the Government's social and environmental objectives, which raises sufficient revenue to pay for that investment in our public services, and to which everyone must contribute their fair share.

Table 1.1: Customs and Excise revenues, 2001-02

Tax Regime	£ billion
VAT	61.0
Fuel duties	21.9
Tobacco duties	7.8
Spirits duties	1.9
Beer and cider duties	3.0
Wine duties	2.0
Betting and gaming duties	1.4
Customs duties and levies	2.0
Air passenger duty	0.8
Insurance premium tax	1.9
Landfill tax	0.5
Total	105.0

THE IMPORTANCE OF PROTECTING REVENUE

1.3 People who abuse the tax system undermine the principle that everyone should pay their fair share and attack both the stability of the public finances and the Government's ability to deliver world-class public services. The Government is therefore committed to protecting the tax revenue from these attacks.

1.4 The Government has ensured in all areas that its forecasts of future tax revenues are cautious and reflect the risks of revenue losses caused by fraud, avoidance and other forms of abuse. The action the Government takes to reduce those losses therefore not only protects, but can also increase the revenue available for investment in public services.

1.5 There are other reasons why it is vital to tackle tax abuse:

- it is clear that serious and organised criminal groups are responsible for a substantial proportion of this tax abuse, often using the proceeds to fund their other criminal activities;
- where businesses are paying their fair share, they have a right to expect that their competitive position will be protected against others trying to undercut them by avoiding or evading their tax liabilities; and
- where the taxes charged on certain goods, such as tobacco and fuel, are in part designed to support social, health and environmental objectives, the Government must tackle the evasion of those taxes to protect and further those objectives.

TACKLING INDIRECT TAX FRAUD

1.6 Alongside last year's Pre-Budget Report, the Government published a paper entitled *Tackling Indirect Tax Fraud*, in which it:

- reviewed the progress made since 1997 in reversing cuts in Customs' front-line operational staff and tackling the rising problems of excise fraud;
- explained the shift to a more strategic approach towards tackling fraud, based on assessing the size and nature of each problem, identifying the operational responses required to tackle it, and setting clear targets for delivery;
- reviewed the success of this approach as it had been applied in the first year of its strategy to tackle the growth of cigarette smuggling;
- set out proposals to extend this approach to other indirect tax fraud losses, including those affecting oils revenues; and
- for the first time, published estimates of the size of the revenue losses caused by fraud across the range of indirect tax regimes, along with a technical paper setting out the methodology used to produce the estimates.

1.7 In this new paper, the Government updates the estimates of indirect tax fraud losses and the strategies introduced to tackle them, and describes how its strategic approach will now be applied to revenue losses across the VAT system. It also publishes alongside this paper another technical paper on the methodologies behind its estimates, entitled *Measuring Indirect Tax Losses*.

Box 1.1: The strategic approach to tackling revenue losses

Since 1997, the Government has transformed the approach towards Customs' operational activities; immediately cancelling planned cuts in levels of front-line staff, consistently setting challenging targets, and supporting their delivery through the deployment of increased staff and investment in new technology.

This has been coupled with the development of a new strategic approach towards tackling revenue losses, based on the achievement of outcomes which have a direct and measurable impact on the problems the Government is trying to solve.

This approach has a number of key components:

- **analysis:** understanding the nature of any revenue loss problems is a crucial first stage in measuring their size, analysing the trends in their development, and ensuring the effective deployment of strategies to tackle them;
- **estimates:** it is also crucial to establish a robust baseline of the size of a problem against which targets can be set and monitored. Wherever possible, the best possible estimates of the revenue loss problems facing the indirect tax regimes are now published on a routine annual basis;
- **targets:** each strategy needs to be geared towards a clear outcome in terms of its impact on the scale of the problem, so that the appropriate operational responses can be drawn up to meet those targets, and so the effectiveness of the strategy can be routinely measured;
- **responses:** each strategy must feature a range of measures which apply proportionate and well-targeted pressure at all levels of the problem. In some cases, where losses occur because of fundamental weaknesses in the way the tax is controlled, the first step must be to establish a sustainable control regime; and
- **monitoring:** performance in meeting the key outcome-based targets is measured and reported on a regular basis, accompanied where relevant by operational data which shows progress in individual areas. The development of the problem must also be carefully monitored so that operational responses can be adapted accordingly, and new measures brought forward.

TOBACCO SMUGGLING

Tackling Tobacco Smuggling

2.1 In *Tackling Tobacco Smuggling*, published in March 2000, the Government explained that it had become increasingly concerned at the rapid growth of the tobacco smuggling market, which it was estimated would account for one in every three cigarettes smoked in the UK by the end of 2002, and had become convinced of the need for a new strategic approach to tackling the problem.

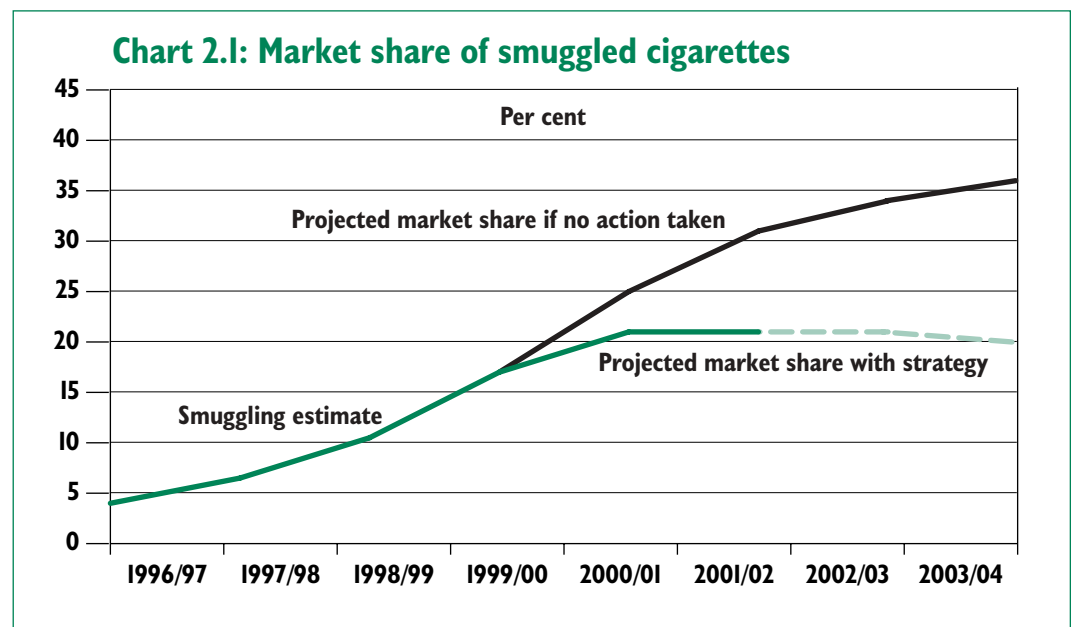
2.2 It therefore launched a new strategy, deploying almost 1,000 additional front-line and investigative staff, investing in a national network of x-ray scanners, introducing 'UK duty paid' marks on legitimate packets of cigarettes, and setting challenging targets for Customs to slow, stabilise and reverse the growth in tobacco smuggling by the end of 2002-03.

2.3 As Chart 2.1 illustrates, without action, the market share of smuggled cigarettes was forecast to rise from 17 per cent in 1999-2000 to 25 per cent by the end of 2000-01 and to 31 per cent by the end of 2001-02.

2.4 In the first year of the strategy, Customs' target was therefore to slow this rapid growth and hold the illicit share of the cigarette market to 21 per cent. Customs achieved this key target, in the process seizing almost a billion more cigarettes than their target for the year.

2001-02 results

2.5 For 2001-02, Customs' next key target was to stabilise the growth of tobacco smuggling and hold the share of the market taken up by smuggled cigarettes to 22 per cent. In fact, Customs has succeeded in restricting the illicit share to 21 per cent, thereby exceeding its target and stopping the growth in tobacco smuggling for the first time in a decade.

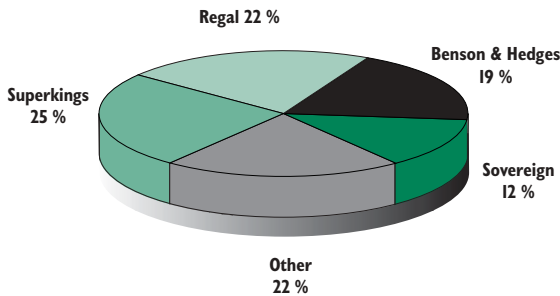


2.6 In addition during 2001-02, Customs:

- broke up 83 major excise smuggling gangs, including 60 involved in large-scale cigarette smuggling, exceeding the previous year's totals by almost half;
- seized almost 2.6 billion cigarettes, making a total of more than 5 billion illicit cigarettes seized in the first two years of the strategy; and

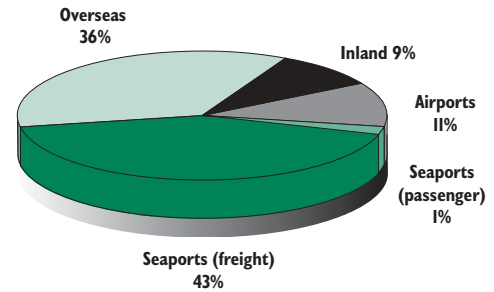
- used their network of x-ray scanners to detect 13 tonnes of hand-rolled tobacco and 325 million cigarettes, 30 per cent of the cigarettes seized at freight seaports.

Chart 2.2: Cigarette seizures by brand



Individual seizures of over 1 million sticks (68 per cent of all seizures in the UK). Includes counterfeit cigarettes, estimated at 15 per cent of the total. 60 per cent of counterfeit cigarettes are branded as Benson & Hedges.

Chart 2.3: Cigarette seizures by mode



Overseas figure represents cigarettes seized en route to the UK in cooperation with overseas agencies

CROSS-CHANNEL PASSENGER SMUGGLING

2.7 The *Tackling Tobacco Smuggling* strategy was also designed to reduce the revenue evaded through smuggling of alcohol and tobacco on cross-Channel ferries, estimated at £1.5 billion in calendar year 2000, and to deal with the serious law and order problems which this type of smuggling had been causing around Dover and other Channel ports.

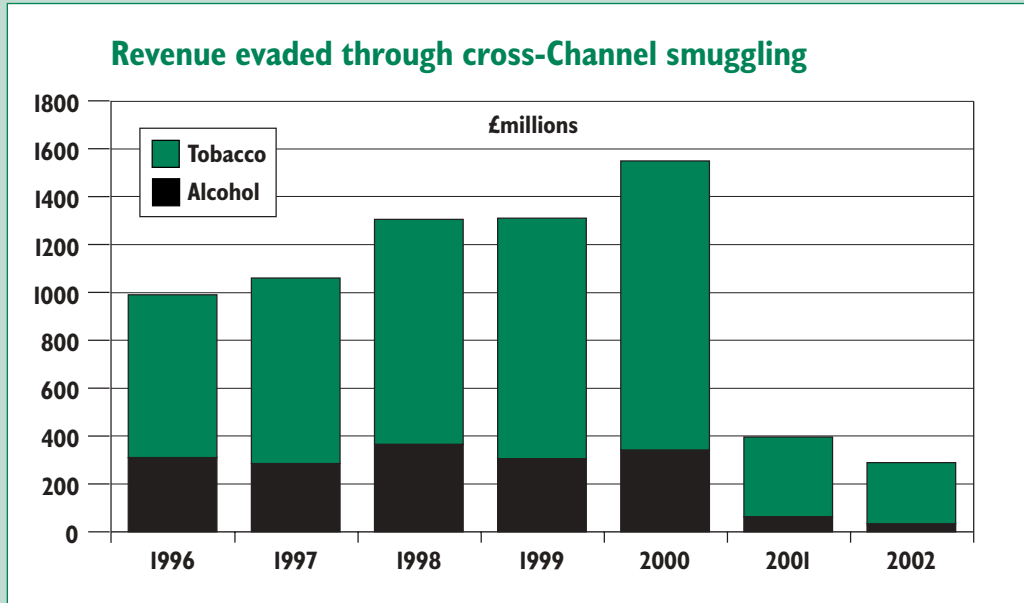
2.8 In 2001, Customs succeeded in reducing this revenue evasion by around 75 per cent, in the process cutting the 'bootlegging' of beer by more than 90 per cent, halving the revenue evaded through smuggling of wine and spirits, and reducing the revenue evaded through passenger smuggling of hand-rolled tobacco by almost 80 per cent.

2002 results 2.9 This success has been taken further in calendar year 2002, with a projected 25 per cent further reduction in the total level of revenue evasion, including:

- a further 22 per cent reduction in revenue evaded through beer smuggling, now costing just £15 million per year compared to £260 million two years ago;
- the halving of revenue evaded through smuggling of wine and spirits for the second year in succession, now costing £15 million per year compared to £80 million two years ago; and
- a further 44 per cent reduction in revenue evaded through cross-Channel passenger smuggling of hand-rolled tobacco, now costing £95 million per year compared to around £700 million two years ago.

Box 2.1: Tackling cross-Channel smuggling: the next phase

As a result of the success of the Government's strategy, cross-Channel smugglers have increasingly sought to pose as honest shoppers in their attempts to evade Customs controls.



In October, the Government therefore announced a new package of measures designed to be fair for honest shoppers, tough on criminal smugglers, and clear about the distinction between the two¹.

To protect the right of honest cross-Channel shoppers to bring back as much tobacco as they want, provided it is for their own use:

- the indicative levels for tobacco were increased from 800 to 3,200 for cigarettes (equivalent to 6 months supply for the average smoker), and from 1 kilogram to 3 kilograms for hand-rolled tobacco;
- a new step-by-step guide to the appeals process has been published, and a review has been launched to simplify the present appeals and complaints system; and
- the burden of proof on the individual to show that goods are for their own use has been replaced with new legislation, obliging Customs to satisfy themselves that goods are for a commercial purpose, and setting out the factors officers may consider in order to come to such a view.

To strengthen the action taken against smugglers, the Government also announced that:

- there will be more prosecutions of large-scale and regular smugglers;
- Customs will prosecute anyone who commits violence against Customs staff;
- while small-scale first time offenders will be offered their vehicle back for a fee equivalent to the amount of duty which has been evaded, large scale and repeat offenders will have their vehicle seized, and not restored; and
- cross-Channel operators will be expected to step up the part they play in cooperating with Customs to catch smugglers, by providing accurate and timely information, both to Customs and the public.

¹ The full text of the speech on 29 October 2002 by John Healey, Economic Secretary to the Treasury, is available at www.hmce.gov.uk/news/nat-nr-8402.htm

OILS FRAUD

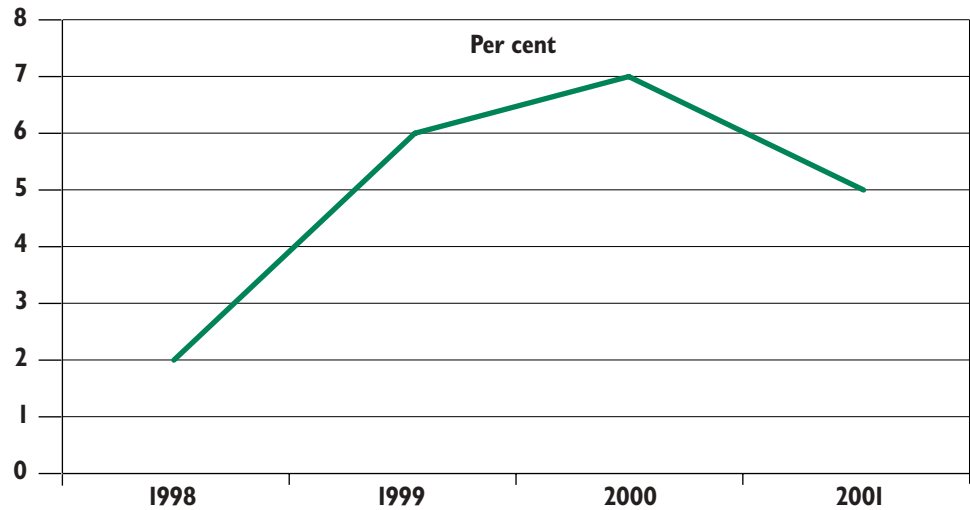
2001 results 2.10 In *Tackling Indirect Tax Fraud*, the Government highlighted the misuse of rebated or low tax fuels supplied for non-road use, such as kerosene and red diesel, which accounts for the vast majority of oils fraud on the UK mainland. Customs made considerable progress in tackling this problem during 2001-02:

- breaking up 30 mainland laundering plants, a tenfold increase compared to 2000-01;
- seizing over 2.2 million litres of fuel, almost three times the volume seized in 2000-01;
- detecting and stopping frauds with a total value of £8.1 million compared to £5.4 million in 2000-01;
- improving the targeting of fraud, with the average value of detection increasing to £3,080 compared to £2,630 in 2000-01;
- increasing the proportion of intelligence-led checks on vehicles and premises for misuse of rebated oils to 27 per cent compared to 7 per cent in 2000-01, producing a significant increase in the detection rate compared to traditional random roadside checks;
- increasing the number of investigations into the organised gangs behind oils fraud, with 11 major gangs dismantled compared to 5 in 2000-01; and
- increasing the number of detections by 30 per cent, increasing the value of confiscation orders more than threefold, and doubling the number of individuals convicted for oils fraud.

The oils strategy 2.11 Nevertheless, the Government remained concerned that the problem could grow rapidly if further concerted action was not taken. Following consultation on proposals set out in *Tackling Indirect Tax Fraud*, Budget 2002 therefore announced a new and comprehensive strategy to tackle oils fraud, involving:

- a new EU-wide 'Euomarker' added to rebated fuels from 1 August 2002, which makes it easier to detect vehicles using rebated fuel purchased abroad for illicit use on the UK's roads and which – alongside the UK's existing fiscal markers – provides an additional barrier to laundering;
- tighter controls introduced from 1 September 2002 on the supply of duty free oils for use in certain industrial processes (known as 'tied oils');
- a new scheme to approve the distributors of rebated gas oil and kerosene, to be introduced from 1 April 2003, which will enhance Customs' control over the distribution network for rebated fuels, and their ability to prevent and detect their misuse; and
- the creation of a dedicated intelligence team to coordinate all of Customs' activities in the oils sector, and the deployment of additional staff and investment in new technology to help legitimate businesses comply with these new controls, and support the increased detection and investigation effort.

Latest estimates 2.12 Chart 2.4 below shows that mainland oils fraud grew rapidly from 1998 onwards, accounting for 7 per cent of the diesel market in calendar year 2000. Partly as a result of Customs' enhanced operational activity, the illicit market share fell to 5 per cent in calendar year 2001 and – to measure the impact of the strategy announced in Budget 2002 – the Government has set Customs the target to reduce it further to 2 per cent by the end of 2005-06.

Chart 2.4: Illicit share of mainland diesel market¹**Box 2.2: Oils fraud in Northern Ireland**

- The oils strategy applies equally in Northern Ireland, although the distinct challenges there – especially smuggling of fuel across the Northern Ireland land boundary, high illicit penetration of the fuel retail sector, and greater involvement of serious criminality – require distinct operational responses.
- In Northern Ireland, it is also not possible at present to distinguish between the large proportion of non UK duty-paid fuel accounted for by legitimate cross-border shopping and the large proportion accounted for by cross-border smuggling and the misuse of rebated and low-tax fuels supplied for non-road use.
- In 2001, the revenue lost from all use of non-UK duty-paid fuel in Northern Ireland was around £370 million, of which £130 million was from petrol and £240 million from diesel, down from a total of £390 million in calendar year 2000.
- Sustained progress towards tackling the problem of oils fraud in Northern Ireland will depend on the successful introduction of a multi-agency strategy which deals with the wider problems of non-compliance in the Northern Ireland fuel retail sector. Customs are playing a leading role in the development of this strategy through the Northern Ireland Organised Crime Task Force, chaired by the Northern Ireland Security Minister, Jane Kennedy, MP.
- In the interim, Customs have continued to take firm action against these problems, seizing 1.75 million litres of illicit fuel in 2001-02, breaking up 8 laundering plants and dismantling 7 of the major gangs behind oils fraud.
- In 2001, deliveries of legitimate fuel to retailers in Northern Ireland increased for the first time in five years, with 205 million litres of diesel and 430 million litres of petrol delivered compared to 190 million and 405 million litres in the previous year, a sign of recovery in the legitimate retail market.
- In advance of the multi-agency strategy, Customs will continue to look for ways to enhance its activities against oils fraud in Northern Ireland, and expects in particular that the approvals scheme for distributors of rebated fuel to be introduced in April 2003 will reduce the ability of suspect retailers to obtain rebated fuel.

¹ While estimates of the overall size of the non-UK duty-paid market remain unchanged from those published alongside the last Pre-Budget Report, the proportions accounted for by cross-border shopping and fraud have been revised as a result of improvements in Customs' methodology, explained in detail in *Measuring Indirect Tax Losses*. This has resulted in a revision of the estimates of the illicit market share in calendar year 2000 from 4 per cent to 7 per cent.

ALCOHOL FRAUD

Latest estimates **2.13** It is estimated that fraud involving beer and wine remained relatively small in 2000-01, and the traditional method of illicit supply of these products – cross-Channel passenger smuggling – has since been cut dramatically. The principal problem remained in the spirits sector, with the illicit share of the UK spirits market estimated at 15 per cent in 2000-01, unchanged from the level in 1999-2000, resulting in revenue losses of £500 million².

2.14 In *Tackling Indirect Tax Fraud*, the Government described the action it had taken to tackle the problem of spirits fraud and implement the recommendations from John Roques' report into excise diversion fraud, but said it believed further action would be necessary to try and reduce the illicit share of the UK spirits market.

Working with the industry **2.15** As part of this process, the Government consulted on the introduction of tax stamps on spirits, designed to help identify smuggled goods. In the light of this consultation, the Government decided in Budget 2002 not to impose tax stamps but instead to work with the industry to help improve Customs' ability to detect illicit consignments of spirits.

2.16 Since then, Customs and the industry have established the Joint Spirits Fraud Task Force, which has already produced a number of practical measures to tackle fraud, with spirits producers, for example, providing testing kits to help Customs identify counterfeit products and allowing front-line officers to call up instant information about suspect consignments they have intercepted.

2.17 Customs have also been stepping up their efforts to tackle fraud through more intensive checks on excise warehouses and those trading in duty-suspended alcohol, and through investigations into the gangs perpetrating fraud. During 2001-02, there have been notable successes throughout the UK in dismantling alcohol fraud gangs, pursuing their assets and closing suspect warehouses, as a result disrupting frauds worth at least £40 million.

2.18 Customs will build on this good initial progress, and will explore both what further support the industry can provide and what new steps, including regulatory measures, might be taken to keep pace with the changing tactics of the fraudsters, and continue to clamp down on alcohol fraud.

² As explained in *Measuring Indirect Tax Losses*, it is not possible to produce estimates of total alcohol consumption, and hence of the non-duty paid share of the market, any more recent than the financial year before last, due to time lags in the availability of data sources. It is estimated that revenue evaded through smuggling and fraud in relation to beer and wine was less than £250 million and £100 million respectively in 2000-01, equivalent to 4 per cent and 3 per cent of their respective UK markets. These figures were largely unchanged from the levels in 1999-2000, but are likely to have fallen significantly in 2001-02 as a result of Customs' efforts to tackle cross-Channel smuggling.

3

TACKLING VAT LOSSES

STRUCTURE OF THE VAT SYSTEM

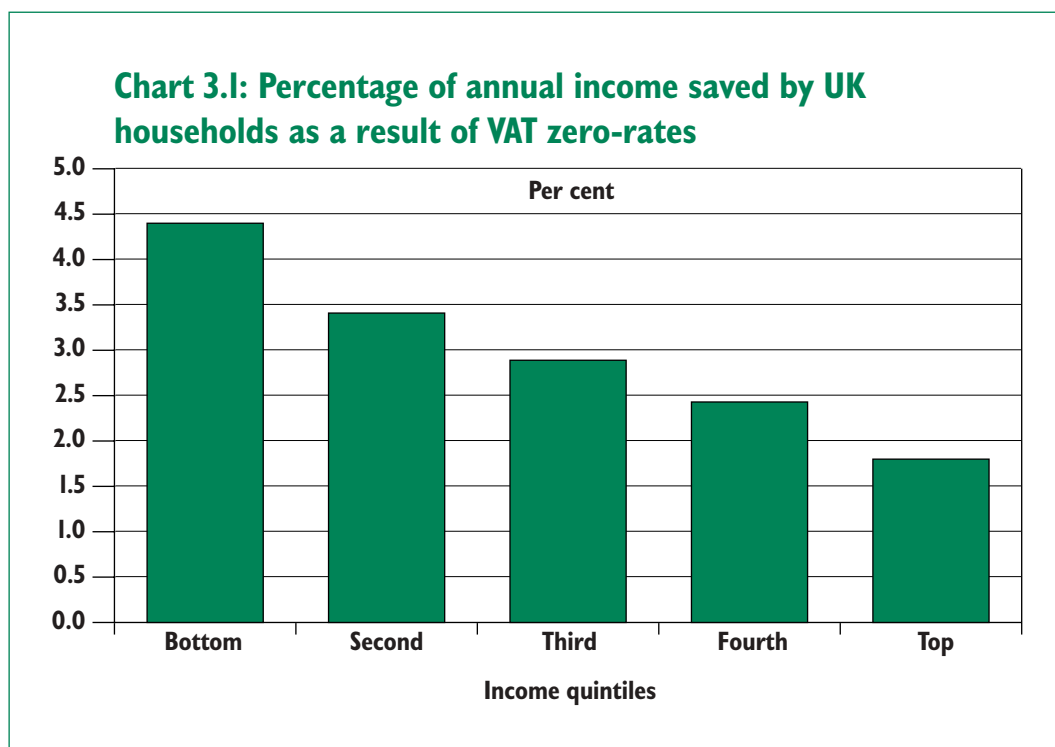
3.1 Value added tax (VAT) was introduced in 1973, after the UK acceded to the European Community, as a tax on the final consumption of goods and services. It is collected in every EU Member State at a median standard rate of 19.5 per cent.¹

3.2 In 2001-02, VAT raised around £61 billion, approximately 16 per cent of Government revenues. If VAT was charged on all the taxable goods and services purchased and consumed in the UK at the EU median standard rate, the Government would raise well over £100 billion each year from VAT.

3.3 The Government chooses instead to structure the UK's VAT system in ways which reduce its burden on particular groups, such as small businesses and low-income households, including:

- retaining the widest range of zero-rated goods and services in Europe – covering items such as food, children's clothes, bus and rail fares, and books – worth around £20 billion in annual reliefs to UK households;
- introducing a 5 per cent rate of VAT – the lowest reduced rate permissible under EC VAT law – for a range of other goods and services, including fuel and power used in the home, a relief worth around £2 billion a year to UK households;
- retaining, at 17.5 per cent, one of the lowest standard rates of VAT in Europe, lower than France, Italy, Ireland, the Netherlands and Belgium.
- maintaining, at £55,000, the highest VAT registration threshold in Europe, which means that around one million of the smallest businesses do not have to charge VAT at all on the goods and services they sell; and
- refunding local authorities more than £4 billion each year in VAT paid on their purchases, so that all the revenues collected from council tax and business rates go towards spending on local services, not on central government tax bills.

¹ The UK has the fourth lowest VAT standard rate in Europe, after Luxembourg at 15 per cent and Spain and Germany at 16 per cent. Above the UK's rate stand Greece at 18 per cent, Portugal and the Netherlands at 19 per cent, France at 19.6 per cent, Italy and Austria at 20 per cent, Ireland and Belgium at 21 per cent, Finland at 22 per cent, and Denmark and Sweden at 25 per cent.



ADMINISTRATION OF THE VAT SYSTEM

3.4 Despite having the highest registration threshold in the EU, there are 1.7 million businesses registered for VAT within the UK. They submitted around five million VAT returns in 2001-02, declaring more than £280 billion of output VAT and £15 billion of import VAT, and claiming back more than £235 billion in input VAT.

3.5 Given the significant number of businesses and the amount of revenue involved, it has long been accepted as fact that there will be some shortfall between the actual VAT receipts collected by the Exchequer and the VAT that would be collected if all businesses paid the right amount of VAT at the right time.

3.6 The shortfall in VAT revenues has historically arisen from a wide range of business behaviours across what may be described as the ‘non-compliance’ spectrum. This range includes:

- making mistakes when submitting VAT returns;
- failing to submit VAT returns on time;
- defaulting on payments;
- failing to register for VAT when moving above the registration threshold;
- engaging in artificial tax avoidance schemes to delay VAT payments;
- engaging in abusive tax avoidance schemes to reduce or avoid liabilities;
- deliberately under-reporting liabilities when completing VAT returns;
- operating a large-scale business in the shadow economy; and
- committing organised fraud against the VAT system.

3.7 While some of the most serious VAT revenue losses result from organised criminal fraud, the bulk of the losses therefore occur either because of abusive tax avoidance or because – at the other end of the spectrum – thousands of ordinary businesses are looking to gain relatively small financial advantages by delaying or reducing their VAT payments, are failing to meet requirements or are simply making mistakes.

3.8 In this context, it is neither realistic nor desirable that Customs try to eliminate these losses entirely. To do so would require such close and rigid control on the business population that the administration of the tax would become highly costly, inefficient and poorly-targeted, and UK businesses would face such high compliance and regulatory costs that the economy as a whole would be damaged.

3.9 Instead, in seeking to maximise the amount of revenue collected and reduce the level of these losses, Customs have historically had to make judgements about whether their activities are efficient and effective in the way they are targeted, proportionate in the burdens they impose on ordinary businesses, and healthy for the wider economy.

3.10 As part of this, Customs are increasingly re-focusing their administration of the VAT system to reflect a more strategic approach, for example: focusing less on the number of VAT assurance visits made, and more on what is achieved from each visit in terms of the support given to businesses and their subsequent record of compliance; less on how much debt is collected from businesses, and more on helping each business manage its debts effectively, acting as a source of help and support for those facing difficulties, and providing advice before they reach the crisis stage.

3.11 While the Government now wishes to apply the same strategic approach it has applied successfully to tackling excise fraud to tackling revenue losses within the VAT system, it has designed this new VAT strategy in a way which is tailored and proportionate to the specific nature of these losses, and which is consistent with the way Customs are re-focusing their approach to VAT administration.

A NEW VAT STRATEGY

3.12 The vast majority of VAT-registered businesses do make their fair contribution to the public revenues. They want a VAT system which is simple to understand and to know they comply with, they want Customs to act as an agency of support and help, and they want to compete on a fair and level playing-field with other businesses.

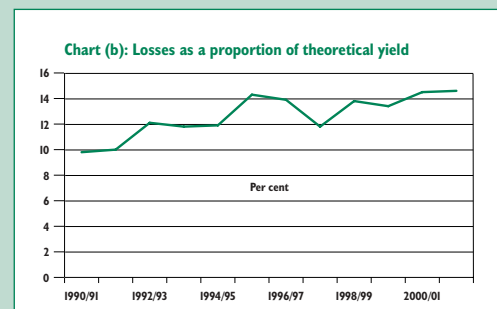
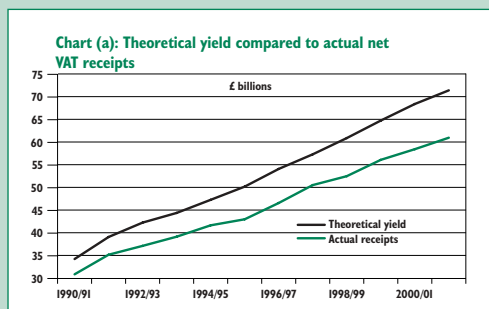
3.13 The Government's new VAT strategy is therefore based on an integrated approach which will continue to improve the service that Customs offers to businesses, make it simpler and less costly for them to comply with the requirements of the VAT system, and crack down hard on those who continue to abuse the system.

3.14 The strategy will be supported by the deployment of more than 1,000 staff to the key problem areas over the next three years, and is designed to reduce the losses currently resulting from Missing Trader Fraud, abusive tax avoidance, non-compliance and the failure of businesses to register for VAT.

3.15 The rest of this section analyses these specific problems and explains the activities which Customs will be undertaking as part of the new VAT strategy to tackle them. It follows the spectrum of non-compliance described above, focusing first on the major type of VAT fraud currently perpetrated by organised criminal gangs, then on abusive tax avoidance schemes, and finally on the range of other non-compliant behaviours.

Box 3.1: Measuring the size of VAT revenue losses

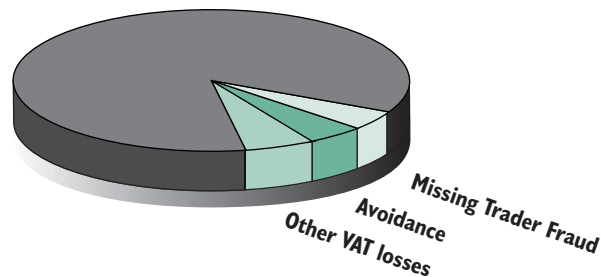
- VAT revenues are best understood as net VAT receipts. Businesses are liable to pay VAT on their purchases, charge VAT on their supplies, and submit a net payment to Customs (or claim a net repayment from Customs). The underlying gross transactions are therefore considerably larger than the net receipts figures show, as indicated in paragraph 3.4.
- The absolute size of the shortfall caused by fraud, avoidance and non-compliance has tended to grow broadly in line with the economy and the attendant increase in the net VAT revenue yield, as shown in Chart (a) below. It does not therefore provide the best baseline against which to measure trends in the losses.
- A more meaningful assessment of the scale of the VAT losses and their growth is derived from measuring them as a proportion of the VAT that should be collected (the theoretical net VAT yield).
- As shown in Chart (b), the size of the shortfall as a percentage of the theoretical VAT yield rose sharply from 10 per cent to 14 per cent in the early 1990s, and has fluctuated within a range of 12 to 14.5 per cent over the past six years.



- Chart (c) shows an illustrative breakdown of the theoretical net VAT yield for 2001-02, including the estimated proportions of the VAT losses accounted for by VAT Missing Trader Fraud, abusive tax avoidance, and other losses resulting from general non-compliance, including businesses operating above the turnover threshold without registering for VAT.

Chart (c): Breakdown of theoretical net VAT yield

Actual VAT receipts



- The methodology used to generate estimates of the shortfall and a full analysis of the trends in its growth is set out in the technical paper accompanying this one, entitled *Measuring Indirect Tax Losses*.

VAT MISSING TRADER FRAUD

3.16 Like the other major indirect taxes, the VAT system has consistently been subject to determined attacks by organised criminals seeking to evade or steal large sums, with different types of fraud emerging rapidly and placing significant amounts of revenue at risk.

3.17 In *Tackling Indirect Tax Fraud*, published in November 2001, the Government explained that:

- Missing Trader Fraud is an EU-wide problem, in which bogus traders register for VAT, complete intra-Community transactions, and disappear before paying over the VAT due to the tax authorities;
- it had been growing rapidly in the UK since 1999-2000 at a rate of £0.45-£0.75 billion per year, and its cost was estimated to have risen to £1.7-£2.6 billion in 2000-01;
- in September 2000, Customs had launched a strategy deploying 340 staff to tackle this type of fraud with the aim of halving the scale of revenue losses to produce an annual saving of at least £750 million by the end of 2003-04; and
- while they had already enjoyed some success in refusing or cancelling suspect registrations, and securing injunctions to meet missing traders' debts, Customs would be looking to refine their strategy further and introduce new techniques to tackle the fraud.

2001-02 estimates **3.18** In 2001-02, Customs succeeded in stabilising the previously rapid growth in losses from Missing Trader Fraud, holding the size of the problem to a range of £1.7-£2.75 billion. This was achieved through a range of activities, including:

- 4,870 pre-registration visits to new traders;
- identifying and refusing 1,128 suspect registrations, preventing frauds which could have cost up to £2 billion if they had gone unchecked;
- cancelling 463 missing trader registrations;
- securing injunctions to a value of £47.5 million to meet the VAT debts of missing traders; and
- bringing prosecutions against 11 individuals for engaging in Missing Trader Fraud, resulting in jail sentences totalling almost 50 years.

Enhancing the strategy 3.19 To reinforce Customs' efforts to tackle Missing Trader Fraud, the wider new VAT strategy provides additional resources designed to:

- tighten pre-registration procedures further to detect and prevent more fraud before it commences;
- step up the enhanced checking of traders in high risk sectors to identify, slow down and stop existing frauds even more quickly; and
- increase efforts to recover missing trader debts from detected fraudsters.

3.20 The Government will keep the problem of Missing Trader Fraud under careful review, and is ready to consider legislative or regulatory steps to reinforce its strategy further, if this should prove necessary.

VAT AVOIDANCE

Box 3.2: The Government's approach to tax avoidance

- Every business has the right to plan its tax affairs efficiently so that they do not incur higher tax liabilities and compliance costs than they need to, or leave themselves at a competitive disadvantage compared to other businesses.
- However, it is not acceptable for businesses to use artificial schemes and devices for the purpose of reducing or delaying their liabilities, and thereby seek an unfair advantage over their competitors.
- It is therefore vital to tackle tax avoidance, not just because of the revenue at stake, but because businesses who pay the amount of tax they are liable to pay and make their fair contribution to the tax system should not be placed at a competitive disadvantage, or drawn into following suit, by those seeking to exploit the rules, abuse the tax system and avoid their liabilities.

3.21 VAT avoidance grew rapidly in the late 1980s and early 1990s. As the market grew, the major accountancy firms launched aggressive campaigns to market VAT avoidance schemes to their clients.

3.22 VAT avoidance can range from simple devices designed to delay the timing of VAT payments on particular transactions and gain a cashflow advantage, to highly complex, contrived and abusive schemes designed to cut millions of pounds off company VAT bills.

3.23 Customs have successfully tackled the most abusive and artificial VAT avoidance schemes in recent years, challenging them through assessments and – if necessary – through the courts, and tightening loopholes in the VAT legislation. For example, three VAT anti-avoidance measures announced in Budget 2002 were estimated to save a total of £350 million in 2003-04.

The new strategy 3.24 To strengthen this effort, the Government's VAT strategy will allocate additional resources to its anti-avoidance work over the next three years, including new specialist staff, expert in identifying and tackling abusive and artificial tax avoidance schemes, and in 'proofing' legislation against potential loopholes. They will increase Customs' ability to:

- close loopholes and bring legislative challenges against existing schemes;
- identify and challenge new schemes before they can be widely marketed; and
- tighten up legislation which could be vulnerable to exploitation.

3.25 Alongside the Regulatory Impact Assessments which accompany new VAT legislation, the Government will also include a specific assessment of the avoidance impact, explaining what elements of the new legislation have been included to prevent avoidance and what steps have been taken to proof the legislation against avoidance.

OTHER VAT LOSSES

Box 3.3: Easing the impact of VAT on business

In recent years, the Government has taken consistent steps to simplify elements of the VAT system, reduce compliance costs, and help businesses both to understand their liabilities and cope better with difficult times.

The Government has sought to ease the impact of VAT on small and newly-registered businesses, in particular by:

- maintaining the highest VAT registration threshold in Europe, keeping around one million of the UK's smallest businesses outside the VAT net;
- offering measures such as the annual accounting scheme and VAT flat rate scheme to small businesses to help them reduce cash-flow and compliance costs; and
- abolishing automatic penalties for small businesses, and instead first offering them advice and help when they are late with their payments.

Customs has also sought to enhance the support it gives to businesses by:

- creating a National Advice Service, to ensure that businesses know where to go for help and are encouraged to do so, with the service now fielding 40,000 calls per week in addition to requests received by post or on-line;
- introducing a network of National Business Managers to act as single points of contact within Customs for the top 1,000 UK businesses;
- running a national programme of open days, providing information and advice targeted at specific sectors and business activities; and
- adopting a more proactive approach to support businesses facing difficulties meeting their tax liabilities, as shown during the foot and mouth outbreak.

In addition to the increased support and education to be offered to businesses under the VAT strategy, the Government will next year:

- extend the VAT flat rate scheme to thousands more businesses and take steps to increase awareness and take-up of the scheme; and
- extend reforms to the VAT penalty system, so that more businesses are first offered support and advice before incurring penalties.

3.26 The biggest component of the VAT revenue losses arises simply because – for a wide range of reasons and in a wide range of circumstances – large numbers of businesses are failing to pay the right amount of tax at the right time.

3.27 At one end, this 'non-compliance' can involve businesses making mistakes on their VAT returns or failing to submit their returns on time. At the other end, it can involve businesses deliberately under-reporting their liabilities or failing to register for VAT when operating at turnover levels above the threshold.

3.28 The Government recognises the need to distinguish between those businesses which have genuine difficulty understanding and complying with the VAT rules, and those which deliberately bend or break those rules. The new integrated approach to VAT compliance will therefore be based on:

- encouraging those who comply at present to continue doing so;
- helping businesses who want to comply but are currently failing to do so;
- vigorously tackling those who deliberately and persistently fail to comply; and
- ensuring that – as forcefully as possible – this activity serves to prevent and deter non-compliance among the wider business population.

**Supporting
compliant
businesses**

3.29 The strategy aims to ensure that non-compliant behaviour is identified and stopped more quickly, tax arrears are dealt with in the most appropriate way for the business concerned and – wherever possible – businesses are kept trading in a compliant way. To help the vast majority of businesses who want to comply, the Government will therefore put in place a range of initiatives, including:

- improved guidance and support at all stages of the business life-cycle, tailored to meet the specific needs of the business in each sector and at each stage in its growth;
- the provision of dedicated, round-the-clock support for businesses through the National Advice Service and Customs' network of National Business Managers;
- a wider out-reach programme – building on the successful approach developed during the foot and mouth outbreak – offering crisis support and specially tailored flexible payment options for businesses in genuine difficulty; and
- more frequent routine contact with businesses to identify potential problems early and offer prompt solutions.

**Cracking down
on non-
compliance**

3.30 However, to crack down on those businesses who continue to engage in persistently non-compliant behaviour, the strategy will increase both the risk of detection and the risk of action to recover arrears, including:

- making better use of intelligence to identify patterns of non-compliance and target assurance activity at high-risk sectors of the economy;
- establishing specialist teams to carry out visiting programmes targeted on high risk sectors – increasing the number of visits to high-risk businesses by more than a third;
- increasing follow-up activity to ensure businesses are remaining compliant; and
- where the level of non-compliance is very serious, making use of the range of penalties and sanctions available to punish revenue evasion.

3.31 The Government will also take specific action to tackle the problem of businesses operating above the turnover threshold without registering for VAT. While some deliberately operate outside the VAT system to obtain an unfair advantage over registered businesses who have to charge VAT on their supplies, others are either unaware of the obligation to register, or too concerned about the prospect of facing penalties to come forward.

3.32 To tackle this problem, the Government will use a two-pronged approach, consistent with the overall approach of the strategy:

- first, it will launch a high-profile scheme under which – for a prescribed time period – unregistered businesses operating above the threshold will be given a one-off opportunity to come forward voluntarily for registration, in return for the mitigation of their penalties;
- second, a tough and ongoing crackdown will follow on those unregistered businesses who decide not to take advantage of the scheme and continue operating above the threshold, as part of which Customs will work more closely with Inland Revenue to identify and tackle businesses operating in the shadow economy.

DELIVERING THE STRATEGY

3.33 To measure delivery of this strategy, the Government has set Customs the initial target of stopping the long-term growth in the size of the VAT losses as a percentage of the theoretical net VAT yield and cutting it to 12 per cent by 2005-06, thereby reducing the size of the problem by one fifth and cutting the scale of the losses to the levels seen ten years ago.

3.34 This target directs Customs' attention to the most important dimension of the problem, which is the total size of the losses as a percentage of the VAT that should be collected rather than a simple money total. The percentage figure accurately reflects changes in the size of the losses, independent of inflation and other changes in the wider economy. It therefore offers the best baseline from which to set targets for the strategy and monitor their delivery.

3.35 The measures outlined in this paper are designed to produce more than £2 billion per year in additional revenues by 2005-06. This is the Government's aim but, in line with its cautious approach to the public finances, and with the agreement of the NAO, a lower figure of £1.4 billion has been incorporated in this year's Pre-Budget Report public finance forecast.

3.36 In line with the approach now established with the other strategies described in this paper, the Government will report progress on the delivery of the VAT strategy in a full annual report, along with its latest estimates of the size and nature of the revenue losses.

3.37 As this new strategy is implemented, the Government will continue to keep the VAT loss problems under careful review, and is ready to consider whatever additional steps may be necessary – including legislative measures – to reinforce the VAT regime, and further reduce the overall size of the problem.

3.38 Based on the success achieved in tackling excise fraud, the Government is confident that its application of the same strategic approach to protecting the VAT revenues will prove equally effective, and – thirty years after the tax was introduced – will help to make tackling the VAT shortfall a fundamental imperative for the effective administration of the tax system.

Box 3.4: The VAT strategy: summary of key measures

The reduction in VAT losses and the additional revenue yield which the Government has set out to achieve will be delivered through an integrated strategy designed to make it easier to comply with the VAT rules and harder to abuse them.

The key measures which will deliver the VAT strategy are as follows:

- the deployment of 1,000 staff both to enhance existing efforts in the key problem areas and provide the resources for the new activities described below;
- a new out-reach programme designed to get businesses, especially newly-registered ones, into a sustained pattern of voluntary compliance;
- a broader-based, intelligence-led, risk-based approach to tackling non-compliance, based on improved analysis of the patterns of non-compliance, and targeting of resources on high-risk sectors of the economy;
- an increase in the use of deposits and guarantees to secure timely VAT payments from businesses with histories of persistent non-compliance;
- a one-off, short-term scheme where unregistered businesses operating above the VAT threshold will be able to obtain relief on their penalties if they come forward for registration voluntarily;
- followed by a tough crackdown – alongside Inland Revenue – on those businesses who continue operating above the registration threshold but outside the VAT system;
- the recruitment of a number of new highly-specialised anti-avoidance experts with proven ability to identify and shut down legislative loopholes and abusive tax avoidance schemes;
- the inclusion – alongside the Regulatory Impact Assessments which accompany new legislation – of a specific avoidance impact assessment, explaining the elements included to prevent avoidance and the steps taken to make the legislation avoidance-proof;
- a substantial increase both in the speed with which avoidance schemes are identified, and in the number of schemes challenged;
- a stepping up of efforts to prevent bogus traders from registering, identify those already on the register, stop their frauds before they grow, and recover VAT Missing Trader debts from the fraudsters; and
- the use of Customs' specialist investigators, with proven track records in dismantling organised criminal operations, to target the gangs behind Missing Trader Fraud.

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