

New responses to new challenges: Reinforcing the Tackling Tobacco Smuggling Strategy

March 2006



HM TREASURY



HM Revenue
& Customs

**New responses to new challenges:
Reinforcing the Tackling Tobacco
Smuggling Strategy**

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ISBN-10: 1-84532-165-0

ISBN-13: 978-1-84532-165-9

Printed by The Stationery Office 03/06 330874

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INTRODUCTION

Tobacco smuggling is not a victimless or harmless crime.

Smoking kills half of all smokers, and organised criminal gangs that smuggle tobacco provide a cheap and unregulated supply which undermines the Government's policy of using tax to maintain the high price of tobacco and help reduce smoking, especially among the young.

Tobacco smugglers also undermine law-abiding businesses and often use the proceeds to fund other forms of organised crime.

Maintaining the stability of the public finances is an essential foundation of a strong economy, and at the heart of our stable public finances is a tax system based on the principle that everyone should pay their fair share. When people evade taxes, they undermine that principle and increase the burden on honest taxpayers. Our commitment to tackling fraud and smuggling in all its forms is therefore integral to maintaining a fair tax system, safeguarding the stability of the public finances and protecting the revenue available for investment in our public services.

The Government launched its innovative strategic approach to tackling tobacco smuggling in 2000, investing more than £200m in new staff and new technology. The strategy has successfully halted and reversed the rapid growth in cigarette smuggling, safeguarding around £6 billion of public money. The UK is now recognised as an international leader in its approach to analysing and tackling tobacco smuggling.

Despite this success, 1 in 6 cigarettes and around half of hand-rolling tobacco smoked in Britain are still illicit. And there is a growing threat from illegal counterfeit cigarettes, which may pose additional health risks to smokers.

With smugglers constantly changing their tactics to try and maintain their profits, the Government constantly needs to anticipate and adapt to new threats and challenges.

This document summarises the progress made in tackling tobacco smuggling since the launch of the strategy in 2000, and analyses how the smuggling problem has changed.

It also sets out clear targets for the next phase of the strategy and plans for new staff, technology, legislation, publicity and cooperation with tobacco manufacturers to reinforce the further clamp down necessary on tobacco smuggling.

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WHY TACKLING TOBACCO SMUGGLING IS IMPORTANT

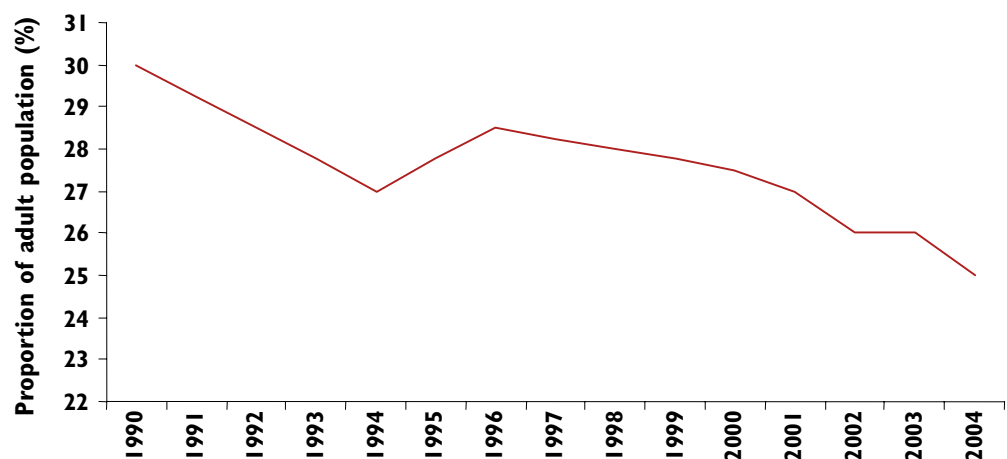
2.1 Smoking is the single greatest cause of preventable illness and premature death; it kills over 100,000 people in the UK every year - a fifth of all deaths. Tobacco kills half of all smokers, and a quarter of all teenagers that start smoking today will die before the age of 70 as a direct result of smoking.

The role of tobacco duty

2.2 Successive UK Governments have had a policy of establishing and maintaining a high level of tax on cigarettes to discourage people from taking up the habit, and encouraging those that do smoke to quit. As a result of this and other non-tax measures, the number of smokers in the UK has fallen from around 40 per cent of the population in the early 1980s to 25 per cent today, and the Government is committed to reducing this further to 21 per cent by 2010.

2.3 The importance of high tobacco prices in helping to reduce smoking is now internationally recognised and other countries, such as France, Germany and Ireland, are starting to follow the UK's lead and have recently raised their tobacco duty rates.

Chart 1: Smoking prevalence (cigarettes and hand-rolling tobacco)



Source: ONS / GHS

The impact of the illicit market

2.4 Tobacco smuggling is not a victimless crime carried out by latter day “Robin Hoods”: it harms the nation’s health by creating a cheap and unregulated source of tobacco, undermining a key Government objective to reduce smoking, especially among the young; it damages legitimate businesses that are undercut by those evading tax; it encourages wider criminality; and it costs the taxpayer nearly £3bn per year in lost revenue.

2.5 Smuggled tobacco can be less than half the price of tobacco sold on the licit market. This cheap source of tobacco undermines the effect of high tobacco duty rates and increases health inequalities. The vast majority of illicit cigarettes are traded in pubs, clubs, on the factory floor, at car boot sales and on the streets. This creates a completely unregulated distribution network, and makes tobacco far more accessible to children and young people.

2.6 Tobacco smuggling also undermines honest retail businesses, which lose not only direct sales of tobacco, but also sales of other products by customers coming into their shop to buy tobacco. This hits employment in the retail and manufacturing sectors that depend on those sales.

2.7 It spawns and funds the growth of criminality both at a serious organised level and at a more casual local level, and is frequently linked to wider criminal activity. The gangs behind tobacco smuggling will often smuggle tobacco alongside other illicit goods such as class A drugs, alcohol and counterfeit clothing, and the illicit tobacco trade breeds contempt for the law by encouraging otherwise honest people to trade with criminals.

2.8 Tobacco smuggling costs £2.9bn per year in lost revenue – the equivalent to 1p off the basic rate of income tax – money that would otherwise be funding schools, hospitals and other important public services.

2.9 When people evade taxes they undermine the fundamental principle of the taxation system, that everyone should pay their fair share. They also increase the burden on honest taxpayers. Our commitment to tackling fraud and smuggling is therefore integral to maintaining a fair tax system, safeguarding the stability of public finances and protecting the revenue available for investment in public services.

3

DEVELOPING THE TACKLING TOBACCO SMUGGLING STRATEGY

New approach to tax fraud 3.1 In 2000, the Government adopted a radically new approach to tackling tax fraud. The new approach was based on six key components.

Box 3.1: A new approach to tackling tax fraud:

- **estimating the size of the problem** – measuring illicit activity is inherently difficult, but understanding the scale of the problem is fundamental to understanding its nature and developing effective solutions;
- **analysing the problem** – properly understanding the economics of fraud and trends in its development so that appropriate operational responses are developed and deployed;
- **operational responses** – developing a range of responses, from additional staff to tougher penalties, rooted in analysis of the problem, to ensure maximum pressure at all different levels of the fraud network;
- **strengthening controls** – underpinning the operational response with an assessment of other changes needed to strengthen controls to prevent a tax regime being exploited by fraudsters;
- **establishing outcomes** – designing clear, measurable and ambitious targets based on impact on the problem being tackled;
- **monitoring and delivery** – consistent and regular monitoring of performance, both against a high level outcome and lower level operational output targets, through mechanisms such as Public Service Agreements (PSAs).

3.2 This new approach underpinned the Tackling Tobacco Smuggling Strategy, the first of its kind in the world. It has been supported by the Treasury Select Committee in its 2004/05 report “*Excise Duty Fraud*”, and has been successfully extended to other areas of the tax system.

Launch of the 2000 tobacco strategy 3.3 In 2000, more than 1 cigarette in 5 smoked in the UK was smuggled – an increase of 50 per cent on the previous year – and this was predicted to rise to 1 in 3 within a few years. Tobacco smuggling was costing over £3bn a year in lost tax revenue and had become endemic in ports in the South East of England, creating serious law and order problems, particularly in Dover and the surrounding area.

3.4 In response to this rapid growth in smuggling, the Government commissioned an independent review by Martin Taylor. Building on the recommendations of the Taylor review, in Budget 2000 the Government announced a new strategic approach to tackling tobacco smuggling.

Principles of the strategy 3.5 Tobacco smuggling is fuelled by the vast profits it can generate. The new Tackling Tobacco Smuggling Strategy was designed to undermine the economics of smuggling, increasing the risks and costs and making the profits less certain. The strategy was therefore underpinned by the following key principles:

- **making it harder for smugglers to source tobacco**, partly through working with the tobacco manufacturers to restrict the availability of their products;
- **disrupting the supply and distribution chain**, increasing the amount of smuggled product detected and seized all along the supply chain;
- **increasing the risks of and reducing the reward from smuggling**, by targeting the individuals and groups in the UK and abroad who run the operations, increasing the chances of being caught and the punishment for those who are, and hitting smugglers in the pocket by increasing the use of civil recovery, asset seizure and other economic penalties to hit profits and working capital; and
- **tackling the demand side**, by raising public awareness of the dangers and consequences of tobacco smuggling through a comprehensive publicity campaign.

Major elements of the strategy

3.6 The key elements of the strategy, launched in March 2000, were:

- investment of an extra £209 million to fund the deployment of almost 1,000 additional front line and investigative staff;
- the introduction of fiscal marks on packs to make identification of smuggled product easier;
- increased punishment for those caught with smuggled goods;
- working with the tobacco manufacturers to restrict the availability of cigarettes to smugglers;
- the deployment of a national network of scanners to detect high volume smuggling in freight containers;
- a publicity campaign to increase public awareness; and
- an ambitious new target to halt the rapid rise in smuggling and reduce the smuggled share of the cigarette market to 17 per cent by 2005/6.

3.7 The Government recognised that, to be successful, the strategy had to move away from a tactical response, focused purely on intermediate – and sometimes misleading – measures of success like levels of seizures. Instead, an end-to-end strategic approach, with unwavering focus on measurable outcomes that would have a direct impact on the problem the Government was trying to solve, was needed.

3.8 This was achieved through this far-reaching package of measures that included unprecedented new investment, but importantly, it also included a clear and ambitious target focussed on reducing the smuggling problem.

Developments since 2000

3.9 Since 2000, the Government has reinforced and refined the tobacco strategy as operational experience of smuggling patterns required. The Government has signed a series of Memoranda of Understanding (MoUs) with the main tobacco manufacturers supplying the UK market, designed to restrict the supply of UK manufactured cigarettes to smugglers. These MoUs have played a crucial role in making it harder for smugglers to source tobacco, and now have a proven record of success.

3.10 In October 2002, the Government introduced a further package of measures, designed to distinguish more clearly between smugglers and genuine shoppers. The package put the onus on HMRC to prove that activity was illegal, and imposed toughened penalties on repeat smugglers. Guide levels for shoppers from within the EU were increased from 800 to 3200 cigarettes, and from 1kg to 3kg of hand-rolling tobacco. These amounts represent about 6 months supply for the average smoker, and allow HMRC officers to concentrate efforts on those who are more likely to pose a risk of smuggling.

3.11 At the same time the Government introduced tougher action for persistent offenders, and for those who use violence against HMRC officers.

Box 3.2: Tough sanctions

Those found guilty of smuggling or handling smuggled tobacco are liable to a variety of sanctions, including:

- forfeiture of goods and any vehicle used;
- unlimited fines; and
- up to 7 years imprisonment and confiscation of any benefit gained.

In addition, anyone trading in illicit tobacco not bearing a UK duty-paid fiscal mark is liable to:

- a fine of up to £5,000; and
- prohibition on sale of tobacco products for up to 6 months.

Anyone permitting use of their premises for the sale of unmarked tobacco products faces a fine of up to £5,000.

Those who use violence against an HMRC officer are liable to:

- an unlimited fine;
- up to two years imprisonment;
- or both.

Revising the target **3.12** HMRC constantly monitor the illicit market share against targets; the impact is set out in the next section. The Tackling Tobacco Smuggling Strategy was highly successful, cutting the illicit cigarette market to 16 per cent by 2003/04. The original target was a reduction in the illicit market to 17 per cent by 2005/06, and meeting this target two years early led the Government to set a new, more challenging target in 2004 for the strategy to reduce the illicit share to 13 per cent by 2007/08.

4

IMPACT OF THE TACKLING TOBACCO SMUGGLING STRATEGY

Success of the strategy

4.1 The National Audit Office, in its 2005 report, concluded:

“[Tackling Tobacco Smuggling Strategy] measures have proved successful in first halting the previously rapid growth of cigarettes smuggling, and then reducing its level.”¹

Since its introduction, the strategy has cut the size of the illicit cigarette from 21 per cent in 2000/01 to 16 per cent in 2003/04 – a reduction of almost a quarter. Without action through the strategy, the illicit market share was predicted to be 36 per cent, with a revenue loss of around £6bn.

Table 1: Size of the illicit cigarette market

	2000/2001	2001/2002	2002/2003	2003/04
Revenue Loss ²	£2.7bn	£2.5bn	£2.0bn	£2.2bn
Illicit Market Share	21%	20%	15%	16%

4.2 In the first two years of the strategy, cross-Channel smuggling of cigarettes fell by over 70 per cent, while cross-border shopping increased by 50 per cent. In addition, the number of cigarettes successfully smuggled into the UK has been reduced by over 5 billion sticks per year, down by over a third since the introduction of the strategy, and around £6 billion in revenue has been protected.

Box 4.1: Results so far

Latest data show that, since the start of the strategy, the Government has:

- seized over 11 billion cigarettes both in the UK at seaports, airports and inland, and en-route to the UK;
- broken up over 320 criminal gangs involved in the large-scale smuggling and supply of illicit cigarettes;
- successfully prosecuted almost 2,500 people; and
- issued £21 million worth of Confiscation Orders.

The current state of the market

4.3 Inevitably, this success has had consequences. Smugglers have adapted to the new environment, changing the patterns and types of smuggling activity and hence the nature of the UK smuggled market.

4.4 After the sharp falls in the illicit market achieved in the first few years of the strategy, the trend now appears to be broadly flat. Latest estimates of the size of the

¹ Comptroller and Auditor General's Standard Report on the Accounts of HM Customs & Excise 2004/05

² Illicit activity (fraud and smuggling)

non-UK duty-paid market in cigarettes were published in the 2005 Pre-Budget Report, and the most recent evidence, including data from the tobacco manufacturers, suggests that the illicit market has stopped shrinking.

Table 2: Comparison of TMA and Government estimates

Market shares paying no UK duty ³	2000	2001	2002	2003	2004
Tobacco Manufacturers' Association (TMA) estimate	31%	30%	26%	28%	28%
HM Revenue and Customs (HMRC) estimate	26%	27%	25%	25%	N/A

New challenges

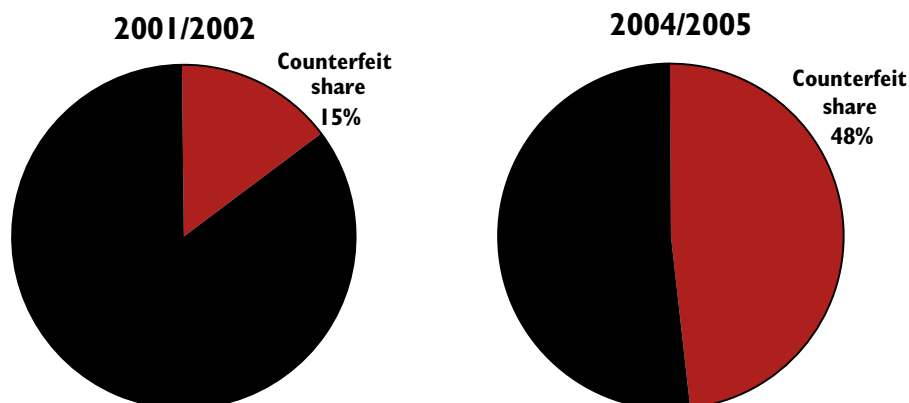
4.5 At the start of the strategy, the illicit UK tobacco market was largely made up of genuine UK manufactured cigarettes bought from outside the European Union (EU) and smuggled back into the UK in multi-million cigarette freight consignments. HMRC estimated that around 80 per cent of the UK illicit market was sourced in this way. This has changed and the illicit UK market is now more complex. In addition to smuggling of genuine UK manufactured cigarettes, which remains a serious problem, a major new challenge is posed by significant smuggling of counterfeit cigarettes, and smuggling of hand-rolling tobacco remains persistently high.

Counterfeit cigarettes

4.6 Through cooperation between the Government and the UK tobacco manufacturers, formalised in the MoUs, smugglers have found it increasingly difficult to obtain supplies of genuine UK manufactured cigarettes. Instead, they have been turning increasingly to counterfeit product, generally sourced from the Far East and countries in Eastern Europe.

4.7 In 2001/02, 15 per cent of large seizures of cigarettes made by HMRC were counterfeit. By 2003/04, this had risen more than three-fold, to 48 per cent.

Chart 2: Proportion of HMRC cigarette seizures⁴ by type



³ Includes cross-border shopping and smuggling

⁴ Large seizures only

4.8 In 2004, seizures from street markets revealed that the majority of cigarettes being sold were counterfeit. On average, 85 per cent of cheap cigarettes sold in London were found to be counterfeit, rising to 100 per cent in some particular hotspots such as Holloway Road in North London.

The counterfeit market

4.9 The counterfeit cigarette market is different from the illicit market in genuine product. Counterfeit cigarettes are generally made to order and visually can be almost indistinguishable from the genuine article. No duty is paid on them anywhere, giving criminals higher profits than smuggling duty-paid product between countries.

4.10 Counterfeit cigarettes are almost always smuggled in commercial quantities, predominantly as maritime freight in containers. The supply chain for counterfeit cigarettes is entirely illicit, so there are no legitimate manufacturers with whom the Government can work to restrict supply. Most counterfeit cigarettes are manufactured in the Far East and Eastern Europe, not in the UK.

4.11 And the economics are completely different – counterfeit cigarettes can cost smugglers only one quarter of the price of genuine product. This massively increases the profits smugglers can make, and means that tackling the counterfeit cigarette market needs a different response from the one deployed to tackle the smuggling of genuine product.

Box 4.2: Tackling counterfeit

HMRC seized 6.2 million counterfeit cigarettes from the Far East in a consignment of pottery destined for a footwear company. A company director was sentenced to 3½ years imprisonment and in October 2005 this year he was also served with a Confiscation Order for £129,000 with a default sentence of 5 years if he fails to pay for his part in the operation.

In February 2004, six men were jailed at Crown Court for conspiring to smuggle counterfeit cigarettes into the UK in a container of rice noodles. The container had been previously imported from the Far East into Felixstowe, where the cigarettes were detected. HMRC officers then followed the container to an industrial storage unit, where it was found to contain nine million counterfeit cigarettes.

In November 2005 a container travelling from the Far East was singled out for inspection as it fitted a known risk profile. The load was declared as delicate ceramics but inspection showed poorly stacked cardboard boxes inside and there were ceramics in part of the container. Examination of the boxes identified over two thirds of the container as being counterfeit cigarettes. A seizure of over six million cigarettes was made, protecting £1 million in tax revenue.

Potential health dangers of counterfeit

4.12 Consumers who buy counterfeit cigarettes generally do so in the belief that the product is genuine. Not only are they being conned, but they may run additional health risks from smoking counterfeit cigarettes.

Box 4.3: The components of counterfeit cigarettes

The health risks associated with smoking counterfeit cigarettes have not been fully evaluated. However, a research team, led by a Senior Lecturer at the School of Geography & Geosciences, St Andrew's University, has tested a number of seizure samples. The results indicate that counterfeit cigarettes contain on average markedly higher concentrations of:

- arsenic (3 times the level of their genuine counterparts);
- cadmium (5 times); and
- lead (5.8 times).

All of these are listed by the International Association for Research in Cancer (IARC) as carcinogens. The research team has attributed the over-application of fertilisers as the most likely cause of the increased presence of heavy metals.

A toxicologist at the Department of Health states that these counterfeit cigarettes have the potential to deliver consistently high levels of heavy metals to the lungs of those who habitually smoke them. Many of these accumulate in the body over time. This phenomenon has only recently been recognised, and the long-term health risks of these heavy metals are presently uncertain.

Additionally, an independent laboratory has tested a representative seizure sample and its results indicate that counterfeit cigarettes contain up to:

- 160 per cent more tar;
- 80 per cent more nicotine; and
- 133 per cent more carbon monoxide than their genuine counterparts.

Hand-rolling tobacco

4.13 Since the early 1990s there has been significant growth in smokers using hand-rolling tobacco (HRT), and since 2000 consumption has increased by a further 15 per cent. Driven by smokers down-trading from high-price cigarettes to much cheaper HRT, the proportion of smokers who smoke HRT has doubled from 11 per cent to 22 per cent since 1990. One in four cigarettes smoked each year in the UK is now hand-rolled.

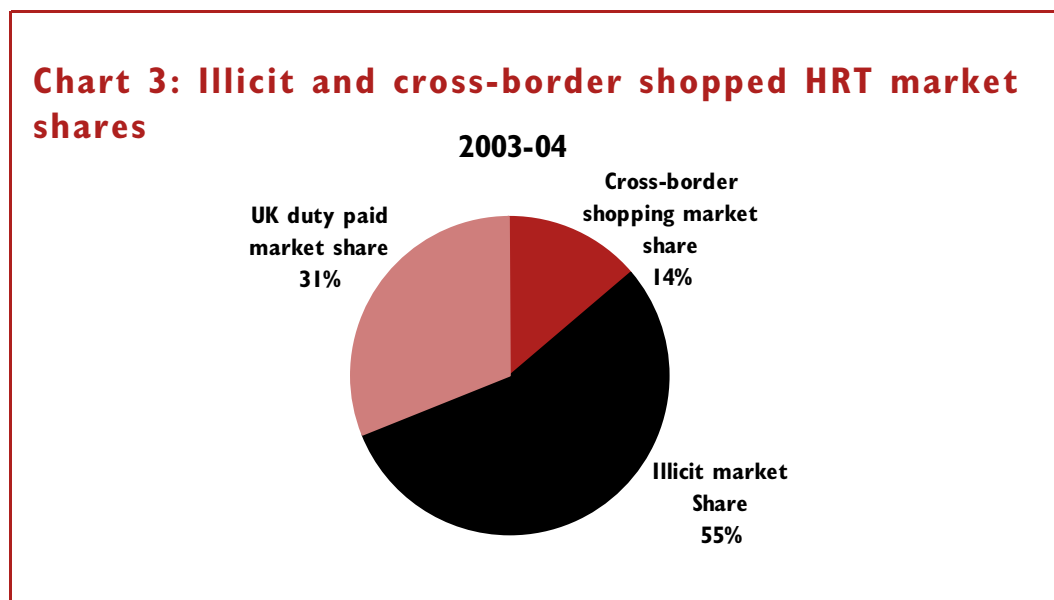
4.14 However, less than a third of HRT smoked in the UK bears UK tobacco duty, and over half of HRT consumed here is smuggled. A significant proportion of the HRT smoked in the UK is also legitimately shopped from other EU countries, and there is some evidence that the level of non-UK duty-paid HRT has now plateaued at around 70 per cent of the market.

Table 3: Size of the illicit HRT market

	2000/01	2001/02	2002/03	2003/04
Revenue Loss⁵	£790m	£770m	£840m	£880m
Illicit Market Share	63%	52%	53%	55%
Cross-border Shopped Share	11%	17%	18%	14%

Sources of HRT 4.15 The illicit HRT market now has some similarities with the illicit cigarette market at the start of the Tackling Tobacco Smuggling Strategy. The illicit market is dominated by a few brands that have been manufactured in the UK, exported, and smuggled back to the UK. However, the illicit UK market in HRT is supplied almost in its entirety, duty-paid, from a few countries predominately within the EU, and there is little current evidence of counterfeit HRT.

Chart 3: Illicit and cross-border shopped HRT market shares



4.16 The majority of smuggled HRT enters the UK smuggled either by passengers or in quantities of at least 100 kg in accompanied freight (heavy goods vehicles), with some additional volumes entering via airports. HRT packages tend to be easier to conceal than cigarette cartons. The way criminal gangs operate is also different – HRT smugglers tend to be more last minute and opportunistic in identifying transport opportunities.

4.17 The large differential between smuggled and legitimate HRT retail prices means that the economics of HRT smuggling are also different from smuggling of genuine cigarettes.

4.18 When the tobacco strategy was launched in 2000, the Government believed that the range of actions taken could be successful in reducing smuggling both of cigarettes and HRT. However, as HMRC’s knowledge and understanding of the market has improved, it has become clear that the market and smuggling methods for HRT are different from those for cigarettes, and different responses are needed.

⁵ Total non-UK duty-paid, including cross-border shopping and smuggling

5

REINFORCING THE TACKLING TOBACCO SMUGGLING STRATEGY

5.1 The Tackling Tobacco Smuggling Strategy has been, and continues to be, successful. But tobacco smuggling is still unacceptably high and latest estimates suggest that the reduction seen since 2000/01 has started to level off. Making further, sustained inroads into the illicit market is going to be a major policy and delivery challenge.

5.2 The Government's approach to tackling tobacco smuggling will continue to be underpinned by the following key principles:

- making it harder for smugglers to source tobacco;
- disrupting the supply and distribution chain;
- increasing the risks of, and reducing the reward from, smuggling by targeting the key individuals and groups in the UK and abroad who run the operations and the working capital and finance behind the crime; and
- tackling the demand side, as well as the supply.

New threats 5.3 However, the strategy also needs to be dynamic and flexible, using HMRC's increasing knowledge and understanding of the international illicit market in tobacco to stay on top of new threats as they emerge. Whilst maintaining the pressure to control smuggled cigarettes, the most important objectives for the next phase of the strategy will be tackling the growing challenge of counterfeit products and achieving significant cuts in the persistently high levels of smuggling of HRT.

New actions 5.4 The Government is therefore building on the resources and controls already in place to tackle tobacco smuggling by introducing a range of new measures to reinforce the tobacco strategy, including specific measures to tackle the smuggling of HRT and counterfeit cigarettes. The new measures are in four main areas:

- **working with tobacco manufacturers** – to improve the targeting of counterfeit product, and further restrict supply of both HRT and genuine cigarettes through existing MoUs complemented with legislation;
- **enhancing HMRC's operational response** – to strengthen enforcement at all the key points along the supply and distribution chain, with 200 extra staff to focus on HRT and a 30 per cent increase in the network of Foreign Liaison Officers;
- **using technology** – to increase HMRC's ability to detect illicit goods and target resources effectively; and
- **publicity and communication** – to increase awareness of HMRC enforcement action and to undermine further the appeal of smuggled product to current and potential consumers.

New target for HRT 5.5 These new measures are underpinned by a new, specific operational target for HRT of reducing the size of the UK illicit market by 1,200 tonnes – equivalent to around 20 per cent – by 2007/08.

Working with tobacco manufacturers

Memoranda of Understanding

5.6 MoUs between HMRC and the UK tobacco manufacturers have been an important element of the strategy, and have played a crucial role in restricting the availability of genuine cigarettes to smugglers. Since its peak in 2000/01, the incidence of UK manufactured cigarettes being smuggled into the UK has fallen markedly, from about 75 per cent of large seizures to 28 per cent in 2003/04.

5.7 In March 2006, HMRC signed new, enhanced MoUs with the UK tobacco manufacturers, replacing the original agreements signed in 2001. The Government welcomes the cooperation of the trade through the MoUs and hopes that the same level of cooperation can continue, especially as new threats come into play from HRT and counterfeit.

5.8 The MoUs have been revised and reinforced. They include important new provisions that will restrict further the availability of cigarettes to smugglers, and for the first time will do the same with HRT. They are also designed to strengthen joint work to tackle the problem of counterfeit material.

Box 5.1: New Memoranda of Understanding (MoUs)

The MoUs commit the UK tobacco manufacturers to:

- sell all their tobacco products (including HRT) in brands and amounts consistent with legitimate demand in the export market;
- consult with HMRC officials before entering UK-sensitive brands in to new markets;
- respond to requests following significant seizures of their product to identify the production and movement history of the consignment; and
- cease supplying customers where they fail to demonstrate effective product control.

The MoUs also commit the manufacturers to take steps to combat counterfeit, including:

- information sharing with HMRC;
- taking steps against trademark infringements;
- putting in place effective controls of raw materials and machinery to prevent their becoming available to counterfeiters.

The MoUs contain forward-looking provisions to undertake regular assessments of anti-smuggling technologies.

The MoUs also commit HMRC to provide certain assistance to the tobacco manufacturers, and to share information about counterfeit production.

5.9 The tobacco manufacturers have detailed knowledge of activity overseas and often have valuable intelligence about potential counterfeit threats. The Government will be working with the manufacturers to identify sites of counterfeit production throughout the world and, in conjunction with overseas authorities, to disrupt, dismantle and prosecute as appropriate.

5.10 HMRC and the tobacco manufacturers will jointly be examining a range of practical measures that could be implemented against counterfeit cigarettes, such as covert markings.

Supply Chain Control Legislation **5.11** At PBR 2005, the Government announced that, following consultation with the tobacco manufacturers, it would be introducing legislation in Finance Bill 2006 to complement the MoUs. The legislation is aimed at preventing organised criminal gangs from exploiting weaknesses in supply chains for tobacco products.

5.12 The legislation, which will cover both cigarettes and HRT, will apply to products smuggled from both EU and non-EU destinations. The scheme will impose obligations on manufacturers and penalise them for failure to comply with those obligations. The legislation is designed to complement the MoUs with the UK tobacco manufacturers, and ensure that those manufacturers that aid HMRC in their efforts to combat tobacco smuggling are not unfairly disadvantaged. Obligations will therefore be imposed on all tobacco manufacturers, whether or not they have signed an MoU with HRMC, to control their supplies to non-UK markets, and to ensure as far as reasonably practicable that they do not facilitate smuggling.

Box 5.2: Legislation to control supply chains

The principles of the legislation will be:

- a general obligation on all manufacturers to:
 - (a) supply markets only in quantities that reflect legitimate demand; and
 - (b) minimise the risks of their products becoming available to those intent on evading duty;
- additional specific obligations on those manufacturers whose products have a significant presence in the UK illicit market; and
- financial penalties of up to £5 million for manufacturers that do not adequately control their supply chains.

5.13 The scheme will facilitate and encourage dialogue between the tobacco manufacturers and the Government. Crucial to this will be developing a shared understanding of the legitimate size of non-UK markets, and of specific supply chain risks and the measures that can be taken to address them.

5.14 Tobacco manufacturers will be liable to penalties of up to £5 million if, having been given a formal warning, they still do not take the necessary steps to control their supply chain adequately. They will not be penalised for the actions of the smugglers, but for failing to take steps available to them to prevent large quantities of tobacco getting into the smugglers' hands.

The Phillip Morris Agreement **5.15** The Anti-Contraband & Anti-Counterfeiting Agreement between the European Commission and Philip Morris International (PMI) provides for PMI to reimburse signatory Member States for the duty lost on seizures above a certain level.

5.16 While the UK has welcomed the EU Commission's success in negotiating a seizure penalty agreement with PMI, the Government believes that the MoUs with UK tobacco manufacturers, and the complementary legislative measures, provide a more comprehensive means of tackling tobacco smuggling, and one that is better suited to the specific circumstances of the UK.

5.17 PMI-distributed cigarettes account for a very small proportion of the UK tobacco market. Furthermore, the EU-PMI agreement is restricted to seizures of tobacco products from non-EU countries and does not cover seizures of HRT. It also has no equivalent to the provisions in the UK MoUs for combating the smuggling of counterfeit tobacco products.

Enhancing HMRC's operational response

Tackling smuggling of hand-rolling tobacco

5.18 The Government announced in the 2005 Pre-Budget Report that HMRC will be deploying a further 200 operational staff to develop and pursue an operational strategy aimed at tackling HRT smuggling. This operational strategy will focus resources on the activities likely to have the highest impact on the problem, such as intelligence-building and supporting the supply chain control provisions, UK and overseas investigation, and intelligence-led interdictions.

Box 5.3: The operational HRT strategy comprises six key elements:

- additional investigation teams in regions of highest risk (Central England, Dover and London), to focus on UK based smuggling and distribution organisations and high-level criminal organisations overseas;
- increased anti-smuggling resources deployed at entry points considered to present the highest risk of HRT smuggling;
- intelligence-building both in the UK and overseas, to support the supply chain control provisions;
- developing tactical and specific intelligence, in particular on large commercial smuggling attempts and inveterate smugglers, and identifying and targeting the major criminal gangs operating in the UK;
- improving analysis in relation to domestic and international markets using independent and industry data to assess evidence of weaknesses in the HRT supply chains; and
- extending and developing contacts with overseas agencies to identify and target overseas-based criminal gangs (including money launderers).

Working at the frontier

5.19 The frontier plays an important role in the supply chain for smuggled tobacco, creating a bottleneck that can increase risks and costs for smugglers and act as a deterrent to those considering smuggling. Frontier disruption activity will always be an essential part of any strategy to tackle smuggling.

Box 5.4: Front line evidence

At least one criminal gang viewed successfully getting its containers into the UK as so difficult that it sold the product to another gang, buying the load back at a higher price once it had been successfully smuggled in. This is why HMRC's disruption activity at the frontier is of such vital importance in undermining the economics of smuggling and creating uncertainty for smugglers.

5.20 At ports, HMRC officers are increasing and improving challenges to both Roll-on Roll-off traffic and unaccompanied freight. The Government is increasingly using technology to free up HMRC officers' time to identify more effectively and target high-risk loads.

5.21 The widespread availability of cheap flights has brought with it a steady increase in smuggling by air passengers over recent years. The Government has therefore developed an integrated air strategy to allow HMRC to identify and target the airports, flights and individuals that present the highest risk of smuggling.

5.22 The Government will be working with overseas partners, travel companies and operators to inform resource deployments in the UK and improve the assessment of risk. Flights from high-risk locations will be targeted and inveterate offenders criminally prosecuted to remove them from the supply chain and provide a more visible deterrent.

Box 5.5: Results at the frontier

- An operation at Luton airport targeting late night flights from a high-risk location over 3 days in September 2005 resulted in the seizure of more than one million cigarettes, including 51 bags containing 700,000 cigarettes on two flights; and nine inveterate offenders have been identified and arrested for criminal prosecution.
- One prosecution at Crown Court resulted in a sentence of 150 hours community service and a Confiscation Order for £45,582.

**Working
inland in the
UK**

5.23 The tobacco strategy is also targeted at disrupting and dismantling the supply and distribution chains for illicit tobacco in UK. Targeted disruption can cause local supply difficulties, resulting in increased prices as illicit tobacco products become scarce. Inland work can also be a key source of intelligence that can drive other work.

5.24 The Government has therefore developed an operational model for inland work aimed at identifying the major smuggling networks and supply chains. This allows HMRC to work with other government agencies to target key criminal organisations, break up supply chains, and inflict maximum damage on the organisation and its finances. The Government will use local, and where appropriate national, media to ensure maximum publicity and impact, to increase awareness of HMRC operations and deter potential criminals by highlighting the potential dangers and penalties.

Box 5.6: Results on the ground

In November 2005 officers acting on information searched premises in Yorkshire, finding in excess of 270,000 cigarettes, 230 kilos of HRT, 2,500 cigars and a quantity of alcohol. The goods were seized and two people were arrested. They are currently on bail whilst inquiries continue.

5.25 There are also some clear regional and employment patterns to the consumption of HRT in the UK that will provide a particular focus for HRT inland work. Smokers in the Midlands, South West and North West are responsible for 41 per cent of all HRT consumption⁶. Certain industries also have higher consumption than others. For example, individuals in the construction industry have the highest consumption rate of HRT, whilst those in engineering and manufacturing industries consume nearly 30 per cent of the total UK HRT market⁷.

5.26 These clear patterns provide the opportunity to target disruption activity at sales and distribution networks for illicit HRT in a way that has not been possible for illicit cigarettes.

⁶ Source: Analysis of General Household Survey (2002/03)

⁷ Source: GHS 2002/03 as above

Working Overseas 5.27 The UK illicit cigarette market is at the end of an international supply chain that stretches to the Far East and Africa as well as closer to home in the Baltic States. HMRC's network of overseas officers has played a key role in disrupting supply chains, identifying criminal gangs operating abroad, and enabling end-to-end disruption of the illicit supply chain.

Box 5.7: Impact of the overseas network

The HMRC network of overseas officers has worked with host agencies to ensure that around 4 billion illegal cigarettes bound for the UK were seized overseas; around 40 per cent of all the illegal cigarettes which have been seized. This network is now working with host agencies to identify and dismantle counterfeit plants:

Intelligence provided overseas led to the seizure of 8.9 million counterfeit cigarettes from a container in Rotterdam hidden in a coverload of quilts. The container was shipped and destined to tranship through Rotterdam for the UK.

Working with a host agency, an overseas officer provided intelligence and operational support so that six counterfeit plants were dismantled, almost 50 million cigarettes seized and a number of arrests made. As a result of this, one of the most significant counterfeit businesses in the host country was dismantled, fundamentally affecting the supply of counterfeit cigarettes to the UK.

5.28 HMRC has been increasingly active abroad, employing a network of Fiscal Liaison Officers (FLOs) who are permanently based overseas, covering 44 countries. In 2003/04 this overseas network intercepted more smuggled cigarettes before they reached the UK than were seized at UK seaports. The Government has increased the FLO network by 30 per cent and will continue to review these resources ensuring they remain appropriate to target the levels of assessed risk.

Criminal Intelligence and Investigation 5.29 The international market in illicit tobacco is highly sophisticated, complex, and constantly changing. Accurate and timely intelligence is fundamental to disrupting and undermining these complex supply chains. HMRC are currently working with other law enforcement agencies, both in the UK and overseas, to identify and target the main individuals and organisations driving the UK smuggled market in tobacco, whether they are based here or abroad.

5.30 Criminal investigations will be aimed at permanently stopping those behind tobacco smuggling. The Government will be targeting key individuals in order to:

- identify and confiscate the working capital and assets of key individuals and their organisations;
- build up evidence to secure custodial sentences and deprive individuals who run illicit activity of their personal freedom; and
- use the intelligence gained in the course of these investigations to inflict on-going damage on the network of the individual or organisation.

Box 5.8: The use of intelligence

An investigation into a multi-national organised criminal group of cigarette brokers led to 10 successful spin-off operations, the seizure of over 60 million cigarettes and £476,000 cash and the prosecution of 32 defendants. The final part of the operation targeted five co-conspirators including the main organiser. Investigations showed that the principal had been able to contact, and bring into the UK, criminal elements from Eastern Europe in order to carry out a highly organised and persistent conspiracy, involving evasion of duty on cigarettes. Charges also included evasion of duty on alcohol and oils and money laundering offences. In November 2005, three defendants were convicted and sentenced to a total of nine years and eight months. Assets in the region of £555,000 have been identified and confiscation proceedings are scheduled for April 2006.

Using enhanced intelligence and IT systems HMRC has, at one UK port alone, seized more than 80 million counterfeit cigarettes from the Far East in the final three months of 2005; that volume would have kept over 40,000 20-a-day smokers going for three months on illegal cigarettes.

Using technology

5.31 Increasing investment in technology has been an important part of the tobacco strategy, and will continue to play a major role as the strategy goes forward. The X-ray scanners introduced at the start of the strategy have been highly effective in detecting smuggled tobacco products in the main freight channels, and HMRC officials are now investigating the development of technology to assist in the detection of smuggled tobacco outside of the main freight channels.

5.32 At ports in the South East, HMRC is currently trialling an Electronic Freight Targeting System (EFTS), aimed at facilitating more effective targeting of both Roll-on Roll-off traffic and unaccompanied freight. Early indications are promising and suggest that this technology could play an important role in improving the Government's ability to effectively target suspect loads. The technology has led directly to at least two significant cigarette seizures in only the first two months of the pilot.

5.33 HMRC officials are in talks with Dover Harbour Board to increase the space available for them. This will allow officers to deal more effectively with the ever-increasing traffic volumes, and in particular make possible the operation of a new generation of scanners that are both more powerful and able to scan more vehicles.

5.34 The Government is also working with the UK tobacco manufacturers to identify possible options for anti-counterfeiting technology.

Publicity and communications

5.35 Effective communications are central to effective delivery of the tobacco strategy.

Box 5.9: The communications strategy has three key aims:

- to broaden the knowledge and awareness of HMRC enforcement action and penalties, in order to increase its deterrent impact;
- to undermine the attractiveness of illicit product to potential consumers by highlighting (a) its counterfeit nature, and (b) its link to organised crime; and
- to encourage the public and businesses to pass on information and intelligence on the illicit market to HMRC.

5.36 To achieve these aims, the communications strategy will focus on supporting inland activity and illicit sales, as well as continuing to advertise HMRC's presence at UK airports and seaports, and raising smokers' awareness of counterfeit cigarettes.

Publicising the penalties

5.37 The strategy includes a range of sanctions and penalties to deal with different illicit activities at different stages of the supply chain. These penalties and sanctions will be widely enforced and used to reinforce their deterrent effect and to raise public awareness of the possible consequences of smuggling.

5.38 The Government will continue to advertise the presence of HMRC officers at UK airports and ports to ensure that warnings to businesses and the general public of the risks of smuggling remain high profile. In particular, for hauliers, it will make clear that:

- their load may be subject to X-ray scanning;
- they face potentially serious penalties if smuggled tobacco is detected; and
- they can help tackle smuggling by checking their loads for illegal cigarettes.

Raising smokers' awareness of counterfeit

5.39 Research indicates that 46 per cent of purchasers of cheap smuggled cigarettes would not buy them again if they thought they could be counterfeit. The Government will continue to undermine smokers' confidence in "cheap cigarettes" by highlighting the potential dangers of smoking counterfeit cigarettes, and alienating the public from the individuals who sell them.

Box 5.10: Publicity

HMRC has already been involved in a local initiative in Islington in conjunction with the local authority and the police, publicising the increased prevalence of cadmium and other dangerous substances in counterfeit cigarettes. Launched in February 2006, the event combines increased HMRC activity in the area, where – according to tests – 100 per cent of illicit cigarettes on sale are counterfeit, with targeting of local press covering Islington and the surrounding areas, the Evening Standard, the BBC and ITV regional evening news programmes, as well as contributing to discussion programmes on London radio stations.

Building public support **5.40** Through maintaining a presence in problem areas and a range of communication channels, HMRC will look to persuade those who smuggle cigarettes and deal in smuggled cigarettes and tobacco that:

- HMRC officers are operating in the areas where illicit cigarettes are sold and there is a real risk of those dealing in them getting caught; and
- there are serious consequences for those who are caught.

5.41 The Government will also be continuing to encourage members of the public with knowledge or suspicions of smuggling to contact HMRC's confidential hotline; *Customs Confidential*, on 0800 595000.

Conclusion

5.42 Cracking down on tobacco smuggling is vital to reducing smoking, maintaining a stable and fair public finance system, tackling serious and organised criminality, and protecting honest businesses. The Government's strategic approach to this problem has been a significant success but smuggling is still unacceptably high. Building on the additional resources and enhanced controls delivered since 2000, the new measures detailed in this paper represent a comprehensive response to new challenges that have emerged as the illicit market adapts and develops. Stretching delivery targets have now been set for both cigarettes and HRT and the success of the enhanced strategy set out here will be judged against these targets. The Government will be making its next report on progress of the Tackling Tobacco Smuggling Strategy at the Pre-Budget Report, in the context of its regular annual report on the indirect tax fraud strategies.

ISBN 1-84532-165-0



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