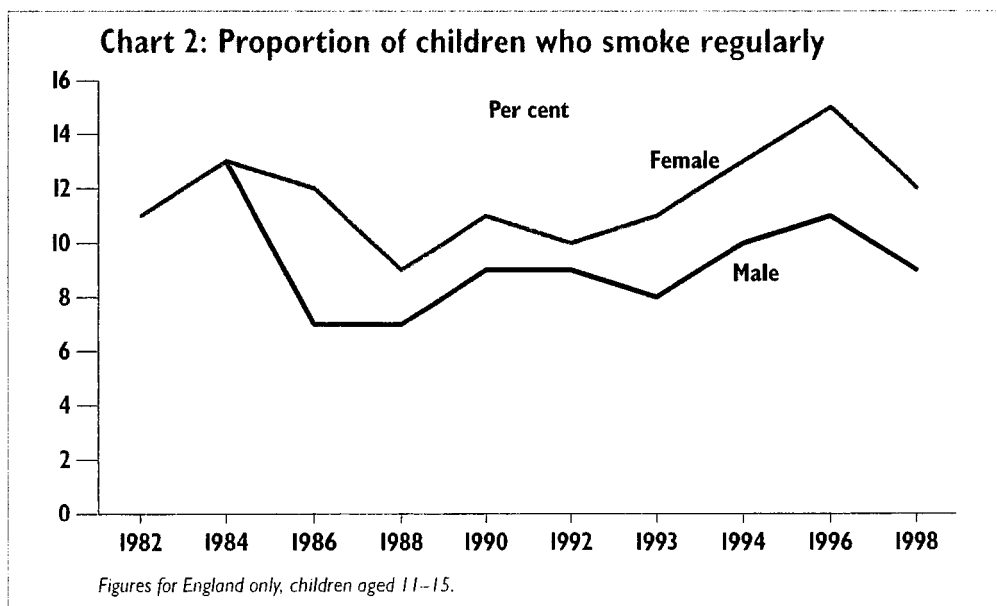


8 Recent trends in smoking are not encouraging. After a prolonged period during which the share of adults who smoke was falling, the long downward trend appears to have levelled out. There has also been an upward trend in the proportion of young people smoking over the past decade. Although the most recent survey suggests a fall, which is welcome, it is too early to tell if this is the beginning of a downward trend.



9 The Government is determined to see a major improvement in health in the UK. The December 1998 "Smoking Kills" White Paper proposed three tough and specific targets:

- * to halt the rise in children smoking by reducing smoking among children from 13 to 9 per cent or less by the year 2010, with a fall to 11 per cent by the year 2005;
- * to establish a new downward trend in adult smoking rates in all social classes so that the overall rate falls from 28 to 24 per cent or less by the year 2010; with a fall to 26 per cent by the year 2005; and

- to improve the health of expectant mothers and their families, by reducing the percentage of women who smoke during pregnancy from 23 to 18 per cent by 2005 and to 15 per cent by 2010.

10 These targets are backed with action to achieve them: regulations to ban tobacco advertising; media campaigns; smoking cessation programmes; and keeping the prices of tobacco products high. Achieving these targets will be a big step towards meeting the Government's overall aims for public health.

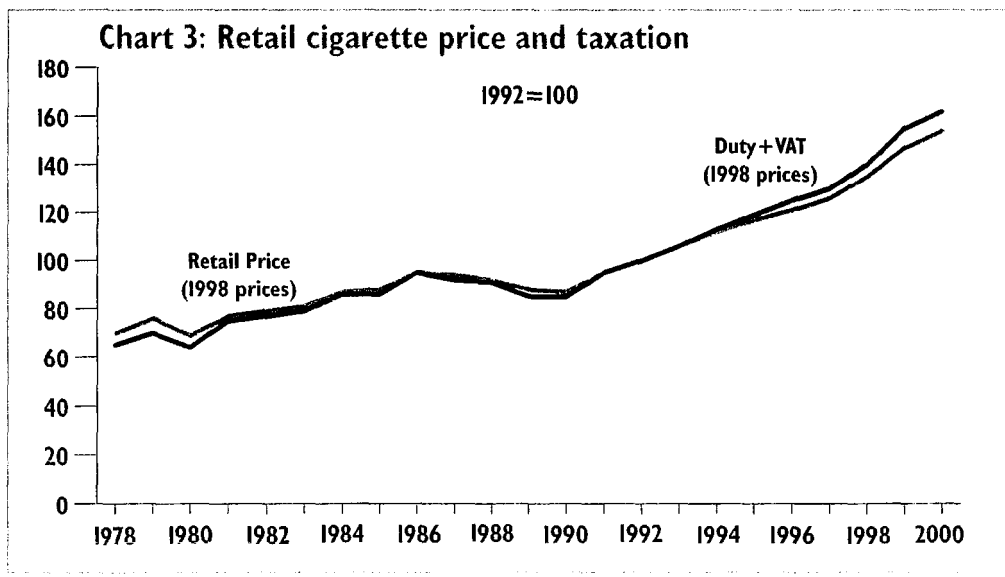
SECTION 3: THE ROLE OF TAX IN REDUCING SMOKING

11 Research suggests that the demand for cigarettes is affected by their price. Estimates vary, but recent work commissioned by Customs suggests that the decline in smoking would be 0.3 per cent¹ if prices were increased by 1 per cent in real terms.

12 So it follows that, if they can be enforced, high tax levels can play an important role in reducing overall tobacco consumption. High tobacco prices have been highlighted by the Department of Health as a deterrent to children tempted to take up smoking. Also a recent report from the World Bank² found that:

"Evidence from countries of all income levels shows that price increases on cigarettes are highly effective in reducing demand. Higher taxes induce some smokers to quit and prevent other individuals from starting. They also reduce the number of ex-smokers who return to cigarettes and reduce consumption among continuing smokers. . . . Children and adolescents are more responsive to price rises than older adults, so this intervention would have a significant effect on them."

13 In order to support health policy on smoking, successive governments have raised tobacco duty. The previous Government announced that in each Budget tobacco duty would always be increased by 3 per cent in real terms. The present Government reinforced this escalator policy, raising the annual increase to at least 5 per cent in real terms in the July 1997 Budget. The escalator has led to a significant increase in the price of legitimate cigarettes. Chart 3 shows changes in the tax on cigarettes, and the retail price of cigarettes. Following the duty increase in Budget 2000, the price of legitimate cigarettes will have risen by 25 per cent in real terms since May 1997. This would have reduced smoking by around 8 per cent if it were not for other factors, such as smuggling.



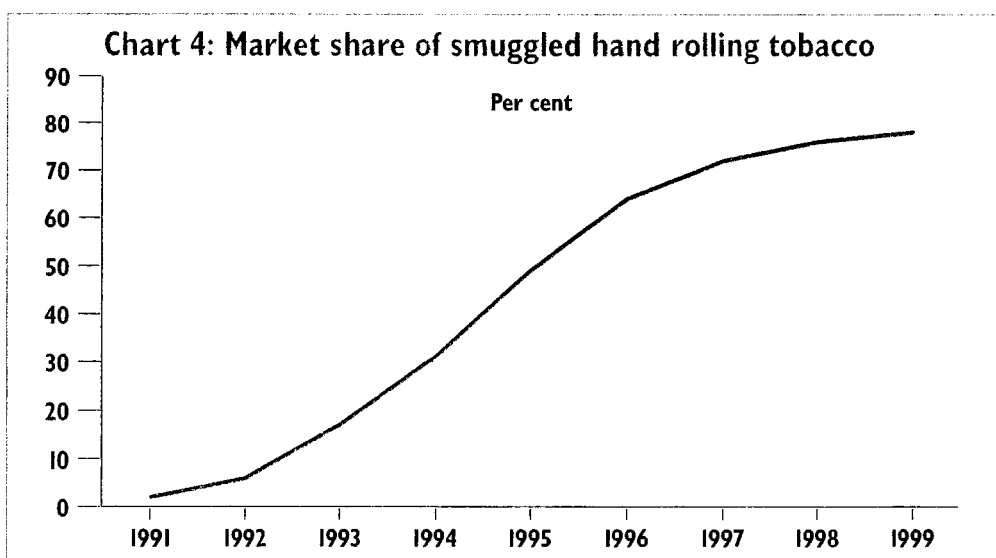
¹ 'Consumers' demand and excise duty receipts equations for alcohol, tobacco, petrol and derv' Marcus J Chambers, University of Essex, Government Economics Service Working Paper No. 138, November 1999.

² World Bank, 'Curbing the Epidemic: governments and the economics of tobacco control', May 1999.

14 There remains a strong ongoing health case for year on year real terms increases in the prices of cigarettes and other tobacco products. But in the present circumstances, increasing duty is not the only way of increasing the overall or effective price of cigarettes. This can also be achieved by reducing the supply of cheap smuggled cigarettes and so raising the share of the market taken by more expensive legal cigarettes.

SECTION 4: THE PROBLEM OF SMUGGLING

15 Initially, the problem of smuggling was confined to cross-Channel smuggling of hand rolling tobacco. But more recently smuggling of cigarettes especially in freight containers has increased very rapidly. Customs estimate that now about 70 to 80 per cent of smuggled cigarettes are transported by freight and 'roll-on roll-off' lorries. The bulk of the remainder is smuggled in vehicles through the Channel ferry ports and Channel tunnel – the so called 'white van trade'. Customs has worked closely with the industry in estimating the size of the problem. The best assessment is that currently around 18 per cent, nearly one in five cigarettes smoked, is smuggled. Without action this could rise to more than one in three, as criminals build up chains of distribution. The experiences of hand rolling tobacco, and cigarette smuggling in other countries (in Canada it reached 60 per cent in Quebec and 40 per cent in some other provinces), show that smuggling can reach very high proportions of total consumption.



16 Smuggling now leads to a substantial loss in revenue. Customs' latest assessment of overall revenue losses associated with all forms of tobacco smuggling in 1999 is of the order of £2½ billion, about 25 per cent of all tobacco revenue (excise duty and VAT) due. So smuggling is leading to less money for schools and hospitals, and forces other taxes to be higher.

17 But smuggling not only costs the Government revenue, it also undermines progress on health objectives by making cheap cigarettes available through unregulated sources. The large annual increases in duty have been successful in driving up the price of duty paid cigarettes. Increases over the period since May 1997, including that announced in Budget 2000, have increased the price of legal tobacco by about 25 per cent in real terms. But the average price of cigarettes, including illicit cigarettes, has increased by less than this, reflecting the availability of cheap smuggled supplies. The illicit street price of a premium UK brand of cigarettes averages around £25 for a pack of 200, the equivalent of £2.50 for a packet

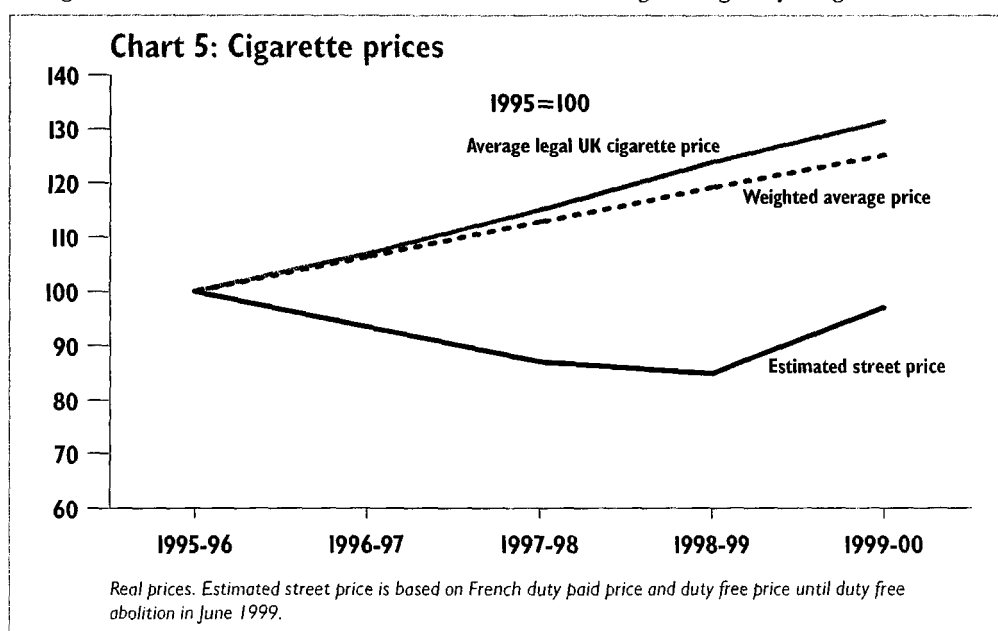
of 20. The legal price of the same packet of 20 will be around £4.20 after the latest increase in duty. Purchasing illicit rather than legal product offers a saving of around £1.70 per packet, or 40 per cent. The growing availability of cheap smuggled cigarettes means that the effect of duty increases in discouraging cigarette consumption is considerably less than it would otherwise be.

Table 1: Revenue lost from tobacco smuggling

£ million	1996	1997	1998	1999
Cross-Channel smuggling of hand rolling tobacco	500	630	685	720
Cross-Channel smuggling of cigarettes & other tobacco	180	160	250	340
Total cross-Channel smuggling of tobacco	680	790	935	1055
Cigarettes smuggling by air passengers	n/a	50	50	50
Cigarette smuggling in freight consignments	n/a	n/a	700	1400
All forms of tobacco smuggling	-	-	1700	2500

Notes: The figures have been independently rounded to the nearest £5 million. Components may not therefore sum to the total shown. Figures for freight smuggling and the overall assessment are rounded to the nearest £100 million. Intelligence sources suggest that hand-rolling tobacco smuggling by air passengers and diversion fraud of tobacco products are both negligible. Freight smuggling is calculated as the residual after other forms of revenue loss have been subtracted from the overall assessment. Customs have only published tobacco smuggling assessments for 1998 and 1999. Estimates for cross-Channel smuggling were first published in 1996.

18 Data on levels of smoking are notoriously unreliable, but up to the point when cigarette smuggling began to appear in the UK market (in the mid 1990s), tobacco consumption was on a downwards trend. Since then the decline may have levelled off, as shown in Chart 1. Although there is no direct evidence that smuggling is responsible for the levelling off in consumption trends in the last few years, it seems likely that the availability of large quantities of cheap cigarettes on the illicit market could lead to an increase in consumption. And there is the added concern that the distribution of illicit cigarettes through unregulated sources could result in an increase in smoking among the young.



19 Alongside the impact of smuggling on health and revenue, there are other undesirable effects. These include the law and order, and social problems arising from the concentration of large groups of criminals in certain areas, particularly Dover and East Kent. And it has resulted in a decreasing respect for the law, as the numbers of people involved in the buying and selling of smuggled goods has risen to many thousands, possibly millions. In addition, large scale tobacco smuggling has the potential to create the building blocks for organised

crime networks run along business lines in a way rarely seen before in the UK, and to finance other serious criminal activity.

Estimating the level of smuggling

Cigarettes

The cigarette smuggling assessment is based on analysis of consumption and duty clearance data. The basic method is to estimate total consumption from survey data and legal consumption from the tax data. Smuggling is then estimated as the difference between the two.

The consumption series is based on data from two separate Office for National Statistics (ONS) surveys; the General Household Survey (GHS) and the Omnibus survey. The GHS has asked questions about smoking habits and tobacco consumption of a large sample of adult respondents since 1974, with the most recent available data relating to 1998. GHS data on levels of smoking in the UK are generally accepted as providing the most consistent time series for such data.

More recent data on cigarette smoking prevalence and weekly consumption are also available from the monthly Omnibus survey. Customs have commissioned GHS-style questions in the Omnibus survey to provide estimates for 1999. The Omnibus survey uses the same household sampling strategy as the GHS but with a smaller sample size. The other sources used are Customs' data on UK clearances of tobacco products and UK adult population estimates.

Tobacco consumption is under-reported in all surveys. In Customs' analysis, under-reporting of cigarette consumption has been assumed to be broadly constant. In order to allow for under-reporting in consumption, the consumption data and the UK clearances are indexed against their respective 1992 levels, just before the start of the Single Market. Any shortfall between consumption and clearances that has arisen since 1992 is then a measure of the increase in levels of penetration of the UK market by non-UK duty-paid product. Making an allowance for legal cross-border shopping, this market share is translated into numbers of illicit cigarettes, and then in to revenue losses, on the basis of excise duty and VAT due at typical legitimate UK retail prices. The estimated revenue losses also take into account Customs' assumption that 100 per cent of smuggled tobacco replaces UK purchases.

Hand rolling tobacco

The hand-rolling tobacco smuggling estimate is based on Customs' survey of sea and Tunnel passengers conducted in June each year. Information from the International Passenger Survey is used to gross-up the sample to an annual estimate.

20 Smuggling also damages legitimate business. Sales of legal tobacco are an important source of business for wholesalers and retailers across the country. Small retailers are often particularly dependent on these sales. And sales of cigarettes are often associated with other purchases which smokers make when they buy tobacco.

21 Some have argued that the answer is to cut duty. But this would undermine the nation's health and would in any case probably not eradicate smuggling. A very substantial proportion of the cigarettes smuggled into the UK come from parts of the world where duty is negligible. Bringing UK tobacco duty rates closer to those of other EU states would have little impact on these smugglers. It is worth noting that many EU Member States, including Italy and Spain, with relatively low tobacco taxes suffer significant smuggling, indicating that even low tax rates do not protect against smuggling from countries where duty rates are even lower.

22 In its recent second report on HM Customs & Excise³ the Treasury Select Committee supported this view. It concluded that:

“Although it is not disputed that reducing excise duty rates would stop the notorious ‘white van trade’ in smuggled alcohol and tobacco, it is less clear that this course would affect large scale smuggling, which appears to be the major problem.”

23 It also commented that in terms of setting overall duty rates:

“The Government has a right to set its excise duty rates at the levels it sees fit, within the framework agreed with international partners, and to defend those levels when undermined by criminality. It must take a wide range of factors into account, including health policy objectives and the need to raise revenue, as well as the impact of duty rates on smuggling. Considering all these factors, and accepting that cutting duty rates, especially on tobacco, might help reduce smuggling, we recognise that the Government’s policies on the level of duty rates will rightly be guided by far wider considerations than those concerned exclusively with alcohol and tobacco smuggling.”

The Government agrees with this.

SECTION 5: MARTIN TAYLOR’S STUDY

24 By Budget 1999 it was clear that more needed to be done to tackle the problem of smuggling, and so the Chancellor announced that there would be an independent evaluation of the problem of tobacco smuggling and the measures needed to tackle it.

25 Martin Taylor, now Chairman of W H Smiths, was invited last summer to carry out the independent evaluation announced in the 1999 Budget. With help from Customs and Excise and Treasury officials, he consulted widely with other government departments and the tobacco industry. He reported to the Chancellor in November. His advice was primarily directed towards reducing the profitability of smuggling. He made the following recommendations:

Measures to increase detection

26 One of the key ways to tackle smuggling is to increase detection. To quote Taylor:

“The frequency of detection and seizure of contraband is the principal factor in the war against smuggling. Increasing the rate of seizures is the most effective means of undermining the economics of smuggling ...”

In order to do this he recommended:

- The Government must ensure that sufficient intelligence resources are put at the disposal of Customs & Excise both directly and through the co-operation of other agencies to increase the effectiveness of interception.
- Investment in scanners, fixed installations at major ports and transportable equipment for use elsewhere, so that five to ten times more freight can be inspected.
- A two thirds increase in the number of Customs Officers operating in the tourist lanes at short Channel crossing points.

³ Treasury Committee Second Report ‘Customs and Excise’ 15 February 2000.

- More excise officers to be deployed inland.
- In total, an increase in the order of 1000 Customs staff and additional capital expenditure of around £45 million on scanners.

Measures to increase the risk or reduce the reward of smuggling

27 Martin Taylor also stressed the importance of increasing the penalties of people caught smuggling:

"This category consists of measures which either increase the penalties of smuggling or are apt to make distribution more difficult and may thus reduce the achieved profit. I recommend that all possible steps be taken to seize and confiscate the assets of criminals, both under existing criminal and planned civil forfeiture rules."

The specific recommendations were:

- All possible steps be taken to seize the assets of criminals both under existing criminal and planned civil forfeiture rules.
- Major and persistent smugglers to face custodial sentences.
- For small scale smugglers, Customs will concentrate on seizing assets.
- Toughening of vehicle seizure and terms on which any restoration is offered.
- A more bracing penalty regime applied to licensees of pubs and clubs whose premises are used for dealing in contraband.
- Introduction of prominent fiscal marks.

Measures to act on public opinion

28 As Taylor noted:

"We need to inform the public about how the law stands, and we need to persuade them to comply with it."

Therefore he suggested:

- Printed notices on tickets sold in the UK and displays on board ferries and terminal shops to explain the legal position on tobacco importation and the penalties for smuggling.
- Advertising to explain the serious criminal nature of smuggling and the consequences of being caught engaged in this illegal trade.

SECTION 6: THE GOVERNMENT'S RESPONSE: A NEW STRATEGY

29 Building on Martin Taylor's work, the Government has now developed a new strategy which aims to put smuggling into decline within three years. The Government's policy is aimed at increasing the chance of being caught, and increasing the penalties when smugglers are caught. This should stop smuggling being profitable.

30 The strategy is underpinned by research into the profitability of tobacco smuggling. This suggests that if Customs could raise its current interception rates three or four fold,

profitability would be so reduced that existing smugglers would be deterred from continuing. Such a large increase in Customs' interception rate indicates the extent of the step change necessary to tackle this problem.

31 The main points of the strategy are a focus on:

- Disruption all along the supply chain involving a step change in interception rates and a severe seizure policy;
- Improved intelligence to optimise interception rates and target major inland distribution;
- Investigation geared to maximum disruption of supplies at import and key distribution points;
- Extra resources both human and technological (x-ray scanners) to enhance the vigour and scope of the enforcement effort and achieve the step change in interception rates necessary to make tobacco smuggling an economically unattractive proposition;
- Targeted measures to apply effective sanctions to those caught involved in inland distribution with a particular emphasis on preventing illicit supplies seeping into the ordinary retail market, thus keeping up the economic pressure on the smugglers' distribution processes;
- Increased emphasis on asset confiscation to remove the economic rewards of smuggling;
- Financial investigation will be an integral part of all large scale smuggling/distribution cases to ensure assets are identified and Confiscation Orders obtained;
- Better use will be made of civil recovery and related economic penalties where retailers are caught making illicit supplies; and
- Enhanced working with other UK agencies both domestically and abroad, notably the intelligence agencies, the police, the Inland Revenue and the Benefits Agency.

Targeted Measures

32 A number of the measures recommended by Martin Taylor and contained within the operational tobacco strategy were announced in the Pre-Budget Report. They were

- Purchase of a national network of x-ray scanners to detect high volume cigarette smuggling in freight;
- Compulsory marking of UK duty-paid tobacco products to make identification of smuggled tobacco easier. These markings will be introduced from early 2001 (see Annex A for further details);
- New offences and penalties for those caught handling or selling unmarked tobacco products; and
- A tougher penalty regime for owners of premises where smuggled goods are sold.

33 Action is well underway to implement these measures announced in the PBR. Indeed, from September 1999 Customs had begun to reprioritise resources to put in additional effort

to disrupt tobacco smuggling by means of blitz exercises at both the frontier and inland and through a parallel investigative attack. There has already been a substantial increase in seizures. For the financial year 1999–00 they are likely to be in the order of 1.6 billion cigarettes compared to 560 million in the previous year. This shows that the trend can be reversed and tobacco smuggling put into decline over the next three years if sufficient additional effort is input and sustained.

34 Now that the Government is able to assess the fiscal position in the Budget it has been able to address the question of resources for Customs. The Government is committing up to £209 million over the next three years for extra staff and technological resources for Customs. Over the course of the next 3 years there will be additional funding for more x-ray scanners to complete the national network and there will be funding for up to 950 extra Customs staff devoted to combating tobacco smuggling.

35 This extra funding will consist of:

- up to 520 additional staff to work with the new x-ray scanners to increase anti-smuggling activity at the high risk border and inland locations. Of these staff, 170 will be dedicated to combating smuggling in the tourist lanes and therefore addressing the Channel Ports law and order bootlegging problem.
- 95 extra staff for intelligence work, including posting more Fiscal Liaison Officers overseas and providing the intelligence to target the new x-ray scanners to maximum effect.
- To break up the large scale organised smuggling gangs, and to give greater emphasis to removing the financial rewards of smuggling, up to 310 more investigative staff in the National Investigation Service to be located at offices around the country.
- An extra 30 staff in the Solicitor's Office to handle the inevitable rise in criminal proceedings, particularly the large commercial fraud cases.

36 At this stage these numbers are indicative. Precise numbers will be decided in the 2000 Spending Review in the light of other reviews of wider co-operation issues between law enforcement agencies. There will be some flexibility in the deployment of additional staff within Customs in order to ensure resources remain targeted against the areas of greatest tobacco smuggling risk.

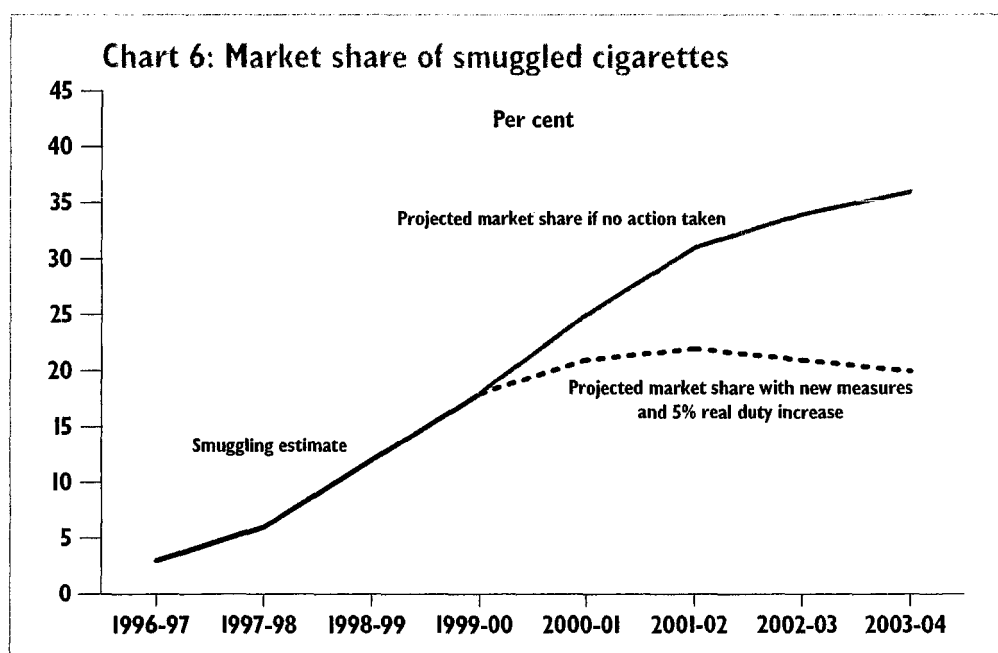
37 However, the Government has decided that it would not be wise to delay launching the assault on tobacco smuggling. It will be easier to tackle the problem now, rather than trying to reduce it once it has an even greater grip. An immediate start is therefore being made by allocating Customs an additional £30 million each year from 2000-01 to allow Customs to deploy the first tranche of new staff described above (around 300 extra staff) on counter-smuggling activities. This will also finance a substantial new publicity campaign and cover the additional costs of a robust vehicle seizure policy. Customs are also in discussion with the travel industry to draw attention to the increased penalties if people are caught smuggling.

Effects of measures

38 As explained above, cigarette smuggling has increased rapidly from a negligible level in 1993 to nearly one in five cigarettes smoked this year. Without new action on the Government's part, this could rise to more than one in three within the next five years.

39 The aim of the measures is to slow the growth of smuggling in the next financial year, and to put smuggling into decline in the third year.

40 Customs expect to raise the number of cigarettes they seize to over 2 billion in 2000–01, 3.5 billion in 2001–02 and to 5 billion in 2002–3. At the same time they will seek to curb the law and order problems associated with cross-Channel smuggling by means of a concerted attack on the relevant crossing points. They aim to reduce the revenue loss from such smuggling by 10 per cent a year. At the same time through their enhanced investigative effort, Customs plan to break or disrupt at least 50 tobacco smuggling gangs next year, 55 the year thereafter and 75 in 2002–3. For the first time Customs will also introduce financial targets against tobacco smuggling involving asset seizures (benefit determined by the courts) of £15 million, £16.5 million and £18 million over the next three financial years. The chart shows Customs' best assessment of the likely growth in market share accounted for by smuggled cigarettes, with and without the additional enforcement effort described in this paper.

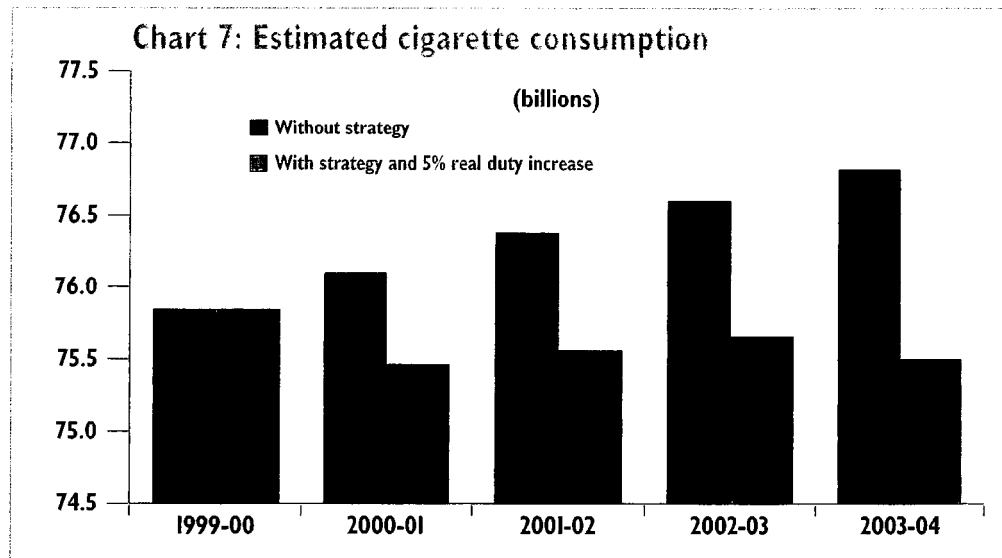


41 It is estimated that the direct effects will yield £2¹/₄ billion over the next three years from higher tobacco duty revenue and consequential VAT.⁴ Including the indirect effects will bring the revenue raised to over £3 billion extra revenue.

42 As noted in paragraph 14, there are two ways of increasing the effective or overall price of cigarettes in present circumstances, raising taxes and reducing smuggling. For the year ahead, the Government has decided to operate through both channels. Duty on cigarettes is being increased in the Budget by 5 per cent in real terms. As a result of the measures outlined in this paper, smuggling will be lower than it would otherwise have been over the coming year. Taking the proposed level of duty and projected levels of smuggling together, the overall or effective price of cigarettes is expected to be at least 2.5 per cent higher in real terms in 2000–01 than in 1999–00. Compared with what they would otherwise have been, the overall price will be at least 4.5 per cent higher in real terms next year. The strategy and increase in duty will also lead to lower cigarette consumption.

43 There is a strong on-going health case for year-on-year real terms increases in the price of cigarettes and tobacco. And the Chancellor will continue to form his Budget judgement on the appropriate level and timing of duty increases taking into account a wide range of factors, including the Government's health objective.

⁴ This assumes that the extra seizures and other reductions in the supply of illegal cigarettes made as a result of the increased anti-smuggling effort are replaced by legitimate supplies at higher duty paid prices. This has the effect of reducing total consumption but raising legitimate consumption over what would otherwise have occurred.



Monitoring progress

44 It will be important to monitor the progress that is being made with the new strategy. The key measure will be the extent to which market penetration of illicit tobacco starts to decline in order to meet the targets set over three years of slowing the growth, stabilising and reducing the level of smuggling. The aim is that the share of the market accounted for by smuggled cigarettes will be at, or below the levels in Table 2. The levels for 2000-01 to 2003-04 will be incorporated into a new PSA target for Customs

Table 2: Maximum level of smuggling

%	1999-00	2000-01	2001-02	2002-03	2003-04 ¹
Smuggled share	18	21	22	21	20

¹As the anti-smuggling strategy covers the three years to 2002-03, while the new PSA targets will extend to 2003-04, this figure is indicative at this stage and subject to review.

45 In addition important data sources for tracking how successful the strategy is include:

- A key part of reducing the profitability of smuggling will be increasing seizures. Monitoring these figures and how they compare with smuggling trends will be a key element of knowing if the strategy is working.
- Other enforcement measures such as the number of vehicles seized, the number of organisations broken up and the range of financial assets confiscated will be important indicators of the extent to which the strategy is increasing the penalties of being caught.
- Total consumption of tobacco, legal sales of tobacco and revenue receipts will be important in tracking the total size of the market. This will be necessary to estimate the percentage of the market that is smuggled and whether the Government is set to achieve its health objectives.
- Monitoring street prices of key brands will shed light on the extent to which smugglers are responding to the greater risk of being caught. It will also enable the Government to monitor the average price of cigarettes which will be important in understanding what is happening to total trends.

46 Customs will report progress against all of these categories on a regular basis to Treasury Ministers. This will enable the Government to ensure that it is going to meet its objectives and so assess whether further action needs to be taken.

Long-term aim

47 The Government has announced a fully worked-up and costed operational strategy for the next three years. On the back of this strategy, it fully expects to put smuggling into decline within three years. Given the strong upward trend in smuggling, this would be a considerable achievement. It would involve reducing the market share of smuggling by over a third by 2002–03 compared with taking no action.

48 But this would still leave around one in five cigarettes smoked being smuggled. This is clearly not acceptable. The longer term aim is to do better than this and to get the share of smuggled cigarettes down below current levels. The Government will review what more, if anything, needs to be done to achieve the long-term aim once it has some experience of how the three year strategy is working.

SECTION 8: TREATMENT IN PUBLIC FINANCE PROJECTIONS AND NAO AUDIT

49 The Government's policy is to adopt deliberately cautious assumptions when making projections of public finances. Accordingly it invited the NAO to comment on the treatment of the anti-smuggling measures in the Budget projections.

50 The NAO's conclusion is:

"The Department has estimated the total yield for all the above measures at £2.3 billion over the three years 2000–01 to 2002–03. They have sought only to include revenue within the fiscal projections that can be projected with some certainty. On these grounds, several of the measures have been omitted from the projections. For the remainder, only the effect of increased seizures has been counted in most cases. The exception is for fiscal marks, a new measure where the balance between seizures and deterrence is uncertain, but where the deterrent effect should be more direct than for the other measures.

The nature of the assumptions made inevitably means that there will be some uncertainty both in the levels of productivity achieved and in the levels of seizures made, especially as some of the measures have not been used in this context before. Nevertheless, within the limitations of the methods used, the approach adopted is reasonably cautious in discounting a number of possible but uncertain impacts of the measures."

The NAO's report on tobacco smuggling is reprinted in full in Annex B.

51 While it is appropriate to be cautious when making fiscal projections, and assessing the fiscal stance, the Government believes that the more uncertain effects should be given some weight when deciding appropriate level of resources and setting PSA targets for Customs. Table 3 gives both the estimates of additional revenue yield included in the forecast, and reviewed by the NAO, and the more uncertain yield from other effects allowed for in the PSA targets. The additional yield over the next three years allowed for in the forecast is £2.3 billion and the potential total additional yield over the same period exceeds £3 billion.

Table 3: Estimated revenue yield¹ from anti-smuggling policy

£ million	2000-01	2001-02	2002-03	2003-04 ²
Effects in forecast	315	825	1170	1195
Other effects	120	295	460	820
Total	435	1120	1630	2015

¹ tobacco duty plus associated VAT

² figures for 2003-04 are indicative and are not discussed in IAD report.

52 The corresponding figures for the market share of smuggling are given in Table 4. The continued rise in the share of smuggling assumed in the forecast is another way of illustrating the deliberately cautious nature of the forecast.

Table 4: Market share of smuggling

Per cent	1999-00	2000-01	2001-02	2002-03	2003-04 ²
With no action	18	25	31	34	36
Assumed in forecast	18	22	24	25	27
Target outcome ¹	18	21	22	21	20

¹ also including "other effects" in Table 3.

² figures for 2003-04 are indicative.

SECTION 9: CONCLUSION

53 The Government is determined to tackle the rising trend in tobacco smuggling because of the threat of lawlessness, the need to protect revenue and above all to meet its health objectives. Having consulted widely, drawn on outside expertise and considered all the alternatives, the Government has taken action to tackle this problem.

54 The Government is implementing a strategy that will take the profit out of smuggling. This should lead to an immediate reduction in the rate of growth of smuggling and put it on a downward trend within three years. The long-term aim is to get it down below current levels. Compared with taking no action, after three years smuggling will be over one third lower than it would otherwise have been. The strategy should yield at least an additional £2¼ billion in tobacco revenue over the next three years and, together with the duty increase in the Budget, reduce cigarette consumption, thereby making an important contribution to meeting the Government's health objectives.

ANNEX A: TOBACCO PACK MARKS

The Government will introduce from April 2001, a scheme of marking cigarettes and hand-rolling tobacco to indicate that they are duty paid. The introduction of the mark will be accompanied by a range of new offences and penalties designed to crack down on sales of illicit tobacco.

The main objective of the scheme is to help prevent, detect and deter the handling, distribution, sale and purchase of smuggled tobacco. The proposal has met with broad support from all sectors of the tobacco industry and from wholesalers and retailers.

Pack marks will contribute to the fight against smuggling and fraud, by helping Customs and Excise Officers (and others such as Trading Standards Officers, the Police and members of the public) to identify smuggled tobacco more readily. The pack mark will take the form of a prominent simple statement "UK DUTY PAID" printed on the cigarette packets and pouches of hand rolling tobacco. The absence of a mark will be a highly visible indication that cigarettes and hand rolling tobacco have not borne excise duty.

To help Customs combat smuggling new offences and penalties will be introduced to combat illicit sales. It will be an offence to possess, transport, sell, or offer for sale or otherwise deal in tobacco products that do not bear a mark. (Exceptions will be made for specific cases permitted under the Customs and Excise Acts, for example movements in duty suspension, products obtained outside the UK, or duty free, by travellers for their own use, and so on.) It will also be an offence to use, or to allow the use of, premises for the sale (by retail or wholesale) of unmarked products. Persons convicted of an offence will be liable to a fine of up to £5,000. Additionally people found guilty of using, or allowing the use of premises for the sale of unmarked product, could be barred from selling tobacco for up to 6 months.

These new offences will deter both individuals and retailers from selling unmarked product and will deter proprietors of establishments such as pubs and clubs and managers of workplaces from allowing sales on their premises. This will help stem the growth in illicit sales of tobacco and deter legitimate outlets from retailing illicit tobacco. The offences, which will be offences of strict liability, will be more easily established because the absence of pack marks will effectively be taken as firm evidence that duty has not been paid. They will therefore enable Customs and the Courts to establish offences and take appropriate action more quickly and cost effectively thereby optimising the use of existing resources dedicated to tackling illicit sales.

Customs' research suggests that in fiscal year 2001-02, their first full year of use, pack marks will protect £220 million of the revenue currently lost to smuggling.

ANNEX B: NAO'S REPORT ON ANTI-TOBACCO SMUGGLING MEASURES

This annex reproduces that part of the National Audit Office's Audit of Assumptions for the March 2000 Budget which relates to anti-tobacco smuggling measures.

Anti-tobacco smuggling measures

The assumption the Chancellor proposes to use is:

For the purposes of projecting the revenue from duties on tobacco, the estimates of additional revenue resulting from the anti-tobacco smuggling measures announced in the November 1999 Pre-Budget Report and the further measures the Government is committed to introducing, are based on the direct effect of these measures, including the deterrent effect of fiscal marks, and exclude their indirect effects.

Report

Anti-tobacco smuggling measures

To combat the growth of tobacco smuggling, measures were announced in the Pre-Budget Report (PBR) (Cm 4479) published in November 1999. These measures were as follows.

- i. Investment in a national network of x-ray scanners to examine between five and ten times as many freight consignments as are currently investigated manually. Mobile, relocatable and fixed scanners will all be procured to combat freight smuggling, which the department believes amounts for some 70-80 per cent of smuggled cigarettes.*
- ii. A scheme for fiscal marks to be introduced from April 2001 to indicate on packs of cigarettes and hand rolling tobacco that duty has been paid. This measure is distinct from the separate possibility of measures to inhibit forestalling rather than smuggling. Forestalling is the practice of building up large stocks of cigarettes ahead of the Budget, and paying duty on the stock just before the changes in duty take effect.*
- iii. New criminal offences will be developed alongside the fiscal marks measure. It will be an offence to possess, transport, sell or offer for sale, or otherwise deal in, tobacco products that do not bear the mark, other than in specified circumstances. And it will be an offence to use or allow the use of premises for the sale of unmarked products.*
- iv. The Department will also confiscate light commercial vehicles used for the smuggling of tobacco products on the first offence and these will not be restored. A similar policy also operates on freight vehicles.*
- v. A new licensing framework including provision for temporary closure of premises and revocation of licences will be introduced.*
- vi. A publicity campaign will be launched which has the aim of publicising the range of measures now being taken and increasing the flow of information from the public.*

A further measure, to be announced shortly, is the deployment of additional staff to work directly on tackling smuggling. This measure is intended to complement those already announced in the Pre-Budget Report.

All of the above measures are intended to reduce the level of smuggling and increase revenue yield. However, HM Customs and Excise have made no allowance for (iv), (v) and (vi) in the fiscal projections because the effects are particularly difficult to quantify. Some allowance for the remaining measures has been made in the fiscal projections, distinguishing between two types of effect:

- additional seizures of smuggled cigarettes; and
- deterrence of smuggling and restricting the growth in the market for smuggled cigarettes.

The additional revenues that have been included in the fiscal projections are as follows:

Table 1: Revenue included in fiscal projections

Revenue (£million) accruing from:	2000-01	2001-02	2002-03
Seizures made by additional staff (Budget)	290	525	675
Seizures resulting from the installation of scanners (Pre-Budget Report)	25	80	230
Seizures resulting from the introduction of fiscal marks (PBR)	0	44	53
Deterrence from the introduction of fiscal marks (PBR)		176	212
Total	315	825	1170

Additional Seizures

For additional staff and the introduction of scanners, the fiscal projections include only the revenue that will accrue from additional seizures. Extra officers are to be deployed over the next three years to implement the department's strategy to tackle smuggling. As well as additional frontier staff, they will include staff for investigative, intelligence and legal work. The Department has estimated the additional seizures that these staff are likely to make using information on current seizures rates. It has also assumed that productivity in terms of cigarette seizures per staff year will increase substantially from current levels as improved intelligence leads to better targeting of higher risk traffic.

In estimating the level of seizures from the introduction of scanners the Department has drawn on the experience of overseas Customs agencies to calculate the increased number of containers and vehicles that it would be able to examine. This increase in efficiency, together with an assumption about the likelihood of an examination leading to a seizure, has led to its estimate of the additional number of seizures that scanners would generate.

Deterrence

The Department has not sought to include the deterrent effects of increased staffing and installation of scanners. Although it has made provisional estimates of these, it does not believe that they can be predicted with sufficient accuracy, and they have therefore been excluded from the fiscal projections.

In seeking to estimate the impact of the introduction of fiscal marks and its associated penalties, the Department has no experience of any recent equivalent measure to draw upon. It has therefore estimated the total impact of this measure, and assumed that 80 per cent of this total will be attributable to deterrence and the remainder to increased seizures. It believes that the increased detectability resulting from the marks, and the new strict liability offences should act as a strong disincentive to handling and stocking smuggled cigarettes, which will impact directly on the propensity to trade in them throughout the supply chain.

Revenue Yield

Having estimated the quantities of smuggled cigarettes prevented, it is necessary to calculate the impact on revenue yield. This will depend on the extent to which the cigarettes are replaced by duty-paid sales. The proportion of cigarettes which are smuggled is estimated to be in the region of 18 per cent, but HM Customs and Excise have assumed that replacement sales for seized cigarettes will all be duty-paid. While not the most restrictive assumption which could be adopted, this broadly reflects the aim of the measures, which is to depress substantially the market share of illicit sales. A much higher proportion of hand rolling tobacco is believed to be smuggled (around 80 per cent) but the product accounts for only 5 per cent of tobacco sales at market prices.

Conclusion

The Department has estimated the total additional yield for all the above measures at £2.3 billion over the three years 2000–1 to 2002–03. They have sought only to include revenue within the fiscal projections that can be estimated with some certainty. On these grounds, several of the measures have been omitted from the projections. For the remainder, only the effect of increased seizures has been counted in most cases. The exception is for fiscal marks, a new measure where the balance between seizures and deterrence is uncertain, but there the deterrent effect should be more direct than for the other measures.

The nature of the assumptions made inevitably means that there will be some uncertainty regarding both the levels of productivity achieved and the levels of seizures made, especially as some of the measures have not been used in this context before. Nevertheless, within the limitations of the methods used, the approach adopted is reasonably cautious in discounting a number of possible but uncertain impacts of the measures.