

## Summary of Oral Evidence: 13<sup>th</sup> January 2013

### Mr Andy Leggett, Deputy Director, HM Revenue and Customs

#### Presentation

1. I am Andy Leggett, head of alcohol, tobacco and gambling taxes in HM Revenue and Customs. It is my responsibility to devise, design and implement the counter-fraud strategies for both alcohol and tobacco.
2. Tobacco duty is an important source of revenue for the government. It brings in about £9.5 billion a year. The revenues have held up relatively well despite duty rate increases over recent years and we still believe we're not at the revenue maximisation point yet.
3. We in HMRC have a long-established strategy to tackling the illicit tobacco market. By the end of the 1990s the size of the illicit market in cigarettes was 21% and in the absence of any action, was predicted to rise to over 30%. Since the introduction of the first tobacco strategy in 2000, we've seen a continued and steady reduction in the size of the illicit market in cigarettes and the latest measure for 2010/11 indicates an illicit market of 9% which is the lowest measure we've recorded. There's been a similar steady decline in the illicit HRT market, to 38%. We rank our compliance risks in the department every year and tobacco remains our top compliance priority.
4. Around 2000, the illicit cigarette market would have been predominantly genuine product made by the multinational manufacturers which would have been smuggled in to the UK, duty unpaid. By 2002/3, it was already beginning to change where a large proportion in this market was taken by counterfeit. By 2011/12, you can see genuine product, and by that we mean, product made by the multinationals, is down to 3%. What we are now seeing is the growth of cheap whites. These are products made by independent manufacturers in eastern Europe and elsewhere.
5. Similarly, in hand rolling tobacco, at the start it would have been primarily genuine product made by the multinationals. Now, we are again seeing significant amounts of counterfeit and a growth in the equivalent of illicit white hand-rolling tobacco. Hand-rolling tobacco tends to be smuggled in small consignments, by road, a lot of it by air, and by post.
6. Our best estimate of lost duty and VAT from the illicit tobacco trade is around £2.5 billion.
7. Those involved in the illicit trade are often "top end" criminals. They're highly organised, very sophisticated, and highly responsive to controls we put in place. They don't have to comply with health and safety regulations, they are very fleet of foot, very responsive, and very directed.
8. The brand loyalties that have been built up over many years are disappearing fast. And that is allowing cheap whites to gain traction in the market. If a packet of cigarettes is available and cheaper and looks reasonable, people will buy it.

9. A picture of the duty differentials across the EU shows generally an east to west trend. The further west and north you get, the higher the taxes. And the further east and south you get, the lower the taxes. In some respects, the geography helps us, much illicit tobacco comes from the eastern border of the EU, and is consumed in Poland and Germany etc. But there is still a lot heading our way.
10. With hand-rolling tobacco, much of it is genuine product from the multinationals which is in the continent, and brought into the UK to exploit the duty differential. Interestingly, we are now seeing the equivalent of illicit white hand-rolling tobacco.
11. The licit tobacco market has changed significantly in the last ten years, particularly with the creation of economy brands. It's much more fluid than previously, brand loyalties have gone, and the differentials between illicit product and genuine product are changing. That affects the illicit market. There are now even counterfeited brands of illicit whites. So where you've got an illicit white brand recognised as a brand in itself, you're getting copies of the illicit whites. That shows how innovative the illicit market is, it is constantly changing and that makes it difficult to counter.
12. The exchange rate of sterling relative to the euro is also stronger than it's been for some time, which means the purchasing power of the UK consumer is greater than previously, and that means greater profits for particularly hand-rolling tobacco, when it is genuine product smuggled into the UK from other EU countries. So, a strong exchange rate is bad news for us, put simply. The general point I would make is just that general economic conditions affect the situation.
13. We also have policy initiatives, such as the retail display ban and potentially plain packaging. And we now have an Illicit Trade Protocol. So there are a lot of external factors that influence, positively or negatively, how the illicit market might move going forward.
14. Counterfeit cigarettes are still a major problem, and a sizeable proportion of the large seizures we get. China remains a major source of counterfeit tobacco brands, often very cheap and of very poor quality. Because it's cheap, it's attractive to those who are most susceptible to price. We are also seeing more seizures of "loose tobacco" in the UK, suggesting that we're witnessing a growth in illicit manufacture in the UK.
15. Our latest strategy, published in 2011 was titled "Building on our Success". So this was not a radical departure. We have some tried and trusted methods to deliver success and what we have tried to do is build on the key elements of the previous strategies that have been successful.
16. Our strategy seeks to achieve three main aims. First, to disrupt the organised criminal gangs behind the fraud. So we have provided additional funding to increase the capability of our criminal investigation resource by 20%. Secondly it is a strategic objective to seize illicit products: the more illicit products we seize, the more uneconomic the fraud becomes. We have seen greater success the more upstream we go to intercept illicit consignments, rather than wait until they reach the border or inland. 2010/11 was the first time we began to seize more illicit product targeted at the UK abroad than we did in the UK itself. We do that through our network of liaison officers throughout the world; they work with host agencies to share intelligence and assist them to intercept consignments that are bound for the UK. We invested a

further £10 million to increase the size of our network, which now covers more than 73 countries, worldwide. The expectation is that we will seize 20% more product than we did previously, through this expansion. Third, we are developing our supply chain control work in relation to hand-rolling tobacco. A large part of the problem remains genuine product, so much of the strategy is about squeezing the multinational manufacturers to tighten the supply chain of hand-rolling tobacco specifically.

17. The new government has provided some £27 million of additional investment for the strategy and £12 million of that went to criminal investigation providing almost 100 extra officers dedicated to tobacco fraud. A further £3.5 million went to additional intelligence resources for those extra officers. £10 million went to increase the liaison officer network, and a further £1.5 million to intelligence resources to support that expansion.
18. The government expects a big return for this investment. We measure the return on our activities as “revenue loss prevented”. The additional investment is expected to deliver an additional revenue loss prevention of £480 million a year.
19. We work closely with colleagues in other countries, and with the EU anti fraud office OLAF. Internally, we work with all the relevant agencies in the UK, for example the UK Border Agency, and trading standards officers, who work at a local level and with whom we have an intelligence sharing protocol. We were a founder member of the North of England programme which did ground breaking work in terms of working across agencies. Coordination is the key to be effective, but it does come at a price and it doesn't come easily.
20. We have a Memorandum of Understanding with the four major manufacturers in the UK, and we also have the EU legal agreements. We also have an anti-illicit trade working group working with manufacturers and others, and which I co-chair. We are quite open about what we do and don't do with manufacturers. Where we have a mutual interest, we do work closely with them, particularly around intelligence sharing on counterfeit product and illicit white product. They also have a distribution network which we would like to tap into to get some of the messages we would like to get across around the dangers of illicit trade. We have a more confrontational arrangement around supply chain controls, which is probably what you'd expect. So we do nuance our relationship with the manufacturers depending on the nature of the conversation.
21. On the Illicit Trade Protocol, the UK has been a strong supporter of the Protocol as has the EU. Most of the mandatory provisions of the Protocol are already implemented in the UK. Some of the discretionary elements around retailers and wholesalers, for example licensing, we will be reviewing as we go forward. The most important provisions are the tracking and tracing article, and the supply chain control elements. We need them to bite in the countries where the illicit whites are being manufactured and transported.
22. The interconnectivity of the gangs involved in illicit trade is startling. They collaborate, they innovate and they sub-contract. I often say that if they put their energy and innovation to legitimate businesses they would be the Richard Bransons of the next decade.

23. When we get to single digit tax gap figures, essentially we've driven out those discretionary players in the illicit market, in terms of those who buy cigarettes, and we're down to the hard core recidivists. In my opinion, we are more likely to make long-term sustainable progress in cutting the demand for illicit products through appropriate health messages and social messages.
24. There is a desire from government and decision-makers to see action locally, at the retail level. We also get pressure from the retailers to be visible locally. We are engaged in localised activity but it is resource intensive, and in terms of overall impact on the illicit trade, it's our worst return. What we really want to do is inflict lasting damage to the distribution network in the UK. Not just take out the odd shop or here or there but gain intelligence on networks from the border to retail outlets. Demand is driven substantially by the availability of product. If there isn't secure and routine availability, then we begin to affect demand.

### Summary of Questions and Answers

25. **Q:** Can I ask you about the estimated tax loss from illicit trade per year? **A:** For 2010/11 it was £1.9 billion for cigarettes and hand-rolling tobacco, cigarettes accounted for £1.2 billion and hand-rolling tobacco just over £600 million, which is the largest proportion it's been of the overall problem since we began measuring it.
26. **Q:** What is the most recent figure for the tax value of goods that you've seized? **A:** Our criminal investigations alone this year, to date, have saved tax revenue of about £330 million, compared with figures for the same period last year of around £120 million.
27. **Q:** How would you assess the strength of the cooperation between all the different agencies involved? **A:** Border Force are an integral part of the enforcement work with HMRC. While we are two separate agencies, we effectively act as one, in terms of tobacco and alcohol fraud, to the extent that the Chancellor writes a remit letter direct to the Head of Border Force and we have a delivery agreement where we set out, annually each year, what we expect Border Force to do and how we expect them to work with us. Every month, I chair a strategy group with all the key players in HMRC and Border Force. Trading standards raises different issues, since trading standards officers are based in local councils and their work depends on local priorities. Where tobacco control is a priority and we have a good local link, it works well. We have an intelligence sharing protocol which sets out how the two agencies can work together. Where we do "blitz" type work, when we want to go to an area as we did in East Anglia this year, we will do the planning with trading standards and local agencies including police. But it is inconsistent, and not a national approach, because they are local agencies. Improvements could be made.
28. **Q:** What should a member of the public do if he or she sees illicit trade taking place, in a pub or a boot fair or the like? **A:** Ring the Customs hotline.
29. **Q:** In relation to the import of chewing tobacco, which is popular in certain communities, what is your approach? This is an issue of concern, for example, I have met with the Bangladeshi Association in east London who are very concerned. They showed me tins of chewing tobacco with no health warnings at all, being sold openly in markets and elsewhere. So there's obviously an enforcement issue there. There is

also the issue of sheesha smoking as well, one academic I have discussed the issue with estimates that up to 95% of sheesha tobacco is illegal. A: we are aware of this risk but in the overall scale of things, it's a relatively small problem, compared for example to the scale of sales of illicit whites. We have put some intelligence effort to understand the nature and scale of the niche product problem and what we could do to tackle it.

30. **Q:** You said the government had put extra resources into your work. Do you have any view on the resources that are available to other agencies that you work with? When I met with trading standards in Bristol, I saw the handheld devices that officers use when they go to car boot sales or wherever and scan packs of cigarettes to find if the covert marking is there or not. I was surprised that trading standards don't seem to have enough of them, in fact, they borrowed from each other, in between local authorities. **A:** In terms of resources, both staff and kit, tobacco work is well resourced in HMRC. As far as trading standards is concerned, I think it's an inconsistent picture at best. There are areas where they are well-resourced and well-prioritised and well-motivated, and there are areas where that is just not the case and action depends on the energy of the individuals, with all due respect.
31. **Q:** How closely do you work with the tobacco manufacturers that operate from the UK? **A:** Where we have a mutual interest, in tackling illicit whites, we work very closely with them. But we have strict rules about what information we could share with anybody else, let alone those working in the tobacco industry. The big manufacturers can be a good source of intelligence, because they have people on the ground locally, often in source countries that would not welcome a local UK intelligence officer. So, where there's a mutual interest, we work very closely, as you might expect because there's something in it for them. We understand that is the nature of the relationship, so in other areas where there is not necessarily a mutual interest, particularly in the supply chain control, we do work much more formally and there are robust conversations between us and the manufacturers all the time.
32. **Q:** How impressed are you with tracking tracing systems already in place in the tobacco industry, and the technology that is available, but not necessarily in use in the tobacco market? **A:** I wouldn't assume or give any kind of assurance that systems proposed by the manufacturers will satisfy what we expect in terms of tracking and tracing. With our EU colleagues, and after the Protocol is ratified, we will look at the tracking and tracing arrangements with the manufacturers and what they have planned. We will come to a view, I hope together with our EU colleagues.
33. **Q:** The Protocol states that Parties should ensure that its competent authorities should interact with the industry only to the extent strictly necessary to be effective in fighting illicit trade. Could you clarify that in your work you meet the requirements of Article 5.3 of the Framework Convention and the Protocol to come? **A:** I am confident that we do meet those expectations in our dealings with the tobacco industry. We have to work with the tobacco industry and meet with them to discuss illicit trade, since they are a key stakeholder and have vital intelligence. We do publish that we've met. We are not cosyng up to the manufacturers, but we do have necessary dealings with them. There are areas where they can be helpful to us, even in some areas where they probably wish we would go away.