

CHANCELLOR OF THE EXCHEQUER

You asked me to look into the question of what should be done to reduce tobacco smuggling, working within the framework of the Government's present policy of escalating excise duties. Over the last three months I have studied this issue with colleagues from Customs & Excise and the Treasury. We have consulted widely with other government departments and agencies, with tobacco manufacturers and distributors and with lobby groups. We have studied the experience of other countries in addressing this question. We have held a seminar to explore the subject of inter-departmental co-ordination, and spent time with Customs staff in the field, both at the ports and inland.

In this letter I shall make some general observations on smuggling and then outline my recommendations. In broad terms these are that, with the current level of duty, the Government needs to:

- enhance its enforcement effort significantly;
- introduce other measures to make things more difficult for smugglers, thereby hitting their profits; and
- put more effort into explaining the law to the public and then convincing them to comply with it.

It needs to be said at the outset that diagnosis and prescription are made more difficult by the inadequacy of statistics, unsurprising given the extent of illicit activity. Thus estimates of the present market share held by smuggled goods vary quite considerably, and it is even unclear whether UK tobacco

consumption as a whole is continuing its trend decline or has started to rise again.

My own suspicions tend to the pessimistic side. Government departments have tended in the past to underestimate smuggling - the level of which only becomes clear with the passage of time. To underestimate smuggling is to underestimate consumption. The Department of Health is concerned about signs of rising consumption among the young; this chimes in all too well with my own views.

Whichever estimate you take, there is no doubt that the current level of smuggling, of both cigarettes and hand-rolling tobacco, represents a serious nuisance. It is causing difficulties in at least six ways.

1. Government revenues from tobacco are declining rapidly and are set to decline further if nothing is done. At an annualised rate, revenue losses may now be running at nearly £3 billion, and the trend rise in smuggled cigarette penetration appears to be tracking the discouraging precedent of hand-rolling tobacco. (The HRT experience is significant not only as a forerunner of cigarette smuggling but because of its role in creating a distribution network for contraband goods).
2. The Government's health objectives are being undermined by the widespread availability of cheap smuggled goods. HRT consumption has increased a great deal (some three quarters of HRT is now contraband) and it is important to add back the cigarette equivalent of this product to one's estimate of cigarette volumes in considering overall consumption. The policy of

raising duty and thus cigarette prices to attack smoking will not work if contraband product, with a street price some 40% below legitimate retail prices, is present in such quantities as to drive average prices down.

3. Criminal organisations are making very large amounts of money out of this activity, which can hardly be desirable.
4. Very large numbers of people - counted respectively in tens of thousands and millions - are engaged in handling and purchasing illegal product. Many are not clear what the law is; it is widely flouted and enjoys little respect. Worrying as the revenue and health implications are, this decreasing respect for the law seems to me possibly the most serious consequence of the high level of smuggling.
5. Legitimate traders are losing business, especially corner shops for which cigarettes are an important product. There is some evidence that the growth in alcohol smuggling has pushed some traders to take up smuggling themselves in order to remain competitive.
6. Tobacco smuggling has brought together a large concentration of criminals in some locations, particularly Dover and East Kent, with unpleasant social side-effects. Customs officers, by nature and training quite robust individuals, are subject to abuse and violence from increasingly insolent criminals, who no longer fear them.

The principal cause of the smuggling, of course, is the high level of duty in the UK, which not only has the world's most expensive cigarettes apart from Norway but is raising their price rapidly. That said, tobacco smuggling is rife throughout Western Europe, and there are other contributory factors. The introduction of the single market in 1993 has made frontier checks more difficult, both operationally and legally. Rising volumes of trade and movements of people, stimulated further by the opening of the Channel Tunnel, make concealment easier and enforcement harder. And cigarette smugglers - certainly when contrasted with drug smugglers - have until recently been treated leniently by the courts.

Looked at as a commercial undertaking, tobacco smuggling offers exceptionally high profits (with margins underpinned by a UK Government price guarantee), moderate chances of detection and modest penalties. Reward is very attractive relative to risk. Measures to counter smuggling must bring about a substantial adverse change in this relationship.

The smugglers fall into three broad categories, worth distinguishing (though there is some overlap) because different remedies apply in the different cases.

1. **Serious criminal organisations.** In general these ship goods in container freight - a single container can hold 8 million cigarettes, but the average load may be nearer half this amount, since smaller quantities are frequently concealed among legitimate goods. The *cigarettes are usually sourced duty-free in the international* wholesale market, that is to say, at about a fifth of their eventual street price. They may be familiar British brands, exotic foreign brands, or counterfeits of the well-known names. The world is

awash with cigarette manufacturing capacity.

2. **Petty criminals - the so-called bootleggers.** It is tempting to neglect this group, since they account for a relatively small proportion of the cigarette revenue losses - maybe only a quarter or a third as much as the freight importers. But they lie at the heart of the law and order issue; they represent a revenue loss (including that on HRT) of several hundred million pounds annually; they keep distribution channels supplied when major freight consignments are intercepted; they break bulk for the serious criminals; they are very active in beer smuggling. Anyone who thinks they are lovable rogues should spend a night on the docks.

3. **The travelling public abusing the indicative personal consumption limits on excise goods.** In terms of lost revenue this group is unimportant. But it's a symptom of the wider disease, since these people - who would surely not consider themselves criminals - employ the same defiant justification of their behaviour as do the final consumers of illicit goods on whom the whole market depends. Sometimes, especially in airborne smuggling, otherwise law-abiding and respectable people are used as 'mules' to carry goods on behalf of criminal gangs.

The main conclusion of our work is that, whilst Customs are tackling the problem in a positive, efficient way, the present enforcement régime is insufficient to collect taxes at the level at which they now stand. If the Government is to sustain the current excise duties, it must act strenuously to

bring enforcement into line. A fortiori, if it wishes to increase duties in line with the escalator it must go further still, since each increase in duty raises the demand for cheap goods and, through its effect on the smugglers' profit margins, their supply. In the absence of escalating enforcement, duty hikes will simply lead to an acceleration of contraband imports.

The smugglers' high margin covers not only routine operating costs, but also their risk of seizure. Suppose that effective disruption requires 30% of smuggled imports to be seized and destroyed. At a yet higher duty rate, the Customs might have to seize 40% of a larger quantity of imports.

I shall group our recommendations under three headings;

- a) Measures to increase detection:
- b) Other measures to raise the risk to the smuggler:
- c) Measures to act on public opinion.

a) Measures to increase detection

The frequency of detection and seizure of contraband is the principal factor in the war against smuggling. Increasing the rate of seizure is the most effective means of undermining the economics of smuggling, but with the present duty premium seizures need to rise to perhaps four times their present level if smugglers are to be deterred.

Britain's island geography gives the ports of entry a crucial (but not exclusive) position for the potential seizure of contraband. It is very important that Customs officers should not be prevented by too delicate an interpretation of European legislation from acting vigorously at the frontier.

The control of smuggling in freight rests heavily on intelligence (in the senses both of information about illicit cargoes and of the recognition of suspicious patterns of movement). The number of incoming containers that can be stopped is drastically limited by constraints of space and time. The Government must ensure that sufficient intelligence resources are put at the disposal of Customs and Excise - both directly and through the co-operation of other agencies¹ - to increase the effectiveness of interception. I also support investment in scanners - fixed installations at the major ports, with some transportable equipment for use elsewhere - which will enable between five and ten times more vehicles to be inspected without disrupting port operations. Additional resources will be necessary to handle the increased interceptions.

To increase seizures among bootleggers we simply need more customs officials. The economics of bootlegging are far less attractive than those of non-duty-paid freight smuggling, so the van criminals are forced onto the shortest and cheapest crossings, which have the additional advantage of being on the direct route from Belgium and Luxembourg.

¹ The interaction of Customs, police, the various intelligence agencies and other interested arms of Government (the Benefits Agency, for example, since many criminals are claiming benefits) is a complex issue in itself on which I am not qualified to comment in detail.

It is perhaps worth saying that failure to align the priorities and objectives of different agencies is likely to breed tension between them and make enforcement less effective. Unlike drugs, tobacco falls overwhelmingly within the Customs ambit, but co-operation with other bodies is nevertheless very important. I support the desire of Customs to make one person responsible for co-ordinating anti-smuggling work in tobacco: fostering smooth working with other agencies should be a specific part of his or her brief.

I recommend that, for the time being at least, the number of customs staff dealing with excise should be increased considerably - by perhaps two-thirds at the South East ports - in order to drive the bootleggers (and some of their suppliers across the Channel) out of business. Eventual manning levels should settle down somewhere between the present level and the peak.

More excise officers should also be deployed inland, where intelligence about distribution networks greatly exceeds the department's physical ability to disrupt them.

Such increases in Customs resources - the department's own initial estimates are that it would require in the order of 1000 additional staff and around £45 million of capital expenditure on scanners - fly in the face of existing plans to cut the department's spending and will lead to a much more intrusive 'policing' role. But they are a necessary corollary of the desire to charge very high duties on tobacco.

b) Other measures to increase the risk or reduce the reward to the smuggler

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. Major or persistent smugglers should of course be prosecuted, and ought to face custodial sentences. But the prosecution of petty criminals is time-consuming and troublesome, and procedures to allow assets (where they have any) to be seized by civil forfeiture seems to me a more

promising route.

Contraband carried in vehicles leaves the vehicle open to seizure as well as the contraband. The vehicle is subject to complex restoration procedures, and appeals may be lodged against the Customs' action; seized vehicles therefore need to be stored for some time. Many bootleggers use either very old vehicles, the seizure of which does not seriously inconvenience them, or rented vehicles, relying on the presumption of third-party innocence to protect the hire company.

There is some debate within Customs and Excise as to the desirability of large-scale vehicle seizures. I believe they are an indispensable weapon for the protection of the duty premium, and urge the Government to increase the fines which permit restoration, even on a first offence and even to rental companies, some of which appear to be deliberately targeting the criminal customer. Confiscated vehicles on which no restoration fine is paid within two weeks should be auctioned off.

A more bracing penalty régime should also be applied inland to the licensees of pubs and clubs whose premises are used for dealing in contraband. Penalties need to be noticeable, but not so onerous that courts will be reluctant to impose them because they appear disproportionate. Shutting pubs or clubs for a week or two at a time would discourage the widespread turning of blind eyes that goes on at the moment.

It may be argued that this will simply drive the illicit trade out into the car park or the street. If that has the affect of making it harder for the criminal, and making it more obvious to the customer that this is an illegal activity, then all

the better.

The introduction of fiscal marks is at an advanced stage of discussion in Government departments. I support the introduction of fiscal marks in preference to tax stamps; I believe they should be more prominent in size than the tobacco manufacturers are likely to welcome; their principal purpose should be the establishment of an offence, the handling of goods without such marks. At this stage the introduction of fiscal marks cannot be justified as a way of keeping control of contraband sales through proper tobacco retailers, since these sales seem to be very limited, unlike the sale of contraband alcohol which largely passes through off-licences. But on present trends smuggled goods will soon be available under-the-counter in many retailers, and it is therefore worth introducing fiscal marks pre-emptively.

c) Measures to act on public opinion

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

Information

The Government should require the legal position on tobacco importation to be explained to travellers by printed notices on tickets sold in the UK and by displays on board ferries or at terminal shops. The public should be told that it is illegal to import excise goods for any commercial use; that Customs will require proof that any goods above the suggested limits are indeed for personal consumption; and that vehicles carrying contraband are liable to seizure. At present some carriers are encouraging confusion in the public mind, and some

are downright unscrupulous. “Buy as much as you like”, or “The good news is, now duty-free’s gone, your personal limits have been abolished”.

Persuasion

The final customers for smuggled tobacco are not well-off, and they are addicts. They believe excise duty on tobacco to be grossly excessive. It is unlikely that appeals to their finer feelings will be successful.

However, there is potentially a role for Government, through the medium of advertising, to demonise the distributors of smuggled goods (by referring to them as ‘pushers’, for example, and explaining that smuggling funds terrorist and other criminal gangs). There is of course a danger that advertising could glamourise the purchase of smuggled goods, or simply draw attention to their availability.

People are more likely to change their behaviour because they are afraid of getting into trouble than because they believe it is morally right to contribute to the government’s finances. (Tobacco duty is an unusual case of a tax which is levied on a minority of adults without regard to their ability to pay.) People need to know that trading in or possession of contraband tobacco is an offence and they need to see that the authorities are treating it as such. Impunity breeds contempt for the law.

Tobacco smuggling has reached a level at which it has become institutionalised, and turning the tide will not be easy. Despite recent increases in resources, for some time now the quantum of enforcement has been falling

steadily further behind the threshold needed to keep smuggling at bay, a threshold which rises with every widening of the UK duty premium. After all, the duty escalator began to be applied just as frontier controls were being dismantled because of the Single Market.

That said, a substantial and immediate increase in the scope and vigour of enforcement stands a good chance of allowing the authorities to re-establish control of the market over a two to three year period.

I should be happy to comment in more detail on any of the recommendations outlined in this letter.

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October 26th 1999

*cc AMG
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Rosanne Culpin*