



30 January 2017

TMA submission to HM Treasury ahead of the 2017 Spring Budget

Introduction

The Tobacco Manufacturers' Association (TMA) is the trade association for the UK tobacco industry. The TMA's members are British American Tobacco UK Ltd., Imperial Tobacco Ltd. and Gallaher Ltd. (a member of the Japan Tobacco Group of companies).

The tobacco market in 2017

2017 will be a year of significant challenges for the tobacco industry:

- a. The continuation of the Tobacco Duty escalator**
- b. Minimum pack sizes and the standardisation of tobacco packaging**
- c. Brexit negotiations**

Some of these will likely fuel the illicit market and further put tobacco duty revenues at risk. However, for example, the post-Brexit introduction of fixed limits, rather than Minimum Indicative Levels (MILs), could provide an opportunity for the Government to reduce the scale of illicit trade.

- a. High tobacco taxation incentivises the illicit market**

The UK's excise duties on tobacco products are very high due to the Government policy of annually raising duties above the rate of inflation – the so-called duty escalator. The effect of this is such that the tax component (excise plus VAT) accounts for more than 90% on some brands¹. The specific duty rate for cigarettes has risen by 65% since 2010², no other consumer product has seen increases in taxation of this magnitude and results in the finding that only 19% of the public consider taxation on tobacco to be too low and 40% believe it is too high³.

¹ TMA calculation

² Ibid

³ Populus 2016

A major effect of high taxation is to create a large illicit market for tobacco products. The Royal United Services Institute have said: “this policy of high taxation has the unintended yet inevitable consequence of generating an illicit market that generates substantial profits for sellers.”⁴

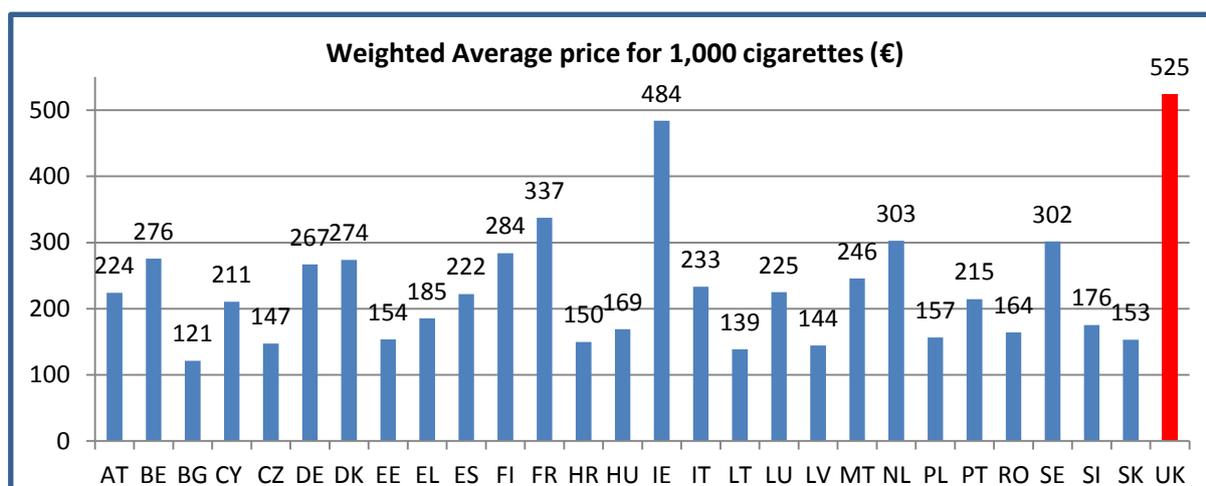
HMRC estimates that illicit trade cost the Treasury £2.4 billion with cross border shopping (including legal duty-free shopping) costing a further £600 million in 2015-16. This is a significant increase on 2014-15 where the total tax gap was £700 million lower.

HMRC central estimates ⁵	2014-15	2015-16
Illicit Cigarettes (£'m)	900	1,600
Illicit Cigarettes (%)	7%	13%
Illicit HRT (£'m)	900	800
Illicit HRT (%)	35%	32%
Total illicit (£)	1,800	2,400
Cross-border Cigarettes (£'m)	400	500
Cross-border Cigarettes (%)	3%	4%
Cross-border HRT (£'m)	100	100
Cross-border HRT (%)	5%	5%
Total cross-border (£)	500	600

The industry undertakes a wide range of programmes to help reduce illicit trade. For example, in 2016 the industry provided over 1,100 pieces of intelligence to UK law enforcement, responded to 1,500 requests for assistance from UK law enforcement and ran campaigns to raise awareness of the consequences of illicit trade⁶.

Comparisons illustrate the uniqueness of the UK’s policies

Due to the Government’s taxation policy, tobacco products in the UK are expensive relative to nearby markets. The average price is significantly higher than all EU countries with only the Republic of Ireland being reasonably close⁷ (see below).



⁴ RUSI, 2014, On Tap, Organised Crime and the Illicit Trade in Tobacco, Alcohol and Pharmaceuticals in the UK

⁵ HMRC, Measuring tax gaps 2016 edition, Tobacco tax gap estimates for 2015-16

⁶ TMA, 2017, Tobacco Tax briefing (forthcoming)

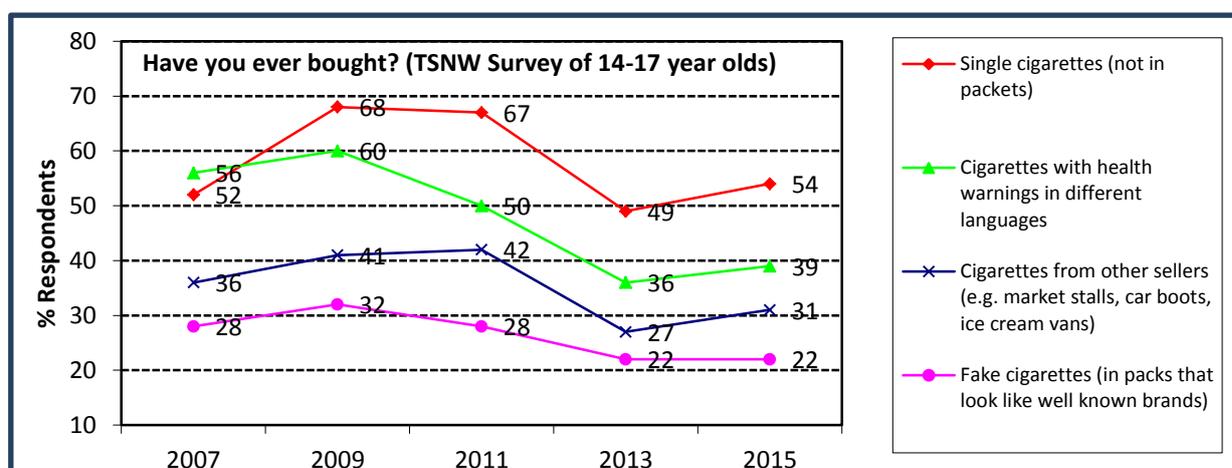
⁷ EUROPEAN COMMISSION, EXCISE DUTY TABLES Part III – Manufactured Tobacco, July 2016

It is worth noting that Germany, with a duty burden of €156.11 per 1,000 against the UK's €353.19 per 1,000, has an illicit cigarette market of just 6%⁸ compared to HMRC's estimate for the UK of 13%

Government tax policy has unintended consequences

As set out in the Government's 'Leaf to Light' report⁹: *"the illicit trade damages legitimate business, undermines public health and facilitates the supply of tobacco to young people. The criminality involved, including the use of the proceeds to fund other crimes, has a devastating effect on individuals and communities across the UK and abroad."*

Higher taxes (and therefore higher prices) are likely to lead to greater access to tobacco for those under the age of 18 through the illicit market. Trading Standards surveys has shown that purchases of illicit tobacco by those 14-17 have risen again¹⁰.



It should also be noted that the industry makes significant contributions towards preventing youth access through the Responsible Tobacco Retailing programme, CitizenCard and No ID No Sale¹¹.

It would be prudent, given the scale of the illicit market to abandon the tobacco duty escalator and undertake a full review of the Government's policy towards tobacco taxation.

b. Minimum pack sizes risk tax revenues

One impact of minimum pack sizes (as required by the revised Tobacco Products Directive) is to constrain the range of prices for which tobacco products can be purchased. For example, instead of cigarettes being available from around £3.50 for a pack of ten, this is likely to double. Packs of 10 cigarettes may well have helped prevent some smokers from entering the illegal market.

The ban on cigarette packs of less than 20 and hand rolling pouches of less than 30gr will be fully implemented by May 2017. The effect of this is to dramatically increase the cost of individual tobacco product purchases and further incentivise the purchase of non-UK duty paid tobacco products leading to tobacco duty revenue loss and a growing tax gap. This could be considerable given that 24% of cigarette

⁸ KPMG, 2016, Project SUN: A study of the illicit cigarette market

⁹ https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/418732/Tackling_illicit_tobacco_-_From_leaf_to_light_2015_.pdf

¹⁰ Trading Standards North West, Young Persons' Alcohol and Tobacco Survey, 2015

¹¹ Further details are available in: TMA, 2016, Global Business Local Focus

consumers and 71% of hand rolling tobacco consumers buy packs smaller than those that will be available post implementation¹².

This measure will also mean that there is revenue loss for small retailers who rely on incidental purchases from tobacco consumers who will now make fewer visits to shops to purchase tobacco. A report by Oxford Economics estimated that the effect of this could be as large as £1.51 billion potentially putting the marginal retailer at risk of going out of business. It could also lead to a tax revenue loss of up to £2.1 billion¹³.

c. Brexit provides the Government with an opportunity to reduce the tax gap

There are several issues for the tobacco industry around the UK's decision to leave the European Union, including an opportunity for the Government to reduce the scale of illicit trade.

Duty revenues may suffer if tariffs were introduced on imported tobacco products as this would lead to price rises and consequentially incentivise illicit trade.

The nature of any transitional period in which the new customs rules are introduced and the nature of the rules themselves could have an impact on the market and the scale of illicit trade.

The introduction of fixed limits, rather than Minimum Indicative Levels (MILs), for personal tobacco imports could cut down the scale of cross-border shopping and lower level smuggling. Indeed, there is scope for some action in advance of Brexit, as demonstrated by Germany which already has such a system from high risk markets.

As there are a number of possible implications of Brexit, the TMA believes the government must engage with the industry to discuss appropriate courses of action.

Conclusion

Given the rapidly changing situation in both the industry and in the UK's wider economy a flexible approach to fiscal and industrial policy is required. The following policies would help achieve this.

- Abandon the tobacco duty escalator to prevent the development of the illicit market
- Commission an independent review of the effectiveness of the Government's tobacco policies
- Engage with the industry to consult on industrial policy process post-Brexit
- Adopt a flexible approach where policies that are failing are replaced or abandoned decisively
- Introduce fixed limits for high risk countries and expand this as part of Brexit.

¹² Oxford Economics, 20161, THE IMPACT OF MINIMUM TOBACCO PACK SIZES ON INCIDENTAL RETAIL SPEND

¹³ Ibid.