tobacco manufacturers' association

Tobacco Manufacturers' Association submission to HM Treasury ahead of the Autumn Budget

22nd September 2017

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).

Policy recommendations

Raising tobacco duty rates at the Autumn Budget would increase the risks of a shortfall in Government revenues and create uncertain futures for the jobs and investment associated with the industry. It would come at a time when very large regulatory and market changes also make the future of tobacco tax revenues uncertain. Wider factors such as exchange rate fluctuations and the UK's decision to leave the EU add further instability to the picture.

In order to best safeguard the tax revenues, jobs and investment delivered by the tobacco industry, the TMA makes the following policy recommendations:

1. The Government should not raise tobacco duty a second time in 2017;
2. The Government should resist the re-introduction of the tobacco duty escalator;
3. The Government should stop using the RPI to uprate tobacco duty;
4. The Government should introduce fixed limits on personal tobacco imports;
5. The Government should not introduce tariffs on tobacco imports when the UK leaves the EU;
6. The Government should undertake a comprehensive review of the fiscal impact of tobacco policy, particularly the introduction of minimum tobacco pack sizes and the tobacco duty escalator.

What the UK tobacco industry delivers

Last year the UK tobacco industry contributed approximately £11.5 billion of tax (£9 billion of tobacco duty and £2.5 billion of VAT) or approximately 2% of all tax revenues; equivalent to that raised by Stamp Duty Land Tax or which would be raised by increasing the basic rate of Income Tax by approximately 2.5 pence[1].

The UK tobacco industry employs almost 5,000 people and supports the employment of tens of thousands of individuals in associated sectors such as haulage, retail and wholesale[2]. The industry also invests tens of millions of pounds in the UK into research and development, particularly into potentially less harmful next generation products[3].

However, the tax gap from tobacco products was £3 billion in 2015-16 with £600 million lost to cross border shopping and £2.4 billion to the illicit trade[4].

How current tobacco tax policy puts revenues at risk

Regulatory changes have put tax revenues at risk

In May 2017, the sell-through period for tobacco packs which didn't conform to the EU's revised Tobacco Products Directive ended. This included a ban on packs of fewer than 20 cigarettes and hand rolling tobacco packs of fewer than 30 grams. The large scale of the change is shown by the prevalence of small packs ahead of the regulatory change. In 2016, 71% of hand rolling and 24% of cigarette smokers bought tobacco that was subsequently banned[5].

Ahead of the ban, the TMA commissioned Oxford Economics to estimate its fiscal impact. They found that tax revenues would fall by £2.1 billion in the first full year of the policy as higher out of pocket expenses increases demand for illicit and cross border tobacco products and lower incidental spend in retailers reduces VAT receipts[6].

Plain packaging became mandatory from May 2017, despite warnings from packaging companies that this would remove distinguishing features from tobacco packs making them "significantly easier to counterfeit"[7]. The production and supply of illicit cigarettes is therefore expected to have become significantly easier since the introduction of standardised packaging. A KPMG study found that after a similar measure was introduced in Australia, the sale of illicit branded cigarettes rose by 154%[8]. Our member companies inform us that counterfeit plain packaged products have been found in the UK.

Concerns regarding the impact of these regulatory changes were reflected in the TMA's annual survey of 12,000 smokers where 45% agreed that recent regulatory changes to tobacco packs made

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[1] TMA, 2017, *Delivering in a year of change*
[2] Ibid.
[3] Ibid.
[4] HMRC, 2016, *Measuring Tax Gaps, Tobacco Tax Gap Estimates 2015-16*
[5] Oxford Economics, 2016, THE IMPACT OF MINIMUM TOBACCO PACK SIZES ON INCIDENTAL RETAIL SPEND AND TAX RECEIPTS
[6] Ibid.
[7] TMA, *Packaging Companies Opposed to 'Plain Packaging' of Tobacco Products*
[8] KPMG, 2013, *Illicit Tobacco in Australia*

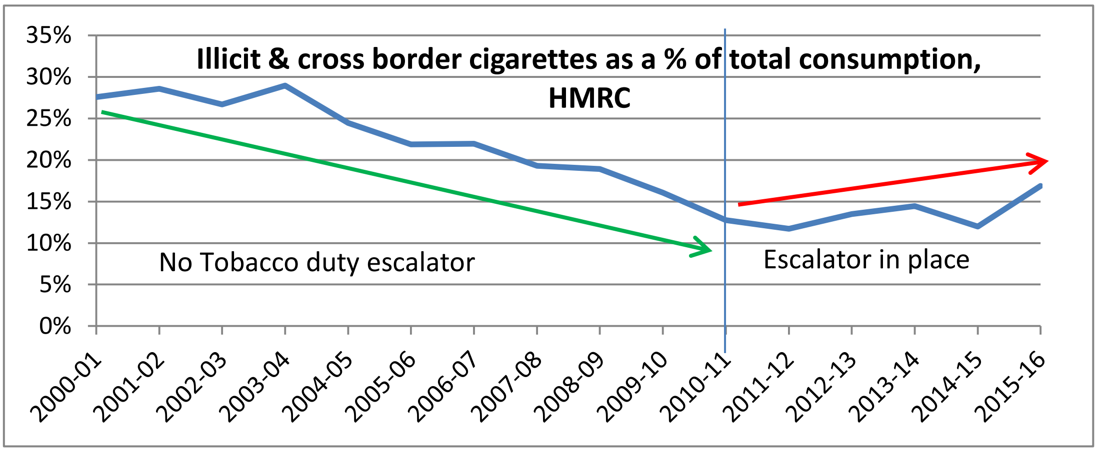
them more likely to purchase tobacco that was not subject to UK taxes[9]. These regulations risk growing the demand for, and easing the supply of, illicit and cross border tobacco products and increasing tobacco duty again would compound this risk.

High taxes increase the risk of illicit trade and cross border shopping

The tobacco duty escalator has increased taxes on the average pack of 20 cigarettes by almost 60%[10] since 2010 including a 5.9% increase at the 2017 Spring Budget. Raising tobacco taxes a second time in 2017 would further strain consumers' budgets and continue to push them to engage in the illicit and cross border tobacco markets where tobacco products are much cheaper[11].

Large, tax driven, UK/EU price differentials allow relatively easy access to such cheaper NUKDP tobacco products. In Euros, only the Republic of Ireland has higher tobacco prices than the UK[12]. However, this has only been the case since the devaluation of Sterling since the referendum on the UK's EU membership and UK prices remain significantly higher than those in all other EU nations.

Prior to the reintroduction of the escalator in 2010, illicit and cross border cigarettes as a proportion of total consumption had been falling. Subsequently, this trend has not continued and has arguably reversed[13]. This is particularly important given that cigarettes make up approximately 85% of tobacco duty revenues[14].



The link between rising tobacco duty and the purchase of non-UK duty paid (NUKDP) tobacco is well understood. The Royal United Services Institute noted that the "policy of high taxation has the unintended yet inevitable consequence of generating an illicit market that generates substantial profits for sellers"[15]. A TMA survey of 12,000 smokers found that 57% agreed (24% disagreed) that

[9] TMA, forthcoming 2017, *TMA Smokers' Anti-Illicit Trade Survey 2017; Attitudes, Awareness and Understanding (Add reference to Mitchla(?) here to show independence?*
[10] HMRC, 22nd August 2017, *Tobacco Bulletin* with TMA calculations
[11] The TMA's 2017 survey of 12,000 smokers found that 49% of UK smokers who have seen illicit cigarettes sold in their local area report that a pack of 20 is sold for less than £4 – approximately half the price of duty-paid equivalents.
[12] https://ec.europa.eu/taxation_customs/sites/taxation/files/resources/documents/taxation/excise_duties/tobacco_products/rates/excise_duties-part_iii_tobacco_en.pdf
[13] HMRC, 2016, *Measuring Tax Gaps, Tobacco Tax Gap Estimates 2015-16*
[14] HMRC, 22nd August 2017, *Tobacco Bulletin* with TMA calculations
[15] RUSI, 2014, *On Tap; Organised Crime and the Illicit Trade in Tobacco, Alcohol and Pharmaceuticals in the UK*

rising prices tempt them to purchase tobacco that has not been subject to UK taxes and that 72.5% of smokers had bought such tobacco in the last year[16].s

To safeguard tobacco tax revenues and to reduce the risk of growing the tax gap the Government should resist raising taxes for a second time in 2017.

Exchange rate changes add uncertainty

Lower GBP/EUR exchange rate is associated with smaller illicit and cross border tobacco markets[17]. If the GBP/EUR exchange rate were to continue to reverse[18] its recent relative weakness in the future, it would incentivise greater cross border and illicit tobacco shopping as the price discrepancy between UK and EU products would grow. Tax increases would exacerbate this and may result in strengthening the incentives associated with the illicit and cross border tobacco markets

Previous tax rises have been artificially large

The inflation measure used to uprate tobacco duty, the Retail Prices Index (RPI), has been found to be methodologically flawed and not an accurate reflection of price changes in the UK. In *UK Consumer Price Statistics: A Review*, Paul Johnson found that "the use of the Carli [average price calculation formula] is inappropriate and that the RPI is upwardly biased because of its use" and "the RPI is not a credible measure of consumer price change"[19]. This view has been reiterated by the ONS[20].

This means that tobacco duty has risen by a greater amount than it would have if a more accurate measure of inflation (such as the Consumer Prices Index) had been used. This, in turn, will have impacted tobacco consumers' budgets and provided an even greater incentive for them to NUKDP tobacco than if a more accurate inflation measure had been applied.

As a consequence of the RPI's methodological flaw, the Johnson review recommended that "Government and regulators should work towards ending the use of the RPI as soon as practicable" and specifically "taxes, benefits and regulated prices should not be linked to the RPI"[21].

Further considerations

High taxes put further pressure on law enforcement

The organised criminality associated with the illicit trade places significant pressures on law enforcement resources, as evidenced by the latest IP Crime Report[22] which shows that illegal

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[16] Ibid.

[17] Czubek & Johal, 2010, Econometric analysis of cigarette consumption in the UK, HMRC working paper number 917 found that that the GBP/Euro exchange rate has a significant impact on the tax gap. They found that a higher exchange rate (i.e. a fall in the value of GBP relative to the Euro) is associated with a reduction in both illicit and cross border markets.

[18] Since 29th August GBPEUR has risen from 1.077 to 1.355 https://uk.finance.yahoo.com/quote/GBPEUR=X/

[19] 2015, Paul Johnson, *UK Consumer Price Statistics: A Review, Summary and Recommendations*

[20] https://www.ons.gov.uk/news/statementsandletters/statementontheredesignationofcpihasanationalstatistic

[21] Ibid.

tobacco is the number one seized product at the UK border, inland it is the most investigated product by Trading Standards. The industry works extremely effectively with law enforcement in tackling illicit trade as highlighted in the report but further tax increases will only undermine this progress.

Tobacco taxation is regressive

Years of above RPI tax increases have put pressure on tobacco consumers' budgets and particularly for those with low incomes as tobacco duty is highly regressive (i.e. tobacco duty costs more as a percentage of income for those with low incomes than those with high incomes). ONS statistics[23] show that, as a percentage of disposable income in 2015-16, tobacco duty cost households in the bottom fifth of the income distribution more than double the amount it cost the average household.

Post-Brexit tariffs would put tax revenues at risk

The majority of tobacco products cleared for sale in the UK will be imported by the time the UK leaves the EU and the TMA hopes the Government will agree a free trade deal with the EU. If this is not the case, the Government should not introduce tariffs on tobacco as this would either increase the price of tobacco products in the UK, which would incentivise the illicit and cross border markets. Or, if compensating measures were taken in the excise regime that offset these tariffs, there would be a significant additional amount of complexity introduced to the system. Additional complexity would likely increase costs to tobacco manufacturers, wholesalers and retailers which would push up tobacco prices risking growth in the demand for illicit tobacco products.

Brexit offers the Government an opportunity to shrink the tax gap

Currently, individuals can purchase unlimited quantities of tobacco from EU countries and bring it back to the UK without paying UK excise taxes providing it is for personal use. Minimum indicative levels (MILs) of personal tobacco imports are a guideline to the relevant enforcement personnel (usually Border Force) that the quantity being brought back may not be intended for personal consumption and should therefore be treated with suspicion (although there is no 'free-pass' for quantities below the levels). MILs are currently 800 cigarettes, 1kg of hand rolling tobacco and other levels for other tobacco products such as cigars and cigarillos.

This is a system that has been abused by some individuals who bring in large quantities of tobacco from EU countries and sell it on without paying relevant duties. Analysis by the Royal United Services Institute has suggested that the little and often 'ant smuggling' approach is on the rise and is a significant contributor to the tax gap[24].

To reduce this smuggling, the Government should introduce fixed limits on personal tobacco imports from 'high risk' countries while we remain in the EU (as Germany has done) and to all EU countries once the UK has left the EU. This would align the rules on personal tobacco imports to the UK from

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[22] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/642324/IP_Crime_Report_2016_-_2017.pdf

[23] ONS, 2017, *The effects of taxes and benefits on household income* with TMA calculations

[24] RUSI analysis in KPMG, 2017, *Project Sun, A study of the illicit cigarette market in the European Union, Norway and Switzerland,* 2016 Results

the EU with those from the rest of the world and it would significantly simplify the work of Border Force and other enforcement agencies.