

An example of the buffer function of FCT from the UK

London Economics' analysis for ESTA

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What has happened to illicit FCT consumption and tax receipts over time?

The UK has suffered from some of the highest levels of illicit trade over the last decade. At the time of the suspension of the tobacco duty escalator (2000-01), approximately **60%**¹ of total consumption of FCT was accounted for by illicit trade, with a further **12%** associated with cross border trade. Reflecting the inflation-only increase of FCT duties over the next decade – and subsequent re-introduction of the tobacco escalator at moderate levels, the level of illicit trade declined to its lowest level of **28%** in 2016-17, with a further **4%** associated with cross border trade.

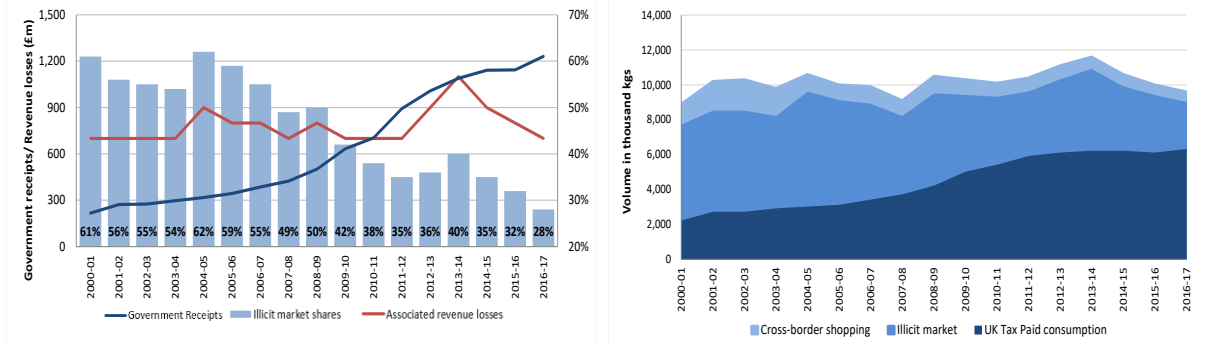
The long-term decline in the level of cross border and illicit trade in FCT, alongside the increase in UK-duty paid consumption has resulted in **significantly increased tobacco taxation receipts** for the UK government (from **£272 million** in 2001-02 to **£1,231 million** in 2016-17). However, despite this decline in illicit trade, it is important to note that the loss in government tax revenues has remained high (at between **£1,100 million** and **£700 million** between 2013-14 and 2016-17). This is driven by the fact that although the *proportion* of illicit trade has generally declined over the period, total FCT consumption has increased leading to only a moderate decline of illicit FCT (in absolute terms).

Total FCT consumption demonstrated a small increase in demand between 2001 and 2016 despite an increase of 174% in the price of duty-paid FCT. However, since 2014, demand has declined by 16%

Clearly, there is a close relationship between the duties levied on tobacco products and the level of cross border and illicit trade. Since the re-introduction of the tobacco duty escalator in the UK, and in particular, the sharp increase in 2012, for the first time in a decade, the level of illicit FCT trade increased again to **40%** in 2013-14 (up from **35%** in 2011-12) (see Figure 24, left hand panel), with a corresponding increase in the FCT tax gap to **£1.1 billion** (up from **£700 million** in 2012-13). With the subsequent reduction in the above-inflation duties imposed as part of the tobacco duty escalator (to 2%), illicit trade declined to **28%** of total FCT consumption in 2016-17, alongside a recovery in taxation receipts to **£1.231 billion** (from **£1.007 billion** in 2012-13), and reduction in the tax gap to **£700 million**.

¹ Note that all estimates presented relate to mid-point estimates contained in HMRC Measuring Tax Gaps official publications.

Figure 24: Illicit market share/revenue losses and government tax receipts associated with FCT (2000-01 to 2016-17) and total FCT market breakdown (2001-02 to 2016-17)



Note: The estimates of revenue losses shown in the graph represent HMRC midpoint estimates. Figures are rounded to the nearest 1% or £100 million. Revenue losses include *both* excise duty and VAT (provided independently by HM Revenue and Customs). Revenue receipts include actual excise duty (derived from HM Revenue and Customs and EC DG TAXUD) receipts along with an estimate of the associated VAT receipts. To estimate Government VAT receipts, we estimate the proportion to total Government receipts accounted for by VAT on an annual basis, and apply these VAT proportions over and above actual estimates of excise duties. **Source: HM Revenue and Customs Measuring tax gaps (various years).**