

# Tobacco taxation, consumption and illicit trade in the UK

## London Economics' analysis for ESTA

September 2018

### Key messages

The UK currently has imposed some of the **highest duties** on fine-cut tobacco (FCT) across the European Union. At the same time, the UK has experienced some of the most **significant levels of illicit trade** in FCT (as high as **62%** in 2004-05). Increased enforcement activities and moderate increases of the duties imposed on FCT, have resulted in a reduction in the level of illicit trade to its **lowest recorded level** of **28%** of total FCT consumption in 2016-17. Reflecting the role of FCT as a **buffer** between FMC and illicit non duty paid consumption, there has been an improvement in government FCT taxation receipts - by **38%** since 2011-12 (equivalent to an additional **£338 million** since 2011-12).

*"I have decided to strengthen the commitment on tobacco duties that the Government have given in the past. I intend to increase tobacco duties on average by at least 3%p.a. in real terms in future Budgets. I believe that the approach we are adopting is the most effective way to reduce smoking"*

**Chancellor of the Exchequer**  
**November 1993 Budget Statement**

### Excise duty taxation policy changes over time

With the key objectives of both **reducing smoking prevalence** and **sustaining contributions to government revenues**<sup>1</sup>, the UK adopted a tobacco 'escalator' policy (initially between 1993<sup>2</sup> and 2000) to drive up the excise duty on tobacco products in **real terms**. Specifically, excise duties rose by **3%** more than inflation each year between November 1993 and November 1997 and by **5%** above inflation each year between November 1997 and March 2000 (see Figure 22 below).

In response to spiralling levels of illicit trade, in March 2001, the escalator policy was halted and taxes on tobacco products were **frozen** in real terms. This taxation slowdown continued – essentially unchanged – until 2010. During the period of the suspension (2001-10), UK tax-paid consumption of FCT **doubled**. **This increase in UK tax paid FCT was largely a result of consumer switching from FMC, as well as the decline in the level of illicit FCT** (from **60%** of total consumption in 2000-01 to

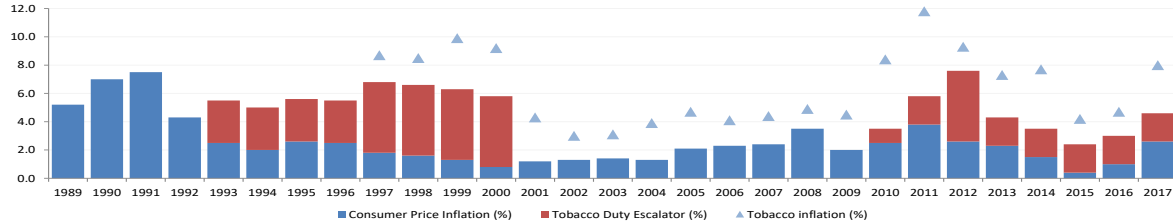
<sup>1</sup> HM Treasury. 2014. Budget 2014 - Tobacco duty rates. Available ([here](#)).

<sup>2</sup> Clarke, K. 1993. *Budget Statement*. 30 November. House of Commons, Transcript available ([here](#)).

38% in 2010-11)<sup>3</sup>. The tobacco duty escalator was re-introduced in March 2010 with excise duties increasing 1% above inflation in 2010 and 2% above inflation until 2014<sup>4</sup>.

However, in the 2012 Budget, it was announced that duties would rise by 5% above inflation<sup>5</sup>. Between 2013 and 2017, tobacco duties were increased by 2% above inflation in each year with the Chancellor announcing (in the 2014 Budget) that the escalator would be further extended. Since this final amendment, illicit consumption has further declined to 28% of total market share by 2016/17.

**Figure 22: UK Consumer Price Index and tobacco tax escalator (1989-2017)**



Source: London Economics’ analysis of House of Commons and Office for National Statistics data

These significant shifts in tobacco taxation policy have had substantial effects on **consumer switching** and the levels of **illicit trade**, and as a consequence, the level of **government taxation receipts**.

### What has happened to UK duty-paid FCT consumption over time?

*UK has some of the highest tobacco taxes in the world with huge profits to be made: a 40ft container of cigarettes has a revenue value of approx. £2.5m. [...] Evasion of tobacco duty is rated the highest risk in HMRC’s Tax Compliance Risk Overview*

**Judith Kelly, HMRC Head of Tobacco Strategy, 2013**

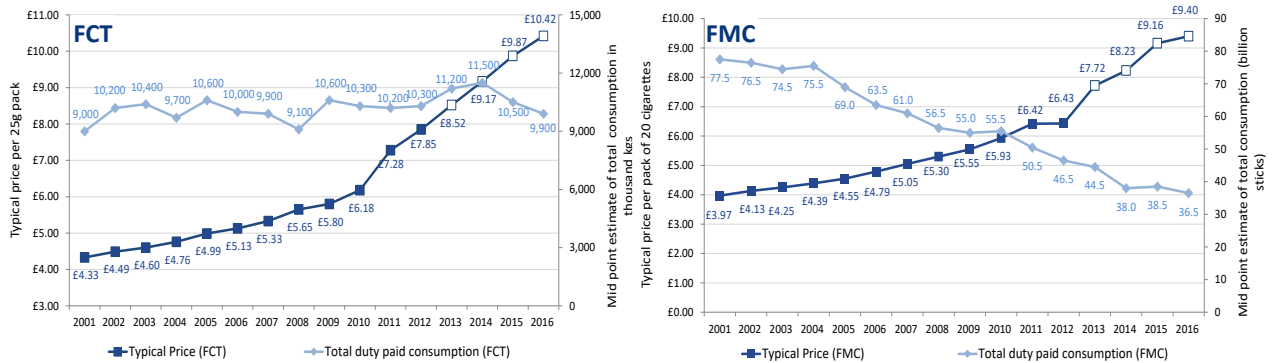
Since 2001, the high level of UK tobacco taxation has resulted in a significant increase in the retail price of FCT (by approximately 174% in nominal terms between 2000 and 2017). Normally, from an economic perspective, *holding all other factors constant*, any increase in the price should result in a reduction in the quantity of duty-paid FCT purchased.

However, the information presented in Figure 23 (left hand panel) shows that the total duty paid consumption of FCT has *increased* over time (and stabilised at these higher levels), predominantly as a result of both the relative affordability of FCT following sharp increases in the FMC taxation (and subsequent price increases), as well as the very noticeable declines in the level of illicit and cross-border trade.

<sup>3</sup> London Economics’ analysis of HMRC Tax Gap Tables ([here](#))

<sup>4</sup> Budget Statement, 2010. House of Commons, Transcript available ([here](#)).

<sup>5</sup> Budget Statement, 2012. House of Commons, Transcript available ([here](#)).

**Figure 23: Nominal retail price and total consumption of FCT and FMC (2001-2016)**

Notes: FCT presented in left panel; FMC presented in right panel. Prices of typical mid-price brand.

**Source:** *Prices from Tobacco Fact Sheet 2012 (HMRC). In the case of FCT, beyond 2012, we have applied the index of tobacco taxation prices (derived from the Consumer price index) to the latest available year. Note that this index applies to all tobacco products, but has been applied solely to FCT (represented by the unshaded markers). In relation to FMC, beyond 2012, the information presented refers to a 'typical' pack of 20 cigarettes. Tax-paid consumption from Measuring tax gaps tables 2017 (HMRC). Consumption estimates refer to previous tax year.* Note that price information is not available in 2013 as the series was discontinued. The estimate of total FMC consumption in 2013 is based on a mid-point estimate of illicit consumption equating to 10% of total consumption

Over the same period, in contrast, purchases of FMC have declined by **53%**. It is likely that tax increases have to some extent encouraged cessation or a reduction in consumption (alongside the full range of other anti-smoking policies); however, part of the decline is attributable to individuals substituting to cheaper **products (including FCT)**, as well as non-UK tax paid cross-border and **illicit** produce.

*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%*

The increased enforcement activity implemented by the UK government since 2000, combined with the **buffer function** of FCT between the legal and the illicit tobacco market, explains in part why total consumption of duty-paid FCT **increased** between 2001 and 2016 despite the substantial price increases over the same period. However, although the level of illicit trade in FCT has fallen significantly over the period, the revenue losses to the government have remained stubbornly high (standing at approximately **£4.4 billion** in aggregate over the last 5 years).

## 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%**<sup>6</sup> 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 tax gap is defined as the difference between the value of the tax that theoretically should be paid compared to the value of the tax and duties that is actually recovered.*

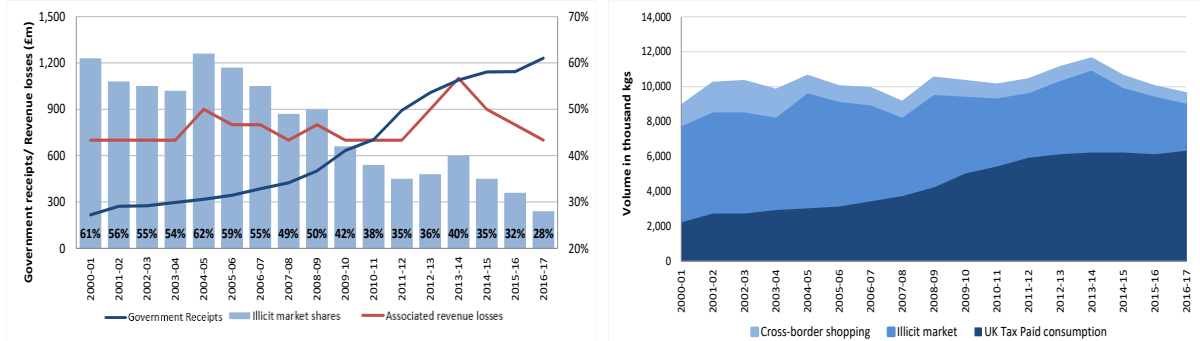
*The FCT tax gap in the UK declined from **£1.1 billion** in 2013-14 to **£0.7 billion** in 2016-17*

<sup>6</sup> Note that all estimates presented relate to mid-point estimates contained in HMRC Measuring Tax Gaps official publications.

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) .

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**.

**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).**

## Conclusions

The UK currently has imposed some of the **highest duties** on fine-cut tobacco (FCT) across the European Union. At the same time, the UK has experienced some of the most **significant levels of illicit trade** in FCT (as high as **62%** in 2004-05). Increased enforcement activities and moderate increases of the duties imposed on FCT, have resulted in a reduction in the level of illicit trade to its **lowest recorded level** of **28%** of total FCT consumption in 2016-17. Reflecting the role of FCT as a **buffer** between FMC and illicit non duty paid consumption, there has been an improvement in government FCT taxation receipts - by **38%** since 2011-12 (equivalent to an additional **£338 million** since 2011-12).