Turning point: Insights into illicit tobacco in the UK

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Trajectory
Seventh Floor
22 Upper Ground
London
SE1 9PD
+44 (0) 20 8004 4861
www.trajectorypartnership.com

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1 Introduction and background

The measurement of illicit tobacco consumption is a contentious issue in the UK. The two main sources of information are provided by HMRC and KPMG, the latter on behalf of the tobacco industry. Each portrays a different picture of trends in illicit tobacco consumption: for example, the latest KPMG data says that illicit cigarette consumption was 16% of total UK consumption in 2014, sixty per cent higher than the most recent HMRC mid-point figure of 10% in 2013/14. (See section 3.4 for the definitions of different types of illicit tobacco).

It has been suggested that the tobacco industry overestimates the size of the problem in the UK and in particular, the risk from "illicit whites"[1]. Why does the tobacco industry want to depict high levels of illicit tobacco consumption? Ideally it wants to counter any measure that reduces consumption and impacts on its profits, hence for example the opposition to the introduction of plain packaging and keenness to retain control of supply chain monitoring. The tobacco industry argues that the already bad situation (in terms of high levels of illicit tobacco) will be made worse with the implementation of plain packaging[2] and as a corollary tax revenues will be lost to the government.

At the same time, HMRC data has been under scrutiny by the NAO and the UK Parliament – while in general its method is held up as being transparent and reputable[3], HMRC itself has said it needs *"to seek to improve its methodology for estimating tax losses from tobacco fraud"*[4] as it may be underestimating recent growth in illicit tobacco consumption.

Added to this confusing picture, some academics and experts also accuse European governments (including the UK) and the tobacco industry of collaborating to protect vested interests[5].

This is a critical time for all involved as the status quo is changing. The EU's 2014 Tobacco Products directive is coming into effect between now and 2019. This includes measures to tackle Illicit trade in tobacco products and, inter alia, requires that all tobacco traded in Europe be identified by "track

[1] Towards a greater understanding of the illicit tobacco trade in Europe: a review of the PMI funded 'Project Star' report – Bath University et al 2013

[2] Tobacco industry manipulation of data on and press coverage of the illicit tobacco trade in the UK 2014
- A Rowell, K Evans-Reeves, A B Gilmore

[3] Progress in tackling tobacco smuggling – NAO 2013

[4] HMRC Annual Report and Accounts 2014-15

[5] European Watchdog is failing to hold tobacco industry to account over smuggling 2015 - M McKee, A B Gilmore

and trace" systems by 2019. The tobacco industry is promoting its own system, Codentify. There are concerns that this system will place too much control in the hands of the tobacco industry *"despite its long history of involvement in the illicit trade and of manipulating data about the illicit trade."* [5]

It is too soon to say what impact the recent referendum result will have on the EU directive in the UK – but one thing that is certain is more uncertainty.

At the same time, smokers themselves want to see more action taken against illicit tobacco. A study commissioned by Public Health England and seven local UK councils has found that *"60 percent of the 1,200 smokers surveyed said something should be done about the sale of cheap illegal tobacco."*[6]

Given that change is imminent and smokers themselves want to see action, the Trajectory team have decided to take an independent critical look at the existing data on illicit tobacco. Our objective is to identify insights that will clarify the current confusing picture, establish the true nature and size of the problem and help determine the best possible solutions for tackling it.

Trajectory have identified the following areas for study - each of which could have an impact on policy moving forward:

1. What are the trends in illicit tobacco consumption in the UK?
    - How do trends in illicit tobacco consumption compare with overall crime trends?
2. What is the market for illicit tobacco products?
    - Is it confined to particular types of people or is consumption widespread?
3. Where are illicit tobacco products purchased?
    - How important is peer group – do people buy from people known to them or from people outside their social circle?
4. What is the make-up of illicit tobacco products in the UK?
5. What brands of illicit tobacco do people smoke?

Trajectory has used a combination of existing data and also data collected in a new survey of smokers conducted by the market research agency ICM in November 2015. Trajectory commissioned the online survey of 1,000 smokers (nationally representative) using ICM Research's online panel - 1,006 smokers completed the survey. The results were weighted so that they were representative of all UK smokers using data from ONS.

[6] https://asiantrader.biz/industry-news/Public+Health+England+study+finds+smokers+back+action+on+black+market+tobacco+trade/3325

The team would like to thank SICPA for agreeing to fund the report. SICPA is a privately owned company providing governments with secured identification, traceability and authentication solutions and services: SICPA systems have been applied to control flows of excisable goods including tobacco products in a number of countries worldwide.

2 Executive summary

Consumption of illicit tobacco increasing in the UK - Since 2011/12, illicit consumption of tobacco in the UK appears to be growing again after a long period of decline. This indicates an increase in availability of illicit tobacco and in turn, an increase in successful trafficking. This is not in line with total crime in UK which has continued to decrease over the same time period.

The market for illicit tobacco is likely to be widespread in the population, particularly those under 35 – it is a nationwide issue not linked to any social class or gender. The link between price and illicit tobacco consumption is complex – data from 2007 show that *"the proportion of tobacco consumption that was illicit was higher in low income than in high income countries – despite the fact that the price of legal cigarettes was much lower in such countries."*[7] Our findings indicate that the market for illicit cigarettes and hand rolling tobacco is likely to be widespread in the UK. It is not restricted to just a few consumer types. Younger people under the age of 35 are most likely to buy illicit tobacco products but our data show no statistically significant differences at all by gender or social class and no region in the UK has a significantly lower propensity than the national average.

It is easy to get hold of illicit tobacco. Illicit tobacco products are purchased in a wide range of outlets – both official outlets monitored by trading standards, such and shops and markets, and unofficial sources such as through the workplace and in people's homes. Peer group does appear to be important but there are also a significant proportion of smokers of illicit tobacco products who buy from people who are not known to them.

Trafficking of genuine brands is the main problem in the UK, in particular Marlboro. The majority (over 70%) of illicit cigarettes consumed in the UK are Genuine Brands non-UK duty paid. The biggest genuinely branded illicit cigarette is Marlboro by a large margin. On its own, it accounts for the second largest category of illicit cigarette at 1.72 billion cigarettes a year.

In conclusion illicit tobacco is easy to get hold of and over half of all smokers are likely to consume it. This is not a niche market or a small scale problem. The largest proportion of illicit products in the UK consists of genuine brands that have a legal market in the UK but are sold at a much cheaper price with no duty paid – the biggest problem is not Jin Ling and other illicit whites as

[7] Joossens L, Merriman D, Ross H, Raw M. How eliminating the global illicit cigarette trade would increase tax revenue and save lives. Paris: International Union Against Tuberculosis and Lung Disease, 2009

emphasised in the executive summary of the KPMG Project Sun report, but as KPMG show in the UK section of their 2015 and 2016 reports, Marlboro produced by PMI.

Illicit tobacco is embedded in the UK and the signs are that consumption levels are increasing. The tobacco industry itself is linked by association with the illicit trade[8] but is spending time and effort to confound policy makers and disassociate itself from it[9] - among the 3 800 000 000 cigarettes seized by EU Member States customs, only 0.5% of that quantity was recognized as genuine by the tobacco companies and generated payments from them[10] – this is completely at odds with the data in the Project Sun report funded by the tobacco industry. Something isn't working. Given the environment of Government cut backs, policy makers need to explore creative, cost effective approaches from outside the tobacco industry to stop its growth further.

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[8] European Watchdog is failing to hold tobacco industry to account over smuggling 2015 - M McKee, A B Gilmore

[9] http://www.who.int/fctc/publications/The-Tobacco-Industry-and-the-Illicit-Trade-in-Tobacco-Products.pdf?ua=1

[10] http://tobaccocontrol.bmj.com/content/early/2015/05/20/tobaccocontrol-2014-052218.abstract?sid=bb6fcb74-43d7-4a3d-bae7-d7ff69415c84

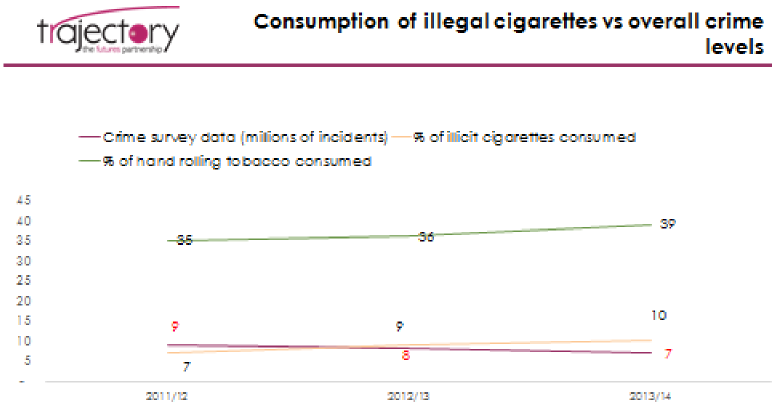
3 Key findings

3.1 What are the recent trends in illicit tobacco consumption in the UK?

Illicit tobacco consumption has fallen significantly since the millennium. In 2000, illicit tobacco product shares were "*22 per cent for cigarettes and 61 per cent for hand-rolling tobacco. In 2013–14, the shares were 10 per cent for cigarettes and 39 per cent for hand-rolling tobacco*"[11]

However, this success story masks the fact that since 2011/12 illicit tobacco consumption has been increasing. HMRC data show that in 2011/12, 7% of all cigarettes and 35% of hand rolling tobacco were illicit, compared with 10% and 39% respectively in 2013/14 – there has therefore been an increase of 43% in illicit cigarette consumption and 11% in hand rolling tobacco consumption since 2011/12.

Figure 1



Source: HMRC and CSEW

Comparison with the ONS crime statistics for the same years (Figure 1) shows that whereas crime in general has been decreasing at a rate of one million incidents a year between 2011/12 and 2013/14, consumption of illicit cigarettes and hand rolling tobacco has been increasing over the same time period, indicating that the criminal trafficking of illicit tobacco products is not in decline.

The HMRC method of estimating consumption of illicit tobacco is well documented. They take a top down approach using data on duty collected

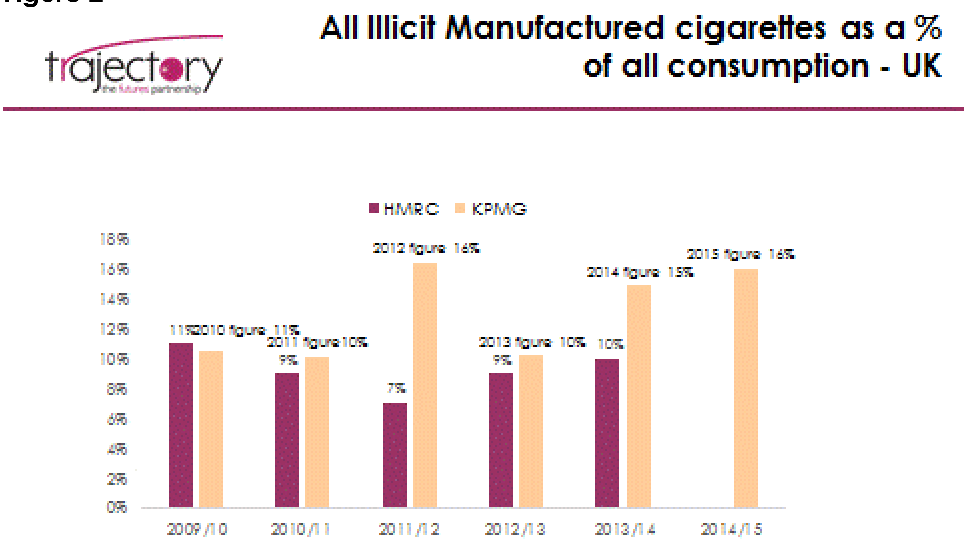
[11] HMRC and Border Force strategy 2015 - Tackling illicit tobacco: From leaf to light

supplemented by survey data to estimate the level of consumption. KPMG data is collected using a very different and more opaque approach. They use industry sales data to create an estimate which is supplemented with an analysis of empty packs and expert views of the industry.

Note: the KPMG data represents the calendar year whereas the HMRC figure covers a 12 month period over two years. The KPMG figure for 2012 is skewed by the Olympic Games which had an impact on the empty pack survey results and the strengthening of the Pound against the Euro has made non-domestic cigarettes more affordable increasing the level of consumption of illicit tobacco products in 2014 and 2015[12].

Despite these differences in approach and differences in the actual consumption figures that result, Figure 2 shows that KPMG data has also seen a rise in the consumption of illicit cigarettes in the three most recent years for which data are available. In other words, both HMRC and KPMG data indicate a recent rise in the consumption of illicit tobacco, which in turn implies an increase in successful trafficking of illicit tobacco products.

Figure 2



Source: HMRC Measuring the Gap 2015 and KPMG Project Sun 2015 and 2016

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[12] KPMG Project Sun 2015 and 2016

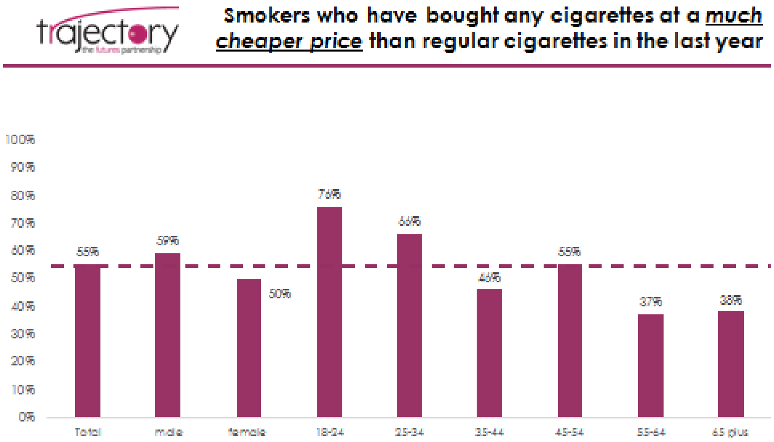
Key insight: Since 2011/12, illicit consumption of tobacco in the UK appears to be growing again after a long period of decline. This indicates an increase in availability of illicit tobacco and in turn, an increase in successful trafficking. This is not in line with total crime in UK which has continued to decrease over the same time period.

3.2 What is the market for illicit tobacco products?

Research about the purchasing of illicit tobacco is difficult for a number of reasons: first, many smokers do not want to admit in a survey that they have purchased illicit products in case there are repercussions. Second, smokers may be unclear about what constitutes illicit tobacco products – do they include buying a few packs from a friend who has brought back too many cigarettes from holiday? Or the cheap packet of Marlboro purchased from their local newsagent? Or the packet of unusually branded tobacco?

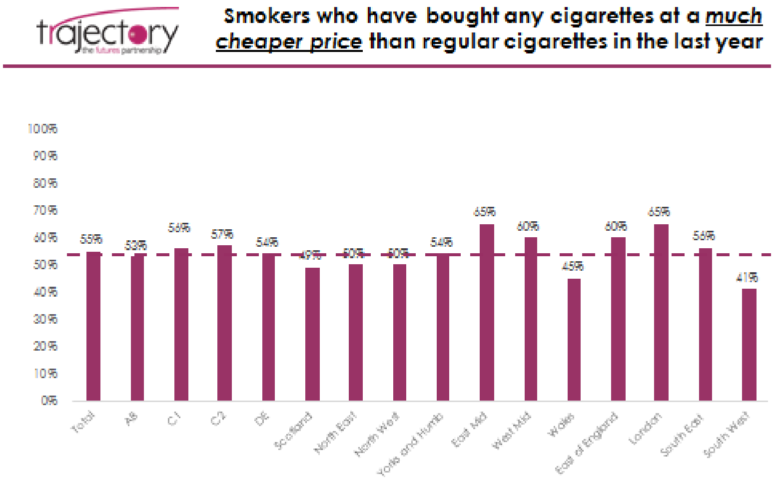
For these reasons in order to gauge the size of the market for illicit tobacco products, we have looked instead at the proportion of smokers in the UK who admit to buying tobacco products that are <u>*much cheaper*</u> than <u>*regular*</u> cigarettes or hand rolling tobacco. We have also conducted the poll online to avoid any possible interviewer effect. While this proxy may result in an overestimation, we believe this indirect method will result in a truer picture of which UK adults are potentially in the market for illicit tobacco products than questions that directly ask about actual illicit tobacco purchase. We also believe it is better than relying on empty pack surveys. KPMG states in their Project Sun report that "*[Empty pack survey] relies purely on physical evidence, avoiding the variability of consumer bias found in interview-based methods.*" However, the problem with empty pack surveys is that they cannot distinguish between packs bought for example, abroad on holiday for legal consumption back home, from contraband/ bootlegged packs bought overseas and sold for profit in the UK. Empty pack surveys (EPS) will underestimate these categories of illicit tobacco. A shortfall that KPMG tacitly acknowledges as it now supplements the EPS data using consumer data - "*Proprietary consumer surveys owned by manufacturers who participated for the first time in 2013. These data sources have been used in the 2013 and 2014 reports*".

Figure 3



Source: Trajectory; Survey of Smokers (n=821)
Q9b. What proportion of all of the cigarettes you have bought in the UK last year have been bought at a much cheaper price than regular cigarettes?; all those who cigarettes

Figure 4



Source: Trajectory; Survey of Smokers (n=821)
Q9b. What proportion of all of the cigarettes you have bought in the UK last year have been bought at a much cheaper price than regular cigarettes?; all those who cigarettes

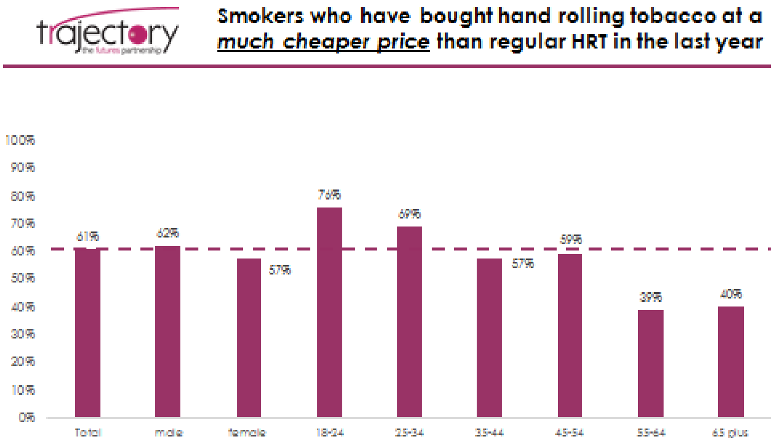
The data in figures 3 and 4 show that over half of all smokers (55%) have bought cigarettes at a much cheaper price than regular cigarettes in the last year. Analysis by demographic group shows the following:

- There is no statistically significant difference between the likelihood of male and female smokers buying *much cheaper* cigarettes – therefore, we can infer that around half of both male and female cigarette smokers fall into the target market for illicit cigarettes, there is no statistical difference by gender.
- Younger adults up to the age of 34 are significantly more likely to buy *much cheaper* cigarettes and older adults over the age of 55 are

significantly less likely to buy *much cheaper* cigarettes – therefore, we can infer that younger adults under the age of 34 are more likely to fall into the target market for illicit cigarettes.

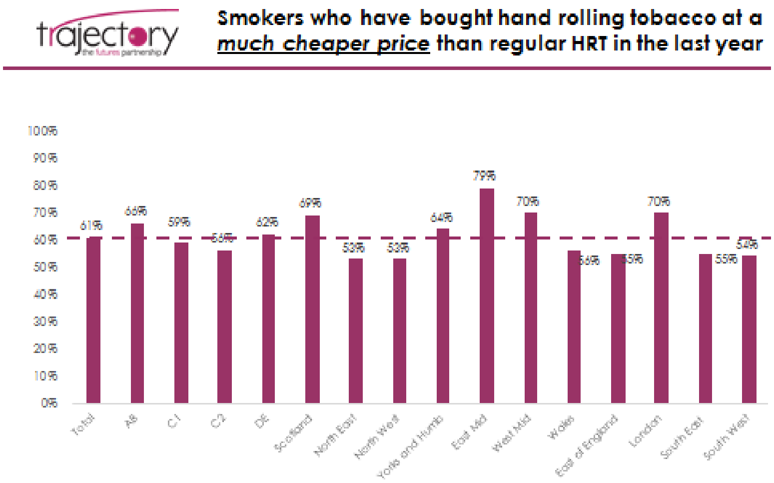
- There is no statistically significant difference between the likelihood of smokers from different social classes buying *much cheaper* cigarettes – therefore, we infer that again around half of smokers from all social classes fall into the target market for illicit cigarettes, there is no statistical difference by social class.
- The only statistically significant difference by region is London (where smokers are more likely to buy *much cheaper* cigarettes).

Figure 5



Source: Trajectory; Survey of Smokers (n=628)
Q9b. What proportion of all of HRT you have bought in the UK last year has been bought at a much cheaper price than regular HRT?; all those who smoke HRT

Figure 6



Source: Trajectory; Survey of Smokers (n=628)
Q9b. What proportion of all of HRT you have bought in the UK last year has been bought at a much cheaper price than regular HRT?; all those who smoke HRT

The data in figures 5 and 6 shows the same data for smokers of hand rolling tobacco – they show that smokers of hand rolling tobacco are significantly more likely than smokers of cigarettes to have bought *much cheaper* HRT in the last year (61% vs 55%). The key findings are as follows:

- Again there is no statistically significant difference between the likelihood of male and female smokers buying *much cheaper* hand rolling tobacco – therefore, again we can infer that around three out of five male and female smokers of hand rolling tobacco fall into the target market for illicit product, there is no statistical difference by gender.
- As for cigarettes, younger adults up to the age of 34 are significantly more likely to buy *much cheaper* hand rolling tobacco and older adults over the age of 55 are significantly less likely to buy *much cheaper* hand rolling tobacco – therefore, we can infer that younger adults under the age of 34 are more likely to fall into the target market for illicit hand rolling tobacco. This finding is compounded by the fact that young people are also more likely to buy HRT in the first place – our survey shows that only 17% of under 35 year old smokers never buy HRT compared with 34% of smokers aged 35 plus.
- There is no statistically significant difference between the likelihood of smokers from different social classes buying *much cheaper* hand rolling tobacco – therefore, we infer again that around half of smokers from all social classes fall into the target market for illicit cigarettes, there is no statistical difference by social class.
- The only statistically significant difference by region is in the East Midlands (where smokers are more likely to buy *much cheaper* HRT).

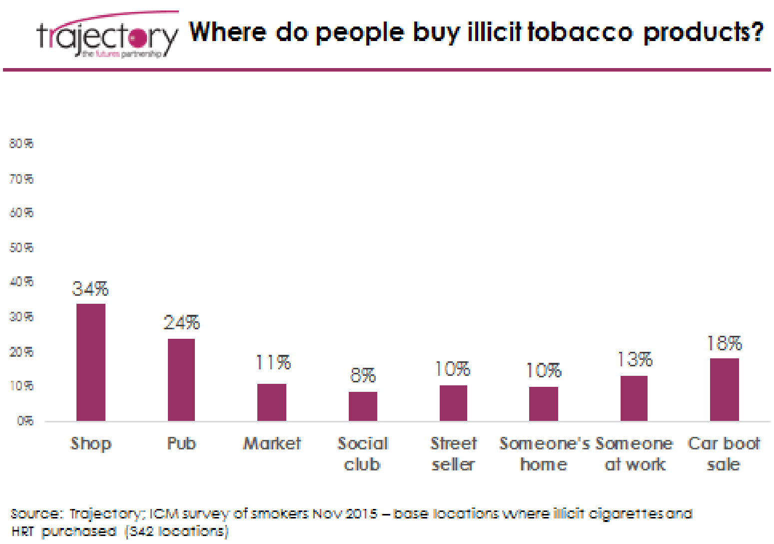
Key insight: these findings show that the market for illicit cigarettes and hand rolling tobacco is likely to be widespread. Over half of all smokers buy *much cheaper* tobacco products and are therefore, more likely to fall into the target market for illicit tobacco. Younger smokers are more likely to fall into the target market than older smokers, but there are no statistically significant differences at all by gender or social class and no region in the UK has a significantly lower propensity than the national average. Illicit tobacco is a nationwide issue.

3.3 Where are illegal tobacco products purchased?

In our survey we asked people where they buy cigarettes and tobacco products including foreign brands bought in the UK, UK brands that they think might be fake bought in the UK, a UK brand with foreign labels bought in the UK – all of which fall into the illicit category.

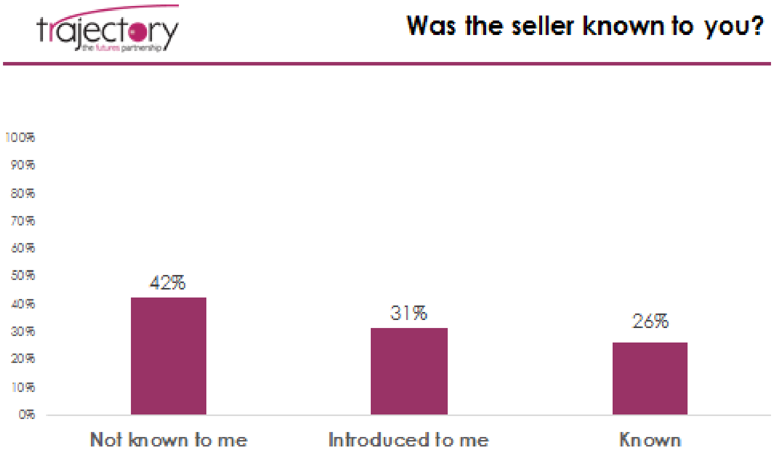
Our data show that illicit products are purchased through a wide range of different channels – from shops and other official outlets covered by trading standards such as pubs and markets, to unofficial channels such as someone's home or through someone at work.

Figure 7



In order to find out the importance of peer group, we looked at whether people buy from people known to them or from people outside their social circle

Figure 8



Source: Trajectory; ICM survey of smokers Nov 2015 – base relationships with seller of illicit cigarettes and HRT (436 relationships)

The data show that more than half of relationships between seller and purchaser of illicit tobacco products are based on some knowledge (31% have been at least introduced and 26% are known to each other). However, there are a significant proportion of relationships where the seller and buyer are not known to each other (42%).

Key insight: Illicit tobacco products are purchased in a wide range of outlets – both official outlets monitored by trading standards and also unofficial sources such as through the workplace and in people's homes. Peer group does appear to be important but there are also a significant proportion of smokers of illicit tobacco products who buy from people who are not known to them.

3.4 What is the make-up of illicit tobacco products?

Illicit tobacco products can be categorised into three main categories – illicit whites, counterfeit products and genuine 'non-UK duty paid' products.

The following guidance was provided by HMRC to aid the Institute of Trading Standards Operation Henry exercise conducted in 2014 and defines what each of these categories means – in addition, we have added the KPMG definitions used in Project Sun where they vary from the HMRC original.

Description Guidance

- **Genuine Non-UK Duty Paid Cigarettes -** Brands that have a legal, legitimate market in the UK, that have been smuggled into the country from another location without any or all of the required Excise/Tobacco Duty having been paid.
  Note: KPMG refer to these as Contraband (brought in from other countries or acquired without taxes for export purposes) and Domestic Whites re-classified as Non-Domestic Whites (priced below the minimum tax yield), both are sold illegally for a profit.

- **Illicit White Cigarettes –** these cigarettes are produced entirely independently of the International Tobacco Manufacturers (ITMs) that, crucially, have no true, or a very limited, legitimate market. Effectively, illicit whites are brands manufactured for smuggling. Examples include "Jin Ling", "Fest", "Richman" and "Bon".
  Note: KPMG add in their definition of illicit whites: "Cigarettes that are usually manufactured legally in one country/market but which the evidence suggests have been smuggled across borders during their transit to the destination market under review where they have limited or no legal distribution and are sold without payment of tax" to the country they are distributed in.

- **Counterfeit Cigarettes –** Product that is manufactured illegally and sold by a party other than the ITM trademark owner (e.g. "Marlboro", "Benson & Hedges")

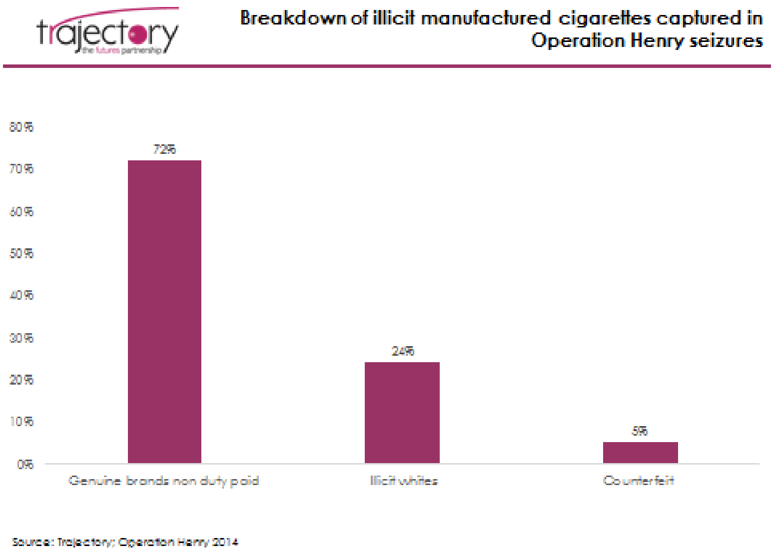
- **Counterfeit Hand-Rolling Tobacco -** Product that is manufactured illegally and sold by a party other than the ITM trademark owner (e.g. "Golden Virginia" and "Amber Leaf").

- **Genuine Non-UK Duty Paid Hand-Rolling Tobacco -** Brands that have a legal, legitimate market in the UK however have been smuggled into the country from another location without the any or all of the required Excise/Tobacco Duty having been paid.

In 2014, the Chartered Institute of Trading Standards ran an operation to seize illicit tobacco products from retail outlets, markets, pubs and clubs across England. Though small scale, the total budget was just over £40,000, the operation resulted in multiple seizures from across the whole of England.

Our analysis of the data gives the following breakdown of the types of illicit cigarette found in all 206 seizures conducted between May and November 2014 by the Operation Henry team.

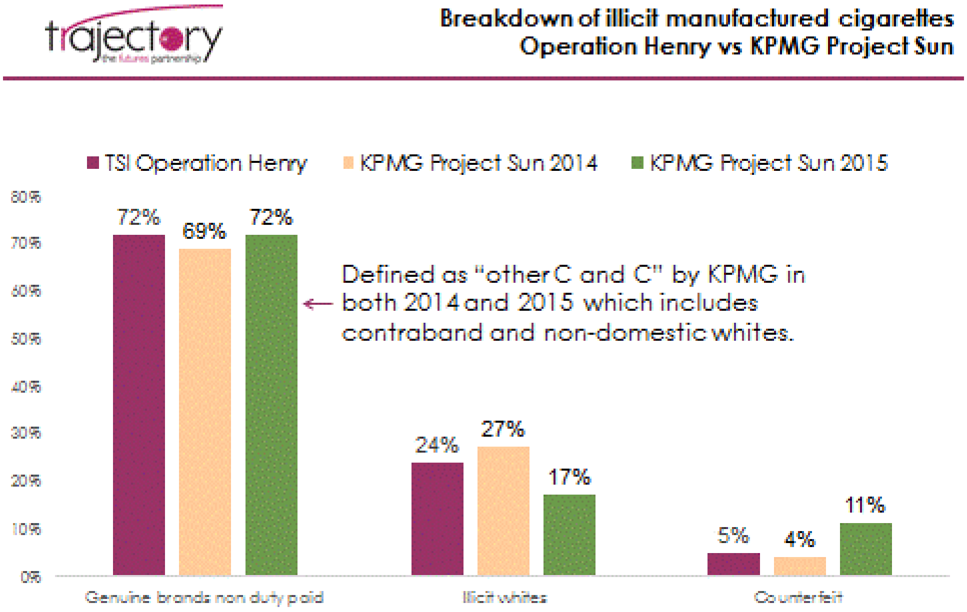
Figure 9



The data show that the vast majority of illicit cigarettes seized were genuine brands where no duty had been paid (72%), just under a quarter (24%) were classified as illicit whites and only 5% were counterfeit cigarettes.

We then compared this with the KPMG data for the UK presented in the 2015 and 2016 Project Sun reports which include data for 2014 and 2015 – figure 10 shows how the Operation Henry and KPMG sets of data compare.

Figure 10



Source: Trajectory: Operation Henry 2014 and KPMG Project Sun 2015 and 2016

Note that the KPMG data relates to "Other C and C" which includes contraband and non-domestic whites and excludes illicit whites and counterfeits. As noted above in our definitions, this is equivalent to the HMRC definition used by Operation Henry of Genuine brands non duty paid. We believe that we are making a like-for-like comparison.

The data show only very small differences between the break down in types of illicit tobacco product achieved in the Operation Henry seizures and as presented in the KPMG data in 2014. It is difficult to assess the statistical significance as we do not have details of the KPMG approach, but given the small scale of Operation Henry, it is unlikely that the differences between the two sets of results are significant. In other words, given that the two sets of findings are similar, this indicates that this is likely to be a realistic picture of the current makeup of illicit cigarettes in 2014.

The KPMG report Project Sun prepared on behalf of the tobacco industry shows a slight increase between 2014 and 2015 in the proportion of all illicit cigarettes that are classified as "other C&C" from 69% to 72% - they also show a decrease in "illicit whites" over the same period from 27% to 17%. Overall, the Operation Henry data appears to confirm the KPMG finding that the vast majority of illicit cigarettes consumed in the UK as Genuine Brands non-duty paid.

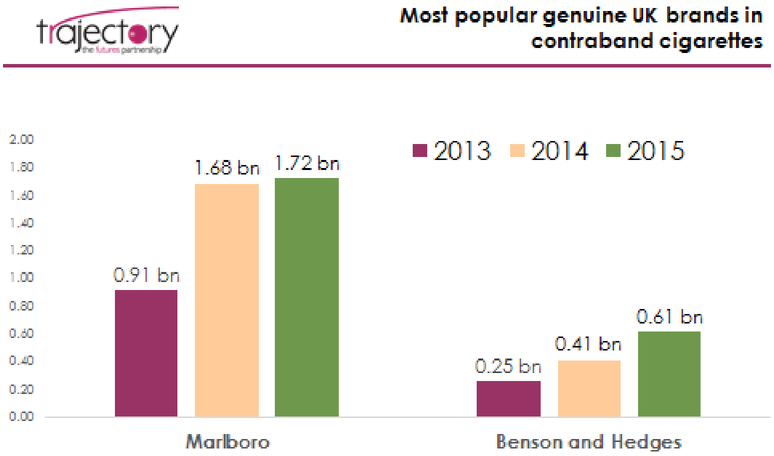
Key insight: The vast majority (over 70%) of illicit cigarettes consumed in the UK are Genuine Brands non-duty paid. These, and not illicit whites, are the main problem in the UK.

3.5 What brands of illicit tobacco do people smoke?

In this next section we look at the most popular brands of illicit cigarettes. First, we will look at the most popular genuine brands that have been sold without tax in the UK for a profit. Then we will put these findings within the context of all illicit cigarettes to identify whether the trafficking of these particular genuine brands is growing.

Recent KPMG Project Sun reports show that the most popular brands of genuine cigarettes, where no duty has been paid, are Marlboro and Benson and Hedges. Figure 11 shows how numbers of contraband Marlboro and Benson and Hedges have been growing since 2013. Together these genuine UK brands with no duty paid, now account for 35% of all contraband and counterfeit cigarettes in the UK.

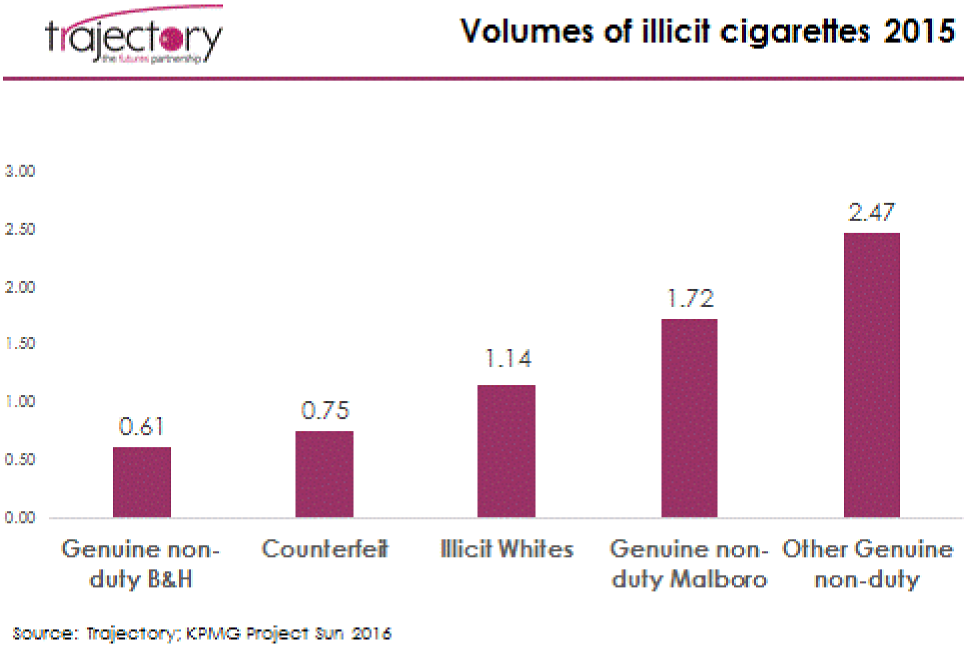
Figure 11



Source: Trajectory; KPMG Project Sun 2015 and 2016

Figure 12 shows the breakdown of the 6.69 billion illicit cigarettes in the UK in 2015.

Figure 12



At 1.72 billion cigarettes a year, the KPMG data using industry data shows that if Marlboro were in a category of its own, it is the second largest type of illicit cigarette consumed, lying only behind all the other illicit genuine brands combined excluding Marlboro and B&H (2.47 billion cigarettes a year).

Key insight: The biggest genuinely branded illicit cigarette is Marlboro by a large margin. On its own it accounts for the second largest category of illicit cigarette at 1.72 billion cigarettes a year.

4 Conclusion

The insights delivered in this paper indicate that the status quo in terms of illicit tobacco is not just affected because of changes to the way governments, law enforcement and border agencies will be required to control trafficking of tobacco – there are also signs that the level of illicit tobacco consumption is increasing again after years of decline. This is in contrast with the main trends in crime in the UK, which is still following a downward path.

Illicit tobacco is embedded in the UK, it appears to be relatively easy to get hold of, and there is no need to have the right contacts in your peer group. Access to illicit tobacco products can be through official outlets monitored by the trading standards such as shops, pubs and markets as well as unofficial channels such as work colleagues. It is a complex problem for Law Enforcement Agencies to tackle.

The market is widespread in the UK – over two thirds of young smokers and a third of older smokers admit to buying tobacco products at *much cheaper prices* than *regular* products. At the same time the market for tobacco is not restricted by gender, class or region. In other words, illicit tobacco is both easy to get hold of and over half of all smokers are in the market to consume it. This is not a niche market or a small scale problem.

In addition, the largest proportion of illicit products in the UK at over 70% is made up of genuine brands that have a legal market in the UK but are sold at a much cheaper price with no duty paid – the biggest problem is not Jin Ling and other illicit whites as emphasised in the executive summary of the KPMG Project Sun report, but as KPMG show in the UK section of their 2015 report, Marlboro produced by PMI.

In conclusion, illicit tobacco is embedded in the UK and the signs are that consumption levels are increasing. The tobacco industry itself is linked by association with the illicit trade. Given the environment of Government cut backs, policy makers need to explore creative, cost effective approaches from outside the tobacco industry to stop its growth further.

Appendix

Sources

1. Standardised packaging of tobacco – independent review Sir Cyril Chantler, The Kings Fund – 2014 http://www.kcl.ac.uk/health/10035-TSO-2901853-Chantler-Review-ACCESSIBLE.PDF?utm_source=rss&utm_medium=rss&utm_campaign=standardised-packaging-of-tobacco-report-of-the-independent-review-undertaken-by-sir-cyril-chantler-pdf
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