



House of Commons
Committee of Public Accounts

HM Customs and Excise Standard Report 2003–04

**Fifteenth Report of
Session 2005–06**

*Report, together with formal minutes,
oral and written evidence*

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The Committee of Public Accounts

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Summary

HM Customs & Excise (Customs, now part of HM Revenue and Customs) collected £162 billion of gross receipts in 2003–04 in value added tax (VAT) and excise and customs duties from over 1.8 million business traders. The two most significant revenue streams are VAT, which generates £63.6 billion net, and hydrocarbon oils duty, mainly on petrol and diesel, which provide £12.7 billion and £9.8 billion net respectively.¹

Hydrocarbon Oils

Customs provide annual estimates of the level of hydrocarbon oils fraud, and report that it cost the Exchequer some £850 million (6% of the market) in 2003. Customs have devised and implemented a strategy to tackle this fraud and to meet their Public Service Agreement target to reduce the scale of the illicit market to 2% by March 2006. The most recent available data show that at the end of 2003, earlier reductions in fraud appear to have levelled out and amounts lost are increasing.²

Some oils are not subject to the standard rate of fuel duty. Those used for agricultural purposes or as heating oil, for example, attract a lower rate of excise duty than that charged on fuel for road vehicles. Misuse of rebated fuel, particularly diesel, represents a significant risk to revenue. Customs have responded with a regulatory scheme, the Registered Dealers in Controlled Oils (RDCO) scheme, to control the supply of rebated oils. This scheme requires all dealers in controlled oils to register with Customs and to provide returns giving details of their customers. Dealers are also required to take reasonable steps to ensure that their sales are for legitimate purposes.³

The RDCO scheme has been implemented successfully but there have been problems along the way. In its Regulatory Impact Assessment, used to inform decisions about the effect of new legislation and regulation, Customs estimated that some 1,200 traders would be required to register under the scheme, but in practice some 4,700 have registered. Through their initial research, Customs did not correctly identify the number and average size of traders to be affected. Traders have been slow to use e-filing for returns required under the scheme and Customs have had to use more staff for manual processing.⁴

The effectiveness of the UK Oils Strategy rests on reducing the size of the illicit market. But the data to underpin Customs' estimate of the level of fraud are available only annually from the Office for National Statistics and the Department for Trade and Industry, so

1 *HM Customs and Excise: Annual Report and Accounts 2003–04* (HC 119, 2004–05), p 140, Appendix A

2 C&AG's Report, *HM Customs and Excise: Standard Report 2003–04* (HC 119, 2004–05), paras 2.2, 2.8–2.9

3 *ibid*, paras 2.3, 2.17

4 *ibid*, paras 2.20, 2.26

Customs cannot measure progress in closing the tax gap on an in-year basis. Better information would enable Customs to use resources to tackle fraud more effectively.⁵

VAT compliance in small and medium-sized enterprises

Customs estimate that VAT losses cost the Exchequer £11.9 billion a year.⁶ Customs have a VAT compliance strategy aimed at reducing VAT losses from 15.8% of total theoretical yield in 2002 to 12% by 2006. The results for 2003–04 indicate that they have made good progress, with the VAT gap reducing to 12.9%.⁷

Small and medium sized enterprises pay around 56% of total net VAT receipts (£38.6 billion in 2003–04). Regional Business Services are the Customs team responsible for collecting VAT from these traders. To use resources efficiently and to minimise the compliance burden on legitimate businesses, Customs do not make direct contact with all traders every year, but use risk assessment to select traders for assurance activity. Customs' VAT compliance strategy has led to a more flexible and varied approach to risk assessment and resource deployment, co-ordinated by a national risk management structure. But this new approach has not yet been consistently applied by all regions.⁸

Customs' focus on risk assessments places greater reliance on the underlying trader and trade sector data. They have undertaken new projects to help to understand the trader population and the risks posed by individual businesses and business sectors. Customs have launched an internal campaign to improve the quality of the information through an initiative to establish minimum requirements for information held for all traders.⁹

5 *HM Customs and Excise: Standard Report 2003–04* (HC 119, 2004–05), paras 2.52, 2.60

6 36th Report from the Committee of Public Accounts, *Tackling VAT Fraud* (HC 512, 2003–04), para 2

7 C&AG's Report, para 3.44

8 *ibid*, paras 3.1, 3.7, 3.10, 3.23–3.24

9 *ibid*, paras 3.32, 3.35

Conclusions and recommendations

- 1. Customs cannot validate the accuracy of in-year evidence about fraud and the effectiveness of their work until 8 months after the end of the year,** when they get the estimate of annual losses due to oils fraud. Oils fraud is continually evolving and Customs need to have timely information on the nature and scale of the problem to tackle it effectively. They could also target resources to tackle key risks more effectively with a better analysis of the scale and type of oils fraud, for example, by region, or by identifying different groups involved in such fraud.
- 2. In using intelligence information, different Customs regions display different levels of productivity,** in terms of information packages produced per officer, and number of successful operations (“hits”) per information package. In 2003–04, on average, officers in Northern Region produced more than 100 information packages each, while officers in London and South Regions produced less than 20 information packages each. But whilst just over 1 in 10 packages in the North generated successful hits, in London and the South East the ratio was 1 in 5. In identifying and disseminating best practice, Customs should consider measures of productivity and effectiveness to assess the quality of intelligence work and compare performance across the regions.
- 3. Customs have not set a target deadline for traders under the Registered Dealers Scheme to provide returns electronically rather than manually, or sought to incentivise greater use of electronic submission.** Processing manual returns and inputting data is a resource drain for Customs. Electronic submission of returns will allow reductions in processing resources and deliver efficiency gains. Customs should provide incentives for traders to move from manual, paper-based returns to lodging returns electronically, and set a target date for the full electronic submission of returns.
- 4. Customs’ assessment of the Registered Dealers Scheme was inadequate and based on an incorrect assessment of the number of traders dealing in rebated oils.** Regulatory Impact Assessments need to be founded on a sound understanding of the nature of the issues and the likely effect of the proposed regulations.
- 5. Few traders were successfully prosecuted by Customs in 2003–04, and sentences for fraudsters average at 15 months.** Customs should review whether the penalties for oils fraud provide a proportionate deterrent or punishment for the seriousness of the criminal activity. Customs also need to consider whether their prosecutions strategy is delivering the results needed to deter potential fraudsters.
- 6. Customs cannot identify the contribution of each element of their VAT Strategy towards closing the VAT gap and improving trader compliance, nor determine accurately the increase in receipts as a result of their own work as distinct from economic growth.** Customs have a programme of activities to reduce VAT losses, some aimed at improving general compliance by traders, but cannot measure on a timely and accurate basis their impact on compliance and closing the VAT gap. They should investigate the feasibility of analysing the VAT gap on both a regional and sectoral basis as well as nationally.

7. **Customs cannot automatically compare a trader's payment and compliance performance to that of other traders within the same sector or industry.** Customs rely on manual analysis of data from the VAT mainframe system to carry out such comparisons, and any analysis is ad hoc and far from systematic. Customs should fully develop their National Business Picture, which aims to provide this capacity by generating an overall picture of risk to revenue across the United Kingdom based on automatic analysis of trader records.

1 Customs' strategy for tackling oils fraud

1. In 2003 Customs estimated that they lost excise revenue totalling £1,250 million due from fuel duties (largely petrol and diesel) as a result of fraud and smuggling and legitimate cross-border shopping in Great Britain.¹⁰ Most of these losses arose from the illicit use of diesel, where fraudsters use rebated fuel oil for use in road vehicles. Losses attributable to oils fraud are estimated by Customs in absolute terms and as a percentage of the total market. But the data they need to produce these estimates are only available 8 months after the end of the calendar year to which they relate.¹¹

2. Customs first estimated these revenue losses in Great Britain in 1999 and put the total loss at £700 million. The estimated amount increased for 2000 and has since shown a small reduction (**Figure 1**).¹²

Figure 1: Estimated Losses from Diesel Fraud

Year	1999	2000	2001	2002	2003
Estimated Loss (£ million)	700	1000	950	750	850
Percentage Loss	6	8	7	6	6

3. Customs calculate an estimated 'tax gap' for duty payable on hydrocarbon oils. The calculation is based on annual consumption data which show the quantity of refined fuel which is released on to the UK market, and legitimate deliveries of fuel made to filling stations. Customs use this data to work out the total revenues that should be collected, and from this subtract the total receipts. After an adjustment in respect of legitimate cross-border shopping, Customs are able to produce an estimate of total losses due to fraud and smuggling.

4. Using the 'tax gap' methodology to estimate fraud provides a good macro view of oils fraud. But the breakdown of fraud into its component parts is not so well understood. Customs believe there are three main areas of fraud: the improper use of rebated red diesel in road vehicles (usually heating oil or diesel provided for agricultural use) by mixing it with ordinary duty-paid diesel; laundering rebated diesel to remove the marker dyes that it contains; and most commonly, the diversion of rebated diesel intended for agricultural use to road vehicles required to use duty-paid diesel. Customs have not, however, been able to break down the revenue losses between smuggling and diversion and cannot, therefore, provide an accurate picture of the risks posed by diesel smuggling, or the scale of the smuggling problem.¹³

10 *HM Customs and Excise: Annual Report and Accounts 2003–04* (HC 119, 2004–05), p145, Appendix B

11 *ibid*, para 2.52

12 C&AG's Report, para 2.2

13 Qq 104, 138

5. Intelligence underpins Customs' approach to dealing with diesel fraud, and informs the deployment and targeting of resources. Customs disseminate best practice guidance and lessons learned to all staff to improve the standard of work across the United Kingdom.¹⁴ Customs have management information available which describes not only the overall amount of intelligence material produced by region ('quantity'), but also the ratio of successful hits resulting from this information ('quality'). In identifying and disseminating best practice, it is important that both elements are fully considered.¹⁵

6. Customs have not yet agreed with the trade a mechanism for encouraging more traders to file electronically the returns required under the Registered Dealers Scheme, or set a deadline for the adoption of full electronic submission. The Federation of Petroleum Suppliers has explained that its members prefer to submit hard copies of the information required. But Customs need more staff to process such information.¹⁶ Customs have applied considerable pressure on VAT registered traders to use electronic lodgement as a way of delivering efficiency gains. Similar pressure on registered oils dealers leading to improved take up of electronic submission would also contribute towards these efficiency targets through the reduction in staff resources needed to process and input returns.¹⁷

7. Customs' Regulatory Impact Assessment for the introduction of the Registered Dealers Scheme was based on an imperfect understanding of the industry and its associated risks. The assessment was flawed, with a consequent risk that Customs failed to consider properly the Scheme's impact on traders. They estimated that some 1,200 traders would be required to register under the Scheme, but in practice nearly four times as many have registered.¹⁸

8. The outcome of prosecutions is an indicator of the effectiveness of Customs' Strategy in tackling oils fraud. Customs focus their prosecution activity where they believe it will be most effective. The number of convictions has increased, with 21 in 2003–04 for perpetrators of oils fraud, compared to 11 in 2002–03, but this still seems a very low number for the level of fraud that is taking place.¹⁹ The average length of sentence for oils fraud has increased from 11½ months in 2002–03 to 15 months in 2003–04. Customs' prosecution strategy aims to publicise penalties and punishments to provide a deterrent effect for other potential fraudsters.

14 C&AG's Report, para 2.49

15 Qq 15, 18, 24

16 C&AG's Report, para 2.27

17 Qq 4, 58–59

18 Qq 28, 49, 55

19 C&AG's Report, para 2.50

2 Customs' action to close the VAT gap

9. Customs have developed a method for calculating the total revenue losses due to VAT fraud. The estimate uses National Accounts data on consumers' expenditure to identify the total tax liability within the economy. From this, Customs subtract the actual receipts collected to provide a 'VAT gap' estimate. This estimate is then compared to data on the actual levels of fraud identified by Customs in their assurance work, which is subject to statistical analysis and extrapolation.

10. Customs have reported that they reduced the VAT gap from 15.8% of theoretical tax liability in 2003 to 12.9% in 2004.²⁰ They estimate that of the additional £5.5 billion of VAT collected in 2003–04, £1.7 billion was due to the effect of their activities aimed at closing the VAT gap. General non-compliance is one of the four main categories used by Customs to classify VAT losses, the other three being missing trader fraud, tax avoidance and failure to register. Customs can assess and measure the effect of certain of their activities in relation to general non-compliance on the VAT gap, but not in all of them. Customs have a range of activities within their work to tackle general non-compliance which they believe improve the level of VAT compliance, but without a readily measurable effect on the VAT gap.²¹ As a result, it is difficult to identify the effectiveness of resources deployed in this area, and to determine whether resources used could be more usefully deployed elsewhere to generate greater benefit for the Exchequer.

11. Customs' Regional Business Services are responsible for the collection of net VAT receipts from more than 1.8 million small and medium enterprises.²² Regional Business Service comprises 7 regions which have been set targets for collecting VAT receipts totalling over £38 billion in 2003–04 rising to over £42 billion in 2004–05 to contribute to the closure of the VAT gap (**Figure 2**).

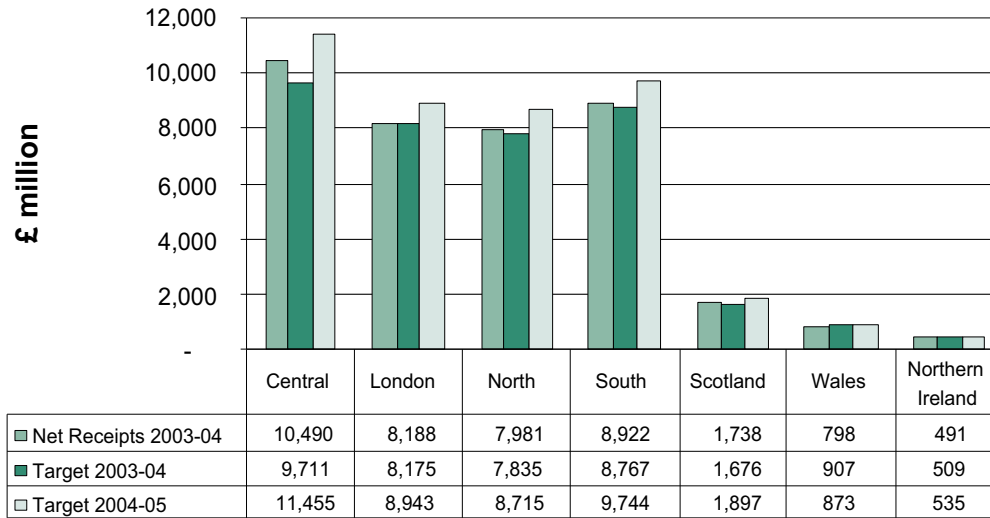
12. Customs can measure performance against these monetary targets and Regional Business Services as a whole exceeded their target by more than £1 billion in 2003–04. As Figure 2 indicates, five of the seven regions, accounting for more than 95% of net receipts, met or exceeded their revenue targets.²³

20 C&AG's Report, para 3.44

21 Q 12

22 C&AG's Report, paras 3.1, 3.7

23 *ibid*, para 3.48

Figure 2: Net Regional Business Service receipts by region²⁴

13. Customs cannot currently isolate the individual contributions made by each region to the closure of the VAT gap overall, and do not know the scale of the VAT gap within individual regions. The 'VAT gap' calculation is reliant on National Accounts data, prepared to an internationally agreed standard, which are not disaggregated by region. Any estimate of VAT fraud by region would need to utilise alternative economic and consumption data produced by the Office of National Statistics. If this were feasible, Customs could identify which regions were most effective at reducing the VAT gap and where the problem was greatest. They would then be better placed to deploy resources to tackle fraud, and disseminate best practice.²⁵

14. Customs conduct credibility and validity checks on individual trader payment records and return histories. But they cannot compare automatically a trader's performance with that of other traders within the same sector. Customs' overall analysis of VAT risk includes trends within a sector, but the standard analysis is not sophisticated enough to highlight individual traders whose performance is unusual by reference to comparable traders. Customs' National Business Picture will, in due course, allow the Department to develop a more sophisticated analysis.²⁶ Customs have not provided additional resources to build this capacity, however, instead prioritising developments in other areas.

²⁴ C&AG's Report, Figure 3.9

²⁵ Qq 13, 85-86

²⁶ Qq 31, 36, 43-44

Formal minutes

Wednesday 16 November 2005

Members present:

Mr Edward Leigh, in the Chair

Mr Richard Bacon

Greg Clark

Mr Ian Davidson

Helen Goodman

Sarah McCarthy-Fry

Jon Trickett

Kitty Ussher

Mr Alan Williams

Draft Report (HM Customs and Excise Standard Report 2003–04), proposed by the Chairman, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 14 read and agreed to.

Conclusions and recommendations read and agreed to.

Summary read and agreed to.

Resolved, That the Report be the Fifteenth Report of the Committee to the House.

Ordered, That the Chairman do make the Report to the House.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

[Adjourned until Monday 21 November at 4.30 pm

Witnesses

Wednesday 2 February 2005

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Mr David Varney, Mr Paul Gray, and Mr Mike Eland, HM Customs and Excise

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The reference number of the Treasury Minute to each Report is printed in brackets after the HC printing number

Oral evidence

Taken before the Committee of Public Accounts

on Wednesday 2 February 2005

Members present:

Mr Edward Leigh, in the Chair

Mr Richard Allan
Mr Richard Bacon
Mr Ian Davidson
Mr Brian Jenkins

Jim Sheridan
Mr Siôn Simon
Jon Trickett
Mr Alan Williams

Mr Tim Burr, and Mr Mike Suffield, National Audit Office, was in attendance.

Mr Brian Glicksman CB, Treasury Officer of Accounts, HM Treasury, was in attendance.

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL:

HM Customs & Excise: Standard Report 2003–04

Witnesses: Mr David Varney, Executive Chairman, Mr Paul Gray, Deputy Chairman, and Mr Mike Eland, Director General, Law Enforcement, HM Customs & Excise, examined.

Q1 Chairman: Good afternoon. Welcome to the Committee of Public Accounts, where today we are looking at HM Customs & Excise Standard Report 2003–04, and we are joined once again by David Varney who is the Executive Chairman of HM Customs & Excise. Would you like to introduce your colleagues, please?

Mr Varney: On my right is Mr Paul Gray, Deputy Chairman of Customs & Excise; on my left Mike Eland, who is Head of Law Enforcement of Customs & Excise.

Q2 Chairman: Thank you very much. I want to deal with two subjects, first of all the United Kingdom's oil strategy and then improving compliance of small and medium size enterprises. I will start with looking at the United Kingdom oil strategy. In the Comptroller and Auditor General's Report you will find a reference to this starting at page 110, at paragraph 2.2. You can see from that paragraph that the level of oils fraud is static and cash losses are increasing. Why are you not producing results, Mr Varney?

Mr Varney: I think we are producing results, although it is true that the level of percentages has plateau'd. The value has gone up because the value of the diesel market in total has gone up. In 2003 we were rolling out the scheme which we had for the registered controlled dealers of oil, and that had not begun to have a full impact, and we are looking forward to that having an impact in 2004.

Q3 Chairman: Let us look at one way in which we might improve matters. If you look please at page 115, paragraph 2.29, it deals there with electronic submission, which obviously improves matters, but have you thought about making this mandatory for traders?

Mr Varney: We are keeping it under review, is the appropriate response. We are conducting a review of the registered dealers' arrangements and of our experience to date, and we can keep that under review.

Q4 Chairman: But you accept it would produce considerable savings in jobs and money in your organisation.

Mr Varney: It may do.

Q5 Chairman: It may do or might not do? Give us a flavour of why not.

Mr Varney: We have come a long way with the involvement of the people who work in the industry, and we have achieved a lot with the voluntary approach, but we do want to look at it again. We want to take our time to make sure we do a proper appraisal.

Q6 Chairman: Obviously, the Inland Revenue is joined up with the Customs & Excise and you are looking for staff savings of 12,000 and 98,000—is that right?

Mr Varney: It is 12,500, yes.

Q7 Chairman: How are you going to achieve them if you are not going to take opportunities such as requiring electronic submission? Savings of 12,000 in numbers of staff is a very large number.

Mr Varney: We are looking at 12,500. A number of savings will come from greater use of e-filing. In this particular case, for reasons I have explained, we are giving it more careful consideration. In other areas we have made progress in terms of mandatory action, typically with a part of the total

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population, and we continue to look at the balance between voluntary compliance and mandatory action.

Q8 Chairman: What are the reasons for not making it mandatory for traders?

Mr Varney: Again, if we are getting the results with voluntary compliance, we would rather go with voluntary than compulsory.

Q9 Chairman: On page 116 in paragraph 2.34 you will see that staff working on excise matters do not get the IT systems support enjoyed by their counterparts working with VAT. Is that right? If so, why is that?

Mr Eland: This is a question of priorities. We have a programme to give all our officers electronic access, but we are having to do that in a prioritised way, and we are giving the top priority to VAT.

Q10 Chairman: Why?

Mr Eland: Because of the scale of the problems we have had in the past there in terms of tackling fraud, in relation to which, as the Report shows, we are making some very good progress in reducing the size of the tax gap.

Q11 Chairman: If we now look at fraud rates, if you look at page 119, paragraph 2.52, you will see there that it took you almost a year to establish that fraud rates for diesel did not decline between 2002 and 2003. Why is that?

Mr Varney: It is a function of the information that we rely on to do these sorts of judgments, and there is a time lag in putting together the regional information, which I accept does complicate coming to the level of activity of fraud.

Mr Gray: It is worth adding, Chairman, that although there is further progress to be made on this, as the Report itself brings out in paragraph 2.52, on an international comparison we are already leading the field here in term of our ability to estimate losses attributable to fraud. That does not mean that we are complacent about wanting to move a lot further, but there are serious difficulties that we are having to tackle piece by piece.

Q12 Chairman: I will now look to improving compliance in small and medium size enterprises, so perhaps we can turn to page 131, paragraph 3.46. Obviously, you are quite proud of your strategy in closing the VAT gap, but could it have been because of your own strategy or could it be largely the result of fiscal economic factors?

Mr Varney: Let us first of all give thanks to the fact that the gap has been closed, and then we can argue about how much is our influence and how much is the general economy. We have tried to separate out, using our analysis and intelligence capabilities, what we think is due to the economy and what we think is due to ourselves. We think the VAT receipts rose in 2003–04 by £5.5 billion and we think the reduction in the tax gap was about £1.7 billion of that. We go through quite a process, but I would be the first to say that this is not an exact

science. This is trying to attribute changes and shifts in the components of the gap and seeing what we can do. Some things we can tie back to specific activities we are doing; in some, the totality of what we are doing has a general impact on increasing the level of VAT compliance.

Q13 Chairman: A matter of interest to the National Audit Office is the impact of the regional business services, and you can see that reference is made to that in paragraph 3.48 on page 132. Is it possible to isolate the contribution made by these regional business services in reducing the VAT gap?

Mr Varney: No.

Mr Eland: Again, it is the same sort of issue as we have had in relation to the general gap. Yes, you can measure some specific contributions from a particular part of the department, but the key thing with developing VAT strategies and other compliance strategies of this kind is that you are trying to get each part of the department to contribute to an overall whole, and therefore you can be sure that some contribution is coming from each particular area, but you cannot precisely divide up the whole in very precise terms.

Q14 Chairman: Let us try and look at that a bit closer. If you look at paragraph 3.30 on page 129, can you say something about your work in assessing trader risk as opposed to allocating staff resources? Are you getting it right?

Mr Varney: We are going through a process of looking at different groups of traders by virtue of size, experience, and trying to cull all that we know and then make a decision about how to deploy the resources. With the passing of time, we will move our attention from one group to another. There is a temptation to think that if you have a very high-risk group, you should put all your resources in that; but as you saw happened in the year that is being reported upon, we became concerned about the growth in the number of traders who had not been registered, and so we put resources in what was seen as a relatively low-risk group, but which we felt that if we did not pay attention to, could become a higher risk group. There is an element where the variability of where we address resources is an element in increasing voluntary compliance.¹

Q15 Mr Williams: Mr Varney, would you turn please to paragraph 2.9 on page 119 I want to concentrate in my few minutes entirely on oil, because we have been on the VAT issue so many times before. These two graphs are very interesting, but in a way they are visually deceptive. They imply a correlation that does not necessarily prove to be of much value. Can I suggest that you look at them somewhat differently? Looking at this, you would say—and the Report says—how well the North has done. In fact, the reality in terms of efficiency is quite the reverse. If you look at London, with very

¹ *Note by witness:* The Chairman gave as an example those traders (referred to in paragraph 3.39 of the NAO Report) allocated to Trader Group 1 which although registered had yet to be contacted because they were regarded as low risk.

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few, it has had four hits with only 15 packages—and it takes four packages to get a hit in London. The second is Northern Ireland, at the other end, which uses 4.5 packages to get a hit. If you move to Central, that needs 5; Wales and the North need 7.5, and 7 is the national average. If you look at the figures differently, one is forced to ask a different set of questions. Why is it that Northern Ireland and London have a much higher and more effective rate even though they do not have the same delivery rate in numbers of packages and hits; that the number of packages they initiate, they are the most effective of the regions—not that you would guess, looking at that diagram? Have you any thoughts on that? Have you looked at it in this way at all?

Mr Eland: First, you are absolutely right; you can look at the graph in different ways. What we are trying to do here is to share good practice right across the regions and ensure that—get as far as possible—

Q16 Mr Williams: That is not answering my question. Have you looked at them from this perspective?

Mr Eland: Yes.

Q17 Mr Williams: In that case, why have you agreed to a Report which presents the North as being the pinnacle to aspire to, when in fact it has one of the lowest hit rates for the packages it brings forward? It is producing more, but is it as efficient, because all the evidence suggests it is not?

Mr Eland: The purpose of the graphs is not simply to show that relationship; there is also a degree of activity—

Q18 Mr Williams: No, I understand that, but we are interested in value for money, you see! We are not interested in who puts most into producing packages. What we are interested in, and what you should be interested in—and if you are going to present best practice you should be asking the question, why is it that London and Northern Ireland are so much more effective in their choice of the packages they produce or initiate, whatever term you use?

Mr Eland: I am agreeing with you that that is one of the things we are doing. Our objective in using this information is to improve performance right across the board.

Q19 Mr Williams: What lessons have you drawn? The impression I get from reading the Report is that your lessons are drawn from the mass producer of packages because they produced more hits, although they are less efficient. What lessons have you learned then from the North and Scotland as to why they are so successful; and what lessons have you drawn from London as to Wales, as to why they are so ineffective in their use of these systems?

Mr Eland: There is a complex mix of different things. There is the volume of activity each area is undertaking—

Q20 Mr Williams: We understand that; that is what you are showing me. I understand that.

Mr Eland: It is very difficult to isolate out one or two reasons and say, “this is why this region has a better match between . . .”

Q21 Mr Williams: Well, I am sorry, that—

Mr Eland: What we are doing is analysing—

Q22 Mr Williams: Yes, but with respect you said you were disseminating best practice, and yet you are not able to answer my question as to what best practice is being pursued in London and Northern Ireland to disseminate to the other others.

Mr Eland: The best practice will be quite detailed things about what areas of intelligence are productive, compared to other avenues that might be being explored. It is that sort of best practice I am talking about here. It is difficult to answer.

Q23 Mr Williams: So why is London, which looks to be the worst, looking at the diagram, so efficient in the rate of return from the packages that are initiated, or whatever term you use?

Mr Eland: Again, it can be for a variety of reasons. It can be the quality of the intelligence they have been able to obtain. That does not mean officers in the North are poor in assessing intelligence.

Q24 Mr Williams: Yes, but you are waffling, with due respect. What I am asking you is, what are the lessons. There are lessons there. There must be lessons. You are saying what it could be, thinking off the top of your head, “damn, I have got to find an answer to this”. The reality seems to me that you have not been asking the right questions.

Mr Eland: I do not think that is the case. I am trying to explain what we have been looking to do in each of those areas in order to compare good practice, which is to analyse the successful areas that we have developed, and then share that across—

Q25 Mr Williams: Then why is that not reflected anywhere in the Report? Why have you not said to the NAO when you saw this—after all, the facts are agreed, are they not, in the Report—“hold on, we have spotted something different and we see it a different way”? The NAO would be very receptive, if they felt it was worthwhile, but I get the impression that you never thought of it.

Mr Eland: I am sorry, but there is a reference in here to precisely this point I am making about the need to develop and share good practice and to develop comprehensive feedback. It is precisely what you are talking about.

Q26 Mr Williams: You are missing my point entirely. I know that sharing best practice is what you want to do, but I am not sure, on the basis of the evidence we have in front of us, and if these are your presentations of performance, that you are looking for the lessons in the right place. However, I am not getting very far with this, and I am floating it as a thought. I do not mean to be

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unpleasant and I do not mean it nastily, but it is another way of looking at it and I think it could be well worth examining from the perspective I have suggested. I have used my time, but Mr Varney I think wants to come in.

Mr Varney: The point is that what lies behind these graphs is a lot of experience, which if we had followed the advice and put what we thought was best practice, would occupy volumes in terms of the nature of the oil market. You saw that the registered dealers—we thought originally were 1,600, but we then got to 4,500 because of the intermediaries; and clearly in places like London with smaller numbers of intermediaries, oil is imported in a clearer way than in the North, I would suggest. Northern Ireland is supplied from outside Northern Ireland. There are different natures of the market that would give different sources of intelligence. I do not think you do best practice just from a couple of graphs. What you have drawn attention to is a very fair analysis of the relative performance and how to present that in a different way. If we were to do justice to what we could learn as best practice—frankly, it is a lot of operational details.

Q27 Mr Williams: That comes back to the Chairman's point about getting more use of IT and so on to help you disseminate this complex information.

Mr Varney: True.

Q28 Mr Williams: I have used nearly all my time just trying to elicit information on one aspect, but can I ask about one other area briefly. If you go to paragraph 2.20 on page 113, why is it that your estimate of the traders was only one quarter of what you now recognise to be the number of traders?

Mr Varney: We started off with 1,200 bulk distributors, and as we got into studying the nature of the problem, we uncovered that there were plant-hire companies, hardware stores and certain businesses that dealt in high-risk oil products, so as we got into it we saw another group of people as intermediaries. As you appreciate, the oil industry starts with big refineries—

Q29 Mr Williams: It explains it in the Report, and I understand that, Mr Varney, I assure you. You seem somewhat surprised that some of the groups on further examination and registration have shown up. We have farmers' machinery for example. Farmers are very popular in this Committee! Eyes will have lit up when people read paragraph 2.20 and saw that they were back with us yet again. Have the farmers been much in evidence in the successful hits?

Mr Varney: I do not have the impression that farmers have been distinguished in that particular field.

Q30 Mr Williams: It is one that you have actually missed? I genuinely do not believe that!

Mr Varney: That is why I was hesitating!

Q31 Mr Simon: Good afternoon, gentlemen. I appreciate my wiser colleagues have done a lot of VAT, but I personally have not done a lot of VAT, although having for many years been a VAT-registered small business myself, I have thought a lot about VAT, and indeed about meeting the VAT man himself! Paragraph 3.14 on page 125 states: "The development of the national business picture marks a significant step forward." Good. "It does not however currently include a mechanism for routinely comparing the performance of an individual trader to the overall performance of their trade sector for which staff are reliant on the main VAT system." Then it goes on to talk about what people do in other countries and IT issues. I just wanted to check that I understood that because that paragraph seems to suggest something that cannot be true, which is that there is no mechanism for comparing the performance of an individual trader to the overall performance of their trade sector. The key bit that explains it must be "for which staff are reliant on the main VAT system"; so what does that mean?

Mr Eland: The main VAT system is used to establish, on a historical basis, compliance—

Q32 Mr Simon: What is the main VAT system?

Mr Eland: The main VAT computer into which return information is fed. If you put in your VAT return, that is fed into a computerised database, which enables us to see what your payment history and the rest of it is.

Q33 Mr Simon: By "the VAT system" it means the system which holds the information that is inputted by traders.

Mr Eland: Yes.

Q34 Mr Simon: "Staff are reliant" means, "if one of our staff happens to have a look at it and it seems that something seems awry"

Mr Eland: Yes. We can go into the main VAT system and look to see at the history of a particular trader. We can do things about aggregating the tax that we get from a particular sector and so on.

Q35 Mr Simon: But there is no—

Mr Eland: What this is getting at is that—

Q36 Mr Simon: What I am getting at is, is there no mechanism automatically that will trigger an alert in the case of an obvious dissonance between a trader and a sector?

Mr Eland: Yes. When a return is made, it is subject to a certain amount of validity checking that does enable some credibility checks to be tested on it. What we cannot do at the moment is judge whether a company's performance economically is in line with that sector. We can check whether there is credibility within the information on the return, but we do not have the databases yet to be able to say,

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“what would you expect currently that sector to be performing at, in terms of economic performance?” and judge on that.

Q37 Mr Simon: You just said, “We can check that there is credibility”, and previously you said: “There are validity checks”. What does that mean? How does that work? Does it actually work?

Mr Eland: Yes, it does. It is a long-established system. It will compare the historical performance so you check whether or not a particularly large repayment claim is being made in one particular quarter, and that could lead to that repayment claim being blocked until it is further investigated and we get an explanation as to why. There are things like that which are used at the moment and work very well. We are looking to develop it further and get a more rounded picture of what you would expect them currently to be doing, in terms of performance in a particular sector and the point in the economic cycle, so that you get a much better intelligence picture.

Q38 Mr Simon: You are effectively saying that you can do it and you reckon you probably often do do it, but you do not necessarily do it, and you have no way of knowing—

Mr Eland: No, I am saying we do it, and we do it systematically and regularly, but only up to a particular point. We want to develop that and make it better.²

Q39 Mr Simon: The same paragraph it says, “Customs’ ability to develop a similar approach is constrained by IT factors.” What does that mean?

Mr Varney: Overall, we have a set amount of IT capacity.

Q40 Mr Simon: Sorry, what does that mean? Why has everybody else got infinite IT capacity but you have a set amount?

Mr Varney: I think everyone has a set amount in some way. We have a budget and we have manpower and resources; and we have a number of system changes we wish to make in a year, and we have to prioritise those for where we put the resources.

Q41 Mr Simon: So it is a resource constraint.

Mr Varney: Yes.

Q42 Mr Simon: If the Government were to allocate more money to you for computers, this would not be happening.

Mr Varney: I would have another level of resource constraint. This budget may still be resource constrained. I do not think the Government could allocate enough money to do everything that we wanted to do on an IT basis. The demand would expand to exceed the supply.

Q43 Mr Simon: Is there a technical constraint or is it only a resource restraint?

Mr Varney: No, it is a resource constraint. It is a question of priorities. We were at the early stage of a strategy that was in a sense world leading and leading edge. As Mike has described, we have used a lot of the information we have got in order to progress the strategy. As we have got more experience of it, we will then have proposals for what IT system changes we want to make, and they will go through the process of asking: is this a priority as against the wider priorities of HMRC?

Mr Gray: Can I add a bit of context on this because your original question was on how much we focus on risk within a trade sector, and it is a dimension of overall risk that we are keen to put more weight on. If we go back a few years, that was not seen in the overall picture of risks as being perhaps of such potential significance as we now see it. What we are looking to do is shift resources in that way and part of the IT issue is to be able to make the adaptations to our systems so that we can make better use of information most of which is already sitting within our systems. How can we join it up more effectively to shine the light, as you want us to do, on trade sectors.

Q44 Mr Simon: Can I just be clear, going back to the initial remarks: are you saying that if an enterprise files a VAT return which is significantly at variance with what an intelligent model would expect from industry comparators, that what you described as the consistent and successful tests that you currently effectively manually do, the validity and credibility checks, would be bound to pick that up, or would be very likely to pick that up?

Mr Eland: They are not manual checks; they are computer checks built in and the parameters set within the system. The question is the degree of sophistication. We cannot do a sophisticated analysis of whether a company is performing as you would expect a company of that size to do within a trade sector. We do not have the—

Q45 Mr Simon: That is what I am asking you about. I am asking about what you can do.

Mr Eland: We cannot do that sophisticated analysis, but we can look at the pattern of that person’s return and spot deviances from it, and so we can do a certain amount of this, but not all of that.

² In Questions 36–38 there may have been some confusion between the functionality of the National Business Picture (NBP) and the “main VAT system” mentioned in the Report. The NBP is a newly developed tool which enabled global VAT data to be manipulated in a number of ways to plot trends and emerging risks. This includes cutting the population by trade sector, but due to IT constraints it is not possible at present to investigate these trends on the NBP down to individual trader level. The main VAT system includes all VAT return data and includes risk analysis systems which test the credibility of individual VAT returns against many parameters, including performance against the trade sector. Our risk personnel make use of this data when determining the need for a VAT inspection.

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Q46 Mr Simon: I was not asking you about whether you could compare a person's return with their previous term; I was asking you about industry comparators. You said that you can do that, and that is done very successfully, but now you are saying you cannot do it at all! I do not understand. Can you do that, or not?

Mr Eland: We cannot do sophisticated comparisons to what a company of a particular size within a—

Q47 Mr Simon: Can you do it in an unsophisticated way?

Mr Eland: We can do some crude sorts of checks, yes.

Q48 Mr Simon: Is that done, as I said, manually?

Mr Eland: No, they are done by building in parameters into the computer system.

Mr Simon: I have to say, I do not feel greatly more informed now than when we started, and, in all humility, I am not stupid, so it cannot just be me! Thank you anyway.

Chairman: Perhaps you could try and inform Mr Allan now!

Q49 Mr Allan: I want to go back to oil and the point that Mr Williams raised about the regulatory impact assessment. Paragraph 2.20 tells us that you put forward a regulatory impact system when asked to set a scheme up, saying there would be 1,200 traders registered, and it turns out that you now have 4,700. Is that a major failure, Mr Eland—and I address that to you because you were responsible at the time, I assume? From Parliament's point of view, we make regulatory impact assessments and make decisions on the basis of them. Do you think it is a major failure that you did so badly and get that one wrong?

Mr Eland: We clearly did misunderstand one particular part of the scheme, yes. We did not realise that particular groups that were subsequently identified should be in at the outset. We started with the most immediate groups that we knew would be involved and talked to the trade associations that those groups are represented by, to get a feel for the sector. This was a new sector that we had not had any dealings with initially before.

Q50 Mr Allan: You had not had any dealings with it before, admittedly, but you were responsible for collecting the duty—

Mr Eland: No, and this is the point. We collect the duty at the top point in the chain, but this is bringing in people further down the chain who are in the distribution network and who are being brought in to the scheme to enable us to build up an intelligence picture of the distribution network. The duty is paid at an earlier point.

Q51 Mr Allan: But you have always been responsible for enforcement against people in the chain. That is not a new responsibility, is it, if this is where the fraud is happening?

Mr Eland: We have always been responsible for tackling fraud but that can occur at any level of the chain. Our understanding of the industry was very much focused at the top point.

Q52 Mr Allan: Where do you think the fraud occurs? Do you think it occurs at the top point or down—

Mr Eland: No, we believe it occurs, obviously, at lower levels.

Q53 Mr Allan: And those are the levels you did not understand.

Mr Eland: This is part of building up the picture. The fraud is a recent phenomenon, and as we have developed our means of tackling it so we have tried to improve our understanding of the industry and distribution networks, and to bring the next level down into some sort of regulatory control.

Mr Gray: An important point here is that although clearly the absolute numbers proved to be very much higher because of these types of activity, the main category we missed was activities where fuel distribution is in most cases a smaller and secondary part of the business activity. Okay, we should have spotted that more clearly earlier on. In terms of assessing the overall risk right through the distribution network, the issue we are now looking to focus on, having understood better the nature of the distribution network, is our understanding of where the risk lies. Part of the post implementation review of this exercise will be to look at these large numbers of small secondary suppliers to see if they represent a risk, and whether we are adding excessive burdens to them.

Q54 Mr Allan: Where are you in the assessment now? You have registered 4,700 dealers. To what extent are the dealers complicit in the fraud, and how many of them are doing it? You must have some kind of working assumption to understand who you are talking about as doing the fraud. This is 6%, 850 million a year—big sums of money, and you must have some idea who is doing it.

Mr Gray: My sense is that the greater part is in the larger operators rather than in these small secondary areas. I hesitate to offer a firm opinion on that, because this is work in progress as we gather this information and try to assess whether there is significant risk in these large numbers of smaller operators.

Mr Varney: I used to work in the oil industry and I used to be responsible for an oil company in the UK. It is not in the interests of the big oil companies for this market to exist with a large amount of fraud because basically it is tax-free diesel competing against taxed diesel. Whilst it is unfortunate that we did not get the numbers, it is also a reflection of the state of knowledge in the industry about what was going on.

Q55 Mr Allan: That is what is making me nervous. You are trying to police something and you do not even know what it is you are trying to police. That is what it sounds like.

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Mr Gray: Even after consultation with trade bodies we did not unearth the scale of the numbers.

Mr Varney: There are lots of bits where we are combating fraud or serious evasion, where we start with knowing there is a problem but we are not quite sure how big it is or what the nature of it is. If you look at missing trader intra-community, we have quite a lot of knowledge which we have built up. We tend not to share it because we do not want people taking advantage of that knowledge to do more mischief. Particularly in these new approaches, we are learning about the scale of the problem. We start with something we think is right, and it turns out not to be correct, and in this case we under-estimated the complexity of the industry.

Q56 Mr Allan: Mr Varney, if we now have registered all the dealers, is it your target that 100% of the dealers that you have registered should not be involved in fraud; in other words, is it realistic to assume that if you have registered somebody and you are policing them properly, there should be no fraud taking place at that level?

Mr Varney: One of the penalties of having a registered dealer scheme is that if they are not complying with their responsibilities, they can be de-registered.

Q57 Mr Allan: Have you de-registered any so far?

Mr Varney: Not so far. In regard to the Inland Revenue, let me say again with regard to Customs & Excise: the dilemma, when we introduced the new approach is to try in the first year or so to get as much understanding of the new approach so we give priority to explaining and persuading, and then we move to harder enforcement. You see that we have started to step up our enforcement activities.³

Mr Eland: Although we have not de-registered anybody, we have prevented people becoming registered. About 40 or 50 people have been refused because they have criminal records or whatever, and so we are able to stop people coming in, and we have this sanction for non-compliance, as the Chairman has explained.

Q58 Mr Allan: In paragraph 2.27 we are told that the institute body, the Federation of Petroleum Suppliers, pointed to cultural differences whereby traders appeared to be more comfortable supplying data in hard copy, and they say that they have systems for submitting returns electronically but choose not to use them. Are you being a soft touch here? Can they really stand up and say, “we do not like doing it electronically and therefore we will keep using the system that is a real pain and less enforceable”? That is okay, is it, and we can leave them? There are cultural differences, and it is an extraordinary—

Mr Eland: Mr Chairman, we are trying to bring in a new scheme with a degree of soft touch because the great majority of these people are legitimate

businesses. We do not want to put excessive cost on them, and we have been trying to do that in a sensible and sympathetic manner. Clearly, this is something we are not just going to stop at; we are talking to businesses and to the trade associations. We want to get voluntary agreement that it should be submitted electronically.

Q59 Mr Allan: You are seeking for electronic filing of VAT returns.

Mr Varney: Yes.

Q60 Mr Allan: That is not going to—does that not move towards 100%?

Mr Eland: We want electronic filing. We want to encourage people to do that. We want to tackle that cultural issue, but to do it voluntarily first of all rather than going straight into compulsion.

Q61 Mr Allan: You are saying to all small VAT-registered businesses that they will have to move to electronic filing.

Mr Varney: We are trying to encourage them rather than saying “you have to”. At the moment we get the vast majority of volume filings done electronically; but they are only a small percentage of the total number of files.

Q62 Jon Trickett: I want to focus on the tax gap, which is the estimated difference between the amount of tax due and the amount of tax which people pay. The estimate, which is rather precise, is that at the moment the tax gap at the beginning of this period is 15.8%, and the target is to get it down to 12% eventually.

Mr Varney: Yes.

Q63 Jon Trickett: Can you tell the Committee about the accuracy of the data upon which you are basing your estimates? It seems to me slightly preposterous to suggest that you have the figures very accurately in some ways.

Mr Varney: I do not think it is right to the nearest penny. We are trying to assess the total amount of expenditure in the economy that theoretically is available for VAT. Then we look at the tax liability on that expenditure, based on the commodity breakdown, so we have some sort of model run by economists and statisticians. We then take a view of what would be legitimate deductions from VAT liability through schemes or relief or government policy, and that would give us a net VAT theoretical tax liability, which goes by the entrancing name of VTTL.

Q64 Jon Trickett: Given the national debate going on at the moment about the Chancellor’s estimates on the economic activity within the nation, and given the fact that we have so many different points of view about whether the economy will upturn in any quarter, consultation you tell us if you use the same statistical base to synchronise with the Treasury’s estimates? Secondly, given the

³ Note by witness: Up to the end of 2004 four traders have had their registration revoked due to the risk they pose to the revenue.

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inaccuracy of everybody else in estimating where we are going to be, how is it that you are producing something that you think is accurate?

Mr Varney: We use the Office of National Statistics data.

Q65 Jon Trickett: Is that synchronised with the Treasury estimates?

Mr Varney: The Treasury is dealing about the future.

Q66 Jon Trickett: So are you, are you not?

Mr Varney: This is a historic Report on the gap. We do some forecasting of what we think the gap might be and what it might involve in terms of our target, but what we are reporting is historic, so we are looking through the rear-view mirror and using the data we have got—what we thought should have been the theoretical VAT payments as against the actual, and then estimating the gap. Of course, we are joined up with the Treasury in terms of forecasts.

Q67 Jon Trickett: At what point do you produce your results?

Mr Varney: We will give you the latest data we have. Some of that data is subject to revision as the Office of National Statistics gets more data. When we get that, we obviously revise the data.

Q68 Jon Trickett: At what point do you produce figures?

Mr Varney: At the Pre-Budget Report.

Q69 Jon Trickett: They are based on the previous year.

Mr Varney: Yes.

Q70 Jon Trickett: So in November you estimate what the tax gap was for the previous year.

Mr Varney: Yes.

Q71 Jon Trickett: Does that change any further, generally speaking?

Mr Varney: I am sure there are minor changes backwards and forwards, hopefully, in the right direction.

Mr Gray: If the underlying accounts data changes, then, yes, it will change with it.

Q72 Jon Trickett: You have a percentage-based calculation which you then turn into financial targets.

Mr Varney: We are set a percentage target under our PSA.

Q73 Jon Trickett: You turn that into cash, and give that as targets to the Department.

Mr Varney: We do a bit of both. We have a target of percentage, and we obviously look at how much money we think we have collected in terms of

increased VAT, and how much we think is general economy, as against how much has come from our VAT-compliance strategy.⁴

Q74 Jon Trickett: Looking at paragraph 3.8 on page 131, you turned the tax gap, which is in percentage terms in terms of your objectives, into increased cash returns. As I understand that table, that is the percentages turned into a million pounds. When you said you are looking in the rear-view mirror, somehow you have turned the rear-view mirror into guiding you on what motorway you are on, and turned it from percentages into millions of pounds.

Mr Varney: What we have done there is use the—I think we are trying to discuss two things: the historic percentage you started with, which was the answer—how do we do it in the rear-view mirror; in terms of increase in yield, those are fed in to the PBR type forecasts and those are derived numbers using the basis of the assumptions for the economy going forward.

Q75 Jon Trickett: I was talking all the time about the projected gap actually, and you may have answered different questions from the ones I was posing, but somewhere I read that you have achieved 12.9%.

Mr Varney: Yes.

Q76 Jon Trickett: Your objective was to get down to 12%, was it not?

Mr Varney: Yes.

Q77 Jon Trickett: That 12.9% was at 2003–04. Is that figure of 12.9% accurate?

Mr Varney: It is our best estimate at this point in time.

Mr Gray: it is based on pretty firm figures for the actual amount of VAT that we collected.

Q78 Jon Trickett: We are making heavy weather of this. Let me try to push forward a little bit. Paragraph 3.8 talks about £35 million. I understand that that was your projection of the decrease in the tax gap or the VAT gap that you would achieve in that particular year.

Mr Gray: It is one part of the gap. It just relates to one of our areas we are looking to focus on, this general non-compliance area, which was the area of VAT activity that the NAO Report concentrated on; but there are other areas such as the—⁵

Q79 Jon Trickett: What was your projection of the increased yield produced by the decrease in the tax gap for 2003–04 because ostensibly this looks as though it is supposed to be £35 million? You are now clearly saying it is only the fourth part of it.

⁴ Questions 66–73 refer to the PSA target for reduction of the VAT gap, this was set as a percentage rather than a monetary amount in an attempt to enable measurement free from wider economic factors.

⁵ *Note by witness:* The reference to paragraph 3.8 is incorrect and should actually refer to Figure 3.8.

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Mr Varney: We are saying that in terms of reducing the tax gap there are a variety of activities in which we engage, of which this general compliance is one element. We have got a breakdown in terms of the missing trader fraud, which we think probably contributes somewhere between £480 and £610 million.

Q80 Jon Trickett: I have not been the only Member so far who has asked questions to you—and I am putting it in my words rather than their words—I am wading through treacle with you. I am just simply to trying to find out what your estimates of the increased yield will be to achieve your target reductions in the tax gap. How much would you expect the increased yield to be in millions of pounds to achieve these targets?

Mr Varney: We think broadly about £2 billion.

Q81 Jon Trickett: £2 billion per year?

Mr Gray: Yes, each year.

Q82 Jon Trickett: How much are you anticipating you will achieve in the current year?

Mr Varney: About £1.5 billion.

Mr Gray: But that covers all sources of VAT non-compliance.

Q83 Jon Trickett: Are you able to tell the Committee in a single answer how much additional investment you have made to achieve a £1.5 billion return?

Mr Varney: About £110 million.⁶

Q84 Jon Trickett: I was hoping we would get through all of those questions in the first two minutes of my nine minutes. On regional distribution, at paragraph 3.9 on the following page, presumably those are not percentages; they are billions of pounds to be achieved by each region. Do they include targets for reductions in the tax gap or VAT gap by region?

Mr Varney: Yes.

Q85 Jon Trickett: Are you able to tell the Committee whether there is a differential tax gap between the regions?

Mr Gray: No, we cannot because we cannot estimate—we do not have the national accounts data on a regional basis, and therefore we could not do that. What this does give is the allocations of the overall reduction we are looking for, allocated

out by region according to what we think is a sensible distribution of those targets across the country.

Q86 Jon Trickett: I wanted to ask you about the way you have distributed the £150 million additional expenditure to produce a £1.5 billion additional income, but I will just put this final question because my 10 minutes has gone now. Would I be right in assuming that the London economy has a larger tax gap than, say, the North, where I live; or is that something you have no idea about?

Mr Gray: We do not know because we do not have the underlying regional—

Q87 Jon Trickett: You have no idea at all whether you are more effective in garnering VAT from London as to the North or Scotland or anywhere else? You do not have a clue.

Mr Gray: We have a clue, but it is not based on our ability to say precisely what is the tax gap region by region. We have a number of other indicators about compliance which we use to try and inform how much resources to put into those areas.

Q88 Chairman: Did you say “we have a clue”?

Mr Gray: Yes we have a clue.

Jon Trickett: Can you provide us with any information you have at all on this matter? It is important if the North, for example, or Scotland, are paying far more VAT per head than London, as I suspect might be the case. I am curious now whether any work has been done on it at all.⁷

Q89 Jim Sheridan: Mr Varney, can I concentrate my contribution on VAT on fuel, or VAT fraud on fuel, and particularly how that affects the legitimate industries such as the road haulage industry, a very competitive industry that is struggling to compete because of the fraud element contained in it. Can you estimate how much revenue is lost to the Chancellor of the Exchequer through smuggling of fuel?

Mr Varney: The number in 2003 was about £850 million.

Q90 Jim Sheridan: That is just for smuggling.

Mr Varney: We do not have enough statistics to be able divide it up between the various categories of illegality. If we say that illegality, as far as we estimate it—the illicit market is about £850 million.

Q91 Jim Sheridan: One of the things the Road Haulage Association is extremely concerned about is their competitors running with fuel tanks full the length and breadth of the country without paying any VAT whatsoever. The figures that I have is that they can fill their tanks up with something like 1,400 litres of fuel, which will take them 2,500 miles throughout the whole of the UK.

⁶ *Note by witness:* Questions 80–83: The PSA target for SR2002 is to reduce the VAT Gap from 15.8% in 2002–03 to 12% by 2005–06.

To reduce the VAT Gap, VAT receipts must grow at a greater rate than the increases in VTTL that reflect the underlying changes in expenditure and growth of the economy.

Reductions in VAT Gap are synonymous with increases in VAT Receipts. Over the three years of the PSA measure [SR2002 period], based on current models, we need to increase VAT receipts by £5.5 billion over and above the increase in receipts attributable to general economic growth.

⁷ Ev 20

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Mr Eland: That is right. There is also legitimate cross-border shopping, about £300 million in terms of fuel bought overseas and brought back to the UK. It is legitimate under single market rules. What the Government is doing to counter that problem is introducing a new scheme, a lorry road user charge, whereby lorries of that nature coming in to the country would pay a tax according to their use of the roads, and there will also be a rebate scheme for UK hauliers who purchase in the UK. The issue you are talking about is being addressed by a policy change.

Q92 Jim Sheridan: When will this legislation come in?

Mr Gray: The legislation will be brought forward over the course of successive finance bills. The Government's last announcement indicated the intention to bring in the lorry road user charge by 2008.

Mr Eland: The road haulage industry is obviously involved in discussions around that and is supportive of the concept.

Q93 Jim Sheridan: What is the legal limit of fuel allowed to be brought into the country in these lorries? The reason I ask is that I am extremely concerned about this because I have anecdotal evidence of lorries coming outside the UK bringing spare tanks of fuel with them. From a safety aspect, they are bringing barrels of oil with them as well.

Mr Eland: Yes.

Q94 Jim Sheridan: So they are re-fuelling in this country but not paying any VAT whatsoever.

Mr Eland: It is illegal to bring in fuel of that kind in an additional tanker that is not for use on that journey but is for re-sale or something. We do have checks to try and detect that at the frontier.

Q95 Jim Sheridan: How do you carry these checks out?

Mr Eland: We examine lorries.

Q96 Jim Sheridan: That leads me into another problem with road haulage that has been identified. These illegal operators usually drive during the night when there are no checks. They rest during the day and drive during the night. How will you be able to check them during the night?

Mr Eland: At somewhere like Dover we have a 24-hour presence, so we do checks at different times of day and night.

Mr Varney: We have the capability of looking inside a vehicle using electronic scanning from outside.

Q97 Jim Sheridan: You only check them at Dover.

Mr Eland: Dover is not the only 24-hour port that we do have—that is a principal entry point for lorries, and we also have the Channel Tunnel fixed link. Where there is a very big volume of traffic, we would have a 24-hour presence.

Q98 Jim Sheridan: Are they also checked on the way out in terms of checking the mileage when they come into the country?

Mr Eland: We would not be doing those checks. We are looking for smuggling not use of the petrol or diesel while it is in the UK. We are looking for concealed goods; we tend to do it but in port rather than outside.

Q99 Jim Sheridan: They would come into the country with full tanks and maybe excess tanks, run the length and breadth of the country for maybe a couple of weeks and then back down again and they would not be checked to see what their mileage is or what fuel they have used?

Mr Eland: We cannot completely police that. We are looking for the deliberate smugglers. It would be very difficult for us and very resource intensive. I do not think it would be the best use of our resource to do that sort of checking but we do checks for smuggling.

Q100 Jim Sheridan: Organisations like the Road Haulage Association are trying to compete with these people and would argue that it is a good use of your resources.

Mr Varney: We have to make choices. What the road haulage industry can usefully do is whistle blow on those where it is organised. If they have ideas about rogues, we will follow them up because that is what we are in the business of trying to stamp out to make sure there is fair competition and that the Exchequer gets its just deserts.

Q101 Jim Sheridan: There is no fair competition. You can cross the border in Northern Ireland, fill your tanks up, spend a week in the UK delivering and go back again and not pay a penny in VAT. How do legitimate taxpayers or VAT taxpayers like the Road Haulage Association compete, apart from the loss to the Treasury in terms of VAT?

Mr Varney: In Ireland it is a particular problem because you have a land border which people can drive across. We have tried to bring activity to bear where there is systematic illegality, but there are limits to what we can achieve. All we can do is enforce the law that is there and what is reasonable on the way in.

Q102 Jim Sheridan: You said “enforce the law that is there”. Is there a suggestion that you need further improvements to the law or further resources to deal with it?

Mr Varney: The proposal that is coming forward on the lorry road user charge is a reflection of a consideration among a number of governments, switching the basis on which they tax large vehicles so that they find it more difficult to evade taxation when they use the road or discharge into the environment.

Q103 Jim Sheridan: Could you clarify the extent of the misuse of red diesel and how effective you are in terms of trying to deal with it? It is a big problem for those in that industry.

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Mr Eland: The largest part of that figure, the 850 million, is concerned with misuse of red diesel as a substitute for legitimate diesel. That is the most common form of fraud.

Q104 Jim Sheridan: How much is lost in terms of smuggling fuel into the country if the largest part is used for red diesel?

Mr Eland: It is very difficult to break down that 850 figure between smuggled and UK-produced red diesel which is then used improperly. The most common form of fraud is diversion of red diesel into the legitimate market.

Q105 Jim Sheridan: What about levelling the fuel duty on all kinds of fuel? Would that be helpful in terms of dealing with VAT fraud?

Mr Varney: It is rather difficult because red diesel attracts a low rate of tax because the belief was it went to industries where they could not bear the level of taxation that could be borne by road transport.

Q106 Jim Sheridan: That is no longer the case. Do you accept that?

Mr Varney: It is not whether I accept it; that is the policy that we are having to operate under at the moment. The difficulty is if you were to end up with a flat rate of tax you would collect a lot less money and have a lot of economic impacts which would be second order, which would be on the viability of some of the activities which would then have to pay much higher rates of tax.

Q107 Mr Bacon: Mr Eland, were you aware of the payments of £50,000 a month being made in the criminal trial referred to on page 88, section five, of the resource accounts?

Mr Eland: I became aware of the payments in February 2003.

Q108 Mr Bacon: February 2003?

Mr Eland: Sorry; February 2004.

Q109 Mr Bacon: It is quite a big difference. You became aware of the fact that these payments to the police were being made in February 2004?

Mr Eland: Yes. My concern at that point was how long the police investigation was likely to last and whether or not these payments were justifiable in policy terms. When we began to examine it—

Q110 Mr Bacon: When did you begin to examine it?

Mr Eland: We started to examine the issue from that time onwards.

Q111 Mr Bacon: In policy terms, you did not tell the Treasury until July 2004.

Mr Eland: In May 2004 I received advice from the finance officer that these payments might contravene some of the rules in government accounting.

Q112 Mr Bacon: You mean they were unlawful?

Mr Eland: They might fall outside the ambit of our vote. At that point, we notified the police that we would stop the payments. We stopped them in May 2004. That last payment was the payment for March 2004 and then we began a discussion with the Treasury.

Q113 Mr Bacon: Mr Byrne, in his letter to the Committee, says that he informed you in October 2003 that it was his view that it was improper for Her Majesty's Customs and Excise to be paying for the police to investigate suspected criminality which, on the face of it to a layman, would seem to be a correct view.⁸

Mr Varney: Can I—?

Q114 Mr Bacon: I am asking Mr Eland.

Mr Varney: I am trying to answer.

Q115 Mr Bacon: If you do not mind, Mr Varney, I am asking Mr Eland the question.

Mr Varney: I think there is some protection if you come here as an Accounting Officer.

Mr Bacon: With respect, I am asking—

Chairman: Mr Bacon, let him answer the question.

Mr Bacon: I have not asked it yet. I am asking Mr Eland a question about a letter to the Committee that refers to Mr Eland.

Chairman: If Mr Varney wants to answer the question, he can.

Q116 Mr Bacon: I have not finished asking it yet.

Mr Varney: I am here to answer questions for the Committee. I also have a duty to protect my staff. If you want to ask a question I am more than willing to answer it.

Mr Bacon: My question, which is to Mr Eland, is about the note from Mr Byrne that says, "I informed Mike Eland (then acting Chairman)"—this was before Mr Varney was appointed; he separately had a conversation with Mr Evans—"... to see if it was true that we... were making such payments to the police." You just said, Mr Eland, that you became aware of this in February 2004. Mr Eland says this happened in October 2003. My question to Mr Eland, which I think Mr Eland will be able to answer better than anyone else, is what were you, Mr Eland, doing between October 2003 and February 2004?

Q117 Chairman: If Mr Varney as the Accounting Officer responsible to this Committee wishes to answer the question he may on behalf of Mr Eland, or Mr Eland can answer it, as the Revenue desires.

Mr Varney: I came into this completely new and conducted a thorough investigation and cooperated with the National Audit Office. We have received the letter from Mr Byrne who was excluded from the investigation.

Q118 Mr Bacon: I am aware of that. It says so in the letter.

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Mr Varney: He was excluded from it because of the relationship with one of the people who was under investigation. The investigation was picked up originally as a result of the court case. It was first of all picked up by the Metropolitan Police. Within a few weeks of the Metropolitan Police picking up the case, they were made aware there was an allegation that they may have been involved in some of the activity which was under investigation.

Q119 Mr Bacon: They being?

Mr Varney: The Metropolitan Police. They therefore referred it to another police force, the Thames Valley Police Force. Under the rules by which one police force refers a case to another police force, the police force that gives the case away ends up funding the investigation. That is part of ACPO's guidance to various police forces. This payment was made by Customs and Excise and the full details of this have been made available to me and shared with the NAO.

Q120 Mr Bacon: With respect, none of this has anything to do with my question which I will happily direct to you. My question to you is: what was Mr Eland doing between October 2003 when he was informed about this problem and February 2004 when he just told us that he knew about it?

Mr Varney: There is no evidence that an issue of the propriety of the payment was raised. What was raised was a longstanding view that a number of people in the Department had that the Department should not find itself in a situation where it was funding a police review which was trying to look at whether there was a case against an officer of Customs and Excise. There was no suggestion in any of the correspondence we have seen that this fell outside the rules of the ambit of the Department so that the Department was making a payment which was not covered by its ambit. I have read Mr Byrne's letter. I have shared it with the NAO. I have sat down and gone through all of the basis on which we established the views established in the report we put to you and I do not see one scintilla which would cause me to change the view we have put to you.

Q121 Mr Bacon: This is on page 88 of the blue report. When you consulted the Treasury in relation to the 2002 case, in relation to which payments had already been made, they gave you advice that Treasury approval should have been sought and they went on to conclude that it could be held to fall within the Department's ambit but later at the bottom of this paragraph it says that HM Treasury concluded that it was not open to them to approve the payments because it should be more properly characterised as in support of ongoing criminal investigations by the police. Then it goes on to say that the Department—that is you—is revising its internal guidelines. In his letter, Mr Byrne says the following: “Entirely consistent with my general (and probably quite well known in the Department) view about the inappropriateness of ‘bonus’ funding for law enforcement (like ‘speed

cameras’, bonus funding distorts priorities and undermines responsible management of public funds), I immediately took the view that it was improper for”—inappropriate, to use your word—“for HMCE to be paying for the police to investigate suspected criminality that was entirely proper to their constitutional and statutory remit and that was outside matters ‘assigned’ to HMCE. I informed Mike Eland (then acting Chairman) and, separately, promptly confronted Paul Evans in October 2003 to see if it was true that we (HMCE) were making such payments to the police. His immediate response was that ‘we were but only at the beginning and not now’. That statement was, I was to discover later, not true.” Mr Eland said he first became aware of this in February 2004. It is clear from this that Mr Eland was informed of concerns in the Department that the behaviour was improper, that this expenditure was improper—or, to use your word “inappropriate”—in October 2003. Mr Varney, I repeat my question to you: what was Mr Eland doing between October 2003 when he was informed about the potentially improper nature of these payments and February 2004 when he just told the Committee he became aware of it?

Mr Varney: Let me be clear about the issue that faced the management. I have talked to Sir Richard Broadbent as well about these events who does not share Mr Byrne's point of view. The investigation was ongoing. That investigation was as a result of a court case. The people conducting that investigation were the Thames Valley Police. Any decision about what to do had to be tinged with getting the investigation which the court had required properly done. I have no evidence at all that anybody was aware that this was outside our ambit. There were discussions about whether we should be paying the police which have been part of a—

Q122 Mr Bacon: Mr Byrne is saying explicitly in this letter, if I may interrupt, that he raised concerns inside the Department in October 2003 with Mr Paul Evans and with Mr Eland that these payments were improper. That is the word he uses.

Mr Varney: If you would let me finish, which you are not doing—

Q123 Mr Bacon: You have twice said you that you have no evidence that there were any improper payments.

Mr Varney: You can have a dialogue with yourself or you can use the advantage of me being here to account. Paul Evans was removed from the case by Sir Richard Broadbent because of the impact on his health and the fact that he reported to Terry Byrne. He had no knowledge at the time in that letter that he was asked something.

Q124 Mr Bacon: I am nearly out of time and I am still waiting for an answer to my first question which I will repeat. What was Mr Eland doing between October 2003 and February 2004 about

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this case which had already been brought to his attention as something which was held to be an improper payment?

Mr Eland: In October 2004, I was told—

Q125 Mr Bacon: October 2004?

Mr Eland: Sorry; October 2003. Terry Byrne told me that the payments had been made to the police and also that subsequently, as he says in his letter, they had ceased. There was no issue for me to do anything about.

Q126 Mr Bacon: Could you repeat that?

Mr Eland: In October 2003, Mr Byrne said that he understood payments had been made to Thames Valley Police and he then subsequently told me they had ceased. Therefore, there was no issue for me to confront.

Q127 Mr Bacon: That was based on the information he was supplied, presumably. Were you aware that they had not ceased?

Mr Eland: No. I thought they had ceased. My only source of information at that point was Terry Byrne.

Q128 Mr Bacon: You were the acting chairman and you did not know they were ongoing. He was the director of law enforcement and he did not know they were ongoing. Who did know they were ongoing and who was authorising them?

Mr Eland: The previous chairman.

Mr Varney: Terry Byrne was explicitly taken out of the loop.

Q129 Mr Bacon: It says so in the letter.

Mr Varney: It does not reflect in the rest of the letter, with great respect. The rest of the letter is couched as if there was a complete awareness of what was going on. We have shared with the National Audit Office everything in regard to this case that I have. I have no interest at all in doing anything other than the right thing.

Q130 Mr Bacon: It is quite difficult to get straight answers to straight questions.

Mr Varney: You are getting straight answers but you may not choose to take them.

Mr Bacon: My first question took 10 minutes to get an answer to.

Q131 Chairman: In fairness to other Members we have to draw this to a conclusion because everybody else has kept within their time. Perhaps I could ask the NAO to comment on this and whether they have any concerns about this matter? Mr Varney has told us that he has shared everything with you and he has nothing to hide.

Mr Burr: I do not think we have any particular concerns. The reference to autumn 2003 is an assertion in Mr Byrne's letter and it may be right but we do not have any evidence for that date.

Q132 Chairman: The National Audit Office does not think it is necessary to take this matter any further?

Mr Burr: No, we do not.

Q133 Mr Jenkins: If a lorry comes in here from, say, France to Dover and it has 1,400 litres of fuel in its tanks, it then goes to a depot, comes back to the dock having 150 miles on its clock but it now has 100 litres of fuel in its tank; it goes across to France, loads up with fuel and runs back across the continent. It gets back here next week. It comes back into the country with 1,400 litres and does this on a week in, week out basis with 10 wagons or units. You will probably save that company £300,000 a year. That fuel is decanted in the depot and put into other lorries. This is smuggling. If it is decanted and used for another vehicle, it is smuggling and therefore a crime. Right?

Mr Eland: Yes.

Q134 Mr Jenkins: Mr Sheridan asked you do you, on any suspicion you have, check what the milometer says when it goes out to say this vehicle is doing regularly 150 miles. It is not doing 2,000 or 1,500. Therefore, ding, ding, ding, I have a suspicion that this lorry is smuggling.

Mr Eland: What I was talking about was not checking that came in and then checking them again when they went out, measuring how much fuel they have. If we have intelligence or a clear repeat trade where we can use number plate readers and so on to spot frequent travel that we think is not justified by commercial reasons, we can act on that to tackle it but we do not routinely check fuel usage of lorries going in and going out. We do not think that is the best way to use our resources to tackle the problem.

Mr Varney: We would pick up a vehicle that was regularly doing the same trip. That would pick up on our number plate recognition and one would hope we would start to ask a few questions as to what was happening.

Q135 Mr Jenkins: I like to have some assurances. I can name lorries that go out every week, regularly and come back. I am not saying they are loaded with 1,400 litres of diesel but if I was in the docks and someone said to me, "When you check these lorries coming in and out it is a waste of resources to check the milometer and dip the tank to see how much fuel he has on a couple of occasions," to stop a £300,000 swindle, if you are saying five minutes per lorry is not the most effective use of your time, what is?

Mr Varney: I invite you to come down and look at Dover and the scale of traffic that is going through Dover. We get pressure to let that traffic move with the minimum of interference and, at the same time, do our job. We want to keep people moving but, at the same time, we want to do our job. That is why we have invested, for example, in intelligence screens and we have devices which try and pick and choose which vehicle we should target based on our assessment of the risks. Part of that is if somebody

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is coming regularly backwards and forwards. I think we see them as a source of attention. Why are they doing it? What is the nature of their business? If somebody is very competitive—as you said, the road haulage business is a competitive business—we hopefully also get whistle blowers who will say that something is going on. It is not just us. The Health and Safety Executive no doubt would be quite concerned about people decanting fuel without a licence and probably without the proper processes and procedures.

Q136 Mr Jenkins: It has been brought to your attention. That is all I can do. If I walk down this fuel route, which of the areas would you say are the most fraudulent? Petrol, diesel or rebated fuel? Have you considered how much we are losing in these areas?

Mr Varney: We see diesel as the biggest market.

Mr Eland: Yes. The largest amount of fraud is in the diesel area. The petrol element is very small. We see the biggest risk in the diesel area as being diversion of red diesel.

Q137 Mr Jenkins: That is why I gave you the three areas. I gave you rebated fuel—commonly known as red diesel—as a separate area. We are not talking about diesel fraud with red diesel.

Mr Eland: We are talking about red diesel being used as ordinary diesel.

Q138 Mr Jenkins: Which activity is now the greatest in your estimation? Is it the cleaning of the red diesel or just making use of the red diesel in vehicles?

Mr Eland: Of that market, predominantly, I think it is laundered diesel, although again it is extraordinarily difficult to break these down into different categories with any precision. There is just straightforward use of red diesel for wrong purposes; there is mixing it to dilute it in with ordinary diesel and there is laundering, where the dye has been totally removed. Laundering is the biggest risk.

Q139 Mr Jenkins: And the hardest to detect in use?

Mr Eland: It is harder to detect although technology is such that generally we can detect it. You cannot totally remove the dye.

Q140 Mr Jenkins: You can detect it? You stop the lorry, dip the lorry and detect it?

Mr Eland: Yes.

Q141 Mr Jenkins: You have adequate powers to seize that lorry?

Mr Eland: Yes.

Q142 Mr Jenkins: How many lorries have you seized in the last year?

Mr Eland: I do not think—

Q143 Mr Jenkins: Is it a figure greater than nought?

Mr Eland: It certainly is, yes. I will have to let you have a note.⁹

Q144 Mr Jenkins: I thought you might have brought it with you because the last time, with the misuse of something like hydrocarbon oils 2001–02, this Committee suggested as one of the recommendations that sanctions should be best effected as well as exploiting the possibility of introducing a more rigorous vehicle seizure policy for the misuse of rebated fuels. We said we would like you to take the message out there quite clearly. If you are seizing a £60,000 unit, that seems to be a very clear message.

Mr Varney: Yes. In 2001–02, when we were in front of you, we had made 16,000 challenges on the road. This year, we made 84,000. The detection rate was at 3,300. We have done 3,700 detections. We have assessed people and it has risen from eight to 11 million. What we do tend to look at is the number of plants we have disrupted. There were 40 plants in 2001, 53 last year and 35 this year.

Q145 Mr Jenkins: Can you give us a note on how many vehicles?

Mr Varney: Yes.

Q146 Mr Jenkins: You are going to have incentives to traders to use the service. What incentives? Have you used any?

Mr Eland: We have not used any at the moment. We are examining generally within the Department—

Q147 Mr Jenkins: There is no progress on that?

Mr Eland: We are still considering whether or not we should incentivise the use.

Q148 Mr Jenkins: In the Report it says you are considering using incentives. I thought you would have some ideas of incentives: the first 100 to record will get a free holiday in Spain or the Bahamas or the ones that do not and cost a lot of money, effort and time we will just send them a bill. It is page 127, paragraph 3.5. There is an increase in the visits paid to low risk traders and a decrease to risky traders. Why?

Mr Varney: This was because we felt there were risks that we might not have adequately uncovered in the trading group one because we had not inspected them with the frequency and we felt—this was a judgment call—we were making an impact in the higher risk areas. We thought it was a good idea to concentrate on the trading group one, which we may have miscategorised, and then get back to the high risk group.

Q149 Mr Davidson: You said earlier on that you thought it was in the interests of the oil companies to reduce fraud. Surely it is the converse?

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Mr Varney: The problem is that they pay duty ex-refinery and their product has to compete with people who are competing on an illegal basis with a lower rate of tax. In a market place which is competitive, their prices get dragged down so in the end they suffer.

Q150 Mr Davidson: Surely not, since they produce both varieties?

Mr Varney: Some of it may be imported.

Q151 Mr Davidson: If they produce varieties, if anything, more of the cheaper and perhaps even greater consumption would be better for them. The parallel in my mind is the tobacco companies where they clearly have an interest in stimulating demand by allowing and condoning smuggling and any suggestion that you would get cooperation from them was incorrect. I wondered whether or not you might be making the same mistake here.

Mr Varney: On the tobacco one, your analysis is correct. The issue for the big oil companies is that their profitability is not affected by the tax in the sense that what goes out of the refinery pays tax or does not pay tax, but the product that has paid tax is competing with illegal, unpaid tax product in the same market. The impact of that is to drag down the average price that applies in the market because you have two people with a different cost structure, so they suffer.

Q152 Mr Davidson: They do not, surely even by that logic, because they are losing out to red diesel, say, which has been produced by them anyway. Since they do not get a percentage of the final selling price, their profit is from a share of the price out of the door before tax is added.

Mr Varney: They also have retail businesses which take the product outside the refinery and sell it. Those retail businesses take as a cost—

Q153 Mr Davidson: I was thinking in terms of manufacturing side. That is maybe a draw then. You say the UK is the only country which produces an estimate of diesel fraud in the EU. Why is that?

Mr Eland: That is a good question. We are the country that has started to focus on tax gap analysis to try and get our performance outcome based. Others have not done that yet.

Q154 Mr Davidson: That is providing a competitive advantage to people in the EU who are using the cheaper fuel because presumably if they are engaging in tax fraud the higher percentage of fuel that they use is not tax paid; therefore their costs are lower etc.

Mr Varney: I know from the time when I was in Europe that there are regular prosecutions for frauds on the Rhine, taking red diesel back into the undyed market. We got to this partly from a combination of PSA targets and Customs and Excise having a look at how they could create a business environment in which, under the leadership of Sir Richard Broadbent, and how they could target resources in an appropriate way. What

we are now doing is fielding interest from other revenue authorities around Europe and the world in what we are doing. They are coming with insights which are helpful to us and also seeing the extent to which it makes sense, but that is a product of what their tax environment and structure are.

Q155 Mr Davidson: In terms of smuggling from the Irish Republic, can I clarify whether or not you feel you are getting all the assistance you might from the Irish Republic authorities?

Mr Eland: Yes. We participate in a task force within Northern Ireland with other bodies including the police and we also get cross-border support.

Q156 Mr Davidson: Everything you ask for, they have provided?

Mr Eland: I am not aware of any problem areas.

Q157 Mr Davidson: From the oil companies, in previous discussions there was a suggestion that oil companies were selling huge amounts to traders just inside the Irish Republic border in the sure knowledge that that was intended for smuggling over to the north. Has there been full cooperation from oil companies based in the Irish Republic, many of whom will be multinationals?

Mr Eland: I do not know the answer to that. It has not been drawn to my attention as a problem since I took over this area but I will check.

Q158 Mr Davidson: Could I come back to the question of convictions? We have a figure here for the number of convictions. I am not clear about how many papers were sent forward and not proceeded with or how many prosecutions failed and what the penalties were and, in terms of the risk ratio, the scale of the penalty as compared with the scale of the profit that was achieved by committing the offence. Can you give me a feel for any of that?

Mr Varney: In general Customs and Excise has a pretty successful record when it is in front of the courts with convictions in about 92% of the cases.

Q159 Mr Davidson: I think it is paragraph 2.50 where 21 convictions were secured in 2003–04 as compared to 11 in 2002–03. I do not have a feel for the scale of penalties.

Mr Varney: The scale was about 13 or 14 months.

Mr Gray: The average across those 21 was 15 months.

Q160 Mr Davidson: Which is seven months and, with time off for good behaviour, six months. What was the scale of people engaged in these activities which led them to these successes?

Mr Gray: I cannot give you a precise figure.

Q161 Mr Davidson: I am trying to clarify whether or not it is taken sufficiently seriously.

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Mr Gray: The average length of sentence has gone up a little over recent years. For 2002–03 the average was 11 to 12 months so it went to 15.

Q162 Mr Davidson: That does not help me if the offences are now are much bigger. Turning to VAT fraud, in terms of other European countries, do you have any indication of the level of VAT fraud there and how that compares with the UK?

Mr Gray: Not in terms of the analysis that we have developed of estimating a VAT gap. It is of interest that in an international meeting of heads of tax authorities which included two other European Union countries there was quite a lot of interest from them in relation to VAT as in oils about the methodology that we are adopting.

Q163 Mr Davidson: I would imagine tax authorities would be interested. What I am not clear about is (a) the scale and (b) whether or not governments in the other European Union countries are putting the same push behind this as we are. Clearly, if you do not pay your tax it affects the share of the contribution made to the EU budget overall. Therefore, we end up paying more than our due share because we are more compliant on VAT. I wonder if the NAO have anything on this? If not, could we have something?

Mr Suffield: We do not have any figures but we can certainly look into that.¹⁰

Mr Varney: Confiscation orders for 2001–04 were about 1.2 million. You asked how much money had we seized.

Q164 Mr Davidson: What do I compare that to?

Mr Varney: In terms of the fraud assessment detected, we have a figure of £11.5 million so, if you take recent years, seven convictions, 14 months' jail sentence and confiscation orders so far this year running at about £170,000.

Q165 Mr Davidson: £170,000 is not a lot, is it? Could we have some sort of paper on that because that is something we might want to take up. In terms of the scale of fraud, you are telling us that £2 billion is roughly the VAT gap, which means that one in eight pounds of VAT is being lost through fraud, which is an incredibly high figure. You look puzzled. I base it on 12.9%. When I look at all the attention that is paid to fraud in terms of welfare benefits and the like, none of those figures is anything like as high as this. The business community must be full of thieves and villains if one in eight pounds of VAT is being lost.

Mr Eland: That two billion is not solely related to fraud. It is the loss between the amount that is calculated should be paid and the amount we receive. It can occur for a variety of reasons, including error.¹¹

Q166 Mr Davidson: Error you would normally expect to balance itself out. Therefore, there would be a nil factor. This is like dealing with farmers. If you find the errors are always in the same direction, you would think this is perhaps not error but deliberate. One in eight seems to me to be an astonishingly high figure. This indicates widespread dishonesty or incompetence amongst British business, does it not?

Mr Eland: A very significant part of it is what is called missing trader fraud, which is criminal attacks on the system from outside rather than fraud by businesses inside the system. There is also avoidance which is legal. It is not a straightforward defrauding figure.

Q167 Mr Davidson: If it is avoidance, how can it be part of the VAT gap, if it is legal for them to avoid it?

Mr Eland: It is avoidance that we are challenging.

Q168 Mr Davidson: Maybe it is not legal then?

Mr Eland: It is whether their interpretation of the law is correct.

Q169 Mr Davidson: If their interpretation of the law is correct, it will reduce the gap by definition.

Mr Eland: It would go into the top bit of the equation, yes.

Q170 Mr Bacon: Mr Burr, can you confirm that the reason the National Audit Office qualified the accounts of Customs and Excise is because there were payments made to the police in support of ongoing criminal investigations which Customs and Excise had no authority to make?

Mr Burr: Yes. The payment was outside the scope of the vote.

Q171 Mr Bacon: Mr Eland, you said you were unaware of the fact that these payments were ongoing when Sir Richard Broadbent handed over the chairmanship to you. He obviously did not tell you and kept you out of the loop. When you handed on the chairmanship to Mr Varney, were there any things that you feel in retrospect you might have told him that you did not and, if so, would you like to tell him now?

Mr Eland: I hope I have properly briefed him on all relevant matters.

Chairman: Thank you very much for what has been a very interesting session.

¹¹ *Note by witness:* The VAT Gap is calculated in percentage terms. The 12.9% referred to in Q165 is the size of the gap reported for 2003–04. In monetary terms this equates to a difference of approximately £10.2 billion between actual VAT receipts and that which is theoretically due.

Supplementary memorandum submitted by the National Audit Office

Question 163 (Mr Davidson):

At the hearing on the C&AG's Standard Report on HM Customs and Excise on 2 February, the Committee asked the National Audit Office for details of VAT tax gap measurement made by other EU member states.

This is an issue which is regularly discussed by European Supreme Audit Institutions including the NAO at meetings of the European VAT Working Group, which examines VAT fraud issues common across the EU and looks at measures to target anti-fraud work effectively.

In the EU, only HM Customs and Excise in the UK have a sophisticated mechanism to estimate VAT losses due to error and fraud using statistical data produced by the Office for National Statistics. Losses reported by other EU members are limited to actual frauds uncovered, or extrapolations based on uncovered frauds.

CURRENT EU FRAUD ESTIMATES/FRAUDS DISCOVERED

- Austria—Missing trader fraud estimate €700 million/annum.
- Italy—Guardia di Finanzia—fraud detected €2.2 billion.
- Belgium—Estimated VAT fraud losses €2 billion.
- Germany—Estimates VAT losses as “significant”.
- Poland—No firm estimate—under review by Ministry of Finance.

The NAO chairs the Core Working Group of the European VAT Working Group, which is looking into the issue of measuring VAT losses. A meeting will be held in the summer, in London. In advance, members of the group have been asked to provide further information about known and estimated VAT losses.

The Committee also asked about the potential impact of VAT fraud on payments to the European Union. The mechanism through which countries pay VAT to the EU (traditionally called Own Resources), is set out in VAT Directives and implemented and amended through decisions by the Commission and ratified by member states.

When governments agreed to provide own resources to the EU, member states were obliged to pay 1% of their VAT base (as disclosed in National Accounts)—this was later increased to 1.4% in 1985. When the finances of the EU were reformed in 1988, it provided the EU with a more predictable and stable financial base making it less dependent on traditional own resources, as a result more recently there have been reductions in the amounts of VAT paid over to the EU. The amount due fell to 1% in 1999, 0.75% in 2002 and 0.50% in 2004.

For the purposes of agreeing amounts due to the EU, the VAT base of each member state was capped at no more than 55% of gross national product, later reduced to 50% of gross national product in 1999 (member states eligible for assistance under the Cohesion Fund were subject to a cap of 50% from 1995). Under this regime for setting contributions to the EU, it is clear that the level of fraud per se will have little impact on the level of payments.

February 2005

Letter from Mr Terry Byrne to the Chairman of the Committee

On 17 November, I alerted Chairman of HMCE, David Varney (and Sir Andrew Turnbull, Head of the Home Civil Service) to my concerns about planned statements with the Department's annual accounts for 2003–04 and advised that, if the statements were to be made as I understood them to have been drafted, I would be obliged to put material before your Committee. From my direct knowledge of relevant events, I had my doubts that the statements as drafted—and, thus, the Department's financial statements—did give a true and fair view of the position and whether the C&AG had received all the information he required for his audit. I have now seen the published accounts and accompanying statement by the Accounting Officer and the Comptroller and Auditor General.

The relevant statements are as I understood them to have been drafted and I must, therefore, put my concerns before your Committee. It is not now for me to cast any judgement on the significance or otherwise of the matters I bring to your attention and I do not do so.

By way of background, I was, at the time I alerted David Varney to my concerns, suspended from duty (on full pay) and, as long planned, have since retired at age 60 on 25 November. During the relevant period from autumn 2002 until my suspension at the end of September 2004, I was a Commissioner and the Director General Law Enforcement in HMCE. At the relevant times, Richard Broadbent was the Chairman (autumn

2002 to June 2003), Michael Eland was acting Chairman (July 2003 to August 2004), David Varney was Chairman (September 2004 to date) and Paul Evans worked to me as the Director Investigation throughout the period from September 1999.

The statements I refer to concern payments by the HMCE to a police force for the investigation of alleged criminal conduct and allied disciplinary matters by one or more Customs Officers. It is, of course for your Committee to judge what the statements made about this matter with the annual accounts convey I start from the following impression that they convey the following:

- In autumn 2002, Richard Broadbent and Paul Evans agreed that the police force would investigate an allegation of misconduct by a senior customs investigator.
- With ambiguous terms of reference that investigation pursued from the outset—and throughout its (still continuing) existence both criminal conduct proper to police duties and disciplinary conduct proper to HMCE internal investigation and management responsibilities.
- Unknown to other senior managers in HMCE, Richard Broadbent and Paul Evans agreed that HMCE would pay the police costs.
- Unconscious that that may have expended HMCE funds improperly and outwith the knowledge of other senior HMCE managers, this state continued unwittingly until July 2004.
- In July 2004, as an accidental consequence of a referral for advice to the Treasury on another police force's request for HMCE funding for a separate investigation of Customs' misconduct the improper use of HMCE funds was identified.
- The position was regularised promptly.
- "Systematic failure" had been the root cause of the inappropriate expenditure and, therefore, to avoid similar failures in future, there was a need to issue guidance (widely it must be inferred) to staff and this was done.

I am obliged to add the following facts:

- Though within my direct management line, in autumn 2002, Richard Broadbent and Paul Evans withheld all of the police investigation from me until after it had been set up and was running. I was a long time colleague of the Customs Officer at the centre of the allegation and understood their reasons for doing so.
- Gradually, through 2002 and 2003, while properly kept away from any involvement in or detailed knowledge of the police investigation, it was inevitable that I would become or be made aware of various elements of the ongoing police investigation. I was, however, not told by Paul Evans, Richard Broadbent or, after his departure, Michael Eland of the substantial monthly payments made to the police.
- By accident, I became aware of these payments—made from a budget head within the Investigation Service that was part of my law Enforcement command that I had not been made aware of—in September/October 2003.
- Entirely consistent with my general (and probably quite well known in the Department) view about the inappropriateness of "bonus" funding for law enforcement (like "speed cameras", bonus funding distorts priorities and undermines responsible management of public funds), I immediately took the view that it was improper for HMCE to be paying for the police to investigate suspected criminality that was entirely proper to their constitutional and statutory remit and that was outside matters "assigned" to HMCE.
- I informed Mike Eland (then acting Chairman) and, separately, promptly confronted Paul Evans in October 2003 to see if it was true that we (HMCE) were making such payments to the police. His immediate response was that "we were but only at the beginning and not now". The statement was, I was to discover later, not true.
- Because of my close relationship over many years with the Customs Officer under investigation, it had remained inappropriate for me to be closely involved in or to know or to seek details of the ongoing police investigation and, under the impression from Paul that the payments had been limited to starting the operation off and had long since ceased, with no reason to believe otherwise, I accepted that there was nothing, in autumn 2003, that justified my further intervention or any longer needing regularising.
- Around six months later in April 2004, I became aware that the payments—running at around £50,000 per month,—were, in fact, ongoing and had been so throughout the operation. In total, the expenditure was then over £600,000.
- I immediately brought this to the attention of Michael Eland and confronted Paul Evans. Paul's response was that it was nothing to do with him, he was not responsible for the liaison with the police and he did not know (and not known at the time of our autumn 2003 discussion) of the ongoing funding arrangements.

- Continuing to believe strongly that it was improper for HMCE to be paying the police to carry out their investigative responsibilities—and believing that this “bonus” funding was encouraging the evident lack of responsible management of the police operation—I pressed Michael Eland in early May 2004—on the basis that the payments from HMCE funds were improper—to take prompt action to call to a halt that HMCE expenditure.
- My insistence that the payments were improper was not sufficiently persuasive to stimulate urgent action; other senior officials were consulted—as a further month went by.
- By happy coincidence from my perspective, another police force wrote asking HMCE to fund a separate investigation. Knowing of my strong concerns but unwilling to make their own judgements about the propriety of paying the police to carry out the police’s statutory responsibilities, “the department” sought some reason from the Treasury to refuse this police request.
- Treasury officials duly provided the confirmation that the payments should not be made to the second police force—and that some of the past payments to the first police force should not have been made. The initial Treasury view was that the payments were “illegal” but that judgement was altered subsequently.

I expressed the view to Mike Eland, long before the position was supposedly examined in July 2004 with the Treasury, that the payments by HMCE to the first police force should not have been made. (It is perhaps irrelevant to the purposes of this letter but I took the view that it is both desirable and practical to separate the investigation of allegations of criminal conduct from the investigation of non-criminal disciplinary conduct. The confused and confusing mixture of coercive powers provided by Parliament for criminal matters with powers assumed under, management authority for disciplinary matters when criminal and disciplinary are intertwined runs self-evident risk of breaching human rights and fairness.) Had I not been misled about payments in autumn 2003 or had the concerns I raised at the time and, more forcefully, in April/May 2004 been given due attention, the improper expenditure of HMCE vote should have been addressed much sooner.

I take exception, and voiced this back in August, to the obvious inference—from the declaration that further guidance was needed and has been issued across the Department—that there was some systematic failure that caused the improper payments and, implicitly at least, that staff lower down therefore needed to be instructed in order to avoid similar future failures. I took the view at the time—and stated so to Mike Eland—that that was an unfair and unworthy shifting or sharing of blames. Staff handling the monthly payments within the budgets of Law Enforcement command had not been failing in their duties. Even accepting that there was some reasonable justification for the original decision by Richard and Paul to make some payments to the police for the to carry out their responsibilities, a small number of top managers were subsequently responsible for failing to stop improper expenditure earlier, certainly as early as November/December 2003. It was not the later, fortuitous, reference to the Treasury on the request from the second police force that highlighted the impropriety.

Terry Byrne

30 December 2004

Letter from Mr David Varney, Chairman, HM Customs and Excise, to the Chairman of the Committee

Terry Byrne, former Director General Law Enforcement in HM Customs, wrote to you on 30 December volunteering his observations on the way in which the above matter has been addressed in the Department’s 2003–04 Accounts. Mr Byrne’s assertions are based on only a partial knowledge of the facts and an apparent misunderstanding of the material in the Annual Report and Accounts. As Mr Byrne himself states, he was precluded from some of the discussions and consideration involved by virtue of his friendship with one of the individuals under investigation.

I should begin my assuring you and your Committee that the C&AG and his officials have been afforded the fullest possible access to relevant papers and information, both in the preparation of their report on the excess vote and, more recently, in their further review of these matters in the light of Mr Byrne’s letter.

Contrary to the impression conveyed in Mr Byrne’s chronology of events, it was not the case that he was a lone voice raising concerns about these matters. Nor, as he implies, was there a failure to act on the part of top management once they were alerted to all the dimensions of the position in early 2004. Having consulted my two predecessors as accounting officer, I remain satisfied that the relevant statement in our Accounts gives a true and fair view of this matter, and that the C&AG’s Report is soundly based upon a full and open disclosure to the NAO.

I should add that there has been no attempt whatsoever to “shift the blame” on to staff in Law Enforcement dealing with the mechanics of the payments. As part of a much wider initiative we had, in 2003–04, been strengthening internal disciplines on the authorisation of expenditure. The lessons which we rightly drew from this particular episode led us to do two things: first, to underscore, to budget holders

across the Department, the need to consult the central finance team in any instance where expenditure might be “novel or contentious”; and, second, significantly to reinforce our governance arrangements at the top of the organisation for the systematic oversight of all such police investigations and related enquiries.

David Varney
Chairman

26 January 2005

Supplementary memorandum submitted by HM Customs & Excise

Questions 87–88 (Mr Trickett):

The way the VAT system is structured makes comparison of VAT yield against the general population for individual geographical regions difficult. Each trader is registered for VAT in a single region even if it collects VAT from the whole country. So for example a very large retailer may be registered in the London region and all VAT receipts for that company will be shown against London even though much of this VAT will have been paid by consumers in other parts of the UK.

The VAT Gap calculation itself is reported at a national level only, as the VAT Theoretical Tax Liability is currently only calculated on a national basis. We are working with our analysts to identify ways to break the calculations down further and this may eventually include a regional breakdown. However we do monitor and analyse patterns of VAT receipts at a number of levels including region, trade sector and size of business. We also use a number of other compliance indicators, which enable us to monitor compliance and target VAT risks on a regional and trade sector basis.

Question 143 (Mr Jenkins):

Customs’ Annual Report and Accounts for 2003–04, published in December 2004, show that in 2003–04 Customs detected 2,043 commercial vehicles misusing illicit fuel, although this will include commercial vehicles other than HGVs.

Customs’ sanctions policy states that when detected misusing illicit fuels commercial vehicles should be seized together with the fuel in their tanks. These vehicles should then be restored in accordance with the following scale:

- *First offence*—100% of revenue evaded plus non-rebated value of fuel in the tank plus any storage costs incurred by the Department **or** the value of the vehicle whichever is the lower.
- *Second offence*—200% of revenue evaded plus non-rebated value of fuel in the tank plus any storage costs incurred by the Department **or** the value of the vehicle whichever is the lower.
- *Third offence*—non-restoration.

In addition, civil penalties of £250 should be issued for taking in and/or using rebated fuels for use in road vehicles. A visit should be made to the trader and an audit carried out to determine the history of fuel purchases and usage in the previous three years (or since the previous detection, whichever is the most recent). On the basis of this audit an assessment should be raised for the revenue evaded.

Finally, for repeat offenders who have failed to respond to other sanctions Customs will consider prosecution.

It should be noted, however, that officers will always act in accordance with the principles of proportionality. There may therefore be a limited number of instances within the figures above where the vehicle was not seized.

Question 157 (Mr Davidson):

Customs do receive full co-operation from the oil companies who have bases in the Republic of Ireland, although as they are multinationals we will tend to deal with the UK end of the operation in practice.

22 February 2005