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**RIS**  
Research and Information System  
for Developing Countries

Core IV-B, Fourth Floor  
India Habitat Centre  
Lodhi Road  
New Delhi-110 003, India.  
Ph. 91-11-2468 2177-80  
Fax: 91-11-2468 2173-74-75  
Email: [dgoffice@ris.org.in](mailto:dgoffice@ris.org.in)  
Website: <http://www.ris.org.in>  
Website: <http://www.newasiaforum.org>

# RIS Discussion Papers

**Trade Facilitation and Customs  
Valuations in India :  
Identifying the Gaps**

**Sachin Chaturvedi**

**RIS-DP # 115**



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Core IV-B, Fourth Floor, India Habitat Centre  
Lodhi Road, New Delhi – 110 003 (India)  
Tel: +91-11-2468 2177/2180; Fax: +91-11-2468 2173/74  
Email: [dgoffice@ris.org.in](mailto:dgoffice@ris.org.in)

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## Trade Facilitation and Customs Valuations in India : Identifying the Gaps

Sachin Chaturvedi\*

**Abstract:** In recent past, India has taken several measures to implement the trade facilitation measures. These have helped the private sector in a major way and have also helped in setting the stage for a WTO agreement in this regard which is all set to be launched – depending on the negotiation dynamics. However, one of the key areas of concern among the private sector firms has been the one related to the customs valuation. There are varying perceptions regarding the implementation of WTO Customs Valuation (CV) Agreement in India especially in the context of trade facilitation (TF). In this paper, we present results of a survey conducted to understand the major issues confronting this important link of CV to achieve a TF friendly trade regime in India.

After interviewing a large number of firms, custom house agents and government officials we found that the Central Board of Excise and Customs (CBEC) and Ministry of Finance have put in place a large administrative set up to implement India's commitments to the CV agreement. The introduction of risk management system (RMS) has provided a great support to the accredited traders as their consignments are cleared at much faster track. However, there are still many cases where industry has to wait for long in getting the goods cleared.

There are several reasons responsible for this situation including the large number of cases in which under invoicing is done especially by the traders which triggers a much closer examination of goods and hence much longer time in clearance and this also invites the discretionary powers being used by the customs. Other challenges come from the lack of clear instructions to the ground staff on new technology goods, the import of which is expanding at a fast pace. A greater coordination between industry and customs agencies and intense training programmes for the ground staff may help in a major way to overcome these constraints.

### Introduction

Since the launching of the WTO Negotiations on Trade Facilitation (TF), it is being realized that as most of the other pieces fall in place, one of the most significant challenge emanates from customs valuation. This makes it all the more clear that TF is not a stand alone concept for promoting global

\* Fellow, Research and Information System for Developing Countries (RIS).  
Email: [sachin@ris.org.in](mailto:sachin@ris.org.in)

convergence and modernization of customs practices. In fact, it is sum of several features which add up to the overall framework of trade facilitation. The various components include advance ruling, risk management, identification of star performers and above all customs valuation. Slow progress in any one of these would affect the larger commitment for trade facilitation irrespective of achievements at the TF negotiations.

The Agreement on Customs Valuation (ACV) provides a set of valuation rules, expanding and giving greater precision to the existing provisions on customs valuation in the original GATT agreement. The fundamental approach behind the ACV is to reduce trade barriers and transaction costs arising from customs and border control practices including uniform application of the harmonized system and the valuation agreement so that they are not slow, unpredictable and non-transparent. The ACV is largely a manifestation of Article VII of GATT which was revised during the Tokyo Round of GATT Negotiations. This was a substantial advancement over the Brussels Definition of Value (BDV) approach, prevalent in most of the European countries in fifties and sixties (Majumder 2005). In 1950, in an effort to achieve greater harmonization of rules and greater discipline in customs matters, 13 European governments developed the BDV, taking into account the broad principles and guidelines prescribed by the GATT agreement (Rege 1999). The responsibility for administering the rules of the BDV and for promoting its use on a worldwide basis was given to the Customs Cooperation Council (CCC) which is now known as the World Customs Organization (WCO).

Although all WTO member countries are supposed to implement Article VII of GATT, developing countries were given an additional time period of five years after the Uruguay Round (UR) ratification in 1995. It is not clear, in case of many member countries, whether the use of the ACV methods as identified are rightly followed.

Since the ACV represents best practices, it would be useful to look into the experiences in India with customs valuation. It is often claimed that customs valuation and the way it is carried out may become a trade barrier or more importantly a vehicle for domestic protection from imports (Alburo, 2006). In this study we would look into some of these issues. Whether the

manner of valuing goods is arbitrary or is based on some notional price, customs valuation can be an effective trade instrument in hands of authorities.

India played a key role during the Tokyo Round GATT negotiations by placing a new proposal in September 1978, with the suggestion of transaction value for valuation purposes.<sup>1</sup> This proposal encouraged some other developing countries to join the negotiations. However, many developed countries rejected the proposal as they felt that it gave too much authority to the customs officials. As a result, the Tokyo Round was concluded in April 1979 without a multilateral agreement on customs valuation but rather a plurilateral code that countries could opt into.<sup>2</sup> India was one of the signatories. However, India took rather long to implement this international commitment. It was only in 1988 that the Customs Act 1962 was amended with effect from August 16, 1988 to bring in elements of international commitment related to transaction value for valuation purposes. It is also important to note that India has not subscribed to pre-shipment inspection (PSI) services. It is allowed only in cases of metal scrap and such other imports which may pose security concerns. Pre-shipment inspection is the practice of employing specialized private companies (or “independent entities”) to check shipment details - essentially the price, quantity and quality of goods ordered overseas.<sup>3</sup> This is followed in countries where customs department is not very strong.

In India, a survey conducted in 2004-05 as part of ARTNeT/RIS study on trade facilitation, identified customs valuation as the key problem for trading community.<sup>4</sup> As mentioned earlier, much before accessing to the WTO Agreement of Customs Valuation, India accepted the concept of ‘transaction value’ as a primary method for valuation. It was done as part of the GATT valuation implementation in August, 1988 itself. As part of this, the customs department is bound to accept the value stated by the importer through the invoice unless the department has additional information to substantiate under-invoicing. Some importers take advantage of this legal situation and under value their imports with fake invoices knowing that customs authorities may not be able to place them. As of now, it is reported to have a revenue loss of almost Rs. 100,000 million.<sup>5</sup> In this context, the related Uruguay Round ministerial decision gives customs administrations the right to request for further information in cases where they have reasons

to doubt the accuracy of the declared value of imported goods.<sup>6</sup> If the administration maintains a reasonable doubt, despite any additional information, it may be deemed that the customs value of the imported goods cannot be determined on the basis of the declared value. However, the efforts by the Customs Department to minimize loss of revenue often lead to situations which make the system slow, unpredictable and non transparent. This defeats the very reason d' etre for trade facilitation.

As would be clear from the study, there are issues related to Indian traders, especially the small and medium size companies facing constraints and similarly to the multinational companies in the context of transactions between related parties. Similarly, as pointed out by the Sathpathy (2002), there are cases of fraudulent re-invoicing in third countries, double invoicing with the connivance of the foreign suppliers, mis-declaration of description, quantity and quality of imported goods to suppress value, over-valuation of exempted and low-rated imports to transfer hard currency abroad and overvaluation of exports to get additional export incentives by the private sector.<sup>7</sup> Though implementation of programmes like risk management system (RMS), accredited traders and valuation corridors may help to a great extent, some supplementary efforts may make the system more effective.

In this context, international institutions and linkages may also play a crucial role. At the WCO and during the negotiations for trade facilitation, it has come up forcefully that the national governments should cooperate for exchange of information so that legal basis may be ascertained. This would strengthen the Article 11 of Agreement on Customs Valuation where members are obliged to have strong judicial systems for review of decisions taken by the customs authorities.

In this study, we make an effort to look into some of these intricate issues. We provide an overview of institutional and policy framework in India in Section II. This Section also attempts to put together details on the revenue composition and broad experience with Agreement on Customs Valuation. The Section III provides the private sector perceptions on the implementation of the ACV and their response to

our questionnaire. The last Section draws the conclusions and provides policy recommendations.

## **Institutional and Policy Framework**

The Central Board of Excise and Customs (CBEC) is the key government agency to overview policy planning and development of institutional infrastructure to support it. It established the Directorate of Valuation (DOV) in 1997 for providing guidance to the field staff and develop mechanisms so as to ensure uniform application of rules and regulations for valuation purposes. DOV is headed by a Director General and is based in Mumbai with two zonal offices in Delhi and Bangalore. The CBEC has also delegated to DOV the customs valuation work being done by India as part of WCO. Thus, DOV is effectively linked with international processes India is engaged in. As part of its international mandate, DOV organized training courses for customs officials from other developing countries.

The major challenge before DOV is to ensure the monitoring of those goods in which valuation often comes up as an issue. In order to address this challenge effectively, DOV has developed a network to gather information and feedback on the international price movement of these commodities. DOV issues Valuation Guidelines for the field offices. These are collected on the basis of information received from agencies like Reuters, *Metal Bulletin*, PLATTS and different other sources. DOV has also developed its own data bases as well.

In India, efforts have been made, as per Article 11 of the ACV, to have institutional arrangements for ensuring rights of appeal. The Customs, Excise and Service Tax Appellate Tribunal (CESTAT), formerly known as Customs, Excise & Gold (Control) Appellate Tribunal (in short CEGAT), was established in 1982. Initially, first appeal may be made at the customs department itself followed by the option for the tribunal. The cases may also go to public judicial system at appropriate levels.

Recently, India officially launched a country-wide Accredited Clients Programme (ACP) and RMS for importers. Under the ACP, regular importers with a reputation of prompt compliance would be accredited under the

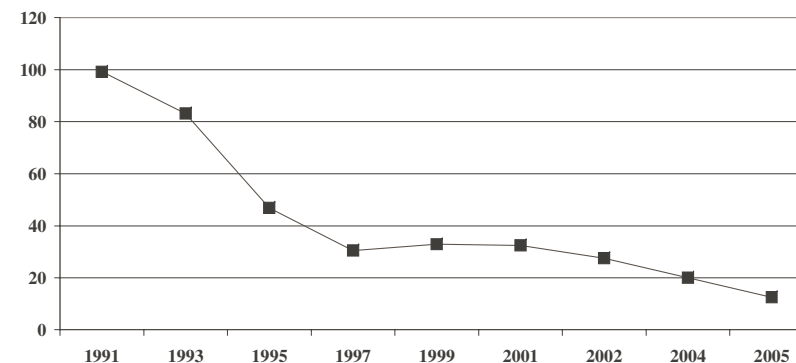
scheme. This accreditation would secure them assured facilitation at major customs ports throughout the country. The trading community would be able to attempt self assessment and there would be no need for examination by the customs. This may help in assuring of quick delivery of their imported consignments. It would help importers in terms of reducing paper work besides reducing transaction cost. This may also help in minimizing the constraints faced on the front of valuation. Declaration of Bills of Entry and the Import General Manifest (IGM) filed electronically in the ICES (Indian Customs EDI System) either through the service centre or through the Indian Customs and Excise Gate Way is forwarded to the system. The RMS then processes the data in the Bill of Entry and the IGM and generates an electronic output for the ICES. This output will determine whether the Bill of Entry will be taken up for action (appraisal or examination, or both, by the officers) or such self assessed bill is given out of charge directly - after duty payment but without assessment and examination. The RMS which was operational earlier at a limited level has now been launched by the Finance Minister at the national level.

It is too early to look into the impact of these measures on the customs revenue as such. However, in the next section we deal with some of the details placing revenue from customs in a wider context.

### 1. Revenue Composition

Though as part of WTO commitments all member countries are bound to reduce customs duties, India on her own has been continuously slashing rates of commodities taxes, both customs and excise duties. In recent past, different annual budgets have attempted to bring down customs duties in India eventually intended to be at the level of ASEAN countries. The average peak rate has declined from 15 per cent in 2005 to 12.5 per cent in 2006 (Figure II.1). In the Budget for 2006-07 peak rate basic customs duties have been retained at 12.5 per cent. However, additional customs duty at the rate of 4 per cent is imposed under the section 3(5) on all goods imported into India to compensate for internal taxes like VAT, sales tax and CST. The additional customs duty is not applicable to the goods exempted from basic as well as CVD goods imported for servicing export promotions schemes; DTA clearances to EOU/EHTP/

Figure II. 1: Decline in Average Tariff Rate in India (1991-2005)



Source: *Economic Survey* (2006); Mohanty (2004).

STP/SEZ units provided such goods are not exempt from sales tax/VAT, etc. This also includes precious metals like gold, silver and imports by EOUs and units in EHTP/STP or SEZ. In the Budget (2006-07) CVD was imposed on most imports in lieu of value added tax (VAT) on domestic goods.<sup>8</sup>

As is evident from the Table II.1, in the period 1990-91 to 2004-05 revenue from direct taxes, particularly corporate income tax, has expanded manifold. In this period the share of indirect taxes declined from 78 per cent to 56 per cent while that of the direct taxes went up from 19 per cent to 44 per cent. In the same period the share of corporate income tax expanded from 9 per cent to 28 per cent.<sup>9</sup>

In case of indirect taxes, the share of revenue as percentage of gross domestic product declined from 7.9 per cent in 1990-91 to 5.7 per cent in 2004-05. In the same period, the share of customs duty declined from 3.6 per cent to 1.7 per cent of gross domestic product while as part of the gross tax revenue, share of customs declined from 36 per cent to 17 per cent. In absolute terms, the numbers, however, stands at Rs. 210,000 million in 1990-91 to Rs. 540,000 million in 2004-05. As is clear from Table II.1, there are fluctuations in the revenue from customs. In the period (1999-00 to 2001-02) there was a continuous deceleration in customs revenue. The decline was as high as 17 per cent while in the period 2002-03 to 2004-05

**Table II.1: Sources of Tax Revenue in India(Rs. Million)**

	1990-91	1999-2000	2000-01	2001-02	2002-03	2003-04 (RE)	2004-05
Direct (a)	110240	579580	683060	691970	830800	1034000	1395100
PIT	53710	256540	317640	320040	368580	402690	509290
CIT	53350	306920	356960	366090	461720	629860	884360
Indirect (b)	451580	1124500	1186810	1161250	1312840	1500290	1775990
Customs	206440	484200	475420	402680	448520	493500	542500
Excise	245140	619020	685260	725550	823100	923790	1091990
Service Tax	0	21280	26130	33020	41220	83000	141500
Gross Tax Revenue #	575760	1717520	1886030	1870600	2162660	2549230	3177330

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Tax revenue as per cent of gross tax revenue

<b>Direct (a)</b>	<b>19.1</b>	<b>33.7</b>	<b>36.2</b>	<b>37.0</b>	<b>38.4</b>	<b>40.6</b>	<b>43.9</b>
PIT	9.3	14.9	16.8	17.1	17.0	15.8	16.0
CIT	9.3	17.9	18.9	19.6	21.3	24.7	27.8
Indirect (b)	78.4	65.5	62.9	62.1	60.7	58.9	55.9
Customs	35.9	28.2	25.2	21.5	20.7	19.4	17.1
Excise	42.6	36.0	36.3	38.8	38.1	36.2	34.4
Service Tax	0.0	1.2	1.4	1.8	1.9	3.3	4.5

Table II.1 continued

Table II.1 continued

	1990-91	1999-2000	2000-01	2001-02	2002-03	2003-04 (RE)	2004-05
Tax revenue as per cent of gross domestic product*							
Direct (a)	1.9	3.0	3.3	3.0	3.4	3.7	4.5
PIT	0.9	1.3	1.5	1.4	1.5	1.5	1.6
CIT	0.9	1.6	1.7	1.6	1.9	2.3	2.8
Indirect (b)	7.9	5.8	5.7	5.1	5.3	5.4	5.7
Customs	3.6	2.5	2.3	1.8	1.8	1.8	1.7
Excise	4.3	3.2	3.3	3.2	3.3	3.3	3.5
Service Tax	0.0	0.1	0.1	0.1	0.2	0.3	0.5
Gross Tax Revenue #	10.1	8.9	9.0	8.2	8.8	9.2	10.2

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PIT: Personal Income Tax. CIT: Corporate Tax\* Refers to gross domestic product at current market prices

Note: 1. Direct taxes also includes taxes pertaining to expenditure, interest, wealth, gift and estate duty. 2. The ratios to GDP for 2004-05 (BE) are based on CSO's Advance Estimates released in February, 2005.# Includes taxes referred in (a) and (b) and taxes of Union Territories and "other" taxes.

Source: Economic Survey (2004-05), Ministry of Finance.

the increase was in the order of 21 per cent. In the period 2001-02 to 2002-03 the revenue expanded by 11 per cent.

The growth in the customs revenue largely attributes to the policy framework adopted and the spurt in trading activities. The merchandise imports have grown by almost 40 per cent in 2004-05 which is highest growth in last two and half decades.<sup>10</sup>

The non-oil imports, however, increased by 31 per cent. A significant import boost came from import of precious and semi-precious stones (8.6 per cent), electronic goods (8.9 per cent), metals especially gold and silver (10 per cent) and capital goods (11.5 per cent).

## 2 . Changing Policy Regime

After independence in 1947, India revised her customs valuation provisions, particularly the Sea Customs Act of 1878, to bring it in conformity with the GATT provisions. The Sea Customs Act of 1878 was based on real value. This was defined as the wholesale price for which like goods are capable of being sold at the time and place of importation (excluding duties payable). The Sea Customs Act also contained provisions for taking over the imported goods by Government on payment of an amount equal to declared real value (Section 32). The changes in this act were made on the basis of recommendations from Customs Reorganization Committee 1958-59, which led to the enactment of Customs Act, 1962. The provisions of this were in accordance with Article VII of GATT, which helped in standardizing various procedures, at par with other countries, for determining value and laid down certain principles to avoid fixing of arbitrary or fictitious values. The system was based on actual value of imported goods. In this, even the values of goods of notional origin were also ruled out. The provisions enabled acceptance of the invoice price so long as the buyer and the seller were unrelated and the price was the sole consideration for sale.<sup>11</sup> The rules were notified through Customs Valuation Rule 1963.<sup>12</sup>

As part of India's commitment at the Tokyo Round Agreement on Customs Valuation, the Customs Act 1962 was subsequently amended and the Customs Valuation (Determination of Price of Imported Goods) Rules, 1988 were implemented, which provided scope for basing the valuation

exercise on the basis of transaction value. The new valuation rules of 1988 largely reflected provision of Article VII of General Agreements on Tariffs and Trade, 1994 (WTO valuation code). The Customs Valuation Rules, 1988, lays down six methods for the valuation of imported goods. The primary basis for valuation is the "Transaction Value". However, it is subject to adjustment by certain Valuation Factors (Rule 9). There are also certain conditions for the transaction value method to be applicable (sub-rule 2 of Rule 4). In certain situations, the Customs authorities could reject the declared value (transaction value method), if the truth or accuracy of the declaration is reasonably suspected (Rule 10 A). In all such cases where the transaction value method is not applied, goods shall be valued by applying the subsequent methods in a strictly hierarchical order (Rule 3). These methods are summarized in the context of Indian Customs Act (1988) in Box II.1.

Since the major switching over from an earlier system of valuation to a new regime in 1988, there are few amendments in the Act. These amendments were made in the subsequent years of 1989, 1990 and 1991 to bring in measures which provided maneuvering space to the Customs Department. In the 1990 amendment it was introduced that there would be a requirement for production of manufacturers' invoice at the time of valuation. This was vehemently opposed by the industry which led to another amendment (1991) only to make it conditional depending upon requirements from customs department.<sup>13</sup>

<b>Box II.1 Compatibility in GATT Valuation Methods and Indian Customs Act (1988)</b>		
Methods	Titles	Indian Act Provisions
(a) Method 1:	The transaction value method	Rule 4
(b) Method 2:	The transaction value of identical goods	Rule 5
(c) Method 3:	The transaction value of similar goods	Rule 6
(d) Method 4:	The deductive method	Rule 7
(e) Method 5:	The computed value method	Rule 7A
(f) Method 6:	The fall-back method	Rule 8

*Source:* Majumder (2005).



After India signed the Marrakech Agreement for establishment of WTO, certain more amendments were made in the Customs Act (1988). An amendment was made in 1998 to enable the bringing in of the decision 6.1 of Uruguay Round Ministerial Declaration to provide discretionary powers to the customs authorities if they are not convinced with the information provided. In 1995 the rules were amended to introduce computed value method. The Customs Valuation Rules, 1988 were again amended through a notification in September 2001. This amendment again provided arbitrary and discretionary powers to the customs department.<sup>14</sup> The amendment covered collection of additional duty of customs based on maximum retail price for the notified items on which domestic excise duty is levied on a similar basis. It also proposed certain linguistic changes in Article VII of GATT. The private sector views on these changes would be discussed in Section III.

### **3 Institutional Infrastructure**

In light of increasing global integration of Indian business several institutional initiatives have been launched to provide policy support and facilitate work for customs valuation. The Directorate of Valuation has launched several initiatives like the establishment of National Import Data Base (NIDB), Central Registry Database (CRD), etc. DOV has also launched a monthly bulletin entitled, *Valuation Bulletin* incorporating all value related information, including international price trends of important commodities and market intelligence reports from various sources. This is published and distributed to all field offices in the customs department. The *Bulletin* is basically for officers in the field, as an important source of information on valuation questions in their day-to-day assessment work. Apart from this, DOV also launched specific studies on select commodities depending upon their sensitivity for domestic market. Some of the initiatives mentioned above are being discussed below.

#### ***National Import Data Base (NIDB)***

The NIDB was launched to collect and analyze data for goods imported at almost all the customs stations in India. The idea was to provide instant access to the combined data duly analyzed by the DOV so as to check under

valuation and valuation frauds.<sup>15</sup> This initiative has become possible since most of the major customs points are now linked with electronic data processing system (EDI). The required data is retrieved by special software and transmitted to a central server in the Valuation Directorate through a dedicated Intranet called ICENET. In case of non-EDI stations, the required data is sent to the Valuation Directorate via email. This data is analyzed on a weekly basis in DOV with the help of intelligent software packages.

The analyzed data is transmitted to all customs stations every week by electronic means, i.e. via ICENET to major customs stations and via email to other stations. Weekly transmissions are consolidated at Custom stations and stored in MS access format with easy search and retrieval facilities. This data is made available to assessing officers at custom stations on LAN. When the declared value is found to be below 10 per cent the weighted average, the consignment is flagged as an outlier.<sup>16</sup>

#### ***Special Valuation Branch (SVB)***

The Special Valuation Branch was established to deal with specialised investigation of transactions involving special relationships and certain special features. It also looks into technical collaborations and texts of joint venture agreements etc. It has its branches located at four major custom houses, viz. Chennai, Calcutta, Delhi and Mumbai. Any decision taken in respect of a particular case in any of these major custom houses is conveyed to all other custom houses by the SVBs which have all India jurisdiction and hence on line communication with all Custom Stations.

An order issued by the SVB remains in operation for a period of three years. The order by the SVB is based on the replies/documents furnished by the importer. If there is any suppression of fact or misdeclaration on the part of importer, necessary penal action is taken separately in accordance with the provisions of law. If the importer is having continuous imports over a period of time extending beyond three years, he has to file replies and documents atleast three months before the completion of three years, so as to take up the renewal of the case. In all cases, where the importer is aggrieved by the order passed by the SVB, he may file an appeal to Commissioner of Customs (Appeals) against that order.

### ***Central Registry Database (CRD)***

DOV has established a Central Registry Database working as part of Special Valuation Branch (SVB) cases relating to importation involving complex valuation issues such as related party imports, cases involving payment of royalties, licence fees, supply of materials and services by the importer, etc. The CRD is made available on the Directorate's website for reference by departmental officers in their day-to-day assessment work.

### ***Valuation Risk Assessment Module (VRAM)***

In the context of the development of a Risk Management System (RMS) for import cargo clearance, the Directorate has joined hands with the national Risk Management Team for devising the strategy for valuation risk assessment and control. On the basis of discussions, the valuation component of the RMS, namely, Valuation Risk Assessment Module (VRAM) has been designed. It is composed of three parts. The first part is a 'Valuation Corridor' consisting of a database of very highly sensitive commodities.<sup>17</sup> Most of them have permissible value band defined for allowing clearance without intervention. Any consignment having declared value below the lower limit of value band, will be directed for assessment by officers. The second part of the valuation component of the RMS is Valuation Alerts, which are issued by DOV. If any importer imports the commodity covered by the list of Valuation Alerts, then the consignment is sent to an officer for verification. The third part is that of poor data quality. If the importer declares unusual Unit Quantity Code (UQC), that is not normally used UQC (SQC), then the consignment is sent for assessment.

### ***Export Commodity Data Base (ECDB)***

The Directorate has initiated work on the development of an Export Commodity Data Base (ECDB), which will focus on the valuation of export goods. This is primarily to check the possibility of over valuation of export goods, a mechanism followed by unscrupulous exporters to claim high level of export incentives under different schemes based on export value. The export data will be compiled on a daily basis in the electronic form from Customs stations that are linked by the dedicated Customs Network (ICENET). The data will be extracted in a predetermined format from all the ICES locations, transmitted via ICENET and merged at DOV into a

single data source. The data will be analyzed by special software on weekly basis to provide unit values, averages, percentage deviations, etc. so that it could be used as a real time source of information for valuation by the field based assessing officers. The analysed files are transmitted to all field formations through ICENET for building up local database for utilization by officers.

### **4. Experience with Agreement on Customs Valuation**

The Indian experience with the implementation of ACV is rather mix. Though India has largely adopted Article VII of GATT, it has made certain variations for ensuring smooth implementation of customs valuation agreement. These variations include, for instance, adding of method 7 for Settlement of Dispute, in customs valuation under Rule 11 of Indian Customs Valuation Rules. Similarly, Rule 10A of Customs Valuation Rules was introduced to provide a ground for rejection of the declared value, based on the existence of reasons to doubt so that Customs Authority could have a fair determination of customs value. This provision came from the Decision 6.1 of the Uruguay Round WTO Ministerial Declaration. According to this, burden of proof is shifted to the importer. However, there are several judicial pronouncements in India, which have directed the customs department to exercise restraint in application of Rule 10A.<sup>18</sup> In fact, there is a pattern in the promulgation of amendments in the Customs Valuation Rules of 1988 and putting in of new rules and the valuation related rulings by the judicial delivery system. The Rule 10A itself was outcome of a judicial decision. As would be clear in the section on the private sector perception of customs valuation, several legal judgments have instructed the Department to follow 'transaction value' as the first basis for valuation. The Eicher Motor case (2000) became a turning point in this regard (see Box II.2).

### ***Impact of Enhancement in Valuation***

In recent past there are several measures introduced by DOV to minimize revenue losses. As the Table II.2 shows, there has been a remarkable increase in extra revenue realized because of enhancement of declared transaction value.

### Box II. 2: The Eicher Tractor Case

The Supreme Court of India (SCI) in their judgment on Eicher Tractors Limited vs. Commissioner of Customs, Mumbai, case held that unless the price actually paid for a particular transaction falls within the exceptions laid down, customs authorities are bound to charge duty on the transaction value (TV).

The case is an interesting example demonstrating how customs department may implement provisions which completely overlook fundamental requirements for trade facilitation. In this case, the Eicher Tractors Limited imported tailor made bearings manufactured in 1989 from Japan. Part of the consignment was rejected and later was imported in 1993. Since the Japanese exporter could not sell this product (being tailor made to specific requirements) to any other firm, the transaction was at the one-third of the 1989 price. The customs department rejected the TV. Eventually, SCI while ordering of acceptance of the TV directed that the price of imported goods is to be determined in accordance with time and place of importation and absence of special circumstances.

After the judgment the Indian government amended the Customs Valuation Rule in 2001 whereby the sales below cost is no more specifically excluded from being valued on the basis of transaction value.

*Source:* Based on Excise Law Time (ELT [122] 2000).

During 2003-04 the reported value of this under valuation was Rs. 1930 million. During 2004-05, the additional revenue realized was Rs. 3340 million, which was 73 per cent higher compared to the previous year. Similarly, in the year 2005-06 an amount of Rs. 4550 million of extra revenue was realized, as against Rs. 3340 million during the corresponding period by enhancement in value of imported goods. During the month of April 2006 additional revenue due to enhancement in the value was realized to the tune of Rs. 281 million.

### Private Sector Perception and Response

As part of an earlier ARTNeT study on the TF in India, it was found that customs valuation is one area which most of the traders find highly

**Table II.2: Extra Duty Realized on Account of Enhancement in Valuation**

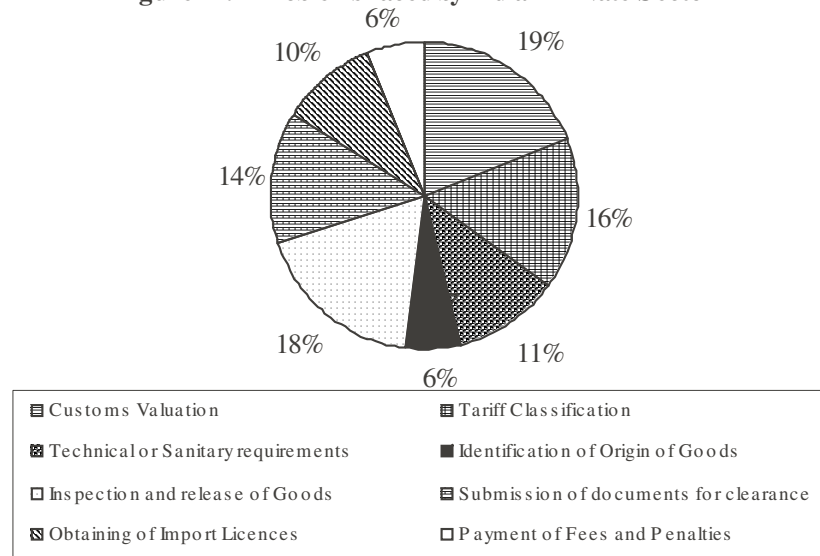
Financial Year	Total Revenue (Rs. in million)	Amount Realized (Rs. in million)	Per cent change over previous year
2003-04	486,250	1930	
2004-05	542,500	3340	+73.06%
2005-06	648,380	4550	+36.23%
2006-07 (upto July' 06)	108,938	660 (Rs. 470 million during the corresponding period last year)	+40.42%

*Source:* SCF (2005).

challenging.<sup>19</sup> The private sector survey received a reasonable response on both aspects of the questionnaire, viz. perception about the level of implementation of the TF measures and also ranking of needs and priorities.

The private sector firms helped in identifying the key problem areas in the TF which are mentioned in the Figure III.1. The key problem areas identified by respondents of the survey are in the following order: customs valuation (19 per cent); inspection and release of goods (18 per cent); tariff classification (16 per cent); and submission of documents for clearance (14 per cent). In this survey method was based on a questionnaire, developed with the help of the ARTNeT Secretariat and select interviews with key industrialists and representative from leading private sector firms including the major Customs House Agents (CHAs). The sample size was selected taking into account the relative importance of various sectors in total exports of India. At the sectoral level, export shares were worked out and accordingly a representative target base was identified. In this group manufacturing goods represented a greater share, hovering at around 76 per cent, primary products are at around 16 per cent and petroleum products occupy approximately 5.2 per cent. The questionnaire was sent to various firms according to the weight assigned to their respective sectors. Out of 1020 firms approached we could get responses from 51 firms. The highest emphasis was given to manufacturing sector in which 620 firms

**Figure III.1 Problems faced by Indian Private Sector**



Source: Chaturvedi (2006)

were approached and out of that more than 41 firms responded excluding three more firms from the category of others.

### 1. Survey Instrument and Methodology

While interacting with different stakeholders concerning customs valuation in India, we came across number of issues which need empirical examination. It is commonly observed by the stakeholders that under-invoicing takes place in large number of imported products because of several reasons. The issue of under-invoicing continue to remain important in selected number of products for the Indian customs department. During the course of our interaction, we received several insights for further analysis which may be divided into three broad categories for empirical analysis, viz. (a) what is the relationship between average firm size in terms of magnitude of under-invoicing and number of firms associated with such practices, (b) If there is any trade-off between them, and (c) how frequently the customs department jumps on the ‘fall-back’ option. These may have deeper policy relevance for controlling activities and improving state revenue.

### Data Constrains

For undertaking the empirical analysis, we tried to look for existing primary data but the same was not available from the Department of Customs. Even the domestic/international secondary source data available from different sources is too scanty to undertake the empirical analysis. However, we found name of the key companies against which the cases for evasion came up at the CESTAT. The decisions of CESTAT and available details were supplemented by undertaking an all India sample survey for collecting information on level of under- invoicing by the importing firms in different sectors but since many firms were based in Delhi and Mumbai the focus remained on these cities. On account of paucity of time, a full-flagged survey was not possible, and therefore we have resorted to a pilot survey. Possibly, the outcome of the present exercise may induce further work in this area in future.

### Benchmark Survey in Other Sectors

So far there is no comprehensive survey undertaken on the subject of under invoicing of imports at the firm level in India. Certain surveys and estimates exist for some other sectors such as black money, parallel exchange rate, etc, but not in this sector. The depth and size of under-invoicing of imports at the country level are not yet known as no scientific analysis is attempted in this regard. A benchmark survey can provide some insight on the coverage and depth of under invoicing in the country. Sample surveys may present trends of the sector from time to time.

### List of firms and CESTAT Decisions

The information concerning involvement of firms in under-invoicing activities is gathered from the decisions made at the CESTAT. As discussed earlier, India has specifically designated a tribunal to deal with cases relating to the customs valuation. The Tribunal is a quasi-judicial body where disputes related to the custom valuation issues between individual firms and the Department of Customs are settled in a legal framework. At present, the tribunal has three branches in different locations in India. As a matter of practice, cases brought before the tribunal are notified and are placed in the public domain. We have picked up some of these cases relating to under-invoicing placed before the tribunal and prepared a list of firms to be covered for the present

survey. In total 500 firms were identified from several notifications of the tribunal based on number of criteria. Out of this data could be collected only for 320 firms.

### ***Criteria for Choosing Sample***

In the absence of benchmark survey on customs valuation, we had very little *apriori* knowledge about the statistical distribution of the under invoicing in India and its statistical parameters. Therefore, we relied on information provide by stakeholders on the nature of under invoicing practices in India in general and activities of firms in this area in particular. We are informed that under invoicing activities take place in several products, but based on the information from the tribunal on nature of reported cases we chose 50 important products for undertaking pilot survey.

It was reported that large number of reported firms are located in metropolitan cities, mostly in Delhi and Mumbai, and take their locational advantages. Some stakeholders also feel that such activities are highly predominant in areas like machine tools, plastic products, base metals, etc. We have given adequate attention to these suggestions while selecting firms for the pilot survey.

### ***Survey Methods***

Taking into consideration the time constraints, we have chosen to collect firm-wise information using the method of tele-interviews and also the support of local customs house agents. In the process of data collection, we gave special attention to get information on nature of product imported, HS classification used for these transactions, value of imports, extent of undervaluation settled in the court at present and also in the past, etc from individual firms with confidentiality. While interviewing firms, no structured questionnaire was formally circulated to them. Since many of the importing firms are not engaged in manufacturing, and reluctant to divulge much of their company-information, we tried to restrict our number of queries to suffice our data requirements for the empirical analysis. For this reason, we could not collect detailed information from these firms during the pilot survey. Because of obvious difficulty in getting information from firms, we could gather information from 320 firms covering fifty products at HS 10-digit national

lines of India. Most of the firms are engaged in such economic offences in multiple products. The pilot survey is all-India in nature, but it is more focused on certain areas and products as discussed earlier in this section.

## **2. Survey Results**

The survey interviews received good response and we could collect key constraints being faced by the private sector in customs valuation. While presenting the results, we are broadly aggregating the views expressed by the manufacturing companies and the customs house agents. Though some of them have their formal industry organizations as well, most of the representatives spoke in their individual capacity.

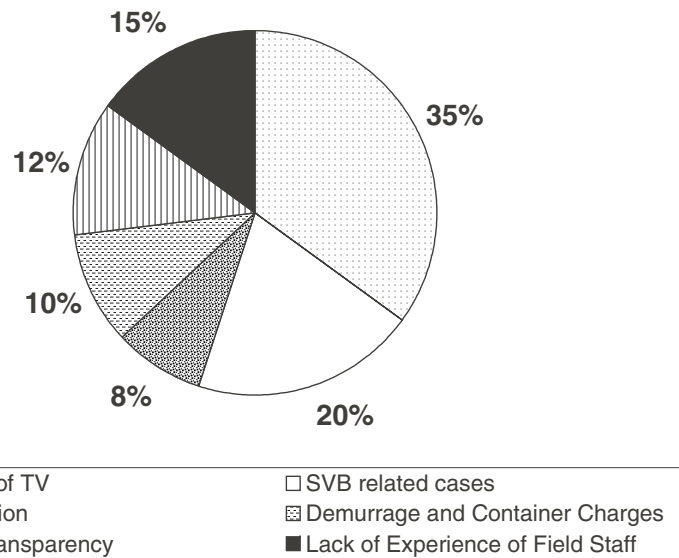
The survey based interviews revealed some key concerns. Most of the private companies interviewed for this study along with CHAs have confirmed that customs valuation continues to remain a gray area among all its activities. However, it was also pointed out that importers are not subject to a penalty merely because they decide to appeal against the determination of the customs value by the customs authority. In the discussions it came up that after rejection of transaction value till agreed customs duty figures come up, the importing firm ends up paying huge demurrage charges to the Custodian (Port Trust, International Airport Authority of India, IAAI etc.).

As the Figure III.2 shows most of the respondents found rejection of transaction value as a key constraint (35 per cent), followed by frequent reference of cases to special valuation branch (20 per cent); lack of experience of field staff (15 per cent); lack of transparency (12 per cent); imposition of demurrage charges and container retention charges (10 per cent); and classification (8 per cent).

### ***Frequent Rejection of Transaction Value***

According to the interviews conducted it has come to the fore that customs department officials follow the usual hierarchy of options as mentioned in the Customs Valuation Rule 1988 but jumps straight on fall back method which is Rule 8 of Indian Customs Valuation Rules, 1988. Though, we could not get data from customs to substantiate this,

**Figure III.2 Major Concerns within Customs Valuation**



Source: RIS Survey 2006.

however, the growing number of cases with CESTAT may support this. As per the Rule 10A of Customs Valuation Rules, 1988 authorities may reject transaction value method in cases of suspected valuation fraud. This actually should apply in instances when there is reason to doubt the truth or accuracy of the value declared by the importer but there is no evidence with the customs department to establish fraud.

Though arrangements for provisional assessment is made, it requires bonds of very high order. Moreover, the excess amount paid by private firms does not come back, being part of ‘unjust enrichment’. However, some of the problems related to classification have been minimized after harmonization of HS classification. There were very few who raised this as an issue (8 per cent). Largely, problems are coming up for those goods which are completely of different makes like, for instance, there is just one type of server generally imported in India which has shelves and two to three hubs, for which import duty is clearly defined but recently, a new type of server was imported which had separate provisions for CVD, DVD and

such other applications. The customs department insisted on imposition of duty on each one of them separately. Thus, with more convergence of technology and nature of goods the classification may emerge as one of the potentially contentious area.

***Lack of Transparency***

It is found that by frequent rejection of transaction value the scope for transparency is reduced to a great extent. Most of the private operators find tools like National Import Data Base (NIDB) given to officers are extremely useful and important for facilitating the customs valuation work. However, the traders interviewed have come out with an opinion that many times the Appraising Officers simply enhance the declared value on the basis of contemporaneous imports without paying attention to the quantity imported. As per Rule 5 (identical goods) and Rule 6 (similar goods) the comparable consignment shall be charged at the same commercial level. But the officers do not do adjustments in price taking into account the different quantity.

***Special Valuation Branch***

The Directorate of Customs Valuation has a Special Valuation Branch (SVB) for dealing with cases relating to importation involving complex valuation issues such as related party imports, cases involving payment of royalties, license fees, supply of materials and services by the importer, etc. Most of the complicated cases are transferred to the SVB which takes long period of time as it is poorly manned, felt most of the respondents to our survey. They suggested that more trained manpower should be provided to SVB for improving efficiency and reducing the time span.

It seems that the working of SVB is a major constraint for traders. Some of them shared with us a circular from the CBEC which suggests that, after submission of all documents by the importer the Customs Department shall finalise the case within four months but in practice this hardly . It takes place the case continues upto two years in many cases and during this period the importer continues to pay 5 per cent extra duty deposit (EDD). No multinational company likes to show EDD as pending with Customs in their balance sheets. Here the version of different importers

varies. Some suggest that the refunds never come from the Customs Department while others say it takes 3-4 years.

### ***Shifting of Officers from Other Services***

The private sector has also pointed out that on several occasions it is found that the officers from other services are moved to important and sensitive positions in customs department especially at the field level where quick decisions are to be taken by the officers. As is clear, some of these decisions have immense economic implications. It was pointed out in an interview that these shiftings are done without realizing the immense severity of situations. The provisions of the ACV are very detailed and are supplemented by detailed interpretative notes which require special training and better administrative skills. This is also seen as one of the factors contributing to the growing number of orders, passed by these officers, being set aside by the Appellate Tribunal.

### ***Import of Sub-Standards and Second Hand Goods***

Most of the private companies have reported this to be a major constraint with the customs department. They find it extremely difficult to convince customs department to opt for transaction value method. Usually, it is difficult to find identical or similar goods under this category where scrap and other goods are being imported. Eventually, it is reported that, the customs officers prefer to go for fall back method.

The recently amended Foreign Trade Policy and Procedures (2006-07) allows import of second-hand capital goods but restricts import of re-manufactured goods.<sup>20</sup> However, the definitional part of re-manufacturing is left on customs department. As there is a surge in reconditioned goods, lack of specifications and clear statement on definition may create more confusion. Sometimes, the old machines are dismantled and re-assembled, with some new components put in place of old ones. It will be left to the discretion of the Customs to determine whether a machine is re-manufactured.

### ***Narrowing the Problem***

Most of the private sector companies are of the opinion that the additional restrictive measures taken by the customs department is generally because

of mis-deeds done by a few traders in the business community who may account for at best 15 to 18 per cent of total trade transaction. There was an opinion to distinguish these traders from the others. In this context, there may be some choice between pre-clearance control and post-clearance control. It is suggested that the manufacturing units may find it easier to deal with post-clearance audit. While in case of the traders pre-clearance control should be made more stringent. The recent introduction of risk management system is being seen as an important step in this direction.

### ***Customs Valuation and Transfer Pricing***

Several key industries feel that efforts need to be made to explore the possibility of convergence between customs valuation procedures and transfer pricing norms, the lack of which is increasing litigations in India. In the light of the fact that, with the fast expansion of intra-firm trade in India there is a growing need to explore the gap and interplay between customs valuation and other commitments like direct taxation between related parties. Some of the companies also raised the expectation that the government should ensure greater convergence of rules and administrative practices in this area. Transfer pricing is used by multinational enterprises to determine the price and conditions for the transfer of goods, services and assets between their affiliated companies situated in different tax jurisdictions.<sup>21</sup> These multinational enterprises are said to account for 60 per cent of world trade and transfer pricing has become the number one issue in the international tax arena. While the focus has traditionally been on direct taxation, the customs duties dimension of transfer pricing now increasingly attracts the attention of both governments and business.

In India, provisions under the Customs Act (1988) Section 14 1(A) and 14 1(B) provide for customs valuation of transactions which are not arms length; Sections 112 and 114 (or Section 167 (8) of the Sea Customs Act), penalise 'improper' trade transactions and Section 111, allows for their confiscation. Over- as well as under-invoicing of imports (section 112) and exports (section 114) are recognized as punishable economic offenses.

However, in the ACV there is more to be attempted to bring in this kind of convergence. In the Tokyo Round Agreement in 1979 and

subsequently in Article VII of GATT, 1994, there is hardly any reference to transfer pricing though it does make a case for arms length price for customs valuation.<sup>22</sup>

### **3. Empirical Analysis**

The under valuation issue is a pressing problem in India, and such economic offences are often noticed in a sizable number of products. Such activities are very closely associated with a specific products where the market premium for the product plays an important determining factor. Detection of such offences by firms is a complex task as similar economic offences are not committed uniformly across all imported products. For understanding vulnerability of products susceptible to under invoicing, we have used survey data.

#### ***About Sample***

While using the survey data for analysing firm behaviour at the product level, we found that there is an asymmetry in the distribution of firms engaged in under invoicing activities in different products. The trend shows that the average level of under invoicing per firm is large in certain products where number of firms engaged in those products is low. Such relationship between average level of under invoicing per firm and the number of firms associated with such economic offences, generally hold good at the individual product level, and therefore generalisation of firm-product behaviour at the aggregate level (i.e. either at the HS section or chapter level) becomes less relevant. For example, average level of under invoicing at the firm level is relatively high in the case of certain machinery (HS section 16) imports such as metal rolling the mills, paper making machines, etc. where number of firms involved in under-invoicing is small. This does not mean that all machinery products are subject to high intensity of economic offences.<sup>23</sup> There are products in the same broad product category of machinery (HS section 16) where intensity of economic offences are relatively low such as excavators, embroidery machines, etc. Therefore, under-invoicing activities are associated with short term demand for micro-products in the market and, therefore, policy options to prevent such economic offences should be focused at the individual product level rather than

at aggregated product level. However, it is important to understand how different sectors are being affected by under invoicing, and consequent implications of such economic offences on collection of customs revenue.

Based on the survey of firms, the effects of under invoicing in different sectors are presented in Table III.1. For the analytical purpose results are presented at the section level (in bold figures) and also at the HS Chapter level under each section level to show variations within the subgroups. Though under invoicing is taking place in several sectors, concentration of such activities are predominantly noticed in certain product segments. For understanding the pattern of under invoicing in India, we have presented some of the indicators at the HS Section (in bold figures) and HS Chapter level separately using survey data. The experience indicates that distribution of reported undervaluation of products is highly skewed across HS Sections, and within each section, some HS chapters dominate in the under-invoicing products basket. Some of the large product segments at the HS Section level are base metals, machinery and mechanical appliances and textiles. Some other important broad product groups are mineral products, articles of plastics, optical photography instruments and other manufactured items. Moreover, high degree of variability in under-invoicing within these broad product groups (i.e. at the HS Section level) are also observed from the survey (i.e., at the chapter level). For example, detection of under-invoicing is very large in the product segment of base metals (Section XV), and break-ups of its sub-components at the chapter level are also presented. From the total customs undervaluation detected in base metals, nearly 43 per cent of it is shared by the iron & steel (chapter 72). Similar is the case in other broad aggregates at the HS section level. It is important to note that detected undervaluation in three sectors including base metals, machinery and textiles constitutes nearly three fourth of the overall under valuation detected in India.

The implications of detection of under invoicing on the customs revenue is important in the context of fast decline of customs revenue on account of sweeping economic reforms in India, leading to steep decline in the rate of customs duty. As rate of custom tariff differs from one product to another, the revenue implications are varied in different product segments.



Product group-wise (i.e., at Section/Chapter level) likely increase<sup>24</sup> in customs revenue is presented in Table III.1, and average of each section is also presented.<sup>25</sup> The results show that there is an improved prospect of generating more revenue in certain sectors, and those are textiles, chemicals, stone & plasters, base metals and other manufacture products.

Results show that importing firms are highly dispersed in their engagement in committing economic offences across product (groups), and in that case, what could be the possible reason? We have postulated that average volume of under-invoicing per firm could be the possible reason for variations in the concentration of firm in different sectors. The last column of Table III.1 shows firm-wise average level of under-invoicing based on survey data. We have used weighted average over chapter level data to arrive at average evaded revenue at the section level. The results show that number of firms is thinly spread where in those sections where the level of average evaded revenue is around rupees one hundred thousand, and some of these sections are minerals, chemicals, plasters, etc. On the other hand, some HS sections having relatively low level of evaded revenue witness crowding of firms. Such sections are wood products, machinery, cinematography, and other manufacturing products. Looking at such relationship between average level of under invoicing and the crowding of firms at the aggregated product level there is a need for examining this relationship at the product level.

We have examined crowding of firms engaged in under-invoicing activities in specific product segments. The concentration of firms is extremely high in certain broad product groups, and not necessarily in those products where level of under invoicing is very high. Some of the important HS sections having large concentration of firms are plastics and rubber articles, textiles, machinery, base metals, etc. Within the broad product groups at HS Section, concentration of firm engagement in illegal activities at the HS Chapter level is also highly dispersed. There is a need for examining the relationship between the level of revenue evasion and the number of firms associated with disaggregated level of product for designing policy strategies to minimise occurrence of such illegal economic offences.

**Table III.1: Coverage, Distribution and Magnitude of Under Valuation at Firms Level**

Sec/Chp	Description	Distribution of Under Valuation (%)	Potential Revenue to rise (%)	Sectoral Distribution of Firms (%)	Evaded Revenue per firm (Rs)
<b>V</b>	<b>Mineral Products</b>	<b>5.81</b>	<b>0.84</b>	<b>2.99</b>	<b>113507</b>
25	Salt, Sulphur; Plastering Materials, etc.	3.30	24.06	0.63	304287.40
26	Ores, Slag and Ash	1.06	21.32	0.31	196974.60
27	Mineral Fuels, Mineral Oils and Products	1.44	0.35	2.04	41251.65
<b>VI</b>	<b>Products of Chemical/Allied Industries</b>	<b>2.73</b>	<b>6.63</b>	<b>1.41</b>	<b>113019.10</b>
29	Organic chemicals	1.72	4.58	0.21	476452
33	Essential oils and resinoids	1.01	13.22	1.20	49172.74
<b>VII</b>	<b>Plastics &amp; Rubber and Articles</b>	<b>3.49</b>	<b>4.35</b>	<b>28.09</b>	<b>7270.58</b>
39	Plastics and articles thereof	1.45	1.90	27.42	3093.06
40	Rubber and articles thereof	2.04	14.46	0.67	176938.60
<b>IX</b>	<b>Wood &amp; their Articles</b>	<b>2.01</b>	<b>1.15</b>	<b>3.31</b>	<b>35573.98</b>
44	Wood and its articles	2.01	1.15	3.31	35573.98
<b>XI</b>	<b>Textiles &amp; textile articles</b>	<b>17.24</b>	<b>11.00</b>	<b>8.98</b>	<b>112148</b>
50	Silk	8.06	10.36	2.15	218390.50
53	Other vegetable textiles fibres; paper	0.90	53.04	0.08	593622.40
54	Man-made filaments	0.23	5.13	0.37	36669.780
59	Impregnated, coated, textile fabrics	4.38	8.63	4.31	59363.30
63	Other made up textile articles	3.65	34.71	2.04	104201.40

Table III.1 continued

Table III.1 continued

Sec/Chp	Description	Distribution of Under Valuation (%)	Potential Revenue to rise (%)	Sectoral Distribution of Firms (%)	Evaded Revenue per firm (Rs)
<b>XIII</b>	<b>Articles of Stone, Plaster, Cement</b>	<b>0.86</b>	<b>5.94</b>	<b>0.56</b>	<b>90073.27</b>
68	Articles of stone, plaster, cement, etc.	0.86	5.94	0.56	90073.27
<b>XV</b>	<b>Base Metals and Articles of Base Metal</b>	<b>31.11</b>	<b>4.95</b>	<b>18.37</b>	<b>98890.45</b>
72	Iron and steel	13.40	3.83	10.77	72701.52
74	Cooper and articles	6.17	7.22	1.43	252032.40
76	Aluminium & articles	7.16	4.77	4.62	90432.38
79	Zinc and its articles	4.36	11.93	1.54	164857.80
<b>XVI</b>	<b>Machinery &amp; Mechanical Appliances</b>	<b>26.34</b>	<b>3.25</b>	<b>21.65</b>	<b>71052.2</b>
84	Nuclear reactors, boilers, machinery	21.27	5.28	12.05	103090.50
85	Electrical machinery & equip. & parts	5.06	1.59	9.59	30814.28
<b>XVII</b>	<b>Vehicles, Aircraft and Vessels</b>	<b>0.15</b>	<b>2.89</b>	<b>0.13</b>	<b>68478</b>
87	Vehicles other than railway or tram	0.15	2.89	0.13	68478.00
<b>XVIII</b>	<b>Optical, Photographic, cinematography, etc</b>	<b>5.07</b>	<b>5.16</b>	<b>7.32</b>	<b>40523.05</b>
<b>XX</b>	<b>Miscellaneous Manufactured Articles</b>	<b>5.13</b>	<b>12.54</b>	<b>7.15</b>	<b>41897.77</b>

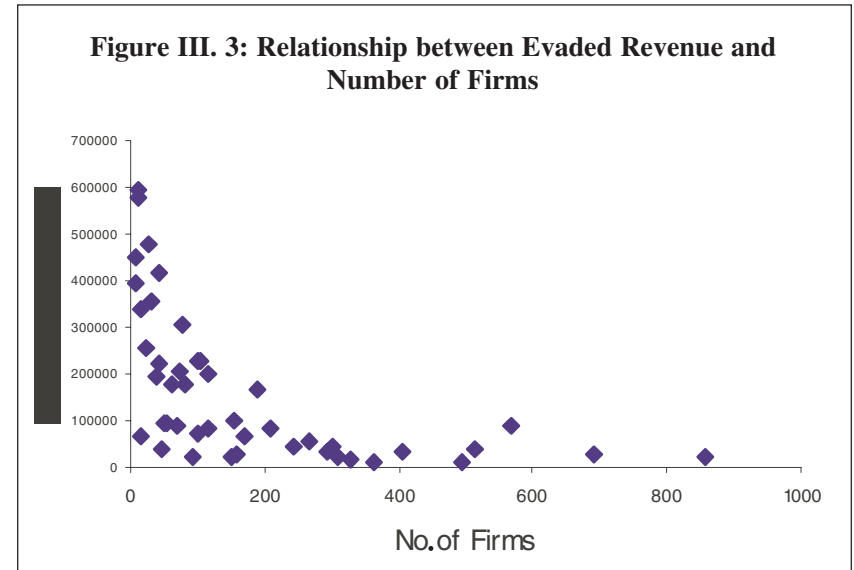
Source: Survey conducted by RIS.

Note: Figures in bold refer to HS Sections, where as other figures refer to HS Chapters. In column 3 and 5, HS section figures are distributed across their corresponding HS Chapters. In column 4 and 6, weighted average of HS chapters is taken to estimate average for the corresponding HS Section. In the later cases, number of firms in each HS chapter is used as weights to arrive at average for each HS section.

### Crowding of Firms and Evasion of Customs Revenue

The preceding analysis presents that the relationship between firm-evasion of customs revenue and number of firms engaged in such economic offences; and nature of such relationship can be examined empirically by using data at the product level. It is mentioned earlier from survey that 320 firms are engaged in 50 disaggregated product lines, and most of the firms are engaged in under invoicing in multiple products. For the analytical purpose, we have reorganised our database and used an econometric model to address the aforesaid problem. In this exercise, if a firm is engaged in under-invoicing activities in four different products, we consider them as four firms engaged in four different activities. After expanding the firm-wise database, we have aggregated them by product at 10-digit HS to generate a separate database for the present analysis.

It is imperative from the sample survey that inverse relationship exists between number of firms engaged in under-invoicing of imports (firms) and average level of evaded revenue per firm (firmevd). There could be several reasons for this assertion. The engagement of number of firms is less in those product categories where the level of evaded revenue is high because of entry barriers in these products. In case of these products, market premium is high,



and, therefore, firms are motivated to indulge in under invoicing activities. In case of several other products where average evasion of revenue is relatively low, the crowding of firms are likely to be more because the possibility of being caught after committing the economic offence could be less. With a large number of importing cases with low average customs- evasion, officials are, in fact, less concerned to track such evaders. This impression induces economic offenders to operate in a big manner in these products. Moreover, traders are generally dominated in this category and the average size of under invoicing is low.

The relationships between the number of firms engaged in under-invoicing and evaded revenue per firm are presented in Figure III.3. The scattered diagram provides the impression that the two variables are (a) inversely related, and (b) non-linear relationship exists between them.<sup>26</sup> For examining the trade-off between the two variables, the survey data is used by using type of activities.<sup>27</sup>

For the choice of appropriate model, the most appropriate source has been the scattered diagram. Based on the approach of Johnston (1972) and the scattered diagram, we have chosen double-log function for the survey data.<sup>28</sup> The following model is used in this analysis.

$$\mathbf{firms}_i = \hat{\alpha} \mathbf{firmevd}_i^{\hat{\alpha}} e_i \dots\dots\dots (1)$$

where  $\mathbf{firms}_i$  denotes number of firms in the i-th product,  $\mathbf{firmevd}_i$  for average size of customs revenue evasion in the i-th product; and  $\hat{\alpha}$  &  $\hat{\alpha}$  as parameters.

It is assumed that equation (1) is a well-behaved function, where  $\hat{\alpha}$  is positive and  $\hat{\alpha}$  negative, representing elasticity of the function. Using survey data, equation 1 is estimated as the following:

$$\mathbf{firms}_i = 14.03016 \mathbf{firmevd}_i^{-.8226609} e_i \dots\dots\dots (2)$$

The results have reaffirmed the inverse relationship between  $\mathbf{firms}$  and  $\mathbf{firmevd}$  as the sign of  $\hat{\alpha}$  is turning out to be negative. The non-linear regression results are presented in Table III.2.

The non-linear model suggests the inverse relationship between the model variables. The variations in the number of firms are significantly explained by the size of evaded revenue per firms as indicated by the coefficient of determination. R-bar<sup>2</sup> is turning out to be 0.685 and F is 107.32, which are statistically significant. The elasticity is significant at one per cent level.

The estimated equation has two policy implications in the contest of developing countries. A country may choose any of the two policy options or a combination of both, in order to accommodate the broad domestic policy requirements of an individual country. From the empirical results, the following policy options may be considered.

(a) *If average level of customs evasion is more, number of evaders may be less* - If a country decides to reduce the number of economic offenders engaged in under invoicing, irrespective of the amount of customs revenue losses to the state, one can hold this policy option. In cases of relatively better-off countries, having less dependent on customs revenue for undertaking various official activities, and also strong adherence to high order of ethical norms, such policy is rather more suitable for maintaining broader national objective. In this category of policy, the number of evaders may be less because most of them belong to the category of manufactures and less will be the proportion of traders in such economic offences. In this case, traders are likely to be affected more adversely than manufactures.

**Table III.2: Relationship between Crowding of Firms and Evaded Revenue per Firm**

Ln( $\mathbf{firms}_i$ ) = ln( $\alpha$ ) + $\beta$ ln( $\mathbf{firmevd}_i$ ) + $e_i$ Dependent Variable – Evaded Revenue per Firm						
Variable	$\beta$	Intercept (ln $\alpha$ )	R <sup>2</sup>	Adj-R <sup>2</sup>	F	n
Firms	-0.822 (-10.36)	14.03 <sup>†</sup> (15.13)	0.691	0.685	107.32	50

**Source:** Nation-wide survey conducted by RIS  
**Note:** Figures in the parenthesis denote t-values. <sup>†</sup> denotes significance at the 1 per cent level.

(b) *If number of evaders is more, average level of customs evasion may be less* – This policy options may be appropriate for a country where customs revenue constitutes a large segment of the overall revenue of the government. In low income countries where customs tariff forms the bulk of government’s revenue, it can not afford to loose more revenue to be siphoned out, and the government has to make all efforts to keep the average level of under invoicing low in order to reduce the level of customs revenue evasion to the minimum. In this case, number of evaders may be large as more trades are engaged in under invoicing activities in selected products even with low margin of profit. Taking into account the Indian experience, traders dominate in this product segment. Under this policy alternative, traders will be rather under less pressure than manufactures.

These are the two extreme situations, where no county can afford to choose between the either of the policy options. Depending upon country’s domestic compulsions, it can choose a combination of the alternative policy options to fulfil the domestic requirements. This empirical analysis has significant policy implications for India and other developing countries.

#### 4. Response on the Key Constraints

In light of the key constraints raised by the private sector we juxtapose here the information collected from the government agencies. The point that customs refunds are not there was not found to be correct as the Table III.3 shows that the refunds from the department in the period 2000-01 to 2004-05 hovered around 0.45 per cent as share of total customs revenue. In 2004-05, it was Rs. 18.7 million. In our interviews, it is, however, confirmed that 60 to 70 per cent cases of SVB are settled at the level of Customs Commissioner (Appeal). It is pointed out that similar numbers of cases (60-70 per cent) are rejected at the commissioner’s level. However, 15-20 per cent cases go upto the level of the tribunal. This raises one important point regarding the working of this mechanism because initially, it is at the commissioner’s level that permission for initiating a SVB enquiry is granted. The CBEC is very clear in their circular that it would be imperative for the concerned Commissioner of Customs to critically examine the issues involved and decide whether any particular case deserves detailed enquiry by SVB.

**Table III. 3: Customs Refunds by Custom Houses for the Years 2000-01 to 2004-05**

	Refunds				
	2000-01	2001-02	2002-03	2003-04	2004-05
Total	122.60	188.92	301.08	256.00	186.60
Net Customs Revenue	47615.91	40096.50	44912.31	48599.66	57565.73
% share in Customs Revenue	0.26	0.47	0.67	0.53	0.32

*Source:* SCF (2005).

Similarly, on the issue of under-invoicing we found that several situations are possible on which different data may well be collected for detailed research in future. Some of these possible cases are being presented in Box III.1. In this some five cases are being imagined in which third country invoicing and possibilities for double invoicing using different destinations and sources are being mentioned.

#### Conclusion and Policy Recommendations

As discussed, the imports in India have expanded at a phenomenal rate of 40 per cent in recent times. Despite this increase, there are very few cases which face customs valuation related constraints. As discussed earlier, it now constitutes nearly 3 to 4 per cent of the total transaction. However, this assumes importance in the light of the wider efforts being made by India for ensuring trade facilitation. It is pointed out that a difficult CV regime reduces the impact of and gains from a successful implementation of the trade facilitation agreement as well. In this respect there are certain important measures which may be taken by the national government, international community and the trade partners.

One factor contributing in the decline in reporting of the cases of underinvoicing is the fact that the customs duties in India have come down in a major way. However, this still remains as a key concern for the trading community. It is a common perception that importers are generally engaged in under-valuation activities particularly in consumer goods, but the survey

### **Box III.1: Nature of Under Invoicing in Different Cases**

In recent times the nature of under invoicing has diversified where the traders engage different strategies. Some of them are enumerated below:

#### **Third Country Invoicing – Goods shipped from one country, but invoiced from another country**

In a shipment of 8000 MTs of a polymer manufactured in country M, the invoice was raised in country X by a trading firm. The goods were directly shipped from the manufacturing country, but were invoiced at US \$ 500 PMT, as against the ruling international prices of 850-880 US\$. Enquiries revealed that the importer had an arrangement with the supplier for a much higher price and the balance was settled through unauthorized payment channels.

#### **Double Invoicing – One invoice for the country of export and another for the country of import**

Glassware of a reputed brand was imported at a price much lower than the manufacturer's price list. On enquiry through reliable sources, it was revealed that the invoice submitted at the importing country was about 45 per cent lower than the price declared at the exporting country.

#### **Adjusted Invoice Selling price of Supplier is adjustable**

Import of apples originating from country X was declared at 15 Currency Unit (CU) per carton of 20 Kg. As the price was far lower compared to contemporaneous imports, the supplier in the country of export was contacted through email to ascertain the selling price. The supplier quoted a price of 28 CU per carton. He further offered that LC be established at a reduced rate provided that until relationships have been established, he would require the balance to be remitted prior to shipment.

#### **Grades of Material - Importing Prime and declaring as Grade II**

Gum Arabic imported from country X was declared as Grade II with an invoice price of 500 CU PMT. As there was no market price available for the second grade, the supplier was contacted for details. He confirmed that there was no difference in grades and that he sold the product for 1000 CU PMT only. However, he used to make invoice for half the price indicating a lower grade for duty purposes. In such cases, advance payment of 50 per cent was collected before arranging the shipment for the half priced invoices.

#### **Data Exchange - Different value by 3rd Country invoice.**

Camera parts imported through a supplier in third country was invoiced at about 13 per cent of the actual price. In one consignment, the declared price was 4800 CU as against the actual value of 37000 CU. The under valuation was established through a verification process with the help of the Customs administration in the exporting country.

*Source:* Rehman, S. K. (2006).

results indicates that firms are engaged both in manufacturing and consumer products. The survey analysis indicates that there is a high concentration of underinvoicing detected in selected import sectors while other sectors are thinly reported about occurrences of such economic offences. At the macro level, the detection of under invoicing is so much so that the customs revenue is likely to rise significantly when revenue on evaded customs products are properly assessed and taxed. There is a large number of firms engaged in these activities of under-invoicing and the number of such firms varies significantly across sectors. It is important to note that the average level of evaded customs valuation per firm differs significantly across sectors.

The other factor which eventually may contribute in further decline of underinvoicing is the launching of a country wide Accredited Clients Programme (ACP) and Risk Management System for importers. As part of this, the regular importers with a reputation of prompt compliance would be accredited under the scheme. This accreditation would secure them assured facilitation at major customs ports throughout the country. The self-assessment with assurance of quick deliveries of their imported cargo without any examination by the customs department is some of the key features. It would help importers keep lean inventories besides reducing transaction cost. Some of the major conclusions and policy recommendations are being summarized herewith.

### **Problem of Under Invoicing**

The under-invoicing of imported goods is an extremely serious and complex problem that negatively impacts on Indian economy in several ways. It means that the duties and taxes escape the net and result in gross economic distortions. This also leads to an uneven playing field, unfair competition and is disadvantageous to goods manufactured in India. However, with the general decline in the customs duties there is no major decline in the instances of under invoicing as it is still large given severe resource demand in India. As has become clear from the study, it is largely attempted by the traders and but the manufacturers are also not far behind. The question is the magnitude and frequency of evasion. On the basis of the nature of firms we have identified the sectors. The estimated loss due to this activity is close to Rs. 100,000 million. The increased vigilance and the deployment of modern

systems in India like the introduction of electronic RMS which may alert staff to possible under invoicing, as well as an indicative values database for imported goods, may help in minimizing this loss. Apart from this there seems to be some scope for the customs to work more closely with industry players such as CHAs, etc. to identify wrongdoers. The Indian proposal at the WTO also assumes importance in this context, where help of other authorities in different countries may also be taken for obtaining evidence of underinvoicing.

### **Lowering of Customs Duties**

The continuous lowering of the customs duty seems to have helped in reducing the cases of under invoicing. In India consistent efforts have been made for lowering of import tariffs as India integrates with the ASEAN economies. The Budget Speeches of different Finance Ministers in the last decade have reduced the peak customs duty. In 1991, when the average customs duty was 99 per cent, it came down to 15 per cent in 2005. In this year's Budget it has again been reduced to 12.5 per cent in 2006. It is being expected to eventually come down to 10 per cent next year to match the ASEAN levels. This year it was avoided maybe to dampen the impact of lowering tariff barriers. This lowering of duty has direct impact on the constraints related to the CV, as lowering may remove the incentives for underinvoicing. Thus the continuation of the policy of lowering duties may eventually contribute in tackling the problem of underinvoicing.

### **TV as the Main Approach**

India is one of the few developing countries which had shifted to the transaction value method while implementing the commitments made at the Tokyo Round of GATT negotiations in 1988. Thus, the implementation of ACV in India, even after the relaxed time frame of five years given for the developing countries did not affect the system in a major way. The transaction value, by and large is accepted as a key technique for assessing the trade consignments. It is being expected that the new schemes like the "Valuation Corridor" may help strengthen the working of the TV system. It consists of a database of very highly sensitive commodities. Most of them will have permissible value band defined for allowing clearance without intervention. Any consignment having declared value below the lower limit of value band

will be directed for assessment by the department. The second part of the valuation component of the RMS is about its contribution to the general risk evaluation. Here the risk is computed statistically for various risk elements, including valuation. Each area is assigned a maximum risk index and every commodity under import will be evaluated in terms of a percentage of the total risk. The third part of the Valuation Risk component will be the use of intervention corridor in the RMS to study the valuation trend of newly identified sensitive commodities, and to monitor the efficacy of the valuation corridor. In this context, the role of special valuation branches should also be analyzed in an objective manner. As revealed by several private sector persons, SVBs occupy a huge discretionary space which at times, costs enormously to the trading community and eventually enhancing the transaction costs.

### **Narrowing the Problem**

As is clear from the empirical analysis, the elasticity is significant at one per cent level implying that one rupee increase in the per capita firm evasion of revenue would lead to decline in the number of firm by 0.822 units in average. This has significant policy implication for India and other developing countries. Since most of the private sector companies are also of the opinion that the additional restrictive measures taken by the customs department are because of very few traders in the business community who may account for at best 15 to 18 per cent of total trade transaction. It is important that those firms or sectors are identified so that all do not face same treatment. One idea is to distinguish manufacturing and trading firms separately. In this context, there may be some choice between pre-clearance control and post-clearance control. It is suggested that the manufacturing units may find it easier to deal with post clearance audit. While in case of the traders pre-clearance control should be made more stringent. The recent introduction of risk management system is being seen as an important step in this direction.

### **Voluntary Compliance Culture**

The private sector, along with the agencies concerned at the sectoral level, would have to be encouraged to promote a culture of voluntary compliance. In case of exports this is being attended to in the context of SPS/TBT commitments as in India there is excessive focus on exports while very little attention is being paid at the industry responsibility in helping the Customs

manage the constraints like under-invoicing. Though the industry and customs department have informal links for collecting such information, there are no structured mechanisms within the industry forums to address challenges like these. There are different export councils working at this point with sectoral focus. Their help may be sought to identify the incidents of fraud that include under-invoicing, tariff misdeclarations, incorrect use of tariff headings, non-declaration of goods and the import of counterfeit goods. The private sector along with other stakeholders may also help in the realignment of resources including arranging of appropriate equipment to continue and improve reform process so that their firms and the industry as a whole remains at par with the new technologies being adopted by the customs department.<sup>29</sup> The role of private sector is particularly important in this regard. This help would be most important in terms of fighting against fraud in the import process and in continuing the dialogue with all stakeholders to identify specific areas where the private sector can support capacity building. Another means to promote ownership of reform that the customs department may introduce is to have identified sectoral profiles of industrial groupings which could help in potentially finding of common solutions to shared problems through exchange of experiences.

### **Frequent Updating of Databases**

The launching of the services like NIDB has helped the department in terms of facilitating the work of assessment. However, it is equally important to maintain the facilities created by DOV, such as NIDB, to update them so that full benefits in terms of enhancing trade facilitation potential may be realized. As is pointed out by the private sector survey, there is a huge time lag in updates, which creates different problems among different set of importers. It may be a pre-requisite to institutionalize such changes and the appropriate bureau resources appropriately dedicated to the maintenance and upgrading of the databases. The NIDB is to improve its product description convention so that it becomes more precise and the data is regularly updated in line with the market. This may help in reducing unnecessary friction between customs authorities and importers regarding the use of the value range information system.

### **Sharing of Information**

The joint proposal by India and the United States in TN/TF/W/57 sets out the basic approach to establish a multilateral mechanism for exchange and handling of information between Members. It is the second communication from India which spells out exchange of trade transaction information consisting of the data elements and documents that are usually collected by customs, at the time of importation or exportation.<sup>30</sup> Such exchange of information may be through a nodal agency to be designated by each customs administration and this would be kept confidential as per the Article 10 of the WTO Agreement on Customs Valuation. There may be a cooperation mechanism for exchange of specific information at the multilateral level as bilateral agreements are not always easy to enter into, and at times, they are limited in nature. Initially this may be for a limited number of cases for collecting information such as on customs valuation, HS classification, full and accurate description, quantity, origin of goods in identified cases where there is reason to doubt the truth or accuracy of the declaration filed by the importer or exporter. There may not be severe implications of this as far as technical assistance needs are concerned, as this can be effected through the existing administrative set up of the customs administrations. During the negotiations, some countries raised objections on data sharing quoting domestic laws about confidentiality. Therefore, it would be pertinent to have some understanding on these sensitivities. However, it is to be realized that the idea for such a multilateral arrangement is as old as the ACV itself. An International Convention on Mutual Administrative Assistance for the Prevention, in 1977 at Nairobi under the auspices of the CCC was conceived.<sup>31</sup> This convention, known as the Nairobi Convention, acknowledged in its preamble that “offences against customs law are prejudicial to the economic, social and fiscal interests of States and to the legitimate interests of trade” and that “action against Customs offences can be rendered more effective by cooperation between Customs administration.” This convention still looks for needed endorsement but such frameworks are needed as part of ACV.

### **UN Valuation Data Bank**

The WCO has been discussing this at different fora in different forms but in order to promote global convergence and uniform application of the harmonized system and the valuation practices, it would be useful that any

agency under UN system may consider taking a lead to establish a valuation data base which is referred to widely whenever needed by any member country customs.<sup>32</sup> This may help in checking of further erosion of the WTO Valuation Agreement. As several companies undermine the prescribed duty rates and indulge in activities like under invoicing, some mechanisms for back up information would be extremely important. In the United Nations (UN) Trade Database, it is possible to capture the value of imports reported by a country with the value of exports in the SITC classification taking due note of the amount of “costs including freight” which may vary from country to country, depending on the size of insurance premiums, transport charges, port charges, etc but still this data base may help a great deal.

### **Training of Manpower**

It is pointed out that despite of several steps taken by customs department the field staff is often not aware of valuation and assessment procedures. The Examiners and Appraisers are the first ones to interact with importers but they are often not aware of nuances in this area. It is also observed that department officials especially those who come from agencies other than customs are often not aware of the nuances of customs policies which makes things extremely complicating for the CHAs and the importers. Most of the complicated cases are transferred to SVB which takes long period of time as it is poorly manned. It is suggested that trained manpower in adequate numbers should be provided at the field level and at the SVB for improving efficiency and reducing the time span. In this context, the government should also pay attention at the transfer policy for the officials from other agencies to the key postings in customs atleast where technical work like valuation is involved, transfer should be avoided

### **Convergence of Approaches in Transfer Pricing and Related Party Transactions**

In several meetings with the private sector it was pointed out that the government should pay attention in terms of exploring the possibility of converging different approaches being taken by the Customs Department and the Income Tax Department. It was pointed out that this is leading to several litigations in India. There is thus a need to develop an international understanding preferably as part of ACV so that national governments may

work out their policy responses on this. The further elaboration of ACV provisions related to transfer pricing which at this point only cover arms length price comparable to test values arrived from sale of identical or similar goods may help. This elaboration may come close to the OECD guidelines related to transfer pricing but there one would have to see the interest of developing countries which predominately bring in the question of revenue generation.

In the context of related party transaction customs valuation poses a huge challenge. The issue becomes more pronounced in situations where the imported product is a combination of hardware and software. Software is often customized to suit the specific country/customer requirements. The differentiation in product supplied to other countries, in such cases, is extremely difficult and requires fair degree of technical knowledge to understand and adjudicate matters. Also, the price at which goods are supplied to other countries may or may not represent comparable price as various factors are considered in pricing a product for a country. Customs authorities often do not have adequate information or training to understand the differences. More often than not, price at which identical or similar goods are supplied by the exporter to subsidiaries/joint ventures in other countries is accepted as comparable price by the Customs authorities in India. In fact, it is specifically asked by the department to declare the price at which goods are supplied to India. However, importers in India find it extremely difficult to obtain this information from the exporters especially, if the exporter is holding a small stake in the importer (say 5-10 per cent) as such information is considered confidential. With increasing global trade and investment, there is a need to consider whether shareholding of less than 26 per cent in the absence of any other relationship ought to be considered as “relationship” for the purpose of valuation under GATT Valuation rules. Also, there is need to have clear provisions for working out the effect of indirect holding for determining the stake. It is a fact that shareholding is often through a web of entities and it becomes very difficult for the importer to obtain full information.

### **Regional Cooperation in Asia and Pacific**

In Asia and Pacific region there is a sudden spurt in activities related to bilateral, sub-regional and regional trade and customs cooperation. It would



be pertinent to take note of arrangements within different bilateral agreements, regional rules (harmonized forms/certificates and other support documents such as road consignment notes, contracts, and import licenses; requirements in origin/destination and transit; transport charges) Given the many agreements that have been formed in the region, there is a need to determine how to realize their potential benefits especially for the current concern of customs valuation.

In this context the work being done at the Customs Cooperation Committee (CCC) facilitated by the Asian Development Bank is worth noting.<sup>33</sup> As of now the participating countries include largely the Central Asian countries like Azerbaijan, Kazakhstan, Kyrgyz Republic, Mongolia, the People's Republic of China, Tajikistan, Turkmenistan, and Uzbekistan. This work may further be expanded to subsume an Asia wide programme to provide support to the customs valuation related work as well.

## Endnotes

- <sup>1</sup> Streatfeild (2006).
- <sup>2</sup> Streatfeild (2006).
- <sup>3</sup> Goorman and Wulf (2005).
- <sup>4</sup> Chaturvedi (2006) and Duval (2006).
- <sup>5</sup> Based on estimation by Mr. C. Satapathy (persona l communication).
- <sup>6</sup> Uruguay Round Ministerial Decisions adopted by the Trade Negotiations Committee on 15 December 1993 and 14 April 1994.
- <sup>7</sup> Satapathy, C. (2002).
- <sup>8</sup> *The Financial Express*, July 27, 2006.
- <sup>9</sup> *The Hindu Business Line* (2006).
- <sup>10</sup> *Economic Survey* (2005-06).
- <sup>11</sup> Satapathy (2002).
- <sup>12</sup> For details see Majumder (2005).
- <sup>13</sup> Sriram (2001).
- <sup>14</sup> Sriram (2001).
- <sup>15</sup> Srivastav (2003).
- <sup>16</sup> SCF (2005).
- <sup>17</sup> www.dov.gov.in
- <sup>18</sup> Majumder (2005).
- <sup>19</sup> Chaturvedi (2006).
- <sup>20</sup> Rajagopalan, TNC (2006).
- <sup>21</sup> WCO (2006).

- <sup>22</sup> Satapathy (2001).
- <sup>23</sup> We are referring to a case where the average under invoicing per firm for a product is relatively higher than that of other products.
- <sup>24</sup> The figures are indicating percent rise in revenue collection in the post-detected period over the customs declared before detection.
- <sup>25</sup> For arriving at Section level figure (in bold) we have used weighted average to the chapter-level data. In this case number of surveyed firms in each chapter is taken as weight while calculating average at the section level.
- <sup>26</sup> The choice of model for the analysis is based on scatter diagram. For more details of the specification of model see Johnston, J (1972), *Economic Methods*, Second edition, McGraw-Hill international book company, pp. 47-55.
- <sup>27</sup> For detailed discussion, see page 1.
- <sup>28</sup> The scatter is so accurate for the present model that there is no need for choosing other models for this purpose.
- <sup>29</sup> Mikuriya Kunio (2002).
- <sup>30</sup> WTO (2005).
- <sup>31</sup> Satapathy (2000).
- <sup>32</sup> WCO (2003); Satapathy (2002).
- <sup>33</sup> Asian Development Bank (2002).

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