

# Customs in international relations: the Indian context<sup>1</sup>

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## Abstract

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This paper, adapted from the first BN Banerji Memorial Lecture, uses the Indian context to discuss the role of Customs in international relations, and provides a wide-ranging overview of the impact of customs duties imposed on imports and exports on cross-country relations. Examples are provided of specific instances of, for example, the application of anti-dumping taxes, and the roles of the World Customs Organization (WCO) and the World Trade Organization (WTO) in lowering customs duty rates internationally as well as in monitoring unfair competition. The paper concludes that the role of Customs in international economic relations is all-pervasive and growing, and that the growing role includes addressing the many challenges that are present in a globalised world, such as an increased need to monitor contraband, channels of money laundering, and international terrorism buttressed by modern developments in information and communication technology (ICT), highly trained staff with increasingly common international principles, and broadened cooperation with other related departments.

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## 1. Introduction

The role of Customs in international relations, by its very concept, deals with two inter-related functions inasmuch as Customs is required to ensure compliance with international policies and maintain national border controls. This poses special issues and challenges that policymakers and officials encounter when designing customs tariffs and implementing the customs code.

In this paper, section 2 addresses conceptual issues together with the rationale and objectives of a customs regime. Section 3 deals with revenue generation through customs tariffs in emerging countries. Section 4 focuses on India by, first, recalling the role of the World Trade Organization (WTO) in the reform of the structure of customs tariffs and, second, by examining the progressively reduced customs tariffs in the industrial sector and pointing to the diminishing role of Customs as a revenue generator. Section 5 illustrates the expanding role of computerisation in customs processes. Section 6 brings up another administrative instrument, that of Large Taxpayer Units (LTUs) and the inclusion of Customs in its activities. Section 7 provides examples of how Customs should function to provide a seamless service rather than becoming an impediment to international economic relations through bureaucratic approaches. The examples selected are from a wide variety of cases, including the impact of customs duty structure, customs administration and exports, interpretation of licence requirements, the effects of international treaties, anti-dumping duty on imports, and containing money laundering. Section 8 touches specifically on the role of international organisations such as the World Customs Organization (WCO), the WTO and the European Customs Union (ECU) to emphasise the crucial role that Customs has played and continues to play in international economic relations. Section 9 draws conclusions from the views expressed.

It is true that, as globalisation spreads and tariff barriers to trade diminish, so too will revenue diminish from customs tariffs. While this role is not expected to disappear from emerging economy concerns, increasingly the typical customs department is taking on an expanded international role to combat challenges that include an increased need to monitor contraband, channels of money laundering, and international terrorism buttressed by modern developments in information and communication technology (ICT), highly trained staff with increasingly common international principles, and broadened cooperation with other related departments.

## 2. Concept, rationale and objectives of Customs

Let me begin with the concept of customs duty. The rationale for imposing customs duty is couched in the need to protect domestic industry – typically infant industries – so that it is sheltered from aggressive foreign competition that may occur even before domestic units have had adequate time to catch up with that competition. Once the economy develops, the argument for continuation of high customs tariffs cannot be easily maintained. Indeed, over the years, they have been inexorably scaled back in India, for example. The WTO has played a significant role in making economies more competitive through scaling back customs tariffs. Subramanian and Wei provide evidence that ‘the WTO has had a strong positive impact on trade, amounting to about 120 per cent of additional world trade or USD8 trillion in 2000 alone’ (Subramanian & Wei 2007, p. 151) compared to the counterfactual of a world without the WTO. Bolhöfer (2008) has looked at the role of WTO law in trade facilitation and how the latter is negotiated.

The operations of a customs department straddle a wide variety of objectives. First, it collects customs duty. Second, it collects some domestic taxes such as the value added tax (VAT) or the goods and services tax (GST) on imports. These are taxes on domestic consumption. The consumption items can be from domestic or international sources and the tax should be the same irrespective of its source. Thus VAT or GST is collected at the customs point on incoming goods. In India this is termed countervailing duty (CVD) in the sense that it countervails – or equalises – domestic with foreign sourced consumption items of the population. Note the conceptual difference between customs tariffs and countervailing duty. The implication is that while the tariff structure is scaled back to reflect international agreements and arrangements, the countervailing duty reflects the domestic consumption tax rate.

In India, so far, state-level VAT is not collected on imports at the customs point, though conceptually, it should be. Otherwise, domestic producers and sellers are being put at a disadvantage. This lacuna reflects simply the absence of a mechanism for state-level taxes to be collected by the Centre. Once an overarching GST – covering both the Centre and the states – is introduced as planned, then both CGST (central) and SGST (state) on imported items should certainly be collected by Customs which is a central level department.

Another point worth mentioning is that the customs duty on a product, in itself, does not reflect the extent of protection. If there is a customs duty on inputs and raw materials, then the ‘effective’ protection rate is the customs duty on the final good minus the customs duty on all imports. This is because the domestic producer of the final good has to pay customs duty on the inputs and raw materials and, to that extent, the protection of the final good actually diminishes. Corden (1966) introduces this concept, explaining why the nominal rates of tariff by themselves cannot indicate the level of protection.

A second operational objective of Customs is to minimise smuggling of demerit goods such as cigarettes and alcoholic beverages across borders since these items are usually highly taxed and their tax rates may also vary significantly across borders. Sometimes the same bill of lading may be used by vehicles to transport several loads of the items across borders and customs checks play an important role in keeping such practices to a minimum. Shome (2012a) deals in some detail with modern tax administrations such as the United Kingdom (UK) that have sharpened their instruments of detection of risk through

intelligence that continually identifies and contains smuggling and fraud. A well-known instance is what has been called 'carousel fraud' where sellers collect and do not pass to the Exchequer the tax collected from buyers and the illicit gain is shared between the sellers through collusion. It was originally detected by Customs in the export-import circle; hence the term.

Over the last two decades, anti-money laundering and drugs trafficking responsibilities have also been assigned to customs organisations over and above border patrols belonging to security departments. In particular, curbing money laundering is a deeply challenging added task for Customs. Buchanan, for example, describes money laundering as 'a global phenomenon and international challenge, money laundering is a financial crime that often involves a complex series of transactions and numerous financial institutions across foreign jurisdictions' (Buchanan 2004, p. 115). It is the cross-border aspect where the role of customs departments emerges. To meet these objectives, cooperation among customs departments across the globe has intensified over the years. Vaithilingam and Nair (2009) explored the key factors that accompany high or low incidence of money laundering such as internet penetration rates, brain drain, efficiency of legal system, and effective tax and financial systems in 88 countries. They found that pacesetters have high internet penetration, low brain drain, sound legal, tax and financial systems, and low incidence money laundering. Money laundering is a complex charge that has fallen on the laps of customs departments, albeit shared with other related departments and organisations worldwide.

A third operational objective is the collection of statistics. For future policymaking, it is important for any economy to keep account of the flow of goods and services to and from the economy in its international trade relations. Increasingly, trade classification has been finessed over the years into more and more digits. Svendsen (2004) explains in some detail how this is carried out by the WCO (and initially, by its forerunner, the Customs Cooperation Council) whose objective is the attainment of the highest possible degree of harmony and uniformity. Weerth describes the 2007 Harmonized System for the Description and Coding of Goods (HS) which is based on rules that have been developed for classification, headings and subheadings. Thus 'the HS 2007 contains 380 notes and 56 subheading notes which are valid worldwide, and the EC [European Community] has added 98 additional notes within the CN [combined nomenclature] and the CCT [Common Customs Tariff] ... The 534 notes that accompany the 1,221 HS-headings, 5,052 HS-subheadings and 9,720 CN-subheadings are proof of the complexity of the rules of the CCT which contains more than 16,500 legal rules for the classification of goods' (Weerth 2008, p. 111). This micro information has to be meticulously noted and entered, a task that is often assigned to the customs department.

The more complex a customs tariff structure is – as is the case in India – or the higher the tariff rates – as was the case in India though, progressively, the rates have been scaled back – the greater is the challenge on customs officers to impose and collect the right tariff on the imported good. Mishra, Subramanian and Topalova, using the variation in tariff rates across time and products, identify 'a robust positive elasticity of evasion with respect to tariffs' (Mishra, Subramanian & Topalove 2008, p. 1907). In other words, evasion increases proportionately faster than the rise in tariff rates. It is here that moral hazard can pose a problem if a section of the customs officers becomes unscrupulous. Leadership in the customs department is crucial in keeping this problem at bay. To combat this problem, many countries have simplified their tariff structure, the most extreme simplification being the case of Chile which has only a single tariff. Thus, if more revenue is needed, that rate is increased and, when revenue needs are less, the rate is scaled back. To avoid tracking the import and export of goods and towards the objective of making the customs department exclusively an operational department, in some countries this function has been passed to the official statistics department.

The next section deals with selected issues of a policy, operational and administrative nature that are of relevance to the role of Customs in international economic relations.

### 3. Revenue generation through customs duty in emerging developing economies

Emerging developing economies, in their nascent period, depend quite heavily on customs duty not only to protect infant industry but also for a robust source of revenue. In an early paper, Shome (1988) points out the likely structure of a tax system in developing countries, reflecting the low elasticity of certain taxes given their truncated bases. Mahdavi (2008) reiterates that the foreign trade sector of the economy has been traditionally a base that is easier to tax. This reflects the fact that ‘administrative costs of monitoring, assessing, and collecting taxes on goods that go through a limited number of ports of entry are relatively low. Accordingly, many governments in developing countries heavily rely upon trade taxes (especially customs duties on imports) to generate revenues’ (Mahdavi 2008, p. 610).

Baunsgaard and Keen penetrate related aspects more deeply. They show that, ‘In the early stages of liberalisation, the revenue consequences of reform may be relatively minor. Indeed the first steps – often involving reducing prohibitively high tariffs, ...eliminating exemptions, and raising low tariff rates in moving towards a more uniform tariff structure – may plausibly lead to an increase in trade tax revenues ... There must come a point, however, at which further movement towards free trade reduces trade tax revenues’ (Baunsgaard & Keen 2010, p. 563). Thus, in the final analysis, revenue growth has reflected the duty structure. Invariably, as duty rates decline, revenue growth tends to be arrested. Of course, as a slight caveat, it might be noted that the lower customs tariff structure’s negative effect on customs revenue gets countered somewhat as international trade expands as a result of lower duty rates.

It is worthwhile reviewing some of the constraints for revenue generation through customs duties in developing economies that were pointed out by Shome (1988). First, revenue growth from customs tariffs reflects a country’s industrial strategy. For example, as the economy increases its share of manufacturing in gross domestic product (GDP), capital goods, intermediate goods and raw materials may need to be taxed at lower rates than final goods. This is because such goods are directly needed in the process of production. And there is no provision – because there is no rationale – for customs duty on intermediate goods to be setoff or receive input tax credit. Thus customs tariffs on such goods are lower. Further, as the share of manufacturing in GDP increases, the share of imports of intermediate goods vis a vis the imports of finished products tends to increase. This would especially be the case if the growing manufacturing sector is significantly dependent on imported capital and intermediate goods. Thus if the share of lower-rated to higher-rated imports goes up, that would reduce the growth rate of revenues from customs duties.

Second, if the manufacturing – private or public – sector expands while enjoying exemptions from import duties, as is likely to be the case under tax incentive provisions, the share of exempt imports in total imports also grows. The role of tax incentives in efficiency costs as well as revenue expenditure – a term used for the loss or sacrifice of revenue caused by tax incentives – has been described in some detail by Shome (2012b). As industrialisation progresses, the automatic growth in customs duty revenue tends to decline. Also, as countries promote export orientated growth, more of the commodity taxes – both domestic and on imports – have to be refunded to export orientated firms because all attempts are made to enable exports to enter international markets competitively, or without any embedded taxes in their value or price.

Third, though it has been pointed out by Zee, Stotsky and Ley that ‘duty drawback schemes – tariffs are first payable upon importation of all inputs, but are then refunded on that portion of imported inputs embedded in goods that are actually exported; refunds are typically provided on the basis of some input-output relationships of the exported goods in question’ (Zee, Stotsky & Ley 2002, p. 1506), field level experience reveals that, in fact, revenue erosion may deepen as duty drawback systems tend to be based not on actual duty paid but on somewhat magnified sector-wide formulae for duty drawbacks that are typically used for administrative convenience.

Fourth, discretionary measures also tend to affect the import tax base. Sometimes, customs duty structures shift from ad valorem towards specific rates, in pursuit of greater administrative simplicity. Specific rates of customs duty tend to apply in a very limited number of goods, with only a few countries having taken this route. Also, as industries mature, the rates of nominal protection are frequently reduced over time as was mentioned above.

Fifth, it is not uncommon to use artificial exchange rates for import duty valuation purposes which further reduce potential revenue. There are, therefore, several factors that stand in the way of a naturally growing revenue base from imports.

It is seen in any cross-country comparison that, with economic development, the role of customs duty in revenue generation declines while other roles that have been mentioned earlier move forward even as domestic consumption taxes and income taxes become the revenue drivers. Using a panel of 80 developing and industrial countries over the period 1970 to 1998, Khattry and Rao confirm 'the inverse relationship between the level of development and dependence on trade taxes as a source of revenue [while] as countries become more developed their tax revenue/GDP ratio rises' (Khattry & Rao 2002, p. 1436).

## **4. Changes in customs duty structure: the Indian experience**

In light of the above discussion, in this section, we review the experience of tariff structure changes in India.

### **4.1 The context of the WTO**

The WTO has made concerted efforts to facilitate trade through reduction/elimination of tariffs as well as by removal of non-tariff barriers. Baldwin (2009) has reviewed the negotiation process in the post Second World War era, pointing to how future negotiations can be made more successful. Reflecting the low level of reforms in agricultural tariffs, the focus below is on trade in non-agricultural products. In the first GATT rounds, tariffs were cut on a selective product-by-product basis through requests and offers made between participants. However, subsequently, countries decided to use formulae to cut tariffs across the board. For example, during the Kennedy Round (linear cut formula) and in the Tokyo Round (Swiss formula<sup>3</sup>), developed countries applied formulae, but with several exceptions. In the Uruguay Round, developing and developed participants negotiated their tariff cuts using a variety of methods to reach a reduction average target comparable to that of the Tokyo Round (one-third cut). In the Doha declarations, the ministers agreed to launch tariff cutting negotiations on all non-agricultural products. The aim was 'to reduce or, as appropriate, eliminate tariffs, including the reduction or elimination of tariff peaks, high tariffs, and tariff escalation, as well as non-tariff barriers, in particular on products of export interest to developing countries'.

The chastened reality is that these negotiations are still going on in the absence of consensus. The negotiations on reductions in tariff on non-agricultural products are referred to as non-agricultural market access (NAMA) negotiations. NAMA refers to all products not covered by the Agreement on Agriculture. In practice, it includes manufacturing products, fuels and mining products, fish and fish products, and forestry products. Over the years, NAMA products have accounted for almost 90% of the world's merchandise exports.

The Uruguay Round produced significant improvements in market access for NAMA products in developed country markets, as tariff averages were reduced from 6.3% to 3.8%. In the case of developing countries, the most important contribution was made in the form of new tariff bindings. Binding coverage

for NAMA products in developing countries increased from 21% to 73%, which has considerably increased the predictability of trade.<sup>4</sup>

## 4.2 Tariff reforms in industrial goods

In the mid-1980s, the tariff rates in India were very high and the structure complex. The Indian government's 1985-86 Long-Term Fiscal Policy (LTFP) emphasised the need to reduce tariffs, apply fewer and more uniform rates, and reduce and eventually eliminate quantitative restrictions on imports. This was applied selectively by rationalising the rates for specific industries such as capital goods, drug intermediates, and electronic goods. However, contrary to the LTFP recommendations, tariffs continued to be raised for revenue reasons, the weighted average rate increasing from 38% in 1980-81 to 87% in 1989-90. By 1990-91, the tariff structure ranged from 0% to 400%. More than 10% of imports were subject to tariffs of 120% or more. Reflecting the influence of various special interest groups regarding tax policy, wide-ranging exemptions were granted outside the budgetary process, further complicating the system and rendering it ad hoc.

The reform of import duties in earnest began in 1991-92 when all duties on non-agricultural goods above 150% were reduced to this level. This 'peak' rate was lowered over the next four years to 50%, and then to 40% in 1997-98, 30% in 2002-03, 25% in 2003-04, 20% in 2004-05 (January 2004), 15% in 2005-06, 12.5% in 2006-07 and finally, to 10% in 2007-08. It is important to note that these reductions were not mandated by any WTO requirements as India's applied rates are considerably below the bound rates – and the duty reductions were made even for unbound items.

Table 1 gives a broad view as to where we stand in terms of tariffs. India's Trade Weighted Average (TWA) for agriculture is highest at 44.2%. However, since agriculture's weight is low, India's TWA for agriculture plus industry is 6.9%, lower than Argentina's 12.2%, Brazil's 10%, and Pakistan's 9.8%, but higher than Indonesia's 2.4%, Malaysia's 5.1%, and the Philippines' 5.1%. Also, India's binding coverage continues to be lower than the sample countries other than the Philippines.

Table 1: Cross-country tariff rates (not including countervailing duty [CVD])<sup>5</sup>

| Country       | Average (Agr) | Average (Indy) | Average (All) | TWA (Agr) | TWA (Indy) | TWA (All) | Binding coverage |
|---------------|---------------|----------------|---------------|-----------|------------|-----------|------------------|
| India         | 31.8          | 10.1           | 13            | 44.2      | 5.1        | 6.9       | 73.8             |
| Argentina     | 10.3          | 12.9           | 12.6          | 9.8       | 12.3       | 12.2      | 100              |
| Australia     | 1.3           | 3.0            | 2.8           | 2.7       | 4.0        | 3.9       | 97.1             |
| Brazil        | 10.3          | 14.2           | 13.7          | 11        | 9.9        | 10        | 100              |
| Canada        | 11.3          | 2.6            | 3.7           | 11.2      | 2.7        | 3.4       | 99.7             |
| Indonesia     | 8.4           | 6.6            | 6.8           | 3.4       | 2.2        | 2.4       | 95.8             |
| Malaysia      | 10.9          | 7.6            | 8.0           | 14.4      | 4.3        | 5.1       | 84.3             |
| Pakistan      | 17            | 13.4           | 13.9          | 9.1       | 9.9        | 9.8       | 98.7             |
| Philippines   | 9.8           | 5.7            | 6.3           | 15.7      | 3.7        | 5.1       | 67               |
| Singapore     | 0.2           | 0              |               | 1.2       | 0          |           | 100              |
| United States | 4.9           | 3.3            | 3.5           | 4.3       | 2.0        | 2.1       |                  |

*Notes:*

- Average tariff is the simple average of all applied tariff rates at 6-digit level.
- 'Agr' – Agricultural products
- 'Indy' – Non-agricultural products
- 'TWA' – Trade weighted average or simply the collection rate which is obtained by dividing the total revenue by the total value of imports. Revenue from basic customs duties alone has been taken into account.

Source: WTO World Tariff Profile 2011. (All figures are in %)

Collection rate is the ratio of revenue collected (all duties collected at Customs including basic duty and CVD) to value of all imports (including exempted imports). Figures available in the Economic Survey include all revenue collected at Customs (including CVD) which explains the difference in the effective tariff rates in Tables 1 and 2. The collection rate at Customs has declined from 47% in 1990-91 to 31% in 1996-97, 27% in 1997-98 and 23% in 1998-99. The rapid and continuing decline in later years is depicted in Table 2, which shows the ratio declining to 10% in 2005-06, and 8% in 2010-11. Before we end the observations over collection rate, it must be acknowledged that the decline is not just due to lower tariff rates but also to a plethora of exemptions that continue to prevail and are even newly introduced.

*Table 2: India: change in collection rate at Customs (including countervailing duty [CVD])*

| S no. | Commodity group     | 1990-91 | 2005-06 | 2006-07 | 2007-08 | 2008-09 | 2009-10 | 2010-11 |
|-------|---------------------|---------|---------|---------|---------|---------|---------|---------|
| 1.    | Food products       | 47      | 32      | 23      | 19      | 4       | 3       | 3       |
| 2.    | POL                 | 34      | 6       | 5       | 6       | 3       | 2       | 6       |
| 3.    | Chemicals           | 92      | 20      | 22      | 22      | 16      | 14      | 17      |
| 4.    | Man-made fibre      | 83      | 34      | 28      | 30      | 17      | 22      | 30      |
| 5.    | Paper and newsprint | 24      | 9       | 10      | 10      | 8       | 8       | 8       |
| 6.    | Natural fibres      | 20      | 13      | 12      | 13      | 6       | 4       | 5       |
| 7.    | Metals              | 95      | 25      | 24      | 24      | 17      | 17      | 22      |
| 8.    | Capital goods       | 60      | 13      | 14      | 16      | 13      | 11      | 13      |
| 9.    | Others              | 20      | 5       | 6       | 6       | 4       | 4       | 4       |
| 10.   | Non POL             | 51      | 12      | 12      | 13      | 9       | 8       | 9       |
| 11.   | Total               | 47      | 10      | 10      | 10      | 7       | 6       | 8       |

*Source:* Economic Survey 2011-12.

## 5. Benefits of computerisation in customs processes as international practice

The use of information technology (IT) is imperative for customs processes. Lewis defines ICT and identifies the importance of its use in customs environments. He provides reasons why ICT solutions should be adopted, concluding that 'Prudent management of ICT is a means to reap benefits that impact positively on the effectiveness of all customs operations, and hence the improvement of national finances' (Lewis 2009, p. 3). Focusing on customs and excise in India, two systems integrators were designed to achieve connectivity of all offices across the country, thereby sharpening tax administration and improving taxpayer services. In 2006, Shome elaborated on the actual processes that were planned. Now the Indian Customs electronic data interchange (EDI) system (the e-commerce gateway [ICE]) enables easier online filing and assessment of import and export documents. It also enables remote control between the customs department and the customs agent, so that the customs agent does not have to be physically present in the customs department. Facilitation should also have occurred between the customs department and the Reserve Bank of India, other banks and custodians like the Port Trust, and so on. This has functional status in 35 locations and covers about 85% of India's international trade.

ICE has been functioning since 2004 and has enabled e-filing of import or export goods declarations, filing of manifests by airlines and shipping agents, and exchange of data between Customs and agencies such as the Director General of Foreign Trade (DGFT). So, again, all declarations and filing are going through an electronic channel.

An extremely important advancement in management and practice, is that clearance of customs drawbacks and refunds has been sped up through a risk management system so that the total time for clearance is diminished to a fraction of what it was a few years ago, with risk management techniques helping to identify suspect cargo. Today, in a world that requires enhanced security, there may be a need

to revisit this kind of system reflecting exogenous factors, though it is hoped that the customs authorities will be able to carry out and adhere to the risk management system and reduce processing time even more in the future.

Enhanced computerisation is leading to the production of more meaningful statistics and data management so that on the customs and excise side, the type of data that have been generated can be much better utilised for policymaking and for administrative improvements. For example, excise and service tax, apart from Customs, depend on a system for excise and revenue monitoring. This enables a buildup of profiles of assesseees and an information database of returns of units that are paying Rupees 1 crore or more in tax. During the period being referred to, about 5,000 units tended to file electronically; hence it provides a good data set to carry out analysis. At the present time, that number should certainly have gone up considerably.

Electronic registration of assesseees has also been enhanced. A digital certifying authority enables electronic transactions using digital signatures. ISAT functioned through five registration authorities in Bangalore, Chennai, Delhi, Kolkata and Mumbai within the customs house premises.

Looking ahead, the future of the customs, central excise and service tax departments in India lies in further deepening computerisation following international norms. The best way to convince those officers who still have doubt is not to force it on them but to have intensive workshops to train them and to visualise for them the benefits of IT. There must also be a concerted effort in reducing moral hazard through minimising the interface between officers and customs agents. The benefits of a robust and healthy customs service through rapidly increasing the use of IT has to be convincingly conveyed to officers in growing numbers. This remains the greatest challenge for department heads.

The national data centre is almost completed. It comprises an electronic hardware storage database and facilities management, and is linked through a wide area network (WAN) and local area networks (LAN) in offices across the country.

It may be pertinent to revisit one international example of the benefits that was mentioned earlier. It comes from the role of Customs as a monitoring instrument in international trade and flows. In the international arena, Customs plays an important monitoring role in checking the borders for contraband, smuggling and such other non-tax criminal activities. But they may also be tax-related. The previously mentioned 'carousel fraud' problem in the UK was detected through electronic monitoring. It pertained to the VAT that is applicable in the European Union (EU) at different country-specific rates. In essence, it is the practice of errant taxpayers who collect VAT from those to whom they sell but, instead of passing the net (tax debit – tax credit) amount to the authorities, they just pocket it.

In fact, it was discovered that the practice was carried out in connivance between the two parties, or in full knowledge of the buyer who was supposed to have paid VAT to the seller. It was essentially discovered at the customs point as a practice of collusion between an importer (buyer) and exporter (seller) – hence the name 'carousel' that was observed by continuing examination of their declared accounts. But essentially it can occur between a domestic buyer and domestic seller as the two colluding parties. The revenue that is not passed on to government can then be shared by the two tax evaders. This is the kind of role that customs officers increasingly take on in developed countries even as their role in collecting revenue from customs tariffs may have diminished as customs tariffs themselves are very low today.

## 6. Large Taxpayer Units (LTUs)

The quality of tax administration can improve significantly if information on taxes that businesses pay could be considered under one umbrella. Baer (2002) and McCarten (2004) describe the advantages of and challenges posed by Large Taxpayer Units (LTUs) in developing countries. To quote McCarten, 'The classic LTU monitors large taxpayers exclusively through auditing, registration, tax accounting,



collections, and taxpayer service provision covering more than one type of tax' (McCarten 2004, p. 2). Baer (2002) looked at 40 countries and concludes that, to assess their effectiveness, 'tax administrations must identify and compile performance indicators, which are the basis of effective management reporting'. She emphasises that 'The LTU needs continuous reform and modernisation like the rest of the tax administration ...' (Baer 2002, p. 2). Shome (2012a) elaborates how a developed country tax administration such as that of the UK has structured its entire tax administration by categorising Large Business Services (LBS) into different economic sectors, which are supported by functional departments. This structural setup is described in more detail below. There remains little doubt that LTUs are playing a significant role in modern methods in tax administration across the globe.

Macedo takes the argument forward by proposing 'the creation and development of Large Traders' Customs Units (LTCU). The proposal considers the successful experience of tax administrations in implementing ... LTUs' (Macedo 2011, p. 63). It must be pointed out, however, that the concept of LTU embraces the concept of facilitating the management of and payment for all taxes under the same unit with the objective of taxpayer facilitation as well as to obtain the synergy of cross-information on all taxes being paid by a taxpayer that becomes available to the tax administration, thereby improving administrative efficiency through enhanced verification as well as taxpayer compliance. Businesses pay corporate income tax, excise, VAT/GST and customs duty. Tax authorities should be able to sit across a large business with full information. That crucial element in an LTU has to remain its central objective. In India, in a pilot experiment in one state, it has been found that some businesses declare different turnover for different taxes. If that is the case, then even at a most rudimentary level, it may be concluded that these taxes should be considered under the same roof, so to speak. From a taxpayer's point of view, it is needless to assert their compliance costs should also decline if they are able to clear all taxes at one point. The challenge for LTUs in developing countries is to provide this service in an effective way, going beyond just locating all tax units in one location as is prone to occur if strict vigilance is not maintained on the manner of their functioning.

It is with this motivation that 50 countries globally and 20 in Asia have opted for LTUs that require large taxpayers to file all taxes at the same window. In India, the concept was initiated in four metropolitan cities, Bengaluru, Chennai, Delhi and Mumbai. Income tax administration on one side and indirect taxes on the other were linked in one unit. One lacuna in the Indian design was to make LTUs optional for large businesses to sign on to, the concern being that large taxpayers should not feel that they were being coerced into joining this mechanism of tax payment at least in the initial stage; it was also to be observed whether the administration could stand up to the special challenges that LTU operations were expected to pose.

A specified number of large taxpayers opting to participate in the LTU was the criterion for establishing an LTU in a city. Though there was some apprehension initially that both departments had different concerns and objectives, and that functioning under the same roof would not help to any significant extent, nevertheless the process of induction began successfully at Bengaluru on 3 October 2006. Chennai soon followed with a well-functioning LTU, and Delhi and Mumbai did not remain behind. LTUs were expected to bring the two departments together in terms of operations, exchange of information through computerisation, and provision of similar taxpayer facilities. In each city for all large taxpayers as defined, the LTU would enable them to take advantage of a single window facility to pay all taxes in a customer friendly environment. However, among the LTUs' objectives, while large taxpayer facilitation has been successful, the synergy that was anticipated in terms of exchange of information between the two departments has not yet fully taken hold.

As mentioned earlier, in the UK, the tax administration is organised as LBS, divided by sector. They are oil and gas, banking, insurance, telephone and telegraph, autonomous agencies (for example, municipal corporations and universities), and others. Each department is located in a city and houses specialists in both corporate income tax and VAT in the same department. There is also a trade specialist who is

recruited usually from the private sector for a finite period but who can also be laterally absorbed into the department later. They are topped by a customer relations manager (CRM) who has the overview of the sector with an overall taxation perspective. Together they have regular consultation meetings with a large business in their sector in a continuous dialogue regarding economic trends, sectoral developments and revenue potential. There is no one-to-one interface in this model.

If we can imagine the sectoral departments as one horizontal line, then supporting the line is the stem that comprises functional departments including legal, debt, banking, risk and intelligence, knowledge and analysis, and so on. Sectoral departments have to ‘buy’ staff time from the functional departments for the various functions performed. This is how resources get allocated across departments. This T-shaped organisation of Her Majesty’s Revenue and Customs (HMRC) was the result of a committee that produced a report entitled, *A Review of the Revenue Department* (2004) that resulted in the amalgamation of the two departments in 2006 with the type of synergies that were mentioned earlier. Interestingly, therefore, the UK moved away decidedly from the organisation they helped establish in different parts of the globe to one that has a sector and function orientation and has turned out to be more open, transparent and consultation-based.<sup>6</sup>

## **7. Customs’ balancing role in international economic relations: selected Indian cases**

Almost all the functions of Customs have international ramifications since, by their very nature, customs departments deal with imports and exports. In turn, these could have political ramifications. Smoother relations in customs formalities and reasonable restrictions in the clearance of goods and persons foster good political relations. Unduly tight control or delay in clearance of goods at the point of import or export leads to strains in international relations, both economic and political, apart from the usually discussed rise in business costs. All international commercial transactions are enforced at the border by Customs. The commerce department designs the policies on licensing, quantitative restrictions, and subsidy to import or export, but such policies are put into effect by Customs at the point of import and export. Thus trade facilitation by a customs administration is a significant consideration in promoting good economic and political relations between two countries, and its absence may prove to be a significant impediment in those relations.

### **7.1 Customs duty structure**

A high or low customs duty structure not only has an impact on revenue as argued earlier, it is also an issue in fostering comfortable or tense international economic relations. By raising the customs duty structure very high, import from any country can be effectively blocked. Sometimes it is directed against cheap imports of selected goods from some country against which the indigenous industry cannot compete, which may go well beyond the infant industry argument. Duty on cars in India, for example, has been high to protect the car industry (Kathuria 1987). In particular, secondhand cars are protected with high duty in addition to receiving protection through licence requirements. Another example is the high duty on agricultural goods in India that makes agricultural imports unprofitable. And the limit imposed by the WTO in this respect is high enough that it has enabled India to keep its duty rates within that limit. At one stage, high customs duty on shoes imported by the United States (US) made export by other countries to the US impracticable. Thus, countries sometimes create tariff barriers to protect domestic industry.

### **7.2 Customs administration and exports**

If duties on exports and their inputs are high, the post-tax cost of goods is high and exports become uncompetitive. Duty drawback assumes great importance in such cases. These are usually designed by the commerce department in consonance with the customs department and implemented by the latter.

Achieving appropriate design and implementation is a major task in ensuring export competitiveness by removing embedded taxes from exports. Reflecting the complexity of duty drawback, some developing country environments have not been fully cognisant of the need to provide duty drawback or offset for VAT against exports.

A recent visit to Myanmar by this author at the invitation of its government, heading the first international tax reform mission there<sup>7</sup> as the country opens up to international norms and practices reveals that exports do not receive input tax credit or setoff. Though customs duty on import components of exports is theoretically given drawback, unless the manufacturing unit is fully export orientated, it is difficult for the business to receive drawback for the portion that is exported, reflecting the lack of a formula based on which partial drawback could be given. This is giving rise to tensions among the domestic business community and their international competitors who are being invited to operate in new Special Economic Zones (SEZs) with the full facility of customs duty drawback and input tax credit/offset of commercial taxes paid.<sup>8</sup> Thus administrative practices at Customs can have an adverse impact on international economic relations.

### **7.3 Proper interpretation of licence requirements by Customs**

The role of promoting good international relations can be understood more from what adverse impact customs activities could have on international relations. An account is given by an ex-customs officer of how the relations between India and Bangladesh came under severe stress some years back due to the action of Customs at the border. It was a religious occasion in Bangladesh when the consumption of onion goes up significantly. Last minute supply of many truckloads of onions from India was held up by Customs at the India-Bangladesh border due to non-compliance with some customs formalities by onion exporters at the Indian end. It created almost a crisis situation across the border and led to frantic telephone calls by the diplomatic staff from the Embassy of Bangladesh. Last minute intervention by the most senior customs officer in Kolkata prevented the crisis and saved the day from precipitating an economic and political situation between the two neighbours.

Unduly harsh customs interpretation of licence requirements or regulations also upset jute trade with Bangladesh. There was an instance when, for an apparently insignificant violation of a licence given for the purpose of importing raw jute, whole shiploads of raw jute consignments were held up by Customs. It was only after timely intervention by the higher authorities that such consignments were released. Thus overtly strict positions by Customs on smaller matters should be considered from a realistic perspective otherwise international economic relations would certainly suffer. Customs has to rise to this responsibility over and above attending to its routine tasks and calls.

### **7.4 Customs and international treaties**

The interplay between Customs and an international treaty can be seen both as a theoretical premise and in practice. In theory, it is important because at the stage of negotiation of the treaty, the role of Customs is to help arrive at desirable rates of duty in relation to existing rates in terms of the impact of the proposed rates on the economy. At the execution stage, the role of Customs is perhaps even greater because it has to ensure that the intention of the treaty is achieved in implementation. In the case of treaties with Nepal, for example, it is incumbent on Customs to ensure that the goods intended for Nepal do not flow back to India. Nepal, being a land-locked country, has the right to import via India and there are treaties to enforce this right. However, often it is noticed that Nepal's imports are of a kind that are not needed in Nepal. For example, enormous amounts of zip fasteners and machinery are imported which cannot be absorbed there in practical terms. It is the duty of Customs to maintain a balance between needed measures to check the apparent attempts to import goods into Nepal for clandestinely exporting them back to India and the need to maintain friendly relations with an important neighbour in both geo-political and socio-political terms. No excessive measure can be taken that might tilt the balance in an

unwarranted direction. Thus the nuanced role expected of Customs in enforcing international treaties in a fine quantitative and qualitative balance cannot be exaggerated.

### 7.5 Anti-dumping duty on imports

Anti-dumping duty is imposed by countries to protect their industries from unjustified competition that does not reflect market forces. It is leviable under Section 9A of India's *Customs Tariff Act, 1975* read with the Rules which are framed under Section 9A(6). It is imposed and collected by Customs. The customs department has to make the initial enquiry about valuation of the imported goods. It has to be satisfied that the under-valuation, if so found, is a pure case of declaring less value in comparison with the same or similar products, or that it is a case of dumping. Dumping needs to be proved by demonstrating that the price declared is less than the cost of manufacturing in the country of origin. The role of Customs is in assisting the commerce ministry, through investigation and detection, come to a conclusion as to whether any dumping has taken place and, if it has, how much of it is really to be compensated through anti-dumping duty. This has to be determined by investigations carried out by Customs and the commerce ministry. At the implementation stage, it is the role of Customs which is paramount not only in charging the duty but also in enforcing other related laws.

Thus, if the customs department uses the anti-dumping instrument within appropriate limits, the international economic and political relations are not disturbed. If there are too many anti-dumping cases where they should not be imposed, or if there are cases of under-valuation of imports where, instead, allegations of dumping are made, then clearly international economic relations between the concerned countries suffer. It erodes the benefits of globalised trade. Such examples are not rare with countries pointing towards unfair use of anti-dumping duty by trading partners, for example, by both India and the US, and certainly they are not the only ones.

Taking one example, Indian steel has always found it difficult to export to the US due to anti-dumping duty on some varieties of steel. Even Europe felt the barrier and seemed determined to take counter measures against the US anti-dumping duty on steel. The WTO viewed the Byrd Amendment, the US law that allowed cash receipts from foreign exporters (to the US) to be distributed to affected domestic industry as protectionist and declared it illegal.

Subsequently, the law was repealed by the US Congress but the repeal took effect from October 2007. In the meantime, the law was used by the US to collect cash from foreign exporters, for example, of shrimps. This action by the US on the anti-dumping front had been to prevent the import of shrimps from China, Thailand, India, Brazil, Ecuador and Vietnam. The attempt to protect the domestic producer of shrimps from foreign competition did not even succeed after imposing 5% to 10% anti-dumping duty because exports from these countries nevertheless remained profitable for them. Not satisfied with this, the Southern Shrimp Alliance representing US shrimpers and processors, wanted an upward review of the duty. Though looking into the books of accounts of hundreds of small exporters was not feasible, they were asked to comply. And, if they did not reply or cooperate, they would have to pay nearly 50% anti-dumping duty. To avoid such a reprisal, the foreign exporters agreed to pay up to 2% of the value of the goods which could be legally collected as settlement money and distributed to the Southern Shipping Alliance.

Another recent example is the case of the high anti-dumping duty levied by the current US administration against the import of Chinese tyres which were feared to be dumped in the country. That led to an angry reaction from China and it had to be settled by diplomatic efforts at the highest level. It must be said that the EU also uses barriers that may not always be so apparent but through non-tariff avenues such as environmental or labour conditions that tend to have similar adverse ramifications for exports from emerging developing economies.

Use of the instrument of anti-dumping duty has become as widespread as globalisation itself. The attempt by the WTO to thwart protectionist tendencies could succeed only if greater power were to be given to it in order to make its findings immediately effective and not after two years or so, as in the case of the Byrd Amendment. The US's use of anti-dumping duty or occasional reaping of returns from protectionism cannot be said to enhance the tenets of globalisation.

While anti-dumping duty is counter-positioned to globalisation, its absence may again allow the domestic industry to suffer. So, it is a matter of balance that has to be struck by Customs and commerce departments when using the anti-dumping duty instrument.

## **7.6 Containing money laundering and terrorism**

There is a clear role of Customs at the borders with neighbouring countries. For India, the borders with Pakistan, Bangladesh, Nepal and Myanmar are important not only in respect of the military but also in respect of cross-border smuggling. The work of collecting customs duty and checking for contraband are important international aspects that customs officers have to perform.

These days, customs offences have superseded those related to mere customs duty evasion, having transcended to money laundering, narcotics, terrorism, and narco-terrorism. Hence, Customs have to be in close touch with Interpol which is the international nodal agency for coordination and execution of anti-terrorism activities. Simply put, a rationally structured and effective customs organisation is needed to contain the occurrence of international terrorism.

## **8. International customs organisations**

The establishment and functioning of multilateral customs organisations have had a restraining and smoothening effect on the stresses and strains that can and do erupt in international trade relations. An examination of the role is, therefore, pertinent.

### **8.1 World Customs Organization (WCO)**

The WCO is an independent intergovernmental body whose mission is to enhance the effectiveness and efficiency of member customs administrations. The WCO was originally established as the Customs Cooperation Council (CCC) in 1952. The CCC adopted the name 'World Customs Organization' in 1994 in order to reflect its transition to a truly global intergovernmental institution. It has two wings, valuation and classification. It is headquartered in Brussels. With its worldwide membership, the WCO is recognised as the voice of the global customs community. It is particularly noted for its work in areas covering the development of international conventions, instruments, and tools on topics such as commodity classification, valuation, rules of origin, collection of customs revenue, international trade facilitation, customs enforcement activities, combating counterfeiting in support of Intellectual Property Rights (IPR), and so on.

The WCO maintains the international HS which is a nomenclature for goods, and administers the technical aspects of the WTO Agreements on Customs Valuation and Rules of Origin. The same nomenclature for goods and the same system of valuation of goods are followed all over the world as almost all countries have joined the WCO. Trade has thus become very smooth since the meaning of the goods is clear once a particular nomenclature is used. For example, if a good is described as 5402 20 10 in the invoice of the manufacturing country, wherever it is sold in the world, it will be taken as synthetic filament yarn of terylene dacron. There will be no need to test the goods chemically unless the customs administration has any specific information to the effect that the goods have been misdeclared. This has made customs clearance, maintenance of statistics and all other related activities transparent and seamless.

## 8.2 World Trade Organization (WTO)

The WTO is responsible for a large part of work pertaining to Customs. This organisation keeps a check on the activity of Customs in individual countries in case they go beyond international interests. In this capacity, it does not allow countries to impose very high protective customs duty or anti-dumping duty when there is no justification for them. It prevents trade wars arising from customs duty or quantitative restrictions on imports or exports.

## 8.3 European Customs Union (ECU)

The ECU, as a part of the EU, performs the job of consistent customs regulations within the EU. That the EU has a separate organisation within its fold exclusively for the purpose of customs activities, underlines the importance that Customs plays in international trade and economic relations within the EU in particular, and with the global economic community in general.

## 9. Summary

To sum up, the role of Customs in international economic relations is all-pervasive and growing. Over the years, internationally, customs duty structures have been scaled back and narrowed so that their application has become far easier. At the same time, other means such as anti-dumping duty have been used, sometimes resulting in unfair competition. Multilateral organisations, such as the WCO and WTO, have played an important role in lowering customs duty rates internationally as well as in monitoring unfair competition. The responsibilities of customs administrations have moved forward from monitoring only whether the right customs duty is applied to more sophisticated responsibilities and challenges that cover matters of international money laundering and terrorism. The use of IT in both traditional and newly emerging functions cannot be over-emphasised. Indian Customs faces increasingly complex demands as various case examples discussed above reveal. An ever vigilant customs administration should be able to deliver on those international objectives and assist in furthering international economic relations.

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## Notes

- 1 Adapted from the First BN Banerji Memorial Lecture, 4 June 2012. Mr Banerji was the first Chairman of India's Central Board of Excise and Customs, 1964-67. The address was delivered when the author was Director and Chief Executive, Indian Council for Research on International Economic Relations (ICRIER), New Delhi.
- 2 The author acknowledges the contribution of Sukumar Mukhopadhyay, Member, Board of Excise and Customs (retired) and Gautam Ray, Chief Commissioner, Excise and Customs (retired) on Indian customs duty structure and selected case studies. All opinions expressed are, however, those of the author.
- 3  $t(\text{new}) = (a \times t(\text{old})) / (a + t(\text{old}))$ , where  $t$  is the tariff rate and  $a$  is the coefficient to be negotiated. See Baldwin 2009, p. 518.
- 4 The NAMA negotiations are also attempting to address the issue of non-tariff barriers to trade, though forward movement on this front has been limited.
- 5 Note that CVD is the domestic consumption tax CENVAT applicable on imports. Though Indian nomenclature includes this under customs duty, any cross-country comparison should exclude it.
- 6 Can India contemplate deep and meaningful changes in a comparable direction? See Shome 2012a.
- 7 Organised by the International Tax and Investment Center (ITIC) in Washington, DC.
- 8 Myanmar does not yet have a VAT but has a commercial tax against which offset is given for goods tax though not for tax on services.

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