

# INVISIBLE ENEMY

A Threat to our National Interests



Gold



Machinery & Parts



Fabrics, Silk & Yarn



Electronic Items



Cigarettes

Extent, Causes & Remedies

A study on the **top five** products **smuggled into India**

## About this Report

*This report has been prepared by*



Thought Arbitrage Research Institute (TARI)  
for FICCI Committee Against Smuggling and Counterfeiting Activities  
Destroying the Economy (CASCADE).

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## About Thought Arbitrage Research Institute (TARI)

TARI is a not-for-profit organisation set up under Section 25 of the Indian Companies Act, 1956, to bridge the gap between policy initiatives and common perception through evidence-based research and comprehensive data-based reasoning.

TARI is a privately-funded, independent, non-partisan Indian think-tank and works with government, industry, civil society and other stakeholders on:

- Corporate Governance
- Sustainability
- Economics
- Public Policy

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## Foreword



Globalisation has been an important engine of economic growth, significantly enhancing trade facilitation. On the other hand, it has also increased opportunities for illegal business operators to engage in illicit trade across borders, posing multi-dimensional challenges to national administrations.

Illicit trading activities such as smuggling are a pervasive socio-economic threat entrenched in the global trade system. Their syndicates are drawn by huge profits, while benefiting from weak legislation. Enforcement agencies face the formidable task of facilitating the flow of legal trade while dismantling organisations involved in smuggling operations. Smugglings dampens the economy in multidimensional ways. It destabilises the legal industry, restrains innovation and investments, reduces government revenues, fuels transnational organised crime and hampers the health and safety of consumers.

FICCI's dedicated Committee Against Smuggling and Counterfeiting Activities Destroying the Economy [CASCADE] has been actively working towards elimination of illicit trading activities. In furtherance of its agenda, CASCADE has come out with a one-of-a-kind-study titled: **Invisible Enemy - A Threat to our National Interests: Extent Causes and Remedies**, which estimates the extent of smuggling of the top five key goods into India, namely:

- Gold
- Machinery and Parts
- Cigarettes
- Fabrics, Silk and Yarn
- Electronic Items

This report further attempts to highlight the key challenges posed by smuggling and the possible solutions needed to make compliance and processes more robust which will reduce the threat of smuggling.

I would like to thank and congratulate all stakeholders who have contributed towards this study particularly Thought Arbitrage Research Institute (TARI). It is hoped that this study will stimulate deliberations to identify the issue as a critical and mammoth problem that the nation is facing currently and the challenges ahead if concerted efforts are not taken to curb this menace.



**Dr. A. Didar Singh**  
Secretary General  
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## Executive Summary

## Executive Summary



### Smuggling: A Pervasive Socio-Economic Threat

Smuggling is defined as “the clandestine import of goods from one jurisdiction to another.”<sup>1</sup> According to the Customs Act, 1962 the term “smuggling” has vast connotations and means “any act or omission which will render such goods liable for confiscation under Sections 111 or 113 of the said Act.” This report focuses on smuggling of legal goods (excluding prohibited goods) into Indian borders and which can be confiscated under the Customs Act 1962.

#### Smuggling of Goods/ Products: Terms and Interpretations

Outright smuggling as defined by the Directorate of Revenue Intelligence (DRI) is “the secret movement of goods across national borders to avoid customs duties or import or export restrictions.” Non-declaration (where no product is declared at port of entry) as well as not being in possession of any legal import documentation can also be considered as outright smuggling. On the other hand, smuggling could take place through legal channels of trade by various means to evade customs duties and other taxes applicable on such goods and products. This is referred to as Technical smuggling and such goods are liable for confiscation under section 111 of the Customs Act 1962. Ways and means of technical smuggling may be classified into four categories based on seizure data of DRI:

- Undervaluation
- Mis-declaration
- Misuse of End Use and Other Notifications
- Other Means

#### Smuggling and Its Impact on the Country

The effects of smuggling are numerous and economically significant. Smuggling is a serious problem and its impacts are far reaching, affecting various stakeholders including

Government, domestic industries and citizens of the country.

#### Impact of Smuggling

- Direct Loss to Government Revenues
- Negative Impact on Economy
- Impact on Local Industries
- Threat to Society
- Health and Safety Risks
- Impact on Innovation and Investment

#### Determinants of Smuggling

From a microeconomic viewpoint, there are various determinants for smuggling or illegal trade. These factors lead smugglers to adopt different ways and means of smuggling. As smuggling is secret, hidden and an inherent risky activity, there are additional factors which act as determinants of smuggling. Following are key factors that determine extent of smuggling into a country:

High Tariff Rates

Restrictions and Prohibitions

Rule of Law

Extent of Corruption

<sup>1</sup> Deflem, M. & Henry-Turner, K. (2001). Smuggling, the Encyclopaedia of Criminology and Deviant Behaviour, Clifton D. Bryant, Editor-in-Chief., Crime and Juvenile Delinquency, 2, 473-475



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Price and Type of Product

Demand-Supply Gap

Lack of Innovation and Weaknesses of Domestic Industry

### Estimating Smuggling of Key Goods/ Products: Methodology

The basis of selection of key goods for analysis of smuggling in this report is the seizure data of the DRI and customs officials. Based on review of literature and subject to availability of data, this study adopts the methodology that estimates **“discrepancies between the trade figures of India with her trade partners”** for ascertaining the extent of smuggling.

In order to estimate illicit trade and smuggling accurately using mirror statistics, imports are adjusted for CIF and other factors in the range 21% - 10% to arrive at FOB value of imports. This range of adjustment of imports is taken to determine the breadth of smuggling that takes place to evade customs duty in India. Selection of this range is based on International Monetary Fund and Central Board of Excise and Customs guidelines.

**Smuggling of Product ‘A’ into India** using this methodology is computed as: <sup>2</sup>

Exports reported by World (partner countries) for Product A to India during period i minus Adjusted imports reported by India for Product A during this period i

**Smuggling Estimate (%) of Imports may be depicted as:**

Exports reported by World (partner countries) for Product A to India during period i minus Adjusted imports reported by India for Product A during period

Exports reported by World (partner countries) for Product A during period

### Estimates of Smuggling in Five Key Goods/ Products

Based on the selected methodology, this study has estimated the extent of smuggling in India for five key goods/products that are most widely smuggled according to DRI estimates. The following table presents the summary of findings for the extent of smuggling in India in identified goods/products. The figures are averages for the period 2011-2015.

Extent of Smuggling in India (in ₹ crores)	
Gold	(15,637) – (41,896)*
	20.9 – 48.0**
Machinery and Parts	26,561 – 41,586
Cigarettes#	7,561 – 8,946
Fabrics, Silk and Yarn	5,390 – 8,038
Electronic Items	3,353 – 17,516

\* Negative Smuggling (arising out of over-invoicing of quantity of imports and under-declaration of value per tonne)

\*\* Under valuation per tonne of gold

# Increase from 2013 to 2015

#### Gold

Mirror statistics show that value of gold exported by all partners is lower as compared to imports reported by India. As a result, technical smuggling reports negative values for all years except for the year 2013. At an average it ranges from (minus) US\$ 3,625 Mn to (minus) US\$ 8,246 Mn.

An analysis of quantity of gold imports by India and quantity of gold exported by all countries to India reveals an interesting picture. India gold imports for period 2011 to 2015 is more than nearly 1,295 tonnes of what is exported by the rest of the world to India. Further, analysis of mirror statistics of exports and imports of gold in terms of value per unit (US\$ Mn per tonne) indicates undervaluation of gold. The average undervaluation during the period 2011 and 2015 is between 3.7 and 8.4 US\$ Mn per tonne.

Smuggling of gold in India is primarily driven by the demand and supply gap, where imports fulfil about 90% of the total requirements. The continued demand, relatively price inelasticity of gold demand, low domestic supply of gold, increasing GDP per capita provides unscrupulous persons opportunity to smuggle gold while evading taxes of the legal channels.

<sup>2</sup> Buehn, A., & Eichler, S. (2011). Trade misinvoicing: The dark side of world trade. *World Economy*, 34(8), 1263–1287.

Average per annum smuggling in Gold in terms of volume is (minus) 258.99 tonnes (that is, 'negative' smuggling: India shows higher quantity of imports than exports by rest of the world). This translates into value of negative smuggling ranging from (minus) US\$ 3625 million and (minus) US\$ 8246 million, equivalent to (minus) ₹15,637 crores and (minus) ₹41,896 crores. This implies that gold is undervalued by around US\$ 3.7 million to US\$ 8.4 million, equivalent to ₹20.9 crores to ₹48 crores per tonne and is indicative of illicit money transfers from India.<sup>3</sup>

### Machinery and Parts

The extent of technical smuggling in machinery and parts in India for the 5 year period under consideration ranges at an average between US\$ 4,789 Mn and US\$ 7,397 Mn. This translates to smuggling an average of approximately 17.7% to 27.8% of imports.

A plausible explanation for smuggling of machinery and parts in India can be over dependence on imports and the lack of capacity in the domestic sector and the MSMEs as to fulfil domestic needs. Another important reason for dependence on imports is that India's current level of technology depth ranges from basic to intermediate, indicating limited ability in fundamental research on materials and components and low absorption of product technologies which ultimately hamper domestic production. Greater reliance on imports offers opportunity for illicit traders adopt different ways and means of technical smuggling to evade taxes and have financial gains.

Average per annum smuggling in Machinery and parts ranges from US\$ 4,789 million to US\$ 7,397 million, equivalent to ₹ 26,561 crores to ₹ 41,586 crores.<sup>4</sup>

### Cigarettes

Worldwide cigarettes smuggling is a low-risk, high-reward criminal activity because high taxes on cigarettes induce great financial incentive for smugglers to earn huge profits. Persistently increasing taxes on cigarettes provides a lucrative opportunity for tax evasion due to tax arbitrage between the country of exports and in the importing country. The legal cigarettes industry in India has been bearing the brunt of the flourishing illicit market, with consumption of legal cigarettes witnessing a massive 22% drop in volume from 2011 to 2015. Illicit market on the other hand has been increasing constantly.

Technical smuggling of cigarettes in India over the period 2011-2015 at an average ranges from US\$ 4.73 Mn to US\$ 7.01 Mn. The data reveals technical smuggling in cigarettes has consistently come down after 2012, coinciding with massive increase in tax rates during the period. Thus under-declaration of the value of

cigarettes or other forms of technical smuggling does not provide adequate incentive or compensate the smugglers for their risk reward equations. These high taxes and duties provide smugglers the opportunity to earn huge profits by engaging in outright smuggling where illegal movement takes place through clandestine channels so as to avoid duties and taxes at the official ports of entry.

Due to above factors, a study based on trade gap alone will not provide accurate estimation of total size of smuggling of cigarettes in India, hence other corroborative methodologies are used.

- Seizures, Consumption and Estimation of Smuggling in Cigarettes

Therefore, as supported by reputed research studies, this study determines the extent of smuggling based on consumption of cigarettes in the country both illicit and legal. Global studies suggest that smuggled cigarettes range anywhere between 3% and 8.5% of total cigarette consumption. Considering the growing proportion of illicit cigarettes in total cigarette consumption in India along with weak enforcement infrastructure and vast porous borders, this study estimates that the percentage of smuggled cigarettes to the total consumption in India is in the range 8% -10% in the period 2013 to 2015, in line with global estimates.

The total volume of smuggled cigarettes and their respective values, estimated based on the above methodology for the period 2013 to 2015 are:

Estimated Extent of Smuggling in Cigarettes		
Year	Smuggled Cigarettes (Mn sticks)	Smuggled Cigarettes ( ₹Crores)
2013	9,704	7,561
2014	10,593	8,410
2015	10,950	8,946

Smuggling in Cigarettes has increased from ₹ 7,561 crores (US\$ 1,250 million<sup>5</sup>) in 2013 to ₹ 8,946 crores (US\$ 1,349 million) in 2015, indicating an increase of 18.3% between 2013 and 2015.

### Fabrics, Silk and Yarn

The extent of technical smuggling of fabrics, silk and yarn in India, based on the trade gap for the 5 year period under consideration ranges at an average between US\$ 962 Mn and US\$ 1416 Mn. This translates to smuggling an average of approximately 20.34% to 30.08% of imports.

<sup>3</sup> Using RBI exchange rates for respective years as on March 31 of each year

<sup>4</sup> Using RBI exchange rates for respective years as on March 31 of each year

<sup>5</sup> Using RBI exchange rates for respective years as on March 31 of each year

## Executive Summary

The smuggling in fabrics, silk and yarn is primarily driven by demand supply gap and dependence on imports. The Indian textiles industry faces acute shortage of raw materials in the form of cotton and raw silk. While India is the second biggest producer of silk, it is also the second biggest importer of silk in the world (12% of total world imports) after Italy. India's dependence on imports of silk and yarn has seen a consistent increase over the last 5 years, having grown from 0.8% to 1.12% of the total imports. This clearly indicates that domestic production is highly insufficient to meet the growing domestic demand fuelling smuggling in the sector.

Average per annum smuggling in Fabrics, Silk and Yarn ranges from US\$ 962 million to US \$ 1416 million, equivalent to ₹ 5,390 crores to ₹ 8,038 crores.<sup>6</sup>

### Electronic Items

The extent of technical smuggling in electronic items ranges at an average between US\$ 581 Mn and US\$ 3004 Mn during 2011 to 2015. Smuggling as percentage of imports on an average ranges between 2.82% to 14.70% during period.

Higher demand supply gap and value of electronic items makes it more susceptible to smuggling. Electronic items are third most imported products contributing to nearly 7% of the import

basket of India. Given the limitations of domestic production, where majority of value addition is still in the final assembly line, domestic demand is largely fulfilled by imports. Technical smuggling in electronic goods is mainly taking place through Singapore, Hong Kong, Korea, Vietnam and USA.

Average per annum smuggling in Electronics Items ranges from US\$ 581 million to US \$ 3004 million, equivalent to ₹ 3,353 crores to ₹ 17,516 crores.<sup>7</sup>

### Challenges in Dealing with Smuggling

The rapidly changing global trading environment, marked by steadily growing volumes and complexity of supply chains, and heightened security concerns have had a large impact on the role and functions of Customs administrations everywhere. On the one hand, globalisation has been an engine of economic growth, enhancing the importance of the trade facilitation role of Customs. On the other, it continues to offer new opportunities for criminal organisations to engage in new types of frauds, posing multidimensional challenges to Customs administrations.

The structural and operational challenges that the Customs authority in India face in controlling the spread of smuggling are:



<sup>6</sup> Using RBI exchange rates for respective years as on March 31 of each year

<sup>7</sup> Using RBI exchange rates for respective years as on March 31 of each year

### Way Forward

Smuggling severely harms the economy of a country in multidimensional ways. It undermines the local industry, suppresses innovation and investment, discourages legal imports, reduces the volume of revenues collected from duties and levies by the government, fuels transnational crimes

and hampers the health of citizens. Globalisation has made possible vast increase in trade, more mobility and fast means of communication—all of which have made smuggling easier. Coordinated efforts of the government and industry bodies are therefore needed to control the spread of smuggling.

Some recommendations for the country to tackle the problem of smuggling are:

**Strengthening domestic manufacturing and reducing demand-supply gap**

**Stronger enforcement of: Punishments and Rule of Law**

**Leveraging Technology and boosting Innovation**

**Capacity building of Human Resource at Customs**

**Strengthening Risk Management Capabilities of Customs**

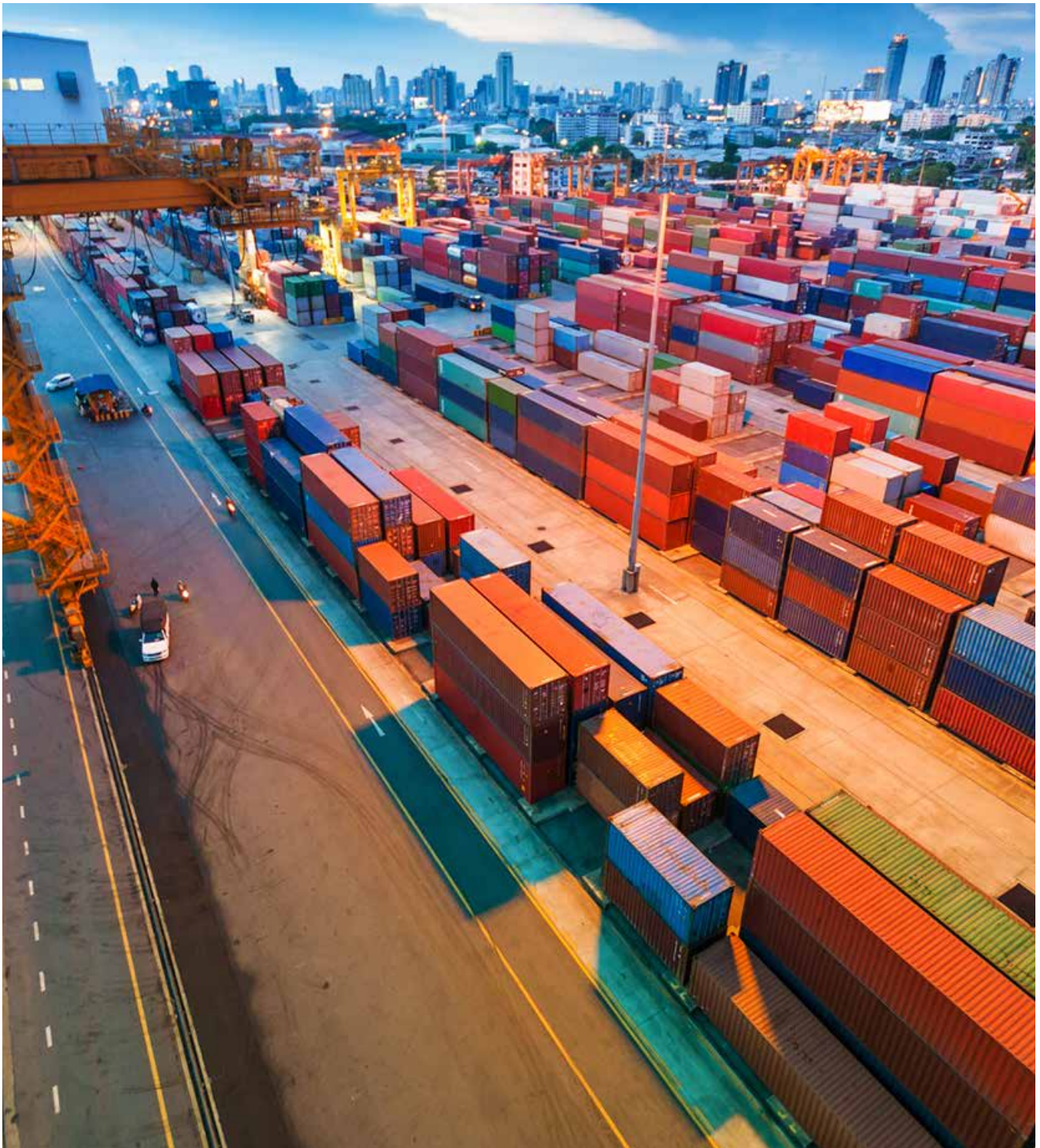
**Electronic Tracking System**

**Rationalisation of Tariffs**

**Better Coordination among various Enforcement Agencies**

*Smuggling is a deep scourge whose brunt is directly borne by industry, government and society. This study estimates smuggling for only five products which suggests that the extent of smuggling in the country is a cause for great concern. The customs department is doing its bit to manage legal trade movement and the parallel illegal channel. It has had to move away from the "gatekeeper" approach and is now investing heavily in technology, simplifying processes and recognising information as the basic lever of control. However, to effectively tackle the growing menace of smuggling in India, a lot more needs to be done to make the compliance and processes more robust and detection of such crime easier. In this, concerted efforts of the government and industry bodies are needed to tackle and address this challenging and mammoth task.*





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## Section I: Smuggling: A Pervasive Socio-Economic Threat



## Section I: Smuggling: A Pervasive Socio-Economic Threat



### Smuggling of Goods: Definition

Smooth international trade happens between countries depending upon the demand, supply and financial factors affecting goods/products. Whenever normal official trade gets hindered due to economic or non-economic considerations, illicit trade comprises sizeable proportion of trade among such countries. This unofficial or illicit trade is referred to as smuggling.

Smuggling can be defined as “the clandestine import of goods from one jurisdiction to another.”<sup>8</sup> The World Customs Organisation (WCO) glossary defines smuggling as, “Customs offence consisting in the movement of goods across a customs frontier in any clandestine manner, thereby evading customs control.”<sup>9</sup> Smuggling, therefore, is a criminal offense of bringing into or removing from a country those items that are prohibited or upon which customs or excise duties have not been paid.<sup>10</sup>

In context of the Customs Act, 1962 the term “smuggling” has vast connotations and means “any act or omission which will render such goods liable for confiscation under Sections 111 or 113 of the said Act.” The word ‘confiscation’ implies appropriation consequential to seizure. Section 111 and 113 enumerate specific/ different categories of violations under which import or export goods are liable for confiscation.

This report focuses on smuggling of goods into Indian borders and which can be confiscated under the Customs Act 1962. It excludes any illegal movement of goods out of India borders.

In general, goods are considered to be smuggled into India and liable to be confiscated, if they attempt to enter into the country by route other than land routes notified under Section 7 of the Customs Act 1962. The imported goods are also

liable to confiscation if there is an intention to evade Customs duty. Non-declaration (where no product is declared at port of entry) as well as not being in possession of any legal import documentation is considered to be smuggling. It also includes goods which are liable to confiscation if entered for importation that does not correspond in respect of value or in any material particular with the entry made or in the case of baggage with the declarations made.<sup>11</sup>

Smuggled goods may be confiscated even if its form has been changed. In addition to confiscation of goods, the conveyances, i.e., vessels, aircrafts or vehicles, or animals used in the smuggling activities or unloaded without permission of the proper officer are liable to confiscation.<sup>12</sup> However, this report excludes conveyances from its analysis on smuggling.

### Smuggling by Products Types

In general, smuggling includes illegal trade of both legal and illegal goods.



<sup>8</sup> Deflem, M. & Henry-Turner, K. (2001). Smuggling, the Encyclopaedia of Criminology and Deviant Behaviour, Clifton D. Bryant, Editor-in-Chief., Crime and Juvenile Delinquency, 2, 473-475

<sup>9</sup> [http://www.aseansec.org/economic/customs/glos\\_wco.htm](http://www.aseansec.org/economic/customs/glos_wco.htm)

<sup>10</sup> M Merriman, D. (2002). Understand, Measure and Combat Tobacco Smuggling. World Bank, Economics of Tobacco Toolkit, Tool 7.

<sup>11</sup> Section 77 of the Customs Act, 1962

<sup>12</sup> Section 115 of the Customs Act, 1962



## Smuggling: A Pervasive Socio-Economic Threat

### Smuggling of Prohibited Goods

“Prohibited goods” under the Customs Act 1962 means “any goods the import or export of which is subject to any prohibition under this Act or any other law for the time being in force but does not include any such goods in respect of which the conditions subject to which the goods are permitted to be imported or exported have been complied with.”

Customs rules and other applicable laws determine these products. Some examples of prohibited goods includes narcotics drugs, military weapons, fake currency etc. These products are not at all allowed to trade through legal channels and all smuggling is outright smuggling. This report will not focus on the smuggling of prohibited goods.

**Seizure of Smuggled Goods by Product type (₹ Crores)**



Source: Report No.5 of 2016 Union Government (Indirect Taxes Customs)

### Smuggling of Legal Goods/Products

The smuggling of legal products is the import of those products for which the government accounts for custom duties and taxes at the time of the preparation of annual budgets. In fact, these products can be traded legally through payment of official duties and taxes. The main motive for undertaking smuggling in these products is evasion of customs and other applicable taxes.

The above table shows that smuggling in prohibited goods in 2014 and 2015 has come down, but it has increased substantially in legal goods. Machinery, agricultural goods, electronic items, automobiles and their parts are examples of legal goods. These goods/products do not need the permission of relevant governmental organizations for importing or exporting. These groups of goods/products are determined by the Ministry of Commerce in annual import and export regulations.

Some trade restrictions are imposed by the Government on import of these products to protect domestic industry.

### Smuggling of Goods/ Products: Ways and Means

Transnational smuggling through illegal channels, involving outright smuggling of products or mis-declaring/under invoicing of values is a common and rapidly growing problem in India as in most other parts of the world.

Smuggling of goods / products (herein “goods/products” means only “legal” or non-prohibited goods/ products) may take place through both direct illegal ways of smuggling or legal channel of trade but adopting different ways and means to evade customs duties. Smuggling taking place by illegal channels is referred to as outright smuggling. Smuggling through legal channels of trade involves various means to evade customs duties and other taxes applicable on goods and products. This is often referred to as technical smuggling or even commercial fraud. However, these means also come under definition of smuggling as goods are liable for confiscation under section 111 of the Customs Act 1962.

### Outright Smuggling

Directorate of Revenue Intelligence (DRI) defines outright smuggling as “the secret movement of goods across national borders to avoid customs duties or import or export restrictions.” It takes place through unauthorized channels not covered under Customs Act 1962. Non-declaration (where no product is declared at port of entry) as well as not being in possession of any legal import documentation can also be considered as outright smuggling.

Financial incentives for outright smuggling are large enough for smugglers to avoid legal means and route. It typically occurs when either the customs duties are high enough to allow a smuggler to make a large profit on the clandestine goods or when there is a strong demand for goods, as in case of gold.

Outright smuggling may be distinguished in two ways:

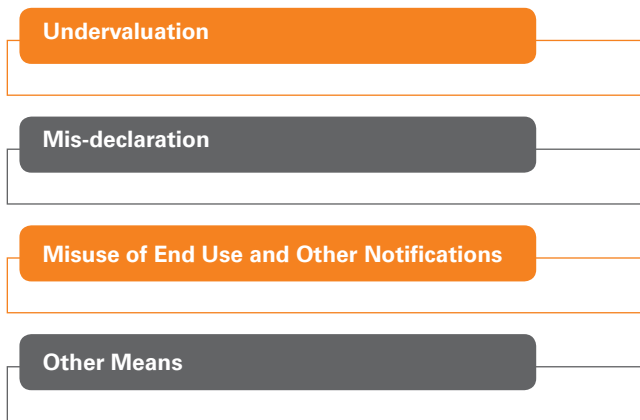
- Goods that do not undergo customs clearance in either the exporting country or in India (importing country) (Type A)
- Goods that pass through customs clearance in the exporting country, but not in India (Type B)

Smugglers fully evade the customs duty and trade restriction in both A and B type of outright smuggling. In type A outright smuggling, smugglers need to undertake more risk and also high financial gains as they are able to fully evade inland taxes in exporting country (Value Added Taxes – VAT). In type B smuggling, risk for smugglers are lower in exporting as it is through legal channels and also they can avail of some export incentives such as duty drawback. Outright smuggling is difficult to detect and among main challenges for customs official and DRI.

## Technical Smuggling

Researchers<sup>13</sup> have empirically proved that the legal and illegal trade takes place simultaneously. Within an institutional framework firms use legal trade to camouflage illegal trade. This illegal trade taking place along with legal trade is a kind of commercial fraud, where intention of importer is to reduce their custom duty burden by adopting different ways and means and can be referred as “technical smuggling.” This type of smuggling takes place through only authorized channels under the Customs Act 1962.

Importers may adopt different means to evade customs duty on goods and products. Such goods are liable for confiscation, and come under the definition of smuggling of the Customs Act, 1962. Ways and means of technical smuggling may be classified into four categories based on seizure data of DRI:



While different practices are involved in each case, each of these means of evading custom duties lead to shipments registered by the importer being lower than those registered by the exporter, for high-tariff products. The link with tariffs may arise from the higher pay-off of escaping normal taxation; this suggests that finding a comparable product with substantially lower tariff is easier for products facing high tariffs (and therefore, low tariff product imports may include mis-classified imports composed in fact of high tariff products).

### Undervaluation

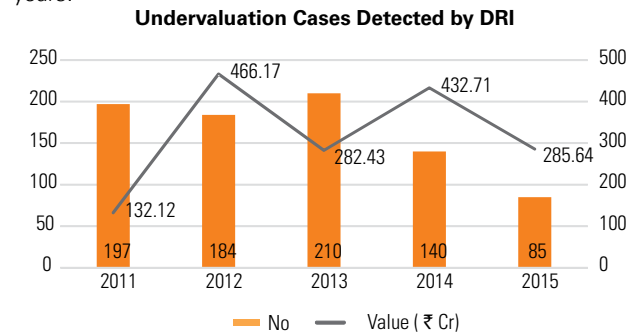
Undervaluation is one of primary ways of technical smuggling. It can be undertaken in two ways:

- under invoicing of goods/products
- under weightment of goods/products

Undervaluation is primarily effected by incorrect declaring of weight, quantity or value, and invoices differing from the bill of lading to the Customs authorities show and support suppressed values to minimize payment of customs and other applicable taxes.

Another modus is by way of non-inclusion of allied cost components in the assessable value by making partially correct declarations at the time of filing bills of entry.<sup>14</sup> These may include price/value manipulation by inflating insurance, freight and handling costs, non-declaration of costs, inflated costs etc.<sup>15</sup>

DRI has detected several cases involving undervaluation of items like plants and machinery, consumer goods, computer parts and accessories, motor vehicle parts and accessories. The number of cases detected by DRI has come down in recent years.



Source: Report No.5 of 2016 Union Government (Indirect Taxes Customs)

Example: Five companies in 2011 imported 21 consignments of ‘Laptop computers LCD Monitors and Softwares’ through Chennai Commissionerates. The goods were assessed to countervailing duty equivalent to excise duty on the declared value of RSP allowing applicable abatement specified in notification no.49/2008–Central Excise (N.T.) dated 24 December 2008. The retail sales price (RSP) declared was much less than the imported cost of the goods, resulting in mis-declaration of RSP and undervaluation of the imported goods of value ₹ 54.10 lakh.<sup>16</sup>

### Mis-declaration

Mis-declaration is another commonly resorted means used by technical smugglers to avoid customs duty. Unscrupulous importers mis-declare products from categories with high customs duty (including CVD, anti-dumping duty) to lower customs duty category.

Example: Woven fabrics’ misclassified as ‘Other woven fabrics’ containing synthetic filaments. ‘Woven fabrics’ containing 85% or more by weight of polyester filaments are classifiable under

<sup>13</sup> Bhagwati & Hansen (1973). A Theoretical Analysis of Smuggling. The Quarterly Journal of Economics, 87 (2), 172-187; Pitt, M., 1981. Smuggling and Price Disparity. Journal of International Economics, 11(4), 447-458.

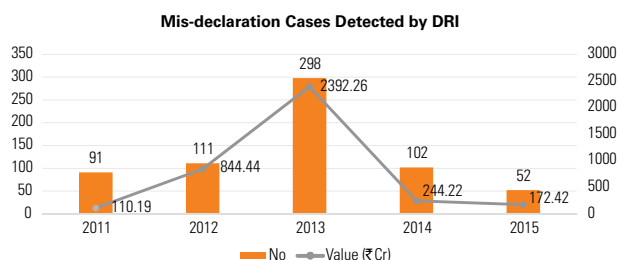
<sup>14</sup> Directorate of Revenue Intelligence (DRI)

<sup>15</sup> FRIDGE Research – Customs Fraud And Illegal Imports Final Report (Phase 1 – 4) dated 31 March 2010

<sup>16</sup> Department of Revenue Intelligence (DRI)

## Smuggling: A Pervasive Socio-Economic Threat

Customs tariff heading (CTH) 540761/540769 and leviable to BCD at the rate of 10% or 36 per sqm whichever is higher. Imported good mis-declared and mis-classified under classified under CTH 54077200 as 'Other woven fabrics' containing 85% or more by weight of synthetic filaments dyed. In that case, BCD is charged at 24 per sqm instead of higher rate of 10 per cent or 36 per sqm resulting in custom duty avoidance for the importer.

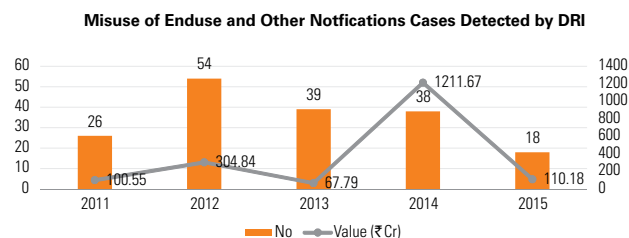


Source: Report No.5 of 2016 Union Government (Indirect Taxes Customs)

Mis-declaration cases were quite high in 2013 with seizures made by DRI amounting to ₹ 2392.26 crores. In 2014 and 2015, number of mis-declaration detected by DRI has come down significantly as compared to 2013.

### Misuse of End Use and Other Notifications

Government of India issues Exemption Notifications to facilitate specific group and boost certain sectors. However, these exemption notifications come with certain pre-conditions that either restrict the eligibility or requires fulfilment of certain post import requirements. These notifications are prone to be misused by the importers through mis-declaration of imports under such exemptions and not fulfilling pre-conditions thereafter.<sup>17</sup>



Source: Report No.5 of 2016 Union Government (Indirect Taxes Customs)

Example: Exemption to goods of foreign origin for repairs and returns, theatrical equipment, pontoons, photographic filming, sound recording etc. (Notification No. 153/94 Cus. dated 13.7.1994) are exempted from duty subject to fulfilment of conditions specified therein. The importer is required to execute

<sup>17</sup> Department of Revenue Intelligence (DRI)

<sup>18</sup> Preface of Report No.5 of 2016, Compliance Audit Customs, Union Government, Department of Revenue

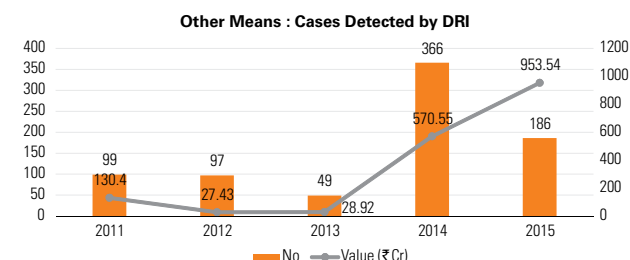
a bond binding him to pay on demand the duty leviable at the time of importation but for exemption in case of failure to re-export the same within prescribed time.

Report on Compliance Audit Customs<sup>18</sup> highlights that during period between December 2010 to June 2014, 56 consignments of Spherical Roller Bearings and various other items of foreign origin valued at ₹17.08 crores were imported in ten Commissionerates availing benefit of duty exemption under aforesaid notification. The importers misused the notification to avoid customs duty and did not fulfil pre-conditions of exemptions by not submitting any proof of re-export of the goods within stipulated time resulting in loss of ₹4.18 Crores of customs duty otherwise leviable to the Government.

### Other Means

The Government of India has many bilateral and multilateral preferential trade agreements to promote trade and expand international market. These foreign /preferential trade agreement (FTA/PTA) confers on the exporting country certain tariff and/or non-tariff benefits. Unscrupulous imports and mis-declare country point of origin to avail certain benefits and avoid customs duties under these FTA/PTA.

Another means resorted by fraudsters and smugglers is the Mis-use of Import-Export Code (IEC) in various manners. DRI highlights bogus or dummy IECs to minimize the possibility of enforcement trail and thus avoid penal action. DRI has detected significant increase in both number and value in these means to avoid customs duty.



Source: Report No.5 of 2016 Union Government (Indirect Taxes Customs)

### Smuggling and Its Impact on the Country

Regardless of different approaches to definitions of this complex issue, the effects of smuggling are numerous and economically significant. Smuggling is a serious problem and its impact are far reaching, affecting various stakeholders including Government, domestic industries and citizens of the country. Most customs, border and law enforcement officials, policymakers, and academicians agree that illegal trans-border trading results in major financial and social costs to economy and society - globally.

Impact of Smuggling

- Direct Loss to Government Revenues
- Negative Impact on Economy
- Impact on Local Industries
- Threat to Society
- Health and Safety Risks
- Impact on Innovation and Investment

### Direct Loss to Government Revenues

The smuggling of goods or products can be considered as one of tax violations that attack a country's tax system. It dampens legal imports and drastically decreases the volume of revenues collected from various duties and levies by state agencies. Customs duty forms a significant part of the Central Government revenues, which shows a decreasing trend over the past few years.

Customs Revenue and Its Contribution to Indian Economy							
Year	GDP	Gross Tax Revenues	Gross Indirect Taxes	Customs Receipts	Customs Revenue as% of GDP	Customs Revenue as% of Gross tax	Customs as% of Indirect taxes
FY 2011-12	77,95,314	7,93,307	3,45,371	1,35,813	1.74	17	40
FY 2012-13	90,09,722	8,89,118	3,92,674	1,49,328	1.66	17	38
FY 2013-14	1,01,13,281	10,36,235	4,74,728	1,65,346	1.63	16	35
FY 2014-15	1,13,55,073	11,38,996	5,00,400	1,72,033	1.52	15	34
FY 2015-16	1,25,41,208	12,45,135	5,49,343	1,88,016	1.50	15	34

Source: Preface of Report No. 5 of Compliance Audit Customs Union Government Department of Revenue

### Negative Effect on Economy

Monetary costs arise from smuggling due to evasion of taxes and tariffs. Smugglers, by evading legal duties and taxes/tariffs, are an extra burden for the government's budget. A developing country relies more on indirect taxes as compared to direct taxes and low indirect tax collections may have harmful consequences for the government's ability to provide public goods. The provision of public goods increases productivity of economy<sup>19</sup>, and thus not creating such public goods has a negative effect on productivity, development, and economic growth.<sup>20</sup>

Smuggling may have a negative effect on official indicators such as growth and income distribution. It involves bribery and other forms of corruption and tends to promote criminal behaviour in the economy. Smuggling may result in mass lay-offs in domestic companies who are unable to counter cheap imports, leading to surge in unemployment in country.

### Impact on Local Industries

Smuggling may affect local industries by distorting prices of commodities. It affects domestic consumption pattern with supply of cheap or even contraband products. Smuggling drastically cuts prices of products, thereby destroying the market for local products. Domestic industries become unviable in such a distorted market. The impact may be so severe that it may result breakdown of domestic industries and their bankruptcies may affect the local economy.

### Threat to Society

Smugglers involved in clandestine activities also pose serious threat to country. It affects the internal structure of a society by creating powerful illegal institutions.<sup>21</sup> It expands black market and increases convergence between organised crime, terrorist groups and other threat networks.<sup>22</sup> Smugglers and their network outwit the national borders imposing security threat and earnings from this illegal activity may be used finance insecurity that increases the policing costs.<sup>23</sup>

<sup>19</sup> Loayza, N.V. (1996) The economics of the informal sector: A simple model and some empirical evidence from Latin America, Carnegie-Rochester Conference Series on Public Policy, 45, 129-162; Johnson, S., Kaufmann, D. and Shleifer, A. (1997) The unofficial economy in transition, Brookings Papers on Economic Activity, 2, 159-221

<sup>20</sup> Norton, D. (1988). On the economic theory of smuggling, *Economica*, 55(217), 107-118. Deardorff, A. and Stolper, W. (1990) Effects of smuggling under African conditions: a factual, institutional and analytic discussion, *Weltwirtschaftliches Archiv*, 126(1), 116-41.

<sup>21</sup> Dominguez, J. (1975). Smuggling, *Foreign Policy*, No. 20, pp. 87-96+161-164.

<sup>22</sup> The Global Illicit Trade in Tobacco: A Threat to National Security, available at: <http://www.state.gov/documents/organization/250513.pdf>

<sup>23</sup> Burke, T. (2013). The Effect of Excise Taxes on Cigarette Smuggling : An Instrumental Variable Approach (CMC Senior Theses). Retrieved from [http://scholarship.claremont.edu/cmc\\_theses/764](http://scholarship.claremont.edu/cmc_theses/764)

## Smuggling: A Pervasive Socio-Economic Threat

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### Health and Safety Risks

Smuggling of counterfeit parts have infiltrated the supply chains of safety related products as well as industries like automobiles and aviation. The credibility and reliability of these cheap smuggled products cannot reasonably be compared to standard original products, especially since there is no accountability of the shadowy supplier or producer. These are more likely to fail early than standard products risking life of many. Smuggling of prohibited goods like narcotics and illicit tobacco pose serious threat to the life of many citizens of the country.<sup>24</sup>

### Impact on Investment and Innovation

Innovation in the form of conception of new ideas for development of new products or processes and experimentation, has been recognised widely as an important driver of economic growth. Innovators protect their ideas through patents, copyrights, design rights and trademarks. Without adequate protection of these intellectual property rights, the incentive to develop new ideas and products is reduced, thereby weakening the innovation process. In industries where product development requires significant investment and innovation, smuggling of counterfeit product impairs investments and innovation by undermining the efforts of innovators and discouraging them from further research and development, which ultimately hampers overall growth of the economy.

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<sup>24</sup> Global Agenda Council on Illicit Trade, Davos Annual Meeting, January 2012, World Economic Forum (WEF)







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## Section II: Determinants of Smuggling

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From a microeconomic viewpoint, there are various determinants for smuggling or illegal trade. These factors lead smugglers to adopt different ways and means of smuggling. As smuggling is secret, hidden and an inherent risky activity, there are additional factors which acts as determinants of smuggling. Following are key factors that determine extent of smuggling into a country:

**High Tariff Rates**

**Restrictions and Prohibitions**

**Rule of Law**

**Extent of Corruption**

**Price and Type of Product**

**Demand-Supply Gap**

**Lack of Innovation and Weaknesses of Domestic Industry**

### High Tariff Rates

The concept of import duty is very wide and is applicable on almost every product/item imported to India barring goods such as food grains, fertilizer, lifesaving drugs, etc. These duties are levied by customs authorities to increase government revenues and also protect domestic industries from competition.

Basic duty is a type of tax imposed under the Customs Act, 1962, the rate of which varies for different items from 5% to 40%. Central Government has power to amend duty rate time to time under Finance Act. The duty may be fixed on ad-valorem or specific rate basis. In addition to customs duty, there are other types of taxes imposed on imported items that includes: additional customs duty; special duty, anti-dumping duty.

Additional duty, also known as countervailing duty (C.V.D), is equal to excise duty imposed on a like product manufactured or produced in India. It is implemented under the Section 3 (1) of the Custom Tariff Act, 1975. Goods, however, when imported into India for subsequent sale, have been exempted from the whole of the additional duty of customs.<sup>25</sup> Special Additional Duty of Customs is imposed at the rate of 4% in order to provide a level playing field to indigenous goods which have to bear sales tax.<sup>26</sup> Further, Government of India has formulated certain guidelines and policies for anti-dumping of imported goods and anti-dumping duty is imposed whenever required.

High import duty on goods/ products increase price differential and therefore provides financial incentives and motivation for

<sup>25</sup> Section 3 (5) of the Customs Tariff Act vide Customs Tariff Notification No. 102/2007 dated 14th September 2007.

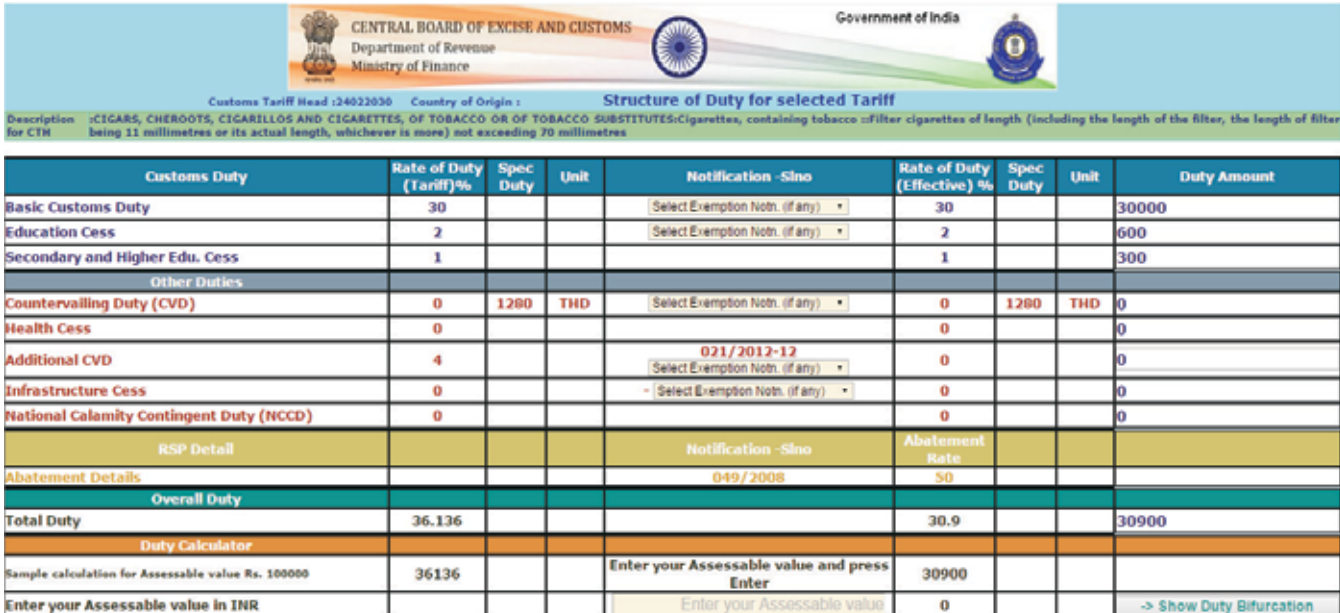
<sup>26</sup> leviable under section 3 of the Customs Tariff Act, 1975 (c.v.d.)

## Determinants of Smuggling

engaging in smuggling activities. Buehn and Farzanegan<sup>27</sup>, based on their empirical findings, point that higher tariffs are important push factors for smuggling.

Cigarettes, which is a highly taxed tobacco product, is hugely smuggled worldwide as it provides handsome returns to smugglers. In India, cigarettes attract a customs duty of 30%

and CVD equivalent to imposed excise duties. Figure below shows the import duties on the filter cigarettes not exceeding 70mm. Total import duties on cigarettes increase the price of imported cigarettes so high that official imports are restricted and profit margins are quite significant to engage in outright smuggling.



Customs Duty	Rate of Duty (Tariff)%	Spec Duty	Unit	Notification -Sno	Rate of Duty (Effective) %	Spec Duty	Unit	Duty Amount
Basic Customs Duty	30			Select Exemption Noth. (if any)	30			30000
Education Cess	2			Select Exemption Noth. (if any)	2			600
Secondary and Higher Edu. Cess	1				1			300
Other Duties								
Countervailing Duty (CVD)	0	1280	THD	Select Exemption Noth. (if any)	0	1280	THD	0
Health Cess	0				0			0
Additional CVD	4			021/2012-12 Select Exemption Noth. (if any)	0			0
Infrastructure Cess	0			Select Exemption Noth. (if any)	0			0
National Calamity Contingent Duty (NCCD)	0				0			0
RSP Detail				Notification -Sno	Abatement Rate			
Abatement Details				049/2008	50			
Overall Duty								
Total Duty	36.136				30.9			30900
Duty Calculator								
Sample calculation for Assessable value Rs. 100000	36136			Enter your Assessable value and press Enter	30900			
Enter your Assessable value in INR				Enter your Assessable value	0			-> Show Duty Bifurcation

Source: [https://www.icegate.gov.in/Webapp/duty\\_details1.jsp](https://www.icegate.gov.in/Webapp/duty_details1.jsp)

Thus, higher tax rates cause higher tax evasion through smuggling activities. Several studies have examined tax evasion by analysing relationship between tax rates and reporting discrepancies (Bhagwati, 1964; Fisman and Wei, 2004; Mishra et. al., 2008)<sup>28</sup>. These studies, by exploiting the variation of tariff rates across product classification, confirm that higher the tax rate in a products category, greater is the incidence of reporting discrepancy in that segment.

### Restrictions and Prohibitions

Stringent trade restriction and administrative polices cause significant price disparity between domestic and international market of a good/product. Such mark-ups on restricted items provide noteworthy financial incentive for smuggling and tariff evasion.<sup>29</sup> Buehn and Farzanegan<sup>30</sup> in their empirical research find that trade restrictions are important push factors for smuggling.

In India, some goods are “prohibited goods” as defined under section 2(33) of the Customs Act, 1962 and are prohibited for imports. Apart from them, some specified goods/ products are restricted/ prohibited under other laws such as Foreign Trade (Development & Regulation) Act, Foreign Trade Policy, Environment Protection Act, Wild Life Act, Foreign Exchange Management Act, Trade Marks Act, Arms Act, Drugs and Cosmetics Act, etc. Prohibitions under those Acts will also be treated as Prohibitions under the penal provisions of the Customs Act, rendering such goods liable to confiscation for imports under section 111(d) of the Customs Act.

Drugs, Narcotics, fake currency and foreign currency are some of the restricted/prohibited items that are the most smuggled into India as these provide high financial gains to smugglers.

<sup>27</sup> Buehn, A. and Farzanegan M.R. “Smuggling around the world: evidence from a structural equation model”, Applied Economics, 2011, 3047-3064

<sup>28</sup> Bhagwati, J. (1964). On the under invoicing of imports. Bulletin of the Oxford University Institute of Statistics, 26, 389-397; Fisman, R., & Shang-Jin Wei. (2004). Tax Rates and Tax Evasion: Evidence from “Missing Imports” in China. Journal of Political Economy, 112(2), 471-496; Mishra, P., Subramanian, A., & Topalova, P. (2008). Policies, Enforcement, and Customs Evasion : Evidence from India. Journal of Public Economics, 92(10-11), 1907-1925

<sup>29</sup> Pitt, M. (1981): Smuggling and price disparity, Journal of International Economics, 11(4), 447-458.

<sup>30</sup> Buehn, A. and Farzanegan M.R. (2011). Smuggling around the world: evidence from a structural equation model, Applied Economics, 44(23), 3047-3064

## Rule of Law

Rule of law acts as a deterrent to smuggling. Researchers have shown that higher expected costs, including fines and punishment costs, reduce the net gain of smuggling.<sup>31</sup> The expected costs of smuggling depends on the probability of being caught and punished by law enforcing authorities, i.e., on the efficiency of the monitoring system and efforts of the police. The expected costs of smuggling arise from the risk of being caught and punished by authorities and stricter enforcement increases the costs of smuggling as smuggling is counted as an illegal activity and the smuggler is always faced with the risk of detection, confiscation and punishment. Low risk of the law enforcement with profitability from tax evasion from smuggling enhances the motivation for illegal act of smuggling.

Empirical findings of researchers show that intensifying law enforcement is deterrent to smuggling and enables authorities to reduce the extent of smuggling. Mishra et al. (2008) show that the elasticity of tax evasion with respect to tariffs is a decreasing function of the quality of tariff enforcement.<sup>32</sup> Direct financial costs in terms of higher penalties has a significantly negative impact on the absolute amount of imports under-invoicing. Buehn and Eichler finds that by increasing the level of fines to GDP by one percent, the share of under-invoiced imports reduces by 17 to 18 percent.<sup>33</sup> Rule of law index also has significant negative correlation with smuggling. A one standard deviation increase in this index reduces smuggling by more than 0.50 standard deviations.<sup>34</sup>

In India, smuggling is higher as compared to developed countries in large part due to poor enforcement and compliance. An important measure of lack of an effective enforcement mechanism is the number of policemen per lakh of population, which in India is 76, compared to 298 in Germany, 256 in the US and 307 in UK with median being 300.<sup>35</sup> Developed countries also have higher investment in technology and training that support surveillance, which enables proactive and effective enforcement actions possible. In the case of India, what makes situation further difficult is

enforcement of rule of law through courts. The 2016 Doing Business report of the World Bank ranks India at the 130th position worldwide in terms of enforceability of contracts. As per the report, it takes around 1,420 days from the date of filing a claim to the enforcement of a judgment. More problematic is that the probability of conviction of that person for a cognizable crime is only 0.006.<sup>36</sup> Considering such a poor rate of conviction, a person has rather low risks and high gains from smuggling activities. This provides people greater incentives and motivation to undertake such acts.

## Extent of Corruption

High level of institutional pervasiveness of corruption in the country reduces the probability of getting caught while extorting bribes. This in turn increases the marginal utility of the bribe to the customs official. If smugglers have been apprehended and their operations exposed, they can facilitate their activities through the bribing of officials to turn a blind eye.<sup>37</sup>

Studies also indicate that smuggling tends to rise in line with the degree of corruption.<sup>38</sup> A one standard deviation increase in the 'lack of corruption' index decreases the level of smuggling by more than 0.20 standard deviations.<sup>39</sup> Fisman and Wei (2007)<sup>40</sup> analysed illicit trade in cultural properties and finds that technical smuggling in such products is highly correlated with the extent of corruption in the exporting country. Berger and Nitsch (2008)<sup>41</sup> also confirmed the same on an extended set of product categories. It can be observed that as high level of corruption undermines the rule of law in a country, both are inversely related to each other.

According to Transparency International, the Berlin based corruption watchdog, India ranks 76 out of 168 countries in its latest Corruption Perception Index-2015, with its score remaining the same as in 2014 and increasing by just 2 points from 2013.<sup>42</sup> Indian's low ranking is indicative of the intensity of the problem and how it may be abetting the illicit trade or smuggling.

<sup>31</sup> Martin, L. and Arvind Panagariya (1984). Smuggling, Trade and Price Disparity: A Crime Theoretic Approach, *Journal of International Economics*, 17(3/4), 201-17; Norton, D. (1988). On the Economic Theory of Smuggling, *Economica*, 55 (217), 107-118.

<sup>32</sup> Mishra, P., Subramanian, A., & Topalova, P. (2008). Policies, Enforcement, and Customs Evasion : Evidence from India. *Journal of Public Economics*, 92(10-11), 1907-1925

<sup>33</sup> Buehn, A., & Eichler, S. (n.d.). Uncovering Smuggling : Worldwide Evidence for Four Types of Trade Misinvoicing. Business. Retrieved from <http://eit.org/WorkingPapers/Papers/Other/FREIT176.pdf>

<sup>34</sup> Buehn, A. and M. R. Farzanegan. (2011) Smuggling around the World: Evidence from a Structural Equation Model. *Applied Economics*, 44(23),3047-3064

<sup>35</sup> [http://www.gutenberg.us/articles/list\\_of\\_countries\\_by\\_number\\_of\\_police\\_officers](http://www.gutenberg.us/articles/list_of_countries_by_number_of_police_officers)

<sup>36</sup> Dutta, K. & N. Srivastava (2014). Corporate Fraud: Risks and Challenges Ahead. *The Prime Directory- 2014*. pp. 104-116.

<sup>37</sup> Brodie, N., Doole, J., and Watson, P. (2000) Stealing History: The Illicit Trade in Cultural Material, McDonald Institute for Archaeological Research.

<sup>38</sup> <http://siteresources.worldbank.org/INTETC/Resources/375990-1089904539172/474683-1089904575523/TobaccoFacts1-6.pdf>

<sup>39</sup> Buehn, A. and M. R. Farzanegan. (2011) Smuggling around the World: Evidence from a Structural Equation Model. *Applied Economics*, 44(23),3047-3064

<sup>40</sup> Fisman, R., and S. Wei. (2007). The smuggling of art, and the art of smuggling: Uncovering the illicit trade in cultural property and antiques. NBER Working Paper No. 13446.

<sup>41</sup> Berger, Helge, and Volker Nitsch. 2008. Gotcha! A profile of smuggling in international trade. Paper presented at the CESifo Venice Summer Institute 2008. July 14th -15th. Venice, Italy.

<sup>42</sup> <https://www.transparency.org/cpi2015/#results-table>



## Determinants of Smuggling

### Price and Type of the Product

Price or type of product is one of the important factors that establish whether to engage in smuggling of a product or not. The thumb rule is that higher the value of product in the domestic market, higher is the propensity for smuggling. Highly expensive products are in the radar of smugglers as they have a high risk-reward payoff. Products such as gold, diamond and narcotics/ drugs that are very high in value terms but small in quantity terms are always on the radar of smugglers due to their ease of smuggling and high financial gains.

Significant price arbitrage between two countries for a commodity is one of the underlying causes of the smuggling activities as they increase the profit margin for smugglers.<sup>43</sup> Goel (2008) points that a substantial price difference across different jurisdictions in case of luxury items is one of the guiding factors in their smuggling.<sup>44</sup> High value electronics goods and luxury watches are among highly smuggled products in India.

Products that can be easily counterfeited are more prone to smuggling. Usually it is seen that in industries where there is a large illicit or informal market, the demand of product to the extent which is illicit, is met through smuggled goods. Contraband goods/products provide so much profit to smugglers that over the long term, it makes a false market. Smuggling of contraband cigarettes in India provide huge financial gains for smugglers as it is one highly taxed products and smokers opt for them as they are less expensive than legal brands.

In addition, technical smuggling in differentiated products is more as compared to homogenous products as it is quite difficult to assess total shipment value for a differentiated product.<sup>45</sup> Traders can easily misclassify a differentiated product, like machinery or electronic items from higher tax category to a lower tax category.

### Demand -Supply Gap

Smuggling of goods depends upon the market size of the commodity or product. If the domestic market is large and is not fulfilled by the domestic supply of goods, imports step in

to fill the vacuum for such goods. Greater reliance on imports, volume of international trade and value of the products give impetus to technical smuggling to evade taxes and duties.

Smuggling of gold in India is primarily driven by the demand and supply gap. India is the second largest consumer of gold in world. The Indian gold jewellery industry is almost completely dependent on imported raw materials and about 90% of requirement are fulfilled by imports.<sup>46</sup> The large domestic market provides smugglers enough arbitrage to fulfil needs of the market through smuggled goods.

### Lack of Innovation and Weakness of Domestic Industry

Lack of innovation in the country increase weakness of the domestic industry to produce new products. Further, domestic industries may not have the technology and capability to produce these goods or products.<sup>47</sup> Demand of these products in such cases is largely met through imports. The imported products satisfy the needs of the consumers with emerging technologies, new products with better quality and performance.

Smuggling of imported goods expands due to enhanced public demand. Aspirational value of imported goods with perceived better quality compared to domestic goods, coupled with enhanced purchasing power tend to provide impetus to smuggling. Findings of the subsequent section on extent of smuggling shows that weakness of domestic industry in producing quality machinery and electronic goods could be one of causes for smuggling of imported goods.

Electronics manufacturing is an intensive research and development (R&D) area and requires large capital expenditure. The local value addition in electronic products in India is still limited and majority of manufacturing is only in the final stage assembly line. Considering low level of R&D and state of manufacturing of electronic products, dependency mainly lies on the imports of electronic products and components that increases propensity for tax evasion through illicit trade activities.

<sup>43</sup> Pitt, M. (1981). Smuggling and Price Disparity. *Journal of International Economics*, 11(4), pp. 447-458.

<sup>44</sup> Goel, R. K. (2008). Cigarette smuggling: price vs. nonprice incentives. *Applied Economics Letters*, 15(8), 587-592.

<sup>45</sup> Mishra, P., Subramanian, A., & Topalova, P. (2008). Policies, Enforcement, and Customs Evasion : Evidence from India. *Journal of Public Economics*, 92(10-11), 1907-1925

<sup>46</sup> The Gems & Jewellery Industry Contributing to "Make in India" (2015). ASSOCHAM and TARI.

<sup>47</sup> Bakhtiyari, M., & Salarzaei, A. H. (2016). Causes and Factors Affecting the Crime of Tobacco and Goods Smuggling in Iran. *International Journal of Law* 2(2), 52-57







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**Section III: Estimates of Smuggling of Key Goods/ Products**

## Section III: Estimates of Smuggling of Key Goods/ Products



Due to its secretive nature and lack of verifiable data, it is never easy to calculate with absolute precision the size of smuggled goods. This section focuses on estimating the extent of smuggling of key goods into India. Selection of key goods in this study is done on the basis of seizure of goods. Based on the review of literature, a suitable methodology has been adopted to determine the extent of technical smuggling (smuggling through legitimate channels).

### Identification of Key Smuggled Goods

The basis of selection of key goods for analysis of smuggling in this report is the seizure data of smuggled goods into India. This includes seizure done by DRI as well as customs officials. However, it is reasonable to say that seizures are just a minuscule fraction of actual smuggling (both outright and technical smuggling) taking place.

Analysis of seizures of smuggled goods (excluding prohibited goods) during 2011-12 to 2015-16 reveals an irregular trend. There was a dip in seizure of smuggled goods during the period 2012-13 and 2013-14. Total seizures to value of imports ranges between 0.02% and 0.13% and remain stagnant at 0.05% in recent years.<sup>48</sup>

Smuggled Goods Seizure vs. Imports					
Year	2011-12	2012-13	2013-14	2014-15	2015-16
Seizures of Smuggled goods (₹ Crores)	2,159.86	853.65	564.24	1,235.84	1,261.45
Value of Imports (₹ Crores)	16,83,467	23,45,463	26,69,162	27,15,434	27,37,087
Total Seizures to Value of Imports (%)	0.13%	0.04%	0.02%	0.05%	0.05%

Source: Report No.5 of 2016; Union Government (Indirect Taxes Customs)

Even so, seizure data provides a sound basis for selection of key product/ good for estimating the extent of smuggling in India. The table below shows seizure data of various goods and products smuggled into India. We have selected top five goods/products for analysing extent of smuggling that we will do in detail in the following part of this section.

Seizure of Smuggled Goods ( ₹ Crores)			
Product/ Commodity	2013-14	2014-15	2015-16
Gold	99.35	692.35	1119.11
Machinery parts	69.5	563.18	447.1
Cigarettes	20.57	90.75	162.0
Fabric/silk yarn	49.89	24.03	41.78
Electronic items	71.66	37.85	17.98
Diamonds	9.46	6.62	14.81
Watches/parts	8.88	1.17	2.44
Computers/parts	18.6	0.46	1.78
Veh./Vessel/Aircrafts	306.08	472.89	62.66

Source: Report No.5 of 2016; Union Government (Indirect Taxes, Customs), CBEC, Lok Sabha Questions

### Estimating of Key Goods/ Products: Methodology

Estimating smuggling is difficult and challenging because it is an illegal and hidden activity. Research has shown that different methods are available to estimate smuggling, but each one comes with its own limitations. These methods may be classified into direct and indirect approaches. Direct methods are based on contacts with or observations of persons and/or firms, to gather direct information about smuggled products.

<sup>48</sup> Report No.5 of 2016; Union Government (Indirect Taxes, Customs)

## Estimates of Smuggling of Key Goods/ Products

Indirect approaches use secondary data to analyse and estimate extent of smuggling. Further, indirect methods for estimating smuggling may be classified into four categories:<sup>49</sup>

- Discrepancies between the sale of goods and the estimated consumption of those products by using household surveys
- Discrepancies between the sale of goods and the estimated consumption of those products by using econometric estimation
- Discrepancies between the trade figures of the target country with her trade partners
- Model approach or MIMIC (Multiple Indicators and Multiple Causes) method

In view of paucity of data availability, this study adopts the methodology that estimates **“discrepancies between the trade figures of India with her trade partners”** for ascertaining the extent of smuggling in selected key goods.

This method has been widely used by researchers to assess the extent of smuggling and conducting empirical analysis. This method has its origins in the work of Morgenstern and is further developed by Bhagwati<sup>50</sup> who used this technique to compare the import data of Turkey from other countries with the recorded figures of export from trade partners of Turkey and found evidence of under-invoicing in the official imports of Turkey.

International trade statistics contain substantial information about the legal exchange of goods between countries. In international trade, each country records exports and imports of each product by country of destination. This method measures smuggling by comparing reported exports of products X destined for a country to that country's reported imports of the product X. While there could be several possible reasons for this discrepancy, one explanation is purposeful misrepresentation in order to evade duties and taxes. Persistent discrepancies between these amounts—discrepancies that cannot be explained by other factors—provide an estimate of the amount of smuggling.<sup>51</sup>

The benefit of this method is that it relies on well documented information, and its application is simple and uncomplicated. This method, however, is not able to estimate the extent of outright smuggling carried out through illegal channels and not recorded in official records of international trade.

### Determining the Estimates of Smuggling: Process

The smuggling of a good/product into the country can be determined by assessing the gap between values of country's import from the reported amount of exports by all partner countries of the world.<sup>52</sup>

The estimates provided by this method are based on the implicit assumption that all goods lost between export and import are eventually smuggled into the country designated as the destination country by the exporter and are not diverted to a third country. If the gap using this method is positive and consistent, then there is certainty that smuggling in a given good/product is taking place through various ways and means, such as outright smuggling, under-invoicing, mis-declaration and misuse of exemptions and notifications as discussed in section I.

Following steps are undertaken to determine extent of technical smuggling in key goods/ products:

#### Exports Reported by World (Partner Countries)

UN COMTRADE reports exports by a country to an importing country in terms of free on board (FOB) value. This value includes the transaction value of the goods and the value of services performed to deliver goods to the border of the exporting country.<sup>53</sup> We have extracted exports by world (all partner countries) of key goods/products to India using HS 96 codes up to 4 digits from the UN COMTRADE database.

#### Imports Reported by India

UN COMTRADE highlights that imports of a country are recorded as CIF type value. CIF-type values include the transaction value of the goods, the value of services performed to deliver goods to the border of the exporting country and the value of the services performed to deliver the goods from the border of the exporting country to the border of the importing country.<sup>54</sup>

We have extracted imports data of selected key goods/products from the UN COMTRADE database relevant to 4 digit HS 96 code for the period 2011 to 2015. Import data for these goods/products is also extracted from the Directorate General of Commercial Intelligence and Statistics (DGCIS) database of the Government of India. Imports data from UN COMTRADE was compared with DGCIS database and we did not find any significant difference between the two. For our analysis of technical smuggling of key goods/products, we have used imports reported under UN COMTRADE to achieve better comparability and to reflect mirror statistics.

<sup>49</sup> Merriman, D. (2002). Understand, Measure and Combat Tobacco Smuggling. World Bank, Economics Of Tobacco Toolkit, Tool 7. Available at: <http://www1.worldbank.org/tobacco/pdf/Smuggling.pdf>

<sup>50</sup> Bhagwati, J. (1964). On the Under Invoicing of Imports. Bulletin of the Oxford University Institute of Statistics, November 1964.

<sup>51</sup> Carrère, C. & Grigoriou, C. (2015). Can mirror data help to capture informal international trade? Working Paper 123, Development Policies. Fondation Pour Les Études Et Recherches Sur Le Développement International.

<sup>52</sup> Buehn, A., & Eichler, S. (2011). Trade misinvoicing: The dark side of world trade. World Economy, 34(8), 1263–1287.

<sup>53</sup> UN COMTRADE : <http://unstats.un.org/unsd/tradekb/Knowledgebase/50290/Mirrors-statistics?Keywords=cif>

<sup>54</sup> Ibid

### Adjusted Imports

As mentioned previously, exports by a country are reported on FOB basis while imports on CIF basis. To have exact mirror statistics and make data comparable for analysing trade discrepancy due to smuggling related activities, the imports data needs to be adjusted for this difference. The imports data should be adjusted for cost of transport, freight and insurance and other discrepancies to make it comparable with exports by world (partner countries).

Apart from cost of transport, insurance and freight cost, there are other discrepancies that may affect mirror statistics of the exports by world and imports reported by country for a given product. These may be attributed to: difference in classification between the exporting and importing countries, definition of the recorded flow and relative lax control of customs declaration by exporting country, transit time, transit of goods (through a third country) and exchange rate conversion issues between local currency and US dollar.<sup>55</sup>

In order to analyse illicit trade and smuggling more accurately, imports are adjusted for CIF and other errors to arrive at FOB value of imports. We have adjusted India reported imports to their FOB prices at the range 21%-10%. This wide range of adjustment on imports is taken to assess the breadth of smuggling that takes place to evade customs duty in India. Selection of this range is based on International Monetary Fund (IMF) and CBEC guidelines and suggestions as discussed below.

CIF is the cost of good/product including insurance and freight costs, while FOB refers to free on board cost of good/ products without transport costs. Imports and exports are in CIF and FOB prices. In order to make imports comparable with exports, imports are adjusted by 10% as suggested by IMF that cost of freight and insurance usually make such percentage of goods/ products.<sup>56</sup>

The Customs Valuation Rules, 1988 in Rule 9(2) provides that for imports other than by air a flat rate of 21% should be added towards freight and insurance charges, wherever the actual charges are not available.<sup>57</sup>

We have taken 21% as the upper limit for adjusting imports to measure trade gap. We provide estimates of smuggling for each of selected goods/ products after adjusting imports for both 10% and 21%.

**Smuggling of Product 'A' into India** using this methodology is computed as:<sup>58</sup>

Exports reported by World (partner countries) for Product A to India during period i minus Adjusted imports reported by India for Product A during this period i

**Smuggling Estimate (%) of Imports may be depicted as:**

Exports reported by World (partner countries) for Product A to India during period i minus Adjusted imports reported by India for Product A during period i

Exports reported by World (partner countries) for Product A during period i

### Estimates of Smuggling in Key Goods/ Products

Based on the selected methodology, this study estimates the extent of smuggling in India for five key goods/products that are most widely smuggled according to DRI estimates. The methodology used, as described above follows an indirect approach to estimate the extent of smuggling and is based on certain assumptions. Our methodology therefore, provides only an approximate level of technical smuggling for the following goods/products identified based on seizure data:

Gold

Machinery and Parts

Cigarettes

Fabrics, Silk and Yarn

Electronic Items

<sup>55</sup> Chlendar, C., Raballand, G. & Rakotorisoa, A. (2016). The use of detailed statistical data in customs reform : the Case of Madagascar. Policy Research Working Paper 7625. Governance Global Practice Group, World Bank Group.

<sup>56</sup> IMF (1993), A Guide to Direction of Trade Statistics.

<sup>57</sup> <http://www.dov.gov.in/newsite3/cir5.asp>

<sup>58</sup> Buehn, A., & Eichler, S. (2011). Trade misinvoicing: The dark side of world trade. World Economy, 34(8), 1263–1287.



## GOLD





India with 29% of global consumption is the largest consumer of gold in the world. Gold in India is considered as a symbol of prosperity and appeals to both the young and old across social strata. It has a unique emotional position in the minds of Indians and is also considered a source of social security for large sections.

Gold is in demand for both investment and consumption purposes. Gold contributes a large amount in total domestic jewellery consumption, mainly used in ceremonial and bridal wears, and accounts for about 80%-85% of total domestic consumption. Gold is also purchased as an investment option with nearly 76% people considering it as safe. For investment

purposes Indians buy gold coins, bars and jewellery. According to a study during the period 2005-12 investment demand for gold bars and coins increased by a CAGR of 43% and that of jewellery by 22%. Consumption demand increased by a CAGR of 23% during the same period.<sup>59</sup>

### Research Findings

Under the Harmonized Commodity Description and Coding System, gold is recorded under HS code 7108. The table below provides world exports of gold to India and adjusted imports of gold by India after adjusting for the CIF- FOB margin and other errors at 21% and 10%. As explained in the methodology, the mirror statistics provide estimates of technical smuggling.

Technical Smuggling in Gold (US\$ Mn/ Per Tonne)					
Year	World Reported Exports to India	Adjusted Imports: CIF-FOB margin @ 21%	Adjusted Imports: CIF-FOB margin @ 10%	Technical Smuggling: CIF - FOB margin @ 21%	Technical Smuggling: CIF - FOB margin @ 10%
	A	B	C	D=A-B	E=A-C
2011	14,326	42,412	48,317	-28,085	-33,991
2012	46,114	41,559	47,346	4,554	-1,232
2013	35,044	29,792	33,941	5,251	1,103
2014	26,804	24,521	27,936	2,283	-1,131
2015	25,522	27,650	31,500	-2,127	-5,977
<b>Average</b>	29,562	33,187	37,808	-3,625	-8,246

Source: Authors' Calculations, UN COMTRADE Database

Analysis of mirror statistics shows that value of gold exported by all partners is quite low as compared to imports reported by India. As a result, technical smuggling calculation shows negative values for all years except for the year 2013. At an average it ranges from (minus) US\$ 3,625 Mn to (minus) US\$ 8,246 Mn.

A further analysis of quantity of gold imports by India and quantity of gold exported by all countries to India reveals an interesting picture. India gold imports for period 2011 to 2015 is more than nearly 1,295 tonnes of what is exported by the rest of the world to India. Thus it may be surmised that such a huge quantity has entered Indian markets in the form of 'negative' technical smuggling of gold through **over-invoicing the value of the quantity** of gold that is imported. The average technical

smuggling during 2011-2015 is nearly 259 tonnes with highest being 781.34 tonnes in 2011.

Imports and Smuggling of Gold			
Year	World Exports (Tonnes)	India Imports (Tonnes)	'Negative' Technical Smuggling (Tonnes)
2011	300.16	1081.50	781.34
2012	882.52	983.17	100.65
2013	750.16	836.18	86.01
2014	690.23	915.47	225.24
2015	943.47	1045.19	101.72
<b>Average</b>	713.31	972.30	258.99

Source: UN COMTRADE, CBEC

<sup>59</sup> The Gems & Jewellery Industry Contributing to "Make in India" (2015), TARI.

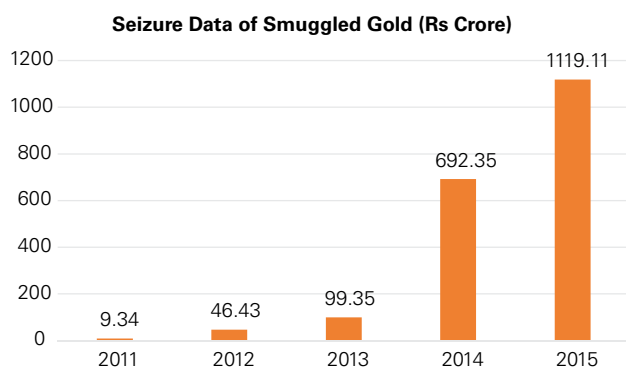
## Estimates of Smuggling of Key Goods/ Products

Further, investigation of mirror statistics of exports and imports of gold in terms of value per unit (US\$ Mn per tonne) indicates undervaluation of gold. Analysis of value and quantity together shows that even though quantity of imports are much more than quantity of exports of gold to India, in value terms per tonne (in US\$ Mn) it is much lower after adjusting for CIF-FOB

margin at 21% and 10%. The average undervaluation during the period 2011 and 2015 is between 3.7 and 8.4 US\$ Mn per tonne. The table below shows that undervaluation per tonne has been consistently increasing from 2011 till 2014 and showing sudden dip in 2015.

Technical Smuggling in Gold (US\$ Mn/ Per Tonne)					
Year	World Reported Exports to India	Adjusted Imports: CIF-FOB margin @ 21%	Adjusted Imports: CIF-FOB margin @ 10%	Technical Smuggling: CIF - FOB margin @ 21%	Technical Smuggling: CIF - FOB margin @ 10%
	A	B	C	D=A-B	E=A-C
2011	47.7	39.2	44.7	8.5	3.1
2012	52.3	42.3	48.2	10.0	4.1
2013	46.7	35.6	40.6	11.1	6.1
2014	38.8	26.8	30.5	12.0	8.3
2015	27.1	26.5	30.1	0.6	-3.1
<b>Average</b>	42.5	34.1	38.8	8.4	3.7

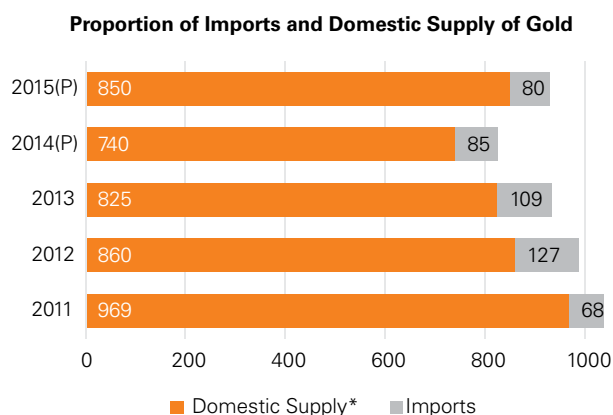
Source: Authors' Calculations, UN Comtrade



Source: CBEC Data

Seizure data in the above graph shows an exponentially rising trend with seizures of smuggled gold rising significantly in 2014 and 2015. Such sudden rise in seizures with imports remaining more or less stable reflects that outright smuggling in gold has started on a large scale after 2012. The spurt in outright smuggling of gold may be attributed to doubling of customs duty on import of gold products in 2012. Please refer to Annexure 3 for further details on notifications of customs duty on gold.

Smuggling of gold in India is primarily driven by the demand and supply gap. Indigenous availability of raw material plays a crucial role in the growth of any industry; the Indian gold jewellery industry is almost completely dependent on imported raw materials. Almost 90% of requirement are fulfilled by imports. Interestingly while India has the largest aboveground gold stock it continues to depend heavily on imports of gold to meet consumer demand.<sup>60</sup> The chart below shows the trends in supply of gold in the country:



Source: World Gold Council and ICRA estimates<sup>61</sup>, \* Includes recycled gold and other domestic sources

<sup>60</sup> The Gems & Jewellery Industry Contributing to "Make in India" (2015), TARI.

<sup>61</sup> (<http://icra.in/Files/ticker/SH-2014-H2-4-ICRA-Jewellery.pdf>), \* Includes recycled gold and other domestic sources

Limited recycling and inefficient mining of gold are the main reasons for low domestic supply of gold. Less than 10% of total above ground stock in India is used for recycling and goes into domestic supply. Further, demand for gold in India is unique and to some extent inelastic to price. Part of the relative inelasticity of gold demand to price is explained by the religious and cultural significance of gold. An increasing trend in GDP/capita also reflects increase in domestic consumption of gold.<sup>62</sup>

Along with widening demand supply gap, the smuggling in gold is also stimulated due to price of the gold in the domestic market. Gold is a precious commodity, small in size and high in value per kg which makes it easy for smugglers to hide from enforcement agencies. In addition, there lies a significant price arbitrage between domestic and international market that provides strong financial incentives for smugglers to earn handsome profit.

The continued demand, relatively price inelasticity of gold demand, low domestic supply of gold, increasing GDP per capita provides greater consumption of gold to be met through gold imports. This provides unscrupulous persons opportunity to smuggle gold to take benefit of both price and demand-supply arbitrage while evading taxes of the legal channels.

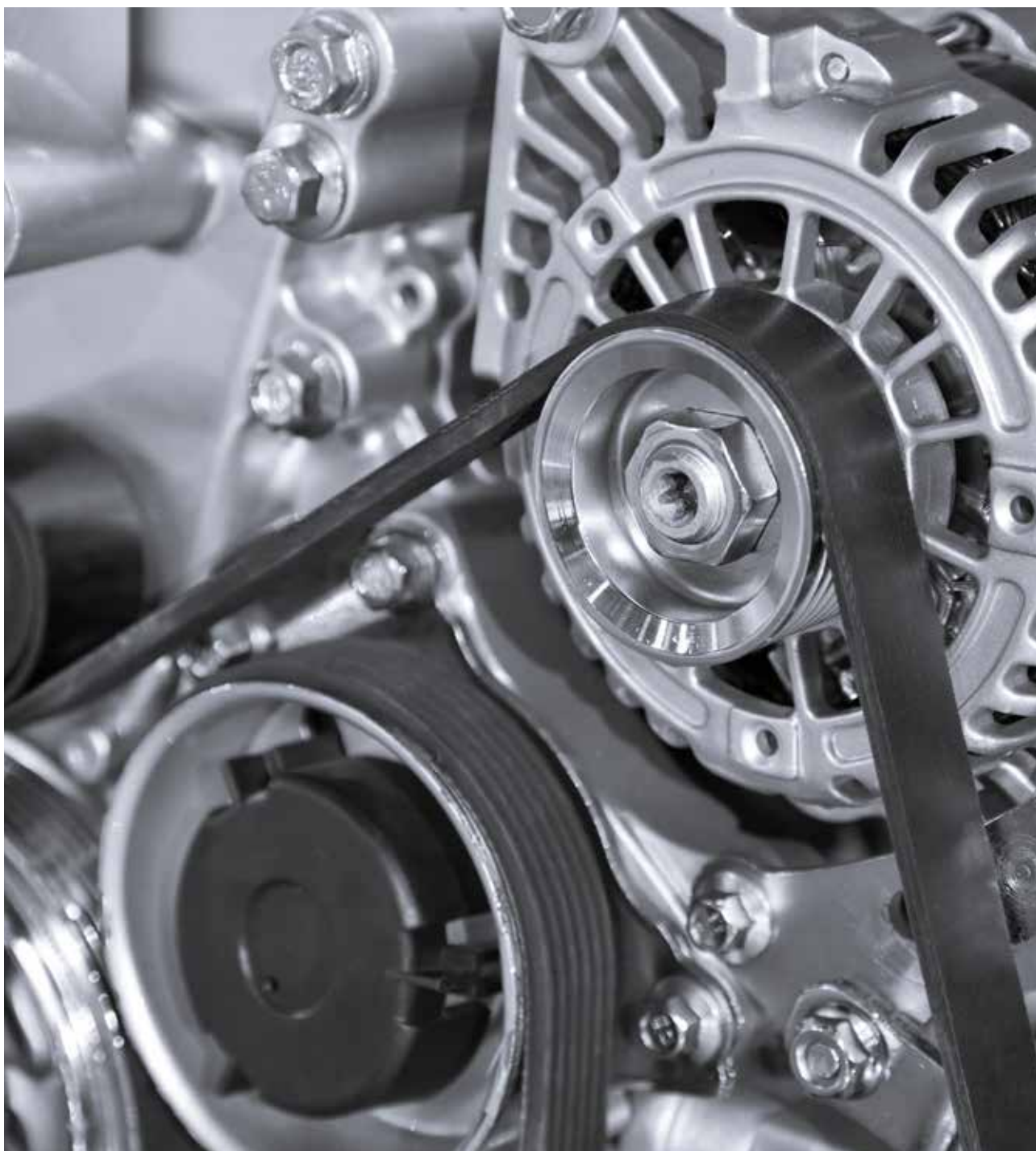
**Average per annum smuggling in Gold in terms of volume is (minus) 258.99 tonnes (that is, 'negative' smuggling: India shows higher quantity of imports than exports by rest of world). This translates into value of negative smuggling ranging from (minus) US\$ 3625 million and (minus) US\$ 8246 million, equivalent to (minus) ₹15,637 crores and (minus) ₹41,896 crores. This implies that gold is undervalued by around US\$ 3.7 million to US\$ 8.4 million, equivalent to ₹20.9 crores to ₹48 crores per tonne and is indicative of illicit money transfers from India.<sup>63</sup>**



<sup>62</sup> The Gems & Jewellery Industry Contributing to "Make in India" (2015). ASSOCHAM and TARI.

<sup>63</sup> Using RBI exchange rates for respective years as on March 31 of each year

## Machinery and Parts





Machinery and parts form a major segment of the capital goods industry in India which currently contributes 12% to India's manufacturing sector and around 2% to India's GDP. Capital goods industry provides a diverse range of machinery and equipment to serve a cross section of user industry segments ranging from defence, oil and gas, refinery, nuclear, chemical and petro chemicals, machine tools, to consumer durables, fertilizers, automobiles, textiles, steel, cement, paper, construction, mining, etc. It has a significant multiplier effect on overall economic growth as it provides the foundational building blocks for such a large number of user industries by providing critical inputs, that is, machinery and equipment, necessary for manufacturing.

Capital goods is a large sector with a market size of around ₹ 282,000 crores and total production of approx. ₹ 230,000 crores in 2014–15.<sup>64</sup> However, the growth of the sector has been lagging, with domestic market size de-growing at 3.6%<sup>65</sup> and the total production increasing by only 1.1% per annum over the last 3 years, a stark contrast to the targeted growth

rate of 16.8% p.a. during the 12th Five Year Plan period by the Planning Commission.<sup>66</sup>

Capital goods imports have been growing at the rate of 9.8% p.a. over the last 5 years. The share of imports in the Indian capital goods market has increased from 34% in 2009-10 to 40% in 2014-15, indicating a looming threat to India's self-reliance and national security. Surprisingly, even then, the capacity utilisation of domestic manufacturers is only about 60%-70% across the sub sectors of the industry.<sup>67</sup>

### Research Findings

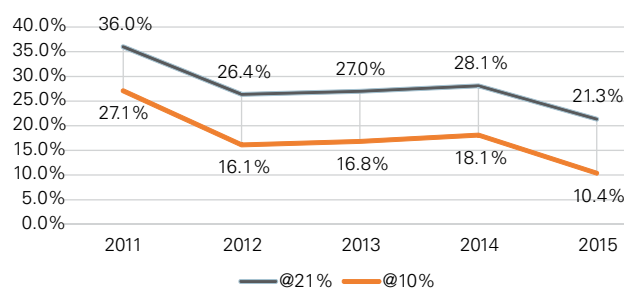
Under the Harmonized Commodity Description and Coding System, machinery and parts are recorded under the 2-digit HS code 84 (refer annexure for code details). The average exports reported by the rest of the world (ROW) and imports reported by India from ROW for the 5 year period under consideration stood at US\$ 26,131 Mn and US\$ 18,734 Mn respectively. As explained in the methodology above, the imports are adjusted to FOB prices at 21% and 10%.

Technical Smuggling in Machinery and Parts ( US\$ Mn)					
Year	World Reported Exports to India	Adjusted Imports: CIF-FOB margin @ 21%	Adjusted Imports: CIF-FOB margin @ 10%	Technical Smuggling: CIF - FOB margin @21%	Technical Smuggling: CIF - FOB margin @10%
	A	B	C	D=A-B	E=A-C
<b>2011</b>	32063	20,520	23,377	11,543	8,685
<b>2012</b>	28106	20,699	23,582	7,407	4,525
<b>2013</b>	24319	17,759	20,232	6,560	4,087
<b>2014</b>	24013	17,264	19,668	6,749	4,345
<b>2015</b>	22154	17,425	19,851	4,729	2,303
<b>Average</b>	26,131	18,734	21,342	7,397	4,789

Data indicates that the extent of technical smuggling of machinery and parts in India for the 5 year period under consideration ranges at an average between US\$ 4,789 Mn and US\$ 7,397 Mn. This translates to smuggling an average of approximately 17.7% to 27.8% of imports. The graph below presents the year wise range of smuggling of machinery and parts in India as percentage of imports.

As the graph shows, smuggling ranges from a minimum of 10.4% of imports to a maximum of 36.0% in the 5 year period 2011-15 for machinery and parts. A further analysis of the seizure data suggests that ratio of seizures to smuggled products in the machinery and parts industry has gone up and at an average ranges from 0.75% to 1.29% during the 5 year period under consideration.

Smuggling of Machinery and Parts as % of Imports to India



Source: Authors' Calculations, UN COMTRADE Database

<sup>64</sup> National Capital Goods Policy 2016 (<http://dhi.nic.in/writereaddata/Content/NationalCapitalGoodsPolicy2016.pdf>)

<sup>65</sup> Industry associations, sub sectors, DGCIS data

<sup>66</sup> Report of the Working Group on Capital Goods & Engineering Sector for the 12th Five Year Plan 2012-2017

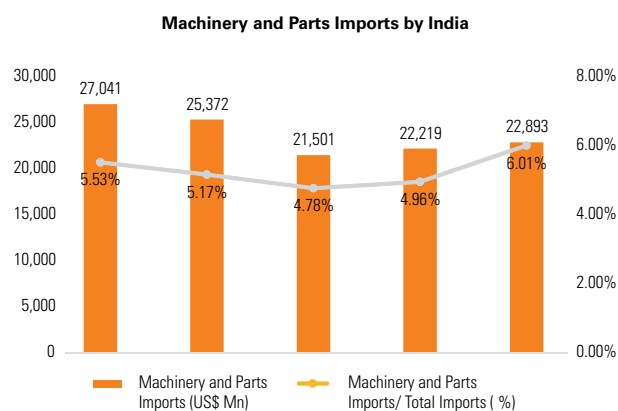
<sup>67</sup> National Capital Goods Policy 2016 (<http://dhi.nic.in/writereaddata/Content/NationalCapitalGoodsPolicy2016.pdf>)



## Estimates of Smuggling of Key Goods/ Products

Taking imports from one country, China, UN COMTRADE data indicates that in 2015-16 China reported the highest exports of machinery and parts to India at US\$ 613.7 Mn. In the same year, the imports of machinery and parts from China reported by India stood at US\$ 561.7 Mn. After adjusting to FOB prices @10%, the mirror statistics show a trade gap of US\$ 108.2 Mn. This means that smuggling in the form of mis invoicing/under valuation or other technical means, of machinery and parts from China stood at approximately 18% of imports.

A plausible explanation for smuggling of machinery and parts in India can be the over dependence on imports and the lack of capacity in the domestic sector and the MSMEs as mentioned above. In recent years, production of machinery and parts has not grown fast enough to match domestic demands, leading to a growing dependence on imports. In 2014-15 and 2015-16, India's imports of machinery and parts stood at US\$ 22219 Mn and US\$ 22893 Mn respectively.



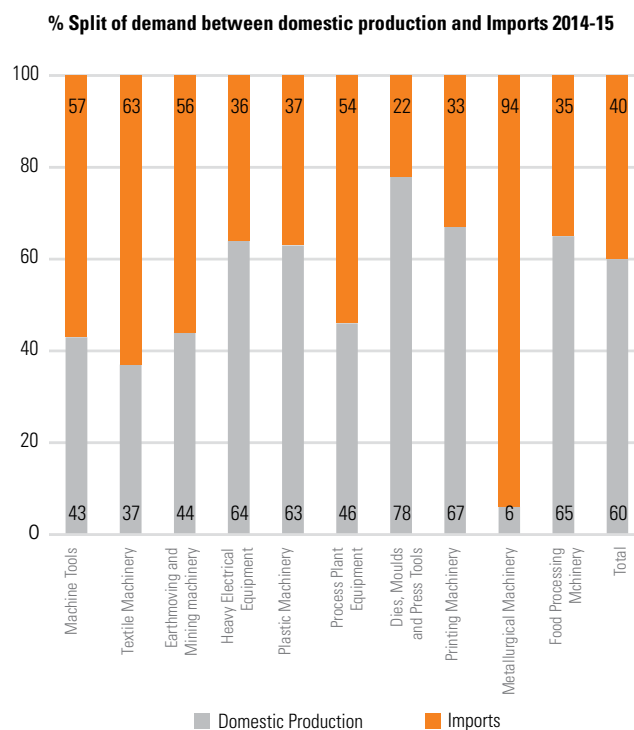
Source: DGCIS data

Another important reason for dependence on imports is that India's current level of technology depth ranges from basic to intermediate, indicating limited ability in fundamental research on materials and components and low absorption of product technologies which ultimately hamper domestic production.

As can be seen from the graph above, the rate of smuggling in this sector has been decreasing. This can largely be attributed to the reduction in customs duties for machinery and parts over the past 4 years (refer annexure for details of reduction of duties)<sup>68</sup> that have resulted in reducing the price differentials across borders, thereby discouraging smugglers.

**Average per annum smuggling in Machinery and parts ranges from US\$ 4,789 million to US\$ 7,397 million, equivalent to ₹ 26,561 crores to ₹ 41,586 crores.<sup>69</sup>**

The continuous growth in imports since 2013 signifies consistent demand in the market but from sources outside India. The figure below clearly indicates the reliance on imports to fulfil demand. This gap between domestic demand and supply presents an opportunity for illicit traders to step in to fulfil domestic demand and at same time earn profits through tax evasion.



Source: National Capital Goods Policy 2016 using data from sub sector industry associations and DGCIS

<sup>68</sup> <http://www.cybex.in/india-budget/2012-2013-budget-changes-in-customs-duty.aspx>

<sup>69</sup> Using RBI exchange rates for respective years as on March 31 of each year

## Cigarettes



## Estimates of Smuggling of Key Goods/ Products

Worldwide cigarettes are amongst the most sought after product for smuggling because high taxes on cigarettes induce great financial incentive for smugglers to earn huge profits. Persistently increasing taxes on cigarettes provide a lucrative opportunity for tax evasion due to tax arbitrage between the country of exports and in the importing country.

In India, cigarettes constitute only 15% of the total tobacco consumption while other tobacco products like chewing tobacco, bidis and gutkha etc. comprise rest of the 85% when considered in volume terms. However, if one considers value terms, statistics are reverse of volume figures, that is, other tobacco products account for only 15% in total taxes, while cigarettes attract 85% of total taxes levied on tobacco. The entire tobacco market (including all tobacco products) produced in India (either factory, home or unorganised units) is estimated to be around ₹1,44,000 crores in 2015.<sup>70</sup>

Illicit cigarettes in India is a national threat as the country is now the 4<sup>th</sup> largest illegal cigarette market in the world, as estimated by Euro monitor International.<sup>71</sup> The illicit cigarette trade can pose serious security threat as there is evidence, globally, that organized transnational criminal groups are involved in it and money earned through it is used to fund serious criminal activities, including terrorism.<sup>72</sup> In absence of data or research, the same might not be said about India but the threat cannot be ignored.

Globally, cigarette smuggling is considered a low-risk, high-reward criminal activity. The traffickers can make millions with little risk of detection or harsh punishments. It allows traffickers and their networks to circumvent borders; proceeds can be used to finance insecurity and instability.<sup>73</sup>

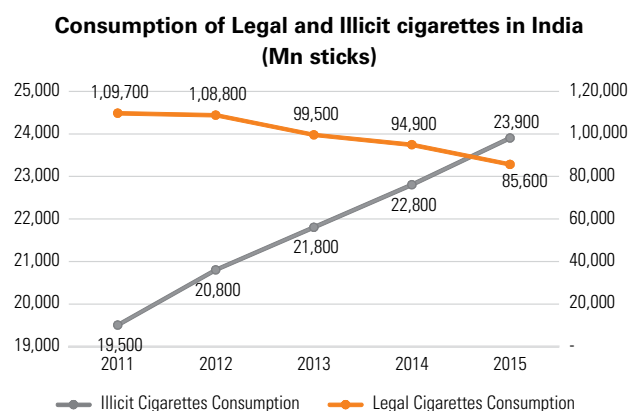
A number of international studies have been conducted in the past which highlight the involvement of counterfeiting and smuggling of tobacco products in financing terrorist activities. International Consortium of Investigative Journalists (ICIJ)<sup>74</sup> reports that some of the world's most feared terror outfits like Hezbollah, Taliban and al-Qaeda have been found to be involved in smuggling cigarettes, as are the Real Irish Republican Army (Real IRA) and the Kurdistan Workers' Party (PKK). Louise Shelley, a transnational crime expert at George Mason University and adviser to the WEF on illicit trade, has been quoted as saying that terrorist financing through cigarette smuggling is huge because "no one thinks cigarette smuggling is too serious, so law enforcement doesn't spend resources to go after it."<sup>75</sup>

For instance, in Australia, according to an assessment by the Australia Crime Commission<sup>76</sup>, involvement in Australia's illegal tobacco market is perceived by organised crime groups as a low risk, high profit activity in which large profits can be made with minimal risk detection or significant penalties. Organised crime has sustained access to cheap tobacco product overseas which can be illegally imported, avoiding tax obligations to supply tobacco in the Australian market. Minimal quantities of illegal tobacco are produced domestically. The assessment further states that in 2011-12 the ACBPS (Australian Customs and Border Protection Service) detected and seize 46 sea cargo importations of illegal tobacco, comprising a combined 175 ton of tobacco and 122 million cigarettes with duty evaded on these estimated at 128 million Australian dollars.

The UK government in their Report of October 2014 estimated that they lose about 1.3% of their total tax collection due to criminal networks, mainly from smuggling.

The legal cigarettes industry in India has been bearing the brunt of the flourishing illicit market, with consumption of legal cigarette witnessing a massive 22% drop in volume from 2011 to 2015. Illicit market on the other hand has been increasing constantly. The key driver for the rampant increase of smuggling is due to high taxes which create a significant arbitrage to fuel such activities.

The following graph depicts the trend in consumption of legal and illicit cigarettes in India over the last 5 years:



Source: Euromonitor International, 2016 for illicit cigarettes and GOI data on Excise from Cigarettes Shipments from Factories for legal cigarettes

<sup>70</sup> FICCI-CASCADE (2016). Need for policy reforms to combat illicit markets: Case study on Tobacco Industry

<sup>71</sup> <http://indiatoday.intoday.in/story/cigarette-smuggling-increases-multi-fold-in-india/1/694312.html>

<sup>72</sup> United States General Accounting Office, 'Terrorist Financing: US Agencies Should Systematically Assess Terrorists Use of Alternative Financing Mechanisms', Report to Congressional Requesters GAO-04-163, available at <http://www.gao.gov/new.items/d04163.pdf> and <http://www.ftc.org/what-is-the-ftc/the-work-of-the-fca/illicit-trade/the-facts>

<sup>73</sup> The Global Illicit Trade in Tobacco: A Threat to National Security, Department of State, US, December 2015

<sup>74</sup> Terrorism and tobacco (2009), International Consortium of Investigative Journalists, available at <http://www.icij.org/project/tobacco-underground/terrorism-and-tobacco>

<sup>75</sup> Ibid

<sup>76</sup> Organised Crime in Australia, 2013, an assessment by the Australian Crime Commission

According to Tobacco Institute of India, over the last three decades, the share of legal cigarettes in total tobacco consumption in India has declined from 21% in 1981-82 to 11% currently. During the same period the overall tobacco consumption in the country has increased by 38%. In terms of quantity the legal cigarettes reduced from 86 million kgs to 62 million kgs while the consumption of other forms of tobacco went up from 320 million kgs to 500 million kgs during the same period. This drop in consumption of legal cigarettes is reflected in the shift of consumers to the illegal cigarettes and the unorganized sectors of the Industry, which are hazardous and have grave social and economic consequences.

### Research Findings

- Trade Gap Analysis**

Under the Harmonized Commodity Description and Coding System, cigarettes are classified under the 4-digit HS code 2402. The exports reported by the rest of the world and the imports reported by India after adjusting for the CIF- FOB margin for the 5 year period under consideration are presented in the table below.

Technical Smuggling of Cigarettes ( US\$ Mn)					
Year	World Reported Exports to India	Adjusted Imports: CIF-FOB margin @ 21%	Adjusted Imports: CIF-FOB margin @ 10%	Technical Smuggling: CIF - FOB margin @21%	Technical Smuggling: CIF - FOB margin @10%
	A	B	C	D=A-B	E=A-C
<b>2011</b>	24.73	14.32	16.31	10.41	8.41
<b>2012</b>	28.02	16.06	18.29	11.96	9.73
<b>2013</b>	23.92	16.63	18.95	7.29	4.97
<b>2014</b>	21.30	17.44	19.86	3.86	1.43
<b>2015</b>	18.97	17.44	19.87	1.53	- 0.90
<b>Average</b>	23.39	16.38	18.66	7.01	4.73

Source: Authors' Calculations, UN COMTRADE Database

Data shows that 'technical' smuggling of cigarettes in India over the period 2011-2015 at an average ranges from US\$ 4.73 Mn to US\$ 7.01 Mn. The above table reveals technical smuggling in cigarettes has consistently come down after 2012, which is in line with massive increase in tax rates during the period, where under-declaration of the value of cigarettes or other forms of technical smuggling does not provide adequate incentive or compensate the smugglers for their risk reward equations.

Cigarettes in India attract significant customs duty as well countervailing duty on their imports. In addition to central excise, cigarettes also attract very high rates of VAT and other state level taxes. Table below shows central excise on cigarettes for period 2011-15. It reveals that excise duty on cigarettes has increased substantially and almost doubled after 2013-14.

Excise Duty on Cigarettes (₹ per, 000 sticks)					
Length of Cigarettes (mm)	2011-12	2012-13	2013-14	2014-15	2015-16
<b>Plain</b>					
<b>Up to 65</b>	689	689	689	1185 (71.89%)	1440 (21.57%)
<b>&gt;65 to 70</b>	1517	1770 (16.63%)	2088 (17.99%)	2318 (11.00%)	2590 (11.76%)
<b>Filter Cigarette</b>					
<b>Up to 65</b>	689	689	689	1185 (71.89%)	1440 (21.57%)
<b>&gt;65 to 70</b>	998	1230 (23.21%)	1451 (18.01%)	1700 (17.10%)	1900 (11.80%)
<b>&gt;70 to 75</b>	1517	1770 (16.63%)	2088 (17.99%)	2318 (11.00%)	2590 (11.76%)
<b>Others (&gt;75 mm)</b>	2434	2872 (17.98%)	3389 (18.01%)	3389	3790 (11.84%)

<sup>77</sup> <http://www.tiionline.org/facts-sheets/tobacco-consumption/>

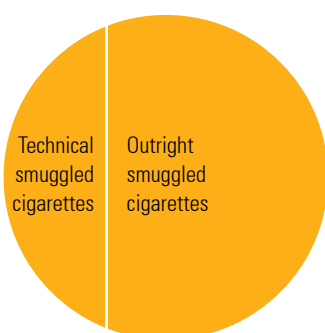
## Estimates of Smuggling of Key Goods/ Products

In their recent study, FICCI CASCADE also conclude that based on qualitative evidence, as the price of the legal cigarettes goes up due to higher taxes, consumers are willing to trade down and patronise smuggled cigarettes or even cheap and tax-evaded locally manufactured cigarettes. About three-fourth of cigarette smokers who participated in this study were willing to switch to such cigarettes, even when they knew it would jeopardise their health and wellbeing.<sup>78</sup>

Therefore even though technical smuggling in cigarettes has been declining from 2013 to 2015, these high taxes and duties provides smugglers an opportunity to earn huge profits by engaging in outright smuggling where illegal movement takes place through clandestine channels so as to avoid duties and taxes at the official ports of entry. That is, where either no product is declared at the port of entry or no legal import documentation is available.

This is further manifested in the fact that seizure of cigarettes has been increasing sharply from 2013 to 2015. In fact in the year 2015, the value of seized cigarettes amounted to ₹162 crores, which is higher than the total value cigarettes import of ₹131 crores. Technical smuggling in cigarettes is very small as compared to the large illegal cigarette market or the total consumption in India, also indicating that outright smuggling of cigarettes is quite pervasive in India, which fills up the gap between consumption and production by licensed manufacturers.

### Smuggled Cigarettes in India



Due to above factors, a study based on trade gap alone will not provide accurate estimation of total size of smuggling of cigarettes in India, hence other corroborative methodologies are needed.

### Seizures, Consumption and Estimation of Smuggling in Cigarettes

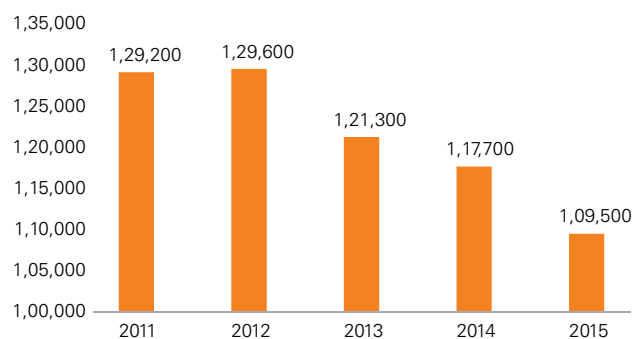
Merriman and others (2000) have carried out analysis to determine the extent of smuggling of cigarettes based on a combination of factors including discrepancies in reported imports and exports, estimates of smuggling derived by external studies and price differentials between countries. Using this model, they estimated that between 6% and 8.5% of worldwide cigarette consumption is smuggled.<sup>79</sup>

Thursby and Thursby<sup>80</sup> (2000) in their holistic analysis, allowed for wholesale smuggling, as well as bootlegging and cross-border shopping and analysing data from 39 US states from 1972 to 1990, found that cigarette smuggling ranges between 3% and 5% of US consumption in recent years of their study. In another study DeCicca, Sing, and Liu (2010) based on a survey directly observed smuggling behaviour and the extent of smuggling and found that 5% of smokers were engaged in the smoking smuggled cigarettes.

In another study, Yurekli and Sayginsoy (2010)<sup>81</sup> estimate that worldwide cigarette smuggling based on data from 110 countries, accounts for roughly 3.4% of global cigarette consumption. However, researchers have pointed that there may be difference in values from country to country due to wider selection of countries.<sup>82</sup>

Based on existing literature, this study determines the extent of smuggling based on consumption of illicit and legal cigarettes in the country. The graph below provides year wise consumption of cigarettes (both illicit and legal):

### Total Cigarette Consumption (in Million Sticks)



Source: Euromonitor International, 2016 for illicit cigarettes and GOI data on Excise from Cigarettes Shipments from Factories for legal cigarettes

<sup>78</sup> FICCI CASCADE (2016): Need for policy reforms to combat illicit markets: Case study on Tobacco Industry

<sup>79</sup> Merriman D., Yurekli, A. and F. J. Chaloupka (2000) .How big is the worldwide cigarette smuggling problem? Tobacco Control in Developing Countries, ed., Prabhat Jha and Frank Chaloupka, (Geneva: Oxford Medical Publications, 365.

<sup>80</sup> Thursby, Jerry G., and Mary C. Thursby. (2000). Interstate Cigarette Bootlegging: Extent, Revenue Losses, and Effects of Federal Intervention." National Tax Journal 53.(1), 59-78.

<sup>81</sup> Yurekli, A., and O. Sayginsoy. (2010). Worldwide Organized Cigarette Smuggling: An Empirical Analysis." Applied Economics 42 (23): 542-61.

<sup>82</sup> Burke, T. (2013). The Effect of Excise Taxes on Cigarette Smuggling : An Instrumental Variable Approach (CMC Senior Theses). Retrieved from [http://scholarship.claremont.edu/cmc\\_theses/764](http://scholarship.claremont.edu/cmc_theses/764)



Though the total consumption of cigarettes both legal and illicit have decreased but the consumption of tobacco in India has increased over this period, signalling a shift from legal products to the cheaper substitutes or illicit products, which have no or little tax element in them. This shift has grave social consequences being hazardous for security and health, as such products are with little oversight of regulators etc.

Global studies suggest that smuggled cigarettes range anywhere between 3% and 8.5% of total cigarette consumption. Merriman and others point out that even though 8.5% is upper bound of cigarette smuggling based on consumption, it certainly exceeds this level in some countries. According to Euro monitor International, India is now the 4th largest illegal cigarette market in the world and hence the presence of smuggled markets is higher than developed countries.

As discussed in detail in section II, smuggling increases with the rise in degree of corruption. India's dismally low rank on the Corruption Perception Index-2015 (ranking 76 out of 168 countries) indicates the intensity of the problem.<sup>83</sup>

The other factors that lead to higher prevalence of smuggling are level of enforcement and compliance. Low ratio of policing, where India has 76 policemen per one lakh population as compared to the UN Median of 300 makes effective surveillance and enforcement extremely challenging. This low level of deterrence manifested through lower enforcement personnel coupled with porous borders gives rise to rampant smuggling in India.

India has over the years improved its surveillance and border patrol efforts and the seizure amounts have been increasing. However, ratio of seizures to smuggled cigarettes in India vary from 0.3% in 2013 to 1.8% in 2015 (determined from estimated smuggled cigarettes) is much lower than global thresholds which an OECD report on illicit trade highlights that in 2011 average seizure rate was close to 10% for the European Union.<sup>84</sup>

Studies show that high taxation is not the only driver of illicit trade in cigarettes. Illicit trade also result from lack of control on cigarette manufacturing and the movement of cigarettes and other tobacco products across international borders to facilitate illicit trade. Also, it is run by criminal organisations with sophisticated systems for distributing smuggled tobacco products. Illicit trade is more common in low-income countries than high ones.<sup>85</sup>

Considering the growing proportion of illicit cigarettes in total cigarette consumption in India along with weak enforcement infrastructure and vast porous borders, this study assumes that the percentage of smuggled cigarettes to the total consumption in India is in the range 8% -10% in the period 2013 to 2015, which is in line with global estimates.

The economic unit price or value of smuggled cigarettes has been derived from the implicit rates (as shown in the table below) as declared by the government in relation to the cigarettes seized.

Seizure of Smuggled Cigarettes			
Year	Seizure Volume (Mn sticks)	Seizure Value (₹ Crores)	Ratio of value of seized cigarettes to volume (₹ crores per Mn sticks)
2013	26.4	20.57	0.78
2014	114.3	90.75	0.79
2015	198.3*	162	0.81

Source: Lok Sabha answers on July 24, 2015, CBEC, \* calculated annualised figures

The total volume of smuggled cigarettes and their respective values, estimated based on the above methodology for the period 2013 to 2015 are:

Estimated Extent of Smuggling in Cigarettes		
Year	Smuggled Cigarettes (Mn sticks)	Smuggled Cigarettes (₹ Crores)
2013	9,704	7,561
2014	10,593	8,410
2015	10,950	8,946

**Smuggling in Cigarettes has increased from ₹ 7,561 crores (US\$ 1,250 million<sup>86</sup>) in 2013 to ₹ 8,946 crores (US\$ 1,349 million) in 2015, indicating an increase of 18.3% in the between 2013 and 2015.**

<sup>83</sup> <https://www.transparency.org/cpi2015/#results-table>

<sup>84</sup> OECD (2016), Illicit Trade: Converging Criminal Networks, OECD Reviews of Risk Management Policies, OECD Publishing, Paris

<sup>85</sup> Joossens L, Merriman D, Ross H, & M. Raw (2010). The impact of eliminating the global illicit cigarette trade on health revenue. *Addiction*, 105, 1640-95.

<sup>86</sup> Using RBI exchange rates for respective years as on March 31 of each year

## Fabrics, Silk and Yarn



Fabrics, silk and yarn are core to the textiles and apparels industry. This industry is one of the important industries of India as it contributes about 5% to GDP, and 14% to the overall Index of Industrial Production (IIP). Synergistic efforts of all the stakeholders, including GOI, has resulted in the industry growing at 8-9% in the last 2-3 years as compared to 3-4% during the last six decades.<sup>87</sup>

The industry currently estimated at around US \$108 billion, is expected to reach US \$ 223 billion by 2021. The domestic demand is expected to grow at a CAGR of 10.2%. Rising disposable incomes and evolving lifestyles of India's prospering urban consumer, are broadening their clothing needs. Today, Indians are more inclined to buy apparels for a specific purpose, than consumers in other markets. Family celebrations and weddings in India continue to eat up an enormous share of Indian consumers' clothing budgets, especially silk.

The textile and apparel industry consumes a diverse range of fibres and yarns but is predominantly cotton based. India stands top in production of jute yarn and is the second largest producer of cotton, cotton yarn, cellulosic fibre/yarn and silk. Moreover, India is fourth largest producer of synthetic yarn/ fibre.<sup>88</sup> However, in certain segments such as silk, India faces strong competition from countries such as China, with Chinese silk and yarn products flooding the Indian market.

### Research Findings

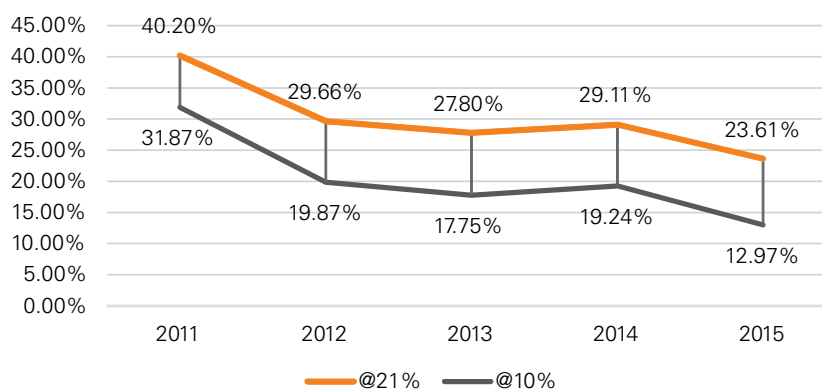
Under the Harmonized Commodity Description and Coding System, fabrics, silk and yarn are recorded under the 2-digit HS codes 50, 52, 53, 54, 55, 56, 58, 59, 60. Please refer Annexure II for detailed 4 digit HS code. The table below presents the exports of silk and yarn to India by ROW and the imports reported by India after adjusting for the CIF- FOB margin and other errors at 21% and 10% for the 5 year period 2011-2015.

Technical Smuggling of Fabrics, Silk and Yarn ( US \$Mn)					
Year	World Reported Exports to India	Adjusted Imports: CIF-FOB margin @ 21%	Adjusted Imports: CIF-FOB margin @ 10%	Technical Smuggling: CIF - FOB margin @21%	Technical Smuggling: CIF - FOB margin @ 10%
	A	B	C	D=A-B	E=A-C
<b>2011</b>	5,009	2,996	3,413	2,013	1,596
<b>2012</b>	4,473	3,146	3,584	1,327	889
<b>2013</b>	4,545	3,282	3,739	1,264	807
<b>2014</b>	4,910	3,481	3,965	1,429	945
<b>2015</b>	4,430	3,385	3,856	1,046	575
<b>Average</b>	4,673	3,258	3,711	1,416	962

Source: Authors' Calculations, UN COMTRADE Database

Mirror statistics show that the extent of technical smuggling of fabrics, silk and yarn in India, based on the trade gap for the 5 year period under consideration ranges at an average between USD 962 Mn and USD 1416 Mn. This translates to smuggling an average of approximately 20.34% to 30.08% of imports. The graph below presents the year wise range of smuggling of silk and yarn in India as percentage of imports.

**Smuggling of Fabrics, Silk and Yarn as % of Imports to India**



Source: Authors' Calculations, UN COMTRADE Database

<sup>87</sup> India Brand Equity Foundation, Textile Industry in India, July 2016

<sup>88</sup> Golden Decades for India's Textile and Apparel Industry, Alok Industries, 2014



## Estimates of Smuggling of Key Goods/ Products

A further analysis suggests that at an average the percentage of smuggled fabrics, silk and yarn seized at borders ranges from 1.14% to 1.65% during the 5 year period under consideration. This percentage has however continued to decrease from 2011 to 2014 with a slight increase in 2015 indicating the growing threat to the fabrics, silk and yarn industry in India.

The Indian textiles industry faces acute shortage of raw materials in the form of cotton and raw silk. Fluctuating prices and uncertainties in the availability of raw materials leads to low production and sickness of mills. This in turn results in dependence on imports of raw materials for silk and yarn. India's dependence on imports of silk and yarn has seen a consistent increase over the last 5 years, having grown from 0.8% to 1.12% of the total imports.

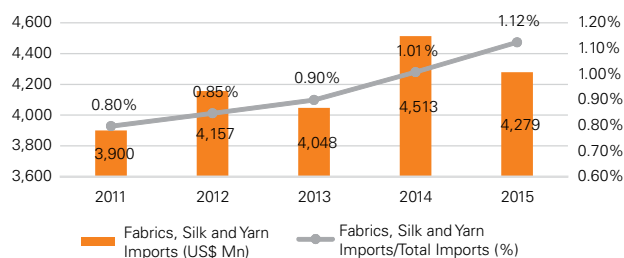
While India is the second biggest producer of silk, it is also the second biggest importer of silk in the world. According to UN COMTRADE data, India imports 12% of the world silk, second only to Italy's 21%. This clearly indicates that domestic production is highly insufficient to meet the growing domestic demand for silk. In addition, as much as 89% of silk imports in India come from China.

Sericulture in India has taken a severe beating with cheap silk coming from China and flooding the Indian markets. According to a report,<sup>89</sup> India imported around 9,258 tonnes of silk worth over six billion rupees in 2015 from China, the world's largest silk producer. Nearly 49,000 hectares of mulberry crop was uprooted in Karnataka as cocoon prices crashed resulting in a loss of 3,000 tonnes to the country's overall silk production, according to statistics released by the Central Silk Board.

Dumping of silk yarn from China has affected the production of silk; while China produced 69,000 metric tons of raw silk last year, India stood far behind with 16,000 metric tons.<sup>90</sup>

Another alarming fact is that while the import of cheap silk yarn from China is increasing power loom production, it is also threatening to push traditional handloom weavers into poverty. Chinese silk yarn lends itself well to power looms as it is lighter and smoother with less winding breakage than its Indian counterpart.<sup>91</sup> Apart from China, import of cheap silk yarn from Taiwan and Japan are also playing havoc with Indian silk and yarn handlooms.

**Fabrics, Silk and Yarn Imports by India**



Source: DGCIS data

**Average per annum smuggling in Fabrics, Silk and Yarn ranges from US\$ 962 million to US \$ 1416 million, equivalent to ₹ 5,390 crores to ₹ 8,038 crores.<sup>92</sup>**



<sup>89</sup> <https://www.talpro.in/indian-silk-industry/>

<sup>90</sup> *ibid*

<sup>91</sup> <http://www.thehindu.com/features/magazine/a-looming-crisis/article5124157.ece>

<sup>92</sup> Using RBI exchange rates for respective years as on March 31 of each year

## Electronic Items





## Estimates of Smuggling of Key Goods/ Products

Electronic items as market definition include both electronic products and components. As per a report, market for electronics items in 2015 touched US \$75 bn of which electronic products contributed about 82% of the market with components contributing the remaining portion. The electronics products have grown from US \$ 50.9bn in 2013 at CAGR of 10.1% to US\$61.8bn in 2015. The electronics components have also risen from US \$ 10.8 bn in 2013 at CAGR of 11% to reach the levels of US \$13.5 bn in 2015.

The electronics market in India is witnessing an exponential rise and expected to grow at a CAGR of 41.7% to reach at US \$400 bn by 2020. However, considering the typical rate of growth of domestic production, it will be able to meet demand of about US \$100 bn only. Given the limitations of domestic production,

where majority of value addition is still in the final assembly line, domestic demand is largely fulfilled by imports.

### Research Findings

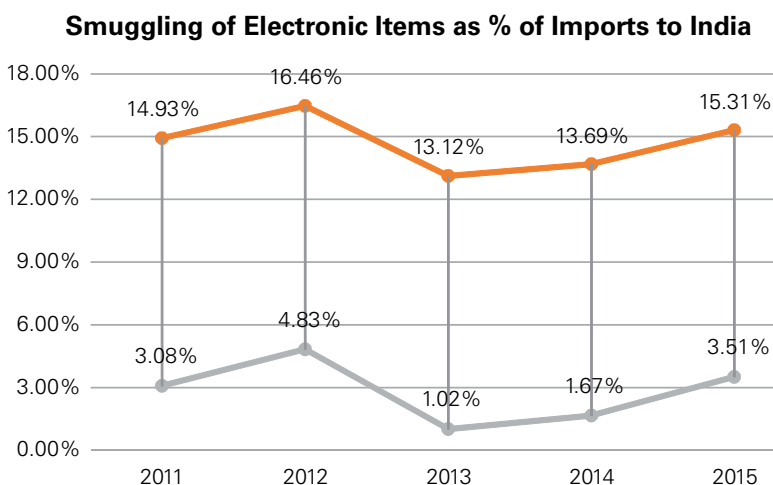
Under the Harmonized Commodity Description and Coding System, electronic items are recorded under the 2-digit HS code 85. Four digit HS codes for electronics items selected for this study are given in annexure 2.

The table below provides world exports of electronics items to India and adjusted imports of electronics goods by India after adjusting for the CIF- FOB margin and other errors at 21% and 10%. As explained in methodology section, the mirror statistics should provide us technical smuggling taking place through legal channels.

Technical Smuggling in Electronic Items ( US\$ Mn)					
Year	World Reported Exports to India	Adjusted Imports: CIF-FOB margin @ 21%	Adjusted Imports: CIF-FOB margin @ 10%	Technical Smuggling: CIF - FOB margin @21%	Technical Smuggling: CIF - FOB margin @10%
	A	B	C	D=A-B	E=A-C
<b>2011</b>	20,345	17,308	19,718	3,037	627
<b>2012</b>	18,398	15,369	17,509	3,029	889
<b>2013</b>	18,347	15,940	18,159	2,407	188
<b>2014</b>	20,448	17,649	20,107	2,799	341
<b>2015</b>	24,503	20,752	23,642	3,751	861
<b>Average</b>	20,408	17,404	19,827	3,004	581

Source: Authors' Calculations, UN COMTRADE Database

Based on adopted methodology, the extent of smuggling in electronics items ranges at an average between US\$ 581 Mn and US\$ 3004 Mn during 2011 to 2015. Data reveals that technical smuggling of electronic products has suddenly increased in 2015 and maximum in last 5 years. Technical smuggling as percentage of world exports to India on an average ranges between 2.82% to 14.70% during period. The graph below presents the year wise range of smuggling of electronic products in India.



Source: Authors' Calculations, UN COMTRADE Database

<sup>93</sup> Turning the "Make in India" dream into a reality for the electronics and hardware industry, ASSOCHAM and ET, April 2016

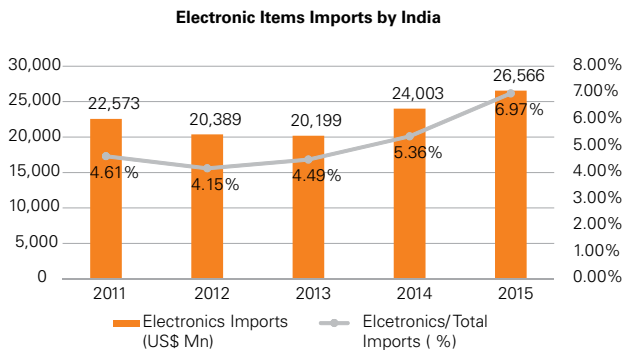
<sup>94</sup> <http://www.india-opportunities.es/archivos/publicaciones/Electronics-january-2016.pdf>

<sup>95</sup> ELCINA

A further analysis of seizure of smuggled electronic products vis-à-vis technical smuggling suggests that average ratio for electronic products during period 2011-2015 ranges between 0.62% and 1.09%. The ratio is less than 1% and also shows a decreasing trend.

Electronics items are third most imported products contributing to nearly 7% of the import basket of India. Low levels of seizures in comparison to the quantum of imports reflects that outright smuggling in electronic products is low and smuggling largely takes place through technical ways and means to evade duties. Further, financial incentives in comparison to products like cigarettes are not sufficiently high to induce outright smuggling. Many of the high technology products, such as telecommunication equipment, semiconductors, semiconductor manufacturing and testing equipment, software, scientific instruments, as well as most of the parts and accessories of these products are covered under Information Technology Agreement (ITA) that attracts zero or minimal customs duties.

The smuggling in electronic products can also be explained by the demand supply gap in domestic market. Graph below shows greater reliance on the imports to meet country's demand of electronics products. Higher demand supply gap and value of electronic items makes it more susceptible to technical smuggling.



Source: DGCIS data

Electronics manufacturing is an intensive research and development area and requires large capital expenditure. The local value addition in electronic products in India is still

limited and majority of manufacturing is only in the final stage assembly line. Considering low level of R&D and state of manufacturing of electronic products, dependency mainly lies on the imports of electronic products and components. According to a report, around 50% - 60% of the domestic demand of the electronic products is met through imports. For electronic components, reliance on imports is much higher as it fulfils around 70% - 80% of the demand.

China (including Hong Kong), Korea, Malaysia, Singapore and Vietnam are key countries that account for nearly 85% of the electronics items imports by India. Analysis of mirror statistics from UN COMTRADE after adjusting CIF-FOB @10% shows that technical smuggling in electronic goods is mainly taking place through Singapore, Hong Kong, Korea, Vietnam and USA. Electronic product and components like electronic integrated circuits and micro assemblies (HS code 8542), television receivers, video monitors and projectors (HS code 8528) and transistors, diodes and semi-conductors (HS Code 8541) are among key products in which highest technical smuggling is observed. This in line with fact that India has very limited component supplier base and relies on imports for these high value or critical components.

**Average per annum smuggling in Electronics Items ranges from US\$ 581 million to US \$ 3004 million, equivalent to ₹ 3,353 crores to ₹ 17,516 crores.<sup>96</sup>**

### Summary of Findings

The following table presents the summary of findings for the extent of smuggling in India in identified goods/products. The figures are averages for the period 2011-2015.

Extent of Smuggling in India (in ₹ crores)	
Gold	(15,637) – (41,896)*
	20.9 – 48.0**
Machinery and Parts	26,561 – 41,586
Cigarettes#	7,561 – 8,946
Fabrics, Silk and Yarn	5,390 – 8,038
Electronic Items	3,353 – 17,516

\* 'Negative Smuggling (arising out of over-invoicing of quantity of imports and under-declaration of value per tonne)

\*\* Under valuation per tonne of gold

# Increase from 2013 to 2015

<sup>96</sup> Using RBI exchange rates for respective years as on March 31 of each year



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**Section IV: Legal and Institutional Framework for  
Control of Smuggling**

## Section IV: Legal and Institutional Framework for Control of Smuggling



Smuggling takes place when unscrupulous elements try to evade the duties leviable and bypass various prohibitions/restrictions in relation to imports by attempting to bring the goods into the country from places other than the notified ports/airports/Land Customs Stations without reporting or presenting the goods to Customs.<sup>97</sup>

The legal framework governing the control of smuggling in India are based on two regulations, namely: the Customs Act, 1962 and the Smugglers and the Foreign Exchange Manipulators (Forfeiture of Property) Act, 1976. This section briefly discusses provisions of these two acts aimed at dealing with smuggling activities and smugglers.

### Customs Act, 1962

The Customs Act, 1962 is the basic statute which governs and regulates the entry and exit of different categories of vessels, crafts, goods, passengers, etc. into or outside India. According to the Act, as stated earlier, Smuggling is defined as “as any act or omission which will render goods ‘improper imports’ and liable to confiscation.”

Section 115- Conveyances (vessels, vehicles or aircraft)

- Conveyance used in smuggling activities, or if goods are thrown overboard to evade seizure, or unloaded without permission of proper officer

Section 118 - Packages and their contents

- In case of goods imported in a package liable for confiscation, the package and its other contents are also liable for confiscation

Section 119 - Cover goods

- Goods used for concealing smuggled goods are also liable for confiscation

Section 120 -Smuggled goods mixed with other goods

- Smuggled goods can be confiscated even if they have changed their form or are in an inseparable mixture form with other goods

Section 121 - Sale proceeds of smuggled goods

- Sale-proceeds from smuggled goods are liable to confiscation

Confiscation means seizure of private property by the Government without compensation to the owner, often as a consequence of conviction for crime, or because possession or use of the property was contrary to law. A customs officer can authorise seizure of goods if he has good reasons to believe that goods are liable for confiscation under section 110 of the Act, as in case of smuggled goods. The sensitive goods, like narcotics and arms which are prohibited under the Act are absolutely confiscated.

### Coverage of Smuggling

The specific violations that come under definition of smuggling, under which the “improper imports” are liable for confiscation are enumerated under section 111 of the Customs act, 1962. The lists of activities considered as smuggling or “improper imports” have been given in the annexure -I to this report. Apart from section 111, smuggled goods can also be confiscated under the following provisions of the Customs Act 1962:

Source: Customs Act, 1962 with consequent amendments

<sup>97</sup> Customs Manual, 2015, CBEC, GOI



## Legal and Institutional Framework for Control of Smuggling

### Powers of the Customs Department

The Customs Act, 1962 confers sufficient authority to the Customs officers to act as quasi-judicial authorities and adjudicate duty, fines, penalties etc. It empowers Customs officers to carry out searches, arrests and prosecution of persons involved in such offences related to smuggling and lays down the procedures for imposing the penal provisions before action is taken against offending goods, persons or conveyance (vessels, vehicles or aircraft) involved in the violations.

The officers of customs department has adjudication authority under section 122 of the act which is based on value of confiscated goods:

Adjudicating Officer	Value of goods liable for confiscation
Commissioner/Jt. Comm.	No limit
Assistant/Deputy Comm.	Not exceeding ₹ 5 lakh
Gazetted officer of lower ranks	Not exceeding ₹ 50,000

Source: Customs Act, 1962 with consequent amendments

Special provisions of Customs Act to effectively deal smuggling includes: <sup>98</sup>

### Burden of proof

One of the significant changes in the Customs Act of 1962 is that of burden of proof. After 1973 amendment, the burden of proof in case of smuggling is on the person from whose possession the goods were seized or who claims to be the owner of the goods seized u/s 123. It applies to seizure of gold and manufactures thereof, watches and any other class of goods which the union government notifies.

### 'Mens rea'

Mens rea is standard common law test of criminal liability expressed in the Latin phrase "actus reus non facit reum nisi mens sit rea"; i.e. "the act is not culpable unless the mind is guilty". Customs department does not have to prove "mens rea" for imposing penalty. The penalty depends on the gravity of the offence and is meant to act as a deterrent.

### Civil and Criminal Liabilities/Punishments for Smuggling

The Customs Act of 1962 provides for civil and criminal punishments. The civil punishment involves confiscation of goods and imposition of penalty by the departmental authorities. In grave offence cases, the Customs Act of 1962 provides for prosecution with imprisonment up to a maximum of 7 years. This involves criminal proceedings in a court of law, after sanction from the competent Customs officer.

<sup>98</sup> Customs Manual, 2014, CBEC, Department of Finance, GOI

### Penalties for Smuggling Activities

Penalty for improper import of goods liable for confiscation is ₹ 5,000 or value of such goods/ duty payable, whichever is higher u/s 112.

Offence	Penalty
(i) Prohibited goods	Value of goods or ₹5,000, whichever is higher
(ii) Dutiable goods, other than prohibited goods	Not exceeding 10 percent of the duty sought to be evaded or ₹5,000 whichever is higher
(iii) When declared value is higher than value thereof	Difference between declared value and value thereof or ₹5,000, whichever is higher
(iv) Goods falling in both (i) and (iii)	Value of goods or the difference between declared value and value thereof or ₹5,000, whichever is highest
(v) Goods falling under both (ii) and (iii)	Duty sought to be evaded or difference between declared value and value thereof or ₹5,000, whichever is the highest

Source: Customs Act, 1962 with consequent amendments

Customs Acts 1962 allows imposition of penalties for smuggling related activities:

#### Short-levy or non-levy (Section 114A)

In cases of non-levy/short-levy of duty or interest or erroneous refunds by reason of collusion or any wilful mis-statement or suppression of facts, the concerned person is liable to pay the duty or interest ( section 28 (8)) and also required a pay penalty equal to the duty or interest so determined. Further, if such amount, along with interest and penalty, is paid within 30 days, the penalty gets reduced to 15% of the duty or interest, amended in 2015 from 25%.

#### Use of false and incorrect material (Section 114AA)

If a person knowingly or intentionally uses false and incorrect material in the transaction of any illicit trade, he may be penalised upto five times the value of goods.

#### Person in charge of conveyance (Section 116)

If any goods loaded in a conveyance for import into India, or any goods transhipped under the provisions of this Act or coastal goods carried in a conveyance are not un-loaded at their place of destination in India, or if the quantity unloaded is short of the quantity to be unloaded at that destination, and if the failure to unload or the deficiency is not accounted for to the satisfaction of the Assistant Commissioner of Customs or Deputy Commissioner of Customs, the person-in-charge of the conveyance shall be liable for:



Offence	Penalty
(a) in case of goods loaded in a conveyance for importation into India or goods transhipped under the provisions of this Act	not exceeding twice the amount of duty that would have been chargeable on the goods not unloaded or the deficient goods, as the case may be, had such goods been imported
(b) in the case of coastal goods	not exceeding twice the amount of export duty that would have been chargeable on the goods not unloaded or the deficient goods, as the case may be, had such goods been exported

Source: Customs Act, 1962 with consequent amendments

### Criminal Proceedings

The Customs Act of 1962 also provides for criminal prosecution in a court of law for serious offences to effectively tackle smuggling, apart from penal action by the department. Such serious offences include:

#### Outright smuggling

- Outright smuggling of high value goods such as precious metal, restricted items or prohibited items or goods notified u/s 123 of the Act, where the value of offending goods exceeds ₹ 20 lakh

#### Import of trade goods involving wilful mis-declaration

- Import of trade goods involving wilful mis-declaration in description of goods/concealment of goods covered u/s 123 with a view to import restricted or prohibited items and where the CIF value of offending goods exceed ₹ 50 lakh

The grounds spelled out for arrest are: false declaration / false documents (section 132); obstructing officers of Customs (section 133); evasion of duty or prohibition (section 135).

All offences covered under section 104(6) were bailable till 2013. However, with the rising threat of smuggling in the country, a major amendment was made to this section in 2013, where certain offences described below were made non-bailable that are:

- Evasion or attempted evasion of duty exceeding ₹50 lakh;
- Prohibited goods;

- Import of any goods not declared under provisions of the Act, whose market price exceeds ₹1 crore;
- Fraudulently availing of or attempt to avail of drawback or any exemption from duty, if such drawback or exemption exceeds ₹50 lakh.

The Commissioner will sanction prosecution only after being satisfied, based upon the results of investigations and evidence brought on record, that there are sufficient reasons justifying criminal prosecution. Prosecution is normally launched after completion of adjudication proceedings. But in certain offences relating to items like fake Indian currency notes, arms, ammunitions and explosives, antiques, art treasures, wild life items and endangered species of flora and fauna may be launched immediately after the show cause notice.<sup>99</sup>

### Smugglers and Foreign Exchange Manipulators (Forfeiture of Property) Act, 1976

This law provides for the forfeiture of properties illegally acquired by smugglers and foreign exchange manipulators. Applicability of this regulation is covered under following laws and action for forfeiture of illegally acquired property can be taken against every person and its relative or associate.<sup>100</sup>

#### Sea Customs Act of 1878

#### Customs Act of 1962

#### Foreign Exchange Regulation Act of 1947 and 1973

#### Conservation of Foreign Exchange and Prevention of Foreign Exchange and Prevention of Smuggling Activities Act (COFEPOSA) of 1974

The illegally acquired property is forfeited to the union government by the 'Competent Authority' so appointed by the government under the law. The Competent Authority and the Appellate Tribunal for Forfeited Properties have the powers of a civil court in these matters and has powers to take possession of property on which fine is not paid within due time.

As in Customs Act of 1962, the burden of proof is on the person affected.

<sup>99</sup> Guidelines for launching of prosecution in relation to offences punishable under Customs Act, 1962- reg., Circular No. 27/2015-Customs, Oct. 2, 2015

<sup>100</sup> <http://www.cadelihi.gov.in/content/page/forfeitureunder.html>

## Legal and Institutional Framework for Control of Smuggling

### Penalties for Smuggling Related Activities

The Competent Authority, after hearing may pass such order, as it deems fit, either forfeiting properties to the union government free from all encumbrances or releasing some or all of them after recording a finding in respect of each property.

If more than 50% of the source of funds invested in the purchase of property identified for forfeiture is explained satisfactorily, the Competent Authority shall give an option of paying in lieu of forfeiture and a fine equal to one and one fifth times the value of such part after affording him with an opportunity of being heard.

### Structure and functioning of key enforcement agencies

The Central Board of Excise and Customs (CBEC) is the key enforcement agency in India as far as anti-smuggling activities are concerned.

#### Central Board of Excise and Customs

CBEC is the nodal agency for formulation of policy concerning levy and collection of customs duty as well as prevention of smuggling. It is the administrative authority of various subordinate organisations looking into various aspects of governance relating to customs duty and smuggling. Some of its key functions include:<sup>101</sup>

Collection of customs duties on imports and exports;

- Enforcement of the Customs Act of 1962;
- Enforce prohibition and restrictions on import and export;
- Prevention of smuggling and
- International passenger clearance.

CBEC has various field formations to levy and collect revenue and prevent smuggling under the Customs Act of 1962. These include 11 zones of Customs & Customs (Preventive) and 35 Commissionerates spread across the country.<sup>102</sup> These commissioners have been given the task of:

- Implementation of the Customs Act of 1962 and the allied acts, which includes levy and collection of customs duties and enforcement functions in their earmarked jurisdiction (Commissioners of Customs) and
- Surveillance of coastal and land borders to prevent smuggling activities. Marine and telecommunications wings are available with the Board to assist these Commissionerates in their anti-smuggling work and surveillance of sensitive coastline (Commissioners of Customs (Preventive)).

In addition to the Customs Act, the Customs Department also works to ensure compliance with various other national and international laws and regulations. It is the responsibility of the Customs to handle international traffic speedily and effectively while ensuring that all movement of goods and passengers across the national borders are in conformity with the laws of the land.

Appellate and adjudication machinery of the CBEC has 67 Commissioners of Central Excise and Customs (Appeals). There are four Commissioners (Adjudication) – one each in Mumbai, Delhi, Chennai and Bangalore who deal with both customs and excise related cases. In addition, the union government has appointed 11 more Commissioners (Appeals).

### Anti-smuggling machinery

There are two key units of CBEC which work for preventing smuggling – Directorate of Revenue Intelligence (DRI) and Directorate of Logistics (DoL).

#### Directorate of Revenue Intelligence (DRI)

DRI is a major intelligence agency working under CBEC to prevent smuggling. It was constituted on 4th December 1957 and exercises all the powers specified in Section 100, 101, 103, 104, 106, 107 and 110 of the Customs Act, 1962. DRI has established an intelligence gathering network which relies on traditional human intelligence resources as well as contemporary technical gathering tools.

DRI collects, analysis and disseminates intelligence to the field formations, helps in investigation and keeps statistics of seizures and prices/rates etc, for watching trends of smuggling, movement of other contraband and suggests remedies for fixing loopholes in existing laws and procedures.

The charter<sup>103</sup> of the organization lists the following activities:

- Collection of intelligence about smuggling of contraband goods, narcotics, under-invoicing etc. through sources of India and abroad, including secret sources;
- Analysis and dissemination of such intelligence to the field formations for action and working on such intelligence, where necessary;
- Keeping watch over important seizures and investigation cases. Associating or taking over the investigations which warrant specialized handling by the Directorate;
- Guiding important investigation/prosecution cases. Keeping liaison with foreign countries, Indian Missions and Enforcement agencies abroad on anti-smuggling matters;

<sup>101</sup> Customs Manual, 2015, CBEC Customs Manual, 2015; CBEC, Department of Revenue, GOI.

<sup>102</sup> <http://www.cbec.gov.in/htdocs-cbec/info-act/customs/customs>

<sup>103</sup> <http://dri.nic.in/home/charter>

- To keep liaison with C.B.I. and through them with the INTERPOL. To refer cases registered under the Customs Act to the Income Tax Department for action under the Income Tax Act;
- To keep statistics of seizures and prices/rates etc. for watching trends of smuggling and supply required material to the ministry of Finance and other ministries
- To study and suggest remedies for loopholes in law and procedures to combat smuggling. The investigations carried out by DRI are done in accordance with the provisions of the Customs Act 1962. Details of investigations conducted during the year are maintained in the database called in DRI Profiling System (DRIPS) along with the status of show cause notices.

Headed by a Director General, DRI has 7 zonal units across India. These units are further divided into several regional, sub-regional and intelligence units. The working strength of DRI is 544 against sanctioned strength of 740. However, the percentage of the deputation staff is about 43% of the posted strength and average vacancy is at 26.50. DRI uses IT systems for the Intelligence Support System (ISS) and DRI Profiling system (DRIPS). All headquarters and zonal offices are well connected with these IT systems.<sup>104</sup>

### Intelligence/ Information Gathering Mechanism

DRI receives Information through various sources such as e-mails, phone calls, personal visits, and post etc. Once information is received, it is examined and analysed for its prima facie authentication for further actions. The intelligence / information is recorded under DRI -1 database (a specific mechanism for recording of information which also enables the informer to reward). In addition to information, DRI also detects and investigates technical smuggling cases on the basis of intelligence gathered and developed on the basis of import/export data.<sup>105</sup>

The informers and the Government servants are eligible for reward up to 20% of the net sale proceeds of the contraband goods seized and/or amount of the duty evaded plus amount of the fine and penalty levied/ imposed and recovered.<sup>106</sup>

The Customs Overseas Intelligence Network (COIN) unit of the DRI gathers information from overseas or information as requested by the Zonal units.

### Investigation and Adjudication

Investigation is done by DRI under the various provisions of the Customs Act, 1962. Database of investigations during the year is maintained in the DRI profiling system along with status of the show cause notices (SCN). SCN are issued after investigation is over within the stipulated time period of six months. Special extension is taken as provided for in section 110 of the customs act 1962, where goods are seized during investigation, unless provisional release of goods is allowed. In case of the duty evasion in imports, whenever the extended period of 5 years is invoked in terms of the section of 28 of the customs act 1962, SCN has to be issued within 5 years.<sup>107</sup>

The adjudication of cases lies with the adjudicating authority which is part of the Commissionerate system. A copy of the adjunction order is sent to the respective DRI Zonal Unit for updating of the adjunction records in DRIPS. However, DRI does have monitoring of adjudication of SCNs.

### Coordination and Information Sharing

Information are shared with zonal units, field formations and other ministries and departments on case to case basis depending on the nature of information/ intelligence. Sharing of intelligence/ information is done with other agencies such as ED, IT etc through central economic intelligence bureau (CEIB), and regional Economic Intelligence committee (REIC) meetings that are held periodically. DRI is the nodal agency for contact with Regional International Liaising office (RILO) that works under the umbrella of the World Customs Organisation (WCO).<sup>108</sup>

### Directorate of Logistics

Directorate of Logistics (DoL) is an attached office of CBEC which provides logistical support to prevent smuggling. It was set up in 1979 by re-organising the Directorate of Anti-smuggling, Directorate of Communication and Directorate of Marine to co-ordinate all the activities related to anti-smuggling (logistics) under the CBEC.

DoL has its headquarters at New Delhi and is under the supervisory control of a Commissioner rank officer. It has a multilevel structure, constituting three divisions – Anti-smuggling, Communication and Marine Divisions. It is the nodal agency to monitor the logistical requirements of field formations pertaining to the three divisions. It works in close co-ordination with the CBEC, Chief Commissioners and Commissioners of Customs & Central Excise including DGDR. I.

<sup>104</sup>Chapter II Working of DRI, Report No. 8 of 2015, Union Government of India ( Indirect Taxes)

<sup>105</sup>Chapter II Working of DRI, Report No. 8 of 2015, Union Government of India ( Indirect Taxes)

<sup>106</sup>Ministry of Finance circular no. R-13011/6/2001-Cus (AS), 20th June 2001

<sup>107</sup>Chapter II Working of DRI, Report No. 8 of 2015, Union Government of India ( Indirect Taxes)

<sup>108</sup>Chapter II Working of DRI, Report No. 8 of 2015, Union Government of India ( Indirect Taxes)

## Legal and Institutional Framework for Control of Smuggling

The function of these three Divisions of this Directorate have been enumerated in the said circular and are summarized below:

Anti-Smuggling Division	Communication Division	Marine Division
Assessment of the needs of Anti-Smuggling Equipment (including arm & ammunitions) of field formation, formulation of proposals for their purchase, obtaining of sanctions from the Ministry and acquisition, installation/distribution of the same.	Examining proposals for appropriation/condemnation of vessels received from maritime Commissionerates and extending technical support.	To plan and formula to wireless communication proposals for Customs Preventive Commissionerates and obtaining sanctions from the Ministry for acquisition of wireless equipment.
Monitoring of the stocks of seized, confiscated and ripe for disposal goods with the Commissionerates.	Procurement and supply of technical and general sea stores through Central Stores Yard, Mumbai.	Distribution of wireless equipment amongst the Commissionerates and monitoring wireless traffic passed over the wireless networks.
Inspection and stocks taking of the anti-smuggling equipment and stocks of seized, confiscated and ripe for disposal goods in the anti-smuggling wings of the Commissionerates/Custom Houses.	Overall supervision and control over the four workshops for repair of the vessels.	Providing support for the maintenance and repair of wireless equipment in the Commissionerates and Inspection thereof, and training of telecommunication staff.
Maintenance of statistical data bank relating to Investigations, Adjudications, Rewards, Prosecutions stocks and disposal of goods and preparation of monthly Performance Indicators bulletin.	Maintaining statistical data pertaining to crafts and crew.	Coordination with regional command Security Committees under Ministry of Defence in the matters relating to breaches of communication security.
Loaning of seized/confiscated arms to departmental officers and acquisition and deployment of Sniffer dogs.	Recruitment of trained and disciplined technical personnel for operating vessels, workshops and Central Stores Yard.	

Source: Directorate of Logistics, (<http://www.dolcbec.gov.in>)

This Directorate caters to the needs of about 66 operational Customs Stations alongwith international borders, 94 ports including 12 major ports and 36 international ports handling cargo and baggage, besides foreign post offices and Land Customs Stations, ICDs etc. which too are vulnerable to smuggling. Thus, DoL provides logistical support at the land and at the sea. There are designated Chief Commissioner of Customs to handle passengers and air-cargo – imports and exports.

All smuggling related activities of import and export in India are governed through a structured machinery under the statute of law. Customs authorities have continued to make all efforts to curb illicit trade and facilitate movement of legal trade. The Government of India too has, in their support, made regular amendments to the Customs Act, 1962 to suit the changing environment and rising threat of smuggling. Yet, there are leakages in the process which result in huge losses to the government and industry. There are several constraints faced by the Customs authorities which hamper their efficiencies. The next section discusses these in greater detail.







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**Section V: Challenges in Dealing with Smuggling**

## Section V: Challenges in Dealing with Smuggling



Smuggling is a widespread phenomenon, entrenched into the trade systems of most countries. National Customs and border enforcement agencies face the formidable task of facilitating the flows of licit/legal trade while concurrently disrupting illicit trade flows and dismantling organisations involved with smuggling operations. This parallel mandate can lead to operational inefficiencies within the Customs agencies leading to increased cost, delivery disruption, time delays, interruptions in the smooth flow of products and services, traffic and port congestion etc.<sup>109</sup>

The rapidly changing global trading environment, marked by steadily growing volumes and complexity of supply chains, and heightened

security concerns have had a large impact on the role and functions of Customs administrations everywhere. On the one hand, globalisation has been an engine of economic growth, enhancing the importance of the trade facilitation role of Customs. On the other, it continues to offer new opportunities for criminal organisations to engage in new types of frauds, posing multidimensional challenges to Customs administrations.

This section discusses the structural and operational challenges that the Customs authority in India face in controlling the spread of smuggling. These are:



<sup>109</sup>Lee, HL & Whang, S 2005, 'Higher supply chain security with lower costs: lessons from total quality management', International Journal of Production Economics, vol. 96, no. 3, pp. 289-300.

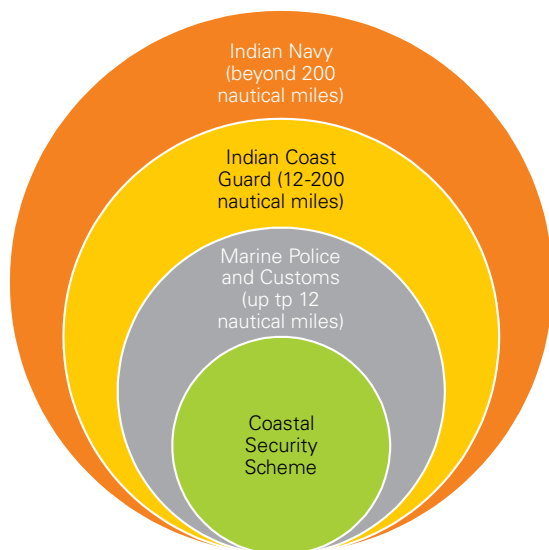
## Challenges in Dealing with Smuggling

### Large and Porous Borders

India's geographical size is 3,287,590 square km with land boundary being 14,103 km long and coastline being around 7,000 km long.<sup>110</sup> Customs formations are deployed all along the border and extensive coastline.

India shares its land border with Bangladesh, Burma, Bhutan, China, Nepal and Pakistan. With the fencing of the western border, the risk of smuggling has considerably declined. The Indo-Nepal border and Indo-Bangladesh border, however, continue to be porous. Long and narrow boundaries with neighbours get it difficult to control and monitor the entry and exit of goods from the borders. Such boundaries make it costly and impossible to use advanced facilities and modern equipment at border bottlenecks. In such circumstances, risks of smuggling and venturing for the law violation increases.

India's coasts on the other hand are guarded by a well-organised coastal security plan involving the Navy, Coast Guard, Marine Police and Customs depending on the area covered. Customs occupy the innermost layer in this multi-layered approach to security. However, the vast coastline and cost in monitoring pose significant challenges in dealing with unscrupulous activities.



### Complexity of Transportation Geography

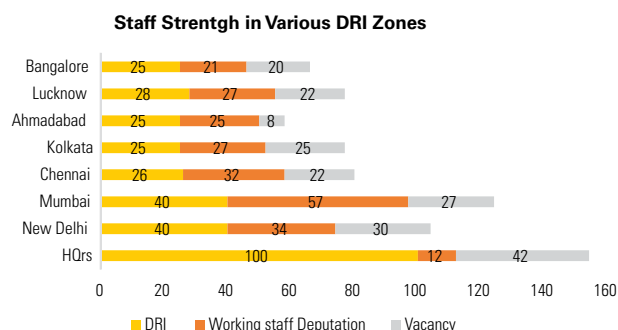
Analysis of transportation geography involves the examination of linkages between spatial constraints, attributes of the origin and destination, the extent, the nature, and the purpose of movements<sup>111</sup>. Such analysis in the context of trade movement is of particular importance to Customs and border control and

security agencies with respect to the facilitation of legitimate trade and deterrence of illicit trade.

Professional smugglers often have a good understanding of transport geography. They use this knowledge in making decisions regarding transportation routes, modes, use of specific transport infrastructure etc. The informal border crossings between two countries are often porous and traversed by foot, by horse or all-terrain vehicles. Moreover, resources at formal border checkpoints, such as drug-sniffer dogs are lacking, allowing smugglers to run rampant moving everything from illegal narcotics and illicit arms to oil and endangered wildlife.<sup>112</sup>

### Human Resource Constraints

Along with the sheer scale of managing the physical transport security of borders, Customs agencies are commonly faced with resource constraints. DRI faces severe resource crunch in most of its zones. As of March 2014, DRI had a working strength of 544 against a sanctioned strength of 740 staff members. There were accordingly 196 vacancies that constitutes 26.5% of total sanctioned staff. Moreover, 239 staff (43.2% of the total sanctioned staff) in DRI is on deputation which creates uncertainty that increases problems and does not allow staff to develop expertise of effectively dealing with smuggling.



Source: Report No.8 of 2015 - Union Government (Indirect Taxes - Customs)

### Lack of Adequate Infrastructure

The Compliance Audit Report of the Customs Department<sup>113</sup> that infrastructure available with Customs' agencies at Land, Air and Sea Custom Stations are not always adequate and sufficient. Like Air and Sea Ports, an institutional framework viz. Land Ports Authorities of India (LPAI Act 2010) was also established and entrusted with the responsibility of undertaking the construction, management and maintenance of Integrated custom port (ICPs) for regulatory and support functions in an integrated manner in one complex with a single agency.

<sup>110</sup><http://www.india.travelsphoto.com/india-facts.php>

<sup>111</sup>Rodrigue, JP, Comtis, C & Slack, I. (2006). The geography of transport systems. Routledge, New York, NY.

<sup>112</sup>Townsend, J (2006). The logistics of opiate trafficking in Tajikistan, Kyrgyzstan, and Kazakhstan. China and Eurasia Quarterly, 4 (1), 69-91.

<sup>113</sup>Report No.5 of 2016 Union Government (Indirect Taxes Customs)

These Customs stations and ICPs have outstanding issues duly supported by DRI, Local Risk Management (LRM) inputs with security implications impacting border control functions of Customs e.g. availability of full body truck scanners, inadequate system of examination of passenger baggage and passengers at passenger terminal; mechanism to inspect the purity of gold/ Precious stones; absence of facility of X ray/ non-intrusive investigation (NII) techniques, ICES coverage of Precious Cargo Customs Clearance (PCCC), Foreign Port Officer (FPO), hand baggage; access to Directorate of Valuation database, etc. This often led to smuggling of unauthorized goods and /or lack of facilitation.

Further, the monitoring of cargo management is manual, time taking and also not trade facilitative. The current system of reconciliation of cargo movement involves documents being forwarded from the station of import to the receiving station and returned with an endorsement for receipt of the cargo. This process is however dilatory, costly and unreliable since paper movement is involved.

### Lack of Knowledge and Practical Acquaintance of Enforcement Agencies

Law enforcement agency as the largest mission-centered institution in the country should educate people and spread awareness of its work. In the strategic policies of this agency, it is important and essential to pay attention and determine the real value of intellectual capital as an incentive to compete with organizations and to improve and better control security and order in society.<sup>114</sup>

In the backdrop of growing volumes and complexity of international trade, and the continuing expansion of ports, inland container depots, etc., the shortage of knowledge and skills leads to increasing thinning of its resources. This poses major challenge before the CBEC which clearly needs a strategic response.

Language barriers and cultural differences also hamper anti-smuggling activities by the Customs authorities. This, according to the Customs department<sup>115</sup>, is a peculiar problem in the south of India. The issues arise as selection is done by centralised Staff Selection Board (SSB), where large number of candidates from other regions and very few with knowledge of local languages and familiarity with local culture. The difficulties this creates are particularly acute in anti-smuggling operations, which involve posting in remote areas where such officers stand out and are easily identified as Customs officers. This makes it virtually impossible to maintain secrecy in their movements, an essential operational requirement. Further, intelligence gathering requires Customs officers to mix freely

and easily with the local population, which again is difficult because of the language barrier and cultural differences.

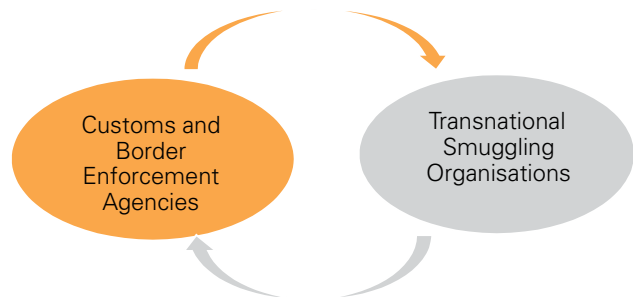
### Operational Polices of Customs Department

According to the Second TARC report<sup>116</sup>, though the Customs authority in India are better equipped to develop comprehensive intelligence on activities along the coast than the other agencies involved, this is mainly attributable to their traditional informer base and network, which enables them to tap information more easily from the people and fisherman. In spite of this, there are several operational difficulties that the personnel on the ground have to face.

One of the major problems is that despite having acquired a modern fleet, much of it is non-operational because of the difficulties in manning the boats. Due to this, these valuable assets remain underutilised. Further, there is very little encouragement or incentive for the personnel to develop specialisation in the anti-smuggling areas since the transfer policies adopted by the department involves regular rotation of officers. Considering the often inhospitable locations of many postings, this often has a great impact on the effectiveness of customs formations as unsuitable or unwilling personnel get posted to such check posts.

### Interdiction-Adaptation Cycle between Customs/Border Enforcement and Transnational Smugglers

Customs and border enforcement agencies in every country, through their activities, focus on interdicting and disrupting the flows of illicit trade by air, sea, and land. These initiatives utilise advanced technologies and control methods, customised for anti-smuggling efforts. All efforts are made to prohibit any kind of smuggling activity and protect the country borders. However, economists argue that it is these very interdiction initiatives by the Customs that trigger adaptation mechanisms among smugglers<sup>117</sup>. For any activity by the Customs to control or prohibit illicit trade, smugglers with their wide networks and technological support, devise ways to adapt to such increased security at the borders.



<sup>114</sup>Rayanpour, 2010

<sup>115</sup>Tax Administration Reform in India Spirit, Purpose and Empowerment Second Report of the Tax Administration Reform Commission Ministry of Finance, Government of India New Delhi September 2014

<sup>116</sup>Tax Administration Reform in India Spirit, Purpose and Empowerment Second Report of the Tax Administration Reform Commission Ministry of Finance, Government of India New Delhi September 2014

<sup>117</sup>Basu, G 2014b, 'Concealment, corruption, and evasion: a transaction cost and case analysis of illicit supply chain activity', Journal of Transportation Security, vol. 7, no. 3, pp. 209-26.

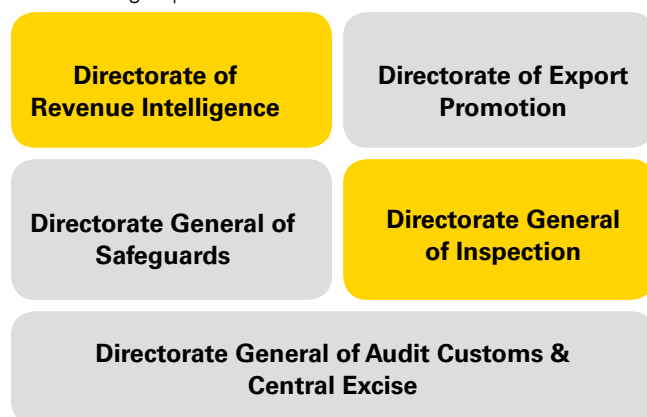


## Challenges in Dealing with Smuggling

The institutional friction generated between Customs/border enforcement agencies and transnational smugglers creates an interdiction-adaptation cycle where every action by the Customs is met with a counter action by the smugglers. This cycle can vary in time from days and months to years and decades, making it extremely difficult for the Customs agencies to effectively operate.

### Institutional and Inter-Organisational Coordination Problems

Effective and efficient control of illicit trade needs proper coordination within and across the various departments and agencies involved in the process. In India, Central Board of Excise and Customs (CBEC) has several field formations to help it discharge its responsibilities of levying and collecting customs duties and preventing smuggling under the Customs Act, 1962. It is assisted in specific customs related functions by the following department:<sup>118</sup>



According to the Second report<sup>119</sup> of the Tax Administration Reform Commission (TARC), Ministry of Finance, Government of India, there are often coordination problems between the various departments and with other governmental agencies in relation to border procedures. Hall<sup>120</sup> points out that from the time institutional governance structures began to be differentiated into departments and agencies there have been complaints that one agency does not know what the other is doing, and that their programmes are contradictory, redundant or both. He argues that evidence suggests that placing many disparate agencies and departments under one roof has created more coordination problems than it has solved.

Accordingly to Savoie and Peters,<sup>121</sup> coordination problems between and among institutions also arise due to politics and power, resulting in turf battles. Their study finds out that agencies that were the closest together ideologically were the most difficult to coordinate. Such organisations tend to fight over the same policy and budgetary resources, while more diverse organisations found cooperation less threatening. This is because, fighting over turf among similar organisations solidifies positions about the relative importance of their services.

### Safe and Secure Dissemination of Information

Usage and exchange of data or information often leads to challenges on its security and ethical use. The centralised data format, where-in data or information is aggregated in one place and used by many people, needs to have the correct balance between creating safeguards for organisational data and ease of use. The most rudimentary security technique to secure data is to apply access controls to the data where users are granted data access only on an as-needed basis.

Adopting and incorporating best practices around data security is imperative to maintain data integrity and privacy, prevent fraudulent use and ensure easy and efficient use of data and information.

According to the Second TARC report<sup>122</sup>, the present working of the CBDT, the CBEC, the Central Economic Intelligence Bureau and the Financial Intelligence Unit have not paid attention to setting up a robust mechanism for data or information exchange among each other. There is so far no openness or transparency for setting up an interoperability framework for data or information exchange.

### Weak Enforcement and Rule of Law

Weak enforcement and rule of law is one of the impediments to effectively deal with the smuggling menace. Delay in investigation of smuggling cases by the enforcement agencies take out the bite of deterrence mechanism and makes the entire exercise worthless. A Government of India report shows that as of March 2014, the percentage of investigations pending for more than six months ranged from 29 per cent to 73 per cent, with 3 cases pending in Kolkata for more than 5 years. In addition, there were 497 investigations (57 per cent) pending for more than six months of a total of 868 investigations, although as per section 110 of the Customs Act, 1962, SCNs are stipulated to be issued in a time period of six months.

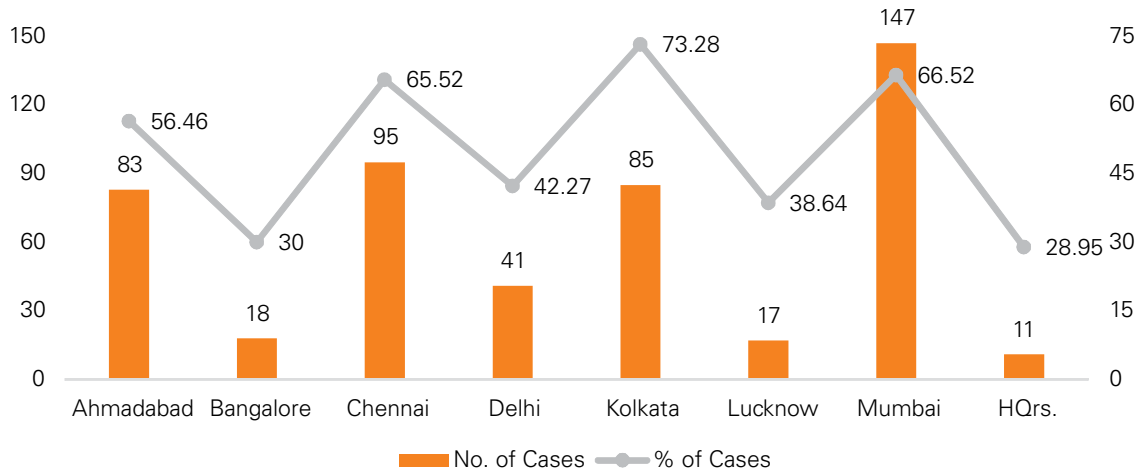
<sup>118</sup><http://www.cbec.gov.in/htdocs-cbec/deptt-othersites>

<sup>119</sup>Tax Administration Reform in India Spirit, Purpose and Empowerment Second Report of the Tax Administration Reform Commission Ministry of Finance, Government of India New Delhi September 2014

<sup>120</sup>Hall, R (1978). Interorganizational coordination in the delivery of social services', in L Karpik (ed.), Organization and environment: theory, issues, and reality. Sage, Beverly Hills, CA, pp. 110-38.

<sup>121</sup>Savoie, DJ & Peters, BG (1998). Programme review in Canada and United States, Canada Centre for Management Development, Ottawa.

<sup>122</sup>Tax Administration Reform in India Spirit, Purpose and Empowerment Second Report of the Tax Administration Reform Commission Ministry of Finance, Government of India New Delhi September 2014

**No. of Investigation Cases Pending for More than 6 months**


Source: Report No.8 of 2015 - Union Government (Indirect Taxes - Customs)

What makes the situation more serious is that the probability of a cognizable crime committed by a person being registered is 0.082. Further, the probability of conviction of that person for such crime is only 0.006.<sup>123</sup> Considering such a paltry rate of conviction, a person has rather low risks and high financial gains from involvement smuggling activities. This provides people greater incentives and motivation to involve such type of fraudulent act.

### Corruption and Coalition of Enforcement Agencies

Corruption among some enforcement agents at the borders leads to fixed-income jobs being subordinated to smuggling and it is only to be expected for smuggling agents to bypass legal mechanisms of importation of goods by lateral investments. One of the main objectives of these hidden investments is to attract cooperation or ignorance of some factors by the enforcement agents that will lead to the financial corruption and the result is silence or inaction of such brokers.<sup>124</sup>

In one of the recent cases detected by the Intelligence Bureau, Jabin an immigration employee working on deputation at Kochi International Airport was involved in a gold smuggling racket . He along with 32 people are alleged to have smuggled about 1.7

tons of gold in worth ₹ 400 crores in India between February 2012 and April 2015.<sup>125</sup>

### Emergence of E-Commerce

The emergence of e-commerce is creating a global, virtual and borderless marketplace. This has a direct correlation with the growth in express cargo, as this, together with the postal channel, is the primary mode for delivery of goods, bought over the internet, to consumers overseas. In future, with increase in customer demand due to changing lifestyles and the lack of time, the trade volume through internet channels is only expected to increase.

With the growth of e-commerce however, the global customs community is presented with the challenge of handling growing volumes of expedited clearances while maintaining sufficient control to prevent the abuse of this channel. A study<sup>126</sup> conducted to assess the correlation between smuggling and e-commerce concluded with statistical evidence that there exists a relation between the two with some industry sectors being more susceptible to smuggling via e-commerce. For example, the WCO Illicit Trade Report 2014<sup>127</sup> indicated an emerging trend in seizure cases - an increase in IPR-infringing goods transported in small consignments handled by express companies and by post.

<sup>123</sup>Bibek Debroy (2013), Corruption in Public Services, in Fighting Corruption - The Way Forward, ed. Samuel Paul. Academic Publishing, New Delhi

<sup>124</sup>Bakhtiyari, M., & Salarzaei, A. H. (2016). Causes and Factors Affecting the Crime of Tobacco and Goods Smuggling in Iran, 2(2), 52–57.

<sup>125</sup>Basheer, C. (2015). At 28 , this airport constable made Rs 8 crore. Written by Shaju Philip (<http://indianexpress.com/prople/author/shaju-philip/>) | Thiruvananthapuram | July 9, 2015

<sup>126</sup>Viboonthanakul, S. (2009) "Smuggling via e-commerce: effect on tax revenue", Journal of International Trade Law and Policy, 8 (3), pp.272 - 290

<sup>127</sup>World Customs Organization, Illicit Trade Report, 2014

<sup>128</sup>Emerging Challenges to Legitimate Business in the Borderless World, FICCI CASCADE – Grant Thornton 2015

## Challenges in Dealing with Smuggling

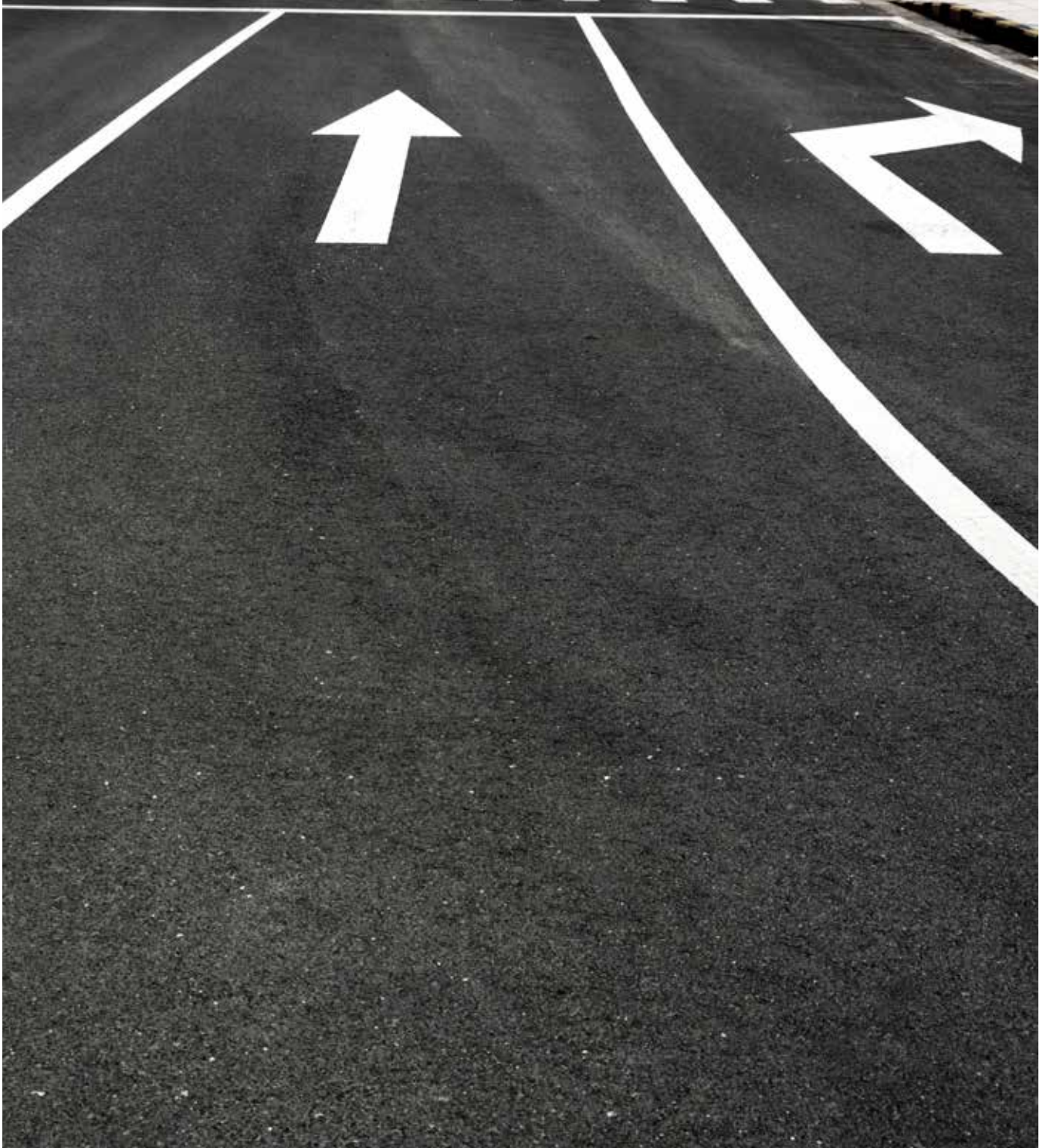
According to a FICCI Grant Thornton report<sup>128</sup>, as perpetrators of counterfeiting and smuggling activities become sophisticated, online marketplaces are increasingly coming to be a preferred hub for illicit trade, owing to their wider reach and ease of access. In the absence of any specific e-Commerce legislation in India, there is need for a separate e-Commerce law in the country to make online shopping a safe experience for the customers.

To cope with these diverse emerging challenges faced by them, Customs administrations have moved from the traditional administrative approach to a more strategically oriented and better compliance management approach. Their aim is to maximise voluntary compliance through strong and reliable risk management. Even so, there is a lot more that needs to be done to tackle this growing problem. The next section discusses the way forward and recommendations for the consideration of the government and industry in controlling the spread of smuggling.









**Section VI: Way Forward**



## Section VI: Way Forward



Smuggling severely harms the economy of a country in multidimensional ways. It undermines the local industry, suppresses innovation and investment, discourages legal imports, reduces the volume of revenues collected from duties and levies by the government, fuels transnational crimes and hampers the health of citizens. The ill effects of smuggling are felt widely across industries. In India, commodities where maximum smuggling takes place are drugs and narcotics, cigarettes, gold, silver, diamonds, machinery and parts thereof, arms and explosives, wristwatches, electronic goods and synthetic fibres. The extent of smuggling and the challenges faced by the enforcement agencies to control it signal toward the criticality of the problem faced by the country.

Smuggling is an economic offence broadly driven by the following motives:

- to evade customs duty
- to gain undue export incentive by over-valuation of exports
- to launder funds ill-gotten through invoice manipulation
- to evade prohibition under the Customs law and any other law governing anti-smuggling activities in the country

Globalisation has made possible vast increase in trade, more mobility and fast means of communication—all of which have made smuggling easier. Coordinated efforts of the government and industry bodies are therefore needed to control the spread of smuggling. This section discusses the possible way forward for the country to tackle the problem of smuggling and the recommendations for consideration. These are:

**Strengthening domestic manufacturing and reducing demand-supply gap**

**Stronger enforcement of: Punishments and Rule of Law**

**Leveraging Technology and boosting Innovation**

**Capacity building of Human Resource at Customs**

**Strengthening Risk Management Capabilities of Customs**

**Electronic Tracking System**

**Rationalisation of Tariffs**

**Better Coordination among various Enforcement Agencies**

### Strengthening domestic manufacturing and reducing demand-supply gap

To control the spread of smuggling, the most important and effective measure is to increase the country's domestic production and reduce the demand and supply gap. With rising incomes and growth of the economy, the demand for goods and products has been on a constant rise across industries. The supply or production however has not been able to match the demand resulting in increased dependence on imports to fulfil this gap.

The electronics and machinery sectors in particular have had to depend heavily on imports to fulfil domestic demand. Taking advantage of the situation, smugglers step in to supply these products at lower prices, by evading import duties, to fulfil domestic demand while a part of it is fulfilled through domestically produced counterfeit products.

To tackle this problem, it is imperative that the manufacturing sector in India is strengthened, as also envisaged by the government's flagship programme to boost manufacturing in India – "Make in India." Realising the need, Gol is increasing its focus on the electronics sector and aims to transform it from a predominantly consumption-driven market to one with manufacturing capability to cater to local and overseas demand while focusing on producing high-value add electronic products. Further, to boost the machinery sector, a definitive step taken by the government is through the National Capital Goods Policy 2016<sup>129</sup> which aims to increase production from ₹ 230,000 crores in 2014-15 to ₹ 750,000 crores in 2025 and raising direct and indirect employment from the current 8.4 million to round 30 million as well as facilitate improvement in technology, increase skills and promote growth and capacity building of MSMEs in the sector.

As far as the silk and yarn sector is concerned, India's dependence on imports has seen a consistent increase over the last 5 years. This has been mainly due to shortage of raw materials such as raw silk and cotton and its fluctuating prices. Therefore, there is imminent need for boosting the raw material base in the sector so as to make the sector self-sufficient to fulfil domestic demand.

Gold Monetisation Scheme<sup>130</sup> of the Finance Ministry of India is another effort by the government to help curb flooding of gold in the country through unofficial channels. Through this scheme, households and others are encouraged to part with idle gold lying with them in exchange for attractive interest rates. This gold will then be recycled in the economy thereby increasing the supply and reducing the demand-supply gap and ultimately to a large extent blocking the inlet of smuggled gold into the country.

### Stronger punishments and respect for Rule of Law

Increasing the rule of law and reducing corruption are most necessary to control smuggling. In order to reduce the size of smuggling in the country it is necessary to strengthen the deterrence mechanism for committing the crime. The customs law mandates penalties to be levied on those violating the law; however, these penalties may not always be enough to discourage smugglers from committing these crimes.

Further, even in cases where the crimes have been tracked and criminals arrested, the slow rate of prosecution and judgements encourages the smugglers to continue their crimes. For curbing the widespread menace of smuggling and sending out a message to those involved in the crime, it is important to expedite judgements in such cases so that there is enough deterrence for the criminals to curb their activities for the fear of law.

### Leveraging Technology and boosting Innovation

While it is impossible for the customs agency to physically monitor, control, and secure borders through manpower alone, the use of advanced technologies, such as unmanned aerial vehicles (UAV), embedded sensor and actuator solutions in transport assets, cargo shipment data mining with risk analytics, next generation surveillance cameras, x-ray technologies, and robotics, more so in the developed countries have aided Customs and border patrol agencies in deterring the flow of illicit trade and smuggling operations<sup>130</sup>. India too could follow such example, thereby reducing the burden on the Customs agency of detection and seizure of illicit goods. By leveraging technology, Customs can alleviate some of the burdens associated with managing the physical scale of transport geography.

Further, the process of induction of non-intrusive inspection technologies such as container scanners, X-Ray scanners, etc., needs to be expedited. A strong capacity for an innovative adoption of latest technologies through experimentation and pilots needs to be created.<sup>132</sup> With smugglers adapting quickly and efficiently to any new prohibition or rule by the customs, it is imperative for the customs department to invest in R&D to find out better ways to track down smuggling at international borders. The Directorate of Logistics needs to be strengthened and the required expertise in technology, procurement and contract management needs to be created and sustained in the directorate. It should regularly engage with industry and technical institutions to keep its knowledge current.

<sup>129</sup>National Capital Goods Policy 2016 (<http://dhi.nic.in/writereaddata/Content/NationalCapitalGoodsPolicy2016.pdf>)

<sup>130</sup><http://finmin.nic.in/swarnabharat/gold-monetisation.html>

<sup>131</sup>Basu, G. (2014). Combating illicit trade and transnational smuggling: key challenges for customs and border control agencies. *World Customs Journal*, 8(2), 16–25

<sup>132</sup>Tax Administration Reform in India Spirit, Purpose and Empowerment Second Report of the Tax Administration Reform Commission Ministry of Finance, Government of India New Delhi September 2014

## Capacity building of Human Resource at Customs

One of the major tasks that lie ahead of the Customs authority in India is to enhance the skills and capabilities of their staff as smuggling and illicit trade are growing and the means is becoming more and more sophisticated in nature. Along with new technology tools, it is important to enhance the analytical abilities of staff members to enable them to make extensive use of data analytics for identifying potential economic crimes. Capacities need to be built in ICT related areas such as computer forensics.

India could also follow the example of the European countries where electronic training is integrated with other forms of learning within Customs and Taxation training. The European Commission developed e-Learning courses on topics of common interest in collaboration with customs and taxation administrations and representatives of trade taxation.<sup>133</sup>

According to the Second TARC report<sup>134</sup>, direct recruitment of appraisers is a practice that CBEC has discontinued. In fact, the knowledge about different industry sectors, groups of commodities, etc., is acquired by appraising officers only in the course of their working. This has resulted in a drastic fall in the levels of knowledge and ability of the staff.

For enforcement to be effective, a sharper focus on the quality of investigation is essential. Therefore, it is imperative that investigative skills of the personnel are honed. It goes without saying that cases of deliberate fraud and those that involve a difference of opinion or interpretation need to be dealt with separately. The latter would usually involve technical issues in which there could be more than one opinion and need to be handled differently. Normally, the dispute resolution mechanism should be adequate to take care of such cases. The former on the other hand need detailed painstaking investigation that uncovers evidence, sufficient to sustain the case in prosecution; for prosecution is the strongest deterrent to such malfeasance.

There is also need for specialised training in anti-smuggling operations, which is tailored to specific requirements, including the peculiarity of local conditions in the diverse environment in which these operations have to be carried out. Considering the often inhospitable locations of many postings, this often has a great impact on the effectiveness of customs formations as unsuitable or unwilling personnel get posted to such check posts. Corrective measures need to be taken to incentivise willing and able officers to elect for such postings and stay there for a sufficient length of time to contribute effectively in keeping vigil along sensitive coasts and borders of the country. They may also be incentivised by provisions like special

allowances, the retention of government accommodation in places where adequate medical and educational facilities are available, etc.

## Strengthening Risk Management Capabilities of Customs Department

The Risk Management Division of the customs department needs to be substantially revamped and strengthened to enable it to support in developing programmes and policies to handle trade and at the same time improve risk assessment to levels of such accuracy where legitimate traders are not affected and illegitimate transactions are tracked down with ease.

The division must undertake constant evaluation of the performance of risk management systems (RMS) to ensure that there is sharpening of risk rules, targets or interventions inserted by the national and local risk managers to improve the quality of matches with suspect profiles. This will ensure that a large number of consignments are not unnecessarily checked, thereby adding to delays in clearance and associated costs on the one hand and waste of customs resources on the other. Under the current system, the local risk managers at the custom houses have the ability to insert targets and interventions for their respective locations.

Further, the customs agency must progressively move away from a local approach in risk management to a strong national approach and move towards setting up a national targeting facility such as the ones set up in US, Australia and New Zealand.<sup>135</sup>

## Electronic Tracking System

The current system of reconciliation of cargo movement involves documents being forwarded from the station of import to the receiving station and returned with an endorsement for receipt of the cargo. This process is however dilatory, costly and unreliable since paper movement is involved. According to the Customs department, this process is also not trade facilitative since trade has to wait long for the cancellation and return of bonds/guarantees executed by them.

To tackle this, deployment of an electronic tracking system that uses the GPS, GPRS technology is a possible solution not only to enhance Customs control over the movement of such cargo but also to ease procedural/documentation requirements, eliminating heavy paperwork. Customs should leverage the adoption of the emerging "internet of things" by the logistics industry to real-time tracking of movement of goods across the supply chain, including to CFSs, ICDs, SEZs etc. and eliminate dilatory, costly and unreliable paper based processes.

The benefits of such a system are many :<sup>136</sup>

<sup>133</sup> Taxation and customs union, European Commission, [http://ec.europa.eu/taxation\\_customs/eu-training/general-overview\\_en](http://ec.europa.eu/taxation_customs/eu-training/general-overview_en)

<sup>134</sup> Tax Administration Reform in India Spirit, Purpose and Empowerment Second Report of the Tax Administration Reform Commission Ministry of Finance, Government of India New Delhi September 2014

<sup>135</sup> Ibid

**Improving predictability of cargo and vehicle movement**

**Enabling live tracking of cargo/vehicle movement by customs, preparing for action against any breach**

**Facilitating cross-border transit/transport by simplified formalities and procedures at border points to remove congestion**

**Ensuring efficient fleet management for transport operators and container deployment for shipping lines**

Such systems have been conceptualised by the UNESCAP as the Secure Cross Border Transport Model (SCBTM) and are being applied in Thailand, PR China-Hong Kong border, Jordan, Kenya, etc., enabling live tracking of cargo vehicles and checking the integrity of the container seal.

Deployment of such technology in India will aid in enhancing Customs control over the significant volumes of cargo being transported without payment of customs duties and will also help in facilitating legitimate trade.

### Rationalisation of Tariffs

A major reason for flourishing of smuggling is the opportunity and arbitrage that it provides to smugglers to make money by evading taxes and duties. High taxes exacerbate the threat of smuggling especially in high value commodities such as gold and high in demand products such as cigarettes.

India, the highest importer of gold, faces a grave threat from smuggled variety due to the high import duty levied on legitimate import. An increase in the import duty in gold in Budget 2016 to 12.5% with input credit, has further encouraged smugglers to smuggle illegal gold into India through clandestine channels.<sup>137</sup>

As the report findings also suggest, cigarettes are also smuggled mainly through outright channels where duties are completely evaded. Customs seizure data also indicates that there has been a consistent rise in the outright smuggling of cigarettes in India.

To curb the threat of outright smuggling, it is imperative that import duties are rationalized to such an extent that it is no longer profitable for smugglers to carry out illegal imports through underground channels and such imports are carried out legally and brought into the formal trade channels where tracking is easier.

Buen and Eichler<sup>138</sup> argue that although tariffs protect domestic producers, they seem to provide an incentive for illegal trading activities. Thus, forming free trade areas and reducing tariffs could not only reduce this crime, it might be also beneficial for government revenues.

### Better Coordination among Smuggling Enforcement Agencies

The first report of TARC, Ministry of Finance, Government of India stated that “enhanced integration between the CBEC and CBDT would result in a more harmonious and convenient taxpayer experience. At the same time, greater sharing of information between them would reduce opportunities for fraud.” However while the two Boards hold bilateral meetings to understand mutual requirements and availability of data, they have not yet moved towards life cycle management of data – creating ‘one data and many users’.

In order to tackle the common menace of smuggling, greater capacity needs to be built in customs to counter trade based money laundering by greater use of analytics and strong co-ordination among the DRI, RMD, FIU and Directorate of Enforcement.

Smuggling is all pervasive with industry, government and society directly bearing its brunt. The extent of smuggling in the country is a cause of great concern. The customs department is doing its bit to manage legal trade movement and the parallel illegal channel. It has had to move away from the “gatekeeper” approach and are now investing heavily in technology, simplifying processes and recognising information as the basic lever of control. However, to effectively tackle the growing menace of smuggling in India, a lot more needs to be done to make the compliance and processes more robust and detection of such crime easier. Naturally, concerted efforts of the government and industry bodies are needed to achieve this challenging and mammoth task.

<sup>136</sup>Tax Administration Reform in India Spirit, Purpose and Empowerment Second Report of the Tax Administration Reform Commission Ministry of Finance, Government of India New Delhi September 2014

<sup>137</sup><http://www.thehindubusinessline.com/markets/gold/import-duty-hike-worries-gold-trade/article8296587.ece>

<sup>138</sup>Buehn, A., & Eichler, S. (n.d.). Uncovering Smuggling : Worldwide Evidence for Four Types of Trade Misinvoicing. Business. Retrieved from <http://eiit.org/WorkingPapers/Papers/Other/FREIT176.pdf>

## Annexures

### Annexure -1: List of Improper Import as per the Customs Act of 1962

As per section 111 of the Customs Act of 1962, the following goods brought into India from a place outside India are considered improperly imported goods and are liable to confiscation:

<b>(a)</b>	any goods imported by sea or air which are unloaded or attempted to be unloaded at any place other than a customs port or customs airport appointed under clause (a) of section 7 for the unloading of such goods;
<b>(b)</b>	any goods imported by land or inland water through any route other than a route specified in a notification issued under clause (c) of section 7 for the import of such goods;
<b>(c)</b>	any dutiable or prohibited goods brought into any bay, gulf, creek or tidal river for the purpose of being landed at a place other than a customs port;
<b>(d)</b>	any goods which are imported or attempted to be imported or are brought within the Indian customs waters for the purpose of being imported, contrary to any prohibition imposed by or under this Act or any other law for the time being in force;
<b>(e)</b>	any dutiable or prohibited goods found concealed in any manner in any conveyance;
<b>(f)</b>	any dutiable or prohibited goods required to be mentioned under the regulations in an import manifest or import report which are not so mentioned;
<b>(g)</b>	any dutiable or prohibited goods which are unloaded from a conveyance in contravention of the provisions of section 32, other than goods inadvertently unloaded but included in the record kept under sub-section (2) of section 45;
<b>(h)</b>	any dutiable or prohibited goods unloaded or attempted to be unloaded in contravention of the provisions of section 33 or section 34;
<b>(i)</b>	any dutiable or prohibited goods found concealed in any manner in any package either before or after the unloading thereof;
<b>(j)</b>	any dutiable or prohibited goods removed or attempted to be removed from a customs area or a warehouse without the permission of the proper officer or contrary to the terms of such permission;
<b>(k)</b>	any dutiable or prohibited goods imported by land in respect of which the order permitting clearance of the goods required to be produced u/s 109 is not produced or which do not correspond in any material particular with the specification contained therein;
<b>(l)</b>	any dutiable or prohibited goods which are not included or are in excess of those included in the entry made under this Act, or in the case of baggage in the declaration made u/s 77;
<b>(m)</b>	any goods which do not correspond in respect of value or in any other particular with the entry made under this Act or in the case of baggage with the declaration made u/s 77 in respect thereof, or in the case of goods under transshipment, with the declaration for transshipment referred to in the proviso to sub-section (1) of section 54;
<b>(n)</b>	any dutiable or prohibited goods transited with or without transshipment or attempted to be so transited in contravention of the provisions of Chapter VIII;
<b>(o)</b>	any goods exempted, subject to any condition, from duty or any prohibition in respect of the import thereof under this Act or any other law for the time being in force, in respect of which the condition is not observed unless the non-observance of the condition was sanctioned by the proper officer;
<b>(p)</b>	any notified goods in relation to which any provisions of Chapter IVA or of any rule made under this Act for carrying out the purposes of that Chapter have been contravened.



## Annexures

Annexure II - Four Digit HS Codes of Key Products for Determining Extent of Smuggling	
<b>Gold</b>	7108
<b>Machinery and Parts</b>	8402, 8403, 8404, 8405, 8406, 8407, 8408, 8409, 8410, 8411, 8412, 8413, 8414, 8415, 8416, 8417, 8418, 8419, 8420, 8421, 8423, 8424, 8425, 84231, 8432 8433, 8434, 8435, 8436, 8437, 8438, 8439, 8440, 8441, 8442, 8444, 8445, 8446, 844, 8448, 8449, 8451, 8452, 8453, 8454, 8455, 8456, 8457, 8458, 8459, 8460, 8461, 8462, 8463, 8464, 8465, 8466, 8467, 8468, 8474, 8475, 8476, 8477, 8478, 8479, 8480, 8481, 8482, 8483, 8484, 8485
<b>Tobacco</b>	2402
<b>Fabric/ Silk Yarn</b>	<b>50(Silk)</b> -5001,5002,5003,5004,5005,5006,5007
	<b>52(Cotton)</b> - 5201, 5202, 5203, 5204, 5205, 5206, 5207, 5208, 5209, 5210, 5211, 5212
	<b>53(Vegetable textile fibres /paper yarn/woven fabric)</b> - 5301, 5302, 5303, 5304, 5305, 5306, 5307, 5308, 5309, 5310, 5311
	<b>54( Manmade filaments)</b> -5401,5402,5403,5404,5405,5406,5407,5408
	<b>55(Manmade staple fibres)</b> - 5501, 5502, 5503, 5504, 5505, 5506, 5507, 5508, 5509, 5510, 5511, 5512, 5513, 5514, 5515,5516
	<b>56 (Wadding, felt, nonwovens, yarns, etc)</b> - 5601, 5602, 5603, 5604, 5605, 5606, 5607, 5608, 5609
	<b>58(Special woven or tufted fabric)</b> - 5801, 5802, 5803, 5804, 5805, 5806, 5807, 5808, 5809, 5810, 5811
	<b>59(Impregnated, coated or laminated textile fabric)</b> - 5901, 5902, 5903, 5904, 5905, 5906, 5907, 5908, 5909, 5910 ,5911
<b>60(Knitted or crocheted fabric)</b> -6001,6002	
<b>Electronics</b>	8517, 8518, 8519, 8520, 8521, 8522, 8523, 8524, 8525, 8526, 8527, 8528, 8529, 8532, 8533, 8534, 8540, 8541, 8542

### Annexure III - Notifications for Increase in Customs duty of Key Products

#### Changes in Customs Duty of Machinery and Parts

##### in Budget 2012-13

84.1 Basic customs duty on Marine seawater pumps with fibre impellers and Automatic fish/prawn feeder is being reduced from 10% to 5%. [S. No348 of notification No. 12/2012-Customs dated 17.03.2012 refers]

84.2 Basic customs duty is being reduced from 7.5% to 2.5% on specified Agriculture Machinery viz. Sugarcane planter, Root or tuber crop harvesting machines and Rotary tiller/ weeder. Parts and components required for manufacture of these items would also attract BCD@ 2.5%. [S. No399 of notification No. 12/2012-Customs dated 17.03.2012 refers]

84.3 The Concessional import duty regime of 5% basic Customs Duty + Nil CVD +SAD presently applicable to food grains and sugar under project imports scheme is being extended to goods required for installation of mechanized handling systems and pallet racking systems in mandis and warehouses for horticulture produce [S. No515 of notification No. 12/2012-Customs dated 17.03.2012 and notification No. 17/2012-Customs dated 17.03.2012 refers]

84.4 Full exemption from basic customs duty exemption is being provided to shuttle less looms, parts/components of shuttle less looms by actual users for manufacture, specified silk machinery viz. Automatic reeling silk reeling and processing machinery and their accessories including cocoon assorting machines, cocoon peeling machines, vacuum permeation machine, cocoon cooking machine, reeled silk humidifier, bale press and raw silk testing equipments.[S. No.406 of notification No. 12/2012-Customs dated 17.03.2012 refers]. The existing concessional duty rate extended to specified textile machinery is being restricted only to new textile machinery.

84.5 A concessional rate of 5% BCD is being extended to raw materials, intermediates required for the manufacture of parts of blades for rotors of wind operated generators. [S. No 362 of notification No. 12/2012-Customs dated 17.03.2012 refers]

84.6 An unconditional full exemption from Basic Customs Duty and additional duty of customs (CVD) is being provided to tunnel boring machines and parts and components thereof for use in the assembly of Tunnel boring machines. [S. No 397 of notification No. 12/2012-Customs dated 17.03.2012 refers] In addition the full exemption from basic customs duty and CVD is being extended to Tunnel Excavation & Lining Equipments consisting of Drilling Jumbos, Loaders, Tunnel excavators, Shotcrete Machines and 3 Stage Crushers for use in highway development projects [S. No 368 of notification No. 12/2012-Customs dated 17.03.2012 refers]

84.7 The benefit of existing exemption from Customs duty on Road Construction equipment is being extended to projects awarded by Metropolitan Development Authority also. [S. No 368 of notification No. 12/2012-Customs dated 17.03.2012 refers]

84.8 Basic customs duty on Power weeding machine for coffee plantations, Coffee grinder, Coffee processing machine, sprayers, Coffee packaging machine, Coffee bagging machine and mechanical harvester for coffee plantation is being reduced from 7.5% to 5% [S. No 384 of notification No. 12/2012-Customs dated 17.03.2012 refers]

84.9 Basic customs duty on Coffee vending machine and brewing machines other than of a kind used for domestic purpose is being reduced from 10% to 5%. A concessional rate of BCD of 2.5% is also being provided to parts required for the manufacture of such machines. [S. No 385 of notification No. 12/2012-Customs dated 17.03.2012 refers]

##### in Budget 2013-14

84.1 The BCD on 20 specified machinery for use in the leather industry or footwear industry is being reduced from 7.5% to 5%. Descriptions of certain leather and footwear machinery items are being modified. S No 390 (List 29) of notification No. 12/2012-Cus, as amended by notification No. 12/2013-Customs, dated the 1st March 2013 refers.

84.2 The BCD on all textile machinery and parts thereof falling under headings 8444 to 8449 is being reduced from 7.5% to 5%. Notification No.12/2012-Customs, dated 1st March, 2012 as amended by notification No. 12/2013-Customs, dated 1st March, 2013 refers. S. No. 406A contains the changes.

## Annexures

### in Budget 2014-15

CVD exemption hitherto available on specified road construction machinery has been withdrawn. These specified machinery will henceforth attract CVD and SAD. Exemption from the basic customs duty will however continue [Sl.No.368A of the Table read with List 16A of notification No.12/2012-Customs, dated 17.03.2012 as amended by notification No.5/2014-Customs, dated 17.02.2014 refers].

### In Budget 2012-13

85.1 Full exemption from basic customs duty, additional duty of customs presently available on parts, components and accessories of mobile handsets including cellular phones is being extended to parts, components and sub-parts of parts and components required for manufacture of Memory Cards for mobile phones [S. No 431 of notification No. 12/2012-Customs dated 17.03.2012 refers]

85.2 Full exemption from Special Additional Duty of customs on parts, components and accessories of mobile handsets including cell phones valid up to 31.3.13 is being extended to parts, sub-parts and components of Memory Cards for mobile handsets including cellular phones. The validity of this exemption is being extended upto 31.3.2013. [S. No 5 of notification No. 21/2012-Customs dated 17.03.2012 refers]

85.3 The exemption from basic customs duty on poly laminated aluminium tape and poly laminated steel tape is being withdrawn. [Notification No. 25/2005-Customs dated 1.03.2005 as amended by notification No. 15/2012-Customs dated 17.03.2012 refers]

85.4 The customs duty exemption provided for specified raw materials for use in electronics/IT industry is being withdrawn [Notification No. 25/1999-Customs dated 28.02.1999 as amended by notification No. 16/2012-Customs dated 17.03.2012 refers]

85.5 Excise duty is being reduced to 6% on LED lamps & LEDs required for manufacture of such lamps and SAD is being fully exempted on LEDs used for manufacture of LED Lamps [S. No 90 of notification No. 21/2012-Customs dated 17.03.2012 refers]

85.6 Full exemption from Basic Customs Duty is being extended to LCD and LED TV panels for 20 inches and above. [S. No 432 of notification No. 12/2012-Customs dated 17.03.2012 refers]

85.7 Basic customs duty of 10% is being imposed on Digital Cameras which are capable of recording video with minimum resolution of 800 x 600 pixels, at minimum 23 frames per second, for at least 30 minutes in a single sequence using the maximum storage (including expanded) capacity. [Notification No. 25/2005-Customs dated 1.03.2005 as amended by notification No. 15/2012-Customs dated 17.03.2012 refers]. Basic Customs Duty on parts and components of such cameras is being reduced to 5% subject to actual user condition [S. No 429 of notification No. 12/2012-Customs dated 17.03.2012 refers]

85.8 Basic customs, additional customs duty and special additional duty of customs (SAD) on Lithium ion automotive battery for manufacture of Li ion battery packs for supply to hybrid/electric vehicle manufacture is being reduced from 10% to Nil, 10% to 6% and 4% to Nil respectively [S. No 438 of notification No. 12/2012-Customs dated 17.03.2012 and S. No 6 of notification No. 21/2012-Customs dated 17.03.2012 refers]

### in Budget 2013-14

85.1 The BCD on Integrated Decoder Receiver, also known as Set Top Box, is being increased from 5% to 10%. S. No411 of notification No.12/2012-Customs, as amended by notification No. 12 /2013-Customs, dated the 1st March 2013 refers.

85.2 LCD and LED TV Panels of 19" and above are presently exempt from BCD under notification No 12/2012-Customs (S. No. 432). In this connection, a doubt has been raised whether this exemption is available for LCD and LED TV Modules or otherwise. It is clarified that LCD and LED TV Panels and LCD and LED TV Modules are one and the same thing for the purpose of exemption under this notification.

85.3 Presently, all goods required for the manufacture of the goods falling under heading 8541 are exempt from BCD subject to actual user condition. Solar cells and solar modules are classified under heading 85.41. It has been brought to the notice of the Ministry that this exemption has been denied at certain places although the imported goods are required for the manufacture of solar cells and solar modules. It is clarified that the BCD exemption under S No 39 of notification No. 24/2005-Customs, dated 1st March, 2005 is available to all goods including chemicals and electronic parts required for the manufacture of solar cells whether or not assembled in modules or panels.

### Changes in Customs Duty of Gold

#### in Budget 2012-13

71.1 Basic customs duty is being increased on gold dore bars having gold content not exceeding 95%, imported for refining and manufacturing serially numbered gold bars in India from 1% to 2% [S. No 318 of notification No. 12/2012-Customs dated 17.03.2012 refers]

71.2 Basic customs duty is being increased on Gold bars, other than tola bars, bearing manufacturer's or refiner's engraved serial number and weight expressed in metric units, and gold coins having gold content not below 99.5% from 2% to 4%. [S. No321 & 323 of notification No. 12/2012-Customs dated 17.03.2012 refers]

71.3 Basic customs duty is being increased on Gold in any form other than above, including tola bars and ornaments, but excluding ornaments studded with stones or pearls from 5% to 10%.

71.5 Basic customs duty of 2% is being prescribed for Cut and polished coloured gemstones. [S. No 313 of notification No. 12/2012-Customs dated 17.03.2012 refers]

#### In Budget 2013-14

71.1 Basic customs duty is being reduced on pre-forms of precious and semi-precious stones from 10% to 2%. Notification No.12/2012-Customs, dated 1st March, 2012 as amended by notification No.12/2013-Customs, dated 1st March, 2013 refers. S. No.312A contains the changes.

71.2. Under the Foreign Trade Policy (paragraph 4A.2.2), an exporter with annual export turnover of Rs 5 crore for each of the last three years is allowed to export cut & polished diamonds (each of 0.25 carat or more) abroad to any of the designated laboratories/agencies with re-import facility at zero duty within 3 months from the date of export. In this regard, a variance not exceeding +\_1mm in height and circumference and not exceeding +\_1 cent in weight is allowed between exported and re-imported cut and polished diamonds. In this connection, Explanation 1 of notification No. 9/2012-Customs, dated the 9th March, 2012 refers. This limit is being revised in respect of height and circumference from +\_1 mm to +\_0.01 mm. The variation in respect of weight shall remain unchanged. Notification No. 9/2012-Customs, dated the 9th March, 2012 as amended by notification No. 11/2013-Customs, dated the 1st March, 2013 may be referred to for details.

### Changes in Customs Duty of Silk and Yarn

#### in Budget 2012-13

54.1 Basic Customs duty on Aramid thread/Yarn/ fabric for manufacture of Bullet proof helmets for Defence and Police personnel is being reduced from 10% to Nil with Nil CVD and Nil SAD (S. No. 16 of Notification No.39/96-Customs dated 23rd July, 1996 as inserted vide Notification No.11 /2012-Customs dated 17th March, 2012 refers).56.1 Basic customs duty on Hydrophilic Non –Woven, Hydrophobic Non –Woven ( CTH 56031100) imported for use in the manufacture of Adult Diapers is being reduced from 10% to 5%, With 5% CVD and Nil SAD on actual user basis [S. No295 of notification No. 12/2012-Customs dated 17.03.2012 refers]

56.1 Basic customs duty on Hydrophilic Non –Woven, Hydrophobic Non –Woven ( CTH 56031100) imported for use in the manufacture of Adult Diapers is being reduced from 10% to 5%, With 5% CVD and Nil SAD on actual user basis [S. No295 of notification No. 12/2012-Customs dated 17.03.2012 refers]

#### in Budget 2013-14

50.1 The BCD on raw silk is being increased from 5% to 15%. S. No.276 of notification No.12/2012-Customs, as amended by notification No.12 /2013-Customs, dated the 1st March 2013 refers.

53.1 Presently, coir yarn (53.08) is mentioned at S. No. 43 of notification No. 27/2011-Customs. In column (4), which is presently blank, the entry Nil is being inserted. This is a technical rectification. In this connection, notification No.15 /2013-Customs, dated the 1st March 2013 refers.

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In the recent past India's economic growth story has attracted world's attention bringing new challenges for the domestic economy. One of the challenges currently faced is the growing illicit trade in counterfeits, pass offs and smuggled goods. These activities are also threatening brands not only in every region of the country but across the globe.

Contraband and counterfeit products hurt the integrity of the brand, further diluting the brand owner's reputation. This not only results in erosion of sales of the legitimate product but further [CASCADE]s onto affect the consumers in the form of health and safety hazards. With the above insight the Federation of Indian Chambers of Commerce and Industry (FICCI) took the initiative to dedicate a forum by establishing the Committee Against Smuggling and Counterfeiting Activities Destroying the Economy - CASCADE on 18th January, 2011.

FICCI Committee Against Smuggling and Counterfeiting Activities Destroying Economy (CASCADE)

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