Report of the
Comptroller and Auditor General
of India

for the year ended March 2015

Performance Audit on Natural or cultured pearls, precious or semi-precious stones, precious metals, metals clad with precious metal and articles thereof, imitation jewellery, coins (Chapter 71 of CTH).

Union Government
Department of Revenue
Indirect taxes – Customs
No. 6 of 2016

Laid on the table of Lok Sabha/Rajya Sabha __________

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Preface

This Report for the year ended March 2015 has been prepared for submission to the President of India under Article 151 of the Constitution of India.

The Report contains significant results of the performance audit on natural or cultured pearls, precious or semi-precious stones, precious metals, metals clad with precious metal and articles thereof, imitation jewellery, coins (Chapter 71 of CTH) during 20010-11 to 2014-15.

The instances mentioned in this Report are those which came to notice in the course of test audit during the period 2015-16.

The audit has been conducted in conformity with the Auditing Standards issued by the Comptroller and Auditor General of India.

Audit wishes to acknowledge the cooperation received from Ministry of Commerce and Industry (DoC), Department of Revenue (DoR) and its field formations and Reserve Bank of India (RBI) at each stage of the audit process.

Abbreviation

AA	:	Advance Authorisation
APR	:	Annual Performance Report/Annual Progress Report
BOA	:	Board of Approval
BCD	:	Basic Customs Duty
BE	:	Bill of Entry
BLUT	:	Bond cum Legal Undertaking
BTP	:	Biological Technology Park
CAD	:	Current Account Deficit
CBEC	:	Central Board of Excise and Customs
cif	:	Cost, insurance, freight
CPD	:	Cut and polished Diamond
CSEZ	:	Cochin Special Economic Zone
CST	:	Central Sales Tax
CTH	:	Customs Tariff Heading
CVD	:	Countervailing Duty
DC	:	Development Commissioner
DEA	:	Department of Economic Affairs
DFIA	:	Duty Free Import Authorisation
DGFT	:	Directorate General of Foreign Trade
DGoV	:	Directorate General of Valuation
DG (Systems)	:	Directorate General of Systems and Data Management
DoC	:	Department of Commerce
DoR	:	Department of Revenue
DRI	:	Directorate of Revenue Intelligence
DTA	:	Domestic Tariff Area
EDI	:	Electronic Data Interchange
EHTP	:	Electronic Hardware Technology Park
EO	:	Export Obligation
EODC	:	Export Obligation Discharge Certificate
EP	:	Export Performance
EPCG	:	Export Promotion Capital Goods
EoU	:	Export Oriented units
FEMA	:	Foreign Exchange Management Act
FOB	:	Free on Board
FTP	:	Foreign Trade Policy
FTDR Act	:	Foreign Trade (Development & Regulation) Act.

FSEZ	:	Falta Special Economic Zone
GDP	:	Gross Domestic Product
G&J	:	Gems and Jewellery
GJEPC	:	Gems and Jewellery Export Promotion Council
HBP	:	Hand Book of Procedure
ICES	:	Indian Customs EDI System
ISEZ	:	Indore Special Economic Zone
ITCHS	:	International Tariff Classification (Harmonised System)
LoA	:	Letter of Approval
LoP	:	Letter of Permission
MEPZ	:	Madras Export Processing Zone
MKSEZ	:	Manikanchan Special Economic Zone
NA		Nominated Agency
NFEE	:	Net Foreign Exchange Earnings
NIDB/ECDB	:	National Import Database/ Export Commodity Database
NII	:	Non-Intrusive Inspection
NOC	:	No Objection Certificate
NSEZ	:	Noida Special Economic Zone
PCA	:	Post Compliance Audit
PCCCC	:	Precious Cargo Customs Clearance Centre
QPR	:	Quarterly Performance report
RBI	:	Reserve Bank of India
RLA	:	Regional Licencing Authority
RMS	:	Risk Management System
SB	:	Shipping Bill
SCN	:	Show Cause Notice
SEZ	:	Special Economic Zone
STH/PTH	:	Star Trading House/Premier Trading House
STP	:	Software Technology Park
SVB	:	Special Valuation Branch
UAE	:	United Arab Emirates
UAC	:	Unit Approval Committee
SEEPZ	:	Santacruz Electronics Export Promotion Zone
VSEZ	:	Visakhapatnam Special Economic Zone

Executive Summary

The Gems and Jewellery (G&J) industry occupies an important position in the Indian economy as it is a leading foreign exchange earner and one of the fastest growing industries. It contributed to 15 per cent of the national export basket. The major product categories of this industry are gold and diamond jewellery. Gold jewellery forms around 80 per cent of the Indian jewellery market while the remaining market demand is of studded jewellery that includes diamond studded as well as gemstone studded jewellery. Over 65 per cent of the World's polished diamonds is manufactured in India in terms of value, 85 per cent in terms of volume and 92 per cent in pieces. India's diamond manufacturing sector employs about ten lakh people across the country. Majority of the diamond manufacturing activities takes place in Surat, Gujarat. The Bharat Diamond Bourse in Mumbai, a modern trading complex which began its operations in 2010, is the largest bourse in the World, and accounts for nearly 90 per cent of India's total diamond trade. The manufacturing of jewellery and coloured gemstones is centred at Jaipur, which is the World's largest manufacturing center.

Rough diamond, precious coloured gemstones and gold are not produced in India. These are imported from major source countries or trading hubs. These are essential inputs for the Gems and Jewellery (G&J) sector. G&J sector in India has a unique availability of traditional skills, a huge socio-economic importance and a large domestic market for different kinds of plain and studded jewellery. This sector also generates a fair amount of economic activity and contributes to the GDP of the country if value is added to the final product. Currency and asset demand of gold in India is one of the highest in the world vis-a-vis other currencies and investment asset categories. Given global demand for Indian design and workmanship, Cut and Polished Diamond (CPD) and jewellery has been one of the top exporting products for decades. Conversion of rough diamonds to CPD and gold to plain/studded jewellery creates substantial value integration with ramifications on all the economic factors.

The import of gold, jewellery et cetera increased from ₹ 3,50,396 crore in 2010-11 to ₹ 3,81,515 crore (9 per cent) in 2014-15. Export of similar goods also increased to ₹ 2,53,940 crore (28 per cent) in 2014-15 from ₹ 1,98,886 crore in 2010-11. In 2014-15 the share of imports of Chapter 71 goods to all imports was 13.93 percent whereas the share of its exports was 13.39 percent. While imports grew by 10.57 percent, the exports grew only by 0.7 percent over the last year.

Trade deficit has decreased from 43 per cent (FY 11) to 34 per cent (FY 15) but the duties foregone have increased from 14 per cent (FY 11) to 20 per cent (FY 15) of the value of imports.

During this period, value of the US Dollar increased by 34 percent making the imports proportionately expensive and exports cheaper. The entire five year period saw, imports of gold as a major component of the imports under the chapter 71 but it suffered a negative Net Foreign Exchange Earnings (NFEE) vis a vis corresponding exports of jewellery. International gold prices reached its peak in 2012 and steadily declined by 2015. Evidently, in 2013-14 rough diamonds formed the dominant category of the Chapter 71 imports and CPD formed the majority of the exports with a positive NFEE between these two categories. The value addition in this category of goods was however, far better during the previous period 2010-2013. Import, re-import and export of CPD through PCCCC, Mumbai alone had increased manifolds. Re-import of CPD to total import grew from 27 to 79 per cent and re-import of CPD to exports increased from 10 to 29 per cent in the last five years.

India barely produced diamond or gold. It was the highest average importer of gold in the last five years. There was a sharp increase in the share of import of gold after 2007-08 because of its rise in its asset demand. Interestingly, in 2013-14 the export of rough diamond and non monetary form of gold was also at maximum levels of 10.10 and 11.04 percentages, respectively.

The difference between the transaction wise valuation of trade between India and its exporting/importing partners indicated that India ranked 4th in volume of illicit financial outflows in the world. This was almost $83 billion USD in 2013 and growing, akin to the last ten years trend. It is around 4.5 per cent of India's GDP (against global average of 4 per cent) and totally comprises of outflows due to trade mis-invoicing.

The export growth (0.7% in 2014-15) was much below the rate of 25 per cent envisaged in the DoC strategy, affecting employment generation and other economic indicators. Mid-Term review of DoC's strategy indicated downward revision of the export targets almost by 30 percent (2013-14) owing to both global and domestic conditions. FTP 2015-20 acknowledged the suboptimal performance of the sector and highlighted need for better use of information technology infrastructure in trade transactions; input based indirect tax remission for export price competitiveness and augmenting production and labour efficiency.

Export-import data of DoC in respect of import of gold jewellery from Singapore, Malaysia, Indonesia, Hongkong, Thailand and UAE during 2010-11 to 2014-15 as mentioned in Appendix 2A revealed that there was a surge in import of gold jewellery from Asian Countries during the year 2013-14 and 2014-15 when 20:80 scheme was in operation, since import of gold bar was restricted for normal importers during the above period. UAE's diamond trade slumped after 2011, post imposition of the 2 per cent customs duty (January 2012) when gold and gold jewellery received a boost.

It has been observed that on an average 64 per cent of imported gold jewellery were from Switzerland, UAE and Hong Kong out of the 120 odd source countries. However, the importing countries were not being exported to, except in case of UAE and Hong Kong. Similarly, 63 per cent exports of jewellery were to UAE and Hong Kong. Analysis of the trade of four main goods category gold, diamond, CPD and jewellery of Chapter 71 with UAE in 2014-15 reveals that 15 percent (of the total like goods imported) were imported from UAE and 29 percent of the total like goods were exported to UAE. The country trade analysis further indicates repeated transactions between each of the four categories of products under Chapter 71; cases of related party transactions, inverted duty structure and re-export. Evidently, trade with UAE involving re-export did not create major economic activity while inflating the total value of the trade. It necessitated a detailed examination to distinguish imports and exports tied to the real economy through value addition and creation of economic growth, rather than from the re-exports simply passing through the trade accounting and bank financing channels.

No analysis of the incremental changes in the transaction cost associated with the sector was measured by DoC. The change in gold price, import regulation, export promotion schemes did not have a material impact on the gold trade. The G&J trade related financial outflow continued unabated.

DoC was mandated to facilitate creation of an enabling environment and infrastructure for growth of Gems and Jewellery sector through accelerated growth in exports and to earn the precious foreign currency. Higher domestic value addition led exports could have reduced the trade deficit in this sector and consequently eased the Current Account Deficit (CAD). FTP 2015-20, however, did not make any defining provision for the G&J sector despite withdrawal of 20:80 Scheme in 2014 and climb down from the set target of the DoC's Strategy, after its Mid-term review.

Role of RBI was to regulate the external sector by regulating the foreign exchange. Audit found that Gems and Jewellery sector alone contributed to around 13 per cent of the total foreign exchange outgo. RBI in consultation with the government introduced 20:80 scheme in August 2013 to reduce Current Account Deficit and to discourage consumption of gold in the domestic market. As a result the import of gold moderated, till the scheme was modified by DEA and in May 2014, RBI allowed Star/Premier trading houses to import gold.

Similarly, CBEC/DoR was mandated to provide improved tax payer services, implement export promotion measures and effectively collect the tax revenue. Total Customs duty forgone was ₹ 12,26,033 crore for the period 2010-11 to 2014-15 whereas the share of gems and jewellery sector in the above was 25 per cent (₹ 3,01,042 crore) for the same period. Gaps in the valuation database management and Customs electronic data application allowed gradual increase in trade mis-invoicing over the period leading to foreign exchange/capital outflow.

G&J sector was last audited in 2008 however most of the improvements recommended by audit were not achieved.

Lack of an impact assessment of the scheme prior to its implementation and an outcome assessment after implementation, or on exit, rendered the policies ineffective due to insufficient coordination, control and monitoring; cases of operational malfunction, non compliance; inadequate ICT infrastructure for tax administrations, border control, facilities and certification.

DoR, CBEC and DoC, DGFT need to improve coordination; implement the EDI systems with full functionality; reduce transaction cost; regulate related party transactions, tariff and re-export, for a growth led licit Gems and Jewellery trade to avoid inflated export figures through mere trade accounting.

This performance audit has revenue implication of ₹ 1,003.37 crore in addition to systemic issues worth ₹ 19,522.67 crore and internal control matters which could not be quantified.

Summary of recommendations

1. *Department of Commerce should undertake an outcome analysis of the important schemes implemented to boost the gems and jewellery sector from an economic, trading and revenue perspective. All inverted duty structures, transaction costs, related party transactions, re-export transactions, facilitation measures need to be carefully reviewed before designing an effective promotional scheme.*

2. *CBEC should maintain a robust and updated valuation data for all the tariff lines so that these could be utilised and shared with other concerned departments.*

3. *CBEC may consider rationalising the duty structure so that Foreign Exchange Earning could at least be at par with duty foregone under the FTP.*

4. *CBEC may expedite implementation of ICES 1.5 to all the high valued and sensitive commodities. The EDI system may be extended to import/export of gold dore bars, export of gold jewellery, hand baggage and disposals. Effective mechanism may be adopted to ensure the updating of tariff value, exchange rate and duty rate in the EDI system in a timely manner.*

5. *Department of Commerce may consider introducing suitable provisions in the SEZ rules, to prescribe a minimum value addition by the SEZ units; to provide certain minimum percentage of examination of goods to check the purity of Gold jewellery, caratage of Diamonds and for regular stock verification to check diversion into DTA. The provisions should include value of procurements made by SEZ from DTA (on payment in foreign currency) for the purpose of calculation of NFEE.*

6. *Department of Commerce may review the export incentives allowed on G&J exports, product category and country wise, considering the volume and value of re-imports involved, to safeguard the interest of revenue and to prevent round tripping.*

7. *Existing mechanism for fixing tariff value may be reviewed by CBEC so as to facilitate a balance between the revenue management and valuation concerns.*

8. *To maintain the consumer and trade confidence in Indian diamond industry, CBEC may consider a clear categorization for manmade diamonds to differentiate from natural diamonds.*

9. *A suitable control mechanism may be established by Department of Commerce to get assurance and reliability of the data furnished in APR by SEZs/EOUs.*