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Cross-Border e-commerce: Issues Of Unfair Subsidy, Tax Evasion And Counterfeiting

By Professor John Manners-Bell

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John holds an MSc in Transport Planning and Management from University of Westminster and is an Associate of King's College London where he studied Classics and Theology. He is a Fellow of the UK Chartered Institute of Logistics and Transport and former Chair of the Supply Chain and Logistics Global Advisory Council of the World Economic Forum. He has also advised the European Commission Directorate-General for Energy and Transport.

He has written five books on the industry including 'Supply Chain Ethics' and 'Supply Chain Risk Management' which won the Mention Speciale ACA-Bruel Prize for supply chain literature in 2014.

CROSS-BORDER E-COMMERCE: ISSUES OF UNFAIR SUBSIDY, TAX EVASION AND COUNTERFEITING

The cross-border e-commerce market has grown spectacularly in the last few years as foreign traders, particularly those located in China, have been able to use online platforms to more easily access Western markets. However, the mechanisms which have facilitated this boom in global trade are increasingly being called into question due to the way in which they directly and indirectly impact on the market.

Foremost of these criticisms is the artificially low cost of international postal services which allow foreign traders to compete unfairly against e-retailers and manufacturers based in the West. Moreover, it seems that taxpayers in many developed countries could be subsidizing these postal rates and even facilitating trade in counterfeit goods as well as aiding the fraudulent non- or mis- declaration of VAT. This paper looks at some of the issues involved.

TERMINAL DUES – WHAT'S GONE WRONG?

The commercial relationships which exist between the world's postal organizations are coordinated by the Universal Postal Union (UPU), a United Nations agency which manages the mechanisms by which postal organizations are compensated for the end delivery of mail and packages (up to 2kg or 4.4lb) which originate in a different country. The fees which are set by the 192 country member body are called 'Terminal Dues'. The postal rates which the sender is charged includes the collection, handling, international movement, handling and final delivery to the end-recipient and the postal organizations involved are compensated for their respective roles. In other words, the delivering post office will be paid by the post office in the market of origin at an agreed rate. For years, the system has worked with very little fuss. However, the e-commerce revolution has changed all that.

The key issue revolves around the level of these Terminal Dues. As operators in developing countries are typically charged a low fee under UPU agreements, significant imbalances in the global trading economy have developed. When the system was devised it would have seemed unimaginable that millions of small packages would be shipped through the postal system around the world or that the agreement would enable exporters in developing markets to compete directly with Western counterparts. The mechanism was designed primarily to compensate postal operators fairly for the movement of mail and personal packages between various jurisdictions. Now, however, the system stands accused of:

1. Providing a subsidy to foreign traders in the form of postal rates which are lower than those available to domestic competitors.
2. Allowing foreign traders the opportunity to evade VAT/GST, denying tax revenues to

Western governments and creating unfair competition.

3. Creating a system which facilitates the movement of counterfeit goods into Western markets.

UNFAIR SUBSIDY OF INTERNATIONAL POSTAL RATES?

As an example of the disparity in domestic and international postal rates, according to the UK's Financial Times, a package under 2kg can be shipped from China to the UK for as little as £0.80. This compares with a domestic postal charge of £2.95 (second class)[1]. Obviously, this can make a huge difference in markets which are highly sensitive to price.

The Financial Times believes that about 2 million items are shipped from Asia to the UK a week with Asian traders buying goods very cheaply from locally based wholesalers and then selling them on a multitude of web platforms to UK consumers. These products are then shipped by airmail arriving in days. The low rate means that they can be supplied far cheaper than UK based retailers who have to bring the goods in through other logistics channels.

As one commentator put it, '...online has spawned a huge cottage industry in private sellers making pennies on each sale and are happy doing this, undercutting margins required when importing the same product in bulk into the UK by sea or air.'[2]

Paul Navarro, assistant to the US president for trade and manufacturing policy, makes another point. He asserts that a US business would pay around $8 to move a 1lb package domestically across the US. In comparison, the USPS would receive only around $2.50 for a package sent from China to a destination in the US. He estimates that the postal service loses $1 on each of these cross-border packages[3]. Therefore, not only does the system allow Chinese exporters to compete unfairly with US domestic eretailers but the cost which they pay for moving their product to the US is subsided by the US taxpayer. Another gripe is that whilst the US handles half the world's mail it only has one vote at the UPU. Therefore, it believes that reform is impossible with the only option being that of 'self-declared rates.'

Although there is little visibility of what each postal operator charges each other for end delivery, there are reports that discounts are being offered over and above the agreed UPU rate (which is about 70% of the cost of domestic delivery with further reductions for developing countries). This is because, as many competing express companies believe, it protects post offices' dominant position within the ecommerce sector.

The system has created other problems. As discussed in the following sections, foreign traders have been able to mis-declare the value of the products they are shipping for VAT

purposes. There are also few checks on product standards and little can be done to stop the supply of counterfeit goods to Western markets. Not only has this resulted in safety implications for EU and North American consumers, but US and European retailers have had to compete against foreign traders selling knockedoff goods effectively subsidized by their own postal organizations.

CONSUMPTION TAX (VAT/GST) AVOIDANCE

One of the major problems for small and medium size businesses engaging in the cross-border trade is the regulations relating to payments of VAT/GST. A criticism of the present arrangements related to the cheap cost of international mail is that it allows traders in some countries (especially Asian markets) to serve Western markets without declaring and paying VAT – thus putting them at an advantage to importers in the EU or North America who have no option but to abide by the rules.

According to KPMG, the "digital revolution" has disrupted traditional business models. 'The VAT revenue foregone by not taxing cross-border sales of digital goods and services generated serious concerns for many tax authorities worldwide. In New Zealand, for example, a VAT leakage of 180 million New Zealand dollars (NZD) (114 million US dollars (USD)) per year has been reported as a result of crossborder services, intangibles, and goods.'[4]

Consumption Tax is usually levied on the 'destination principle'. That is to say, according to an OECD report on the matter, '...tax is ultimately levied only on the final consumption that occurs within the taxing jurisdiction... the destination principle places all firms competing in a given jurisdiction on an even footing.'[5] OECD guidelines on the tax have now been endorsed by 100 countries, seeking to standardize their approach to the challenges provided by a market which is being transformed by the rapid increase in B2C business. The problem is that if there is no importing business to hold accountable for the payment of VAT (as there would have been in a more traditional B2B structure), it is more difficult for a Customs agency to recover the tax, either from the end-recipient (the consumer) or from the original trader.

At present one way to mitigate costs of collection are for tax authorities to apply De Minimis Thresholds (DMTs). This means that under a certain value there is a tax exemption, a situation which is in effect a trade-off for the authority between what it costs to collect the tax and the likely tax receipts.

The EU has adopted a new set of regulations which will go some way to address the issue of evasion. Although not entirely designed to combat fraud committed by non-EU traders, the

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EU has recognised that European SMEs are at a particular disadvantage when it comes to administering such a burdensome tax. Currently, European online traders have to register for VAT in all the Member States to which they sell goods. The European Commission (EC) estimates that a business incurs average VAT compliance costs of €8,000 annually. As the EC comments, 'The VAT exemption for the importation of small consignments as well as high rates of non-compliance means that EU sellers (both online and traditional businesses) are at a severe disadvantage to non-EU sellers. It is estimated that as much as €25 billion in trade (25% of total cross-border B2C sales of goods) is non-compliant.'[6]

The problem is not only affecting EU traders but their governments as well. The EC estimates that governments lose out on €1 billion VAT due to VAT exemption and €4 billion from non-compliance. This is estimated to rise to €7 billion by 2021. At present small consignments imported into the EU valued at less than €22 are exempt from VAT whereas EU traders are required to apply VAT on all consignments. Around 150 million parcels are imported free of VAT into the EU each year (2016 figures – this will have increased possibly to over 200 million parcels today). An easy way for non-EU traders to avoid the tax is to mis-declare the value of the goods. Even high value items such as smartphones or tablets are being declared below the VAT threshold value. Consequently, this exemption will be removed from 2021.

In its place, the EC will establish what it calls a 'VAT One Stop Shop' to which trustworthy sellers from outside the EU can register. Foreign traders will alternatively be able to designate an EU intermediary (including couriers, postal operators or customs agents) to deal with VAT-related compliance for sales of goods not more than €150 in value. The EC believes it will be an efficient system due to the high number of low value consignments and the familiarity of intermediaries with the EU VAT system, procedures and Customs authorities.

Its proposal will ensure that VAT is paid in the Member State of the final consumer, leading to what the EC calls a fairer distribution of tax revenues amongst EU countries. Many countries and jurisdictions are also making intermediaries, including e-marketplaces, responsible for the collection of VAT/GST.

Impact on Express Carriers, Postal Operators and Customs Authorities

The EC recognises that the new VAT system will involve additional reporting requirements by postal operators and couriers although there will be simplified procedures.

As the EC comments, 'Operators will also be able to act as intermediaries for non-EU traders

in the 'VAT One Stop Shop'. Most importantly, operators will be able to make periodic reports to tax authorities for VAT purposes, as opposed to the individual declaration for each package at the moment.' Couriers and express operators will have until 2021 to prepare for the changes.

In terms of the impact on customs administrations within the EU, clearance procedures will be simplified for those foreign traders and marketplaces registered for the VAT One Stop Shop.Consignments with a value up to €150 will no longer be stopped at customs for VAT clearance and VAT collection for these goods will be managed on a self-assessment basis. The EC commented, 'This marks an important change in the world of customs, moving from clearance per transaction to clearance on overall sales.'

COUNTERFEIT GOODS

The present international postal arrangements which have allowed the boom in cross-border trade in ecommerce goods have no doubt been a significant factor in the reforms which are being made to VAT/GST. They can also, indirectly, be blamed for the surge in trade in counterfeit goods. One complaint from EU and North American traders is that it is cheaper for Western consumers to buy and ship 'knock off' versions of their products from Asia than it is to buy the real thing.

According a Europol report, Serious and Organized Crime Assessment (SOCTA) EU Customs seized 80,000 shipments in 2015, containing 40 million products valued at €642m[7].

An earlier report by the OECD and the European Union Intellectual Property Office[8] estimated that counterfeit goods amounted to 2.5% of international trade and 5% of trade with the EU. Not all of these were e-commerce shipments, but there is no doubt that online marketplaces are an important source. The report identified that this type of trade is mainly facilitated by the international postage system which is the primary mode of choice due to the small shipment size involved. Between 2011 and 2013 around two thirds of all seizures worldwide were postal shipments.

The supply chains involved in moving the counterfeit goods are complex. According to the report, as well as the largest logistics hubs such as Hong Kong and Singapore, other intermediary transit points include countries where there is weak governance and where criminal and terrorist networks are able to operate at will. The report's authors suggest that such supply chains are very dynamic, with criminals able to make routing decisions based on the quick identification of vulnerable logistics nodes.

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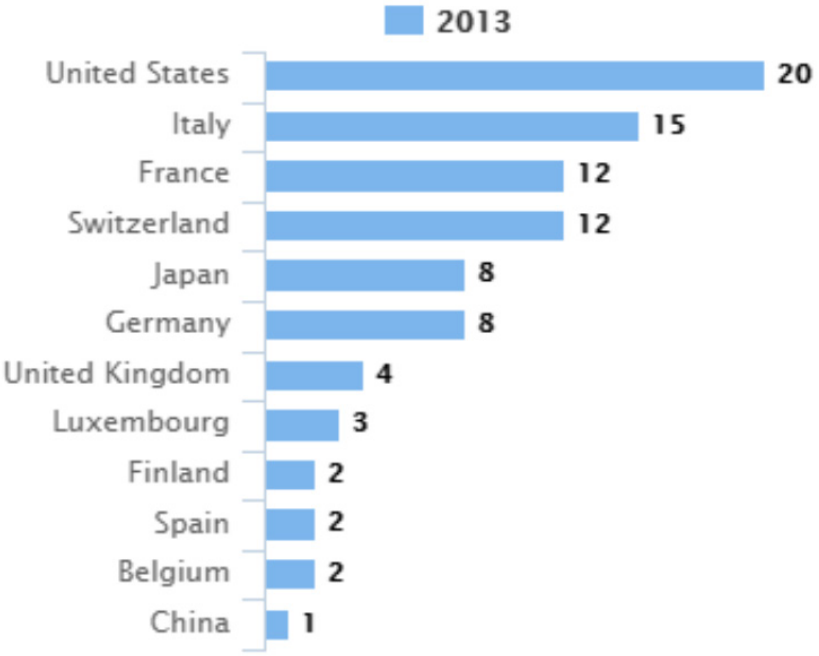
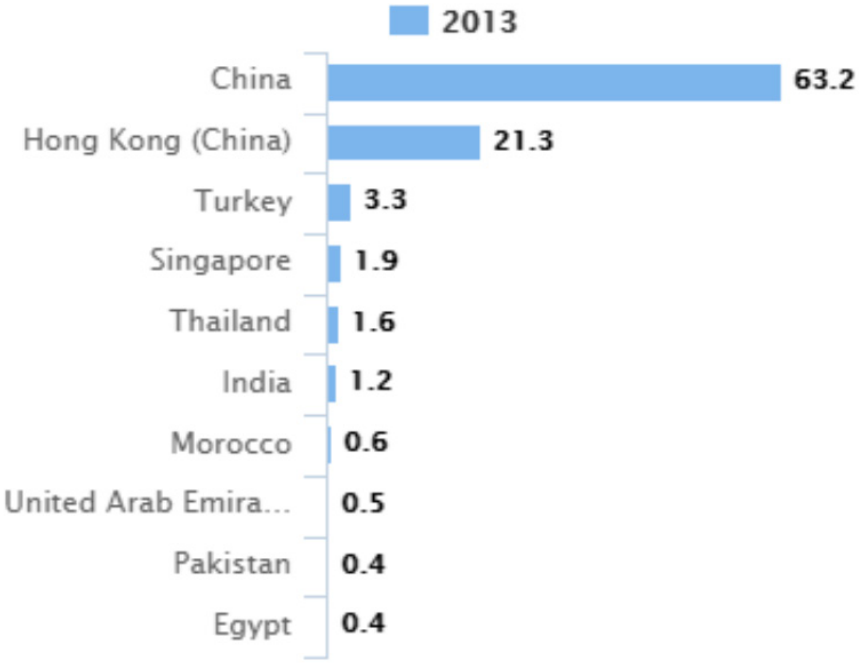
Figure 1: Countries most affected by counterfeiting



Source: Trade in Counterfeit and Pirated Goods: Mapping the Economic Impact

Figure 2: Countries of origin for fake goods



Source: Trade in Counterfeit and Pirated Goods: Mapping the Economic Impact

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Even though counterfeit goods originate from every country and region, China is by far the biggest culprit. Around 85% of goods seized originated in either China or Hong Kong, with Turkey being the third most frequent country of origin, albeit with a much smaller proportion (c.5%). In terms of the commodities most likely to be counterfeited, footwear and clothing stood out as the most important categories, although electrical machinery and equipment and watches were also frequent targets. The report only measured the numbers of seizures in terms of volumes, not in terms of value. Hence although pharmaceuticals was one of the smaller categories, it can be assumed that in financial terms it is far more important.

Taobao, one of the Alibaba platforms, was blacklisted in 2011 by the US government due to its inability to address the problem of counterfeit goods being sold on its websites. Even Amazon has faced accusations that traders use its marketplaces to sell 'knock off' goods. However, in many cases it is much smaller websites, which it is impossible to regulate, where the problem lies. These will typically use the postal operators to quickly, cheaply and easily get their counterfeit goods to market.

China is well aware of the impact of counterfeiting on its reputation. The Chinese government has passed a law which will make the major e-commerce platforms accountable for any fake goods sold over their marketplaces. The extent to which the law will be enforceable is another matter.

CONCLUSION: REFORM IS ON ITS WAY

Regardless of the political row which is occurring presently, plans had been put in place to 'level-theplaying-field'. By 2021, China Post will be paying the same as many European post offices. Since 2016 China, Russia and Turkey all have had to pay more Terminal Dues as they moved into a middle income category, as set by the UPU.

This is being welcomed by the express parcels industry. Speaking in 2016 to Postal and Parcel Technology International, Alexander Edenhofer, spokesperson for Deutsche Post DHL Group commented, '...from Deutsche Post DHL Group's point of view, this can be considered an important step in the right direction as the new remuneration rates encourage competitive pricing in the growing ecommerce area.'

Speaking in relation to the Trump administration's memo on Terminal Dues, UPS called the approach, 'a positive step' towards addressing 'longstanding imbalances in the global postal market.'

It will be very interesting to see what effect postal reform has on the volume of cross-border

ecommerce parcels. If, as might be thought likely, an increase in postal rates results in a headwind to the growth of the sector or even a reduction in volumes, there could well be a corresponding increase in domestic movements. This would be welcomed by oliticians cognisant of the negative impact which subsidized international postal rates have had on retailers in Western markets. In addition, it could be argued that VAT/GST reforms would not have been necessary if it had not been for the subsidized growth of the cross-border e-commerce market, and nor would markets for counterfeit goods have developed to the level which are evident today.

However, reform may count for nothing if Postal Organizations believe that it is in their best interests to continue the subsidy of international rates, regardless of the level agreed at the UPU for Terminal Dues. This may be a valid commercial decision if the post office concerned is not subsidized by the taxpayer. However, it will become an increasingly difficult position to take, if, as in the US, the taxpayer believes that not only is it subsidizing a loss-making enterprise but supporting a mechanism which fosters unfair competition and indirectly leads to tax evasion and the proliferation of counterfeit goods.

ABOUT

About the Foundation for Future Supply Chain

Established in 2021, the Foundation for Future Supply Chain is a not for profit organization dedicated to improving the understanding of some of the industry's most pressing challenges.

The Foundation provides governments, inter-governmental organizations, NGOs and business leaders with an independent source of thought leadership, addressing and advising on critical policy issues such as sustainability and ethics; security and risk; innovation and disruption; future mobility and automation.

About Ti

Ti Insight is a leading market research and analysis company which for 20 years has provided products and services to the logistics and supply chain industry including market reports; its own unique Global Supply Chain Intelligence (GSCi) online knowledge platform; consulting; training, conferences and webinars.

Ti has acted as advisors to the World Economic Forum, World Bank, UN and European Commission as well as providing expert analysis to governments, manufacturers, retailers, banks, consultancies, shipping lines and logistics service providers.

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