CHAPTER

1 The Future of Fiscal Frontiers and the Modernization of Customs Administration

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One of the great ironies of intellectual history is that Adam Smith, the apostle of free trade, ended his days as a Comptroller of Customs. By the same token, it may seem strange that the International Monetary Fund (IMF), committed to the principles of free trade, should devote a good deal of its technical assistance activities to strengthening the performance of customs administrations. In each case, however, the explanation is easily found. For Smith, the position of Comptroller at Kircaldy, a post his father had also held, was an attractive sinecure (as customs posts continue to be in all too many countries). For the IMF, the support of improvement in customs administration reflects the recognition that although customs administration would wither away in an ideal world, in practice trade taxes are likely to be a significant source of revenue for many of its members, especially developing countries, for the foreseeable future; and that if trade taxes are to be levied, it is best that this be in a way that does least collateral damage to international trade flows.

This book describes and reviews the key challenges that arise in ensuring that customs administrations perform their core revenue functions with minimal adverse impact on trade activities and the allocation of resources—and suggests how they can be addressed. More particularly, it provides a distillation of the central lessons that the IMF—and especially the Fiscal Affairs Department (FAD), which takes the lead in matters of customs administration—has learned from its extensive technical assistance activities in this area. The central theme of this book, as of all FAD's work in this area, is the potential for considerable benefit, to both public and private sectors, from modernizing customs administration in the light of continuing and rapid changes in the pattern, extent, and nature of international trade.

This chapter provides the broad context for this concern with modernization. Section A explains why modernization of customs administration is so vital. It might be thought that with the trend toward trade liberalization over recent decades the revenue role of customs is gradually but surely fading away. But this is far from being the case: many current developments make the role of the customs administration both more important and harder. Section B then describes the essence of modernization, which later chapters elaborate upon.

A. Customs Administration and the Future of Fiscal Frontiers

History and geography combine to select and create border posts as convenient points at which to control the movement of goods and people, managing the interface between distinct national legislations and identities. Control of the movement of people is generally the function of a distinct immigration service. The primary tasks of customs administrations relate to the movement of goods. The many such functions of this kind include protection against terrorist activities (a role that has come to prominence in the United States, in particular, after the attacks of September 11, 2001), the enforcement of quantitative restrictions on imports or exports of particular commodities (perhaps from particular countries), the detection and seizure of prohibited items, the enforcement of sanitary and phytosanitary restrictions and of rules relating to endangered species and intellectual property rights, the implementation of exchange restrictions (becoming less important), checking for movements of large quantities of cash suggestive of money laundering (becoming more important), and the collection of revenues from import tariffs and export taxes.

This book is concerned only with revenue-related aspects of the work of customs administration, and with particular reference to developing countries, where trade taxes remain an important source of government revenue. The links between the various functions just described always need to be borne in mind, however. At the most general level, the need for border controls to serve these other purposes may reduce the costs, and hence increase the attractions, of using them also to raise revenue; conversely, countries that for wider political reasons wish to remove frontiers between themselves—historically a key step in the process of building federations and nations—will find that tariffs too must be dismantled. In more practical terms, there is little gain in speeding up the clearance of goods for tariff purposes if their onward movement is further delayed by, for example, lengthy security or health inspections.[1]

The focus of the book being on the role of customs administration in relation to fiscal frontiers—the interface, physical and otherwise, between the tax and tariff systems of different countries—a key strategic issue is the likely pattern of developments in the nature of those frontiers. Many current trends suggest that, despite continued measures of trade liberalization—indeed to some degree

[1]In one country, black pepper required laboratory inspection by four separate agencies before release from the port.

because of them—that role is unlikely to become any less important in the foreseeable future, and is likely to become even more challenging.

The continuing growth of international trade

The workload of the customs administration is largely driven simply by the magnitude of the trade flows with which it must cope. As shown in Figure 1.1, between 1980 and 1999 the volume of all merchandise exports grew by over 250 percent. Their value rose even more markedly, by 280 percent. These increases outstripped that of world GDP, which rose by 164 percent. They have also been even more marked for developing countries than for developed: developing countries' trade more than tripled in volume over the last 20 years.

These increases in both the absolute and the relative importance of trade flows doubtless reflect, in part, the impact of trade liberalization. But, short of complete free trade, the work involved in processing them is to a large degree independent of the level of the tariffs applied (though the amount of resources optimally allocated to customs administration is not): the steps that must be followed to impose a 5 percent tariff are essentially the same as those required for a 40 percent tariff. Moreover, so long as some commodities bear a tariff, even those that do not require some control in order to prevent evasion of trade taxes through misdeclaration. The increased use of just-in-time methods of production has further increased the importance of timely and effective administration of customs requirements, and the increasing importance of small consignments—requiring at least some monitoring—has added to the work pressures.

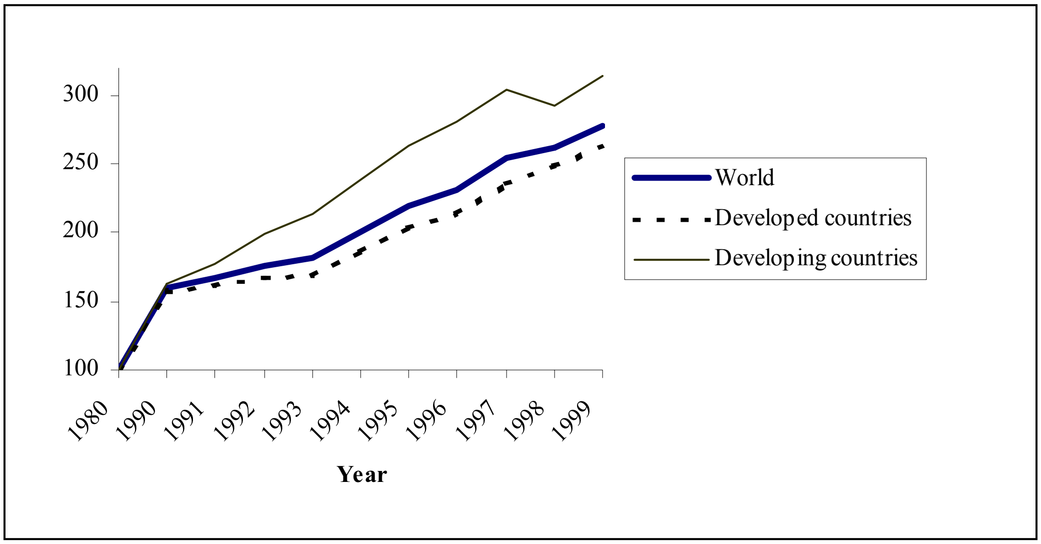
It may be that much of the growth in world trade in coming years will be in relation to services, for which the role of customs is generally limited (for the simple reason that intangibles cannot be intercepted at borders). But there is every sign that the secular trend increase in merchandise documented above will continue. The challenges of processing remaining trade taxes with the minimum disruption to trade are likely, if anything, to intensify.

Tariffs will remain an important source of revenue

Although there has been significant liberalization of trade over recent decades, in many countries trade tax rates continue to be quite high, and the receipts they yield are a key component of the public finances.

Table 1.1 shows the development of collected tariff rates—tariff revenues as a percentage of import value—over the last 25 years. While these have more than

Figure 1.1. The Growth of Trade Volumes, 1980–1999 (1980 = 100)



Source: UNCTAD (2001).
Note: Figures are averages of export and import volumes.

halved in the developed countries of the Organization for Economic Cooperation and Development (OECD), elsewhere in the world the reduction has been less marked. In particular, the average effective tariff rate in Africa has barely changed.[2] These averages conceal, however, considerable variation in developments across countries. The significant reduction in the average collected rate for the Middle East over the 1990s, for example, reflects marked reductions in Egypt and Pakistan. Elsewhere in the region the collected rate hardly fell, or even slightly increased.

The continuing importance of the revenue that governments collect on trade—both imports and exports[3]—is shown in Table 1.2. In Africa, more than one-third of total revenue still comes from trade taxes, whose relative importance actually increased over the 1990s. Elsewhere in the world there is a clear

[2]Export taxes, in contrast, have fallen markedly in almost all regions (though they have also long been less significant than import tariffs). In Africa, export tax revenue fell from 1.6 percent of GDP in 1975 to 0.3 percent by the mid-1990s.

[3]Not including, it should be noted, value-added tax (VAT) collected at the border.

Table 1.1. Collected Tariff Rates by Region
(*Unweighted averages, percent*)

Region	1980	1990	1998
All countries	11.4	11.7	9.3
OECD [1]	4.2	2.9	1.2
Non-OECD	14.3	15.3	11.4
Africa	17.4	19.6	17.0
Asia and Pacific	12.0	12.9	5.6
Middle East	14.3	18.2	10.4
Western Hemisphere	12.7	10.3	8.7

Sources: Various issues of IMF, *Government Financial Statistics* and *World Economic Outlook*; OECD, *Revenue Statistics*.
[1] Excluding Czech Republic, Hungary, Luxembourg, and Poland.

downward trend, but reliance still remains high: one-fifth of all revenues in Asia and the Pacific, and one-quarter in the Middle East.

These figures do not mean, it should be emphasized, that there has not been significant trade liberalization, and this is so even in countries where the collected tariff rate remains high. Trade liberalization is not simply a matter of cutting tariffs and export taxes, but of lightening a whole range of restrictions on trade flows. One key element, in particular, has been the conversion of quantitative restrictions on imports into explicit tariffs, a measure that—in so far as revenue was not collected from quotas by selling licenses to import—tends to raise both collected tariff rates and trade tax revenue. Moreover, if motives of protectionism lead to tariffs being set about revenue-maximizing levels—prohibitively high tariffs, most obviously, raise no revenue—small reductions in their level will actually lead to an increase in tariff revenues. While trade liberalization must thus ultimately lead to a decline in trade tax revenues, in the early stages, at least, revenues may not be greatly affected, as Ebrill, Stotsky, and Gropp (1999) document.[4]

For the foreseeable future, in any event, the central lesson is clear: for many developing countries, and especially the poorest of them, tariff revenue will continue to be a core component of government finances for many years to come.

[4]More generally, any revenue lost by trade liberalization may in principle be more than recovered—while leaving domestic consumers no worse off and preserving the efficiency gains from trade liberalization—by shifting to domestic taxes; see, for instance, Keen and Ligthart (2001).

Table 1.2. Trade Taxes as a Share of Total Tax Revenue
(*Unweighted averages, percent*)

Region	1980	1990	1998
All countries			
OECD [1]	4.7	2.7	1.1
Non-OECD	24.2	20.5	17.7
Africa	38.6	31.9	37.5
Asia and Pacific	29.0	27.6	19.2
Middle East	31.7	28.9	25.2
Western Hemisphere	24.9	14.3	14.2

Sources: Various issues of IMF, *Government Financial Statistics* and *World Economic Outlook*; OECD, R*evenue Statistics*.
[1] Excluding Czech Republic, Hungary, Luxembourg, and Poland.

Customs' role in the collection of domestic taxes

Customs administration also has a key role to play in enforcing fiscal frontiers between domestic tax systems.

The role in relation to direct taxes is limited. Some developing countries levy withholding taxes on imports and/or exports, treating this as partial or complete discharge of income tax liability. The resolution of transfer pricing disputes sometimes revolves around establishing proper valuation of imports, though the more problematic cases concern the treatment of trade in intangibles not monitorable at the frontier.

In relation to indirect taxes, on the other hand, customs administration has a crucial role. These taxes are generally levied on the destination basis, meaning that all domestic consumption of any given commodity—whether domestically produced or imported—is taxed at the same rate, while exports leave a country tax-free.[5] It then falls to customs to play a pivotal part in ensuring that commodities entering a country are brought into tax, and that commodities

[5]Under the origin principle, in contrast, tax is levied on all forms of domestic production, whether ultimately consumed domestically or exported. While this is rare in practice—the main exception being that many of the bilateral trade flows between Russia and other countries of the Commonwealth of Independent States (CIS) were on this basis until July 1, 2001 (and energy products still are)—in this case too the VAT poses important challenges for customs administration, especially in guarding against false claims that final goods have been imported and bear foreign tax (giving rise to exclusion from domestic tax) and undervaluation of exports.

claimed to be exported (and so relieved of domestic tax) are indeed transferred abroad, and not diverted to the domestic market.

In this respect, the importance of customs has actually been increased by the remarkable spread of the value-added tax (VAT), even though this has in many cases been adopted as a conscious adjunct to trade liberalization.[6] The essence of the VAT—now applied in over 120 countries, and adopted by many developing countries over the last decade or so—is that tax is charged at each stage of production; taxes paid on inputs are credited against tax due on output, or refunded to the extent that they exceed output tax. This means that VAT needs to be charged on all imports, whether for final consumption or use as inputs.[7] As a consequence, and as shown in Table 1.3, much VAT revenue is actually collected on imports: more than half in almost all the countries shown (and there is no reason to suppose these to be exceptional), and often considerably more. Much of this revenue will be credited or refunded further down the production chain; but the key point is that it is at the border that governments typically first get their hands on much of their VAT revenues.

On the export side too the presence of the VAT lends added importance to customs administration; one of the most attractive and common forms of VAT fraud is to falsely claim that commodities have been exported, so enabling a dishonest trader not merely to escape tax but to qualify for a refund. Guarding against abuse while promptly relieving tax on genuine exports is one of the most severe challenges in implementing a VAT, and requires considerable effort from customs both directly and in cooperation with the inland VAT administration.

So central is the role of customs in relation to the VAT that Hong Kong, so committed to free trade that it currently has no customs administration, has been advised to consider creating one if it decides to adopt a VAT.

Smuggling will continue

Webster's Dictionary defines smuggling as importation or exportation contrary to the law and without paying duties imposed by the law. Our concern in this book, as noted earlier, is with the latter aspect: the underpayment of duties. We shall rarely speak of smuggling, however, which is too imprecise for most of our purposes. Undervaluation of imports, for instance, is a form of smuggling, even

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[6]The economic rationale for shifting from tariffs to domestic consumption taxation is discussed in Chapter 2.

[7]Some protection against failure to bring commodities into tax at the border is however provided under the VAT—indeed this is one of its attractions—by the prospect of recovering tax on subsequent sales, whether of the commodity itself or others created from it (since the full value of the commodity will then be brought into tax).

Table 1.3. VAT on Imports as a Share of All VAT Revenues

Albania	70
Bangladesh	64
Benin	70
Bolivia	58
Bulgaria	70
Burkina Faso	51
Cameroon	43
Gabon	51
Ghana	50
Guinea	62
Haiti	70
Jamaica	47
Kyrgyz Republic	30
Mauritania	66
Mauritius	60
Pakistan	64
Peru	40
Philippines	44
Togo	68
Uganda	58
Zambia	67

Source: Ebrill and others (2001); IMF staff estimates.

though it does not involve the physical concealment often associated with the term.

So long as tariffs are levied, or domestic taxes differ across countries, there will be potential money to be made from smuggling. In many developed countries, in which revenue from trade taxes is relatively low, the main revenue risks from smuggling relate to the evasion of domestic taxes, especially excise taxes on such readily transported items as cigarettes. The role of customs in enforcing domestic taxation, stressed above, is thus largely one of dealing with the risk of smuggling. In many developing countries, on the other hand, the continuing importance of trade taxes creates a significant risk of smuggling—in the broader sense of Webster—to avoid those taxes. Much of this book is concerned with mitigating these revenue risks. Box 1.1 sets out some of the main elements of a strategy for dealing with any form of revenue-motivated smuggling.

Box 1.1. Dealing with Smuggling

Reduce incentives. The impact of increasing tax rates on smuggling should be considered carefully, especially for excisable goods. Problems occur often when countries raise rates far above the rates in neighboring countries, thereby increasing both the incentive and opportunity for smuggling. In the early 1990s, for example, extensive smuggling of cigarettes from the United States into Canada rendered the relatively high excise rates levied by the latter unsustainable. Dealing with such incentives may require explicit coordination of tax policies in order to avoid mutually damaging tax competition as countries seek to protect their tax bases (or encroach on others'). The European Union, for example, has adopted minimum excise rates binding on all member states.

Identify highest risk areas. Customs administrations should carefully assess the major threats to the revenue. For example, security in the port area—to prevent the disappearance of full container loads of highly taxed goods—may be much more important than the threat posed by fishing boats landing small quantities of goods along the shoreline. Similarly, and especially in developing countries, undervaluation, tariff misclassification, and exemption fraud are very often a much more significant threat to the revenue than, for example, individuals bringing small quantities of goods through uncontrolled paths along the land border.

Design effective countermeasures. Developing and analyzing information is key to countering the various threats from smuggling (which will vary from country to country, depending, for instance, on relative tax and tariff rates and geography). Threats posed from the disappearance of containers from the port can be countered by tightening the reporting of goods and manifest controls. Close cooperation and intelligence sharing with the tax department can uncover major areas of smuggling. Enlisting the help of the trade community can often result in the identification of illicit goods and traders, since honest traders have no interest in their success. As discussed at length later, post-release verification and audits can be implemented to address undervaluation and other fraud that cause significant revenue losses. Implementation of programs such as preshipment inspection (PSI) may have a positive impact on addressing issues of undervaluation and tariff misclassification; however, they are not effective in detecting goods that are never reported to the customs administration. There may also be some scope for such devices as the use of tax stamps or other product marking to identify goods on which proper tax has been paid—but these are vulnerable to counterfeiting.

Undertake joint actions. The customs administration alone is unlikely to be able to counter the threat from clandestine introduction of goods into a country. In these cases, it is necessary to enlist the aid of other government agencies, such as the border patrol and/or coast guard. Formal memoranda of understanding should be developed among these agencies to define their respective roles in countering smuggling.

The proliferation of regional trading arrangements

One of the most important developments in trade policy in recent years has been the spread of regional trading agreements, whether in the form of free trade areas—members levying no charges on trade between themselves but perhaps differing in the tariff they apply to third countries, as with the North American Free Trade Agreement (NAFTA)—or customs unions—free-trade areas with the added feature of a common external tariff as with the European Union (EU).

The World Trade Organization (WTO) reports that by 1996 there were 76 such arrangements, over half of them created in the 1990s; and one estimate is that these covered around two-thirds of world trade (Kilikelly, 1997).[8] There is controversy—discussed in Chapter 2—as to whether this proliferation of preferential arrangements facilitates or retards movement toward global free trade. What is clear, however, is that it poses significant challenges for customs administrations. Indeed, a recent survey by the World Customs Organization (WCO, 2001) finds this to be one of the three main pressures for modernization.

Some degree of complexity is inherent in the need to apply different tariff rates to commodities imported from different countries. But the most fundamental of the challenges resulting from the proliferation of preferential arrangements is not the multiple rate structure itself, but the need to apply rules of origin so as to ensure that these rates are applied appropriately. Such rules are needed to ensure that preferential tariff rates apply only to commodities substantially created within partner countries: especially in the absence of a common external tariff, there would otherwise be a risk of imports from third countries being routed through the member country with the lowest external tariff. Within the Association of Southeast Asian Nations (ASEAN), for example, at least 40 percent of value must be added within member countries in order to receive preferential treatment on importation into another. These rules add considerable complexity to the task of customs administration: their description in the NAFTA runs to over 200 pages.

All these difficulties are especially great when a country belongs to a number of regional agreements, as has become commonplace in Africa.[9] Namibia, to take one example, needs to distinguish between imports coming from Botswana, Lesotho, Swaziland, and South Africa (which may move without restriction, free trade being in place among these countries of SACU[10]), those coming from other COMESA[11] countries (which receive preferential treatment relative to Namibia's most favored nation rates), and those from elsewhere.

[8]At the time of writing, there were believed to be around 300 regional trade arrangements, including bilateral free trade agreements.

[9]To the extent, indeed, that logical inconsistencies may be implied: a country that is a member of two customs unions with nonoverlapping memberships may be required to simultaneously charge imports from a country that belongs only to one both a zero rate (by virtue of free trade within the union to which they both belong) and the nonzero common external tariff of the union to which that other country is not a party.

[10]Southern Africa Customs Union.

[11]Common Market for Southern and Eastern Africa.

Moreover, a central implication of establishing free trade among a subset of countries is the need to ensure proper control of imports from third countries. This then becomes a crucial pressure point for customs administrations. Indeed, through this route the quality of customs administration in each participating country will be to a large extent determined by the quality of the weakest among them. This is especially so when—as in the EU, and aspired to elsewhere—border controls between members are removed. Thus a key concern in negotiations with potential accession countries to the EU, for example, is establishing adequacy of customs controls. Moreover, some degree of harmonization of administrative procedures (such as the adoption of the Single Administrative Document for customs processing in the EU) and intensified cooperation between customs authorities (in the control, for instance, of goods in transit across more than one member of the agreement) is likely to be needed to avoid distortions of and impediments to trade into and among the participating countries.

New ways of doing business

Customs officers have traditionally not had a good public image. At best, they have been seen as physically intrusive, form-laden bureaucrats working in drab offices and fetid warehouses; at worst, as an expensively corrupt obstacle to business. Recent years have seen significant change, however, in the expectations placed on customs administrators. The two other key forces for modernization identified in the WCO survey referred to above relate precisely to these: developments in information technology, and the increased importance of government performance review. Further expectations have been created, in some parts of the world at least, by the renewed emphasis on the security role of customs controls.

The Internet

The staggering advances in information technology over the last decade or so have created huge challenges for customs administrations, but even greater opportunities. Private enterprises now heavily reliant on the new technologies expect customs administration to adapt accordingly. Domestic tax administrations in many countries are indeed moving toward paperless operations—and not only in the most developed countries. Thus there is considerable pressure on customs administrations to use these technologies to further facilitate trade flows, and considerable potential advantages to them from doing so. Making full use of these opportunities, however, means a shift of customs control mechanisms away from a tradition heavily reliant on physical inspection and toward greater use of selective audit based on accounting records.

Concern is often expressed that the Internet will facilitate tax evasion, leading to erosion of revenues both directly and by inducing jurisdictions to engage in tax competition to preserve their tax bases. But these threats appear to be significantly less serious in relation to customs than they are, in particular, in relation to domestic indirect taxation (and even these may have been overstated). For the key tax problems relate to the delivery of digitized commodities over the Internet (and, ultimately perhaps, to services more generally) and to the direct tax assessment of multinational enterprises. But the role of customs administrations in these areas is already very limited. To the extent that a transaction conducted over the Internet gives rise to a movement of physical commodities, that movement will in principle be subject to all the same procedures and controls as apply to transactions completed by traditional means. The principal effect of the Internet through its impact on commercial transactions is thus likely to be quantitative rather than qualitative, with the increased ease of international transacting giving a further boost to trade flows, especially in the form of small shipments, which are disproportionately burdensome to monitor.[12]

The facilitation of communication with the private sector, other parts of the tax administration, and with customs administrations in other countries that advances in information technology enable should be more of a boon to customs administration than they are a threat. Nor are the opportunities ones that only developed countries can realize. Developing countries have long proved perfectly capable of dealing, for instance, with the technological requirements of the airline industry. There is no inherent reason why they should not perform similarly well in modernizing the management and use of information for customs administration.

Governance issues

The private sector, and private citizens more generally, have also come to expect more of government officials in terms of the probity of their behavior. And customs, to be blunt, is often recognized to be one of the most corrupt agencies of government. The money to be made by colluding in the evasion of tariffs and domestic taxes dwarfs the salary of most customs officers: in the early 1990s, for instance, the potential gain from smuggling a semitrailer of cigarettes into Canada was in the order of US$350,000 (Fleenor, 1998). For the EU, it is estimated that the revenue at risk for a full truckload of cigarettes is well over US$1 million, and even for live animals can be over US$20,000.[13] Moreover, officers' ability to impose losses on business by delaying the clearance of shipments gives them considerable ability to extort heavy rents. Reforming the incentive structures

[12]On the other hand, the workload of customs will tend to be reduced to the extent that new technologies enable "physical" goods to be transformed in a way enabling digitized delivery. But this effect is likely to be limited, at least for the foreseeable future (which, admittedly, tends to be rather short in this period of rapid technological change): the WTO estimates that trade in products that could be digitized (mainly books, software, and the like) accounts for only about 1 percent of world trade and customs revenue.

[13]Table 2 of Joosens and Raw (1998).

within the customs administration is a great challenge in many developing countries, and one that is central to addressing governance problems in the public sector more widely.

Security concerns

The perception of a heightened terrorist threat since September 11, 2001 has led to a renewed emphasis, especially in the United States, on the physical inspection of cargoes—one of the immediate consequences of the attack was a huge and costly increase in delays at U.S. border points. Those delays pointed to the clear potential for tension between security concerns on the one hand and trade facilitation on the other. Indeed to a large extent, a renewed focus on physical inspection runs counter to the clear trend in recent years in the opposite direction (on which we elaborate below), toward reduced physical controls and increased stress on post-release controls.

In the months since the attacks, the United States has developed a new approach to customs control that is intended to heighten protection against terrorist attacks—key concerns including the shipment of weapons of mass destruction in container ships (the "nuke in the box") and massive disruption to key ports—without increasing, and perhaps even reducing, costs to traders. At the heart of this approach is the Container Shipment Initiative (CSI), described in Box 1.2. At the time of writing, implementation of CSI is just beginning, and there remain many issues to address. Not the least of these is the risk of trade diversion, with ports not in the scheme disadvantaged. (Goods might be transshipped, for example, from Jakarta, which is not yet in the scheme, to Singapore, which is.) It remains to be seen how extensive and effective the CSI scheme will become, and how it will affect traders' costs.

B. Modernizing Customs Administration: Key Elements

It has become fashionable to refer to the work of customs administration, and its improvement, as an aspect of "trade facilitation." This is close to being Orwellian newspeak. Customs administration is inescapably an impediment to trade. The point of modernization is to reduce these impediments—manifested in the costs of both administration incurred by government and compliance incurred by business—to the minimum consistent with the policy objectives that the customs administration is called on to implement, ensuring that the rules of the trade game are enforced with minimum further disruption. These impediments are potentially very costly. One estimate is that the costs of trade transactions in the early 1990s represented about 7–10 percent of the value of world trade, and that improvements in customs administration could generate savings of US$75 billion

Box 1.2. The United States' Container Shipment Initiative (CSI)

The essence of CSI is that shipments are cleared for security purposes at the port of export, rather than, as has been normal, that of import (somewhat similar, in this respect, to preshipment inspection schemes, discussed in Chapter 12). A container bound from Rotterdam to Charleston, for instance, would undergo security checks in Rotterdam (with the involvement of U.S. Customs officials posted there) and normally be subject to no further controls (other than to check that seals have not been tampered with) on entry into the United States. The process would involve the use of security criteria together with radiation and other technology to identify high-risk containers for inspection, and the development of "smart" secure containers to facilitate entry. In this way, CSI is intended to extend each country's protection—from the nuke in the box, for example—away from its own borders, and the global trading network buttressed against disruption at any single port.

While the business community has been concerned at the potential impact of CSI on traders' costs, the hope of its proponents is that this will be minimal—and that costs may even fall—as the security checks take place during what is already "down-time" at the point of exit rather than at the point of entry,

The United States aims, as a first step, to establish CSI—on a reciprocal basis—with the 20 most important exporting ports to the United States (several of which are in developing countries). The intention is to extend the scheme more widely, both in terms of ports covered and to air freight. The WCO has passed a resolution enabling all members to develop programs using CSI principles.

per year (UNCTAD, 1994). Other studies find traders' costs in complying with border formalities to be in the range of 27 percent of the value of the shipment, and often far higher in developing countries; allowing for the cost of delays, the cost could be well over 10 percent. Even within the EU, the cost of internal border controls was put at 3–4 percent of the value of internal trade (Cecchini, Catinat, and Jacquemin, 1988)—and that was a context in which no trade taxes were actually being levied.

There are thus very significant economic costs involved in inefficient customs operations. Especially in many developing countries, ameliorating them in the face of the many challenges described in the previous section calls for wholesale modernization of customs administration. Subsequent chapters discuss in detail what is needed. The remainder of this one provides an overview of the key features.

Modernization: the essentials

At some risk of caricature, the archetypal traditional and unreformed customs administration is readily described. The whole process of assessing and collecting trade taxes is built around extensive physical inspection of shipments at points of entry. This task is overburdened and complicated by outmoded legislation—in many cases mandating 100 percent inspection—and by trade tax policies that involve extensive rate differentiation and pervasive exemptions, so adding to the difficulties of monitoring trade flows. Some use is made of information technology to process and record shipments, but little creative effort is made to use that technology to simplify the compliance burden on the private sector or to ease the inspection effort. Shipments commonly experience substantial and unpredictable delays—20 days is not uncommon—before release from port. Procedures governing such routine but critical operations as establishing accurate import values and monitoring against misuse of exemptions are haphazard in design and/or poorly implemented. Organizational procedures inhibit full information exchange and cooperation with other branches of the tax administration. Corruption is widespread in the customs administration, almost institutionalized and taken for granted as a normal feature of business activity. In some cases, customs administration has been largely taken out of the hands of domestic officials and handed over to private inspection companies—arrangements that have not proved entirely corruption-free and have in any event left in doubt the future of the domestic customs administration. Relations between the private sector and the customs administration are adversarial; on both sides, morale is low and—sometimes with good reason—suspicion is high.

The modernization of customs administration requires fundamental changes in both the environment within which the customs administration works and the way in which it undertakes its activities. Change is required in four key areas:

- ***Establishing coherent trade policies and clear supporting legislation.*** In its revenue functions, customs administration is a tool of trade and fiscal policy. Well-designed policy measures, simple and encapsulated in transparent legislation describing both the policy itself and the means of its implementation, are essential if the work of the customs administration is to convey benefits to society that offset the costs it necessarily involves. Moreover, badly conceived and/or complex policies, lacking a coherent rationale and often characterized by considerable arbitrariness, are by their very nature often hard to administer.

- ***Adopting modern, simple procedures.*** Customs administrations must cope with a wide range of special issues, many of which pose considerable danger to revenue and other policy objectives. Goods that are given remission of duty on the grounds that they are in transit to another country, for instance, or because they are to be used to produce exports, may be fraudulently diverted to the domestic market. Exemptions given to particular goods, perhaps conditional on particular uses being made of them, may also be abused. Goods may be undervalued in order to reduce the duty payable. To provide protection against these threats without unduly interfering with legitimate trade requires well-designed, simple procedures. All too often, cumbersome procedures built on outdated methods continue to be used in many countries, managing both to jeopardize revenue and to impose significant burdens on the honest trader. Such procedures do exist. Computerization and the use of modern methods of data exchange have a key role to play. Alone, however, they are not enough and indeed can be a distraction from the key issue—the improvement of basic procedures.

- ***Shifting to substantial reliance on self-assessment by taxpayers, supported by movement from physical to post-release controls.*** It is increasingly recognized that the key to effective tax administration is voluntary compliance by the taxpayer, and that the key to voluntary compliance is self-assessment: a system, that is, which relies on taxpayers to themselves declare, and pay, the tax due—but, crucially, provides a system of ex post checks of those declarations, with penalties for misdeclaration. This is as true in the area of customs as it has proved, for instance, in relation to VAT or the income tax. In the customs context, this means a deemphasis on physical inspection at the point of entry, with importers (or their agents) themselves declaring the duties payable—but with effective control exercised after goods have been cleared for entry, involving post-release audit and other checks focus on addressing transactions where the risk of misdeclaration is greatest.

- ***Ensuring incentive and organizational structures conducive to integrity and effectiveness in customs administration.*** Like any large body, customs administration requires an organizational structure attuned to the objectives it is set and the tasks it must execute. Customs administration must be given a clear mandate, freed of political interference, and well placed to cooperate with other branches of tax administration (not least in relation to VAT, as noted above). Corruption can never be eradicated, given the magnitude of the potential gains from illegal movement of goods, but it can be tempered by providing customs officers with both reasonable rewards for work well done and effective penalties for impropriety. The private sector may have a role to play in this, with some element of outsourcing of customs activities—for example, by the use of preshipment inspection companies—though this approach runs the risk of dealing with the problem of an ineffective domestic capacity by, in effect, ceasing to aspire to having such a capacity.

The purpose of this book is to explore in some detail these requirements for establishing effective customs administration. The task is clearly not easy. Modernizing customs administration requires strategic planning in often difficult circumstances, effective use of technical assistance, and, indispensably, strong political commitment. Measuring the potential gains from modernization is extremely difficult: past episodes of modernization have typically been accompanied by many other changes, for example in tariff rates and structures, that make it hard to isolate the effects of administrative changes. And, there have been few attempts to measure the compliance costs that customs arrangements impose on taxpayers, and still fewer attempts to do so before and after reform. It

Box 1.3. Two Examples of Successful Customs Administration Modernization

Morocco

In 1996, the average stay of containers in the port at Casablanca was 16 days, of which 10 days were attributable to customs controls. The authorities then embarked on a reform program that embraced all the elements discussed in this book: the customs code was improved, procedures were streamlined and simplified, controls were based on risk assessment, performance standards and effective internal audit were established, effective use was made of information technology, and a consultation process with the private sector was established to resolve potential problems. After three years, the processing time for customs declarations had fallen from ten days to three hours, and after five years 85 percent of declarations were processed in under an hour and a half—all with no apparent cost in terms of customs revenue collected.[1]

The Philippines

In the first half of the 1990s, the authorities were faced with a huge increase in import volumes—by over 160 percent between 1990 and 1996—while at the same time being committed to reducing the workforce in customs administration by about 15 percent. Faced with these pressures, the authorities embarked on a thorough reform of customs administration, including the use of risk-management techniques, increased emphasis on controls pre-arrival and post-release rather than at the point of entry, and improved use of information technology. Despite the huge increase in volume, these measures resulted in cargo clearance times falling from an average of around one week to less than 48 hours for selected shipments and less than 15 minutes for super greenlane shipments. Revenue, meanwhile, increased by over 60 percent.

[1]For further detail on the Moroccan experience, see World Bank (2002).

is clear from experiences, such as those recounted in Box 1.3, however, that the gains—even if hard to quantify—can be considerable.

The role of international institutions

The smooth functioning of international trade, and hence the effectiveness of customs administration, is inherently a multilateral concern. In consequence, a range of international organizations have come to play a key role in shaping the demands upon, and the work of, customs administrations. The functions of two of the most important of these—the World Trade Organization and the World Customs Organization—are described in Box 1.4. Further detail on key WTO rules on trade and tariff policy is given in the next chapter.

This book derives, of course, from the interest of the IMF in matters of international trade. This interest is central to the IMF's core mandate, one of the central objectives laid down in its Articles of Agreement being to facilitate the expansion and balanced growth of international trade. In pursuit of this

Box 1.4. The WTO and the WCO

The **World Trade Organization** (WTO)—successor to the General Agreement on Tariffs and Trade (GATT), established in 1948—provides the institutional framework for trade negotiations and the resolution of trade disputes. Its 142 members commit to standards of good conduct in relation to trade policy, including the specification of "bound" tariff rates that they will not exceed other than in emergency. (Countries may however impose an across-the-board increase in tariff rates when faced with a balance of payments emergency, with the IMF playing a role in determining whether such circumstances do indeed exist.) Recognizing the possibility that over-valuation of imports for tariff purposes could lead to indirect protection, the WTO has for many years taken the lead role in establishing proper procedure for the valuation of imports.

The **World Customs Organization** (WCO)—based in Brussels—grew out of efforts at restructuring in Europe after the Second World War, but is now a global organization—it has more than 160 members, accounting for over 95 percent of all world trade. Its purpose is to promote effective customs administration, aiding in the design of measures of harmonization and simplification—most notably through its development and maintenance of the Harmonized Commodity Description and Coding System for product classification and the Kyoto Convention on the Simplification and Harmonization of Customs Procedures—and promoting experience sharing and the dissemination of best practice in these areas. Further detail on these is provided in Box 3.1 in Chapter 3.

Table 1.4. IMF Technical Assistance in Customs Administration, 2000

	Missions [1]	Expert Person-Months [2]
Total	30	64
Of which:		
Africa	10	34
Asia and Pacific	4	11
Eastern and Central Europe	2	1
Baltics, Russia, and other CIS	5	6
Middle East	3	10
Western Hemisphere	6	2

Source: Staff calculations.

[1]Missions typically last two weeks and have three members. In some cases, joint customs and tax administrations are undertaken.

[2]This includes long-term (more than six months), short-term, and peripatetic assignments.

objective, the IMF does all it can to encourage and assist its members to move toward global trade liberalization, while being mindful of—and helping to address—the political problems, revenue risks, and administrative challenges that they face in doing so. These concerns are reflected in all three of the IMF's main areas of activity. In its routine surveillance of member countries' economic policies, the IMF generally includes an assessment of its trade policies and, where problematic, its customs administration. In its work involving loans to members—and whether the program is prompted by an immediate crisis or focused on longer-term development and crisis prevention—reform of both trade policy and customs administration is frequently a major component, and the loans are often made conditional upon reforms in these areas.[14] In the IMF's technical assistance activities (which may be, but need not be, tied to program work), FAD has offered extensive technical assistance in the reform of both trade policies and customs administration.

The analysis and conclusions presented here arise from the extensive experience of FAD in delivering technical assistance on the modernization of customs administration. Table 1.4 gives an impression of the extent and nature of this assistance, most of which is focused on developing countries. One-third of all short-term missions are now to, and over one-half of longer-term assignments are in, Africa. Box 1.5 describes the main areas in which FAD provides technical assistance on customs-related matters.

The IMF is not the only provider of technical assistance in modernizing customs administration.[15] The World Bank has also attached considerable importance to this area, and has been especially active in the support of large reform programs. The WCO itself also provides some training and technical assistance, particularly in relation to the harmonized system and valuation rules. Much assistance is also provided by regional organizations and on a bilateral basis. Indeed technical assistance on customs administration has received renewed emphasis in recent years as part of the wider effort to integrate poorer developing countries more fully into the world trading system. Most notably, the ministerial declaration following the meeting of the WTO in Doha in November 2001 called for a substantial increase in resources devoted to these activities. Developing and coordinating all this work has become an increasingly difficult and urgent task, and has been taken up under the Integrated Framework for Trade-Related Technical Assistance. This is an inter-agency effort—bringing together the work in this area of the IMF, International Trade Center (ITC), United Nations Conference on Trade and Development (UNCTAD), United Nations Development Program (UNDP), World Bank, and WTO, and

[14]See IMF (2001).

[15]The WTO lists over 50 providers of trade-related technical assistance.

Box 1.5. Technical Assistance Provided by the Fiscal Affairs Department in Relation to Trade Liberalization

Technical assistance might cover any or all of:

1. **Developing a strategy** to help government to define the main thrust of reforms, identifying the main stumbling blocks and how they might be overcome, and coordinating trade liberalization with other fiscal reforms.

2. **Proposing a new tariff structure** to provide the basis for the work of a national committee of experts responsible for holding consultations with the private sector and estimating the impact on government revenues.

3. **Identifying compensating revenue measures** to offset any revenue loss from tariff reform, by improving domestic taxation and the tax administration.

4. **Promoting reform** by holding information seminars and discussions with the government agencies concerned (customs, tax, trade, industry, and agriculture departments) and the private sector.

5. **Reviewing the work of the national committee of experts** to ensure that the new amended tariff is consistent with the objectives defined at the outset, that the estimated fiscal impact is accurate, and that recommendations are put forward for a definitive reform project.

6. **Modernizing the customs administration** to (a) ensure proper application of the tariff and (b) facilitate international trade.

supported by bilateral donors—to enhance the efficiency and effectiveness of trade-related technical assistance to LDCs.

The important point for the purpose of this book, however, is that there is considerable agreement among technical assistance providers, and recipients, as to both the importance of modernizing customs administration and the practical steps that this requires.

C. Outline of This Book

The challenges to be faced in modernizing customs administration will naturally vary across countries, reflecting the different positions in which they initially find themselves. There are, however, many common problems to be addressed, and much experience as to the ways in which they can be resolved. The purpose of this book is to provide a sense of what those solutions are, and how they can be realized.

Chapter 2 considers the trade policy and fiscal objectives that, it must always be remembered, are the reason for having a customs administration in the first place. The importance of having a strategy for reform, and its key elements—sketched above—are considered in Chapter 3. Chapter 4 addresses the modernization and simplification of basic procedures, and Chapter 5 then turns to the central feature of modernization: a strong emphasis on post-release controls. The problem of establishing accurate valuation for imports—one of the most troublesome areas of customs administration in many developing countries—is considered in Chapter 6. Problems associated with transit, duty remissions, and exemptions are discussed in Chapters 7 and 8. Remaining chapters take on key issues of management, structures, and incentives: computerization (Chapter 9), organization structure (Chapter 10), dealing with corruption (Chapter 11), and the use of the private sector (Chapter 12). Chapter 13 concludes.