CHAPTER

2 Trade Policy and Customs Administration

Anne-Marie Geourjon

For many decades, and despite the conclusions of classical economic theory in favor of free trade, the opening up of an economy to trade was widely regarded as a good idea only for developed countries with strong industrial sectors that could stand up to competition without protection.[16] A complete reversal of economic thinking on these issues for developing countries came toward the end of the 1970s. While free trade has thus gradually become the declared objective—at least ultimately—of almost of every country, defining and applying strategies for reaching this goal has been no easy task. Under these circumstances, trade and tariff policies are key issues for developing countries, especially since taxes on imports are a mainstay of their government revenues (as seen in Chapter 1). Their evolution has had a strong and direct influence on the customs administrations that are responsible for implementing them.

The purpose of this chapter is to review the framework and instruments of trade policy (Section A), to outline the policies pursued by most countries before and after reforms introduced to liberalize trade (Sections B and C), and to show the relationship between changes in trade policy and in customs policy (Section D).

Since trade and tariff policies deal mainly with the importation of goods, this chapter—indeed, this book—does not address other aspects such as exports, trade in services, environmental protection, and intellectual property.

A. The Framework and Instruments of Trade Policy

In 1994, the World Trade Organization (WTO) replaced the General Agreement on Tariffs and Trade (GATT), which dated from 1948. Upon joining the WTO, each new member country reaches an agreement with the other members on a maximum level of tariff protection for each commodity—known as the "bound"

[16]The agricultural sector is still highly protected, however.

tariff rate—and makes a commitment to liberalize its foreign trade. However, all of the WTO agreements contain special provisions that give developing countries and the least-developed countries (LDCs) preferential treatment. The WTO ensures the gradual opening up of its members' economies and facilitates trade, but, in so doing, limits their freedom of action in trade, tariff, and customs policies. It recognized, for instance, the key role that the notion of "customs value" plays in determining tariff levels, and so decided long ago to provide a strict definition that is to be applied by all of its members.

The 142 WTO members are bound to comply with the organization's rules when setting their national trade policies. The WTO rules constitute the multilateral framework for international trade.

Understanding trade policies requires distinguishing between two sets of rules: the standard rules and exceptions.

The standard rules

These are the rules that apply in the absence of any exceptions. Logically, they should be the rules currently in force, which is why they have always received so much attention from reformers. The main purpose of trade policy is to define the general rules aimed at protecting domestic economic activities and consequently changing the system of incentives. Two types of instruments are used for this purpose: customs duties and nontariff barriers.

Customs duties

Definition

The official tariff schedule lists all the duties and taxes on imports of each item in the customs nomenclature and gives the corresponding tax rates. Only customs duties and taxes with equivalent effects provide protection, since they are levied on imports but not on domestic production: this creates a bias against imports and in favor of locally produced goods.

Other taxes listed in the official tariff schedule, such as sales taxes, VAT, and excise taxes, are domestic taxes. In principle, they apply equally to both imports and locally produced goods. The main purpose of such taxes is to raise revenues for the government.

When joining the WTO, members enter a number of commitments:

- not to increase rates of duty above agreed bound levels and to remove them progressively;

- to levy tariffs on an ad valorem basis (that is, as a proportion of the price) rather than in specific form (specified in monetary form), the rationale being to make it easier to assess the level of protection being granted[17] (though the use of ad valorem tariffs also makes it critical to establish the proper valuation of goods, a problematic task discussed at length in Chapter 6); and

- to charge administrative fees for customs services only in amounts in line with the cost of the services rendered: this means that fees must be a flat charge per transaction, regardless of the value involved.

Economic effects[18]

Customs duties on imports of goods have several effects. They harm local consumers by increasing the domestic prices of the goods concerned, and they protect local producers of competing goods by enabling them to charge higher prices on the domestic market. Duties also generate revenue for the government. Standard economic theory emphasizes that—given certain assumptions—tariffs give rise to a net welfare loss for the country that imposes them.[19] That is, the gains to local producers and the government are less than the losses to consumers: by distorting production away from the pattern that maximizes national income at world prices, tariffs ultimately reduce a nation's real purchasing power. In cases where those assumptions do not hold, customs duties may, in principle, result in welfare gains—but the practical importance of these possibilities is doubtful (see Box 2.1).

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[17]Ad valorem and specific tariffs have equivalent economic effects in competitive markets for homogeneous products. When product quality varies, however, or product markets are imperfect, the two can have different effects: broadly speaking, predominantly ad valorem taxation tends to favor relatively low quality products and to lead to relatively low final prices. See, for instance, Helpman and Krugman (1989), and Keen (1998).

[18]For a more detailed discussion see, for instance, Krugman and Obsfeld (1997).

[19]The key assumptions required are (1) that the original situation is one of free trade; (2) that the country concerned is "small" in world markets, meaning that domestic demand and supply have no influence on world prices; (3) that markets operate efficiently, and (4) that each dollar of private gain or loss accruing to the various agents involved—consumers, producers, and government—has the same social value.

Box 2.1. Two Economic Arguments in Favor of Customs Duties

The optimal tariff for "large" economies

If a country is important enough in the market for some commodity for its demand and supply to affect its world price, then by using taxes and tariffs it can manipulate that price to its advantage. By imposing a tariff, for example, it can drive down domestic (and thus world) demand and hence the world price of its import. In this case, the duty will improve the terms of trade by forcing foreign exporters to bear some of the loss of welfare. The classic "optimal tariff" is the one that maximizes a country's national welfare in this way. It should be noted, however, that such a tariff is only optimal from the perspective of the country imposing it: this gain comes at the expense of the countries with which it trades. Indeed, if all countries were to impose optimal tariffs of this kind then all might end up worse off than they would be under free trade. In any event, developing countries are rarely large enough in the world market for any good to use this argument to defend duties.

Market inefficiencies

If markets are in some way imperfect, tariffs may have a corrective role to play. For instance, if the consumption of some good generates pollution, increasing its price by imposing a tariff on imports may increase social welfare. Or, the classic (perhaps infamous) "infant industry" argument, temporary protection may enable a nascent sector to develop the financial resources and/or technical expertise needed to sustain itself in world markets. Such arguments can look very strong—at first glance. But they rarely have much practical appeal when examined more closely. First, it is difficult to identify and measure inefficiencies in domestic markets, which means that it is virtually impossible to put forward appropriate interventionist policies (and, conversely, that it is possible to rationalize on these grounds almost any bizarre policy). Second, trade policy is generally not the best-targeted device for dealing with imperfections in domestic markets. In the first example above, if consumption generates pollution, then the consumption of domestically produced items should be penalized just as much as that of imports: the best response, that is, is not a tariff but a consumption tax. In the second, public provision of a loan and/or production subsidies can address the underlying market inefficiency without unduly discouraging domestic consumption. While it can be hard to identify such corrective policies in practice, protection is rarely the best available approach.

Customs duties give domestic producers a price advantage by raising the cost of competing imported goods, but at the same time penalize them to the extent that they raise the cost of imported inputs that they use. The level of protection that local producers enjoy is measured by the extra value-added that differentiated customs duties enable them to obtain per unit produced. This distortion is known as *effective protection.*[20]

[20]The effective rate of protection for activity j is given by $EP_j = (VA_j^d - VA_j)/VA_j$, where VA denotes value-added at world prices. Denoting the price of good j by P_j, the proportionate tariff rate on j by t_j and by $a_{jk,}$ the amount of good k used to produce each unit of output of good j, $VA^d = P_j(1+t_j) - \Sigma_k \alpha_{jk}(1+t_k)$, and hence

$$EP_j = \frac{t_j P_j - \Sigma_k \alpha_{jk} t_k P_k}{P_j - \Sigma_k \alpha_{jk} P_k}.$$

It is easily seen that the effective rate of protection is higher than the nominal rate of protection on the finished product whenever the average tariff rate on inputs is lower than that on the final product. Intuitively, the activity gains more from the protection of its output than it loses from protection of its inputs. Similarly, the greater the excess of the tariff rate on the final product over that on inputs, the more effective protection differentiated duties offer local producers. This means that a differentiated tariff structure can produce substantial economic distortions. Import substitutes enjoy an advantage and thus divert investment away from export industries. In addition, export industries are penalized by tariffs on their own inputs and on those of their local suppliers. Special customs rules, such as drawbacks and temporary admission (see Chapter 7), enable exporters to escape paying duty on their inputs. The purpose of such rules is to offset some of the bias that a differentiated tariff structure creates against export industries.

Nontariff barriers

Definition

Nontariff barriers are all measures other than explicit customs duties that are likely to give local production an advantage over imports. This definition covers an extremely broad range of measures since it includes quantitative restrictions, quasi-tariff measures, and measures that have been diverted from their original intent to be used as protectionist measures (such as technical standards and anti-dumping duties).

The severity of quantitative import restrictions depends on the form they take. This can range from outright import prohibition to import licensing. Market conditions also determine the impact of quantitative restrictions, since the severity of a measure depends on the elasticity of demand for the import in question.

Quasi-tariff instruments are measures to increase tariff protection without actually changing the rates of customs duties. They involve either an increase in the reference prices, officially established minimum values, or administrative values used for assessing duties,[21] or the setting of a minimum duty charge.

Technical standards intended to maintain competition or protect consumers, anti-dumping duties, and import prohibitions on certain goods to protect public

[21]Official values were originally introduced as a reference for customs administrations that had difficulty assessing the customs value of certain products. The WTO's definition of value now prohibits the use of official values, with the exceptions noted in the text below. See Chapter 6 for details.

health are sometimes put in place with the primary goal of protecting local producers of competing goods. But they can have the effect, intentional or otherwise, of unduly favoring domestic producers, with the wrongful use of such instruments often difficult or impossible to prove.

The WTO bans nontariff barriers aimed at protecting local producers. For developing countries, however, it may accept limited lists of official values for certain products after receiving prior notification.

Developing countries, which have been granted extra time to apply WTO rules, have mainly relied on the first two categories of nontariff measures up until now. Developed countries, which have long since been banned from using quantitative restrictions or quasi-tariff measures, are more likely to divert measures originally intended for other purposes to provide occasional protection for specific industries.

Economic effects

Unlike customs duties and quasi-tariff instruments, quantitative restrictions and other nontariff measures do not generate any extra revenues for the government, unless import quotas are auctioned.[22] As with customs duties, nontariff measures lead to higher domestic prices that penalize consumers and give local producers an advantage. The level of protection provided in this way is often very high because it is "hidden" protection that is more politically acceptable.[23] In practice, it is impossible to assess the nominal protection provided by nontariff measures in most cases,[24] since the differential between the world price for a good and its domestic price can result from the combined effects of tariff protection, nontariff protection, natural protection, voluntary export restraints agreed to by supplier countries, and fraud. Such measures tend to make protection systems opaque and unstable since they can be changed by government decree, whereas changes in the official schedule of tariffs have to be passed by lawmakers.

The use of nontariff barriers also tends to give rise to rent-seeking behavior. Krueger (1974) discusses the effects of such behavior, particularly with regard to

[22]The few experiments with such auctions were short-lived because of the implementation difficulties.

[23]The nominal protection provided by customs duties is published in the official schedule of tariffs. The official nature of this protection makes it more difficult for excessive rates to be adopted. On the other hand, the use of official values, for example, can provide protection that has many times been found to be equivalent to customs duty rates of over 200 percent, or even 500 percent in many cases.

[24]The equivalent tariff protection level of quasi-tariff measures can be estimated by calculating the ratio of custom duties levied to the declared value of imports and comparing the result to the official customs duty rate published in the official schedule of tariffs.

quantitative restrictions, emphasizing that the loss of welfare resulting from import quotas is much greater than the loss resulting from equivalent tariff measures[25] when the wasted time and resources involved in rent-seeking are taken into consideration.

Nontariff measures are often very popular with local producers, because they can be expected to provide a high level of protection. Yet the negative economic effects of such instruments are now universally acknowledged. Replacing a tariff by a quota that implies the same level of imports, for example, tends to strengthen the market power of domestic firms, since it removes the threat that by raising the price charged to domestic consumers they will induce an increase in imports.[26] Except for direct subsidies, which are the most targeted and the most reliable way of granting domestic producers a price advantage, customs duties are still the most efficient or, rather, the least inefficient—instrument for protection.

Exceptions to the standard rules

The standard rules apply in principle to all goods imported for consumption in the domestic market, with two exceptions: either the importer has been granted an exemption or the exporting country has signed a preferential trade agreement with the importing country.[27] In these two cases, the tariffs on imports are assessed at reduced or even zero rates.

Exemptions[28]

Different categories of exemptions

Some exemptions are imposed by international agreements or practices. The advisability of other exemptions granted for social or economic purposes is more debatable and depends on their economic effects.

A key issue here is the categorization of customs duty exemptions, since this is crucial in order to define and evaluate policy in this area. For example, in Ghana,

[25]The tariff equivalent of a nontariff measure corresponds to the percentage increase in the domestic price of the good resulting from the measure.

[26]On the comparison between tariffs and quotas under imperfect competition, see Helpman and Krugman (1989).

[27]Goods exempted from customs duty are officially exempted in all types of transactions. Therefore, these exemptions are not exceptions to the standard rules.

[28]Goods imported under suspension arrangements are not considered to be exempted from duty since they are not consumed in the domestic market. If such imports are released into the domestic market after the suspension arrangement ends, they may be exempt from duty or subject to preferential rates if they come from a specific country.

some exemptions are classified according to the beneficiaries and others are classified according to the agency that grants them, but their original purpose is never taken into account. The classification of exemptions is also important because any lack of transparency surrounding the exact content of exemption categories and the corresponding official texts tends to promote discretionary decision making.

Even though almost all countries use some exemption categories, such as diplomatic privileges and migrants' belongings, there is no "official nomenclature" of customs exemptions and each country defines its own categories. The need for standardized categories of customs exemptions has been more keenly felt with recent moves toward regional integration. In a customs union, standardized categories are critical for harmonization of exemption policies and for ensuring that the common external tariff is actually applied. One such general categorization is developed in Chapter 7; more specifically, Box 2.2 shows the categories of customs exemptions to be used as a basis for harmonizing exemption categories in the countries belonging to the West African Economic and Monetary Union (WAEMU). The categories are clear-cut and cover all cases. They could serve as a guide for countries seeking to improve their policies in these matters.

Economic effects

The traditional categories are those under headings 1, 2, 4, 5, 6, and 8 in Box 2.2. While one can argue about their merits in principle, the key issue here is practical: customs administrations must take special care to make sure that they are not abused to serve the needs of the underground economy. The several ways of improving monitoring of these exemptions and making them easier to administer are discussed in Chapter 7.

Ad hoc exemptions (Category 7 in Box 2.2) have long accounted for a substantial share of customs exemptions. There is no justification for maintaining these exemptions; discretionary exemptions undermine the transparency of the exemptions system, induce rent-seeking and corruption, and have rarely proved effective in achieving their original goals: there is a strong presumption that all such exemptions should be abolished.

Box 2.2. The WAEMU Expert Committee's Suggested Categories for Customs Exemptions

The following categories and their definitions were proposed at a workshop in Ouagadougou in September 2000 to harmonize the classification of customs exemptions in the WAEMU countries:

1. **Diplomatic privilege and similar exemptions**: diplomatic privileges; institutes and schools (Florence convention); international and regional organizations.
2. **Migrants' and personal belongings**: migrants' belongings; personal belongings; exemptions granted to travelers.
3. **Investment incentives**:[1] investment codes; mining codes and other industrial codes; authorized companies; Build-Operate-Transfer projects.
4. **External financing**: public procurement; agreements and project financing.
5. **Grants and assistance**: grants to social welfare bodies and development associations; grants for the Red Cross; social and cultural grants; grants to the central government and its agencies.
6. **Nongovernmental organizations.**
7. **Exceptional exemptions**:[1] discretionary exemptions.
8. **Conditional exemptions**: coffins and last remains; trade samples; religious objects; documents with no commercial value; prizes and awards.

[1]It was proposed at the workshop that categories 3 and 7 be omitted.

Customs exemptions aimed at promoting investment (Category 3) are the most controversial. They are widely used in developing countries. While there is no doubt that such measures can stimulate investment, the evidence strongly suggests that other factors, such as political stability and the quality of infrastructures, have a far greater influence. They are also susceptible to mutually damaging tax competition, as countries do themselves mutual damage in offering generous incentives to inward investment. Thus Zee, Stotsky, and Ley (2002) conclude that "...the empirical evidence on the cost-effectiveness of such incentives in stimulating investment is highly inconclusive." Developing countries are thus generally best advised to eliminate customs duty exemptions used as investment incentives and to deploy less costly measures instead, such as more generous depreciation allowances. Developing countries should also be encouraged to review their standard tax rules concerning capital goods and inputs.[29]

Regional integration agreements (RIAs)[30]

Different types of agreements

Logically, regional integration agreements are inconsistent with the Most Favored Nation clause (MFN) in the WTO agreements (GATT Article I), which requires that a country apply the most favored nation's tariff to all other countries.

Nevertheless, the WTO does allow such agreements.[31] By way of example, Box 2.3 shows the implications of accession to WTO membership and the implications of signing an RIA in the case of Algeria, which is currently negotiating its accession to the WTO and has signed a free trade agreement with the EU.

One can distinguish between four types of RIAs, differing in the speed and depth of integration that they entail:

- *Free trade areas* or preferential trade areas, in which participating countries undertake to eliminate or reduce barriers to trade without changing their policies with regard to third countries. Examples include NAFTA and agreements between the EU and certain Mediterranean countries.

- *Customs unions*, which are free trade areas in which the members apply a common external tariff (CET). Examples include the WAEMU and the agreement between the EU and Turkey.

[29]Some countries allow deferment of VAT payments on imported capital goods until the time of the next return, so recognizing the cash flow difficulties of companies in their start-up phase without having to grant VAT exemptions.

[30]For a more detailed discussion, see Panagariya (2000).

[31]These are governed by GATT Article XXIV.

Box 2.3. Algeria's Request for Accession to the WTO and of a Free Trade Agreement with the EU

The WTO must be notified of any plans for a free trade area, whose creation is governed by GATT Article XXIV. The purpose of a free trade area must be "to facilitate trade between the constituent territories and not to raise barriers to the trade of other contracting parties with such territories." For this purpose, Article XXIV sets out three key principles: (1) tariff and nontariff barriers to trade with countries outside the free trade area must not be higher than they were before the free trade area was created; (2) most of the trade involving products from countries in the free trade area must be liberalized; and (3) the free trade area between the member countries must become effective within a reasonable period of time.

As part of its accession to the WTO, Algeria must agree to tariff bindings and tariff concessions. Tariff bindings, which may be theoretical in nature—the bound tariff being higher than that currently applied—are intended to block excessively high rates (rates can be decreased, but not increased). They cover all products. Tariff concessions involve nonagricultural products only, since Chapters I through XXIV of the Harmonized System are excluded. The tariff concessions that Algeria will be required to make for its accession to the WTO are less than those required for its free trade agreement with the EU.

The free trade agreement with the EU gives Algeria 12 years to eliminate its tariffs on imports from the EU covered by Chapters XXV and up of the Harmonized System. As far as agricultural products are concerned, the terms of the 1976 agreement, which do not require the elimination of tariffs, will be renewed. The elimination of tariffs will proceed on the basis of the customs tariffs in force at the signature of the agreement in April 2002.

Logically, regional integration takes place gradually and moves through the different types of RIAs in succession: the EU is one example, now being something more than a common market but something less than an economic union. The WAEMU, which is a customs union, eventually hopes to become a common market and then, ultimately, an economic union.

Economic effects

RIAs institute preferential relationships between their members and thus change international trading patterns and conditions. The "traditional" effects of RIAs are trade creation, trade diversion (Viner, 1950), and impact on the terms of trade and economies of scale.

- "Trade creation" refers to the increase in internal trade as tariff and nontariff barriers between members are reduced. This is a positive effect since it leads to a more efficient allocation of factors of production within the agreement area, in line with the different members' comparative advantages.

- "Trade diversion," on the other hand, is an adverse effect of RIAs on the allocation of resources. A country in an RIA may find that the elimination of tariff and nontariff barriers under the agreement makes it cheaper to buy its imports from one of the other members even though the tariff-exclusive price of imports purchased from outside the agreement—which reflects the true cost to society of acquiring them—is lower. Switching from a more competitive supplier that is not a member of the agreement to a supplier that is less efficient in terms of production costs but enjoys a price advantage nevertheless because of the RIA is an inefficient use of resources.[32]

- If the countries in an RIA are large enough to influence world prices, the increase in trade between the RIA signatories and the reduction in their imports from the rest of the world will lead to a fall in world prices of their importable goods that will improve their terms of trade.

- For small countries, joining an RIA increases the size of the market accessible to its producers and may thus enable fuller realization of economies of scale.

RIAs may also influence economic policies and potential investors' perceptions of these policies. Fernandez (1997) emphasized two major positive effects of RIAs. First, they can facilitate implementation of rational economic policy measures that would have been more difficult to implement in their absence. For example, a country in an RIA may be less tempted to give in to pressure from domestic interest groups to protect certain industries: a "preference dilution" effect. Second and more generally, an RIA shows investors that a country is committed to an open trade policy and makes the associated liberalization more credible.

The proliferation of RIAs has led to an extensive and sometimes heated debate in the academic literature. Aside from the empirical question as to the practical significance of trade diversion and trade creation, this has focused on such issues as the relative merits of creating a free trade area and a customs union, and the impact of RIAs on patterns of activity in the regions concerned.[33] One such issue

[32]Suppose, for instance, that country A can either buy some commodity for $100 from outside the RIA or at a cost of $120 from its partner country B. Imagine that A initially imposes a tariff of 30 percent on all countries. It will then buy from the rest of the world. If the tariff is eliminated on imports from B, however, the private sector will now prefer to import from B: this is a cheaper source for them (since $120 is less than $130), but not for the country as a whole (since the relevant cost for the nation is the tariff-exclusive cost, and $120 is more than $100).

[33]Krugman (1993); Winters (1994); Bhagwati and Krueger (1995); Wonnacott and Wonnacott (1995); (1996); Venables (2000).

is the comparison between a hub-and-spoke form of integration—in which several countries (spokes) sign separate free trade agreements with another country or group of countries (hub), without any liberalization of trade between the spokes—and a free trade area; the general conclusion is that, not surprisingly, the hub derives the greatest advantage from this arrangement and, moreover, that a hub-and-spoke system is less efficient than a free trade area or, better yet, a customs union between all of the countries concerned. The most important question, however—which remains unresolved in both theory and practice—is whether the proliferation of RIAs will prove to be part of a process that leads to multilateral liberalization or, to the contrary, an obstacle to it:[34] whether, in Bhagwati's phrase, they will prove a building block toward global free trade—or a stumbling block.

B. Trade Policies Prior to Liberalization

Inward-looking trade policies

Developing countries' trade policies were long influenced by the dominant economic thought of the 1950s, which called for inward-looking development models. Developing countries were encouraged to opt for import substitution strategies to fight their exposure to what seemed a secular deterioration in their terms of trade, which entailed promoting domestic industrial development behind high protective barriers.[35] Proponents relied strongly on the infant-industry argument that a developing country may have a potential comparative advantage in the long run in an industry that is already established in the rest of the world, but the industry requires temporary protection in order to become competitive. If the expected future gain is large enough to offset the immediate losses inherent in providing temporary protection, then such protection can be justified. Another argument in favor of protection cited the frequent inefficiencies found in developing countries' domestic markets (see Box 2.1). Introducing a customs duty or a quantitative restriction creates a distortion, but this is justified because it offsets the consequences of market inefficiencies. In both cases, however, it would still be better to provide a direct subsidy, which is a domestic policy measure aimed directly at the source of the problem: if the infant industry problem ultimately reflects a capital market imperfection, for instance, making it impossible to borrow against future profits, then the best

[34]On this, see Bhagwati, Gleenaway, and Panagariya (1998) and Ethier (1998).

[35]See Dornbush (1992) and Krueger (1997).

policy is typically to address that imperfection directly. Targeted subsidies are often the most efficient instruments in principle, but they can be difficult to implement in countries with weak administrations, governance problems, and severe budget constraints.

Complicated and mostly inefficient protection systems

The analyses drawn up by the World Bank since the 1970s showed the complexity of existing systems and the scale of the economic distortions created. The tariff protection system applied under standard trade rules is generally extremely complicated. It allows for many exceptions, and the frequent reliance on quantitative restrictions makes the whole system much less transparent.

By way of illustration, Box 2.4 shows the general features of the tariff protection systems in force during this period in most of the countries in sub-Saharan Africa.

The complexity of tariff systems under the standard rules is compounded by the existence of scores of exceptions, mainly in the form of total or partial exemptions from custom duties. In some cases, more than half of a country's imports are subject to special tax rules.

In principle, tariff protection is reinforced by the systematic use of quantitative restrictions on imports. This means that the level of protection for some industries may be extremely high, while others, such as exporting industries, are put at a disadvantage. Thus, strong official protection can be harmful as well as inefficient. It can encourage fraud, especially in countries with weak customs administrations. A local industry may officially enjoy a high level of protection, but rampant fraud may mean that it faces unfair competition on the domestic market from contraband products, which have been imported without paying customs duty or domestic taxes. In this case, the protection measures are counterproductive and entail a substantial loss of revenue for the government.

How did such systems come about?

This is the question asked by Krueger (1993), who also asks how they have managed to survive when they are clearly unable to produce the intended results.

For lack of a clear-cut overall strategy, "trade policies" have often been nothing more than a succession of makeshift measures devised on the spur of the moment to generate extra revenue or to provide or increase protection for a particular industry or economic sector. The juxtaposition of these improvised decisions explains the complexity of the systems and, more particularly, the vast number of instruments used, which stems from the creation of new taxes and the use of tariff and nontariff measures.

Box 2.4. Main Features of Customs Tariffs in the Countries of Sub-Saharan Africa Prior to the Reforms Introduced Under Structural Adjustment Programs

A large number of taxes

Some taxes are levied on an ad valorem basis and others on a specific basis. Some taxes are indirect external taxes and others are indirect domestic taxes. The distinction between the two is critical in order to assess the degree of nominal protection provided. Yet the distinction is not easy to make because (1) tax definitions are sometimes deceiving (for example "consumption" taxes that only apply to imports); and (2) certain domestic taxes are applied in a discriminatory manner to imports,[1] which make them to some degree de facto external taxes (Rajaram, 1994)

A large number of tax rates

Widely differing rates are applied to different items in the eight-digit classification of goods, and several rates may be applied under a single heading. This plethora of rates means that very similar products are taxed at different rates and encourages fraud. Rates sometimes differ according to the recipient of the imported product, which means that two further digits have to be added to the nomenclature to create distinctive codes.

Wide differentials between rates

Some products are taxed at 0 percent, while others are taxed at more than 100 percent. This encourages fraud and corruption. Often, there is no systematic attempt to levy lower tax rates on more raw materials and intermediate goods, and higher tax on final products. Instead, the tariff rates on imported products depend on whether or not they are also produced locally. This is a way of providing greater protection for existing industries, but it can lead to anomalous tariffs. For example, imports of inputs that are also produced locally can end up being taxed at a much higher rate than imports of the finished products incorporating them. In this situation, the local industry concerned may be penalized by the customs tariff.

Massive use of quasi-tariff instruments

The drawbacks of such practices—such as the use of reference values, official values, or the like—are clearly understood. They usually provide a very high level of protection, but this is hard to quantify and varies as a function of world prices. They also rely entirely on the government's discretion, whereas changes in the official schedule of tariffs have to be passed by lawmakers.

These characteristics make it a long and arduous task to assess even the nominal protection provided for each category of product. Consequently, such assessments are rarely made. Under these circumstances, the tariff becomes an especially inefficient instrument of economic policy because it is impossible to control or verify its effects.

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[1]This discrimination is either official, with a higher tax rate on imports, or unofficial, simply because taxes like the VAT are easier to collect on imports at the border than on locally produced goods sold on the domestic market.

The decisive role of political economy considerations in the shaping of trade policy is now clearly established. In practice, trade policy decisions are often shaped as much or more by pressures from special interest groups as by the maximization of some notion of national well-being. Such groups can influence policy by a range of devices, from political contributions, mobilizing support in key constituencies, and by outright bribery. Not only do the policies to which such "rent-seeking" activities lead generate inefficiencies but the rent-seeking itself is a socially unproductive use of resources in itself. The inefficiency of such policies means that they could in principle be removed in such a way as to leave all economic agents—including the lobbies themselves—better off: providing support as direct transfers rather than by distorting economic activity, in particular, would often be a more efficient policy. Why this does not happen remains a matter of some controversy. Clearly, however, transparency and effective democratic institutions have a key role to play.[36] The beneficiaries of protection are often small, clearly identified, and well-organized groups that have enough influence to ensure that they retain their advantages. Thus supposedly temporary measures of protection can become de facto permanent ones. Some "infant" industries still enjoy protection after 20 years, and special agreements are often renewed again and again. Under these circumstances, and despite the change in thinking on these issues since the end of the 1960s, it is still difficult to implement changes in the direction of trade policy and improvements in the system of incentives.

Unsuccessful attempts at regional integration

The experience of the European Community in the early 1960s spurred developing countries to also launch themselves into efforts of regional integration. The first attempts were seen in Latin America, followed by sub-Saharan Africa a few years later. But this first "wave" of regional integration was not as successful as hoped; see Box 2.5.

Two reasons have been given for this failure (de Melo, Panagariya, and Rodrik, 1993). First, regional integration, which corresponds to an outward-looking policy, is not consistent with an inward-looking industrialization policy based on import substitution. Second, the first regional integration agreements were "South-South" agreements that linked only developing countries. This meant that they were less economically advantageous for developing countries than

[36]There is a large and growing literature on the political economy of trade policy, a fairly recent survey being Rodrik (1995).

Box 2.5. Attempts at Regional Trade Integration in West Africa Prior to the Creation of the WAEMU

Ever since they gained independence, the countries of West Africa, like the other countries of sub-Saharan Africa, have constantly expressed their political will to achieve regional integration. But the first wave of regional integration efforts did not produce the hoped-for results.

Three regional integration agreements were adopted in West Africa prior to the signature of the WAEMU Treaty in 1994:

The West African Economic Community (WAEC). Like the Central African Customs and Economic Union (CACEU), the WAEC, established in 1973, brought together a group of countries that shared a common currency, the CFA franc, for the purpose of creating a customs union. However, the WAEC never managed to do more than create a preferential trade area, instituted in 1973. The free circulation of people within the area was introduced in 1979.

The Economic Community of West African States (ECOWAS). The Lagos Treaty that established the ECOWAS was signed in 1975 and revised in 1995. It calls for the creation of an economic and monetary union in 2005. More than 25 years later, and mainly because of the predominance of Nigeria within the zone, tariff and nontariff differentials still exist within the treaty area and the relative share of trade between the member countries has not increased.

The African Economic Community (AEC) was created in 1991, under the aegis of the Organization of African Unity (OAU), by the Abuja Treaty, ratified in 1994. The purpose of the AEC is to achieve economic union in 2025 on the basis of existing economic communities. The timetable is unlikely to be met in view of the delays encountered in the implementation of many regional integration projects, such as the ECOWAS.

The WAEC ceased to exist in January 1994, being replaced by the WAEMU. The ECOWAS and AEC agreements are still in force.

"North-South" agreements that link countries with different levels of development.[37]

C. Reform Strategies

Since the early 1970s, work on trade policy (particularly by the World Bank) has shown clearly how adverse import substitution strategies have been for growth and incentives in most of the countries concerned. The debt crisis in the 1980s

[37]Venables (1999) shows that it is in developing countries' interest to link up with countries with higher incomes, with RIAs that include high-income countries tending to lead to convergence of members' income levels, which naturally works to the advantage of the countries with the lowest incomes.

provided an opportunity for introducing reforms aimed at liberalizing foreign trade, with national leaders' growing awareness of its wisdom combined with the constraints of conditionality attached to structural adjustment loans.

Between 1985 and 1995, nearly 70 percent of the World Bank's structural adjustment programs included a trade policy component, usually involving some conditionality.[38] In the 1980s, the World Bank played a key role in defining "best practices" and in developing the "Washington Consensus." The conditions attached to various forms of adjustment assistance, and more particularly to IMF programs, made it possible to introduce reforms that would have previously been politically difficult. Since the early 1990s, the IMF's role in promoting trade liberalization has become more prominent.[39]

Basic objectives

The central objectives in reforming trade policy have remained constant since the early years of the structural adjustment programs, despite the occasional pauses in the liberalization process. They are to make the system more neutral in its effects; to make it simpler and more transparent in its operation; and to ensure that the reform process is durable and credible.

Neutrality

Traditionally, trade liberalization is defined on the basis of the concept of neutrality: see, for example, Papageorgiou, Choksi, and Michaely (1990). Neutral trade rules are ones that result in equal incentives to produce goods for the domestic market or for the export market, and so place countries in a position to exploit their comparative advantage to the full. Free trade, which is the ultimate end-point of liberalization, ensures such neutrality. When neutrality exists, or when export industries are favored, the trade strategy is said to be outward-looking. On the other hand, when there is a bias against exports, the trade strategy is said to be inward-looking (Bhagwati, 1988).

Simplicity and transparency

Simplicity is indispensable for making the protection system comprehensible and transparent, which in turn makes it easier to enforce. Simplicity helps economic agents to interpret and respond appropriately to the signals sent by the incentive

[38]See Greenaway and Milner (1993) and Edwards (1997a).

[39]See Papageorgiou, Choksi, and Michaely (1990); Sharer and others (1998); and Krueger and Rajapatirana (1999).

system. Transparency prevents discretionary decision making and is a de facto disincentive for rent-seeking.

Durability and credibility

As Rodrik (1989) stresses, "It is not trade liberalization *per se*, but *credible* trade liberalization that is the source of efficiency benefits." Successful reform means that factors of production are shifted from the most protected industries to those sectors in which the country enjoys a comparative advantage. Entrepreneurs will be willing to bear the necessary adjustment costs only if they are convinced that the change will be a lasting one.

Once a reform has been introduced, the stability of the reform or, more specifically, the durability of the change in direction induced, becomes essential for its success. If entrepreneurs are not convinced that a new direction in trade policy is going to last, they will focus their efforts on obtaining a new form of protection, not on restructuring their activities.[40]

Components of reform

Reform of the protection system

Trade liberalization involves two types of change: changes in tariff rates and changes in instruments (with the removal of nontariff measures).[41]

Removing quotas

In developing countries, prior to reform, most nontariff measures took the form of quantitative restrictions. Consequently, the first measure proposed was usually their elimination.[42] Dropping such instruments is an important step in the process of liberalizing foreign trade since it frees agents to import products with

[40]See Thomas, Matin, and Nash (1990).

[41]To shift to an outward-looking strategy from an inward-looking one, many developing countries—for example, the Republic of Korea, Brazil and Mexico—have used export incentives to offset bias against exports without dismantling their import barriers. This alternative route to outward-looking trade strategy faces major problems. When export subsidies are used to offset the anti-export bias, they put a heavy strain on administration, could be captured by selective interests, and induce rent-seeking. Moreover, where the overvaluation of the exchange rate caused by high import protection is large, the export subsidies required to offset the anti-export bias are too great. Finally, subsidies by developing countries have increasingly become subject to countervailing duties in some industrial countries (World Bank, 1987).

[42]Dean, Desai, and Riedel (1994).

simplified procedures and no restriction on quantities, and it reduces protection. The latter effect stems from the fact that tariff protection alone is unlikely to be greater than the protection resulting from the combined application of tariffs and quantitative restrictions. Replacing quotas with tariffs having an equivalent effect on the volume of imports—"tariffication"—in itself has the advantage of transforming into revenue for the government the rents enjoyed by those holding licenses to import, and undoes the anti-competitive effects of quotas under imperfect competition noted above.

Agreeing to a timetable for eliminating quantitative restrictions does not usually raise any major problems, since the least vulnerable industries are usually the first to undergo liberalization. New tariffs, which diminish over time, are sometimes introduced for more vulnerable industries to give them time to cope with the loss of their protection. In most cases, the elimination of quantitative restrictions leads to an increase in the number of importers, which substantially increases the workload of the customs administration.

Tariff reform

Once quantitative restrictions have been eliminated, reformers need to concentrate on the customs tariff, since it becomes the sole instrument for protection. The direction that tariff reform should take is clear—toward neutrality and, ultimately, free trade—but a number of alternative strategies can be pursued to that end.

One approach is to reduce all tariffs by the same proportionate amount. Such "radial contractions" have strong theoretical attractions: under weak conditions—the most important being competitive product markets—they can be shown to improve economic efficiency,[43] whether applied unilaterally by a single small country or multilaterally by all together.[44] Moreover, the point to which a series of such reforms leads is the appropriate one of free trade. In practice, radial contractions have been adopted in multilateral trade negotiations, but are rarer for unilateral reforms—perhaps because there is then no reciprocal gain to set against the perception of a likely loss of revenue.

[43]In the precise sense that such a reform increases consumer welfare when the revenue loss it implies is offset by an increase in lump-sum (that is, nondistorting) taxation.

[44]For the proofs, see Dixit (1985) and Keen (1989).

Another strategy is to aim for a uniform tariff structure, with, in the limit, a single nominal tariff rate applying to all imports. A uniform nominal rate will in turn imply a uniform effective rate,[45] so that no activity is favored relative to another. Reaching such a uniform structure generally requires applying the "concertina" method of reform: lowering the highest[46] tariff rates and/or increasing the lowest. The theoretical case for such a reform as a means of easing production inefficiencies is less clear-cut than that for the radial contraction strategy. Lowering the highest tariff rate is efficiency-improving if the affected good is a net substitute for all others (meaning that an increase in its producer price increases imports of all others). Intuitively, reducing this distortion will increase efficiency so long as it does not worsen the costs of the distortions implied by other tariffs; and if the most heavily tariffed good is a substitute for all others, then reducing the tariff it bears—implying a reduction in its domestic price—will tend to reduce net imports of those other goods, which has the beneficial effect of reducing the artificial expansion of imports implied by those other tariffs. The complexity of production relations, however, is such that substitutability cannot be taken for granted: reducing the tariff rate on gasoline, for instance, could further reduce imports of cars. Thus it is not the case that movement toward a uniform nominal tariff structure always increases production efficiency.[47] By the same token, there is no theoretical presumption for the superiority of a uniform rate of effective protection. Moreover, and in contrast to the strategy of radial contraction, movement toward a uniform rate does not have free trade as its logical end-point.

Nevertheless, a uniform rate structure does have significant merit. First, it can preserve tariff revenue without any need for offsetting adjustments to other taxes: in this respect the concertina method of combining a cut in the highest tariff rate with an increase in the lowest can be especially attractive. Somewhat more generally, although raising any given amount of tariff revenue in the way that does least harm to the efficiency of production generally requires tariff rates that vary across commodities in potentially quite complex ways, reflecting differences in the price elasticities of net demand, policymakers rarely have available the kind of information on private sector responses needed to implement these theoretically ideal tariff structures (as stressed, for instance, by Edwards, 1997b), so that uniformity may be a sensible benchmark to aim for.

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[45]At least for importables whose production does not involve the use of exportables (or if these exportables are subject to an export subsidy at the same rate).

[46]Highest, that is, when measured as an ad valorem rate.

[47]Hatta and Ogawa (2002) investigate conditions under which it does: broadly speaking, a uniform tariff is closer to optimal the closer the substitutability between imports.

Indeed simulation studies suggest that the loss of welfare from employing a uniform tariff structure rather than one that raises the same amount of revenue in the most efficient way is likely to be relatively small.[48] All these arguments rest, however, on the revenue-raising role of tariffs: in a broader setting, the key object of policy must be to strengthen the domestic tax system so as to develop more efficient ways of raising whatever revenue is needed and so dispense with tariffs altogether. Second, a uniform tariff reduces the opportunity for evasion—with or without the connivance of customs officers—by deliberately misclassifying items into lower tariff bands: empirical work by Fisman and Wei (2002), using detailed data on trade between Hong Kong and China, tends to confirm that this can indeed be a significant form of evasion. Third, a uniform tariff structure is extremely transparent in its structure and effects. Fourth, and related to the previous point, strong commitment to uniformity can serve as a defense against lobby group pressures for special treatment (a point elaborated upon by Panagariya and Rodrik, 1993).

A third strategy, which is commonly recommended in practice but has received little attention from economic theorists, is to set nominal tariff rates that increase with the degree to which products have been processed: the lowest rates, for instance, would apply to raw materials and the highest to finished consumer goods. The principal rationale for this appears to be that in this way one can achieve a significant degree of effective protection at relatively low nominal rates.[49] This is not an especially persuasive argument, however, since it is the level and pattern of effective protection—however achieved—that presumably determine the distortionary cost of the tariff system. In practice, however, the "degree of processing" strategy often differs little from the concertina method and can in that sense be seen as a strategy toward establishing a uniform tariff structure. Practical tariff reform rarely takes its cue from the results of formal theoretical analyses of the kind referred to in the preceding paragraphs. It has to be defined with due regard for the specific constraints in each case, including the political determination of governments, international commitments, the capacities of the customs administration and other reforms under way, and in keeping with international best practice.

A typical example of the kind of tariff structures proposed during reforms would have

- customs duty levied on an ad valorem basis with three or four rates that are multiples of five;

[48]Mitra (1992a) finds that welfare is lower by only about 0.05 percent, while Dahl, Devarajan, and van Wijnbergen (1994) find an even smaller loss of 0.005 percent.

[49]It also guards against negative effective protection, meaning that the tariff structure actually mitigates against the activity concerned.

- a maximum rate of 20 percent to 25 percent and a minimum rate of 5 percent, this serving to reduce rate dispersion; and

- the classification of products between the different rate categories based on the amount of processing involved, being higher on more processed goods.[50]

This type of structure was used to define the common external tariff of the WAEMU, which is to be applied as part of the ECOWAS. Such a structure is also being planned for Northern Africa.[51]

The advantage of reforms aimed at improving the neutrality, simplicity, and stability of the protection system is that they can extend the application of the standard rules by drastically reducing the number of customs exemptions. For example, automatic classification of capital goods in the lowest rate category should make the customs exemptions contained in investment codes obsolete. It is, moreover, essential to control and then eliminate other categories of exemptions (ad hoc exemptions) in order to limit distortions and discretionary decision making. Reform of customs exemptions policy is thus a crucial complement to tariff reform.

Domestic tax reform

Given many governments' continuing heavy reliance on revenues from taxes on foreign trade (documented in Chapter 1), the fiscal impact of trade liberalization is almost always a major practical consideration (Tanzi and Zee, 2000). Estimates of revenue losses resulting from liberalization using simple accounting methods can give alarming results. For instance, FAD's estimates of revenue losses stemming from the introduction of the WAEMU Common External Tariff range from 1.3 percent of GDP for Burkina Faso to 1.7 percent for Senegal.

The implementation of a free trade agreement with the EU would decrease government revenues in North African countries by between 1 percent and 4 percent of GDP (Abed, 1998).

The prospect of such revenue losses, however, does not in itself put in doubt the case for reducing taxes on foreign trade, but rather should focus on domestic tax instruments that could recover such revenue losses without jeopardizing the efficiency gain from trade liberalization. Keen and Ligthart (2001), for example, show that offsetting tariff reductions point-for-point by increases in domestic

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[50]Products should not be allocated between rate categories depending on whether or not the same product is produced locally. Though naturally often sought by local producers this gives rise to tariff discrepancies and creates a bias in favor of existing industries that it is often in a country's best interest to diversify away from.

[51]See Abed (1998).

consumption taxation would preserve the beneficial reorientation of the prices that guide production brought about by tariff reduction while actually increasing tax revenue (since this would now be collected not only on imports but on all domestic production) and at the same time leaving consumer prices (and hence consumer welfare) unchanged.[52] Moreover, the fiscal impact of trade liberalization may actually be positive, even in the short term, depending on the original protection system. This is particularly the case if liberalization takes the form of replacing quantitative restrictions by tariffs or reducing exemptions. Moreover, protectionist motives may lead to tariffs being set at above revenue-maximizing levels. Ebrill, Stotsky, and Gropp (1999) show that revenue gains from the relatively early stages of liberalization have been far from uncommon.

Compensatory measures may need to be implemented right from the start of any trade liberalization program in order to avoid having to halt or reverse trade reform for fiscal reasons (Sharer and others, 1998). The most natural compensating measures are to raise excise taxes and/or a general tax on consumption; indeed, the need to offset revenue losses from trade liberalization by strengthening domestic taxation has in many cases been a key consideration in the adoption of a VAT. Of course, exemptions should also be reduced. At the same time, other tax reforms involving oil taxes, direct taxes, and modernizing the administration should be implemented to ensure that other revenue sources successfully replace tariff revenues.

Other aspects of trade policy

Local producers often maintain that eliminating nontariff barriers exposes them to unfair competition in the form of dumping and imports of low-priced,[53] poor-quality products that developed countries refuse to buy. There is no doubt that certain aspects of developing countries' trade policies are not advanced enough to ensure compliance with rules relating to competition and consumer protection. Quantitative restrictions, reference values, and other instruments have been officially introduced for this purpose in many cases.

In order to overcome such challenges to eliminate these nontariff measures, it is crucial to establish and use modern instruments that can replace them, such as quality standards, technical standards, and WTO safeguard measures.[54] Reliance

[52]Consumers too could then gain by using some of the increase in the government's revenue to cut tax rates.

[53]Precise definitions vary, but, broadly speaking, "dumping" refers to a situation in which goods are exported at a lower price than that charged on the domestic market.

[54]In case of temporary difficulties in specific sectors.

on such techniques makes it possible to switch from excessive and discriminatory protection to legitimate and neutral protection by offering everybody the same coverage in case of unfair practices or situations. This is a key element of a liberalized market economy. There is still the risk, mentioned earlier, that these instruments may be diverted from their original purpose and be used abusively to restrict trade (Maskus, Wilson, and Otsuki, 2000).

Unsuccessful reforms aimed at liberalizing trade

Substantial efforts have been made to liberalize trade in the developing countries since the end of the 1980s. The approaches taken varied in each region of the world. The World Bank's review of these experiences in 1994 shows that the least progress was made in Africa, where there were even several cases of backsliding, notably in Senegal and Côte d'Ivoire.[55]

Two main factors explain this relative lack of success, which has undermined the credibility of the reform process. The first has been the failure to take fiscal constraints into consideration. Even though the impact of liberalization on government revenues is not alarming in the long run, a lack of immediate compensatory measures can mean having to halt or reverse reform in the short term for fiscal reasons. Proper coordination between trade liberalization and reform of the domestic tax system, and especially the VAT, is crucial for attenuating this fiscal constraint. The second factor is the potential impact of trade reform on the distribution of real income. In most cases, those who gain the most from liberalization (chiefly exporters and consumers in the early stages) are too few in number and too poorly organized in the short term to take political action to maintain reforms. On the other hand, those who have the most to lose (local producers) are already organized in pressure groups and ready to use all the necessary resources to take charge of the process and regain their advantages. Reform can be made easier in several ways, for example by providing well-targeted restructuring assistance, introducing compensatory measures to protect vulnerable groups, and improving governance. Such measures reduce the risk of backsliding.[56]

Trade liberalization and regional integration

With the renewal of interest in RIAs, questions concerning the interactions between regional integration and trade liberalization, and the comparative

[55]Dean, Desai, and Riedel (1994).

[56]Winters (2000).

effectiveness of RIAs and multilateral action in achieving free trade, have become key topics for discussion. Even though the controversy surrounding these issues is far from settled, much recent work has helped to inform the debate.

Bhagwati and Krueger (1995) stress the potential dangers that lie in an excessive number of RIAs and the need to promote multilateral trade negotiations. They put particular emphasis on the dangers involved in extending the "spaghetti bowl" of RIAs, which would lead to many different rules applying to the same types of imports, depending on which country they come from—already a significant issue in Africa, where many countries, for instance, belong to more than one RIA (such as SADC and COMESA), and they highlight the risk of developing a world system of trading blocs instead of multilateral trade liberalization.

Nevertheless, in view of the problems encountered in multilateral negotiations, the current development of RIAs may be seen as making a practical contribution to trade liberalization. It remains to be seen how such developments will affect the incentives for RIA members and others to promote multilateral liberalization.[57]

A look at the institutional aspects of RIAs makes it possible to identify some of their positive effects and, in particular, the preference-dilution effect referred to above, which reduces domestic political pressures from special interest groups.[58] The fact that regional institutions are responsible for decision making helps to free governments from the influence of domestic pressure groups. This makes it possible to introduce more efficient economic policies with redistributive effects that are counter to the interests of well-organized groups, thus depriving them of their ability to obstruct liberalization. This effect was probably a decisive factor in pushing through the Common External Tariff (CET) in the WAEMU countries. The previous attempts of some member countries to introduce such reforms at the domestic level had failed. Regional integration can also help enhance the credibility of reforms.[59]

Endogenous determination of the CET level in a customs union is also a critical determinant of whether RIAs will be favorable to liberalization. Olarreaga, Soloaga, and Winters (1999) point out that there are broadly two main sets of

[57]See Andriamananjara (2000).

[58]See de Melo, Panagariya, and Rodrik (1993).

[59]Gould (1992).

considerations pointing in different directions. One is the prospect of taming the power of pressure groups, along the lines just mentioned. The other is the incentive of the RIA to deploy its CET so as to bring about favorable improvements in its terms of trade; to the extent that the creation of a larger internal market increases the RIA's bargaining power, this points toward a more protective CET.

D. Trade Liberalization and Customs Administration

Developing countries' trade and tariff policies have changed substantially with trade liberalization and the second wave of RIAs. Both the direction of policy and the policy instruments used have changed, and the international context has shifted. Customs administration obviously needs to adapt to these changes; but it is also the case that, conversely, changes in customs administrations will impact on the trade policy reform process and its results, as stressed by Faria and Yucelik (1995).

The direct link between customs administration and trade policy

Customs' role in trade policy

Customs administrations are directly involved in instituting trade policy reforms. They have all the information needed to conduct the preliminary research that is essential for planning and designing future reforms. All of the legal documents are available from customs administrations, and customs procedures can be monitored to find out exactly how the rules are applied. The computer systems in widespread use (such as ASYCUDA) can provide the necessary statistics on foreign trade and information on how the various tax amounts are calculated by customs. Customs administrations thus have a decisive role to play in the planning phase of reforms, and are also able to provide technical input on the enforceability of the measures being considered.

The customs administration is responsible for implementing the core aspects of trade policy reforms and so is critical in determining whether the process succeeds or fails. If the administration turns out to be unable or unwilling to implement the planned changes fully and with appropriate rigor, the initial objective of the reforms will not be reached and the whole process will come into question and lose its credibility. If, for example, the customs administration is solely responsible for setting the customs value of goods, then it can change the level of nominal protection out of negligence, bias, or lack of training, even though the official rates do not change. Similarly, its key role in facilitating trade could help to enhance "deep" trade integration between the members of an RIA and thus maximize the benefits of integration.[60]

A hesitant attitude to modernization on the part of the customs administration can be a real obstacle to the success of trade policy reform. Even though modernization will result in a simplification of its tasks and an enhancement of its role—which should in themselves be reasons for it to cooperate in the process—customs administrations may not be eager to engage in the process. There are two main reasons for such resistance to change. First, modernization will mean organizational disruption that will disrupt the lives of customs personnel, at least temporarily. Second, such measures as reducing protection, streamlining inspections, and simplifying and automating procedures may restrict opportunities for corruption and thus reduce customs officers' incomes.

Influence of trade policy on customs administration

Trade policy reform changes the tasks of the customs administration and requires it to review its own policy in order to come up with a strategy to adapt to its new circumstances. Its new role requires a redeployment of its resources to fulfill new functions, or functions that have become more important. In particular,

- reliance on protection based solely on duties levied on an ad valorem basis requires customs administrations to strengthen their valuation functions;
- facilitating trade through liberalization means a reduction in physical inspections, which in turn requires the introduction of a risk profiling and targeting system supporting more frequent reliance on post-clearance audits;
- RIAs make it critical to initiate inspections according to the origin of imports; and
- the drastic reduction in exemptions often leads to a rise in fraudulent use of suspensive regimes, such as bonded transit and warehousing, making it critical to strengthen the monitoring and supervision of such arrangements.

Proper synchronization of trade policy reform and customs modernization is thus crucial to the success of both undertakings.

[60]See Hoeckman and Konan (1999). There are expectations of this kind for the "Mahgreb Initiative" aimed at reducing barriers to trade between Algeria, Morocco, and Tunisia through such measures as modernization of customs administrations.

Customs and the rules of fair trade

Trade liberalization is one aspect of developing countries' overall progress in building a strong market economy. Providing the best possible guarantee of compliance with the rules of fair trade is a key to market efficiency. Customs administration can play an essential role in this area, even though it may not have previously been used to its full potential.

In more general terms, customs administrations are able to make a substantial contribution toward improved transparency. They have extremely detailed data records that are underused or ignored in most cases. Specific and targeted analyses, along with regular information sharing with other organizations and administrations, can reveal shortcomings that are often indicative of serious governance problems. Once these problems have been brought into the open, they can be addressed and the transparency of the system as a whole greatly enhanced.

Box 2.6 provides examples of the capabilities of customs administrations in this area, which could be gradually incorporated into the customs modernization process.

Box 2.6. Three Examples of Customs' Role in Promoting Good Governance

Benin: Exposing cases of discretionary determination of customs value. Customs data showed that the unit values used to calculate the duties and taxes on two consumer products ("R 20" batteries and tomato concentrate) with the same origin and packaging were 50 percent lower on average when imports were not checked by the company responsible for preshipment inspection.

Moldova: Estimating fraud and undervalued imports. Statistical analysis to compare data on the value of Moldova's imports and the value of its main suppliers' exports made it possible to assess the impact of fraud on government revenues, revealing a revenue loss equal to 3.8 percent of GDP.

Senegal: Evaluating the extra profit margin unofficially enjoyed by the local refinery. In 2000, the system for pricing oil products made it possible to calculate the selling prices of locally refined products by applying the official margin of protection to an import parity price derived from the Mediterranean FOB price. Any difference between the import parity price and the customs value of the same imported finished product would alter the refinery's profit and its level of protection. Analysis of customs data showed that the customs values derived from foreign suppliers' invoices were more than 20 percent higher than the import parity prices of the various products, meaning that the refinery's unofficial profit margin was 1.4 times the official margin built into the price system.

E. Conclusion

The review of the framework, instruments, and evolution of trade policy presented in this chapter has shown the radical changes in this area over the past two decades, and the importance of customs administration in this context.

The efficacy of these changes in trade policy—and tariff policy in particular—has depended directly on the effectiveness and competence of the customs administration, and on the government's willingness to modernize customs. The general opening of trade now pursued in many parts of the world will place

further demands on that administration, which is now called on to integrate itself in the global process of liberalization and trade facilitation. This will require, in many countries, a profound reevaluation of the various objectives of the customs service, and a redefinition of its functions, organization, and methods of operation.