

Changing Customs

Challenges and Strategies for the
Reform of Customs Administration



Editor
Michael Keen



International
Monetary
Fund

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International Monetary Fund
Washington, DC

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Production: IMF Multimedia Services Division
Typesetting: Alicia Etchebarne-Bourdin
Cover Design: Massoud Etemadi

Cataloging-In-Publication Data

Changing customs : challenges and strategies for the reform of customs administration / Michael Keen, editor — [Washington, D.C. : International Monetary Fund, 2003]

p. cm.

Includes bibliographical references.
ISBN 1-58906-211-6

1. Customs administration. 2. International trade. I. Keen, Michael. II. International Monetary Fund.
HJ6609.C43 2003

The views expressed in this work are those of the authors and do not necessarily represent those of the IMF or IMF policy. The IMF has not edited this publication. Some documents cited in this work may not be available publicly.

Price: \$25.00

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Foreword

International trade has always been an extraordinarily effective device for raising living standards and the quality of life. By enabling nations and individuals to realize their full productive potential, and to draw on the skills and resources of others, it is a source of huge mutual advantage. Trade liberalization, and the facilitation of trade more generally, must therefore play a central role in any strategy for improving global economic prospects and alleviating poverty. Of course, there are difficulties to be faced in easing restrictions to trade: these are often exaggerated and, in any case, can be addressed by sound policies. All too often, the many obstacles to trade that remain—not least in many of the less developed countries—serve only the advantage of narrow and privileged interest groups.

Consistent with its mandate to “. . . facilitate the expansion and balanced growth of international trade . . .”, the International Monetary Fund (IMF) has long encouraged its members to improve and liberalize their trade policy regimes. It does this in all three of its main activities: in its surveillance work (urging developed economies to improve access to their markets for exports from less developed countries, for instance); in its program work (with trade policy reform often a major concern); and in its technical assistance activities.

This book draws on the Fund’s technical assistance experience. Within the IMF, the Fiscal Affairs Department (FAD) has devoted considerable effort to helping countries modernize their customs administrations. Such modernization, by easing the international flow of goods and tackling what are often some of the most stubborn governance problems, can do a great deal toward enabling a fuller realization of the potential benefits of trade. It is not, of course, a substitute for reform of restrictive trade policies. But it can be an important measure of liberalization in itself.

Reflecting as it does the expertise that FAD has developed in this area, this very practical book will help countries respond to the challenge of modernizing their customs administration and so both secure their public finances and reap more fully the vast potential benefits from international trade.

Anne Krueger
First Deputy Managing Director

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Preface

For many years, the Fiscal Affairs Department (FAD) of the IMF has worked hard to help countries strengthen their customs administrations. This book, by some of those most directly involved in this work, seeks to make the lessons of FAD's technical assistance experience in this area available to a wider audience.

The basic strategy for modernizing customs administration that the book spells out is straightforward: establish transparent and simple rules and procedures and foster voluntary compliance by building a system of self-assessment buttressed by well-designed audit policies. Implementing this, however, requires addressing a range of issues, involving links with trade policy, organizational reform, the use of new technologies, the appropriate nature and extent of private sector involvement, designing incentive systems to overcome governance issues—and many others.

This book is not an encyclopedic “how to” manual that tries to address all these problems in all their detail. Rather, it describes the contours of the broad strategy that we, and others active in this area, have found to work in practice and to offer the best prospect for improvement.

Teresa Ter-Minassian
Director, Fiscal Affairs Department

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Acknowledgments

This book has its origins in long days and late nights spent working with customs and other officials in many countries around the world. In this time we and our colleagues in FAD have seen and learned much. We have found cats making their homes among “active” taxpayer files, counted trucks full of contraband driving unmolested through border posts, and seen customs dues paid in the form of fresh meat rather than money. This book is the fruit of these and many other experiences.

It also reflects the lessons we have learned from present and former colleagues at the IMF and elsewhere, including Jean-Paul Bodin, John Crotty, Milka Casanegra de Jantscher, Adrien Goorman and Victoria Perry. Solita Wakefield and Asegedech WoldeMariam provided very helpful research assistance, and Beulah David showed great patience and expertise in producing the text.

We are very grateful to Sean M. Culhane of the External Relations Department, who provided editorial comments and oversaw the production of this volume. Our greatest debt, however, is to the many officials with whom we have been privileged to work. This book has to address the serious problems of corruption in many customs administrations. One of the joys of our work, however, has been to encounter officials, at all levels, committed to the highest standards of public service, often in extremely trying circumstances. If this book were dedicated to anyone, it would be to them.

Michael Keen
Patricio Castro
François Corfmat
Anne-Marie Geourjon
James Walsh

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1**The Future of Fiscal Frontiers and the
Modernization of Customs Administration***Michael Keen*

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

¹In 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.

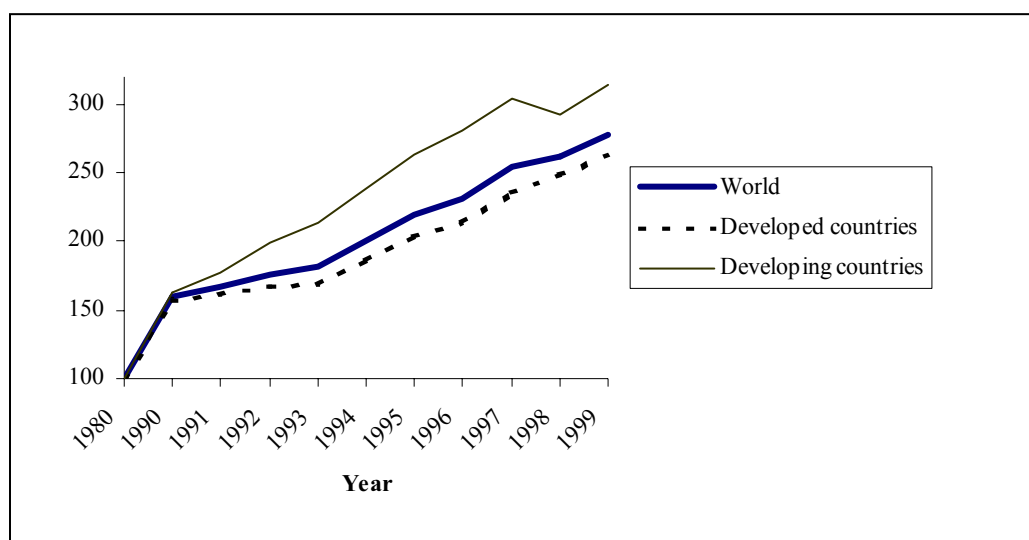
It may be that much of the growth in world trade in coming years will be in relation to services, for which the role of customs is generally limited (for the simple reason that intangibles cannot be intercepted at borders). But there is every sign that the secular trend increase in merchandise documented 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 exports³—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

²Export 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.

³Not 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.

⁴More 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, *Revenue 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

⁵Under 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

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

⁷Some 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 others⁷). 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 SACU¹⁰), those coming from other COMESA¹¹ countries (which receive preferential treatment relative to Namibia's most favored nation rates), and those from elsewhere.

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

⁹To 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.

¹⁰Southern Africa Customs Union.

¹¹Common 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

¹²On 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.

¹³Table 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.

¹For 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
<i>Of which:</i>		
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.

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

²This 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

¹⁴See IMF (2001).

¹⁵The 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.

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”

¹⁶The 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 granted¹⁷ (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 effects¹⁸

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).

¹⁷Ad 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).

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

¹⁹The 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

²⁰The 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 , $VA_j^d = P_j(1+t_j) - \sum_k \alpha_{jk}(1+t_k)$, and hence

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

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

²¹Official 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

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

²³The 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.

²⁴The 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 measures²⁵ 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,

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

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

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

²⁸Goods 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.

¹It 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.

²⁹Some 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.

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

³¹These 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

³²Suppose, 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).

³³Krugman (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

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

³⁵See 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.

¹This 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

³⁶There 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

³⁷Venables (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

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

³⁹See 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

⁴⁰See Thomas, Matin, and Nash (1990).

⁴¹To 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).

⁴²Dean, 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.

⁴³In 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.

⁴⁴For 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 highest⁴⁶ 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.

⁴⁵At 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).

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

⁴⁷Hatta 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;

⁴⁸Mitra (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.

⁴⁹It 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

⁵⁰Products 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.

⁵¹See 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

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

⁵³Precise 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.

⁵⁴In 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

⁵⁵Dean, Desai, and Riedel (1994).

⁵⁶Winters (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

⁵⁷See Andriamananjara (2000).

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

⁵⁹Gould (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.

⁶⁰See 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.

Strategy for Reform

James T. Walsh

Most customs administrations are undertaking reform of their operations—even the most advanced see modernization as a continuing process—with change being driven by a desire to achieve the objectives of revenue collection, trade policy administration, and interdiction in the most effective and efficient manner possible. Reform is ongoing, with each customs administration at a different point on the reform spectrum. “The old maxim that ‘the only constant is change’ is no longer a clever statement of contradiction but a dominant reality of business life.”⁶¹

Governments and administrations are often intimidated by the scale of the reform task that they face and need a well-defined strategy and plan of action to implement it. The same strategy is not necessarily appropriate for every customs administration. Nevertheless, there are certain principles that should be addressed first, particularly in those countries where improving revenue collection is the primary objective. This chapter sets out those principles, and the need to embed them in a coherent strategy for which the country itself takes ownership. It sets out and begins the exploration of key themes developed further in subsequent chapters, and in doing so provides an overview of the approach to the reform of customs administration advocated in this book.

A. Problem Areas

Experience points to several key and common problem areas:

Outdated customs procedures that have not kept pace with developments in transportation, technology, and business practice.

Inadequate legislation, embodying overly complex trade policies and procedures, making it difficult to introduce the changes required to support new ways of doing business. All too often, however, customs administrations use

⁶¹Frame (1994).

legislation inadequacies as an excuse to delay, or not adopt at all, new systems or procedures.

A belief that computerization is the answer to all problems. Too little thought is given to understanding the role of computers, the need to simplify procedures, and the use of information produced by computer systems to effectively control operations effectively.

Little attention to the organization and staffing needs of a modern administration. Many administrations accept passively the standard civil service rules—including controls on organization structure, job classifications, and salary levels—instead of striving for control of their own organization.

A lack of understanding of the need for coordination and cooperation between tax and customs administrations. In an era when most countries have a VAT, there is more reason than ever (for reasons noted in Chapter 1) for close cooperation between these administrations.

High levels of corruption that continue to plague many administrations, causing loss of revenue, inequity, and wider economic inefficiencies.

By its very nature, customs administration is complex. The legislative base and the procedures are difficult and complicated to administer, and, over time, too little attention has been paid to the costs imposed by this complexity on the private sector and to its impact on the effectiveness of controls. It is now understood, based on the experiences of modern customs administrations in industrialized countries, that these problems can best be addressed by developing a strategy for reform that is based on transparent legislation and simple, well-designed, and well-understood procedures. This is critical to create an environment for improved increased compliance by taxpayers and reduced costs not only for the government but also for taxpayers themselves.

B. Undertaking Reform

Reform of a customs administration must be accompanied by commitment of the government and strongly supported by senior management within the administration. Ownership of the reform process requires that the administration itself be involved in the design and implementation of the changes.

The trade community should also be invited to contribute to the reform process. This is often accomplished through the creation of a modernization committee with participation from importers, exporters, transportation companies, port and airport authorities, and customs brokers. Their contributions are particularly important in identifying areas in which service improvements would be most beneficial.

The scope and magnitude of the reform process normally requires that competent and dedicated resources be assigned full-time to the project team responsible for the reform. Too often the reform is looked upon as a part-time undertaking that can be accomplished on top of day-to-day tasks. The problem with this approach is that fighting fires—dealing with whatever the immediate crisis happens to be—usually takes precedence, with the result that less attention is paid to the reform requirements, and deadlines are often missed. In Canada in the early 1980s, it was found that the major reform effort to introduce changes to the customs commercial system was falling further and further behind schedule. The successful solution was to create a headquarters directorate whose sole responsibility was to develop and implement changes to legislation, systems, and procedures based on an approved modernization plan.

Investments are required to undertake both the design and implementation of the reform program and for ongoing operations. At the outset, it is important that a realistic estimate of the resource requirements be developed and that the government commit to providing them.

C. The Context and Priorities of Reform

This section considers the first three of the four key areas of reform set out in Chapter 1 (the fourth—focused on organizational and management issues—is taken up in Section D). These are the needs for the existence of appropriate and transparent legislation; simple, up-to-date procedures; and a revenue control strategy based on an assessment of risk and selective controls targeted at high-risk goods and enterprises. The new revenue control strategy has, as its center piece, effective post-release verification and audit.

At the outset, and as the basic starting point for the reform of the customs administration, each country should make a conscious decision to align its legislation and procedures with international standards and practices. This should include a country's international obligations, notably those required by membership in the World Trade Organization (WTO) and the internationally accepted practices outlined in the conventions and recommended practices of the World Customs Organization (WCO). By using agreed international standards, the customs system will be aligned to international practices and a country will be more fully integrated into the world trading community. Box 3.1 outlines three of the more important conventions and declarations that a customs administration should take into account when it reforms and modernizes.

Box 3.1. World Customs Organization Conventions and Declarations

The following three conventions and declarations of the WCO should form an important part of a customs administration's reform and modernization program.

Harmonized Commodity Description and Coding System (HS). The HS is the de facto world standard coding system that is used for tariff classification and trade statistics purposes. It comprises about 5,000 commodity groups, each identified by a six-digit code, arranged in a legal and logical structure, and is supported by well-defined rules to achieve uniform classification. It is used by 179 countries and customs or economic unions representing approximately 98 percent of world trade. The WCO manages the HS and it is updated periodically (every 4–6 years) to take into account developments in technology and changes in trade patterns. While the HS establishes the rules for classifying goods, each country establishes its own rates of duty applicable for each code. In addition, many countries expand the coding structure beyond the internationally agreed six digits for their own purposes.

International Convention on the Simplification and Harmonization of Customs Procedures (Kyoto Convention). The original Kyoto convention came into force in 1974 with the objective of simplifying and harmonizing customs procedures to promote international trade. It includes a series of standards and recommended practices for all major customs procedures. In June 1999, a revised Kyoto convention was approved by the WCO. It includes a comprehensive package of up-to-date customs procedures dealing with such topics as assessment, collection, and payments of customs duties, application of information technology, appeals, and virtually every procedure that must be dealt with by a customs administration. The revised convention is awaiting the required signature of 40 countries before coming officially into force.

Declaration of the World Customs Organization Concerning Integrity in Customs (“Arusha Declaration”). In 1993, in recognition of the significant problems of corruption in customs administrations, the WCO adopted the Arusha declaration. The declaration sets out the main features that should be present to promote integrity, including clear and precise legislation; simple and consistent procedures; automation; merit-based hiring and promotions; good training; adequate remuneration; and an open and transparent relationship with the business community.

Appropriate and transparent legislation

A country's economic characteristics and international trade relations may make some degree of complexity unavoidable. For example, preferential trade arrangements or implementation of a customs union introduces a degree of complexity in customs administration through the need to apply differential tariff rates and to validate the origin of imports. Most complications for customs administrations, however, result from restrictive and protective foreign trade policies, an irrational tariff structure, and a lack of coordination with the domestic tax administration.

As discussed in Chapter 2, many tariff systems are characterized by complex rate structures and/or high tariff rates, with little economic justification. High tariff

rates increase the incentives to evasion (through undervaluation, misclassification, and outright smuggling) and the pressure for exemptions. Multiplicity of rates facilitates evasion through the incentives and opportunities for the importer to classify imports in the lower-rate categories, and requires extra vigilance and control by customs. This is a recurring finding in Fiscal Affairs Department (FAD)'s technical assistance work, one mission finding, for instance, that⁶²

A major cause of the difficulties faced by the customs administration was a tariff regime that was one of the most complex in the world. The myriad of tariff rates (which could change weekly), import surcharges, licenses, industry specific plans, exemption and drawback provisions, and export incentive schemes would have seriously taxed the ability of any customs administration to operate effectively.

For revenue reasons, some countries may need a higher tariff level than others. But this does not mean that they need a complicated tariff. Both the revenue objectives and the proper degree of protection of domestic activities can be achieved through a simple, easy-to-administer rate structure. As argued in Chapter 2, the trade and import tax system should ensure that

- the tariff is the main instrument for protection, and there are only minimal nontariff restrictions;
- there is a very limited number of duty rates (i.e., no more than three or four) and all rates are ad valorem;
- exemptions are limited to those provided for in international conventions and trade agreements;
- duty relief and/or drawback is in place for imported inputs incorporated in export products; and
- VAT and excise duties apply equally to domestic products and imports.

The procedures administered by the customs administration are incorporated in the customs code⁶³ and the supporting regulations. It gives authority to the customs administration to

- establish control over goods and people and the means of transport for entering and leaving the country;
- collect duties and taxes (such as VAT and excises on imports); and

⁶²FAD technical assistance reports are confidential to the country concerned, so the precise source is not given for this or other quotations.

⁶³The customs code, in some countries, may be referred to as the customs "act" or customs "law."

- enforce other government agencies' rules and regulations related to imports and exports (ensuring, for instance, that health and/or agricultural certificates are presented with the customs declaration when required).

As in the case of the tariff and trade laws, the customs code can contribute to the complexity of administration. Experience shows that operational inefficiency in many customs administrations results from the application of antiquated provisions in the customs code. Customs legislation is among the oldest in the world and, over the years and especially the last few decades, it has had to adapt to far-reaching developments in technology, international trade, and the economic environment in general. The failure to update the customs code to allow for change impedes the reform of the customs administrative system. Problems frequently encountered in the legislation include

- the requirement that every single importation be physically checked;
- inadequate provisions for the reporting of goods by transportation companies;
- lack of clear treatment of the various customs regimes (e.g., temporary admission);
- lack of authority for customs administrations to review declarations after the goods have been released and to audit the books and records of traders; and
- obsolete penalty provisions (e.g., penalties may not be applicable for violations detected after the goods have been released).

Modern, simple procedures

Procedures related to the processing of goods should be simple, transparent, and easily understood by the trade community. Customs administrations in most developed countries understand that the costs imposed on traders by inefficient procedures are just as real a cost to them as are the trade taxes themselves. There is, however, less appreciation of the scope and significance of these compliance costs in the customs administrations among developing countries.

The design of customs procedures should be based on an assessment of risk and selective controls targeted at high-risk goods and enterprises. Administrations that have not implemented this approach continue to impose high, unwarranted costs on their importers and exporters, as another finding from an FAD technical assistance mission illustrates:

The control systems are the same for all importers regardless of their record with customs. A large multinational pharmaceutical manufacturer, with approximately 2,500 declarations a year, must have samples taken for laboratory analysis from every shipment prior to release. No violations were ever detected; nevertheless, no thought was given to changing the procedures.

The continued application of such procedures reduces the competitiveness of the industries concerned, distorting and dampening economic developments. At the same time, there is evidence to suggest that these types of controls are much less effective than the risk-based, selective controls that are in place in modern customs administrations.

As a first step in introducing modern, up-to-date procedures, the processing of imports should receive priority. The procedures should be designed to

- ensure that all goods are reported and placed under customs control;
- process import declarations based on the principle of self-declaration by the importer or agent;
- reduce the number of processing steps to a minimum;
- introduce selective and effective goods inspection;
- release goods from customs control in the least amount of time possible;
- ensure that the correct amount of duties and taxes is paid and deposited to the government account; and
- ensure that information is provided to support timely reporting of import trade statistics.

While these basic, simplified procedures can apply to all importers, the administration can go even further. This could include the introduction of simplified procedures, with minimum controls prior to release, for large importers who have a good compliance record: Another mission found that:

... nine importers represented 21 percent of import transactions. The impact of developing new procedures for these importers, based on audit, was self-evident—the largest contributors to the economy would immediately benefit from reduced costs of customs intervention; significantly fewer staff would be required for physical and documentary control; and customs control resources could be redirected to high-risk goods and traders.

Implementation of simplified procedures for the processing of exports (which are typically relieved of import tariffs) is next in priority for reform. The procedures should be designed in a way to keep controls to a minimum. At the same time, however, there must be sufficient control to ensure that the goods really have left the country and are not diverted, duty-free, to the domestic market. This is particularly important for the verification of zero rating for VAT (false export claims are one of the most frequently committed VAT frauds)⁶⁴ and

⁶⁴The processing of VAT refunds is a key challenge under the VAT; see Ebrill and others (2001) for a discussion of the problem and potential responses.

the processing of drawback claims (for the repayment, that is, of duty on imported goods used in the production of exportables). Not only must there be adequate means of verifying that the goods have left the country, but there must also be a good system for sending information from the customs administration to those responsible for administering the VAT.

Effective post-release control

In modern customs administrations, the basic approach to customs control has changed from 100 percent pre-clearance control to a heavy reliance on post-release control. (This is analogous, as noted in Chapter 1, to the shift toward self-assessment in other taxes, with taxpayers declaring their own liability subject to selective audits conducted to verify compliance, sometime after the return and payment have been made). Many customs administrations have now designed systems and procedures that provide for certain basic verifications to be completed when the goods are under customs control supplemented by audit-based controls that are undertaken after the goods have been released.

Controls prior to the release of the goods, including physical inspections, have a role to play, particularly for the verification of quantity, ensuring that the description of goods is sufficient for tariff classification and origin purposes, detection of contraband, and the enforcement of laws not related to revenue (for instance, phytosanitary, drugs, intellectual property rights, money laundering, anti-terrorism measures, and the control of endangered species). However, such controls are less effective for the verification of tariff classification, valuation, drawback, and exemptions that often requires an accounts-based audit to verify compliance.

Post-release controls should be designed to identify and correct inconsistencies in the application of the legislation and procedures at the time of release of the goods. Typically, a selection of declarations is made for in-depth review based on criteria designed to identify high-risk transactions. For example, declarations that claim a zero rate may be misclassified for tariff purposes, claims for duty and tax exemptions require special attention, and drawback claims require verification. Post-release control is discussed at length in Chapter 5.

One of the most frequently identified problems—discussed at length in Chapter 6—is the valuation of imported goods. Import duties remain relatively high in many developing countries, which, especially when combined with value-added

taxes and excises on imports, can result in a total tax and customs burden that is a powerful incentive to undervalue goods.⁶⁵

The international standard for valuing goods is the WTO Valuation Agreement. It relies primarily on the transaction value, that is, the price paid or payable by the importer.⁶⁶ All countries that are members of the WTO must base their valuation legislation and procedures on the agreement. Therefore, in addition to addressing day-to-day valuation problems, each country that has not yet implemented procedures based on the agreement must put in place a plan to implement such procedures, including the elimination of the use of minimum values.

In response to problems related to valuation, some countries have implemented pre-shipment inspection (PSI) programs. Based on an inspection of the goods in the country of export, a report of findings, including an assessment of value, is issued for use in preparation of the import declaration. PSI programs have had some degree of success in those countries where there are sound procedures to ensure that the PSI reports are used and cooperation between the customs administration and the PSI company is good. Nevertheless, PSI programs are expensive (with the PSI company taking around 1 percent of the value of the goods inspected, which can be a high proportion of the revenue collected). Therefore, there should be a clear indication of the benefits expected before a program is implemented. Experience with (and alternatives to) PSI, and other forms of private sector involvement in customs administration, are discussed in Chapter 12.

D. Changes Required to Support the Priorities for Reform

To support implementation of the reform strategy, changes will be required in computer systems, in the organization and management of the customs administration, in its recruitment and training policies, and in the services it aims to provide. A coordinated effort to undertake significant changes in all of these areas will result in a new way of doing business for the customs administration. For example, one cannot simply introduce computerization and expect that it will result in a reform of the customs administration. Similarly, changing the

⁶⁵In principle, detecting undervaluation at time of importation is not important for VAT purposes (in relation to goods used as inputs into production) because undervaluation will be picked up at the next level of sale. However, not too much reassurance should be taken from this: if an importer goes to the trouble of falsifying invoices at the time of importation, it is unlikely that these goods will ever appear in the books and be declared as taxable. And for items of final consumption, VAT missed at the border is lost forever.

⁶⁶The agreement also has alternative methods for determining value in cases where the transaction value cannot be used: transaction value of identical goods; transaction value of similar goods; deductive method; computed method; and fall-back method. See Box 6.1 in Chapter 6.

organization and making it part of an autonomous revenue authority will not in itself achieve the results expected from a major reform.

Major reform of a customs administration should be designed to achieve very clear objectives and should be implemented on a phased basis. It should always be kept in mind that, while major changes are being planned and implemented, the normal activities of the administration must continue. A sound strategy for undertaking procedural reform is by implementing the changes first in a pilot office; here they can be tested, evaluated, and modified before being implemented in other customs offices. In many countries, the priority is to implement changes that have the greatest revenue impact and, therefore, the changes would normally be phased in starting with the offices that have the highest revenue collections.

Computerization

The computerization of customs procedures should be undertaken on the basis of certain objectives:

- a reformed customs administration should operate in a fully automated environment with information moving electronically from the local offices, where individual transactions are processed, to the regions and headquarters;
- enterprises should transmit information electronically to the customs administration; and
- electronic information should be available to support post-release verification and audit, and for statistical and management purposes.

While these are objectives that every customs administration should strive for, each administration is not at the same stage of reform and, therefore, the plan should be realistic and designed to move step-by-step toward the desired goals.

Once the decision to computerize is made, the specifications of the system should be defined, and a detailed implementation plan should be prepared. The plan should consist of clearly defined objectives, with a list of actions, target dates, and resources required. As outlined earlier in this chapter, the first priority to be addressed in reforming the administrative procedures is the simplification and modernization of the import declaration processing procedures. Therefore, the first step in computerization is to develop the system to support the simplified import procedures.

Development of application software for processing import and export declarations and the collection of revenue typically requires significant resources to support the high cost of development, a high level of expertise to design and develop the system, and a long period of time for development. Therefore, the acquisition of a software package is recommended for most developing

countries.⁶⁷ These have the advantage that they have already been tested and are operational in other countries, they use internationally agreed standards and codes, and their cost is generally lower than in-house development.

The majority of customs administrations in developed countries receive a significant proportion of their information electronically, by, for example,

- direct access by members of the trade community to the customs computer system (as in Argentina and the United Kingdom);
- electronic filing of declarations (the United States and Canadian customs administrations receive 95 and 85 percent, respectively, of their declarations electronically); and
- the filing of declarations on diskette (South African Customs receives the majority of declarations on diskette at its largest offices).

Recently implemented systems in the Philippines and Turkey also feature direct data input either through a kiosk in the customs office or directly from the broker's premises. In the Philippines, the kiosk is operated by the Chamber of Commerce, which charges a small fee for the service.

In Australia, electronic data interchange (EDI) has been extended to transportation companies and banks, with the result that 98 percent of transactions are paperless. The EDI-based Singapore TradeNet system results in all trade participants using an electronic system to file and process their trade transactions. The system is essentially paperless and operates 24 hours a day, year round.

Organization

Traditionally, customs administrations have been part of the ministry of finance and have been subject to public service rules and regulations. The location of the customs (and tax) administration within the ministry of finance is based on the importance of its fiscal role. The main advantages of this arrangement are that it provides the minister of finance, who is responsible for budgetary revenue, with full control over a revenue-collecting department, and it provides a close link between tax policy decisions and the departments administering and enforcing the policy. It also should facilitate cooperation and exchange of information between revenue-collecting departments.

⁶⁷Three main software packages are available: ASYCUDA, developed and maintained by UNCTAD; SOFIX, which is the export version of the software from the French customs system; and TIMS, developed by Crown Agents.

An emerging trend in public administration is to provide more accountability to the head of an organization and to the management of functional units.⁶⁸

Recently, a number of countries have provided more autonomy to their revenue administrations. Greater autonomy means

- flexibility in the management of resources, including authority to recruit staff, change the organizational structure, and invest in computerization;
- authority to allocate resources between salary and nonsalary areas, provide performance-based incentives, and match salary levels for specialized staff with the private sector; and
- the ability to contract out certain functions to the private sector. Coupled with the increase in autonomy provided to these agencies, their degree of accountability to meet performance targets, and for meeting the government's objectives related to both revenue collection and trade facilitation, has also increased.

Several approaches can be used to increase autonomy and accountability. Some revenue agencies have remained within the ministry of finance, although with enhanced authority to manage their affairs. Others have been established as largely autonomous units, with the head of the organization responsible to the executive branch or to parliament. At the same time, there have been moves toward the unification of customs and tax departments under a single revenue board, which, in turn, may or may not be independent of the ministry of finance.⁶⁹

A customs administration requires a decentralized organizational structure consisting of

- a central office (headquarters), with a head who has overall responsibility for customs administration in the whole country;
- regional offices, responsible for administering a geographical area; and
- local offices, where customs control and clearance operations take place.

The number of regions and local offices will vary according to the size of the country and the nature of the trade and transportation patterns (small countries may not need regional offices, for instance). Nevertheless, there should be a clear separation between headquarters' planning and monitoring functions and operational activities that properly belong in the field.

⁶⁸For a study of experience of such reform in the British customs service, see Colvill, Dalton, and Tomkins (1993).

⁶⁹See Jenkins (1994b) and Terkper (1999).

Management

Another critical area in implementing a customs administration reform program is that of management. The change process itself must be organized and managed, but even more important is the need to implement effective management practices that will enable the customs administration to meet its objectives. As just noted, headquarters should be responsible for the development of operational policy and the communication of the policy to the field offices and the trade community. Its responsibilities do not end there, however, as headquarters must also have in place mechanisms to monitor implementation of the policy. These should include

- development of strategic and operational plans that clearly set out what the organization is trying to achieve;
- development of performance criteria for the offices in terms of, for example, revenue targets, service standards, and resource utilization (such as the number of staff required to process the number of declarations presented at a particular office);
- ensuring integrity in the organization;
- creating an effective internal audit function responsible for determining that the policies, systems, and procedures have been followed and for investigating cases of corruption; and
- implementing a strategy to inform both staff and the trade community of planned changes.

Recruitment and training

In support of a fundamental change in the way a customs administration operates, attention must be paid to the type of staff that is required to administer the new systems and procedures, and the training that needs to be undertaken to ensure that all staff are able to carry out their new responsibilities. For most administrations that undertake reform, many of the new skills required will not be present or will be in short supply. Two fundamental changes in the way the customs administration will operate involve audit and computerization, but typically, customs administrations do not have sufficient personnel with the requisite skills to support these functions.

The training requirements of a reformed customs administration are multidimensional. Retraining of all customs professional staff will be required to support the new systems and procedures resulting from changes in legislation, simplification of procedures, and the introduction of computerization. In addition, training will be necessary to support entirely new requirements, such as audit, and new approaches to supervision and management.

Service

As was seen in Chapter 1, the costs associated with customs controls are significant and ways must be found to reduce them. Improving service to the trade community is one of the most effective ways of reducing such costs. The problem is not unique to customs administrations but is faced by many tax administrations as well:

All too many countries seem to do their best to make it difficult for taxpayers to comply with the law. The law is complex, contradictory, hard to interpret, and even hard to find; the necessary forms are hard to locate and sometimes even have to be purchased; forms and payments have to be submitted at inconvenient times and places; and many who become involved with tax officials feel annoyed or harassed.⁷⁰

One of the most important areas in which better service is required is in the time taken for goods to be released from customs control. It is often found that governments were considering major investments to expand the facilities at seaports and airports without a clear understanding of the time taken to release goods from customs control, and of the improvements that could be introduced to reduce this time. If the time taken can be reduced significantly, the investments required to expand facilities can be reduced as well.

There are relatively simple changes that can be undertaken to improve release times without jeopardizing revenue. Possibilities include

- pre-arrival processing, under which the declaration is processed prior to the arrival of the goods;
- release prior to payment based on the posting of a financial guarantee (often a blanket guarantee for more than one declaration),⁷¹ and
- as described above, reduced physical inspections for known importers with a good record.

One measure that has been implemented in recent years in several countries (Thailand being one) is based on a recognition that certain traders should be entitled to benefits, resulting in improved service. These programs—often referred to as “gold card” schemes—are offered to traders who typically have a significant number of import and/or export transactions and who have demonstrated the ability and willingness to maintain a high level of compliance. The benefits offered may include electronic filing of declarations and verification,

⁷⁰LeBaube and Vehorn (1992), p. 311.

⁷¹For many years in Canada, importers and brokers were permitted “end of day” settlement privileges. The duties and taxes for goods released on one day had to be paid by 10:00 a.m. the following day.

periodic payment (perhaps once-a-day payment for companies, such as customs brokers/agents that have numerous transactions with the customs administration), and very low levels of physical inspections. Verification of gold card companies is normally through periodic audits of their books and records.⁷² Such schemes can prove very effective but do require a good audit capacity, and perhaps a dedicated gold card audit team.

E. Conclusion

This chapter has outlined an approach to managing the reform of a customs administration. Everything cannot be done at once, so it is important that careful consideration be given to the priorities for reform and the sequencing of their implementation. For most middle- and low-income countries, revenue from trade taxes is still very important; therefore, the strategy should be designed in a way that maximizes the potential from these revenue sources. At the same time, each administration must be mindful of the costs imposed on the trade community by unclear, complex legislation and inefficient procedures.

The reform strategy and plan of action should be based on the principles of simplification and ownership and commitment to the reform program. From these principles, each administration should identify ways to make more transparent its legislation and procedures; adopt simple but effective procedures for dealing with such key issues as valuation and the control of exemptions; reorient its control strategy from a pre-release transaction-by-transaction approach to a risk-based, post-release verification and audit; and deal with the risk of corruption. In order to implement this strategy, changes will be required in computer systems, organization, management, recruitment and training, and service. The following chapters consider each of these elements in detail.

⁷²The “gold card” program can be implemented as part of the establishment of a large taxpayer unit for domestic taxes. Most often, the large taxpayers and gold card companies are the same, and programs such as joint audits provide both better service to the taxpayers and a more comprehensive approach to compliance verification.

4

Simplifying Procedures and Improving Control Prior to Release of Goods

François L. Corformat

A central element in reforming customs administration is the streamlining of basic procedures, with the aim of enhancing revenue and quickening customs clearance operations. This chapter considers the three main areas of the customs process prior to release of goods from the point of entry that typically require attention: the control of manifests, the assessment and verification of duties due, and procedures for the payment and collection of those amounts.

A. Control of Manifests

The cargo manifest is the prime document for control of imported goods. It provides sufficient information to permit identification of the goods, the names of the consignee and consignor, and certain other information (such as weight and container number). The manifest may be a specific customs form or the commercial forms (bill of lading, airway bill) that meet the information needs of the customs administration. In many customs administrations, this information is available electronically from the carriers or transportation agents.

Correct use of the manifest is essential to ensure that all imported goods are brought under customs control and presented to customs for clearance formalities and payment of duties and taxes when applicable. Customs procedures to capture and process data from cargo manifests are generally weak in most countries. Even in developed countries, the reconciliation process to match information on customs declarations with data from manifests is an area where improvements are only quite recent. For example, U.S. Customs reviewed its control procedures in the mid-1980s, and automated systems for processing manifests were not introduced until 1989 for air cargo and late 1991 for sea cargo. It is important to realize that strengthening the capacity for customs to control information from cargo manifests means reducing the possibilities of fraud and leakage, thereby consolidating the import tax base and increasing revenue.

There are three main reasons for the difficulties related to processing cargo manifests:

- the exchange of information for cargo shipments between carriers and customs authorities is usually not properly organized;
- the responsibilities between customs and port/airport authorities for tallying unloaded goods are unclear; and
- the matching and writing-off process of data on manifests with customs declarations is not done in a timely manner or even, in some countries, not done at all.

Two series of operations are essential to ensure adequate treatment of manifests: first, the manifest should be adjusted, as necessary, at the time of the unloading of incoming goods (the tallying process); second, all the details of the manifest (consignments) should be cleared or written off by a customs declaration within a statutory period of time.⁷³

A number of procedural steps are necessary to secure these controls, in particular to ensure that the writing-off process is carried out in a timely manner. Moreover, it is important that customs regulations assign responsibility and provide for penalties for transportation companies if there are excesses or shortages of cargo. The same rules should apply to port/airport authorities (or transit shed operators) when unloaded goods are missing. In addition to penalties, duties and taxes should be paid for any missing goods unless operators can satisfy customs that the goods were not shipped or were lost prior to arrival in the country.

Once responsibility has been determined and control procedures have been established, computer applications for the processing of data from cargo manifests should be developed. They should provide, in particular, for automated reconciliation of manifested goods with the goods shown on the declarations, and for rapid information retrieval to allow the investigation of discrepancies and excesses. For the computer system to work correctly, carriers must assign a unique identifier to each manifest and to each consignment. The WCO is working toward providing recommendations and guidelines on a Unique Consignment Reference (UCR) number that could be used for this purpose. See Box 4.1. Advanced techniques for dispatching information should also be introduced, including the use of interface systems between port authorities and

⁷³The statutory limit varies from one country to another and should be in the range of 15 to 45 days. The customs declaration assigns the goods a status or a destination (import for consumption, bonded warehousing, transit, reexportation, or temporary admission).

Box 4.1. The UCR mechanism

The Unique Consignment Reference (UCR) number is a reference number to be used by customs authorities (of exporting and importing countries) as a generic mechanism to facilitate legitimate trade. A UCR number binds together (using a maximum of 35 alphanumeric characters) all the information about a chain trade transaction (information would include calendar, country of export, company ID, and transport references), from the initial order and consignment of goods by a supplier, to the movement of those goods and arrival at the border, through to their final delivery to the importer. Because of its tracking capability, the use of the UCR number will also facilitate bilateral and multilateral cross-border customs audits.

The WCO has been working on the UCR concept and technical issues related to its use for several years within ad hoc committees, including customs representatives of its member countries and representatives of international associations of freight forwarders, carriers, and the transportation industry. It is to produce a recommendation and guidelines on the structure, requirements, and use of the UCR number. For example, use of the UCR number will require an automated environment using e-commerce technologies as well as international standards for electronic messages—such as UN/EDIFACT or XML (eXtensible Mark-up Language)—for import and export cargo and goods declarations (on which, see Chapter 9).

customs, or, where conditions and infrastructures permit, the connection of customs systems to networks that will allow the processing of information from manifests before cargo arrival.

B. Assessment and Verification Procedures

Assessment and verification procedures (by which is meant customs operations and controls performed during the clearance process, prior to release of the goods from the port of entry) include such activities as the tariff classification of goods, customs duties and tax computation, the application of other legislation, and the subsequent examination of documents and goods. These procedures usually start with the self-declaration by the importer/exporter or customs agent (broker). Many administrations impose complex and time-consuming control procedures for customs clearance of imports. Many customs administrations in developing countries have not yet organized selective controls. The tariff classification and valuation of goods, which are essential to verify the accuracy of the assessment process, are in some cases left to the individual initiative of customs officers. Not enough effort and resources are devoted to the collection of relevant information from importers, to the establishment and maintenance of a reference data base on values of imported goods, and to training in these areas. A lack of efficiency in classification and valuation methods and controls leads to considerable losses of revenue and to a distortion in tariff protection levels.

The simplification and rationalization of customs controls during clearance should aim at avoiding excessive processing steps for declarations, defining the responsibilities of customs clearance officers, reducing opportunities for collusion with traders, and curtailing delays in customs clearance operations. To that end, the principle of self-declaration should be the norm, and penalties should be in place to help ensure that good-quality information is presented to customs. The profession of customs agents/brokers should, ideally, be organized and supervised by the customs administration through an accreditation system of licenses to ensure quality service to the trade community and to facilitate clearance formalities.

Cargo examination should be selective, based on such criteria as patterns of trade, origin of goods, importer's and customs broker's performance, discrepancies between declarations and supporting documents, value of consignment, and incentive for misclassification. The selection process for the physical examination of goods should be based on an information system using a methodology to determine risks and the possible types of fraud (as discussed further in Chapter 5). Cargo selectivity criteria should be developed using both local information (from customs regional offices), and national priorities (from headquarters) to create an automated system for the assessment of risk. It should also be used to develop the audit criteria for customs. In addition, random and surprise checks should be carried out. As a general guideline, the physical examination of consignments and goods should not exceed the rate of 20 percent of the total number of customs declarations. Guidelines should also be developed for the type of examination to be conducted, for example, cursory (counting the number of packages and verifying marks and numbers), selected goods examination (say, one in ten packages), or intensive (inspection of all goods). Access to customs inspectors' offices should be strictly limited, so as to ensure that these staff can work without interruption and reduce opportunities for traders or brokers to influence the verification process.

C. Payment and Collection Procedures

The payment of customs duties and taxes by importers (or the provision of adequate assurance that they will be paid) is a precondition for the release of imported goods. As long as this condition is not met, the goods should remain under customs control. This is in accordance with the principle by which the goods serve as a guarantee for payment of duties and taxes. Provisional advanced payment should be authorized to allow the quick release of perishable goods that justify urgent delivery. However, as a general rule, deferred payment schemes for import duties and taxes should be permitted only for registered importers who have a good record with customs and who have posted security with them and have a taxpayer identification number.

In many developing countries, customs does not secure payment before release and traders are given too easy an access to deferred payment mechanisms without adequate guarantee and documentation. To evade payment of import duties and taxes, traders often make extensive use of temporary relief systems, such as warehousing, temporary admission, and transit. With these systems, some traders expect (often with good reason) that customs will lose track of the goods and payment obligations. Arrears in customs duty and tax payments should not exist, but often do—and they are then an indication of how serious customs control problems have become.

An approach to collection that has proven successful in many countries, and that is recommended, is to have banks perform the cashier function in large offices. Customs, of course, should retain responsibility for the supervision of the collection system and for ensuring that the monies collected by the banks are deposited in the government accounts. Where the banks are authorized to collect customs revenue, the number of banks (and branches) should be restricted. A proliferation of banks may create difficulties in ensuring that correct duties have actually been paid, in identifying the accuracy of bank receipts presented to customs, and in reconciling remittances to the central bank and/or the treasury.

D. Paperless Processing of Imports

Many ports still suffer from chronic delays in the reception and clearance of cargo because the interfaces between carriers, traders, agents, customs, and port authorities are clogged by import procedures relying mainly on the processing of paper. The application of information technology to support customs operations “as an alternative to paper-based documentary requirements” is a standard stated in the revised Kyoto Convention.⁷⁴

Working in a paperless environment can bring significant benefits to both traders and customs administrations. When customs administrations manage imported goods based on automated manifest data, all the imported goods will be accounted for and cleared; in a manual system it is difficult to know whether the cargo is missing, and whether, if so, that is intentional or not. Modern customs administrations that have introduced self-assessment and operate in a fully automated environment also use a green, orange, and red channel system for declarations processing; this significantly reduces paperwork and improves the release time of consignments. Such a system requires the development of risk-based criteria for control and automated selectivity systems (as discussed in

⁷⁴See Chapter VII of the General Annex. The Customs Cooperation Council recommendation of June 26, 1990 concerns the use of the UN/EDIFACT rules for electronic messages between customs and other trade users.

Box 4.2. Paperless Processing of Imports	
Principal Steps	Main Benefits
<i>Cargo agent and importer/broker activities prior to presentation to customs</i>	
<ul style="list-style-type: none"> • Shipping agent transmits the manifest via EDIFACT or other electronic protocol into the customs computer system. • Broker receives and verifies required documentation and inputs import declaration information into the computer system. Broker pays duty and taxes electronically. A message notifies that the declaration has been paid. • The computer system automatically designates the channel (red, orange, or green). The declaration is printed in the broker's office. 	<p>No paper manifest.</p> <p>Declaration prepared in advance from electronic messages. Electronic messages for payment.</p> <p>Automatic selection of goods for verification or documentary control.</p>
<i>Customs operations</i>	
<ul style="list-style-type: none"> • For green channel declarations, the release of the goods is done automatically and the broker proceeds directly to the warehouse. • For orange channel declarations, the system notifies the broker of the requirements and the broker certifies through the system that the required licenses and so on are available. The system releases the goods automatically and the broker proceeds directly to the warehouse. • Broker keeps on file all of the required supporting documentation (such as invoice, delivery order, bill of lading, and certificate of origin). • Red channel goods are taken by the warehouse operator to the inspection area where they are physically inspected for classification, origin and valuation. Results are input in the system. Certain goods may be scanned for enforcement purposes. Inspection results are recorded and release is authorized if no discrepancies are found. 	<p>Goods released without face-to-face contact.</p> <p>Broker fully responsible for orange channel declaration subject to audit by customs.</p> <p>Customs does not retain paper documentation.</p> <p>Certain red channel goods are scanned rather than physically inspected.</p>
<i>Release at the gate</i>	
<ul style="list-style-type: none"> • Terminal operator verifies release of the goods and inputs notification of exit from the terminal into the system. On a random basis, release officer at the gate verifies that the shipment is as described on the declaration. 	<p>Electronic notifications for exit. Terminal operator responsible for exit control.</p>
<i>Post-release review</i>	
<ul style="list-style-type: none"> • Certain declarations are selected with the assistance of the computer system (using risk-based criteria) for in-depth valuation, tariff classification, origin, and exemption review. Broker is requested to provide the declaration package. 	<p>Increased use of post-release verification and audit for valuation, tariff classification, and origin.</p>

Chapter 5). Moreover, data generated by automated systems can also be analyzed to address structural problems that delay import clearance processing.

Box 4.2 outlines paperless processing systems that are used in customs in a number of countries. A prerequisite for the use of EDI and information-sharing systems is that the customs legislation code allow for the use of electronic signature and the elimination of paper forms.

E. Conclusion

The trend in international trade is toward the elimination of barriers and an increase in speed and flexibility of services among international trade partners. The simplification of customs procedures should be placed high on the agenda of a customs modernization program. Such reforms will save time, reduce costs, and speed up the movement of goods. At the same time, simplified systems and processes will have a rapid impact on the effectiveness of revenue collection and the transparency of customs clearance operations. Moreover, computerization cannot be successfully implemented without first undertaking a thorough review of customs procedures aiming at the elimination of unnecessary processing steps, the simplification of and/or elimination of forms, and the streamlining of the document processing flow.

Documentary and physical verification before the release of goods is not effective for certain types of controls. In-depth controls related to valuation, origin, incentives schemes, and exemptions are better suited to post-release examination of documents and, when necessary, to audits and investigations on the premises of importers, exporters, or customs agents. Such post-release controls are examined in the next chapter.

Post-Release Verification and Audit

James T. Walsh

The centerpiece of effective customs modernization is a shift away from physical controls at the point of entry and toward the use of checks after goods have been released from the port. This chapter sets out this approach to revenue collection and trade policy administration.

This approach is particularly effective for verification of valuation, tariff classification, origin—increasingly important, given the proliferation for regional trade agreements described and discussed in Chapters 1 and 2—and entitlement to exemptions. Undertaking most, if not all, verification activities when the goods are under customs control (that is, prior to release) is no longer appropriate, given the need for customs administrations to become more efficient, the demands of the trade community for better service and lower costs, and the increasing complexity of import and export transactions. Most modern customs administrations have recognized this fact and developed a control strategy that combines selective, risk-based controls before the goods are released with post-release verification and audit.

A. Pre-Release Controls and the Need for Post-Release Verification and Audit

The compliance control strategy of a customs administration for commercial importations normally involves five steps.⁷⁵

Step 1: Cargo reporting

For all modes of transport (i.e., air, sea, rail, and truck), the carrier is required to report to the customs administration the goods that are being brought into the country. This initial cargo report from the transportation company is usually in the form of a customs manifest. At this point in the process, there is limited

⁷⁵While the control of exports is important particularly to prevent fraudulent claims of zero rating for VAT, in general, more stringent verification efforts are required for imports for both revenue and protection reasons.

information available concerning the value and tariff classification of the goods. The cargo report creates an inventory of goods that have entered the country and that are awaiting further processing (e.g., transit through the country, entry for consumption, temporary admission for further processing, reexport, etc.). All of the goods in the inventory must be accounted for within a specified period of time.⁷⁶ Key features arising at this stage, the control of manifests, are discussed in detail in Chapter 4.

Step 2: Declaration processing

The declaration (paper or electronic version) is the most important document in the customs process. In itself, it is simply a summary of the information contained in the supporting documentation, such as the commercial invoice, packing list, exemption authorization, certificate of origin issued in the country of export, and so on. Under a self-assessment system, the importer or agent certifies to the truthfulness of the declaration and the supporting documentation.

The declaration is thus the importer's statement of the circumstances surrounding the goods being imported and the treatment that is being requested for them.⁷⁷ For many transactions, this includes the calculation of the duties, taxes, and other fees payable. For other transactions, an exemption may be claimed and the declaration will summarize the reasons for the exemption claim. The information on the declaration is critical. It is used to conduct verification activities prior to the release of the goods—including ensuring that certain documentation has been presented (for instance, certificates from the departments of agriculture, health, and other government departments for certain goods)—and to select goods for physical inspection. And it is also the basis for post-release verification activities and the preparation of trade statistics. More generally, the information on the declaration should be used carefully to

⁷⁶The customs law normally sets out the time periods for the required actions, for example, a declaration for goods for consumption may be required within 30 days of the manifest report while goods in transit may require an exit report within 5 days.

⁷⁷The WCO defines a goods declaration as “a statement made in the form prescribed by the Customs, by which the persons interested indicate the Customs procedure to be applied to the goods and furnish the particulars which the Customs require to be declared for the application of that procedure.” In most customs administrations, the declarations are prepared and presented by customs clearing agents.

Box 5.1. Risk Analysis for Selective Verification

Selection of declarations for physical inspection and/or documentary controls should be based on simple risk evaluation criteria combined with in-depth study of international trade databases, the objective being to be able to predict the risk of fraud. Risk evaluation can support three levels of control: (1) “green channel” (no controls), (2) “orange channel” (documentary controls), and (3) “red channel” (documentary controls and physical inspection of goods).

The selection system for shipments to be physically inspected should focus on the most important elements of the international trade transaction, which are (1) the origin of the goods and the routing of the shipment; (2) the type of goods; and (3) the importer, exporter, and others involved in the transaction.

The essence of the system is an automatic mechanism for selecting transactions. Each criterion (i.e., operators, goods, and routings, singly or in combination) is graded on the basis of available statistical information as to how good an indicator it is of the potential for fraud. An overall “score” for the level of risk in any particular declaration is then obtained by totaling the weighted scores attributed to the various criteria (the weighting coefficients being established by econometric analysis of data from previous declarations, with more weight given to those criterion that are the best indicators of risk). The declaration is then assigned to the appropriate channel based on the assigned score: highest risks to red, lowest risks to green. (The weights should of course not be made known to traders, since that would enable them to manipulate the perceived risk of their transactions.)

In addition to the selections made automatically in this way, additional declarations should be selected by these further criteria:

- Verification all new operations, meaning those that involve an operator, a good, or a routing that is not known in the database. For example, if the declaration contains a false importer identification code, the declaration will be reviewed intensely and the shipment will be physically inspected.
- Mandatory selection for documentary review and/or physical inspection of certain transactions based on one or more of the characteristics on the declaration (e.g., block the release of a shipment pending an inspection by the health or agriculture department). Selection may also be triggered if, for example, goods for a certain importer have not been physically inspected for several weeks.
- An element of purely random selection, which provides a risk of inspection for all declarations and also helps to maintain and update the database on which the selection mechanism is built.

It is essential that the results of the documentary reviews and physical inspection are recorded in the system, so that the risk analysis system always make use of the latest information.

determine how a particular shipment should be treated, with an increasing number of countries using automated techniques of risk assessment for this purpose; see Box 5.1 for a description of these techniques.

Step 3: Physical inspection

Physical inspections have a role to play in verifying quantity, ensuring that the description of goods is sufficient for tariff classification, detection of contraband, and the enforcement of laws and regulations not related to revenue (for example, phytosanitary, drugs, intellectual property rights, and control of endangered species). Physical inspections are less effective for valuation, tariff classification, origin, and exemption determination that are dependent upon the terms of sale, detailed technical descriptions, the presence of certificates or letters of authorization, etc. (i.e., information that is normally available from the books and records of the importer). Therefore, these inspections should be targeted at high-risk shipments where there is some expectation that the suspected violation can be detected through physical inspection (e.g., certain importers may have a history of misdescribing goods on the declaration to attract a lower rate of duty).

Step 4: Post-release verification and audit

This activity is best suited to detecting violations that have a direct impact on revenue, including undervaluation, tariff misclassification, origin fraud, and illegal use of exemptions. It relies heavily on the analysis of information both from the declarations themselves and from other sources (e.g., tax department) to assist in detecting areas for review. As with physical inspections, a risk-based approach should be used to identify the transactions and companies that should be subject to full review. For example, in order to determine the customs value of the goods under the WTO Valuation Agreement, it is necessary to ascertain certain facts about the transaction (such as the relationship between buyer and seller). The information may not be readily available prior to the release of the goods and can only be determined through correspondence with the importer or audit.

Step 5: Investigations

Serious violations occur in all customs systems and, for this reason, it is necessary to establish an investigation capability to detect fraud. Good intelligence is the key to effective investigations and, therefore, it is important that sources of intelligence be developed both within and outside the country (most customs administrations have developed good working relationships with neighboring countries and other countries with which there is considerable trade activity). The analysis of information that is available from all customs activities (e.g., cargo reports, declarations, post-release reviews, etc.) is also an important part of this work.

The need for an emphasis on post-release controls

Even when the compliance strategy is based on the five steps just described, there remains the difficult issue of determining how the limited resources

available to the customs administration should be allocated between them. This determination is not easy because the provision of good service to the trade community is becoming increasingly important and, at the same time, the verification activities of the customs administrations have become increasingly complex and, hence, difficult. The consensus is that there is a need for customs administrations to move away from the traditional approach of transaction-by-transaction processing to an accounts-based approach that relies on certain verification activities being undertaken while the goods are under customs control but with an emphasis for revenue-related verification on post-release controls, including the audit of the books and records of importers. For many administrations, this is a dramatic shift in emphasis as they have been used to intensive verification activities before release of goods (including in some developing countries some level of physical inspection for 100 percent of declarations). In some countries, the legislation does not anticipate the need for post-release verification and audits as a routine matter but only in cases where fraud is suspected; this is very different approach from that in most modern tax legislation, which is based on self-assessment-supported verification through audits and routine reassessments. While it is difficult to specify a percentage of activities/resources that should be used in the post-release verification activities, it would not be unreasonable to assign 50 percent of the total number of professional personnel dedicated to the processing of commercial transactions to post-release verification and audit.

B. Organization and Procedures

Post-release verification and audit is thus an essential part of the overall compliance verification strategy. For the program to be effective, it is important that the post-release control units be properly organized and that procedures be developed to ensure that the appropriate amounts of revenue are paid.

Organizational structure

In most modern customs administrations, it has been recognized that tariff classification, origin claims, exemption verification, and valuation are sufficiently complex to justify employing specialist staff to undertake a detailed verification of import declarations in selected cases after the release of the goods. If this verification reveals that additional duties and taxes are due, then these will be collected along with fines or penalties where appropriate. It might also be decided to visit the trader to carry out a full audit to investigate whether or not the loss is one of a series, or perhaps a part of a systematic fraud, where there is a much greater threat to the revenue.

Classification, origin, exemption, and valuation checks are still an important part of the declaration processing system because these checks are related to the evidence available at the time, including the results of reviews of the

documentation and physical inspection of the goods. However, an effective control strategy also recognizes the importance of highly developed post-release verification procedures.⁷⁸

Teams are typically established on a regional basis and staffed with officers carefully selected on the basis of their experience, technical knowledge, and motivation.⁷⁹ It is important to grade and pay the officers employed in the post-release control units at a higher level than the officers who perform the routine controls to attract more qualified members of staff to these positions. It will recognize the importance of this work and also give them status among their colleagues, motivating other members of staff to acquire the same skills.

Systems need to be set up for the selection of declarations and importers and exporters for in-depth scrutiny and check. These factors, as discussed in more detail subsequently, include known high-risk tariff headings, goods that are frequently found to be undervalued, those that come from areas where origin is doubtful, and goods and importers claiming exemptions. The teams should be set up on the basis of individual officers working as specialists—taking the lead on several chapters of the tariff and being accountable for the proper application of the rules in that area. They should select and work on high-risk importers and exporters and organize verification activities related to targeted chapters of the tariff or declarations from selected countries (e.g., to verify origin).

Even though officers will have primary responsibility and will be accountable for a clearly defined area of work, they should work as a team. For example, an officer concentrating on high duty rates would be expected to work very closely with the valuation expert as the fraud or undervaluation may well be found in that area. In these circumstances, even if the declarations and supporting documentation appear to be acceptable, there may be justification to ask the importer for additional information or to carry out an audit of the books and records. If the records indicate that the trader is a regular importer and the duty potential of errors or fraud is high, this may require a team of two or three

⁷⁸This approach has proved to be very effective in the customs services of the United States and Canada. Import or commodity specialists located at regional offices and headquarters undertake these reviews. They are normally organized in teams by commodity (each specialist or group of specialists is made responsible for a certain number of chapters of the Harmonized System). In both countries, the specialists are at a higher grade and pay level than the officers working in the local offices. Officers working in the local offices are motivated to gain specialist knowledge in these fields as they see gaining one of these positions as an opportunity for advancement; this provides a major benefit for the administration.

⁷⁹For purpose of this discussion, it is assumed that the customs administration is organized in local offices reporting to a regional office that, in turn, reports to headquarters. It is further assumed that the post-release verification activity takes place at the regional office although this is not the case in all customs administrations. In some developing countries it may be more appropriate to implement the post-release verification activity at headquarters when there is a heavy concentration of import and export activity in one or two locations, usually including the city where the headquarters office is located.

officers. The team will need expert knowledge of audit techniques, valuation, and tariff classification. The unit should work out an agreed management plan with clearly set aims, objectives, and targets, and regularly report on their progress.

Selection of transactions for review

Not all declarations will be reviewed after release. Therefore, the objective is to identify or select the declarations that should be reviewed, and the selection is usually related to the potential additional revenue that may be realized from the review.

Following the processing of the transactions at the local office and the release of the goods, the declaration is forwarded to the regional office to be filed. Prior to filing, it should be determined if the declaration meets the selection criteria for post-release review. If declaration processing at the local office is automated, selection criteria can be run following release, and the declaration can be forwarded to the region with a note that it has been selected.⁸⁰ Even in customs administrations where declaration processing is not automated, there is usually an automated system that captures information from the declarations for trade statistics purposes. Criteria can be developed to select transactions for post-release review as the transactions are being entered into the trade statistics database.

The selection of transactions for post-release verification is normally made on the basis of the following criteria, either singly or in combination:

Importer taxpayer identification number.⁸¹ Importers with a history of false invoicing, undervaluation, and misdescription of goods should be identified as high risk and subject to a high probability of verification. For a period of time, all declarations from new importers should also be selected for verification.

Origin. The customs administration may have recurrent problems with goods from certain countries or may be required to verify origin in particular circumstances (e.g., goods from countries in the customs union). Criteria can be developed to target shipments from these countries for in-depth review.⁸²

⁸⁰Alternatively, when the transaction arrives at the regional office, before it is filed, the declaration number can be entered into the system and a message will appear to show whether or not it has been selected.

⁸¹The customs administration should use the taxpayer identification number issued by the tax administration.

⁸²The mere presence of a certificate of origin is not sufficient, in all cases, to permit customs clearance at a lower, preferential rate of duty. Investigations of origin claims may be required in certain circumstances.

Tariff heading. Goods that are free or subject to low rates of duty should be reviewed for tariff classification purposes. On the other hand, goods with high rates of duty are more likely to be undervalued.

Exporter name. As with importers, certain foreign exporters may be high risk. There will also be certain domestic exporters who are not reliable and information from the tax department may be useful in identifying those exporters who are suspected of VAT fraud.

Value of shipment. Value will often be used as a basis for selection as high-value importations are an obvious risk category. Because the potential loss of revenue is less for low-value shipments, a “cutoff” limit may be used to exempt low-value shipments from close review. (This criterion must be used with care, however, since it gives importers an incentive to break up or misdeclare shipments so as to take them below the threshold. It may be wise, for instance, to keep this threshold confidential.)

Exemptions. While, at the time of declaration processing, the eligibility for an exemption is verified, there are certain exemptions that require follow-up after release. Declarations can be selected if the exemption was “conditional.” For example, there may be a need to determine if a “use” requirement has been met (i.e., importations where duty-free access is granted for certain goods that are to be used to manufacture other goods require the customs administration to follow up to determine if the goods were used as required). In other cases, goods are admitted free of duties and taxes for purposes of manufacturing exports (i.e., temporary admission), and follow-up action is necessary to ensure that all of the goods entered for this purpose have been used to produce exports (i.e., the imported goods were not diverted to the domestic market).

Random selection. Once the declarations have been selected based on the predetermined criteria, the remaining declarations not selected should be subject to random selection (at a rate of approximately 1 to 2 percent). The random feature is designed to sample declarations to assist in the identification of other risk areas that may not have been identified or to amend existing selection criteria—and, not least, to ensure that all importers are aware that there is some chance of audit.

As is the case with selection criteria used during declaration processing, it is important that the post-release selection criteria be reviewed and evaluated on an ongoing basis. The results of the reviews of the selected declarations should be recorded and reports produced that show their effectiveness. Full-time resources should be dedicated to the development and maintenance of the selection criteria.

In addition to selecting declarations for review after release, there will often be a need to search the database of declarations to retrieve those that meet certain

criteria. For example, as a result of the review of one declaration from one importer, it may be found that goods have been misclassified. In this case, it will be necessary to retrieve and review all similar transactions for that importer for the period of time (e.g., for the past 6 to 12 months). It may also be desirable to review declarations for the same goods from other importers if it is suspected that the reasons for the misclassification by one importer may also apply to the others (e.g., the wording of a particular tariff heading is subject to misinterpretation).

Once the declaration and supporting documentation has been reviewed, it may be necessary to request additional information from the importer. For example, for transaction value,⁸³ it may be necessary to determine the total payment made or to be made; the inclusion or exclusion of freight and insurance charges in the terms of sale; and, if the buyer and seller were related, whether or not this relationship influenced the price.⁸⁴ In order to satisfy any questions concerning tariff classification, technical literature may be requested, for example in the case of textiles, it may be necessary to determine the exact mixture of man-made and natural fibers. In other cases, such as origin investigations, it may be necessary to contact the exporter and/or the customs administration in the country of export to request information to verify the importer's claim for a tariff preference.

⁸³Under the WTO valuation system, transaction value is the primary method of determining the customs value of imports. See Chapter 6.

⁸⁴Of course, it will be very difficult for any customs administration to determine if the transaction has been made at "arm's length." The cooperation of other customs administrations may be helpful in investigations of this nature.

6

Customs Valuation*James T. Walsh*

Evasion of duty through undervaluation or misdescription of imports is an acute problem for administrations in developing countries. This chapter considers how they can be addressed.

A. The Valuation Problem

The World Trade Organization (WTO) agreement establishes rules for the valuation of imported goods that must be applied by all member countries. These are described in Box 6.1. Countries that are signatories to the WTO are required to adhere to this valuation agreement,⁸⁵ but coming to terms with its provisions of the agreement has often proved problematic, since they include the introduction of modern principles of tax and customs administration, such as self-assessment.⁸⁶

On the one hand, most governments in developing countries have recognized the benefits to be derived from reducing trade barriers. On the other hand, customs administrations are frequently striving to bring systems and employees up to the level of skill required to counter valuation fraud in a more relaxed regulatory environment. Valuation fraud is a serious problem in most countries, in particular, in developing countries that have relatively high rates of duties and other ad valorem taxes on imported goods. It is often exacerbated by a generally poor level of tax compliance throughout the country, a tendency for many importers to deliberately maintain poor records, and the existence of “special

⁸⁵Under the GATT, countries could opt not to use the valuation agreement and many developing countries chose not to.

⁸⁶Importers or their agents complete the customs declaration, including the value and tariff classification of the goods, and calculate the duties and taxes owing. The customs administration verifies the information to the extent necessary (i.e., selective verification based on risk-assessment techniques).

Box 6.1. WTO Valuation Agreement

One of the results of the Tokyo round of GATT trade negotiations was the Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade. It officially came into force on January 1, 1981 and was adopted by various signatories from the mid-1980s onward. With the WTO having now become the successor organization to the GATT, we refer to this as the WTO valuation agreement.

Many of the countries that participated in the negotiations believed it important to establish rules for the valuation of imported goods as customs valuation is a major feature of tariff systems. It is also an important element in a variety of other aspects of international trade, including statistics, quota and licensing arrangements, taxes and other charges levied on imports, and the application of preference systems. The Tokyo round had as one of its major goals the reduction and eventual elimination of non-tariff barriers, and it was recognized that certain valuation practices could have restrictive effects on international trade.

The agreement is intended to provide a fair, uniform, and neutral system for the valuation of goods for customs purposes, which conforms to commercial realities and prohibits the use of arbitrary or fictitious customs values. It provides, as its basis, the use of transaction value (selling price) between buyer and seller. At the same time, it specifies alternative methods to be used in sequential order for determining value when the transaction value cannot be used. These methods are summarized, as follows.

Transaction value (Articles 1 and 8). This method focuses on the value that a purchaser and vendor attach to goods in an open market. For the most part, value is based on the selling price in the export transaction.

Transaction value of identical goods (Article 2). Where the transaction value cannot be used, as for instance with transactions within companies, this method provides for the determination of value based on the transaction value of identical goods exported at or about the same time, in the same quantities, and at the same level of trade (retail, wholesale, and so on) as the goods being valued.

Transaction value of similar goods (Article 3). Where neither of the first two methods can be used, the transaction value of similar goods produced by the same producer is used. The conditions respecting quality, level of trade, etc. are the same as in the second method.

Deductive method (Article 5). If the imported goods cannot be valued using the first three methods, value may be determined based on the sale price in the country of importation from which certain costs (e.g., expenses and profits) are deducted.

Computed method (Article 6). This method provides for the determination of value based on the costs of material and production in the country of export plus certain other costs (e.g., packing, engineering, and development work). In addition, amounts for profit, general expenses, and insurance are also included in the value.

Fall-back method (Article 7). Value can be determined based on any of the previous methods as adjusted in a flexible manner to account for special circumstances (e.g., it may be necessary to provide an alternative method to value used automobiles).

relationships” with suppliers.⁸⁷ An opinion expressed by officials in many developing countries is that the WTO valuation rules require an administration to accept the declared-transaction value (even when clearly unreasonable), unless the authenticity of the supporting invoice can be unequivocally disproved by the authorities. This is not so, as will soon be seen.

B. The WTO Customs Valuation Agreement⁸⁸

Like many important innovations, the WTO Customs Valuation Agreement is based on a very simple idea: that it is in the interests of both customs administrations and traders that trade in goods be taxed based on the realities of the commercial transactions taking place. This is what is known as the “transaction value method,” which is the primary method of customs valuation in the agreement.

The agreement has four main components:

- a set of methods to determine the customs value, with their interpretative notes;
- provisions to balance the interests of importers and customs administrations;
- a number of supporting provisions including definitions of particular terms; and
- an institutional framework: Part II of the Valuation Agreement provides for Administration, Consultation, and Dispute Settlement, including creation of a GATT Committee on Customs Valuation and a Technical Committee on Customs Valuation (whose operation has been delegated to the World Customs Organization (WCO)).

There are also three annexes to the agreement dealing with the special role of the WTO valuation technical committee and a number of special clauses for developing countries that are dealt with in detail below. The essentials of the agreement are contained in Articles 1, 7, and 8, and the interpretative notes to these Articles, plus the General Note. The WCO estimates that, based on the experiences of countries that have implemented the agreement, these provisions provide the legal basis and the tools to carry out at least 90 percent of the valuation transactions based on method 1 (i.e., transaction value). This leaves about 10 percent of trade that requires a more complex approach based on one of the other methods.

⁸⁷Many importers have links with suppliers/traders in exporting countries who are willing to participate in the falsification of documentation.

⁸⁸This section draws on Malone (1997).

Thus a central implication of this primary rule of valuation is that it is the information relevant to the particular commercial transaction that is important for customs valuation purposes. Other factors external to the transaction taking place between the buyer and seller should not normally be taken into account in determining the customs value.

Implementation

Implementation of the agreement must be founded on a secure base, covering not only its actual content but also the associated administrative tools, powers, and mechanisms to allow it to function successfully. An adequate administrative and legal structure is vital to its successful implementation. The legislative and regulatory framework adopted will be influenced by a country's existing legislative practice; however, it has been found that comprehensive legislation covering all aspects of valuation is the preferred option. Apart from the obligation to generally ensure that the content of the agreement appears in national law, implementation requires members to make specific provision in their national legislation for the following:

Rates of exchange. Article 9.1 requires members to publish the rates of exchange to be used for currency conversion. It is necessary to determine how and when rates of exchange will be published. In some countries, such as Argentina and Canada, the exchange rates are adjusted daily and made available to the importing public through the customs computer systems.

Time of currency conversion. Payments for imported goods are often expressed in a currency other than that of the country of importation. The payments need to be converted to the equivalent amount in the currency of the country of importation by the use of rates of exchange. Article 9.2 of the agreement allows members to choose between the time of exportation or importation as the basis for converting currencies.

Right of appeal. Article 11 requires that the legislation of each member provide a right of appeal, without penalty, to the importer or any other person liable for the payment of customs duty in connection with the determination of customs value. Article 11.2 provides that a final right of appeal to a judicial authority must also be available. Therefore, countries should establish a fair and independent review mechanism within the customs administration as a first point of redress for importers. For example, an importer not satisfied with the determination of customs value by a regional office should have the right to have the determination reviewed at headquarters. If the importer is not satisfied with the results of that review, the importer should then have the right of appeal to a judicial authority. A system that provides for the first level of appeal within the administration usually results in a quick and reasonably inexpensive solution for resolving disputes. It also fosters uniform and consistent valuation practices and ensures that appeals to a judicial authority occur only in cases where there is a

genuine dispute between the importer and the administration about the determination of the customs value.

Release of goods before final determination of customs value. Article 13 requires members to make provision in their legislation to allow an importer to withdraw their goods from customs control in situations where the final determination of customs value is delayed. Where necessary, a guarantee in the form of a surety or a deposit could be taken to cover the potential liability for customs duty as determined by the customs administration.⁸⁹

Transport and insurance costs. Under Article 8.2, countries must include in their legislation a provision to either include or exclude costs of transport, insurance, and so on in the customs value (so-called CIF or FOB basis for valuation). The vast majority of countries value goods on the CIF basis, with the notable exceptions of Australia, Canada, and the United States.

Delay in application by developing countries

Under the WTO agreement, developing countries were given the right to delay implementation of the valuation provisions for a period not exceeding five years from the date of entry into force of the agreement establishing WTO membership for that country.⁹⁰ Developing countries who elected to delay application of the agreement were required to notify the Director General of the WTO accordingly. Most developing countries requested such a delay, but their five-year grace period ended in 2000.

There are other accommodations made in the agreement that developing countries can use, if they so choose. They include the following:

Retention of a minimum values system. Under Annex III, paragraph 2, developing countries that value goods on the basis of officially established minimum values may enter a reservation to retain such values, on a limited and transitional basis, under such terms and conditions as may be agreed to by the members of the WTO valuation committee.

Delay in application of computed value method. Article 20.2 permits delays in its application because the costing and accounting information necessary to determine the value under the computed value method would generally be held

⁸⁹Without this provision, customs administrations could hold goods under customs control until the valuation issues have been settled. This can be time-consuming and costly to the importer. As the disputes usually relate to the terms and conditions of the transaction and not to the goods themselves, it is not necessary to hold the goods until these issues have been resolved.

⁹⁰Developing countries that had already accepted Article VII of the GATT Valuation Agreement were not entitled to delay application when the WTO became operational.

by a manufacturer outside the country of importation. Therefore, verification of the information provided by the importer, particularly in the early years of implementation of the agreement, would often be difficult.

Reservation of the right of an importer to reverse the order of Articles 5 and 6. The hierarchy established by the agreement requires that the alternative methods of valuation be applied in sequential order. Article 4 provides an exception to this principle. Under Article 4 the importer may elect, in certain circumstances, to have the order of Articles 5 and 6 reversed so that value may be determined under the computed method (Article 6), before the deductive method (Article 5). In recognition of the difficulties that can occur with the verification of information provided by an importer under the computed method (see Article 20.2 above), a developing country that considers that the reversal of the sequential order may give rise to real difficulties may make a reservation in respect of Article 4 (i.e., a reversal of the application in the order of Articles 5 and 6 will occur only when the customs administration agrees).

Reservation related to valuing goods for further processing. A developing country may reserve the right to value imported goods subjected to further processing in the country of importation, in accordance with the provisions of Article 5.2 (the deductive method), whether or not the importer requests use of that method. This would allow a developing country to exhaust all the possibilities for determining value under the deductive method before attempting the computed method.

As can be appreciated, many of these provisions are complex. Therefore, it is important for a developing country to study them closely and to make an assessment of the capacity of the customs administration to administer these provisions of the valuation agreement. Based on this review, a decision can be made whether or not to request a delay in any or all of the provisions that are provided for.

C. Valuation Control

It is recognized that difficulties can arise in establishing the value of goods, when faced with an importer determined to mislead the authorities. However, customs administrations need not accept the situation. The rights of customs administrations to challenge importers' values was reaffirmed by a decision taken

Box 6.2. Decision Regarding Cases Where Customs Administrations Have Reasons to Doubt the Truth or Accuracy of the Declared Value

Ministers invite the Committee on Customs Valuation to take the following decision:

Reaffirming that the transaction value is the primary basis of valuation under the Agreement on Implementation of Article VII of the GATT 1994 (the Agreement); recognizing that the customs administration may have to address cases where it has reason to doubt the truth or accuracy of the particulars or of documents produced by traders in support of a declared value; emphasizing that in so doing, the customs administration should not prejudice the legitimate commercial interests of traders; and taking into account Article 17 of the Agreement, paragraph 6 of Annex III to the Agreement, and the relevant decisions of the Technical Committee on Customs Valuation, the Committee on Customs Valuation decides as follows:

- When a declaration has been presented and where the customs administration has reason to doubt the truth or accuracy of the particulars or of documents produced in support of this declaration, the customs administration may ask the importer to provide further explanation, including documents or other evidence, that the declared value represents the total amount actually paid or payable for the imported goods, adjusted in accordance with the provisions of Article 8. If, after receiving further information, or in the absence of a response, customs still has reasonable doubts about the truth or accuracy of the declared value, it may, bearing in mind the provisions of Article 11,¹ be deemed that the customs value of the imported goods cannot be determined under the provision of Article 1. Before taking a final decision, the customs administration shall communicate to the importer, in writing if requested, its grounds for doubting the truth or accuracy of the particulars or documents produced, and the importer shall be given a reasonable opportunity to respond. When a final decision is made, the customs administration shall communicate to the importer in writing its decision and the grounds therefore.
- It is entirely appropriate in applying the agreement for one member to assist another member on mutually agreed terms.

¹Article 11 provides for the right of the importer to appeal against a valuation decision.

by ministers during the Uruguay round of trade negotiations (shown in Box 6.2), now incorporated into WTO rules.

The lengths to which the administration should go in challenging declared values is dependent on a number of factors, such as the amount of revenue at risk, importer's previous history, estimated percentage undervaluation, etc. But where the administration decides to adopt a firm stance against malpractice, the following represent some of the countermeasures that may be taken to protect the revenue:

- Adopt, as a matter of national policy, a low-tolerance approach and a firm attitude toward tackling blatant undervaluation.

- Reinspect selected shipments using special regional or headquarters teams.
- Insist that the importer furnish additional supporting evidence and carefully scrutinize it in terms of credibility, wherever possible matching it against price reference data (establishing and maintaining, for instance, a pricing database that includes information from declarations, suppliers catalogs, and other sources).
- Especially where there are several problems of underinvoicing, give priority to those items that generate the bulk of customs revenue.⁹¹
- Write to the importer setting out reasons for not accepting the declared value and their rights to appeal the decision.
- Conduct issue-orientated audits using officers with sound experience in valuing goods, supported by effective intelligence gathering.
- Collaborate with the tax administration in examining the overall business activities of troublesome importers. For example, a low import value when compared with the price of goods on sale locally suggests a high profit margin. Therefore, it is reasonable to check if this is reflected in the income declared by the company for corporate tax purposes.
- Obtain information from customs attachés in exporting countries.
- Develop collaborative arrangements, possibly supported by memoranda of understanding with the customs services in trading partner countries.
- Improve the administrations' commercial fraud intelligence capability and develop investigators with specialized valuation expertise.
- Prosecute cases of serious undervaluation that stand a good chance of success, and seek media publicity on successful completion of the case.

Post-release verification, including the auditing of importers, is now generally viewed as the key aspect of customs valuation control. This involves the audit of records and, in particular, of the international trade operations in which importers have been involved. For the best results, in terms of both revenue protection and minimizing obstacles to trade, such controls should be performed on the basis of selective targeting and risk analysis. As discussed in the previous chapter, customs administrations are increasingly accepting that it is no longer necessary or effective to concentrate all their controls at frontiers. This change in approach, often resisted by customs traditionalists, is of particular benefit for valuation control. Valuation work has always been ideally suited to post-release

⁹¹In small and medium-sized countries, 60 percent or more of revenue may come from only 100–150 of the 5,000 or so import categories identified in the harmonized system.

controls, because the complete picture that provides the basis for valuation is only fully available from an importer's records.

During an audit, particular attention would normally be paid to

- checking for special relationships between buyer and seller;
- credibility of transaction value and false invoicing;
- ensuring that the importer has not represented an advanced payment or final payment as the full dutiable cost;
- checking that the importer has not claimed an unjustified discount (e.g., price reduction for demonstration goods);
- ensuring that the importer has not failed to declare onward sale arrangements through which a separate payment accrues to the seller, selling commission, profit-sharing arrangements that benefit the seller, royalties, etc. (these are usually to be included in the value for duty); and
- looking for evidence of overseas bank transactions, because an importer may have paid part of the true selling price from foreign bank sources.

To facilitate their adaptation to this new environment, many customs administrations have found it useful to rely on preshipment inspection (PSI) services or some variant on this theme. PSI companies provide up-to-date price comparison data and physical inspection in the country of export, for customs administrations faced with unscrupulous importers and unreliable officials. PSI is recognized under the WTO. However, the services are expensive (around 1 percent of the value of the goods inspected) and the results have been mixed in the countries that have used the services. Therefore, there should be a careful study of the costs and benefits of PSI before a country decides to use the service. Chapter 12 considers PSI and other forms of private sector assistance in customs administration in more detail.

Organizational structure

Developing an organizational structure to support effective valuation control requires a balance between the need to provide information and service (at the local level) and the need for trained specialists who can interpret the law and

detect problem areas. The WTO valuation agreement is a factual-based system⁹² and, as it may take some time to determine the facts for a particular transaction, it may not be practical nor appropriate to deny release of the shipments until all of the facts are known. In addition, the agreement is complex, so that it is necessary to develop expertise in its interpretation and application. It has been found that the best way of implementing the measures necessary to verify value is to organize the control function with clearly defined roles for the local, regional, and headquarters offices.⁹³

Local offices. At the time of declaration presentation and processing at the local office, a decision must be made regarding the level of verification that is required for customs valuation. As the information from the declaration is processed (ideally, in an automated environment), certain data are compared with information in the selectivity system to determine, for example, if the importer has a past history of undervaluation, the type of goods that are often undervalued, and for exporters in certain countries that are known for false invoicing, etc. If any or all of these factors are met, it may be necessary for additional verification activities to be conducted. This may include physically inspecting the goods to ensure that the description on the invoice matches the goods and is detailed enough to support verification after the goods have been released. For example, it may be necessary to ensure that the brand name, model, and serial numbers are recorded so that the later verification activity can be targeted to a specific good. However, detailed enquiries should not be carried out at the local office level, especially if the goods are to be kept under customs control pending an answer.⁹⁴

Regional offices. Typically, regional offices are responsible for conducting post-release valuation reviews. Declarations are selected based on criteria that have been developed to identify high-risk transactions (e.g., when the importer has self-declared a high rate of duty the goods may be undervalued). In other cases, based on information that has been developed over time from previous cases, it may be known that goods from certain countries are suspected of undervaluation. Selections could also be based on known exporters who have violated the law in the past. Once the declarations have been selected, reviews are conducted that may involve comparing the supporting documentation to

⁹²Previously, many developing countries used the Brussels Definition of Value to determine the value for customs purposes. This was based on a “notional” concept, whereby the normal value that the goods would fetch on the open market under certain conditions was used. Many customs administrations developed minimum values for goods to be used as the normal market value.

⁹³Most customs administrations are organized along these lines. In geographically small countries, however, or in countries where most of the commercial activity is concentrated in one or two locations, there may be no need for regional offices.

⁹⁴Goods will be kept under customs control in cases where smuggling is discovered or if there are requirements that must be met before the goods are released (e.g., certificates may be required for health or safety reasons).

other information that may be available (such as importations of the same goods by other importers, previous importations by the same importer, prices of the goods in the export market, and prices of the goods in the domestic market). Once this information has been developed, it may be necessary to write to the importer to ask for an explanation of the circumstances surrounding the transaction (e.g., what type of discounts have been applied, are there any royalties that will be paid later, etc.).⁹⁵ Depending upon the answers received from the importer, it may be decided that an audit is warranted. However, before this decision is finalized, a search of the previous importations by the importer should be conducted to determine how many identical or similar transactions occurred in the preceding 6 or 12 months. Audits can have salutary effects on compliance even if they raise little additional revenue; indeed, in an ideal world the threat of auditing and punishment would ensure that all declarations are truthful. In practice, however, this is unlikely to be the case. And it then makes most sense—both in itself and for its deterrent effect—to focus audit activities on cases in which there is the greatest potential revenue at stake. If there is evidence to suggest undervaluation but no other similar transactions have recently occurred, for instance, then it will normally be best to issue a reassessment without audit. Even in this case, however, the occasional audit is needed to ensure credibility of the post-release process.

Headquarters. The valuation unit at headquarters would be responsible for developing valuation policy, procedures, and monitoring compliance among the regional and local offices. The monitoring may include reviews of selected transactions to determine if the policies are being applied correctly. The audit would also monitor international developments, particularly the actions of the WTO and WCO respecting the valuation agreement.

Another key element in the development of effective valuation verification and audit is the recruitment of staff and their training. Valuation legislation is complex and the methodology required to effectively apply the legislation is difficult. Therefore, well educated personnel must be recruited and training programs must be developed to ensure that the staff is able to apply the legislation. However, it is not simply enough to be well trained in the legislation. Effective verification and audit requires the ability to identify suspect transactions, to analyze information, and to audit the books and records of selected importers. These skills are not always present in a typical customs administration.

⁹⁵The customs legislation normally provides the administration with the authority to request any information that may be relevant to the determination of the value of the importation.

D. Conclusion

The obligation on developing countries to implement the WTO valuation agreement in 2000 has caused considerable concerns. Many countries have not prepared well to administer complex valuation provisions that place much of the onus on the customs administration to show that a declared value is not correct. Therefore, it is incumbent upon the customs administrations to develop the systems and procedures necessary to effectively control undervaluation. This is done by taking an aggressive approach to detecting undervaluation by establishing specialist staff who are well educated and well trained, and organizing them in post-release verification and control units. These units will review selected transactions, undertake audits, and issue reassessments where undervaluation is detected.

Customs Duty Relief and Exemptions

François Corformat and Adrien Goorman

In addition to the valuation problems addressed in the previous chapters, there are two other areas in which customs systems are commonly vulnerable to significant abuse. The first is in the duty relief regimes that are commonly provided to ensure that—consistent with the basic trade policy objective of imposing import tariffs only on domestic consumption and production—goods in transit, and goods used to produce exports, do not bear duty. The second is in the provision of exemptions from duty often extended, however unwisely, to particular goods, persons, or activities. This chapter and the next—which focuses on the special issues associated with transit—deal with the associated problems of control.

A. Duty Relief Regimes

Customs laws make provisions for these regimes and establish regulations for their administration and control. The regimes falling in this category are temporary admission for inward processing (TAP), drawback, bonded manufacturing warehouses, duty-free zones or free trade zones (FTZs), duty-free shops, bonded warehouses (for storage), and temporary admission for reexportation in the same state.

The implementation of duty relief regimes requires specially designed procedures to allow customs administrations to monitor the temporary entry of goods and enforce payment of duties, taxes, and penalties when an offense takes place. While the administrative requirements and control procedures for some of these regimes are relatively simple, for others they are complicated. Experience shows that many countries have had great difficulty in properly administering and monitoring the regimes, which has resulted in abuse, fraud, and significant revenue leakage. In several developing countries, the inability of the customs administration to properly implement duty relief systems for their export industry has increased production costs, thus reducing their manufacturers' competitiveness in export markets, and has had a negative impact on the ability of these countries to attract investors. Faced with serious administrative difficulties in administering temporary admission or drawback systems, and with

revenue loss, some governments have seen no better solution than closing down bonded warehouses or zero-rating imported industrial inputs despite critical revenue needs. These solutions are likely to have been less optimal than those that could have been adopted if effective customs administration had existed.

The discussion here is limited to a discussion of the main regimes, in particular the three main duty relief systems for export: the TAP, drawback, and FTZ.

Rationale

The purposes of import tariffs are to raise revenue for the government and protect favored domestic activities. To the extent that imported goods are used to produce exports, however, tariffs will tend to reduce a country's competitiveness in world markets. The effect is akin to imposing an export tax on these commodities, but with the additional effect of distorting firms' production decisions by inducing them to substitute away from the use of imported intermediate goods. Most countries do not wish to have this effect, and so establish systems to mitigate the anti-export bias of tariffs by ensuring that tariffs are not paid on intermediate inputs into the production of exported goods. If it is desired to tax exports, this is best done directly, without distorting production decisions. In theoretical terms, the case for excluding exports from tariffs on the use of intermediate inputs is not entirely clear: it mitigates the effect of protecting domestic producers, which may be part of the purpose of the policy; and if the purpose of the tariff is to raise revenue, the exclusion of use in exports implies a higher rate, and hence more distortions, on domestic activities. Nevertheless, it is usual practice to seek the exclusion from import tariffs of intermediate purchases used directly⁹⁶ in the production of exports. The concern in this chapter is with how best to implement this standard policy.

Same objective, different mechanisms and risks

TAP and drawback have the same objective, but there are significant differences in the mechanisms by which they are implemented, the revenue risk involved, and the advantages they give to the export manufacturer. The choice between TAP and drawback depends on preference rather than feasibility. TAP is preferred by exporters, but carries a greater revenue risk through the possibility of leakage of the goods to the local market. Drawback involves less risk to the revenue, but the experience of delays and uncertainties about repayments have acted as a disincentive to exporters, or have led them to factor the delays and

⁹⁶Unless further measures are taken, exporters will still bear import tariffs to the extent that they make use of inputs purchased from domestic firms that have paid tariffs on their imports.

uncertainties into their cost and price calculations. The ideal policy is likely to involve using both TAP and drawback: TAP, typically negotiated with customs, may be appropriate, for instance, for those who export all their product—and know in advance that this will be the case—and drawback for those who sell both abroad and domestically. However, in situations where fraud is a particular problem and the administrative capacity to administer the programs is lacking, drawback only may be the best approach. This provides the government with the revenue up front, and it is able to verify later that the exports have taken place before the refund is paid. A disadvantage for business is that the manufacturer must pay the duties and taxes and often wait a considerable period of time before the refund is made, thereby reducing the company's working capital.

FTZs have the same basic objective as TAP and drawback, but are established on the basis of a broader set of objectives and rules, and may not be an appropriate solution in many cases. There are variations on these regimes, such as duty-free importation for materials of the same kind, technical specification, and quality as local materials that were incorporated in goods already exported. This regime can be allowed for manufacturers exporting only occasionally or only a small part of their production.⁹⁷

Temporary admission for inward processing

Definition and characteristics

Temporary admission for inward processing is the regime under which imported materials intended to be used in the manufacture of export goods, or to be transformed or repaired, are conditionally exempt from duties and taxes. Manufacturers exporting a given minimum percentage of their production can register for the system provided they establish security for the duty in the form of a bond and keep prescribed books and records to document the quantities of materials used and products manufactured and exported or sold in the local market. The TAP system is relatively difficult to administer and requires well-developed and efficient customs administration. It is effectively implemented in many developed countries and some developing countries.

Although, as already noted, TAP is more attractive to exporters than is drawback—because no funds are used in paying import duties and there are no problems of refund—this approach may be impractical for small manufacturers, since it could create an excessive administrative burden and a higher revenue risk. For small or irregular exporters, a quick, reliable system of export drawback should be available that includes the following features: simplicity of program and regulations (easily understood by manufacturers and easily administered by

⁹⁷Such a regime is applied in various countries, including the EU (EXIM system), Chile, and Brazil.

customs); precise definitions of the types of goods and companies that qualify; and assurance of quick refunds of the import duties paid (see section on drawback).

Revenue risk and problems experienced

Where customs controls are weak, revenue may be lost if exempt materials are used in the production of goods sold in the local market, thus evading the duties and taxes due. Because inputs into production are normally taxed at low tariff rates, the size of possible revenue loss is reduced. However, if the system is widely abused, the loss may still be significant. The temporary admission entails, therefore, a higher risk to customs revenue than the drawback system.

In several developing countries, temporary admission for industrial inputs is the only system of duty relief available to export manufacturing. In many cases the customs administrations of these countries do not have the resources to effectively administer either the TAP system or a drawback system. Their only alternative is to exempt the raw materials and components imported by export manufacturers and apply whatever administrative controls are within their capabilities to verify that the materials are being used for the stated purposes and the final products are actually exported. The more limited controls that are in place often leave a great deal of opportunity for abuse and revenue loss. Because of the revenue risk, some governments have restricted the regime to certain goods or to large companies. This often leaves a significant part of the nontraditional export sector without duty relief and, therefore, impairs the development of export industries.

Administrative requirements for effective control

The main requirements for effective administration of the TAP regime include the following:

- A bond needs to be provided by the approved export manufacturer to secure duty payment in case of abuse or fraud. The bond can be waived for established and solvent companies that pose little revenue risk.
- The ratio of imported materials used in one unit of output (“input-output coefficients”) needs to be determined and agreed upon between the manufacturer and the customs administration. It needs to be updated periodically and each time manufacturing processes or tariff rates are changed.
- Records and accounts of raw materials imported and duties and taxes paid need to be maintained together with details of materials stored, materials used in production, and accounts of final goods produced, exported, and sold in the local market.

- There are two principal methods to account for, and control, the system. One is the matching of export documents with specific import documents, which is a traditional and complicated method and should be avoided. The other is to make a single, global declaration of the total quantity of materials imported during a given period and the total quantity of final goods delivered for export (and thus exempt) and delivered to the local market (with duties and taxes due) in the same period. This is the recommended method for the most effective control of the system. It requires detailed accounting by the trader and careful verification by customs.
- Customs headquarters, and possibly additional units at the customs offices of the main industrial centers, need to be established to monitor and audit the manufacturing companies approved under the system.
- A selected number of staff need to be trained in the audit of TAP.
- Because it is administratively demanding, for both the manufacturer and the customs administration, the TAP system should be available only to manufacturers that, on a regular basis, export a given minimum percentage of their production. Manufacturers that export only a small part of their production, or only export sporadically, should be given duty relief through drawback.
- The TAP control system should be fully computerized.

Drawback

Definition and characteristics

Drawback is a system under which the import duties and taxes paid on imported inputs are refunded to the exporter. Drawback is not an export subsidy and is, therefore, in compliance with World Trade Organization (WTO) rules⁹⁸ so long as it only provides for a refund or remission up to the amount of duties and import charges levied on the imported inputs actually used up in the production of the exported goods.

In most countries drawback may be claimed only by direct exporters.⁹⁹ Goods eligible for drawback should include all raw materials and intermediate goods used for the production of final exports, including imported packaging. The refund should be for 100 percent of the duties and taxes paid on the inputs. The refund does not necessarily have to be in cash and some countries, such as

⁹⁸Under the Agreement on Subsidies and Countervailing Measures.

⁹⁹In Korea, Chile, and Colombia, for example, the drawback scheme includes direct and indirect exporters (the latter being firms that sell to exporters).

Brazil, issue credit certificates to the exporter that can be used for paying duties on future imports.¹⁰⁰

Drawback, like TAP, is based on a calculation of the duty on imported inputs incorporated in one unit of output. The amount to be refunded should equal the product of the value of each imported input used in producing exports and the corresponding tariff rate. There are two methods to determine the import duty content of exports that are commonly used: fixed drawback rates and individual drawback rates.

Under the fixed-rate system, the refund is calculated according to a preset schedule for each exported good based on input-output coefficients. Korea and Taiwan use this system and publish updated drawback schedules every six months. It provides ease of administration as it uses automatic rates of drawback not related to the specific performance of the manufacturer. However, it requires the estimation of a potentially large number of coefficients—possibly hundreds—and their frequent updating. The calculated amount can sometimes be too low, in which case the exporter does not receive full relief of the duty element in his export products, or too high, in which case the drawback contains an element of subsidy and does not comply with WTO rules.

Under the individual rate system the drawback is based on the manufacturer's performance and is verified by an audit of the books and records of the enterprise by customs. This system relies more heavily on self-assessment as the manufacturer is responsible for establishing rates of yield or conversion ratios to claim drawback. It is the responsibility of the administration to verify the yields or conversion rates through audits. This approach is fairer to all manufacturers because it relates specifically to the performance of an individual company and is not based on an industry average.¹⁰¹ Most industrialized countries use this system.

The administration of drawback requires largely the same information, administrative control, and organizational setup as the administration of TAP. It has a similar degree of difficulty, although the payment of refunds under drawback imposes an additional administrative burden that does not arise under TAP. On the other hand, the greater revenue risk under TAP—the money being collected up front under drawback—requires tighter control on the use made of the imported input.

¹⁰⁰This contradicts, however, the principle of quick refunds and can be a disadvantage as the manufacturers may have to wait a considerable period of time, thereby reducing their working capital.

¹⁰¹Individual drawback can lend itself to corruption insofar as its implementation involves direct contact between importer and customs collector. The proper response to this, however, is to move—as a key part of the overall modernization strategy described in this book—away from face-to-face contact and toward audit-based methods of control.

Revenue risk and problems experienced

The revenue risk is limited, because the duties and taxes that might be due if the final products are not exported but are sold in the local market have been paid. However, the customs administration has to be alert to possible false drawback claims.

Among the main problems experienced with drawback systems are the following:

- The drawback system is often restricted to products included in an exhaustive list.
- Drawback refunds are often made only after long delays. In some instances, the refund is never made because of poor customs administration.
- Under many of the systems in developing countries, refunds can only be made from a specially approved annual budget. Often the budget is inadequate so it runs out and refunds cannot be made.
- In the absence of effective control significant abuses occur.

The most serious problem in many developing countries is that while the system is available theoretically, and exporters would like to make use of it, the customs administration is incapable of implementing the system efficiently. This situation, clearly, is a serious impediment for a country's manufacturing exports sector. By discouraging exporters or creating uncertainties about their ability to obtain refunds, it may also make them more likely to attempt to evade duty and tax.

In some countries, where the tariff rates on raw materials are relatively high and the drawback system is not available or does not function well, exporters have pressed their governments for outright exemption. This has resulted in revenue loss as no effective control mechanisms were in place to verify that the imported materials were used in export manufacturing.

Administrative requirements for effective control

Important administrative aspects include the following:

- Simplicity of the drawback system is of crucial importance. The system must be easily understood by manufacturers and easily administered by customs. Simple administrative procedures allow refunds to be made without delay.
- Responsibility for setting drawback rates should rest with a high-level committee consisting of industry, trade, and customs departments.
- Importers should be refunded in as short a time as possible. Payment should not be delayed until all controls are finalized. Once the customs verification of the export (checks on quantity, price, and type of product) is done and

actual exportation takes place, the refund should be made. The control of the eligibility for the refund should be made later through periodic audits of the books and records of the manufacturer.

- To speed up refunds, provisional payments can be made, supported by a bank guarantee from the exporter, for example, for 80 percent of the duty due, with adjustments later.
- It should not be necessary to give proof of foreign exchange receipts (as is required in some countries), since these are already required by foreign exchange regulations.
- A refund under duty drawback should concentrate on any duties and taxes paid on importation. Refunds arising from the zero-rating of exports under the value-added tax (VAT) will normally be made by the revenue department administering the VAT.¹⁰²
- To make the best use of information collected and resources available, joint audits should be made for VAT and drawback purposes, at least on occasion.
- A special unit at customs headquarters needs to be established to monitor and audit the manufacturing companies approved under the system and to audit drawback claims.
- Specially selected staff need to be trained in drawback audit.
- The drawback system should be fully computerized.

Free trade zones

Definition and characteristics

Free trade zones are geographical areas that are legally outside the customs territory. They are established in order to manufacture goods for export and to provide services to foreign enterprises. The underlying objectives for establishing FTZs are to stimulate exports of nontraditional manufactured goods, strengthen the competitiveness of exporters, diversify the economy, create employment, attract investors, transfer technology, and achieve development and growth. In recent years, with the shift of emphasis from import substitution to export-oriented industries, many developing countries have been attracted to

¹⁰²When it concerns other forms of sales tax and excise duties, the refund may be made either by the revenue department administering these taxes or through the duty drawback system. If the arrangement is that refund of domestic indirect taxes is dealt with under the duty drawback system and not under the relevant tax administration procedures, the exporter, to obtain refunds for domestic as well as trade taxes, should not have to deal with both customs and the revenue department. In such cases, it is preferable for customs to be responsible for administering the refunds and payments of both the customs duties and the taxes collected on behalf of other revenue departments, thus making the procedure simpler for the exporter.

establishing FTZs, and their use has proliferated. However, many of these zones have proved to be a bad investment because of poor location, high investment costs, mismanagement, or weak customs administration. Even when these problems are avoided, moreover, it is clear that lasting export success requires more than tax advantages: Zee, Stotsky, and Ley (2002) find, for instance, that “there is little compelling evidence that [FTZs] *alone* are capable of promoting exports.”¹⁰³ Other factors, such as a good supporting infrastructure, access to an appropriate labor force, and a stable policy environment seem likely to have a more marked effect. A common, almost defining, feature of FTZs is duty-free importation. They differ quite widely in the other tax advantages that they may offer to qualifying enterprises. These may include exemption from domestic taxes, including sales taxes, excise duties, and company taxes, as well as additional benefits relating to labor regulations, foreign exchange, and others. FTZ regimes require that all output be exported, but in some countries sale to the local market of a part of the output is allowed.¹⁰⁴

Since FTZs are neither defined nor referred to in the WTO agreements, they are not governed by WTO rules. However, a number of provisions and operating procedures of FTZs—including any remission of corporate or other direct taxes¹⁰⁵—can constitute export subsidies and thus be subject to WTO rules under the Agreement on Subsidies and Countervailing Measures.

Revenue risk and problems experienced

The risk that FTZs pose to customs revenues is medium to high, and customs control of geographically separated FTZs may be easy or difficult depending on local conditions. They are commonly also a risk to other such taxes to which they offer advantages: zero or reduced corporate tax rates, for instance, can be exploited by transferring prices into FTZ-enterprise profits earned on domestic activities. With weak customs control, goods imported or manufactured in the FTZ can enter the local market fraudulently. Thus, FTZs are usually restricted to a designated industrial area. However, more recently, factories outside the restricted area have been approved as single factory zones.¹⁰⁶ Customs control over these zones is difficult to organize for many developing countries because they are located outside the enclave, and the revenue risk is much higher.

¹⁰³Emphasis in original.

¹⁰⁴For instance, in Israel, Syria, and the United States.

¹⁰⁵In relation to company taxes, there are exceptions for low-income countries; see Madani (1999).

¹⁰⁶For example, in Egypt, Mauritius, Mexico, Senegal, and the United States.

Administrative requirements for effective control

- For geographically separated FTZs, adequate customs control needs to be established to prevent goods from entering the local market. Clearance facilities need to be established where the regime allows sales in the local market.
- If sales in the local market are provided for in the regime, they should be limited to wholesale transactions. It would be impossible for customs to effectively control retail transactions.
- For single factory zones, the use of imported inputs and quantities of manufactured products exported should be checked through audits of the manufacturers' accounts.

B. Exemptions

The policy issues surrounding the provision of outright exemptions from customs duties were discussed in Chapter 2. This section focuses on practical issues related to the revenue risks associated with the proliferation of exemptions and on administrative measures to improve their effective monitoring and control. But it should be stressed that, as a critical element not only of any modernization strategy but also of any short-term search for additional revenues, all exemptions without a coherent and persuasive rationale should be removed.

Categories of exemptions

Exemptions can be broken down into two broad categories:¹⁰⁷

Exemptions provided for in international conventions or practices

Temporary entry—There are various possibilities under which duty- and tax-free temporary entry may be granted for goods that are to be reexported. This would include, for example, goods for display at exhibitions and professional equipment, such as computers, television cameras, sports equipment, and means of transport.

Diplomatic goods—Goods designated by the Vienna Convention for use by diplomatic missions. Similar privileges are granted as well to United Nations agencies.

¹⁰⁷The categorization that follows is similar to that proposed for WAEMU, described in Box 2.2.

Individuals—Tourists and returning residents normally receive limited exemptions, which are granted primarily to ease the administrative burden of processing them through the border. Immigrants also receive some concessions to enable them to bring with them their household possessions.

Exemptions with specific economic and social objectives

Discretionary exemptions—These are exemptions introduced on an essentially ad hoc basis (an example being the exemption by several African countries of inputs into HIV-controlling drugs).

Foreign financed aid or investment projects—Often as a condition of a loan or an aid agreement, projects financed by international institutions (such as the World Bank) or under bilateral agreements must be granted exemption from duty and tax.

Investment code—In order to attract investment, duty- and tax-free entry of the goods to support the investment may be granted.

Humanitarian aid—Humanitarian aid intended to relieve suffering or consequences of natural disasters may be granted exemption.

Government purchases—In a number of instances, governments exempt their own purchases.

Revenue risks and problems experienced

Exemptions erode the bases of import duties and taxes. It is not uncommon in developing countries to find complex systems of exemptions. As discussed in Chapter 2, their proliferation is due mainly to ad hoc attempts to use investment laws and other incentive schemes as policy instruments for development, containing exemption provisions that totally or partially exempt imported goods from duty and taxes. Exemptions may also be used on equity grounds as a means of helping the needy and to encourage importation of staple foods. Whenever there has been a departure from the principle that legislation on exemptions should be restrictive, considerable pressure has been exerted to grant more exemptions—often by powerful lobbies—leading to their proliferation. The widespread use of exemptions needs to be reexamined in the light of medium-term trade policy and fiscal objectives, as they can run counter to development efforts and are always detrimental to revenue-raising objectives.

When looking at building revenue enhancement measures, especially in the context of trade reform, government authorities should review all categories of exemptions with a view to removing them unless they are justified beyond doubt or in accordance with international agreements. There is, for example, no good reason to exempt government or quasi-governmental institutions from import

duty and taxes. The argument that this policy does not have a net revenue effect is neither entirely correct nor relevant because it leads to abuses and leakages, as most countries are unable to control the use of imported materials. Such exemptions may also provide an artificial incentive for government agencies to undertake activities themselves rather than purchase from the private sector, since the latter will bear tariffs on inputs.¹⁰⁸ In cases where exemptions have been granted by law or other legal arrangements over specified periods of time, it may be necessary to wait until such exemptions have expired.

On administrative grounds, perhaps the most dangerous institutional arrangement, which is found in many developing countries, is the one conferring broad power on ministries to grant exemptions. Effective monitoring and control of customs exemptions require specific legislation and procedures to prevent abuses that erode the revenue base. For administrative control, it is essential that transparent and simple rules for various categories of exemptions be established. These rules should state clearly who may benefit and what goods are eligible. There should also be an estimate of the monthly or quarterly import volume from each category of exemptions and the corresponding amount of revenue forgone to facilitate monitoring, detection of abuses, and the conduct of audits; computer systems for the processing of data from import customs declarations now make it easy to compile statistics on the various categories of exemptions and the corresponding revenue forgone. In addition, exemptions should be granted with enough precision so that the customs administration is able to control them in order to minimize fraud.

Requirements to limit proliferation and loss of revenue

In taking steps to limit exemption proliferation and the possible loss of revenue due to abuses, the following principles should be respected:

- All exemptions must be provided for by law, and provisions relating to exemptions should be compiled in a specific code rather than scattered in various pieces of legislation.
- There should be no authority for the minister of finance (or any other governmental or ministerial authority such as an investment board), customs head, or any local customs officer to authorize an exemption on a discretionary basis.
- All exemption requests for categories such as foreign-financed investment projects, investment codes, and government purchases should state the amount of duty and taxes normally payable.

¹⁰⁸The issues of principle here are similar to those that arise under the VAT, which are discussed in Ebrill and others (2001).

- All duty- and tax-exempt imports for foreign-financed investment projects under the investment code should be authorized or countersigned by the minister of finance and/or the minister of revenue, principally because of their revenue-eroding effects.
- Exemptions may be proposed by other government departments (ministry of trade) with a recommendation that the exemption be granted pursuant to a provision in the law. But the proposed exemptions should then be reviewed by a committee, chaired by the minister of finance, who will determine the merits of the application (e.g., economic justification). Moreover the committee should have clear terms of reference and its decision should be made public.

Administrative requirements and procedures for effective control

For the customs administration to be in a position to administer and control exemptions, a number of measures should be put in place at the time the exemptions are granted, including the following.

Limits for each exemption

This should include the precise conditions that apply to exemptions. Conditions related to the end use of goods should be especially avoided, since monitoring that they are indeed used in particular ways is administratively difficult. The commodities to which the exemption applies should be identified by a harmonized system heading in the customs tariff nomenclature. The quantity of goods that are exempt should be specified and so, too, should be the time frame for exemption.

Controls at the time of importation

Customs should verify that only qualified and registered entities receive the exemption, before imported goods are released from customs control, and that the types of goods and quantities are as specified by the exemption-granting authority.

“End use” conditions

Customs officials should be able to inspect and/or audit enterprises receiving exemptions in order to confirm that the enterprise is engaged in an activity for which the exemption was granted, and that there has been compliance with its conditions. For example, if raw materials have been exempted on the condition that they will be used to produce a specified end product, the customs administration should be able to verify that the quantities imported were used for that intended purpose. For registered VAT taxpayers who receive

customs-related exemptions, it may be appropriate for the VAT auditor to include verification of these exemptions at the time of the audit.

The treasury-voucher system

One of the methods for controlling exemptions, at the time of declaration processing, is to implement a “treasury-voucher” system. Under this system, the duties and taxes are calculated in the normal manner. Instead of payment, the importer presents a voucher in the amount of the duties and taxes. The voucher is issued by an exemption-processing unit located in the ministry of finance. The advantages of this approach are that the vouchers remain under strict control, in a centralized location, and the customs administration has no discretion in granting the exemptions (i.e., the administration must accept the usual method of payment or the voucher for the duties and taxes). The downside, however, is that such approaches have on occasion proved susceptible to the falsification or counterfeiting of vouchers.

Table 7.1 outlines, for each type of exemption, the conditions, verification controls, and the type of declaration required at the time of importation.

C. Conclusion

The various duty relief and exemption schemes discussed in this chapter are intended, in their different ways, to promote economic development. But they have their costs, in terms of both revenue forgone and the opportunities they can create for cheating and abuse. Procedures need to be carefully designed, and implemented, so as to minimize the considerable risks they may involve. None, however, is foolproof. Regarding exemptions, it always needs to be borne in mind that the best guarantee against revenue loss—and the best economic policy—is usually not to give any in the first place.

Table 7.1. Monitoring and Controlling Exemptions

Type of Exemption	Computation Duty and Tax Forgone	Conditions for Exemption	Declaration Required	Customs Verification
Temporary entry	Yes	Authorized by importer, type of good, and length of time that the good will remain.	Commercial Import Declaration	Verify authorization of importer and type of good. Establish a control file to track eligible length of time.
Diplomatic goods	Yes	List of authorized diplomats. Approved annual quantities for alcoholic beverages and cigarettes.	Commercial Import Declaration	Verify authorizations of both persons importing and quantities.
Individuals (tourists, returning residents, and immigrants)	No	<i>Tourists:</i> Personal possessions for the length of stay. Restrictions on the value of gifts to be left in the country and the amount of alcohol and tobacco. <i>Returning residents (short term):</i> Personal possessions that accompanied the persons when they left the country. A value limit on the amount of new purchases (e.g., US\$100) and the quantity of alcohol and cigarettes. <i>Immigrants and returning residents (long term):</i> Personal possessions that would normally be required to set up a household. High-value items (e.g., automobiles) may be restricted by value or quantity.	Verbal Verbal Simplified Written Declaration	Selective luggage examination in cases of doubt. Selective luggage examination in cases of doubt. Declaration to include a list of all goods either accompanying the traveler or to follow. Selective examination.
Discretionary	Yes	Request for authorization supported by an export order or plan including a description of the proposed imported inputs (description with Harmonized System (HS) heading, quantity, value, and time frame for importation).	Commercial Import Declaration	Verify that the importation matches the approved authorization (e.g., name of importer, description of goods, etc.). Validate exports of planned goods. Conduct audits of manufacturers to verify that the quantities of imported inputs are used to manufacture corresponding quantities of exports.

Table 7.1 (concluded)

Type of Exemption	Computation Duty and Tax Forgone	Conditions for Exemption	Declaration Required	Customs Verification
Partial tariff	Yes	Goods meet the origin requirements to benefit from the preferential rate.	Commercial Import Declaration	Self-declaration by the importer of the origin of the goods with selective verification when tariff preference is claimed.
Foreign-financed investment projects	Yes	Request for authorization supported by project description and list of imported goods (description with HS heading, quantity, value, and time frame for importation).	Commercial Import Declaration	Verify conditions for the exemption are met (i.e., importer name, HS description, and quantity). Conduct on-site visits to confirm imported goods are being used for the intended purpose.
Investment code	Yes	Request for authorization supported by project description and list of imported goods to support the project. Approval may include: description of imported goods for facility construction; factory equipment; and inputs for the manufacturing process.	Commercial Import Declaration	Verify conditions for the exemption are met (i.e., importer name, HS description, and quantity). Conduct on-site visits to confirm imported goods are being used for the intended purpose.
Humanitarian aid	No (Estimate)	Approve the organization eligible to import humanitarian aid. Specify the types of goods by HS heading and the quantities approved.	Commercial Import Declaration	Verify conditions for the exemption are met (i.e., importer name, HS description, and quantity). Conduct on-site visits to confirm imported goods are being used for the intended purpose.
Government purchases	Yes	Purchases to be made on a duty- and tax-inclusive basis.	Commercial Import Declaration	Ensure that all government purchases pay duty and tax on the same basis as commercial importations.

Transit

François Corformat and Adrien Goorman

Goods being carried under transit are generally not subject to the payment of duties and taxes, provided the conditions laid down by the customs administration are complied with.¹⁰⁹ Customs transit systems are designed to facilitate the movement of goods crossing the territory of one or more states without jeopardizing revenue through diversion of such goods to the domestic market. To do this, while avoiding excessively burdensome and costly formalities, a balance has to be struck between the requirements of the customs authorities and those of the transport operators. This chapter considers how this might best be done.¹¹⁰

A. Definitions, Principles, and Procedures

Customs transit means the customs procedure under which goods are transported under customs control from one customs office to another.¹¹¹ To facilitate the international transport of goods that have to pass through a number of customs territories, arrangements are made under bilateral or multilateral agreements for the application of standard procedures. In this context, customs international transit is the passage of a consignment through a national customs territory, by entering the territory at a border office, port, or airport and leaving the country via another office, in order to continue its movement to its final destination. The 1971 Convention on the International Transit of Goods and the 1975 Convention on International Transportation by Road (Transport International par Route, TIR) were introduced to facilitate international transport, in particular to improve the efficiency of combined (or multimodal) transport. To date, the TIR Convention has nearly 60 contracting parties, including the European Community. It covers the whole of Europe and reaches

¹⁰⁹Some countries levy transit or service fees, which, so long as they are set at no more than a cost-recovering level, should not be considered as customs duties.

¹¹⁰Parts of this chapter draw on Goorman (1997).

¹¹¹This definition is in Annex E of the revised Kyoto Convention.

out to North Africa and the Near and Middle East. The United States and Canada are contracting parties, as are Chile and Uruguay.

Customs transit may also refer to a purely domestic movement, such as movement from a border station, port, or airport to a customs office or bonded warehouse in the interior of the country. The jargon distinguishes among (1) through transit (office of entry to office of exit); (2) import transit (office of entry to inland customs office); (3) export transit (inland customs office to office of exit); and (4) internal transit (one inland customs office to another).

Customs transit procedures and formalities are usually straightforward and simple to administer; see Box 8.1. At the office of departure, the main requirements for goods in transit include a written declaration; the provision of security;¹¹² examination and identification of goods (when deemed necessary, customs seals are affixed to the preapproved transport unit);¹¹³ and, in the case of goods subject to high duty or tax rates, a number of specific measures considered necessary to ensure security of the goods in transit, such as a prescribed itinerary and time limit, customs escort, and customs seals and identification marks for packages.

Box 8.1. Basic Requirements Under the TIR System

In order to ensure that goods travel with a minimum of interference and yet offer maximum safeguards to customs administrations in all countries of transit, the TIR system contains four basic requirements, called the four main pillars of the TIR transit system:

- Goods should travel in secure vehicles or containers.
- Duties and taxes should be covered by an internationally valid guarantee.
- Goods should be accompanied by an internationally accepted carnet in the country of departure and serving as a control document in the countries of departure, transit, and destination.
- Customs control measures taken in the country of departure should be accepted by the countries of transit and destination.

¹¹²When required, security is generally set with regard to the import duties and taxes potentially chargeable.

¹¹³Transport units are preapproved for the transport of goods under customs seal in accordance with various international agreements, namely the Customs Convention on Containers and the TIR Convention.

With respect to the termination of a customs transit operation, customs formalities usually require that the goods and the relevant goods declaration be presented at the customs office of destination within the time limit fixed, without the goods having undergone any change and with customs seals, fastenings, or identification marks intact.

B. Main Problems and Issues

In many developing countries, the main difficulties for customs in administering the transit regime result from the poor training of customs officers, the lack of physical infrastructure, difficult communications, and the absence of coordination with customs services of neighboring countries.

A major problem with transit operations in developing countries is the complexity of regulations and high costs associated with various formalities, in particular from maritime to landlocked countries. Legislation and regulations may impose high insurance premiums, high demurrage charges on containers and transport vehicles, high additional storage and documentation charges, payment of carriers' container guarantees or deposits, payment of customs bonds, and other unpredictable handling and processing fees. In some countries of West Africa, for example, the cost of moving a container of cargo inland to the importer's premises may reach up to three times the cost of its shipment from the port of export in Europe or the United States. Moreover, there are often high levels of loss of goods in transit operations due to lack of security, poor tracking of cargo, and corruption.

The revenue risk

Security is usually in the form of cash, bank guarantees, customs, or surety bonds. Experience shows that the transit regime is often used as a means to import goods fraudulently. Transit carries a high revenue risk, because the revenue loss on any shipment diverted from its destination is total. When it involves alcoholic beverages, tobacco products, electronic consumer goods, motor vehicles, and other goods subject to high duty or tax rates, the revenue loss can be very high indeed. The European Union estimates that some US\$4 billion is lost every year through the illegal diversion of transit goods into domestic consumption in the EU.

It is not unknown in developing countries for hundreds of truckloads or containers to come in under cover of transit documents and remain unaccounted for, in the sense that reexportation of these shipments is never recorded, leaving customs not knowing whether the goods actually left the country. In many cases, even if it is known to customs that the shipments did not leave the country, they are unable to recover the duties and taxes lost because of the following factors:

- Lack of strict documentary follow-up on the transit movement.
- Lack of timely action when the conditions of the transit regime are not met (see administrative requirements below).
- Transit being allowed to take place with vehicles that cannot be properly closed and sealed.
- Lack of security or solvency on the part of the transporter making it impossible to recover duties owed in case of nonexecution of the transit.

The specific problem of the guarantee

In some developing countries and economies in transition, the banking system is not sufficiently developed for customs to require that all transit shipments be covered by a bank guarantee. Requiring a monetary deposit from the transporter is often impractical. Defining the proper amount of a bank guarantee or deposit is also often difficult, because of a lack of infrastructure at the border station, which prevents even a cursory examination of a shipment that would allow customs to make a calculation of the amount of duties and taxes to be paid.

In one country that was faced with this situation, the customs director general accepted the “personal guarantee” of the customs broker to allow goods to move in transit from the border to an inland office. While not as good as a general guarantee, this temporary measure proved to be successful because the brokers were concerned that they would lose their license to operate if shipments were not accounted for.

C. Ensuring Effective Control

Administrative requirements

The administrative requirements for effective monitoring and control of transit can be easily imposed and enforced in most countries. The main requirements are the following:

- A centralized control system (e.g., a central unit at customs headquarters) must be established to monitor transit operations.
- A system of bonds/securities/guarantees must be in place that covers the liability for duties and taxes and allows the customs administration to collect the duties and taxes due when noncompletion of the transit or related acts of fraud take place.
- The guarantee needs to cover the liability for duties and taxes calculated on the highest tariff and tax rates that might be applicable in case the transit is

not completed. It cannot be released until the shipment has reached the customs border office or the clearance station in the interior and customs has certified that the shipment has arrived intact.

- Transit can only be carried out by bonded carriers, approved for transit by the customs administration on the basis of solvency, reputation, and past record. Transit by the owner of the goods could be allowed if adequate security is provided and all the other requirements and conditions are fulfilled.
- Carriers must assume liability for duties and taxes until the transit is completed (shipment has left the country) or responsibility is transferred to another party (for internal transit). Making carriers financially liable creates an incentive for them to complete the transit correctly and to obtain the necessary evidence of exportation or, alternatively, of arrival at the office of destination.
- Transit documents must give a full and complete description of both the consignments and their quantities, so that customs at the point of destination can effectively detect shortages or substitutions.
- Transit must follow the prescribed route and be completed within the prescribed time limit and the vehicle must be sealed.
- Information on transit shipments leaving the customs post at the departure/entry point should be communicated (e.g., by e-mail, telex, or fax) to the centralized control unit at customs headquarters, as well as to the border station of exit or the interior clearance office, to allow for monitoring and, if needed, for early action to be taken when shipments do not arrive on time.
- The release of the guarantee should be authorized by the centralized control unit upon receipt of the proof of exportation and/or arrival of transit shipments (complete and intact) at the customs clearance office of destination.
- In case of noncompletion of transit or other irregularities, the guarantee should be used for the payment of duties, taxes, and fines.
- Customs should selectively escort and/or check consignments during transit.
- Especially for landlocked countries, the adoption of the TIR system should be promoted, or an agreement should be made with the neighboring country/countries from which shipments are sent, to use the same transit document to cover the journey from the office of departure to the office of destination (final clearance office). They could agree on the validity of each

other's existing national transit documents, or on a new international transit document.¹¹⁴

New techniques

Software applications and new techniques have been recently developed to assist in the monitoring of transit procedures and the tracking of cargo.

The United Nations Conference on Trade and Development (UNCTAD) has made available since 1999 a specific module called MODTRS to handle transit documents in conjunction with other modules of the ASYCUDA++ system covering the main customs clearance functions (see Box 8.2). The module for the management of transit procedures in ASYCUDA++ handles three documents, namely the *TIR carnet*; the *T1 form*, based on the single administrative document (SAD); and the *first identification procedure*, which is an authorized preclearance procedure. The module can be used for all types of transit as defined in the Kyoto Convention and covers the movements of through transit, import transit, export transit, and internal transit.

Electronic seals have been developed to provide for the identification, detection, and tracking¹¹⁵ of trucks transiting through a country. Trucks are “sealed” with a seal marker when entering the country. The electronic monitoring system (see Box 8.3) will report to the customs service all pertinent data and “anomalies” related to the actual route taken by an electronically sealed truck.¹¹⁶

¹¹⁴The latter is preferable, since the document will need to consist of several copies, which is unlikely for the existing national documents.

¹¹⁵This is not a continuous tracking but the recording by fixed detection sites of the actual route.

¹¹⁶Although there has been no report on the use/cost of the system, it is considered to be efficient, reliable, able to handle a substantial number of trucks, and low in cost.

Box 8.2. ASYCUDA++ Transit Control System

This system allows for data capture by traders (brokers or carriers), using a specific module for DTI (Direct Trader Input, discussed in Chapter 9) or by customs officers. After the cargo is presented to customs and, if necessary, controlled, the document is validated in the computerized system. Upon validation of the document by customs, a message is automatically transmitted to the office of destination where the goods should be presented again to customs. This is done by the appropriate ASYCUDA software, A++GATE (ASYCUDA Global Access to Trade Efficiency), through the national telecommunications network. This message informs the office of destination that a cargo should arrive in a specified period of time. When the cargo arrives at the destination, the transit message is retrieved based on the paper document presented by the driver, and the customs control is performed. If everything checks out, the transaction is closed and a release message is automatically sent to the office of departure via the same media. The receipt of the message at the issuing office allows the latter to sign off on the transit document and release the guarantee, as the trader has fulfilled his obligations.

Box 8.3. Electronic Seal System

The electronic seal system includes

- a visible electronic seal (or marker) that can be affixed to or removed from a truck;
- an electronic “transit card” linked electronically to the seals;
- a fixed detection network and mobile detection equipment (for customs officers);
- seal electronic stations at customs checkpoints and inland customs offices for data input and output; and
- a central computer system managing the system and the electronic detection network.

D. Conclusions

Wherever diversion of transit cargo is a significant revenue risk, an evaluation of the transit control system should be conducted along the lines listed above. As a first step, political will and adequate legislation to enforce penalties and sanctions are necessary for successful transit operations.

Regional agreements should be sought to promote the adoption of the TIR or an equivalent system, together with the development of a regional agreement among banks to support the issuance/release of bank guarantees.

New techniques, including software applications and electronic seal systems, should be adopted by countries with significant truck traffic with high-value or sensitive cargo.

Computerization of Customs Procedures

François Corformat and Patricio Castro

In the last 40 years, computers have become an essential tool in the administration of customs control. They are used to speed up the processing of information, ensure accurate interpretation and application of tariff law, control manual labor costs, focus on specific target consignments, encourage compliance by traders, and improve the quality as well as the timeliness of data on external trade. While it is thus a necessary part of modern customs administration, computerization alone is not enough to bring about an effective modern approach to customs administration.

Even though computerization is not a sufficient condition for modernization, it is a necessary one. This chapter sets out the objectives of computerization and describes the main applications of computer systems in customs administration. It also provides an overview of the types of new technology that can be used in customs computerization and examines the strategy and preparations that experience suggests are essential to the effective introduction of a customs computer system.

A. Computerization in the Strategy for Modernization

Customs specialists have no doubts that computerization yields its best results for customs administration when it is accompanied by complementary reforms in organization and procedures. However, there is still a common belief that the administrative difficulties of customs clearance operations can be overcome simply by having a small staff equipped with up-to-date computers and with no other changes. Although there is no doubt that the use of computers can increase the efficiency of well-run operations, computerization is not a miracle solution to existing problems.

Computerization of customs procedures needs to be part of an overall modernization reform. However, international experience has demonstrated that customs administrations often find it difficult to implement these complementary components of the modernization effort. It is not difficult to

find examples where the inappropriate introduction and use of computer systems have exacerbated existing problems. In both developed and developing countries, a disturbing pattern has been observed in which investment in computer systems in customs departments has grown steadily, while the average time needed for the release of cargo still exceeds several days, with no clear improvement in assessments and the detection of fraud.

When introducing or expanding computerization, customs authorities face a number of important decisions regarding design and implementation. Should the system be centralized or decentralized? Should they computerize current operations first, and then change procedures and organizational structures? Should they use off-the-shelf packages or should they develop their own systems? Should they immediately establish on-line links with the banks, customs agents/brokers, and some of their largest importing companies? These are a few examples of the common questions, and they raise the more fundamental issue of which strategy and reforms need to be established to ensure the success of computerization. They also point to the benefits of learning from the experiences of other countries, for example, in the approach to and sequencing of reforms.

B. Objectives of Computerization

The computerization of customs administration must be linked to the ultimate objectives of revenue administrations, which are, broadly, the collection of revenue, the enforcement of trade policy, and the protection of society from prohibited goods. More specifically, the objectives are to expedite the processing of declarations and the release of goods, to verify the accuracy of customs valuation (in order to collect the proper amounts of duties, taxes, and fees on imports), and to ensure the effective control of goods in transit, entering warehousing, or being imported under temporary admission.

To ensure that computer systems meet the objectives set by management, performance measurement needs to be established for the systems already in use so the new system can be evaluated against the old one. The main performance measures should include

- the clearance time for release of goods from customs control, including such activities as the processing of customs declarations and payment;
- the monitoring of exemption programs based on such items as CIF import values per type of exemption and revenue forgone;
- improvements in statistical data and management information;
- more effective enforcement through faster processing of data and the matching of information;
- improvements in the consistency of enforcement of the tariff law;

- improvements in the quality of record keeping;
- improvements in the verification of trader-supplied data; and
- control of labor costs by improving the rate of declarations processed per staff member.

C. Main Applications

General

Computer systems generally consist of a number of logical subsystems. In the customs area these are

- control of the cargo manifest;
- processing of declarations;
- tariff and documentation control;
- import valuation;
- control of goods in transit, entering warehousing, or imported under temporary admission;
- risk management; and
- maintenance of trade statistics.

In addition, customs administrations have systems to track receipt of revenues. These systems maintain accounts of duties and taxes paid, penalties assessed, credit ceilings and debits, and refunds and balances due, at the level of the individual customs agent/broker or importer. At a summary level, the accounting system tracks revenue transfers from customs collection offices or banks to the treasury and reconciles reports of revenues received by the treasury with the revenue recorded.

The principal benefits expected from these basic applications (or modules) include faster processing of entries, targeting of controls to specific traders, improved revenue collection and control, data exchange, improved accuracy of entries and accounts, improved management information, and up-to-date statistics. All this, in turn, plays a key role in supporting post-release control activities.

Three key specific features characterize modern customs computer systems:

Separation of functions. The separation of functions in the process of customs clearance is necessary to maintain a controlled environment and to minimize the risk of collusion between customs officers and importers/agents. It is important, for example, that sensitive data (such as risk profiles or price information) are not accessible to officers dealing with the day-to-day processing and verification of declarations.

The use of “open” system technology (that is, the use of international standards and codings as the basis of the architecture of the computer system). This is essential to allow for interface with other systems and to improve the efficiency of customs procedures. The adoption of an open system architecture will also ensure that customs has autonomy of action with hardware procurement.

The distinction between “advanced,” “on-line,” and “batch” processing of information. To speed up the flow of goods while maintaining an effective deterrent against fraud, computer systems are organized to meet both trade facilitation and control objectives. “Advanced” or pre-arrival processing of transactions enables the submission of pre-arrival declaration data, thus allowing the rapid release of cargo out of customs control soon after its arrival. However, most of the computer equipment and resources is generally allocated to “on-line” transactions, as the combined use of computer and electronic data interchange (EDI) systems—discussed below—can allow for quick release of goods and assess almost instantaneously (in “real time”) the customs risk of a particular consignment. Less time-sensitive management tasks are often handled through “batch processing.” This allows the computer to collect data and process it at a later stage to maintain official records, produce daily and periodic accounting statements, and compile official reports and tables.

Organization of functions

The customs computer functions and the interactions between headquarters and field offices need to be determined in order to ensure the efficiency and flexibility of the systems and to reduce dependence on central systems. Generally, control files, maintenance of tariff files, and compilation of trade data need to be centralized to ensure uniform application of the laws and regulations, while the handling of manifests, declarations, and accounts needs to be decentralized to customs clearance offices.

Headquarters functions should include¹¹⁷

- coordination among automated customs offices;
- centralization of all data from the customs field offices;
- collation of all information on the integrated tariff;
- codification of references and control elements;
- processing entries from nonautomated offices;
- resolving technical problems received from various offices;
- hardware maintenance and purchasing;
- operator training;
- program development;
- management and distribution of trade statistics; and
- postclearance valuation control and investigation.

Field office functions should include

- declaration processing, which includes duty and tax assessment, routine tariff classification and valuation checks, selection of entries for documentary control, and physical examination of goods;
- cargo and inventory control;
- accounting; and
- transmission of declaration files to headquarters.

Customs computer applications should be developed to assist customs officers in the efficient performance of their duties, keeping in mind the principal objectives to speed up clearance, maximize revenue yield, and improve statistical information. While computerized customs systems may differ significantly in terms of technological approach to implementation, the hardware and basic software platforms required, the flexibility to interact with other external systems (such as tax administration and accounting), their scope, and the basic functions that are automated are very similar. A system is usually composed of a number of

¹¹⁷As discussed in Chapter 10, the typical customs administration organizational structure often includes regional offices, in addition to headquarters and local offices. In this case, a determination needs to be made concerning the computer support that is required at the regional level. This will depend on the operations that are being performed in the regional office—for example, refund processing, exemption verification, post-release reviews, and monitoring of operations.

subsystems or *modules*, each of which is more or less self-contained and automates the different phases of a specific customs function.

Specific applications

Manifest handling

The importance of simple procedures for handling manifests was seen in Chapters 4 and 5. Computer applications in this area deal with the capture of manifest data and the control of entries against manifests. The application writes off entries against manifests (the acquittal process) and prints out control reports. Information from manifests can be entered manually, but newly developed systems use EDI or other electronic data transmission facilities, allowing manifests to be transmitted in electronic format directly to customs by the carrier or freight forwarder.

Declaration processing

The processing of customs declarations constitutes the core of customs day-to-day work and most systems now use the European Union single administrative document (SAD) as a standard declaration format. Automated declaration processing requires the creation of a set of files (called the “integrated tariff”) that contain, for each customs tariff heading, all the data needed to verify that goods meet the legal requirements necessary for customs clearance, such as quotas, licenses, prohibitions, and health regulations. It also calculates the duties, taxes, and fees payable. The system usually performs automatic verification of all declaration types (imports, exports, warehousing, and reexports) through the use of the on-line integrated tariff and reference files.

The application includes the capture of input data, registration of entries, calculation of duties and taxes, control of payments, control of warehousing and reexport regimes, and a printout of entries. This application usually provides on-line help to accredited importers/exporters and customs agents/brokers to guide the user through the completion of the customs declaration. Once the tariff classification and the value of the goods have been approved by a customs officer or preapproved by routine checking modules, the system will compute the duties and taxes to be paid and will validate the declaration. The system also takes into account duty reliefs, exemptions, or adjustments that may apply to specific transactions on the basis of tariff laws, Customs Code, and regulations.

Warehousing and transit management

The automated processing of duty and tax suspensive regimes (in the case of warehousing and for the temporary admission of goods) is performed through a module that provides information about when the goods arrive and are removed

(entry date) or are to be removed (for clearance or new status), where goods can be inspected (physical location), the description of goods, and the status of fee and levy payments or cash deposits or guarantees.

With transit operations—discussed at length in Chapter 8—the computer module provides facilities to log and control the goods in transit, with specific information on the mode of transportation (sea, air, road, or rail), the identification of the carrier and vehicle (license number), the port of entry and the place of final destination (or port of exit), and cargo (general description). In addition, it provides the required security measures (bonds/guarantees, seals, and restriction of movement with respect to routes and checkpoints on transit routes); and the time limits for reporting to the final destination and for the acquittal of cargo documents. Accurate and timely information from local offices is essential for tracking the movement of cargo at a central processing site or at the final destination site (the acquittal process). Recent developments in transit control include the usage of “smart cards”¹¹⁸ to record and control transit information, “intelligent” seals affixed to containers to enable transit follow-up using simple portable readers, and even transponders attached to containers or to cargo vehicles, allowing for follow-up through satellite-based systems such as GPS (Global Positioning System).

Duty and tax accounting

This application controls the different revenue receipts and payments. It includes the registration of payments (in cash or through a credit account); automatic account maintenance (through the management of bond payment, credit limits, and cash transactions); the printing of assessment notices and receipts; and the generation of statements for users of credit or bond facilities. Consolidated accounts are usually produced by customs headquarters, which also provide the required revenue statistics to the treasury department or central bank.

Clearance controls

This application consists of separate subsystems that allow customs officers to perform documentary controls with the assistance of programs using information from reference files (tariff nomenclature definitions, documentation based on laws and regulations, countries, traders, currencies, etc.) and risk-analysis profiles (see Box 5.1 in Chapter 5). For example, a transaction can be passed through a risk profile module (combining criteria such as product, country of origin, importer, value, etc.) to determine the risk potential and trigger further preventive action. A major risk element is the price charged for goods.

¹¹⁸These are credit-card size cards incorporating a high-capacity chip on which information can be stored and updated.

Price information stored on a system allows price comparison from reference data gathered from reliable sources and previously approved transactions.

Statistical reporting

This application allows the integration of all declaration files into a database; aggregation of data on external trade and revenue; database interrogation; and reports. Standard reports generated by the system may be tailored to specific requirements, in particular for external trade statistics and management information purposes. Standard reporting includes the following types of reports: total imports/exports; source country; duty and tax; imports/exports by commodity classification; product price; insurance and freight; customs entry point; importer/exporter relationship; and importer/customs agent relationship.

Management information reports on such areas as changes in work loads, fraud analyses, and collection and administrative costs are obtained by combining data (e.g., customs value, duties and taxes, revenue loss, net weight) and criteria (e.g., number of customs staff and declarations, trader balance, trader product, trader/country) gathered from the processing of customs declarations. Management reports and other intelligence information allow customs to conduct audits and investigations on current transactions, as well as internal audits on the actions of individual customs officers.

D. Strategy and Preparation for Implementation

There are a number of fundamental issues that have to be considered to ensure the success of computerization, and a sound strategy for design and implementation must be developed and strictly adhered to. Such a strategy should address the fundamental issues, weighing the different alternatives against the local context and the actual constraints in terms of resources and infrastructure that a particular administration faces. From this exercise, the best approach and sequencing of reforms can be derived, and an action plan prepared.

There are, however, several prerequisites that have to be adequately addressed before actual implementation of computerization begins. Optimal conditions for success require support from the political authorities, simplification of customs legislation, and an in-depth reform of procedures, including documentation, planning, and a strategy for implementation.

Support from the political authorities

To significantly improve the effectiveness of customs administration, the government must be politically committed to the reforms. Explicit support of the reform effort and the tax and customs administration's management from

the country's top government officials is of fundamental importance. The government's political commitment should be visible to the public and to the staff of the revenue departments. Successful implementation of changes in the customs structure and in systems and procedures also requires a committed management team. The management team in charge of the customs administration and of the reform program should be headed by a highly motivated and trained group of professionals at customs headquarters.

In addition, the reform measures must be politically sustainable, and the management and staff of the customs administrations must be involved in the design and implementation of the reform project from the beginning. It is essential that the customs department have "ownership" of the project. Reform projects that do not sufficiently reflect the concerns of the country's own customs administrators and are imposed by outsiders will not succeed.

Simplification of customs legislation

One of the most important lessons learned from IMF experience is the requirement for the prior simplification of customs tariffs and legislation. A customs tariff with a limited number of rates and limited exemptions has proved to be much easier to administer and to result in higher compliance by traders, uniform application of the law, and faster processing of declarations. There is also less opportunity for customs officials to engage in circumvention of the law and to exact commissions for services provided to release cargo.

Reform of procedures

Development of a self-assessment system

The development of a self-assessment system—the essence of customs administration modernization—and the development of a computer system are complementary. Under a self-assessment system, customs agents/brokers or importers are able to complete their own declarations and make the duty and tax payment at the time required. Computers, after the capture of data through EDI or other forms of electronic filing, are then used to perform routine functions such as verifying Taxpayer Identification Numbers (TINs) and carry out other credibility and arithmetic checks, maintain individual accounts, and match payments with declarations.

Self-assessment allows customs administrations to devote more of their resources to the facilitation of procedures and to the detection of noncompliance and fraud. Self-assessment, together with the extension of computerization, also enables them to cope with the additional workload resulting from any increase in the number of declarations.

Simplification of customs procedures and documentation

One of the major tasks in preparing for automation is the simplification of existing manual systems, procedures, and documents. In many customs administrations, the existing computer system is often grafted onto the manual system rather than replacing it in whole or in part. This results in a duplication of procedures and an excessive number of administrative steps for the processing of customs declarations. In customs administrations where the procedures and the processing systems of declarations are entirely or essentially manual, the number of administrative steps imposed by customs is usually considerable.¹¹⁹

When introducing computerization or upgrading existing systems, it is important to first review the current manual systems, procedures, and documents. In most cases, the review will lead to modifications in legislation, the transfer of staff, and changes in work habits. If computer systems are superimposed on badly organized or ill-conceived manual procedures, they will prove useless and probably exacerbate existing problems. Moreover, from the outset, these reforms have to be established in conformity with both automation requirements and internationally agreed-upon norms and procedures.

Planning and preparation for implementation

Once the prerequisite changes have been initiated and the decision to computerize is made, the functions and organization of the system should be defined, and a detailed implementation plan should be prepared. The plan should consist of clearly defined objectives, with a list of actions, target dates, and resources required. The team responsible for implementing the system should be involved in the preparation of these plans, the determination of resource requirements, and the setting of deadlines.

The computerization of customs procedures will require specialized staff to carry out the analysis, development, and implementation of the system. For a system to be effective, users need to understand how to work with it and what results to expect from it. To obtain user cooperation, they need to be involved in the development and implementation of the system.

One of the key elements of the strategy is a *phased approach*, based on the identification of a set of tasks that should be completed and consolidated before the next activity begins and the use of one or two *pilot sites*. In these pilot sites, the new systems and procedures should be developed and tested in a controlled way, without disrupting day-to-day operations. Later, the new systems and

¹¹⁹In many customs administrations visited by IMF missions, the processing of customs declarations involved over 20 separate steps.

procedures can be replicated in other offices, once they have been thoroughly tested and have shown they work properly.

Software development

When considering the introduction of a customs computer system, there are two basic options for software development: either to develop an “in-house” system or to acquire an existing software package. Each option has its advantages and disadvantages.

The advantages of an in-house system are that it is developed to meet the specific needs of the individual customs administration, changes are controlled locally, and customs has full control of the computer software. However, the disadvantages are the very high cost of development, the high level of expertise required to design the system, and the long period of time required for development.

Several well-tested software packages are available. The most popular are ASYCUDA, which was developed and is maintained by UNCTAD, and SOFIX, a version based on the French Customs system SOFI. Both have been installed in a number of countries. Offerings by private companies include the TIMS system developed by Crown Agents and successfully implemented in Mozambique. Recent announcements by private groups promote Internet-based (i.e., remotely managed) customs packages, although so far none of these has actually reached the market.

Using such a package has several advantages. It has already been tested and may be fully operational in other countries. It may include the automatic provision of ongoing updates to user countries, and the software uses internationally agreed-upon standards and codes. While the software is generally free, substantial implementation costs can be involved. Nevertheless, the cost is generally much less than for an in-house product. The disadvantages of a software package system are that it has to be adapted to meet the specific requirements of the country, and changes to the system may have to be approved by the vendor. The IMF experience is that countries that opt for the software package system often make demands for too many specific requirements to be included, which can negate the advantages of choosing that option.

Today, personal computers (PCs) offer high performance and capacity at low cost and are easily maintained. Therefore, it is preferable that the selected software package be capable of operating in a PC environment. This may include stand-alone PCs, units linked to a network (most probably a local area network for a particular work location), or units linked to computer servers to cover a wider geographical area (most probably in a client-server architecture).

Other issues to be considered prior to and during development include the existing power supply, telecommunications network, computer hardware suppliers, and the availability of local maintenance services. Each of these will influence the choices of hardware, software, and the approach to contingency planning (e.g., it may be more cost-effective to provide an additional processor in case of equipment failure than to rely on the availability of maintenance personnel in each location).

E. Trends in Customs Computerization

In recent years, a wide range of new computer technologies have been introduced by various tax and customs administrations. This section discusses the most important of these: (1) electronic data interchange, a structured and typically expensive approach to securely exchange data between computer systems; (2) direct trader input, a means for customs administrations to acquire data from the trade community; (3) advance cargo information systems, operational arrangements that allow carriers pre-arrival processing of their transactions through specific modules of the computerized customs system; and (4) the use of the Internet as an inexpensive and easy-to-use option for connecting computer systems to make secure transactions and exchange data.

Electronic Data Interchange (EDI)¹²⁰

The merging of computer technology with communications technology provides the opportunity to speed up international trade transactions and reduce paperwork. Customs administrations have been quick to grasp the importance of electronic data interchange (EDI). The objective of EDI is to get data from one computer system into another computer system by a method and in a format for the receiving system to fully understand and process it. For EDI to work properly, rules must be defined about the characteristics of the data that will be exchanged, which data items are included in the Electronic Data Interchange for Administration, Commerce, and Transportation (EDIFACT) message, their format, and where they will appear within the message.

Introduction of EDI

Customs must first develop the capacity to process data through computers before considering transmitting data using EDI. Without basic customs automation, the use of EDI to support trade is not possible.

¹²⁰This section draws on Kloeden (1997).

Such innovations and changes in the customs administrations of developing countries can only be introduced gradually. Those customs authorities that can interface with other trade participants' systems (both nationally and internationally) are in a strong position to promote the effective coordination, integration, and standardization of systems by user groups. Because of the variety of participants both large and small, this also makes the role of customs in developing countries more complex. Customs must be aware of the degree of computer readiness of the organizations and companies with which it deals in order to plan its computer installations and assess the likely volume of data transactions with which it will have to cope. Although the widest possible use of EDI should normally be encouraged, for economic and practical reasons, it is more sensible to cater to large users and provide incentives for the most important trade participants to use EDI. It is important, therefore, that customs makes its plans known and works in cooperation with the trade community. An advisory committee (ADP/EDI Steering Committee) should be formed, consisting of administration officials and members of the trading community, and it should meet on a regular basis. Through these meetings, trade participants (including importers, exporters, banks, port and airport authorities, shippers, brokers, and freight forwarders) are able to agree on such matters as trade data interchange standards, telecommunications standards, and other specific conditions and security arrangements to be adopted.

Concepts and facilities of EDI

The flow of information between organizations has always been based on paper documents. Documents are typically generated by one computer system only to be followed by the manual input of the information in that document into the computer system of the recipient. The inefficiency of this approach was the impetus for a better method to get data from one system into another and led to the development and implementation of EDI.

There are two predominant international EDI standards in use, although some industry-specific standards have survived. The American National Standards Institute (ANSI) developed the X.12 standards, which have been uniformly adopted in North America, Australia, and New Zealand. Europe went in a different direction, with the EDIFACT standard developed under the auspices of the United Nations Economic Commission for Europe (UN/ECE).

Components of an EDI system

An EDI system has three main components. First, the originator of an EDI message needs a method to extract data from its computer system and translate this data into a standardized format ready for transmission to the intended recipient. EDI translation software provides this capability. This software may be either fully integrated into the originator's computer programs or independent

from the existing systems. The end result must be the same, which is an EDI message conforming to the guidelines issued by one of the two message parties (i.e., the originator or the recipient).

Second, when one or more EDI messages have been generated, a method is needed to deliver the message(s) to the intended recipient. This could be as simple as copying the messages to some form of magnetic media (tape, cartridge, or floppy disk) that is then physically delivered to the recipient. However, for an organization sending EDI messages to many addressees, the exchange of magnetic media is often impractical, although it has typically been an approach used in some countries between financial institutions such as banks. Where possible, some form of data communication method is preferred, because of the advantages of speed and simplicity.

Many EDI users prefer to use the services of a separate, and typically independent, network to pass messages. Such network providers are called “Value Added Network Services” (VANS). VANS are essentially electronic post offices, allowing subscribers to pass EDI messages via the network to other subscribers of the service. They are closed and secure networks that are only open to paying subscribers. A variety of connection methods may be available to transmit EDI messages from the subscriber’s computer system via VANS. Normal voice-grade telephone lines are often used to establish dial-up connections. For subscribers with a heavy volume of EDI messages to send or receive, a leased data line may be cost-effective. Many countries have a public Packet Switched Network (PSN) based on the X.25 communications protocol which is often a good method for transmitting EDI messages, and some VANS may even support wireless connections using cellular systems or wireless packet switching. Unlike the Internet, the main benefits of using VANS for data transmission are reliability and security. VANS normally guarantee the secure and prompt delivery of messages in an uncorrupted state. Access is password-controlled, and the network normally employs integrity checking to prevent the corruption or duplication of data. Audit control functions provide a high degree of reliability, and charges are usually based on message volumes. The main shortcoming of VANS is the cost per transaction: usage of a private network has a much higher cost than using the Internet.

The third main component of an EDI system is an EDI Interpreter/Translator. The recipient of an EDI message must be able to decipher the contents of the message and translate it into a format that can be recognized and processed by its computer system. As most EDI users must send and receive messages, the same software is typically used for both purposes.

Advantages of using EDI

There are a large number of participants in even the most simple commercial transaction, such as a purchaser ordering a product from a foreign supplier. At

the purchaser's or importer's end of the order are the purchaser, customs broker, shipping agent, and bank, plus the importing customs administration and its bank. The seller or exporter deals with a shipping company, a customs broker, a bank to receive payment for the goods, and the exporting customs administration, and many documents are exchanged by these different organizations over one transaction. In today's business world, many, if not all, of these enterprises employ computer systems, resulting in the information printed by one computer system in the chain being manually entered into the computer system of the next organization in the transaction chain. Even today, it is estimated that more than 70 percent of all information entered into a computer system has been generated by another system. Every time data are entered into a computer, there is a risk of introducing error. Furthermore, data entry is expensive and can require large numbers of staff. All this adds to business costs, delays the completion of the transaction, and introduces unnecessary risks, whereas, exchanging data by an electronic method costs typically a tenth of what it costs to use paper-based information exchange.

The degree to which EDI would be used in any particular scenario depends upon the desire and capabilities of the participants to the transaction. While it is feasible for EDI to be used at every step in the transaction, the lack of EDI capability by one or more of the participants could force a reliance on paper-based information exchange for that part of the transaction. More and more businesses are now moving to time-critical-based inventory systems, such as the "just-in-time" method, requiring fast and accurate transportation and processing. Government agencies such as customs administrations must also provide effective services that are sensitive to the time, cost, and low-error needs of the trade community. For example, the importance that Singapore has given to trade facilitation and modern data processing and communications methods is no coincidence to their success in attracting and retaining international trade. EDI is, therefore, an important component of business-enabling technology and is employed successfully by competitive businesses and government agencies throughout the world.

Direct Trader Input (DTI)

There are two methods available for a customs administration to acquire or capture data from the trade community. Customs can assume most of the responsibility itself by inputting manifest data received from shipping companies and declaration data received from brokers or importers and exporters. The problem with this approach is that customs bears the cost of providing the data-entry terminals or workstations, the maintenance and operation of the data-entry computer programs, and the staff to enter the data. Although this cost could be passed on in higher processing fees, customs is obliged to deploy substantial resources and effort that could be more effectively used elsewhere. The second approach is to transfer the data-entry task from customs to the trader. This shifts the cost and burden away from customs, but normally the trade community will

seek an offsetting gain, such as faster release times, reduced processing charges, and simplified procedures. Under either strategy, of course, due weight should be attached to the burden being borne by traders.

For more than 20 years, French customs has employed a kiosk operation for traders to input declaration data into their SOFI system via terminals at customs offices. But requiring traders to visit a customs office to enter data into the customs system also has drawbacks. It is much more convenient for traders to enter data into the customs system from their own offices, where they have access to all the source documents, and without having to compete for access to a kiosk terminal. This is called remote data entry or, more usually, Direct Trader Input (DTI). It has been so successful in France that only about 10 percent of entries are input to SOFI at the customs kiosk, while the vast majority are entered from the traders' premises. To encourage early and widespread acceptance of their new computerized system, the Australian Customs Service incurred the cost of installing terminals on the premises of those traders involved in importing and exporting.

Compared to the manual preparation of a declaration, DTI is a superb solution. The information that a trader enters is interactively validated, and when complete, the declaration is printed, eliminating the need for typing or manual completion of the form. However, for traders with their own computer systems, most of the data entered manually via DTI probably already exists on their system. The traders' systems may already be capable of printing a declaration listing all the information needed by customs. Printing it out so that it can be reentered into the customs system becomes redundant and inefficient. EDI is the obvious solution to avoid this duplication.

Advance cargo information systems

In many instances, the information required to complete customs formalities is available prior to the arrival of the consignment. To make a cargo declaration, carriers in a growing number of countries have the option of sending their data through EDI to customs brokers, and the latter to customs, in advance of the arrival of the physical shipment. Before the shipment arrives, customs is able to process the cargo and release data through an automated cargo/release selectivity system. As soon as the shipment arrives, customs can provide cargo release notification through EDI, if no further examination is required. (See also Box 4.2 or the Unique Consignment Reference number.)

Preamival processing of transactions through advance cargo information systems (ACIS) can make a substantial contribution to cost savings in transport and storage operations, especially for transit cargo. The submission of data through EDI facilitates this process and, with appropriate safeguards, the control objectives of customs are not compromised.

The Internet

The Internet has a longer history than EDI, but until recently it was mainly limited to academic and research uses. The advent of the World Wide Web and the exponential proliferation of its use have been explosive. Meanwhile, businesses and governments have invested heavily in EDI, and in most developed countries it is inconceivable for enterprises in certain sectors of the economy to be competitive without EDI. Simplification of standards (such as EDIFACT and X.12) and constantly dropping prices for hardware and telecommunications have helped spur demand for EDI, although software costs have not declined in the same manner, and in many cases have actually increased in real terms.

EDI has been, and probably will continue to be, dominated by wholesale commerce rather than retail commerce. EDI is particularly cost-effective for moving large and small volumes of data between the computer systems of commercial traders and agencies. Electronic commerce on the Internet and the web on the other hand, has initially focused on the retail level, giving individual consumers alternatives to conventional shopping methods such as department stores and mail- and phone-order businesses. At first, traditional EDI advocates were alarmed about the Internet and its potential to encroach on their domain. However, these fears are unwarranted in the immediate future for various reasons. First and foremost, the Internet is unregulated and simultaneously owned by everyone and no one. Although enormous progress has been made in recent years, security and reliability are still problems, as the Internet is an international connection of many computers. While there are technological firewalls available to protect individual servers on the Internet from attack or abuse, data and programs that are transmitted across the Internet remain open to interception, manipulation, or even imitation. Encryption and other security methods have been developed, but many of these solutions are not yet stable or standardized. Certain encryption technology developed in the United States, for example, remains subject to export restrictions. An EDI VANS, on the other hand, is a safe, secure, and reliable environment. EDI users can be confident that their messages will be safely delivered to the ultimate addressee via VANS without the risk of corruption, although this type of service obviously comes at a price.

In spite of these problems, the Internet cannot be ignored. Those EDI users who are thinking ahead should be considering the potential for enhancing the capabilities of their EDI investments with new opportunities provided by the Internet. Colombian Customs, for example, implemented in 2000 a system that accepts the input of manifest and declaration data via a website. While initial usage by traders was quite limited, one year after introduction about 80 percent of all transactions were being input via the Internet or through a customs-managed extranet, in lieu of traditional EDI transfer methods through VANS. Many customs administrations now use the Internet to exchange information on

customs frauds via the World Customs Organization (WCO).¹²¹ In March 2002, UNCTAD announced a web-based version of its customs automation system, ASYCUDA, which will allow customs and traders to handle most of their transactions—from customs declarations to cargo manifests and transit documents—via the Internet.

Just like any seriously competitive business, a modern customs administration also cannot afford to ignore EDI and electronic commerce. Failure to provide EDI and Internet capabilities will have negative implications in terms of higher transaction costs, possibly longer consignment release times, and ultimately poorer trade facilitation, compared to countries providing these services, with implications for international competitiveness.

In addition to the facilities allowing the input of manifest and declaration data described above, the more common services that customs administrations have made available on the Internet include the following:

- *Forms and publications.* Importers can download customs forms and guides instantly over the Internet rather than wait to receive them through the mail. In addition to providing better service, this function offers potentially significant savings in printing costs for customs administrations.
- *Procedures and regulations.* Customs administrations allow users to obtain details of the application of procedures or a particular regulation through keyword searches. A large number of international organizations specializing in tax and customs matters have also developed their own websites. This is the case, for example, of the WCO site, which provides the opportunity to view or download the texts of WCO conventions, recommendations, and other technical documents related to customs procedures and rules on valuation and origin. Customs administrations can also gain access to collections of data on specific types of fraud or contraband.
- *Frequently asked questions (FAQs).* FAQs normally address questions, such as how to complete customs forms, what items are taxable, and how customs brokers can contact customs service staff.

F. Conclusion

Modern customs administrations need computerization to support their operations. The trend is to substitute electronic data for paper documents and to connect computer systems (of government agencies and businesses) to securely transact and exchange data on trade. The move to risk-based decision systems

¹²¹The WCO Permanent Technical Committee on Customs Fraud and Offences acts as a pooling institution for member countries, the UN, UNESCO, and ICP/Interpol.

requires that customs administrations focus as much on managing information as they have focused in the past on managing physical goods.

All this requires careful planning and a phased approach. The process should start with taking stock of the current situation. Then the requirements for the new system must be defined and specified. Once this is done, a decision must be made on how to achieve the desired systems. This decision should be based on an analysis of the gaps between the existing and future systems. Options for closing these gaps could range from further enhancements of the existing systems to the wholesale replacement of the entire suite of programs and applications. While cost will be a key consideration in making that decision, timing issues will also be crucial; and for both reasons the adoption of an existing packaged system is likely to be preferred to a complete in-house development from scratch.

Any organization trying to improve its use of information technology must beware of being excessively influenced by the outwardly visible components of the plan—hardware and infrastructure. Before attention is given to the acquisition of infrastructure, the focus must be on streamlining procedures and business practices that are then reflected in the new applications. The premature acquisition of hardware is a common mistake in the rush to demonstrate progress: at best, the equipment will underutilized for a significant portion of its useful life; at worst, the hardware will be obsolete by the time the systems are ready for deployment.

The Organization of Customs Administration

Patricio Castro and James T. Walsh

This chapter outlines the type of organizational structure that is required to deliver effectively and efficiently a customs administration program: a decentralized structure consisting of headquarters, regional, and local offices. It then discusses current trends that are emerging in organizing customs (and tax) administrations.

A. Organizational Structure

As outlined in Chapter 3, most customs administrations are decentralized, having headquarters, regional, and local offices. A customs administration's control responsibilities related to both goods and people require offices to be located in seaports, airports, and at land border crossings. (Most customs administrations also have "inland" offices that are far removed geographically from the border to process goods that have moved in transit to a location that is typically closer to the importer or exporter.) Organizations of this type must clearly delineate responsibilities among the various levels to ensure that good service is being provided and that legislation and procedures are being applied consistently across the country.¹²²

Headquarters

The primary responsibility of headquarters is to develop operational policy and procedures for the regional and local offices. In addition, headquarters should develop performance criteria and monitor compliance with them. This may include reviewing selected transactions to determine if the policies are being applied correctly (by, for instance, operational reviews and/or internal audits). Headquarters should also be responsible for monitoring international agreements

¹²²A constant theme of the private sector is the need for certainty in the customs treatment of its transactions. Companies need to know that the rates of duties and taxes applied on goods will be the same at all customs offices, so that they can make informed business decisions about the landed cost of their imports. They also need to know how long goods will be under customs control to assist in determining their inventory requirements.

and developments, particularly related to the World Trade Organization (WTO) and World Customs Organization (WCO), to ensure that current legislation and procedures are up-to-date and in compliance with a country's undertakings. In addition, headquarters should interact with policymakers, in the ministry of finance and elsewhere, to agree on such matters as revenue targets and to provide input on the administrative impact of proposed policy options.

Another important responsibility of headquarters is the development of recruitment and training policies and plans. Customs legislation and procedures are complex and difficult to apply (even after legislation and procedures have been simplified to the extent possible). Therefore, well-educated personnel must be recruited and training programs must be developed to ensure that staff are able to interpret and apply the legislation.

Headquarters organizational structures vary from country to country. Figure 10.1 outlines a typical structure that has a reasonable span of control for the head of the administration, overseeing divisions that are responsible for developing policies and procedures and monitoring implementation of key elements of the customs program.

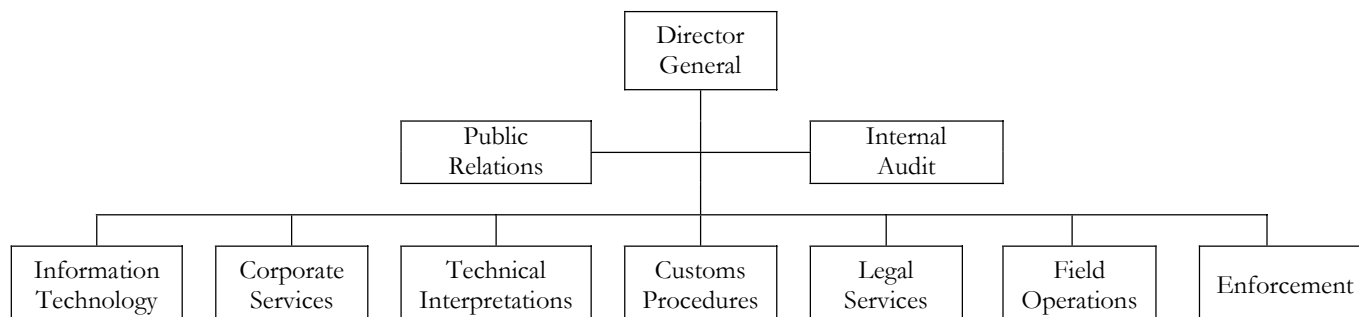
Regional offices

Typically, regional offices are responsible for supervising the activities of several local offices. This would include ensuring that the offices are meeting the agreed-upon performance criteria and, when necessary, identifying the measures necessary to bring performance up to standards. In addition, the regions may carry out certain operational activities, such as responding to first-level appeals, processing and approving refunds up to a preestablished limit, and undertaking post-release verification activities, including valuation reviews. Typically, the regions archive the declarations and supporting documents for their local offices.

Local offices

These offices are the primary point of contact between the trade community and the customs administration and, as such, staff must be well informed and well trained. They are responsible for deciding on the level of verification that is required when processing a declaration and releasing goods. Of course, this decision should be based on guidelines that are established by headquarters and the regions. Nevertheless, in every customs administration, a great deal of discretion is in the hands of the local officials. In modern customs

Figure 10.1. Typical Structure of Customs Administration Headquarters



Notes: **Internal Audit.** Review financial, administrative, and operational systems, and monitor compliance with management policies.

Public Relations. Develop internal and external communications policies and procedures.

Information Technology. Manage computer operations, maintain hardware and software, and develop application software.

Corporate Services. Develop policies and procedures for human resource services (including training), administration, finance, and corporate planning.

Technical Interpretations. Develop policies and procedures related to valuation, tariff classification, exemptions, and origin determination, including contacts with the World Customs and World Trade Organizations and other customs administrations.

Customs Procedures. Develop policies and procedures related to import and export declaration processing, cargo reporting, transit, temporary admission, warehousing, and others procedures related to the processing of goods and passengers.

Legal Services. Draft legislation, provide legal interpretations, adjudicate appeals, and advise on policies and procedures related to penalties and prosecutions.

Field Operations. Manage all regional and local offices, including monitoring operations against preestablished performance criteria.

Enforcement. Develop policies and procedures for investigations and intelligence gathering and analysis.

administrations, much of this discretion is removed as information from the declaration is processed in an automated environment; certain of the data are compared with information in the selectivity system to determine, for example, if the importer has a past history of undervaluation, the type of goods that are often misdescribed, exporters in certain countries that are known for false origin certificates, etc. The system determines the level of verification that is required. The local office is accountable for meeting established performance criteria

related, for example, to the time required to process a declaration or physically inspect goods.

In some local offices, particularly at border locations, it is necessary to provide service for processing goods and passengers on a 24-hours-a-day, seven-days-a-week, 365-days-a-year basis. This requires preparation of staffing schedules that meet established traffic patterns (flight schedules and the like). In addition, the customs administrations should be sensitive to the needs of traders for extended hours of service (up to 24 hours a day) at inland warehouses to process imports and exports.¹²³ However, with the increased use of computers and information moving electronically, there are opportunities to separate information processing (such as declaration processing and payment) from the physical clearance of the goods. For example, a customs declaration can be sent electronically to the customs system before the arrival of the goods and, once accepted by the system, payment can be made by electronic funds transfer. Upon arrival at the border, a comparison of the information in the computer and the goods (container and seal number, for example) can be undertaken and the goods released. The implication for the organization are clear—there needs to be a very close working relationship between the border and inland offices and fewer staff will be required at the borders.

B. Trends in the Organization of Customs Administrations

The preceding discussion has dealt with some of the day-to-day organizational issues that are encountered by customs administrations. A more fundamental problem that many countries are now confronted with is how to organize tax and customs administrations to increase both efficiency and effectiveness. These discussions have grown out of a realization that emerging trends, such as globalization, trade liberalization, the increased scope for transfer pricing, and the explosion of e-commerce have a significant impact on tax and customs operations. In turn, this has led to discussions of how best to organize revenue administrations to respond to these and other new challenges. For any country that is engaged in the reform and modernization of its customs administration, changes in the organizational structure are often an important component of the reform.

The degree of autonomy given to the revenue departments is one of the key aspects to be dealt with in the context of a reform effort.¹²⁴ In recent years, there has been a trend toward increased autonomy for revenue administrations as a

¹²³Many customs administrations pay shift-differential bonuses to compensate staff who are required to work holidays, weekends, and evening and night shifts.

¹²⁴The term “revenue department” (or “administrations”) refers to the institutions that administer both direct and indirect taxes.

way of facilitating change, especially in developing countries.¹²⁵ Giving more autonomy to the administrations is seen as an effective way of facilitating change and addressing such chronic problems as low salaries, tolerance of low levels of performance and/or corruption, and slow and ineffective procurement and budgeting.

Two main arguments are often made to support these recommendations. First, successful revenue administrations in developed countries have traditionally enjoyed significant degrees of independence. Second, in developing countries, so called “autonomous” public sector institutions—in particular central banks—have been found to be more efficient and to have better human and material resources than tax and customs administrations.

The term autonomy has different meanings in different circumstances. Moreover, greater autonomy for revenue administrations is pursued for different reasons in different countries. In some countries, the main objective is to improve the quality of the resources devoted to revenue administration and to combat corruption. In others, the purpose is to insulate daily operations, as much as possible, from political interference. As used in this chapter, the term autonomy represents the set of conditions that confers a reasonable level of independence from political influence and independence in the administration of human and material resources. One can distinguish between two different dimensions of autonomy: “hierarchical autonomy,” related to the degree of independence from political influence; and “operational autonomy,” related to financial and procedural independence from the general rules of the public sector that govern the administration of human and material resources. Both dimensions of autonomy serve different purposes, and—as will be seen—an administration can enjoy different degrees of each.

Restructuring revenue administrations to provide increased autonomy represents an attempt to satisfy the more stringent demands of a professional service while maintaining an adequate degree of accountability. This is not always easy to achieve.

The role of autonomy in effective customs administrations

Effective customs administrations display certain common characteristics—shown in Box 10.1—even though their specific organizational structures and degree of autonomy differ widely. In many countries, it has long been recognized that the customs administration should be a highly professional career service, where all positions are filled solely on the basis of competence, and continuity of tenure and promotion on the basis of merit are assured. Customs administration

¹²⁵See, for example, Jenkins (1994b).

Box 10.1. Characteristics of an Effective Customs Administration

Effective customs administrations are expected to ensure that duties and taxes are collected as prescribed by the legislation, and to do so in the most efficient way and in a manner that is as free as possible from corruption and political influence. The experiences of many countries point to some key characteristics that permit the customs administration to operate effectively:

- A clear separation between the setting of tax policy and its administration, with laws and regulations that are as simple and transparent as possible.
- Confidentiality of taxpayer information (for example, the ministry of finance and other government departments should not have access to individual taxpayer files or transactions, except under well-defined and controlled circumstances in exceptional cases).
- Performance criteria adopted for the customs administrations, including revenue targets, service expectations, and the resources required to meet the established criteria.
- A body of professional customs administrators that are well trained and well paid.
- A code of conduct for the staff of the customs administrations that clearly spells out expectations and consequences of nonperformance (not least, the disciplinary actions that will be taken in cases of corruption)—and that is enforced.
- An effective internal audit function within the customs administration, with responsibility for determining that the systems and procedures have been followed and investigating cases of alleged corruption.
- An atmosphere that encourages taxpayers to raise issues of interpretation of the tax laws and their administration. Many countries establish a formal consultative mechanism with taxpayers (e.g., industry associations) to address this issue.

has become a complex and specialized field where merit, training, and experience, protected by secure tenure, are essential.

Reliance on an effective civil service yields an additional measure of independence to government entities: a professional civil service avoids political appointments, which are often subject to political interference. This supports another key feature of effective customs administration, its lack of politicization. The quality of the mechanisms against political interference built into the institutional system is very important. One of the key features present in many countries with effective customs administrations is the presence of an independent judiciary or magistrates who are authorized by law to undertake independent reviews of all tax matters, particularly cases of fraud and corruption.

Thus, the most important questions are: How does a customs administration undertake a successful reform and achieve the characteristics described above? And what degree of autonomy is required to ensure that they are implemented?

Degrees of autonomy in a customs administration. As a starting point for an analysis of the possible degrees of autonomy of a customs administration, two basic dimensions should be addressed: the degree of centralization;¹²⁶ and the type of external control exercised over the agency.

The degree of centralization given to government entities is a useful tool to analyze the many possible alternatives of organization found within the civil service structure. At the nucleus of the government are the most centralized agencies, which are usually hierarchical bodies headed by high-level civil servants or deputy ministers who are accountable only to a minister. These agencies, whose names may vary in accordance with the type of government (parliamentary or presidential, unitary or federal, and so on), are usually referred to as “departments.” These departments are centralized in the sense that they are an integral part of the government’s administrative structure. Traditionally, customs administrations fit this definition.

In contrast with these more traditional, highly centralized governmental entities, there are other structures, distinguished by varying degrees of decentralization. These entities can be generically described as “decentralized administrative structures,” and they usually enjoy a higher level of autonomy than centralized agencies. In practice, these structures may be constituted as boards, commissions, agencies, etc., and may be established for a number of reasons:

- Decentralized agencies may be established in response to particular economic or business concerns, when a specialized agency, insulated from political pressures, is needed. These agencies typically deal with licensing, rates, and other regulatory matters, in areas such as telecommunications and transportation.
- Where commercial or quasi-commercial activities are involved, a decentralized agency free from many of the procedural controls common to the public service may be created (e.g., state-owned enterprises).
- In federal countries, decentralized administrative agencies allow cross-delegation of powers between the federal and state or provincial governments, or between the latter and municipalities.

The degree of decentralization in a particular agency depends on many factors and is subject to wide variation. In most cases, however, the permanent staff of the agency are directly answerable not to a minister, but to a board, a commission, or an individual office holder less directly connected with the government.

¹²⁶As used here, the term “centralization” is not related to any geographical or operational characteristic of a government agency, but rather to its relative standing within the government’s administrative structure.

Recent trends: revenue boards and other autonomy-related measures

Since the early 1990s, several countries have restructured their revenue administrations, aiming at increased effectiveness. Two distinct trends have emerged in connection with these efforts. The first has been the unification or merging of previously separate revenue agencies into an integrated tax and customs administration. Since the early 1990s, this has taken place in, for instance, Denmark, Canada, Mexico, Venezuela, Guatemala, and Argentina (in the latter, the administration of social security taxes was also merged into a new single agency). The objectives of these mergers have been the improvement of services to taxpayers, by reporting to a single government agency and better adapting to new trends in international trade; increased efficiency, by combining common functions such as personnel and administration; and increased effectiveness, by the establishment of joint audit and investigation services.

Second, in many cases an attempt was made to increase the degree of autonomy of the revenue administrations (for instance, Spain, Peru, Argentina, Bolivia, Venezuela, Ghana, and Uganda). As mentioned before, autonomy for administrations is sought for different reasons in different circumstances. Some countries with effective administrations see autonomy as a way of better adapting to new operational challenges while preserving independence from political influence. Countries with less effective administrations see autonomy as an instrument for liberating the administration from the limitations of underfinanced civil services and from inadequate personnel regulations. This has been the case in many developing countries in recent years.

The civil services of most of the developing world are characterized by an unsatisfactory level of development of human resources and inadequate resources. Systems theoretically based on competence and experience as criteria for hiring and promotion end up in practice being driven by political needs. In such a context, continuity of tenure becomes more a means of protecting a person from being fired after a change in government than an essential ingredient of a professional civil service. Furthermore, hiring practices that are part of the political patronage system imply that, most of the time, the main remuneration of employees arises from their ability to exploit their position within the administration for personal benefit. There are few places in the public sector where there are greater opportunities for this than in customs administrations.

All this leads to a civil service that is generally perceived as incompetent, inefficient, and corrupt. This, combined with severe budgetary restrictions, often leads to an erosion of the compensation system whereby civil servants' salaries are allowed to deteriorate, until they reach levels that are just too low to recruit and retain skilled, competent, and honest people. In this environment, revenue administrations simply cannot be effective. This is one of the main reasons why

the idea of the separation of revenue administrations from the civil service has gained momentum.

Recent trends toward increased autonomy in developing countries cover several possibilities. At one end of the spectrum, some countries (such as Argentina and Colombia) have chosen to maintain the hierarchical relationship of their revenue administrations within the ministry of finance. At the same time, the agencies have been given increased operational autonomy, specifically control over organization, administration, procedures, enforcement, personnel,¹²⁷ and procurement. At the other end of the spectrum, revenue authorities outside the ministry of finance have been established in a number of countries (such as Peru and Uganda), with the purpose of providing the degree of autonomy that central banks typically enjoy. In some instances (Peru, Venezuela, and Bolivia), financial independence has been provided by assigning a fixed percentage of total collections to cover the operational expenses of the agency. This may be accompanied by a “contract” between the ministry of finance and the revenue agency that defines performance-related allocations of resources, as is the case in Bolivia. A high degree of administrative independence; specific procedures for personnel selection, compensation, and dismissal; and special rules for appointment and dismissal of the head of the service are usually given to these newly created entities.

In the context of the reform of customs and tax administrations that suffer from lack of effectiveness, the different alternatives considered for autonomy aim at achieving essentially the same objectives, namely,

- financial independence—the agency should be able to allocate its budget as it deems appropriate;
- administrative independence—the agency should be capable of formulating its own administrative policies and objectives; and
- independence from the civil service—the agency should be responsible for its own recruitment, salary structure, career path and training, and establishing a code of conduct for its employees.

C. Experience in Selected Countries

Traditionally independent revenue administrations

United States. The Customs and Internal Revenue services have traditionally been part of the Treasury Department, reporting to the Secretary of the

¹²⁷Including the establishment of an independent pay scale different from the common civil service salary structure, at times including the creation of a specific career path for the customs administration.

Treasury,¹²⁸ reflecting the desire to forge close coordination of revenue policy and revenue collection. But much of the authority of the Secretary of the Treasury with respect to the administration of both services has been delegated (through formal documents of delegation that clearly define the area of authority being delegated), so that the services are in practice independent. They have guarded this independence in administering the laws to ensure that tax collection is nonpolitical and that the services are career-oriented.

The terrorist attacks against the United States on September 11, 2001, however, have led to a fundamental repositioning of the Customs Service, which is to be moved out of the Treasury and into the newly created Department of Homeland Security. With combating terrorism now “the No.1 priority of the agency,”¹²⁹ the rationale of this restructuring is to better align the work of customs both with national security concerns and with the work of other organizations with border responsibilities. Though potentially significant in that wider context, this repositioning in itself seems likely to have little effect on—indeed, if anything, it would tend to enhance—the traditional de facto independence enjoyed by the U.S. Customs Service in its revenue-collection function.

New Zealand. The Customs and Inland Revenue departments have responsibilities similar to those of their U.K. counterparts. However, the departments are independent of the Treasury, each reporting to separate ministers who are responsible to Parliament for their operation. The commissioners are appointed by the state services commissioner and are statutorily charged with the overall leadership and operational direction of the departments. The commissioners are autonomous, with certain specific exceptions, and have powers of delegation. There is no involvement of the ministers in the administration of taxes, with respect to decisions relating to individual taxpayers.

United Kingdom. Although the Treasury has the ultimate direction and control of the Boards of Inland Revenue and of Customs and Excise, and has statutory rights to issue instructions, it has no direct role in day-to-day activities—the actual administration of taxes. In that respect, the members of the boards, although they are full-time civil servants, enjoy a considerable degree of independence. The boards have a distinct legal status, as their members are appointed by the Crown and hold positions created by statute, unlike other U.K. civil servants. This status means that the boards exercise some powers and functions that in other departments would be exercised by a minister.

¹²⁸The Treasury Department equates to the Ministry of Finance in other countries and the Secretary to the Minister.

¹²⁹Speech of U.S. Customs Commissioner Robert C. Bonner, August 26, 2002.

Autonomous agencies

Argentina. In 1988, the General Tax Directorate was given autonomy in its organization, administration, personnel, procedures, and control. Similar measures were introduced at the same time in the National Customs Administration. In October 1996, both agencies were merged into an autonomous revenue agency within the Ministry of Economy and Public Works, the Federal Administration of Public Revenue (*Administración Federal de Ingresos Públicos*, AFIP). The General Director of AFIP is appointed by presidential decree and has the authority to organize and regulate the internal functioning of the agency.¹³⁰ Thus, AFIP enjoys a high level of operational autonomy. AFIP is responsible for the administration, collection, and audit of taxes and social security contributions, while tax policy issues are dealt with by the Secretary of Finance. The General Director has considerable autonomy in day-to-day operations and has the overall authority to administer the laws as they relate to specific cases.¹³¹

Bolivia. After several attempts at institutional reform along traditional lines, a new customs law was adopted in August 1999, whereby the customs administration has greater autonomy and is managed by a board approved by congress. The new autonomous customs service is headed by a five-person board, appointed by the executive branch from a list of candidates proposed by Congress. Board members have a five-year tenure and cannot be removed except in cases of grave offenses. The board has considerable autonomy in matters of personnel policy and material resources. The president of the board is appointed by presidential decree and has full authority to organize and regulate the functioning of the agency. A percentage of revenue collection is earmarked to cover operational costs. The law requires that the president of the board reach an annual agreement with the minister of finance on issues such as revenue targets, performance criteria to be met, staff development objectives, etc.; additional resources for the service are contingent on the achievement of these targets. A new career service was created for customs staff, supported by a comprehensive recruitment and training program. In 2002, a law was passed granting a similar organization to the National Tax Service.

Canada. Since confederation in 1867, there has always been a separate revenue department headed by a member of the federal cabinet. The Department of National Revenue was responsible for the collection of federal direct and indirect

¹³⁰Including organizational structure, personnel policy (including the establishment of monetary incentives for productivity to deal with the potential for corruption), hiring, assignment of functions and responsibility, as well as establishing its own procedures for procurement and administrative matters.

¹³¹The tax regulations establish that the Secretary of Finance (equivalent to a deputy minister) and then the Minister are responsible for appeals on certain tax cases.

taxes and social security contributions.¹³² Two organizations, Taxation and Customs and Excise, operated quite distinctly from one another, each under the direction of a deputy minister (the highest level of civil servant in Canada) until 1993, when the two departments were merged. On November 1, 1999, this merger was followed by the creation of the Canada Customs and Revenue Agency to replace the Department of National Revenue. The agency carries out the same functions as the previous department but it also has an enlarged mandate that enables it to enter into agreements directly with the provinces for the administration of their taxes.¹³³ Tax policy, including the setting of rates, is the responsibility of the minister of finance.

Peru. In July 2002, the National Superintendency of Customs (*Superintendencia Nacional de Aduanas*, SUNAD) was merged with the National Superintendency of Tax Administration (*Superintendencia Nacional de Administración Tributaria*, SUNAT). The main goal of this process, which has SUNAT as the incorporating entity, is to consolidate tax administration in one agency in order to facilitate cross-checking through improved information integration. SUNAT continues under the direction and control of the ministry of finance, although in practice the agency is quasi-independent. The head of the agency, who is appointed by presidential decree, enjoys complete independence in the areas assigned to the agency.

Russia. The State Customs Committee, an executive agency of the federal government, manages seven regional directorates, which supervise 140 customs offices. The regional and customs offices, however, enjoy considerable autonomy, being separate agencies with their own current accounts under the federal budget. A number of other customs-related activities are managed by separate agencies that also enjoy autonomy in financial management and human resources. These arrangements appear to have given scope for significant political interference by regional governors.

Spain. In 1991, a new autonomous revenue agency was created, the Tax Administration State Agency (*Agencia Estatal de Administración Tributaria*, AEAT). AEAT is subject to the control of the Ministry of Finance and has responsibility for the administration of all taxes, including customs duties. The creation of AEAT came as a response to perceived problems of inadequate human and material resources.¹³⁴ AEAT enjoys less horizontal control than other centralized agencies in the government and has a considerable degree of discretion in the

¹³²Personal income taxes were also collected on behalf of several provincial governments.

¹³³The Minister of National Revenue is responsible to Parliament for the delivery of the tax, customs, and trade programs. The commissioner of the agency is the chief executive officer responsible for day-to-day operations. There is a board of management responsible for overseeing the organization and management of the agency. The board has 15 members, 11 of whom are nominated by the provinces and territories.

¹³⁴See Yubero (1992).

creation and application of rules for hiring, salaries, and other personnel matters, as well as for handling material resources. At the same time, AEAT enjoys a significant degree of independence in all operational areas. There is no direct involvement of the Minister of Finance in the administration of taxes, nor intervention in decisions relating to individual taxpayers.

Venezuela. In 1994, the Integrated National Service of Tax Administration (*Servicio Nacional Integrado de Administración Tributaria*, SENIAT) was created following, in part, the Peruvian model. SENIAT is a decentralized, public agency, vested with its own financial, administrative, technical, and functional autonomy. Unlike its Peruvian counterpart, however, SENIAT reports to the Ministry of Finance. SENIAT is charged with the administration of internal taxes and, through the Customs Directorate, with the administration of taxes on foreign trade. By law, SENIAT receives between 3 percent and 5 percent of the central government non-oil revenue to cover its expenses. The superintendent (appointed by presidential decree with Parliament's consent), enjoys considerable autonomy in matters of personnel policy and material resources. There is no involvement of the ministry in the administration of taxes and the SENIAT is free to carry out day-to-day operations.

Revenue boards

In certain countries in Africa, the approach to civil service reform has been to separate or “enclave” certain functions of government in the hope of rapidly improving performance. This approach has been applied to tax and customs administrations through the creation of revenue authorities in Ghana in 1985 and Uganda in 1991. (The approach has more recently been introduced in Zambia, Kenya, Tanzania, and Malawi.) The creation of revenue authorities is seen as a means of improving tax collection as it provides the mechanism to address poor management, low pay, and corruption. It is also seen as an expedient way to improve performance of the revenue agencies in the context of a revenue crisis.¹³⁵

Ghana. The National Revenue Secretariat (NRS) was set up independent of the civil service with its own conditions of service and pay, the ability to recruit and dismiss, and control over its own management policies and organization structure. Salaries were raised to a par with the private sector. Fixed revenue targets were established and bonuses were paid for the achievement of the targets. Operational expenses are met from the proceeds of the revenue collected. The secretariat implemented tough sanctions for tax evasion and fraud and enforced them rigorously. However, by the mid-1990s, the NRS no longer

¹³⁵Prior to the adoption of the new approach, collections in Ghana had fallen to about 4.5 percent of GDP. In Uganda, the ratio was about 5 percent.

functioned effectively and internal revenue, VAT, and customs and preventative services were operating independently, each with its own board overseeing operations. At the same time, it had lost much of its independence and had become closely integrated with the Ministry of Finance.

Uganda. The revenue authority was created with many of the same features of the Ghanaian Revenue Secretariat. One major difference was the decision to absorb the entire previous workforce. The intent was to eliminate poor performers at a later date, but this proved to be very difficult, reportedly due to political interference. In fact, as many examples in other countries have shown, this issue—whether the old staff is universally accepted into the new revenue administration or if some selective criteria are applied for the transfer—is one of the key aspects of the reform. Although it is politically sensitive, experience has shown that automatic transfer of all staff into the new administration could seriously undermine the whole reform effort.¹³⁶

The revenue authorities in both Ghana and Uganda were established with high degrees of both operational and hierarchical autonomy. A similar level of autonomy has been granted to the revenue boards recently established or under consideration elsewhere in Africa.

Table 10.1 summarizes the degree of operational and hierarchical autonomy for the countries described in this section.

¹³⁶ The Fiscal Affairs Department's advice is that all current staff should be screened based on objective criteria that include a review of performance and financial asset disclosures. In some countries, this assessment has been contracted out to management consulting firms that have both designed the evaluation criteria and conducted the testing and interviewing.

Table 10.1. Operational and Hierarchical Autonomy for Selected Countries

Selected Countries	Operational Autonomy ¹			Hierarchical Autonomy ²		
	High	Medium	Low	High	Medium	Low
Argentina	X				X	
Australia			X	X		
Bolivia	X			X		
Canada	X			X		
Ghana	X			X		
New Zealand			X	X		
Peru	X			X		
Russia	X			X		
Spain	X			X		
Uganda	X			X		
United Kingdom			X	X		
United States of America			X	X		
Venezuela			X		X	

¹ “Operational autonomy” refers to the degree of independence from normal civil service rules and regulations.

² “Hierarchical autonomy” refers to the degree of independence from political influence in the day-to-day operation of the administration.

D. Summary and Conclusions

Customs administrations will continue to be required to provide service related to both goods and people at border locations, around the clock every day of the year. For this, a modern customs administration needs an organizational structure that balances the assignment of its staff and responsibilities among the different levels—headquarters, regional, and local. Achieving this, and implementing an effective organizational structure, requires both a commitment to change and an ability to do so.

In the context of a major reform of the tax policy and customs administration—including legislative changes oriented toward a simplification of the tax system and general improvements in its efficiency—the degree of administrative autonomy required to support the reform needs to be considered. Increased autonomy can facilitate the separation of tax and customs policymaking from its

administration, and lead to the development of a well-trained and well-motivated customs service. But autonomy will in itself do little to improve performance. It does not automatically solve the problems of a weak customs administration, and may lead to new problems if the newly autonomous administration is not properly accountable for its performance.

The choices of the level of hierarchical autonomy and of the degree of independence from the ministry of finance will, in the end, be conditioned on what can be achieved in practice. It can be argued that complete independence from the ministry of finance may not be desirable, since it can lead to conflicts over the division of power in the area of tax policy, and over the degree of oversight at the highest levels of the revenue authority. It is clear, however, that it is of the utmost importance to preserve day-to-day operations of the customs agency from interference from the political system, be it through the ministry of finance or through the parliament. Unfortunately, there is no sure-fire way to do this: experience in many developing countries has been that autonomy by itself is not enough to prevent political interference. It is only when the highest levels of the government are publicly committed to insulate the revenue administration from direct control by politicians that independence is achieved.

11 Practical Measures to Promote Integrity in Customs Administrations

James T. Walsh

The purpose of this chapter¹³⁷ is to outline an approach to promoting integrity—that is, reducing corruption—in customs administrations. It does not deal with the economic impact of such practices,¹³⁸ but instead provides a framework for changing the incentive structure and for establishing the legal and administrative procedures that are necessary to detect, punish, and reduce such undesirable behavior.¹³⁹

A. Causes of Corruption

In reviewing the causes of corruption, it is important to address not only the overall factors that may lead to corrupt practices but also the specific nature and causes of corruption in customs administrations. General factors include (1) extensive intervention of the government in the economy; (2) cultural norms and practices that influence the behavior of officials; (3) excessive discretionary power in the hands of officials, whether at headquarters level (in the granting of exemptions, for instance) or in local offices (in relation, for example, to the release of shipments); (4) lack of supervision and guidance; (5) lack of accountability; and (6) inadequate control systems. In addition to these general factors, incentives and opportunities to engage in corrupt practices exist far more in customs (and tax) administrations than in many other administrations. Nobody likes to pay taxes. Therefore, some importers and/or their agents will take every opportunity and make every effort to reduce their tax burden, including, if necessary, the bribing of a customs official. In the case of customs

¹³⁷Which draws extensively on Goorman (1993) and Dos Santos (1995).

¹³⁸On this, see, for example, the survey by Bardhan (1997) and collection of articles in Abed and Gupta (2002).

¹³⁹In 1993, at the annual meeting of the World Customs Organization in Arusha, Tanzania, the delegates agreed on a code related to integrity within customs administrations. It is known as the Arusha Declaration and it lists 12 steps that can be taken by a customs administration to address corruption or assist in detecting it. The recommendations in this paper are consistent with the code.

transactions, the incentive goes beyond just the desire to reduce the tax burden, as the importer is also interested in obtaining the goods as quickly as possible; this places the customs official in a strong position to extract bribes in order to “facilitate” their release.

The most important factors conducive to a lack of integrity in the customs administration of duties and taxes include the following:

- Complex and restrictive tax and foreign trade systems that lead to rent seeking and corrupt behavior. There is often a lack of information that allows importers and exporters to determine their liability and comply voluntarily with the law. Without this information and with complex rules, importers and exporters may have no choice but to meet with an official to seek an explanation or the exercise of the discretionary power that the official may possess.
- High tax and tariff rates. The higher the tax rates, the greater the incentive to engage in corrupt practices to reduce this burden. A dramatic example of this is in the area of high excise duties, particularly on tobacco and alcohol, where organized crime is involved in the bribery of revenue officials, resulting in widespread illegal production and smuggling of these goods. As noted in Chapter 1, the sums at stake can be huge, especially in relation to customs officers’ salaries. For instance, one Fiscal Affairs Department (FAD) mission found that on a container of vodka valued at US\$48,000, the combined import duty, VAT, and excise payments came to US\$172,000—about 15 times the annual salary of a customs officer.
- Exemptions. In addition to exemptions that are provided for in the law, discretionary exemptions that can be granted by the ministers and/or the head of the customs administration create the opportunity to engage in corrupt practices. They undermine the fairness of the system and may create, in the mind of the importers who are paying the duties and taxes, a doubt about the reasonableness of continuing to comply.
- Complex and bureaucratic procedures. Instead of making it easy for importers and exporters to voluntarily comply and pay taxes, multiple forms and steps are often introduced that require stops at many desks and visits to many offices—each one potentially associated with the payment of speed-money or some other illicit fee to facilitate processing.
- Weak control systems. Too little attention is paid to the implementation of systems that make it difficult for officials to engage in corrupt practices. Individuals take into account the perceived threat of being detected when they decide to engage in corrupt practices and, if the risk is low, many more will be willing to take the risk.
- Lack of effective disciplinary measures. Sanctions are an important factor in deterring corrupt behavior. If the penalties are not severe enough and applied

each time inappropriate behavior is detected, they will not be effective in reducing corruption.

- Lack of professionalism. Too often employment in customs administrations is seen as an opportunity to work for a short period of time to enrich oneself and not as a long-term professional career.

B. Building a System to Promote Integrity

Building a system to promote integrity in customs administration requires not only the effort to put in place the necessary measures to combat corruption but also ongoing vigilance to ensure that the measures continue to operate as intended. Even in those countries that are considered to have the most efficient and honest administrations, considerable effort is still invested to ensure that the controls continue to operate and that corrupt behavior is detected and dealt with. Honest behavior by customs officials cannot be taken for granted: even in countries with generally low tax and tariff rates, criminals involved in drug smuggling have the ability to pay large amounts of money to a customs officer to allow a shipment to proceed without inspection.

In order to deal effectively with corruption, at the outset there must be a commitment from the government to address the problem. This goes beyond mere statements that corruption will not be tolerated to the actual actions of ministers and other high-ranking government officials. Too often these officials believe and act as if they are above the law and demand special treatment from customs officials (e.g., proceeding through customs without paying duty). Given this atmosphere, a government cannot, in all honesty, expect a customs officer to collect duties and taxes from every other importer. Once the commitment has been made, there are certain essential actions that must be undertaken to build a system that has integrity and that will produce the returns expected by the government. Most of these involve designing measures to reduce the incentives and opportunities to engage in corrupt practices and, at the same time, creating organizations that are interested in and committed to doing a good job. In one small African country, as part of their customs reform program, small incentives were introduced to enhance officers' pay. At the same time, actions were initiated to identify and discipline corrupt staff. The message was clear: the government was willing to invest in modernization, including better pay, but it expected officers to behave in a certain manner in return.

A clear and well-understood policy framework

Simplification of the tax and tariff system (such as reducing the number of rates to the minimum and restricting exemptions) is not only good economic policy but it also reduces opportunities for corruption. From a customs officer's point of view, simple, clear legislation creates the framework for the development of

systems and procedures that are easily understood by both the trade community and officials. This policy framework should be based on the following principles:

A small number of rates. Rationalization of tax and tariff rates and clear definitions of how and when different rates apply reduce the need for interpretation by officials. In turn, this reduces the need for face-to-face negotiations that may result in the exchange of money for a favorable ruling.

Low rates. If it is generally perceived that the system is fair, which means, among other things, that the tariff rates are reasonable, there is less incentive to become involved in fraudulent activities.

Minimal exemptions. While it is virtually impossible to eliminate all exemptions, customs and tax legislation should be written to include exemptions in the law and to eliminate the discretionary power of ministers or government officials to grant exemptions.

Minimal exercise of discretion. For the majority of transactions with the customs administration, it should be possible for the importer to understand the law and to meet the procedural requirements (especially if the importer is able to submit the information electronically). There should be little room for the exercise of discretion by the customs officer.

Minimal nontariff barriers to foreign trade. The need for numerous approvals for foreign trade licenses, and multiagency authorization to import and export, creates the opportunity and incentive to engage in corrupt practices.

Effective penalty system. A good penalty system should provide the administration with the ability to impose administrative penalties for minor offenses. This may include fines, for example, for exceeding the time allowed for completing a transit shipment and presentation of declarations with an unacceptable number of errors. It is not enough, however, for stiff penalties to be provided for in the legislation; they must also, where appropriate, be applied—and seen to be applied. This may seem (and is) obvious, yet in many countries what appear to be quite strong penalties are rarely (and sometimes never) enforced.

An independent appeal mechanism. Every tariff and tax law, no matter how well written and detailed, is capable of being interpreted differently. In order to preserve the independence of the officials and the integrity of the system, it is

important that importers have the ability to challenge decisions and be assured of a fair and equitable hearing and that decisions be widely publicized.¹⁴⁰

In addition to a clear and simple policy framework, there is also the need to separate the setting of policy from its administration. Policymakers should engage in whatever dialogue is necessary during the design of the policy and the drafting of legislation, including discussions with the trade community. However, once the policy has been established and provided for in the law, there must be a clear separation between the policymakers and the officials. It must be clear that the law, as interpreted by the officials, will be applied and that it is not possible to obtain more favorable treatment through the influence of the policymakers. It should not be the responsibility of senior policymakers or ministers to review and rule on individual cases. Among others, the customs administrations in the United States and the United Kingdom have clearly established rules supporting this separation of responsibilities.

Transparent procedures

It is the responsibility of customs officials to put in place simple, easily understood systems and procedures. Such procedures reduce (1) compliance costs for the importers and exporters, (2) opportunities for corruption, and (3) costs of administration.

The most important principle in the design of simple, straightforward customs procedures is self-assessment. Importers should determine their duty and tax liabilities and, based on their understanding of the law, present to the customs administration a declaration that includes a calculation of the amounts owed. This must be supported by documentation and information as requested by the administration and is, of course, subject to verification, either at the time of presentation or later through post-release verification. To be effective, and to reduce the opportunities for corruption, the self-declaration system should be based on the following:

One-step process. A customs declaration should be lodged at the reception counter of the customs office and the paperwork processed by the administration with no further need for personal contact, until the processing has been completed.

Minimal information and documentation requirement. Customs administrations must define their information and documentation needs in a way that minimizes the administrative requirements for importers and exporters. For example, the customs declaration can be used for multiple purposes

¹⁴⁰In many countries, tax cases can be appealed to a separate tax or tariff tribunal where the adjudicators have specialized knowledge of the tax laws.

(e.g., calculation and payment of duties and taxes and preparation of foreign trade statistics).

Consistent interpretations. Importers can only be expected to self-declare their liabilities in an environment where the interpretation of the laws is consistent and procedures are standardized, with each transaction treated in the same way as the previous one.

Computerization. The introduction of computerized support for the processing of customs declarations, perhaps more than any other change, provides the opportunity to implement standardized procedures that leave little need for face-to-face contact or opportunity for the use of discretion of officials. A properly designed system ensures that (1) the correct rates of duties and taxes are applied; (2) exemptions are only granted to authorized organizations and for authorized goods and services; (3) the required information and documentation is presented; (4) time frames for payment are met; and (5) those who do not comply with filing and payment time frames are identified and follow-up action is taken. In addition, the system can provide useful management information, including, for example, identifying transactions that do not meet time standards for processing or individual officers who undertake actions that are out of the ordinary (e.g., physically inspecting too many shipments).

Professional customs administrations

Experience in developed countries has shown that the best way of ensuring fairness and neutrality in the administration of the customs system is to develop a professional administration with clearly defined responsibilities and accountability for performance. The development of a professional customs administration is important, not only to improve the effectiveness of the administration, but, at the same time, to address issues of corruption. Too often, governments are unwilling to provide authority to the administration to enforce the laws or to invest the resources necessary to build and provide ongoing support for efficient and effective administration. A professional customs administration includes the following:

Professional management. It is important that the customs administrations include skilled, knowledgeable supervisors and managers. This is not always the case. A further problem is that senior officials in the administrations often change as governments change, and individuals with little or no knowledge of legislation, regulations, systems, and procedures are put in charge of collecting revenue. In these circumstances, staff may perceive that they have limited career opportunities in the organization and little, if any, “loyalty” to the organization and, consequently, may be more open to corruption. For those who join a customs organization for the term of a new government, working in that organization may be seen as a reward for past favors and an opportunity to

enrich themselves through the provision of exemptions and other concessions to the business community.

Management controls are an essential component of well-run customs administrations. These include a clear statement of goals and objectives; well-documented operating procedures; supervision of day-to-day activities; and a regular review of the performance of employees. Management should also consider the results of its internal audits, feedback from importers and exporters, and the views of its employees in evaluating the operations of an office.

Appropriate compensation and working conditions. Customs officials must be provided with sufficient compensation to reduce the incentive to engage in corrupt practices. While civil service pay can never be at a level that will discourage all corrupt behavior (e.g., there are many reported cases of well-paid customs officers in developed countries who have accepted tens of thousands of dollars to allow a shipment of drugs to pass through the border), compensation can be set at a level that provides a good standard of living and eliminates the need to accept “facilitation fees.” In recognition that it may not be possible to address low civil service pay in general, some countries have implemented special pay scales and incentives for staff in revenue agencies. As stressed in the preceding chapter, adequate pay will not by itself ensure that there is no corruption in a customs administration. Nevertheless, if the pay provides an adequate standard of living, the administration can expect the officer to do a good job and not to solicit extra payments from the taxpaying public.

Some countries have sought to encourage honesty and diligence in tax officers by providing bonuses related to the amount of tax they collect. The difficulty with this is that, especially where appeal processes are weak, this provides unscrupulous officials with an incentive to exaggerate tax due. If bonuses are to be used, they should be targeted not merely—and perhaps not at all—on revenue collection, but on other aspects of performance, such as quality of service provided to taxpayers and adaptability to change.

Appropriate working conditions are also important. These include proper office space, equipment (telephones, computers, transportation, and so on), and supplies. The administration should not have to rely on importers, exporters, or their agents to provide any facilities or equipment, which could imply that a favor is expected in return.

Staff rotation and annual leave. Any regulatory agency is better able to carry out its functions in an impartial manner if it remains at arm’s length from those it is charged with regulating. Revenue agencies are no different. Accordingly, it is important that staff rotations take place on a regular basis to reduce opportunities for collusion. Similarly, all staff and, in particular, managers and supervisors, should be required to take their annual leave (so as to reduce the

chance of excessively close relations emerging undetected). Relief managers should then be placed in their positions.

Training. Staff training is crucial to the development of professional customs administrations. In this regard, it is important that a careful analysis of the needs of both the organization and its staff be completed to ensure that the training matches their needs. Too often, new legislation and procedures are introduced with inadequate attention given to the training needs of staff. In addition to improving technical skills, training can also serve to build team spirit and an awareness of the need for responsibility and loyalty to the organization, thereby promoting integrity.

Merit-based promotions. An important part of establishing a professional administration is a clearly defined career path and promotion policy that is based on merit. Each individual must feel that there is an opportunity, based on hard work, to advance and that to engage in inappropriate behavior may jeopardize this opportunity (and lead to dismissal in serious cases). Customs administrations should not be seen as places to exercise political patronage and reward party loyalists.

Recruitment. As part of the plan to develop professional administrations, it is important that the personnel requirements be clearly defined, including the education and experience of those being hired. Revenue administrations, because of restrictive civil service rules, are often unable to hire people with the skills required to carry out specialists' tasks.

Separation of responsibilities. The creation of an organizational structure in which the key functions for the tax administration—such as assessment, collection, and audit—are separated across distinct departments is one of the most effective ways of combating corruption.¹⁴¹ Too often, individual officers are assigned responsibility for all activities related to an importer or exporter. This invites collusion and the granting of favors. Through the separation of responsibilities, checks and balances are built into the system. For example, the processing of a customs declaration and physical inspection of goods, when carried out by different officers, can reduce the opportunity to influence decisions, such as the tariff classification and valuation of goods.

Complaint monitoring. Administrations should establish a special unit for the receipt of complaints concerning the performance of officials.

¹⁴¹Ebrill and others (2001) discuss the relative merits of functional and other organizational structures for tax administration—mainly with respect to the VAT, but the essential points apply also to customs.

Performance standards.¹⁴² Building on a base that includes transparent legislation and clearly articulated, simple procedures, customs administrations should put in place performance standards that enable policymakers, management, and the public to measure how well an administration is performing. This has several advantages. First, it enables policymakers, including ministers, to hold heads of administrations accountable, if standards are not met. Second, it enables management to measure the performance of offices and individuals and to identify potential problems. Third, it makes very clear to the employees that there are expectations and that their performance will be measured against these expectations. Fourth, the public is made aware of what is expected and, therefore, should be willing and encouraged to bring to the attention of management cases where the standards have not been met.

Too often, the only performance standard established for the administrations is the requirement to meet certain revenue targets. This is not enough, particularly if corruption is a problem. The most corrupt revenue administration in the world may, over the short term, be able to meet revenue targets. However, this may do little to ensure that the law is applied in the same manner to all taxpayers and that the collection of expected revenue from new policy initiatives will be achieved. Performance standards in revenue administrations should include the following:

Service standards. These should be clearly articulated standards for the various functions that are to be performed. For importers, it is very important that they know the time that the goods will be under customs control, as this can significantly affect estimates of inventory requirements. By establishing service standards (e.g., for the release of goods) and making them known to staff and to importers and exporters, an administration can establish monitoring mechanisms to identify transactions, offices, and officers that do not meet the required standards. Reports from the monitoring system may also help to identify areas that should be investigated for potential corrupt practices.

Code of conduct. It is important that employees and importers and exporters be aware of the conduct that is expected of both parties. By clearly articulating expectations, customs administrations can hold employees accountable for performance and take appropriate action when these standards are not met. Many administrations publish a “code of conduct” with these expectations.¹⁴³ For such a code to be effective, it must also include a description of the disciplinary actions that will be taken if unacceptable behavior is discovered and disciplinary action must be taken on a regular, consistent basis. The political and social context of a particular country is important in establishing the rules for

¹⁴²Crotty (1996) provides a detailed account of performance standards.

¹⁴³Some customs administrations also issue a “code of ethics” (sometimes called a customs “charter”) that sets out not only what traders can expect from them, but also what they expect from traders, such as honesty and the prompt production of complete and accurate information.

acceptable conduct, and the rules guiding participation of tax and customs officials in activities outside their official responsibilities will vary from country to country. However, the code should normally include standards concerning the following:

- **Maintaining integrity.** The acceptance of gifts, favors, or benefits to influence decisions is not permitted. Disciplinary action up to and including dismissal is normally taken in cases where employees accept a gift of any significant value.
- **Confidentiality of information.** Information from customs declarations as well as that obtained from post-release reviews is confidential and, as such, must not be used by employees nor disclosed in an unauthorized manner.
- **Conflict of interest.** Employees are normally prohibited from engaging in activities that are in clear conflict with their official position. For example, a customs officer would not be permitted to own a customs brokerage business or to engage in any business that involves extensive import and export activities. Many administrations also have a requirement that employees disclose their assets at the time of hiring and update this information on a regular basis so their managers can detect, at an early stage, that an employee has accrued assets inconsistent with the level of compensation received by the employee.
- **Appearance and conduct.** Standards for appearance and conduct normally include observing the hours of duty; dressing appropriately; dealing courteously with the taxpaying public; refraining from the use of intoxicants in the workplace; and using government equipment, including vehicles, only for business purposes.

Effective internal audit

While it is the overall responsibility of management to monitor performance and to ensure that operational policies are being followed and performance standards are being met, this must be supplemented by effective internal audit. Usually, the internal audit department reports to the head of the administration and is responsible for carrying out regular reviews of all operations in the organization. It is often the internal auditors in customs administrations who are the first to detect instances of corruption when reviewing compliance with procedures.¹⁴⁴ Serious cases of corruption, involving violations of the law, are usually turned over to law enforcement officials for criminal prosecution. Internal audit activities normally include the following:

¹⁴⁴In some administrations, there is also a separate Internal Affairs department that is responsible for dealing with specific cases of alleged corruption, such as the misappropriation of funds. If management or internal audit uncovers cases of corruption, they are turned over to this organization.

Compliance with operational procedures. Based on clearly defined procedures usually laid out in manuals or procedure guides, an auditor reviews the actual operation of the customs offices. This might include, for example, reviews of declaration processing and procedures for the selection of shipments for physical inspection.

Expenditure/use of government funds/assets. There are opportunities in the administration of large government departments to misappropriate funds and it is one of the roles of internal audit to review activities related, for example, to the purchasing of supplies, awarding of contracts, and the hiring of personnel. (Some countries, for instance, have a serious problem with nonexistent “ghost workers” appearing on the payroll.)

Administrative autonomy

As discussed in the previous chapter, one strategy that a number of countries have adopted in recent years has been to increase the autonomy of the customs administration. While there are a number of alternatives to providing greater autonomy, most share the following common features: (1) a degree of financial independence, in the sense that the administrations are able to allocate budget funds as they deem appropriate; (2) administrative independence, meaning that the administrations are provided with the authority to formulate their own administrative policies and objectives; and (3) independence from general civil service requirements, meaning that the administrations are responsible for their own recruitment, salary structure, career path and training, and establishing performance standards and codes of conduct.

Given appropriate checks and balances on such customs administrations and the willingness of the government not to interfere in day-to-day operations, increased autonomy may be effective in putting in place measures to increase integrity and combat corruption.

C. Other Important Considerations

There are other very important considerations that can affect the ability of customs administrations to build organizations based on integrity and to battle against corruption. These relate very much to the culture and history of a particular country and can greatly influence efforts to put in place measures of the kind outlined in this chapter.

Are traders comfortable entering a dialogue with the customs administration?

The seeking of information and entering into a reasonable dialogue with the trade community on the interpretation of legislation and procedures are

important features of a good customs system. Too often, however, this does not happen and it can be very difficult to foster. Foreign-owned companies that may be familiar with this approach in their own countries may be reluctant to enter into discussions on issues of interpretation of the law in a country where corruption is widespread, for fear that they may be asked for a bribe (which, under the laws in their home country, they are required to report).¹⁴⁵ They may often prefer to pay a fee to a middleman to intercede on their behalf and not request a detailed explanation of how the fee is used.

Is the judiciary independent?

Many customs-related decisions end up in court. It may be possible to create professional, honest customs administrations, but their work to ensure compliance with the revenue laws can lose much of its impact if the judicial system is corrupt. In the worst cases, the courts may overturn sound decisions made on the interpretation of customs legislation, criminal prosecutions for fraud, and prosecutions of corrupt employees.

Is there a free press?

It is often the media that exposes corruption in government. It has a crucial role to play in questioning some of the decisions that are made at the highest level (in the granting of exemptions, for instance) and in exposing corruption in local offices.

In the absence of a broader political and social environment that encourages interaction with the administrations, an independent judiciary, and freedom of the press, it is very difficult to sustain the benefits of implementing an honest customs administration. That is not to say that changes of the kind discussed in this chapter should not be implemented, but there must be a recognition that their impact will not be as far reaching.

D. Conclusion

It is clear that there is no easy or quick solution to the problem of establishing integrity in customs administrations. What is needed is a comprehensive approach, putting in place the range of required measures and ensuring that they operate effectively. These include a clear, well-understood policy framework; simple, transparent procedures; a professional customs administration; performance standards; performance-related pay; a strongly enforced code of conduct; effective internal audit; and freedom from political interference. In

¹⁴⁵Under U.S. anticorruption legislation, for instance, it is an offense to bribe foreigners in a foreign country.

support of these elements, there should also be an atmosphere that encourages members of the trade community to come forward and discuss issues with the administration; an independent, honest judicial system; and a press that is interested, able, and allowed to raise issues of corruption.

The Role of the Private Sector in Customs Administration

James T. Walsh

Many governments in developing and transition countries have engaged the private sector to provide certain services that have traditionally been the responsibility of the customs administration. This option is often seen as a way to address corruption, as well as to combat smuggling and improve customs revenue collections more generally.

A. Traditional Private Sector Support for Customs Administrations

Traditionally, the uses made of the private sector in administering customs include the operation of customs warehouses, the use of approved and/or licensed customs agents or brokers, customs-approved/licensed duty-free shops, and customs-bonded transportation operators. Customs administrations, like other public sector institutions, also often use banks to provide cashiering services and other private firms for computer systems development, operations, and maintenance services (such as cleaning). The private sector is also used by some customs administrations to provide laboratory analysis. The focus here is on its role in operational aspects of customs work.

B. Import Verification Programs

The use of the private sector in direct customs operational activities has been largely restricted to developing countries and countries in transition, where there are significant problems of corruption and/or lack of capacity, or in post-conflict countries where there has been a need to implement quickly a customs administration following the cessation of hostilities. The types of programs that have been implemented include investigations and intelligence operations supported by antismuggling teams headed by experienced foreign customs officers; the outsourcing of the management of the customs administration;

Box 12.1. Import Verification Programs

In the past several years, various programs have been implemented using the private sector to assist with verification of quantity, quality, value, and tariff classification of imports. In addition to PSI, discussed separately below, these include the following:

Investigations and intelligence operations. In the mid-1990s in Latvia and in 2001 in Bulgaria, a private sector company provided support for the development and implementation of customs intelligence and investigations that was designed to combat smuggling. The key component of the programs was the creation of antismuggling teams led by experienced foreign customs officers. In addition, the programs provided for the development of intelligence to be used to assess risk—identifying importers, exporters, transportation companies, routes, and so on, that posed the greatest threats—supported by a computerized system. The foreign customs officers worked with local counterparts, in order to increase the capacity of the customs administration to continue with this type of activity when the contract was completed.

Outsourcing the management of the customs administration. In Mozambique (1996) and Angola (2001), the management of the customs administration was outsourced. The company responsible for the management of the customs administration employs large numbers of experienced foreign customs officers to staff key positions within the administrations. The projects are designed to introduce the legislative changes necessary to support a modern customs administration, develop systems and procedures that support effective revenue collection, address issues of smuggling and fraud, and develop and implement computer systems to support import and export declaration processing and risk analysis. The programs also include capacity-building measures designed to ensure that the local customs administration is able to regain its full range of responsibilities in the future. Programs of this type may be appropriate for a period of time in certain post-conflict countries where taxes on imports make a significant contribution to total revenue and where it will take considerable time to build capacity to manage the customs administration effectively.

Destination inspection. This is a new concept that is fully operational in one country, Ghana. Like PSI, this program uses resources of private sector companies to certify the value and tariff classification of the goods to be imported and to determine the duties and taxes payable prior to the importation of the goods. The major difference is that physical inspections are carried out on a risk-based selective approach in the country of importation. Inspections are conducted jointly by the private sector company and the customs administration. In Ghana, it has beneficial features including sending customs administration staff to the inspection companies to undertake the valuation and tariff classification of the importations under the supervision of inspection company staff. These determinations are based on information from the overseas affiliates of the inspection companies that conduct the preliminary investigation of the value and tariff classification who send the information to their office in the country of importation for final determination. It also includes the use of an x-ray scanner for containers, although this is not a necessary part of a destination inspection program.

destination inspection; and the widely used preshipment inspection (PSI) program, which over the past 25 years has been implemented in more than 40 countries worldwide. Box 12.1 describes the first three of these programs—PSI is discussed in more detail later in this chapter.¹⁴⁶

¹⁴⁶In addition to these private sector programs, bilateral donors have financed the recruitment of senior foreign customs officials to assume senior line positions (including head of the administration) in a number of countries; the U.K. development agency, for instance, has financed such programs in Malawi, Zambia, and Uganda.

Implementation of a contract with the private sector to undertake certain operations in the customs administration can be very expensive: PSI contracts, for example, typically cost between 0.75 percent and 1 percent of the value of the goods inspected. In addition, experience indicates that most governments that enter into such contracts do not reduce the costs associated with customs administration. Therefore, the cost is added to ongoing operating costs and, as a result, there must be real, measurable benefits to ensure that the investment is worthwhile.

As countries consider the option of contracting out certain traditional customs operations to the private sector, they need to consider carefully whether the government and the customs administration can manage the implementation of the necessary reforms on their own. In other words, would the several million dollars or so that it would cost to engage the private sector achieve the same or better results if it were, instead, invested directly in the customs administration?

Typically, private sector offerings include components that are not available readily in the customs administration (e.g., to address undervaluation, the administration needs access to pricing information and this can be acquired from private sector companies). Similarly, risk-assessment and risk-profiling methodologies can also be acquired. If the administration does not have the information technology support that it needs, in the short term, support can be obtained from the private sector.

C. Preshipment Inspection

PSI programs are offered by a number of companies and are used by more than 40 countries all over the world: Box 12.2 lists the countries that have contracted for such services (as of November 2000).

The objectives and priorities of PSI programs have evolved over time and they vary among governments. In the early 1960s, PSI programs were used almost exclusively to address issues of capital flight (by preventing overvaluation of imports). In more recent years, as trade has been liberalized and exchange controls have been removed, the emphasis of PSI programs has been shifting toward revenue issues. Today, the key objectives of PSI programs are to detect false invoicing (over- and underinvoicing); provide governments with accurate information on importers' activities and tax liabilities; and, in some cases, verify the appropriate use of donor funds provided for import support.

**Box 12.2. Countries with Preshipment Inspection Program Contracts
(as of November 2000)**

Africa

Angola, Benin, Burkina Faso, Burundi, Cameroon, Central African Republic, Comoros, Congo, Côte d'Ivoire, Democratic Republic of Congo, Ethiopia, Gambia, Ghana, Guinea, Kenya, Liberia, Madagascar, Malawi, Mali, Mauritania, Mozambique, Niger, Nigeria, Rwanda, Senegal, Sierra Leone, Tanzania, Togo, Uganda, and Zanzibar.

Latin America

Argentina, Bolivia, Ecuador, Mexico, and Peru.

Middle East

Iran.

Asia

Bangladesh and Cambodia.

Former Soviet Union

Georgia, Moldova, and Uzbekistan.

Main features of PSI programs

Goods are inspected by the PSI company in the country of export before they are shipped to the country of destination, in order to verify that the price paid by the importer is reasonable and that the goods conform with the specifications of the contract (quality and quantity). Price verification focuses on the declared invoice price of the goods, comparing this with “the price(s) of identical or similar goods offered for export from the same country of exportation at or about the same time.”¹⁴⁷ PSI programs typically cover all imports, with some notable exceptions. Most programs specify a threshold value (such as US\$3,000), below which goods are not required to be inspected. Certain categories of goods (such as newspapers, diplomatic goods, personal effects, and fresh produce) also may be excluded from inspection.¹⁴⁸ Most of the recently implemented PSI

¹⁴⁷Article 2.2b of the WTO Uruguay Round Agreement on PSI. For WTO members, the price verification rules in a PSI agreement must conform with WTO valuation rules (discussed in Chapter 6).

¹⁴⁸There are also examples of contracts in certain countries with much more extensive lists of goods that are not required to be inspected (e.g., government importations, exempt goods, and goods to be further manufactured).

programs are comprehensive, in that they include verification of value, determination of tariff classification, computation of the duties and taxes to be paid by the importer, and reconciliation of the PSI documentation with import declarations and duty payments.

Costs for the PSI service may be borne by the government or the importer. As mentioned earlier, these costs are typically around 1 percent of the f.o.b. value of the goods inspected, with a minimum inspection fee (around US\$250 per inspection). The role of the customs administration in countries with a PSI program is to control goods that are not subject to inspection and to ensure that the laws and procedures related to PSI are applied.

Views on PSI

Proponents of PSI see it as a means of deterring fraud in international trade. As nearly all developing countries suspect suppliers, importers, and multinationals of manipulating invoice prices to the detriment of their economy and revenue collections, the fee is judged to be well justified.

Detractors of PSI are of the opinion that physical inspections by PSI companies create delays and generate additional costs for both exporters and importers. They argue that substitution of goods can easily occur after inspection, due to the difficulty of totally sealing all consignments. The discretion given to PSI companies to dictate quality standards and the obligation on the part of exporters to entrust commercially sensitive pricing information to PSI agencies are perceived by some as an unnecessary intrusion into commercial dealings and confidentiality. It has been argued that the hard currency required to pay for PSI services is a scarce resource that could be better spent elsewhere. Perhaps most fundamentally, some argue that the use of PSI agencies is an admission of failure on the part of the government in its attempts to police and reform a corrupt customs administration. This is indeed a risk unless a clear exit strategy is in place for building up a strong domestic customs capacity to take over, within the foreseeable future, from the PSI company.

It is difficult to quantify performance results of PSI programs and to take at face value results reported by PSI companies on foreign exchange and revenue savings. It is virtually impossible to determine the weight to be assigned to the individual elements of PSI programs, since governments often are undertaking other reforms at the same time. For example, a number of years ago, Indonesia and Peru experienced significant improvements in revenue collections shortly after PSI schemes were introduced; but government officials in those countries could not determine with precision how much was attributable to any particular aspect of the broad customs reform package. It is important to note that the inspection of cargo in the country of export does not solve, in and of itself, the

problem of an ineffective and/or corrupt customs administration in the country of import.¹⁴⁹ In addition, the implementation of PSI contracts may not always have been undertaken in the best interests of the country, as the awarding of certain contracts has not been transparent (awarded on the basis of public tenders) and has resulted in corrupt practices by government officials and PSI companies.

In a comprehensive study for the World Bank, Low (1995) found that the effects of PSI have often been disappointing, particularly on the revenue side. This reflects a lack of serious monitoring and follow-up of information generated by the inspections, with the implication that “governments that contract PSI services should use them to greater effect than appears to have been the case to date in many countries.”¹⁵⁰

The World Customs Organization (WCO) has also taken a dim view of PSI, concluding from a review of PSI in 1994 that it did not provide value for money, with any additional revenues gained lower than the costs. Moreover, it was felt that PSI had a detrimental effect on the long-term development of the local customs administration.

In October 1994, the United Nations Conference on Trade and Development (UNCTAD) conducted an international symposium on trade efficiency in Columbus, Ohio, in the United States, where a Ministerial Declaration covering trade practices was adopted. In relation to PSI, it made the following recommendation:

While recourse to the services of preshipment inspection agencies to carry out customs-related activities might be a necessity in certain circumstances, this should be regarded as an interim measure, and governments should avoid long-term use of such services. Where appropriate, governments should initiate customs reform programs aimed at enhancing the efficiency and effectiveness of their customs services, thereby avoiding the need to use the services of PSI agencies.

A common criticism of PSI operations is that there is no arrangement for monitoring and auditing PSI firms.¹⁵¹ Nor are there always assurances of the transfer of skills to local customs administrators. It is sometimes the case that PSI companies operate for long periods of time with the result that the needed

¹⁴⁹The passage of a law to implement PSI and the signing of a contract for the services will not deter unscrupulous importers from bribing customs officers to allow goods into a country without the required inspection. It will also not prevent outright smuggling.

¹⁵⁰Low (1995).

¹⁵¹The program in Argentina, which began in November 1997 (and was terminated in 2001), included the appointment of independent auditors to review a sample of the PSI companies' reports of findings.

buildup of local administrative capacity is delayed or frustrated. Of course, there is little incentive for PSI companies to assist in the reform of the customs administration if it means that their contracts may not be renewed.

Lessons from experience

Any government considering PSI should understand the program's strengths and weaknesses, with special consideration given to the following potential problems:

- PSI cannot provide protection against all threats facing a customs administration. Smuggling will continue and other fraud can be undertaken, for example, through bonded warehouses, free economic zones, and duty-free shops.
- There could be a shift in the types of fraud away from the ones for which PSI is designed to deter toward those beyond the reach of PSI. For example, importers might claim exemption from PSI by declaring the value of their goods below the inspection threshold. In many countries, it has been found that importers split shipments to avoid inspection. With a threshold of US\$3,000, for example, goods worth \$9,000 might instead be shipped as three consignments, each falling below the threshold. "Household goods and personal effects" can become a camouflage declaration to escape inspection, as can humanitarian aid, parcel post, samples, and other exempt items.
- The customs administration must avoid becoming too dependent on PSI. For example, staff may see little incentive to acquire the skills required for customs valuation if they perceive that all the valuation work is being carried out by the PSI company.
- Experience shows that the inspection undertaken by a PSI company is no guarantee that the goods arriving in the country are the same ones reported in the PSI inspection certificate. Many techniques have been employed to circumvent these inspections. Container seals have been tampered with and containers have been opened after being sealed without breaking the seals. Goods have been substituted or goods added after the departure of the inspectors from the premises of the shipper.
- For many imports, physical inspection at the port of exportation may not be the most appropriate way of preventing undervaluation. When the nature of the product being imported is clear from the documents presented to the inspection company, a physical inspection is not necessary for the proper valuation of the goods.

Experience suggests that the following are critical to the success of PSI arrangements:

- The option of introducing PSI should never be considered in isolation. Instead, it should be integrated into an overall strategy for the reform and modernization of a customs administration. In particular, there must be careful delineation of the functions to be performed by the PSI company and those that remain the responsibility of the customs administration.
- The comprehensive customs reform package should address (1) updating legislation; (2) harmonizing duty rates; (3) simplifying procedures supported by computerization; and (4) introducing controls based on risk and post-release controls. The reform program should include organizational issues, raising ethical standards, and developing effective human resource strategies, including training plans. The expected role of the PSI company in assisting with training and skills transfer should be clearly set out and monitored throughout the life of the contract.
- The detailed specification of services to be provided by the PSI company is a crucial step and the following provisions should be included in a contract:
 - A fixed term of—say—two or three years. This provides enough time for the reform measures to be developed and implemented.
 - Clear definition of the goods to be inspected, including the threshold for inspections, prohibition on the splitting of shipments, and goods that are exempt (e.g., household effects, postal shipments, etc.).
 - Supply of pricing information to the customs administration, ideally through access to a database of prices.
 - Systematic reconciliation of PSI inspection reports against customs declarations and payments.
 - Measurable performance criteria that will enable the government to assess whether the contract is being fulfilled and providing value for money. It is important here to set performance standards (such as response times for completion of physical inspections and the time within which the inspection report will be produced), with specified penalties (such as withholding the PSI company's fees) for failure to meet them.
 - Contract commencement accompanied by a publicity campaign to alert the trading community.
 - Full briefing of the customs administration concerning the contract terms and conditions and the scope of the program.
 - Clear specification of proposed methods of skills transfer from the PSI company to the customs administration.
 - Regular and timely reports from the PSI company including the number of shipments inspected, irregularities uncovered, value of

uplifts,¹⁵² complaints lodged, appeals against decisions, and other benefits derived by the government (training provided to customs staff, technology transfer, and the like).

- There is a need for full cooperation between the PSI company and the customs administration, which will happen only if there is high-level (political and administrative) support for both the PSI program and customs reform, including clearly defined roles for both organizations. In many countries, this has proved very difficult to achieve when the customs administrations feel threatened and have been given little incentive to cooperate.
- The creation of a PSI steering group can do much to ensure that the PSI contract is properly managed and performance standards are adhered to. Any tensions that arise between the PSI company and the customs administration can be quickly resolved.
- There should be an anticipated end date to the PSI service and an exit strategy whereby functions can be returned to the customs administration (assuming success has been achieved in implementing the customs reform program). The critical path leading to this return should be clearly mapped out and progress monitored.
- An evaluation of the performance of the customs administration should be conducted regularly after the PSI program has been completed to determine if there is a need to reintroduce PSI for some or all of the goods that were previously covered.

Emerging trends in PSI

Over time, there have been changes in the ways some countries have made use of PSI services. A number of governments have moved away from (or are currently examining alternatives to) the traditional system of “blanket” PSI coverage and instead have turned to innovative solutions specifically aimed at key problem areas. Some of the features of recently negotiated PSI contracts include the following:

- The customs administration determines which goods are to be inspected by the PSI company based on an assessment of risk related to, for example, the types of goods, record of the importer, origin of the goods, etc.
- PSI contracts are not awarded to a single service provider, instead several companies are allowed to compete in the local market, thus giving importers a choice as to which company to use.

¹⁵²That is, valuation adjustments.

- The PSI company creates databases and develops management information systems for the customs administration.
- The PSI company develops risk-profiling techniques and trains customs officers in their use.
- The PSI company monitors import trends, tax incentive schemes, and duty exemptions.
- The PSI company provides quality assurance testing of government imports and analytical services such as laboratory testing.
- The PSI company inspects only consignments with the highest tariff rates or with the possibility of misdescription, for example, chemicals, textiles, and high-technology products.

There is now a growing realization, even among the PSI companies, that traditional services may no longer be the most effective way to address issues and that the needs of customs administrations are changing. The strong movement toward trade liberalization and the relatively high cost of PSI against the backdrop of the general lowering of rates of duties on imports worldwide have raised questions about the usefulness of traditional PSI services. In response to these developments, PSI companies are redesigning their services to include more measures to facilitate trade and reduce the cost of customs controls. Other emerging services relate to

- assisting customs administrations in the field of electronic commerce;
- advising on compliance with WTO conventions;
- developing risk-analysis systems;
- setting methods for verifying origin determination;
- establishing systems to control transit trade;
- setting up post-release verification and audit units; and
- certifying that goods meet International Standards Organization (ISO) standards.

D. Conclusion

Experience shows that contracting out services to the private sector is not a miracle cure for treating inefficient or corrupt customs services. Nevertheless, in certain circumstances it can provide the authorities time to bring about institutional improvement, if it is implemented as part of a comprehensive and well-designed customs reform program. Before any such program is implemented, however, there should be a careful analysis of the costs and benefits to establish that the money being invested will bring a reasonable return.

13

In Conclusion

Michael Keen

The position of customs officer may not be quite the oldest profession in the world, but its lineage is ancient: the Bible refers to a customs collector called Zacchaeus¹⁵³ (who was corrupt but, happily, reformed). And the profession is still in a state of change—perhaps more so, indeed, than ever.

As we have seen in this book, customs administrations face a range of pressing challenges: securing revenues in the face of continued expansion in the volume of trade and the complications associated with regional trade agreements, rooting out corruption, coping with rapid changes in ways of doing business, and serving the wide range of nonrevenue functions still expected of them—all while seeking to minimize obstacles to legitimate trade. Adding to these challenges is the renewed awareness of the interdiction role of customs after September 11, 2001. The immediate reaction to these events was an increase in the intensity of physical inspections—witness the long lines at the U.S.-Canada border in the days following those events. These renewed concerns might seem at first to run counter to the developments urged in this book, which seek to move away from heavy reliance on physical inspection. But better ways will need to be found to reconcile intensified security concerns with the need to facilitate trade, and this is likely to mean more rather than less reliance on the methods discussed in the book—more effective methods of risk assessment and more efficient exchange of information between the private sector and customs administration, and among customs administrations in different countries.

What makes these challenges particularly daunting is the wide range of responses they require: in procedures, legislation, organizational structures and incentives, the use of information technology, and relations with—and use of—the private sector. They also require resources, though in many cases it is not money but commitment that has been lacking. While it is hard to quantify with any accuracy the potential benefits of modernizing customs administration—they are hard to

¹⁵³Luke 19:1–10.

disentangle from the myriad of other effects on customs revenue and collection costs—there is ample experience of the improvements that can be made in raising revenue and facilitating trade. The purpose of this book has been to give a firm sense of the practical steps needed to realize them.

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