

Forthcoming World Bank publication

**CUSTOMS
MODERNIZATION HANDBOOK**

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D R A F T

OVERVIEW

This Handbook aims at making a positive contribution to the efforts that many countries are undertaking to modernize their customs administration. The Handbook views a competent and well-organized customs service as one that successfully balances its various responsibilities to ensure a high level of compliance with revenue objectives and regulatory requirements while at the same time intervening as little as possible in the legitimate movement of goods and people across borders.

The Handbook recognizes that conditions differ greatly across countries, so that each customs administration will need to tailor its modernization efforts to national objectives, implementation capacities, and resource availability. Nevertheless, it is possible to generalize that meeting the modernization objectives will most likely require the adoption of a few core principles discussed in this Handbook: adequate use of intelligence and reliance in risk management; optimal use of information and communications technology (ICT); effective partnership with the private sector including programs to improve compliance; increased cooperation with other border control agencies; and transparency through information on laws, regulations, and administrative guidelines.

Success in customs modernization is, as importantly, tied to the overall trade policy environment. Simple, transparent, and harmonized trade policies reduce administrative complexities, facilitate transparency, and reduce the incentives and opportunities for rent-seeking and corruption. Customs modernization, therefore, also needs to be examined from the broader and complementary perspective of trade policy reforms.

Good Diagnostics are the Key Starting Point

Customs operations consist of sets of interlocking processes. To be efficient and effective they need to be adapted to changing trade practices, and modern management approaches as well as reflect the various objectives of the country. Yet customs practices in quite a few countries are not well attuned to these criteria. Rooted in long standing traditions, they tend to delay the clearance of cargo and conduct operations in a non-transparent manner. Experience shows that effective customs modernization processes generally start with good initial diagnostic work to identify the shortcomings of the existing system, to define a strategy for the reform, and to mobilize stakeholder support. It also requires a comprehensive approach, i.e., one that encompasses all aspects of a customs administration to address the issues identified, as well as an adequate sequencing of actions. Strategies need to be realistic and should consider the country's capacity to implement, the time that is required, and the level of stakeholder and political support that is needed.

These reform efforts also need to be consistent with the trade policies pursued and should have the capacity to adapt to changing circumstances. For example, the emphasis on issues such as trade facilitation and national security are now more prevalent than in the past.

Human Resource Policies Need to Be at the Center of Customs Reforms

The task of customs has become increasingly complex because of the growing complexities of trade policy on account of the proliferation of regional and international trade agreements, the greater sophistication of traders, and the multiple and shifting objectives imposed on customs. Security is now a new important challenge. Uniformity of customs operations across the territory and across cargo categories is important, and speedy release of goods is crucial to underpinning the competitiveness of traders. There is also a need to adhere to international standards on value and classification, as well as regional standards on rules of origin.

Good human resource management (HRM) is the linchpin to effective and efficient customs administration. This is too often neglected. The management of HRM is multifaceted. It includes recruitment, training, staff compensation and promotion, as well as enforcement. None of these tasks is easy, and often must be implemented in a very constrained environment. These difficulties should not discourage the investigation of possible new initiatives and alternative approaches. However, case studies do suggest that within these constraints still much more attention should be given to HR issues.

To address the constraints imposed on human resource reforms by rigid and often outdated civil service administration policies, many countries have pursued drastic organizational changes. For example, Autonomous Revenue Agencies (ARAs) have been established to avoid the rigid civil service rules, as well as to provide more financial autonomy and greater flexibility in operational matters. However, experience has shown that creating an ARA is no guarantee for success as they have too often been focused on providing better staff compensation without sufficient attention to the other elements of customs operations that enhance effectiveness and efficiency of their operations. Also, quite a few ARAs failed to maintain, over the longer term, the flexibility and the autonomy with which they were originally established.

Another mechanism to implement reforms has been the pursuit of management contracts with the private sector. Management contracts can indeed improve aspects of customs operations if they are well designed and monitored. So far these management contracts have largely been tested in very unique circumstances in countries emerging from severe conflicts (e.g., Mozambique and Angola) and where institutional capacity was exceedingly weak. Engaging private service operators in those countries had the advantage of substantially improving the revenue performance in the short run and under very difficult circumstances. The track record for transferring management capabilities to nationals, however, is still being tested. Initial reports suggest that this has proven more difficult than initially assessed.

Changes in the organizational structure of Customs can at times be instrumental to improving performance, as they can lift important operational constraints. But, evidence

suggests that such changes will only have lasting effects if they contribute to good human resource management and better customs clearance practices.

An Adequate Legal Framework is Important

The modernization of customs laws and regulations as well as their supporting legal environment are an essential component of the reform effort. In this area, countries can refer to (or adopt) the Revised Kyoto Convention, which provides both the legal framework as well as a range of agreed standards to improve customs operations with a view to standardizing and harmonizing customs policies and procedures worldwide. Countries that are signatories of the Convention can still tailor their policies and procedures in specific ways to meet their unique legal, political, cultural, and economic requirements.

In particular, in many countries the Customs Code needs to be modernized, especially to exclude non-core customs elements, seek harmonization and compliance with agreed international commitments, and ensure transparency and predictability by providing basic information on matters such as rules, decisions, consultation mechanisms, and adequate appeals processes. A revised Code can also help in trade facilitation by supporting the use of risk management practices and by eliminating complex or redundant customs formalities that delay clearance and create opportunities for unnecessary discretionary interventions. Finally, the Code should also grant adequate authority for customs to achieve its enforcement and compliance goals.

Improved Integrity is a Key to Promoting Investment and Growth

Customs is frequently perceived as being corrupt. To the extent that this is true, this image negatively affects the overall investment climate of the country and the processing of international trade transactions. Corruption undermines the country's external competitiveness and its attractiveness to domestic and foreign investment. If left unchecked, this corrupt image undermines the growth potential of the country.

Customs is vulnerable to corruption because the nature of its work grants its officials substantial authority and responsibility to make decisions that impact on the duty and tax liability of traders or the admissibility of goods. High tariffs and complex regulations enhance opportunities and incentives. That many customs staffs are poorly paid adds to the problem.

The adoption of procedures that provide little discretion to customs staff and that have built-in accountability mechanisms reduce both the opportunity and incentive for corruption. In conjunction with improved trade policies, the first line of defense against corruption consists of implementing modern procedures that reduce face-to-face contacts between traders and customs officials and reduce the discretionary powers of customs officials' decisions. In addition, providing adequate staff compensation, enhancing the risk of detection and strengthening the capacity to investigate and prosecute breaches of integrity would go a long way to promoting integrity in customs. Most customs managers are of the opinion that corruption is such a prevalent phenomenon today that

counter measures would require the implementation of especially designed policy efforts. This is the approach that is promoted by the World Customs Organization and is incorporated into the Revised Arusha Declaration on Integrity in Customs.

In looking to implement the key elements in the Revised Arusha Declaration, experience suggests that a good starting point is to conduct a comprehensive assessment of the situation to identify the shortcomings that present opportunities for corruption and to establish realistic priorities, as well as practical objectives and activities; all leading to an integrity plan that should be a part of all comprehensive customs reform efforts.

Risk Management Underpins Much of Modern Customs Practices

In an effort to achieve an appropriate balance between trade facilitation and regulatory control, customs administrations are generally abandoning their traditional, routine “gateway” checks and are now applying the principles of risk management with varying degrees of sophistication and success.

Organizational “risk” refers to the possible events and activities that may prevent an organization from achieving its objectives. Risks facing customs include the potential for non-compliance with customs laws as well as the potential failure to facilitate international trade. Customs, like any other organization, needs to manage its risks and do so while interfering as little as possible with the flow of legitimate trade. There clearly is a trade off between control and trade facilitation. Too much of one makes it difficult to achieve the other. Customs therefore needs to apply a set of management procedures that takes this into account. These procedures include the identification, analysis, evaluation, and mitigation of the risks that may impact on the achievement of these objectives.

Basic risk management has always been fundamental to customs operations, and has guided the formulation of anti-smuggling policies; the functioning of border controls to verify the movements of goods and passengers; as well as the establishment of documentary controls and physical inspection procedures. However, in recent times, the increasing complexities, speed and volume of international trade, fueled by the technological advances that have revolutionized global trading practices, have significantly impacted on the way in which customs authorities implement risk management. This has led many customs administrations to adopt a more disciplined and structured approach to managing risk.

Customs needs to evaluate the risks that are presented by the nature of its operations. This includes the need for Customs to review its operational procedures and assess where breaches of procedures are likely to jeopardize the attainment of stated objectives. Such assessment could be included in the above mentioned overall diagnostic exercise. In other words, Customs needs to provide a risk map that identifies the potential vulnerabilities of the customs processes and determine how its procedures may need to be geared towards ensuring better realization of its objectives. On the basis of the risk assessment, a risk containment strategy should be defined. This implies that priorities would be set,

operational details would be geared towards these priorities, and resources would be effectively and efficiently deployed. If smuggling turns out to be a major problem, then the strategy should reflect this, and borders posts and mobile inspection teams may need to be strengthened. If under-valuation is a major problem, there may be a case for strengthening the valuation unit and for the number of traders subject to post clearance audit. If the risk is that goods tend to be misclassified to attract a lower tariff rate or are declared with lower unit counts or weights, there may be a need to physically inspect the cargo. In any event risk management should ease the controls on the less risky aspects of trade and should focus on that part that represent the greatest risk. This would, thus, reflect a balanced approach between control and trade facilitation.

Customs Valuation is a Core Customs Function

Customs valuation practices are subject to the WTO Agreement on Customs Valuation (ACV), which mandates that the customs value of imported goods, to the greatest extent possible, should be the transaction value, i.e., the price paid or payable for the goods. However valuation fraud is frequently reported as a major problem in developing countries and many of them still find that implementing the ACV presents one of the most challenging aspects of customs work. Valuation work is particularly difficult in some countries where the reliability of commercial invoices tends to be poor, and where trade undertaken by the informal sector and in second hand goods is significant. Also, many countries are still ill equipped to undertake post clearance audit.

Substantial efforts have so far been made to explain the intricacies of the ACV to customs officials of developing countries. Yet most observers realize that valuation reforms, in the absence of comprehensive customs modernization programs, is likely to disappoint. A narrow focus on valuation work is likely to disappoint if reforms take place within an administratively and technically ill-equipped customs. The reform elements that will benefit valuation work most include the streamlining of operational procedures, the introduction of a modern customs compliance improvement strategy based on a formalized risk management strategy, the use of post clearance audits, the development of a commercial intelligence capacity, and the adoption of appropriate incentives and disincentives designed to progressively increase the level of voluntary compliance.

Direct technical assistance for improved valuation work might be more productive if such assistance were to be concentrated on the development of valuation databases, risk management systems, and post release review and audit. A valuation database should be established and constantly updated to provide Customs with a practical tool for research and risk management purposes. The valuation function in Customs could be strengthened by setting up an appropriate legal framework; establishing valuation control procedures based on selective checking, risk analysis and management, and post release audit; establishing central and regional valuation offices; and providing specialized training.

The hiring of pre-shipment inspection (PSI) companies may be useful in assisting Customs to facilitate valuation work during its initial reform stages, where capacity is being enhanced to carry out the valuation function. However, if and when PSI services are used,

care needs to be exercised in order to maximize their utility and to ensure maximum consistency with the WTO valuation principles. This Handbook spells out a number of conditions that should be investigated when considering the adoption of PSI services or when evaluating their contribution.

Rules of Origin Should Be Simplified

Ascertaining the country of origin, or the ‘nationality,’ of imported products is necessary for the application of basic trade policy measures such as tariffs, quantitative restrictions, antidumping and countervailing duties, and safeguard measures, as well as for requirements relating to origin marking, public procurement, and for statistical purposes. Such objectives are met through the application of basic or non-preferential rules of origin. Countries that offer zero or reduced duty access to imports from certain trade partners apply preferential rules of origin. These differ most frequently from the non-preferential ones. Preferential rules are designed to ensure that only goods originating from participating countries enjoy preferences. However, rules of origin can be designed to restrict trade and therefore can and have been used as trade policy instruments. The proliferation of free trade agreements with accompanying preferential rules of origin is increasing the burden on Customs in many countries since the clearing of preferential trade is more complex than non-preferential trade. This suggests that the trend towards more preferential free trade agreements may conflict with trade facilitation.

The determination of the country of origin of products has, in the last few decades, become more difficult as technological change, declining transport costs, and the process of globalization have led to the splitting-up of production chains and the distribution of different elements in the production of a good to different locations. The issue becomes which one or more of these stages of production define the country of origin of the good.

WTO members have so far failed to reach an agreement on the definition of rules of origin, despite efforts undertaken in the WCO since 1995. Having harmonized rules of origin for non-preferential purposes would save time and cost to traders and customs officers and provide for greater certainty and predictability of trade. They would also help avoid trade disputes that arise due to uncertainties in the determination of the country of origin with regard to antidumping and countervailing duties, safeguard measures, and government procurement decisions. In general, clear, straightforward, transparent, and predictable rules of origin, which require little or no administrative discretion, will add less of a burden to customs than complex rules.

Good Duty Relief and Exemption Control Systems are Important

Customs may provide duty relief for some imports. This practice is mainly used for the importation of inputs used for the manufacture of export products. The justification for doing so is simple. Any duty paid on these inputs would increase the cost of the exports and make these exports less competitive. In fact, following the widely accepted destination principle of taxation, only goods destined for domestic consumption should bear a tax burden. Duty relief for inputs that are directed towards the production of

exports can be granted in two ways: either a suspense regime is applied and no duties for imported inputs are paid at the point of import; or duties are paid and later refunded, when the products in which the inputs are incorporated are exported. The WCO Revised Kyoto Convention provides guidelines on how this should be done and these can be reflected in the Customs Code and translated in operational guidelines for importers and customs staff. However, experience shows that many developing countries have difficulty in properly administering and monitoring duty relief and exemption regimes, which have resulted in abuse, fraud, and revenue leakage. In the absence of smoothly operating duty relief mechanisms, export manufacturers have to produce at higher cost than would be the case if they had full and easy access to production inputs at world prices.

Export manufacturers have a preference for temporary admission systems, bonded warehouses, and export-processing zones as compared to duty drawback, especially when tariffs are high, when inflation erodes the duty refunds, and when interest rates for working capital are high. The pre payment of import duties on inputs increases the production cost of the exporter. The drawbacks have all too often been disbursed late, thus substantially eroding their real value when inflation and financing costs are high. However, governments in most developing countries require Customs to focus on revenue collection rather than trade facilitation and, therefore, tend to prefer drawback to temporary admission systems.

Managing duty relief schemes in a secure and cost effective way requires well-defined processes and controls. It requires that special mechanisms are put in place to ensure that claims for duty relief are legitimate and correctly executed, and that goods admitted under duty suspense regimes are effectively incorporated in exports and not diverted for home consumption.

The scope of duty exemptions should be limited as much as possible as exemptions can be abused, thus leading to unfair competition and revenue losses. Moreover, there are good economic and administrative reasons for maintaining duty exemptions only for those required by international conventions and those for non-commercial goods. Until the redundant exemptions are eliminated, Customs should devote adequate technological and manpower resources to the control and monitoring of such exemptions.

Customs Procedures Should Facilitate Transit

Poor transit procedures are major obstacles to trade and penalize many landlocked developing countries. A transit system aims at facilitating the transport of goods through a customs territory, without levying duties and taxes in the countries of departure and transit, in accordance with the destination principle of taxation that states that indirect taxes should only be levied in the country of consumption. The Customs Code should provide transit-related legislation, failing which transit should be regulated by a binding agreement between Customs and the different parties affected by the transit operation.

The Core provisions for a good transit system include that the shipments be sealed at the point of departure, that guarantees can be made available to ensure the payments of duties and taxes in case traders do not provide proof that the goods have left the country and that Customs have an information system that informs them when the goods have left the country so that the guarantee can be released. In many countries these core elements are either lacking or weak and should be the focus of any transit modernization initiative.

Trade policies should recognize that customs transit is only one part of a wider range of policy issues that impact on transit. These other issues pertain to many other participants and procedures including cross-border vehicle regulations, visas for the truck drivers, insurances, police controls and the quality of infrastructure. Even if customs transit procedures are made effective and efficient, full trade facilitation will require that these issues be addressed. The TIR (international road transit procedures) and its network of national guaranteeing associations propose the best current reference system.

Effective and efficient transit facilitation institutions such as corridor agreements can promote active cooperation between and among transit and landlocked countries. Transit agreements are important in forming and shaping such cooperation, either at the bilateral, sub-regional or regional level. Transit operations will benefit from good public-private cooperation that can identify deficiencies in border-crossing procedures.

Security as a Customs Objective

The emergence of international terrorism has caused security to become a major issue for many governments, and customs are increasingly called upon to contribute to national security objectives. In the past, many customs administrations performed most of their preventive operations as goods arrived in seaports, airports and land borders, based upon an entry declaration made at the time of importation. To provide the level of security that is required, governments will increasingly depend on information and risk assessments that are undertaken in advance of the arrival of the cargo in the country of destination. International conventions that apply to sea and air transport provide for agreed upon mechanisms to enhance the security of these modes of transportation, their vehicles, cargo and personnel, as well as how these transport modes are operated. Several national governments, particularly that of the United States of America, have issued regulations and have promoted private-public sector agreements to enhance security. These again are largely based on the advanced submission of information and certification that the particular companies adhere to a range of security standards. Such regulations are constantly being refined and implemented. Customs' skill in assessing the information through analytical processes, deployment of resources, effective communication and decision-making, therefore, has become even more important than in the past.

Protecting society involves protection of the entire international trade supply chain from the moment that the cargo leaves the export country to the moment of arrival at the destination country. This changing environment requires an "all of government" approach. In this way, governments can utilize customs as a key resource in border security, using the experience of managing risks and their knowledge of international trade as an important element of national security. Thus, it would be useful to

complement the contributions made by other competent agencies, such as immigration, intelligence agencies, and those involved in policing maritime, aviation, and land operations.

While security is of great importance to governments and traders, Customs has an equal responsibility to facilitate legitimate trade. If applied correctly, security can enhance facilitation by building business confidence, increasing predictability and, as a consequence, facilitating inward investment. However, the international community will need to monitor how specific security initiatives and advance notice requirements will affect the weaker trading partners, particularly those that use ports that are not receiving technical assistance to strengthen their security to the satisfaction of the ports of destination. These traders may have difficulties in fully complying with the advance notice requirements.

While it is not possible at this time to predict the trade-related consequences of the heightened security agenda, it seems probable that the countries that feel vulnerable to terrorist attack will regard consignments from certain countries as representing a higher risk. In this regard, the level of integration of the world economy is such that even countries that are not directly involved in a conflict or subject to terrorist attack, suffer losses in trade and welfare as a result of increased security concerns and higher frictional costs of trade. For those countries with a high degree of reliance on trade (ratio of trade to GDP), as many developing countries do, the need for concerted action on the security area becomes a key priority in their development agenda.

ICT Promotes Customs Modernization

An effective customs administration that leverages technology can lead to improved transparency, greater efficiency, and enhanced security. However, the benefits that could be derived from the reliance on ICT has at times been undermined by the failure to streamline customs procedures, thus creating a process where outdated manual practices continue alongside computerized practices. Although ICT for customs administration is not a panacea or an end to itself, it can powerfully contribute to effective customs administration and operations when integrated into a broader modernization effort.

To meet its mission, a customs administration must effectively integrate modern practices and processes with ICT driven customs management systems. In doing so, Customs should identify realistic and practical sets of targets and objectives that are tailored to its own specific circumstances. Desirable ICT solutions are not necessarily the very latest and most sophisticated ones available; but rather, the ones that are most appropriate for the country's operating environment, resource base, telecommunications infrastructure, and realistic development ambitions. In any event, the ICT solution chosen must assist Customs in all its core business functions and must provide a platform that facilitates achievement of its long-term vision.

In their choice of computer solutions, Customs has the option of either developing a national system that is adapted to national needs, or acquiring an "off the shelf" system. National solutions have the attraction of perfectly matching the specific requirements of a

given country, of developing national computer skills and facilitating the system's maintenance and development. Yet such national solutions tend to be expensive, and it has at times proven difficult for customs officials to convey to the ICT technicians the very complex transactions that need to be programmed. "Off the shelf" solutions benefit from the fact that the various modules have been tested and avoid the need to "reinvent the wheel." Where these solutions do not fully satisfy the national needs, or where the national Customs desires a variant of the solution offered, there is the possibility of customizing the solution or of adding on separate modules that interface with the "off the shelf" solution. On balance, the Handbook advocates that policy makers take a very careful look at "off the shelf" solutions before they consider designing a national solution.

ITC solutions tend to be expensive, even if they enhance efficiency. Experience suggests that much is to be gained from a well balanced financing plan, for the initial installation, maintenance and upgrading; as well as financing plans to include external and domestic resources. Also, procurement procedures should be transparent and should ensure value for money by carefully weighing both the technical and financial proposals.

Structure of the Handbook

This volume has three parts. The chapters in Part I cover cross cutting issues that provide insights to the key elements of a successful customs modernization strategy. They discuss key organizational issues that any customs service needs to deal with and focus on the legal framework of customs and the issues of integrity and risk management. The chapters in Part II provide lessons from a select set of customs reform initiatives as well as from the World Bank's own experience with its support for customs reform. The chapters on Part III successively discuss and provide guidelines on a number of issues that impact on customs operation and trade facilitation. These are customs valuation, rules of origin, duty relief and duty exemption regimes, transit and security, and the use of ICT.

Each of the thirteen chapters begins with a short introduction or background section that is intended as a reader's guide to the issues. This is followed by the analysis and discussion of the issues, as well as by the chapter's main operational conclusions and recommendations. Most chapters include an annex with a checklist of issues that need to be addressed in the areas covered. Sections on further readings and references follow this annex. The boxes included in the chapters illustrate specific points or describe specific cases. Many of these boxes were prepared by the editors of the Handbook, drawing on papers prepared for this project and on the literature. A glossary of customs-related terms is included at the end of the Handbook. The glossary provides succinct descriptions and definitions of key customs related institutions and policies.