



## Increasing the effectiveness of preshipment inspection services

# 22680

*Preshipment inspection services can improve customs administration, but they are no substitute for comprehensive reform.*

Preshipment inspection refers to the verification of unit prices as well as the examination and reporting of the quantity and quality of exports before they are shipped to the importing country. Preshipment inspection can help control overinvoicing or underinvoicing of imports, misclassification of imports, undercollection of taxes on imports, and misappropriation of donor funds provided for import support. Other possible benefits of preshipment inspection include monitoring of origin and of compliance with national regulations and tariff exemption schemes, better data management, technical assistance and training, trade facilitation, and consumer protection.

Preshipment inspection services can provide information that is not readily available to customs authorities in small countries. Such services are provided by private companies in the exporting country. Thus preshipment inspection can be thought of as a temporary quasi-privatization or contracting out of selected customs functions to meet specific objectives.

Of the various objectives for customs reform, trade facilitation is arguably the most important for efficiency and growth. Because of the potential long-term gains from reform, governments should focus on implementing an effective program for customs modernization and institutional reform, and not view preshipment inspection services as a substitute for this effort. This note reviews recent evidence on the

effectiveness of preshipment inspection services; for a comprehensive assessment of preshipment inspection issues through 1994, see Low (1995).

### Use of preshipment inspection services

The 1993 ratification of the World Trade Organization's Agreement on Preshipment Inspection gave preshipment inspectors new legitimacy in international trade. Since then the number of countries using preshipment inspection has increased from 27 to 37, with Africa having the most active programs (table 1).

Perhaps the most striking change in recent years has been the increase in the number of split contracts. While in 1993 Peru was the only Latin American country allowing importers to choose the company they wish to employ from a pre-approved list, in 1999 all Latin American user countries had adapted this approach. This change has allowed more providers to participate. Iran's program involves 16 providers of inspection services.

The shift in preshipment inspection work away from capital flight and overinvoicing toward customs and underinvoicing is reflected in recent contracts. In 1993 all active contracts embodied at least a small amount of capital flight work, but today most contracts focus exclusively on customs work to minimize opportunities for tax evasion—reflecting today's more liberalized capital regimes.

Preshipment  
inspection offers  
benefits for customs  
authorities in  
importing countries

TABLE 1 ACTIVE PRESHIPMENT INSPECTION CONTRACTS, JUNE 1999

<i>Region/country</i>	<i>Type of contract</i>	<i>Type of competition</i>
<i>Africa</i>		
Angola	Customs/foreign exchange	Monopoly
Benin	Customs/foreign exchange	Monopoly
Burkina Faso	Customs	Monopoly
Burundi	Foreign exchange	Monopoly
Cameroon	Customs	Monopoly
Central African Rep.	Customs	Monopoly
Comoros	Customs/foreign exchange	Monopoly
Côte d'Ivoire	Customs	Monopoly
Congo, Dem. Rep.	Customs	Monopoly
Ghana	Customs/foreign exchange	Geographic segmentation (4)
Guinea	Customs	Monopoly
Kenya	Customs	Geographic segmentation (3)
Liberia	Customs	Monopoly
Madagascar	Customs/foreign exchange	Monopoly
Malawi	Customs	Monopoly
Mali	Customs/foreign exchange	Monopoly
Mauritania	Customs	Monopoly
Mozambique	Customs/foreign exchange	Monopoly
Niger	Customs/foreign exchange	Monopoly
Rwanda	Customs	Monopoly
Senegal	Customs	Monopoly
Sierra Leone	Customs	Monopoly
Tanzania/Zanzibar <sup>a</sup>	Customs/foreign exchange	Monopoly
Togo	Customs/foreign exchange	Monopoly
Uganda	Customs	Monopoly
<i>Latin America</i>		
Argentina	Customs	Importers' choice (6)
Bolivia	Customs	Importers' choice (2)
Colombia	Customs	Importers' choice (3)
Ecuador	Customs	Importers' choice (4)
Mexico	Customs	Importers' choice (3)
Paraguay	Customs	Importers' choice (2)
Peru	Customs	Importers' choice (3)
<i>East Asia</i>		
Cambodia	Customs	Monopoly
Philippines	Customs	Monopoly
<i>South Asia</i>		
Bangladesh	Customs	Geographic segmentation (3)
<i>Middle East and North Africa</i>		
Iran	Quality/quantity	Importers' choice (16)
<i>Europe and Central Asia</i>		
Uzbekistan	Foreign exchange	Monopoly

Note: A foreign exchange contract is designed to monitor capital flight. Numbers in parentheses are the number of service providers.

a. Tanzania and Zanzibar have separate preshipment inspection programs. Tanzania has an exclusive contract with Cotecna covering customs, while Zanzibar has one with SGS covering foreign exchange.

Source: Preshipment inspection companies.

## Usefulness of preshipment inspection services

In general, preshipment inspection is a second-best policy for countries with serious

weaknesses in customs administration. Wherever feasible, a preferred approach would combine a relatively open capital account (reducing incentives for overinvoicing as a capital flight mechanism), trade liberalization (reducing incentives for underinvoicing as a tax evasion mechanism), and local institution building aimed at improving all customs functions.

But a practical tension often arises. Institution building and structural revenue changes take time. Shorter-term revenue requirements are often pressing in countries that rely on trade taxes as an important source of government revenue. Different views on the effectiveness of preshipment inspection reflect different policy priorities as well as a lack of clear empirical evidence on impact. Consider the three main functions of preshipment inspection.

### *Disbursement verification*

Low (1995) finds that the World Bank's policy of encouraging governments to use preshipment inspection—and sometimes requiring it as a loan condition—has been driven by concerns about the use of donor funds. This rationale is in line with basic Bank procurement guidelines on import documentation for investment operations.

In addition, the desire to ensure the efficient use of funds through a trade verification procedure is relevant for loans with disbursements that are linked not to the inputs needed to implement specific investments, but rather to balance of payments support through procurement of general imports. In such cases there is a need to verify that prohibited goods are not procured or that agreed goods are procured. Where governments have poor statistical capacity, preshipment inspection can provide useful evidence. But no study exists on the benefits and costs of alternative forms of disbursement verification.

### *Revenue collection*

Probably the most important reason that governments seek preshipment inspection services is to deal with inefficient or corrupt customs administrations. Such administra-

tions introduce distortions through widespread evasion of trade taxes, either through misspecification of quantity, misclassification of tariff heading, or undervaluation of goods.

It is not easy to directly assess the costs and benefits of preshipment inspection in this area. Preshipment inspection services are often introduced at the same time as policy reforms affecting revenue collections and customs performance, and the full benefits depend on other government actions. Moreover, many preshipment inspection programs have been poorly implemented by administrations that did not want the services because they would reduce available rents.

Although reported revenue savings generally exceed preshipment inspection fees—which are about 1 percent of the value of inspected goods—case studies suggest that the information provided by preshipment inspection companies has often been disregarded, so potential revenue increases have not been realized. Revenue collection shortfalls of up to 50 percent are reported to have occurred in some countries.

Unless governments consistently use a reconciliation system and act on generated information, preshipment inspection will not contribute much to revenue collection. For sustainable revenue collection, customs modernization and institutional reform are also needed, and should specify how preshipment inspection services will be phased out over time. Ideally, this should be a prerequisite for any country signing a preshipment inspection contract (see Low 1995, ch. 3).

#### *Trade facilitation*

Opponents often argue that preshipment inspection hinders the flow of goods with the rest of the world. They point out that at best, preshipment inspection creates a series of additional costly steps for traders—and at worst, results in further costs and delays when customs authorities duplicate control functions and question the findings of preshipment inspectors. The extra cost is alleged to be especially burdensome for small exporting firms.

Most evidence in this area is anecdotal, and not a single complaint has been lodged

under the World Trade Organization's Preshipment Inspection Agreement. A plausible explanation is that affected firms must file complaints as identifiable corporate entities, which they may be reluctant to do for fear of jeopardizing commercial relationships.

On the other hand, the Indonesia Chamber of Commerce has argued that preshipment inspection facilitated trade by speeding up the *de-douanement* (clearing of customs) process. This is an area where further quantification of impact would be helpful. The ultimate objective for customs should be a fully integrated export and import system based on a single submission of minimal control data for all official purposes, backed by upgraded information systems and technical staff trained in risk assessment and profiling (see UN 1995). With recent advances in information technology, automation, Internet use and electronic data interchange, and business practices such as risk management systems, such an approach should be feasible for most countries if there is political will for change.

Overall, for preshipment inspection to make a positive contribution, it appears essential to ensure:

- Transparent procurement rules for the preshipment inspection contract.
- Preshipment inspection values and classifications are an integral part of import documents.
- Good use of provided services (with reconciliation by the ministry of finance as a minimum).
- Arbitration provisions to settle disputes swiftly without holding up goods.
- Enhanced competition for service provision and fee setting (see below).

### **Options for increased competition**

How can preshipment inspection services be made an effective transitional instrument for improving revenue collection and facilitating trade?

#### *Competition among service providers*

A careful assessment is needed of the benefits and costs of parallel competition (split

More research is needed to quantify the impact of preshipment inspection

Governments  
should consider  
separating  
preshipment  
inspection support  
from customs  
modernization  
assistance

contracts) and serial competition (bidding for a time-bound monopoly franchise, either at the country level or within a certain area). With split contracts, the benefits of competition need to be weighed against higher transactions costs and possibly perverse incentives. With advances in information and control technology, the government's transactions costs in monitoring several suppliers and ensuring effective reconciliation need not be significantly more burdensome. But split contracts can create conflicts of interest, because importers may threaten to switch to another service provider if they are not assessed sufficiently low duty payments. It would be useful to explore why so many Latin American countries have adopted this model, and what other forms of parallel competition might be conducive to increased competition.

For serial competition, the challenge is to design and supervise a bidding process that awards contracts often enough to render the market contestable. With both contract options, termination clauses are desirable for poor performance. It would also be desirable to explore the commercial feasibility of allowing fuller price competition, where pricing reflects actual services rendered rather than the current ad valorem practice. For instance, bulk goods such as wheat or petroleum could be exempted or should face lower fees.

*Competition to strengthen customs administration*

Even though preshipment inspection services are described by the industry as temporary, a number of countries have been using them for more than 10 years without concomitant customs modernization. Although one possible solution is to insist on a clearer link between preshipment inspection and customs reform, there may be a basic conflict of interest in appointing a preshipment inspection company as the primary external agent

responsible for customs modernization. If the company is successful in customs modernization, it closes off far more profitable flows from preshipment inspection work.

Governments should consider separating preshipment inspection support from customs modernization assistance. This does not preclude governments from using the customs modernization skills of preshipment inspection companies, but merely ensures that a distinct agent be responsible for modernization. That agent could include a preshipment inspection company not participating in the country's preshipment inspection work. Such unbundling can facilitate different fee structures for distinct lines of business, making it easier for prices to reflect services rendered.

**Further reading**

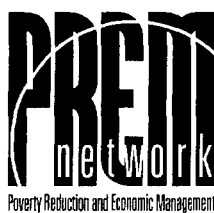
Dutz, Mark. 2000. "The Use and Usefulness of PSI Services." In *Pre-shipment Inspection: Past Experiences and Future Directions*. Trade and Enterprise Paper 2. London: Commonwealth Secretariat.

Low, Patrick. 1995. *Preshipment Inspection Services*. World Bank Discussion Paper 278. Washington, D.C.

UN (United Nations). 1995. "Customs—Facilitation and Control." Trade/WP.4/R.1130. Economic Commission for Europe, Economic and Social Council, Working Party on Facilitation of International Trade Procedures, Committee on the Development of Trade, New York.

*This note was written by Mark Dutz (Senior Economist, Development Research Group, Development Economics Vice Presidency). It is based on Dutz (2000).*

*If you are interested in similar topics, consider joining the Trade and Competitiveness Thematic Group. Contact Dorsati Madani, x37925, or click on Thematic Groups on PREMnet.*



This note series is intended to summarize good practice and key policy findings on PREM-related topics. The views expressed in these notes are those of the authors and do not necessarily reflect the views of the World Bank. PREMnotes are distributed widely to Bank staff and are also available on the PREM website (<http://prem>). If you are interested in writing a PREMnote, email your idea to Sarah Nedolast. For additional copies of this PREMnote please contact the PREM Advisory Service at x87736.

Prepared for World Bank staff