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Editorial

The 2010 PICARD conference which was held in Abu Dhabi, UAE, marked a significant milestone in the partnership between the World Customs Organization (WCO) and the academic world. We covered a great deal of ground during the two and a half days of the conference, and in doing so a number of key issues emerged, the details of which are set out in our Special Report in Section 3. The conference concluded that we have achieved much of what we originally set out to achieve, that is, to raise the academic standing of the customs profession. The implementation phase is completed, and it's now time to take things forward by acting on the possibilities that have been identified. This can best be achieved through ongoing collaboration among and between academic institutions and customs administrations.

On 26 January this year – World Customs Day – Dr Kunio Mikuriya, the Secretary General of the WCO, announced this year's theme for the organisation: *Knowledge, a Catalyst for Customs Excellence*. The chosen theme further reinforces the value of maintaining a partnership approach – working together to identify sound policy and practical operational solutions based on scientific enquiry and empirical evidence. The articles published in the following pages help to build the knowledge base required to identify such solutions, and for this I thank the contributors.

I would also like to take this opportunity to wish Mr Erich Kieck every success in his new role of Director, WCO Capacity Building Directorate. Erich has been a strong supporter of the PICARD program since its inception. One of his first duties will be to oversee the 2nd Session of the Capacity Building Meeting in May this year which will discuss, among other things, the development of a strategic roadmap to ensure the sustainability, relevance and responsiveness of WCO Capacity Building. We look forward to working with Erich on this and other important initiatives during his term in office, including this year's PICARD conference. While the final details of the conference are yet to be settled, the research themes will be: coordinated border management, performance measurement, economic security and poverty reduction, and integrity. The call for papers will be released in early May and, as in previous years, all conference papers will be considered for publication in the next edition of the *World Customs Journal.*

David Widdowson
Editor-in-Chief

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Section 1

Academic Contributions

Withdrawal, revocation and suspension of AEO certification

Lothar Gellert

This article was first published as Chapter 7, 'Rechtwirkung, Überwachung, Aussetzung & Widerruf', in Ronald Kaltenbäck & Heike Hohensinner-Blüthner 2009, *Das AEO-Handbuch,* Verlag Kitzler Ges.m.b.H., Vienna, and is reprinted in English with the permission of the author and of the publishers. The assistance of Dr Christopher Dallimore in preparing the article for publication in the *World Customs Journal* is acknowledged.

Abstract

The benefits and advantages of Authorised Economic Operator (AEO) status have been examined and discussed widely. However, the withdrawal, revocation and suspension of AEO certification have not been as closely examined. This paper addresses a range of issues that relate to European Community law and in particular, to the way in which German and Austrian regulations are applied. It is concluded that there are far-reaching legal and factual consequences that go beyond the provisions of the relevant customs legislation and suggests that any company that holds an AEO certificate or has applied for it needs to ensure that it satisfies the conditions of the certificate at the time of application and in the years thereafter.

1. Introduction

For some time, well-known experts in customs law have tackled the question as to what benefits are related to the AEO status of economic operators. They stress that, amongst many advantages for the economic operator, the most important is the much quicker customs clearance of their goods for importation and that it will profit the reputation of their company if they can point to the fact that they and their contractors in the supply chain have Authorised Economic Operator (AEO) status, which guarantees the security of their supply chain.

However, until now not much attention has been paid to what will happen if the AEO certification is withdrawn, revoked or suspended.

This article addresses the following questions:

1. Can AEO certification be regarded as an 'administrative act' pursuant to national fiscal legislation?
2. Is AEO certification to be interpreted as a 'customs decision' pursuant to the European Community (EC) Customs Code (CC) and the Customs Code Implementing Provisions (CCIP)?
3. Do the provisions of national fiscal legislation and/or EC legislation allow the withdrawal, revocation or suspension of certification?
4. How is it possible to appeal against withdrawal, revocation or suspension?
5. What are the legal and factual consequences of withdrawal, revocation or suspension of AEO certification:

5.1 for the AEO?

5.2 for the AEO's contracting partner in the supply chain?

5.3 concerning a possible obligation to inform other customs administrations on the basis of the consultation procedure?

5.4 concerning a possible obligation to inform administrations of third party states which have entered into agreements of mutual recognition of the AEO status of their economic operators?

5.5 concerning a possible breach of competition law if the former AEO continues to promote their company with AEO status despite its withdrawal, revocation or suspension?

2. The legal character of AEO certification

2.1 A 'decision' pursuant to German and Austrian tax administration law?

The question of whether AEO certification is based on national tax administrative law in these two countries requires consideration of the German *Abgabenordnung* ('Fiscal Code' - AO)[1] and the Austrian *Bundesabgabenordnung* ('Federal Fiscal Code' -BAO).[2] Section 118 AO states the following:

> Definition of 'administrative act':
>
> An administrative act shall be any order, decision or other sovereign measure taken by an authority to regulate an individual case in the sphere of public law and intended to have a direct, external legal effect. A general order shall be an administrative act directed towards a group of people defined or definable on the basis of general characteristics or relating to the public law character of a matter or its use by the public at large.

There can be no doubt that AEO certification is both a 'decision' and a 'sovereign measure' because it is issued by the customs authorities. As the certification is granted to a certain natural or legal person, it also regulates an 'individual case'. Customs legislation forms part of German fiscal law in accordance with Section 3 (3) AO, indicating that import and export duties referred to in the CC are 'taxes' in accordance with the AO. Owing to the fact that fiscal law forms part of public law, the certification of AEO status represents a sovereign act of an authority to settle an individual case in the field of public law. This certification also produces some external legal effects, such as simplified customs controls and therefore has direct legal effect on the outside world.

Therefore, it can be confirmed that the certification as AEO satisfies the conditions of an 'administrative act' pursuant to Section 118 AO.

The legal situation in Austria is similar. According to Section 92 BAO, transactions by the fiscal authority are issued in the form of a decision, where for individual persons:

(a) rights or obligations are constituted, amended or repealed, or

(b) facts relevant for tax law are established, or

(c) the existence or non-existence of a legal relationship is established.

According to Section 1 (1) BAO, this law also applies to matters of import and export, subject to the provisions of customs legislation. The mirror-image provision to Section 1 (1) BAO in the national Austrian customs legislation is Section 2 (1) of the *Zollrechtsdurchführungsgesetz* ('Austrian Customs Implementing Act' - ZollR DG),[3] which states *inter alia* that the provisions of general fiscal law also apply to all matters of European Union (EU) and national law relating to the cross-border movement of

goods not covered by the CC (that is, other import or export duties) and other cash benefits, to the extent that the customs administration is responsible for enforcement in accordance with federal law or other legislation and that there are no provisions to the contrary.

As AEO certification confers rights on the person concerned and is issued to a single person, it falls within the scope of Article 92. According to relevant Austrian literature and case law, a decision is an individual, sovereign, external administrative act (normative or confirming act).[4] This act therefore corresponds to the German administrative act.

To summarise, German and Austrian law offers a legal basis for granting certification for AEO status. In the following discussion, however, the question of whether these national rules may be applied at all or whether they are overruled by supranational rules of Community law is examined.

2.2 Customs decisions pursuant to the Customs Code, future Modernised Customs Code and its Implementing Provisions

Article 4, no. 5 CC defines the term 'customs decision' as:

> [A]ny official act by the customs authorities pertaining to customs rules giving a ruling on a particular case, such act having legal effects on one or more specific or identifiable persons.

This definition resembles a fiscal 'administrative act' in German tax law and the related concept under Austrian law. The certification of AEO status satisfies the requirements for a 'customs decision'. It is a measure issued by the customs administration in the field of customs legislation. Since this measure is not issued in relation to private activities but on the basis of a public relationship between economic operators and Customs, it is also represents a sovereign act. That it concerns the field of customs legislation can be deduced from the fact that the conditions for granting AEO status are directly enshrined in Community customs law, (that is, Article 14a ff. CCIP). The decision by the customs authorities concerns an individual case, that is, a specific person. The certification is issued in response to an application by a specific economic operator. The holder and beneficiary of AEO status is the person to whom the decision is addressed. The benefits are claimed by the operator externally, since the AEO will always insist that the customs administration grants that operator the benefits associated with certification. The operator will therefore claim the benefits and the customs administration will grant them externally. Certification does not only produce internal administrative effects.

Therefore, AEO certification also satisfies the conditions for a customs decision pursuant to Article 4, no. 5 CC.

2.3 Applicability of national legislation

As stated above, the granting of AEO status represents both an 'administrative act' and a 'customs decision' in accordance with German-Austrian law and Community customs legislation respectively. This should not be taken to mean that it is possible to use both provisions as a legal basis for certification: it could be the case that national provisions will be overruled by supranational Community law. Community customs law takes precedence over national law as higher-ranking law in accordance with Article 288 of the Treaty on the functioning of the EU.[5]

Early in the history of the EU, the European Court of Justice (ECJ) ruled that national administrations were obliged to apply Community law in the interests of the proper functioning of the EC. In its decision of 15 July 1964,[6] the ECJ ruled that where the relationship between the national and the Community law was concerned, the incorporation of Community law into national law effectively prohibited Member States from introducing *a posteriori* unilateral measures. This ruling was justified by the argument that it would threaten the realisation of the Treaty's goals, if Community law was applied in Member States differently, according to their *a posteriori* legislation. The primacy of Community law was confirmed

by Article 189 which stated that Community regulations were binding and directly applicable in each Member State. Therefore the law created by the Treaty could not be circumvented by any national legislation whatsoever, if the legal basis of the Community was not to be challenged.

This view was supported by later decisions of the ECJ.

In case 48/71,[7] the Court had to decide how long national provisions demanding a progressive duty by Italy for the export of goods of artistic, historical, archaeological or ethnographic interest which did not comply with Community Law remained effective.

In its decision of 13 July 1972, the ECJ decided that a national provision found to be non-compliant with Community legislation would not be effective even if its annulment or amendment would lead to problems, for example, in relation to the legislative procedure. To hold otherwise would imply that the application of the Community norm would be subordinated to the law of individual Member States. As far as the application of Community law was concerned, applying a national provision in spite of this ban had been found to contravene the Treaty. In order to achieve the objectives of the Community, all rules of Community law had to be applied in the same way across the entire territory of the Community, free of any obstacles created by the Member States. Accordingly, Member States had transferred their rights and responsibilities to the Community and thereby limited their sovereignty; this process could not be obstructed by national provisions.

With regard to agricultural policy, the ECJ held on 26 February 1976,[8] that a national provision relating to agricultural prices applicable to levels of trade already regulated by the system of Community prices contravened Community law.

Gerhard Reischl, the Advocate General, expressly stated in his opinion of 21 January 1976, that the national administrations did not have any regulatory powers in those cases where Community authorities had taken appropriate legal measures themselves. National measures could not endanger the objectives and the functioning of the common market. In the decision of 7 July 1976,[9] which concerned the validity of national Italian regulations regarding the registration of foreigners, the ECJ held that the primacy of Community law over national law applied in all matters.

According to the ECJ,[10] the principle of the primacy of Community law, provisions of the Treaty and the directly applicable legal acts of the institutions result in each and every conflicting provision of national law becoming inapplicable once the former enter into force, and the introduction of new national provisions is to be avoided if they contravene provisions of Community law. If national legislative acts in those areas where the Community has legal competence were to be held valid, they would deny the unconditional and irrevocable obligation of the Member States under the Treaty and call into question the very foundation of the Community. The Court called on every national judge to ensure the full effectiveness of Community law by setting aside conflicting provisions of national law. The ECJ also upheld the primacy of Community law by its ruling of 21 May 1987[11] and declared that this principle applied to all decisions taken by Community institutions in accordance with their competences and addressed to Member States.[12]

From the foregoing it can be concluded that non-harmonised national law or national law which is identical in wording is not invalid but rather inapplicable to the extent that the matter in question is regulated by the Community Code.[13] That said, the latter also allows national provisions to be applied in relation to certain legal questions. This is supported by the fact that the CC directly refers to national law, by the legal power given to customs authorities to settle certain matters and finally, by the exercise of administrative discretionary power in cases where the CC allows the customs authorities to make a discretionary decision. Since the CC does not contain any details on how this discretion is to be exercised, customs authorities can have recourse to the legal standards which govern the legal area in question.[14] In addition, national law can also be applied in cases where the CC uses undefined terms whose content

cannot be deduced from the text of the CC itself or if terms are used that have been modelled on German legal concepts such as the definition of a 'customs decision' in Article 4, no. 5 CC.

It is not expected that the Modernised Customs Code (MCC) will make any changes to this interpretation. Although the operative provisions of the MCC do not define the term 'customs decision', a definition is contained in recital 12 which states:

> All decisions, that is to say, official acts by the customs authorities pertaining to customs legislation and having legal effect on one or more persons …

This essentially corresponds to the definition of 'customs decisions' in the applicable CC so that the statements above also reflect the legal situation under the MCC.

3. Does national tax administration law and Community customs legislation allow the withdrawal, revocation and suspension of AEO status?

3.1 Revocation, withdrawal and suspension under national tax administration law

In principle, the grant of AEO status is valid indefinitely. However, events may arise which require the certificate to be reviewed. Customs administrations have two options to verify that the conditions for AEO status are still satisfied, namely, reassessment and monitoring.

Reassessment is currently regulated in Article 14q (5) sub-para. 1 CCIP and serves to verify that the AEO still meets the conditions at a certain point in time. It will usually be carried out if the legal situation changes or if there is evidence that the holder of the certificate does not meet or no longer meets its conditions.

In addition, the customs administration can perform monitoring. This possibility is provided by Article 14q (4) CCIP which permits checks to be carried out on an ongoing basis and in the absence of a special event.

In Germany, the provisions of the AO mean that it is not possible to cancel or withdraw an AEO certificate.

Withdrawal is regulated by Section 130 (2) AO, which states:

> (2) An administrative act which gives rise to a right or a substantial advantage in legal terms or confirms such a right or advantage (that is, a beneficial administrative act) may only be withdrawn where:
>
> 1. it has been issued by an authority without requisite jurisdiction over the subject-matter,
> 2. it has been obtained by unfair means such as deceit, threats or bribery,
> 3. the beneficiary has obtained the administrative act by providing information which was essentially incorrect or incomplete,
> 4. the beneficiary was aware of its illegality, or was unaware thereof due to gross negligence.

The revocation of a certificate is regulated by Section 131 (2) AO which states:

> (2) A lawful and beneficial administrative act, even if invalid, may be revoked in whole or in part with *ex nunc* effect only if:
>
> 1.revocation is permitted by law or a right of revocation is reserved in the administrative act itself,
>
> 2. the administrative act is combined with an obligation which the beneficiary has not complied with at all or on time,

3. the revenue authority would be entitled, as a result of subsequent changes in circumstances, not to issue the administrative act and if failure to revoke it would endanger the public interest.

Section 130 (3) shall apply accordingly.

German law does not regulate the suspension of the AEO certificate, however. In addition, Articles 124 (3) and 125 AO regulate the invalidity of an administrative act and AEO certificate in the same way.

Unlike Germany, Austria does not regulate the cancellation and withdrawal of decisions in either the BAO or the ZollR DG. In the working instruction regulating the AEO, the revocation and suspension of AEO certificates are directly based on the corresponding provisions in Community law. The revocation or suspension of the AEO certificate is made by a decision issued in accordance with the rules of the BAO (that is, a revocation or suspension order).

3.2. Revocation, withdrawal and suspension under Community customs legislation

Articles 8 and 9 CC contain provisions concerning the withdrawal and revocation of favourable customs decisions. Granting AEO status is clearly a favourable decision.

Withdrawal and cancellation are definitive measures. As far as procedural simplifications are concerned, it is important that AEOs do not lose certification permanently should the conditions for certification not be fulfilled. Furthermore, the requirement that a three-year period elapse before a new application for AEO status can be submitted is related to revocation in accordance with Article 14v (4) CCIP.

The CCIP therefore allows temporary suspension besides cancellation and withdrawal.

It should also be noted that owing to the law rule of specialty, the general rules of Articles 8 and 9 only apply in the absence of any special arrangements. However, with the provisions of Article 14r ff. CCIP, a special rule is in place.

a. Suspension

AEO status can be suspended for three different reasons:

Non-compliance with the conditions or criteria for AEO certification. Article 14r (1) (a) CCIP provides the first reason for suspension, namely, where the customs authority establishes that the operator does not comply with the conditions or criteria for the AEO certificate. This also covers cases where the conditions did not exist at the time of the certification (although the German version suggests something different). The English version of Article 14r refers to 'non-compliance' but does not specify the relevant point in time. The same applies to the French version which speaks only of 'le non-respect of the conditions ou Critères de Délivrance du certificat AEO a été établi'.

Sufficient reasons to believe that a criminal act took place. If the customs authorities have sufficient reason to believe that an act that gives rise to criminal court proceedings and is linked to an infringement of the customs rules, has been perpetrated by the AEO then the certificate can be suspended in accordance with Article 14r (1) (b) CCIP. This provision covers both customs offences *per se* and criminal offences in connection with customs offences such as fraud, money laundering or the forgery of documents.

However, the customs authority may decide not to suspend the AEO status if it considers an infringement to be of negligible importance in relation to the number or size of the customs-related operations and does not cast doubt on the good faith of the AEO.

Request for suspension of AEO status. The third reason for suspension is on request of the AEO. This possibility is contained in Article 14u (1), 1st sentence CCIP.

In accordance with Article 14r (1) sub-para. 3 CCIP, the customs authorities are to communicate their

findings to the economic operator concerned before taking a decision. The latter is entitled to correct the situation and/or express their point of view within 30 calendar days, starting from the date of communication.

In the event of non-compliance with the conditions for an AEO certificate, the operator may take measures such as remedying safety deficiencies, improving customs processes, reorganising their accounts or restoring solvency. However, such measures are not possible in the event of the second reason for suspension, that is, where the customs authorities have sufficient reason to believe that an AEO has committed an offence (Article 14r (1) (b)).

If the operator fails to eliminate the reason for suspension within a period of 30 days, the customs authority will suspend the AEO certificate. The period of suspension depends on the reasons. In the case of non-compliance with the relevant criteria, the suspension will generally last 30 calendar days. If the economic operator concerned cannot regularise the situation within this period but proves that the conditions can be met if it were to be extended, the issuing customs authority is to suspend AEO status for a further 30 calendar days in accordance with Article 14r (4) CCIP. Multiple extensions of 30 calendar days are also possible.

b. Revocation

Revocation in accordance with Article 14v CCIP comes into consideration if the economic operator is to be deprived of AEO status permanently. There are three main reasons for revocation:

(i) Where the AEO fails to take the necessary remedial measures within the suspension period in accordance with Article 14 (1) letter (a).

In this case, the economic operator has failed to take the necessary remedial measures needed to comply with the requirements of the relevant AEO certificate and therefore does not meet the certification requirements.

(ii) Where serious infringements related to customs rules have been committed by the AEO and there is no further right of appeal in accordance with Article 14v (1) (b).

In this case, a prior suspension is not necessary and the certificate can be immediately revoked.

A mere 'connection with an infringement of the customs rules' is insufficient justification for revocation, however. The conviction must have been in relation to a 'serious' customs offence. However, the customs authority may decide not to revoke the AEO certificate if it considers that the infringement(s) are of negligible importance in relation to the number or size of the customs-related operations and they do not raise doubts about the AEO's good faith.

It should be noted that the conviction must relate to the economic operator. In many Member States (including Germany), companies cannot be convicted of a criminal offence. Accordingly, it is only possible to revoke the AEO status under Article 14v (1) (b) CCIP in relation to natural persons and not economic operators organised as a legal person or group.

(iii) Upon the request of the AEO.

The AEO may also apply for the revocation of its status under Article 14v (1) sub-para. 1 (d) CCIP. However, Articles 14r to Article 14v CCIP do not cover the situation where the operator fails to comply with the obligations imposed by the AEO certificate – particularly the obligation to inform the customs authorities of changes relevant to certification in accordance with Article 14w (1) CCIP.

In such cases, revocation will be based on Article 9 (2) CC. However, a less drastic alternative would be to ensure the enforcement of the relevant obligation (for example, by a request to perform the obligation concerned under the threat of revocation).

c. Withdrawal

It is questionable whether Article 8 (1) CC applies in cases where the AEO certification was issued illegally owing to incorrect or incomplete facts and the operator knew or should have known the inaccuracy or incompleteness of the facts. The fact that there is no preliminary procedure in accordance with Article 14r CCIP is acceptable. However, a withdrawal pursuant to Article 8 CC would not trigger the three-year period stipulated by Article 14v (4) CCIP and this would work to the economic operator's advantage. The withdrawal of the certificate in accordance with Article 8 CC absent the three-year period would therefore contravene the aim of Article 14v (4) CCIP.

3.3 Applicability of national legislation

The comments made above regarding the applicability of national law are also true here: accordingly, national law is only applicable if there are gaps in Community law.

4. Appeals against suspension, revocation and withdrawal of AEO status

All methods of annulling AEO status (that is, suspension as referred to in Articles 14r, 14u CCIP and revocation under Articles 14v CCIP and 9 CC) represent decisions pursuant to Article 4, no. 5 CC, which can themselves be appealed against and revoked. However, the CCIP does not regulate such cases: Articles 8 and 9 CC deal exclusively with favourable rather than unfavourable decisions; therefore it is necessary to apply national law in order to fill this regulatory gap. In Germany, it is possible to withdraw an unlawful revocation of the certificate in accordance with Section 130 AO and to revoke a lawfully issued certificate in accordance with the requirements of Article 131 AO. In Austria, the provisions of the BAO concerning the correction and annulment of decisions are largely overruled by Community law (that is, the provisions on revocation in the CC and CCIP). However, it may be possible to correct spelling and calculation errors (Section 293 BAO).

The economic operator is clearly in need of legal protection if the customs authorities decide to suspend or withdraw the AEO certificate. Accordingly, the operator can lodge an appeal in accordance with the procedural rules in Articles 243-245 CC: Articles 243 and 244 CC contain the basic rules and Article 245 CC refers to national law.

There are two stages to an appeal: in the first stage, the plaintiff can lodge an appeal in accordance with Article 243 (1) sub-para. 1 and (2) (a) as well as Article 245 CC in conjunction with Section 347 (1) 1st sentence no. 1 AO (for Germany). At the second stage of an appeal, the operator may lodge a claim before the court in accordance with Articles 243 (1) sub-para. 1 and (2) (b) as well as Article 245 CC in conjunction with Section 40 (1), 1st alternative of the 'Fiscal Court Act' (FGO). The aim at both stages is to withdraw the suspension or revocation of the AEO certificate. As the addressee of the suspension or the revocation, the operator is directly and personally affected by such a measure and therefore entitled to lodge an appeal. The appeal will be justified if the suspension and revocation were ordered illegally.

Austria provides an extensive two-stage appeal in accordance with Sections 85a to 85f of the ZollR DG. The first stage is to lodge an appeal and the second to lodge a complaint to be decided by the *Unabhängiger Finanzsenat* ('Independent Financial Panel').

The operator may also seek to prevent revocation by applying for an injunction against the enforcement of the revocation decision. In Germany, it is possible to request the suspension of enforcement in accordance with Article 244, 245 CC in conjunction with Section 361 (2) 1st sentence AO and Section 69 (2) 1st sentence of the FGO from the customs authority which issued the decision to revoke the certificate. Austrian legislation contains a similar provision.

The economic operator seeking to oppose the revocation of AEO status must establish two reasons against suspension, that is, reasonable doubts as to the legality or the threat of significant damage. Concerning the first reason, there will be a 'reasonable doubt' if a summary review reveals circumstances which support and oppose legality. It is not necessary that the latter prevail. Doubts concerning legality can be either factual or legal in nature. Concerning the former, it is unclear whether facts relevant to the decision actually have to exist; as far as doubts of a legal nature are concerned, a distinction should be made between interpretation and validity. There will be doubts about interpretation if the legal situation is unclear, if the legal issue in question has not been decided by superior courts or if judicial literature questions the legal grounds for the decision. There will be doubts about validity if the legal norm upon which the decision was based is considered invalid.

The second reason for suspension in accordance with Article 244 (2), 2nd alternative CC requires the suspension of AEO status to cause significant damage to the person concerned.

The ECJ[15] requires 'serious and irreparable damage'. This requirement will be satisfied if the situation resulting from the immediate implementation of suspension cannot be reversed by annulling the contested decision in the main proceedings.[16] In addition, according to the settled case-law of the Court, the condition of 'irreparable damage' requires the judge hearing an application for interim measures to examine whether the possible annulment of the contested decision by the Court giving judgment in the main action would make it possible to reverse the situation that would have been brought about by its immediate implementation and conversely, whether suspension of operation of that decision would be such as to prevent its being fully effective in the event of the main application being dismissed.[17]

As a rule, purely financial losses are not regarded as constituting an 'irreversible' situation. Rather, examples of consequential damages would be an irreversible loss of market share or the risk that a company would become bankrupt.[18] The reference to 'might' suggests that a 'reasonable degree of probability' concerning the occurrence of loss will suffice.[19]

In terms of loss resulting from the deprivation of AEO status, a distinction must be drawn between disadvantages caused by the loss of the legal benefits connected with AEO status and those caused by the withdrawal of AEO status itself (see below).

A reason not to suspend AEO status will be made if the operator can claim reasonable doubts as to the legality of suspending AEO status, the impending loss of market share or a risk of bankruptcy. In this case, the customs authority will decide not to revoke or suspend AEO status.

Although the rejection of an application for suspending enforcement is a decision pursuant to Article 243 (1), sub-para. 1 CC, the suspension procedure of Article 244 CC is independent with the result that the provisions of Article 243 CC relating to the regular procedure do not apply.

5. Legal and factual consequences of revocation, withdrawal or suspension of AEO status

5.1 In relation to the AEO

The annulment of AEO status will result in many legal and factual disadvantages.

The loss of simplified customs controls will have financial consequences in the shape of extended waiting periods and the increased costs of personnel and materials. Any penalties incurred by late deliveries payable in accordance with Section 338 of the *Bürgerliches Gesetzbuch* (German Civil Code) will result in a financial disadvantage. However, this is reversible. Accordingly, there is no 'serious and irreparable damage' in this respect. The same applies to the obligation to submit regular records in accordance with the prior notification procedure.

Concerning the facilitations for AEO-C a distinction must be made between the currently applicable CCIP and the MCC which will enter into force in 2013. Currently, even operators who do not possess AEO status can obtain authorisation for simplified procedures. Following the entry into force of the MCC, however, some simplifications will only be granted to AEOs. Operators who do not have this status or fail to obtain the status will suffer considerable economic disadvantage in relation to their competitors on the market who do, owing to the latter's competitive advantage. Accordingly, operators who lack AEO status are likely to receive fewer orders from potential partners than AEOs.

Currently, the legal advantages of AEO-C certification are simplified customs controls (Article 14 (b) (4) CCIP) and authorisations for using simplified procedures (Article 14b (1) CCIP).

The withdrawal of simplified customs controls means that the economic operator will be checked more often and not given any priority treatment. The person concerned will also be tied to the jurisdiction of the customs authority in question. Above all, economic operators who are suspected of being unreliable should expect more frequent checks.

As far as legal consequences are concerned it should be noted that, regardless of status, AEO-C simplifications already issued and authorisations for simplified procedures in accordance with Article 14s (2) CCIP will basically continue to apply. In particular, operators who apply for AEO-C status will be those who already benefit from procedural simplifications on the basis of previously issued individual authorisations. Since AEO certification does not form the basis for these individual authorisations, the suspension of AEO status will not have any direct impact on their validity. The fact that AEO-C status is not connected to individual authorisations for simplified procedures is confirmed in Article 14o (5) CCIP, which states that the rejection of an application for AEO status will not result in the withdrawal of existing authorisations. In addition, Article 14s (3) CCIP states that those individual authorisations granted on the basis of the AEO-certification and whose conditions are still fulfilled will not lose their effect because AEO-C status only means that the conditions already checked during the AEO-application will not be re-examined.

In the event that AEO-C status is suspended, the conditions for the individual authorisation of procedural simplifications will often not be met either. In this case, an individual authorisation pursuant to Article 14s (2) CCIP, issued without reference to AEO-status, will be revoked in accordance with Article 9 (1) CC.

In accordance with Article 14s (1) CCIP, suspension will not apply to any customs procedures already started before the date of the suspension.

Once the MCC enters into effect, a withdrawal of the legal benefits granted by AEO-C status will cause even greater disadvantages because certain authorisations will only be granted to holders of AEO-C certificates. Suspension will have the effect of eliminating such simplifications. For example, the future simplified procedure will require AEO-C status. Operators who do not have this status will have to declare each export of goods to the customs office individually and completely, thereby eliminating the possibility of entry in the records. Suspending AEO-S status will have the effect of cancelling all facilitations related to security-relevant controls and the possibility of transmitting a reduced set of data to the customs authority on the basis of prior notification in accordance with Article 15b (3) CCIP.

Therefore, the greatest disadvantages will be suffered by those AEOs holding AEO-C and AEO-S certificates. However, partial suspension of the latter is also possible if the relevant conditions are no longer fulfilled. Accordingly, customs simplifications may remain unaffected.

Suspension will also lead to the loss of economic benefits by depriving economic operators of the seal of quality associated with AEO status. This suggests that an operator is unreliable thereby damaging its reputation. Accordingly, third parties will be less likely to contract with such operators and may even cancel existing contracts due to the fact that dealings with non-AEOs could adversely affect their

own risk rating. The economic disadvantages are therefore considerable and in some cases could even endanger a company's continued existence.

Revocation of AEO status takes effect immediately after the day of its notification (Article 14v (2) 1st sentence). Partial revocation is also possible; in this case revocation will be limited to security aspects.

In the event of revocation, an economic operator will be prevented from submitting a renewed application for AEO status for three years in accordance with Article 14v (4) CCIP, unless the suspension or revocation was requested by the economic operator itself.

5.2 In relation to contracting-partners in the AEO's supply chain

The absence of AEO status will have very important repercussions for the AEO's partners. They should expect less favourable risk assessments owing to the cancellation of the AEO-status of their partners in the supply chain. As a result, they themselves may no longer fulfil the requirements of other international partnership programs such as the United States C-TPAT (Customs-Trade Partnership Against Terrorism) program. In this case, the only solution would be to place fewer orders from the former AEO or to cancel existing contracts.

5.3 Regarding a possible obligation to inform other customs administrations under the consultation procedure

All information about revocation, withdrawal and suspension is exchanged via the economic operator system, so that all Member States are informed about changes. This is necessary because the AEO certificate takes effect throughout the EC. All customs authorities of other Member States have to be informed of all decisions relating to AEO certification by means of the AEO information and communication system laid down in Article 14x CCIP.

The withdrawal of the legal effects of AEO status is regulated in Article 14r (2) 2nd sentence, (3) 2nd sentence, Article 14u (1) sub-para. 2 CCIP. In accordance with the wording of the text, the extension of the suspension period as referred to in Article 14r (4) CCIP is not subject to the obligation of mutual information. However, this gap is to be filled through the analogous application of the notification obligation as stipulated in Article 14r (1) sub-para. 2, 2nd sentence CCIP in relation to the initial suspension.[20]

As far as a request for suspension is concerned, Article 14u (2) sub-para. 2 CCIP expressly provides that the customs authorities of other Member States are to be notified of a prolongation of the period to regularise the situation using the communication system referred to in Article 14x.

In case of the withdrawal of suspension or the full or partial revocation of AEO status, the customs authority is to inform the customs authorities of other Member States in accordance with Article 14t (1) sub-para. 1, 1st sentence, and Art. 14t (2) sub-para. 1 CCIP. The customs authorities must also inform the customs authorities of other Member States of the revocation of AEO status in accordance with Article 14v (4) CCIP.

5.4 Regarding a possible obligation towards third countries which have concluded an agreement on mutual recognition of the respective AEO status of their economic operators with the EU

The EU has already completed a series of agreements on the mutual recognition of AEO status and others will be signed in the near future. The exchange of information on changes (revocation and suspension) of AEO certificates forms an essential component of these agreements.

5.5 Regarding an infringement of competition law if the former AEO continues to advertise this status

a. Under national law

Germany protects the rights of market competitors by the *Gesetz gegen den Unlautern Wettbewerb* (Act Against Unfair Competition - UWG).[21] Section 5 deals with misleading commercial practices:

> (1) An unfair practice shall be deemed to have occurred where a person adopts a misleading commercial practice. A commercial practice is misleading if it contains untruthful information or other information suited to deception regarding the following circumstances:
>
> …
>
> 3. the nature, attributes or rights of the entrepreneur such as his identity, assets, including intellectual property rights, the extent of his commitments, his qualifications, status, approval, affiliation or connections, awards or distinctions, motives for the commercial practice or the nature of the sales process…

If a company advertises itself as an AEO despite the fact that the certificate has been suspended or revoked, it will be guilty of a misleading commercial practice insofar as the fraudulent advertisement of AEO status and any related authorisations is capable of deceiving another party into contracting with the former AEO. Competitors on the market can oppose this by applying for an order to cease and desist in accordance with Section 8 UWG. In addition, the former AEO will be ordered to pay damages under Section 9.

In Austria Section 1 (1) of the *Bundesgesetz gegen den unlauteren Wettbewerb* (Federal Act against Unfair Competition - Austrian UWG)[22] provides that a person who in the course of business applies an unfair practice or other unfair act likely to distort competition to the detriment of companies to a not insignificant degree or who adopts an unfair practice which contravenes the requirements of professional diligence and which, with regard to the product in question, is capable of influencing the economic behaviour of the average consumer affected by the practice or act can be ordered to cease and desist the same and, if at fault, to pay damages.

In accordance with Section 1 (3) of this Act, 'unfair practices' refers in particular to practices which are misleading pursuant to Section 2. According to the latter:

> A commercial practice will be deemed misleading if it contains inaccurate information (Section 39) or is otherwise likely to deceive market participants in relation to the product concerning one or more of the following points and that will cause the market participant to take a transactional decision he would not otherwise have taken:
>
> …
>
> 6. the person, the attributes or the rights of the contractor or his representative, such as his identity and assets, his qualifications, status, authorisations, memberships or relations and ownership of industrial, commercial or intellectual property rights or his awards and distinctions …

In this respect, misleading information regarding the status and authorisations of the company will also constitute a misleading practice.

b. Under European law

Directive 2005/29/EC regulates the legal relationship between consumers, entrepreneurs and competitors at European level.[23] Article 5 prohibits 'unfair commercial practices'. Such practices are those that are misleading (Art. 5 (4)). According to Article 6 of the Directive, a practice will be deemed to be 'misleading', if it contains false information and is therefore untruthful. If a company advertises itself

as holding AEO status despite the fact that this information is incorrect, it will be guilty of an unfair commercial practice. The Directive does not impose any sanctions but states in Article 11 that Member States are to ensure that adequate and effective means exist to combat unfair commercial practices in order to enforce compliance with its provisions in the interest of consumers.

6. Conclusions

Revocation, withdrawal and suspension of AEO status are permitted under Community law. However, such measures have far-reaching legal and factual consequences that go beyond the provisions of the relevant customs legislation. Considering these consequences, any company that holds an AEO certificate or has applied for it must ensure that it satisfies the conditions of the certificate at the time of application and in the years thereafter.

Endnotes

1 Tax code as amended by the notice of the 1 October 2002 (Federal Law Gazette I S. 3866; 2003 I p. 61), most recently by Article 2 of the Act of 30 July 2009 (Federal Law Gazette I S. 2474).

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4 Walter/Mayer, Verwaltungsverfahrensrecht, Tz. 379) Administrative Court 15.9.1995, 92/17/0247; 11.12.2000, 2000/17/0237.

5 OJ EU, no. C 115 v. 9 May 2008, p. 47.

6 Case 6/64, EuGHE 10, 1251.

7 Case R 48/71, DöV 1973, 410.

8 Case 88 to 90/75, EuGHE 1976, 323.

9 Case R 48/71 and 118/75, EuGHE 1976, 1185.

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11 RS 249/85, EuGHE 1987 2345.

12 Opinion of the advocate of General Carl Otto Lenz of 5.12.1986, EuGHE 1987, 2301.

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14 Henke Reginhard / Huchatz, Wolfgang, op. cit., 230.

15 ECJ, 17.07.1997 - Case C-130/95, *Bernd Giloy v. HZA Frankfurt am Main-Ost*, Coll. 1997, I-4291 (Marginal Number. 35 et seq.) = ZfZ 1997, 335 (337 f.).

16 ECJ, 19.07.1995 - Case C-149/95 P(R), *Commission v. Atlantic Container*, ECR 1995, I-2165 (Marginal Number 22).

17 ECJ, 19.07.1995 - Case C-149/95 P(R), *Commission v. Atlantic Container*, ECR 1995, I-2165 (para. 50); ECJ, 17.07.1997 - Case C-130/95, *Bernd Giloy v. HZA Frankfurt am Main Ost*, ECR 1997, I-4291 (para. 36) ZfZ = 1997, 335 (337).

18 ECJ, 23.05.1990 - Case 51 and 59 / 90 R, *Como Tank v. Commission*, ECR. 1990 I-2167 (para. 24); CFI, 07.11.1995 - Case T-168/95 R, *Eridania Zuccherifici v. Council*, ECR 1995, II 2817 (para. 42).

19 ECJ, 17.07.1997 - Case C-130/95, *Bernd Giloy v. HZA Frankfurt Main Ost*, ECR 1997 I-4291 ff. (para. 39) =ZfZ 1997, 335 (338) from 19.07.1995 - Case C-149/95 P(R), *Commission v. Atlantic Container*, ECR 1995, I-2165 (para. 38).

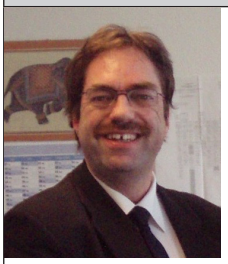
20 Natzel, Der Zugelassene Wirtschaftsbeteiligte, Münster 2007.

21 Act Against Unfair Competition (Federal Law Gazette I p. 254).

22 Federal Law Gazette. No. 448 / 1984 amended by Federal Law Gazette I no. 79 / 2007.

23 Directive 2005/29/EC of the European Parliament and of the Council of 11 May 2005 concerning unfair business-to-consumer commercial practices in the internal market and amending Council Directive 84/450/EEC, Directives 97/7/EC, 98/27/EC and 2002/65/EC of the European Parliament and of the Council and Regulation (EC) No. 2006 / 2004 of the European Parliament and of the Council ('Unfair Commercial Practices Directive'), Journal No. L 149 of 11/06/2005 p. 0022-0039.

Dr Lothar Gellert



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Risk management systems: using data mining in developing countries' customs administrations

Bertrand Laporte

Abstract

Limiting intrusive customs inspections is recommended under the revised Kyoto Convention, and is also a proposal discussed as part of World Trade Organization (WTO) trade facilitation negotiations. To limit such inspection, the more modern administrations intervene at all stages of the customs chain using electronic data exchange and risk analysis and focusing their resources on *a posteriori* controls. Customs administrations of developing countries are slow to move in that direction. Risk analysis would therefore seem to be a priority for modernising the customs systems in developing countries. The most effective risk management system uses statistical scoring techniques. Several simple statistical techniques are tested in this article. They all show a good capability to predict and detect declarations that contain infractions. They can easily be implemented in developing countries' customs administrations and replace the rather inefficient methods of selectivity that result in high rates of control and very low rates of recorded infractions.

Introduction

Limiting intrusive customs examinations is recommended under the revised Kyoto Convention. It is also a proposal discussed in the context of World Trade Organization (WTO) trade facilitation negotiations. To limit these intrusive examinations, the more modern governments now intervene at all stages of the customs chain, using electronic data exchange and risk analysis, and focusing their resources on *a posteriori* inspection (Revised Kyoto Convention 1999; Keen 2004; eds De Wulf & Sokol 2004).

Developing countries' customs authorities are slow to move in this direction and implement the latest risk analysis and management techniques (Geourjon & Laporte 2005; Geourjon, Laporte & Rota Graziozi 2010). These techniques are used in many areas which are facing the risk of fraud, for example, in insurance, credit banking, and so on (for a review, see Bolton & Hand 2002; Phua et al. 2005). Yet risk analysis is a priority for modernising customs in developing countries. Indeed, it is a powerful lever for conducting a comprehensive operational reform in particular because it calls for closer cooperation between different departments in charge of information management and also because it allows for the redeployment of agents to *a posteriori* inspection. Risk analysis should be accompanied by a reform in human resource management, with recruitment on the basis of job profiles and specific skills.

Most developing countries have outsourced risk management systems to private inspection companies when implementing pre-shipment inspection programs and/or scanning services. The systems offered by these companies work only for imports/exports that depend on their contractually-defined scope of intervention. Their effectiveness is often compromised by a limited exchange of information with customs authorities (Johnson 2001). For imports/exports falling within customs intervention, risk management systems are based on simple criteria of selectivity – most often as blacklists focusing on the goods, the origin of the goods and the importer, plus a random target. This risk management system

has not proven to be particularly effective. It requires customs authorities to monitor intrusively a large number of containers which, as identified in unpublished technical reports, frequently results in recorded offence rates of less than 3 per cent in the cases of Benin, Côte d'Ivoire, Mali and Senegal.

Selectivity as a risk management method was forced on many countries as a result of using the integrated customs clearance management system, ASYCUDA (**A**utomated **SY**stem for **CU**stoms **DA**ta) with 80 countries using the system today. Up to its latest version (ASYCUDA World), this system was closed and did not allow customs authorities to develop efficient risk management applications. ASYCUDA's risk 'management' module was forced on Customs and depended on the option of being able to apply and combine simple selection criteria (lists of importers, origins, etc.). The new version of ASYCUDA is more open and allows the development of country-specific applications. Côte d'Ivoire, Mali and Senegal (the latter country uses its own computer system for customs clearance, GAINDE) have therefore undertaken to develop their own risk management applications, notably with the technical assistance of the International Monetary Fund's (IMF) West Africa Regional Technical Assistance Centre (West AFRITAC).

The aim of this article is to present and compare simple statistical techniques that contribute to the modernisation of customs administration systems by enabling efficient targeting of the declarations to be inspected. These techniques can be developed by most developing countries' customs authorities, which are increasingly recruiting officers with the necessary statistics and mathematics skills.

From descriptive statistics to decision-making statistics

Whatever the sector of activity, statistical targeting techniques use available data. In Customs, data come from declarations, from the results of first- and second-line inspections, and from private inspection companies via the verification certificates that they issue.

The information obtained from these various sources makes up the customs information system which, among other things, allows a risk management system to be constructed and declarations to be directed to the different customs clearance channels. Unfortunately, customs authorities only exploit a small part of the wealth of information available that flows through the customs clearance process and their control activities.

Indeed, information processing is essentially qualitative in terms of the approach to selectivity. The selectivity criteria used are often few in numbers and the analysis for each criterion is most often dual (whether or not it is listed). Thus, if origin X is in the list of risk sources, as soon as a declaration gives that origin, an intrusive examination will be triggered – even if the declaration is made by a known and serious importer. There is thus no gradation in risk perception and this reduces targeting performance. This leads to high rates of intrusive inspections in exchange for low rates of reported infractions; that is, a relatively inefficient risk management system. This low targeting efficiency is determined by a defective statistical analysis of risk that does not leverage the available customs information in an optimal manner.

Descriptive statistics: data mining

To succeed in accurately targeting declarations that present a risk of infraction, it is necessary to carry out prior work on data analysis, on descriptive statistics. This work requires Customs to identify the characteristics of declarations that, in a preceding period (for example, over the previous twelve months) has resulted in an infraction, and then deducing the 'statistical regularities' in those infractions. For this reason, all available information is used, that is, the contents of verification certificates, detailed declarations, and the results of inspections during a reference period. These statistical regularities enable risk profiles to be established.

Indeed, while the information is essentially qualitative in its use of selectivity criteria, statistical analysis makes it possible to establish a 'quantitative' risk scale. Let us take the example of importers: to measure the 'quality' of importers, the frequency of infractions is calculated for each importer (this is the ratio between the number of declarations made by an importer involved in a customs infraction and the total number of declarations made by that importer during the period in question). Thus, importers are rated on a scale from 0 to 1 (or 0 to 100), where 0 is for importers that represent no risk and 1 for importers that represent a high risk. This type of calculation can be done for all potential risk criteria: origin, HS position, billing currency, freight agents, and so on. These calculations enable the establishment of risk profiles for each criterion (see Figure 1).

Decision-making statistics: referring declarations to a customs clearance channel

Next, we need to combine these risk profiles to facilitate the right decision with regard to referring the declaration to a particular customs clearance channel. The combination of criteria may be simple (statistical average) or more elaborate (econometric analysis). In both cases, the objective is to assign a score to each new declaration, obtained by combining the frequencies of infraction for the different criteria (risk profiles). At best, this score should reflect risk of infraction (or even the probability of an infraction occurring). Referral to one of the customs clearance channels is based on the score and thresholds previously determined through statistical analysis (see Figure 1).

With the simplest system, the score for the declaration is obtained by applying a simple or weighted average of infraction frequency for the different criteria, or by taking only the value of the highest frequency from among the criteria used (other combinations can be thought of). Prior to this, the most significant criteria will have been determined *ad hoc* by customs officers responsible for control activities. The most common and significant criteria are importer, freight agents, HS position and origin.

A more elaborate system uses statistical distribution properties to effectively combine customs information. Econometric models (combining statistical and mathematical approaches) enable (1) the determination of risk criteria relevant in accounting for an infraction; and (2) the calculation of the probability of infraction for each new declaration introduced in the customs clearance system. This probability is the calculated score for the declaration. For this purpose, it is first necessary to estimate the following econometric equation on the background history of the declarations:

$$\Pr(Infraction_{ij} = 1) = \alpha + \beta_1 fq\_critère1_{ij} + \beta_2 fq\_critère2 + \ldots\ldots_{ij} + \beta_N fq\_critèreN_{ij} + \varepsilon_{ij}$$

where Pr is probability; Infraction $_{ij}$ the binary 0/1 variable for declaration i, product j (1 if infraction, 0 if no infraction for the declaration j and for product i) fq_{ij}, the frequency of customs infractions for each criterion of risk associated with declaration i and product j, ε, error term (which is not explained by the criteria used in the equation) and α and β as the parameters of the equation to be estimated.

The use of background history involves looking over all the declarations for a reference period, giving a mark of '1' to those that have been found in infraction and '0' to those that have not. The binary variable 0/1 is thus constructed ('explained' or 'dependent' variable). This variable is then 'explained' by risk criteria ('explanatory' or 'independent' variables), the values of which are continuous between 0 and 1.

The estimate can be drawn from a linear probability model, a PROBIT model or a LOGIT model. The last two of these models are the most appropriate for estimating a model with a binary explained variable. Indeed, some stochastic assumptions are violated in linear regression. The error term occurs through heteroskedastic construction and does not follow normal distribution. Furthermore, the predicted value cannot be interpreted as a probability of infraction since it does not belong to the interval [0, 1]. If the LOGIT and PROBIT models are 'in theory' the most appropriate, then the end goal is to find a model

capable of better targeting those declarations that present real risk of infraction. The three models can therefore be tested and the one presenting the best results should be accepted.

From theory to practice: results from some empirical tests

The tests presented use a database created by Senegalese customs authorities. Indeed, in 2011, the Senegalese customs authorities propose incorporation of a risk management module into their customs clearance system, GAINDE 2010[1]. The confidentiality of customs data and the effectiveness of the system itself preclude the specific presentation of the criteria used, but this does not impede comparison of the results according to the different methods proposed.

The database used covers twelve months. Data comes from detailed declarations and monthly statements of customs infractions for the two main offices in Dakar. Verifications certified by the inspection company are not taken into account. Risk profiles (based on frequency of infraction) were calculated for six different criteria: importer, freight agents, HS position, origin, provenance, and customs regime. Only declarations from operators with an identification number were taken into account in these tests.

Six different scoring calculations are done and their performance is compared for the purposes of targeting declarations. The effectiveness of targeting is measured by comparing, for each declaration from the period in question, the occurrence of an infraction with the calculated score. If the calculated score is high, –that is, if the estimated risk of infraction is high, the declaration should be subject to an infraction (binary variable = 1). If this is the case, the system enables the targeting of risky declarations. On the other hand, if the calculated score is high and the declaration was not subject to an infraction (binary variable = 0), the calculated score does not enable effective targeting. Similarly, if the calculated score is low, the declaration should not be subject to an infraction (binary variable = 0). If this is the case, the system enables good targeting. If the opposite is the case, it does not enable good targeting. This method of measuring effectiveness is applied regardless of the score calculation method.

Simple methods for score calculation

Among the six criteria adopted *a priori*, three were identified as very important by the Senegalese customs authorities. Thus, for all the declarations stored in the database, the score of each declaration was calculated based on the risk profiles for these three criteria in accordance with three different methods: (1) a simple average of the frequency of infraction; (2) a weighted average of the frequency of infraction, with 0.5, 0.3 and 0.2 weighting; and (3) by accepting only the maximum value for the frequency of infraction for the three criteria adopted.

To facilitate the analysis of the results, declarations are grouped into ranges of scores (those that have a calculated score of between 0 and 0.01, then between 0.01 and 0.02, and so on). The results can be seen in the following tables. The choice of intervals is important because it will determine the thresholds that refer declarations to the various customs clearance channels. Ten intervals have been chosen here to make it easier to read the tables.

Figure 1: Risk Management System: an illustrative example
(Score of declaration = result from a probability model; all data shown here are fictitious)

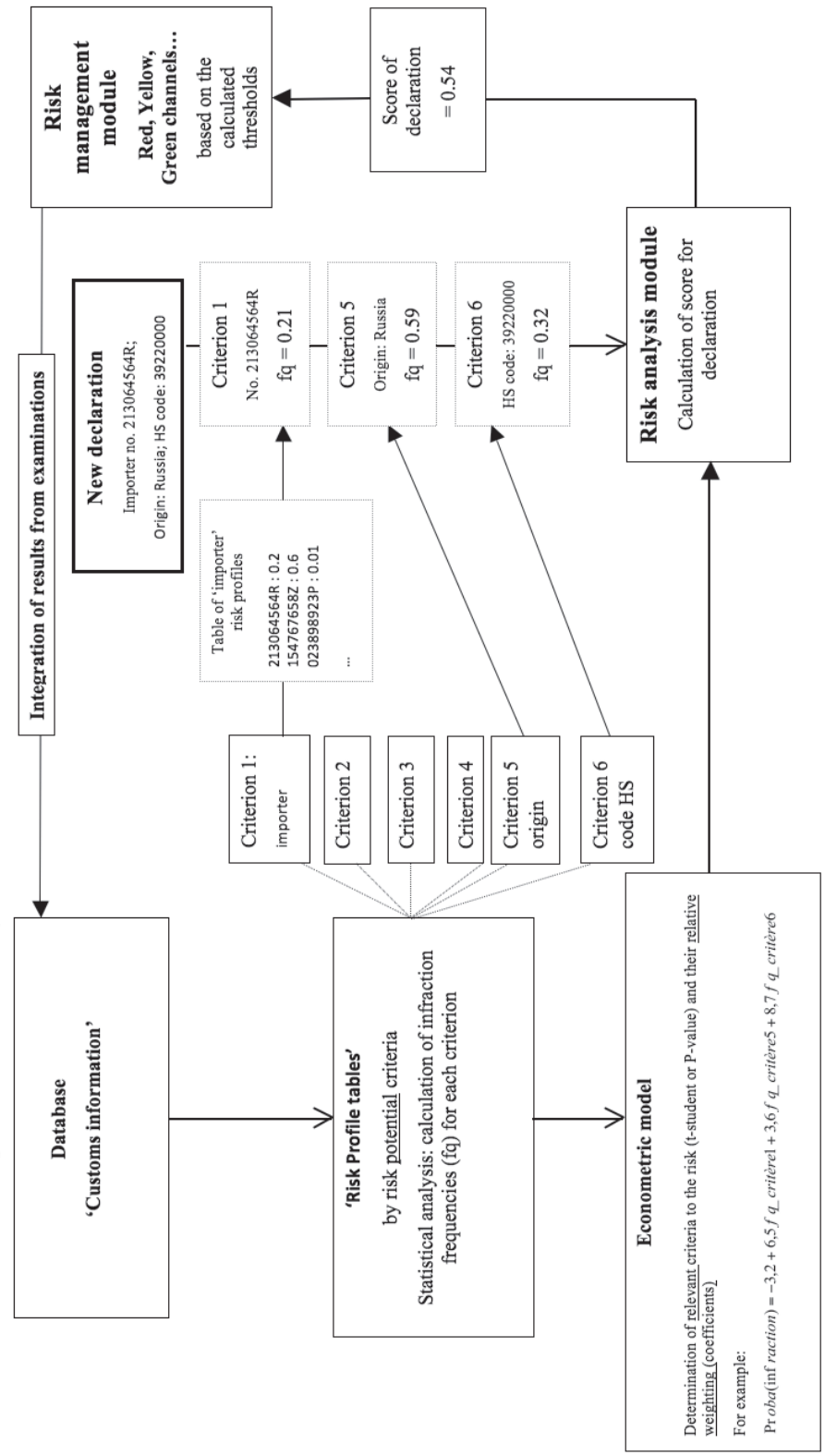

Table 1: Effectiveness of targeting – simple average (1)

Score interval	Number of declarations for the interval	Number of accumulated declarations	Accumulated declarations (%)	Number of declarations with infraction	Number of accumulated declarations with infraction	Rate of infraction by interval	Accumulated declarations with infraction (%)
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
[0.5 : 1]	0	0	-	0	0	-	0.0
[0.1 : 0.5]	825	825	0.8	351	351	42.55	31.8
[0.07 : 0.1]	503	1328	1.3	112	463	22.27	41.9
[0.06 : 0.07]	470	1798	1.7	61	524	12.98	47.4
[0.05 : 0.06]	618	2416	2.3	63	587	10.19	53.1
[0.04 : 0.05]	1014	3430	3.3	130	717	12.82	64.9
[0.03 : 0.04]	2027	5457	5.2	124	841	6.12	76.1
[0.02 : 0.03]	4895	10352	9.9	142	983	2.90	89.0
[0.01 : 0.02]	20292	30644	29.3	81	1064	0.40	96.3
[0 : 0.01]	74053	104697	100.0	41	1105	0.06	100.0
Total	104697			1105		1.06	

Table 1 is read as follows: Column 1 shows the selected intervals. Column 2 shows the number of declarations with a calculated score within the range: 20,292 declarations have a calculated score of between 0.01 and 0.02. Column 3 shows the cumulative number of declarations: there are 30,644 declarations with scores between 0.01 and 1. Column 4 shows these cumulative declarations as percentages: the declarations that have a calculated score of between 0.01 and 1 (that is, greater than 0.01) represent 29.3% of all declarations. Column 5 shows the number of declarations showing an infraction by interval: among the 20,292 declarations with a calculated score of between 0.01 and 0.02, 81 have actually been subject to an infraction. Column 6 shows the cumulative number of declarations that have had an infraction: there are 1,105 declarations that involved an infraction – an infraction rate of 1.06% (column 7). Column 8 shows the cumulative number of declarations showing infractions: 96.3% of declarations showing infractions have a calculated score of between 0.01 and 1 (that is, above 0.01).

Table 2: Effectiveness of targeting – weighted average (2)

Score interval	Number of declarations for the interval	Number of accumulated declarations	Accumulated declarations (%)	Number of declarations with infraction	Number of accumulated declarations with infraction	Rate of infraction by interval	Accumulated declarations with infraction (%)
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
[0.5 : 1]	98	98	0.1	94	94	95.92	8.5
[0.1 : 0.5]	1165	1263	1.2	348	442	29.87	40.0
[0.07 : 0.1]	954	2217	2.1	121	563	12.68	51.0
[0.06 : 0.07]	448	2665	2.5	56	619	12.50	56.0
[0.05 : 0.06]	788	3453	3.3	98	717	12.44	64.9
[0.04 : 0.05]	1152	4605	4.4	85	802	7.38	72.6
[0.03 : 0.04]	2427	7032	6.7	109	911	4.49	82.4
[0.02 : 0.03]	2645	9677	9.2	83	994	3.14	90.0
[0.01 : 0.02]	11897	21574	20.6	73	1067	0.61	96.6
[0 : 0.01]	83123	104697	100.0	38	1105	0.05	100.0
Total	104697			1105		1.06	

How to analyse these results. By targeting (inspecting) all declarations that have a calculated score above 0.02, that is, 9.9% of declarations, the system captures 89% of declarations that have been subject to infraction. If the threshold is lowered to 0.01, this rises to 96.3% of declarations that have been subject to infraction, captured by inspecting only 29.3% of declarations.

How to use these results. If customs authorities set a 0.01 threshold for intrusive examinations, any new declaration recorded in the customs clearance system that shows a calculated score higher than 0.01 will be referred to an intrusive examination channel; that is, approximately 30% of declarations. The threshold can be adjusted according to the customs authorities' objectives.

Score calculation based on weighted average improves targeting effectiveness. By targeting all declarations with a score higher than 0.01 (that is, 20.6% of declarations), the system captures 96.6% of declarations with infractions, that is, an inspection rate much lower than is currently practised in many developing countries.

Table 3: Effectiveness of targeting – maximum value (3)

Score interval	Number of declarations for the interval	Number of accumulated declarations	Accumulated declarations (%)	Number of declarations with infraction	Number of accumulated declarations with infraction	Rate of infraction by interval	Accumulated declarations with infraction (%)
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
[0.5 : 1]	143	143	0.1	126	126	88.11	11.4
[0.1 : 0.5]	2954	3097	3.0	510	636	17.26	57.6
[0.07 : 0.1]	1926	5023	4.8	136	772	7.06	69.9
[0.06 : 0.07]	956	5979	5.7	41	813	4.29	73.6
[0.05 : 0.06]	2569	8548	8.2	68	881	2.65	79.7
[0.04 : 0.05]	3172	11720	11.2	56	937	1.77	84.8
[0.03 : 0.04]	7691	19411	18.5	60	997	0.78	90.2
[0.02 : 0.03]	23027	42438	40.5	41	1038	0.18	93.9
[0.01 : 0.02]	49402	91840	87.7	61	1099	0.12	99.5
[0 : 0.01]	12857	104697	100.0	6	1105	0.05	100.0
Total	104697			1105		1.06	

Calculating the score according to maximum value is the least effective, since 18.5% of declarations need to be targeted in order to capture 90.2% of declarations with infractions.

Econometric methods for score calculation

Three estimations were used: (4) estimation by a linear probability model; (5) estimation using a LOGIT model which uses the logistical distribution, and (6) estimation using a PROBIT model, based on normal distribution.

The linear probability model

The equation is estimated using the ordinary least squares method, corrected by heteroskedasticity. The explained variable is the binary (0/1) 'infraction' variable. The explanatory variables are the risk criteria. Four of these variables show a coefficient that is significantly different from zero. The adjusted R^2 is 0.23. The failure to respect the residual normality hypothesis means the usual econometric tests cannot be run. Estimating the variable coefficients in the equation enables calculation of the score for each declaration and conduct of the targeting effectiveness test.

Table 4: Effectiveness of targeting – Linear Probability (4)

Score interval	Number of declarations for the interval	Number of accumulated declarations	Accumulated declarations (%)	Number of declarations with infraction	Number of accumulated declarations with infraction	Rate of infraction by interval	Accumulated declarations with infraction (%)
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
[0.5 : 1]	147	147	0.1	131	131	89.12	11.9
[0.1 : 0.5]	2506	2653	2.5	489	620	19.51	56.1
[0.07 : 0.1]	1455	4108	3.9	157	777	10.79	70.3
[0.06 : 0.07]	957	5065	4.8	48	825	5.02	74.7
[0.05 : 0.06]	1234	6299	6.0	55	880	4.46	79.6
[0.04 : 0.05]	1407	7706	7.4	61	941	4.34	85.2
[0.03 : 0.04]	1500	9206	8.8	39	980	2.60	88.7
[0.02 : 0.03]	2287	11493	11.0	37	1017	1.62	92.0
[0.01 : 0.02]	7171	18664	17.8	43	1060	0.60	95.9
[0 : 0.01]	86033	104697	100.0	45	1105	0.05	100.0
Total	104697			1105		1.06	

Although econometric estimation is biased by construction, its result in terms of targeting is good and slightly better than that of the simple methods. By targeting all declarations with a calculated score higher than 0.01, that is, 17.8% of declarations, the system captures 95.9% of declarations with infractions.

The PROBIT and LOGIT models

These two nonlinear models enable an estimate of the probability that a declaration may contain an infraction. The variables used are the same as for the linear probability model. The estimates are adjusted for the heteroskedasticity problem.

The estimate of the equation based on the LOGIT model has a Pseudo-R^2 of 0.32 and that based on the PROBIT model results in a Pseudo R^2 of 0.36. The six explanatory variables are significant. Both estimates enable the calculation of the probability that a declaration may contain infractions.

Table 5: Effectiveness of targeting – Probability calculated with a LOGIT model (5)

Score interval	Number of declarations for the interval	Number of accumulated declarations	Accumulated declarations (%)	Number of declarations with infraction	Number of accumulated declarations with infraction	Rate of infraction by interval	Accumulated declarations with infraction (%)
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
[0.5 : 1]	414	414	0.4	251	251	60.63	22.7
[0.1 : 0.5]	736	1150	1.1	173	424	23.51	38.4
[0.07 : 0.1]	306	1456	1.4	60	484	19.61	43.8
[0.06 : 0.07]	148	1604	1.5	18	502	12.16	45.4
[0.05 : 0.06]	274	1878	1.8	33	535	12.04	48.4
[0.04 : 0.05]	335	2213	2.1	18	553	5.37	50.0
[0.03 : 0.04]	701	2914	2.8	65	618	9.27	55.9
[0.02 : 0.03]	1799	4713	4.5	117	735	6.50	66.5
[0.01 : 0.02]	7702	12415	11.9	178	913	2.31	82.6
[0 : 0.01]	92282	104697	100.0	192	1105	0.21	100.0
Total	104697			1105		1.06	

Table 6: Effectiveness of targeting – Probability calculated witha PROBIT model (6)

Score interval	Number of declarations for the interval	Number of accumulated declarations	Accumulated declarations (%)	Number of declarations with infraction	Number of accumulated declarations with infraction	Rate of infraction by interval	Accumulated declarations with infraction (%)
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
[0.5 : 1]	405	405	0.4	245	245	60.49	22.2
[0.1 : 0.5]	889	1294	1.2	215	460	24.18	41.6
[0.07 : 0.1]	396	1690	1.6	52	512	13.13	46.3
[0.06 : 0.07]	221	1911	1.8	32	544	14.48	49.2
[0.05 : 0.06]	255	2166	2.1	18	562	7.06	50.9
[0.04 : 0.05]	341	2507	2.4	35	597	10.26	54.0
[0.03 : 0.04]	709	3216	3.1	61	658	8.60	59.5
[0.02 : 0.03]	1988	5204	5.0	115	773	5.78	70.0
[0.01 : 0.02]	5618	10822	10.3	160	933	2.85	84.4
[0 : 0.01]	93875	104697	100.0	172	1105	0.18	100.0
Total	104697					1.06	

Although the method is statistically more rigorous, estimates on the basis of a LOGIT or PROBIT model do not enable improvement of targeting effectiveness. Indeed, by targeting declarations that have a calculated score above 0.01 (that is, between 10% and 12% of declarations, depending on the model), the system captures only 82-84% of declarations containing infractions depending on the model, that is, a rate lower than that of other calculation methods.

Why do we get these results? The quality of the database is certainly the most plausible explanation. Indeed, declarations with infractions are rare (about 1% of the declarations in this database), which the LOGIT and PROBIT models find hard to accommodate. The reality is certainly different.

Good targeting is a factor in improving customs information systems and, hence, the database that feeds the system. Indeed, by controlling less and in a different manner (second-line controls that substitute first-line controls), services are made to control better. Over time, database quality improvement should restore advantage to the PROBIT and LOGIT models which are especially well-suited to scoring.

Some lessons for customs authorities of developing countries

Streamlining customs controls is one of the keys to modernising customs administration in developing countries. Using statistical techniques can substantially improve the efficiency of targeting declarations to be inspected. The 'statistical techniques' aspect is no obstacle to customs authorities developing an effective risk management system. The simple methods proposed are accessible to all staff trained to a masters degree level in economics or statistics.

The proposed tests show that statistical techniques allow effective targeting of declarations. They have a good ability to predict and detect declarations containing infractions.

Thus, a developing country's customs authorities can build, stage by stage, a risk management system at the pace at which it acquires staff skills and practice, while serving as the driving force behind the modernisation of the first stage. A period of two to three years is sufficient to develop such a system in three main stages.

The first stage is to establish risk profiles by criterion and simply combine them (in a weighted average, for example). This stage is already possible in most developing countries' customs authorities; countries such as Côte d'Ivoire, Senegal and Mali have managed this fast. This system can effectively replace the current, rather inefficient systems of selectivity, without risk to either tax revenues or the country's security.

Since the database is fed by more reliable data, the second stage is to apply econometric scoring techniques – usually more effective than averaging – because they are based on statistical distributions. Binomial models are the easiest to implement. The information analysed on the background history of declarations is binary: has the declaration been subject to an infraction – yes or no? The information returned is binary too: does the new declaration present an increased risk of information – yes or no? The model says nothing about the nature of the infraction. The second stage comes into play when the customs information system is not sufficiently informed about the nature of the infractions confirmed. The information revealed is the presumption of infraction, whereby the control officers must define the nature of the infraction.

The third step entails setting up a comprehensive and accurate customs information system on recorded infractions. These multinomial models are then used to provide information about the nature of the infraction that is being considered.

These statistical methods are just one component of the risk management system. Random controls, selectivity on new fraud forms detected by the intelligence services, selectivity from the moment one characteristic of the declaration is not entered in the database, are complementary to the statistical analysis.

The combination of all these elements creates an effective risk management system that helps reduce the number of intrusive inspections without risk to the country. Reducing the number of first-line inspections makes it possible to improve the inspection performed as well as to develop *a posteriori* inspection. Developing *a posteriori* inspections should be an opportunity to bring together Customs and tax authorities, thereby contributing to greater efficiency in total government revenue. Trade facilitation and improving revenue collection are therefore perfectly compatible.

External technical assistance regarding risk management systems enables developing countries to invest more quickly and solidly in modernising their customs authorities. This external technical assistance, however, is beneficial only if the customs authorities adopt an up-to-date management of their human resources: staff in charge of these technical matters should be recruited on the basis of well-defined job descriptions and personnel assigned to risk management services should be appointed for the long term.

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Endnote

1 'GAINDE' is the French acronym for Automated Management of Customs and Economic Information.

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The role of Customs and other agencies in trade facilitation in Bangladesh: hindrances and ways forward

Md Almas Uzzaman and Mohammad Abu Yusuf

Abstract

This paper examines the role of the Customs service and other government agencies in trade facilitation in Bangladesh with the aim of suggesting some ways forward. A combination of primary and secondary data sources were used in the study which found that traders in Bangladesh face delays due to too many official formalities, inefficiencies and arbitrary discretion in conducting their trade. These problems mostly occur in Customs and the Port Authority. Other factors such as inaccurate Clean Report of Findings (CRF) certificates issued by Pre-shipment Inspection (PSI) agencies, lack of testing facilities, cases filed by traders and false declarations by the trading community are also found to be responsible for such delays and inefficiencies in import and export clearance. The study suggests that the efforts of a single Customs or Port administration are not sufficient to facilitate trade; rather an integrated approach is imperative to this end.

Introduction

Trade facilitation is defined as: 'The simplification and harmonisation of international trade procedures' where trade procedures are the 'activities, practices and formalities involved in collecting, presenting, communicating and processing data required for the movement of goods in international trade' (WTO 1998 quoted in Grainger 2008, p. 17). Grainger has further extended the definition of trade facilitation. In his view, trade facilitation also covers the improvement of transport infrastructure, removal of government corruption, reduction of customs tariffs, resolution of non-tariff trade barriers, export marketing and export promotion (2008, p. 20). The main objective of trade facilitation is to improve the overall trade environment and reduce trade costs.

Trade facilitation is of significant importance because it is all about reducing time in international trade. It provides a comparative advantage for the country undertaking trade facilitating reforms in its Customs, port and other agencies. Li and Wilson (2009) find that time to export is a significant determinant of comparative advantage. Facilitation of trade through improving Customs and port administrations, as well as removing other non-tariff barriers supports the just-in-time supply chain approach required by internationally competitive manufacturers. It has been estimated that each day of delay in shipping time approximates 0.8 per cent of the cost of manufactured goods. According to the Organisation for Economic Co-operation and Development (OECD), for every 1 per cent saving achieved in transaction costs, the worldwide benefit would be USD43 billion (Sandford & Temby 2010). Hoekman and Nicita (2010) find domestic trade costs to be more limiting for international trade than tariffs. According to them, a 10 per cent reduction in the cost associated with importing (exporting) would increase imports (exports) by about 5 per cent.

At the international level, trade facilitation has become an important aspect of the current World Trade Organization (WTO) negotiations following the Doha Ministerial Declaration, and prior to that it was high on the agenda at the 1996 Singapore Ministerial Conference. Within the WTO negotiations, GATT Articles V, VIII and X relate to trade facilitation. These articles deal with trade facilitation issues and specifically address the freedom of transit, fees and formalities, and publication and administration of trade regulations respectively.

OECD research finds that Customs and administrative procedures have substantial effects on international trade. Also, cumbersome Customs and administrative procedures have been found to be a challenge for developing countries in exporting to developed and other developing countries (Wilson 2007).

One reason why trade facilitation is seen as an intricate as well as important agenda item for international organisations such as the World Customs Organization (WCO) and WTO is because international trade operations involve a number of government organisations and private sector entities. Apart from Customs, other government agencies also have a stake in the control of national borders and the movement of goods. It is therefore important to assess the roles of other government organisations, to identify the institutional limitations of these agencies, and to remedy the limitations when seeking to reduce the overall transaction costs.

This paper contributes to the growing body of literature on trade facilitation. Particularly, it highlights the fact that not only Customs but also other agencies and parties involved in trade have important roles to play in relation to cross border trade facilitation. It builds a case for more efficient trade infrastructure (Customs, port, logistics, skilled labour force and testing agencies) using evidence from Bangladesh.

Methods of data collection: To increase the authenticity of data and confidence in the findings, we have based our study on both primary and secondary data. In collecting data from primary sources, we have used in-depth face-to-face interviews of different stakeholders involved in border trade. The stakeholders included traders (importers and exporters), customs officials, customs brokers, port officials, and PSI agency representatives. Thirty semi-structured interviews[1] were conducted (28 interviews during 2006 to March 2007, and two in 2011 to update the information). The respondents were: 12 from the trading community, five from Customs, two from the Port Authority, seven from customs brokers and four from PSI agencies. Purposive sampling was used in selecting the respondents.

Simplification and harmonisation of customs procedures

Many developing countries have initiated unilateral reforms of customs administrations and procedures, the main objective being to simplify procedures and facilitate trade. In order to simplify customs procedures, the WCO has undertaken a number of important initiatives. Among others, it has formulated guidance on good customs procedures. This guidance is available from the WCO's *International Convention on the Simplification and Harmonization of Customs Procedures*, known as the Revised Kyoto Convention (1999). It comprises a set of principles and 31 Annexes that provide standards and best practices for customs procedures and related arrangements. However, the Convention has not been a very successful multilateral instrument since it was originally drawn up in 1973, because of its non-binding nature.

Role of different government agencies in trade facilitation

Trade facilitation needs an integrated approach because it requires the combined effort and efficiency of a number of government agencies as well as private parties and individuals. The World Bank's Logistics Performance Indicators (LPIs) suggest that customs authorities are only responsible for approximately one-third of the delays that the trading community encounters at the border, and that a number of other government institutions are responsible for the majority of the problems traders face at the border (eds McLinden, Fanta, Widdowson & Doyle 2011).

Customs and other agency issues

Excessive control and inefficiencies in customs procedures, combined with a monopoly of service providers at key entry points in importing countries, are prevalent in many parts of the developing world. For example, complexities and resultant disputes over classification, valuation and overall clearance procedures stand as depressing phenomena in the case of trade facilitation in Association of Southeast Asian Nations (ASEAN) countries (Chia 2010). In the case of valuation, Customs usually presumes under-invoicing and sometimes arbitrarily raises the values declared by importers.

Some importers also have the tendency to submit false invoices to Customs. The recent detection of gross under-invoicing and incorrect classification of goods imported by Airtel and GrameenPhone at Dhaka Customs House, Bangladesh (*The Daily Jugantor*, 7 February 2011) highlights importers' tendency to undervalue with a view to evading duties and taxes. Such under-invoicing and incorrect classification results in an increased dependency on physical verification, often in the presence of other organisations (such as Customs' intelligence directorate, Bangladesh Telecommunication Regulatory Commission [BTRC]) resulting in further delays in customs clearance.

Excessive documentation, physical inspection, and sometimes multiple inspections in the presence of more than one agency cause lengthy delays and cost escalation in customs clearance. One estimate shows that cost may increase 7 to 10 per cent of the value of world trade (Staples 1998).

Like other countries, customs procedures in Bangladesh also suffer from manual operations, arbitrary decisions, corruption and delays in clearance. Despite simplification of customs procedures in recent times, customs formalities in Bangladesh are still lengthy and less than efficient, leading to delays in the release of goods from Customs.

With regard to delays and arbitrary decisions by Customs, the majority of respondents from the trading community stated that discretion in the Customs Act along with the shortage of manpower and logistics often created problems in the prompt delivery of goods. One key respondent from the business community stated:

> In Bangladesh, clearance of a consignment usually takes 2-5 days in Customs. If a dispute arises with regard to classification, valuation or importability, it may take even up to months. In that case, we suffer from great uncertainty because no one can tell the actual delivery time. Layers in decision making, the tendency of physical inspection and the manual system contribute to the delay. Introduction of Pre-shipment Inspection (PSI) has improved the situation to some extent. Nevertheless there are still problems such as wrong classification and false description of goods in CRFs and delay in issuing corrections by the PSI agencies (Interviewee 10, 2006-07).

Another respondent from a business chamber observed:

> The delay and harassment we face are mainly caused by Customs, port, and political programs like strikes/hartal. Physical examination hinders the legitimate flow of goods and increases cost. We prefer non-intrusive means of examination to save time and cost. I, however, agree that sometimes clearance of shipments takes a longer time when documents are 'unclean' and 'inadequate' (Interview T7, 2006-07).

Regarding delays in Customs, an official of a customs brokers' association observed:

> Due to an inadequate testing facility in Chittagong Customs House (CCH), we have to send samples for test to Bangladesh Standards and Testing Institution (BSTI) or Bangladesh Council of Scientific and Industrial Research (BCSIR). It is time consuming. Requirement of approvals by multiple officials on the same customs declaration (locally called Bill of Entry) increases processing time. However, significant progress has been made in the efforts to simplify customs procedures. The

> ASYCUDA ++ system is in operation in customs houses. The introduction of a single administrative document (SAD) for export and import and Direct Trader Input (DTI) facility for traders to lodge import declarations electronically has made export-import declaration easier. However, we are yet to be able to electronically track cargo movements (Interviewee, 2006-07).

According to a majority of the trading community, introduction of online facilities to submit declarations, risk-based examination, reduction in the number of signatures required for clearance, and reduction of physical inspection from 100 per cent to 10 per cent made customs procedures faster. The introduction of the PSI system also reduced processing time. They, however, criticised the PSI agencies for obvious errors in classification and valuation of goods (Interview, 2006-07). One representative of the PSI agency declined criticism against his agency. However, he conceded an incident of mis-declaration in relation to the importation of high value cars through Clean Report of Findings (CRF) certificates.

With regard to delays in customs clearance, a senior customs official said:

> I do not rule out the complaints of delays and formality in Customs. Sometimes we have to ask for more documents to ensure authenticity of declarations. Lack of necessary personnel, and physical facilities such as inadequate IT facilities, inspection equipment, office equipment and testing facilities stand in the way of quick customs clearance. Customs Houses do not have a testing laboratory, except the CCH. The CCH laboratory is not equipped with modern instruments. It also lacks skilled technicians, re-agent and other supplies necessary to test huge import consignments of chemical items (Interview, 2006-07).

The majority of the customs officials stated that the customs offices lack adequate staff, space and warehouse facilities, and in particular, this is so in land customs stations located in Benapole, Hilly, Satmasjid, Bhomra, Akahuara, and Teknaf. There has been no direct recruitment of inspectors and appraisers in the last 20 to 22 years through the Public Service Commission (PSC). Furthermore, Customs do not have access to the current market price of goods due to capacity constraints of the Valuation Commission. This contributes to disputes between Customs and importers on valuation aspects (Interview, 2006-07).

Interview findings on the shortage of staff in Customs concur with the secondary evidence. As a renowned daily English newspaper, published in Bangladesh, put it: 'The customs house is running with the workforce less than what was approved for it back in 1982 though its activities increased by several times by now [*sic*]...With no recruitment taking place since early nineties' Chittagong Customs House authorities were forced to engage 'part-timers, known as "Tonni"... 'Thus being engaged in confidential and important works like assessment of goods, Tonnies some times get involved in corruption and irregularities (Mahmud 2010).

Institutional limitations of the Customs Department: It has been found that no recruitment took place at the inspector/appraiser level in the last 25 years. As a result, the department is running with an inadequate workforce and with lower level staff who are not well qualified to do the job. In this regard, Mahmud and Rossette (2007) found that 33.3 per cent of posts in Chittagong Customs House (CCH) were vacant against approved posts.

Furthermore, although full automation of CCH has been on the government agenda for some time, and some initiatives have been taken in this regard, the continuity of the automation programs such as ASYCUDA ++ and Direct Trade Input (DTI) has suffered at times. Lack of funds and human resources, a disconnect of vision and the fear of change particularly by those with a vested interest have hampered post-automation works. It has been found that 'the post-implementation costs associated with Customs automation exceeds by far the cost of implementing a new automation system' (Mikuriya 2006, p. 27). IT is considered to be vital to establishing a mechanism for long-term funding, in particular with regard to information and communication technology (ICT) adoption and ICT-based interventions. It is to be noted, however, that the complete package of ASYCUDA software is not yet in operation.

Role of the PSI agencies: During the 1980s, customs formalities were cumbersome and time consuming due to excessive documentation and almost 100 per cent physical inspection. This situation was not trade and investment friendly because physical inspection of the contents of every container is costly and labour-intensive. In such a context, customs assessment procedures were outsourced to private sector PSI agencies in an effort to simplify customs clearance procedures. Initially introduced on a voluntary basis in 1994, the use of the PSI system was made mandatory from 15 February 2002. These PSI agencies are responsible for inspection of imported goods before their shipment and issue of CRF certificates containing the description, value, quantity and classification of goods. To expedite clearance, acceptance of CRF certificates was made mandatory as the basis of customs assessment. Although some improvements took place in speeding up the clearance of goods following the introduction of the PSI system, the system gradually became ineffective and corrupt. The government is now being deprived of a huge amount of revenue from imported goods due to false declaration, undervaluation and incorrect Harmonized System (HS) classification in CRF certificates, and the PSI agencies are also accused of conniving with unscrupulous importers to help evade taxes (Haque 2011).

Some business people complained (Interview, 2006-07) that their consignments were inordinately delayed due to disputes between Customs and PSI agencies with regard to the classification and valuation shown on CRF certificates. Haque (2011) reported that more than 8,000 writ petitions are pending in higher courts against the certifications by the PSI agencies. Under-valuation and incorrect classification of goods led to an excess of CRF certificates being amended, causing delays in the clearance of goods (Chowdhury 2007). As a case in point, Mahmud and Rossette (2007) stated that during 2002-06, 8,695 CRFs (out of 418,988) were found to be incorrect, for which an amount of Taka 26.9 million was imposed as a fine on the PSI agencies. A further 695 CRFs were found to contain false declarations from July 2005 to February 2006 and from July 2006 to February 2007 at CCH. Although the percentage of defective CFRs looks small (about 3 per cent), their extent is huge. Chowdhury (2007) brought to the fore the gravity of irregularities caused by incorrect CRF certificates:

> In 2006 a number of consignments certified to contain touch lamps were detained by the Customs authority ... On examination of the consignments, contents were found to be cigarette and liquor, which are not only high duty items but also prone to smuggling. Again, from December 2006 to March 2007, eighty five consignments of chemicals of different nature certified by the PSI companies were subjected to laboratory test by the Customs authorities and found to contain different kind of chemicals than those certified by the PSI companies.

Also in 2007, a number of motor vehicles with brand names such as Hummer, Porsche, Mercedes, etc., were found to have been certified grossly under-valued by a PSI agency (Chowdhury 2007). The nature of false declarations and under- or over-valuation detected by the customs authorities in PSI certified consignments in the last few years is a manifestation of the gravity of the problems with PSI agencies. It also indicates that the outsourcing of customs officials' duties through the introduction of private sector PSI agencies did not result in a noticeable improvement in trade facilitation.

The flaws with CRF certificates indicated above represent a partial picture of the overall errors generated by the PSI agencies. This is because a maximum 10 per cent of CRFs issued by PSI agencies are checked randomly by Customs.

Role of the Port Authority

Chittagong port is the main sea port in Bangladesh through which 80 per cent of the trade takes place. Productivity of the port remains very low[2] due to many reasons including its reliance on manual operations[3] (Asian Development Bank 2004). Loading and unloading of ships at Chittagong Port are often delayed for reasons such as unjustified formation of labour gangs, bribes and tips, worker movements and the 'go slow policy' of the workers' union. If tips are not paid at agreed rates to handling and equipment workers,

equipment is left unmaintained, handling is not done and containers are deliberately damaged (Mahmud & Rossette 2007). With regard to the sorts of difficulties the business community face in using the port, a garment manufacturer (also an exporter) stated:

> The port runs short of equipment, and the equipment available is not used properly. Dysfunctional equipment is not being replaced either. The port should procure modern equipment. User parties await permission to use the private equipment. We, therefore, are deprived of quicker services, when required (Dey 2010).

The majority of the respondents from the trading community stated that the Chittagong Port Authority (CPA) is an important government department which suffers due to inadequate port facilities, labour movement, manual operation and corruption. The following quote from a key respondent from the trading community illustrates:

> Chittagong port is plagued with many problems such as lack of gantry cranes to lift containers, lack of straddle carriers for stacking and moving containers, inadequate space and labour movement and strikes. It is, however, [necessary] to mention that workers often remain unaware about the logic of movement and are used by outside forces to create unrest in the port. These middlemen use the workers to satisfy their ill motives (Interview, 2006-07).

Bhattacharya and Hossain found that, 'while it takes 2 to 3 days to clear a vessel in Bangladesh, the same is only a couple of hours in Singapore or Thailand ... scarcity of logistics is a major problem for trade facilitation in Bangladesh' (2006, p. 11). Similar problems also exist in other ports. For instance, container handling at the Internal Container Depot (ICD) located in Dhaka is often delayed due to frequent breakdown of handling equipment and inefficiency of the private handling company. 'The laden containers often remain piled up at the depot because of poor handling' (Hasan 2007).

With regard to inefficiency and corruption, an official from the CPA mentioned that Chittagong Port is not an isolated case and experiences similar problems to other public offices. Apart from internal problems, namely lack of staff and space, the efficiency of the port is also adversely affected by external factors such as political instability and union programs (Interview, 2006-07).

Kumar and Mukherjee (2006) found about 2,500 official positions to be left vacant in Chittagong Port. This observation concurs with the interview findings.

The customs brokers (locally known as clearing and forwarding agents) say that lack of infrastructure and service mentality at the port and customs authorities are mainly responsible for delays in trade. A leading official of the association observed:

> In Customs and Port offices, we have to face delays in import-export business due to the manual system of operation, employee movement and bribe culture. Warehousing facility is also significantly lacking in Benapole port and other LC stations (Interview, 2006-07).

Litigation

According to the Customs Department, clearance of import consignments is often delayed due to writ petitions filed by traders (Interview, 2006-07). Customs brokers and the business community also agree with this view. Importers usually file cases/writ petitions when they think their business interest is hampered because of alleged wrongdoing by PSI agencies or Customs. A research report found that:

> Importers file cases with or without valid grounds when the customs raises any objection against the release of any consignment. "Most of the cases are lodged by debating the certified prices fixed by the pre-shipment company," stated TIB research, adding that, the number of such cases climbed to 10,033 till February last year [2007], blocking revenues of nearly Tk 1,233 crore (Haque & Manik 2008).

These findings suggest that the Customs Department and Port Authority are the two main stumbling blocks in the way of trade facilitation. Traders not only suffer from delays emanating from these two offices, they also undergo significant uncertainty resulting from differences in interpretation of laws/provisions. The delays and uncertainty add cost to international trade transactions and reduce export competitiveness. Nonetheless, the working environment has been improved to some extent in recent times following partial automation of customs procedures.

Trade facilitation initiatives

Despite the limitations stated above, significant progress in computerisation of customs procedures has been made in recent times. The latest version of ASYCUDA, that is, ASYCUDA++ has been in place in Dhaka Customs House, CCH, Benapole Customs House, Monga Customs, Dhaka ICD, and the Export Processing Zone. DTI has been introduced in Dhaka Customs House, CCH and the ICD; but most of the functions are still conducted manually. The tariff structure has also been rationalised and simplified significantly in the last few years. For example, four rates of customs duty were brought down to three namely, 7.5 per cent on basic raw materials, 15 per cent on intermediate goods and 25 per cent on finished goods in the budget of fiscal year 2005-06. Similarly, the supplementary duty structure in respect of goods of a general nature was brought down from five tiers to three. Furthermore, tariff anomalies have been largely eliminated. In the fiscal year 2010-11, 328 unnecessary H.S. Codes have been eliminated, and Baggage Rules have also been simplified to facilitate clearance of wage earners' baggage.

The CCH was automated in 2008 (during the non-party caretaker government) in cooperation with Chittagong Chamber of Commerce and the Customs Brokers Association with a view to enabling the users of CCH to use online facilities.[4] The continuity and envisaged benefits of automation, however, remain to be seen as it is yet be fully operationalised. The Customs Act, 1969, was amended in 2001 in line with the Revised Kyoto Convention in order to harmonise customs procedures. Risk-based clearance has been introduced on a limited scale in Customs Houses through green, yellow and red channels. In particular, customs clearance of passenger baggage in airports has been simplified, and more than 95 per cent of passengers pass through the green channel without any intervention and delays by Customs. Most Customs Notifications are published in the National Gazette and Statutory Regulatory Orders (SRO) in compliance with GATT Article X. Government consults with the private sector and takes proposals from that sector particularly prior to the annual budget preparation. Bangladesh Customs, however, does not provide any preferential treatment by granting AEO[5] status to the private sector (Hossain 2009).

Of late (2009), Customs installed four container scanners at the Chittagong port at a cost of Tk 430 million (Haroon 2010) to detect contraband/illegal shipments and weapons, aimed at ensuring security while facilitating legitimate trade.

The overall impression is that the customs processes in Bangladesh have been much simplified over the last decade. As Weerakoon, Thennakoon and Weeraratne put it: 'The decline in the number of signatures required for an export and import clearance, from 25 in 1999 to five in 2002, indicates the degree of progress in the direction of trade facilitation' (2005, p. 271). The reduction of signatures needed in Customs is a significant improvement compared to many developing countries.[6] Customs clearance time has also been reduced, and the number of import declarations cleared in two days or less has increased by close to 25 per cent per month. 'Green channel' imports are released without any physical verification and with minimal documentation checks (Bhattacharya & Hossain 2006). The findings presented here also indicate that the imposition of penalties on traders is, in most cases, commensurate with the gravity of the offences. This suggests that Bangladesh Customs complies with GATT Article VIII that requires Members not to impose penalties on traders that are out of proportion to the degree of the violation of Customs/Import regulations.

The study has identified seven important areas (Table 1) where measures for trade facilitation are needed.

Table 1: Top seven priority areas in trade facilitation

SL no.	Areas of trade facilitation
1	Further simplification of documentation requirements in Customs
2	Capacity building in Ports and Customs through adequate logistics, manpower, training
3	Establishment of testing laboratories in Ports/Customs houses
4	Improvement in customs inspection, assessment and control procedures (to avoid writ petition and litigation by importers)
5	Computerisation and automation of trade procedures in both Customs and Ports
6	Timely publication and dissemination of trade rules and regulations and establishment of enquiry points
7	Consultation with business/stakeholders for proper implementation of regulations, mutual trust and cooperation

Source: Interviews with public and private officials, 2006-07

In order to facilitate trade, new measures and reforms are to be taken in these seven areas, including the following proposals.

The way forward

Cumbersome customs procedures, layers in decision making and inadequate use of IT are still severe impediments to trade. For trade facilitation, a number of steps such as reduction in the number of signatures required, full use of IT, the use of new technologies in physical inspections (for example, non-intrusive devices such as large-scale X-ray and gamma-ray machines), use of reliable valuation data, and electronic processing of trade documents need to be ensured.

Risk-based verification of goods is another significant avenue by which to facilitate trade. Chapter 6, page 9 of the Revised Kyoto Convention requires the general adoption of a risk-managed style of regulatory compliance. Through risk profiling, Customs should replace random examination of goods and documents with risk-based selection and examination of goods, transport and persons. Factors such as commodity code, the history of the importer/exporter and their level of compliance, the origin and routing of the goods, value, reputation of the agent, duty involved and prohibitions should be used in selecting which persons, goods and means of transport will be examined and to what extent. There should be a *risk register* which will record the rationale behind selecting the risks.

Moreover, establishment of Customs-to-Customs networks (an important thrust of the SAFE Framework) to exchange timely and accurate information would help the Customs Department to manage risk on a more effective basis by improving its ability to detect high-risk shipments in the supply chain.

Widdowson (2007) suggested that risk-based customs control needs (a) to focus on high-risk cargoes, (b) to increase the ability to detect offences and non-compliant traders and travellers, and (c) to offer priority treatment to compliant traders and travellers.

Offering priority treatment to complaint entities through the introduction of Authorised Economic Operator (AEO) programs for importers, exporters, warehouse operators and customs brokers (that meet certain compliance criteria) is another significant way in which trade may be facilitated. Necessary

amendments to the Customs Act, 1969, are needed to introduce an AEO program[7] such as that introduced by Japanese Customs. Under the AEO approach, authorised persons/entities would benefit from minimum inspection and simplified procedures. The top ten trade facilitation economies such as China, Hong Kong and Singapore, have also introduced such a scheme (Strachan 2009). The capacity of customs intelligence also needs further improvement to support risk-based Customs control. Furthermore, Customs needs to abandon the 'gatekeeper' mentality that has traditionally dominated their thinking to embrace trade facilitation measures. This is because, in a climate of ever-increasing volume of trade and limited resources, Customs cannot counter all frauds or all forms of corruption comprehensively as recognised by Cantens, Raballand and Bilangna (2010).

A qualitative improvement in trade facilitation is possible if the shortage of revenue officers and staff is addressed through new recruitment. The Bangladesh Finance Minister recognised this: '…with the recruitment of new revenue officers soon, the customs department will be able to achieve a qualitative improvement in its services' (Budget Speech, Budget 2010-11, in *The Daily Star* 2010, p. 91).

Consultative mechanism: Under the auspices of the National Board of Revenue (NBR), the Customs Department will need to establish mechanisms to consult with stakeholders such as representative federations including importers, exporters, carriers, customs brokers and business chambers, regarding major changes in customs procedures and barriers that traders have encountered earlier. This kind of dialogue between Customs and the trading community is conducive to mutual trust and cooperation between Customs and the private sector, and assists in improving trader compliance. The Customs Department in Bangladesh currently adopts such a consultative approach on a limited scale only.

Automation: For trade facilitation to occur, the customs administration, ports, Ministry of Commerce, shipping agents, and testing institutions need to be fully automated and interconnected. Modern customs management techniques and software need to be introduced and implemented in all customs stations. Improved management, provisioning for handling equipment, operation of private ICDs to their full capacity and full automation of port activities can contribute to trade facilitation. It is to be noted that the Government of Bangladesh has already taken initiatives to automate Chittagong Port at a cost of Tk 2.25 billion. As part of this, the Port will be fully computerised under the Chittagong Port Trade Facilitation Umbrella Project (*The Financial Express*, 21 March 2010).

Enquiry points: Furthermore, trade desks or enquiry points providing necessary information on import export procedures and practices should be set up for use by traders and the public. These desks may be located in Customs Houses. Such practices are being increasingly adopted in many countries including within the European Commission (Lux & Malone 2006).

An environment of predictability: The NBR could further facilitate trade by providing the trading community with greater predictability through advance rulings on matters such as origin,[8] tariff classification and valuation. Clear and explicit grounds for customs rulings on these matters also need to be made available to the stakeholders. It is expected that advance rulings with proper reasoning for such rulings will increase the credibility of customs decisions and reduce the level of disputes between Customs and Trade.

Early reporting of cargo: Bangladesh Customs could also require traders to submit declarations electronically prior to cargo arrival. Early and accurate reporting of cargo would allow Customs to risk assess high-risk cargoes and, if appropriate, clear them prior to their physical arrival. Australian Customs has implemented such cargo reporting requirements (Sandford & Temby 2010).

Testing facilities: In the absence of testing facilities at Customs Houses, samples of food and chemical items are required to be sent to the Bangladesh Standards and Testing Institute (BSTI). However, BSTI is also not yet scientifically equipped to undertake all sample testing (Kumar & Mukherjee 2006), and samples often need to be tested in public universities or Bangladesh Council of Scientific and Industrial

Research (BCSIR). An upgrade of existing testing facilities including the development of new testing facilities centres at two major Customs Houses and ICD would allow testing of the physical and chemical attributes of imported consignments, thereby facilitating the detection of false declarations and potential revenue leakage.

Strengthening other agencies: While acknowledging the pivotal role that Customs plays in facilitating trade, it is not the only government agency with such responsibility (Zhang 2009; Arvis et al. 2010). The World Bank has recognised the role of other agencies in its 2010 Logistics Performance Index (LPI):

> …the time taken to clear goods through customs is a relatively small fraction of total import time… Core Customs procedures converge strongly across all performance groups, but physical inspection – and even multiple inspections of the same shipment by different agencies – are much more common in low performance countries…A corollary of the gradual convergence of Customs procedures worldwide is that other border agencies are seen to be an increasingly serious constraint on supply chain performance in many countries (Arvis et al. 2010, p. 16).

The observation made above indicates that for trade facilitation to happen, it is vital for other government agencies and private interests to be proactive, efficient and responsive. Better coordination among the agencies and private sector players (port, Customs, customs brokers, traders, and shipping agents) involved in border clearance are also important. As recognised by Zhang:

> Close communication and cooperation among all the stakeholders such as the national government, Customs, OGAs [other government agencies], donors, and the private sector, are integral to smooth implementation (Zhang 2009, p. 126).

Addressing problems at Chittagong Port: It is imperative for political leaders to keep Chittagong port free from all political programs considering it is the epicentre of the national economy. The *turn-around time*[9] at Chittagong port is much higher (6 to 10 days in Chittagong versus two days in Bangkok and one day in Singapore) than that of other ports in neighbouring countries (Hasan 2007). The turn-around time must be reduced in the interests of the overall efficiency of business. In this regard, it is pertinent to note that Bangladesh has to ship, on average, 10 per cent of its garment production by air to be certain to meet the schedules of European buyers (Arvis et al. 2008, p. 57).

Adequate staffing, necessary logistics and office equipment need to be supplied to enhance the efficiency of the port and to reduce business costs as business costs rise steeply with declining logistics performance. Also, port workers should be treated with more respect, their wages and other benefits need to be paid on time, and the Port Authority needs to examine and address genuine grievances. At the same time, a culture of discipline needs to be developed and respected in port operations.

What seems to be most pressing is the need to introduce competition in port services by allowing the entry of private operators. With regard to port services, Devlin and Yee (2005) commented that a transition to the 'landlord' port model[10] with unbundled regulatory functions would help to increase the efficiency of cargo handling. Such a model could be tested in Bangladesh.

Implications

The research found that apart from Customs, other agencies/parties are also responsible for the overall delays in border trade. Therefore, for trade facilitation to be achieved, a *whole-of-government* approach (as recognised by the Revised Kyoto Convention and referred to in Widdowson, 2007) to border management is pivotal where other government agencies involved in international trade flow need to become efficient and responsive in the global trade facilitation effort. This signifies the necessity for the Government of Bangladesh to develop cooperative arrangements between Customs and other agencies involved in international trade in order to facilitate among other things, the seamless transfer

of international trade data. The WCO SAFE Framework of Standards encourages such arrangements (WCO 2007). In establishing the proposed cooperative relationship, Customs should take the lead role because it is the 'agent' (according to Holloway, 2010) of other government agencies at the border and therefore needs to ensure compliance with all import/export regulations, including those relating to health, foreign exchange and safety.

It is notable that given the security threat to supply chains, especially after the events of 2001 in the USA, initiatives taken by government to specifically address supply chain security such as the Container Security Initiative (CSF[11]) and Additional Carrier Requirements for cargo arriving in the US by ocean vessels (commonly called the 10+2[12] rule) have some merit. However, these are widely criticised and opposed by trade[13] within the USA and are not seen as a cost-effective approach. It is therefore important for the Government and business to work together to achieve better solutions for supply chain security. By harnessing its partnership with business, government can better understand the 'anomalies' and 'abnormalities' of shipments in the supply chain. Furthermore, trade is an integral part of global supply chain (Widdowson & Holloway 2009, p. 17) and an insecure supply chain has negative effects on both government and business. Collaborative arrangements with supply partners are also important. Finally, a good intelligence network is one of the most effective tools for the government to detect potential security threats posed by a consignment prior to its arrival.

Conclusions

The WCO provides a broad vision for Customs in the 21st century, which is to support international development, security and peace by securing and facilitating international trade. In the rapidly changing globalised world, increased connectedness between all agencies/parties involved in international trade and travel supply chains is essential. As two important bodies in trade facilitation, both Customs and Port Authorities have an obligation to better serve the trading community. Capacity enhancement and development of a service mentality are two main avenues by which to extend support to trade. Reorientation of customs authorities from a revenue collection to a trade facilitation focus would immensely benefit the country by promoting increased trade, investment and growth. As an 'agent' of other government departments at the border with a charter to oversee proper implementation of state regulations relating to prohibitions and restrictions on imports/exports, border security, and revenue protection, Customs is uniquely placed to facilitate trade. In doing so, the main challenge for Customs is to strike a balance between apparently conflicting objectives, that is, quick clearance for trade facilitation, and enforcement of control measures to protect public health, the economy and community security.

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Endnotes

1 The interview guide is held by the authors and can be made available on request.

2 Average container dwell time at the port has remained almost unchanged over the past few years at about 18 days compared with about 10 to 12 days at comparable container terminals in the region (Asian Development Bank 2004).

3 Documents pass through many stages, requiring 48 endorsements which, in addition to increasing dwell times, create opportunities for corruption (Asian Development Bank 2004).

4 After automation, importers/customs brokers can submit customs declarations online (DTI) (Bill of Entry Module) and Import General Manifest/Export General Manifest can be submitted by shipping agents (Manifest Module).

5 The AEO program is consistent with the 'SAFE Framework' developed by the WCO.

6 In Egypt, clearing goods through Customs requires 32 signatures for manual filing of documents (Devlin & Yee 2005).

7 Japan Customs did this (Aoyama 2008).

8 The WTO Agreement on Rules of Origin requires Members to provide rulings on origin without, however, stipulating that they are to be made available to the public (Lux & Malone 2006).

9 Turn-around time means the time taken for a ship to enter the port and come out after unloading and loading the cargo.

10 Under this model, instead of the port providing both commercial and regulatory functions, the private sector is invited to set up and operate commercial facilities while the port authorities continue to own the land and basic infrastructure assets as well as discharge their regulatory functions. This model is designed with a view to decreasing the investment costs for port operators. It helps to lower terminal handling charges (Kurian 2010). Under this framework, the private sector can replace the public sector in the provision of services to the vessel and its cargo. It allows the public sector to retain ownership of the land and infrastructure and to continue regulating their use, while sharing responsibility for capital investment (viewed 7 February 2011, www.adb.org/documents/books/developing_best_practices/ports/exec.pdf).

11 A government program to allow the US Customs and Border Protection (CBP) to inspect high-risk ocean containers prior to loading on vessels in foreign ports.

12 Ten data elements are to be provided by the importer and two other data elements (namely, vessel stow plan and container status messages) are to be provided by the carrier.

13 ISF is opposed because the 10 information (name and address of manufacturer, seller, buyer, importer of record, consignee, 'Ship to' party, consolidator, 6-digit HS classification, country of origin and container stuffing location) that the importer is required to provide may be impossible to obtain or verify before the cargo is loaded on the US-bound vessel. Furthermore, shippers and forwarders are concerned about the associated added costs and cargo delays while the importers locate origin and destination information (Widdowson & Holloway 2009).

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Designing and implementing Customs-Business partnerships: a possible framework for collaborative governance

Shujie Zhang and Rob Preece

Abstract

The emergence of the Customs community's interest in building Customs-Business partnerships (CBP) can be examined in the overall context of the development of government to business partnerships, including the often successful public-private partnerships (PPP) model. The concept of CBP is that relationships between Customs and business are shifting away from the former adversarial and interventionist approaches and moving towards relationships that represent an ambition of working together for a common purpose. Based on a theoretical review of the partnership dynamics, a conceptual collaborative governance framework is proposed and the key elements in designing and implementing CBP arrangements are identified and developed. It is argued that CBP should be interwoven with the overall strategies of Customs reform and modernisation and should go beyond operational and technical matters for effectiveness and sustainability.

1. Introduction

In the world of administrative reform some people have been inclined to adopt 'buzz words' or 'catch-phrases', concepts that are more symbolic than having actual substance. In the context of 'government to business' relationships, both the concept and the use of the term 'partnership' have emerged as potential catch-phrases and are used by policy makers and academics to suggest government and business are working together to achieve common goals. Whilst many of these government to business 'partnerships' seem to be lacking any real substance, there is an increasingly popular model known as a 'public-private partnership' (PPP) which has, in fact, been delivering tangible benefits to both partners, and to the broader community. This paper looks at the progress of the 'customs to business partnership' concept in this context, and discusses issues such as 'tangible benefits' and 'substance' whilst also proposing a possible framework to further develop the customs-business partnership approach.

Seemingly, the Customs community is not immune from following this new move to form 'partnerships' with business, and it is worthwhile considering whether the Customs approach to partnering is simply following the 'buzz'. The World Customs Organization (WCO) designated 'Customs and Business improving performances through partnership' as the theme of its 2010 International Customs Day in which various partnership approaches at both regional and national levels were celebrated.

To highlight the significance of Customs-Business partnership (CBP), Dr Kunio Mikuriya, Secretary General of the WCO, stated:

> This [CBP] means that Customs cannot act alone without taking into account the interests of its partners. It must further develop consultation, promote information exchange and cooperation,

and reduce the barriers to the smooth flow of trade by jointly identifying bottlenecks and offering solutions (Mikuriya 2010).

The WCO's promotion may be a symbolic gesture without evidence of actual mutual actions that have led to these types of objectives being met. We need to look at what concrete steps, if any, have been taken by the WCO and national customs agencies to form partnerships with business, and equally, it is important to try and understand what business may expect from a CBP. As part of this analysis, this paper discusses ways in which both parties can strengthen future CBP initiatives to create 'real' and 'meaningful' partnerships between Customs and industry.

The concept of government partnering with business is not new, and certainly did not originate with Customs. Government and business partnerships have a long history with the development of the PPP model which has now been accepted in developed and developing countries since the 1980s. PPPs have their origin as a major theme of New Public Management and governance reform. Has Customs picked up this same approach and applied it with the same success as many PPPs, or does the CBP fall short of the same effectiveness we see in many of these successful PPPs? Perhaps a key to the success of the CBP may lie in observing some of the factors we see in successful PPPs and determining whether they have been, or can be implemented in a CBP.

Enthusiasm alone by Customs to embrace the CBP approach does not necessarily mean that partnership-like relationships and infrastructure are in place for implementing CBP programs such as the emerging Authorised Economic Operator (AEO) program. Theoretically, CBP calls for conceptual clarification which provides guidance for policy makers. Practically, problems in implementing AEO have arisen, namely, a lack of legal frameworks, deficiencies in tangible benefits, 'discrimination' against small and medium-sized enterprises (SMEs), lack of expertise on security verification, and problems with mutual recognition across countries (ROCB A/P 2010).

The WCO's diagnosis missions under the umbrella of the Columbus Program find that the business sector is generally not satisfied about relationships with Customs, and consider that advocacy of partnership by Customs is still at the 'rhetoric' stage as opposed to any 'concrete action'. This may be particularly true for Customs in developing countries, as the CBP approach still sits uncomfortably in their national context.

For both Customs and business, it is desirable to resolve some of the following types of lingering doubts:

- Why do we need CBP?
- What is the nature of CBP?
- Is there substance, or is CBP a gimmick, or a fad?
- How does the trade community respond to CBP initiatives like AEO programs?
- Is it possible to propose a CBP model which overcomes these doubts?

This paper now explores the issues and suggests answers to these questions.

2. Partnership and public-private partnership: theoretical view

Partnership

Before analysing the CBP, it is worth defining and discussing the development of the term 'partnership'. We can start by looking at the dictionary meaning. In Merriam-Webster Online Dictionary, 'partnership' means: (1) participation; (2) a legal relation existing between two or more persons contractually associated as joint principals in a business; (3) a relationship resembling a legal partnership and usually involving close cooperation between parties having specified and joint rights and responsibilities (2010).

Collins Essential English Dictionary offers a broader definition: 'a relationship in which two or more people, organizations, or countries work together as partners'.

These definitions help to clarify the major dimensions of a 'partnership': first, partnership is not a new human activity; second, partnership is in essence a relationship between two or more parties, which can be informal or formal; third, partnership involves cooperation, collaboration and participation; and finally, partnership is a term commonly used in the business world. These characteristics are now proposed as the basis for constructing a 'conceptual framework' for the CBP.

Going beyond the literal understanding of 'partnership', the literature in relation to strategic management provides further insight. Strategic management challenges the stereotyped division between competition and collaboration and argues for the importance of partnership and collaborative working, as opposed to competitive behaviour. Within the school of strategic management, '*collaborative advantage*' was conceptualised. According to Huxham (1993), this means that 'synergy can be achieved by integrating the resources and expertise of one organization with that of others'. Partnerships can contribute to competitive and/or collaborative advantage in the following ways: providing *economies of scale and economies of scope* in the provision of certain services or activities, and *opportunities for mutual learning* between partners (Bovaird 2004). The relationship between 'competitive advantage' and 'collaborative advantage' is not a kind of substitution. It is argued that only when all participants have become expert in achieving 'collaborative advantage' with their partnership is it likely that the partnership as a whole will be able to gain competitive advantage against other rival partnerships (Huxham 1993; Kanter 1994).

In the modern business and corporate world, it is not uncommon for businesses to cooperate with their stakeholders for shared objectives such as cost reduction, joint technology development, and shared market. Kanter (1994) argued that such arrangements move along a continuum from weak and distant to strong and close. She identified three major types: at one extreme, in *mutual service consortia*, similar companies in similar industries pool their resources to gain a benefit; at mid-range, in *joint ventures*, with the strongest and closest collaboration in *value-chain partnerships*.

Historically, although international cross-licensing agreements were a widespread form of cooperation in manufacturing as early as the 1930s and, after 1945, many large corporations formed joint ventures with local companies in order to start up operations in foreign countries, it was not until the 1980s that real strategic alliances began to develop (Dussauge & Garrette 1999). Since the 1990s, forging such alliances has extended beyond national boundaries to multinational companies, the main players of globalisation (Bleeke & Ernst 1991; Kanter 1994). Longer-term strategic alliances typically involve closer cooperation than this, with relationships based on trust, sharing of assets (including knowledge bases) and a commitment to mutual learning opportunities (Lorange & Roos 1992; Dror & Hamel 1998).

Public-private partnership

When we think of partnerships between government and business, it prompts us to better know what 'Public-Private Partnerships' (PPP) mean. As Wettenhall summarised, PPP is becoming a more established concept in the area of public sector management. However, he also argued:

> The term partnership is now a dominant slogan in the rhetoric of public sector reform, arguably capturing that status from privatization which held similar dominance through the 1980s and 1990s (Wettenhall 2003).

Jung and Osborne (2008) believe that 'Partnership is an ill-defined and vague concept that is applied inconsistently across the literature'. Conclusively, in spite of its popularity both pragmatically and ideologically, there is no agreed definition or consensus on an integrative conceptual framework of PPPs (Rosenau 1999, 2000; ed. Osborne 2000; Wettenhall 2003; Hodge & Greve 2007; Khanom 2009).

According to Osborne's and Jung's (2000) analysis, two broad schools of thought can be identified within PPP and partnership literature. Such observation is echoed by Hodge and Greve (2007) in their international review of PPPs.

The first school of thought sees partnership as mainly a language game, drawing attention to the moral appeal of the concept. While ideas such as 'contracting out', 'market' and 'privatisation' carry negative associations and cause opposition in New Public Management in western countries, 'partnership' heralds inclusiveness, synergy, harmony, moral value and superiority (Hodge & Greve 2007). The second group perceives partnership as a governance tool and a practical answer to increasingly interdependent and complex social systems (Lowndes & Skelcher 1998; Peters & Pierre 1998; Rhodes 1988, 2007; Stoker 1998). However, there is little definitional consensus about this umbrella term.

Traces of the CBP development can be found in both schools. Leaders of Customs may use partnership as a pleasing 'selling' phrase both among internal and external stakeholders. This is consistent with the views of Teisman and Klijn (2002) and Wettenhall (2003) who suspect 'partnership' in the government to business context may be just 'rhetoric rather than reality'.

On the other hand however, there is evidence that some of the principles of partnership are being translated into tangible CBP measures, especially in developed countries. Implementing AEO programs at the global level can also be seen as a step forward in forging the CBP.

Literature on the theoretical roots of partnerships and PPPs has highlighted several possible reasons for the development of this partnering approach (Linder 1999; Wettenhall & Thynne 1999; Wettenhall 2003; Selsky & Parker 2005; Khanom 2009). In short, these developments appear to be linked to collaboration theory (game theory), economics (transaction cost), organisation theory (resource dependence), and governance theory (network and others). All of these theories shed light on why PPPs are needed and how they are designed and implemented.

Game theory. Why do different individuals and organisations like to cooperate in their transactions and interaction? Axelrod's (2004) application of game theory in economic development partnership between a donor and a recipient is meaningful and helps to understand partnerships in the context of a PPP. Axelrod's studies found that to a certain degree, cooperating partners working on a problem tend to cooperate and bring about mutual benefits, rather than parties who do not work together.

Such discussions on game theory can be extended in a meaningful way to help our understanding of the relationship between Customs and business. Similar to prison/prisoner relationships, the traditional command-and-control model between Customs and business has a history of low trust, adversarial approaches, and differences in opinion on many issues. However, under a model of partnership, misunderstanding and misinterpretation can be minimised, with enhanced communication, cooperation, consultation and collaboration between Customs and business.

Transaction cost theory is one of the main thrusts of the new institutionalism in economics and sociology. The key notions are that individuals are self-interested, opportunistic and bounded by rationality; any transaction between entities incurs cost; contractual relationships may be unreliable; there is always a problem of information asymmetry; and concerns over transaction costs may encourage parties to cooperate to minimise those costs.

Applying these theoretical arguments to the CBP, it can be assumed that both Customs and business seek to reduce costs (financial and non-financial) in their interactions. As such, partnership may be an institutional innovation to lower transaction cost.

The third area of discussion is **resource dependence**. This idea falls into the sphere of organisational development by taking the perspective of meeting organisational needs or solving organisational problems through cross-boundary cooperation. The core arguments are:

- organisations collaborate because they lack critical competencies and cannot develop them on their own or in a timely fashion
- their environments are more uncertain or turbulent today
- many resources are scarce, and environments are turbulent
- any organisation has an inherent tendency to attempt to overcome uncertainty.

These arguments may be particularly relevant to the Customs context. The tension between increasing workloads and reduced resources compels Customs to seek external resources from the private sector to meet its policy objectives, such as information, expertise, commitments and support. On the other hand, the resources of information and power held by Customs are also valuable to the business sector.

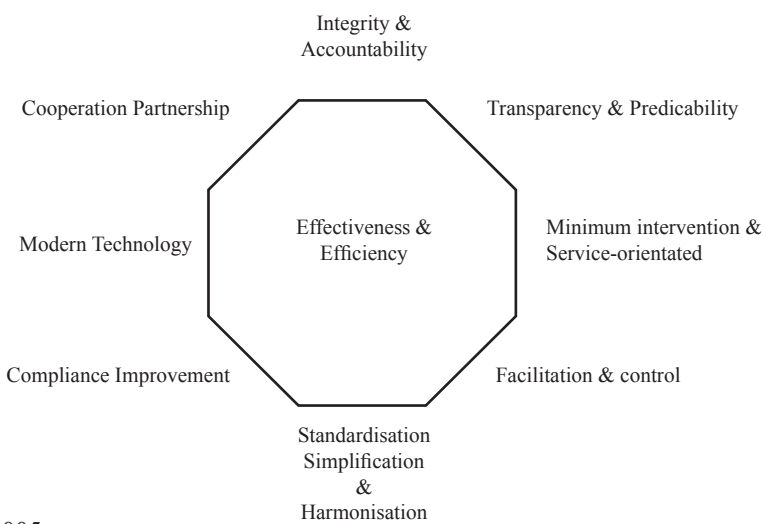
Finally, **governance and network theory**. Nearly all of the literature on PPPs traces its origin to the broad themes of New Public Management and governance reform. The logic is that the boundaries of the public, private and social sectors are blurring (Rhodes 1988; O'Toole 1997; Stoker 1998; Pollitt 2003). Such blurring of sectoral boundaries occurs when an organisation in one sector adopts or captures a role or function traditionally associated with another sector, such as when governments contract out social welfare functions to nonprofit organisations or business.

Another element is the emergence of 'wicked problems', which are problems well beyond the boundary of one organisation (Rhodes 1988). It means that traditional sector solutions cannot address certain challenges and therefore, must be enhanced by learning and borrowing from expertise in other sectors. This has led to increased emphasis on governance through network structures as a 'new process of governing; or a changed condition of ordered rule; or the new method by which society is governed' (Rhodes 1988).

Rhodes (1988) put forward the bold notion of 'governance without government', which is sometimes coined as 'the third way of governance' (Stoker 1998). Based on Rhodes's seminal work, network theory in public administration has developed. PPPs come within such discourse.

This broad theoretical and practical development in governance has much bearing on the understanding of the CBP. Firstly, the main principles for a 'modern' Customs can be identified as being the underpinning of good governance, transparency, accountability and integrity, for which cooperation and partnerships with outside stakeholders are critical (WCO 2005). The WCO has set out these principles (see Figure 1).

Figure 1: Modern Customs: governance perspective



Source: WCO 2005.

Secondly, as part of government, customs reform must remain consistent with the pace and priorities of administrative and/or governance reforms occurring in their countries. Thirdly, customs modernisation is a holistic process, and the effectiveness of the CBP is contingent on effectiveness of other aspects.

However, we must realise that equal status, that is, power among participants proposed by the network theory, may not be applicable to the CBP because the CBP arrangements, informal or formal, are generally initiated or 'dominated' by Customs. This raises doubts about whether such partnership is 'genuine' or not and this will be expanded upon later in this paper when we seek to analyse the CBP from a business perspective.

To summarise, the literature suggests that the CBP should be understood under the broad movement of New Public Management and governance reform, in which PPP has been a key concept and commonly utilised tool. However, the CBP is unique: it differs from general PPPs as CBP arrangements concentrate on assisting Customs, supposedly to develop better policy, standards, and guidelines, and to enhance compliance of the industry, rather than on jointly providing a service. Or are they different? This question will be developed further, particularly by a better understanding of what Customs and business want from a CBP and how this should be put in place.

3. Development of CBP under the WCO framework

The concept and practice of the CBP is not new in the customs environment. The developments of CBP are embodied in three key WCO instruments: the Revised Kyoto Convention (1999), the Framework of Standards to Secure and Facilitate Global Trade (the SAFE Framework) (2007), and the policy document 'Customs in the 21st Century' (2008).

Firstly, the Preamble to the Revised Kyoto Convention, calls on:

> … cooperation wherever appropriate with other national authorities and *the trading communities* (emphasis added).

General Annex, Chapter 1, Article 3 further stipulates that:

> The Customs shall institute and maintain *formal consultative relationships with the trade* to increase co-operation and facilitate participation in ... (emphasis added)

These two provisions formally establish the principle of partnership in the process of policy, stressing wide participation with business and institutionalisation of the relationship. On an operational level, special procedures for *authorised persons* under transitional standard 3.32 are stipulated, and the principle of compliance and facilitation is upheld. However, under the concept of authorised persons, trade security is not yet treated as a 'must have' condition.

Secondly, detailed standards are incorporated in the SAFE Framework (2007) and the WCO AEO Guidelines (2009) where the scope and dimensions of partnership are expanded. Under the pillar of Customs-Business partnership, six standards are outlined to establish the international accredited trader regime. The AEO guidelines serve as a starting point for national AEO programs. The key notion of the AEO regime is to adopt integrated international supply chain management and control to secure trade security and facilitation.

Under the SAFE Framework, an AEO is defined as 'a party involved in the international movement of goods in whatever function that has been approved by or on behalf of a national Customs administration as complying with WCO or equivalent supply chain security standards' (WCO 2007, p. 36). The scope of AEO encompasses all stakeholders in the international supply chain: manufacturers, importers, exporters, brokers, carriers, consolidators, intermediaries, ports, airports, terminal operators, integrated operators, warehouses, distributors. It can be said that an AEO is a more advanced stage of a CBP arrangement.

Finally, the WCO reconfirms CBP as a key building block in its strategic policy paper, 'Customs in the 21st Century' (WCO 2008). In this blueprint for a future modern customs environment, it reiterates:

> Customs in the 21st Century should enter into strategic pacts with trusted economic operators. Customs needs to understand the concerns of business, while business needs to know the requirements of Customs. Most importantly, there is a need to translate this relationship into a partnership that results in mutually beneficial outcomes (WCO 2008, p. 7).

Tracing the conceptual and pragmatic development of partnerships within the WCO framework, we can tell that a partnership-like relationship between Customs and business is not a new concept. The dimensions of such relationships become ever more substantial and concrete through 'trusted persons' to 'authorised economic operators'. However, it should be noted that AEO is not all about CBP. CBP should not stop at the implementation of AEO programs. Therefore, incorporation of CBP as an integral part of modern Customs will indicate that building and sustaining partnerships has gone beyond the operational or technical aspects of customs administration. Rather, effective external cooperation and partnership with stakeholders (mainly the business sector) is a hallmark of modern Customs.

4. Customs and business: what business seeks in a partnership

So far, this paper has been concerned with the use of the term 'partnership' by Customs and has suggested that the phrase 'partnership with business' is being used with increasing frequency. This 'partnering with business' phraseology is seemingly becoming an automatic part of the first response to any and all contemporary trade or compliance issues being addressed by Customs.

The question now is whether this is positive for industry, as it is potentially able to increase its input to future policy and standards, or whether this phrase of 'partnership with business' is at risk of being over-used and seen more as a 'marketing tool' or even as a 'gimmick' by Customs to show that it has become inclusive in addressing trade and compliance issues.

The question can, perhaps, start to be answered by looking at whether there has been or are 'concrete' partnerships that are delivering tangible benefits to both Customs and business, or whether such partnerships are merely a mechanism for industry to have input to customs considerations. Indeed, we have 'concrete' government-business partnerships against which we can benchmark if applying the PPP model that is being used with increasing effect in many countries. The PPP model has been delivering clear commercial benefits to the private sector whilst government partners have enjoyed seeing delivery of services that are likely unable to be provided without private sector investment. Although PPP projects are generally applied to infrastructure, education, and health, as opposed to law enforcement, regulation and revenue collection, there are factors to consider for the partnerships being built between Customs and industry.

There are a number of Customs and industry-based partnerships in place for us to consider such as the Customs-Trade Partnership Against Terrorism (C-TPAT), and the related 'Customs-to-Business Partnership' pillar of the SAFE Framework mentioned above. However, from a more commercial perspective, do both parties get clear benefits from these types of CBPs, or are they a little 'one-sided'? One view expanded upon in this section is that rather than a true 'partnership' we have a 'relationship' in which the partnership is being pushed on to business in what one industry representative body for the transport sector alluded to as a 'forced marriage' to facilitate legitimate trade (BIMCO 2010).

From a business perspective, we need to explore what business considers is a partnership and then analyse whether these considerations are being met in the current CBP developments. The business view of a partnership can be broken down into tangible basic elements just as we did when broadly defining a 'partnership' in the introduction to this paper. In a business context however, the term 'partnership' is more focused and likely means: that there is more than one party in the relationship; that there is a

common enterprise or objective from the relationship; that there is an economic or other benefit by working together; and that there is some legal formality to the relationship.

The remainder of this section of the paper applies these elements to the current situation.

Is there more than one party in a CBP?

There are clearly two parties in a CBP: firstly, Customs and secondly, the 'business'. We do, though, need to define the parties which comprise both sides as we have an almost 'layered' or 'tiered' range of 'partnerships' alluded to in the CBP context. There can be partnerships between Customs and business at the 'industry-wide level' which generally occurs as a means for customs authorities to be 'inclusive' in terms of policy development or in making changes to administration or process. These relationships can be at the international level and at the national level. Examples may include the 'partnership' between the WCO and say, the International Chamber of Commerce (ICC), which the ICC interestingly refers to as a 'public-private' dialogue when referring to the work it is doing with the WCO to implement an efficient AEO program for global businesses (ICC 2009).

On a separate level, there may be relationships created between the customs agency of a nation and a representative industry body. An example here may be a recent agreement between the Royal Thai Customs Department and the Federation of Thai Industries (FTI) on implementing the National Single Window in Thailand (Wichit Chaitrong 2011).

Finally, there will be relationships between individual customs agencies and individual business entities for purposes of facilitation programs such as the AEO, or border protection initiatives such as 'Frontline' in Australia, or the 'Industry Partnership Program' (IPP) in the United States.

Common objectives between Customs and business

It could be stated that business would probably not choose to subject themselves to any form of regulation! However, provided business has indeed accepted that there are sovereign laws around the importation and exportation of goods, then this opening statement could be adjusted to state that business would choose not to subject themselves to any unnecessary regulation. From this, it can be derived that the objective of business in this context is to reduce the amount of intervention by Customs in the importation/exportation process, thereby reducing costs and being able to rely on the movement of goods and their availability for sale.

Whilst customs agencies recognise their roles in administering import/export legislation and operating the respective import/export processes, they too would seek to achieve these objectives in the most cost-effective manner. This would include reducing intervention where possible, limiting such resource-intensive intervention to only those businesses or transactions whose risk warrants it. These risks too are changing, and whereas revenue has been a traditional focus, risks now increasingly include security against terrorist attack, and the potential for trans-national crime.

Business, on the other hand, has commercial objectives and seeks to both maximise revenues and reduce costs to deliver desired levels of profitability. Importantly, we need to split the business community into the larger 'legitimate' and 'seeking to be compliant' categories whose risks are inherently lower than the other categories of trade that would be considered 'illegitimate' or 'profit before compliance' and pose greater risks. Whilst both legitimate and non-compliant businesses would seek lower rates of customs intervention as objectives, legitimate traders also have objectives relating to 'level playing fields in markets' and would share a common objective with Customs of incorporating strong risk management and compliance procedures in import/export processes.

Limited intervention in a low-risk environment is a central part of the modern customs approach; it not only allows for cost-effective border management, it also allows for trade facilitation, so important to the growth of the economy. Trade facilitation initiatives benefit both the business community and

governments. Industry is better able to compete locally and internationally in a number of areas relating to time, predictability and costs which will be discussed in more detail below. Whereas for the customs agencies, they are better able to 'enhance controls, ensure proper collection of revenues due and at the same time contribute to the economic development through increased trade and encouragement of foreign investment' (WCO n.d.).

In short, there is likely to be a common objective for business and Customs in a partnership context, that is, to reduce the level of intervention in international trade transactions, albeit for differing reasons.

Economic benefit from working together

This element of a partnership is certainly a focus for business, and is perhaps an element for which there can be tangible measurement. There are numerous and often significant costs in conducting international trade in goods, and the analysis becomes one of whether, and by how much, these costs can be lowered through reduced customs intervention directly attributable to the partnership.

Whilst the nature and value of costs will vary from trader to trader dependent on factors such as the type of goods, speed of delivery required, scale of operations, level of knowledge, and so on, there are studies which have attempted to look at the impact of various costs associated with the import/export of goods, some of which are directly attributable to the clearance process.

Looking at these relevant costs of international trade, we find several surveys and studies have attempted to put a value on the cost expressed as an *ad valorem* tax equivalent (Anderson & van Wincoop 2004; Brooks 2008). In this regard, 'international trade costs' were found to be equivalent to a 74 per cent *ad valorem* tax, of which 21 per cent are transport costs, and 44 per cent are border-related costs. Significantly, these figures are for developed economies, and can rise markedly in developing economies.

In this cost figure, there is also reference to 'time costs' which for the United States were measured at an *ad valorem* tax equivalent of 0.8 per cent per day while goods are in transit (Hummels 2001), which equates to a 16 per cent *ad valorem* tax for an average sea cargo consignment in transit for 20 days. These costs can then rise significantly depending on the nature of the business and/or the nature of the goods being traded. For example, we would see many more cost sensitivities for perishable goods, or businesses such as express couriers whose business relies on 'next day' or a guaranteed time of delivery.

Hummels (2001) also suggested that time costs hurt international competitiveness and that in the case of the United States, business is 1-1.5 per cent less likely to trade with a country for every additional day of perceived delay it may place on moving cargo. Whilst customs processes are not the only factor in time delays, they certainly are contributors. That suggests that customs authorities need to continually look at possible reforms and other opportunities to reduce time costs for industry in line with other time savings which are occurring, such as speed and routing of ships and aircraft and stevedoring practices.

Another area of economic benefit which is sought by business is that of 'certainty'. This applies not only to access to goods upon arrival (or that they will be loaded on to the nominated export vessel) but also applies to ongoing treatment in terms of reporting, payment of duties and taxes and processes (GEA 2010). This certainty allows businesses to plan for pricing, distribution and long term contracts with either suppliers or customers, each of which can have an impact on eventual costs.

Therefore, where business believes it will be able to reduce costs in the areas of reduced transport times, and in less intrusive and more certain clearance processes, it will be keen to form such partnerships with Customs as clearly there are potential economic benefits.

Interestingly, if we look at the relationship between the customs process and some of the key international trading costs of time, border clearances and certainty, we should also ask whether Customs can reduce these costs through improvements and reforms without requiring a level of formal partnership with business. Should it be the initiative of national customs agencies to improve and reform their processes

and procedures to create economic benefits and productivity for their economies, irrespective of how business operates?

Further, should Customs attach the benefits of reduced intervention, or limit these benefits only to those businesses that go through certain processes and certification to enter a formalised partnership with Customs? Thus, we come back to the earlier concept raised, that of a 'forced marriage' where perhaps one partner is gaining more from the relationship and certainly enjoys more control over that relationship.

There is scope for industry to set up trading systems and other business practices which ensure full compliance with national revenue, reporting and security regulations as this must reduce costs by avoiding non-compliance and lowering risk ratings (and associated attention and intervention) by Customs. Again, this benefit can occur irrespective of a partnership arrangement with Customs, and just be 'good business practice'. As such, this question is likely best dealt with by observing that if there is some formal recognition of a trader's low risk and guaranteed benefits flowing from this recognition, we again return to a point where 'yes' there is an economic benefit for individual businesses to enter partnerships with Customs.

Is there a formal agreement?

The term 'partnership' needs to be used with some care from a business perspective as in many jurisdictions the term may have a legal meaning, and may also convey that there is some form of formal legal agreement such as a contract which covers structure and accountabilities created by the arrangement. One issue, therefore, in a CBP is to look at the array of existing partnership arrangements and determine if these set out such accountabilities, and perhaps more importantly, whether they are binding or simply representative of a type of relationship.

In 2010 the WCO celebrated 'Customs-Business Partnerships' (CBP) as its theme on International Customs Day. An article by the WCO Chairman (WCO, 2010b, p. 16) outlined the WCO's thoughts and achievements in terms of these partnerships and interestingly, did not appear to refer to any formal agreement documentation or processes. Instead, terms like 'collaboration' and 'co-operation' are used which suggest that CBPs are very much at a strategic, 'direction setting level', and played out in the context of forums and meetings between Customs and industry. Nothing in the article suggests that these partnerships are contractual or binding on either party in any way and it is assumed that Customs will eventually set standards and guidelines, albeit with industry input, with which industry will need to comply. These types of joint discussions are occurring at the WCO level with international industry representation (ICC 2009), and at national levels between Customs and national business representatives.

The main benefit of this type of partnership for industry is perhaps one of industry being able to have these various standards and guidelines created, and then adopted in forms which will result in future economic benefits to the industry. However, the question can be asked as to whether this in fact is a 'partnership' or whether it is simply a new approach to policy and standards development, an approach which now is more inclusive of industry.

The same article from the WCO Chairman does discuss the AEO concept, which is a point worth exploring further. Potentially, the AEO program is the only actual CBP which will meet all of the elements that are discussed in this paper and constitute a 'partnership' which is 'formal' and which has joint objectives and economic benefit. The granting of recognition and entry to the AEO is likely to be the 'formal agreement' between Customs and business. However, the form of this recognition of AEO status will vary from country to country, but much of the literature reviewed to date suggests that this will be in the form of 'certification' rather than contractual commitment. Currently there are around 15 AEO programs in operation which follow this principle (BIMCO 2010).

Again, 'certification' may suggest that there is a lack of a binding nature, and that a failure to adhere to the aspects of the AEO program would mean removal of a business 'certification' as a consequence. It is

not clear what consequences would be placed upon a customs agency if, for example, it failed to release low-risk cargo of a certified business in a timely manner.

Thus, perhaps that is what is missing from the current concepts of the CBP which apply at a Customs to individual trader level – a form of binding contractual arrangement for which clear accountabilities are spelt out for each partner, along with consequences for each partner should any conditions of the agreement be breached. However, from our review, under existing 'direction setting' partnerships, industry is still lobbying for improvements to actual AEO programs' standards, data, mutual recognition, IT systems, and so on, rather than looking at any binding nature of any operational agreements (ICC 2009; BIMCO 2010)!

What next for Customs-Business Partnerships?

If we look back to an observation in this paper about the argued success of the PPP model, elements of that success can be examined in the context of the CBP. These elements would include clarity in shared objectives and risks of the public sector service provider and the private sector service provider to effectively deliver those services, and of legally binding contractual agreements which set out the terms of the partnership including the remuneration to the private sector service provider.

In its purest sense, a PPP model operating in the CBP context suggests that a customs agency contracts a private sector service provider to undertake the clearance of import/export cargo, and collection of revenue. This is, in fact, not too distant from the AEO level CBP, where the level of compliance, security of supply chains and remittance of accurate revenue liabilities have been 'moved' on to individual businesses with Customs 'moving' to a certification role.

What we can use from the PPP model, particularly at the AEO level, is the formality of the agreement in that the contracting parties can clearly specify a range of roles, responsibilities, risks and accountabilities in the partnership, about which both parties will be held to. The formality certainly gives a greater perception of equity in the CBP for industry, and would see Customs taking responsibility for any failures on its part through normal contractual provisions covering breaches. So, we may have lessons for CBP in the PPP model approach.

5. CBP: a possible framework for collaborative governance

Based on the theoretical review and input from a business perspective, the authors have attempted to construct a conceptual framework for design and implementation of the CBP. Among the theoretical observations discussed above, the literature on 'collaborative public management' is perhaps more relevant. In 2006, *Public Administration Review* dedicated a special issue to a symposium on collaborative public management and invited noted scholars and practitioners in public administration to take part (O'Leary, Gerard & Bingham 2006). The aim was to generate a common definition and to benefit from cross-fertilisation in academic fields.

The term 'collaborative public management' describes the process of facilitating and operating in multi-organisational arrangements to solve problems that cannot be solved or easily solved by single organisations. 'Collaborative' means to co-labour, to cooperate to achieve common goals, working across boundaries in multi-sector relationships.

In the literature on 'collaboration', an integrated framework to understand cross-sector collaboration proposed by Bryson, Crosby and Stone (2006) is inspiring. Their framework is based on extensive review of the literature relating to cross-sector collaboration, organisational development and the notions of collaboration formation, process, structure and governance, constraints, and contingencies. In this paper, the authors have adapted that framework to the context of CBP.

We start by replacing the term 'collaborative public management' with the term 'collaborative governance' where we are looking to achieve 'good governance' in the context of Customs and business working towards building a partnership to deliver good policy, efficient trading and full compliance with relevant customs laws. The framework identifies a structure and key factors in the CBP, as we build a possible framework product which can be found in Figure 2.

Under each cluster of factors, brief theoretical and practical discussions are put forward, and propositions for designing and implementing the CBP arrangements are discussed.

Initial conditions

This first group of issues, 'Initial conditions' relates to why the CBP approach has emerged. This cluster focuses on environmental factors, what has gone wrong and what has happened to give rise to the need to introduce a CBP.

Environment factors. We start the discussion by going back to the idea of 'resource dependence theory', and ask whether Customs and business have the tendency to build linkages to decrease uncertainty and increase organisational stability. Bryson, Crosby and Stone (2006) identified that collaborations are subject to both competitive and institutional pressures. The competitive pressures have direct impacts on business, as it needs to build competitive advantages in ways such as improving supply chain management to reduce costs. The institutional environment for a CBP can include the broader governance reform at national level, challenges posed by globalisation like requirements of trade facilitation and trade security, increased public expectations and other strategic drivers (Mikuriya 2007; Widdowson 2007; WCO 2008).

It can be argued, therefore, that a CBP is more likely to form or emerge in turbulent environments which include both competitive and institutional dimensions.

Social failure. Bryson, Crosby and Stone (2006) refer to social failure as 'the often-observed (albeit general) agreement on the problem definition that single-sector efforts to solve a public problem are tried first and found wanting before cross-sector efforts are attempted'. In terms of the key notion of integrated international supply chain management, the WCO (2007) acknowledged that Customs does not own supply chain but Customs' work has much bearing on efficiency and effectiveness of supply chain management.

In the face of increasing complexity and volume of trade, and potential risks in revenue collection, and community protection, Customs itself cannot take all the responsibility. Therefore, Customs and business are more likely to collaborate when they realise separate efforts by one side cannot address the cross-boundary problems or issues.

Direct antecedents. Bryson, Crosby and Stone (2006) point out three conditions. Firstly, a brokering organisation or a legitimate convener can facilitate collaboration. As for the CBP, Customs is usually the initiating party and leaders from Customs have the ability or the authority in many cases to conduct boundary-spanning activities.

Secondly, there needs to be an initial agreement on the problems identified. This may be problematic, for example, in programs like the AEO as those programs are focused on trade security for Customs, which business may not yet have flagged as a priority. .

Thirdly, the role of prior relationships or existing networks is important for any CBP. Again using the AEO program as an example, past compliance and adequacy of a trader's internal business systems are important. Thus, in terms of antecedents, a CBP is more likely to succeed when one or more linking mechanisms like a brokering organisation, agreement on the problem, and prior relationship are in place.

Process component

Different authors may stress different aspects of partnership building. Bryson, Crosby and Stone (2006), for example, have identified six components of partnership building which are relevant here: forging initial agreements, building leadership, building legitimacy, building trust, managing conflict, and planning. It is noted that discussion of process may overlap with some aspects of initial conditions and structure. For example, a key process in partnership is negotiating formal and informal agreements about the purpose of such a partnership. As well as agreeing with the purpose, partners may consider elements of structure, such as roles, responsibilities and decision-making authority.

Forging initial agreement. For collaboration, the parties should first negotiate and agree on a broad purpose, mandate for each party, resources commitment, decision-making structures, and so on. Such agreement can be informal at the beginning, but formal agreements are expected to evolve to sustain the partnership and support accountability. The drafting process itself is also meaningful as high participation and involvement by stakeholders and implementers are critical.

Next, consider the actual CBP arrangements discussed in this paper, where it is thought that three levels of agreement could evolve. First is the level of goodwill and intention. As stipulated in the preamble to the Revised Kyoto Convention, Customs should encourage business to participate widely in policy consultation and other relevant discussions. This level is likely to be more at an 'industry-wide' level, with a representative industry body partnering with Customs through a mechanism such as a non-binding Memorandum of Understanding (MOU) or exchange of goodwill letters.

The next level is some form of approval, such as the issue of a licence or permit, through to a form of certification, such as that under an AEO program. However, it is argued that this type of approval or certification is perhaps somewhat one-sided with all the decisions and approvals granted by Customs. Finally, there is an advanced level where a formal agreement, such as a legally binding contract, is expected which holds both partners to account and could well be a future extension of the AEO program. For this advanced or more formal level of partnership agreement, lessons can possibly be drawn from PPP where formal agreements such as legal contracts are in place.

Building trust. Trust in relationships is often depicted as the essence of collaboration. Trust can comprise interpersonal behaviour, confidence in organisational competence and expected performance, and a common bond and sense of goodwill (Chen & Graddy 2005). It is emphasised that building trust is an ongoing requirement in any relationship (Huxham & Vangen 2000, 2004). Collaborative partners build trust by sharing information and knowledge and demonstrating competency, good intentions, and follow-through. In this regard we believe that a CBP is more likely to succeed when trust-building activities are continuous.

Leadership. Political will and commitment are recognised as priorities in customs modernisation and capacity building (WCO 2004). Partnership building provides multiple roles for formal and informal leaders. Formal leadership might include co-chairs of Customs-Business consultative committees, coordinators in charge of AEO programs, and leaders of trade associations. It is expected that these people need formal and informal authority, vision, long-term commitment to the partnership, integrity and relational and political skills. Conversely, informal leadership is especially important because participants often cannot rely on, or wait for, clear directions from the formal process. Therefore, a successful CBP requires formal and informal leadership at many levels.

Communication. Communication is widely recognised as a key building block. Open, timely and effective communication will reduce possible misinterpretation and misunderstanding between Customs and business. This is particularly so for programs like the AEO where communication needs to include identifying points of contact, establishing procedures and mechanisms to report incidents in supply chain

management, and mutual training programs. The CBP is more likely to be fostered through effective communication between Customs and business counterparts, and relevant mechanisms should be in place.

Mutual benefits and incentives. Partnership, in its essence, should be voluntary, and certainly not perceived as a 'forced marriage' as we discussed earlier. Therefore, tangible benefits should be designed and provided to attract business to join a partnership. Possible benefits that Customs can offer to business could include measures to expedite cargo release, reduce transit processing time and logistics costs, access to information of value to AEOs, special measures during periods of trade disruption or elevated threat level, and priority in new cargo processing programs (WCO 2004; USAID 2010). Thus, mutual benefits should be embedded in any CBP arrangements. For voluntary AEO programs, tangible incentives should be identified and provided to business.

Managing conflict. Conflict is an integral and permanent facet of partnerships (Jung & Osborne 2008). Bryson, Crosby and Stone (2006) pointed out that conflict can emerge from many circumstances including differing aims and expectations of partners, differing views about strategies and tactics, and from attempts to protect or magnify a partner's control over the partnership. No matter how positive the development of partnerships appears to be, the inherent conflict of interest between Customs and business cannot easily be removed. This is because the primary role of Customs is as an enforcement agency, but the inherent conflict can be managed. Conflict may be worse when the partnering parties differ in status, and industry may view itself as the least powerful of the partners should issues arise. Conflict is unavoidable in any partnership arrangement, but a CBP is more likely to succeed when partners use resources and tactics to manage conflict effectively.

Transparency. Under the explanation of 'game theory', transparency of gaming rules enables gamers to expect the other party's reaction in a predictable, clear manner. Transparency, as a key principle for modern Customs is critical in designing and implementing a CBP. Only after businesses understand the requirements of Customs can they improve compliance. Equally, they need to know how Customs will respond when differing views on compliance issues arise. We consider that a CBP is more likely to succeed when Customs is dedicated to establishing channels and mechanisms to readily provide necessary information to business for better compliance.

Structure and governance

Bryson, Crosby and Stone (2006) argued that structure is influenced by context, including system stability and the availability of resources. Another factor to be considered is that structures are likely to be dynamic because of the ambiguity and complexity that is inherent in collaboration. This sheds light on the various cooperation arrangements between Customs and business.

Contingencies and constraints

Contingencies influence a partnership's process, structure, and governance, as well as its overall sustainability. There are two major factors relevant to CBP: power imbalance and risk allocation.

Power imbalance. According to Huxham and Vangen (2004) power imbalance among collaborating partners can be a source of mistrust and therefore have an impact on effective collaboration. As discussed above, the relationship between Customs and business is traditionally dominated by Customs which can create barriers to an equal partnership and can be a source of conflict. Therefore, a CBP is more likely to succeed when it builds in resources and tactics to deal with power imbalances including, for example, formal agreements which provide for certain rights and redress for business in times of dispute.

In any formal partnership agreement between Customs and business it would be advisable to include dispute resolution processes and the identification of consequences should either party breach any clause of that agreement. In the context of equal partners and power balance, this would include consequences

for Customs in breaching the agreement such as a failure to release cargo on time, and consequences for business such as non-notification of key changes to systems and personnel.

Risk allocation. In any partnership we look for mutually achievable objectives and benefits which can be shared. However, the converse is that there may be risks of failure to meet objectives and of not receiving benefits. These risks need to be understood and ways of managing them need to be assigned to each party. The relationship can again become one-sided or imbalanced if only one party carries all of the risk.

To expand on this concept, the AEO program does create new risks in that there will be minimum intervention by Customs in the transactions of a certified trader. This is a risk that needs to be identified and captured in any formal partnering agreement and may, for example, lead to a clause in an agreement which guarantees automatic or speedy release of cargo that has been identified as being for a certified trader and within the scope of the AEO program. If, say, Customs wanted to retain the right to intercept and subject a certified trader's transaction to full risk management processes, the business is no longer an equal partner and loses benefits such as absolute certainty and timing of delivery.

On the other hand, business needs to look at risks associated with the AEO program, including granting to Customs the right to examine all business systems of the organisation which may relate to compliance and extend this right through the supply chain to service providers such as brokers and freight forwarders. If, however, business was to insist on the right to deny access to certain areas which are considered too commercially sensitive, Customs would feel that the balance was in favour of business.

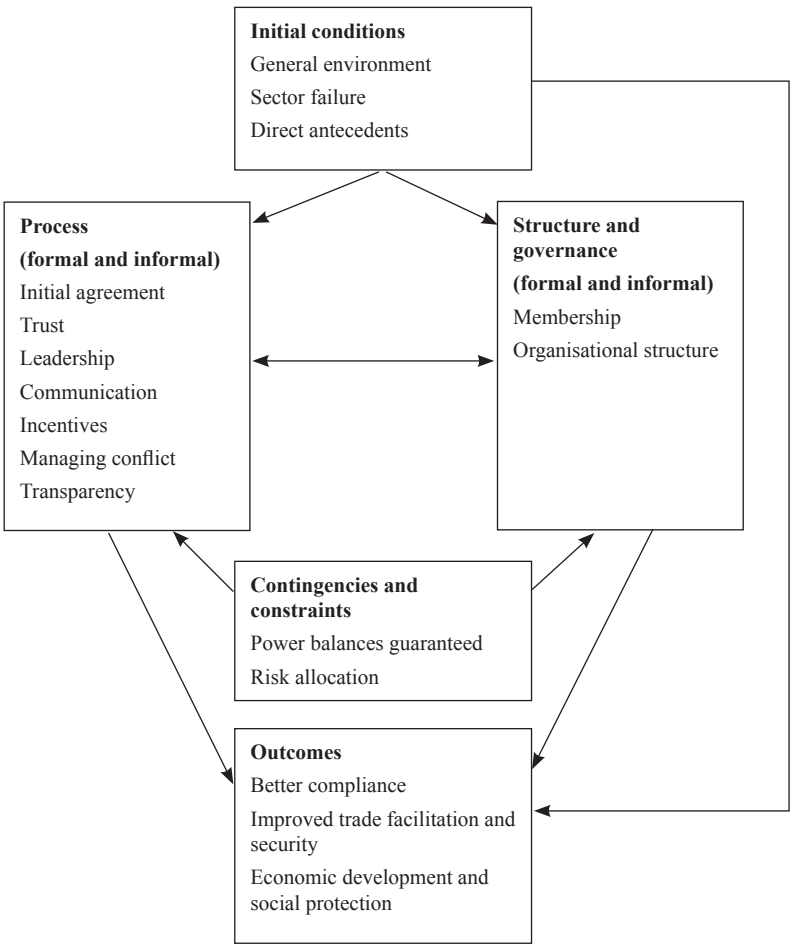
Thus, if neither side is able to accept risks such as in these examples, the benefits to Customs and business of partnering in programs like AEO are minimal. However, if one side was to break the agreement, perhaps business establishes new controls in its systems which are inadequate and are allowing errors to occur, this is a different issue and dealt with through redress mechanisms in the formal agreement, and not dealt with by looking to establish 'risk-free partnership' agreements.

Outcomes

Finally, we look at the outcomes. Bryson, Crosby and Stone (2006) argued that creating and sustaining cross-sector collaboration ought to be the production of 'public value' that cannot be created by single sectors alone. Public value in cross-sector collaborations is more likely created by making use of each sector's characteristic strengths while finding ways to minimise, overcome or compensate for each sector's characteristic weaknesses. In regard to the CBP, expected outcomes are better compliance, improved trade facilitation and security, and ultimately, economic development and social protection. To achieve these outcomes, a CBP is more likely to create 'public value' when it is built on the self-interests and characteristics of both Customs and business.

As Bryson, Crosby and Stone (2006) said, 'cross-sector collaborations are complex entities that defy easy generalisation is an understatement'. The above elaboration of the proposed collaborative framework serves as a basic starting point for both parties of CBP to understand the relationships among the initial conditions, processes, structure, governance, contingencies and outcomes. However, the variables identified above may lead to success, but 'they are more likely to be inter-related with, moderated by, or mediated by other variables; embedded in fairly complicated feedback loops; and change over time' (Bryson, Crosby and Stone 2006).

Figure 2: Custom-business partnership (CBP): a collaborative governance framework



Source: Adapted from Bryson, Crosby & Stone 2006, p. 45.

6. Conclusions

The relationship between Customs and business is undergoing a paradigm shift from a 'traditional bureaucratic model' to a 'new governance model'. It may be time to examine the concept of CBP and whether both Customs and business are benefiting from this new approach.

CBP could be examined in the context of the development of some very successful public-private partnerships (PPPs) which themselves have evolved from the broader reforms of New Public Management and governance both in developed and developing countries. Examining the roots of PPPs tells us that CBP is a different model to that of PPPs given the unique role of Customs, however, there may be lessons to adopt for the CBP.

What is important at this stage of development of CBPs is that any perceptions that they are mere 'gimmicks' or that they lack substance, are quickly extinguished by setting standards or adopting a framework that ensures future CBPs are effective, beneficial and binding on equal partners. The on-

going development of the AEO program as a type of CBP is a good place to start this new framework approach, which can only improve the quality and perception of quality of the partnerships envisaged by this type of program.

Based on the perspective of 'collaborative governance', this paper puts forward a possible 'conceptual framework' for designing and implementing CBPs in line with this desire to ensure future CBPs have perceived substance. The conceptual exploration is a starting point in the study of the future of the CBP, and more empirical research will be conducted later in order to test the framework.

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Large Traders' Customs Units

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Abstract

Revenue collection, a core function of many customs administrations, has recently come under strain owing to the global financial crisis. The World Customs Organization (WCO) Revenue Package initiative, launched in 2009, seeks *inter alia* to promote the exchange of experience and best practices with tax administrations in order to improve the capacity of Customs to collect revenue. This paper describes the experiences and insights of tax administrations in their implementation of Large Taxpayers Units (LTU) and discusses the creation and development of Large Traders' Customs Units (LTCU).

Introduction

The collection of revenue (that is, customs duties, VAT, and other taxes on traded goods) represents a core function of most customs administrations. This function has been negatively affected by the global financial crisis which introduced a sudden and unexpected volatility in trade, resulting in most administrations experiencing a severe reduction in revenue collections. This decline in revenue and the new global economic conditions pose challenges for administrations on how to analyse such trends and effectively perform their core role.

With this in mind, the World Customs Organization (WCO) launched the Revenue Package initiative in 2009 in response to a request by its Members (WCO 2009). This initiative encourages Members to fully and effectively utilise existing WCO tools and instruments related to revenue matters. The WCO Revenue Package also seeks to promote an exchange of experience and best practices with tax administrations in order to enhance customs' capacity to collect revenue.

This paper discusses and recommends the creation and development of Large Traders' Customs Units (LTCU). The proposal considers the successful experience of tax administrations in implementing Large Taxpayers Units (LTU).

This paper highlights the importance of LTCU to customs and revenue collection in terms of revenue risk mitigation. In particular, it focuses on the benefits of creating such units, particularly in relation to concentrations of trade. It also encourages customs administrations to use these units as a means of implementing pilot projects aimed at improving the speed of pre-clearance procedures and the effectiveness of post-clearance audits.

Economic theory: the 'Pareto principle'

The Pareto principle is an economic concept which is used in different fields of research. The principle states that, for many events, roughly 80 per cent of the effects come from 20 per cent of the causes.

Pareto Principle/Postulate
(Business theory) The concept that, when a large number of individuals or organizations contribute

> to a result, the major part of the result comes from the minority of the contributors. The Pareto Postulate is that 20% of your effort or clients will generate 80% of your results or business. This is commonly referred to as the 80/20 rule. An actual percentage can be calculated by ranking customers or contributors by volume or any other factor (Hinkelman 2005).

The principle was named after Italian economist Vilfredo Pareto, who observed in 1906 that 80 per cent of the land in Italy was owned by 20 per cent of the population. He developed the principle by observing that 20 per cent of the pea pods in his garden contained 80 per cent of the peas.[1]

Over the years the Pareto Principle or 80/20 rule has manifested itself in various ways, including (a) 80 per cent of the results are achieved by 20 per cent of the group; (b) 20 per cent of your effort will generate 80 per cent of your results; and (c) in any process, few elements (20 per cent) are vital and many elements (80 per cent) are trivial;

The Pareto principle is largely used in quality control, finance, biology and other fields of research. It focuses on the unequal distribution and imbalance in relationships. There are different degrees of imbalance (high, significant, moderate, and low) and the Pareto Principle provides a basis for the development of new strategies.

Large Taxpayers' Units

The introduction of Large Taxpayers Units (LTUs) by tax administrations is a well-established practice which is based on the premise that a few large taxpayers account for the majority of an economy's revenue collection (Pareto principle). Tax administrations recognise that large taxpayers are different from other groups of taxpayers, requiring specially designed tax and compliance programs. As such LTUs provide large taxpayers with a single point of contact with the tax administration, and enable the administration to tailor their compliance programs to meet the specific circumstances of the taxpayers' commercial activities.

Several international organisations recommend the practice of establishing LTUs. In particular, the Centre for Tax Policy and Administration (CTPA) at the Organisation for Economic Co-operation and Development (OECD) has published a guide on LTUs. The Centre highlights common compliance issues associated with large taxpayers and identifies practices, innovative programs and initiatives employed by tax administrations to meet these challenges. Among the key findings listed in the guide are:

- Criteria to identify large businesses vary from country to country and include turnover, assets, tax paid, specific industry and other special factors (for example, international transactions).
- The characteristics of large taxpayers are generally very similar in all participating countries. According to the guide they have a complex structure with multiple operating entities engaged in international business and account for a large share of tax revenue.
- All tax administrations structure the compliance operations of their LTUs along industry lines which, for some, reflect the main sectors of their economy. In addition, some tax administrations have special units to perform risk analysis and intelligence-gathering, provide technical advice, and to monitor and evaluate performance.
- Tax administrations use risk management extensively to manage and prioritise their tasks. Although there are some general similarities in the approach adopted, the levels of risk analysis and response vary from one country to another in reflection of their experience with compliance issues and the degree of non-compliance by large taxpayers.
- Compliance issues may vary from one country to another. However, all participating countries cite tax compliance as a major area of activity and concern in relation to international transactions and business structures.

- All countries are focused on nurturing a better relationship between the tax administration and large taxpayers and this approach is contributing to greater co-operation and openness.
- There is an increase in compliance activities using non-traditional approaches. Trends suggest a shift from the post-filing of tax return examinations towards a 'real-time' evaluation of risk and resolution of compliance issues. A number of countries have commenced various programs to provide certainty to large taxpayers as well as to identify and resolve compliance issues at an early stage.
- Certain tax administrations are devoting greater attention to corporate governance principles and practices. Considering the importance of tax as a financial asset, a number of them believe that the responsibility of a company's tax policy should be vested in the management. Corporate governance principles in some countries are influencing large taxpayers' behaviour and there are indications that tax administrations are using these principles to improve tax compliance.
- In order to enhance enforcement and customer service, all participating countries have programs in place to develop, train and maintain a highly qualified workforce. All countries recognise that the complexity of tax law, business structures and transactions in the large business segment have created a need for specialised knowledge and expertise in certain areas.
- Most participating countries have made it clear that tax policy is the responsibility of the Ministry of Finance but they also recommend that the tax administration should play an active role in providing input and feedback on tax policy to ensure that the tax administration's needs are taken into account.
- Technology should be utilised to manage compliance and improve the quality of service to large taxpayers. This includes the ability to identify risk early and the increased operational efficiency of large business units. A number of countries have developed programs and systems to collect additional data in a timely fashion thereby enhancing compliance risk assessment, facilitating resource decisions and ensuring the consistent treatment of large taxpayers in certain business segments (OECD 2009).

The Fiscal Reform and Economic Governance Project (2010) regards the creation of LTUs as a tax administration structural indicator. Those tax administrations that have set up a unit devoted solely to the largest taxpayers tend to receive a better evaluation than those that have not.

> **Large Taxpayers Unit (LTU)**
>
> This is a tax administration structural indicator. Tax administrations that have a unit devoted solely to tending to the largest taxpayers are indicated with a '1' whereas those tax administrations that do not have such a unit are indicated with a '0'. It is received [*sic*] wisdom that tax administrations should establish large taxpayers units. In some countries, segmentation of taxpayers may go much further. Indeed, some countries establish special units for medium and small taxpayers, as well (Fiscal Reform & Economic Governance 2010).

The International Monetary Fund (IMF) is another international organisation that emphasises the importance of establishing LTUs in order to improve the effectiveness of tax administrations.

> Beginning in the 1980s, the IMF has recommended that member countries facing revenue crises establish an LTU as a means to strengthen tax administration. In addition, establishment of an LTU has allowed many countries with scarce resources to begin implementing reform measures for immediate and visible results (Baer, Benon & Toro 2002, p. 36).

Hemming, Cheasty and Lahiri (1995) writing about ways to mitigate the revenue decline in the Baltic countries, Russia, and other countries of the former Soviet Union underline the need to create an LTU:

> A large-taxpayers unit should be created. It would monitor collection of taxes from important taxpayers who, although not numerous, account for the major part of tax revenue. In energy-exporting economies, a few large taxpayers can account for 90 per cent of total revenue. In some countries, large taxpayers engaged in cash cropping and processing account for a substantial part of revenues. A large-taxpayers unit properly focuses initial efforts of tax administration reform on the adoption

> of more efficient procedures for the more important taxpayers, rather than on the increasing number of small taxpayers whose revenue contribution is not substantial (Hemming, Cheasty & Lahiri 1995, p. 91).

In summary, a significant number of tax administrations has established, with positive results, the special treatment of different taxpayers or taxpayer segments. A few examples are Australia, Bangladesh, Brazil, India, the Netherlands, New Zealand, Pakistan, Sri Lanka, the United Kingdom and the United States of America.

The concentration of international trade

In several economies a relatively small number of traders and a few significant import/export products account for a large share of international trade. The degrees of trade concentration depend on factors such as geography, internal market size, industrialisation, national income, and dependence of exported/imported commodities.

Concentration of traders

The globalisation of business together with firms' increasing ownership of different stages of the production process have contributed to the growth in intra-firm trade over the last decade. Nowadays, it is common to find trade between multinationals and their majority-owned foreign affiliates.

It is important to note that the size of a large trader will vary from country to country although some major characteristics remain the same:

- Revenue concentration: a few traders account for a disproportionately large amount of trade and revenue
- Business complexity: large traders conduct complex business operations
- Professional advisers: large traders have professional advisers for customs procedures and taxes
- Multinational companies: large traders are generally related to multinational companies.

When dealing with large traders, customs administrations are faced with a range of compliance management issues such as multiple units of operation; high volume of imports/exports; complex international sales contracts (royalties, engineering projects, financial terms); cross-border transactions with related parties; complex fiscal issues relating to tax law and accounting principles; policies and strategies to minimise tax liabilities as well as complex financing and business structures.

Concentration of products

The International Trade Statistics Report 2009, issued by the World Trade Organization describes merchandise trade by product. This approach highlights the importance of trade in agriculture, fuels and mining products, manufactured goods, office and telecom equipment, automotive products, clothing, cut flowers as well as the importance of Export Processing Zones (EPZs).

According to the report, several countries spend a significant part of their foreign exchange earnings on importing fuels and mining products. In some cases this share exceeds 75 per cent. Large emerging economies rely heavily on the import of ores and other minerals.

Iron and steel are the primary exports of manufactured goods followed by chemicals and transport equipment. Office and telecommunications products (for example, mobile phones and computer components) are designated high-risk products due to the fact that they are high-value and low-volume goods.

China is the leading exporter of clothing products. The competition in this export sector is fierce and involves countries from Asia (such as India and Bangladesh), and the Americas (such as Mexico, Brazil and the Dominican Republic).

The report is an important source of information concerning the concentration of regional and national products in imports and exports. Customs administrations should make full use of such statistical reports and tools in order to understand the conditions of international trade which are constantly fluctuating. It is necessary to identify high- risk products such as office and telecommunications equipment, automotive and pharmaceuticals products as well as clothing and machinery, and to monitor them closely.

LTCU and Authorised Economic Operators

The WCO's SAFE Framework of Standards is an international instrument designed to provide a safer world trading regime and new working methods for customs administrations. The Authorised Economic Operator (AEO) concept is one of SAFE's core elements of promoting partnerships between customs and business. An AEO is defined as:

> [A]… party involved in the international movement of goods in whatever function that has been approved by or on behalf of a national Customs administration as complying with WCO or equivalent supply chain security standards. Authorized Economic Operators include inter alia manufacturers, importers, exporters, brokers, carriers, consolidators, intermediaries, ports, airports, terminal operators, integrated operators, warehouses, distributors (WCO 2007).

Several customs administrations have developed AEO programs under different names and which reflect different approaches: the United States (C-TPAT – Customs-Trade Partnership against Terrorism), United Kingdom, Sweden, the Netherlands, New Zealand (SES – Secure Export Scheme), Singapore (STP – Secure Trade Partnership), Brazil (Express Customs System – Blue Line), Canada (PIP – Partners in Protection) and several others.

Some AEOs programs are open to all operators in the supply chain while others are restricted to importers/exporters. The ultimate goal of such programs is mutual recognition. This refers to the recognition of accredited AEOs in different countries thereby contributing to the establishment of secure supply chains. Some countries have already accredited operators on the basis of Mutual Recognition Agreements (MRA).

At present, countries have the challenge of implementing AEO programs and signing an MRA without having a specific structural unit to perform the task. Depending on the structure of the customs administration, the existing clearance and/or audit units will be the ones in charge. However, they are preoccupied with other problems and have few resources to develop new initiatives.

The innovative concept of the AEO and its apparent complexity makes it perfectly suited to the LTCU. As a matter of fact, most accredited AEOs also happen to be large traders/taxpayers. Therefore, the LTCU would fill the gap as the ideal unit to develop, implement and host the program. Technical assistance and capacity building on best practices for LTCU could be provided by international organisations.

This proposal is plausible since the conditions and requirements for AEOs already suggest that an AEO will probably be a large trader/taxpayer (WCO 2007, pp. 37-48):

A. **Demonstrated compliance with customs requirements:** Customs shall take into account the demonstrated compliance history of a prospective AEO when considering the request for AEO status.
B. **Satisfactory system for management of commercial records:** The AEO shall maintain timely, accurate, complete and verifiable records relating to import and export. Maintenance of verifiable commercial records is an essential element in the security of the international trade supply chain.

C. **Financial viability:** Financial viability of the AEO is an important indicator of an ability to maintain and improve upon measures to secure the supply chain.

D. **Consultation, co-operation and communication:** Customs, other competent authorities and the AEO, at all levels, international, national and local, should consult regularly on matters of mutual interest, including supply chain security and facilitation measures, in a manner which will not jeopardize enforcement activities. The results of this consultation should contribute to Customs development and the maintenance of its risk management strategy.

E. **Education, training and awareness:** Customs and AEOs shall develop mechanisms for the education and training of personnel regarding security policies, recognition of deviations from those policies and understanding what actions to be taken in response to security lapses.

F. **Information exchange, access and confidentiality:** Customs and AEOs, as part of an overall comprehensive strategy to secure sensitive information, shall develop or enhance the means by which entrusted information is protected against misuse and unauthorized alteration.

G. **Cargo security:** Customs and AEOs shall establish and/or bolster measures to ensure that the integrity of cargo is maintained and that access controls are at the highest appropriate level, as well as establishing routine procedures that contribute to the security of cargo.

H. **Conveyance security:** Customs and AEOs shall jointly work toward the establishment of effective control regimes, where not already provided for by other national or international regulatory mandate, to ensure that transport conveyances are capable of being effectively secured and maintained.

I. **Premises security:** Customs, after taking into account the views of AEOs and their necessary compliance with mandatory international standards, shall establish the requirements for the implementation of meaningful Customs-specific security enhancement protocols that secure buildings, as well as ensure the monitoring and controlling of exterior and interior perimeters.

J. **Personnel security:** Customs and AEOs shall, based on their authorities and competencies, screen the background of prospective employees to the extent legally possible. In addition, they shall prohibit unauthorized access to facilities, transport conveyances, loading docks and cargo areas that may reasonably affect the security of those areas in the supply chain under their responsibility.

K. **Trading partner security:** Customs shall establish AEO requirements and mechanisms whereby the security of the global supply chain can be bolstered through the commitment of trading partners to voluntarily increase their security measures.

L. **Crisis management and incident recovery:** In order to minimize the impact of a disaster or terrorist incident, crisis management and recovery procedures should include advance planning and establishment of processes to operate in such extraordinary circumstances.

M. **Measurement, analyses and improvement:** The AEO and Customs should plan and implement monitoring, measurement, analysis and improvement processes in order to:
   - assess consistency with these guidelines;
   - ensure integrity and adequacy of the security management system;
   - identify potential areas for improving the security management system in order to enhance supply chain security.

It is likely that large traders/taxpayers will be able to comply with the WCO conditions and requirements.

In summary, the concept of an LTCU is directly related to the AEO concept and should be seen as a complementary strategy to achieve positive results in relation to Customs' priority mission (that is, providing a safer system of world trade and developing modern working methods).

Brief guidance on LTCUs

Some of the key components in the establishment of an LTCU include the mission, human resources, risk management, audits and enforcement. The following briefly outlines some of these components.

LTCU mission

The mission of an LTCU should be to recognise the different characteristics and behaviours of large traders in order to obtain the most favourable balance between compliance and facilitation programs. This will ensure more effective risk management and higher levels of compliance.

Human resources

Human resources is a key element of a successful LTCU program. The complex business activities of a large trader demand that human resources assigned to the LTCU should be well versed in information technology (IT) and audit skills. Training courses should also ensure that participants understand the economic conditions governing trade at national and international levels. Thereby, Customs will focus controls on the most important sources of trade in order to optimise their use of restricted human resources.

Risk management

Risk management should be extensively used to manage and prioritise customs tasks. A focus on establishing Customs-Business partnerships is of fundamental importance in improving risk management.

IT also plays an extremely important role in the creation of a successful risk management and LTCU program. For example, there should be an effective registration process for assigning a unique taxpayer identification number (TIN) to each existing taxpayer. Normally, tax administrations already have a unique TIN and so Customs should arrange to use this system and make adjustments or improvements where necessary.

Since taxpayers are not necessarily traders, Customs can impose special controls on those taxpayers who are also large traders. This would serve to expand the base of legitimate large traders and to help stamp out fraudulent importers.

IT could also be harnessed by LTCUs to introduce self-assessment principles for filing, payment and simplified collection procedures.

Audits and enforcement

Audit selection by LTCUs tends to produce better results in terms of enforcement and tax collection. The creation of such units will serve to shift responsibility for audit selection from local units to customs headquarters or important regional units.

The experience of LTCUs in Bosnia and Herzegovina illustrates this recommendation:

> Tax enforcement intensified with the new Tax Administration Law. Several divisions that were established in the months preceding enactment of the Law—including units for Enforced Collections, Investigation and Intelligence, and a Large Traders' Customs Unit (LTCU)—were carried over under the new organizational structure to perform a variety of enforcement-related functions. … Audit selection was shifted from the cantonal offices, which were rumored to be susceptible to local influence, to the Tax Administration headquarters in Sarajevo. With the establishment of the Investigation and Intelligence Unit, and with the cantonal offices reporting directly to the central office, audits and investigations began to be conducted on a more consistent basis (Rozner, Šahinagić & Marjanović 2005, p. 33).

In some cases, this type of audit will necessitate a Mutual Assistance Agreement (MAA) to be concluded between different national customs administrations.

An LTCU's enforcement plan should be directed towards fraudulent importers who account for large revenue and economic losses. One example is Missing Trader Intra-Community (MTIC) fraud which is divided into two main types: acquisition and carousel fraud. Using the UK as an example:

> **Acquisition fraud** is where the goods are imported from the EU into the UK by a trader who then goes missing without completing a VAT return or Intrastat declaration. The 'missing trader' therefore has a VAT free supply of goods, as they make no payment of the VAT monies due on the goods. He sells the goods to a buyer in the UK and the goods are available on the home market for consumption.
>
> **Carousel fraud** is similar to acquisition fraud in the early stages, but the goods are not sold for consumption on the home market. Rather, they are sold through a series of companies in the UK and then re-exported to another Member State, hence the goods moving in a circular pattern or 'carousel' (Ruffles et al. 2003, p. 59).

This type of fraud is also found in other countries with VAT or internal taxation controlled by different states.

Conclusions

This paper has argued that Customs should learn from the tax administrations' successful experience with LTUs and create LTCUs where they are needed. This proposal is supported by economic theory and the concentration of international trade which suggest that a few traders and products are responsible for a large share of total customs revenue.

The advantages of establishing LTCUs in the customs environment should be similar to those reported by tax administrations when establishing LTUs: (1) improved identification and knowledge of large taxpayers and their operations; (2) more timely and accurate return filing and payment by large taxpayers; (3) earlier detection of taxpayers' failure to comply with filing and payment obligations; (4) more effective audits targeted by economic sector and performed by better-trained auditors; (5) a reduced stock of arrears, and therefore more targeted efforts by collection enforcement officers; and (6) better-trained staff able to deal with more complex tax issues, provide quality services to taxpayers as well as to detect irregularities and corrupt practices (Baer, Benon & Toro 2002, p. 16).

To maximise their utility, LTCUs should be staffed by motivated officers who would monitor and analyse commercial trends as well as the compliance behavior of relevant traders and other stakeholders. This approach will also provide an important avenue for enhancing customs expertise in the area of compliance management.

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Endnotes

1 The Pareto Principle is also referred to as 'Pareto's Law', the '80/20 Rule', the '80:20 Rule', and the '80 20 Rule'.

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Towards customs valuation compliance through corporate income tax

Santiago Ibáñez Marsilla[1]

Abstract

Customs valuation is based, primarily, on the price actually paid or payable for the goods. The customs administration is a third party to the price, and so needs to rely on the price declared by the parties. Nevertheless, Customs can cross-check the value declared with the cost declared for the purposes of the corporate income tax base determination. The need for coherence between these two values is an important control tool for the customs administration, if properly used. The relationship between customs valuation and the inventory cost of the goods is complex, and an adequate understanding of this issue is necessary to make correct use of this control tool. This article provides an overview of the possibilities available to customs administrations.

1. Introduction

This paper explores the possibilities of corporate income tax as a control tool for customs valuation. Since imported merchandise will constitute an input in the importing country, the value of imported goods will be relevant for the determination of the profits taxed by corporate income tax. The lower the customs value, the lower the inputs cost and, hence, the higher the profit taxed by corporate income tax. Therefore, in general the taxpayer will prefer a lower customs value and a high input value, since that way both customs duties and corporate income tax will be lower. Obviously, the interest of the authorities will be exactly the opposite, in order to maximise revenue.

The paper begins with an analysis of the respective valuation rules for customs and corporate income tax purposes, to identify their similarities and their differences (section 2). Then the legal connection established in United States (US) legislation between those two values is examined (section 3), followed by a connection found, in the absence of an explicit provision to that end, by the Courts in the Spanish system (section 4).

In this paper, the valuation of the imported goods for corporate income tax purposes is referred to as 'inventory cost' (US legislation uses the expression 'basis or inventory cost' in Sec. 1059A IRC).

2. Same concept, some differences

The relevance of corporate income tax as a tool to ensure compliance in customs valuation rests on the assumption that there is a relationship or connection between the valuation rules in both taxes. If that were not the case, it would not be possible to make an inference about one from the amount determined for the other.

Customs valuation methods are established in the World Trade Organization's (WTO) Customs Valuation Code (CVC).[2] Member States have transposed that regulation in their internal law. The main valuation method is **Transaction Value** (TV). According to this method, valuation is based on the price in a sale

for export to the importing country, with some adjustments. The CVC establishes some circumstances which preclude the use of transaction value, chief amongst which is that the existence of a relationship between the parties has had an influence on the price. Transaction value, as defined by customs valuation rules, **and an arm's length price** of the goods (which is the objective of transfer pricing rules in the Income Tax) should basically be the same thing. Of course, we are assuming that TV is based on a sale in which the buyer is the importer. But customs valuation rules allow that TV be based on an earlier sale, between a manufacturer and a middleman, where both parties might not be residents in the country of importation.[3] That is the case both in the US and European Union (EU) legal systems. In such cases, the link between customs valuation and the transfer price would be broken.

However, some differences must be highlighted: some elements of cost which are not included in transaction value but which, nevertheless, are part of the arm's length price of the goods for income tax purposes. It is interesting to note that some of these elements of cost not included in transaction value are included in the VAT tax base on imports by way of adjustments. In EU law this is the case, for example, as regards import duties and other duties and taxes paid on importation; transport and incidental costs incurred up to the first place of destination within the territory of the Member State of importation; and, in general, other costs incurred before goods reach their first place of destination (under this provision, customs agent fees and buying commissions might be included).

Depending on national legislation, there are also elements of cost that would be included in a transfer price which are not included either in the customs value or in the tax base of VAT on imports. That could be the case, for example, of:

- import quotas paid by the importer
- transport costs and incidental costs after goods reach their first destination in the Community
- charges for construction, erection, assembly, maintenance or technical assistance, undertaken after importation on imported goods such as industrial plant, machinery or equipment
- activities undertaken by the buyer on the buyer's own account
- payments for the right to distribute and re-sell the goods that were not included in the customs value because they weren't a condition of sale.

The point here is that transaction value and the transfer price will not be identical, but we can establish why and by how much they will differ and, therefore, we can make the necessary adjustments to go from one to the other. As long as we have clearly identified the elements requiring adjustment, that should not be too troublesome.

As for the **concept of related parties**, both customs valuation rules and the income tax share basically the same definition. The only substantial difference in this regard is that it seems that, in some jurisdictions, such as the US, relationship may be held to exist not only on the basis of legal relationship (that is, formal, legal ties between the parties) but also in terms of economic relationship (on what is called 'economic control').[4] This is not the case in all jurisdictions; for example, Spain adheres to the requirement of a traditional formal, legal relationship in order to determine that the parties are related for income tax purposes.

In any case, this difficulty should not be overstated because the concept of related parties in customs valuation could be interpreted to include cases of 'economic control' to accommodate the corresponding transfer pricing rules when necessary. Certainly customs valuation rules do not expressly include cases of strict 'economic control', but neither do they exclude them, so it would not entail much difficulty harmonising both sets of rules, perhaps by means of a Decision of the Committee on Custom Valuation, in order to avert any perception of a possible breach of the uniformity aspirations of the CVC. Therefore, with only one minor difficulty, we can agree that both customs valuation and the income tax share a common concept of related parties.

If the parties are related, we need to ascertain whether the existence of such relationship has had an influence on the price because if that were the case, the use of transaction value would be precluded. For that purpose, the CVC provides two tests: the 'circumstances of sale' test and the 'value test'.

Under the 'circumstances of sale' test, the relevant aspects of the transaction are analysed, including:

(1) the way in which the buyer and the seller organise their commercial relations, and

(2) the way in which the price in question was arrived at, in order to determine whether the relationship influenced the price.

Under this test the price will be accepted provided that:

(a) the price was settled in a manner consistent with the normal pricing practices of the *industry in question* (that is, the industry that produces goods of the same class or kind. This test does not focus on the function performed by the parties, as transfer pricing rules do.)

(b) the price was settled in a manner consistent with the way the seller settles prices for sales to buyers who are not related to it (this test is equivalent to 'comparable uncontrolled price' in transfer pricing rules), or

(c) the price is adequate to ensure recovery of all costs plus a profit that is equivalent to the firm's overall profit realised over a representative period of time in sales of merchandise of the same class or kind (this test is equivalent to 'cost plus profit' method in transfer pricing rules, but focuses on merchandise of the same class or kind, and not the functions performed by the parties).

As for 'test value', it is met (and where met, the price declared accepted as a basis for transaction value) when the price declared closely approximates one of the following values:

(a) the transaction value in sales to unrelated buyers of identical or similar goods for export to the same country of importation

(b) the deductive value of identical or similar goods

(c) the computed value of identical or similar goods

occurring at or about the same time (in the US, at the time of exportation).

If the relationship is found to have had an influence on the price, we will have to resort to alternative valuation methods. The CVC methods are very similar to the transaction-based methods used for transfer pricing, as defined by the OECD Guidelines.[5] However, we must note that customs valuation rules establish a strict order in which the different methods have to be applied, while transfer pricing rules do not establish a preference for the methods to be used (in each case an assessment of the best available method will be made). Nevertheless, the preference established by customs valuation rules will also make sense for transfer pricing most of the time, that is, if a given customs valuation method can be applied, we can assume that the equivalent transfer pricing method will provide the most accurate results. So, again, this difference is not as important as it might seem at first sight, although it has to be taken into account.

However, when we compare **the alternative valuation methods** provided in the CVC with their equivalent methods in the OECD guidelines, we can observe some differences.[6]

Starting with the **Transaction Value of Identical goods and the Transaction Value of Similar goods** (TVI and TVS), in customs valuation, these methods are equivalent to **the Comparable Uncontrolled Price (the CUP)**, in transfer pricing. All of them take the value determined for a comparable transaction as a starting point, and then make some adjustments to arrive at the value for the transaction that is being appraised. Despite this basic similarity, we can find some differences:

- Customs rules have two different methods, one for 'identical' and the other for 'similar' goods, with a hierarchical preference for identical over similar goods. This difference is not established in the CUP method, although this difference is minor because it is obvious that identical goods are a better 'comparable' than similar goods, so the CUP method would yield more accurate results using identical goods as a 'comparable' when available.
- Adjustments for the TVI and TVS are strictly limited to those arising from differences in commercial level, quantity and transport costs. Meanwhile, in the context of the CUP, adjustments can have a broader scope and focus in the functions performed by the parties, taking into account assets used and risks assumed. Therefore, the resulting differences in adjustments can be important.
- The customs methods require that the goods in the comparable transaction must be produced in the same country as the goods being valued. The CUP method does not establish such a limitation, although we feel that goods produced in the same country will provide a more accurate comparable and, therefore, should also be preferred for transfer pricing purposes.
- Customs rules establish a preference for comparables in which the seller is the same person (referred to as 'internal comparables'). Transfer pricing rules do not establish this preference expressly, but there is no doubt that an internal comparable is preferable to an external comparable (which is where the transaction is undertaken by a different seller).
- In the case of the EU, the comparable transaction for customs valuation purposes could be the value determined for any importation that takes place in the Common Customs Territory, that is, in the whole of the EU. For CUP purposes, national jurisdictions will have a preference for transactions undertaken in their own jurisdictions, not in the whole of the EU.
- If payment is to be made in a foreign currency, the exchange rate for customs purposes will be that prevailing at the time of export or at the time of importation. In the case of the EU, for example, it will be the existing exchange rate at the time of the determination of the customs duties. For transfer pricing purposes, national legislation could establish a different moment to determine the applicable exchange rate (the date of delivery or the date of payment, for example).
- In the TVI and TVS, the time to establish the parameter transaction is the time of export, while for the CUP method it is the time of the sale, which can be different from the time of export.
- In the TVI and TVS, there is a rule establishing a preference for the lower value when more than one comparable transaction has been found. In the CUP method, we will have a range of acceptable values, and there is no preference for the lower value, rather the preference is for the average value.
- In the TVI and TVS, the parameter is a transaction value. This means that the differences between the transaction value and the arm's length price that we have referred to before will also be relevant here, and also we must bear in mind that the parameter transaction could be a related party sale. This is another difference with the comparable uncontrolled price method.

The next customs valuation method is the **Deductive Value Method (the DVM)**, which is similar to the **Resale Price Method (RPM)** in the transfer pricing rules. Both take a later sale as a starting point and subtract from the price of that sale some elements of cost incurred by the seller and a profit that approximates the acquisition value of such seller. So, basically, the DVM and the RSM start from a later point (a later sale) and then go backwards by means of adjustments (deductions) to the implicit acquisition value of the importer. The differences we can find between these two methods are as follows:

- In the DVM, the margin of the seller can only be determined from data obtained within the country of importation (or the Common Customs Territory in the case of the EU). In the RPM such limitation is not made expressly, although for obvious reasons the tax authorities will prefer to use data available and registered in operations in their own jurisdictions.

- The DVM establishes a limit of 90 days (before or after importation) for the acceptability of the sale prices. The RPM does not need such time limit because profit will be determined at year-end, and so there is no need to speed up the valuation of the goods.
- If there are several sales (that is, several parameters), the DVM directs us to take the price at which a greater amount of the goods has been sold, that is, not the average value but the value most repeated. In statistical terms, this value is known as the 'statistical mode'. Instead, the RPM will determine a range of acceptable prices, with a preference for the average value.
- In order to determine the benefit of the importer-seller, the RPM directs us to make an analysis of the functions performed, taking into account assets used and risks assumed. Customs valuation rules do not direct us to make such an analysis, they simply require that we make a deduction of an amount equal to the 'usual' profit and general expenses.

The next valuation method for customs purposes is the **Computed Value Method (CVM)**. This method is very similar to the **Cost Plus Profit** method (C+) of the transfer pricing rules. Both methods use the costs of the exporter as a starting point and make the proper adjustments to obtain a value which can equal the exporter sale price. So basically, these methods go one step before the transaction we need to value and make the proper additions to reach the value of such transaction. The only – and quite unremarkable – difference between these two methods is that for the CVM one takes the profit and general expenses of the exporter as a unique amount, while the C+ method determines profit and general expenses separately. But this difference is unremarkable because we are not interested in the profit made by the exporter, so the disaggregation made in the transfer pricing method will be irrelevant in the importing country.

When none of the previous customs valuation methods can be applied, in customs valuation we come back to the valuation methods we have seen and apply them with some degree of flexibility. Instead, transfer pricing rules establish two additional methods which basically focus on the profit arising in the sale, the **Profit Split Method** and the **Transactional Net Margin Method**. Obviously the methodology differences here between customs valuation and transfer pricing rules can be huge and the reconciliation of both values could prove to be impossible.

3. The normative approach

Notwithstanding the differences in valuation that have been highlighted, the concept of value in customs valuation rules and in the corporate income tax remains basically coincident. This similarity has been noticed in the US legal system, where a provision was enacted that reflects the connection between these two values. Section 1059A of the Internal Revenue Code (IRC) provides:

> **Sec. 1059A. Limitation on taxpayer's basis or inventory cost in property imported from related persons.**
>
> (a) In general
>
> If any property is imported into the United States in a transaction (directly or indirectly) between related persons (within the meaning of section 482), the amount of any costs –
>
> **(1)** which are taken into account in computing the basis or inventory cost of such property by the purchaser, and
>
> **(2)** which are also taken into account in computing the customs value of such property,
>
> shall not, for purposes of computing such basis or inventory cost for purposes of this chapter, be greater than the amount of such costs taken into account in computing such customs value. …

It has to be noted that Section 1059A IRC establishes a limit only for related party transactions, so this rule will not apply when goods are imported by an unrelated importer. Besides, the rule does not apply in

situations where no duty has to be paid (property not subject to customs duty; portion of an item that is a US good returned and not subject to duty; property subject to a zero rate of duty; property subject only to the user fee or the harbour maintenance tax) or when duties are not calculated on value. These exclusions probably aim to clear any possible intent to influence the inventory cost determination by means of an artificial customs valuation that does not result in duties to be paid.[7]

In essence, Section 1059A IRC provides that customs value sets a limit for the inventory cost on the part of related taxpayers in respect to the elements of cost which are included in such customs value.[8] That is, inasmuch as most of the components of the customs value will be relevant for the inventory cost of the goods, the importer is not allowed to claim a higher value for those components in the income tax than the value declared for customs valuation. The provision aims to prevent situations such as that in *Brittingham v. Comr*.[9] In that case, the plaintiff had customs value determined based on the price paid for products that Customs regarded as similar to those entered, resulting in a low customs value. When the IRS tried to determine the corporate income tax based on the value ascertained for customs purposes, the plaintiff argued that it was erroneous that both products were similar, since there was a relevant difference in quality, and stated that it had paid a higher price. The Tax Court concurred that the valuation by the Customs Service was not indicative of an arm's length price. That way Brittingham played both ways, obtaining a low customs value and a higher inventory cost for the same goods. The legislative history of the provision contains an express mention of this case:

> Congress understood that some importers could claim a transfer price for income tax purposes that was higher than would be consistent with the transfer price claimed for customs purposes. See *Robert M. Brittingham*, 66 T.C. 373 (1976), *aff'd*, 598 F.2d 1375 (5th Cir. 1979). Congress was particularly concerned that such practices between commonly controlled entities could improperly avoid U.S. tax or customs duties.[10]

Since the relationship between customs valuation and the inventory cost is not one of identity, Section 1059A IRC properly establishes the connection between the two values inasmuch as the same elements of cost are included in both. In this regard, Levine and Littman (1994) have stated that 'Section 1059A does not appear to act as an overall limitation on tax basis, but is instead a limitation upon each of the components of basis that are also components of customs value'.[11] Elaborating on this model, the regulations provide some upward adjustments to customs value to arrive at the inventory cost, such as freight charges, insurance charges, expenses incurred for the construction, erection, assembly or technical assistance provided with respect to the property after its importation into the US, differences in the allocation of the value of assists and 'any other amounts which are not taken into account in determining the customs value, which are not properly includible in customs value, and which are appropriately included in the cost basis or inventory cost for income tax purposes'.[12] It is important to stress that, in order to allow an adjustment, the element of cost could not be properly included in customs value. On the other hand, the regulations also provide for offsets to adjustments, when a rebate or reduction in the price is made after importation and, for that very reason, was not allowed for customs purposes but nevertheless has to be computed to determine the inventory cost, reducing it.[13] The elements explicitly enumerated suggest that the provision aims to allow the adjustments for differences in value that can be determined, that is, for elements of cost whose impact on valuation can be properly ascertained. As we have seen in the previous section of this paper, we can basically distinguish two types of differences between customs value and inventory cost; the first would be those for which an adjustment is possible (such as those referred to in the regulations of Section 1059A); the second would be those differences for which an adjustment might not be possible since we will not be in a position to quantify its impact on valuation.

This distinction is relevant because it highlights the fact that it will not always be possible to maintain the connection between the two values. In such cases, the customs value should not set a ceiling on the inventory cost. The legislative history provides grounds for this understanding when it states that:

> Congress expected that the Secretary will provide rules for coordinating customs and tax valuation principles, including provisions for proper adjustments …[14]

This seems to take for granted that coordination rules include adjustments, but also need to encompass other types of rules. One of the circumstances in which coordination rules are required is that of multi-tiered sales, where the customs value is based on a price between a manufacturer and a foreign intermediary. In customs law this possibility was recognised by the Court of Appeals for the Federal Circuit (CAFC) in two relevant cases: *E.C.McAfee Co. v. U.S.* and *Nissho Iwai American Corp. v. U.S.*[15] where the Court rejected Customs' understanding that valuation should be based on the price registered in the sale that most directly caused that the goods were exported to the US, and decided instead that customs value could be based on any sale that could be properly regarded as a sale for export, that is, a sale resulting in the goods being clearly destined for export to the US. The Court further rejected any analysis requiring the weighing of the relative importance of two viable transactions. When the customs value is based on the price registered in a sale between a manufacturer and a foreign middleman, then the price paid by the importer will be different from the price used as a starting point for the customs valuation determination, and so the inventory cost should take into account this factor. In PLR 9406026 the IRS accepted that, if the correct value had been reported to Customs for duty purposes and that value was based on a sale to a foreign middleman, then the limitation in Section 1059A should be reviewed to take into account the higher price paid by the importer.[16] We note, however, that the so-called 'first-sale rule' is now challenged by *Commentary 22.1* of the Technical Committee on Customs Valuation, where the Committee expresses its view that:

> the underlying assumption of Article 1 is that normally the buyer would be located in the country of importation and that the price actually paid or payable would be based on the price paid by this buyer. The Technical Committee concludes that in a series of sales situation, the price actually paid or payable for the imported goods when sold for export to the country of importation is the price paid in the *last sale* occurring prior to the introduction of the goods into the country of importation, instead of the first (or earlier) sale.

This new understanding of the Valuation Code proposed by the Technical Committee, however, has not been introduced in US legislation or regulations so far,[17] or in the EU legal system.[18] Leaving aside the – well-grounded – merits of the interpretation on which the first sale rule is based, from the perspective of the relationship between customs valuation and inventory cost it has to be recognised that the understanding of the Technical Committee would approximate both values, since customs value would invariably be based on a sale to an importer located in the country of importation (and thus subject to corporate income tax in that country of importation). Therefore the connection between those two values would not be broken by the interposition of an earlier sale to a non-resident middleman who is not subject to income taxation in the country of importation.

The limit established in Section 1059A takes the form of a maximum amount for the elements of costs involved, which means that the value used for customs purposes will not necessarily be accepted to determine the inventory cost. Therefore, 'although customs value (as appropriately adjusted) provides a ceiling on transfer price valuation for income tax purposes, it does not provide a floor on that valuation'.[19] Hence, this limit does not apply to the tax authorities.

In this regard, it is especially troublesome for the trade community that, for Section 1059A purposes, the customs value is considered to be finally determined 90 days after notice of liquidation to the importer, unless a protest is filed.[20] The problem is that customs liquidation could be issued after that period and, in case of an increase in customs value, that increase would be disregarded for purposes of establishing a limit on the inventory cost, thus resulting in a high customs value and a low inventory cost. That situation can arise especially in cases where the importer participates in Customs' Automated Commercial System Reconciliation Prototype Program (Reconciliation Program). This program allows importers to file initial

declarations with Customs at the time of importation providing the best available information at the time, using the 'reasonable care' standard. Entries where relevant elements are undetermined or unknown at the time of entry are flagged by the importer, to let the Customs Service know that further data will be provided when available. The entry information will be supplemented at a later date with more accurate data through a reconciliation declaration that has to be filed during the following 21 months. After the reconciliation is filed it is liquidated, resulting in duties, taxes and interest due (or in a refund, when the importer paid at the time of entry an amount in excess of the liquidation). This mechanism is very useful to defer the determination of the customs value to a later date when the price has finally been settled, both for Customs and income tax purposes, thus avoiding any inconsistency between those two values. The problem then is that the time limit set in the regulations of Section 1059A reduce the usefulness of this mechanism, since customs liquidations made after the expiry of the 90-day period since the entry liquidation might be deemed irrelevant to determine the ceiling for corporate income tax purposes. Probably 'rules for coordinating customs and tax valuation principles', as the legislative history indicated Congress expected from the Secretary, should be provided in order to avoid this type of situation (just as we have seen was made regarding multi-tiered sales) in order to avoid an importer being left paying more customs duties and denied the corresponding increase in the inventory cost.[21]

Another problem of coordination arises when the inventory cost is determined to be lower than initially declared – resulting in a higher income tax due – and the corresponding review of the customs value is denied. In this case we are outside the scope of Section 1059A, that only establishes a ceiling on the inventory cost. But fairness demands that customs value be reduced to maintain consistency. We are, in fact, in a reverse situation to the Brittingham case. The grounds on which Customs justifies its denial of a reduction of the customs value are in 19 U.S.C. § 1401a(b)(4)(B), that provides:

> Any rebate of, or other decrease in, the price actually paid or payable that is made or otherwise effected between the buyer and seller after the date of the importation of the merchandise into the United States shall be disregarded in determining the transaction value.[22]

First of all, it has to be stressed that this rule is nowhere to be found in the Agreement on the Implementation of Article VII of the GATT 1994 (the 'Valuation Code'), although customs authorities in other countries also have a tendency to disregard discounts or rebates effected after importation. The provision seems to evolve from an understanding that when the Valuation Code establishes that transaction value is 'the price actually paid or payable for the goods *when* sold for export to the country of importation adjusted …' the term 'when' denotes a reference in time. That understanding clashes with the terms 'price *actually* paid or payable' and was rejected by the Technical Committee in its *Interpretative Note 1.1*. The US specificity in this case is the result of unduly transposing the Valuation Code provisions through the lens of the previous US valuation system. It is important to note that in the EU, the ECJ has decided that importers have a right to have their declaration reviewed even after the release of the goods unless the authorities can properly justify a denial.[23]

That said, it still remains unclear that a review of the transfer price might be regarded as a 'rebate' or as a 'decrease' in the price. As Pike (2006) highlights, transfer pricing adjustments 'are made to bring the transaction value of imported merchandise into compliance with IRS's arm's length pricing regulations … Instead, the adjustment reflects what should have been reported upon entry, had such information been available at the time'.[24] These adjustments are part of the nature of transfer prices, that have an element of artificiality to them, and the Valuation Code clearly wanted that, inasmuch as possible, goods imported by related parties were valued according to the transaction value method, so the Valuation Code assumed this element as the lesser evil. Therefore it seems reasonable to agree with Pike (2006) when he states that 'Customs' apparent stance completely ignores fundamental concepts of logic and fairness. If importers are expected to report upward transfer pricing adjustments and tender any underpayment of duties, taxes and fees (as CBP has expressly indicated), why would a downward adjustment fail to result in a refund of any overpayments?'.[25]

Many authors have dedicated considerable effort to enhance the position of importers regarding the problems that arise in connection with the relationship between customs valuation and transfer pricing. One of the recommendations is to apply to the Customs Reconciliation Program that, as has already been said, will allow modification to the customs value when more accurate information is available. Another advice that is repeated is to plan customs aspects of international-related party transactions in advance. In particular, since Customs denies 'rebates' and 'decreases' in price effected after importation, importers are advised to prepare contracts and commercial documentation that thoroughly contemplate instances in which a price reduction will be granted by the seller, so that the reduction can be argued to pre-date importation. Therefore, it is important to carefully design price review formulas so that they take into account as many contingencies as possible.

The main focus of attention in this area has been on Advanced Price Agreements (APA), that is, formulas to calculate transfer prices that are acceptable to the IRS because they fall in a range of acceptable values. The aim is to make the most in terms of customs valuation relevance of the considerable effort that both tax authorities and taxpayers put in order to agree to a mutually satisfactory APA. In this regard, the US Customs and Border Protection has made several rulings recognising that prices agreed in an APA can be relevant for customs valuation purposes when the differences in methodology do not prevent this.[26] This relevance concerns mainly the determination about whether or not the relationship influenced the price (in the context of the 'circumstances of the sale' test, discussed above), which is a requisite to depart from transaction value.[27] So, if the prices declared to the customs authorities are consistent with an APA and no relevant differences in the methodology are detected, the customs authorities will accept the price declared.[28]

A Transfer Price study (the records and documents that companies must prepare and keep in relation to their related party transactions) is not considered sufficient grounds to establish the acceptability of the resulting price as a basis for transaction value. In a case in which the importer had been audited by the IRS and the Transfer Price study had been considered correct, Customs denied that such study could be regarded as sufficient evidence as to the acceptability for customs purposes of the prices derived from the application of the methodology contained in it.[29]

The US customs authorities have made clear some difficulties in this regard:

- Customs laws require that a customs value must be determined for every imported article. It is necessary to determine the correct customs value for each product, not for all the products as a whole. It should be borne in mind that transfer pricing rules allow for aggregation of transactions and offsetting adjustments in appropriate circumstances.

- There are differences in valuation methods. In order to establish the existence of a comparable transaction, transfer pricing rules look for companies that perform similar functions. In customs valuation, the 'circumstances of sale' test focuses on product similarity to identify comparable transactions.

Even with an APA price in hand, the importer is not guaranteed in every case the acceptance of the declared price for customs purposes as a basis for establishing the transaction value. In some rulings, however, the US customs authorities have stressed the importance of their participation in the discussions before an APA is made, and also of disclosure of the APA documentation to them. These two points should thus be considered when entering an APA with the US tax authorities, the IRS.

Other countries have followed a similar path on this issue. For example, the position of the Canadian Customs Administration is fundamentally similar to the US position.[30] The language of the Memorandums released by Canadian Customs could make us think that Canada is more ready to accept that when the price declared to Customs is consistent with an APA it can be concluded that the relationship did not influence the price. But a careful reading of Canada's statements reveals that they also maintain some

reservations on this issue. They are committed to accept APA-consistent prices as an indication that the relationship did not influence the price, but that is subject to the relevance of such APA price for customs purposes. On their part, the Australian Customs Service stresses the importance of avoiding aggregate data and the need to offer detailed data for each product instead and highlights the importance of being provided all the supporting documentation prepared in the context of the APA.

4. The interpretative approach

The Judgment of the Spanish *Tribunal Supremo* (Supreme Court) of 30 November 2009 provides an interesting case to illustrate an alternative approach regarding the connection between the customs value and the inventory cost, one we can refer to as the 'interpretative approach'.[31] Some aspects of the case are noteworthy. Coca Cola Spain, the plaintiff, imported some components to prepare refreshments. In previous years, Coca Cola Spain had manufactured those components itself. When the goods were imported, the customs authorities examined the value and determined a higher value than that declared. Years later, Coca Cola Spain was subject to a corporate income tax audit. In the course of the audit, the authorities contested the inventory cost that Coca Cola Spain had used to determine the taxable profit, and considered that such value was too high. It has to be noted, in this regard, that in previous years Coca Cola Spain manufactured at a lower cost the components they later decided to import and that the value determined for customs purposes was higher than the market value of the components. Besides, Coca Cola Spain imported those components from related parties that benefited in their jurisdiction from a ten-year tax exemption in corporate income tax, so a higher value determined a global lower taxation for the group of entities, since it lowered the Spanish corporate income tax without incurring any foreign tax as a result. The higher value determined by Customs seemed made to fit with a tax planning opportunity.

In the audit the authorities applied the RPM that resulted in a lower value for income tax purposes. Coca Cola Spain appealed the corporate income tax determination, alleging that the authorities were bound by the previously determined customs value in establishing the taxable profit. The Court of First Appeal (*Audiencia Nacional*) decided that the decision of the authorities was correct since customs valuation rules and transfer pricing rules are two different sets of rules, so the value established for the purposes of one of them is not binding when determining the other. The authorities, reasoned this Court, had correctly applied corporate income tax rules.

On appeal, the *Tribunal Supremo* disagreed with this finding. First, it concluded that the concept of value in both customs duties and corporate income tax is based on an open market sale price (an arm's length price). The Court found that there is an essential coincidence between the two sets of valuation rules. According to corporate income tax legislation in force at the relevant time, the authorities had discretionary powers regarding the valuation method to be used among the various methods provided in the regulations, one of them being to resort to a value previously determined for the purposes of another tax.[32] In this context, the Tribunal Supremo argued that where the legislation bestows a discretionary power on the authorities, the exercise of such powers is subject to adequate justification. And in the case judged, the Court concluded that such power was not properly exercised because the authorities ignored their previous customs duties determination, and therefore acted in clear contradiction of their previous action, thus violating the good faith standard (*estoppel*).

One can wonder whether such doctrine can be applied under the current legislation in force, since it no longer provides for a valuation method based in a value previously determined for another tax for transfer pricing.[33] Nevertheless, two basic elements taken into account by the Court remain unchanged: (1) Both Customs and corporate income tax valuation methods are essentially equivalent and, (2) therefore, establishing a different value would contradict the previous determination of value unless a proper justification for such difference is provided, detailing the facts on which that difference is based (*estoppel*).

In the cases decided by the Court, the authorities had verified the customs declaration and determined a higher customs value than the value declared. But such situations will not be the most typical. Typically, the authorities will accept the value declared. In order to decide the relevance of the doctrine established by the Court, it has to be determined if in these cases it can also be held that the authorities are in contradiction of a previous value determination. In this regard, it is relevant to take into account that customs duties in the EU are always assessed by the authorities, based on the data provided by the declarant unless the declaration is verified.[34] The assessment can be implicit, when the release of the goods is provided without an express assessment, and in that case the duties due will be those entered, 'for guidance', in the customs declaration.[35] Being the assessment of duties generally based in the data filed by the declarant, it could be questioned whether such assessments create an estoppel situation, since in these cases the authorities are simply accepting the data provided by the declarant without further scrutiny. At the same time, denying any relevance to the fact that the authorities issue an assessment (even if they do so implicitly by allowing the release of the goods) would seem unsatisfactory, since this act on the part of the authorities has the legal effect of creating an obligation on the declarant, and an act of such legal effect should also produce legal effects on the issuer, the authorities. To conclude otherwise would be tantamount to saying that the authorities claim debts they know nothing about, and that they do not even check if the information provided by the importer in their declaration is consistent with their value determination.

For the aforementioned reasons, probably a middle ground solution would be to consider that the authorities would be in contradiction of a previous valuation inasmuch as they do not justify that they have had access to relevant information which was not made available to them when the previous valuation was made. That is, the authorities could claim that *estoppel* does not apply inasmuch as they can base their new finding on information they did not have previously. This means, for example, that when the importer filed incomplete or inaccurate data at entry, the authorities would be able later to depart from the customs value determined inasmuch as such incompleteness or inaccuracy have an impact on value.

But the *estoppel* doctrine that the judgments of the *Tribunal Supremo* project on the authorities can also be applied to the importers. Importers would contradict their customs declaration if, afterwards, they try to claim an inventory cost that is not consistent with the customs value declared. Interestingly, the *estoppel* would enter into play in respect of importers in every case, since they should be fully aware and be made responsible for the value declared. Only when customs value and inventory cost essentially differ due to one of the factors that have been identified in section 2 of this paper (for example, when the Profit Split Method or the Transactional Net Margin Method are applied for transfer pricing purposes) and it is not possible to make an adjustment to bridge that difference, the importer could claim that the connection between those two values does not apply. This idea leads us to conclude that, although the judgments of the *Tribunal Supremo* mentioned find in favour of the taxpayer, potentially their doctrine is more beneficial to the authorities than it is to taxpayers. More so when one takes into account that the statute of limitations for customs purposes is only three years from the date of entry of the declaration, while the statute of limitations for corporate income tax will usually be longer than that, so the importer might be caught with a reviewed inventory cost that does not result in a symmetrical reduction of the customs value.[36]

In any case, what these judgments make clear is that, even in the absence of an explicit provision in the legislation establishing a connection between customs value and inventory cost, both authorities and taxpayers should be well aware that such connection can nevertheless be relevant in a valuation dispute. That conclusion could well be relevant in other legal systems whose transfer pricing rules are aligned with the OECD guidelines. In this regard, it is interesting to note that in the US system, before Section 1059A IRC was enacted, the Tax Court decided in the *Ross Glove Co. v. Commissioner* that the methods adopted by the Customs Service and the IRS were quite similar, and so the markups used by the Customs Service to determine the value of the goods purchased from a related party were adequate to determine the arm's length price for corporate income tax purposes. The Court found that the customs value was

the 'best evidence available as to amounts that a seller would receive to cover overhead and profit in an arm's length sale'.[37]

The 'interpretative approach' has the advantage of providing the necessary flexibility to avoid inconsistent or unfair results that we have seen in the 'normative approach' of the US system. Besides, the connection between customs value and inventory cost travels both ways and is not only a control tool in the hands of the authorities but also a protection for importers, since it prevents the authorities from making inconsistent value determinations.

In each case the Judge will decide, based on the merits of the facts and supporting evidence provided, whether or not a relationship between the customs value and the inventory cost exists, and in case it does (which can be expected to be the most common situation), the adjustments necessary and their amount. But in this advantage lies also the weakness of the 'interpretative approach', since it assumes that the Judge will have, in the absence of any guidance from the law, the complex knowledge required to ascertain the intricate details of the relationship between two sets of complicated valuation rules. At the very least this is clearly not the best approach to provide legal certainty.

5. Conclusions

The relationship between customs value and inventory cost is not one of identity but one of proximity. In most cases, the differences can be bridged with proper adjustments, to take into account elements of cost that are not included in the customs value that, nevertheless, are part of the inventory cost. In some cases, though, an adjustment will not be possible because the difference in methodology will not allow it. Customs and tax authorities, as well as the trade community, must be prepared to face both scenarios as possibilities.

When the differences between those two values can be bridged with adjustments, consistency should be the guiding principle, both for the authorities and taxpayers. This principle has several consequences:

- An importer should not be allowed to claim a low customs value and a high inventory cost unless the adjustments for the differences in the elements included in the inventory cost that are not properly includable in the customs value allow for such difference. Therefore, the principle of consistency reveals that corporate income tax is a relevant tool to control the value entered for customs purposes.
- If there is an upward adjustment to the customs value, the importer should be allowed to claim a higher inventory cost as well. Also, if the inventory cost is lowered, then the customs value should be reduced correspondingly.
- Procedural difficulties or excuses should not be put in the way of consistency. Time limits or non-allowance of certain adjustments that result in unfair results should be removed to favour a healthy relationship between the taxpayer and the authorities based on mutual trust.

The relationship between the two values can be expressly stated in legislation or it can be found by the Courts. Although the latter option has the advantage of flexibility, it also has the burden of a more complicated implementation and legal uncertainty. Therefore, legislation carefully drafted, that takes consistency as the guiding principle and not just the maximisation of revenue collection, seems a more desirable option.

The trade community also has some tools at their disposal in this matter. It is important to plan ahead in respect of customs issues, to prepare contracts and commercial documentation taking into account possible contingencies that might arise regarding the determination of the customs value, to prepare detailed price formulas and, when available, to apply for a deferment of the final determination of the customs value. If the importer is planning to conclude an APA with the tax authorities, it seems advisable to invite Customs to participate, so that they too have the opportunity to acquire a deep knowledge of, and trust in, the methodology agreed in the APA.

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Endnotes

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2 Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade 1994 (Customs Valuation Code, 'CVC'), www.wto.org/english/docs_e/legal_e/20-val.doc.

3 We will come back to this topic in the next section of this paper.

4 See Ainsworth 2007.

5 OECD 2010.

6 An extended comparison between customs valuation methods and their equivalent transfer pricing methods can be found at Martín Jovanovich (2002), and also in Ibáñez Marsilla (2002). A more concise comparison is offered by Maisto (2001).

7 As we explain below, though, Section 1059A IRC sets a ceiling for the importer, but not a floor for the tax authorities. Therefore, one should think that the results absent this rule would be the same anyway.

8 The implementing provisions can be found in 26CFR1.1059A-1. The implementing provisions include useful examples to illustrate its application. Commentaries on these provisions can be found in Dorn & Dorris (1989); Weigel (1993); Neville (1993); Cody (1993-94); Mavridis (1994); Levine & Littman (1994); Sheldrick, Lowell & Briger (1996).

9 66 T.C. 373 (1976).

10 Staff of the Joint Committee on Taxation, at 1062.

11 Levine & Littman 1994, p. 238. In fact, the regulations provide as an 'alternative method of demonstrating compliance' that the taxpayer 'may demonstrate compliance with this section and section 1059A by comparing costs taken into account in computing basis or inventory costs of the property and the costs taken into account in computing customs value at any time after importation, provided that in any such comparison the same costs are included both in basis or inventory costs and in customs value. If, on the basis of such comparison, the basis or inventory cost is equal to or less than the customs value, the taxpayer shall be deemed to have met the requirements of this section and section 1059A' (26CFR1.1059A-1 (c) 6).

12 26CFR1.1059A-1 (c) 2. To allow an adjustment, the regulations require that, when the amounts are paid to a related party, they reflect an arm's length charge within the meaning of Section 1.482-1(d)(3).

13 US legislation, in determining transaction value, disregards rebates of, or other decrease in, the price actually paid or payable that is made or otherwise effected after the date of the importation of the merchandise (19 U.S.C. § 1401a(b)(4)(B); the regulations also include this rule at 19 C.F.R. § 152.103(a)(4)). See further discussion on this topic below.

14 Staff of the Joint Committee on Taxation 1987, *General explanation of the Tax Reform Act of 1986*, at 1062.

15 Decisions of the Court of Appeals for the Federal Circuit *E.C.McAfee Co. v. U.S.,* 842 F.2d 314 (Fed. Cir. 1988) and *Nissho Iwai American Corp. v. U.S,* 982 F.2d 505 (Fed. Cir. 1992).

16 See an analysis of the impact of the CAFC interpretation on Section 1059A limitation in Levine & Littman 1994.

17 The Bureau of Customs and Border Protection (CBP) tried to introduce this interpretation in 'Proposed interpretation of the expression "Sold for Exportation to the United States" for purposes of applying the transaction value method of valuation in a series of sales' (USCBP-2007-0083, published in 73 Fed. Reg. 4254), but the *Food, Conservation and Energy Act* subjected this new approach to a 'sense of Congress provision' that no change be made before 1 January 2011. In response, CBP retired

his proposal (73 Fed. Reg. 49939). See a discussion on this topic in Neville 2008; Ruesmann & Willems 2009; Desiderio & Desiderio 2010.

18 See art. 147.1 Commission Regulation EEC 2454/93 (implementing provisions of the Community Customs Code) and Commentary No. 7 of the 'Compendium of customs valuation texts of the Customs Code Committee' (TAXUD/800/2002-EN).

19 Staff of the Joint Committee on Taxation 1987, *General explanation of the Tax Reform Act of 1986*, at 1062. The text goes on to state that 'in no event does a customs declaration or customs valuation constrain the ability of the Commissioner to adjust transfer prices under section 482' (the provision that deals with transfer pricing in the US legal system). The aim of Section 1059A is to avoid that importers might benefit from a low customs value and a high inventory cost. This idea is again present when the report states that 'In enacting the new provision, Congress did not express the view that valuation of property for customs purposes should always determine valuation of property for U.S. income tax purposes. Instead, Congress was concerned only with establishing a limit on the price an importer could claim for income tax purposes'.

20 26CFR1.1059A-1 (d).

21 This is the core argument made by Offerman 1999.

22 The regulations also include this rule at 19 C.F.R. § 152.103(a)(4).

23 See ECJ Judgment of 20 October 2005, case C-468/03, *Overland Footwear*. In this case, the importer had failed to report and distinguish from the price a buying commission. The importer provided at a later time the documents and evidence to support that part of their payment was in fact a non-dutiable buying commission. The authorities denied a review of the customs value, but the ECJ decided that such denial was not compatible with the Community Customs Code, art. 78. See also ECJ Judgment of 19 March 2009, case C-256/07, *Mitsui*. In this case, the parties agreed that the seller would reimburse the importer of any costs derived from a three-year guarantee provided to final customers. The ECJ decided that the amounts reimbursed by the manufacturer should be properly deducted from the customs value declared at entry.

24 Pike 2006, p. 9. The author offers an extended explanation on the difference between transfer pricing adjustments and 'rebates' or 'decreases' in price.

25 Pike 2006, p. 10.

26 US Customs and Border Protection 2007. See also HQ 548095.

27 When discussing the 'circumstances of sale' test above we have noted in parenthesis some problematic issues stressed by USCBP that arise from differences between that test and the transfer pricing methodology.

28 For a discussion of the differences in methodology, see section 2. As explained above, the situation will be especially troublesome if the method used for the APA is a profits-based one (the Profit Split Method or the Transactional Net Margin Method).

29 HQ 548482 (23 July 2004). An examination of the circumstances of the case and a criticism of Customs' position can be seen in Pike 2006, pp. 7-8.

30 The position of the Canadian Administration is stated in Memorandum D-13-3-6 'Income tax transfer pricing and customs valuation' (2006) and Memorandum D-13-4-5 'Transaction value method for related persons' (2001).

31 Appeal No. 3582/2003. Another Judgment of the *Tribunal Supremo*, of 11 December 2009 (Appeal No. 4113/2003), applies the same doctrine. This is relevant because two judgments of the *Tribunal Supremo* establishing the same doctrine are regarded as setting guiding jurisprudence for the rest of the Spanish Courts.

32 The legislation in force at the time was *Ley* 61/1978 (article 16) and the regulatory provisions were established in RD 2631/1982. The alternative valuation methods were provided in article 169 of the regulations.

33 For transfer pricing, article 16.4 of *RDLeg.* 4/2004 provides the valuation methods elaborated by the OECD (Comparable Uncontrolled Price; Cost Plus Profit and Resale Price; when due to their complexity or lack of information those methods cannot be applied, the law provides the application of the Profit Split Method and the Transactional Net Margin Method). Interestingly, article 57 of the General Tax Act (Ley 58/2003) provides as an administrative valuation method, for the whole tax system, the price or value declared for purposes of another transfer of the goods made in a period of one year.

34 Art. 217.1 and art. 71.2 Community Customs Code (Reg. 2913/1992; 'CCC'). The Modernized Customs Code (Reg. 450/2008, MCC) opens the door to self-assessment of customs duties in art. 116.2(d). The MCC is not yet applicable.

35 Art. 221.2 CCC.

36 The statute of limitations for customs duties is established in art. 221.3 CCC. In the case of Spain, the statute of limitations is four years after the date when the tax has to be filed, and the computation of that period is re-started every time the authorities act on that tax providing notice to the taxpayer or when the taxpayer lodges an appeal or a claim on that tax (see arts. 66 to 68 General Tax Act, *Ley 58/2003*).

37 *Ross Glove Co. v. Commissioner*, 60 T.C. 569 (1973). This judgment predates the legislation implementing the GATT Valuation Code.

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Doubts regarding the origin of goods based on OLAF mission reports *vs* protection of confidence

Ulrich Schrömbges and Oliver Wenzlaff

Abstract

This article concerns the administrative cooperation of the customs authorities of the exporting country and of the importing country when determining the preferential origin of goods in the law of the European Union (EU). It addresses specifically the legal significance of investigations by EU authorities such as the European Anti-Fraud Office (OLAF) vis-à-vis the protection of confidence of the importer in the authenticity and correctness of certificates of a preferential origin and the jurisprudence of the European Court of Justice (ECJ) concerning such protection of confidence. European Union (EU) customs law provides for protection of confidence of the importer in the authenticity and correctness of certificates of preferential origin which have been issued by third countries. The Article concludes that this protection of confidence may be undermined by OLAF missions investigating the authenticity and correctness of certificates of origin in third countries.

Allocation of risks concerning incorrect certificates of preferential origin

The system of administrative cooperation of the customs authorities of the exporting country and of the importing country when determining the preferential origin of goods can provide the basis for legitimate expectations of the importer, protecting their confidence in the correctness of a certificate of preferential origin which has been issued by the customs authorities of the exporting country. The jurisprudence of the European Court of Justice (ECJ) has significantly informed the development of this protection of legitimate expectations, bringing an end to the situation in which the importer bore an almost unlimited risk in trading. The protection of legitimate expectations of the importer, based on the system of administrative cooperation between the customs authorities of the exporting country and those of the importing country, provides a fair balance of the protection of the financial interests of the EU on the one hand and of the legitimate interest of foreign traders in a reliable determination of the origin of goods in the exporting country on the other hand.

However, this current system is an anathema to the European Commission because it is the EU rather than the importer which generally bears the risk of irregularities that have occurred in the exporting country. Consequently, the introduction of the registered exporter in the proposed amendment of Regulation (EEC) 2454/93 laying down provisions for the implementation of the Community Customs Code (CCC)[1] is meant to reverse this distribution of risk. According to the proposed changes to the generalised system of preferences, a statement on origin is to be made by a registered exporter in the beneficiary country instead of a certificate of origin being issued by the customs authorities of the beneficiary country. As

a result, it is questionable, at least, whether an importer will be able to invoke an error on behalf of the customs authorities pursuant to Art. 220 para. 2 lit. b) subpara. 2 of Regulation (EEC) No. 2193/92 establishing the Community Customs Code , if a statement on origin has been made incorrectly by a registered exporter.

Even if some legal questions remain disputed in the current system of administrative cooperation, the jurisprudence of the ECJ has provided clear guidelines on the invocation of legitimate expectations by the importer.

Jurisprudence of the ECJ concerning administrative cooperation between customs authorities

According to the jurisprudence of the ECJ, the determination of the origin of goods is based on the allocation of responsibilities between the customs authorities of the exporting country and those of the importing country, which is monitored jointly by the administrative cooperation between the authorities concerned. In this system, the authorities of the exporting country are responsible for determining the origin of goods because they are in the best position to verify directly the facts on which that is based.[2] In order for this mechanism to function, the customs authorities of the importing country must accept the legally-made determination of the origin of goods made by the customs authorities of the exporting country.[3] Also, this system of administrative cooperation cannot function properly unless the procedures for administrative cooperation are strictly complied with.[4]

Administrative cooperation regarding the verification of certificates of a preferential origin

The procedure of administrative cooperation for determining the origin of goods is regulated in the protocols on the definition of the terms 'product of origin' and 'originating products' and on administrative cooperation of the various agreements on preferential trade between the EU and third countries. According to these protocols, the customs authority of the country of import makes a request for subsequent verification concerning the correctness and authenticity of a certificate of preferential origin to the authorities of the exporting state, if there are any doubts regarding the correctness and/or authenticity of the certificate of origin concerned. The customs authority of the importing country may, where appropriate, give reasons for the enquiry and shall forward any relevant documents and information which suggest that the information given on the certificate of origin is incorrect. The protocols on the definition of the terms 'product of origin' and 'originating products' and on administrative cooperation explicitly stipulate that the *a posteriori* verification of certificates of origin concerned must be carried out by the customs authorities of the exporting country. The result of the verification process is then communicated to the customs authorities of the importing country.

The customs authorities of the importing country do not participate in the process of the subsequent verification of certificates of origin, which may result in the revocation of these certificates of origin. Consequently, there is no room in the verification procedure for a mission by the EU to a third country with the purpose of reviewing the correctness and authenticity of certificates of preferential origin issued by the third country concerned. Hence, the findings obtained in the course of such a mission are, in principle, irrelevant for determining the correctness and authenticity of certificates of origin, irrespective of the European Commission's opinion that a professionally organised circumvention of the rules of origin in a third country can generally only be discovered by means of investigations by the EU in the third country concerned.

The legal significance of investigations by European authorities in third countries concerning the preferential origin of goods

However, this does not mean that the findings of such an EU mission in a third country would be of no legal consequence whatsoever. The jurisprudence of the ECJ shows when a mission by the EU in a third country concerning the correctness and/or authenticity of certificates of origin may become relevant.

The ECJ's judgment in the case 'Pascoal & Filhos Ltd.' concerns a situation in which Portugal as the Member State of importation asked the exporting country Greenland to conduct a joint subsequent verification procedure with the European Commission on the correctness and authenticity of four specific movement certificates EUR.1. As a result, the European Commission participated in the *a posteriori* verification procedure by the authorities of Greenland, resulting in a joint report on the findings of the procedure. On the basis of this report, the customs authorities of Greenland informed the Portuguese authorities that the movement certificates EUR.1 had been annulled, without also informing the Portuguese authorities about the report on the findings. The ECJ held that the notification on the annulment of the movement certificates EUR.1 concerned is binding for the Portuguese authorities and that it entitles the Portuguese authorities to subsequently enter customs duties into the accounts.[5] This shows that the European Commission is indeed entitled to participate in the subsequent verification procedure by the third country of exportation, if the authorities of the exporting country have the sovereignty over the verification procedure and if they, as a result of the verification procedure, annul the certificate of origin concerned.

Furthermore, the subsequent verification procedure must be initiated by a request by the customs authorities of the importing state, as becomes clear from the ECJ's judgment 'Sfakianakis'.[6] The facts of the case are as follows: At the instigation of the European Commission, the Hungarian customs authorities investigated the manufacturing and the value of vehicles made in Hungary which had been imported customs-free into Greece. In the context of these investigations, the Commission asked the Greek authorities to send the certificates of origin concerned to the Hungarian authorities for the purpose of subsequent verification. The request for *a posteriori* verification was answered by the Hungarian customs authorities who confirmed the correctness and authenticity of some movement certificates EUR.1 and who annulled some others. Further, the Hungarian authorities informed their Greek counterparts that some movement certificates EUR.1 had been revoked but that this decision had been challenged in the courts by the exporters concerned. The ECJ held that, in the context of administrative cooperation, the obligation of the customs authorities of the importing country (Greece) to accept the findings of the exporting country on the authenticity and correctness of certificates of origin also extends to judicial decisions of the exporting country and on legal remedies in the exporting country against the annulment of certificates of origin.[7]

Consequently, an EU mission may be carried out in advance of a request for subsequent verification, so that the findings of the mission become the reasons for the request for a subsequent verification procedure by the importing country. However, the request for *a posteriori* verification must still be made by the customs authorities of the importing state, according to the ECJ, even if it is made at the instigation of the European Commission because, otherwise, the system of administrative cooperation could not function.[8]

However, an EU mission cannot substitute for a subsequent verification procedure by the customs authorities of the exporting country and it is not sufficient for a proper verification procedure that the authorities of the exporting country merely accept the findings of an EU mission and adopt them as their own. Otherwise, the due process of law would be undermined because, in contrast to administrative decisions on the annulment or revocation of certificates of origin by the customs authorities of the exporting country, the findings of an EU mission in a third country are not subject to any possibility of appeal. In the 'Sfakianakis' judgment,[9] the ECJ holds:

> As the Court has held on several occasions, the right to an effective judicial remedy is a general principle of Community law which underlies the constitutional traditions common to the Member States (Case 222/84 Johnston [1986] ECR 1651, paragraph 18). Since the Association Agreement is an integral part of the Community legal order, it is therefore for the competent authorities of the Member States to uphold the right to an effective legal remedy in respect of the application of the customs scheme provided for by that agreement.[10]

However, it must be differentiated between preferential tariff regulations based on international agreements between the EU and third countries on the one hand and autonomous preferential tariff regulations unilaterally adopted by the EU:

> (24) It follows from those considerations, first of all**, that the need for the customs authorities of the Member States to recognize the assessments made by the customs authorities of the exporting country does not arise in the same way where the preferential system is established not by an international agreement binding the Community to a non-member country on the basis of reciprocal obligations, but by a unilateral Community measure.**
>
> (25) That is the case a fortiori **where the competent authorities of a non-member country are disputing not the facts found by a mission of enquiry, but that mission's assessment of those facts in the light of the relevant customs rules.** There is nothing to suggest that the authorities of the non-member country have the power to bind the Community and its Member States in their interpretation of Community rules of the kind at issue in this case.
>
> (26) Furthermore, the second factor on which the Court based its interpretation in the Rapides Savoyards judgement, namely **the existence of a procedure for settling disputes concerning origin, is missing in this case**.[11] [emphasis added]

The differences between a preferential tariff measure based on an international agreement and an autonomous, unilateral preferential tariff measure are:

Firstly, the functioning of an autonomous preferential tariff regulation, such as the one which was the subject of the 'Faroe Seafood' case, does not depend on the recognition of the findings of the exporting state to the same extent as the functioning of a preferential tariff regulation, which is based on a bilateral or multilateral international agreement.

Secondly, compliance with the procedural regulations on the *a posteriori* verification procedure in a system of administrative cooperation is indispensable for the clarification of doubts regarding the origin of goods. If an autonomous preferential system does not provide for a formal *a posteriori* verification procedure, the European Commission is not bound by the findings of the exporting country.

Thirdly, in autonomous preferential tariff regulations, the EU is not bound by the interpretation of EU law by the authorities of third countries, in contrast to preferential tariff regulations based on international agreements which, according to the jurisprudence of the ECJ, may only be interpreted by a mutual agreement of all parties to the agreement.

Conclusions

In the framework of agreements on the preferential origin of goods between the EU and third countries, the current system of administrative cooperation between the customs authorities of the exporting country and those of the importing country provides for a fair allocation of risk between the customs authorities and the importer concerning irregularly issued certificates of origin. The jurisprudence of the ECJ has provided clear guidelines on the protection of legitimate expectations of the importer on the correctness and validity of certificates of origin: The customs authorities of the importing country must accept the legally made determinations on the origin of goods by the customs authorities of the exporting country.

If the customs authorities of the country of import hold any doubt about the correctness or validity of a certificate of origin, they may request a verification by the exporting country but are not entitled to review the validity of a certificate of origin themselves. The authorities of the importing country, in particular the European Commission or OLAF, may assist in the verification procedure as long as the authorities of the exporting country have the sovereignty over the procedure, but their own findings may not substitute for a true verification procedure by the authorities of the exporting country.

In this context, the German Federal Finance Court (Bundesfinanzhof) has recently made a reference for a preliminary ruling to the ECJ (case C-409/10). The Federal Finance Court has posed the question of whether it is compatible with the verification process regulated in Art. 32 of Protocol 1 of the ACP-EU Partnership Agreement, if the European Commission essentially takes it upon itself to undertake a subsequent verification of proofs of origin in the exporting country, albeit with the assistance of the authorities of that country, and whether it constitutes a result of verification if these results are obtained by the European Commission and recorded in a report that is co-signed by a representative of the government of the exporting country. This borderline case may result in the further clarification of the issues addressed in this article.

Endnotes

1 Compare this with TAXUD/2046/2007.

2 ECJ, judgment of 12.07.1984, 218/83 *SARL Les Rapides Savoyards et al. v. Directeur Général des Douanes et Droits Indirects* [1984] ECR 3105, para. 26; judgment of 07.12.1993, C-12/92 *Criminal Proceedings against Edmond Huygen et al.* [1993] ECR I-6381, para. 24; judgment of 17.07.1997, C-97/95 *Pascoal & Filhos Ld. v. Fazenda Pública* [1997] ECR I-4209, para. 32.

3 ECJ, judgment of 12.07.1984, 218/83 *SARL Les Rapides Savoyards et al. v. Directeur Général des Douanes et Droits Indirects* [1984] ECR 3105, para. 27; judgment of 07.12.1993, C-12/92 *Criminal Proceedings against Edmond Huygen et al.* [1993] ECR I-6381; para. 25; judgment of 14.05.2996, C-153/94 and C-204/94 *R. v. Commissioners of Customs & Excise, ex parte: Faroe Seafood Ltd., Føroya Fiskasøla L/F and Commissioners of Customs & Excise, ex parte: John Smith and Celia Smith trading as Arthur Smith* [1996] ECR I-2465, para. 19; judgment of 17.07.1997, C-97/95 *Pascoal & Filhos Ld. v. Fazenda Pública* [1997] ECR I-4209, para. 33.

4 ECJ, judgment of 05.07.1994, C-432/92; *R. v. Minister of Agriculture, Fisheries and Food, ex parte: S.P. Anastasiou (Pissouri) Ltd. et al.* [1994] ECR I-3087, para. 40.

5 ECJ, judgment of 17.07.1997, C-97/95 *Pascoal & Filhos Ld. v. Fazenda Pública* [1997] ECR I-4209, para. 14.

6 ECJ, judgment of 09.02.2006, C-23/04, C-24/04 and C-25/04 *Sfakianakis AEVE v. Elliniki Dimosio* [2006] ECR I-1265.

7 ECJ, judgment of 09.02.2006, C-23/04, C-24/04 and C-25/04 *Sfakianakis AEVE v. Elliniki Dimosio* [2006] ECR I-1265, para. 21, 26.

8 ECJ, judgment of 09.02.2006, C-23/04, C-24/04 and C-25/04 *Sfakianakis AEVE v. Elliniki Dimosio* [2006] ECR I-1265, para. 31.

9 ECJ, judgment of 09.02.2006, C-23/04, C-24/04 and C-25/04 *Sfakianakis AEVE v. Elliniki Dimosio* [2006] ECR I-1265, para. 28.

10 See, to that effect, C-12/86 *Demirel* [1987] ECR 3719, para. 7 and 28.

11 ECJ, judgment of 14.05.2996, C-153/94 and C-204/94 *R. v. Commissioners of Customs & Excise, ex parte: Faroe Seafood Ltd., Føroya Fiskasøla L/F and Commissioners of Customs & Excise, ex parte: John Smith and Celia Smith trading as Arthur Smith* [1996] ECR I-2465, para. 24 to 26.

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Section 2

Practitioner Contributions

Behind borders: a high-risk goods tracing system

Chang-Ryung Han

Abstract

One of the basic roles of customs authorities is to ensure that goods that are likely to be detrimental to society do not enter the country. Traditionally, Customs has carried out this role at the border, through the interception of high-risk goods. Inevitably, however, some high-risk goods enter the domestic market and, if subsequently discovered, may be seized or recalled by the relevant regulatory authority. This paper examines a Korean initiative whereby the jurisdiction of the Korean Customs Service has been extended to allow it to trace goods that fall into certain high risk categories beyond the point of importation, through a system of reporting by importers and wholesalers. This system facilitates any subsequent recall or seizure action in cases where goods are found to be harmful to the community. The paper concludes that customs authorities should increasingly examine such innovative approaches to their community protection and other roles.

1. Introduction

Customs authorities play three basic roles at borders: collecting revenue, supporting trade, and controlling the flow of goods and passengers. However, different customs agencies have different perspectives on the relative importance of each of these objectives, based on their specific economic and social environment. In many developing countries, the primary objective of customs authorities is said to be revenue collection. Customs authorities of developed countries tend to concentrate less on revenue collection; instead, they focus on the interception of illegitimate trade and travel without hampering the flow of legitimate goods and passengers. The efforts of customs authorities to harmonise roles in trade facilitation and regulatory control converge in the concept of risk management. In this context, international organisations such as the World Customs Organization (WCO) and the World Bank support the idea of collaborative border management, expanding the risk management approach primarily applied by customs authorities to other border agencies to improve the harmonisation of trade facilitation and regulatory control.

However, no matter how much effort customs authorities devote to sophisticated risk management techniques to screen out high-risk goods that may harm the security, health, and property rights of citizens, some illegitimate and high-risk goods continue to enter domestic markets and communities, frequently initiating phobias about imported commodities, including food. Countries that are highly dependent on international trade and rely on other countries to maintain their food supply often have serious concerns about this issue. They cannot expect all imported goods to be thoroughly inspected before being cleared at the border. Inspecting all imported goods at borders might hamper the supply of necessities for citizens and raw materials for corporations, subsequently leading to increased costs, especially in logistics, and ultimately the price of the imported goods. Customs authorities have a number of options for raising the detection rate of illegitimate goods without impacting the flow of legitimate goods, including gathering intelligence and establishing partnerships with the private sector. In many cases, however, these options

do not produce adequate outcomes in detecting high-risk goods. For example, much of the intelligence gathered and analysed by customs authorities is situational information rather than actionable intelligence.

Before the introduction of the Authorised Economic Operator (AEO) program, national customs authorities had adopted similar approaches to the identification of high-risk goods, but with considerable variation. Even so, existing solutions that are familiar to customs officials are not likely to bring innovative changes in the harmonisation of trade facilitation and regulatory control. The Korea Customs Service (KCS) took a groundbreaking step in risk management by introducing a system to trace high-risk goods following customs clearance. The system does not gather information on cargoes before they depart from exporting countries, but it does follow goods to domestic markets after clearance.

2. Benefits of tracing imported goods

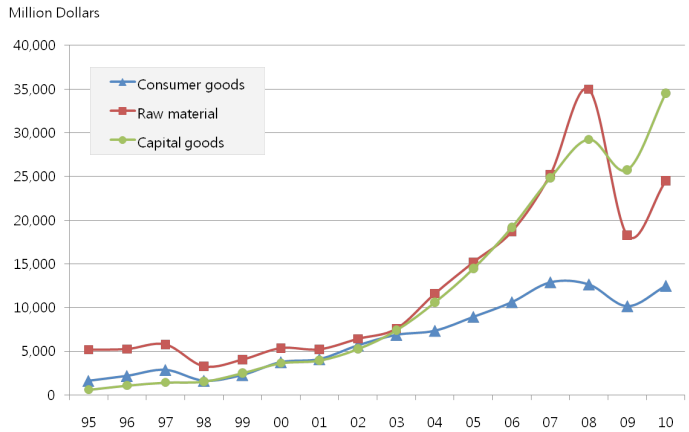
In most cases, customs authorities do not trace declared goods post-clearance due to the jurisdictional constraints of customs administration. For this reason, customs authorities focus on intercepting high-risk goods before they pass through Customs. However, KCS changed its paradigm of risk management by tracing high-risk goods beyond the stage of customs clearance. This dramatic change in risk management resulted from incidents in Korea in 2008.

Because Korea is in geographic proximity to and economically intertwined with China, a number of Chinese products are imported to and consumed in Korea. Korea annually imports Chinese products worth 71.6 billion dollars, which equals 16.8 per cent of Korea's annual import record. Many necessities, including foods, are imported from China because of their low prices. In 2008, a consumer in Korea found a roasted rat head in a bag of snacks imported from China, photographed the incident, and posted it on the internet. The picture was broadcast nationwide and naturally drew considerable attention within Korean society. Soon after the incident, dairy products from China were discovered to contain melamine, which is a chemical usually used in plastics, adhesives, dishware, and whiteboards. At the time, KCS was unaware that the products were illegal imports because the Korean Food and Drug Agency (KFDA) had not realised that the Chinese products in question contained melamine and was thus unable to warn KCS of the problem. The Korean government attempted to recall the cleared products, most of which were selling at retail markets. According to the KFDA, the recall rate of those products that had already been distributed at the retail level was low, about 30 per cent. Neither the KFDA nor the KCS could determine where the products were being sold and were therefore forced to rely on voluntary recall efforts from importers and manufacturers.

Cases of imported goods jeopardising the health of citizens do not always occur simply because customs authorities do not have the capacity to inspect all imported goods. No matter how thoroughly customs officers at borders inspect goods, it is inevitable that a proportion of goods will continue to threaten the security and health of citizens by entering the country undetected. Situations also occur in which customs officers clear goods with certain conditions for use, such as fodder or industrial use, and importers or retailers utilise the goods for other purposes, such as food for human consumption. For example, a certain variety of salt was conditionally imported for industrial use, but some importers were found to have sold the industrial salt into retail markets, claiming the salt was safe for humans.

In addition, importers or wholesalers often manipulate country of origin details to sell their products at higher prices. For example, a set of furniture labelled 'made in China' was cleared but after clearance, the country of origin was changed to 'made in Italy', which is well known as a country that produces more expensive furniture. Beef imported from some less favourable countries, such as the United States, where Bovine Spongiform Encephalopathy (that is, Mad Cow Disease) occurred, was claimed to have been imported from countries safe from Mad Cow Disease or produced in Korea. It is clearly easier to disguise the country of origin of meat than other products particularly when it is cut and wrapped into small pieces for retail sale. Additionally, retailers can manipulate the country of origin of meat in the process of re-wrapping.

Figure 1: Import statistics from China to Korea 1995-2010



Source: National Statistical Office, Republic of Korea.

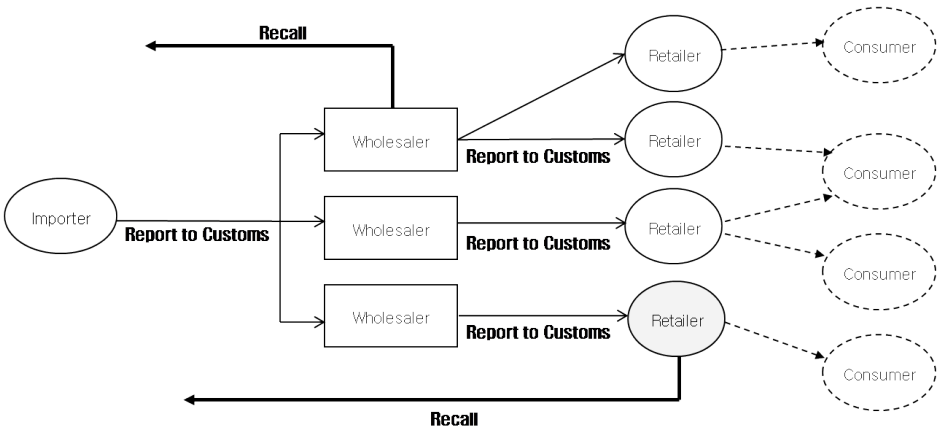
In cases where unqualified and/or deceptive goods have been detected at retail markets, the Korean government has attempted to quickly recall them to minimise the harm caused. However, the detection of certain harmful goods at retail markets has not always led to recalls of the same kinds of goods from elsewhere in the domestic market. Many government institutions have publicised the brands and manufacturers of harmful goods and let citizens voluntarily screen out such goods during the consumption process. On all such occasions, Koreans have criticised the government as incompetent and irresponsible. In this climate, KCS realised that citizens expect Customs to take full responsibility for the safety of goods cleared at the border. Hence, KCS decided to introduce a system of tracing cleared goods to enable quick recall if they are discovered to be harmful. Other government institutions, such as the Ministry of Finance (MOF), the Ministry of Agriculture and Fishery (MAF), and the KFDA, objected to the idea that Customs should trace and recall cleared items, arguing that such an approach is inconsistent with the traditional role of Customs and infringes on their jurisdictions. However, the aforementioned organisations did not present a resolution for the outflow of high-risk imported goods. Many congressional representatives of the Korean Assembly supported the reforms suggested by KCS and worked to enact them.

3. How the system works

The idea of tracing high-risk imported goods after clearance began with the understanding that all imported goods should be declared to Customs, and that KCS is the sole authority in Korea for controlling importers and their declarations. In this respect, KCS was best placed to establish a unified system to trace high-risk imported goods. Although the MAF and the KFDA also maintain information on the imported goods for which they are responsible, such as grains, fish and medicines, they do not have an efficient, centralised system to cover all kinds of imported goods or the workforce to audit and investigate all importers.

Hence, through a revision of the customs law, KCS obtained the power to request importers dealing with high-risk items registered with KCS to report sales transactions when items are sold to wholesalers. In turn, wholesalers who purchase items from importers are required to report transactions to KCS when they sell their items to retailers. This hierarchical structure of information, which tracks what high-risk items are handled and by whom, should assist KCS to quickly and easily trace items for recall. KCS

Figure 2: Mechanism of the high-risk goods tracing system



Source: Korean Customs Service.

developed a computerised system to help importers and wholesalers report sales in connection with its automated declaration system. This system has been evaluated as inexpensive and simple, compared to a system coupled with Radio Frequency IDentification tags to trace the logistics of goods, because anyone with a personal computer connected to the internet can report to KCS.

As of March 2011, KCS is using the system to trace 20 high-risk items post-clearance. The MAF and the KFDA, which had strongly objected to the development of the system, have also asked KCS to register high-risk goods of interest to health and sanitation.

4. Conclusions

Customs authorities in each country function as a gate or shield to protect the security and health of citizens and to collect revenue. However, limiting the traditional jurisdiction of Customs to borders and their peripheries has hampered the ability of Customs to meet the expectations of the citizenry. As many experts have pointed out, the concept of borders has been altered due to the changing role of Customs. It is time to abandon traditional roles for customs officials and to adopt more innovative approaches. The system to trace high-risk goods post-clearance, as introduced in Korea, is a new path for Customs and is an example of such an innovative approach.

Chang-Ryung Han

Chang-Ryung Han has worked at Korea Customs Service (KCS) since 1999. He was awarded a Masters degree in criminology and criminal justice from Rutgers University, Newark, NJ, has worked at the Brookings Institution, Washington, DC, as a visiting fellow for research on cross-border crime, and is now Director of the Financial Investigation Division of KCS.

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Section 3

Special Report

Partnership in Customs Academic Research and Development (PICARD)

Abu Dhabi, UAE

23-25 November 2010

Report from the 5th Conference

1. At the invitation of the United Arab Emirates (UAE) Federal Customs Authority, the fifth annual Partnership in Customs Academic Research and Development (PICARD) conference was held in Abu Dhabi, United Arab Emirates from 23 to 25 November 2010. The conference was jointly organised by the World Customs Organization (WCO) and the International Network of Customs Universities (INCU) and co-hosted by the Centre for Customs and Excise Studies (CCES) of the University of Canberra and Abu Dhabi University Knowledge Group (ADUKG).
2. The conference was attended by some 200 delegates (including a significant number from the Middle East region) representing WCO Members, academia, other international organisations and the private sector, who gathered to share and discuss research topics and outcomes as well as developments in Customs professional education.
3. The core themes of the 2010 conference were:
   - Customs-Business partnerships
   - revenue collection
   - the impact of climate change
   - performance measurement.
4. The conference was co-chaired by Professor David Widdowson, INCU President (University of Canberra) and Professor Hans-Michael Wolffgang, INCU Vice-President (University of Münster) and included a range of speakers from various customs administrations, academia, the World Bank and the private sector.
5. A number of the original research papers presented at the conference have been published in the eighth issue of the *World Customs Journal* which is downloadable at the Journal's website: www.worldcustomsjournal.org.

DAY 1

Opening speeches

6. Dr Kunio Mikuriya, WCO Secretary General, welcomed all delegates and extended his thanks to the conference organisers. Announcing the 2011 WCO theme for International Customs Day, namely 'Knowledge, a catalyst for excellence in Customs', Dr Mikuriya explained the link between the current WCO working agenda and the key topics of the PICARD conference.
7. Ms Heike Barczyk, WCO Deputy Director of Capacity Building, welcomed the delegates and noted that although the WCO Director of Capacity Building, Mr Lars Karlsson, was not able to attend on this occasion, he extended his best wishes for the conference's success.
8. Professor David Widdowson welcomed participants on behalf of the INCU and the CCES. He noted that PICARD 2010 marked a significant milestone in the development of the partnership

between the WCO and the academic world, and that significant progress had been made in raising the academic standing of the Customs profession. Professor Widdowson also provided a brief overview of the development of the PICARD Program and thanked Dr Kunio Mikuriya for his ongoing support of the partnership.

9. Professor Widdowson also pointed out how the PICARD Program has grown since its establishment and identified a number of key achievements including the establishment of standards for the Customs profession, recognition of Customs as an area of academic pursuit, implementation of several internationally recognised Customs university programs, and the establishment of the *World Customs Journal*.

10. On behalf of all INCU members, Professor Widdowson expressed gratitude to Mr Lars Karlsson, WCO Director of Capacity Building, for his exceptional contribution to the development of customs and academic partnerships and for the accomplishments of the Capacity Building Directorate and the PICARD Program which were testament to the dedication, commitment and passion that Mr Karlsson has shown throughout his five-year term as Director.

11. Director-General Mr Khalid Ali Al Bustani, Federal Customs Authority, UAE, then extended his own welcome to participants in his capacity of host administration, stressing the importance of capacity building both regionally and internationally, and the value of PICARD in achieving effective and sustainable outcomes.

WCO presentations

12. Ms Heike Barczyk, WCO Deputy Director of Capacity Building, delivered a presentation on initiatives of the WCO Capacity Building Directorate including an overview of the Directorate itself and an update on its initiatives including the organisation's capacity building strategy and details of various capacity building programs that were under way.

13. Ms Riitta Passi, WCO PICARD Program Manager, then provided further elaboration on recent developments under the PICARD Program including progress with the Professional Standards, WCO recognition of specific university curricula through the award of WCO certificates, governance issues and the development of a WCO Management Development Program.

PICARD Program initiatives

14. Professor Jhon Fonseca, University of Costa Rica, discussed the Regional Centre for Customs and Foreign Trade Excellence, which is currently being implemented in the Americas and Caribbean region. He identified the main elements in that development as being the establishment of an agreement between relevant universities, management and administrative support, planning, analysis, and implementation.

15. Professor Hans-Michael Wolffgang, University of Münster, provided an update on PICARD Program initiatives in Europe. In particular, he provided an overview of study programs and research activities taking place at Brunswick Law School in Germany, University of Le Havre in France, University of Münster in Germany, University of Valencia in Spain, University of Verona in Italy, and the Warsaw School of Economics in Poland. Professor Wolffgang also provided information about international cooperation between some of the European universities and universities in other regions.

16. Professor David Widdowson, University of Canberra, provided an update on PICARD Program initiatives at the University of Canberra in Australia. He outlined the range of PICARD-compliant and WCO-recognised programs being offered in the field of Customs and the

flexible learning approach adopted in respect of those programs, including the establishment of programs with universities in the Middle East, Africa and Asia.

17. Mr Vanco Kargov, Customs Administration, Republic of Macedonia, explained how the concept of enhancing capacity at Customs was introduced and implemented in Macedonian Customs. In particular he discussed responsibilities and challenges, goals, priorities, capacity building and promotion, strategic planning, and other management challenges.

18. Director General Mohammed Abdullah Al Mehrezi, Ras Al Khaimah Customs, UAE, presented his PhD Research Proposal which focuses on the effects of implementing a VAT System in the UAE as a whole, and Ras Al Khaimah Emirate specifically. Mr Al Mehrezi outlined the significance of his research, his objectives in undertaking that research and the key issues that will be addressed.

DAY 2

PICARD Program initiatives (continued)

19. Mr Mikhail Kashubsky, INCU Secretariat, presented an overview of the INCU and its role, and provided an update on recent developments and new initiatives including proposed new membership arrangements, development of a customs research database, the introduction of official membership certificates, and related matters. He pointed out that the main role of INCU is in promoting the academic standing of the Customs profession and providing the WCO and other organisations with a single point of contact with universities and research institutes that are active in the field of customs education, research and training. Mr Kashubsky provided an overview of the main areas of cooperation between the WCO and INCU, and announced that INCU now had 88 affiliated institutions from 56 countries, including 35 universities and research centres and 53 other affiliated institutions.

20. Mr Juha Hintsa, Cross Border Research Association, presented the results of a recent study on e-Customs in Switzerland which examines cost-benefit issues associated with the development and implementation of e-Customs, including opportunities to drive down compliance costs through enhanced e-Customs services. Mr Hintsa also suggested undertaking a wider study and joint research activity on e-Customs for 2011-12 and the development of a global e-Customs index, in collaboration with INCU Members.

21. Mr Ernani Checcucci, WCO Capacity-Building Directorate, introduced delegates to the new WCO Leadership and Management Development Program. He provided an overview of the program including its content, the progress that has been made to date, key findings and proposed developments. He also announced the in-principle decision by the CCES, University of Canberra to formally endorse the program for the purposes of granting credit towards its WCO-recognised postgraduate programs.

22. Mr Thomas Cantens, WCO Research and Strategies Unit, provided an outline of the WCO's Club De La Reforme (CDRL), explaining its purpose and demonstrating the main features and functions of its website.

23. Mr Lars Karlsson, Director of the WCO Capacity Building Directorate was admitted, in absentia, as an Honorary Fellow of the INCU and was awarded an official Certificate of Membership. The certificate was presented by INCU President, Professor David Widdowson, and was accepted by Ms Heike Barczyk on behalf of Mr Karlsson.

Customs and revenue collection

24. Professor Santiago Ibáñez Marsilla, University of Valencia, delivered a presentation on customs valuation compliance in the context of corporate income tax. He provided an analysis of valuation methods and discussed the concepts of related parties and transfer pricing in the context of both customs valuation and corporate income tax. Professor Ibáñez Marsilla noted that customs valuation rules do not refer to profit methods, while corporate income tax rules establish two such methods (profit split method and transactional net margin method). He argued that the 'interpretative approach' which is adopted in Spain could have some advantages over the US 'normative approach' while discussing particular difficulties relating to transfer pricing.

25. On behalf of Mr Leonardo Correia Lima Macedo, who was unable to attend the conference, Mr Ernani Checcucci, WCO Capacity-Building Directorate, delivered a presentation on Large Traders' Customs Units (LTCU) and the use of dedicated compliance teams for large traders. He pointed out that LTCU are important for customs and revenue collection as a strategy to mitigate revenue risks, and that Customs administrations may utilise such units to implement pilot projects in order to develop faster clearance procedures and more effective post-clearance audit regimes.

26. Mr Santiago León Abad, Ecuadorian Customs Corporation, proposed the exchange of information among customs administrations for the purposes of improving the Customs valuation compliance. He drew attention to the differences in export and import records for the same transaction, and provided some practical examples from Ecuador and neighbouring South American countries. He argued that exchange of information between customs administrations would assist in addressing valuation fraud.

Customs-Business partnerships

27. Mr Olivier Tsalpatouros, La Poste Group, discussed the application of international trade and customs rules in the postal environment, the challenges faced by the postal services in the context of new security requirements, market changes and customs reforms that impact on postal processes. He explained the legal basis for customs clearance of postal consignments including those contained in the revised Kyoto Convention and the UPU convention. Mr Tsalpatouros further stressed the importance of cooperation between postal agencies and customs administrations for their mutual benefit.

28. Dr Eng. Arif Ahmad Alfitiani, Jordan Customs, discussed Jordan's electronic transit monitoring and facilitation system. He advised that developing a secure and more facilitative approach to transit traffic and cargo has been a high priority for the Jordan Customs Department. Dr Alfitiani provided an insight into the operation of the system as well as an analysis of operational results, indicating that the electronic transit monitoring and facilitation system has led to a significant reduction in supply chain costs and an increase in compliance.

The impact of climate change

29. Mr Robert Ireland, WCO Research and Strategies Unit, delivered a presentation on the implications for Customs of global climate change mitigation and adaptation policy, and discussed ways in which the customs community can contribute to such policy. The policy options examined by Mr Ireland included carbon import tariffs, trade facilitation of low-carbon energy technology, enforcement against emission permit trading irregularities, customs clearance of humanitarian relief consignments, trade recovery, and Customs' responses to the potential of climate change driven international trade contraction. He pointed out that further

research on these issues will promote rational consideration, formulation and implementation of Customs-relevant climate policies.

Perspectives from the World Bank and the private sector

30. Mr Gerard McLinden, The World Bank, outlined the charter of the World Customs and Border Management Practice Group within the World Bank which is designed to provide a focal point for information exchange and technical support for World Bank staff interested in this expanding area of work. Mr McLinden identified opportunities for cooperation with the WCO and academia. In his presentation, Mr McLinden provided an overview of the World Bank and its Customs agenda. He indicated that World Bank research suggests that Customs is responsible for only one-third of border delays and that Customs is performing better and improving relative to other border management agencies. He also outlined a number of new initiatives such as the WCO/World Bank Customs Capacity Enhancement Program for Sub-Saharan Africa and Customs Assessment Trade Toolkit (CATT). In conclusion, he drew attention to recent World Bank publications that are relevant to Customs and academia and identified knowledge gaps yet to be addressed.

31. Mr Conor O'Riordan, Tradefacilitate, discussed the concept of paperless trade. In particular, he focused on the European Union (EU) paperless trade policy to take effect on 1 January 2011. He identified the need for the private sector to take the lead in providing small to medium enterprises (SMEs) with simple, low cost web-based commercial intra-EU and end-to-end international paper-free solutions that interface with EU Customs. He discussed EU and cross-border trade benefits of paper-free policies including reducing costs, optimising revenue, providing better enforcement outcomes and linking trade facilitation and security imperatives.

DAY 3

Performance measurement

32. Mr Lionel Pascal, University of Le Havre, delivered a presentation on the identification of methods to measure and evaluate the performance of Customs. He noted that the public sector, like the private sector, is subjected to a plethora of performance indicators which give an impression of scientific precision but which are difficult to implement. Mr Pascal also discussed the nature of performance indicators and the difficulty of identifying a good indicator. He pointed to those international organisations which have their own performance indicators relating to Customs, and the need for the WCO to develop its own criteria.

33. Adjunct Professor Stephen Holloway, University of Canberra, examined problems associated with existing methods of performance measurement of border management effectiveness from a variety of perspectives. He identified the need to establish clear objectives that support the design of outcomes-based indicators and analysed the characteristics of effective performance measures that take account of government and private sector needs and objectives. Professor Holloway argued that an integrated performance measurement framework for border management that is meaningful to both business and government can be developed on the basis of existing supply chain and regulatory metrics, but that there needs to be closer consultation and coordination in the implementation of such metrics.

34. In their joint presentation, Mr Thomas Cantens, WCO Research and Strategies Unit, and Mr Samson Bilanga, Cameroon Customs, presented a Cameroon case study that examined the introduction of staff performance measures and discusses how this has served to facilitate administrative reform. They discussed the introduction of a system of performance contracts

within Cameroon Customs and advised that, since its introduction, initial results have been encouraging (including lower corruption, higher revenue collection, and shorter clearance times).

35. Dr Bryane Michael, Stockholm School of Economics, presented the results of a study on reduction of Customs-related corruption through Customs trade facilitation programs. Key issues highlighted by Dr Michael included revenue loss due to corruption, steps that can be taken to improve customs administration in the context of the WCO Columbus Program, the SAFE Framework, the World Trade Organization Valuation Agreement, and methods of detecting corruption. Dr Michael pointed to the need for the introduction of 'big bang' anti-corruption and efficiency improvement programs.

36. Dr Prabodh Seth, Mauritius Revenue Authority, discussed the Mauritian approach to performance measurement. He highlighted the need for administrations to adopt Key Performance Indicators (KPIs) that emanate from strategic objectives, with clear targets or benchmarks to be attained over a certain time period. He discussed performance measurement from a global perspective and provided examples from New Zealand, Jordan, South Africa, Japan, and Egypt, as well as from Mauritius. He advised that the Mauritius Revenue Authority introduced a new performance culture by establishing clear priorities, focused objectives, measurable KPIs, with the major goals/priorities identified. He concluded that KPIs have proved to be an effective performance management tool for Mauritius.

37. Ms Kameswari Subramanian, Ministry of Finance, Department of Revenue, India, shared her experiences from India on excellence in public service delivery and introduced to delegates Project SEVOTTAM, which is a commitment of the Government of India to raise the standard of public services and to empower citizens. She emphasised several issues including commitment to provide quality in service delivery, clear goals with benchmarks of performance measurement, accountability, the Citizens' Charter, service norms for Customs, the use of technology, delivery infrastructure, a Service Quality Manual for Process Control, and a new system for notifying grievances.

Awards ceremony

38. Two universities, the University of Costa Rica and the International Business and Law Institute of Saint Petersburg, Russia were awarded WCO Certificates of Recognition certifying that their customs curricula comply with the WCO Standards for the Customs profession. Dr Kunio Mikuriya presented the certificates to representatives of both institutions.

39. Mr David Hesketh, HM Revenue & Customs, a recent Masters graduate of the University of Canberra, was recognised as Centre for Customs and Excise Studies Student of the Year and was awarded the CCES medal for Academic Excellence by Professor Widdowson.

Concluding remarks

40. It was announced that Ms Riitta Passi's appointment as WCO PICARD Program Manager would be ending in December 2010 and that Mr Ernani Checcucci would be the new PICARD Program Manager, commencing in 2011.

41. Dr Kunio Mikuriya and Professor David Widdowson made closing remarks at the end of the Conference, both noting that the event was successful and beneficial to all participants. In particular, the following points were noted:

    - the importance of maintaining a partnership approach to find practical solutions based on sound information and empirical evidence

- the need to ensure that a balance is maintained between government and business requirements
- the need to encourage the trading community to become involved in the PICARD program
- the need to progress Professional Standards at a vocational level as well as at an academic level
- the need to ensure the practicality of the PICARD standards and programs, including a need to consider the articulation of industry and customs training programs into higher academic award programs
- recognition of how powerful the PICARD network can be as the customs and academic partners pool their resources to address strategically significant issues
- the need to place a greater emphasis on measuring effectiveness of customs activities from an organisational level down to the individual level.

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Section 4

Reference Material

Guidelines for contributors

The *World Customs Journal* invites authors to submit papers that relate to all aspects of customs activity, for example, law, policy, economics, administration, information and communications technologies. The Journal has a multi-dimensional focus on customs issues and the following broad categories should be used as a guide.

Research and theory

The suggested length for articles about research and theory is approximately 5,000 words per article. Longer items will be accepted, however, publication of items of 10,000 or more words may be spread over more than one issue of the Journal.

Original research and theoretical papers submitted will be reviewed using a 'double blind' or 'masked' process, that is, the identity of author/s and reviewer/s will not be made known to each other. This process may result in delays in publication, especially where modifications to papers are suggested to the author/s by the reviewer/s. Authors submitting original items that relate to research and theory are asked to include the following details separately from the body of the article:

- title of the paper
- names, positions, organisations, and contact details of each author
- bionotes (no more than 50 words for each author) together with a recent, high resolution, colour photograph for possible publication in the Journal
- an abstract of no more than 100 words for papers up to 5,000 words, **or for longer papers**, a summary of up to 600 words depending on the length and complexity of the paper.

Please note that previously refereed papers will not be refereed by the *World Customs Journal*.

Practical applications, including case studies, issues and solutions

These items are generally between 2,000 and 5,000 words per article. Authors of these items are asked to include bionotes (no more than 50 words for each author) together with a recent, high resolution, colour photograph for possible publication in the Journal. The Editorial Board will review articles that relate to practical applications.

Reviews of books, publications, systems and practices

The suggested length is between 350 and 800 words per review. The Editorial Board will review these items submitted for publication.

Papers published elsewhere

Authors of papers previously published should provide full citations of the publication/s in which their paper/s appeared. Where appropriate, authors are asked to obtain permission from the previous publishers to re-publish these items in the *World Customs Journal*, which will acknowledge these source/s. Copies of permissions obtained should accompany the article submitted for publication in the *World Customs Journal*.

Authors intending to offer their papers for publication elsewhere—in English and/or another language—are asked to advise the Editor-in-Chief of the names of those publications.

Where necessary and appropriate, and to ensure consistency in style, the editors will make any necessary changes in items submitted and accepted for publication, except where those items have been refereed and published elsewhere. Guidance on the editors' approach to style and referencing is available on the Journal's website.

Letters to the Editor

We invite Letters to the Editor that address items previously published in the Journal as well as topics related to all aspects of customs activity. Authors of letters are asked to include their name and address (or a pseudonym) for publication in the Journal. As well, authors are asked to provide full contact details so that, should the need arise, the Editor-in-Chief can contact them.

All items should be submitted in Microsoft Word or RTF, as email attachments, to the Editor-in-Chief: **editor@worldcustomsjournal.org**

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