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

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

Preshipment inspection services can improve customs administration, but they are no substitute for comprehensive reform. Increasing the effectiveness of preshipment inspection services; for a comprehensive assessment of preshipment inspection issues through 1994, see Low (1995).

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

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

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

In general, preshipment inspection is a second-best policy for countries with serious weaknesses in customs administration. Wherever feasible, a preferred approach would combine a relatively open capital account (reducing incentives for overinvoicing as a capital flight mechanism), trade liberalization (reducing incentives for underinvoicing as a tax evasion mechanism), and local institution building aimed at improving all customs functions.

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

Disbursement verification

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

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

Revenue collection

Probably the most important reason that governments seek preshipment inspection services is to deal with inefficient or corrupt customs administrations. Such administr-
tions introduce distortions through wide-
spread evasion of trade taxes, either through
mismatch of quantity, misclassification
of tariff heading, or undervaluation of goods.

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

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

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

**Trade facilitation**

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

Most evidence in this area is anecdotal,
and not a single complaint has been lodged
under the World Trade Organization’s Pre-
shipment Inspection Agreement. A plausible
explanation is that affected firms must file
complaints as identifiable corporate entities,
which they may be reluctant to do for fear
of jeopardizing commercial relationships.

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

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

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

**Options for increased competition**

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

**Competition among service providers**

A careful assessment is needed of the bene-
fits and costs of parallel competition (split

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

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

**Competition to strengthen customs administration**

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

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

**Further reading**


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

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