



International Chamber of Commerce

*The world business organization*

## **Trade liberalization, foreign direct investment and customs modernization: a virtuous circle**

Committee on Customs and Trade Regulations, 8 October 1999

### **French version**

#### **Introduction**

The International Chamber of Commerce, the world business organization, urges governments, and in particular trade and finance ministers, to recognize that modernization of customs administrations - both of their own countries and of their trading partners - is an important catalyst to economic development. Modernization of a country's internal customs administration benefits growth and investment, while modernization of the customs administrations of trading partners is necessary to ensure the full realization of negotiated trade benefits.

As tariff and other trade barriers are reduced or eliminated through global and regional trade negotiations, customs modernization becomes more and more important to each country's interest in attracting foreign direct investment. As tariff barriers fall, multinational and other companies look increasingly to the existence of business friendly policies in deciding where to invest. Countries that fail to keep pace with world class standards for customs administration will find that investors simply cannot afford the high logistics costs imposed by customs inefficiencies. Finance ministers in these countries will find foreign direct investment (FDI) migrating to nations with more sophisticated customs administrations. Moreover, customs inefficiency imposes a significant tax, hidden but very real, on consumers and traders - taxes whose "revenues" are not realized by the government, but rather comprise a dead waste to the economy.

Because customs administration can be an important barrier to trade, countries with inefficient customs administrations are breaking faith with their partners who have made tariff concessions. Absent a uniformly high standard of customs efficiency, the benefits of market opening are unfairly denied to those countries that have efficient customs administrations and trade with neighbours whose inefficient customs administrations act as non-tariff barriers. Trade ministers in countries with forward looking customs administrations must insist on the modernization of the customs administrations of their trading partners if they are to realize the benefit of the bargains they strike with their neighbours.

Understanding the competitive costs associated with tolerance of inefficient customs administration, trade and finance ministers should be strong internal advocates for customs improvement. Much can be done unilaterally and voluntarily to improve prospects for attracting foreign investment and increasing trade. Additional gains are available from the synergies engendered by an across-the-board improvement in customs efficiency. Consequently, trade and finance ministers should support multilateral and regional initiatives to modernize customs administrations as well. These include World Trade Organization (WTO) initiatives to simplify and improve trade procedures; the work of the World Customs Organization (WCO) on revision of the Kyoto Convention on the Simplification and Harmonization of Customs Procedures; and regional efforts to simplify and harmonize customs procedures.

#### **The virtuous circle**

The accelerating trend toward trade liberalization, both globally and regionally, puts customs

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modernization at the heart of a mutually beneficial "race to the top" in a form of virtuous circle in four steps:

- Increasing levels of trade liberalization become a worldwide reality through WTO and regional negotiations.
- Trade liberalization eases the need to invest behind tariff barriers, and investors are freer to seek business-friendly environments, rather than being forced to invest behind high tariff barriers in each country where they hope to do business.
- Countries that modernize their customs administrations see increasing flows of FDI, putting pressure on their trading partners to respond in kind.
- Improving customs administrations enables further trade liberalization by ensuring that countries will reap the rewards of negotiated trade concessions. Higher levels of trade liberalization increase the competitive benefits of customs modernization, and so on.

While this virtuous circle encompassing trade liberalization, FDI, and customs modernization benefits all who participate in it, the costs of non-participation will become increasingly burdensome in terms of lost investment and increasing economic isolation.

#### **Trend toward trade liberalization**

The initial condition for realization of the virtuous circle is a trend toward trade liberalization, and it is clear that that condition holds in today's world. Trade liberalization at the multilateral and regional levels is progressing at an accelerated pace. The Uruguay round and creation of the WTO have resulted in substantial, continuing tariff reductions, and ongoing work in the WTO will further market liberalization on many fronts. Regional arrangements, such as the North American Free Trade Agreement (NAFTA), the Association of South East Asian Nations Free Trade Area (AFTA), the Asia Pacific Economic Cooperation (APEC), the European Union (EU) and its association agreements, numerous Latin American trade arrangements, and the negotiation of the Free Trade Area of the Americas also contribute to the downward pressure on trade barriers. And the spirit of liberalization has taken firm root; in the face of the Asian financial crisis, members of the Association of South East Asian Nations did not abandon, but rather accelerated duty reduction schedules under AFTA.

At the same time, economic turbulence has the potential to arouse protectionist sentiments that are self-defeating and lead to a vicious circle that can trigger worldwide trade wars and economic depression. Customs frequently is a favored tool of protectionists. Countries must guard against employing their customs administrations as barriers to trade.

#### **FDI and the business environment**

Traditionally, FDI has been driven in substantial part by the need to invest behind tariff barriers. High trade barriers in a country create an incentive for investment to serve consumers of that country that does not depend on efficiency of the workforce, availability of world-class material suppliers, access to other markets, or the maintenance of an effective system of commercial law. Even the advantages to be gained from economies of scale are overwhelmed, often requiring the construction of small, inefficient plants in each of several markets that could be served collectively by a single, scale-efficient factory. Markets traditionally protected by trade barriers often fall behind world standards because the goods and services they provide are not tested by international competition.



When tariff and non-tariff barriers to trade are removed, investment decisions increasingly are made on the basis of the ability of the market to provide an environment that is conducive to the establishment and maintenance of a world-class manufacturing operation to serve the regional market and often to produce for worldwide export. Workforce availability, a stable economic system, and an effective legal system all assume greater importance in making investment decisions. Equally important is logistics - the ability to maintain a reliable, low-cost flow of raw materials and components into a manufacturing facility, and an effective system to distribute finished products flowing out of the facility.

### **Customs modernization as national competitive advantage**

Logistics - the efficient movement of goods to and from a manufacturing facility - is critically important. Any world-class manufacturing facility must have access to world-class sources of raw materials and components. Certainly, many inputs will be available locally in quantities and quality needed to support such manufacturing. However, no single market either developed or emerging, can produce all of the world-class inputs needed for a complex manufacturing operation. Aided by rapid improvements in the speed of information exchange, global corporations are creating sophisticated international supply chain management systems to move goods quickly and economically around the world. Countries that stop or slow down these supply chains will be left out of the process.

Consequently, access to imported raw materials and components is an important consideration in plant siting. And customs administration is critically important to this access in many ways:

- *Clearance time* - In order to support world-class manufacturing, customs clearance time must be measured not in weeks, or even days, but in hours. Any customs administration that can provide reliable, timely customs clearance, or immediate release based on pre-clearance, creates an enormous competitive advantage in attracting manufacturing.
- *Predictability* - Delayed delivery of a key input can shut down an entire manufacturing line, at enormous cost. Unpredictable delivery due to customs administration can require the maintenance of excessively large "safety stock", with unacceptable inventory carrying costs. Arbitrary or unpredictable customs clearance delays are incompatible with efficient manufacturing.
- *Transparency* - Arbitrary or unexplained changes in classification or valuation of goods can disrupt logistical flows and marketing plans, thereby seriously detracting from efficient operation.

The importance of customs administration to FDI decisions is not hypothetical. Case studies of real-world decisions are attached to illustrate the importance of customs in making plant-siting decisions.

### **Reaping the benefits**

Countries that are early in recognizing the competitive advantage of customs modernization will reap the lion's share of the rewards. Experience in the developed world includes several examples of smaller countries that have taken advantage of such factors as favourable location, modern transportation, trade culture and services industries to rank among the largest trading economies. These successes would not have been possible without modern customs services. In the developing world, there are some more recent examples that are following this pattern. The experience in these countries already demonstrates that customs modernization and trade facilitation are compatible with revenue collection and enforcement. It is noteworthy that customs revenues have increased with modernization efforts because greater volumes of trade are processed more efficiently.



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### **Conclusion**

Governments have an important stake in the modernization of their customs administrations and those of their trading partners. As the world moves increasingly toward trade liberalization, the cost of tolerating an inefficient customs administration will become too great to bear. The International Chamber of Commerce urges governments, and in particular trade and finance ministers, to become ardent advocates of internal customs reform and vocal demandeurs of regional and worldwide rules to ensure multilateral movement toward a uniformly high standard of customs administration.

Note: Three case studies are attached to illustrate the importance of customs modernization for trade and investment

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