THE USE OF PRESHIPMENT INSPECTION SERVICES (PSIS)
IN ADJUSTMENT LENDING

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THE USE OF PRESHIPMENT INSPECTION SERVICES (PSIS)

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Abstract

A number of developing countries now use the services of international firms providing preshipment and inspection services for a variety of purposes. The draft OMS 2.43 on "Procurement in SALs and other Adjustment Lending" recommends that, where borrowers do not have in place adequate systems to monitor importation of goods, they should use the services of such firms. Against this background, the paper discusses the nature of services provided by surveillance firms, the reasons for and costs and benefits of hiring their services, and the issues involved in using such firms in the context of adjustment operations.
The Use of Preshipment Inspection Services (PSIS)
in Adjustment Lending

Introduction

1. The draft OMS 2:43 on "Procurement in SALs and Other Adjustment Lending" recommends that, where borrowers do not have in place adequate systems to monitor the importation of goods which would be financed under adjustment loans, they should use the services of reputable international firms providing preshipment inspection and verification services. 1/ This note seeks to clarify the issues involved in using such agencies and provide some guidance to country economists in evaluating and advising borrowers when and how to use PSIS.

2. Over the past few years a number of governments of developing countries have engaged the services of agencies providing PSIS. An important reason for doing so has been the perception that inspection and verification of price, quantity and quality by surveillance agencies help to protect importers in developing (particularly smaller) countries from being exploited by overseas suppliers. Secondly, surveillance is supposed to help reduce collusion between suppliers/buyers abroad and traders in developing countries themselves; such collusion, often in the form of overinvoicing of imports and underinvoicing of exports, can lead to significant

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1/ There are a number of such agencies, the most important of which are Societe Generale de Surveillance (SGS), Crown Agents and Veritas.
capital flight, which many developing countries can ill-afford. 2/ Another reason for hiring the services of surveillance agencies is to protect government revenues in countries where corruption is a serious problem, and collusion between customs officials and local importers and exporters leads to considerable evasion of trade taxes and revenue losses.

**Services provided by surveillance agencies**

3. Surveillance agencies provide a range of services which can be adapted to the needs of individual countries. These include: (a) the traditional function of preinspection of imported goods for quality, quantity and conformity with contractual specifications, undertaken at points of overseas supply; (b) verification of prices charged by overseas suppliers; this usually involves advising clients whether the prices charged by overseas suppliers are reasonable in relation to those charged

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2/ The extent of, and incentives for, collusion and fraudulent trade practices vary widely among developing countries and depend on many complex social, institutional and economic factors. Generally, the degree of overvaluation of currencies and controls over trade and capital movements are among the most important contributing factors; and appropriate reforms in these areas help to considerably reduce the inducements for trade malpractices. However, even where countries adopt appropriate exchange rate reforms and liberalize trade and capital movements, there can still be incentives for trade malpractices. Thus, high tariffs may encourage private sector traders to underinvoice both imports and exports, and/or to collude with customs officials in order to evade trade taxes. A good example is Indonesia where (despite the absence of restrictions on capital movements, although imports are subject to controls), collusion between the private sector and a corrupt customs service to evade trade taxes was an important reason why the government brought in surveillance agencies. On the other hand, lowering tariffs and unifying tariff rates reduce the incentives for tax evasion. There could also be overinvoicing of public sector imports, particularly (but not necessarily) where there is a large government enterprise/parastatal presence, in order to derive kickbacks. Conversely, export rebate schemes and subsidies generally reduce the inducements to underinvoice exports.
by the same suppliers to other buyers or to market prices for similar goods; (c) export inspection in client countries--price checks, conformity with quality standards, contractual specifications, etc.--for such reasons as enforcing local regulations, ensuring product quality, implementation of rebate schemes and tax revenue enhancement; (d) some countries (for example, Philippines and Indonesia) use surveillance agencies in an expanded administrative and policing role by vesting them with the responsibility of issuing clearance certificates and making it mandatory for local importers and exporters to obtain such clearance certificates before the import/export of goods; (e) in some countries (for example, Indonesia) surveillance agencies also undertake verification of customs codes and duty rates for imports and exports in order to reduce the scope for manipulation by corrupt customs officials and enhance trade tax collections.

4. Surveillance agencies claim to perform these functions efficiently, although some reservations should be noted. It is generally agreed that surveillance agencies can and do provide useful benefits to their clients: they discourage fraudulent trade practices; and, where such practices are widespread, may indeed help clients save foreign exchange and enhance tax revenues; they also help enforce quality standards and contractual specifications; and, in the case of project-related imports, these may have additional benefits in terms of facilitating achievement of physical standards and reducing implementation delays; similarly, price checks can help uncover instances of overcharging by suppliers. However, the determination of fair or competitive prices for products with varying degrees of differentiation, particularly for capital goods, is difficult in practice. Accordingly, these agencies do not generally question price differences of
the order of 5-10%. They also do not generally enter into price negotia-
tions with suppliers on behalf of their clients, or advise their clients
about the lowest prices obtainable or alternative sources of supply. 3/
SGS' brief experience in Indonesia with verification of customs codes and
tariff rates (in addition to other regular pre-inspection services) sug-
gests that surveillance agencies can be an effective alternative to corrupt
local bureaucracies in the enforcement of trade and tax regulations. 4/

Issues

5. An important issue to be considered in hiring these agencies is
their cost effectiveness. The annual fees charged by these agencies,
usually about 1% of the value of the goods involved, are high. On the
other hand, as noted earlier, there can be important benefits. Some of the
benefits, such as the impact of PSIS on tax revenues and time savings
effected through improved procedures for customs clearance, can be veri-
fied; but others (such as savings made through price checking) are more
difficult to measure. Nevertheless, whenever there is corruption or incen-
tives for trade malpractices on a significant scale, country officials
should be able to make subjective, but still fairly accurate, judgments
about the effectiveness of these agencies. Such periodic evaluations by
clients would help to keep surveillance agencies on their toes. It may
also be desirable to hire more than one agency for PSIS in order to create

3/ However, in those cases where these agencies are vested with the
responsibility for issuing clearances for imports, this may lead to
some degree of price negotiation with suppliers.

4/ In Indonesia, the streamlining of customs and shipping procedures
together with the introduction of SGS' services are generally given the
credit for significantly reducing the time delays and financial costs
involved in handling and clearing imports and exports through the
ports.
some competition and checks and balances. (Venezuela, for example, has hired a number of surveillance agencies for PSIS.) This may, however, require allocating responsibilities for specific tasks among different agencies; and may raise the overall costs of PSIS work.

6. On the negative side, complaints by exporters and importers are frequently an issue. Generally, exporters complain that the inspection work of these agencies leads to unnecessary delays of shipments, deterioration of perishable cargoes and extra costs. Similarly, importers allege that price checking sometimes amounts to blackmail; and that issuance of clearance certificates prior to shipment, particularly at overseas ports which handle the bulk of a country’s import trade, is unduly slow. Such claims generally need to be investigated on a case by case basis. Where there is substance to such criticism, it may be possible to deal with them by requiring the agencies to increase their staffing at critical points, and/or by bringing in new competition for PSIS as noted earlier.

7. What type of PSIS should a government seek to hire? Should it cover imports and/or exports, include inspection of customs codes and tariffs and/or reforms of custom services? This again would depend on the country situation. In most countries the issue of tax evasion is generally less serious than that of capital flight through over- and under-invoicing. Secondly, surveillance agencies enjoy important competitive advantages over local officials in monitoring a country’s imports; and are generally likely to be more effective in monitoring a country’s imports

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5/ Surveillance agencies themselves may not be suitable for providing expert advise on customs reforms. However, there are institutions such as the Customs Cooperation Council which can provide technical assistance and expertise to developing countries on reforming customs.
rather than exports. In monitoring imports, there are important economies of scale; given their large international networks and contacts, these agencies can perform inspection and verification services at overseas points far more efficiently and economically as compared to country officials. Surveillance agencies also provide skills and technical capabilities which are not often readily available in client countries. These advantages over country officials are less clear-cut in monitoring exports. However, where corruption is a major problem, these agencies may provide an effective alternative to local officials in monitoring both imports and exports. Such agencies usually rotate their staff at brief intervals and supervise them better; are motivated to protect their reputations in order to stay in business; and are generally better able to withstand pressures from local interest groups.

8. Another issue which arises in the context of monitoring of imports by surveillance agencies relates to the desirability of price verification. At a general level, the justification for price verification for reasons of policing or preventing capital flight is weak. Private interest in capital flight is generally to preserve the value of private capital; and, while preserving the value of private capital seems also to be in the public interest, governments at times may have somewhat different interests—to suppress symptoms of bad policy. In such situations the desirable option is to introduce appropriate economic reforms rather than to seek to control capital flight through price verification.

9. At an operational level also, there is little justification for price verification in the context of Bank loans, as well as for all competitively bid procurements. Indeed, price verification when applied to
competitive bidding situations can lead to problems. Firstly, the Bank’s guidelines do not permit post-bid price negotiations for ICBs (international competitive bidding) and LCBs (limited competitive bidding) in the context of Bank loans. Secondly, post-bid price negotiation is likely to encourage unsound practices. If suppliers believe that successful bids would be subjected to price negotiations at a later stage, they would add a cushion to their bids to allow for such negotiations; and such price loading will jeopardize the ICB/LCB process. It is therefore desirable that procurements made under competitive bidding are not subject to price verification. They might, however, still need to be checked for quality, quantity and other contractual specifications. Agencies providing advisory services, could also assist borrowers at the cost-estimation or bid-evaluation stages by supplying clients necessary price information.

10. Finally, what role can these agencies play in helping clients to enhance their own capabilities for PSIS through training and technical assistance? A number of considerations are relevant in this regard. Firstly, these agencies do not provide training in customs inspection work. Secondly, before deciding on training needs, it is necessary to determine what the critical constraints are which necessitate a country to hire these agencies. If a lack of technical skills in the country for monitoring of trade flows is the reason for hiring surveillance agencies, training to help improve and expand those skills will ease the bottlenecks. Indeed, in some countries setting up appropriate monitoring systems and providing technical training and equipment may suffice to meet operational needs of Bank loans. On the other hand, if corruption were to be the problem, training by itself will have little impact. Similarly, as noted earlier,
if the need for PSIS stems from excessive regulation, liberalization of the trade regime and capital movements and appropriate tariff reforms would be the most important steps which should be taken first; while training will play a secondary role. Thus, while there are areas where expanded training will provide benefits (for example in monitoring and inspection of exports undertaken in the client countries), the country economist would need to make the judgments on appropriate training needs according to the country situation.

Role of Bank staff

11. The draft OMS 2.43 points out that, given that adjustment loans involve large amounts of money and require simplified procurement and disbursement procedures, appropriate monitoring and verification procedures need to be carefully planned at appraisal in order to ensure that Bank funds are being used economically and efficiently. Therefore, it is the appraisal mission’s responsibility for ascertaining that adequate monitoring systems are in place, and, if they do not exist, in assisting borrowers to help set up alternative arrangements. In this context, Bank staff could assist borrowers in a number of ways. They should review together with country officials existing arrangements and procedures for monitoring the flow of imports and exports; help determine in what areas governments need to be concerned about (prices, specifications, tax revenues, training needs, delays, etc.); the critical constraints in these areas; and what type of PSIS and other assistance the borrowers need. Bank staff could also point out to borrowers the benefits and costs of using PSIS; assist the borrowers in contacting surveillance agencies; help formulate contracts for services appropriate to country needs; and suggest ways to monitor the effectiveness of these agencies on a regular basis.