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# CUSTOMS AND VALUE-ADDED TAX LEAKAGE

TRADE FACILITATION PROJECT

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The author's views expressed in this publication do not necessarily reflect the views of the United States Agency for International Development or the United States Government.

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## ACRONYMS

ACL	Audit Command Language
ASYCUDA	Automated System for Customs Data
CIS	Commonwealth of Independent States
EU	European Union
GATT	General Agreement on Tariffs and Trade
GCC	Gulf Cooperation Council
MALAM	Israeli Customs Automated Entry Processing System
PA	Palestinian Authority
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Program
USAID	United States Agency for International Development
VAT	Value-Added Tax
WCO	World Customs Organization
WTO	World Trade Organization

# I. OVERVIEW AND SUMMARY OF RECOMMENDATIONS

## Overview

USAID launched the three-year Trade Facilitation Project to stimulate and facilitate trade in the West Bank and Gaza. The project uses a number of strategies to improve management of crossing points, build the administrative capacity of the Palestinian Authority (PA), assist the private sector by increasing transparency in government procedures and reducing compliance costs, and promote Palestinian-Israeli cooperation on crossing point management and security.

USAID, acting through the Trade Facilitation Project implemented by Chemonics International, has identified an area where infrastructure improvements and capacity building within the customs and value-added tax (VAT) office of the PA will meet these four requirements.<sup>1</sup> This arises through anomalous situations where customs procedures for Palestinian trade are controlled at the border by Israel, but audited by the PA, and inter-entity VAT transactions are handled under a hybrid system by both tax authorities.

To investigate the impact of these unique conditions on trade within the region, Chemonics assigned a customs/tax administration and policy expert with more than three decades of experience in this field and over 10 years of experience working in these disciplines in the Middle East and Eastern Mediterranean.

The overarching objective of this consultancy was to review the customs and VAT declaration and revenue collection processes in the West Bank and Israel and to make recommendations where further funding and assistance should address revenue leakage or enhance trade. This objective was divided into three sub-objectives:

- Review customs and VAT procedures for potential revenue and/or other strategic risks, then develop strategies to protect PA Customs and VAT revenue from inadvertent and/or deliberate actions to minimize legitimate revenue flows.
- Review and comment on ongoing efforts of Israeli Customs and others on post-audit, classification, investigation, and other capacity-building programs. Recommend ways the project can assist going forward.
- Advise on a public awareness campaign targeting the entire population on the role of customs and the importance of compliance with customs regulations and taxing those regimes that enforce compliance and raise revenue.

To achieve these requirements, the consultant used an international auditing methodology to review the unique operations in this complex financial situation, a systems-based audit procedure recommended by the World Customs Organization (WCO). The consultant followed a step-by-step procedure in preparing this report:

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<sup>1</sup> These conclusions are supported by the Konrad Adenauer Stiftung. See *Palestinian Private Sector Agenda: Immediate, Short- and Medium-Term Requirements: Industrial Policies*, published jointly in March 2008 with the Palestinian Federation of Industries.

- The first step began with a series of interviews (see Annex A for a list of all meetings held) to gather data on key procedures and then confirm the accuracy of the information through data triangulation. This investigation was limited to the areas falling within the objective and sub-objectives set out above.
- Next, flowcharts were developed from each of the procedure descriptions and these configurations were subsequently confirmed with interviewees who were nominated as subject experts in each case. Experts were drawn from senior Palestinian and Israeli technocrats and members of the trading community.
- Experts performed a risk analysis on the procedures identified, then developed technical solutions for documentation as recommendations in cases where cost-effective solutions were possible to avert risk.
- Experts then validated these technical solutions for practicality. This process led to the production of this report.

### **Summary of Recommendations**

Broadly, the recommendations are set out below in their preferred order of implementation. By carrying them out in this order, later recommendations can build upon the foundations established by earlier activities. These recommendations do not address the related and equally important problems of penalties and enforcement that will arise once the data obtained under Recommendations 1, 2, and 6 identify businesses that are failing to meet their compliance requirements as this was not a subject covered by this work.

There are seven recommendations arising from this work. The four most complex (numbers 1-4) are covered in summary form in this section. Three less complex recommendations (numbers 5-7) are covered completely in this section. Additional information indirectly related to the recommendations is covered in the annexes. The overall structure of the report is shown on the next page in Figure 1.

Currently, the PA Customs operates under a mixture of modern and traditional customs systems. Out of necessity, PA Customs has adopted the best practice for revenue compliance using post-clearance audit to ensure that revenue due is collected. Consequently, PA Customs is one of few Arab customs administrations with the capability to develop an efficient, business-friendly system of controls.

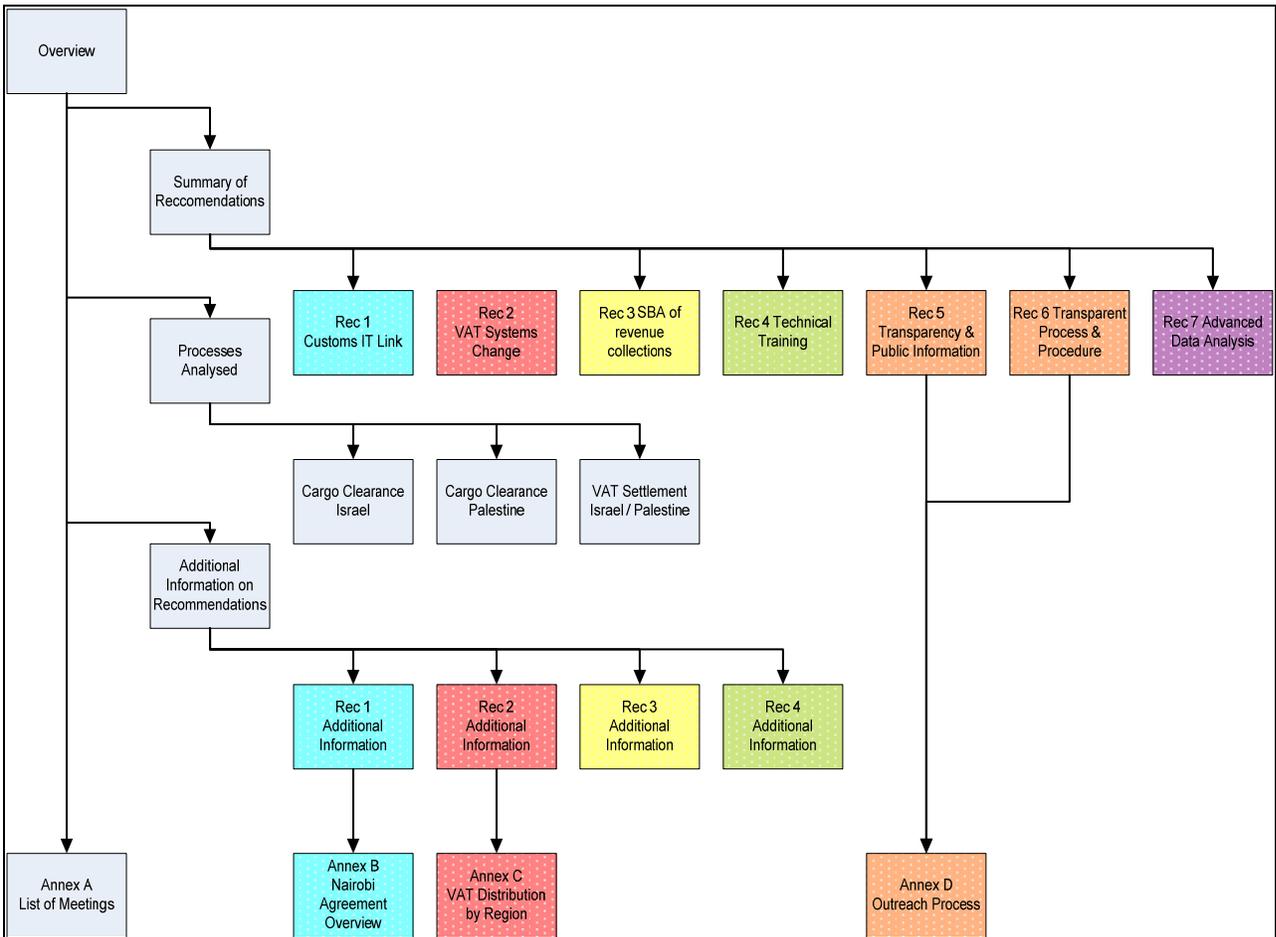
Unfortunately, full exploitation of this potential is handicapped because presently all operations are paper-based, which seriously reduces customs development capacity<sup>2</sup> for efficient analysis, targeting, and information sharing.

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<sup>2</sup> This opinion is also supported by the World Bank. See the final report of the World Bank Trade Mission sent to the Minister of Finance on April 23, 2007.

Israeli Customs is willing to provide electronically all the customs declaration data on goods declared for the West Bank once this measure is approved by the Israeli government. Initially, this will be done monthly as happens now in a paper-based format.

**Figure 1: Structure of the Report**



## Recommendation 1

On this basis, Recommendation 1 is to provide funds for equipment and technical support to implement secure electronic data transfer and shorten the reporting period over time. Initially, this period would be reduced from monthly to weekly reports, then to daily, and finally to almost “live” declarations. This would improve customs compliance processes and Ministry of Finance cash flow planning.

This process must be completed by mid-2009 because then PA Customs will upgrade its database from ASYCUDA ++ to ASYCUDA World, which is compatible with Internet input. If by that time data is not available electronically from Israeli Customs, then PA Customs may force businesses to re-key their declarations into ASYCUDA, thereby

increasing business compliance costs. In the longer term, data interchange should also extend to a “Nairobi” style agreement between the Israeli and Palestinian customs authorities. A more detailed explanation of this recommendation is provided in Section II of this report, “Major Recommendations in Full,” starting on page 15.

## **Recommendation 2**

Recommendation 2 covers inter-entity VAT where there is presently a paper-based settlement system operating broadly under Article VI Paragraph 5 of the Gaza-Jericho agreement. This sets out treatment<sup>3</sup> of VAT on cross border sales.<sup>4</sup> It uses the procedures for internal transactions in each entity, but this is augmented by the use of an accountable control document called the Unified Invoice issued by the VAT office on both entities.

Unfortunately, this paper-based system has none of the control aspects of zero-rating for export, and it also lacks a national supply chain of supporting documents for audit purposes.

Several Palestinian business interests are of the opinion that the current system represents a collective revenue loss to the West Bank and Israel of up to 30 million NIS per month. Consequently, there is justification for the development of a secure Web- and telephone-based electronic control system for both sides. A detailed explanation of this recommendation is provided in Section II.

## **Recommendation 3**

Recommendation 3 arises out of the unusual method used by Israeli Customs to collect customs duty and VAT. Israeli Customs collects duty at the same time the declaration is lodged rather than when the transaction is finalized. This means that some adjustments to revenue, particularly those occurring at the regional level, are paper-based and these appear not to be captured in Israeli Customs’ MALAM database. Consequently, adjustments may not be reported onward to PA Customs.

Israeli Customs recognized this problem and has prepared some material on short payments occurring in Israel that can be collected in the West Bank by PA Customs. However, there is evidence to show that some paper-based revaluations are occurring in Israel and these are not all captured and reported electronically. It is likely the same situation exists in the West Bank when adjustments are made post-audit. To resolve this matter, the Trade Facilitation Project should provide a system auditor to review the post-clearance revenue recording systems for PA Customs and Israeli Customs to identify and document all paper-based revenue receipts and establish how revenue is captured electronically in MALAM and ASYCUDA. If revenue is recorded into some other

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<sup>3</sup> For simplicity, in this section, the transaction is a purchase in Israel that will have further value adding or final consumption in the West Bank. If the situation is reversed and the transaction commences in the West Bank, the argument remains the same.

<sup>4</sup> This article deals with indirect taxes on local production only but, sensibly, its application has been extended to all goods, including imports consigned to one entity but subsequently sold to the other entity.

financial recording system, then it must be ascertained how this information is fed into the overall revenue reconciliation system between the entities. If necessary, this should be done by developing new reporting procedures. A detailed explanation of this recommendation is provided in Section II.

#### **Recommendation 4**

Recommendation 4 concerns training and capacity building within the PA Customs. As with any new organization, there is an extensive need for cost-effective capacity building. This can be best achieved by using the most appropriate training sources suited to each case. As there is extensive international technical support available, the Trade Facilitation Project should restrict its involvement to providing appropriate funding and infrastructure to ensure that each course meets very specific requirements with limited exceptions.

For customs, generally the most complex training issue concerns tariff classification and locally prohibited and restricted goods. Within the common customs envelope, all training in these subjects should be done by Israeli Customs in the foreseeable future.

For other internationally “standard” customs subjects—ethics and standards, risk management, business and commodity analysis, post-clearance audit, and related trade subjects—organizations like the European Union (EU), the United Nations Development Program (UNDP), and the WCO should be supported almost automatically since their presentations will normally meet World Trade Organization (WTO) and WCO requirements as long as they meet acceptable standards of quality and detail.

However, where it is cost-effective, regional expertise from Egypt, Jordan, and Morocco should be considered for these subjects and for matters like the regional free trade agreements, although this should be done only after the material to be presented is reviewed for any possible conflicts with U.S. policy objectives.

As an exception to the general terms of this recommendation, the Trade Facilitation Project should provide direct support to ensure the correct handling of the requirements of the U.S. free trade agreements in the region since their origin requirements differ from those in the inter-Arab and EU agreements and are considerably more complex than those in the inter-Arab agreements.

To maximize the investment value for every case, project funds should be invested in training staff who are capable of training other staff and the public in the subject matter. In about two years, after there is a reasonable amount of electronic data accumulated for the purpose of more advanced analysis, training should be developed as set out in Recommendation 6.

#### **Recommendation 5**

Recommendation 5 concerns PA Customs transparency and public information distribution. It is also related to Recommendations 1, 2, and 4. It covers PA Customs’

potential Internet portal, the future upgrade to ASYCUDA World, and the establishment of a public liaison facility for client advice.

ASYCUDA World is scheduled for implementation mid-2009. It is designed so that PA Customs can service its customers through the Internet. PA Customs is developing its own website; comments here suggest areas where the Trade Facilitation Project can support site development as a source of information and transparency. For example, the prospective website can be used for the declaration confirmation process covered in Recommendation 1.

For greater transparency in customs procedures, the website information should be provided in the principal trade languages of the region—Arabic, Hebrew, and English—as an essential source of client information and a starting point for discussions between Customs and its clients. In addition to providing a technical portal for customs and tax declarations, the following information should be available:

- The customs tariff (this may be available at the ASYCUDA website; if so, a hyperlink to it may be adequate)
- All customs regulations and all tax laws (e.g. VAT)
- Details of customs and tax procedures and penalties (a hyperlink to the Israeli site may be adequate)
- An explanation of any concessional arrangements available, including free trade agreements: generally this will consist of a link to the ministries of trade, foreign affairs, health, or other organization responsible besides customs
- Downloadable copies of all customs documents
- Links to government authorities in the West Bank and neighboring countries.

If any of these facilities are found on another website, then links between these sites should be established.

PA Customs should also establish a public liaison facility that can arrange qualified officers from its head office and regional offices to present short seminars to the public and members of government on customs and tax-related subjects. This facility would not serve as a press office. A detailed explanation of the last part of this recommendation is provided in Annex D, “Outreach Process.”

## **Recommendation 6**

Recommendation 6 would increase transparency and public understanding of taxes and customs role as a follow-on to Recommendation 4. It would expand awareness of modern customs processes within PA Customs and within its client base through a series of one-hour presentations that must be developed after each course for presentation to other staff and the public.

The technical training covered in Recommendation 4 is principally intended for internal capacity building and should be further developed to meet PA Customs’ commitment to

public transparency. If PA Customs is willing to develop the presentations discussed in Recommendation 4 in a format suited to businessmen, government, and other stakeholders, the Trade Facilitation Project could provide some basic equipment assistance. It should also include training in the development of such presentations. These introductory presentations could then be provided routinely by a pair of trained customs officers, one each from head and regional offices. An example of how an outreach program could proceed is set out in Annex D.

### **Recommendation 7**

In about two years, when an adequate amount of electronic data has been accumulated, advanced analytical training can begin. This can focus on revenue management, post-declaration audit, and purposes relevant to sections of PA departments of finance, customs, and tax. Officers should be trained in and have access to Audit Command Language (ACL) software and be trained in business statistical analysis.

ACL software can be used to search and manipulate data provided by Israeli and West Bank businesses, which could be used for both revenue and risk analyses. Training in statistics and analysis should provide the following benefits:

- More accurate cash flow analysis and “what if” modeling using the enhanced statistical information available. This will also enable advanced planning for changes to the tariff and tax regime (i.e. increased pan-Arab free trade).
- Industry-based audit targeting through trend and secular analysis of businesses against industry norms.

In both cases, for the relevant training, rules set out in Recommendation 4 would still apply.

### **Terminology**

A number of customs operations terms vary in the region from country to country. To reduce confusion explanations follow:

- *Broker/agent/officer.* In Israeli and British English, the term customs agent means a person employed by an importer or exporter to process cargo through customs and other agencies. In American English, this term means an operative of the customs authority. The American usage of customs agent and broker is applied here.
- *Entry/declaration/bill of entry.* In Israeli and British English, the term “entry” means the electronic or paper document used to effect a clearance from customs. In American English, the term normally used is “declaration.” In some Arab countries, the term used is “bill of entry.” The American declaration is used here.

## System Review

The current tax and customs control systems operating in Israel and the West Bank are based on Annex IV of the Gaza-Jericho Agreement 1994.<sup>5</sup> This establishes a tax and trade zone broadly similar to those established in this region by the EU<sup>6</sup> or the Gulf Cooperation Council (GCC).<sup>7</sup>

The common feature of each of these tax/trade zones is that liability is established for declaration and payment purposes at the point of origin. Declaration and payment of taxes is made at the point where the goods enter the trade zone, but the tax revenue is allocated under the destination principle to the point of final consignment. This is in line with the principles recognized by the WCO and originally established under the General Agreement on Tariffs and Trade (GATT).

Following are examples of how this is applied in practice:

- An import consigned to either member will be declared at the first point of entry even if that is in an area where the customs service of another member operates.
- Transaction auditing, security processing, all duties, taxes and fees are collected at this point.
- Once cleared, the goods are moved on to the consigned destination by the quickest practical method and routed to the place where they are consigned. There are normally no special transit requirements for passage or transit security/guarantee required.
- Internal sales of goods between members are taxed at the “local” rate at the point of sale rather than zero-rated as exports.
- Disposal in any member other than that to which it is consigned or on-sold is an offense against the law of the member where disposal occurs.
- An additional declaration is required in the place of consignment on delivery or at some specified time thereafter.
- Revenues are periodically verified and outstanding balances settled.

This system is by necessity complex and takes considerable time and effort to operate correctly. As an example, the European Common Market adopted this process in 1995 but was still finalizing the procedures in 2001. Similarly, the GCC is still having procedural difficulties in implementing its settlement system.

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<sup>5</sup> For the full official version, see:

<http://domino.un.org/unispal.nsf/eed216406b50bf6485256ce10072f637/15af20b2f7f41905852560a7004ab2d5!OpenDocument>.

<sup>6</sup> The EU’s customs legislation is contained in Council Regulation (EEC) No 2913/92 and Commission Regulation (EEC) No 2454/93. An up-to-date English version of 800 pages is available at [http://ec.europa.eu/taxation\\_customs/customs/procedural\\_aspects/general/community\\_code/index\\_en.htm](http://ec.europa.eu/taxation_customs/customs/procedural_aspects/general/community_code/index_en.htm).

<sup>7</sup> The Common Customs Law for the Arab States of the Gulf. For a legal English translation, see [http://pilot.dubaitrade.ae/portal/customs/GccExemptedList.jsp?lang\\_code=en](http://pilot.dubaitrade.ae/portal/customs/GccExemptedList.jsp?lang_code=en). There is also an Arabic version on this website.

## Customs and VAT Procedures

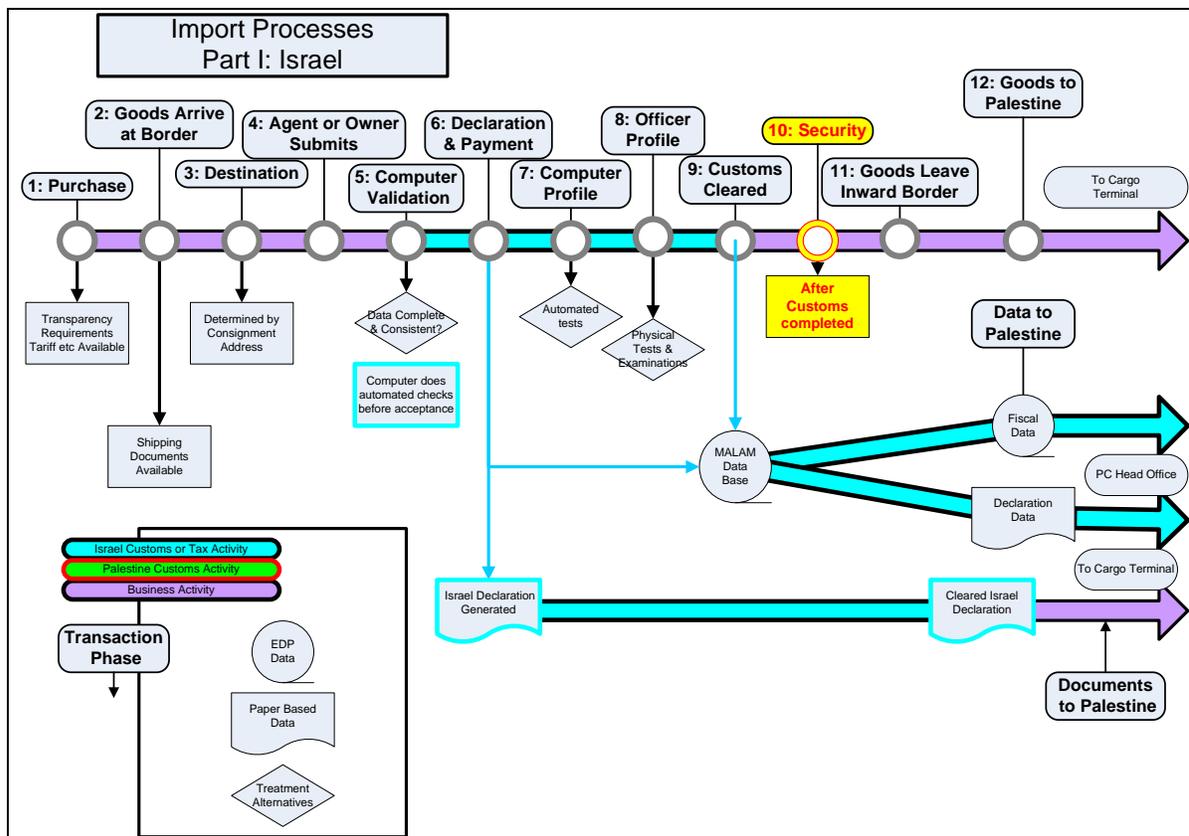
Set out below is a description and analysis of the integrated Customs Clearance and VAT declaration systems in use in the West Bank and Israel. This system description and analysis provides the background information upon which the various recommendations are based.

For simplicity here, each diagram below examines only the goods moving from Israel to the West Bank, although an identical process also applies to goods moving in the opposite direction where appropriate. These processes have been confirmed with either Palestinian or Israeli Customs, as appropriate.

### Cargo Clearance in Israel

Figure 2 below summarizes the actions required by an importer (or the importer's agent) and by Israeli Customs for goods consigned to a final destination in the West Bank or Israel.

**Figure 2. Import Procedures of Israeli Customs**



In Figure 2, the process is identical for all transactions up to point 11 for both Israeli and West Bank consignments. The figure shows the flow of goods, documents, and electronic data. In this process, revenue risks are identified as described below.

*Point 1—Purchase.* Details of tariff, trade regulations, procedures, and penalties are not easily available to the public. This means that the costs and risks for business decision-makers are higher than if adequate information was easily available. This may increase the risk of revenue evasion and associated fraud and smuggling. A possible solution is contained in Recommendation 5 concerning transparency and public involvement.

*Point 3—Destination.* Israeli law requires that goods consigned to the West Bank are declared as such, and full customs data on these declarations are delivered in paper format from Israeli Customs to PA Customs once a month. The use of paper-based information impedes PA Customs’ targeted and risk managed audit. See Recommendation 1 for a possible solution to this risk.

This solution is incomplete, however, as the law does not allow for full disclosure of goods consigned to Israel by West Bank nationals, and then moved subsequently to the West Bank where there is intent to commit fraud.<sup>8</sup> This second leakage will be difficult to resolve as it extends beyond customs law to privacy issues. It may be resolved on an ad hoc basis in cases of major fraud, particularly if a Nairobi Agreement is developed. For more information on such an agreement, see Annex C, “An Overview of the WCO Nairobi Agreement.”

*Point 6—Declaration and Payment.* Israeli Customs automatically collects customs duties and other relevant taxes at the same time as the customs declaration (entry) is formally accepted by the computer. While under some circumstances, this document is amended before it is finalized, there are many cases where duty adjustments occur after the clearance is completed. These adjustments are frequently only recorded on paper and so may not be captured, although Israeli Customs is working hard to capture and report on these outstanding materials. A more holistic solution is proposed in Recommendation 3.

*Point 12—Goods to the West Bank.* Data in Israeli Customs’ MALAM database is transmitted from Israeli Customs to PA Customs in two parts at the end of each month. Basic financial data on each declaration is provided at the end of the month electronically. Full details of each transaction are also provided in a paper format.

Israeli Customs is currently seeking approval to transmit this data in electronic format, which USAID should encourage for the following reasons:

- At least 4,000 documents are generated per month; it is impractical for PA Customs to consistently and efficiently manipulate this data in paper form. If the same information in electronic form is loaded into ASYCUDA, it can be used immediately for post-clearance audit and public safety purposes.<sup>9</sup>

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<sup>8</sup> Given the slow clearance of Palestinian goods in Israel when there are technical restrictions like health or quarantine matters, it is common practice to consign goods to Israel simply to allow for faster clearance.

<sup>9</sup> The UNDP has confirmed that such a transmission is possible with minor software work required first.

- In 2009, the UNDP will upgrade PA Customs ASYCUDA from ++ to World, making it possible for PA Customs clients to declare directly. There is a high risk if data from Israeli Customs' MALAM is not available at that time. PA Customs may require West Bank clients to re-key the data, which imposes upon them a significant cost of compliance.

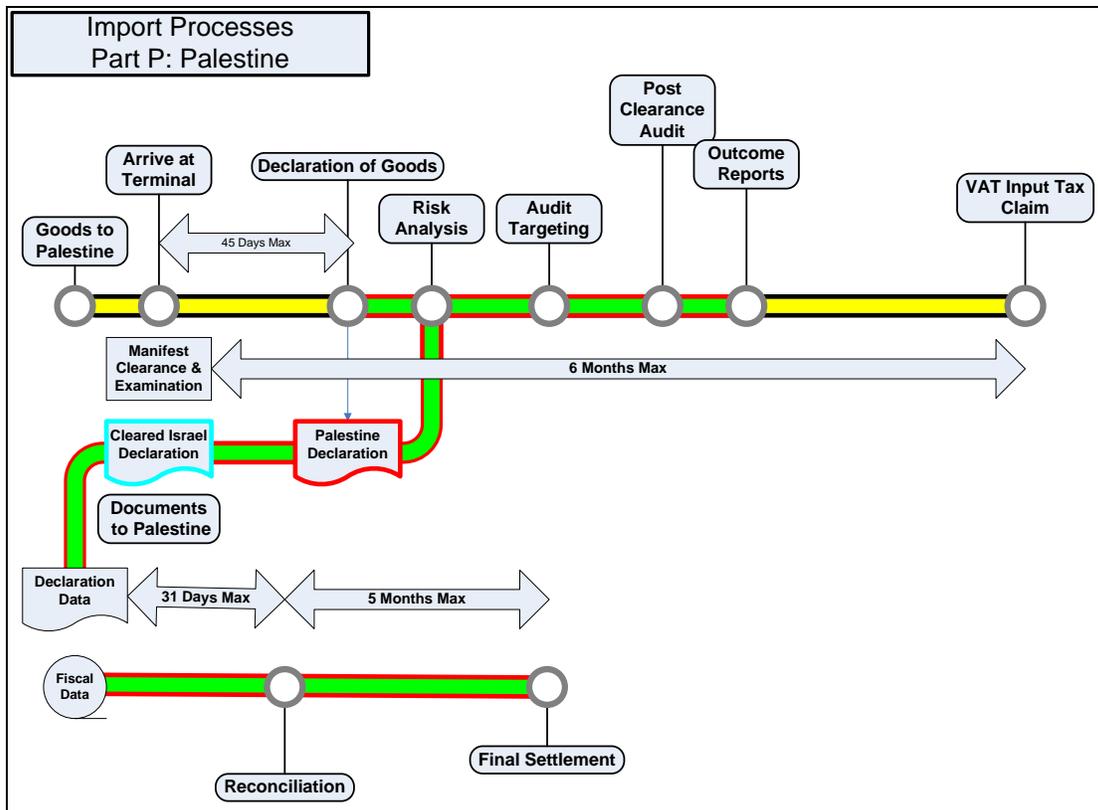
Presently, the electronic data is sent to PA Customs by e-mail because the Israeli government is unwilling to allow a foreign entity direct access to its confidential database. This problem is addressed in Recommendation 1.

### Cargo Clearance in the West Bank

Figure 3 below summarizes the actions required by an importer (or the importer's agent) and by PA Customs for goods consigned to a final destination in the West Bank. It also shows the flow of goods, documents, and electronic data originating in Israel.

The principal weaknesses in the PA Customs system are an adequate supply of data and experienced personnel. The most essential requirement is the full import of data in an electronic format to allow for sophisticated analysis and the supply of that data in a timely manner to allow for targeted audits and other interventions at the earliest possible point after a declaration is made. The problem of timely delivery of electronic data is covered by Recommendation 1, while the problems of risk management and analysis are covered in Recommendations 4 and 6.

Figure 3. Import Procedures of PA Customs



## VAT Clearance between the West Bank and Israel

Figure 4 below summarizes the actions required by a buyer and seller (or their respective agents) and by both customs agencies for goods purchased in one country but intended for a final destination in the other. This figure shows the flow of goods, documents, and electronic data in a simplified format.

**Figure 4. VAT Process for Sales between Israel and the PA**

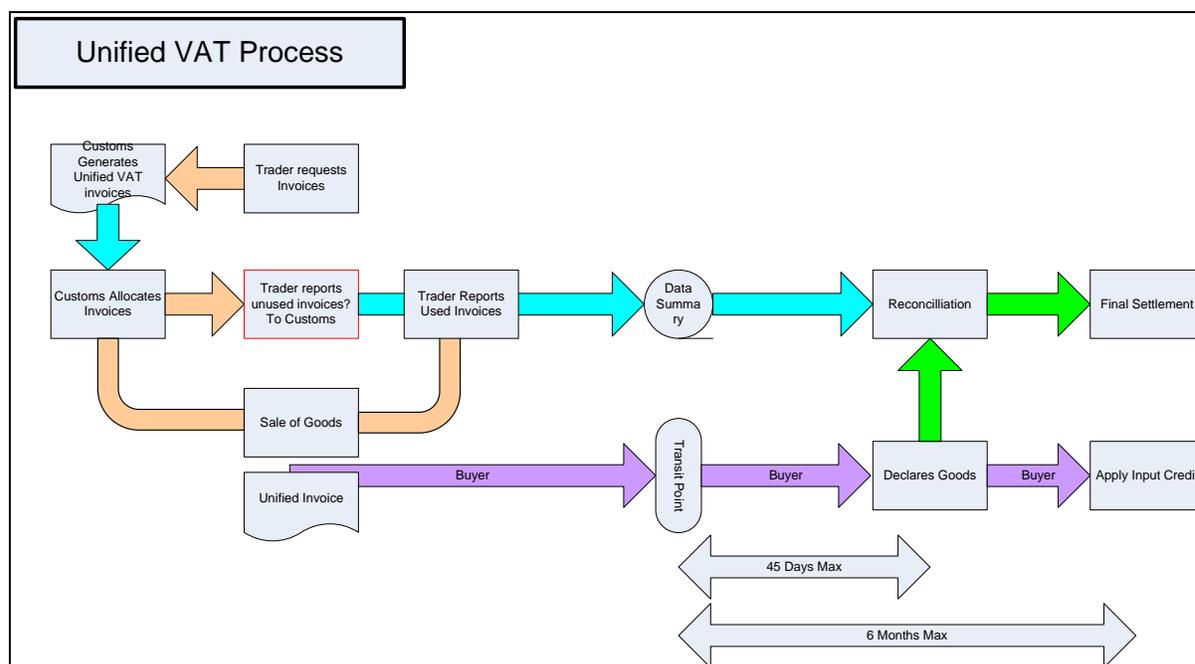


Figure 4 charts the procedures for internal transactions in each entity, but this is augmented by the use of an accountable control document called the Unified Invoice, which is issued by the VAT office in both entities. These are the procedural steps in the order they are followed:

- Palestinian and Israeli tax authorities print numbered Unified Tax Invoices that include security features in their design to reduce malfeasance.
- VAT registered taxpayers apply to tax authority for blank forms and a quantity related to their previous business dealings are normally supplied.
- The seller of goods concludes a sale to a buyer that includes, in some way, a supply of goods that will end up in the other entity.<sup>10</sup>
- The seller takes payment<sup>11</sup> for the goods and also tax payment of the VAT due as if this were a normal internal transaction but, in addition to the normal documentation, the seller prepares a Unified Tax Invoice and provides a copy of this to the buyer.

<sup>10</sup> It does not matter here if the supply occurs in Israel and the goods are taken across the border by the buyer to the West Bank, or if the supplier undertakes to deliver the goods himself to the West Bank. Also, it does not matter if the buyer or seller is Israeli, Palestinian, or of another nationality. Origin and destination determine the applicability of this treatment.

<sup>11</sup> For the purposes of this example, it does not matter if payment is immediate or at some future date.

- This transaction is then reported as part of the seller’s normal periodic VAT return and the VAT collected is paid into revenue in the normal way.
- Declared Unified Tax Invoices are then included in the monthly revenue reconciliation arrangement between the respective Ministries of Finance.
- Meanwhile, the buyer of the goods is required to declare the details on the Unified Tax Invoice within his/her own VAT settlement during a period that may be up to 45 days after the goods move through the transit point. Once declared, the buyer has six months from the date of transit to use the VAT as input tax credit or the credit will expire.

Unfortunately, this paper-based system has none of the control aspects of zero-rating for export and it also lacks a national supply chain of supporting documents for audit. There is a very high risk that sellers of goods “misplace” the invoices and pocket the tax collected, or that buyers can over-claim VAT paid or make up their own fraudulent invoices to claim extra input tax credits.

It is difficult for the tax authority to validate these details as all valuation information is held by the seller in the other entity. This process was originally established under the Gaza-Jericho Agreement and is fully paper-based. A complete analysis of its problems and potential solutions is covered in Recommendation 2.

## II. MAJOR RECOMMENDATIONS IN FULL

### Recommendation 1

To enable the introduction of risk-managed compliance and targeting,<sup>12</sup> each customs authority should be able obtain electronic access to declarations within the approximate same timeframe that they are made to the other authority.

Under Annex IV, Article III, Section 15<sup>13</sup> of the Gaza-Jericho Agreement of 1994, a monthly “clearance” of import-related revenues is made between Israel and the West Bank on about the 28<sup>th</sup> day of each Gregorian calendar month.

Israeli Customs supplies to PA Customs on paper full details of every customs declaration made in Israel with a final destination to the West Bank. Israeli Customs also supplies basic financial data in electronic form. The financial data transfer is through e-mail to protect the Israeli National Commercial Database from external intrusion.

Israeli Customs is willing to consolidate and supply electronically on a monthly basis full declaration data for every customs declaration and to send this too as an e-mail. Israeli Customs is making a request for approval from a higher level of authority in the Government of Israel to move forward with this.

The Trade Facilitation Project should support Israeli Customs in this effort and, upon authorization, should assist both Israeli Customs and PA Customs with hardware and software to enable data transfers to become more frequent, more secure, and eventually fully operational in both directions. The steps envisaged to achieve these outcomes are as follows:

- For stage one, after the Israeli Customs proposals are approved, it will take a few months for the new monthly electronic routine to become accepted.
- During this period, the Trade Facilitation Project should offer support through the supply of one-way (dumb) terminal servers and removable hard drives to each organization, along with related security software. This will enable a fully quarantined system, where data can be sent from MALAM (Israel’s customs database) and SHAM (the VAT database) to a terminal located at an Israeli site. This connection will allow data in one direction only so that the terminal cannot be used to access or interfere with the upstream Israeli systems.

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<sup>12</sup> Currently, the UNDP and UNCTAD plan to provide risk management training for PA Customs staff in early 2009.

<sup>13</sup> Full text of the agreement is at various sites, including the official UN English version at: <http://domino.un.org/unispal.nsf/eed216406b50bf6485256ce10072f637/15af20b2f7f41905852560a7004ab2d5!OpenDoc>.

- This accumulated data will then be periodically encrypted and sent to a similar terminal under PA control. Once the incoming data's integrity is assured, it can be uploaded into ASYCUDA by PA Customs.
- After the arrangement for monthly electronic interchange is fully debugged and is accepted, the period for data "dumps" should be reduced initially to weekly, then to daily, and finally to almost immediate supply of information.
- When ASYCUDA World becomes operational with PA Customs in mid-2009, it would be possible for owners or their customs brokers to access and validate these declarations "Made in Israel" as their correct Palestinian declarations, or amend them as appropriate. Significant amendments are normally treated as "blue line" transactions and are highly likely to be audited.
- This process will allow PA Customs analysts to electronically access more than 4,000 new declarations each month, allowing comparisons of declarants by region, industry, business size, and any other relevant criteria. As an example, if this data was available at present, the customs police could easily obtain samples from imports of foodstuffs from China to check for adulteration with melamine.
- The Ministry of Finance would benefit from becoming informed of short-term future cash flows much sooner than it is now, which would allow it to make better forward estimates and more reliable debt settlements.
- If PA Customs take over reporting arrangements at the border sites, the system described above could be replicated in reverse using the procedures.
- Once a reasonable degree of trust over data exchange is established between the two customs authorities, this limited data interchange can be extended and deepened through the use of a "Nairobi" type agreement on the exchange of information and assistance. This may be developed in a similar format to those that the United States has executed with Israel and Jordan.

### **Benefits of Recommendation 1**

*PA Customs* would have almost live information on its entire client base for analysis and targeting purposes, thus enabling customs analysts and auditors to more accurately and effectively target evasion and under-declaration. Customs police would be able to more easily identify and target dangerous, prohibited, and restricted imports and exports. Assuming that this enhancement identifies evasion amounting to 5 percent<sup>14</sup> of current declarations, the result is a positive revenue yield between 14.5 and 20.8 million NIS a

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<sup>14</sup> Estimate based on research on evasion rates in the EU by David Peacock, published in *The Journal of Financial Crime* in 1997. It is unlikely that local evasion rates are lower in Israel or the West Bank. In Jordan, the standard "shrinkage" in transit cargo moving to Saudi Arabia and Syria is estimated at 30 percent.

month<sup>15</sup> over time as personnel acquires and builds greater expertise. As the World Bank has observed: “Presently, ASYCUDA is using only the green (clear) channel, but if data is available electronically then red (high risk) and blue (audit) channels can also be operated. In this way, the current basic risk management system can be automated and made more sophisticated.”

The *PA Ministry of Finance* would receive more up-to-date information on its major revenue source.<sup>16</sup>

*Israeli Customs* will benefit, particularly after a Nairobi Agreement is arranged, through the more rapid two-way flow of data, which will facilitate targeting and analysis capacity. In addition, PA Customs can provide live advice and assistance to Israeli Customs on Palestinian technical and risk factors falling within its area of expertise as data are analyzed and risks are identified.

*Business owners* will benefit since Palestinians can finalize their declarations online, thus reducing compliance costs. If PA Customs does not gain access to adequate data from Israel, there is a risk that importers will be forced to re-declare and re-key their information into ASYCUDA World when it comes online, thereby adding to their compliance costs.

## **Recommendation 2**

In the inter-entity sales regime for VAT, the use of Unified Invoices should be more tightly controlled by moving from a paper-based system to an electronic system of accountability. The present system of Unified Invoices used for trade in goods in either direction between Israel and the PA has developed a system of VAT accounting that is unique to this trade. While it is broadly similar to the system previously used in the Commonwealth of Independent States (CIS),<sup>17</sup> it differs significantly from the processes normally applied under international trade and recommended by the WTO.

The Unified Invoices procedure varies from normal international practice as follows:

- Normal VAT practice is for registered VAT taxpayers to issue standard tax invoices containing proscribed details<sup>18</sup> for every taxable sale made in the country if for internal consumption, value adding, or for export by that business.

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<sup>15</sup> Based on data provided by PA Customs, this is calculated as follows: Customs duty = 4-7 million; import VAT = 5-7 million; petrol tax = 5-5.5 million; cigarettes = 0.45-1.3 million.

<sup>16</sup> Using PA Customs figures for the first three quarters of 2008, customs duty is 27 percent of total revenue; import VAT is 21 percent; internal VAT is 9 percent; cigarette tax is 5 percent; and petrol tax is 27 percent.

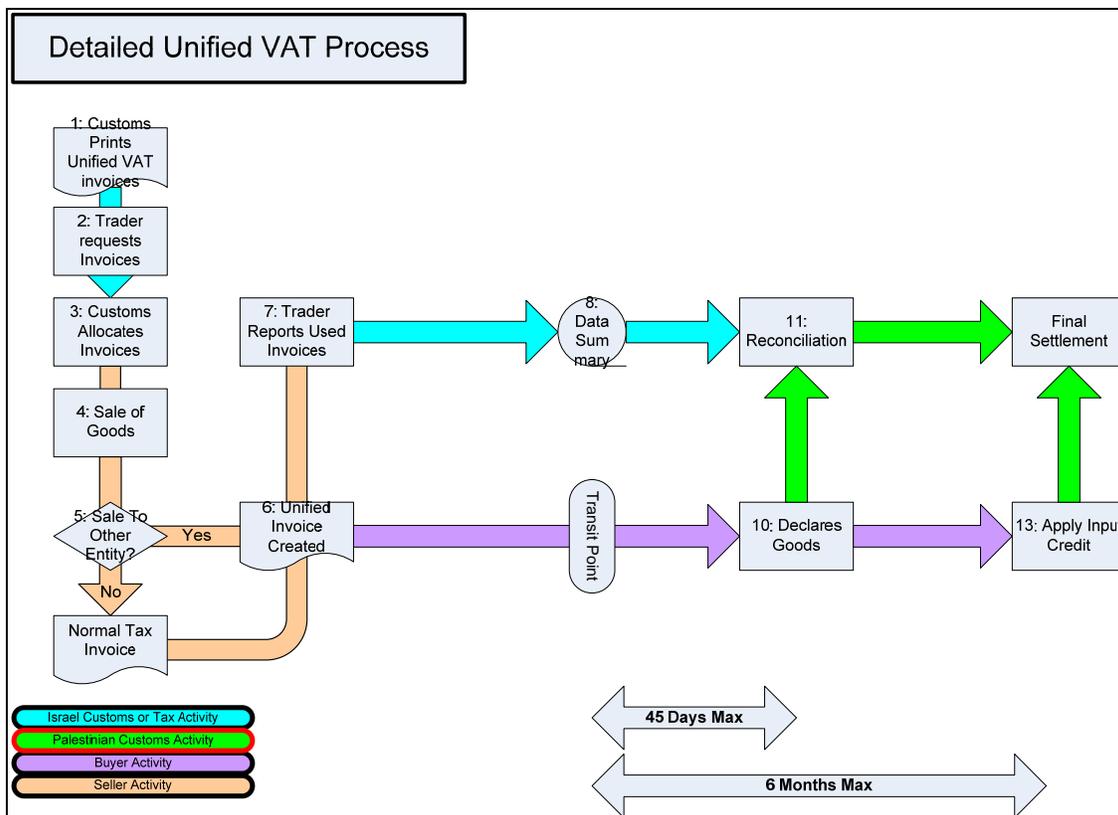
<sup>17</sup> CIS is the trade bloc made up of the former members of the USSR. Most of this bloc initially applied the “Origin Principal.” It has now been abandoned by most members but remains in use between Russia and Belarus. It was also proposed but rejected for Serbia and Montenegro prior to separation.

<sup>18</sup> At a minimum, taxpayer (seller) name and tax number, brief description of goods and/or services, taxable value or sale price of the goods, VAT rate used and whether the sale price includes or excludes VAT. For sales of a significant value, buyer details, including taxpayer number (if relevant), may also be required.

- Normal VAT practice for exports is to allow such sales to be zero-rated,<sup>19</sup> provided that it can be proved that the goods in question have left the country. This proof is normally done through a standardized customs procedure at the border or at a post office/shipping agency.

This is the procedure that would be used at present for a sale of goods from the West Bank or Israel to a Jordanian company or to an American tourist. However, there is a different system used for transactions between Israel and the West Bank and the reverse. Note that the information that follows is a more detailed repetition of the procedures originally covered on pages 13 and 14 of this report. From these current procedures, changes are then developed. Figure 4 is expanded into Figure 5 below.

**Figure 5. Detailed VAT Process for Sales between Israel and the PA**



<sup>19</sup> That is, the rate of VAT on this final national sale is 0 percent. This means that any VAT previously paid is available as a tax credit or refund to either the buyer or seller, depending on the terms of their sales contract. In some countries, refunds are also available on customs duty and on excise taxes (generically called “drawback”). This procedure is allowed for all WTO member-countries under the terms of GATT as part of the process of national treatment.

The system used for transactions between Israel and the West Bank involves the following steps:

1. PA and Israeli government tax authorities separately print in bulk numbered Unified Tax Invoices. These include security features in their design to reduce malfeasance.
2. VAT registered taxpayers apply to the relevant tax authority for blank Unified Tax Invoices in the entity where they sell goods.
3. A quantity of unified invoices related to their previous business dealings is normally supplied.
4. The seller of goods concludes a sale of goods to a buyer that includes, in some way, a supply of goods that will end up in the other entity.
5. The seller takes payment<sup>20</sup> for the goods and also tax payment of the VAT due as if this were a normal internal transaction.
6. In addition to the normal sales documentation, the seller prepares a Unified Tax Invoice and provides a copy of this to the buyer.
7. This transaction is then reported as part of the seller's normal periodic VAT return, and the VAT collected is paid into revenue in the normal way.
8. Details of declared Unified Tax Invoices are then included in the monthly revenue reconciliation arrangement between the respective Ministries of Finance.
9. Both tax authorities periodically follow up on undeclared Unified Tax Invoices. However, there is no fixed follow-up period.
10. Meanwhile, the buyer of the goods is required to declare the details on the Unified Tax Invoice within his/her own VAT settlement during a subsequent period.
11. Monthly data from Step 9 is reconciled with declarations received in Step 10.
12. Formal declaration may be up to 45 days after the goods move through the transit point. This means that reconciliation may be delayed for at least two months. If this occurs, then there are only three months available to identify errors or fraud before the invoices become "stale" and are no longer available for funds transfer.
13. Once declared, the buyer has six months from the date of transit to use the VAT as input tax credit or the credit will expire.

Because the system described above is paper-based, it is not possible to retain electronic oversight for all the used and unused Unified Tax Invoices in the marketplace, which leads to major opportunities for tax evasion:

- Sellers of goods "misplace" the invoices and pocket the tax collected. Subsequently, if an audit seems likely, sellers can make a late declaration and pay any penalty. As sellers conduct the last transaction in the national supply chain, their chances of detection are lower than for any intermediate business.
- Buyers of goods can over-claim VAT paid or make up their own fraudulent invoices to claim extra input tax credits. It is difficult for the tax authority to validate these details since the seller in the other entity holds all valuation information.
- The normal reconciliation method of following transactions down a logistical line are made more difficult here because of the nature of the border system in place; this

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<sup>20</sup> Payment in this case includes a sale on credit or for any non-cash consideration.

means it is not possible to follow a transaction across the border to its next transaction.

The solution to this problem<sup>21</sup> is to use modern automated systems and require buyers and sellers operating under this system to declare the transaction when it occurs. The proposed procedure will only add a small amount to business compliance costs, but will make evasion far more risky.

The proposed procedure would be the same as that in use at the moment, except that a step between Steps 5 and 6—a new additional Step 5a—would be added. This would require the seller to contact the tax authority by phone or Internet to validate and finalize the Unified Tax Invoice before it can be issued. Both of these systems would be fully automated. At this point, the seller would advise:

- Seller's tax file number and password
- Buyer's tax file number and password<sup>22</sup>
- Unified tax invoice number
- Value of the sale, including tax
- Tax amount included in the sale price<sup>23</sup>

Once this information is provided, the system would validate the two username-password sets.<sup>24</sup> Once the tax file numbers and passwords are validated, the system would automatically issue a secure receipt number validating the transaction for tax purposes. If done over the Internet, a printed validation document could be generated at this time. If done by phone, the number would be written onto the invoice document. The same process would be followed by the buyer when the goods arrive at their final destination.

Initially, this system would automatically apply to all buyers and sellers. However, for identified low-risk businesses, the tax authority could allow periodic automatic declaration once they had been audited. The handling of these low-risk taxpayers would fall into the domain of the large dealer unit because it would mainly be the same group of countries.

This procedure can be achieved using software and hardware of the sort that is normally used in electronic bill payment systems. While this interface should have a public face as part of the customs/tax authority's website addressed in a later recommendation, it would be installed in each entity on servers operating independently of the tax authority's databases to prevent it from being used to access those databases illegally or maliciously.

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<sup>21</sup> An alternative solution to establish control points at the transit sites was considered and rejected as it would move VAT control away from compliance and toward transaction audit. It would also slow down the current procedures in place.

<sup>22</sup> In some cases, like sales to tourists, this may not apply, but the likelihood of audit is higher for such sellers than for most other merchants involved.

<sup>23</sup> Both taxable value and total tax are required because not all goods pay the general tax rate.

<sup>24</sup> This process requires the exchange of usernames and password data sets between the two tax authorities so that the systems can do a data match. No other information is provided about each entity's taxpayer base. This process will make it harder to generate fraudulent "buyers."

Data could be transferred into the tax authority's system after it is checked. In addition, the transfers of this data between the two entities' tax authorities should be integrated with the data transfer arrangements covered in Recommendation 1 for customs data.

## **Benefits of Recommendation 2**

Officers of the PA's VAT office believe that up to 5 percent of VAT under the Unified Invoice system is lost. This represents about 9 million NIS a month.<sup>25</sup> Comparatively, several West Bank business organizations expressed confidentially that the current system represents a collective revenue loss to the West Bank and Israel of up to 30 million NIS per month. The higher estimate is reasonable based on regional experience<sup>26</sup> indicating losses could actually reach 40 million NIS a month.

Even assuming the lowest estimate of leakage to be correct, there is a strong cost effectiveness justification for the development of a secure Internet- and telephone-based electronic control system for both sides.

Annex A provides a proportional breakdown of the unified VAT collections on a regional basis.

## **Recommendation 3**

Israeli Customs collects customs duty and VAT as the declaration is lodged rather than when the transaction is finalized. This means that adjustments to revenue may not be captured in Israeli Customs' MALAM or PA Customs' ASYCUDA database and, as a consequence, they are not reported onward to either PA Customs or Israeli Customs.

Israeli Customs acknowledges the problem and has prepared some material on short payments occurring in Israel for PA Customs to collect in the West Bank. However, there is evidence that some paper-based revaluations occur in Israel and are not captured and reported electronically. It is likely the same situation occurs in the West Bank.

To resolve this matter, the Trade Facilitation Project should provide a system auditor to review the post-clearance revenue recording systems for PA Customs and Israeli Customs. This auditor will identify and document all paper-based revenue receipts and establish how they are captured electronically in the MALAM and ASYCUDA. If they are recorded into some other financial recording system, then it must be ascertained that this information is fed into the overall revenue reconciliation system between the entities,

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<sup>25</sup> In August 2008, the total due to the West Bank from Israel was 157 million NIS; the due from the West Bank to Israel came to 19.3 million NIS. This is a total of 178 million NIS. Thus, 5 percent of this figure is 9 million NIS. The Israeli Tax Authority calculated these figures.

<sup>26</sup> Agapētos, G., in "VAT Evasion: Overview of the Greek Experience," *Journal of Modern Greek Studies*, Vol. 17, No. 1, May 1999 (pp. 151-162), estimates the evasion in VAT was more than 45 percent of VAT revenues in developing Mediterranean economies in VAT's earlier years. Using this estimate for comparative purposes, Agapētos' methodology would estimate a potential loss not exceeding 45 million NIS a month in VAT evasion. Therefore, the community estimate above seems reasonable.

if necessary by developing new reporting procedures. If they are not captured, then a system of procedures to do so should be developed so that they are reported and recorded correctly.

It is not anticipated that this review will justify the use of any additional software except for interfaces, if required, to update MALAM and ASYCUDA, or to activate unused interfaces.

### **Benefits of Recommendation 3**

For the customs authorities on the Israeli and Palestinian sides, Recommendation 3 is a particularly cost-effective activity because this information is not only essential for establishing correct financial balances, but also for risk management and audit targeting purposes of what are clearly high-risk declarants.

In addition, this is an area where there is a high risk of employees committing breaches of duty and misappropriating funds if there are inadequate checks and independent reconciliations in place.

### **Recommendation 4**

Customs training is conducted at three different levels—general awareness, expert training, and specialist training—which are outlined below.

*Simple general awareness training* consists of short sessions of one or two hours to raise broader understanding of the issue. These sessions should be developed from the specialist training program and provided as part of the transparency policy to managers as well as staff, businesses, and public agencies, as mentioned in Recommendation 4.

All new customs staff should receive this training as part of their initial indoctrination. Prospective support for this level of training is discussed in Recommendation 5.

In addition to this simple training, there are two more advanced levels of customs training required for capacity development within the PA. These are differentiated below. Before funding is provided for training at either of these levels it is essential to establish that the tests of cost effectiveness described below are met by the proposed syllabus. Otherwise, the return on investment will not be maximized.

*National expert training* is designed to allow international best practices to be applied locally, forming the base of information for subsequent dissemination through general awareness training. National expert training is normally supplied on a “one-off” basis by bringing in a recognized training team from overseas.

*National specialist training* is conducted at the international level and normally limited to central office policy officials. This may also include a trainer who, on return, provides subsequent training at all levels. Funding for this training should be considered using the details below.

The Trade Facilitation Project should provide financial and technical support for customs capacity building in the following disciplines at the national expert training level:

- Tariff classification
- Prohibited and restricted goods
- Ethics and standards
- Law and legal structures
- Risk management
- Trade (shipping, international trading terms)
- Post-clearance audit technique
- Statistical business and commodity analysis

Any of these courses must meet four cost-effectiveness criteria:

1. The course has a realistic syllabus and expected outcomes.
2. During the initial course, the majority (80 percent) of participants have relevant prior experience and will be expected to return to work in a relevant area once they have finished the course.
3. An objective of each course will be to identify participants (before or during the course) with the capacity to reproduce the course for internal use within six months of the initial training (i.e. train-the-trainer requirement).
4. Consequently, each course should provide a training package that includes training manuals in English and Arabic, overhead slides, films and role plays, lecture notes, and so forth. Whenever practical, full sets of these materials will be provided to trainers in both paper and electronic formats before the course starts so they may take notes as they go.

A further outcome of each course will be the generation of a “general awareness course,” which will have three potential uses:

- The course will be delivered to other tax and customs officers to give them a basic understanding of what is expected of them in their daily work.
- The course will become one of a series of units presented to all new staff within six months of commencement<sup>27</sup> to build an understanding of the tax and customs organization and to help staff plan their professional development.
- Course presentation will be tailored to match the interests of members of the public.

This final application relates directly to Recommendation 6, which will increase awareness of modern customs processes within PA Customs and its client base. A series of one-hour presentations must be developed after each course for presentation to other staff and the public.

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<sup>27</sup> Some units would be presented only to customs staff while others would be presented only to tax officers, but there should also be some subjects identified where cross-training is appropriate, such as “Introduction to VAT” and “Basic Commercial Law”.

Item 4 in the cost-effectiveness criteria set out above should be further developed to meet PA Customs' commitment to public transparency if PA Customs is willing to develop the presentations covered by Item 4 in a format suitable to business people, government officials, and other stakeholders. The Trade Facilitation Project could provide basic equipment as appropriate. Assistance should include training in the development of such presentations. A pair of trained customs officers, one each from head and regional offices, could provide routine introductory presentations. See Annex D for a discussion of outreach processes.

### **Recommendations 5, 6, and 7**

Recommendations 5, 6, and 7 are addressed in full in the earlier stages of this report and for that reason are not covered again here.

## **ANNEX A. MEETINGS ATTENDED**

Wednesday, October 29:

Introductory meeting with heads of customs and taxation, VAT, and customs post-entry audit

Sunday, November 2, and Tuesday November 4:

Meet with head of customs audit to develop understanding of current customs declaration and revenue system

Tuesday, November 4:

Meet with local customs brokers to develop understanding of current customs declaration and revenue system from the point of view of importers and their agents

Wednesday, November 5:

Meet with head of Israeli Customs to develop understanding of current customs declaration and revenue system from the point of view Israeli Customs

Sunday, November 9:

Meet with UNCTAD and PA customs training coordinator to discuss aspects of commercial training for customs officers

Monday, November 10:

Meet with director-general of VAT to develop a full understanding of current VAT declaration system, particularly in relation to the Unified Invoice System

Meet with director-general of Customs to develop an up-to-date understanding of current regional staffing

Tuesday, November 11:

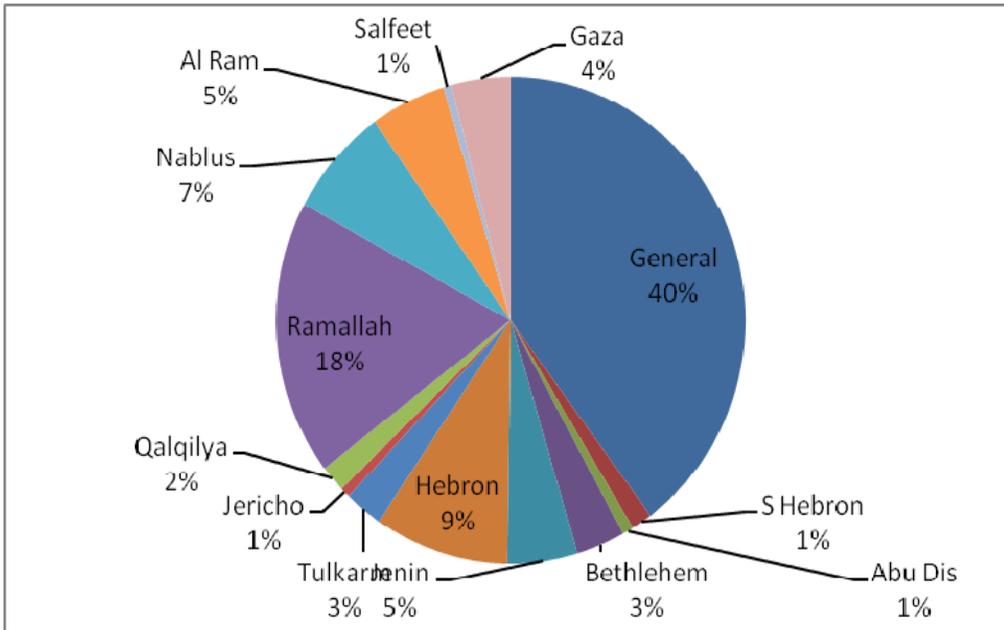
Meet with director-general of Customs to develop an up-to-date understanding of current regional staffing

## ANNEX B. BREAKDOWN OF UNIFIED VAT BY WEST BANK REGION

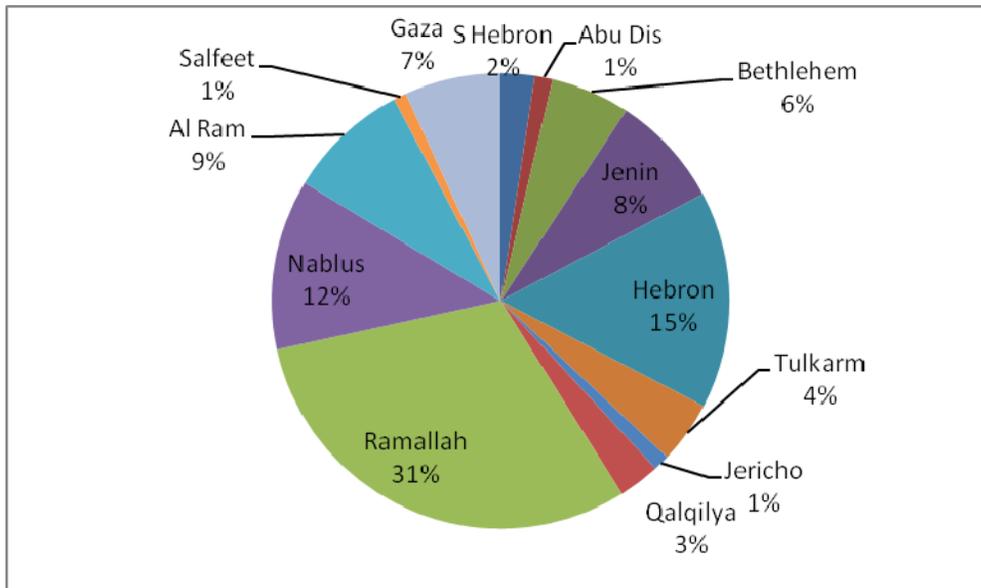
Regional Office Name	Million NIS	Percent of Total
General services <sup>28</sup>	49.8	39.94%
South Hebron	1.8	1.44%
Abu Dis	0.95	0.76%
Bethlehem	4.2	3.37%
Jenin	6.0	4.81%
Hebron	11.6	9.30%
Tulkarm	3.3	2.65%
Jericho	0.85	0.68%
Qalqilya	2.2	1.76%
Ramallah	22.9	18.36%
Nablus	9.1	7.30%
Al Ram	6.5	5.21%
Salfit	0.68	0.55%
Gaza	5.1	4.09%
Total	124.7	

<sup>28</sup> Includes transfers of fuel, electricity, and bulk or public service goods, which are handled centrally on a head office to head office basis.

**Figure 6. Distribution of VAT from all Sources for Sales Originating in Israel**



**Figure 7. Distribution of VAT for all Regions for Sales Originating in Israel**



Based on Israeli and Palestinian data, August 2008.

## ANNEX C. OVERVIEW OF THE WCO NAIROBI AGREEMENT

A “Nairobi Agreement” is the generic expression commonly used for the International Convention on Mutual Administrative Assistance for the Prevention, Investigation, and Repression of Customs Offenses. This convention was adopted by the Customs Cooperation Council (now World Customs or WCO) in Nairobi in 1997. The full text is 79 pages,<sup>29</sup> but it is explained briefly as follows:

- A bilateral agreement is made binding two customs administrations to support each other in a variety of ways to prevent, investigate, and repress customs offences.
- A request for mutual assistance may occur during a customs investigation.
- If the customs administration is not conducting the proceedings, it may request mutual assistance within the customs area of the investigation.
- Mutual assistance does not include arrest or recovery of money for the other party.
- If the assistance sought infringes upon sovereignty, security, or other national or legitimate commercial interests, it may be declined in most cases.
- Any document or information obtained under the agreement may only be used for purposes specified in this Convention and shall be afforded full protection, confidentiality, and official secrecy.
- The information may be used for other purposes only with the written consent of the customs administration that furnished it.
- Communications under the Convention pass directly between customs administrations only.
- Parties designate officials responsible for such communications.

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<sup>29</sup> Available at <http://www2.wcoomd.org/ie/en/Conventions/conventions.html>.

## ANNEX D. OUTREACH PROCESS

The aim of the system set out below is to show how an understanding of the role of taxes and customs can be established and then maintained across the West Bank. The use of such a system will have three primary impacts:

- It will make the population better aware of the general role of taxes and customs in the national economy.
- It will allow targeted presentations to interest groups affected by prospective changes to law or policy.
- It will provide a local “face” for taxes and customs that will allow interested individuals to report matters of malfeasance.

The system described is based on public outreach models used by the Australian Customs Service, the Australian Tax Office, the Department of Internal Revenue in Papua New Guinea,<sup>30</sup> the State of Queensland Treasury and Revenue Office in Australia, and the Ministry of Finance of Montenegro. All of these authorities have regionalized structures:

- Each of the authorities has a coordination and liaison officer attached to the Head of Authorities office. This officer is normally an experienced and qualified tax or customs officer and his/her role is separate from press and public relations functions.
- This officer:
  - Provides a direct link between the Head of Authority, head office experts, and regional managers.
  - Is responsible for control and upkeep of all resources, such as printers and projectors, and for the development of presentations and handouts.
  - Establishes demand for presentations<sup>31</sup> by subject and availability of relevant “experts” within the organization.
  - Identifies speakers and presenters in the head office and in regions to make presentations on various subjects.
  - Develops and maintains a schedule of planned meetings by date, subject, and location.
  - Coordinates presentations to ensure that all identified interests in a region received a formal invitation to appropriate meetings in their region and in adjoining areas.
  - Tailors presentations to meet areas of local interest.<sup>32</sup>

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<sup>30</sup> Papua New Guinea is included here because its structure is broadly similar to Palestinian Customs/VAT/Excise.

<sup>31</sup> Normally, presentations on a subject in any region are provided to both staff and clients as two separate presentations on the same day. The staff presentation is done first so that staff can make the presenters aware of local considerations that should be included in their presentation.

<sup>32</sup> One way to do this is to establish how much tax is being collected locally and to show how this is fed back into the local economy through measures such as building roads or paying the wages of doctors and nurses.

- Prints presentation materials, including business cards for all presenters, the regional manager (if required), and presentation packs where appropriate.
- In each region, the regional manager maintains a contact list of local opinion leaders, business entities, and prospective interested organizations or individuals.<sup>33</sup>
  - Local news outlets
  - Universities and business colleges
  - Associations of opinion leaders, such as teachers, or welfare organizations and nongovernmental organizations

This information is kept up-to-date and used in coordination with national lists held in the head office. The manager advises the coordinator of available local expert staff and situations arising locally where timing might be opportune for a presentation. The presentation at any regional location will normally have the following features:

- At least three officers will be in attendance. These will be the regional manager, one “subject expert” from the head office and one local “subject expert.”
- The manager normally provides the introduction while the experts work out the presentation between themselves.
- Presentations must not exceed 45 minutes to prevent boredom.
- There should then be 30 minutes of open discussion after a coffee break.
- Finally, there should be a period where participants can meet the three officers face to face.
- All participants should receive the business card of the three officers. This is important because if one of the participants wants to make a complaint or provide information and is uncomfortable dealing with any one of the officers, he/she has the option of dealing with one of the others either face-to-face or later by phone.

### **Expected Outcomes**

- The provision of such meetings will increase the level of transparency in tax and customs operations.
- Holding meetings at regional levels improves the attitude of both staff and clients who may otherwise feel that they are ignored by a remote central bureaucracy. This is an especially important consideration in areas of identified high evasion.
- Meetings afford face-to-face opportunities for feedback regarding local concerns and problems, including unintended consequences of policy and information on local areas of identified tax evasion and smuggling.

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<sup>33</sup> In Papua New Guinea, on the introduction of VAT, a register of interested parties was established by placing an advertisement in the local press. This invited bodies to apply in writing to attend seminars. The decision rule used by the DG was that anyone who wrote would be invited to a meeting in their region and if their organization had enough members then it might receive an individual presentation.