

STRATEGIC IMPLICATIONS OF THIRD PARTY CHARGING

**A report prepared for the
New Zealand Customs Service**

by
McKinlay Douglas Limited

June 2003

Contents

	<i>Page</i>
1. Introduction	1
2. Context	2
Customs' Activities	2
ANNUAL REPORT	2
STATEMENT OF INTENT	3
Operating Expenditure for Container X-Ray Equipment	5
3. Findings	6
Long Term Sustainability	6
RISK	6
OPPORTUNITY	7
The Implications for Other Government Objectives	8
Impact of Options	9
Stakeholder Influence	10
TRANSACTION-BASED	11
FACILITY-BASED	12
Managing Risks and Opportunities	12
THE CHANGING FOCUS	12
CHARGING	13
4. Background	15
Legal Constraints on Charging	16
5. The Rationale for Charging	18
Other Possible Fees	20
AN EXPORT FEE?	22
▶ Transhipment and In-Transit Containers	22
▶ What Type of Export Fee?	23
A PASSENGER FEE?	25
6. Public Good versus Private Good	30
7. Conclusion	33

1. INTRODUCTION

This report was commissioned by the New Zealand Customs Service (Customs) from McKinlay Douglas Limited (MDL) with a brief to provide an overview of the issues that Customs should take into account when considering its charging policy, to include (but not be limited to):

- ▶ Long term sustainability - the risk and/or opportunities to Customs if Government became reliant on this source for funding its operations.
- ▶ The implications for other Government objectives, for example regional development.
- ▶ How might the options impact on client behaviour? Are there potential risks or opportunities for Customs' ongoing operations? How would charging support or undermine the voluntary compliance emphasis on Customs' work?
- ▶ Stakeholder influence – what incentives would stakeholders face to frustrate or work with a third party charging regime? How should this be managed by Customs? What are the implications for wider Government policy (eg regional development)?
- ▶ How should any risks/opportunities be managed? What are the implications for management strategies?

In preparing the report, MDL was required to and did:

- ▶ Hold scoping discussions with Customs.
- ▶ Hold discussions with central government agencies, as agreed with Customs.
- ▶ Meet with industry stakeholders, as agreed with Customs.
- ▶ Familiarise ourselves with the operation of the Import Transaction Fee.
- ▶ Undertake a review of relevant international experience.

The intended focus of the report is on the practical implications of different options in order to assist Customs' management arrive at a view, amongst different possible options (general or dedicated taxes; transaction based charges; facility based charges), on the optimal approach to future funding for Customs' activities. The layout of this report reflects that emphasis. It starts with reviewing the implications and then sets out the supporting argumentation.

First however it puts the question of future funding in context, placing particular stress on the shifting real accountability for Customs' activities – from an essentially domestic focus on revenue collection and minimising the extent to which people or goods cross the border in contravention of New Zealand policy to an international focus; being accountable to our trading and travel partners for the integrity of our border security systems (or at least those falling within Customs' area of responsibility).

2. CONTEXT

The immediate context for this report includes:

- ▶ The shifting emphasis of Customs activities.
- ▶ The Cabinet decision on funding operating expenditure for container x-ray equipment.

CUSTOMS' ACTIVITIES

The past two years have seen a significant and ongoing change of emphasis within Customs' activities. In essence, the shift has been from a focus on Customs' border control activities as a means of protecting New Zealand interests to one which, whilst still retaining that focus, is very much concerned with the security of the international trade and transport environment.

The contrast can be seen by comparing Customs' annual report for the year ending 31 March 2001 with its statement of intent for the period 2003-2006.

Annual Report

"The New Zealand Customs Service is New Zealand's primary border management agency and contributes to a wide range of Government Goals covering social, economic, cultural, environmental, international, revenue, and law enforcement outcomes.

Typically the New Zealand Customs Service contribution to these outcomes is delivered by a combination of:

- ▶ *risk management, for example to minimise the risk of entry to New Zealand of drugs, environmental hazards and illegal immigrants, and the export of important items of cultural heritage; and*
- ▶ *facilitation of legitimate travel and trade.*

This combination of risk management and facilitation often occurs in the context of a single process. For example, the checking and clearance of arriving air passengers prevents the entry into New Zealand of a wide range of prohibited items and illegal immigrants, as well as facilitating the entry of non-risk passengers and complying with international obligations on air travel. Thus a single process or activity undertaken by the New Zealand Customs Service contributes to a number of the Government's Goals."

Extract from the Statement of Contribution to the Government's priorities

Statement of Intent

"The international terrorist threat has focused the attention of governments worldwide on the security of their borders and trading channels, and protection of their citizens.

This has applied equally in New Zealand. Our economy is dependent on our participation in global trade, and therefore remains vulnerable to shocks that may adversely impact on our continued ability to access foreign markets. Our continued participation in the global economy relies on New Zealand's reputation as a "safe" trading partner and travel destination. We cannot allow that reputation to be damaged by threats of terrorism or the lack of an ability to provide assurance over the security and safety of our trade and travel channels.

Key trade and travel relationships that could be put at risk as a result of terrorism include:

- ▶ *the \$4.8 billion annual exports to the United States, our second largest export market, that is directly affected by US requirements that every container entering the US be security screened and, where necessary, physically inspected;*
- ▶ *the \$6.2 billion annual exports to Australia, our largest market; and*
- ▶ *the two million international visitors (and rising) who come to New Zealand each year who are directly worth \$6.14 billion to our economy. Not only must overseas visitors be screened to determine risks to our security, but they must see New Zealand as a safe destination in which to holiday and do business."*

Extract from the section "A New Environment: New Challenges"

The shift is potentially significant in terms of Customs' accountability for performance and the sanctions that could result from non-performance. In the pre 9/11 environment, Customs' formal and real accountabilities substantially overlapped. It was formally accountable, through its minister, to Government for delivering in terms of its purchase and performance agreements. This formal accountability essentially overlapped with what could be thought of as its real accountability to the New Zealand public for managing risks to that public associated with travel and trade across the border.

Sanctions for non-performance, if they were applied, would be through normal state sector mechanisms triggered either as the result of central agency reviews of Customs' performance or in reaction to external concerns expressed through ministerial or other channels.

In the post 9/11 environment, Customs' formal accountability and formal sanctions still operate through the same mechanisms. However, its real accountability is now not just to the New Zealand public for managing border related risks. It is also to the international community, most particularly trading partners such as the United States with the new standards it is setting.

The significance of this in practice is a change in the nature of the sanctions for non-performance. Instead of being primarily state sector management sanctions directed towards Customs, the sanctions for non-performance may be directed by other nations against New Zealand's trade or travel services.

This shift puts a new emphasis on Customs' risk management performance. Risk identification, assessment and management is at the heart of Customs' activities. It underpins decisions such as:

- ▶ The percentage of incoming passengers with whom Customs should interact.
- ▶ The level of screening activity of objects moving across the border (containers, boxes shipped by air, mail, etc).

In the pre 9/11 environment, a failure to meet established targets might be readily explained away, for example as the consequence of an increase in passenger arrivals or export activity not accompanied by an equivalent increase in revenue to fund a higher level of activity. The appropriate response by monitoring agencies might be to acknowledge that Customs was doing as good a job as could be expected in the circumstances and support a case for additional funding.

An alternative approach might be to argue that Customs should have been able to manage its resources more efficiently to accommodate a higher level of activity, or to conclude that the levels of activity suggested by its risk management analysis were actually too high. At worst, the consequence for non-performance is likely to be no more than a close scrutiny of Customs operations and supporting analysis.

In a post 9/11 environment, it is doubtful that our trading partners, or key source countries for tourist traffic, will be remotely interested in arguments that Customs could not deliver because it was not adequately resourced. Their sole concern will be whether Customs is actually delivering the secure trading and travel environment they require. As one example, which the statement of intent notes, a failure to meet expected standards for the security of export traffic could put New Zealand's trade with the United States at risk.

The consequences for policy in respect of Customs include:

- ▶ Both the setting of the performance targets that result from risk assessment of cross border activity (export, import, and passenger movement) and their achievement have assumed a new significance. These should now be seen as crucial elements in maintaining New Zealand's reputation as a secure source of exports and a safe destination for passengers.
- ▶ Ensuring that Customs is able to meet performance standards acceptable to the international community must now be seen as a strategic national goal and not just a matter of departmental performance. It follows from this that adequate resourcing of the activities needed to achieve Customs' performance targets must be considered quite differently from the pre 9/11 environment.

This is not to suggest that Customs should be given a carte blanche to manage as it sees fit. Efficiency and effectiveness both remain important. What it does suggest is the

desirability of avoiding arbitrary decisions about appropriate resourcing levels or leaving Customs reliant on funding arrangements that do not respond in an adequate and timely manner to changes in activity.

There are also implications for how Customs' activities are funded. So long as the focus has been primarily on collecting revenue and minimising the extent of movements across the border of people or goods in contravention of New Zealand policy, there is a strong argument that Customs' services should be regarded primarily as a public good. We all benefit from maintaining the integrity of our immigration system, minimising the trade in illegal substances, protecting the revenue and other core Customs' activities.

The new emphasis on maintaining New Zealand's reputation as a secure source of exports and a safe destination for travellers arguably also has public good characteristics about it. However, because of the way the immediate consequences of any failure will impact, it also and much more directly has strong private or club good characteristics, especially, at the moment, for exports moving by sea in containers. If one or more containers on a vessel destined for a US port do not satisfy the requirements of the Container Security Initiative then it is that vessel and its cargo that will be delayed. If that risk is to be minimised, then it is the consignor(s) and others associated with each vessel's cargo that have the greatest incentive to ensure compliance and that should have the scope to contribute to decisions on how that is done (even though the US Customs Service will insist in dealing on a government to government basis).

This does suggest the use of charging mechanisms that:

- ▶ Directly target users
- ▶ Do so in a way that gives users both the incentive and the opportunity to minimise the risk that any shipment will not be compliant with the CSI (or any other security measures of a like kind).

OPERATING EXPENDITURE FOR CONTAINER X-RAY EQUIPMENT

Customs bid in the 2003/04 budget round for capital and operating costs to support supply chain security. Approval was granted, on conditions, for the capital injection required. Instead of approving the operating costs for the years 2004/05 and onwards, Cabinet directed Customs to work with other relevant agencies on charging options and invited the Minister to report back to the Cabinet Policy Committee by 1 August 2003 with recommendations on charging options and associated legislative implications.

This report was commissioned as part of Customs' preparation to respond to that invitation.

3. FINDINGS

In this section we provide an overview of the issues that Customs should take into account when considering the use of charges rather than taxation as a means for funding Customs' activities.

LONG TERM SUSTAINABILITY

This subsection looks at the risk and/or opportunities for Customs if Government became reliant on charges for funding Customs' operations. (The bulk of Customs' costs for processing imports are already funded from an Import Transaction Fee. The other main activities for which charges are a possibility are processing exports (including security-related activities) and processing passengers.)

Risk

There is no risk in the formal sense of whether Government has the power to ensure that charging systems are in place to generate the level of revenue required. Any risks will be political – the possibility that interest group representations to Government could result in revenue falling short of the amount required to finance the level of activity needed to deliver the outputs/outcomes required. (Throughout this discussion we are assuming that any charges will be GATT compliant.)

Risk will be a function of two principal factors:

- ▶ The importance attached by Government – and industry groups – to achieving defined levels of activity.
- ▶ The nature of any charge and thus the incentives to lobby against it.

At pages 2 to 4 of this report we argued that the real accountability for Customs' services is increasingly to the international community. Is New Zealand delivering the secure trade and travel environment its partners require? Increasingly, that is becoming a matter of an agreed approach to risk assessment and management: what processes does Customs have in place for assessing risk, how good is its intelligence and resulting analysis, and how well is this translated into its business plans and activity levels.

Especially given the increased attention internationally to best practice in this area through entities such as the World Customs Organisation, the New Zealand Customs operating environment will become more and more one in which it will be accountable not just to the New Zealand Government and individuals and firms engaged with the New Zealand border, but also internationally. As this happens, it seems logical to expect that successive New Zealand governments, and for that matter interest groups involved with trade and travel, will see meeting expected levels of activity as a strategic national goal and not just a matter of organisational performance. This suggests that the risk of Government reducing charges below the level required to finance agreed activity levels,

at least without making up the shortfall from other sources, should be relatively low (but still one that Customs' management should seek to manage).

Even if there is a general acceptance of the nature of the changed environment, risk will still be affected by the extent to which there is systemic acceptance of the view that Customs, in practice, is increasingly accountable to our international trading partners (including tourist sources) for demonstrating that acceptable levels of security are not just mandated but are achieved. By systemic, we mean not merely a recognition by individuals or agencies within the tax or charging environment that this shift is occurring, but formal acceptance that satisfying international requirements is now one of the objectives of Customs activity with the consequence that funding must be adequate for this purpose.

If future charges are, like the Import Transaction Fee, based on individual transactions, then the incentive to lobby against those charges by the individuals or entities that pay them will be relatively low. As discussed below, they are minimal in relation to the activity involved (though see the discussion on stakeholder influence at pages 10-12). The one group likely to argue strongly against any charge on an ongoing basis is the international airlines represented by the Board of Airline Representatives New Zealand (Inc).¹ Even though any per passenger charge would be relatively low (if fixed simply to recover costs), BARNZ has incentives to argue against it including:

- ▶ A principle based argument that Customs services are essentially a public good and should therefore be taxpayer funded.
- ▶ An institutional imperative to maintain a common stand in different jurisdictions so as not to provide any weakening of arguments in countries such as Canada and Australia where per passenger charges are considerable.
- ▶ An interest in the New Zealand environment in resisting charges on air travel generally (for example, landing fees) and minimising the risk that measures that might be implemented in future (perhaps enhanced security) will be funded through charges.

If charges were facility rather than transaction based (that is, if charges were recovered from ports and airports) then there would be a much stronger incentive for those paying to contest the level and the nature of the charge. This follows from the fact that, if a port or an airport were bulk charged for Customs' costs for processing all passengers or exports passing through that port or airport, then the aggregate sum of the charge to each port or airport entity would be large and a natural focus of management attention in seeking to reduce its impact.

Opportunity

Generally, it is argued that charges should be used as a means of funding public services rather than taxes when the use of charges will promote economic efficiency. In other words, when direct charging will result in users responding in economically efficient ways – typically by changing their demand and/or influencing the nature and level of the

¹ At least initially, the Export Institute could also be expected to oppose the introduction of an Export Transaction Fee or other charge for processing exports.

service. As subsequent sections of this report argue, flat rate transaction fees, charged to individuals, are very unlikely to have any real impact. They are thus unlikely to result in any efficiency gains.

In the Customs environment, efficiency gains are likeliest to come from behavioural changes as, for example, consignors and the parties whose services they use change their behaviours at different stages of the supply chain in ways that reduce risk and thus reduce the percentage of containers that Customs is required to screen.

Responses of this kind are likeliest to come if Customs can find ways of dealing with groups or organisations that have an influence over large numbers of transactions. Possibilities appear to include:

- ▶ If a transaction fee is introduced for exports, doing so in conjunction with the Export Institute and with a specific objective of finding ways of reducing risk and thus lowering the fee (by reducing the costs the fee is intended to cover). The same principle would apply with a passenger transaction fee. Despite the likely opposition of BARNZ, it is still in the interests of its members to ensure that any charge is introduced in a way that has the least disruptive impact on their businesses and to have some opportunity to influence its application.
- ▶ If charges are introduced on a facility rather than transaction basis, then the incentive for an economically efficient response should be somewhat greater. On either an export or a passenger fee, larger facilities would be facing a cost well into the millions, more than sufficient incentive to ensure that they would focus on ways of reducing the cost by working with different elements of the supply chain or with individual airlines on aspects of passenger clearance. This would be particularly the case if charging arrangements were set up in such a way that facilities were able to retain part or all of the benefit of any efficiency gains they were able to achieve. As discussed below (pages 12 & 13), it would be important to work closely with facilities managers on the development, introduction and management of any facilities based charge.

THE IMPLICATIONS FOR OTHER GOVERNMENT OBJECTIVES

For this purpose, there are at least two issues that Government should consider. First is the impact that charges will have on private sector investment decisions in the sense of changing the cost and therefore likely return on different investments. The second is the signal that charges may send regarding Government attitudes to activity that it wishes to encourage or discourage.

On the first point, decisions on whether or not to introduce charges and how to recover them can have a real impact on locational decisions for private investment. Currently New Zealand's three main international airports enjoy an advantage over regional airports as:

- ▶ At the three main international airports, Customs passenger services are provided free (that is, taxpayer funded) during gazetted hours.

- ▶ At regional international airports, Customs services are charged for on a full cost basis (the charge is to the airport company).

This is seen, by current and potential regional international airports, as a disincentive to regional investment and a barrier to attracting international flights. Arguably, the bias against regional international airports can be seen as inconsistent with the Government's regional development objectives.

We would not argue that charges for processing passengers or exports should be used as a form of regional development incentive. Rather, on the assumption that Government wishes to encourage economically efficient investment, costs should lie where they fall. This does carry with it the implication, especially if a passenger transaction fee is ever introduced, that the present somewhat distortionary basis for charging different airports for Customs services should go. In the same vein, there is also probably no longer any logic in the present arrangement that sees Customs services charged to airlines at our major airports outside gazetted hours but provided free within them.

The second issue is somewhat more subtle. MDL understands that the Export Institute will be strongly opposed to the imposition of any Export Transaction Fee. The argument will be based not so much on the cost (which, as already noted, will be minimal in relation to the value of the average export entry), but because of the perceived signal that exporting does not really matter.

The Export Institute argument is that Government needs to be sending positive and supportive signals to exporters, including potential exporters. This includes doing all that it can to minimise costs to exporters. The Institute would argue, also, that the Government should seek to match the level of assistance that other countries, such as Australia, provide their exporters. That is not a matter for this report to consider.

The point is one that should concern both Customs and Government. It is not, however, one that should be taken at face value simply because the Institute asserts it. What it probably does suggest is that part of the brief for the newly established New Zealand Trade and Enterprise, is some attitudinal research on how current and potential exporters view Government attitudes and the attractiveness of export as an option for their businesses, with a focus on barriers that Government might remove (or not create).

Finally, on the implications for other government policies, any initiative that has the effect of encouraging parties in the supply chain to focus on security will almost certainly reopen the debate on the case for a single border control agency. We note, though, that other initiatives such as the IMO International Ship and Port Security initiative could also have this result.

IMPACT OF OPTIONS

This subsection discusses how the options might impact on client behaviour, and the potential risks or opportunities for Customs, and looks at whether charging would support or undermine the voluntary compliance emphasis in Customs' work.

Much of this has been covered in comment on the first two matters dealt with in this section. MDL does not anticipate any significant adverse response by individual clients purely as the result of a charge. Incentives for adverse behaviour, on the part of individuals or firms inclined to minimise cooperation or actively seek to frustrate Customs' objectives already exist – whether it is passengers seeking to conceal dutiable items, avoid biosecurity restrictions (not essentially a Customs matter) or more serious non compliance as with illegal immigration or smuggling – and are significantly stronger than the financial impact of any likely new charges.

If any new charges are introduced, Customs will need to manage the relationship it has with interest groups such as BARNZ or the Export Institute. Their agendas include demonstrating to their members that they are effective on their behalf. Losing an argument over charging would not be a welcome outcome. On the planning for an introduction of any new charge, Customs will need to pay particular attention to managing those relationships.

In practice, there are good reasons why those interest groups should themselves want a continuing positive relationship with Customs. It is an important part of managing the business environment in which their members operate.

The area of greatest potential for impact lies in how Customs (and Government) thinks of the nature of Customs services. If they are thought of as essentially a public good (even though they may be funded through an individual charge), then there is no particular rationale for a close involvement of end users other than the now conventional good practice one of Government consulting with affected citizens about the nature and quality of the service provided.

However Customs services - especially enhanced services such as the response to the container security initiative or the IMO International Ship and Port Security initiative – can look much more like club goods provided to meet the needs of the members of the club. Considered this way, not only should the services be charged to the club but the club should play a significant role in determining the nature and quality of those services. This suggests that:

- ▶ Users should be involved in determining the required standards – which would see them playing a formal role with Customs in setting strategies, and outcomes, for risk identification, assessment and management.
- ▶ They should also be closely involved in devising measures to minimise risk (something that already happens with the secure export scheme). There would, of course, need to be certain non-negotiable elements in Customs' own role, if only because of the requirements of international partners that they deal on a government to government basis and risk management practices have government backing.

STAKEHOLDER INFLUENCE

This subsection covers the incentives stakeholders would face to frustrate or work with a third party charging regime, how this should be managed by Customs, and the implications for wider Government policy.

We consider this set of issues first on the basis that any charge would be a per transaction charge and secondly, on the basis that any charge would be facility based.

Transaction-Based

In MDL's view, and in an extension of the analysis in the previous sub-section, the opportunity for Customs is to optimise the stakeholder relationship from a clear understanding of why any charge is being imposed. If a charge is being imposed mainly as a means of raising revenue, then the signal that Customs (Government) will be giving to stakeholders is that this is really just another tax on activity – a negative signal that will not set a strong basis for increased cooperation.

The alternative is to see any charge as based on the "compulsory club" concept – that the security and related services covered by the charge are ones that theoretically could be provided in the market but that this is unlikely to happen without compulsion because of the need to bring the great majority of transactors (passengers, exporters and importers) within the net.

On that approach, the core outcome is the security benefits for individuals and firms using the border. The national benefits are a positive externality (which arguably might support setting the charge at less than full cost recovery). More importantly, this approach gives stakeholders a legitimate right to be closely engaged by Customs in determining the nature of the service and how it is delivered. This follows from the fact that compulsion is being applied as the only feasible means of delivering a benefit to the club.

This line of argument could result in the response that, if the sole reason for imposing a fee is the need for compulsion within the club, then it does not follow that provision should necessarily be by Customs –provision itself should be contested. The answer to this is that the nature of the service is such that it may need to include delivery by a state agency as it necessarily includes powers such as search and detention, powers that it would be repugnant to vest in a non-state provider. The counter to this is that a non-government operator could make it a condition of use of or access to its services that it had specified rights of search and detention. Ultimately this becomes a matter of political judgement: is Government prepared to accept a situation in which the private sector assumed, albeit under contract, significant rights of search and detention?

Customs (and Government) will need to consider the degree of involvement by third party providers carefully. Rationalising a charge on the basis that it was to pay for what were effectively private or club goods, but then not giving the beneficiaries of that service a significant role in its planning and delivery, or the opportunity of contestability in delivery may create difficulties. It should certainly be seen by any intelligent stakeholder as an inconsistency in the Customs (Government) approach. The appropriate response may be a combination of a reluctance to create a situation in which a private sector operator might seek to obtain significant powers of search and detention and concern that other governments might not be prepared to accept third party service delivery as sufficient to satisfy their security concerns. (We note that the US Federal Government has recently 'nationalised' the provision of security at airports for this very reason.)

On the other hand, acting on the rationale would be consistent with Customs' emphasis on voluntary compliance and on working closely with stakeholders. It would also be consistent with securing stakeholder commitment to management of risk along the supply chain and throughout stakeholders' interaction with passengers.

Facility-Based

This approach would only be feasible if Customs (Government) were prepared to work in partnership with the facilities involved (New Zealand's 13 export/import ports and seven international airports). It would be logical (MDL would argue, virtually a prerequisite) that this approach encompassed the IMO International Ship and Port Security initiative (for which the Maritime Safety Authority is expected to be the local delivery agency) and, with airports, any equivalents emerging out of the International Civil Aviation Organisation (ICAO). (MDL notes that ICAO has not yet moved, as the IMO has, to mandate new compulsory arrangements for airport security.)

MDL would certainly not recommend introducing a facility based charge unless at least the majority of facility owners were prepared to work with this approach and see it as a logical step in managing the security of their own facility and enhancing its reputation internationally in this respect. At the same time it could be well worth while investing some effort in securing agreement as it should have the effect of putting the responsibility for supply chain security for exports right at the heart of the supply chain (or its equivalent for passengers). As noted below, it could also facilitate integration of different security activities.

This approach does have potential implications for other Government policy objectives, especially regional economic development. MDL anticipates that a facilities-based approach would be used as a point of difference competitively with possible implications on choice of port for export/import activity or choice of airport.

It is also likely that such an approach would give renewed impetus to the idea of a single border control agency. This follows from the probability that a facilities-based approach for security matters would raise the question "And why not for biosecurity also?" especially as at least some of the measures that ports and airports would want to take to manage security risks would also have positive implications for managing biosecurity risk.

MANAGING RISKS AND OPPORTUNITIES

We look at this issue first in the context of Customs' changing focus – which applies regardless of whether traditional security activities are funded through taxation or through charging – and then at the implications for management of additional charging.

The Changing Focus

Customs is well experienced in information gathering and assessment in respect of the risks it has traditionally managed. This report notes below some concern at a central agency level about Customs' ability to turn that information gathering and assessment

into a strategic business plan for the management of its business overall. MDL is unable to judge whether there is substance in that view or whether it is simply a symptom of the attitude that a central policy agency can sometimes have towards an operational department. Regardless, it is an issue to address.

Next, we note that the changing focus, encompassing much more of a concern to manage terrorism and associated risks, will require new skills and sources of information. (This is recognised in the capability section of Customs' current statement of intent.)

We suggest Customs' management consider specific measures that will overtly place Customs' stamp on capability in assessing and managing security risks in the post 9/11 environment. This may well be important for credibility, both in dealing with central government agencies and domestic stakeholders, as well as with other Customs agencies. Care will be needed in ensuring that this does not appear to conflict with the role of the Officials' Domestic and External Security Committee.

Possible measures could include quite specifically enhancing Customs' capability in political risk assessment, perhaps initially by engaging recognised external expertise with a brief both to assist Customs in risk assessment in this area and to transfer capability to permanent Customs staff.

Charging

The implications for management of the risks and opportunities associated with charging will depend on the nature of the charge. If any charge is in the form of a transaction fee, then for all practical purposes it is simply a dedicated tax. The main management issues will centre around:

- ▶ Designing and implementing cost effective systems for fee collection, including low cost (to Customs) sanctions for non-payment.
- ▶ Relationship management with key stakeholders. As noted later in this report, any export or passenger fee will run into opposition from groups such as the Export Institute and the Board of Airline Representatives New Zealand Inc. Customs should focus on working closely with key stakeholders to ensure that, even though they may resist the fee, they will at least work with Customs to smooth its introduction. Since the rationale for the fee will be at least in part cost-based, it would be sensible to put in place arrangements for regular review of the processes and costs involved with the objective of reducing costs and passing savings back to fee payers.

Finally, Customs should work closely with key stakeholders to determine that, where possible, the fee structure fairly reflected the level of risk being managed by Customs. (We note that there may be a GATT Article VIII problem with this if the fee is based on one part of Customs activity – processing export documentation – but intended to pay for another – screening.)

If the facility-based option is considered, the implications for management will be more significant. On that approach, Customs would bulk charge facilities for the cost of its activities in respect of all exports or passengers moving through that facility, leaving it to the facility to determine how best to recover that cost from users.

This is an approach that would focus on the preferred purpose of charging, to encourage economically efficient responses on the part of users. Ideally, facilities managers would seek means of minimising the risk status of goods or passengers passing through their facilities, thus minimising the need for screening and other risk management activity on the part of Customs.

Although this is an approach that has the appearance of placing a lot of discretion with facilities managers, it will only be feasible if there is very close cooperation between them, Customs and other border agencies. Especially with ports, the bulk charge approach would have a number of implications. They include:

- ▶ Ensuring that, despite the primary responsibility being placed with the facility, Customs was still able to discharge its international obligations in certifying the integrity of the New Zealand system.
- ▶ Port operators would, logically, want to integrate what they were doing in respect of Customs security requirements with what they were doing to comply with the IMO International Ship and Port Security initiative.
- ▶ Logically, also, they would want to integrate those aspects of security for which they now had responsibility with the Ministry of Agriculture and Forestry's biosecurity activities.

This does suggest that, in practice, there would need to be a shift to joint security planing and implementation at facility level, with Customs and other agencies (MAF, MSA) closely involved.

4. BACKGROUND

Customs is still substantially dependent on Revenue:Crown to meet its operating expenses. In the 2003/04 year, Revenue:Crown is budgeted as \$54.948 million compared with revenue from Government departments of \$0.420 million and Revenue:Other of \$21.760 million (of which \$15 million will be the full year impact of the Import Transaction Fee).

Especially in the context of the post 9/11 environment, Customs is concerned that reliance on Revenue:Crown may not be sufficiently flexible to enable it to maintain required levels of activity as volumes increase.

Customs sees this as an example of the consequence of being dependent upon a fixed base line and contrast it with the responsiveness of the newly introduced Import Transaction Fee. This fee is collected on a per transaction basis for each single importation with a value exceeding \$1,000 (as a line item on an account that Customs already sends electronically to importers). Customs revenue automatically increases as transaction numbers increase so that revenue keeps pace with the increased costs of managing import related risk² (unless the nature of the risk itself changes adversely leading to a per transaction increase in the cost of risk management).

This issue may not be as simple as it appears. Any new charge introduced by Customs will be subject to analysis by other agencies, including the Treasury. In theory, the Treasury should apply exactly the same principles to the analysis of a bid for a baseline increase as it does to considering the appropriate level of a fee or charge.

In applying an output pricing approach to the baseline assessment, the Treasury can be expected to make due allowance for the full costs (including capital charge) associated with the delivery of the output concerned. In considering the alternative of a fee or charge to meet those same costs, Treasury guidelines for setting charges in the public sector make it clear its focus will be on ensuring services are charged at full cost unless there are specific policy reasons for under recovery. The guidelines also note that a fee or charge in excess of full costs could be interpreted as a tax and thus ultra vires unless authorised by an Act of Parliament.

Despite the theoretical argument, from an operational perspective Customs may still prefer the use of a transaction-based fee or charge as revenue will automatically increase as transaction numbers increase. In contrast, a baseline increase requires an explicit Government decision and thus always carries with it risks such as:

- ▶ It may be sought in a year in which the Government, for its own reasons, decides to reduce baselines or hold them constant (as with the so-called 3% cuts of recent years).
- ▶ Central agencies may take a different view from Customs on the costs they should incur or the potential for increased efficiencies.

² This judgement assumes constant costs. In practice, it is likely that Customs face decreasing costs.

In the post 9/11 situation, those risks may be mitigated if Government accepts that meeting the performance standards that Customs has agreed with its counterparts in our trading and travel partners is essential to New Zealand's reputation as a reliable source of exports and destination for travellers.

LEGAL CONSTRAINTS ON CHARGING

Any charging policy developed by Customs will need to take account of both domestic and international legal constraints. Domestically, as already noted, the principal constraint is that any fee or charge that recovers more than the full cost of the service to which it relates is at risk of being defined, legally, as a tax which can only be imposed by Parliament.

More significant for any Customs charging policy are New Zealand's international obligations, particularly under the General Agreement on Tariffs and Trade (GATT). Article VIII of the GATT provides:

"Article VIII

Fees and Formalities Connected with Importation and Exportation

1. (a) *All fees and charges of whatever character (other than import and export duties and other than taxes within the purview of Article III) imposed by contracting parties on or in connexion with importation or exportation shall be limited in amount to the approximate cost of services rendered and shall not represent an indirect protection to domestic products or a taxation of imports or exports for fiscal purposes.*
- (b) *The contracting parties recognize the need for reducing the number and diversity of fees and charges referred to in subparagraph (a).*
- (c) *The contracting parties also recognize the need for minimizing the incidence and complexity of import and export formalities and for decreasing and simplifying import and export documentation requirements.*
2. *A contracting party shall, upon request by another contracting party or by the CONTRACTING PARTIES, review the operation of its laws and regulations in the light of the provisions of this Article.*
3. *No contracting party shall impose substantial penalties for minor breaches of customs regulations or procedural requirements. In particular, no penalty in respect of any omission or mistake in customs documentation which is easily rectifiable and obviously made without fraudulent intent or gross negligence shall be greater than necessary to serve merely as a warning.*
4. *The provisions of this Article shall extend to fees, charges, formalities and requirements imposed by governmental authorities in connexion with importation and exportation, including those relating to:*
 - (a) *Consular transactions, such as consular invoices and certificates;*
 - (b) *quantitative restrictions;*
 - (c) *licensing;*

- (d) *exchange control;*
- (e) *statistical services;*
- (f) *documents, documentation and certification;*
- (g) *analysis and inspection; and*
- (h) *quarantine, sanitation and fumigation.”*

The Article applies both to importation and exportation. It limits any fee or charge to the approximate cost of the service.

MDL understands that this provision is interpreted in a way that requires charges to be targeted to the actual service provided rather than fixed to recover the total cost of a set of services that, although similar in character, may differ in cost depending on the category of export or import involved. In practical terms, this means that a flat rate charge could not be imposed to cover (say) the cost of screening all exports if those costs varied significantly depending on the category or source of the export.

5. THE RATIONALE FOR CHARGING

The Treasury *Guidelines for Setting Charges in the Public Sector* include a set of objectives for user charges.

"The objectives are:

- 1 *Encouraging decisions on the volume and standard of services demanded and supplied that are consistent with*
 - ▶ *the efficient allocation of resources generally, and also*
 - ▶ *the outcomes the Government is seeking in providing the service.*
- 2 *Minimising the cost of supply over the short term, and over the long term when capital costs are significant.*
- 3 *Keeping transaction costs low, and evasion at acceptable levels.*
- 4 *Reducing reliance on funding from general taxation (with its associated costs)*
- 5 *Dealing equitably with the taxpayer, those who benefit from the service, and/or those whose actions give rise to it.*
- 6 *Looking for new ways to lower costs and find appropriate providers."*

A Treasury Board of Canada paper *User Charging in the Federal Government – A Background Document* provides a more detailed discussion of the purpose and objectives of user charges. It starts with the basic principle that, whenever possible and desirable, public services should be charged for rather than given away. It then sets out both an economic and a political/managerial rationale for user charges. It does so in these terms:

"Economic Rationale

The primary economic reason for user charges being levied on the direct recipients of public services is to improve the efficiency with which Canadians in general and federal public agencies in particular make use of the resources they have available. Making efficient use of scarce public resources is especially important now, when general fund financing is decreasingly available.

*But while user charges may be advocated -- or attacked -- as a potential additional source of revenue, their main economic rationale is not to produce revenue. Rather, it is to promote **economic efficiency** by providing information to public sector suppliers on how much clients are actually willing to pay for particular services and by ensuring that the public sector supply is valued at least at (marginal) cost by citizens. In this important sense, the objective of effective public pricing policy is not so much recovering costs as it is improving the efficiency with which Government uses its resources."*

"Political and Managerial Rationale

*Accountability is the key to improved public sector performance, and information is the key to **accountability**. Efficiency requires that scarce resources be put to their best possible use. One of the most important sources of information for determining efficiency comes from prices. Proper user charges can significantly improve accountability by making clients aware of the costs of the services they receive and managers aware of the benefits and costs of the services they provide.*

To gain their support for efficient government, the various user groups need to know what is done, how well it is done, how much it costs, and who pays for it. If users are asked to pay, they should have a say in what programs are delivered, and how. If they are dissatisfied, they will press for greater efficiency and cost effectiveness, explicitly through protests and public actions and implicitly by reducing their use of the services in question. Ideally, imposing user charges will show the real value of public sector services. It will create a new dynamic -- a "market test" -- which forces managers to respond more directly to clients and to allocate their resources as efficiently as possible."

Perhaps more clearly than the New Zealand Treasury guidelines, the Canadian paper makes two very important points:

- ▶ The purpose of user charges is **not** to raise revenue.
- ▶ Instead, the purpose is to promote economic efficiency by providing information to public sector providers on what clients are prepared to pay and ensuring that supply is valued at at least marginal cost.

Implicit in these two principles is that, to be effective, user charges should be applied in such a way that users are not only signalled the cost associated with the service but have the opportunity to change their own conduct in efficiency promoting ways in response to that cost. This could include:

- ▶ Purchasing (using) less of the service (or more, if the purchaser believes that the value of the service is greater than the cost).
- ▶ Acting individually, or collectively with other users, through representations to the provider and to Government, to seek changes in the way the service is provided.

These processes operate best when user charges most closely approximate the function of prices in normal markets, that is when:

- ▶ There are alternative suppliers (thus providing independent checks on the costs of supply).
- ▶ The price is apparent to the purchaser.
- ▶ The level of the price is of sufficient significance to give the purchaser an incentive to look for alternatives including, in the case of a monopoly supplier, simply not requiring the service.

The contrast with funding from Revenue:Crown should be obvious. From the user's perspective, to the extent that services are funded through Revenue:Crown (general taxation), they are "free" to the user. (If the user is also a taxpayer, then he or she will bear a pro rata share of the cost, but that share will normally be so minuscule as to have no incentive impact). Accordingly, the user will have little incentive to consider alternative sources of supply or be concerned about excessive cost in generating the service itself (although the user may have concerns if inefficiency in the provision of the service impacts on the user's needs, for example for prompt processing of trade documentation).

Implicit in the proposition that the user should pay for a service is that the user is the beneficiary of that service. In a pure user pays situation where the user has a genuine choice over whether or not to use the service, the market will quickly provide an answer on whether the user believes that the service has a value equal to or greater than the price. Unless the user believes this, the purchase will not take place.

The services provided by Customs are in a somewhat different category. Whilst it is theoretically correct to argue that exporters, importers or passengers do have a choice (they can decide not to export, import or travel to or from New Zealand), the practical reality is that in most cases the impact of a charge for service will be minimal as representing a very small proportion of the total cost/revenue involved. (There are exceptions - trans-shipment and in-transit containers may be one and airline passengers may be another.)

Why this should be the case is quickly obvious from considering the total cost of Customs operations in relation to the total value of New Zealand's imports and exports. For the April 2003 year, the total value of New Zealand's merchandise trade (export and import) is estimated to be \$62.438 billion dollars. In the 2003/04 year, Customs' operating expenses, related to merchandise trade, will be approximately \$50 million or approximately 0.081% of the value of merchandise trade.

The issue can be seen in the recently adopted Import Transaction Fee. This is a fee of \$16 plus GST for each individual import entry. The value of the goods covered by an entry will be a minimum of \$1,000 and at the upper extreme, could be many millions. The average value of an import entry appears to be around \$34,000³. An Import Transaction Fee set as 0.047% of the value of the average transaction is unlikely to impact significantly on behaviour, especially when the only way of avoiding the fee is to opt out of importing.

The Cabinet paper which sought and obtained approval for the Import Transaction Fee lends substance to the view that the ITF would not have any marked impact on importer behaviour as none of the argument in support included any substantive basis for assuming that importers would change their conduct in response to the fee. The main rationales its imposition appear to be:

- During the 1990s, Customs embarked on a major development strategy that has resulted in swift electronic clearance processes that have brought significant benefit to importers.

³ This figure is arrived at by dividing expected ITF revenue for 2003/04 by the amount of the fee to get the number of transactions and then dividing the total value of merchandise imports by the transaction number.

- Major trading partners such as the US and Australia themselves impose an Import Transaction Fee.

The main argument consistent with the economic efficiency rationale for user charges appeared in paragraph 30 of that paper as:

"The introduction of a fee will provide Customs with an additional incentive to maintain an environment that promotes operational efficiency. Although importers have been closely associated with system developments over the last decade, their interest mainly arose from changes impacting on their own commercial operations. A fee that reflects a portion of processing costs will encourage importers to pay close attention to efficiency levels within Customs. Future proposals to alter the rate of the transaction fee (for example, no more than two yearly) will be considered in consultation with the importing community."

The argument is not persuasive. As already noted, the fee is \$16 plus GST on transactions with an average value of \$34,000. Rational importers will allocate their investment in improving efficiency where they get the greatest return. Arguing the toss with Customs on a \$1-\$2 increase and whether that is justified in terms of Customs activity, seems unlikely. What does seem likely, and has clearly taken place as Customs has developed its systems (an impression confirmed by external informants) is that importers have a real interest in Customs efficiency **because it is a monopoly gateway whose actions affect real time delivery and associated costs.**

OTHER POSSIBLE FEES

The Import Transaction Fee recovers the bulk of Customs' costs on one of its three main cross border business lines, managing importation. There are two other main business lines for which fees could also be considered if user charges are seen as a preferable source of revenue. These are:

- Managing exportation.
- Managing passenger movements (which could be subdivided into inbound and outbound passengers).

An Export Fee?

The first of these two possibilities, a fee related to exports, would be subject to the constraints imposed by GATT Article VIII. There is no equivalent constraint on setting fees on passenger movements (our nearest neighbour sets a passenger departure tax - A\$38 per passenger - which the Board of Airline Representatives of Australia claims raises A\$80 million more than the cost of the associated services).

If Customs is to base the development of any new charges on the rationale that the main argument for user charges is to promote economic efficiency, then the charges and the way in which they are collected need to be designed so that there are both real incentives and real possibilities for users to engage with and influence not just the level of the charge or charges, but the nature and efficiency of the services themselves.

Because of the requirement to report back to Cabinet Policy Committee by 1 August 2003 on charging options for its supply chain security initiative, that is the set of services that will obviously get priority in terms of developing a charging policy.

The budget bid proposed that operational costs should be covered in a ratio of 1:2:2 of imports:exports:trans-shipment containers, reflecting Customs' assessment of the levels of risk, and therefore screening, for each category. The paper identified two preferred options for recovering the costs:

- ▶ A fee on containers crossing the border (which would need to be refined to cover the different costs for export and import containers, and extended to trans-shipment and in-transit containers).
- ▶ A fee on all commercial import and export entries and in-transit containers.

The second of the two was the preferred option on the basis that it would not require the development of new systems. The import component would be recovered by an increase in the Import Transaction Fee. The export component would be recovered by instituting a new Export Transaction Fee payable on filing of an export entry. It is not clear how the fee for in-transit containers would be recovered.

Not all exports and imports move in containers or other boxes that would be subject to x-ray screening. Customs (and ministers) would need to be satisfied that an entry-based fee to cover the cost of container screening did not breach the requirements of Article VIII of GATT. MDL identifies this as a possibility if a fee on non-container traffic were being used to meet part of the costs for a service that applied only to container traffic.

Transshipment and In-Transit Containers

There is a further issue for Customs to consider. Shipping New Zealand sourced containers on a vessel that also carries trans-shipment and in-transit containers poses a significant risk to the New Zealand containers as the entire vessel could be treated as a high security risk in a destination port. The current approach assumes that the appropriate way to deal with this risk is to put in place a screening process appropriate to the level of risk associated with trans-shipment and in-transit containers.

There does seem to be an alternative. New Zealand exporters, and their advisers, should both be very well aware that this risk exists. Accordingly, when selecting the vessel or vessels on which to ship their exports, they have the option to specify that they do not want their containers placed on a vessel that has high security risk cargo. That would surely send a strong message to any shipping lines in the trans-shipment or in-transit business to themselves be proactive in dealing with security matters if they want to pick up New Zealand cargo.

This would leave it to those shipping lines to decide on the optimal means of meeting third country (eg US) security requirements. They might go back to source and work with ports of origin in improving security. They might decide that they do need a New Zealand based screening facility. Customs could be authorised to provide this under contract, if required, but at a fee negotiated to meet the circumstances of each case.

Conceptually, this does seem a somewhat better approach than the New Zealand Government, through Customs, taking on board the responsibility for security of shipments originating in third countries whose security measures do not meet current international minimum standards.

There are possible objections to this approach. First, some containers in this category do cross the border – they may be offloaded at one port and shipped out through another. This should only be an objection if there is a case in terms of security risk to New Zealand for screening those containers. Secondly, the main impact of this approach would be on Pacific Island countries and thus apparently counter to the Government's interest in encouraging the development of Pacific Island economies.

Accepting that objective, the better approach would seem to be dealing with the problem at source rather than complicating New Zealand's border control measures as a means of compensating for non-performance. In other words, treat the issue as one that ought to be addressed primarily through New Zealand's aid programme rather than through border control (although some transitional measures would obviously be necessary).

What Type of Export Fee?

If the costs of the supply chain security initiative are recovered as a per transaction fee, then, as with the Import Transaction Fee, the average cost as a percentage of the value of the average export transaction will be insignificant. The Customs budget bid assumed a total of 450,000 export entries. With a current value of export merchandise trade of \$30 billion, this suggests an average value per entry of approximately \$66,700.

MDL has been assured that recovery of costs through an Export Transaction Fee triggered by the filing of an export entry is the most efficient way. This, however, focuses on administrative efficiency *not* economic efficiency. In a parallel with the argument already traversed for the incentives on importers to critique the efficiency of Customs operations or look for alternative ways of delivering the services or outcomes associated with importation, an Export Transaction Fee recovered per entry would provide virtually no incentive for exporters. (Even substantial exporters such as Fonterra would probably find that it was not worthwhile putting in the time to analyse the Customs approach and develop possibly more efficient alternatives – especially as the average

value of Fonterra's export entries is probably somewhat higher than the \$66,700 average for all entries.)

This suggests that a priority in the development of a charging policy for the costs of the supply chain security initiative should be developing means of recovery that offer users the incentive to look for options and engage proactively with Customs. It is outside the scope of this report to provide any definitive answer to how best to do this. However, there does appear to be at least one possibility worth exploring.

At the moment, and as a parallel response to the post 9/11 situation, the International Maritime Organisation (IMO) is implementing the International Ship and Port Facilities Security Code. The requirements of the Code, as far as ports are concerned, are briefly described as:

"Each Contracting Government has to ensure completion of a Port Facility Security Assessment for each port facility within its territory that serves ships engaged on international voyages. The Port Facility Security Assessment is fundamentally a risk analysis of all aspects of a port facility's operation in order to determine which parts of it are more susceptible, and/or more likely, to be the subject of attack. Security risk is seen a function of the threat of an attack coupled with the vulnerability of the target and the consequences of an attack.

On completion of the analysis, it will be possible to produce an overall assessment of the level of risk. The Port Facility Security Assessment will help determine which port facilities are required to appoint a Port Facility Security Officer and prepare a Port Facility Security Plan. This plan should indicate the operational and physical security measures the port facility should take to ensure that it always operates at security level 1. The plan should also indicate the additional, or intensified, security measures the port facility can take to move to and operate at security level 2 when instructed to do so. It should also indicate the possible preparatory actions the port facility could take to allow prompt response to the instructions that may be issued at security level 3."

In responding to this initiative, the Government (through the Maritime Safety Agency (MSA) and through Customs) is in a sense dealing with two sides of the same coin: designing and implementing measures to improve the security of cross border trade. The IMO/MSA approach will deliver incentives direct to individual port companies to focus on the optimal means of meeting the security outcomes required including determining how best to impose charges for the costs of doing so.

This begs the question of why a separate security focused initiative should be under different control and using a charging mechanism that provides no effective signals to encourage other parties to join in the development of an optimal system. One possible alternative approach for the supply chain security initiative is to shift more of the responsibility to individual ports. This could involve:

- ▶ Simply charging individual ports for the costs of supply chain security measures in respect of cargo moving through that port.

- Requiring each port to implement measures that would deliver the required supply chain security outcomes.

Under the first approach, Customs would retain primary responsibility for service delivery but, instead of its relationship being with individual traders, it would be with port companies and the average annual charge would be substantial (13 port companies and a cost recovery of about \$20 million). They would want to recover those costs and would have strong incentives both to ensure that costs were kept to a minimum and to pass them on in ways that the port company thought likeliest to contribute to security objectives, as well as to ensure integration with IMO/MSA requirements, and debate with Customs both its approach to risk management and the way in which the services were actually delivered.

Under the second option, port companies would be service deliverers but to output/outcome requirements specified by Customs, and thus have greater discretion to integrate supply chain security compliance with IMO/MSA requirements and go back up the supply chain to deal with issues at source. A potential objection to this option is the probability that other jurisdictions would have less confidence in a series of private sector providers than in a single state agency as a means of giving them reassurance that New Zealand was a safe source⁴.

It is possible, also, that under either of these options New Zealand's port companies would play a more proactive role in integrating other border management activities such as biosecurity.

These options are put forward not as definitive proposals but as illustrations of the kind of approach that may be needed to get to the heart of the purpose of charging, which is to put in place both incentives to encourage economic efficiency and arrangements that make it practical to do so.

A Passenger Fee?

The other business stream for which charging could appear a possibility is the processing of inbound and outbound passengers.

As a starting point in considering policy on charging for passenger related services, Customs can note that this is common overseas. There is also some evidence (although debatable) that charging does send signals to passengers.

Administratively, there are different and, we assume, relatively efficient (in administrative terms) means of recovering a passenger related cost. They include:

- A per passenger cost that would be quite specifically a levy on passenger tickets and thus a direct pass through to passengers.
- A charge per aircraft (as with landing fees), thus leaving airlines with a discretion on the extent to which they seek to pass the charges on.

⁴ Typically other governments will insist on dealing on a government to government basis. This would require that Customs perform the interface role but should not preclude the use of third party providers to standards set and monitored by Customs.

From an economic efficiency perspective, the question for Customs (and Government) is who receives what signals and how they might act. The ideal is that any charge impacts in such a way that users have incentives to:

- ▶ Act and/or feed back information to the service provider in ways that lead to efficiency promoting changes.
- ▶ Make choices about the optimal level of the service.

In the passenger area, signalling is complicated by the fact that the passenger is not purchasing Customs services as a separate transaction but as part of a bundle of services the primary component of which is airline transport. Accordingly, if the charge does create any incentive, it is an incentive to consume less of airline services.

For Government, this sets up an immediate conflict with its very clear objective of promoting the New Zealand tourism industry. This places the emphasis on whether there is indeed likely to be such an effect. We are not aware of any New Zealand evidence, although the Board of Airline Representatives New Zealand (Inc) (BARNZ) asserts strongly that this would be the consequence of introducing a passenger charge to recover Customs' costs in servicing inbound and outbound passengers.

We have looked elsewhere for evidence. What we have found is strong resistance amongst airlines and some apparent support for the proposition that charges can have an adverse impact on the demand for air travel. A recent Bulletin article describes Australia's passenger charges as follows:

Current aviation taxes and levies are a dog's breakfast. Apart from the 10% GST, they include the Ansett levy of \$10, a noise levy for Sydney of \$3.40, a safety and security charge ranging from \$1.63 to \$5.50 per passenger, a global insurance levy of up to \$24 a ticket and, of course, the \$38 departure tax. These come on top of aggressive new charging by privatised airport operators. And a new \$1.20 charge will arrive next year to pay for a new "account and authorise" baggage system, without any extra baggage screening levy.

(<http://bulletin.ninemsn.com.au/bulletin/EdDesk.nsf/0/4DD4F67689A6B1B3CA256C47001FB3DC?OpenDocument>)

The Qantas position is set out in a recent article in The Australian "Qantas Boss Demands Fair Go on Tax"

"Qantas boss demands fair go on tax

By Steve Creedy, aviation writer

May 12, 2003

THE burgeoning tax burden on air travellers was affecting demand and the Ansett levy should be dropped immediately, Qantas chief executive Geoff Dixon said yesterday.

He would also like to see wider tax relief for the industry and a recognition by government of some of the issues facing the tourism, travel and aviation industries.

Qantas only received \$22 of a recent \$49 sale fare, with the rest going on taxes.

"If it gets any lower than that we may as well give the game away," he said.

The fall in demand caused by severe acute respiratory syndrome has resulted in pressure on governments around the world to help the industry by cutting taxes and charges.

Qantas has been hit in both the international and domestic markets and attempts to stimulate domestic demand by cutting fares have fallen flat.

Both Qantas and Virgin Blue are unhappy about high taxes on tickets and have expressed concern the federal Government's plan to make the industry pay for a \$180 million aviation security package could add another \$5 to the cost of a ticket."

We have found some rather more substantive material from Canadian sources. The first item is a paper prepared by the Air Transport Association of Canada and Professor Fred Lazer of the Department of Economics at York University "A Crisis in Costs: the Canadian Government and Airline Passengers".

Much of that paper is concerned with the impact of increasing costs and charges (and subsidies to other forms of transportation) on airlines serving regional Canada. The paper does argue strongly that additional costs and charges are a major factor in service decline:

"The 'extra' costs and charges heaped on passengers are one of the main reasons for the deeper traffic decline in this country. Canada's security taxes, by far the highest in the world; and Canada's major airports are charged successively high rents by the Federal Government. The total fee burden on a Canadian airline ticket ranges from 7% to more than 40%. By contrast, the Canadian security fee is three times larger than the US fee and the total US fee burden normally ranges between 4% and 9% of the base fare."

A more substantive piece of work is "Airline Restructuring in Canada: Final Report", the report of the Independent Transition Observer on Airline Restructuring. The Observer was appointed by the Federal Minister of Transport in August 2000 with a brief to review the impacts of airline restructuring on stakeholders (triggered by Air Canada's acquisition of Canadian Airlines Corporation). The final report, delivered in September 2002, contains a very useful section on user pays. We quote the Observer's recommendations in full. All three would be useful guidelines if a passenger fee were to be introduced in New Zealand:

"3.0 Air Policy Recommendations: User Fees

- 3.1 *That the Government of Canada act to ensure that the "all-in" price of airline travel is clearly and transparently communicated to consumers in advertising and promotional material, whenever possible, and that if certain fees or costs are broken out as separate items, (e.g. GST/HST) that there is clear justification or legal requirement to do so.*
- 3.2 *That the government monitor the proliferation and level of all fees, including the Air Traveller Security Charge to assess the cumulative impact of these charges on airline demand, especially short-haul and low-fare travel, and to take corrective action if necessary.*

3.3 *That the Government of Canada review its user-fee/user pay policies and tax structure imposed on the airline sector to ensure that these policies and charges are consistent with those in other transportation sectors."*

Currently a Bill is before the Canadian Parliament proposing a reduction in the air transportation security charge by over 40%. Progress is delayed as the federal opposition wishes to see the charge removed completely.

A different perspective on the impact of passenger charges is found in a World Bank research paper published in September 1999, *Regulating Privatized Infrastructures and Airport Services* (available at [http://wbi0018.worldbank.org/research/workpapers.nsf/0/6fecfad5719d54df8525680400091144/\\$FILE/wps2180.pdf](http://wbi0018.worldbank.org/research/workpapers.nsf/0/6fecfad5719d54df8525680400091144/$FILE/wps2180.pdf))

In terms of demands for air transport services it notes "A demand for landings is generally quite price inelastic, due to the fact that airports usually do not have a local competitor and that airport charges represent a small proportion of airlines direct operating costs".

That comment refers to airport charges rather than passenger fees as such. It is based on research for ICAO, from which the conclusion on demand was drawn, reporting an average figure of 5% for airport and en route fees. Although that research is now more than 10 years old, in the absence of better research based evidence, it is still useful for considering the likely impact of charges in today's environment, even though there is at least anecdotal evidence that passengers are now more cost conscious.

The Australian and Canadian examples just discussed are reflective of the situation with aviation internationally. Post 9/11 and SARS, there has been a quite marked change in the demand for aviation services. Prominent in this has been a shift in demand towards low cost services (Air New Zealand, Air New Zealand's express service, and internationally the success of budget airlines). One consequence is that charges, which might have been relatively insignificant in pre 9/11 days, now bulk much more significantly in the cost of a ticket and in their impact on airline profitability.

It is difficult to forecast what would happen if New Zealand were to introduce a passenger departure (or passenger entry) tax to cover the costs of Customs services for processing passengers. Obviously, the level of any charge would be a key factor in passenger response. Customs expects to process in the order of seven million air passengers and crew in 2003/04 at a total cost (output class D3) of \$22.1 million, including \$5.3 million of Revenue:Other (presumably out of hours charges to Auckland, Wellington and Christchurch airports and charges to Hamilton, Palmerston North, Queenstown and Dunedin).

This suggests a cost per passenger in the order of \$3-\$4 (with both an entry and a departure tax) or a cost of \$6-\$8 on a one way charge (which, administratively, would no doubt be the preferred option). It is difficult to argue such a charge would have an incentive impact equivalent to the Canadian or Australian charges quoted above as they are an order of magnitude higher. For a passenger charge, therefore, the principal issues appear to be:

- ▶ Can any economic efficiency impact be anticipated?
- ▶ If not, would charging simply be a revenue raising measure?
- ▶ Is there a case for tidying up the current anomalies as between the three major international airports and the regional airports?

Again, as with the discussion of a possible Export Transaction Fee above, it may be worth thinking of alternatives. What would happen if airports were charged the full cost of Customs passenger processing? As a first step, they would almost certainly want the ability to discuss how processing services were managed in order to ensure that the costs they were required to bear were kept to a minimum.

Might this also provide a basis for closer coordination between passenger security and supply chain security through airports? Again, as with the IMO/MSA and supply chain security initiative with ports, there would seem to be a good argument that security issues associated with the movement of passengers and goods respectively through airports should be managed together. As with ports, placing the cost with airports should not only provide an incentive to seek out the most efficient means of delivering security outcomes within an airport context, but should also give airport companies an incentive to encourage the improvement of security offsite.

6. PUBLIC GOOD VERSUS PRIVATE GOOD

Discussion so far of the principles that Customs should apply in developing a charging policy has concentrated on the economic efficiency impacts of different charging options. In this section we consider the broader question of public versus private (or club) goods. (We note that these terms are well defined in the Treasury Guidelines paper.)

As a general principle, the optimal means of funding the cost of a good or service should be determined by its characteristics. Thus:

- ▶ Public goods are best funded through taxation.
- ▶ Private goods are best funded through direct user charge to the individuals or firms using them.
- ▶ Club goods are best funded by a charge on the members of the club (in practice, club goods are often charged for on a two-tier basis – a combination of an access fee and a user fee).

The distinctions are quite easily made in theory but often difficult to apply in practice because of the difficulty of determining, in any particular case, the nature of the service. This is further complicated by the fact that such decisions are not just technical in nature. They are often at least as much political in the sense that the decisions on the preferred means of funding are ultimately taken by ministers who, as well as advice from their officials, will also have representations from affected parties.

The Treasury Board of Canada paper referred to above includes the following caution, noting that user charges will often attract challenge arising:

*" ... **from the perception that**, no matter how rationally they are designed, they are "just another tax." Overcoming this can be difficult when: (1) client groups are strongly organized; (2) they can use such general "public policy" arguments as the alleged adverse effects of charges on income distribution; or (3) there appear to be no compensating benefits to offset the new charges. A critical problem in user charge policy is thus how to introduce and communicate such charges to the public at large and especially to those most directly affected."*

The stakeholder consultation that MDL has undertaken in the course of this project makes it clear that those words of caution are very appropriate. It is clear that, in respect of any user charge in relation to passenger movements or the export of goods, affected interests will argue strongly that the primary beneficiaries of Customs services are the New Zealand public as a whole and not individual passengers, exporters, airlines or shipping companies.

The argument is that in both of these areas the primary purpose of Customs services, including the supply chain security initiative, is to protect New Zealand's national interest on the grounds that all New Zealanders benefit from maintaining the country's reputation as a secure source for exports and a safe destination for travellers.

In each case, industry groups will argue that to regard Government determined security and surveillance measures as the equivalent of private services is wrong. They draw an analogy with defence or other taxpayer funded security services. Although operationally these services may deliver an immediate benefit to certain individuals or groups, the overriding beneficiary is all New Zealanders. Without a secure trading and travel environment, all New Zealanders would suffer through loss of opportunity, loss of income and employment, reduced wealth, and so on.

The alternative argument is clearly that benefits to New Zealand as a whole are more in the nature of positive externalities and that the true beneficiaries are the people and firms actually engaged in import, export or international travel. On this argument, the costs of maintaining a secure trade and travel environment are a necessary part of the cost of doing business.

On this line of argument, the principal reason for Government involvement is to correct a technical market failure. Firms and individuals engaged in trade or travel are seeking to purchase not just security services that will reduce the risk they face as passengers or that are faced by their goods and trade, to an acceptable level. They are also seeking to purchase a secure environment so that barriers to trade and travel are minimised.

This is not something they can purchase on their own. Unless all participants are prepared, collectively, to purchase the services as a means of achieving the desired outcome, then effectively none can. Accordingly, Government involvement is required in order to create a "compulsory club".

A further issue arises in the general public good/private good environment - the so-called exacerbator pays principle. On this argument, it is the person or firm whose actions or inactions give rise to the need for specific activities who should meet the cost of those activities.

This is an argument that needs to be applied with some care. MDL understands it has been suggested that airlines should be seen as exacerbators, on the basis that the need for passenger screening arises only because airlines bring passengers here. That is not an appropriate use of the exacerbator pays argument⁵. If anything, it is a private or club good argument to the effect that the cost of screening is a necessary part of the cost of doing business.

If the exacerbator pays argument has a role in allocating the costs of managing the border, it is an argument that those whose specific actions are a breach should meet the costs. On this argument, part of the penalty imposed on illegal immigrants, smugglers,

⁵ MDL understands that the Biosecurity Review takes a wider view, essentially that anyone undertaking an activity that gives rise to a need for a regulatory intervention should be treated as an exacerbator. MDL's preferred perspective is that this usage is too wide. The term 'exacerbator' has a pejorative flavour to it, suggesting conduct that, in some measure at least, is productive of negative social or environmental impacts. It does not seem consistent with this to treat as exacerbators people or firms whose lawful conduct necessarily requires some form of regulatory intervention. Hence our preference for regarding the intervention as a public good (taking an option view of the activity as one that preserves for all New Zealanders the opportunity to undertake activity of the type concerned) or as a club good in the sense of a service that benefits all firms or persons within a particular category, in this case exporters.

or firms whose management of their goods for export fell beneath acceptable standards would be a share of the cost of the services required to detect those behaviours.

Ultimately, the judgement on whether border management services should be seen as a public good or a private (or club) good is a political decision. As illustrations of the difficulty in making these judgements, MDL notes:

- ▶ The comment in paragraph 48 of the Customs paper in support of its budget bid that *"the degree of public versus private benefit in supply chain security is a matter of judgement, and a somewhat arbitrary one at that. This is because processes will contribute in an integrated way to both public and private benefits"*
- ▶ The comment of the Independent Observer on the Canadian air traveller's security charge that *"Securing the safety of airplanes and passengers doesn't only protect them: it protects all Canadians from the use of civil aircraft as weapons of mass destruction. It should be remembered that the first attempt on the World Trade Centre in New York used explosives in a van in the WTC parking lot. By the logic of the Air Travellers Security Charge, it would be equally sensible to charge security fees on vans or parking lots. In my view, the emphasis on extraordinary security charges for airline passengers ignores the reality of the threat to all Canadians and imposes an undue and unfair burden on airline passengers."*

None of this should be seen by Customs as suggesting an unacceptable level of uncertainty over the nature of its services and thus how they should be categorised and funded. It is quite usual in discussions of goods or services provided by the public sector for there to be no clear resolution of the character of any particular good or service along the public/merit/club/private good spectrum. A major reason for this is that, although the technical characteristics of various categories can be described in quite minute detail, actually determining which category any particular good or service fits can turn out to be very much a matter of subjective judgement. As one highly respected Director-General of Health once observed "where you stand depends on where you sit".

The more important question is to determine how any particular means of funding Customs' activity will provide effective incentives for people and firms in the system to work towards better outcomes.

7. CONCLUSION

The brief for this project required MDL to provide an overview of the issues that Customs should take into account when considering its charging policy. This report has identified a number but the ones that MDL recommends merit priority in Customs' consideration of this report are:

- ▶ Gaining broad acceptance of the new security emphasis in Customs' role and the associated shift in real accountability to our international partners.
- ▶ Ensuring that this is carried forward into government and other commitments to funding Customs' activities at the levels needed to satisfy those partners.
- ▶ Demonstrably building the capability to assess and manage the risks arising in this new environment.
- ▶ Developing means of charging that provide real incentives for efficiency improving responses. If transaction fees are used, devising means of working with key stakeholder groups that provide them with the incentive and the means to work for efficiency gains and reduced costs. If facility based charges are used, taking a broad based approach to security issues (eg integrating the response to the IMO initiative) and ensuring that facility managers have the opportunity to manage their security responsibilities in a way that encourages them to seek improvements along the supply chain.
- ▶ If the "compulsory club" analysis of Customs' security services is adopted, accepting the logical corollary that Customs is managing on behalf of the club in those aspects of its operations and ensuring that its organisational structure and relationship strategies support this.