

Background paper prepared for the World Development Report 2005

## **Customs Valuation Reform in the Philippines**

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### **Abstract**

This paper documents the adoption of transaction valuation reform in the Philippines and assesses its impact on collection, customs administration cost, and business transaction cost. It has been a major concern of the Philippine customs authorities and critics of the reform that giving up the use of published official customs values in order to adopt transaction values – defined as the prices actually paid or payable by the buyer to or for the benefit of the seller for the imported goods– would lower customs collection. On the contrary, as this paper shows the use of transaction values expanded customs revenues.

The views expressed are those of the author and do not necessarily reflect official views of the World Bank

## 1. Introduction

This paper documents the adoption of transaction valuation reform in the Philippines and assesses its impact on collection, customs administration cost, and business transaction cost. It has been a major concern of Philippine customs authorities and critics of the reform that giving up the use of published official customs values in order to adopt transaction values –concisely defined to be the prices actually paid or payable by the buyer to or for the benefit of the seller for the imported goods— would lower customs collection. On the contrary, as this paper shows the use of transaction values expanded customs revenues. It seems from the results in this paper that ex-ante fears on this matter may have grossly underestimated the positive response of importers to the lower than published home-consumption transaction values. By conferring the importers the legal right to be assessed on the basis of the transaction values of their imported merchandise, the customs authorities improved the gains for trade facilitation, which accrued to them when they automated import procedures.

There could not have been a more appropriate sequel to the relatively successful automation of customs procedures in the Philippines than modernizing the way customs authorities determine the dutiable value of the imports. Implemented between 1995 and 2000 with World Bank support, the automation program of the Bureau had substantially streamlined customs procedures, reducing the time required to process import cargoes, and improving transparency (e.g. see Bhatnagar, 2001; Hors, 2001, Maniego, 1999)<sup>1,2</sup>. Considered by the World Customs Organization (WCO) as a major force changing the nature and content of customs work worldwide,<sup>3</sup> automation of procedures, particularly of the Bureau's import assessment and cargo clearance system, has provided importers substantial savings in time, finances and costs associated with going through bureaucratic procedures. As a result, the BOC's Automated Customs Operations System (ACOS) has improved the Bureau's productivity and, more importantly, has reduced the expected net benefit of fraud and corruption.<sup>4</sup>

Since the 1950s, many countries assessed customs duties on the basis of the Brussels Definition of Value (BVD) or a variant thereof. The BVD method determined a normal price of

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<sup>1</sup> See Parayno (2003) for a description of the Bureau's automation program. The author was the Commissioner of Customs when the program was implemented.

<sup>2</sup> Of the US\$27 million, the Bureau of Customs borrowed \$19 million from the World Bank to procure hardware and software (Bhatnagar, 2001).

<sup>3</sup> In a recent survey it conducted involving 38 countries or 27 % of its members, 71% of the respondents indicated that information technology is used to assist customs authorities in storing and using data on trade transactions and related information to improve its operations (see WCO, undated).

<sup>4</sup> According to Bhatnagar (2003), information technology supported systems require the standardization and publication of rules and procedures. As a consequence, it reduces the discretion and opportunity for arbitrary action, increases accountability, and enhances the possibility of exposing corrupt practices of civil servants. Maniego (1999) documented the benefits of the Bureau of Customs computerization project.

the imported merchandise, defined to be "the price that a good would fetch in an open market between a buyer and seller independent of each other." According to this system the applicable duties and taxes were assessed. The Philippine customs valuation procedure comprised a series of variants of the BDV, which under Philippine laws since the 1950s had received various labels: home consumption value, fair market value, and published values. All these values were notional prices of specific imported products, and customs authorities maintained, updated and published these. Traders particularly disliked this method because customs authorities adjusted these notional values less frequently than actual market price movements. Moreover, the method failed to consider changes in the relative competitiveness of firms and the prices of new and unusual products.

While the GATT members in 1979 formulated a customs valuation code during its Tokyo Round of trade negotiations, the Philippine government did not sign this stand-alone agreement. The code prescribes the use of transaction values, defined as the price actually paid or payable by the buyer to or for the benefit of the seller for the imported goods, and which includes all payments made as a condition of sale of the imported goods by the buyer to the seller, or by the buyer to a third party to satisfy an obligation of the seller. This manner of determining customs values aimed to provide a fair, harmonized, and neutral customs valuation procedure that was in line with changing market forces.

In 1995, when the Uruguay Round Final Act of the GATT created the World Trade Organization and issued an Agreement on the Interpretation of Article VII, which among other provisions mandated all its members to adopt the transaction valuation procedure, by 2000 at the latest for developing countries. The interpretative agreement provided as well various legally binding rules and procedures for the proper implementation of Article VII. The report discusses the challenges faced by the Philippine government and its responses when it legally enabled this agreement. Between 1995 and 1997, the Philippine government worked to enact R.A. 8181, adopting the transaction valuation system in accordance with its obligation as a WTO member to implement the customs valuation agreement at a time no later than 2000. In 2001, or a year after it implemented this law, the government passed R.A. 9135 to remove the use of published values from the law, which was inconsistent with the use of transaction values.

This report discusses the challenges the Bureau of Customs faced in implementing the transaction valuation law including the setting up of a post entry audit capability and related safeguards to protect its collection. R.A. 9135 authorized post-entry customs audits as a mechanism designed to protect customs collection and at the same time facilitate trade. Another casualty of transaction valuation reform is third party pre-shipment inspection. The Bureau

discontinued pre-shipment inspection, which as used in the Philippines was inconsistent with the spirit and objectives of the law on the use of transaction values. Interestingly, the clamor for safeguards of the private sector in 2000 against possible unreasonable use of discretion, and harassment, inherent in a customs administration perceived to lack transparency and accountability, led to a useful innovation in customs administration with the super green lane (SGL) facility. While it is yet early to make an assessment of the post-entry audits, the paper nonetheless will document the process in setting them up and highlight the features of the programs that require monitoring and improvements.

## **1. Enabling Transaction Values**

The WTO requires all members to use transaction value as the legal basis in assessing the dutiable value of imported merchandise. This is the price that importers actually paid or legally bound to pay for the goods they bring in to the country. Transaction values also incorporate the other expenses necessary in making, exporting and bringing the merchandise into the territory of the importing country, which are not yet included in the price. Such expenses may include commissions and brokerage fees; cost of containers; and the cost of packing, whether for labor or materials; the cost of transport of the imported goods from the port of exportation to the port of entry in the Philippines; loading, unloading and handling charges associated with the transport of the imported goods from the country of exportation to the port of entry in the Philippines; and the cost of insurance.

These other components of transaction values that normally are not observed at the point of importation may include the value of materials, components, parts and items incorporated in the imported goods; tools, dies, moulds and similar items used in the production of the imported goods; materials consumed in the production of imported goods; and engineering, development, artwork, design work, and plans and sketches undertaken elsewhere than in the country of importation and necessary for the production of imported goods. These cost items may also cover the amount of royalties and license fees that the buyer must pay, either directly or indirectly, in connection with the goods being valued, as a condition of sale of the goods to the buyer and the value of any part of the proceeds of any subsequent resale, disposal or use of the imported goods that accrues directly or indirectly to the seller.

The WTO agreement prescribes a hierarchy of six (6) methods that customs authorities need to apply sequentially and conditionally in computing transaction values. Under method 1, the transaction value is the invoice value of the merchandise, as may possibly be adjusted for necessary expenses such as those described above. This method is inapplicable if: (a) the buyer

and seller are related to each other and the relationship had an effect on the price of the imported merchandise; (b) there are restrictions as to the disposition of the imported merchandise where such restrictions influenced the price; (c) there are considerations that influenced the value of the merchandise such as if the transaction in question is tied to another between the two parties concerned; and (d) part of the proceeds obtained in the disposal and use of the merchandise by buyer would accrue to the seller of the good.

Customs authorities apply Method 1, if it is applicable to do so. Otherwise, they need to use Method 2, which is the transaction value of an identical good. If Method 2 could not be used because there is no identical good to calculate the value of, WTO members need to apply Method 3, and this is the transaction value of a similar good. The sequence goes on to Method 4 (Deductive value), Method 5 (Computed Value), and Method 6 (Fallback Value). Under method 6, if this is ever used at all, customs authorities are obliged to disclose how the fallback value was calculated. The agreement defines a clear process of computing transaction values. The likelihood is high the transaction value of an imported merchandise is obtainable under any of the first three methods. In laying down a clear process and enjoining all its members to abide by these rules, the WTO agreement reduces discretion, improves transparency and makes customs valuation procedure all over the world increasingly predictable. Accordingly, the agreement facilitates trade.

### **1.1. *Pre-Reform Valuation Rules***

The series of changes of customs valuation procedures of the Philippine government stretches as far back as about a hundred years ago. Table 1 shows this evolution. Before the Philippine government adopted the WTO's transaction valuation rules, the rules virtually allowed customs authorities to exercise a good amount of discretion. Accurate, reliable and timely information was costly to acquire and the rules failed to provide specific instructions when to use one valuation rule over another. The virtually multiple valuation rules regime subjected import businesses to uncertainty and compelled importers to make deals with customs authorities to secure the most privately profitable terms for their businesses. The high import duties particularly in the 1960s, aimed at protecting domestic industries, compounded the situation by increasing the incentive to negotiate for the appropriate tariff and tax payments, and a favorable decision had to be reciprocated illegally. The regime and practice spawned integrity problems in Philippine customs administration, which spread throughout the Bureau.

Table 1. Philippine Customs Valuation Regulations: 1909 to 1986

Year	Customs laws and Valuation Used	Remarks
1909	Tariff Act required the use of actual market value	Since most of the country's imports came from the United States, Philippine colonial government used customs values published in the United States.
1958	R.A. 1937 required the use of the market value	R.A. 1937 also - authorized the use of domestic market value of the same or similar merchandise when sold in the Philippines, appropriately adjusted to make it comparable to the value of the good at the border; - authorized the use of invoice values
1972	P.D. 34 required use home consumption values	P.D. 34 also required - To contain the growing problem of under-valuation and misclassification of imported merchandise; - To curb the dumping of imported goods; - To neutralize the export subsidies by governments of exporting countries; - deputize revenue
1978	P.D. 1464 reiterated the use of home consumption values	P.D. 1464 codified the country's tariff and customs laws.
1986	EO 156 required the use of fair market value	EO 156 also required - using the actual cost of freight and insurance instead of an across the board 10 percent surcharge; - adding other expenses needed to bringing the goods to the Philippines were added to the price to obtain the dutiable value

Changes to customs valuation rules typically aimed to reduce technical smuggling and corruption. For example, the need to contain the growing problem of under-valuation and misclassification of imported merchandise, which reduced government revenues and aggravated corruption, prompted reforms such as the issuance of P.D. 34 in 1972. Customs authorities were required to use and publish home consumption values, defined to be the wholesale price of the good being exported to the Philippines at about the time of exportation in the principal markets of the exporting country. By causing the publication of home consumption values, the authorities aimed to introduce transparency and provide protection to importers from abuse of authority by corrupt customs officials.

The use of published home consumption values failed to put an end to the technical smuggling and integrity problems in customs administration. While the Commissioner of Customs regularly updated this list, the updates were less frequent than market price changes.

P.D. 34 underestimated the resources and coordination with the various consular offices of the Philippine government required to effectively implement the reform.<sup>5</sup> A survey done in 1987 by Societe Generale de Surveillance (SGS), a pre-shipment inspection firm, revealed that 80 percent of the merchandise imported to the Philippines did not have any published values, ten percent had published values equal to the export price, and the remaining ten percent were the only ones with true home consumption values.<sup>6</sup> The lack of real time synchrony between published official HCVs and market values, the partial coverage of the list of published values or the imperfect distribution of information about published values was a source of friction between taxpayers and customs officials and created the opportunity to negotiate. These were the ingredients for the continued regime of multiple valuation rules, exercise of discretion, and technical smuggling.

## **1.2. Pre-shipment Inspection**

One important reform following the change of government in the Philippines in 1986 was to engage the services of a pre-shipment inspection (PSI) firm, SGS, in authenticating the declared values of imported merchandise. In 1987, the PSI agreement between SGS and the Philippine government covered three countries namely Japan, Hong Kong and Taiwan. The list was expanded to other East Asian countries including Singapore, Thailand, Indonesia, Malaysia, Brunei, South Korea and Macau. In 1992 and with the recommendation of the domestic industries, the SGS contract was expanded to cover all countries and commodities.

Pre-shipment inspection was a pivotal feature in the import assessment and cargo clearance process. The SGS provided validation services for the values declared by the importer and issued a Clean Report of Findings (CRF) to the Bureau of Customs. The CRF indicated the acceptable dutiable value that the importer needs to pay. The process is complicated involving cross-border interaction between the offices of the PSI firm, the SGS-Manila Liaison Office and the SGS inspection office in the exporting country. The CRF document was central to the customs clearance procedure and that granted the PSI firm a very important role in the process. While imported merchandise continued to be assessed on the basis of published values if these were available, the CRF-reported dutiable values were the basis for assessing duties and taxes for those goods without any published values. The SGS inspected goods particularly those that were declared as “used” or “second grade”. In principle, all goods with an L/C of at least USD 500

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<sup>5</sup> The involvement of diplomatic officers only resulted in a redistribution of the rents from under-valuation of imported merchandise. The gathering of price information by diplomatic officers was an added function of these government officials, who tended to implement this duty on a best effort basis. Market information that they provided was irregular, outdated, resulting in home consumption values, which differed with market values.

<sup>6</sup> This information is obtained from Medalla, de Dios, and Aldaba (1997).

FOB were covered by PSI. But regardless of value, the PSI firm was expected to inspect and issue a CRF, if this were appropriate, for goods declared as used or inferior. At its height, SGS pre-shipment inspection covered sixty countries and 95 percent of all imported merchandise came from only ten countries.

Before the implementation of the WTO valuation in 2000, there were calls for the elimination of pre-shipment inspection. Critics claimed that the Philippines did not get a good return from the pre-shipment inspection contract with SGS. The contract, which cost the Philippine government a few billion pesos a year or more than the annual budget of the Bureau of Customs, delivered performance that was difficult to verify. While the PSI firm maintained that it contributed to the expansion of revenues, the data and analysis provided fell short of proving the claim to its critics, a few of whom were in high positions in the Philippine government.

In the meantime, the transaction valuation agreement indicates that pre-shipment inspection could not be used to determine dutiable values. The CRF values generated by the PSI firm became legally worthless, reducing substantially the benefit of pre-shipment inspection. In March 2000, the Philippine government decided to let go its PSI contract with SGS.

### **1.3. *R.A. 8181: A Mishmash of Transaction and Notional Valuation***

Developing country contracting parties had up to 2000 to reflect in their respective domestic laws the provisions of Article VII of the GATT 1994, which is the Customs Valuation Agreement on the implementation of transaction value system. In March 1996, the Philippine Congress enacted R.A. 8181 to implement the transaction valuation scheme on or before January 1, 2000. The President was given the power to recommend to Congress to adopt the scheme earlier than 2000 in accordance with the provisions of the Act.

R.A. 8181 was a badly crafted law. While the law in essence reflected the salient provisions of the customs valuation treaty of the WTO, it nonetheless provided for the continued use of published notional values in determining import assessments. In effect, the law provided for a dual customs valuation regime and it is not clear to the customs authorities when they would use one or the other. After enumerating the sequential steps in determining the transaction value of a merchandise, R.A. 8181 states that “the correct dutiable value of the imported goods referred to above shall be ascertained by the Commissioner of Customs from reports of revenue or commercial attaches or other Philippine diplomatic officers and from such other sources of information as maybe available to the Bureau of Customs’. As written, customs authorities in the Philippines had the power to use either transaction or published home consumption values. In resolving a possible conflict between the two values on the same merchandise, an



implementing rule of RA 8181 states that the customs authorities ought to use the higher of the two, which clearly departs from the treaty provisions.

How R.A. 8181 was finally crafted reflected the concerns of various groups starting with domestic producers. Producers, such as the Federation of Philippine Industries during that time, have been concerned that the new valuation scheme would only facilitate the dumping of imported merchandise in the country, resulting in unfair competition and loss of jobs in the country. These producers had expressed their respective views or concerns about the transaction valuation scheme. They had asked for safeguards against dumping and subsidized exports. If it were up to them, they would not pass R.A. 8181 and would rather have pre-shipment inspection under SGS or any other PSI firm to continue. The valuation regime involving HCVs along with pre-shipment inspection was more supportive of their objectives than transaction valuation procedures. These producers did not get what they aimed for, which is to prevent the enabling of transaction valuation in the Philippines, but that did not stop them in pursuing their objectives, this time through the use of implementing regulations. Thus, about a year before the impending shift to transaction valuation, representatives from these domestic industries requested the Department of Finance to instruct the Customs Commissioner to use domestic wholesale selling price to be the only basis of the dutiable value of imported merchandise. The presumption in their proposal was that all imports are under-valued and in addition to using published values, these producers further asked to limit to 10% of the value the deductions for expenses and profits. They got slightly more under RA 8181, 25% of the import values were allowed for such deductions.

The customs authorities likewise were concerned about under-valuation and how R.A. 8181 would reduce collection, which accounts for about twenty percent of the government's tax income. When the law was deliberated in 1996, the customs officials did not have a good access to information as to how the possible problem of under-valuation is dealt with under a transaction valuation scheme. The available remedy to them during the time was the tried and tested prescription of maintaining a list of published values, which the agency can use against under-valuation. Interestingly, the safeguard excluded pre-shipment inspection although that would not have prevented the government from contracting with a firm for pre-shipment inspection services. PSI services would have complemented the safeguard by providing information that would eventually be processed to update published values by the customs agency. One reason for excluding pre-shipment inspection was that the author of R.A. 8181 had advocated for the cancellation of the PSI contract. The available remedy to under-valuation was to enable customs authorities to use published values, if this were needed in the interest of service. Hence, R.A.

8181 was not fully compliant with the treaty obligations in the WTO customs valuation agreement.

#### **1.4. R.A. 9135: Transaction Valuation Enabled**

While this lobbying was going on in 1999 a year before the implementation of transaction valuation in 2000, legislative bills were filed to amend R.A. 8181 in order to remove any ambiguity in the law. The initiative came from the Steering Committee that was created in order to oversee the transition from home consumption to transaction values. The Deputy Commissioner of Customs for Port Operations and Assessment headed the Committee. The main objective of the Committee was to implement the WTO transaction valuation system, identify the critical areas of concern on both the bureau and other stakeholders, and determine how these concerns ought to be handled. A Technical Working Group assisted the Steering Committee and was headed by the Director for Import Assessment Services. The group reviewed existing laws and regulations to determine the degree of their divergence from the customs valuation agreement and to identify the legislative and administrative changes to be made. It traced the procedural and organizational implications of these changes and determined the additional capability within the Bureau to effect these changes including interface with Automated Customs Operating System (ACOS). It formulated a program of activities leading to the complete implementation of the Agreement. Selected customs officials were appointed to form the technical working group and they were assisted by a technical assistance team, which was made available to the Bureau under a trade capacity building technical assistance project of USAID/Philippines. The technical working group worked with the members of Congress to strengthen the domestic law on the implementation of transactions values and to enable post entry audit to address the revenue concerns of the Bureau.

The bills seeking to amend R.A. 8181 were enacted into law as R.A. 9135 in May 2001. RA 9135 disallowed the use of published values as the basis for customs valuation, and allowed a post entry audit system of value verification. It, in effect, substantially reduced the discretion of customs authorities to determine the value of imported goods at the border. This allowed goods to be released faster. The focus of discussion during legislation was on the problem of under-valuation, which the use of transaction values may inadvertently aggravate. It is recalled that R.A. 8181 offered to solve this problem with the continuing use published values. Disputes arise and in order not to hold

The representatives of the import substituting industries supported the use of published values. Instead of published values, the technical working group offered to Congress the use of

post-entry audits to deter under-valuation. Customs audits had not been allowed under the country's existing customs laws, the primary strategy being for customs administration has been to keep the imported merchandise within the customs zone until officials are satisfied that the importer had complied with the relevant laws and regulations of the country, at the expense of trade facilitation and increased transactions cost. R.A. 9135 incorporated the suggestion of the Bureau which was to use post-entry custom audits not only to deter under-valuation but more importantly also to help the Bureau's clients comply with customs and related laws and rules in general.

With the transaction valuation law, home consumption values or other notional values can no longer be used as basis in determining import assessments. However, customs authorities under the WTO agreement continued to have the right to exercise a doubt on the declared value in a way consistent with the objectives of the transaction valuation agreement of the WTO. They exercise this right through the valuation range information system. However, unless they have evidence that fraud is committed, the authorities are constrained to release the imported article, the declared value of which may remain disputed. This is why post-entry audits may now be needed as a means to deter under-valuation. Post-entry audit is discussed in a separate section below.

This reform was the outcome of the work over a period of two years of the Technical Working Group. In addition to drafting bill, consultations were held with the private sector and numerous information dissemination activities were conducted to explain the proposed revisions to the law and the need for the post entry audits. The group actively advocated in Congress the bill as it went through the legislative process, from committee hearings at the Lower House to sponsorship on the floor in late November 2000. The support from the other executive agencies such as the Finance Department and the National Economic Development Authority was critical, which paved the way for securing a certification from the President that the bill is important and urgent.

## **2. Implementing Transaction Valuation**

Upon the signing of RA 9135 into law in May 2001 by President Arroyo, the Commissioner of Customs constituted the Post-Entry Audit Management Steering Committee (PEA-MSC) and the Post-Entry Audit Technical Subcommittee (PEA-TSC) to plan and manage the implementation of the law, monitor work progress, integrate the PEA program into the whole BOC corporate plan and submit report to the Commissioner. Four technical working groups were

formed under it, namely (a) Legal Matters, (b) Operational Systems and Procedures, (c) Information and Risk Management, (d) and Change Management.

## **2.1. Implementing Regulations**

In November 2001, the Secretary of Finance issued Customs Administrative Order (CAO) No. 5 – 2001, which spelled out how R.A. 9135 ought to be implemented including post entry custom audits. The Customs Administrative Order 5-2001

- Defined the primary and five alternate methods of valuation, with the elements and conditions for the application of each method clearly presented. This provision removes the discretion of customs officers in adopting a valuation method and how such a method is to be applied.
- Provided for reference values as a risk assessment tool and not as substitute values. This is Value Range Information System, the nature and implementation of which is discussed below.
- Set the administrative policies governing currency conversion, tentative releases under guarantee in cases of valuation disputes, finality of liquidation of imports, and appeals on adverse decisions.
- Provided the rules on record-keeping and compliance audit, including the definition of the entity obliged to keep records, the kinds or classes of documents, records or data that must be kept for audit purposes, and the target, scope and authorities of audits, including selection criteria.
- Set the rules on the compulsory acquisition by government of grossly undervalued imports.<sup>7</sup>
- Defined the criminal and administrative sanctions against non-compliance.

The implementing regulations took half a year to be released due to lingering concerns of the private sector stakeholders, which the Commissioner entertained, despite the fact that public consultations had already been held on earlier draft regulations, and because of turnover of top management at Department of Finance in 2001<sup>8</sup>. The Legal Matters sub-committee conducted public consultations on the implementing regulations of the law with the Philippine Chamber of Commerce and Industry, Federation of Philippine Industries and Confederation of Customs

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<sup>7</sup> The idea for compulsory acquisition was obtained from a resource person in a training assistance program on transaction valuation. Compulsory acquisition is a provision in New Zealand's customs laws that had never been used there. In a training organized under the auspices of APEC, this provision was told to Philippine customs officials who were concerned about under-valuation, and the idea stuck in their minds. By putting this into the law, customs has the legal right to buy any good it likes from the importer at the value declared by it.

<sup>8</sup> In the middle of 2001, Secretary of Finance Alberto Romulo was appointed as the Executive Secretary and Secretary Jose Isidro Camacho assumed the finance post. This in turned triggered a change in top management at the Department of Finance.

Brokers Inc., who separately raised the issues on the scope of the audit and record keeping as well as the concern that audits may deteriorate into a "fishing expedition" and used to harass importers and brokers. These stakeholders reiterated their preference for BOC to use published values.

The Legal Matters sub-committee dealt with legal issues associated with implementing R.A. 9135, which it addressed by recommending to the Customs Commissioner the issuance of five separate Customs Memorandum Orders. These implementing issuances included (1) CMO 37-2001 on the role of the Valuation and Classification Review Committee (VCRC), consolidating previous CMOs with additional modifications on cargo clearance; (2) CMO 02-2002 on record-keeping and post entry audit guidelines; (3) CMO 01-2002 on the determination of administrative liability and the imposition of administrative fines; (4) CMO 03-2002 on procedures in protest cases in the determination of the customs value and tariff classification of imported goods under the transaction valuation regime; and (5) CMO 04-2002 on implementing the compulsory acquisition of grossly undervalued imports.

One important, if not the top, issue dealt by the Bureau of Customs was on how to implement the transaction valuation and at the same time protect its collection. Every year, the Bureau has a target collection to meet and being new, the WTO valuation rules have the potential of reducing their collection through undervaluation. Another concern was on how to implement customs audits properly, particularly because the importers and their agents had expressed a possible problem of customs auditors using these powers to harass them.

## **2.2. Valuation Range Information System**

The shift to transaction values has the potential of aggravating the problem of undervaluation. What importers declare as transaction values is legal until proven otherwise, which is difficult to prove considering that customs authorities have imperfect information on the authenticity of declared import values. Not only is this a concern of customs authorities, domestic producers stand to partly lose as well the trade protection they have. The use of published home consumption values accords the customs authorities and domestic producers a protection against possible under-valuation, and reduces uncertainty.

The value range information system (VRIS) was established to deter under-valuation. The system consists of ranges of values of imported articles, which in turn are the respective minimum and maximum values of a given article imported in the immediately preceding the last update of these value ranges. The VRIS is a screen in the selectivity module of ACOS. When the declared value of the merchandise fell out of the value range for that article, the import entry transaction is tagged and the customs authorities require the importer to show to the Valuation

and Classification Review Committee (VCRC) the needed documents showing that the declared value is legitimate before continuing with the import clearance process.

This validation process, according to customs authorities, is consistent with the customs valuation agreement of the WTO in the sense that there is nothing in VRIS that legally restores the use of published values. Article 17 of the WTO Customs Valuation Agreement allows the validation provided that the exercise of this power by any member economy is consistent with the objective of the Agreement as a whole, which is to harmonize customs valuation systems worldwide using transactions values and to facilitate trade. The process manifests BOC's exercise of its mandate under the country's customs code to enforce the country's tax laws and related regulations.

The mainstream approach of the Bureau to customs supervision puts greater emphasis on clearing import transactions, a system that the Bureau had automated with its Automated Customs Operations System (ACOS). ACOS is a set of computer programs, of which the software package ASYCUDA<sup>9</sup> is the main software program. With ASYCUDA, smaller programs form part of ACOS and include the Automatic Matching of Payments and Payables (AMPP) and the On Line Release System (OLRS). The AMPP matches payment made by the importer to an Accredited Agent Bank with the assessment determined by the ASYCUDA program. If the payment matches the assessment, and the OLRs sends a notice to the arrastre to release the goods, completing the entire import cargo clearance process.

The ASYCUDA, the current version of which is ASYCUDA<sup>++</sup>, after receiving the electronic copies of the import entry documents, runs its selectivity module, which selects the import entries that require documentary (yellow lane) or documentary and physical examination (red lane). Unless selected, all import entries are on the green lane. Yellow lane selected entries involve products that are regulated by other agencies such as the Department of Agriculture for sanitary and phyto-sanitary regulations or the Department of Trade and Industry for product standards. While the examination of import documents and the cargo is conducted for a selected entry, automated processing is temporarily suspended. The examination officer, having completed the check, resumes running the ASYCUDA program, in which case the import entry is shifted forward to that part of ACOS where payment and assessment are matched by the AMPP program.

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<sup>9</sup> ASYCUDA was developed and is maintained by UNCTAD. At least 80 countries uses the software for at least their respective import clearance procedures

The Selectivity Module a risk management tool of the Bureau, comprising about 25 screen windows designed to select those entries to be assigned to the yellow or red lane.<sup>10</sup> The Risk Management Group (RMG) under the Bureau's Intelligence and Enforcement Group (IEG) is responsible for updating the selection criteria of the Module. The selection screens need regular updating to reflect the currently discovered risks or new regulations. Ideally, these screens should be updated at least once a month to reflect the most recent import conditions. However, this capability is yet to be developed and institutionalized.

The VRIS is an added screen to the Bureau's selectivity module. A "hit" by the VRIS virtually puts the import entry in the yellow lane and in this lane the responsible official has to check if the import documents are compliant with the relevant regulations. After going through the documentary examination and finding the import documents compliant, the responsible official resumes automated processing of the import entry and puts it back on the green lane.

Integrity problems may arise when an import entry is "hit" by the VRIS and the processing of the entry is suspended. There are unverified reports that import assessors give the importer the option to go to the VCRC as the regulation stipulates or to agree to upgrade his declared values, which is not part of the regulation. The objective of the upgrade is for the import entry to be in the value range. There is asymmetry of information here. The official knows what values are in the range, but the importer may not have the information. A negotiation may occur between the importer and the responsible official. The importer's objective is to avoid the transaction cost in going to the VCRC to submit documents showing the authenticity of the declared value or if that fails to file a bond to secure a conditional release of his goods, which requires resources.

The importer trying to minimize transaction cost needs a favor from the responsible official, which is to put his import entry back to the green lane, and the price for that is a voluntary upgrade of his declaration and the cost of the favor. The cost, comprising the upgrade and facilitation fee to the responsible official, depends upon the seriousness of the VRIS "hit". The problem can be worse and that is when the importer has the intent to under-value and his import entry gets a "hit" by the system. In this case, the importer would be asking a relatively larger favor from the responsible official and that deal has a potentially higher cost.

Top customs management anticipated these problems and that is why it centralized value validation process. All that the assessors do is to send the importer whose entry was hit to the VCRC to validate the value or if this validation took longer to file a bond and get his goods

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<sup>10</sup> Arana, R. (1999) describes the process in conducting a risk analysis using selection filters.

conditionally released. This is a process lasting from one hour to three days. If anecdotal information on what is going on between the importer and examiner as described here is true, then management may need to review the system in order to monitor these “hits”, how these were resolved, who was accountable, and why they were resolved in a particular way.

If the VRIS is not properly implemented, the transaction cost it entails and the potential integrity problem situation it inadvertently causes may progressively deteriorate. The problem approaches annoying situations if the VRIS hits repetitively a routinely imported good, i.e. going to the VCRC repetitively to make the same explanation and disclose the same documents. On the part of customs authorities, this is an unnecessary addition to their duties. The likelihood of this happening increases if the value ranges in the VRIS are not regularly updated and the commodity description is not precise.

#### *a) Better Updates of Value Ranges*

There are two implementation problems to consider here: frequency of value ranges updates and the description of goods. The VRIS is updated every quarter and despite BOC’s automated import clearance system, the updates are done manually. The VRIS update is done by the Value Screen Working Group and involves re-estimating the ranges of the declared values (high and low) of a given imported article from the set of declared values since the last update is made. Because market values change frequently, the more frequent the update is the better it is for the importers. With its computer system, these updates can be done more frequently and automatically. However, problems occur in that some importers do not properly describe the goods that they import in their respective import entries. This can happen and the system is designed such that customs assessors are supposed to correct these mistakes before the data is put into the ACOS database. But a few of them fail to do this job and the mistakes get stored with the data in the database, rendering full automation of updates of value ranges impossible. The Value Screen Working Group would need to check manually the ranges that ACOS estimated in order to correct the erroneous estimates. Because there are a good number of these cases, this process takes time and the updates are done only every quarter. Moreover, the members of the working group have other responsibilities.

A related issue is the phenomenon of progressive downgrades of values in the ACOS database. Suppose a subset of importers who play the game of reducing their tax payments and they do this by producing either fake invoices, or hide components of the transaction values, or both but in a way that the incorrect transaction value that they declare are still within the range. Given this behavior, the declared values of these importers would tend to cluster near the respected minima of the value ranges. Repeated declarations like these will progressively scale



down the value ranges. To offset this phenomenon, customs authorities need to regularly fix their ranges using a valuation database external to the ACOS.

*b) Proper Description of Goods*

The other but related problem is the convention followed by BOC in describing imported goods. An improved description of goods can make the value ranges more precise and reduce the likelihood of unnecessary “hits” and makes full automation of value range updates possible. The following illustrates the unnecessary transaction cost of the VRIS to an importer of a generic product such as a pair of rubber shoes. This product may well be described in ACOS as rubber shoes, the description being silent about whether the pair carries one of the popular brands of rubber shoes. If the imports of rubber shoes in the last quarter were all branded pairs of shoes, the calculated value range for rubber shoes reflect the high values for these types of shoes. In the current quarter, when the importer brings into the country generic pairs of rubber shoes, his entry is “hit” by the VRIS for no good reason. The importer goes to the VCRC to prove that the declared value for his generic pairs of rubber shoes is correct. The problem would have been avoided if the description of goods were further detailed to discriminate among brands and generic products. A better description of goods makes ACOS more intelligent and spare importers the extra unnecessary cost.

The Philippine customs authorities are in the process of making its convention on the description of goods more accurate. In the middle of 2003, it conducted workshops with its appraisers and examiners of the different sections of the Formal Entry Division of its two major ports, the Port of Manila and the Manila International Container Port. The workshops lacked productive cooperation from its participants and did not produce any good results. To analysts, the outcome was expected since the process leads to a clean and intelligent database, which ensures a more efficient and quality decision-making in any stage of the import clearance process and at any given level of the management hierarchy exercising customs control, whether at the border or at post entry. Better-informed decisions help sustain trade facilitation. At the same time, accurate information will also better equip the customs authorities in identifying and tagging non-compliant transactions and impose appropriate intervention mechanisms. On the other side of the coin, this type of database would result in eroding opportunities for soliciting illegal commissions from brokers and importers, and this may explain the grudging cooperation from appraisers and examiners.

Customs authorities consulted with private sector representatives in late 2003 on this matter, particularly the brokers and importers, and this was relatively more productive. Industry experts demonstrated knowledge of the products and brought catalogues and materials that

customs appraisers and examiners failed to deliver. The private sector participants supported the proposal that descriptions for specific products would be assigned specific numbers using the seven digits available in the ACOS to be appended to the HS Code and the convention will be made official by a memorandum circular on the matter from the Customs Commissioner.

### **2.3. *Post Entry Audits***

R.A. 9135 ushered a paradigm shift in customs administration in the country from supervision that was primarily focused at the border to back-end controls. This enabling law also mandated importers and custom brokers to have a more efficient record keeping by maintaining import and business records within a period of three years from date of importation for custom audit purposes, and laid down severe criminal and pecuniary sanctions to be imposed for non-compliance.

Post entry audits are the primary tools of back end customs supervision and complement transaction valuation reform in reducing transaction cost. Customs supervision before this law entailed substantial transactions costs on the part of importers. Goods are held at the border until customs officials would have determined that the relevant laws and regulations had been complied with. Automation helped reduce these costs by streamlining import clearance procedure. However, the underlying philosophy of customs management then comprised the use of official minimum values. The gain for trade facilitation of automation was not enhanced because of valuation related differences between importers and customs authorities.

While their thrust is to facilitate voluntary compliance, post entry audits serve as well to deter tax evasion and violations of customs and other regulations. In an audit, tax payment discrepancies may be discovered and the importer will be asked to settle his remaining obligations to customs authorities. Unless fraud is established, customs authorities regard these discrepancies as unintended mistakes and help importers to comply with the regulations.

Post entry audits are a best-practice tool in today's customs administration all over the world. The key result areas of this vision cover reduced transaction costs, increased compliance through voluntary disclosures, lower incidence of customs fraud, revenue assurance, and improved skills of customs personnel. The situation before the reform is limiting trade expansion in the sense that customs resources are overly focused on border enforcement with its consequent high transaction cost. Personnel have inadequate skills in gathering accurate commercial intelligence and managing risks, an outcome of out-sourcing these services to a pre-shipment inspection service provider. The costs of keeping the Bureau personnel continued to be expended even as the government paid for the services of the pre-shipment inspection company. With post-

entry audits and the related modernization of customs administration using information technology, the agency's personnel improve their skills and customs administration becomes more cost-effective, sensitive to client needs, as well highly adaptive to continuous change.

In the present situation, the Bureau is faced with competing demands. On one hand, it is tasked to increased revenues to help reduce the fiscal deficit. But on the other hand, pressure is rising for trade facilitation. With post entry audits, the agency is better able to manage competing demands. Before audits were authorized, resources of the bureau were targeted at the border. Goods are kept within the customs zone until compliance with taxes and regulations is assured. This approach to customs supervision is inconsistent with the demand for higher trade facilitation. With post-entry audits and transaction valuation, resources of the agency are shifted to back-end control and ensure the accomplishment of revenue assurance and compliance with customs regulations. Importers benefit from this shift through quicker release of their goods. Post-entry audits form a preventive net by undertaking a verification exercise to check the degree of compliance of the Bureau's clients.

There are at least four items of a transaction value that require a preventive net through post entry audits. In general, the following items of transaction values are difficult to determine at the border, as these ordinarily may not be reflected in the invoice. One item includes selling commissions, which are ordinarily paid after the goods would have been released from the customs zone. These costs are payable and thus are part of the transaction value of the imported merchandise. A second item comprises assists such as payment for the use of moulds owned by a third party and used in manufacturing the imported product. The assists are also integral to the transaction value of the good, but since typically the manufacturer/exporter is not paying for the assist but rather the importer, the payment is not reflected in the invoice and accordingly is a potential source of a revenue loss. Lastly, royalty payments and management fees are integral costs to producing the merchandise, but are ordinarily excluded in the invoice of the manufacturer/exporter.

The purpose of a customs audit is to assess accuracy of valuation and tariff classification, ensure internal controls within company are sufficient for customs requirement, and gather commercial intelligence. Post entry audit is a systems-based type validation procedure aimed at helping importers or their brokers comply with customs laws and regulations. The compliance check is not about a particular import transaction but about the importer's business processes in so far as these relate to complying with the customs rules and procedures. These processes include the order processing flow; the receipts and inventory control flow; and the payment flow.

Auditors verify if the importers have adequate controls over their respective business processes of relevance to the importation of goods, and how consistent these are with customs regulations.

*a) Post Entry Audit Tasks*

There are two major tasks in a post-entry audit: risk profiling and field audits. The output of the first task is the audit plan. The plan comprises the set of importers to be audited and the respective audit issues to be pursued during the field audit. The field audit gathers information in the premises of the importer who is to be audited needed to resolve the audit issues and help the importer to comply with the Bureau's rulings. For post-entry audits to attain its objective of balancing the competing goals of tax and regulatory compliance on one hand, and trade facilitation on the other, these tasks need to be undertaken in transparent manner. It is an abuse of this authority when the importers to be audited are not selected following an approved selection criteria, field audits are conducted without determining first the audit issues and objectives of a the field audit or if reports about a field audit are not filed and truthful.

During the legislative proceedings for R.A. 9135, the private sector opposed the inclusion of post entry audits in the amendment of R.A. 8181. Private business saw in customs audits the abuses they see in internal tax audits conducted by the Bureau of Internal Revenue (BIR). The latter are resorted to enforce compliance, producing about two percent of the BIR's tax income. According to a former BIR official, hundreds of letters of authorities had been issued but only scores of tax audit reports had been filed. It is uncertain whether the authorized tax audits had yet to be or had been conducted. There is no system to revalidate the tax audit reports. The private sector pointed their concern that as with tax audits, custom audits are likely used to harass them. In response and to allay these concerns, the BOC officials testified that these audits will be conducted in a transparent manner and controls will be built into the system to prevent abuses. This was one contentious issue in the deliberation that Congress provided that the selection of the importers to be audited will be done in a transparent manner and the selection process is replicable using information technology.

*Risk Profiling*

Risk profiling covers the task of transparent selection of the importers to be audited and the identification of the respective risk areas to be resolved in an actual field audit. The list of firms for audit is generated from importers belonging to two broad risk areas: voluntary and enforced compliance. In the first group are importers that are applying for or accredited to enjoy the privilege of the super green lane (SGL). These are regular and high taxpaying importers of the Bureau. In the second group, the list is a sample extracted from non-SGL importers, the

distinction being that the importers in the former group have agreed to be audited by the Bureau at any time. A random selection of SGL users is undertaken, choosing the appropriate number of importers to be audited coming from the voluntary compliance risk area.

In the enforced compliance group, the list is generated from an analysis of low-performing appraiser sections of collection districts, risk profiling using ACOS database particularly those tagged by the VRIS, and intelligence operations. The revenue performance of each appraiser section in the major ports of entry shall be evaluated against projected revenue forecasts for the section. The importers of low performing sections are likely to be selected depending upon the overall sampling algorithm. The ACOS database contains information about import declarations that were “hit” by the VRIS. Importers of these VRIS-hit transactions as well as the list of non-compliant firms gathered through intelligence gathering are audit candidates. Audit candidates under the enforced compliance group shall be ranked in accordance with the following criteria, potential revenue and the quality of information.

The Commissioner sets an audit ceiling for the year depending on his audit capability post entry audit group. The number in turn is distributed as between voluntary and enforced, and cascaded down as among the various sub-lists in each of the two broad risk management areas. Because the management’s objective with post-entry audits is to encourage voluntary compliance, more importers are selected from the list of audit candidates in the voluntary compliance area. The exact weight for this is a policy decision by top customs management.

An analysis of the CAO-8 2003, which prescribes how the importers to be audited are to be selected, indicates that the process is broad enough as to admit several approaches. The explanation given by authorities is that the regulation is structured so as to give the Commissioner adequate flexibility in choosing whom to audit. It is important to contrast this with how the framers of the WTO customs valuation agreement that paid important attention to having transparency and accountability. While the valuation agreement admits several methods to arrive at the dutiable value, the framers set the rules when each method can be used. Arbitrariness has been precisely the concern of the private sector raised when Congress deliberated on the merits of the proposed law then, for which the Commissioner was instructed by law to prepare this list of importers to be audited using a transparent and computer-aided procedure. In effect, the selection methodology can still be improved to make it more transparent, accountable and replicable.

Risk profiling of every candidate is undertaken using the ACOS database. This is an iterative process analyzing the import performance of the importer for a given number of years, the profile of the business, and the existing regulations and rulings of the Bureau. The objective of this process is to identify risk areas, which will become the focus of a field audit. Risk

profiling activities such as these are required to be documented including information such as the customs officer doing the analysis, the date and duration of such activities, the officer's findings every instance he undertakes the analysis, and the final set of audit issues that need to be attached when seeking the approval by the Commissioner for an authority to audit a specific importer. This is to prevent the abuse of the existing information for private gain. If the Commissioner does not approve the audit issues, the officer responsible will have to address his concerns, which may require another round of analyses.

The possible revenue risk areas include related party situation between parties of the transaction, buying commissions, price-escalation clauses, deposits/part payments, discounts, package deals, "customs purposes only" invoices, management fees, royalty and assists, and freight costs.

### *Field Audits*

Field audits are done at the premises of the importer and its broker and these comprise four phases. The first is the introductory stage which involves giving the importer the overview of how the audit will be undertaken, requesting the importer the information and documents that are needed in the process, and becoming familiar about the business. The second step is to conduct a system audit involving order processing, receipts and inventory control flow, and payment systems. The audit is to gather information how transactions are recorded; how transactions are processed; how internal controls intended to prevent or detect any errors are set up and implemented; and how errors are corrected and reported. The aim is to focus on the weaknesses of the controls of the system, which have a bearing on the preparation of a complete, correct, and accurate import entry. The auditor notes any weaknesses in the system, which may result in possible non-compliance. The payment processing flow involves tracing the settlement/payment of purchases through the importer's books from order to final settlement.

In the third phase, the field audit proceeds with conducting a random transaction test on the system placing particular attention on the possible absence or inadequacy of controls in the system. These random testing of the system can take place in tandem with the verification of the selected shipments. Audit of the importer's broker aims to check on documentation retained by the broker and verify if some of the shipments being identified during profiling will give the Bureau a level of assurance that matters relating to classification and origin are correctly declared. In the exit interview, the importer is briefed about the main findings of the audit, pointing out the weaknesses in the systems observed, and their implications for compliance.

A report is filed at the end of the audit following a standard report format. The report covers the objectives of the audit, its legal authority, its duration and the staff involved. It gives a

profile of the importer's business and of the import activities of the business. The report lists the findings and observations made during the field audit. A summary is provided containing assessment of compliance with the various customs laws, regulations, and rulings; assessment of the importer's control systems; types of errors; the issues to be resolved; and any revenue adjustments.

*b) Post Entry Audit Group*

*Interim Group*

The Commissioner of Customs created an interim post entry audit group in 2001, while preparing for the organization of the permanent post entry audit group. Setting up the latter group requires an Executive Order and a staffing plan that is approved by the Secretary of Budget and Management. Existing customs officials comprised the interim audit group. They belonged to the Technical Working Group responsible in pushing for the enactment of RA 9135. Because the group's members had their regular functions in the customs agency, working for the interim unit was an added task given them. Together with other factors, this slowed down the implementation of RA 9135 and in building up the capability in the agency to conduct post entry audit. The interim group had to be given the time required to complete the organization of the permanent audit group.

The advantage of assigning the members of the Technical Working Group to staff the interim post entry audit group was that these officers had been adequately trained on transaction valuation as well risk profiling and the conduct of field audits. Because they have been with customs agency for at least ten years, the members know general customs administration procedures and have respectively been serving their respective functions within the Bureau. USAID/Philippines primarily provided the technical assistance in training the members of the interim unit on transaction valuation and post entry audit tasks. These officials did not only go through intensive training but also had a study tour to observe how transaction valuation and post entry audits are conducted by the US Customs Service.

The interim unit was able to conduct a field audit in September 2002, the country's first post-entry audit since the passage of Republic Act 9135 in May 2001. TransWorld Trading Corp. Inc., an importer of chemicals and plastic resins, volunteered to be audited in the process of applying to use the Super Green Lane facility. The company was found compliant with customs regulations, and was accordingly recommended to become a user of the Super Green Lane facility. The audit provided the interim group practical insights about the conduct of post entry audits, bolstering the capability and confidence of its members.

The interim audit group did not conduct any further audits, particularly if the importer did not voluntarily submit to be audited. The group decided to wait for the issuance of the Customs Administrative Order on the proper selection of the importers to be audited, which the Secretary of Finance would have to approve. The said CAO would protect the interim audit group from possible criticism of being overly eager to conduct audits or of arbitrarily selecting the importers to be audited. Legal suits may be filed against them by affected parties. The group had been sensitive to the concerns aired by the private sector stakeholders that the customs agency will use the post entry audits are to harass or extort them.

The Customs Administrative Order (CAO 8 2003) on the proper selection of importers to be audited took about a year to process. The Post Entry Audit Technical Subcommittee had a concept paper and a draft CAO as early as the first quarter of 2002. However the CAO came out only in October 2003. Differences on how to select the importers to be audited and the purpose of post entry audits may help explain the delay. The head of the group had been appointed in 2003 and would need to review the proposed draft. The management of the permanent post entry audit group that started to take shape in the first half of 2003 introduced less structure in the selection criteria of importers to be audited towards and preparation of audit issues. The other view, as spelled out in the draft CAO and shared by interim post-entry audit group members looked at audits as primarily a tool to improve compliance and in so doing protect the tax income of the Bureau. This approach required clear, appropriate structures into the work of the group to ensure more transparent, accountable and replicable decisions. Two important provisions in the draft CAO, which are on the preparation of the annual audit plan and the procedure for selecting the importers to be audited, are meant to uphold transparency in the selection process, protect the Commissioner from political pressures to target known supporters of political opponents, protect private sector importers from being arbitrarily selected for audit, and to provide a basis for performance evaluation of the PEAG. The private sector had stressed the need for transparency and accountability so that they would not be the victims of harassment by the audit group. R.A. 9135 reflected the concerns of the private business sector by requiring a computer-aided selection of importers to be audited. The final version of the CAO 8-2003 does not require the Post Entry Audit Group to prepare an annual audit program to be approved by the Commissioner and gives the Commissioner flexibility in choosing those who would be audited.

#### *Permanent PEAG*

In January 2003, Executive Order 160 was issued creating the Post Entry Audit Group of the Bureau of Customs. This new unit under the BOC has the functions to ensure effectiveness and strict implementation of PEA policies, systems and directions; support BOC modernization



efforts; and lead information dissemination program about post entry audits. The unit has two offices. The Trade Information and Risk Analysis Office (TIRAO) is tasked to set framework and benchmarks for compliance measurements of industry groups; develop & implement risk management system; develop audit selection parameters; recommend audit targets; and set policies, guidelines and standard operating procedures on the conduct of audits. The other office, Compliance Audit Office (CAO), takes charge of formulating the audit work plan; conducting field audits; preparing and submitting audit reports; and developing, implementing and monitoring the compliance program. The PEAG is headed by the Assistant Commissioner and is assisted by the Director of the Compliance Audit Unit (CAU) and the Director of the Trade Information and Risk Analysis Office (TIRAO). The DBM approved the staffing pattern in April 2003, paving the way for BOC's screening and recruitment of personnel.

In order to ensure the staffing of PEAG with qualified candidates who are selected based on merit and fitness to the job using objective and multiple evaluation methods, CMO 11-2003 was issued setting up a transparent hiring and selection process. All positions in the PEAG are entry-level to attract qualified candidates. The applicants for PEAG positions have to undergo the following stages of selection processes: pre-screening of qualifications; written psychological and technical examinations; targeted selection interview; background check; calibration and ranking; and medical examination. Pre-screening and written examinations are qualifying steps before an application proceeds to the next stages. A Board of Examiners/Screening Committee was constituted to construct the technical test questions; undertake the screening and assessment activities; monitor and coordinate all activities to ensure implementation of the hiring plan according to schedule; endorse to the Personnel Selection Board (PSB) qualified candidates to fill-up the PEAG positions; and bring to the level of the PSB issues and concerns resulting from the implementation of the hiring plan.

Despite the standards set by the Commissioner in the recruitment of personnel for the PEAG, the implementation of CMO-11 2003 was not completely in accordance with the objectives of the Commissioner contained in this Order. The CMO contains a general provision requiring that pre-screening and written examinations are qualifying steps before an application proceeds to the next stages was not implemented. What occurred was that the Board of Examiners interviewed all applicants for staff positions of the PEAG. It opted not to set a cut off qualifying score for the written examinations, which is inconsistent with a procedural guideline of the CMO and that is the "applicants who pass the tests shall be scheduled for targeted selection interviews by the BOE/SC members".

Based on the decision to interview all applicants, every candidate went through all the stages of the recruitment process and accumulated scores based on the following criteria. Following the CMO, educational attainment, civil service eligibility, and interview results have each a total score of 20 points. Work experience was assigned the total score of 15, while examination results and training were each allocated ten percentage points. Distinction was given the score of 5. Each candidate accumulated points as he or she advances in the selection process. In the end, applicants were ranked on the basis of the composite ratings.

Another decision of the Board that modified the ranking process was on the grouping of candidates into five groups based on their respective educational background as follows: accounting, law, customs administration, information technology, and other courses. Candidates were able to jump ranks because of the grouping. The reason given for the decision was “to provide PEAG with multidisciplinary skills and a solid technical background especially for major industries”. Candidates with composite rating below a cut off mark were eliminated from the short list that the Board of Examiners, meeting as one, reviewed to check for errors in data interpretation and entry. Those candidates belonging to the information technology (IT) group was given a lower cutoff, giving advantage to its members. The BOC Human Resource Division in its public announcement for the vacancies for the PEAG positions specifically required for computer science graduates or those with IT experience in almost all of the positions available.

In January 2004, PEAG is about two-thirds staffed with personnel requiring training on transaction valuation, risk profiling and field audits. It is a critical unit at the Bureau of Customs in the overall implementation of transaction valuation. Most of these have hardly any practical experience in conducting post-entry custom audits. There has yet been one audit conducted since the law was passed in 2001, and was conducted by the interim post entry audit unit, the members of whom were trained on these new developments in customs administration. PEAG replaced the interim unit but the experience of the latter was not transferred to the permanent group.

It is useful if PEAG looks at recent developments at the BIR with respect to tax audits. As is known among large taxpayers, the tax audits by the BIR as practiced are less structured. The Commissioner of Internal Revenue had held off the issuance of letters of authority (LOA) because as there had been so many such LOAs issued in the past, substantively fewer reports had been filed. The few that had been filed had hardly been reviewed at all. The Commissioner of Internal Revenue instead is pushing for his program of “no contact audit”. This is a computer-aided analysis on the truthfulness of tax declarations particularly of large taxpayers using third party information, and the response is that taxpayers increased voluntarily their tax payments upon learning that the BIR already had the capability of using third party information. The

emerging lesson is that flexibility is increasingly regarded more to be a liability, in terms of collection and the reputation of the Bureau. The apparent best practice is to go for transparency, work with well-defined systems and business procedures, which allow for better evaluation of the performance of the units and individuals.

### **3. Effects of Transaction Valuation**

#### **3.1. *Ex-Ante Effects on Revenues***

Medalla, de Dios and Aldaba (1993) analyzed the effect on revenues of shifting to transaction values as represented by the invoice values. The authors did the study in the early 1990s, before the WTO's customs valuation agreement was adopted. The prominent change in customs administration then was the expansion of the pre-shipment inspection contract to cover all of Philippine imports. Because the country implemented the transaction valuation only in 2000, their estimated impact on customs collection was for the hypothetical situation of the Philippines adopting the transaction valuation scheme during that time.

The authors estimated that customs revenues would have declined from 3.95 to 6.5 percent depending upon the trade elasticities used. In their methodology, the change in revenue depended upon the change in import volumes, the HCV/IV ratios, and the trade elasticities. The shift to transaction values was expected to reduce dutiable values and this had a negative effect on revenues. But because values tended to fall, import volumes were expected to increase and the extent of this growth depended on the trade elasticities. With zero elasticity, which applied to import transactions in the first two months following the shift to transaction values, the revenue loss was 6.5 percent. Importers during this time would have already decided on import volumes and thus no changes were expected from the shift. Using low elasticity, and this applied to import transactions three to four months following the shift, the revenue loss was lower, 6.2 percent. Finally, in the third case (high elasticity), which was applicable to import transactions in the rest of the year, the authors put the revenue fall at 3.95 percent. The average annual loss was 4.7 percent.

In the following, the impacts of transaction valuation reform are estimated using a panel data of collection, import volumes, import values, and related variables for each of the 14 sections, in each of the top three collection districts of the Bureau from 1998 to 2001. A section is a set of similar products, e.g. agriculture and food. There are fourteen such groupings followed at the Bureau's Import Assessment Service.

### 3.2. *Import Values and Volume*

#### a) *Import Values*

The impact of the shift to transaction valuation on import values, volume and revenues is estimated using ACOS data for the three major ports of the country, namely the Port of Manila (POM), Manila International Container Port (MICP) and the Ninoy Aquino International Airport (NAIA). All three account for nearly eighty percent of total collection of the Bureau. The MICP has the largest collection of the three ports. In 2001, for example, the MICP collected a total of 33.16 billion pesos, followed closely by the Port of Manila, which earned 26.34 billion, while NAIA was a distant third with a collection of about 14 billion pesos. In 2002, the MICP, POM, and NAIA accounted for 35.5, 32.1, and 11.3 percent of total collection respectively (Table 2). Interestingly, POM had the largest share, 38.8 percent, of total value of imports in that year; however its collection was lower than that of the MICP, which had a share of 28.1 percent to aggregate import values. The NAIA was third with a share of 20.8 percent of total import values.

The data used in the estimation comprises the monthly import transactions from 1998 to November 2001. The information in the import transactions data includes the assessment, volume, values, and exchange rate, by port and collection sections from January 1998 to November 2001. The specific monthly statistics are aggregated from the respective corresponding information contained in the thousands of daily import entries that are stored in the database of the Automated Customs Operations System (ACOS) of the Bureau.

Table 2. Revenue Collection and Imports Processed by Port, 2002  
(Values in million pesos and Shares in percent)

District/Port	Collection <sup>a</sup>		Imports	
	Value	Share	Value	Share
MICP	35,638	35.49	234,316	28.16
POM	32,188	32.06	323,044	38.82
NAIA	11,352	11.31	172,845	20.77
Subic	2,786	2.77	10,206	1.23
Batangas	11,267	11.22	50,001	6.01
Cebu	2,826	2.81	18,683	2.25
Other Ports/Districts	4,013	4.01	22,976	2.76
<b>TOTAL</b>	<b>100,070</b>	<b>100</b>	<b>832,071</b>	<b>100</b>

<sup>a</sup>Includes deferred payment for revenue of previous years.

Source: Statistical Analysis Division, Bureau of Customs for collection performance data; processed ACOS data for imports; as reported in Abrenica, J. and Tecson, G. (2004)

The transaction valuation scheme was implemented in January 2000 by virtue of R.A. 8181. While this law authorized the adoption of transaction values on January 1, 2000, it

nonetheless allowed the continued use of published notional values, as discussed above. With the termination of pre-shipment inspection in the first quarter of 2000, transaction values started to be used. The shift to transaction valuation was boosted in May 2001, when R.A. 9135 was signed into law discontinuing the use of published values in conformity with the Customs Valuation Agreement of the WTO.

Transaction values are generally expected to be lower than their corresponding published home consumption values. The transaction valuation procedure uses the actual value paid or payable for the imported article in calculating the import duties and taxes. These values reflect all the necessary competitive cost of producing and making available to buyers of the imported merchandise. They are what importers claim they actually paid for the imported merchandise. A few cost items contributing to the transaction value such as selling commissions, royalties, and assists may not be reflected in the invoice and are identified ordinarily in post-entry audits. Although it is possible that the importer would want to disclose these items during the lodgment of import entries, such behavior is unexpected. Thus, the declared values reflected in the import entry document at the time it is lodged with customs authorities are likely the cost items reflected on the invoice.

On the other hand, the notional home consumption values are what customs officials determine as the appropriate dutiable values. While these values were set using prices and market information at exporting countries to the extent possible, these values were nonetheless determined by officials, who had been tasked by law to raise revenues and had tended to take a rather short term view that collection increases with dutiable values. Moreover, home consumption values respond to the need of officials tasked to respond to the clamor of local producers to protect domestic industries from unfair trade. The collection mandate and trade protection produced home consumption values that were upgraded transaction values.

Another consideration why transaction values are likely lower than the notional home consumption values is that under the transaction valuation scheme, the importer is legally entitled to use what it declares as its transaction value at the time the import entry is lodged to be the dutiable value, unless the authorities can show otherwise. The perception is that because the taxpayer has better information than agency officials and given that validating the declared value is costly, importers may disclose lower than the transaction values, or exclude cost items that the authorities are likely unable to identify.

To explore whether import values declined after 2000, likely because of the transaction valuation reform, a regression equation was estimated by collection section and by port. The regression equation has as its dependent variable import unit values, and on the other side of it a

dummy variable and an intercept. Import unit values, in US currency, were computed by dividing the values with the corresponding import volume and exchange rate. The purpose of running a regression was to find out if there was a statistically significant change in import unit values before and after 2000. The estimated intercept represents the average import unit value for all the observations. The coefficient of the dummy variable, which takes the value 1, if the import transaction occurred in 2000 and 2001, and zero otherwise, highlights the incremental

Table 3. Changes of Import Unit Values By Section and Major Port: Before and After 2000 (percentage change)

Sections	POM	MICP	NAIA
Agriculture and Food	-14.32	-18.97	-22.87
Textiles, Textile Articles	-33.81	0.00	-15.94
Machinery, Electrical	-41.33	0.00	28.62
Motor Vehicles	-34.21	8.61	-15.99*
Machinery Non-Electrical	-27.75	-13.98	6.02*
Machinery Non-Electrical	-29.16	-32.86	0.31*
Machinery Non-Electrical	-28.63	-10.23	12.13
Iron and Steel Products	-29.73	-20.92	42.1*
Hardware	-17.20	-47.09	2.35*
Fuel and Oil	-36.99	-24.90	-30.01
Plastic and Chemical Products	-6.89	10.55	4.4*
Tobacco and fuel	-29.13	-15.11	-4.75*
Miscellaneous	6.77*	-5.89*	11.64*
Miscellaneous	-35.35	-50.02	1.55*
All sections	-30.33	-18.16	-2.04*

Source of Basic Data: Bureau of Customs

\* not statistically significant

contribution to the common average for the observations occurring after December 1999. The assumption underlying the exercise is that the market values of imported goods change randomly, and in a large collection of imported articles these random changes of market values offset each other. Consequently, a decline of import unit values, which this regression may document, may possibly be attributed to transaction valuation reform.

The results are shown in Table 3 below. Most of the coefficients are statistically significant and their negative signs are as expected, particularly for the sections under the POM and MICP. Import unit values declined after 2000 and this result may indicate the effect of the shift to transaction values. Import values for the POM declined by nearly 30, MICP by 18 percent, while NAIA's sections registered the lowest decline, 2 percent. A few coefficients, however, are positive and statistically significant, mostly corresponding to the import transactions going through the NAIA. Others sections under NAIA have statistically insignificant

coefficients. The observed rise or even the lack of any pattern of changes is not necessarily inconsistent with transaction valuation. Market values can change and businesses adjust their import demands accordingly. Why this happened mostly with the import transactions lodged with the NAIA collection district may, stem from the nature of the imported items going through airports. Because they tend to fetch high values, the basket of goods going through NAIA changes with market opportunities. Comparing the estimates for a given section across the three ports, there is no consistent pattern of the changes. The estimated changes for NAIA's sections tend to depart from the trend of declining values in the case of the other two ports. The respective sizes of the changes of unit values for a given section are not close to one another for a given section. For example, in the case of the two sections of textiles and textile products and electrical machinery, the estimates for MICP are close to zero, while those for NAIA and POM are not. This observation may be explained by the differences in the composition of imported articles going through each port, even though these belong to the same broad category of a section, which

Table 4. Estimated Import Price Elasticities and Changes of Import Volumes  
By Section and Major Port: Before and After 2000

Sections	Import price elasticities			Percent Changes		
	POM	MICP	NAIA	POM	MICP	NAIA
Agriculture and Food	-0.94	-1.48	-0.42	13.47	28.16	9.64
Textiles, Textile Articles	-0.42	-1.22	-0.10*	14.32	0.00	1.66
Machinery, Electrical	-0.26	-0.41	0.84	10.77	0.00	23.92
Motor Vehicles	-0.26	0.60*	0.34	8.92	5.14	-5.43
Machinery Non-Electrical	-0.23*	-0.39	-0.31	6.41	5.39	-1.86
Machinery Non-Electrical	-0.24*	-0.34	-0.33	7.04	11.21	-0.10
Machinery Non-Electrical	0.15*	0.32*	-0.96	-4.34	-3.24	-11.59
Iron and Steel Products	-1.37	-0.04*	-1.26	40.87	0.90	-53.06
Hardware	-0.99	-1.10	-1.08	16.99	51.92	-2.54
Fuel and Oil	-0.97	-1.20	-0.57	35.71	29.98	16.98
Plastic and Chemical Products	-0.82	-0.35*	-0.79	5.68	-3.64	-3.49
Tobacco and fuel	-0.77	-1.46	-0.79	22.31	22.03	3.73
Miscellaneous	-0.99	-1.41	-0.90	-6.71	8.31	-10.45
Miscellaneous	-0.98	-0.16*	-1.27	34.52	7.89	-1.96
All Sections	-1.29	-0.96	0.27	39.19	17.50	-0.56

Source of Basic Data: Bureau of Customs, ACOS data

\* not statistically significant

covers the same set of tariff lines.

#### b) *Import Volumes*

The effects on import volumes are computed using estimates of import price elasticities. A regression line involving the logarithm of import volumes, as the dependent variable, and the

logarithm of import unit values as the explanatory variable, was fitted to the data by sections and by port. Most of the estimated price elasticities, shown in Table 4, are statistically significant and negative. The POM has the most elastic import demand, although all of its sections have inelastic demands except that for iron and steel. While MICP's sections have more cases of price responsive demands, the overall elasticity for the MICP is nearly one. Apparently, the sections on machinery, both electrical and non-electrical, and which have inelastic demands, bring down the price responsiveness of import demands. The estimated elasticities for NAIA's sections on electrical machinery and motor vehicles are positive. The overall import elasticity for the port is also positive, despite the fact that its other sections have the appropriate negative signs. There are two sections of MICP and one of POM, which also register positive import elasticities, but these are statistically insignificant. In contrast, the positive elasticities for some sections belonging to NAIA are statistically significant.

The percentage changes of import volumes, in Table 4, indicate the possible effects on trade of the use of transaction values. These changes were computed by taking the products of the price elasticities and the percentage changes of import unit values reported in Table 3. Because these had the most elastic import demand, POM's sections registered as having the largest positive response to the decline of import values. Import volumes expanded by nearly 40 percent. This expansion is mostly accounted by iron and steel products, although the other sections of POM experienced increases in quantities as well. Hardware products increased the most for the MICP, which registered an overall growth of import volumes of 17.5 percent. There was hardly an expansion of imports of textile and textile products and electrical machineries, the import entries of which were processed at the MICP. NAIA registered decline of volumes by half of a percent.

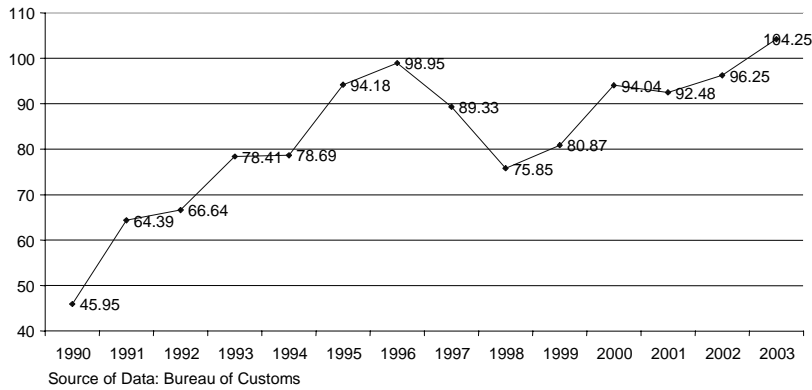
### **3.3. *Ex-post Effects on Collection***

Philippine Customs Commissioner Antonio Bernardo announced during the celebration of the 102<sup>nd</sup> anniversary of the agency in early February 2004 that the collection in 2003 reached 104 billion pesos, the highest ever for the agency. Not only did the BOC exceed its assigned target revenue by about six percent, its cash collection also surpassed 100 billion pesos for the first time. The last record collection occurred in 1996 when the Philippines hosted the APEC summit and before the Asian financial crisis (see Figure 1). The agency's cash collection



however for that year only reached 99 billion pesos.

Figure 1. Philippine BOC Collection: 1990 -2003  
(in billion pesos)



It is generally expected that transaction valuation will reduce the tax income of the Bureau. As earlier noted, Medalla, de Dios, and Aldaba (1993) gave an ex-ante estimate of this effect in the range of 4 to 6.5 percent depending upon the elasticities used in the computation. Using the data on collection in the three major ports of the country for the period before and after the implementation of the reform, the ex-post effect on revenues is computed. The estimates obtained from the exercise dampens the concern that transaction valuation reform would reduce collection is not as serious as expected, and may indicate that the revenue gains of the Bureau of Customs may partly be attributed to the reform in customs valuation.

Table 5. Estimated Effects on Collections,  
By Section and Major Port: (in percent)

Section	POM	MICP	NAIA
Agriculture and Food	-0.84	9.19	-13.23
Textiles, Textile Articles	-19.49	0.00	-14.28
Machinery, Electrical	-30.55	0.00	52.54
Motor Vehicles	-25.29	13.75	-21.42
Machinery Non-Electrical	-21.34	-8.59	4.16
Machinery Non-Electrical	-22.11	-21.65	0.21
Machinery Non-Electrical	-32.97	-13.47	0.54
Iron and Steel Products	11.14	-20.03	-10.96
Hardware	-0.21	4.83	-0.19
Fuel and Oil	-1.28	5.08	-13.03
Plastic and Chemical Products	-1.22	6.91	0.91
Tobacco and Fuel	-6.82	6.92	-1.02
Miscellaneous	0.06	2.42	1.19
Miscellaneous	-0.82	-42.12	-0.41
All Sections	8.86	-0.66	-2.60

Source: Tables 3 and 4.

The estimation involves calculating the percentage change in customs collection by section and by port. The percentage change in collection is simply the sum of the respective percentage changes of unit values and volumes, except for the adjustments that need to be made as the computations involve discreet rather than small changes of the variables. Customs duties, excise and value added taxes are regarded as remaining unchanged between 2000 and 2001, when the transaction valuation rule was implemented. There had been no adjustments of excise and value added taxes in these years. As for import duties, their applied rates have been sliding because of the government's unilateral tariff reform program towards a uniform five percent tariff structure except for a few sensitive products, mostly in agriculture. However, President Arroyo had ordered a review of the government's tariff reform program in 2001, in response to the pressure to roll back the tariff reform program coming from the respective producers of petrochemical and plastic products, sugar and other agricultural products, cement, and steel because of the popularly perceived adverse effects on the economy of globalization. The policy statement put in limbo tariff policy of the country. Accordingly, customs duties were not incorporated in estimating the effects on collection of transaction valuation reform.

The result of the computations is shown in Table 5. Almost all the sections belonging to the POM registered losing revenues apparently because of transaction valuation reform, except particularly the section for iron and steel products, the revenue gain of which carried the result for the entire POM. This section accounts for the largest share in collection for the Port of Manila. While Section 1 comprising agriculture and food imports is the second revenue earner, their loss in revenues, -.84 percent, is small. An equal second to agriculture and food in terms of its share

in collection, section 5 comprising imports of non-electrical machinery registers a loss of -21.34 percent. However, the percentage increase in import demand is relatively low compared to iron and steel (see Table 4). Thus, it is the iron and steel section which carried the overall effect on tax collection for the POM, and that is collection increased by nearly nine percent.

The MICP and NAIA, in contrast, suffered revenue losses by two-thirds of a percent and 2.6 percent, respectively. As for MICP, almost all of its sections, except agriculture and food, are even in terms of their share in total collection of this port. The first section, which accounted for seventeen percent of collection, experienced a revenue gain, 9.19 percent. This increase however was weakened by revenue losses in imports of non-electrical machineries, iron and steel products and miscellaneous merchandise. The performance of the respective sections of NAIA port is likewise mixed. The net impact taking the collection gained or lost of all the sections in each port into consideration indicates a loss of revenues, albeit by a proportion lower than the proportionate

Table 6. Effect of Transaction Valuation Reform on Revenues, By Major Ports (in billion pesos)

	POM	MICP	NAIA	All Three Ports
<i>Revenues</i>				
1998	27.60	29.24	8.54	65.37
1999	31.88	32.63	7.51	72.02
2000	30.70	36.06	3.19	69.94
2001*	26.34	33.16	13.99	73.49
<i>Revenues Gained/Lost</i>				
2000	2.50	-0.24	-0.09	2.17
2001	2.14	-0.22	-0.37	1.55

Source: Bureau of Customs, ACOS data for revenues; see Table 6.

\* Until November 2001 only

gain of the POM.

What is the overall effect of these changes on the total collection of the three ports? On one hand, MICP has the largest collection of the three but based on Table 6 lost revenues. The POM, which came after MICP in collection, on the other hand gained revenues and its gain more than offset MICP's loss. The NAIA is third and like MICP experienced a decline in collection. In Table 6, actual collections are shown and the levels of revenues gained or lost are computed to obtain the overall effect of transaction valuation on tax collection for the three ports. The respective revenue gained or lost of the port in a given year is the product of the proportionate change of the port's collections, as reported in Table 5, and the its revenue in that year, divided by the factor one plus the proportionate change. The POM gained in 2000 and 2001 2.5 and 2.1 billion pesos or 4.6 billion for the two years. Both the MICP and NAIA lost for the two years

close to a billion pesos. The net impact is a gain of about 3.7 billion or 2.6 percent of the two-year collection.

The estimation result provides a different perspective on the relationship of customs revenues and transaction valuation reform. When the reform was introduced, the concern was that the use of transaction values would aggravate the fiscal deficit situation of the country. Customs collection account for twenty percent of the tax income of the government. Given this importance, the use of published values continued to attract advocates within the government even as it would only have distorted the implementation of the reform. Had the government not heeded the call to amend R.A. 8181 with R.A. 9135, the Philippines would have continued the use of published home consumption values believing that it protects, if not increases, customs tax collection, unknowing that published HCVs moderate any increase in customs collection or reduce it by impeding the flow of trade.

Glenday (2002) observed the same positive response of revenues to trade liberalization in Kenya. Kenya implemented a phased trade liberalization program between 1987 and 1994. The average import duty rate was halved, but revenues about doubled. The author used detailed customs data from 1989 to 1999 to analyze the factors that contributed to the change in customs revenue yield including trade volumes, import duty exemption, policy and administration and the number of items classified as duty free, average import duty rates, ) special duty rate regimes for oil and major agricultural products and shifts in the composition of imports and exemptions between different import duty rate groups as the relative gross-of-duty prices of imports changed. The changes in revenue yield are predicted from base periods in terms of changes in trade, exemptions, and import duty rates. The residual unexplained increases in revenue yield are correlated with changes in trade and administrative policy, including the introduction of pre-shipment and secondary destination inspection programs and other customs control programs. The analysis showed that improved administration and compliance raised import duties from at least one-third to over two-thirds higher than could be explained by changes in trade, exemptions and import duty rates.

Table 7. Effect of Customs Valuation: Analysis of Customs Duty Collection Normalized for Changes in Imports relative to GDP, Average Tariff Rates and Duty Exempt Imports

Year	Custom duty over GDP (in %) (A)	Imports over GDP (in %) (B)	Simple average tariff rate (ATR) (in %) (C)	Dutiable imports over total imports (in %) (D)	Imports over GDP times ATR times dutiable import share (E) = (B)*(C)*(D)	Projected customs duties over GDP based on a pre-reform (1993-1999) structure (in %) (F <sup>a</sup> )	Actual customs duty over projected duty (in %) (G) = (A)/(F)
1993	2.8	32.5	23.5	61.0	0.05	3.3	85.27
1994	2.9	33.6	19.7	60.8	0.04	2.8	102.24
1995	2.9	35.7	15.9	61.4	0.03	2.5	118.06
1996	2.7	38.6	15.6	60.8	0.04	2.6	104.63
1997	1.9	44.4	13.4	57.7	0.03	2.4	78.53
1998	1.6	45.3	10.7	40.6	0.02	1.4	115.36
1999	1.4	40.7	10.0	43.1	0.02	1.2	113.24
2000	1.5	42.2	8.1	43.0	0.01	1.0	144.79
2001	1.1	42.1	7.7	48.0	0.02	1.1	100.30
2002	0.9	38.5	6.6	45.6	0.01	0.8	110.20

<sup>a</sup>  $F = \text{Base A} * E_t / \text{Base E}$ ; Base A = 1993 to 1999 average of A; Base E = 1993 to 1999 average of E; t is year.

Source of A through D: Abrenica, J. and Tecson, G. (2004)

Abrenica and Tecson (2004) analyzed the effect on customs revenues of automation using Glenday's methodology. The annual customs data used in the analysis was from 1993 to 2002. The methodology requires comparing the ratio of actual customs duties to gross domestic product with the corresponding ratio involving a counterfactual customs collection estimated using pre-reform information. The estimate is the product of the annual average tariff rate and dutiable import value. If the actual and counterfactual ratios were identical, then it was inferred that automation had no effect at all on revenues. Otherwise, the finding that might be derived from the analysis was either that the reform had enabled customs authorities to outstrip or fall behind their pre-automation collection performance. Their investigation indicated that only in 2000 that actual collection as a proportion of GDP surpassed the corresponding counterfactual collection ratio. Given their results, they concluded that the expectation on automation enhancing the revenue generation capacity of customs has not materialized.

The same technique is applied to analyze the effect of transaction valuation reform on revenues. The analysis is conducted in order to validate the finding obtained using estimated import elasticities. The results of the econometric analysis, shown from Tables 3 through 6 indicate that the use of transaction values in determining the dutiable value of imports in the aggregate increased rather than decreased revenues. The methodology is slightly modified by

using the pre-reform averages of both actual and counterfactual customs duty yields as the benchmark. The data is the same as that used by Abrenica and Tecson (2004), which was from 1993 to 2002. The results of this analysis are shown in Table 7, and they would seem to support that in the post-reform years of 2000 through 2002, collection performance of the Bureau at least was at par with its own standard before 2000. In years 2000 and 2002, actual collections exceeded the corresponding projected pre-reform levels by 45 and 10 percent respectively.

### **3.4. Trade Facilitation Effects**

Transaction valuation reform is regarded as a trade facilitation reform. By harmonizing valuation procedures across the world, the WTO, which spearheads the reform globally, sought to reduce uncertainty and prevent the erosion of market access through customs valuation procedures. In this section, the effect of the reform on importers' transaction cost as measured by the time it takes to process imports through the Bureau of Customs and on the cost of customs administration procedures is evaluated.

Wilson et al. (2003) examined the benefits of trade facilitation efforts, looking into the relationship between trade facilitation, trade flows and gross domestic product (GDP) per capita in the Asia Pacific region for the goods sector. More specifically, the authors used several indicators of trade facilitation such as member-specific trade facilitation indicators for port efficiency, customs environment, regulatory environment and e-commerce use by business. The authors employed a gravity model of bilateral trade flows in order to model cross-border trade and to estimate the effect of trade facilitation on trade. In general, results show that the collection of simulations yields an increase in intra-APEC trade worth about US\$250 billion for APEC as a whole and this is an increase of about 21 percent in total intra-APEC manufacture trade. Moreover, the improvement in port efficiency can bring about US\$ 117 billion of the total gain and 10 percent of the increase in trade. Specifically, about US\$ 139 billion of the total gain can be attributed from the improvements "at the border" in port efficiency and customs environment while another US\$ 116 can be derived from improvements "inside the border" in regulatory harmonization and e-business usage.

On the other hand, UNCTAD (2001 in Wilson et al. 2003) employed a CGE analysis to investigate trade facilitation in the wider context of creating an environment favorable to developing e-commerce usage and applications. The CGE analysis, which considered the relationship between a given size shock to productivity growth, applied equally to all members of the group, on GDP of regional groups of countries, shows that a 1 percent decrease in the cost of maritime and air transport services could result to some US\$3.3 billion increase in Asian GDP.

However, factoring in trade facilitation to include an improvement in the wholesale and retail trade services, an additional US\$3.6 billion could be acquired by a 1 percent improvement in the productivity of that sector.

Meanwhile, APEC (1999 in Wilson et al. 2003) also utilized a CGE analysis and found out that the shock reduction in trade costs from trade facilitation efforts differs by countries: “1 percent of import prices...for the industrial countries and the newly industrializing countries of Korea, Chinese Taipei and Singapore, and 2 percent for the other developing countries”. Further, the study estimated that the trade facilitation effort to reduce costs would boost APEC merchandise exports by 3.3 percent compared to the 7.9 percent long-run increase in merchandise trade from completing Uruguay round commitments.

To measure the impact on trade of greater standards harmonization for e-business and automating customs procedures between Japan and Singapore, the study of Hertel et al. (2001 in Wilson et. al 2003) shows that reforms will enhance not only the trade flows between these countries but also their trade flows with the rest of the world.

#### *a) Effect on Import Processing Time*

A recent study was conducted for the Bureau of Customs with assistance from the Japan International Cooperation Agency (JICA) to measure the average time taken from arrival to release of cargo and identifying constraints affecting the implementation of these procedures (UPECON, 2003). The time required on the part of importers to their imported shipment cleared by the Bureau of Customs covers the duration from the time the vessel or aircraft carrying the import cargo arrives to the time it is leaves the customs zone. The framework of the study is patterned after the time measurement on the release of goods issued by the World Customs Organization in 2000. The sample comprised 16,770 randomly selected import entries in 3 ports, POM, MICP and NAIA, which were assessed and released from March 1 to 29, 2002, representing 4 percent of the total entries in 2002. Because the data obtained in this study reflects the post-transaction valuation reform, it is useful in estimating the effect of the reform on import processing time. Needed to complete the estimation is an estimate of the import processing time before the reform.

The pre-transaction valuation procedures involved pre-shipment inspection by a firm under contract to provide PSI services to the Bureau. The SGS, the PSI firm, issued the Clean Report Finding (CRF), which stated the appropriate tariff classification, the quantity, the applicable duties and taxes, and the dutiable value. Medalla, de Dios, and Aldaba (1993) described the procedure involved in conducting pre-shipment inspection. A flowchart of the procedure (see Figure 2) is drawn based on the authors' discussion in order to highlight the

complexity and the length of time it took to complete the procedure. The process started with the importer or its broker opening a Letter of Credit (LC) with one of the authorized agent banks of the Bureau at least ten (10) days before the scheduled date of shipment. The LC required the following conditions:

- The merchandise is subject to pre-shipment inspection;
- The importer shall inform the seller of the pre-shipment requirement, who in turn shall facilitate the inspection.
- The authorized agent bank shall pay the seller only when the latter submits a final settlement invoice with the confirmation of the pre-shipment inspection firm and the number and date of the Clean Report of Findings of the PSI firm of the inspection it conducted.

The importer or its representative then completed an Import Entry Declaration and paid the advance customs duties and taxes and was issued a customs official receipt by its bank. The bank provided a copy of the declaration, the customs official receipt, the LC, and the pro-forma sales invoice to the Manila Liaison Office (MLO) of SGS. The MLO registered the LC and IED and issued an Import Advice Note (IAN) with an assigned number to the importer and the SGS office at the exporting country, which would conduct the inspection.

The SGS inspection office advised the seller, who should have been informed by the importer of the pre-shipment requirement, that it was to conduct the inspection. The seller in turn informed the inspection office at least seven days before the inspection is conducted when and where to inspect the goods.

The physical inspection would then be conducted, and would focus on the tariff classification, tariff rate, invoice value, and other components of the cost charged by the supplier. The inspection officer determined whether the costs were consistent with the prevailing export market price of the merchandise in the country of origin. The end result of the inspection was a dutiable value that was acceptable to the importer. If the dutiable value determined by the SGS was not acceptable to the importer, then the importer would have to adjust the LC until it accepted the dutiable value cleared by the inspection office, a process that may take up a fair amount of time.

The Clean Report of Findings (CRF) was a key document in the import assessment and cargo clearance system of the Bureau. The seller's final sales invoice for the merchandise that was to be shipped to the Philippines contained the number and date of the CRF and an adhesive security label affixed by the SGS inspection office. The seller or its bank sent this invoice the importer or its bank along with other relevant documents. The SGS inspection office separately



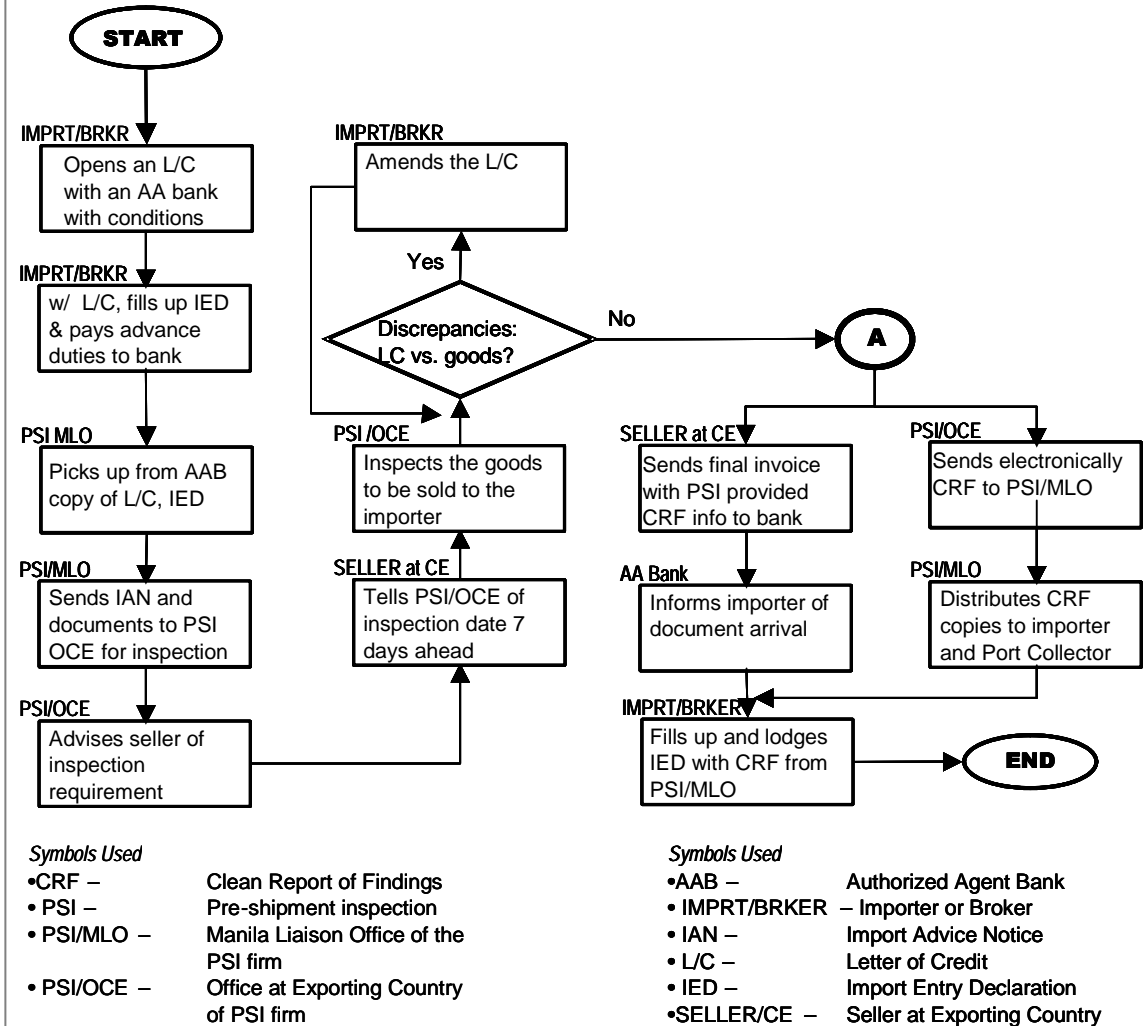
sent the CRF to its Manila Liaison Office electronically, which then provided a hard copy of these documents to the importer and to the Collector at the port where the shipment was expected to arrive.

These documents were to be sent on the day the CRF was issued, but this did not occur as designed. According to Medalla, de Dios, and Aldaba (1993), the lapse time from inspection to the arrival of the CRF in the Philippines ranged from one to five days. On average, it took three days to release the CRF after inspection, and less than a day to transmit this to Manila from the exporting country. The CRFs from Hong Kong and Taiwan arrived after the vessel's arrival, while other countries arrived before the ship docked at one of the international ports in the country. Following the account of Medalla *et al.*, SGS attributed these delays to the exporters, which did not submit to the SGS inspection office the needed export documents at the expected time.

With the CRF, the importer then prepared its Import Entry Declaration, this time using the information contained in the CRF. It indicated in this document the additional duties and taxes that it had to pay, having already paid in advance customs duties and taxes when it opened the LC. The IED was then lodged with the Bureau together with the CRF, and the processing of the IED followed the prevailing import assessment and cargo clearance procedures as described in Figure 2.

A significant amount of time was required to get imported cargoes processed by the Bureau of Customs. Table 8 shows the average time that lapsed from the arrival of goods to their release, tracing the effect on the time interval of transaction valuation reform. The post-reform information of the Table is taken from UPECON's benchmark time measurement study. The lapse time applies to all formal import entry shipments arriving at the Port of Manila, Manila International Container Port, and the Ninoy Aquino International Port. The import entries reviewed by the authors of the study were for year 2002. As for pre-transaction valuation reform, the interval of time is basically the same except for the duration between the arrival of the vessel and the lodgment. Under the pre-reform rules, lodgment could not take place until the CRF was available. Medalla *et al.* (1993) estimated that the delay from the time the vessel docked or the aircraft landed to when the import entry declaration is lodged ranged from a minimum of one day to a maximum of five days. Since the authors did not provide information about the frequency distribution of the delay, the information is provided as a range of estimates in the Table.

Figure 2. Flowchart From Pre-Shipment Inspection Until Lodgment of Import Entries



Source: Author based on Medalla, De Dios, and Aldaba, (1993) pp. 130-131

The total lapse time from the arrival to release of goods ranged from 6.43 to 11.43 days before the transaction valuation reform and when Bureau required pre-shipment inspection. The interval dropped to 5.43 days when the customs valuation reform was implemented. The time saved ranged from 1 to 5 days, representing the delay in the arrival of the CRF from the time the goods had arrived in the country.

**b) Administrative Cost Savings**

The Bureau of Customs terminated its pre-shipment inspection contract with SGS in March 2000. While there may have been other reasons for not renewing the contract, the decision was nonetheless consistent with the shift to transaction valuation in 2000. Even under R.A. 8181, the use of pre-shipment inspection, which was dedicated to setting the dutiable value of imported

merchandise, was inconsistent with R.A. 8181 and R.A. 9135. If the decision had not been made, the Bureau of Customs was on shaky legal ground under a transaction valuation law. It is for this reason that one may view the decision to cancel the pre-shipment inspection as an integral component of the transaction valuation reform, and for which savings in administrative cost are

Table 8. Time Interval From Arrival of Goods to Release: Post and Pre Transaction Valuation Reform, Formal Entries, All Ports (no. of days)

	Post- Transaction Valuation Reform <sup>1</sup>	Pre-Transaction Valuation Reform <sup>1, 2</sup>	
		Minimum	Maximum
		Arrival of Goods to Lodgment	3.31
Lodgment to Assessment	1.01	1.01	1.01
Assessment to Cargo Clearance	0.23	0.23	0.23
Cargo Clearance to Payment of	0.50	0.50	0.50
Payment of Arrastre Fees to Release	0.37	0.37	0.37
Arrival of Goods to Release of Goods	5.43	6.43	11.43
Pre- vs. Post Reform (time saved)		1.00	5.00

<sup>1</sup> Source: Upecon (2003), Table A.1

<sup>2</sup> Source: Medalla, de Dios, and Aldaba (1993)

substantial.

Table 9 shows the administrative cost of processing trade declarations since 1996 to 2002. The Bureau of Customs had saved the average of about US\$ 68 per trade declaration. The savings came mainly from terminating pre-shipment inspection. Pre-shipment inspection focused on valuation issues, although used by many developing countries, is inconsistent with the provisions in the transaction valuation agreement. Thus the substantial savings in administrative cost can be attributed to the transaction valuation reform.

#### 4. Concluding Remarks

There could not have been a more appropriate sequel to the relatively successful automation of customs procedures in the Philippines than in modernizing the way customs authorities determine the dutiable value of the imports. Since the 1950s, many countries assessed customs duties on the basis of the Brussels Definition of Value or a variant thereof. The BVD method determined a normal price of the imported merchandise, defined to be "the price that a good would fetch in an open market between a buyer and seller independent of each other", according to which the applicable duties and taxes were assessed. This is a set of notional prices, which customs authorities maintain, update and usually publish. Traders particularly disliked the

method because customs authorities do not adjust these notional prices at the rate actual market prices change. The method is not dynamic as to consider changes in the relative competitiveness of firms and the prices of new and unusual products. The Philippine customs valuation is a series of variants of the BDV and the dutiable values are known under various labels such as home

Table 9. Administrative Cost: Pre vs Post Transaction Valuation Reform

	1996	1997	1998	1999	2000	2001	2002
<b>Administrative Cost, (M US\$)</b>							
BOC's budget <sup>a</sup>	32.62	28.91	27.05	28.14	23.92	20.5	23.47
Pre-shipment Inspection cost <sup>b</sup>	81.55	72.275	67.625	70.35	0	0	0
<b>Total</b>	<b>114.17</b>	<b>101.185</b>	<b>94.675</b>	<b>98.49</b>	<b>23.92</b>	<b>20.5</b>	<b>23.47</b>
<b>Trade declarations ('000)</b>							
Imports <sup>a</sup>	0.771	0.792	0.751	0.917	1.013	1.007	0.972
Exports <sup>a</sup>	0.407	0.426	0.416	0.563	0.674	0.568	0.642
<b>Total (mln)</b>	<b>1.178</b>	<b>1.218</b>	<b>1.167</b>	<b>1.480</b>	<b>1.688</b>	<b>1.575</b>	<b>1.614</b>
<b>Cost per declaration (US \$)</b>	<b>96.90</b>	<b>83.05</b>	<b>81.13</b>	<b>66.56</b>	<b>14.17</b>	<b>13.02</b>	<b>14.54</b>
<b>Pre- vs. Post-transaction value reform (average cost in US \$)</b>				<b>81.91</b>			<b>13.91</b>
<b>Savings per declaration (US \$)</b>							<b>68.00</b>

<sup>a</sup> Bureau of Customs as reported in Abrenica and Tecson (2004)

<sup>b</sup> Estimated at 2.5 times BOC's budget. The cost of pre-shipment inspection was two to three times that of BOC (see Medalla, de Dios, and Aldaba (1993).

consumption value, fair market value, published values, and so on.

There could not have been a more appropriate sequel to the relatively successful automation of customs procedures in the Philippines than in adopting the transaction values as the basis for import assessments. Since the 1950s and until 1999, the Philippines assessed customs duties using a set of notional import values – variants of the Brussels Definition of Value –, which customs authorities had maintained, updated and published. The delays of these updates, the limited coverage of the list of these values, the lack of consistency of the goods in the published list and those that are actually traded in the market, and the limited and low quality information on the part of the business sector about this list are among the ingredients for the continued regime of virtually multiple valuation rules and arbitrary exercise of discretion. Importers had to make deals with customs authorities to reduce uncertainty or secure the most profitable terms for their imports. This regime coupled with a relatively protective trade policy sowed and nurtured the integrity problems in customs administration in the Philippines.

Previous reforms had failed not only in reducing the uncertainties of businesses in the Philippines but also in putting an end to the technical smuggling and corruption at the border. The various modifications of the rules in determining the dutiable value, the involvement of diplomatic officers in validating invoice values, and even the use of a third party through pre-shipment inspection had fizzled out in the face of an insurmountable task of the authorities to acquire real time information about the dynamic world market that they can use to enforce customs laws, regulations, duties and taxes. Despite its worldwide network, pre-shipment inspection appeared to be overly costly with unverified benefits to the Philippine government. In the end, the opportunism of individuals seeking to take advantage of a governance structure at the border that is weakened with lack of real time information, and the increasing vulnerability of public servants to exploit their respective positions of authority for private gain appeared to prevail.

The transaction valuation reform, adopted by the Philippine government in 2000, legally entitles the various importers to use the price they actually paid or will pay for the goods they imported to the country in determining the duties and taxes due to the government. This procedure helps to make businesses more predictable, erase the setting by which customs authorities exercise undue discretion and to accelerate the customs clearance of imported cargoes reducing transaction cost. Legally enabled in the country by R.A. 9135 and its corresponding regulations, this WTO agreement on the use of transaction values allows the use of various methods of arriving at the dutiable value in recognition of the complexity of the state of doing business in today's world, but prescribes when each method ought to be used in order to minimize discretion, improve transparency and define accountability.

R.A. 9135, which enabled the use of transaction values, ushered a paradigm shift in customs administration in the country from supervision that was primarily focused at the border to back-end controls through post-entry audits. Customs supervision before this law entailed substantial transactions costs on the part of importers. Goods are held at the border until customs officials would have determined that the relevant laws and regulations had been complied with. Automation helped reduce these costs by streamlining procedures. However, the underlying philosophy of customs management then comprised the use of official minimum values. The gains for trade facilitation of automation were constrained by valuation related differences between importers and customs authorities. Post entry audits complement transaction valuation reform and automation in reducing transaction cost.

The use of transaction values compelled Philippine customs authorities to terminate pre-shipment inspection, which they had used for valuation related tasks. Because importers have

generally regarded pre-shipment inspection as having provided them the safeguard, they clamored for safeguards against the arbitrariness, unreasonable use of discretion, harassment and other transaction costs inherent in a customs administration lacking in transparency and accountability. In addressing their concern, the Bureau offered its clients the Super Green Lane facility. This account-based approach to customs administration, by making good use of existing information about the Bureau's clients, segments customs clients on the basis of their propensities to comply. Low-risk importers are accredited to avail of the SGL facility where the highest degree of trade facilitation that the Bureau can offer is provided. The SGL facility of the Bureau joins similar "authorized traders" facility in other customs territories.

With these reforms in place, the customs revenues appeared to increase and not decrease as previously anticipated. Ex-ante studies on the relationship of transaction values and revenues observed that customs revenues would decline from 3.95 to 6.5 percent. With customs collection accounting for twenty percent of the tax income of the government, the customs authorities likewise were so concerned about under-valuation and what this would do to their collection performance, that they in an earlier attempt to legally enable transaction values R.A. 8181 inadvertently pushed for a hodgepodge of notional and transaction valuation regimes. Using the data on collection in the three major ports of the country (Port of Manila, Manila International Container Port, and Ninoy Aquino International Port) for the period before and after the implementation of the reform (1998 through 2001), the ex-post effect of transaction valuation on revenues indicate revenue gains of about 3.7 billion pesos or 2.6 percent of the 2000 to 2001 collection of the three ports. The result suggest that the use of home consumption values ostensibly to preserve, if not increase, tax incomes, ironically appeared to moderate any increase in tax collection at the border, if not reduce it, by impeding the flow of trade. This finding is validated using another technique to analyze the effect of transaction valuation reform on revenues. The results of the validation would seem to support the claim that in the post-reform years of 2000 through 2002, collection performance of the Bureau at least was at par with its own standard before 2000. In years 2000 and 2002, actual collections exceeded the corresponding projected pre-reform levels by 45 and 10 percent respectively.

Transaction valuation reform is among the prominent measures that effectively facilitate commerce. Under the auspices of the WTO, the reform is an important step forward on the road to higher predictability and accountability of procedures worldwide for determining the dutiable value. Because almost all trading countries of the world implement the WTO customs valuation rules, importers and exporters are in a better position to know in advance the amount of duties payable and thus this will likely reduce for the number of disputes and resulting delays.

The contribution to trade facilitation of the reform was estimated. The total clearance time of imported cargoes ranges from 6.43 to 11.43 days before the transaction valuation reform and when Bureau required pre-shipment inspection. The time interval dropped to 5.43 days when the customs valuation reform was implemented, indicating a savings of from 1 to 5 days. These improvements enabled the Bureau of Customs to save the average of about US\$ 68 per trade declaration. The savings comes mainly from terminating pre-shipment inspection. The work can be done under this reform without paying for the services of a pre-shipment inspection firm.

Private sector stakeholders' participation in these reforms emphasizes the importance these firms attach to customs reform. Business firms regard customs inefficiencies as imposing a significant "tax on business", hindering the flow of foreign direct investments in a developing country. In a survey of businesses in the APEC region, about half of respondents viewed the complexity of customs regulations, lack of information on customs laws and regulations, and appeals mechanisms problems as serious to very serious issues. Foreign direct investments would tend to flow towards countries with more sophisticated and transparent customs administration. In an increasingly global trading regime, investors see customs modernization as a national competitive advantage. By reducing clearance time as well as improving predictability and transparency, transaction valuation and related customs reforms become a major determinant of the ability of the Philippines to maintain a reliable and competitive flow of materials and exports to nearby regional markets or worldwide and thus attract more foreign direct investments.

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