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INTRODUCTION

1.1 THE PURPOSES OF CUSTOMS VALUATION

1.1.1 What is customs valuation?

Governments have collected customs duties since the beginnings of international trade. It is recorded that Athens applied 20 percent import duties on corn and other goods, while the Romans, from well before the time of Julius Caesar, depended upon customs revenues to support the expansion and maintenance of their empire. And, where a tax must be collected, there will be disputes over rates and methods – the Roman customs collector was accused of "unfair conduct and vexatious proceedings" against the Roman merchants who, in all fairness, were said to have been commonly engaged in smuggling to avoid customs duties.[1]

Customs valuation – the subject of this book – becomes an issue where import duties are calculated on an "*ad valorem*" basis. An "*ad valorem*" duty rate is one that is expressed as a percentage of the value of the imported goods. Duties may also be assessed on "specific" basis, where a fixed amount is charged on the quantity of goods imported – such as 0.2 cents per liter of imported alcohol. Or, a duty rate on a particular import might be a combination of *ad valorem* and specific rates (a "compound rate"). Nevertheless, *ad valorem* rates are the most prominent in international trade, as they are used by WTO Members against all but a small percentage of goods in their tariff schedules.[2]

For a particular import, the amount of an *ad valorem* duty is determined by multiplying the rate (for example, 17 percent on imports of chocolate milk, in Figure 1) by the ***customs value*** of the imported goods. Thus, how customs officials determine the customs value is as important to the importer as the rate of duty specified in the tariff schedule for the goods, as both the basis – the customs value – and the rate together determine the amount of duty the importer must pay.

[1] W. Smith (ed.), *Dictionary of Greek and Roman Antiquities* (Boston: Little Brown & Co. 1859), 944–45; J. R. McCulloch, *A Treatise on the Principles and Practical Influence of Taxation and the Funding System*, third edition (Edinburgh: Adam and Charles Black 1863), 240.

[2] On average, WTO Members use *ad valorem* rates for more than 97 percent of all tariff lines in their schedules. A notable exception is Switzerland which uses specific type rates for 80 percent of its tariff. WTO, *Trade Profiles 2007*.

Harmonized Tariff Schedule of the United States (2007)
Annotated for Statistical Reporting Purposes

IV
22-3

Heading/ Subheading	Stat. Suf-fix	Article Description	Unit of Quantity	Rates of Duty 1 General	Rates of Duty 1 Special	Rates of Duty 2
2201		Waters, including natural or artificial mineral waters and serated waters, not containing added sugar or other sweetening matter nor flavoured; ice and snow:				
2201.10.00	00	Mineral waters and serated waters	liters	0.25 liter	Free (A, AU, BH, CA, CL, E, IL, MX, P, S)	2.5 ¢/liter
2201.50.00	00	Other	t	Free		Free
2202		Waters, including mineral water and aerated waters, containing added sugar or other sweetening matter or flavoured and other nonalcoholic beverages, not including fruit or vegetable juices of heading 2003:				
2202.10.00		Waters, including mineral waters and aerated waters, containing added sugar or other sweetening matter or flavoured		0.3 liter	Free (A, AU, BH, CA, CL, E, IL, J, JO, MA, MX, P, SG)	4 ¢/liter
		Carbonated soft drinks:				
	20	Containing high-intensity sweeteners (e.g., aspertame and/or saccharin	1 liters			
	40	Other	1 liters			
	60	Other	1 liters			
2202.50		Other:				
		Milk-based drinks:				
2202.50.10	00	Chocolate milk drink	liters	17%	Free (A+, CA, D, E, IL, J, JO, MX, P, CL) 8.5% (BG) 13.6%(MA) 13.6%(BH) 14.1% (AU)	20%

Specific Duty Rate

Ad Valorem Duty Rate

Figure 1 US harmonized tariff schedule: *ad valorem* and specific rates

Today, the rules for valuing imports for purposes of assessing customs duties are well settled. They are defined in the WTO Customs Valuation Agreement (the formal name of which is the **Agreement on Implementation of Article VII of the GATT**), a system that is designed to promote fairness, neutrality and uniformity in customs duty assessment, and which is used by more than 150 WTO Member countries worldwide.

1.1.2 The importance of customs valuation

In 1947 – before the GATT – the average tariff rate applied by industrial countries was between 20 and 30 percent.[3] Fifty years and eight GATT rounds of tariff negotiations later, the average tariff rate applied by industrial countries on non-agricultural goods is about 5.5 percent.[4] With implementation of the 1994 Uruguay Round, for example, the US average tariff on non-agricultural goods is just 3.2 percent, and nearly half the tariff lines applicable to such goods are duty free.[5] Given these diminishing tariffs, one might ask how important is customs valuation? If import duties are reduced to trivial levels or

[3] WTO, *World Trade Report 2007*, at 207.
[4] WTO, *World Trade Profiles 2008* (simple average of applied MFN rates).
[5] *Ibid.*

Figure 2 Taxes on international trade (IMF, *Government Finance Statistics Yearbook 2007*)

disappear altogether, what use will remain for the rules that are used for their calculation?

Despite the successes of the GATT rounds, import duties stubbornly remain a factor in international trade. This is particularly true in developing countries, where the average applied rate for all goods is 16.9 percent.[6] Even in industrial countries, where average rates are low, some industrial products and sectors, and many agricultural products, remain protected by tariffs of 20 percent or higher.[7] Moreover, a number of developing countries continue to depend upon import duties for a significant portion of the national budget (see Figure 2).

Even if import duties were completely eliminated, the need for customs valuation rules likely would still exist. One important reason is the use by a number of countries of value added tax (VAT), excise, or sales taxes on imported products; these taxes, unlike customs duties are not subject to GATT/WTO tariff reductions.[8] Customs authorities commonly apply the same customs valuation rules to calculate these kinds of taxes on imports as they do for customs duties, although they are not obligated by GATT rules to do so.[9]

[6] *Ibid.*

[7] For example, the simple average duty rate applied by the European Union is just over 5%, among the lowest of WTO Members. However, the average rates applied to selected products exceeds 20% (i.e. dairy products (62.4%); sugars and confectionery (29.8%); animal products (25.4%)).

[8] VAT systems are now used in over 120 countries; they are said to have been adopted by some countries to replace the trade tax revenues lost as a consequence of GATT tariff reductions. IMF, *Dealing with the Revenue Consequences of Trade Reform* (February 15, 2005).

[9] GATT Article VII, Interpretative Note *Ad* Paragraph 1.

Apart from tax and duty assessment, customs valuation rules are used by customs authorities in their administration of non-revenue measures, such as:

- Import quotas based on customs value.
- Rules of origin. For example, a country may allow goods from a specific foreign country to enter free of duty if 50 percent of the customs value of the import is contributed by operations carried out in that foreign country.
- Collection of trade statistics.

CUSTOMS VALUATION AND GATT TARIFF BINDINGS

GATT Article II:3 states "no contracting party shall alter its method of determining dutiable value … so as to impair the value of any [tariff] concessions" negotiated among GATT parties.

Under this prohibition, a country may not change its "method of determining dutiable value" to avoid tariff bindings. But this does not prevent a country from maintaining a valuation method that itself allows arbitrary assessments. In the absence of common rules, valuation could thus be (mis)used for trade protection purposes.

"It seems inequitable that while certain countries … apply a liberal [valuation] system, others continue to apply systems which may raise the actual incidence of the duties shown in the tariff and carry many uncertainties because of elements which are arbitrary from the point of view of interested exporters in third countries. *Indeed, the global reciprocity achieved in tariff reductions might be gravely jeopardized*."*

To illustrate the point, consider the following scenario: if the invoice value of an imported product is $100, and the bound tariff rate agreed by the country is 10%, then traders might expect a tariff barrier equivalent to $10 ($100 × 10% = $10). However, customs officials, applying a method of valuation that allows arbitrary uplifts, assign a value to the product of twice that amount. In that case, the actual tariff barrier is $20 ($200 × 10% = $20). In practical effect, the importing country has raised its tariff rate from the 10% tariff ceiling agreed in GATT tariff negotiations to 20%.

Benefits to trade that the exporting country expects from negotiated tariff binding are considerably diminished by such uncertain or arbitrary valuation methods.

* TN.64/NTB/26 (July 7, 1964) (Statement of the European Community) (emphasis added).

1.2 HISTORY

The WTO Customs Valuation Agreement is a result of the 1986–1994 Uruguay Round negotiations, but its terms largely repeat the 1979 GATT Valuation Code. Therefore, to understand the intent underlying the terms of the Agreement, it is useful to recall the conditions of the pre-1979 trading environment (see Figure 3). As will be apparent from the retelling, this history also demonstrates that many of the difficulties of customs valuation that are discussed

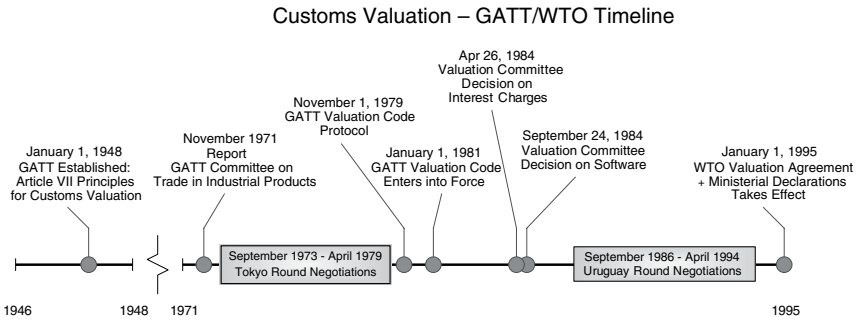

Figure 3 GATT/WTO customs valuation timeline

today – valuation of used goods, questionable invoices, (mis)use of alternative valuation methods, etc. – are by no means new or unique.

1.2.1 Before common valuation rules

GATT Article VII establishes general principles for national customs valuation systems. However, it does not mandate a specific valuation method, but allows countries to develop their own system, subject to these principles.

GATT Article VII Principles

- Customs value shall be based on "**actual value**", which is the price of the imported merchandise, or like merchandise, in sales in the ordinary course of trade under fully competitive conditions
- If "actual value" cannot be determined, Customs shall use the nearest ascertainable equivalent
- Customs value shall not be based on value of merchandise of national origin, or arbitrary or fictitious values
- Customs value shall not include internal taxes on a product that the country of origin or export refunds or exempts
- Currency conversion shall reflect effectively current value of currency in commercial transactions
- Where price of imported merchandise is determined by the quantity purchased, customs value shall be based on prices for comparable quantities or, as long as the result does not disadvantage the importer, prices involving larger quantities in sales in trade between the exporting and importing countries
- Governments shall publicize their valuation methods
- Governments shall report on steps they have taken to implement Article VII and to review the operation of their value methods, upon request of other GATT parties.

In fact, there was a large diversity and inconsistency when it came to customs valuation practices among countries before 1979. Customs valuation systems generally followed one of two conceptually different approaches: those based on a "notional" concept of value, and those based on a "positive" concept.

(a) *Brussels Definition of Value*

The "notional" concept is represented by the 1950 Convention on the Valuation of Goods for Customs Purposes, commonly known as the Brussels Definition of Value (BDV).[10] The BDV was drafted by customs experts of the European Customs Union Study Group, and was given to the Customs Co-operation Council – now known as the World Customs Organization (WCO) – to administer.[11] The BDV had more adherents than any other valuation system. At its peak, it was applied by as many as one hundred countries, including members of the (then) European Economic Community (EEC) and most other countries in Western Europe, as well as Japan and a number of developing countries.

Under the BDV, goods are valued on the basis of their "normal price":

> that is to say, the price which [the imported goods] would fetch at the time when the duty becomes payable on a sale in the open market between buyer and seller independent of each other.[12]

Customs officials would consider the buyer's actual invoice price paid for the goods, but were free to reject it in favor of the notional "open market" price for goods of the same kind.

(b) *Positive value systems*

A positive system of value was used by the United States and Australia, among other countries. Under these systems, customs value was generally based on the *actual* price paid for the goods, rather than an abstract or notional price that might be paid under perfect competitive conditions. Typically, these systems provided for use of secondary valuation methods, in a ranking order, where the

[10] December 15, 1950, 171 U.N.T.S. 307 (entered into force on July 28, 1953).

[11] Convention Establishing a Customs Co-operation Council, December 12, 1950, 157 U.N.T.S. 130; GATT Working Party I on the International Chamber of Commerce Resolutions, *Statement by Mr. F. Redmond-Smith, Representative of the European Customs Union Study Group*, W.7/8 (October 7, 1952). The CCC Convention was also drafted by the European Union Customs Union Study Group, a body established in 1947 to consider freer intra-European movement of goods and services in the context of European recovery from the Second World War. GATT Contracting Parties, *The Work Undertaken by the European Customs Union Study Group on Customs Nomenclature and Questions of Customs Regulations: Statement Made by the French Representative*, GATT/CP.4/45 (April 20, 1950).

[12] Annex I, Convention on the Valuation of Goods for Customs Purposes, note 10, above.

actual invoice price could not be found or used (such as where the goods were imported under a lease, and therefore a sale price did not exist).

For example, the US system, which strongly influenced the structure of the WTO Valuation Agreement, generally required customs to appraise goods first on the basis of the "export value" or price at which the goods were sold or offered for sale for export to the United States or, second, on the basis of the "United States value", which was the selling price of imported goods in the US market; and finally, if the preceding methods failed, on the basis of a "constructed value" or cost of production of the imported goods.[13]

There was also diversity in the application of both of these systems. The BDV was subject to varying interpretations in different countries. Positive systems were equally diverse: for example, the US primary valuation method was based on the export value (the price of the goods at the time of exportation to the United States), whereas Australia used the price paid by the importer *or* the price at which the same goods are sold in the export country market, whichever was higher. Moreover, as noted in the discussion below of the American Selling Price valuation method, some of the "secondary" valuation methods employed by these countries were at best complex and at worst explicitly protectionist.

(c) Early GATT initiatives on common valuation rules

In the early GATT years, a few attempts were made toward creation of a common valuation system. Although ultimately inconclusive, these initiatives triggered the GATT contracting parties to begin to assess the conformity of the different valuation systems then in use with Article VII principles.[14] The results of this early work on valuation led to and informed the GATT's later valuation initiatives. There is also a direct link in the present WTO Valuation Agreement to this early history: the "prohibited methods" listed in Article 7 of the Agreement (the "fall back" method of valuation) references one or another of these older valuation systems. (More on the prohibited methods of valuation under the WTO Valuation Agreement at section 3.4.)

The earliest attempt at a harmonized valuation system within the GATT came in 1951, when the International Chamber of Commerce (ICC) proposed that the GATT contracting parties develop standard worldwide valuation rules. This ICC proposal was a reaction to the BDV which, at that time, had just been completed and opened for signature. The ICC – as the representative of business – had opposed the BDV, because it was based on the use of a "normal"

[13] See GATT Committee on Trade and Development, *Trade Barriers Arising in the Field of Customs Valuation: Note on Implications for Developing Countries of Ad Referendum Solutions*, COM. TD/W/195 (August 2, 1973).

[14] Because the GATT was a treaty and not a legally established organization (in contrast to the World Trade Organization), GATT signatories were called "contracting parties." See WTO, *Understanding the WTO* (2007), at 3.

price as determined by customs administrations. Instead, the ICC favored a simpler "rule-of-thumb method," whereby customs would be required to use the invoice price for the goods presented by the trader, absent a reason to suspect fraud.[15]

This ICC proposal was rejected as premature. With only limited information about the valuation methods used by governments, the GATT contracting parties were, apparently, unwilling to upset the *status quo*. Moreover, it was felt that the GATT should not "pass judgment" on the BDV by developing an alternative international system along the lines suggested by the ICC before the BDV had been given a reasonable time to operate.[16]

However, the ICC proposals did have one positive result. They inspired the GATT contracting parties to obtain detailed information concerning the methods governments used to determine value and the extent to which these methods conformed to Article VII principles.[17] The results of this study, published three years later, suggested that there was a significant amount of diversity in valuation practices among GATT contracting parties. In particular, it was found that governments generally used one of three different criterion to assess value:

(1) the price at which goods comparable with the exported goods are sold in the internal markets of the exporting country ("current domestic value");
(2) the price at which the imported goods are sold from the exporting country to the importing country ("transaction value");
(3) the price at which goods comparable with the imported goods are sold in the markets of the importing country ("import market value").[18]

[15] GATT Executive Secretary, *Resolutions Submitted by the International Chamber of Commerce on Valuation, Nationality of Manufactured Goods and Formalities Connected with Quantitative Restrictions (GATT/CP/123)*, G/22 (August 29, 1952). In addition to international valuation rules, the ICC proposed that the GATT contracting parties issue "general recommendations" to governments based on the following four principles: (i) "systems of valuation should not be used as a method of increasing protection"; (ii) "primary consideration should be given to the price shown on commercial invoices when determining the dutiable value of goods"; (iii) "regulations should state clearly and fully the basis of dutiable value, with adequate publicity"; and (iv) "internal duties or taxes from which exported goods were exempted should not be included in the dutiable value." GATT contracting parties did not accept this proposal, largely on grounds that these ICC principles were largely incorporated in GATT Article VII. GATT, *Report of Working Party I on the International Chamber of Commerce Resolutions*, G/28 (November 1, 1952).

[16] G/28.

[17] GATT, *Methods of Valuation for Customs Purposes: Request for Information*, L/81 (March 12, 1953); GATT, *Valuation for Customs Purposes: Questionnaire for the Ninth Session*, L/228 (September 20, 1954).

[18] GATT Contracting Parties 9th Session, *Comparative Study of Methods of Valuation for Customs Purposes* G/88 (March 2, 1955). The study also found that "apart from the nine countries which are operating a common definition of value under the Brussels Convention, there are numerous differences in practice even between countries which are using the same criterion for establishing value for customs purposes."

In late 1954 and early 1955, governments submitted a number of proposals to amend Article VII in connection with a general review of the operation of the GATT Treaty. Most of these Article VII proposals were technical in nature or narrowly targeted to overcome specific valuation problems.

One proposal did have a broader reach. The Scandinavian countries proposed that the GATT "work toward the standardization as far as practicable, of definitions of value and of procedures for determining the value of products." Under the proposal, this work would have been based upon studies and recommendations of a new "Organization for Trade Co-operation" – which was then being discussed as the permanent body to administer the GATT.[19] However, as that new trade body never came into being, neither did the Scandinavian proposal for a unified valuation system.[20]

The last major GATT initiative on valuation in these early years came in the Kennedy Round of 1964–1967. In that round, for the first time, non-tariff barriers were included in negotiations.[21] One such non-tariff barrier nominated for negotiation by a number of countries was "customs valuation including use of arbitrary or excessive values."[22] The "arbitrary" valuation practice that attracted most criticism was the use by the United States of its "American Selling Price" (ASP) method of valuation.[23] The ASP, explicitly protectionist

[19] "Members shall work toward the standardization, as far as practicable, of definitions of value and of procedures for determining the value of products subject to customs duties or other charges or restrictions based upon or regulated in any matter by value. With a view to furthering co-operation to this end, the Organization may study and recommend to Members such bases and methods for determining value for customs purposes as would appear best suited to the needs of commerce and most capable of general adoption." GATT Contracting Parties 9th Session, Review Working Party II on Tariffs, Schedules and Customs Administration, *Proposals Affecting Customs Administration*, W.9/46 (November 29, 1954).

[20] The Scandinavian proposals were referred to the working party responsible for developing the agreement on the Organization for Trade Co-operation (OTC). GATT Contracting Parties 9th Session, Review Working Party IV on Organizational and Functional Questions, *Scope of the Agreement: Proposals Referred from Working Party II to Working Party IV*, W.9/98 (December 14, 1954). The draft agreement on the OTC included a provision authorizing the OTC to undertake a "study of international trade and commercial policy and where appropriate make recommendations thereon." This provision was explicitly intended to cover the valuation studies foreseen by the Scandinavian proposal. GATT Contracting Parties 9th Session, *Report of Review Working Party IV on Organizational and Functional Questions*, L/327 Rev. 1 (April 4, 1955). However, the Agreement on the Organization for Trade Co-operation, done at Geneva on March 10, 1955, never entered into force.

[21] GATT Meeting of Ministers, May 16–21, 1963, *Agreements for the Reduction of Elimination of Tariffs or Other Barriers to Trade and Related Matters and Measures for Access to Markets for Agricultural and Other Primary Products: Resolution Adopted 21 May 1963*, MIN 63(9) May 22, 1963.

[22] GATT Sub-Committee on Non-Tariff Barriers, *Non-Tariff Measures to be Brought within the Scope of the Negotiations: Note by the Secretariat*, TN.64/NTB/8 (November 15, 1963).

[23] GATT Sub-Committee on Non-Tariff Barriers, *The Use of Arbitrary or Excessive Values in Levying Customs Duties (American Selling Price): Note by the United Kingdom Delegation*, TN.64/NTB/21 (June 19, 1964); see also GATT Sub-Committee on Non-Tariff Barriers, *Valuation for Customs Purposes: Note by the Delegation of the EEC Commission*, TN.64/NTB/26 (July 7, 1964); GATT Sub-Committee on Non-Tariff Barriers, *The Arbitrary or Excessive Valuation for Customs Purposes: Note by the Japanese Delegation*, TN.64/NTB/32 (July 15, 1964); GATT Sub-Committee on Non-Tariff

in design, required certain imports – benzenoid chemical products, rubber footwear, canned clams and knitted woolen gloves – to be valued on the basis of the price at which similar *US-origin* products were sold in the US market, rather than the actual invoice price for the goods. The use of this method was said to result in import duties well in excess of the price of the goods themselves – reportedly as much as 172 percent in the case of yellow-vat dye, for example.[24] Apart from the prohibitive effect of such rates, the ASP method was directly contrary to the GATT Article VII:2 proscription against use of customs valuation methods that are "based on the value of merchandise of national origin."[25]

The United States and European countries reached a conditional agreement in the Kennedy Round, which would have required the European countries to reduce their duties on US chemical exports if the United States ended the use of its ASP valuation method.[26] However, this agreement never entered into force. The US use of the ASP remained a major irritant in these contracting parties' trade relations until finally resolved through the Tokyo Round agreement.[27]

(d) Precursor to an agreement

In November 1967, following the successful conclusion of the Kennedy Round earlier that year, the contracting parties met to do a stocktaking of the first twenty years of the GATT, with a view of setting a work program to enable further expansion of world trade.

Barriers, *The Use of Arbitrary or Excessive Values in Levying Customs Duties: Note by the Danish Delegation*,TN.64/NTB/34 (July 22, 1964).

[24] "Toward Agreement," *Time*, May 19, 1967, at www.time.com/time/magazine/article/0,9171,840930,00.html.

[25] If the ASP was contrary to GATT Article VII, how could it have been used by the United States? The reason is that the ASP predated the GATT. Under the terms of the 1947 Protocol of Provisional Application of the GATT, by which the United States accepted the GATT Treaty, the United States was obliged to apply provisionally Part II of the GATT (which included Article VII) only "to the fullest extent not inconsistent with existing legislation." Thus, while the ASP contradicted GATT Article VII principles, as the United States itself freely acknowledged, its use was nonetheless permitted by this "existing legislation" exception. See GATT Contracting Parties Twenty-Second Session, *Definitive Application of the GATT: Note by the Executive Secretariat*, L/2375/Add.1 (March 19, 1965).

[26] GATT, *Agreement Relating Principally to Chemicals Supplementary to the Geneva (1967) Protocol*, L/2819 (July 17, 1967).

[27] The agreement was not implemented due to the failure by the US Congress to enact necessary domestic legislation to eliminate use of the ASP. The US rubber footwear industry opposed elimination as did the powerful US chemical industry, which was said to be "almost totally opposed to losing ASP protection and question[ed] the value of it of lower duties abroad." Memorandum from Secretary of State Rogers to President Nixon (March 24, 1969) in US Department of State, Foreign Relations, 1969–1976, *Foreign Assistance, International Development, Trade Policies, 1969–1972*, Vol IV, document 188, available at http://www.state.gov/r/pa/ho/frus/nixon/index.htm.