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A Note on Pre-Shipment Inspection of Imports[*]

The government is now considering the reintroduction of some form of pre-shipment inspection (PSI) of imports. Private sector lobbying of Parliament in favor of PSI has been spearheaded by the Indonesian Importers Association (GINSI).[1] The importers complain that corruption and arbitrary decisions on duties and document verification of imports are becoming more common and that the Directorate General for Customs and Excise is colluding with some importers to allow under-invoicing and administrative smuggling of imports into the country. Industry associations in the home electronics (GABEL), textiles and garment (API), and footwear (APRISINDO) sectors have also issued complaints with regard to customs in respect to arbitrary treatment of imports and collusion in smuggling.

PSI is allowed by the WTO under the rules covering non-tariff measures (NTMs).[2] The WTO Agreement on Pre-shipment Inspection is distinguished by the fact that compliance with obligations is contingent upon the behavior of private rather than government entities (i.e., the PSI service providers rather than a government body). The WTO created a Working Party on PSI and it issued a report that presented the view that PSI is a transitional measure that is to be used only until national customs are in a position to do the relevant tasks themselves. The central issue in deciding whether or not to resort to PSI is the competence and efficiency of the national customs authority. In the past, Indonesia decided to use PSI, based upon the judgement that customs was unable to conduct its functions properly. This issue has again come to the forefront as reflected in numerous press accounts of smuggling, improper classification of imports and under-invoicing of the value of import shipments. These problems have become serious matters.

Indonesia relied on PSI conducted by the Swiss Company, *Societe Generale de Surveillance* (SGS) from April 1, 1985-March 31, 1997. Presidential Instruction (Inpres) No. 4 was introduced to simplify and streamline import procedures by contracting SGS to undertake PSI, thus sidelining the customs. Proper valuation of imports and assessment of duties at the point of origin of the imported goods by SGS facilitated direct payment of customs duties to the government through the banks and effectively curtailed the ability of customs to collect bribes and side payments for clearing imports. It is likely that reinstatement of PSI would increase customs revenues to the government even net of the cost of charges for PSI services (reported to be about 0.67 per cent of the value of imports inspected).

There are two major functions of PSI: to ensure that the goods to be imported conform to the sales contract in terms of both quantity and quality and to verify the accuracy of the price declared in the invoice. In addition to these services, PSI companies may provide ancillary services such as verification of the origin of the product, provision of statistical data, and technical assistance and training.

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[*] This note was prepared by William E. James, consultant to the USAID-funded Partnership for Economic Growth (PEG) Project, Ministry of Industry and Trade, January 22, 2002. The views expressed are those of the author and not necessarily of USAID or the government of Indonesia.

[1] For example, see *The Jakarta Post*, December 11, 2001, p. 20, "House supports calls for pre-shipment inspection system on imports," by Adianto P. Simamora.

[2] The Uruguay Round Agreement on PSI addressed some of the concerns that had been expressed by a group of US exporters that had been opposed to its use. The WTO rules covering PSI provide exporters assurances of transparent inspections and rights to appeal to an independent entity in case of disputes. In addition, the rules protect confidential business information.

PSI ensured the smooth flow of imports into the country and helped to stimulate export growth. SGS also provided accurate data on imports so they could accurately be classified as capital goods, intermediates, or consumer goods on a timely basis. Moreover, SGS provided technical assistance to PT. SUCOFINDO and PT Surveyor, both Indonesian state enterprises. Initially, a three-year contract was extended to SGS. The success of PSI however, led the government to renew the program so that it continued for over 11 years.[3]

However, economic nationalists strongly opposed PSI, arguing that it was benefiting a foreign company and pressured the government to fire SGS and hand authority over imports back to the customs office.[4] Authority over imports was finally returned to the Directorate of Customs and Excise in the Ministry of Finance on April 1, 1997.[5]

PSI has the advantage of providing the government with accurate information on the content and valuation of shipments of imports because there is physical inspection of the goods being shipped in the port of origin. PSI thus avoids the problem of under-invoicing and also prevents importers from false classification of goods in HS categories with lower or zero tariffs to avoid payment of duties.[6] (Over-invoicing is not a concern here as there are no exchange controls so overstatement of the value of imports is not used as a means of disguised capital flight as it might be in countries employing capital controls). PSI thus allows accuracy in collecting customs duties and could thus promote international trade by increasing certainty for importers.

In 1996, SGS estimates that PSI services allowed the government to collect $853 million in tariff and tax revenue that otherwise would have gone uncollected. Roughly $700 million of the additional revenue resulted from correction of HS classifications and the remainder was from correction of under-invoicing.[7] Imports inspected in 1996 were valued at $37.4 billion. Applying a cost factor of 0.67 per cent of import value implies PSI services cost Indonesia a total of $250 million. Thus, it appears that the direct revenue benefit-cost ratio was about 3.4--certainly high enough to justify the program, even without taking into account indirect benefits arising from expeditious and smooth flows of imports. A survey conducted by Business Advisory Indonesia in 1989 reported that the time required to clear imports was reduced from 12 days before PSI to 5 days thereafter. Most importers reported lower costs in port clearance as well as savings on inventories. Importers also reported enjoying benefits from less bureaucratic intervention and from fewer discrepancies between the quality and price of the goods ordered and received. Smuggling was also reduced through improved monitoring of containers and loading procedures in ports outside Indonesia.

One other argument in favor of PSI is that price verification procedures used may provide accurate information to the government that can be used to deflect arguments for

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[3] A second Presidential Decree (3 of 1991) was issued to extend the contract.

[4] One of the chief arguments made was that payments for PSI services had a negative effect on the balance of payments and that charges for PSI by SGS were excessive.

[5] PSI was ended at the same time Customs Law UU10 of 1995 replaced the very outdated previous Customs Law. However, there does not appear to be any obstacle to PSI in the law. Since PSI was implemented by Presidential Decree it required no act of Parliament to end PSI, rather this was done simply by revoking the Presidential Decree.

[6] Under-invoicing is the practice of deliberately reporting a value of imports to customs below the actual value of the shipment, thereby evading a portion of *ad valorem* duties and taxes that are imposed based upon customs valuation of the goods imported.

[7] SGS, *Annual Report 1996: Indonesia*.

antidumping measures. The requirements for conducting appropriate price verification are also set out in the GATT Agreement of 1994. The PSI entity is expected to base its findings on prices of identical or similar goods offered in the exporting country. The PSI entity *may not use* the selling price of like goods in the importing country for price verification.

PSI cannot eliminate smuggling, but should help limit the blatant abuse of customs regulations that domestic producers in textiles and apparel and electronics now complain about. I believe PSI is also important in the case of EPZs and Bonded Zones because corrupt individuals or groups may use or allow use of such zones to smuggle goods in for re-sale in the domestic market. For example, in the Philippines there has been rampant smuggling as in the case of a luxury yacht that was smuggled in piece by piece through the Bataan Export Processing Zone. Smuggling limits the extent to which domestic prices can exceed international prices (roughly argued to be in the range of 10-15%). Thus, further tariff reform will ultimately be necessary to minimize the incentive to smuggle. PSI can be used to help establish a risk assessment and management system. However, such a system can only become effective if the customs authority cooperates and behaves appropriately.[8]

It is recommended that Indonesia adopt a PSI program for a period of time necessary to establish a risk management and assessment system.[9] The previous PSI program implemented for Indonesia was perhaps the largest in the world involving physical inspection of thousands of shipments of imports valued at over $37 billion in the final year of the program. A new PSI program will in all likelihood be designed to make use of improvements in information technology that allow PSI service providers to gradually reduce the incidence of physical inspection and, over time, to focus inspection efforts on import transactions that have moderate to high risks of involving false classification, under-invoicing or smuggling.

Among the key questions for the Ministry of Finance is who pays for the PSI services. Importers and private business groups are apparently willing to pay for such services. The cost of PSI services is estimated presently at 0.5 per cent of the value of imports covered. The method of payment is also worth considering. One possibility is for the importers to pay a fee to the government and, in turn, the government then pays the PSI service provider.

A final issue is whether PSI services should be the monopoly of one company or not. In some of the countries currently using PSI, importers are given a choice of PSI firms. They still pay the same fee for the services. The idea is to introduce some competition. However, such an approach may make it more difficult to develop a unified data base for later introduction of a program based upon risk management assessment. Such a program would be cheaper to operate than full-scale PSI.

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[8] The World Customs Organization (WCO) recommends the use of risk management programs and selective inspection as alternatives to traditional PSI programs. Improving the performance of customs is vital to making such approaches succeed.

[9] The government may seek the input of SGS and PT SUCOFINDO on alternative approaches to PSI that might be applicable to Indonesia. Before settling upon a specific approach, the government might also consider alternative PSI systems used in other countries.