



096249  
3.44.0  
73-0408  
UNITED STATES GENERAL ACCOUNTING OFFICE  
WASHINGTON, D.C. 20548

INTERNATIONAL DIVISION

B-177370



NOV 16 1972

The Honorable  
| The Secretary of Defense 5

Dear Mr. Secretary:

23 The General Accounting Office (GAO) has reviewed the Army and Air Force Exchange Service's (AAFES's) Pacific Exchange (PACEX) mail-order-catalog operations. This review -- prompted by our country's balance-of-payments deficits which continue to increase at an alarming rate -- sought ways in which military exchanges might help stem our Nation's increasing trade deficit. 201

By usual standards of measurement, the PACEX catalog sales achievements have been highly successful. These sales were only \$1 million in 1965. They soared from \$16 million in fiscal year 1969 to about \$96 million in fiscal year 1972. We note, however, that the PACEX catalog carries only foreign merchandise. Since every dollar of catalog sales impacts unfavorably on our balance of payments, actions to alleviate this situation are desirable.

BACKGROUND

This is one of several reviews GAO has undertaken to identify ways to help alleviate our adverse balance of trade.

Several congressional committees have recently initiated hearings aimed at exploring ways to expand U.S. exports. The Departments of State, Commerce, and Agriculture and other export-oriented Federal agencies have embarked on a vigorous program to find new ways to help U.S. businesses increase their exports. At the President's direction, the Office of Management and Budget is studying ways to increase the effectiveness of overseas commercial and economic activities.

Because of its substantial overseas expenditures, the Department of Defense (DOD) has taken a variety of special measures to improve our balance-of-payments position. One of the measures authorized a

BEST DOCUMENT AVAILABLE

701317 096249

B-177370

50-percent, domestic-preference rate for DOD purchases. The Office of Management and Budget, following DOD's lead, directed that all Federal agencies apply the 50-percent criterion favoring domestic goods and services for use abroad.

It is DOD's policy that overseas exchanges stock American merchandise within the limits of sound business practice. Overseas exchange officers are directed to display American merchandise prominently and to cooperate with potential U.S. suppliers in meeting foreign competition, especially where customer demand indicates a shift to foreign products. We believe the PACEX catalog is not consistent with this policy.

AAFES advises that it has consistently supported the "Buy American" program, featuring American merchandise in all its facilities, and that the bulk of merchandise sold through AAFES facilities is of U.S. origin. As a retail service organization, AAFES must also respond to customer desires for merchandise assortment and consider its military patron and family needs; therefore, some products of foreign origin are also carried.

Initially, the PACEX catalog was developed to permit the sale of gift items unique to the areas served by military personnel. The catalog was later expanded to give servicemen stationed in Vietnam and Thailand an opportunity to purchase items routinely carried in exchange retail stores in the Pacific area.

AAFES contends that the PACEX catalog contributes to the maintenance of a favorable balance-of-payments position by providing foreign merchandise for resale to Armed Forces personnel at a much lower cost than the individual customer could obtain from foreign retail outlets. They base this contention on the fact that the amount of dollar outflow is reduced by the difference between these two consumer costs and that the profits generated by the exchange store or catalog sales of foreign goods are retained by an agency of the Government--AAFES.

During fiscal years 1969 to 1972, about 75 percent of the total PACEX catalog sales originated in Vietnam. AAFES submitted the following figures and stated that approximately 90 percent of the items listed in the 1972 catalog are not offered for sale in the exchange retail outlets in Vietnam and that these items are a valuable supplement to retail stock assortment offered there.

BEST DOCUMENT AVAILABLE

B-177370

	<u>Fiscal Year Ending January 25,</u>			
	<u>1969</u>	<u>1970</u>	<u>1971</u>	<u>1972</u>
	(in millions of dollars)			
Catalog Sales:				
Vietnam	\$ 12	\$ 31	\$ 61	\$ 72
All other	<u>4</u>	<u>10</u>	<u>21</u>	<u>24</u>
	<u>\$ 16</u>	<u>\$ 41</u>	<u>\$ 82</u>	<u>\$ 96</u>
Retail Sales:				
Vietnam	\$366	\$418	\$364	\$252
All other	<u>222</u>	<u>241</u>	<u>254</u>	<u>236</u>
	<u>\$588</u>	<u>\$659</u>	<u>\$618</u>	<u>\$488</u>
Catalog Sales to Retail Sales:	- - - (in percent) - - -			
Vietnam	3%	7%	17%	28%
All other	2	4	8	10

#### MATTERS FOR CONSIDERATION

Despite its merits the PACEX catalog is inconsistent with the efforts of other Government activities that seek imaginative ideas to help restore a trade surplus. In the following sections we discuss some of the important factors which contributed significantly to the merchandise sales through the PACEX catalog--merchandise promotion; eligibility requirements; pricing; rationing; and mail subsidies. Finally, our conclusions and recommendations are presented for your consideration.

#### Merchandise promotion

AAFES makes it easy for servicemen to buy foreign goods through its mail-order catalog. The 1972 PACEX catalog is made up exclusively of merchandise from eight countries in the Pacific area where American military personnel are assigned or visit. Over 300 high quality technical color pages depict lifelike pictures of some 1,500 foreign items. PACEX officials reported that the 1973 edition will be expanded to 340 pages and will contain 1,800 gift items. Available for purchase are a wide variety of cameras, stereos, jewelry, watches, clocks, clothing, toys, chinaware, and small appliances. About 700,000 copies of the 1972 catalog, costing over a dollar a copy, have been distributed in the Pacific area.

Servicemen stationed in the Pacific area, excluding Hawaii, are each given a copy for their personal use. They merely fill out the order forms and send in checks to cover the cost of the goods, including packaging, postage, and insurance. PACEX does the rest--processes the orders and packs and mails them. Last year AAFES spent \$2.4 million employing over 500 people to provide these services.

In the past, 75 percent of the PACEX orders came from servicemen in Vietnam. Continuing troop reductions there undoubtedly will cause a greater share of purchases to be made from other areas in the Pacific. Distribution of the catalogs to areas outside Vietnam and Thailand has increased almost 30 fold--from 10,000 in 1969 to nearly 300,000 in 1972.

The catalog's wide distribution is defended on the premise that a serviceman may be expected to buy merchandise indigenous to the area in which he is serving. DOD Directive 7060.3 provides that exchange outlets in the Pacific area carry only foreign goods available in the local market. The same directive restricts transshipment of foreign goods between nonappropriated-fund activities in different market areas. We believe the spirit of these restrictions is skirted when foreign goods from eight countries (market areas) are shipped to a warehouse in Japan for sale to customers in the Pacific area without regard to the local market at his duty station. AAFES points out that, without the availability of foreign goods through PACEX catalogs, servicemen would more likely purchase items of uncertain quality directly from the foreign sources at higher prices.

#### Eligibility requirements

Our review identified several categories of competitive American products--small appliances, luggage, sporting goods equipment, selected stereo equipment, watches, and cameras--which might well be included in the catalog. The experts in AAFES's procurement branch could undoubtedly identify more categories of competitive American products which are presently not eligible for sale through the catalog.

PACEX officials explain that American products are excluded from the PACEX catalog because of the additional transportation costs involved. They state that, because 80 percent of catalog sales are destined for delivery in the United States, it makes little sense to ship goods from the United States to their warehouses in Japan and back again. We agree that it would be unwise to incur double transportation costs.

As an alternative, we propose an arrangement in which American merchandise might be drop shipped by the vendor or the manufacturer, duty free, to a stateside addressee. American goods to be used overseas could be shipped routinely from the United States or could be prepositioned if warranted by demand experience. We were told that some American manufacturers would be willing to preposition merchandise in Japan to qualify for the PACEX catalog.

Although AAFES agreed that a drop-ship arrangement with vendors in the United States could be worked out, it would be limited by practical as well as policy considerations. We are advised that certain items are not authorized for sale in domestic exchanges. For example, individual stereo components cannot be sold unless they are included in integrated stereo systems costing less than \$200 each. The limitations placed by the House Armed Services Committee on the types and categories of merchandise which may be sold by domestic exchanges are designed to prevent undue competition with those individuals and firms engaged in the retailing industry. Consequently, the types and categories of items which may be sold in domestic exchanges require the sanction of the House Armed Services Committee. <sup>145</sup>

AAFES said that U.S. products sold overseas for delivery in the United States also required approval from the House Armed Services Committee. Curiously, this same restriction is not applied by AAFES to foreign merchandise sold overseas for delivery in the United States. The very same stereo sales denied to American manufacturers are instead being made by foreign manufacturers with invaluable assistance from the PACEX catalog.

The Mail-A-Gift catalog is a specific exception granted by the House Armed Services Committee for the sale of many U.S. products that could not otherwise be sold by overseas exchanges for delivery in the United States. This alternative to the PACEX catalog is a smaller, limited-distribution catalog of American brand-name items. It is restricted to servicemen in Vietnam and Thailand; servicemen stationed in other parts of the Orient cannot use it. It does not provide the wide selection of merchandise that is available in its counterpart, nor does it have the sale appeal of the PACEX catalog. Consequently, the 1972 sales of American merchandise through the Mail-A-Gift catalog was about 2 percent of the foreign merchandise sold through the PACEX catalog.

B-177370

The present, separate but unequal catalogs treat U.S. manufactured products as second-class merchandise in both distribution and sales appeal. Equity would seem to dictate that the American manufacturer be provided access to this lucrative market or that the foreign manufacturer be denied.

### Prices

In partial recognition of the higher cost of American products, AAFES has applied higher markups on foreign goods. For its best sellers--electronic and photographic equipment--AAFES assigns a 15-percent markup to foreign items; it marks up similar American items only 10 percent. This 5-percent difference, however, has done little to discourage purchases of foreign goods. A greater spread is necessary if more American goods are to be sold.

AAFES believes that any major increase in the prices of foreign products included in the PACEX catalog would have a corresponding adverse effect on the balance-of-payments program because of the increased potential for their purchase in the civilian market. Although some substitute commercial purchases might result, the fact remains that many catalog products are not available at the authorized patron's duty station. This, coupled with the convenience of buying through the PACEX catalog, could be used to give American products an advantage.

### Rationing

Although retail store sales in Pacific exchanges are often controlled by a strict rationing system, similar limitations are not applied to purchases through the PACEX catalog. For example, a serviceman in Korea may buy only one stereo receiver, one tape deck, and one expensive camera during a tour in the Pacific; however, his purchases are not restricted if he chooses to buy through the catalog.

Rationing of PACEX merchandise, according to an AAFES official, would prove to be a costly administrative task for both military and civilian authorities and would provide no positive assurance that this action would prevent procurement from other sources. However, further consideration should be given to devising a ration system (controlled by the patrons' organization) which would provide greater assurance that purchases of foreign products were for qualified individual needs. The rationing system, for certain products shown in the PACEX catalog, could be made consistent with the rationing policy in PACEX's retail

B-177370

outlets and could help attain the desired goals and benefits of preventing black-marketing and purchases by unauthorized personnel.

#### Mail subsidies

AAFES makes it easy for servicemen to order foreign merchandise; it also utilizes the privilege of discount mail service for all orders. This is made possible by Government-subsidized Army Post Office (APO) mailing from overseas. Goods are mailed via APO, free to the buyer, from the warehouse in Japan to San Francisco, California. The buyer bears the cost of postage from San Francisco to the ultimate U.S. destination. In fiscal year 1971 the United States subsidized 30 million pounds of APO surface cargo shipments at a cost of over \$800,000.

AAFES explains that, when APO facilities are used for PACEX catalog orders, PACEX is merely acting as the serviceman's agent and is exercising the serviceman's right to mail his purchases to the United States through the APO facility. We do not wish to deny the serviceman his right to use the APO facility, but when PACEX acts as the serviceman's mailing agent for foreign products, the convenient and low-cost arrangement encourages the purchase and import of foreign items which otherwise might not have been sufficiently attractive.

#### CONCLUSIONS AND RECOMMENDATIONS

The growth of the PACEX catalog is a testimonial to the attractive merchandising service provided to our military and other authorized patrons assigned abroad. Its phenomenal growth unfortunately adversely affects our balance-of-payments problems because foreign producers are major beneficiaries of this service.

Although overseas patrons may have a preference for foreign gift items, we question whether the PACEX catalog should entice them with foreign products not normally produced in the country in which the serviceman is stationed. Merchandise offered in the catalog should be consistent with goods available in AAFES's retail operations, which generally are limited to products produced in the United States or available in the host country where the exchange store is located.

The recent dollar devaluation is expected to add significantly to making American products more competitive. However, positive actions to solidify the advantage accruing from devaluation needs to

B-177370

be implemented. A reassessment of the potential for increasing sales of American merchandise would, we believe, greatly improve our balance-of-payments situation.

We recognize that elimination of the PACEX catalog might not be a realistic alternative. However, we noted too that the huge success of the PACEX catalog has had a further adverse impact. The Navy Exchange in Japan revised its mail-order operations to emulate their highly successful AAFES counterpart. We believe that the foreign merchandise promotion problem should be studied and that action should be taken to improve the imbalance between foreign and American goods sold through exchange catalogs.

Accordingly, we recommend that you:

- Consolidate the PACEX and American mail-order catalogs.
- Limit individual distribution to servicemen in Vietnam and Thailand and confine the catalog to customer service desks in other authorized areas in the Pacific.
- Make American goods more attractive and competitive by increasing the markup on foreign goods and reducing the number of foreign items in the catalog.
- Actively seek American merchandise for inclusion in the PACEX catalog to introduce the overseas patron to quality American products, consistent with the DOD's "Buy American" program.
- Ration desirable and/or luxury PACEX goods, such as cameras and stereo equipment, to prevent unauthorized purchases.
- Consult with the House Armed Services Committee for drop shipment of American products from American manufacturers and wholesalers to stateside addresses.

*C2-5* Copies of this report are being sent to the House and Senate <sup><1500</sup> Committees on Government Operations, the House and Senate Committees <sup><300</sup> on Appropriations, the House and Senate Committees on Armed Services,

BEST DOCUMENT AVAILABLE



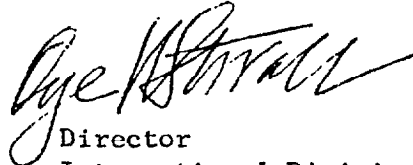
B-177370

the Subcommittee on Non-Appropriated Funds of the House Committee on Armed Services, the Subcommittee on Foreign Operations and Government Information of the House Committee on Government Operations, and to the Director of the Office of Management and Budget.

We would appreciate your views on this matter as well as advice of any action taken or contemplated.

We appreciate the cooperation and assistance given our representatives during this review.

Sincerely yours,

  
Director  
International Division

BEST DOCUMENT AVAILABLE