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Report to the Chairman, Committee on Ways and Means, House of Representatives

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Foreign Trade Zones Program Needs Clarified Criteria

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National Security and
International Affairs Division

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The Honorable Dan Rostenkowski
Chairman, Committee on Ways and Means
House of Representatives

Dear Mr. Chairman:

This report responds to your request that we update our March 1984 report (GAO/GGD-84-52) on the administration and operations of the Foreign Trade Zones. As you requested, we concentrated particular attention on subzones. Given the increased potential economic impact of this program, we concluded that Congress should clarify the nature of the zones program.

As arranged with your office, unless you publicly announce its contents earlier, no further distribution of the report will be made until 3 days from its issue date. At that time, copies will be sent to the Secretary of Commerce, to whom it makes recommendations, to the Secretary of the Treasury, and to other interested parties.

Sincerely Yours,

Frank C. Conahan
Assistant Comptroller General

Executive Summary

Purpose

Dramatic growth and change in the Foreign Trade Zones (FTZ) program, particularly the movement of automakers and other manufacturers to a dominant position, aroused controversy over the program's economic effects. Opponents are concerned that savings from zone procedures may encourage imports, damaging domestic suppliers and the U.S. economy.

The Chairman of the House Committee on Ways and Means asked GAO to update its 1984 report on this program (GAO/GGD-84-52), focusing on growth, economic effects, and U.S. industry concerns about subzones, and operations of the program's governing Board.

Background

To promote U.S. participation in international trade, the FTZ Act of 1934 authorized designation of zones within this country that are considered outside U.S. customs territory. General purpose zones are multiple user facilities located in ports of entry where primary activities are warehousing and distribution. Subzones accommodate single large manufacturing plants. The FTZ Board, composed of the Secretaries of Commerce, Treasury, and Army, approves proposed zones and shares responsibility for monitoring and controlling them with Customs.

Companies may escape, postpone, or reduce tariffs and other restrictions on foreign goods that enter zones. They may reexport zone products without incurring tariffs or send them into the U.S. market after paying applicable duties. Manufacturers in industries with inverted tariffs (i.e. higher rates on parts than on finished products) can reduce duties on imported parts. The number of zones rose from 19 to 239 between 1975 and 1987 while economic activity multiplied 100 fold. Nearly $40 billion in merchandise including $8.8 billion in imports was delivered to zones in 1986, and automakers accounted for 85 percent of operations.

Results in Brief

The primary reason for rapid zones growth has been the opportunity to use inverted tariffs to lower duty rates on imported parts. In 1986 the tariff reductions were about $38 million. The great majority of auto assembly operations are conducted within subzones resulting in reduced parts tariffs. It does not appear that the Act and its 1950 amendment anticipated the extent to which zones would reduce tariffs and become a major base for serving domestic markets.

The Board is using criteria that predicate approval for subzone grants upon proof of a "significant public benefit." However, these criteria have not been officially adopted and the Board has not strictly adhered to them. The Board has sometimes restricted use of zone procedures but has seldom denied applications. It is not always clear that subzone grants result in a significant public benefit when all factors are considered. The Board's hesitance in adopting or enforcing a strict public benefit test may be attributed to the Act's paucity of criteria for zone grants.

The Congress should amend the Act to provide guidance on the nature of public benefits which would justify foreign trade zone grants, particularly those involving manufacturing.

Principal Findings

Inverted Tariffs Stimulate Increased Zone Use

The Act was amended in 1950 to allow manufacturing, but real growth was made possible by a 1952 regulatory change authorizing subzones. Further, Customs regulatory changes in the early 1980s increased available duty savings to encourage foreign manufacturers in industries with inverted tariffs to transfer operations to the United States. Most zone activity is now conducted by manufacturers who take advantage of inverted tariffs. These are unusual in industrial countries because they benefit domestic producers of inputs to production rather than domestic producers of higher value-added finished products.

The legal changes combined with an inverted tariff structure stimulated auto firm interest and allow them to reduce tariffs on imported parts from an average 4 percent rate to the 2.5 percent rate on autos. By the end of 1987, about 80 percent of U.S. auto plants were in subzones.

Need for Clarified Criteria

The Act and the Board's regulations contain minimal guidance on criteria to be applied in evaluating proposed zones. The Act states that the Board shall make grants if the proposed plans and location are suitable to expedite and encourage U.S participation in international trade. The regulations state that anticipated benefits must "justify construction" of proposed zones without distinguishing between subzones and general purpose zones. The Board has informally predicated subzone grants upon proof of a significant public benefit, but has not strictly adhered to this standard.

Subzones are generally approved if applicants project benefits justifying their expense to establish and operate a zone and there is no substantial evidence of offsetting effects. When opposition is expressed by affected industries or federal officials responsible for trade policy measures, the Board seeks compromise solutions. It seldom denies applications and appears hesitant to act when applicants reject restrictions, thus allowing applications to remain pending for long periods.

The Board has continued to approve auto subzones although it is not clear a significant public benefit is being realized. It seems clear that the marginal savings obtained through zone procedures neither provide domestic plants with a meaningful competitive advantage against imported cars nor provide significant incentive for locating production in this country. Their effects on parts suppliers are also unclear. The Board's actions have resulted in a reduction in federal tariff revenue collections and an effective lowering of parts duty rates for auto manufacturers.

Need for Improved Administration

The Board's small staff has been unable to keep pace with the rising numbers of applications for zones and the greater need for monitoring activity. The time required for the Board to act doubled to 12 months for applications filed in 1984-85 compared to 1978-79. As of October 1, 1987, 34 of 56 subzone applications filed during the previous 3 years had been pending an average of 16.8 months. The Board relies on grantee annual reports to monitor zones, but these are of limited use to assess whether zones continue to serve the public interest.

Matters for Congressional Consideration

The Congress should amend the FTZ Act to provide guidance on the nature of significant public benefits that would justify a foreign trade zone or subzone grant and any related tariff revenue loss. The amendment should specify the factors to be considered, such as exports, imports, employment and investment, and could be modeled after draft regulations already developed by the Board.

Recommendations

The Secretary of Commerce should consider providing the FTZ Board with additional professional staff from existing resources within the International Trade Administration on at least a temporary basis to relieve the backlog of applications and facilitate adoption of new regulations.

Agency Comments and Our Evaluation

The Department of Commerce stated that GAO's report focuses on essentially the same major concerns that it has as chair agency of the FTZ Board and agreed that there was a need for congressional guidance as to the general conditions under which subzones and manufacturing should be approved. It stated that the Board would proceed to adopt revised regulations upon receipt of such guidance.

Commerce stated, and GAO agrees, that the relationship between the savings realized under zone procedures and the desired end result of making grants needs to be clarified. Commerce stated that the Board considered significant contributions to improved competitiveness to have merit in approving grant applications even though the savings may not be major. GAO notes that while the aggregate savings to the companies may be substantial, this private benefit does not necessarily mean that a significant public benefit will be realized through the zone grant when all factors are considered.

Commerce agreed that there was a need for improved application processing procedures and noted that a comprehensive revision would depend on the direction received from Congress. Commerce stated that it was already taking some steps to improve matters.

The Department of the Treasury stated that because the case for general economic harm resulting from manufacturing subzones has not been made, GAO's report would be improved if it clarified the particular shortcomings that new criteria could be expected to redress. Treasury added that the report does not support the premise that the criteria currently in use result in actual problems.

GAO agrees that its report does not, and did not attempt to, demonstrate economic harm. As noted by Commerce, zone grants are regarded as a privilege. Currently used criteria require proof of an overall public benefit for subzone grants to be made rather than a lack of evidence that grants will cause harm. However, as discussed in chapter 3, the lack of clarity in these criteria has led to difficulty and delay in decisionmaking and contributed to the controversy over auto subzones. Adoption of clarified criteria based on congressional guidance would give the Board the firm basis it currently lacks for making decisions on applications.

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Abbreviations

FTZ	Foreign Trade Zone
GAO	General Accounting Office
ITA	International Trade Administration
ITC	International Trade Commission
NUMMI	New United Motor Manufacturing Incorporated

Growing Concern Over Manufacturing in Foreign Trade Zones

The Foreign Trade Zones Act of 1934, as amended (19 U.S.C. 81a et seq.), authorized designation of secured zones geographically inside the United States but legally outside its customs territory to expedite and encourage U.S. participation in international trade. Participating companies may bring goods into zones for storage, exhibition, repackaging or other manipulation, manufacturing, and distribution, without subjecting them to formal customs entry procedures and payment of duties. Companies may subsequently bring zone products into U.S. customs territory upon payment of applicable duties and compliance with other laws and regulations, such as quotas, or they may export these products without tariffs and other restrictions being applied.

The number of authorized Foreign Trade Zones (FTZs) multiplied more than 12 fold from 1975 to 1987, and concern about the program's effects grew in corresponding fashion. The most striking feature of this growth is the development of manufacturing within zones to the point where it overshadows other more traditional activities like warehousing and distribution. According to the Department of Commerce, the great majority of goods manufactured in zones is sent into the domestic market and the vast majority of this manufacturing is concentrated in automobile assembly (about 85 percent in 1986.) The program's critics, including labor unions and representatives of industries that compete with and supply zone users, have questioned whether this growth has been beneficial. Among other matters, they are concerned that the savings on imported parts that participating firms obtain through zone procedures may encourage increased importing, damaging domestic suppliers and the U.S. economy in general.

How the Foreign Trade Zones Program Operates

Zones fall into two basic categories, general purpose zones and special purpose subzones. General purpose zones are secured zones under U.S. Customs supervision that are considered outside this country's customs territory (usually in warehouse areas near docks or in portions of industrial parks located adjacent to airports.) Several user companies may conduct business within a zone on either a permanent or temporary basis. These operations can include manufacturing, but most manufacturing under zone authority takes place in subzones.

Subzones are authorized to enable individual companies that general purpose zones cannot accommodate (typically large manufacturing concerns) to participate in the program. Subzones are technically

subordinate parts of sponsoring general purpose zones but are physically removed from them, sometimes at considerable distances.[1] (The FTZ Board defines subzones as "non-contiguous extensions of zones for single users granted when individual firms cannot be accommodated within an existing zone.")

Grants of authority are made by the FTZ Board, composed of the Secretaries of Commerce, the Treasury, and the Army. In Board decisionmaking, agency representatives tend to focus on issues relating to their general areas of responsibility; i.e., Commerce (International Trade Administration-ITA) focuses on issues that affect industry, the Treasury (Customs Service) on matters concerning entry and control of goods in zones, and the Army (Army Corps of Engineers) on zones' physical facilities (e.g. environmental impact matters). The Secretary of Commerce chairs the Board and provides personnel within the ITA to operate the program—an executive secretary assisted by five staff, two at the professional level. The Board and Customs share responsibility for monitoring and controlling zone activity.

The Board is responsible for approving new zones and important changes in existing grants (e.g. significant expansions) upon receipt of "examiners committee" reports containing non-binding recommendations. Examiners committees are composed of a Board staff member and Customs and Army Corps of Engineers representatives from the region of the proposed zone. In practice, the Committee of Alternates, an assistant secretary-level body established by Board regulations, generally approves subzones.

Grants of authority for general purpose zones are most frequently issued to instrumentalities of state and local government, such as port authorities. General purpose zone grantees apply for subzone grants on behalf of companies interested in subzone status. General purpose zone grantees may run their zones on a day-to-day basis or they may engage "operators" (e.g. warehouse management companies) for this purpose. Operators may, at their liability, allow users to handle goods and maintain appropriate records.

[1]For example, one auto manufacturing subzone is located about 60 miles from the general purpose zone in Chicago with which it is affiliated.

Savings Available Through Zone Procedures

Since zones are considered to be outside U.S. customs territory, user firms can avoid payment of U.S. tariffs or compliance with other customs restrictions (e.g., quotas) on foreign goods brought into a zone for processing or manufacturing and then reexported. Subzone status allows a participating textile firm, for example, to avoid paying duties on foreign wool used to manufacture sweaters for export. Since the authorizing legislation provides that most U.S. customs laws (including tariffs) are to be applied against goods only when they are brought into U.S. customs territory from a zone, user firms can realize cash flow savings by postponing tariff payments until goods are eventually entered into U.S. customs territory. Several other subsidiary savings are also possible. For example, merchandise stored in zones is not subject to state and local ad valorem taxation and insurance costs may decline because of the comparatively tight security measures that Customs requires of user firms. Participating manufacturers also do not have to pay duty on goods destroyed in a zone.

The most noteworthy savings, however, are derived from the opportunity zone status affords user firms to choose among applicable tariff rates on imported parts used in goods destined for the domestic market. User firms may request that duties be assessed on foreign goods either at the time they are first brought into a zone, thus acquiring "privileged" foreign status, or when they are actually shipped into U.S. customs territory, in which case they are considered to be in "nonprivileged" foreign status. For zone manufactured products, privileged status is normally more advantageous because duty rates on parts are usually lower than on finished items. However, in inverted tariff situations duty rates on finished products are lower than the rates on some constituent parts. Selecting nonprivileged status in such cases will permit foreign parts to enter the United States as part of a finished zone product at the lower finished product rate.

Objectives, Scope, and Methodology

On March 2, 1984, we issued a report on Foreign Trade Zone operations in response to concerns of the House Committee on Ways and Means about changes in the program to that time.[2] The present report responds to the Committee's June 22, 1987, request that we update and expand upon our previous work, focusing particularly on

- the growth of the program;

[2]Foreign Trade Zone Growth Primarily Benefits Users Who Import for Domestic Commerce (GAO/GGD-84-52).

- the economic effects of subzones;
- industry concern about subzones;
- the operations of the FTZ Board, especially its standards for approving new subzones; and
- the effectiveness of Customs supervision over zone activities;

Our review addressed each of these topics to some extent but concentrated on Board operations. Since most of the recent controversy over this program has concerned grants made for subzone manufacturing, we focused on this aspect of the overall program, paying particular attention to automobile-related subzones, where most zone manufacturing takes place. General purpose zones are relatively non-controversial because little manufacturing takes place within them, and therefore we did not address their operations in detail.

The Chairman also asked the International Trade Commission to make a study of the zones program and asked that the work be coordinated to avoid duplication of effort. The Commission issued its report in February 1988.[3] In view of the Commission's obtaining and analyzing extensive information on subzone activity through distribution of a questionnaire, we did not attempt an overall analysis of subzone grants' economic effects. However, our March 7, 1988, report on the employment implications of Japanese direct investment in the U.S. auto sector[4] reached conclusions that were useful in preparing our discussion of the zones program's economic impact in that industry.

We examined the recent growth in the number of program participants, increased volume of zone activity, and import/export behavior of participating firms, relying on information collected by the Board. We also consulted with a Census Bureau official concerning the information that the Bureau collects on zone activity. The shortcomings of the available data are discussed in chapter 4.

We interviewed both opponents and advocates of the zones program to learn their views and concerns. We interviewed representatives of selected industry groups who believe themselves harmed by the program, most prominently auto parts manufacturers. We also spoke with representatives of the National Association of Foreign Trade Zones and

[3]The Implications of Foreign Trade Zones for U.S. Industries and For Competitive Conditions Between U.S. and Foreign Firms; USITC Publication 2059

[4]Foreign Investment: Growing Japanese Presence in the U.S. Auto Industry (GAO/NSIAD-88-111)

Table 2.1: Numbers of Authorized Zones[a]

Fiscal year	General purpose zones	S
1970	7	
1975	17	
1976	19	
1977	28	
1978	38	
1979	45	
1980	54	
1981	66	
1982	74	
1983	81	
1984	101	
1985	117	
1986	126	
1987	138	

[a]All tables in this chapter are based on information collected by the Board.

Dominance of Auto Manufacturing

Rapid growth in subzone activity, which is almost exclusively r
turing, has overshadowed the growth of general purpose zone a
over the last decade. As shown in table 2.2, goods received in s
rose from $0.4 billion to $37.1 billion over the period 1978-198
goods received in general purpose zones increased only from $(
to $2.6 billion. The fact that just six general purpose zones acc
about 68 percent of all general purpose zone activity in 1986 u
scores the relative insignificance of activity in most of these zc

Table 2.2: Merchandise Received in Zones[a]

Dollars in Billions

Fiscal Year	Total	General Purpose Zones	Subzones	Subzones (percent)
1970	$0.1	$0.1	$0.0[b]	9
1978	0.8	0.5	0.4	44
1979	1.5	0.7	0.8	55
1980	2.6	1.0	1.6	61
1981	3.0	1.2	1.9	61
1982	3.4	1.4	2.0	59
1983	6.5	1.7	4.8	73
1984	15.0	1.9	13.1	87
1985	21.5	2.0	19.5	91
1986	39.7	2.6	37.1	93

[a]Includes imports and domestic goods. Apparent inconsistencies in figures are due to rounding.

[b]Less than $.05 billion.

The increasing participation of auto firms has been the single largest factor behind this shift in the nature of the program. Although the first grant of subzone authority for an auto assembly plant was awarded only in 1977, 36 had been authorized by the end of fiscal year 1987 and they now account for the vast majority of zone activity. Table 2.3 shows FTZ Board figures on this change through 1986, when such plants accounted for about 85 percent of the goods received in all zones. By the end of fiscal year 1987, U.S. auto companies had also obtained 8 subzone grants for affiliated parts plants. Other industries with multiple subzones included petroleum refining (5), shipbuilding (6)[1] and television manufacturing (3).

Table 2.3: Auto Assembly Plant Subzones

Fiscal year	Number active	Percent of All Goods received in zones
1981	1	28
1982	4	29
1983	8	56
1984	12	74
1985	18	78
1986	24	85

[1]Includes two subzones in which offshore oil rigs are manufactured; tariff treatment for such rigs is similar to that afforded ships.

Increased Orientation Toward U.S. Market

Although goods imported and exported through FTZs have both increased in absolute terms in recent years, both have declined in proportion to the greatly expanded volume of domestic trade moving through zones. These overall changes largely reflect the emerging dominance of auto assembly plants.

Table 2.4 illustrates the growth of imports into zones, as reported by participating firms. The reported dollar value of goods imported into zones increased from $0.6 billion to $8.8 billion between 1978-86. However, domestic purchases grew so rapidly at the same time that imports represented only 22 percent of total zone procurements by 1986, down from 75 percent in 1978. Most of the growth in imports is attributable to auto assembly firms, whose imports increased from $0.2 billion to $5.0 billion. However, as a percentage of total procurement, their imports declined from 54 to 15 percent. Affiliates of foreign auto companies conducting manufacturing operations in this country, known as "transplants," reported importing a relatively high percentage of their parts and materials (64% in 1986),[2] and traditional domestic firms have increased foreign sourcing to a reported average of 8 percent. However, the continued dominance of traditional domestic plants over transplants assured that the overall percentage of parts imported would continue to decline. (27 of the 32 auto subzones authorized by the end of 1986 were for traditional domestic producers and accounted for about 91% of all goods received in auto subzones.)

Table 2.4: Imports Into Zones

Dollars in billions; imports as percent of goods entering zones

	All zones		General purpose zones		Auto subzones	
Fiscal year		(%)		(%)		(%)
1978	$0.6	75	$0.3	60	•	•
1979	1.1	73	0.5	71	$0.2	54
1980	1.7	65	0.6	60	0.4	49
1981	2.0	67	0.7	58	0.3	41
1982	2.1	62	0.9	64	0.3	30
1983	2.9	45	1.2	71	0.9	26
1984	4.5	30	1.4	74	2.0	18
1985	5.6	26	1.6	80	2.7	16
1986	8.8	22	2.3	88	5.0	15

[2]This percentage is calculated from aggregate figures reported by four transplants and one Japanese/American joint venture. Two of the transplants also produce products other than autos (light trucks and motorcycles), but separate figures were not provided for these products.

Reported values for exports from FTZs are shown in table 2.5 As with imports, the absolute value of exports from zones has risen during the past few years. However, a large and growing majority of zone goods continues to be sold in the U.S. market. This change can be attributed in large part to the fact that auto assembly plants in subzones produce mainly for the domestic market. According to FTZ Board data, auto assembly plants in subzones exported less than 10 percent of their production in 1986.

Table 2.5: Exports From Zones

Dollars in billions; exports as percent of goods leaving zones

	All zones		General purpose zones		Auto subzones	
Fiscal year		**(%)**		**(%)**		**(%)**
1978	$0.2	32	$0.1	30	•	•
1979	0.3	24	0.2	33	[a]	[a]
1980	0.7	28	0.4	41	[a]	[a]
1981	0.9	32	0.5	49	[a]	3
1982	1.5	39	0.8	53	$0.2	14
1983	1.7	21	0.6	45	0.6	11
1984	2.6	13	0.6	39	1.4	9
1985	3.8	12	0.6	33	2.5	10
1986	4.8	11	0.7	26	3.1	9

[a]Less than $.05 billion or less than 1 percent exported.

Key Legal and Regulatory Changes

The FTZ Act's primary objective was to promote U.S. participation in international trade by facilitating reexport and transshipment activity.[3] However, it did provide for importing goods through zones. Some supporters of the 1934 law believed that sufficient protection for domestic manufacturers was provided by the fact that any article imported into a zone and subsequently sent into domestic commerce would be subject to applicable tariffs. Nonetheless, concern about increased competition led to the original Act's prohibiting exhibiting and manufacturing goods in zones.

The Boggs Amendment of 1950 (ch. 296, 64 Stat. 246) removed the restrictions on exhibiting and manufacturing products within zones. In practice, it had proved difficult for officials to distinguish between permissible "manipulation" and prohibited "manufacturing" operations

[3]Reexport refers to the temporary importation of goods for processing and subsequent export. Transshipment refers to unloading goods coming from one foreign port and reloading them for shipment to a second foreign port.

and to separate exhibition of goods from examination, inspection, and sampling. These prohibitions, and confusion over their application, were largely blamed for the fact that by the end of 1949 the Board had awarded only six grants of authority for general purpose zones. The Boggs Amendment was expected to remove this confusion and encourage more widespread use of zone authority as well as use of domestic materials and labor in finished products that otherwise would be manufactured entirely abroad. It was acknowledged that this amendment could lead to increased imports, but this was viewed as a positive prospect in light of the U.S trade surplus and post-World War II efforts to revive the European economy.

The amendment was not expected to lead to significant manufacturing activity within zones, primarily because of the cost of locating large plants in cramped, expensive port areas. In order to overcome these space limitations, however, the Board revised its regulations in 1952 to authorize designation of subzones. This change paved the way for expanded use of zone procedures by manufacturers.

Nevertheless, the number of authorized zones did not appreciably increase until the mid-1970s, when local authorities became more interested in using FTZ grants to encourage local economic development by attracting new industry and benefitting existing plants. Favorable publicity by the National Association of Foreign Trade Zones and other program advocates contributed to this increased interest. U.S. industry, including automakers, also began to search for ways to compete more effectively in the export market and with foreign competition in the U.S. market.

Two early 1980s regulatory decisions significantly increased the potential duty savings to be realized from using zone procedures, providing a more immediate stimulus to manufacturers' interest in subzone status. Treasury Decision 80-87, issued in 1980, deleted value added in zones (consisting of a percentage of the value of processing and/or manufacturing costs, overhead, and profit) from the dutiable value of the finished product. This change, suggested by the National Association of Foreign Trade Zones, was adopted with the stated purpose of encouraging foreign auto firms, as well as manufacturers in other industries with inverted tariffs, to shift their operations to the United States. In 1982, the Customs Service further reduced the dutiable value of finished products by excluding brokerage and insurance fees and transportation costs from the calculation of such values.

Inverted Tariffs

At least 66 of 84 subzone applications (almost 80%) filed between 1983-87 that we reviewed cited avoiding inverted tariffs as one reason for applying for subzone status. This issue was clearly preeminent for automakers but was also a concern for applicants manufacturing ships, office equipment (e.g. copiers, typewriters, printers), heavy equipment (cranes, forklifts, tractors), ink, appliances, chainsaws, fragrances, and petroleum products. A precise estimate is impossible, but it appears that about 90 percent of the economic activity within zones in 1986 took place at manufacturing firms whose interest in the program was spurred at least in part by the desire to avoid paying inverted tariffs on imported inputs to production.

The auto industry provides a good example of the practical use of zone procedures to overcome inverted tariffs. The tariff on complete automobiles is set at 2.5 percent, but rates on auto parts average 4 percent and can range as high as 11 percent on some parts. Selecting nonprivileged status on imports allows participating auto plants to lower the duty rate on imported parts in cars destined for the U.S. market to the whole car rate of 2.5 percent.[4]

Inverted tariffs are unusual in industrialized countries because they favor domestic producers of inputs to production, including parts, rather than domestic producers of higher value-added finished products. In investigating applications from companies interested in using subzone status to avoid inverted tariffs, the Board staff found that some such relationships (e.g., those affecting bicycle and television manufacturers) had been consciously created and approved by Congress as policy mechanisms to benefit domestic parts producers. In other cases, however, (e.g., auto parts) inverted tariffs did not appear to be the result of any deliberate structuring of the U.S. tariff schedule. They are apparently unintentional byproducts of tariff reductions negotiated under the auspices of the General Agreement on Tariffs and Trade. As such, their distribution through the U.S. Tariff Schedules and their significance for affected industries are not immediately apparent.

In light of this situation, the Board has found itself in the position of acting as a release valve for U.S. firms seeking relief from their own country's tariff laws. In some instances the Board has viewed use of zone procedures to escape from inverted tariffs as appropriate, as illustrated in this excerpt from a 1986 examiners committee report.

[4]The lower duty rate is applied to the imported parts for which nonprivileged status has been selected under zone procedures, not the value of the entire end product.

"It is recognized that the high tariff [on the inputs in question] has been preserved through recent rounds of GATT negotiations, but the prospect of reducing duties through foreign trade zone procedures is an inherent part of our tariff laws. The FTZ concept recognizes that exporters should ordinarily not have to pay duties on foreign inputs and that inverted tariffs tend to favor products made abroad. It seeks to offset noneconomic inducements to offshore production, an objective that is consistent with tariff policy."

When it has determined that inverted tariff relationships were deliberately created, however, the Board has preserved these relationships by approving grants subject to restrictions designed to prevent grantees from circumventing inverted tariffs through use of zone procedures.

The degree to which the Board's authority would come to be viewed as a mechanism for escape from the prevailing tariff rates was not likely foreseen by the authors of the original FTZ Act or its 1950 amendment. The legislative history of the 1950 amendment, for example, contains virtually no discussion of the possible effects of zone manufacturing on competition between domestic and foreign suppliers. Nonetheless, by the end of fiscal year 1987 the Board had granted subzone status to about 80 percent of the 47 auto assembly plants in the United States and applications were pending for 6 more plants. In other words, Board actions have effectively reduced the tariff rates on foreign parts paid by U.S. automakers to a uniform 2.5 percent.

Conclusions

Regulatory actions taken by the Board and by Customs since the amendment of the Foreign Trade Zones Act in 1950, combined with the opportunity thus afforded manufacturers to escape anomalous inverted tariff relationships in the U.S. tariff schedule, have prompted dramatic growth in manufacturing activity in zones. The great majority of the operations of a major industry, auto assembly, are now conducted within subzones. In effect, therefore, the United States has unilaterally reduced tariffs on auto parts, at least insofar as they are destined for use by auto manufacturers, without obtaining compensating tariff reductions from other countries, as may have been done if these tariff reductions had been effected through multilateral trade negotiations. In some other industries the Board has chosen not to permit the use of zone procedures to reduce higher parts tariffs that were created as instruments of trade policy. It is unlikely that the authors of the Act and its 1950 amendment foresaw the extent to which this program would come to be dominated by manufacturers utilizing zone grants as a means to escape inverted tariffs or the degree to which the Board's deliberations

over zone grants would come to center on the advisability of permitting manufacturers to escape established tariffs on imported parts.

Board Needs More Clearly Defined Criteria

The Board's effective criteria for approving or disapproving proposed subzones are unclear. The FTZ Act and the Board's regulations provide minimal guidance as to the standards to be applied in judging grant applications. The Board is using the criteria contained in draft regulations published in 1983 as revised guidelines for evaluating applications. This draft predicates approval for subzone grants upon proof of a "significant public benefit." In practice, however, the Board has not strictly adhered to this standard. It is not always clear that subzone grants will result in a significant public benefit when all significant factors are taken into consideration.

To ameliorate the concerns of affected industries and to prevent zone activities from undermining trade policy measures, the Board has imposed restrictions as a condition for approval in a number of cases. However, it has infrequently denied applications[1] and has appeared hesitant to take negative action (denying applications or imposing restrictions) when proposed restrictions are unacceptable to applicants or when other difficulties are encountered. Board decisions are normally regarded as setting precedents for subsequent actions on similar applications.

The Board needs clear criteria to provide a firm basis for future decisions. The Board prepared revised draft regulations in 1983 and again in early 1986, but neither version was officially adopted in view of ongoing controversy over the program, particularly the economic effects of grants for subzone manufacturing.

Effective Criteria Unclear

The FTZ Act as amended contains minimal guidance for evaluating grant applications. It states that designated "ports of entry"[2] in the United States are each entitled to at least one zone and that

> "If the Board finds that the proposed plans and location are suitable for the accomplishment of the purpose of a foreign trade zone under this act, and that the facilities and appurtenances which it is proposed to provide are sufficient it shall make the grant."

[1]Through the end of fiscal year 1987, we identified only two Board denials of subzone applications. Both occurred in 1973 on the grounds that the applicants presented no evidence of a public benefit. Two more were denied in fiscal year 1988; one because approval would undermine trade policy measures and the other for this reason and also because its net overall economic effect was likely to be negative.

[2]There are approximately 240 designated ports of entry in the United States.

Restrictions on zone activity are authorized by the provision that "The Board may at any time order the exclusion from the zone of any goods or process of treatment that in its judgment is detrimental to the public interest, health, or safety."[3] However, no explicit basis is provided for denying applications, although the law authorizes the Board to revoke grants in the event of "repeated willful violations" of the Act by a grantee.

Courts have held that the Board has a great deal of leeway in deciding what activities should be permitted in zones. Court commentary on two cases is instructive in this regard. In the case of Armco Steel Corporation v. Stans et al., 431 F.2d 779 (2d Cir.1970) (affirming 303 F. Supp. 262 (D.C.N.Y. 1969), the district court concluded that since the Board's findings were based on "substantial evidence" and satisfied the requirements of the Act and regulations, they were not subject to further judicial review. The appellate court commented that the Act provides the Board with wide discretion to determine what activity may be pursued by zone manufacturers subject only to the legislative standard that a zone serve this country's interests in export and import trade. In the second case, Hawaiian Independent Refinery v. United States, 460 F. Supp. 1249 (1978), the court commented that the Board may impose conditions upon zone activity as it deems advisable, with the qualification that such determinations are judicially reviewable at the request of the affected parties "to determine their reasonableness and consonance with the purposes of the Act."

Language in both of these cases supports the Board's authority to place conditions on zone activity when it concludes that the public interest will be served. It seems clear that this authority extends to denying applications when proposed activity is found to be "detrimental to the public interest" or when the proposed activity will not "accomplish the purpose of a foreign trade zone."

The Board's regulations, last revised in 1971, provide the same general criteria for approving both zones and subzones. While providing that the impact of proposed grants on the U.S. balance of payments will be taken into account, the basic criteria state that "an economic survey must demonstrate to the satisfaction of the board that the anticipated commerce, benefits, and returns, both direct and indirect" will "justify construction" of the proposed zone. The survey is to contain materials

[3]The Board's regulations provide that grants may be revoked for failure to comply with any of the conditions of a zone or subzone grant issued by the Board.

describing "the potential commerce and revenue of the proposed zone and other direct and indirect benefits accruing therefrom..." No specific grounds for denying applications are provided, but the regulations do provide that the Board may investigate reports that goods or processes of treatment within a zone are detrimental to the public interest and exclude them from the zone.

These regulations are still officially in effect. However, the Board staff informed us that relevant portions of draft regulations published in the Federal Register in 1983 and an additional revision prepared in 1986 more accurately reflect the criteria currently in use. The Board is using the criteria in the 1983 draft as updated guidelines for evaluating applications. The Board has not officially adopted this draft because of continued uncertainty and controversy over the program but regards its provisions as an elaboration of the regulations rather than a significant departure therefrom.

The 1983 draft provides more detailed criteria, particularly for reviewing subzone applications. Building on the law's "public interest" provision, it defines subzones as ancillary sites authorized "when it can be demonstrated that the activity...will result in a significant public benefit." Among the matters to be considered in evaluating subzone applications is

"whether convincing evidence has been presented as to a resulting significant public benefit, including export development and displacement or substitution of imports, usually measured in terms of new or sustained employment."

To provide a basis for decisions on such matters, the draft regulations ask applicants to provide the Board with

"A discussion of the anticipated economic impact, direct and indirect, of the zone project, including references to public costs and benefits, employment, [and] the U.S. balance of trade .."

For manufacturing operations, the draft regulations solicit information on materials and components that will be foreign source, zone benefits anticipated and how they will affect applicant plans, and the broader impact of the proposed grant on competing domestic industries. Applicants are provided with a page-long explanation of how the information called for in the 1983 draft is to be reconciled with that requested in the regulations.

The draft regulations prepared in early 1986 contain yet more detailed provisions regarding determination of whether proposed subzone grants will "have a positive net economic impact," including consideration for import displacement and encouragement of exports, employment, and investment in this country. This draft also provides explicitly that the burden of proof shall lie with subzone applicants to provide "convincing evidence" that its operations would, inter alia, produce a significant public benefit.

The Board Does Not Strictly Adhere to Stated Criteria

In actual practice, the Board has not strictly adhered to the criteria described in the 1983 draft. Proposed subzones are generally approved if applicants show that the projected benefits will justify the applicant's effort and expense in establishing and using zone procedures and the Board finds no substantial evidence of potentially offsetting negative side effects. This test seems to be derived more from the regulations' criterion of whether zone benefits justify construction than from the significant public benefit criterion contained in the 1983 draft.

Although examiners committees are officially responsible, most of the case review burden is handled by the Board's three professional staff. The staff consults ITA industry specialists and officials of agencies responsible for administering relevant trade policy measures (e.g., Department of Agriculture officials for imported foodstuffs) on proposed grants. ITA industry specialists occasionally prepare studies of the implications of particular proposals; for example such studies were made regarding contested applications from lawn mower and bicycle manufacturers. However, ITA officials stated that they could not often perform such studies because of resource limitations and that, in any case, the information accompanying applications or available from other sources was often inadequate to arrive at creditable conclusions. The capacity of the Board staff to conduct such studies itself is constrained by resource limitations, the increasing numbers of applications being submitted, and the complexity of the issues they raise.

Case files do not always provide specific information on the actual benefits applicants expect to realize from obtaining subzone status. For example, 14 of the case files we reviewed contained no estimation of the expected dollar savings that applicants expected from zone status. The documentation on most of these applications simply asserted that zone status would be a helpful cost reduction measure of unspecified magnitude. Two other cases provided specific information only on the tariff savings to be realized on one imported part.

As for the public benefit of a proposed subzone, some applicants clearly stated that awarding them grants would contribute directly and substantially to the retention and/or expansion of U.S. production and employment. For example, an application from an office equipment manufacturer stated that clearly described savings obtained through zone status would enable the company not only to "preserve the many jobs jeopardized by continued losses, but ... to slow down foreign import sales in the U.S. and also introduce their product lines to the international market." This application detailed the cost differential between importing finished typewriters and importing the constituent parts under the inverted tariff schedule and explained why the proposed subzone grant would not adversely affect any U.S. competitors or suppliers.

These cases notwithstanding, the Board has not required a rigorous demonstration of significant public benefit when reviewing applications. For example, applicants have not been required to show that FTZ benefits are a determining factor in attracting or keeping a plant in the United States to obtain zone status. The Board has deemed it sufficient for applicants to claim that these savings help in meeting foreign competition. For auto makers, as well as other types of participating firms, Board staff acknowledged that savings from zone operations make only a very small contribution to applicant efforts in this regard, one whose effects on employment and production probably cannot be measured. However, they pointed out that the applicant companies had informed the Board that these savings were an important part of larger cost reduction programs aimed at increasing their competitiveness. One appliance manufacturer was granted subzone status primarily on the grounds that the prospective savings would improve its ability to deal with expected future import competition. In many cases, the impact of proposed grants on suppliers or competitors has not been established. The absence of opposition is often taken as sufficient evidence that proposed subzones will not have significant adverse effects on these parties.

Although the 1983 draft calls for consideration of "public costs" in evaluating applications, the Board does not give explicit consideration to the impact that use of zone procedures may have on U.S. tariff revenue collections. Examiners committee reports almost never address this issue. According to Board staff, the important tariff issue is the effect of applicable duty rates on the competitive position of domestic vs. foreign industries, e.g., inverted tariffs in the auto industry provide a competitive advantage to overseas auto producers. Estimates of the tariff revenues foregone through zone grants vary. However, based on its survey

of producers operating in zones, the ITC reported that these companies reduced their tariff expenditures by about $38 million in 1986 while paying about $293 million in duties.

Compromise Solutions Sought When Opposition Encountered

The Board's approach to controversial applications (i.e. those drawing opposition) appears to have been strongly influenced by its hesitancy to deny applications and its limited capacity to undertake thorough economic analyses. In such cases, the Board tries to identify compromise solutions, typically qualifying approval with some restriction that will alleviate the concerns of the opposition. As Commerce Department officials noted, Board procedures in such cases are not so much "adversarial" as "advisory and bargaining." Board staff indicated that they believed this manner of proceeding appropriate as it ensures that a grant's net effect will be to provide a public benefit.

To obtain information on which to base decisions on subzone applications, the Board staff solicits public comment through a Federal Register notice and subsequently prepares an examiners committee report. These reports rely on the information submitted by applicants and respondents to the notice and concerned government officials. Additional information may be solicited from applicants or opponents. Although it would seem important to informed decisionmaking in some cases, the Board's 1983 draft regulations discourage submission of business confidential information in applications, specifying that such information will be requested if deemed necessary. Draft regulations prepared in 1986 indicate that the Board plans to routinely accept such information in the future.

The Board invariably holds hearings on general purpose zone applications and considers subzones in these hearings when, as sometimes happens, applications are submitted simultaneously. Although subzone grants are more often controversial, the Board rarely holds hearings on applications specifically for subzones. The Board's hearings are informal. For example, its regulations make no provision for cross-examination or discovery.

The 1983 draft regulations state that the Board may investigate the advisability of imposing restrictions upon receipt of a complaint or on its own initiative, particularly when "import sensitive" industries are involved. Among other things, these investigations consider whether proposed grants will "undermine a remedial action or program in effect because of an unfair trade practice, or materially or substantially harm

an existing domestic industry." These criteria suggest the circumstances in which restrictions are usually considered, i.e., when federal trade policy measures might be affected and/or when opposition is raised by competing or supplier firms.

Sometimes both conditions apply on one application; i.e., when industries already protected by some trade policy measure register opposition to a proposed subzone grant. Several of the industries showing interest in subzone status (e.g., sugar processing, apparel) are affected by trade policy measures protecting their suppliers (e.g., sugar, textiles). Some applications not so affected (e.g., for ink manufacturing) have nonetheless drawn opposition from concerned domestic suppliers (e.g., pigment producers). The International Trade Commission (ITC) identified 55 applications filed from mid-1982 through mid-1987 that drew opposition[4] (a total of 115 subzone applications were filed during this period). When opposition is encountered, the Board usually follows informal procedures to arrive at compromise solutions. The staff may suggest conditions which will allow the applicant to obtain some benefit from zone status while allaying opponent concerns. Alternatively, the Board may simply approve a compromise arrived at by the disputing parties. For example, steel industry representatives originally opposed subzones for shipbuilders because they might encourage importation of foreign steel with adverse consequences for U.S. producers. To resolve this situation the Board adopted a compromise worked out by shipbuilding and steel representatives in which restrictions would limit adverse effects on steel makers.

By the end of fiscal year 1987 the Board had placed one or more conditions on manufacturing activity in 36 subzones or general purpose zones. The Board most often imposed three types of restrictions: (1) limiting operations to export only (12 instances), (2) stipulating that a company cannot use zone procedures to reduce duties or avoid other restrictions on imported parts used to manufacture products for sale in the United States (20 instances), and (3) making grants for a limited time (2 to 5 years) with the proviso that the Board will subsequently review operations (13 instances). In 18 cases the Board also required grantees to give notice when undertaking new operations to allow review of possible import stimulating effects.

[4]Two involved manufacturing in general purpose zones. According to the ITC, the Board approved 18 with conditions and 11 without. Four were withdrawn due to opposition, and 22 were still pending at the end of fiscal year 1987.

The Board follows a clear policy of not allowing grants of authority to circumvent or undermine trade policy measures taken to protect domestic industries, based on the premise that such circumvention would not be in the public interest. By the same token, proposed activities appearing to advance federal trade policies are viewed favorably.

The Board relies heavily on responsible government agencies to determine how it should handle relevant applications. For example, Commerce's Office of Textiles and Apparel has taken the lead in insisting that grants not permit user firms to circumvent international textile and apparel agreements protecting U.S. industry. Through the end of fiscal year 1987, the Board had approved six textile processing subzones during the prior decade, all with restrictions of one form or another to prevent such circumvention. Preserving the integrity of trade policy measures was also behind the Board's imposition of restrictions on sugar processors, among others. Shipbuilding is a good example of an industry in which trade policy measures favored approval of subzone applications. Relevant examiners committee reports stressed that awarding zone status would support federal policies fostering improvement in domestic shipyards' competitiveness.

Some parties to Board proceedings have commented that reliance on informal procedures has prevented thorough examination of issues relevant to determining the impact of proposed subzones. One opponent of an approved subzone, for example, believed that the Board had not satisfactorily explored significant aspects of the case and that adversarial proceedings where each party could directly challenge information submitted by the other would have provided much better information to serve as a basis for Board decisions.

According to staff of the Administrative Conference of the United States, the Board is under no legal obligation to adopt more formal procedures. They pointed out that formal procedures for adjudicating administrative law cases are set out by the Administrative Procedure Act but do not have to be applied unless required by the law establishing the program in question. The staff said that the relevant standard for judging Board procedures and other informal administrative proceedings is therefore the Constitution's due process clause, as applied by the courts. The staff viewed the Board's procedures as within the range of accepted practices.

However, they suggested several improvements in Board procedures. For example, the Board could issue "scoping" orders that prioritize and

define its criteria in the context of a particular case. Examiners could then pursue the most important unresolved questions. In the interest of developing a more complete record, interested parties could be permitted to suggest or even ask questions themselves at hearings, a procedure that the Board has already used on at least one occasion. Others have suggested that limited discovery procedures could also be implemented, including disclosure of business confidential information, under protective orders, to opposing parties' legal counsel.

The Board Avoids Taking Negative Actions

The Board has avoided taking negative action in cases where denial of applications or imposition of restrictions unacceptable to applicants appear likely.[5] Board officials stated that the low number of denials is misleading. Applicants often withdraw from consideration when the Board appears likely to deny their applications or approve them only with unacceptable restrictions. The Board staff encourages such withdrawals. As of September 1, 1987, nine subzone applications filed between 1978 and 1986 had been withdrawn after remaining in pending status for an average of 22 months. At least four were clearly withdrawn because of opposition. (The Board does not regard applications as officially filed until the staff is satisfied that the material submitted meets minimum requirements for format and content, whereupon it places a request for comment in the Federal Register.) Other cases are never formally filed because the Board staff identifies likely policy problems or private sector opposition in "pre-filing review" (see explanation of this term in ch. 4) and applicants subsequently refrain from going through the bother and expense of actually filing.[6]

Some officially filed applications have remained pending for extended periods of time. As of October 1, 1987, 26 subzone applications had been in pending status for 11 months to 3 years. Inadequate staffing is one reason behind the overall delay experienced by these applicants. (See ch. 4.) However, a variety of other factors contributed to decisions on these cases being postponed. We identified three cases which remained unresolved because the applicant, opposing parties, or both refused to

[5]The Board generally imposes restrictions with the consent of the applicants, who apparently view limited use of zone authority as better than nothing at all. Nonetheless, Board staff informed us that restrictions eliminating access to a company's primary projected benefit (e.g. avoiding inverted tariffs) have on some occasions resulted in companies never actually using subzone grants.

[6]Board staff also attempts to dissuade applicants from officially filing when the costs of setting up and operating a zone will clearly outweigh any possible benefits.

accept proposed compromise solutions (restrictions).[7] Unresolved opposition appeared to be the primary if not the sole reason for delays in nine other cases, four of which date back to 1985 or 1984. The Board staff also cited two cases that were delayed by applicants failing to submit requested information. The staff informed us that the Board had refrained from taking action in such cases because the regulations provide that applicants must be notified of unfavorable examiners committee reports and given the opportunity, without deadline, to present further evidence. One Commerce official, however, stated that the real reason for such Board inaction is that the FTZ Act provides "almost no basis" for denying applications. He added that such inaction is nonetheless a form of denial.

We identified seven cases where Customs concerns contributed to delaying action. For example, Customs concern over controlling petroleum refiners' and blenders' subzone operations contributed to delays experienced by applicants from this industry. The Board approved subzone status for three petroleum firms in September 1985 (with restrictions preventing grantees from circumventing inverted tariffs). However, the Board delayed action on several subsequent applications until Customs concerns were resolved in early 1988.[8] The Board approved the first of these pending applications (filed in Feb. 1986) in March 1988.

Individual Decisions Create Precedents for Entire Industries

Companies submit subzone applications and the Board generally reviews them on an individual plant basis, evaluating each on its own merits and placing considerable emphasis on projected positive local effects. Board decisions are normally regarded as setting precedents for subsequent action; examiners committee reports often cite prior approvals in the same industry as a basis for favorable action. Indeed, Board officials indicated that once the Board has approved one subzone in a particular industry, it is difficult to justify denying subsequent similar applications from competing firms. Consecutive individual Board decisions may therefore effectively adjust tariff rates for entire industries.

Recognizing the potentially far-reaching effects of its decisions, the Board has in some instances extended the scope of its reviews or specified that "special circumstances" surrounding particular grants preclude their being regarded as setting precedents for relevant industries.

[7]As noted at the beginning of the chapter, the Board has since denied two of these applications.

[8]The Board allowed the grantees to begin making active use of zone procedures on a trial basis with continuation beyond 3 years depending on Customs satisfaction with control procedures.

In evaluating the initial shipyard application, for example, the examiners committee considered the potential impact of subzone status on the U.S. shipbuilding industry in general. For a Hawaiian fruit cannery, on the other hand, the committee noted that geography made the plant unique (it relied on foreign sources for tin plate, partially because of its distance from U.S. suppliers) and that therefore approval should not be regarded as establishing a precedent for similar plants on the mainland. We identified three other grants that were approved with similar statements of limited applicability.

In other cases (e.g. petroleum refining and auto assembly) the Board established precedents through approving proposed subzones with limited analysis of the possible ramifications of subsequent wholesale movement into subzones by similar firms. As controversy later arose, the Board undertook more substantial analysis. Through the 1970s the Board refrained from acting on applications from mainland refiners because of opposition from domestic industry and policy considerations.[9] Changes in the oil market during the early 1980s removed this opposition and the Board therefore approved subzone status for several refineries in 1985, with little discussion of the precedent-setting value of these approvals. However, renewed domestic industry opposition to subsequent refinery applications apparently prompted the Board to consider the broader implications of approving subzone grants for oil refineries. This review led to a conclusion that unrestricted use of zone procedures may give participating firms unfair advantages and to the approval of proposed grants with restrictions to prevent this from occurring. The Board's reviews of auto assembly subzone applications have become more involved as controversy about these grants' economic effects has grown. However, the Board continues to make unrestricted grants in this industry without it being clear that a net significant public benefit is being realized.

Controversy Over Auto Subzones

In 1977 the Board approved the first auto plant subzone, for the Volkswagen Manufacturing Corporation of America, on the grounds that the grant would help to encourage the location of assembly operations in the United States that would result in displacement of imported vehicles and therefore create employment. At the hearing on this application, a steel representative expressed concern that the proposed grant might

[9]The Board approved subzones for oil refineries in Hawaii and Puerto Rico, but regarded them as special cases because of their geographical locations.

induce increased steel imports but did not pursue the matter any further. The examiners committee noted that the steel in Volkswagen cars then being imported was not subject to any of the special duties and controls then in place to protect the domestic steel industry and that locating this facility in the United States should create new sales opportunities for domestic steel makers. It added that the Board does have the power to restrict ongoing zone activity at any time, should problems with steel subsequently develop.[10]

Steel industry representatives also opposed the first application for subzone status for a domestic auto assembly firm, filed in 1981. After reviewing the advantages that the domestic auto industry could obtain from participating in the zones program, the examiners committee concluded, in similar fashion to the Volkswagen case, that

"By helping to encourage the location of assembly plants in the U.S., in competition with offshore plants, zone procedures for auto assembly plants should help to either create more steel industry jobs or at least prevent the loss of jobs to foreign competition."

As the numbers of auto subzones increased, the Board formulated a basic policy stance regarding such applications. By 1983, examiners committee reports included a standard statement on the positive impact of the zones program on the auto industry, indicating that awarding zone status was advisable because it would help to promote the location or retention in the United States of auto assembly operations, "all or part of which might otherwise be conducted abroad." Examiners committee reports and other relevant Board documents acknowledged that applicant companies (particularly traditional domestic manufacturers) would realize only small savings from zone status but stated that these savings would help U.S. plants to compete with imported cars and encourage investment in this country.

Regarding the possibility that zone status might encourage participating companies to import more foreign parts, Board documents stated that domestic assembly would be beneficial because these plants' products would compete with imported cars which had 100-percent foreign content; by encouraging the location of assembly facilities in the United

[10]We identified one instance of the Board's restricting ongoing zone activities. In mid-August 1984, the Department of Agriculture determined that sugar-blending operations in FTZs interfered with price support mechanisms for domestic sugar. The Board thereupon imposed an annual limit on imports by the seven sugar utilizing firms, all located in general purpose zones, who were already participating in the program.

States, the program was viewed as actually promoting increased sales opportunities for domestic parts makers. Zone status was not viewed as a determining factor in foreign parts' increasing market penetration. Rising foreign sourcing by traditional domestic firms was ascribed to structural changes in the industry; e.g., the increased international distribution of major manufacturers' component production facilities. Board documents acknowledged that transplant facilities used a greater percentage of foreign parts but presented evidence to suggest that these percentages could be expected to decline (e.g., one existing transplant grantee had actually increased domestic procurement while two others had plans to take such action). Examiners committee reports added that because of past positive experience with auto subzones, more detailed analysis was unnecessary.

This rationale was challenged in mid-1984 when two applications, one for NUMMI (New United Motor Manufacturing Incorporated, a General Motors/Toyota joint venture) and one for Nissan's U.S. subsidiary, were opposed by a competing domestic auto firm and by parts makers, respectively.[11] Chrysler alleged that NUMMI had not established that the proposed grant was in the public interest,[12] while parts makers expressed concern that zone procedures would encourage increased parts imports and reduce employment in the United States.

For the NUMMI application the Board took the unusual step of holding a public hearing for a subzone application not submitted with a general purpose zone application. The examiners committee reports for these cases were relatively more detailed but found no justification for denying zone status in light of the favorable action taken in prior cases. They asserted that zone status had been an important factor in these companies' deciding to invest in the United States and that new production here would displace more imports of 100-percent foreign content than domestically produced cars and therefore would be beneficial. Regarding opposition allegations that transplant production added to foreign firms' total sales at the expense of traditional domestic manufacturers, the examiners concluded that

[11]Nissan's application was for expansion of an existing subzone for truck production to include auto production.

[12]Chrysler also opposed the joint venture on the grounds that it was anti-competitive. However, the Board declined to review any anti-trust issues that may have been present because the Federal Trade Commission had already done so and ruled that NUMMI could proceed to produce autos under certain conditions.

"Only the presence of effective permanent import barriers would force these firms to produce in the U.S. and give some credence to the opposition's arguments. If such barriers were implemented, the FTZ Board might want to review the impact of zone procedures on all auto operations in subzones."

Other auto subzone applications remained pending while the Board gave these two applications greater than usual consideration. The Board approved seven applications filed by domestic firms between March and June 1984 in April 1985. Subsequently, it approved four more subzones for domestic companies on essentially the same grounds cited before the NUMMI and Nissan approvals.

Between May and August 1985, representatives of the domestic auto parts industry registered opposition to another transplant application and two applications from traditional domestic firms, one of which was for an engine plant. Steel industry representatives joined in expressing concern with the two assembly plant applications. The Board approved the transplant application after 9 months on essentially the same grounds as cited in previous cases. However, vociferous opposition to a subzone application filed by Toyota in June 1986, coupled with opposition to domestic firm applications, prompted a general review of auto subzone operations by ITA during 1986. The Board did not make any decisions on pending auto plant subzone applications from April 1986 to April 1987 but then approved the disputed domestic plants in April and June, respectively. A memorandum prepared by the Board staff concerning one of the disputed plants stated that ITA's review had led to the conclusion that the Board should not change its policy "in the absence of evidence of harmful effects on domestic industries based on a case-by-case evaluation." In support of its conclusions that subzone status did not lead to increased parts imports, the examiners committee report on the domestic company assembly plant cited a 1985 ITC report that ascribed rising procurement of foreign parts by U.S. assembly plants to structural changes in the world auto industry.[13]

In similar fashion, paperwork accompanying subsequent approvals for several additional domestic company plants in 1987 pointed out the lack of evidence to suggest that subzone grants cause increased parts imports, adding in two cases that "Most industry analysts agree that auto imports will continue to increase, and all auto producers in the United States are competing with these imports." Once again, examiners committee reports prepared for these cases commented that "Because of

[13]The Internationalization of the Automobile Industry and Its Effects on the U.S. Automobile Industry, USITC Publication 1712, June 1985

the past positive experience with auto manufacturing under zone procedures, there is no need for a more detailed analysis."

Opposition to Toyota's subzone application prompted extensive review of this proposal's merits, including a public hearing, delaying action until December 1987. The conclusions reached in determining that the Board should approve this zone were reflected in the approval shortly thereafter of an application filed by Diamond-Star, a Chrysler/Mitsubishi joint venture. Examiners committee reports on these applications show that the examiners obtained information from the applicants on the displacement effects of the planned production and drew the conclusion that "there appears to be a likelihood of import displacement." During the Toyota hearing the examiners invited the opposition to submit specific information indicating that the tariff rate differential under zone procedures would be significant enough to overcome price differentials or examples of zone status causing a domestic supplier to lose business to a foreign firm. Since no such evidence was submitted, the Board concluded that restrictions on parts imports were not warranted, although it should closely monitor operations in these subzones. Opposition by steel industry representatives, however, did prompt commitments by both applicants to purchase only domestic steel or foreign steel licensed under the President's steel import restraint program.

In recommending approval the examiners committee concluded that the prospect of obtaining zone status appeared to play a role in encouraging establishment of these plants in the United States and pointed out that approval would be consistent with the administration's policy of nondiscriminatory treatment of foreign v. domestic investors. They also noted that Commerce Department officials, including those in the Office of Import Administration, were consulted on these applications and that the Commerce Department had taken the position that the precedents established in prior cases should be followed. Board staff commented that, given the character of the FTZ Act, continued approval for auto subzones was deemed appropriate unless clear proof of adverse effects was found.

Significant Public Benefit Not Established

While the 1983 draft regulations predicate establishment of a subzone upon the creation of a significant public benefit, it is not clear that the Board's actions regarding auto subzones have proceeded on this basis. Material submitted to the Board indicates that most domestic producers can save $10 or less per vehicle by manufacturing in a subzone. However, for large production runs aggregate amounts thus saved may run

into the millions. Eight applicants projected annual savings of more than $1,000,000 in duty differentials alone. However, the average savings claimed amounted only to about 0.04 percent of the price of an average new car in 1987.[14] Because of the higher foreign content in their automobiles, transplants or joint venture firms claimed they may save as much as $50 per car, or as much as $10 million annually. However, even this large a savings translates into a "competitive advantage" of only about 0.4 percent of the sales price of an average car. It seems doubtful whether such savings actually provide cars produced in the United States by either transplants or traditional domestic firms with any real competitive advantage against imports. Rather, these figures point out a central paradox in this program. Although originally created in order to encourage export-oriented trade, in its current form the program provides greater benefits to firms who import more parts.

This program's impact on parts producers is similarly unclear. Zone procedures allow participating auto companies to reduce the tariffs they pay on foreign parts by an average of perhaps 1.5 percent of the cost of the part. These savings are easily overshadowed by other factors, like currency exchange rate shifts. In fact, as pointed out in several examiners committee reports, manufacturers in the United States have expanded foreign procurement in response to larger market forces.

Economic analysis performed by the ITC for its recent report on the zones program indicated that auto assemblers realized increased revenues as a result of their operating in zones while auto parts makers' revenue declined. However, the Commission reached no definite conclusions on the overall employment effects of auto makers locating in zones. Its report commented that "conclusions regarding the direction of net employment effects depend on assumptions regarding the relative degree of supply response to price changes associated with FTZ duty effects. Estimates of supply response are very imprecise."

Parts producers' opposition to auto assembly subzones has centered on grants for transplant operations. Opponents assert that U.S. automakers are facing a no-growth market in which new transplant (and joint venture) firms will displace production by traditional domestic companies. They argue that because transplants use a greater proportion of foreign parts, their locating in the United States results in a net loss of jobs in the U.S economy even if, as examiners committee reports have pointed

[14]According to preliminary Commerce Department figures, consumers paid an average of $13,602 for new cars sold in 1987.

out, they can be expected to expand domestic procurement over time. Because of this alleged net job loss, opponents believe the government should not take any actions (like granting subzone status) that will encourage this foreign investment.

In approving transplant subzones, the Board has concluded that these plants will substitute domestic production for imports, with a net positive effect on the U.S. economy. However, expert opinion is not unanimous on these plant's displacement effects and, at least since 1986, Commerce Department statements have indicated uncertainty in this area. For example, Commerce projected in September 1986 that imports would account for all growth in domestic new car sales from 1985 through 1990 while annual sales of domestically made cars (including transplants) would decline from about 8.2 million to 7.1 million. However, these same projections estimated that transplant production would rise to 1.5 million to 2 million units, implying that traditional domestic firms will be the losers in competition for U.S. market share. One Commerce Department official summed up the situation in a July 1987 statement.

"Assuming the Japanese continue to fill their self-imposed quotas with production from Japan, and further assuming that the total U.S. auto market does not grow rapidly, it seems very likely that these American-made Japanese cars will displace European and particularly American-brand cars. There is really no place else for them to go." (Emphasis added.)

Our March 1988 report on Japanese investment in the U.S. auto industry addresses the employment effects of transplant production. It concludes that auto-related employment in the United States is likely to decline substantially by 1990 for a variety of reasons, including gains in worker productivity, increased use of foreign parts by U.S. automakers, and increased imports. Transplant operations, which use fewer workers and greater foreign content than traditional U.S. manufacturers, could mean greater job losses. Our report points out, however, that whether transplant operations result in more or less U.S. jobs depends on the extent to which they displace other domestic production instead of imports, a factor which cannot be empirically projected.

Importance of Subzone Grants in Investment Decisions

Whether or not attracting transplants to the United States is a desirable objective, it is questionable whether FTZ status has been of any real consequence in convincing transplants (or traditional domestic manufacturers for that matter) to locate or retain assembly operations in this

country. The savings obtained through zone procedures are valuable to the companies involved, but other factors probably outweigh them in decisionmaking.

Obtaining subzone status has clearly not been a determining factor in foreign companies' deciding to locate assembly operations in the United States. The decline in the value of the dollar relative to key foreign currencies, especially the yen, has provided a tremendous incentive for foreign companies to construct production facilities in this country.[15] Japan's substantial foreign trade surplus with the United States has also facilitated Japanese investment in this country, as have incentives offered by state and local governments.

Foreign companies' desire to continue and increase sales in the United States while avoiding protectionist measures designed to keep out imports may be of even greater significance. Traditionally, Japanese auto companies exported complete vehicles from Japan to the United States. However, in view of voluntary restraints on Japanese auto exports to the United States since 1981, changing exchange rates, and increased resistance to imports by the United States, Japanese auto companies adopted the alternative strategy of locating assembly facilities in the United States.

The secondary importance of subzone status in auto company investment decisions has been evident throughout the history of Board action on such applications. According to Board staff, for example, Volkswagen of America clearly indicated when applying for the first automotive subzone in 1977 that it was committed to establishing assembly facilities in the United States regardless of Board action. In NUMMI's case, Toyota and General Motors signed an agreement to establish this facility over a year before a subzone application was submitted. The Japanese press reported nearly a year before Toyota submitted its application for subzone status for its new Kentucky plant that the company had made definite plans to produce cars in the United States, and Toyota officially announced its intentions 6 months before filing. Some examiners committee reports have stated that obtaining zone status appears to have been an important factor in convincing applicant companies to locate in this country. However, these statements have apparently been based on applicant assertions. As previously noted, the Board has not predicated its approval upon a finding that the proposed zone be a determinative

[15]In September 1985 the yen/dollar exchange rate was about 240:1. As of September 1988, it was about 135:1.

factor in investment decisions, but only that zone benefits encourage domestic production that will compete with imported products.

Domestic companies have stated that FTZ benefits would help them to be more competitive overall and retain production in the United States. Examiners committee reports on applications from these firms characterized zone benefits as a small part of larger cost containment strategies to improve competitiveness with foreign producers.

In considering the impact on investment decisions, it should also be noted that various state and local governments have engaged in intense competitions for proposed transplant factories and also domestic company plants. These governments have offered such companies incentive packages worth tens of millions of dollars. In some cases this support amounts to well over $100 million. According to a publication of the University of Kentucky, for example, the state of Kentucky reportedly offered Toyota an incentive package worth an estimated $323 million over 20 years (about half of this in up-front costs).

Tariff Losses

The total reduction in tariff revenue incurred through subzone grants to automakers is uncertain. Auto company respondents to the ITC's survey reported about $32 million in duty savings in 1986. Tariff revenue collections may be further reduced to the extent that production in subzones displaces imported cars that would otherwise generate tariff income. Since the actual displacement rate is uncertain, however, we could not estimate these possible additional reductions. Conversely, tariff revenues could be affected positively by any increased use of foreign parts that may be attributable to the savings on such parts obtainable through zone procedures. This effect is similarly unknown, however. As noted above, opponents of auto subzones have not submitted convincing evidence that zone status has made the difference in specific decisions to purchase foreign parts.

Tariff losses on both parts and whole cars may be offset in whole or in part by the taxes generated by the economic activity taking place in zones. We did not attempt to determine the magnitude of these taxes. Depending on the displacement rate, however, tax revenues generated by a particular plant may be new or simply a shift of revenue from other domestic auto plants. Also, as noted above, FTZ status seems to have been a minor consideration in investment decisions, and therefore it would not be appropriate to give the program credit for the tax benefits produced by these investments.

Suggestions for Stricter Criteria

Critics of the FTZ program have offered varying suggestions for imposing stricter qualifications on grant applications, particularly when manufacturing is involved. They have suggested, for example, that the Board could approve grants for manufacturing only if it is clearly established that positive overall economic effects will result. Particular positive effects could be specified, e.g., creation or retention of jobs or investment in the United States. To limit possible adverse effects on U.S. industry, some have also suggested that grants of authority be limited to reexport activity or that manufacturing be prohibited or permitted (with respect to auto subzones) only when a certain minimum percentage of domestic content is included in any finished products to be brought into the U.S. market. Adoption of domestic content requirements would probably violate the General Agreement on Tariffs and Trade requirement for national treatment.[16] All other conditions being equal, adoption of stricter criteria would tend to result in the Board approving fewer manufacturing operations in zones.

Conclusions

The FTZ Board is informally using criteria in draft regulations that predicate approval for subzone grants upon proof of a significant public benefit. However, these revised regulations have not been officially adopted and the Board has not strictly adhered to the criteria they contain. The public benefit concept remains ill-defined in practice. When opposition is expressed to a proposed zone by affected industries or federal officials responsible for relevant trade policy measures, the Board uses informal procedures to identify compromise solutions that will be acceptable to both sides. The Board appears hesitant to take negative actions and seldom denies applications. Board decisions are normally regarded as setting precedents for subsequent actions on similar applications.

It is not always clear that subzone grants will result in a significant public benefit when all significant factors are considered. The Board has continued to approve subzones for the auto industry, which presently accounts for the vast majority of zone activity, although it seems clear that the marginal savings obtained through zone procedures neither provide domestic plants with a meaningful competitive advantage against imported cars nor provide any significant incentive for locating production facilities in this country instead of overseas. Although these grants' effects on parts suppliers are also unclear, it is clear that the Board's

[16]Part II, Article III of the Agreement states that "No contracting party shall establish or maintain any internal quantitative regulation relating to the mixture, processing or use of products in specified amounts or proportions which requires, directly or indirectly, that any specified amount or proportion of any product which is the subject of the regulation must be supplied from domestic sources."

actions have resulted in a reduction in federal tariff revenue collections. Also, as pointed out in chapter 2, the Board's actions in the auto industry have resulted in this country unilaterally lowering tariff rates on parts for manufacturing operations without attempting to obtain any compensating tariff reductions from other countries.

The Board's hesitancy in either adopting or enforcing a strictly defined public benefit test may be attributable to the FTZ Act's lack of clarity on the character of the criteria to be applied in judging applications. The law permits restrictions to be imposed in the public interest. However, it provides minimal guidance for deciding whether or not grant applications should be approved in the first place. For many years this was not a cause for concern because the central focus of the program remained on non-controversial general purpose zones. However, the rise to dominance of manufacturing in subzones, a development that was not likely foreseen when the Act was originally passed and then amended in 1950, indicates that the Act's minimal guidance may no longer be adequate.

The Congress should provide the Board with clear guidance for making decisions on grant applications, particularly those involving manufacturing. The Board should proceed to develop and adopt regulations which will, in accord with guidance from Congress, clearly define specific criteria which must be met by the applicant before the proposed zone will be approved.

Matters for Consideration of the Congress

The Congress should amend the FTZ Act to provide guidance for decisions on grant applications, particularly those involving manufacturing. Such an amendment should establish that subzone grants, with their potential tariff revenue loss, are a privilege to be based on a demonstrated public benefit. It should also specify factors to be considered, such as the estimated effects of a proposed grant on exports, imports, employment, and investment. The Board's 1986 draft regulations, discussed earlier in this chapter, provide public benefit criteria that could be included in the amendment.

Agency Comments and Our Evaluation

The Department of Commerce concurred in the need for congressional guidance as to the general conditions under which subzones and manufacturing activity should be approved. It stated that the Board would, upon receipt of such guidance, proceed to revise its regulations to include criteria consistent with the standards set by Congress. Commerce, in commenting on a question raised by our draft report, stated

that zone use is already considered a privilege and not a right under current law. This report was revised to reflect that view.

The Department of the Treasury stated that because the case for general economic harm resulting from manufacturing subzones has not been made, the report would be improved if it clarified the particular shortcomings that new criteria could be expected to redress. Treasury added that the report does not support the premise that the criteria currently used by the Board are resulting in decisions that cause actual problems.

We agree that the report does not demonstrate that economic harm has definitely resulted from Board approval for manufacturing subzones. We did not attempt to prove that this was the case. We believe that the current criteria have made Board decisionmaking unnecessarily difficult, led to uncertainty and delays for applicants, and contributed to the controversy over auto subzones. As Commerce stated, zone use is considered a privilege. The draft regulations currently utilized by the Board require demonstration of an overall public benefit for grants to be made rather than a lack of evidence that grants will cause harm. Adoption of clarified criteria, based on congressional guidance, would give the Board the firm basis it presently lacks for making decisions on grant applications.

Although the overall economic effects of these grants may be unclear, it is clear that the primary benefit of subzone grants—the opportunity for duty savings—corresponds directly to a loss in federal tariff revenue. We are suggesting that the Congress may wish to firmly establish the grounds for the Board's making grants which result in such a decrease in federal revenue. As already noted, the FTZ Act is unclear on the character of the criteria to be applied, and the significant public benefit test has neither been officially adopted by the Board nor clearly defined as an operational concept. Subzone grants continue to be awarded although the significant public benefit to be realized, as opposed to private savings, may not have been established.

Treasury also commented that, although the per-unit savings to be realized by auto manufacturers through obtaining FTZ status are small, the aggregate savings are not inconsequential in view of the tightly competitive nature of the auto industry. The Department stated that it would be questionable to conclude that zone status does not offer automakers and other manufacturers a real competitive advantage or is immaterial to investment decisions of foreign or multinational companies. Treasury

stated that the report does not analyze the effects of zone advantages other than reduced duty rates.

The non-tariff savings obtainable through zone operations are discussed in chapter 1. However, it seems clear from manufacturers' applications to the Board and other relevant materials that their primary interest in seeking subzone status is most often to avoid inverted tariffs. This is certainly true for auto plants. We agree, as noted in chapter 3, that the aggregate tariff savings may be millions of dollars for large production runs. Larger considerations, however, including exchange rate shifts and U.S. policy toward imports, must be considered in judging whether FTZ savings have any real impact on the ability of domestically manufactured products to compete with imported products or on corporate investment decisions.

Problems in Administering the Zones Program

Dramatic growth in the FTZ program, together with increasing controversy, has constrained the ability of the Board's small staff to expeditiously process applications and monitor activity in established zones. Because of limitations on available time and resources, we did not attempt a comprehensive review of Customs Service control over zone activity. However, it is unclear whether the resources allocated by Customs are sufficient to carry out Customs own recommended level of supervision over zone activity.[1] Increasing the Board's staff, at least temporarily, is one of several actions that can be taken to allow more timely application processing and better monitoring.

Increased Applications, Static Staffing Produce Longer Processing Times

The volume of applications for Board action has increased substantially since the mid 1970s, but the Board's staffing level has remained virtually static. No time limits have been established for completing action on applications, and the Board's rising workload has substantially increased average processing times. Trade zone association representatives and applicants have registered displeasure with these delays, noting that they create uncertainty and may have substantial financial consequences.

As shown in table 4.1, the average number of applications filed each year increased from 4 during 1973-1975 to 55 during 1983-1985. These totals reflect not only applications for new zones and subzones but also the increased demand for Board action on modifications of existing zones, such as expansions and relocations, that can be expected as the number of authorized zones rises.

[1]For substantive information on Customs difficulties in supervising zone activity in one industry, see GAO's June 1988 report SUGAR PROGRAM: Issues Related to Imports of Sugar Containing Products (GAO/RCED-88-146).

Table 4.1: Numbers of Applications Filed by Calendar Year

Year	General purpose zones	Subzones	Other	Total
1970	1	1	2	4
1971	0	0	0	0
1972	3	1	3	7
1973	1	0	2	3
1974	3	0	3	6
1975	3	0	0	3
1976	7	1	4	12
1977	8	2	5	15
1978	10	4	4	18
1979	11	2	2	15
1980	9	4	7	20
1981	10	5	8	23
1982	10	10	8	28
1983	19	30	6	55
1984	16	37	11	64
1985	12	24	9	45
1986	11	16	8	35

Since table 4.1 displays only applications that have been officially filed, it substantially understates the actual caseload. As of August 1987, the Board staff listed 34 draft applications submitted since June of the previous year that were ready for filing but not yet officially filed. The staff also pointed out that their effective workload has increased because of the greater share of applications drawing opposition; such applications require the investment of greater amounts of time to review and resolve opponents' concerns.

The Board's three professional staff members have been unable to keep pace with this increased workload. The Board's executive secretary stated that the current workload warrants the addition of three economists specifically to perform economic analyses. However, because of competing demands on its limited resources, the Department of Commerce has expanded the Board's staff only by the addition of one clerical worker over the last few years. The executive secretary estimated that present staff could file and process about 35 applications a year using present procedures. However, the increased number and complexity of submissions in recent years and the staff's need to assist in such other projects as internal Commerce Department reviews of the program have led to an increase in average processing time. It is impossible to

determine how much each of the contributory factors added to the overall increase in processing times.

Occasionally, in cases where grants of zone status have clearly been time critical, the Board has moved quickly to complete its review and take action.[2] On average, however, the Board took 12.1 months to complete action on applications for new zones and subzones filed during 1984 and 1985—up from 5.4 months in 1978 and 1979. The 1984-1985 average is understated because it does not take into account 11 applications filed during those years that were still in pending status as of the end of fiscal year 1987.

The Board did not complete action on any subzone applications between mid-May 1986 and late March 1987. During all of fiscal year 1987, the Board completed action on only 7 subzone and 11 general purpose zone applications. Thirty four of 56 subzone applications filed between August 30, 1984 and August 31, 1987 were in pending status as of October 1, 1987. Their average time pending as of this date was 16.8 months.

Controversy, Other Tasks Have Added to Workload

Beyond requiring the investment of additional time to process individual disputed applications, rising controversy surrounding this program has contributed generally to holding up application processing. Board staff devote a great deal of time to preparing correspondence and briefings on the status of applications for concerned business and government figures (e.g. applicants and opponents and governors and other political leaders from both parties' home states.) Board staff have also devoted time to assisting in broader projects concerning program operations, including the management reviews of the program already discussed, and the preparation of revised draft regulations.

The staff spends considerable time responding to general inquiries about the program and advising interested parties on the likely results of potential applications, including the possible necessity for accepting restrictions. According to the staff, preliminary inquiries greatly outnumber applications actually filed. For all applications submitted, the staff conducts a pre-filing review to identify possible problems with the requested grant and/or deficiencies in the paperwork, and it returns a high percentage for completion. Board staff pointed out that this review

[2]For example, the Board approved one subzone application filed in 1985 in a little over 2 months. Public officials from the applicant's locality had requested expeditious treatment because the plant was threatened by imports.

process reduces the number of official applications to be processed by discouraging many applicants for whom zone status would not be appropriate or whose applications would be unlikely to gain unrestricted approval. On the other hand, staff time devoted to this activity is not available for processing officially filed applications.

Increased Need for Board Monitoring

The Board shares statutory responsibility for monitoring and controlling zone activity with the Customs Service. Grantees are required by law to submit annual reports on zone operations to the Board and the Board in turn is required to submit an annual report to the Congress containing a summary of this information. The need for the Board to remain well informed about activity in zones is underlined by the fact that the FTZ Act gives the Board the authority to restrict zone operations "at any time" when it judges particular activities to be detrimental to the public interest. The Board must collect sufficient information to allow conclusions as to whether or not the public interest continues to be served as zone activities change over time. The importance of these monitoring activities has increased in recent years in light of the rising volume of transactions taking place in subzones and the mounting number of grants that have been made for limited times or specific activities with extension dependent on subsequent review.

Because of competing demands, Board staff have little time to conduct active monitoring. They rely primarily on grantee annual reports to obtain information on zone activity. The staff stated that they request additional information when grantee annual reports raise questions; e.g., when increased use of imported parts is indicated. The Board also made arrangements during 1987 to supplement this information with quarterly reports from the Census Bureau summarizing information drawn from Customs forms on imports into all zones combined by product and country and shipments out of all zones combined by product.

The Board provides grantees with written guidance on the required contents of annual reports. This guidance instructs general purpose zone grantees to provide measures for foreign and domestic origin merchandise on hand at the beginning and end of the year and for goods received from and forwarded to U.S. and foreign territory. It also instructs them to submit figures for the five leading commodities and countries of origin for foreign goods and to specify how much of the foreign material was entered in non-privileged status. Subzone grantees are requested to submit similar information.

Late grantee submissions and returns for elaboration or correction have apparently contributed to delaying issuance of the Board's annual reports. To reduce publishing delays and report preparation costs, the FTZ Act was amended in 1986 to eliminate reporting on zone finances and to delete the requirement that individual grantee reports be included in reports to the Congress. Information collected on zone activity remains the same, but it is reported in a more summarized format. The last report under the old system, for fiscal year 1983, was issued in January 1986. By May 1988, the first report under the new system, for fiscal year 1984, had been published.

Board staff stated that the data they obtain permits them to track the general level of imports into zones, which they characterize as their primary concern, and that they pay special attention to auto plant imports. However, the data is of limited use for more in-depth analysis. Board guidelines on their content notwithstanding, grantee annual reports do not provide uniform information and are sometimes lacking in detail. For the 1983 annual report, for example, some auto subzones reported imports of specific parts but others submitted information at various levels of generality, including aggregate figures for total imports. The information provided by Census is more uniform, but has limitations. For example, Census does not generate information at the level of individual zones or companies out of concern for maintaining confidentiality. Domestic goods entering zones are not included and information on imported goods is incomplete for several reasons. Data on shipments from zones are also incomplete because domestic value added is excluded for goods shipped into the United States.

ITA industry specialists and Census officials stated that this data is insufficient to permit creditable analysis of FTZ grants' impact on domestic industries. For example, incomplete information on domestic value added precludes an accurate assessment of the economic significance of zone production. Board staff pointed out that, in any case, present staffing levels do not permit them to thoroughly review all the information that they presently collect.

Customs Monitoring and Enforcement

The FTZ Act requires that the necessary Customs officers and guards be assigned to zones to protect tariff revenues and provide for the admission of foreign merchandise into U.S. customs territory. Customs officials act as the Board's representatives in supervising zone activity. They administer extensive regulations concerning admission of merchandise, inventory control, and subsequent disposition of goods with a

view to preventing users from evading relevant Customs laws and regulations. Among other tasks, they are responsible for monitoring compliance with the FTZ Act, including any restrictions that the Board may have placed on particular grants of authority. The Act formerly provided that zone operators shall pay the cost of maintaining the additional Customs service required to supervise zone operations. However, this provision was eliminated by the Omnibus Budget Reconciliation Act of 1987.

The Customs Service formerly assigned personnel directly to particular zones where they kept records on the admission and withdrawal of merchandise and ensured that zone procedures were not used to evade payment of appropriate duties or compliance with quotas. However, Customs gradually abandoned this system beginning in 1976 when recordkeeping responsibilities were transferred to zone operators, users, or grantees on a voluntary basis. Customs adopted an audit-inspection method of control on a voluntary basis in 1983 and on a mandatory basis in 1986.[3]

Customs changed its approach to zone supervision because (1) Customs officials found that in large scale manufacturing plants they had to rely on the zone users' records to track movements of merchandise rather than maintaining their own and (2) the dramatic expansion in numbers of zone users made direct on-site supervision impractical, unless Customs significantly increased the number of persons assigned to zones. Despite the fact that, until 1988, the law placed the financial burden for relevant Customs operations on zone operators and not the government, Customs did not increase its allocation of staff to zones work because of the administration's policy against expanding the federal work force (the additional personnel would still be counted against personnel ceilings). Pressure by FTZ grantees to reduce customs costs and Customs desire to circumvent potential conflicts of interest in personnel assigned to particular plants for long periods also contributed to the decision to move to an audit-inspection methodology. It should also be noted that Customs has come under rising pressure to devote more time and energy to numerous other issues, including interdiction of dangerous drugs.[4]

[3]Customs also adopted the audit-inspection methodology for monitoring activity in bonded warehouses in 1982.

[4]Customs administers and enforces more than 400 provisions of law on behalf of more than 40 government agencies.

Under the present system, operators are responsible for maintaining their own records, subject to published Customs guidance. Records must provide Customs officials with an "audit trail" to determine compliance with applicable laws and regulations from the time merchandise enters a zone to its final departure. Zone operators must provide Customs officials with a manual that will allow them to understand the recordkeeping system. Customs personnel make audits and inspections separately, but the two types of procedures are intended to be mutually supportive. Audits are thorough examinations of zone operations that are made at least once every 3 years, according to Customs officials. Inspections are spot checks defined as "observational visit(s) by a Customs officer (or officers) of a short duration, normally less than 2 days, to physically examine or verify transactions, records, procedures, or conditions of the zone." Spot checks examine compliance with applicable laws and regulations and assist in planning audits.

Given limited time and resources, Customs sometimes targets spot checks at one or a few aspects of zone activity only (e.g., procedures for admitting merchandise to the zone). However, responsible Customs officials are instructed to insure that all areas of activity in each zone are checked at least once every 2 years. Customs district directors conduct annual assessments of the risk that violations of customs laws may be going undetected in each zone within their districts to serve as a basis for establishing quarterly spot check schedules. According to Customs guidelines, "low risk" zones are to be checked at least once a year, while "medium" and "high risk" zones are to be checked at least two and three times a year, respectively. Customs officials commented that as many as 20 spot checks a year could be warranted for very active zones.

It is unclear whether Customs has allocated sufficient resources to carry out the recommended level of supervision, particularly with respect to audits. Customs allocated its seven regional offices a total of 10 full-time equivalent staff years to spot check zones in both 1986 and 1987. It allocated two regions three staff years each per year, while allocating no staff years to two others. The latter regions were instructed, nonetheless, to devote up to 0.5 staff years each to such operations.[5] The resources specifically allocated for spot checks in 1986 provided an average of 137 staff hours per year for each of the 109 subzones and general purpose zones reporting activity that year.

[5]Customs allocated two of the remaining regions 1 staff year, while the third was allocated 2 staff years.

Customs informed us that 3.7 staff years were expended on zone audits completed during 1987. Customs classifies zones for audit according to the number of entries made per year. Audits at "large" zones (e.g. auto assembly plant subzones) require about 2,500 staff hours of work, "medium" zones require 700 hours, and "small" zones 100 hours. A 3-year audit cycle for 109 zones would require completing about 36 audits per year, with the current level of resources permitting allocation of about 154 staff hours for each one. Just three "large" audits a year would require about 7,500 staff hours—more than the 5,539 hours expended on audits completed in 1987. Customs has undertaken a reassessment of its zone supervision program, focusing on manufacturing subzones. It expects to complete this review by the spring of 1989.

Customs officials stated that few violations have been found in zone operations and that most of the relatively few violations detected have been due to poor recordkeeping. Customs officials recognize, however, that a variety of opportunities exist for FTZ users to avoid customs laws and regulations, and Customs trains its officers to identify such breeches during audits and inspections.

Conclusions

The Board needs to improve its ability to process applications expeditiously. Increasing the Board's staff, at least on a temporary basis, would help to reduce the current backlog of unresolved applications and allow more time for monitoring zone activity. Several factors make it difficult to estimate the additional staffing that would be necessary to permanently reduce by a significant margin the average time required to process applications. Individual applications will require the investment of greater resources to the extent that the Board undertakes more substantive analysis of their likely effects, but at this time the future development of Board review practices has not yet been determined. It is also uncertain whether the Board will continue to receive applications at the elevated pace of the past few years.

The Board could also adopt procedural measures to reduce the delays applicants currently encounter in obtaining Board action, including deadlines for various steps in the process. Amendment of the FTZ Act as discussed in chapter 3 should provide the basis for development and adoption of clarified criteria which should reduce the time currently spent on prefiling reviews and other informal inquiries and delays caused by protracted negotiations among applicants, opponents, and the Board.

Information presently collected on zone activities appears sufficient for monitoring general import levels. Adoption of revised criteria pursuant to congressional action will provide the Board with the basis for re-evaluating the information it needs in order to properly monitor zone activity to ensure that it continues to meet the criteria under which grants of authority were made.

Our limited inquiry did not provide a basis for general conclusions about the adequacy and effectiveness of Customs Service procedures for controlling zone activities and enforcing relevant tariff and trade laws. Given the level of resources it devotes to supervising zones, however, it is unclear whether Customs can meet its standards regarding the frequency of inspections and particularly audits.

Recommendations

The Secretary of Commerce should consider providing the FTZ Board with additional professional staff from existing resources within the International Trade Administration on at least a temporary basis to relieve the backlog of applications and facilitate adoption of new regulations. If applications continue at a high level, these positions could be made permanent.

The Board should revise its application processing procedures to minimize delays, instituting deadlines and revising its criteria in accord with any action Congress may take, as discussed in chapter 3. After clarifying its criteria, the Board should revise its system for acquiring information on zone operations to permit determination of whether grants continue to meet the criteria upon which their award was based.

Agency Comments and Our Evaluation

The Commerce Department stated that it has the Board's professional staff needs under review and that long-term needs will be given further consideration in the context of any direction received from Congress regarding the direction that the program should take. The Department agreed that there is a need for improved application processing procedures, stated that some progress has been made on reducing processing times, and expressed the belief that with new standards and regulations processing times for all cases can be significantly shortened. We did not review the adequacy or effectiveness of the actions the Department has taken in these areas.

The Department of the Treasury pointed out that Customs authority to collect annual and activation fees from zone operators to support Customs supervision of zones had recently been terminated by law and that the Service is conducting a reassessment of its operations in zones. These facts are acknowledged in the text above. The Department commented that the elimination of this source of funding has jeopardized Customs ability to fulfill its responsibilities in zones, and that the Department intends to pursue legislation reinstituting reimbursement for Customs services in this area.

Comments From the Department of Commerce

UNITED STATES DEPARTMENT OF COMMERCE
The Assistant Secretary for Administration
Washington, D.C. 20230

NOV 14 1988

Mr. Frank C. Conahan
Assistant Comptroller General
U.S. General Accounting Office
National Security and
International Affairs Division
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Conahan:

This is in reply to GAO's letter of September 28, 1988, requesting comments on the draft report entitled "International Trade: Foreign Trade Zones Program Needs Clarified Criteria."

We have reviewed the enclosed comments of the Under Secretary for International Trade and believe they are responsive to the matters discussed in the report.

Sincerely,

Kay Bulow
Assistant Secretary
for Administration

Enclosure

75 Years Stimulating America's Progress ★ 1913-1988

UNITED STATES DEPARTMENT OF COMMERCE
The Under Secretary for International Trade
Washington, D.C. 20230

NOV 03 1988

Mr. Frank C. Conahan
Assistant Comptroller General
U.S. General Accounting Office
National Security and
International Affairs Division
441 G Street, N.W.
Washington, DC 20548

Dear Mr. Conahan:

Thank you for your letter requesting the Department's comments on the draft General Accounting Office report entitled "Foreign-Trade Zones Program Needs Clarified Criteria", an update of your agency's 1984 report on foreign-trade zones (GAO/GGD-84-52, 3-24-84). Before addressing the two recommendations directed to this Department, we have some general comments.

It appears that the report has focused on essentially the same major concerns we have as the chair agency on the FTZ Board. We agree that legislative guidance is desirable. We do not believe, however, that the standards question should be viewed in terms of whether the use of zones is an "entitlement" or a "privilege" (zone use is already considered a privilege and not a right under current law; it is the establishment of the first zone in a port of entry that is considered an entitlement based on certain technical criteria). What is needed from Congress is at least a statement as to the general conditions under which subzones and manufacturing activity should be approved. The Board, in turn, would proceed with its plan to revise its regulations, enumerating criteria and factors consistent with the standards set by Congress. Procedures would be revised to improve the processing of applications as well.

Now on p. 36.

The draft report questions whether the savings realized under zone procedures are great enough in auto subzones to result in a significant public benefit (p. 58, et seq.). The 1984 GAO report, on the other hand, viewed the significance of incremental savings more favorably, noting that "subzone status and benefits make domestic (auto) manufacturers more competitive with their foreign counterparts" (GAO/GGD 84-52, p. 13).

This poses a question as to the relationship between the savings realized under zone procedures and the desirable end result. The Board has considered "significant" contributions to improved international competitiveness to have merit, though the savings might not in themselves be "primary" or "major" factors. This same evidentiary issue applies to consideration of the role of zone procedures in encouraging new plant investment. We believe it is an important factor that needs to be considered in developing standards.

We have reviewed the recommendations made in the report and will give them full consideration, taking into account any guidance we receive from Congress. Our comments at this time are:

RECOMMENDATION
Consideration should be given to providing the Board with additional professional staff to relieve the backlog of applications and facilitate adoption of new regulations.

Comment: We are already considering our professional staff needs. In addition, a new permanent clerical position was provided to the FTZ Staff this year, replacing a temporary one. With respect to the application backlog, we have already taken steps to reduce the prefiling review period to 30 days. The longer term needs of the staff will be reviewed in the context of any direction provided by Congress after it receives the report.

RECOMMENDATION
Revise application procedures to minimize delays and institute guidelines.

Comment: We agree there is a need for such improvements. While we are already taking steps to improve the application process, a comprehensive revision would depend upon the direction we receive from Congress. We have reduced the processing time on applications that do not involve manufacturing issues to less than a year, and with new standards and regulations we believe the processing time for all cases can be significantly shortened even further. As a practice, we also consider urgent circumstances a basis for expediting cases.

Mr. Conahan
Page 3

We appreciate this opportunity to comment on your agency's draft report. We look forward to receiving your final report, and we are ready to cooperate with the Legislative branch in its consideration of the report. Please let us know if any further comments are desired at this time.

Sincerely,

Allen Moore

Comments From the Department of the Treasury

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

NOV 04 1988

Dear Mr. Conahan:

Thank you for your letter of September 28, 1988, inviting the Treasury Department to submit comments on the draft report entitled "Foreign-Trade Zones Program Needs Clarified Criteria" (GAO code 483476).

Now on p. 8.

In describing the problem to be addressed, the report states on page 12 that critics of the Foreign-Trade Zone Program "are concerned that the savings on imported parts that participating firms obtain through zone procedures may encourage increased importing, damaging domestic suppliers and the U.S. economy in general." However, as the report itself recognizes, opponents of manufacturing subzones have not made a convincing case that these subzones are resulting generally in increased imports and consequent harm to domestic industries. For example, with respect to automobile assembly subzones, the report notes on page 64 that "opponents of auto subzones have not submitted convincing evidence that zone status has made the difference in specific decisions to purchase foreign parts."

Now on p. 40.

The organization of the draft report, with the first chapter titled "Growing Concern over Manufacturing in Foreign-Trade Zones," would suggest to the reader that the principal recommendation in the report--that the Foreign-Trade Zone Board should be guided by more clearly-defined criteria--is primarily intended to address those concerns, however vaguely defined or unfounded they may be. We do not mean to imply that more clearly-defined criteria could not serve a useful purpose. However, because the case for general economic harm resulting from manufacturing subzones has not been made, the report would be improved if it stated more clearly the particular shortcoming or shortcomings that new criteria could be expected to redress. As a related matter, the report does not offer support for its premise that the criteria the Board now uses, i.e., the "significant public benefit" test, is resulting in decisions that cause actual problems, economic or otherwise.

Our second comment concerns the report's conclusion that zone grants do not provide domestic auto plants with a meaningful competitive advantage against imported cars nor serve as a real incentive to investment in this country.

It is true that zone status is but one of many factors in a decision of a foreign automaker to establish a manufacturing facility in the United States. This point was made in testimony at the public hearing for the Toyota special-purpose subzone in Kentucky (Louisville and Jefferson County Riverport Authority, Foreign Trade Zone 29, August 12, 1987). It would be questionable to conclude, however, that zone status does not offers automakers, as well as other companies operating manufacturing plants as subzones, a real competitive advantage or is immaterial to the investment decision of a foreign or multinational company.

Now on p 36

The analysis on page 58 of the report centers on the duty savings to automakers resulting from avoidance of the effects of inverted tariffs. Such savings are not major on a per-unit basis, but they are certainly not inconsequential in the auto industry, in which tightly competitive markets have made cost-cutting imperative. In addition, with respect to manufacturing plants in general, the report does not analyze the effects of zone advantages other than reduced duty rates. Subzone status for manufacturing plants also allows for duty deferral and avoidance of duty on waste and scrap. Not to be overlooked is the avoidance of having to comply with the procedural and recordkeeping requirements for duty drawback on materials and parts incorporated into products subsequently exported.

With respect to enforcement of zone requirements, the Customs Service points out that Chapter 4 of the report addresses, but does not draw specific conclusions on, the effectiveness of Customs supervision of zone activities. Customs has begun its own reassessment of its zone supervision program, which will focus specifically on manufacturing subzones. Customs expects to complete the reassessment in the spring of 1989.

Now on p. 50.

Additionally, the text in Chapter 4 (page 77) refers to annual fees required by the Foreign Trade Zones Act for maintaining additional service from Customs. The authority to collect these fees, which had included annual fees and activation fees for zones and subzones, was terminated in December 1987 by the Omnibus Budget Reconciliation Act. The elimination of this source of funding has jeopardized the continued ability of the Customs Service to fulfill its zone enforcement responsibilities. Early in the next Congress, the Treasury Department expects to pursue legislation to authorize the Customs Service to be reimbursed for services provided to foreign-trade zones.

Regarding the technical discussion of foreign-trade zones in the background summary and chapter 1 of the report, the text refers to zones as being "outside U.S. customs territory." As a legal matter, we consider this characterization of zones to be incorrect. Accordingly, we recommend deletion of these references in favor of a definition that does not rely on a strictly geographic approach to the zone concept. See 15 CFR §400.101 (1988) and Nissan Motor Manufacturing Corp. U.S.A. v. United States, Slip Op. No. 88-108 (CIT Aug. 16, 1988).

The Treasury Department appreciates the opportunity to submit comments on the draft GAO report and would be pleased to be of further assistance.

Sincerely,

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