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United States General Accounting Office

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

June 1990

U.S. CUSTOMS SERVICE

Merchandise Processing Fee: Examination of Costs and Alternatives

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GAO

United States
General Accounting Office
Washington, D.C. 20548

General Government Division

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June 15, 1990

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

Dear Mr. Chairman:

This briefing report responds to your June 28, 1989, request that we review the U.S. Customs Service's (Customs) merchandise processing fee charged to importers. Unless Congress extends the fee, it will expire in September 1990. To assist in your deliberations on continuing the fee, you asked that we review Customs' costs of processing imported merchandise to determine whether these costs could appropriately be used as a basis for the fee. As agreed, we also evaluated (1) Customs' plans for changing the fee to address international trade concerns on the cost basis and excess amounts that Customs collected through the present fee and (2) the problems Customs could face in instituting changes to the present fee.

On April 27, 1990, we briefed your committee on our results and you asked that we summarize in writing the information we had presented.

Background

The merchandise processing fee was established by the Omnibus Budget Reconciliation Act of 1986 (P.L. 99-509). The fee, which is based on the value of imported merchandise (ad valorem), yielded $729 million in collections during fiscal year 1989. The fee is set by Public Law 99-509 at 0.17 percent of value, and the Secretary of the Treasury can recommend a lower rate to Congress if the rate generates collections exceeding costs. The collections from the fee finance Customs' salaries and other costs associated with commercial activities. Commercial activities costs are those associated with processing passengers, cargo, carriers (trucks and ships), and commercial mail in order to collect duties and examine imports and exports for compliance with trade laws. During fiscal year 1989, Customs estimated commercial activities costs to be $584 million.

The merchandise processing fee has been controversial. In February 1988, the General Agreement on Tariffs and Trade (GATT), a 97-nation organization that oversees world trade and mediates trade disputes, adopted a November 1987 report of a panel it convened to hear complaints from member nations that the fee did not reflect Customs' costs of services provided to individual importers. As a member of the GATT, the United States presented arguments and evidence defending the fee.

After hearing arguments and evidence on this issue, the panel found that the fee was inconsistent with U.S. obligations under international trade agreements that address import fees. Specifically, the panel found that (1) not all of the estimated costs of Customs' commercial services recovered through the fee were proper because Customs included costs for such things as airport passenger processing services that importers did not use and (2) the fee did not approximate the cost of processing an individual merchandise shipment.

In its report, the panel also discussed the problem of excess collections because member nations complained that the rate of the existing fee had been set too high, generating more revenue than needed to cover Customs' costs of commercial activities. Under existing law authorizing the fee, the Secretary of the Treasury can make recommendations to Congress on reducing the fee to offset these past excess collections. The GATT panel did not make a finding on the use of these excess collections.

Results in Brief

Customs lacks data to establish the actual costs that would serve as a basis for the merchandise processing fee. While Customs calculates costs primarily by estimating the number of staff years used to process imported merchandise, it does not keep data on the actual time its employees spend in processing merchandise. As a result, we were unable to determine whether the estimates of staff years used in processing merchandise were accurate. Customs recognizes that it needs data on the time employees spend processing merchandise to establish accurate cost estimates. In April 1990, Customs agreed to collect these data through a new payroll system that is being developed. The system is scheduled to begin operation by the spring of 1992.

According to the Office of the U.S. Trade Representative, since the United States is a member of the GATT, which has adopted the panel report, the United States is obliged, as a matter of international law, to abide by it. Consequently, the Bush administration has decided to replace the fee with one that would address international concerns. Customs developed two alternative fee proposals. Either proposal would require congressional action to be adopted. Agency officials believe either of these alternative proposals could

- bring collections in line with Customs' aggregate costs for processing merchandise and
- link individual fees to the approximate cost of processing each importer's individual merchandise shipment.

Customs generally designed both alternatives to collect enough revenue to offset those estimated commercial activities costs that the GATT panel said could be included in the fee. However, we found that Customs does not have data linking the individual fees contained in either proposal to the cost of processing an importer's individual merchandise shipment. Also, the fees proposed in these alternatives were not reduced to account for past excess collections.

Finally, Customs could face operational problems in instituting either alternative fee proposal. For example, under both proposals, importers could pay less if they combine individual shipment information onto one document as opposed to reporting shipment information individually. While Customs has proposed changes to limit this potential revenue loss, officials agreed they would still have to monitor either proposal to ensure revenue losses do not occur. (See app. III for examples of how importers could pay smaller fees.)

Approach

To examine these issues, we reviewed Customs' planning documents and data on costs. We did not assess the reliability of the accounting and personnel systems that Customs uses to develop its cost estimates. In Washington, D.C., we spoke with officials from Customs' headquarters, the Office of the U.S. Trade Representative, and the Office of Management and Budget. We also visited Customs' ports in four cities (New York City; Los Angeles, California; Laredo, Texas; and Buffalo, New York). At these locations, we spoke with Customs officials responsible for processing merchandise and with customs brokers who represent importers to Customs. We also spoke with representatives from several organizations such as the National Customs Brokers and Forwarders Association. Our work was done from June 1989 through May 1990 and in accordance with generally accepted government auditing standards. Further details on our objectives, scope, and methodology are presented in appendix IV.

We discussed the information in this report with officials from Customs, the Office of the U.S. Trade Representative, and the Office of Management and Budget. They generally agreed with the facts presented.

We plan no further distribution of this report until 30 days after its issuance date, unless you publicly release its contents earlier. After 30 days, we will send copies to the Secretary of the Treasury, the U.S. Customs Service, the U.S. Trade Representative, and other interested parties.

Major contributors to this report are listed in appendix VI. Should you need additional information on the contents of this report, please contact me on 275-8389.

Sincerely yours,

for William Kuwa[illegible]

Lowell Dodge
Director, Administration
of Justice Issues

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Abbreviations

GATT	General Agreement on Tariffs and Trade
MPF	Merchandise Processing Fee
USTR	Office of the U.S. Trade Representative

Customs' Merchandise Processing Fee

Authority for the Merchandise Processing Fee

Before 1986, Customs' costs for processing merchandise were primarily paid by general taxpayers. To recover costs for various services, Congress passed the Omnibus Budget Reconciliation Act of 1986 (P.L. 99-509). The act became law on October 21, 1986, and authorized the Secretary of the Treasury to charge importers a merchandise processing fee (MPF). The MPF is a fee on imports based on the value of merchandise (ad valorem). Public Law 99-509 set the MPF at 0.17 percent, and the Secretary of the Treasury can recommend a lower rate if the rate generates collections exceeding costs. MPF collections are deposited into a user fee account and then are made available through appropriations to pay Customs' salaries and other costs associated with commercial activities. In fiscal year 1989, Customs collected $729 million in merchandise processing fees.

Figure I.1

GAO Authority for the Merchandise Processing Fee

- Omnibus Budget Reconciliation Act (P.L. 99-509) established the Merchandise Processing Fee

- Merchandise Processing Fee collections totaled $729 million in FY 1989

Figure I.2

GAO **Controversy Surrounding the Merchandise Processing Fee**

- GATT panel found that present fee is inconsistent with U.S. trade obligations
- Importing community is concerned that alternative fee proposals
  - are not supported by cost data and
  - could result in revenue losses and fee escalation

Controversy Surrounding the Merchandise Processing Fee

The MPF has been the subject of much controversy from foreign trading partners and members of the importing community (importers, industry associations, and customs brokers). In February 1988, the General Agreement on Tariffs and Trade (GATT), a 97-nation organization that oversees world trade and issues findings on and mediates trade disputes, adopted a November 1987 GATT panel report challenging the fee. The panel heard complaints from member nations that the MPF did not relate to Customs' costs of services provided to importers and reviewed Customs' estimated costs of services recovered through the MPF. The panel agreed with member nation complaints, finding that the MPF was inconsistent with U.S. obligations under international trade agreements that address import fees. The panel objected to Customs recovering costs for services that importers did not use. Customs' costs improperly charged to importers were those associated with

- collecting duties from airport passengers entering the country,
- processing export documentation,
- processing imports exempt from the MPF, and
- carrying out international affairs activities of Customs officials stationed overseas.

The panel also found that the MPF did not approximate the cost of processing an importer's individual merchandise shipment and could result in overcharging importers.

The panel also heard complaints from member nations that the rate of the existing fee had been set too high, generating more revenue than needed to cover all of Customs' costs. Under existing law authorizing the MPF, the Secretary of the Treasury can make recommendations to Congress on reducing the fee to offset past excess collections. The panel did not make a finding on the use of these excess collections.

According to the Office of the U.S. Trade Representative (USTR), since the United States is a member of the GATT, which has adopted the panel report, the United States is obliged, as a matter of international law, to abide by it. Consequently, the Bush administration has decided to replace the fee with one that would address international concerns. The panel did not define the specific fee structure that would bring the fee into compliance with trade agreements, nor did it define the term "approximate cost" in its finding that the fee did not relate to the cost of processing an individual merchandise shipment. To address the panel finding, Customs proposed to replace the present fee with one that would charge different prices for various types of shipments.

In addition to international concerns, importers, customs brokers, and industry associations expressed disagreement with the Customs proposal. As a compromise, Customs developed a second alternative that retains the ad valorem but with certain limits to address international concerns. Importers, customs brokers, and industry associations continue to express concerns that (1) fees contained in the alternatives do not reflect the cost of processing an individual importer's merchandise shipment and (2) importers could pay smaller fees if the proposals were adopted, causing Customs to collect insufficient revenues to offset costs and subsequently requiring Customs to increase the fees to make up for revenue losses.

Costs of Commercial Activities

Costs Recovered Through the Merchandise Processing Fee

Customs is supposed to recover its commercial activities costs through the MPF. For fiscal year 1989, Customs estimated these costs at $584 million. Costs of commercial activities include salaries and other costs associated with the following:

- Customs trade, legal, audit, and technical staff who collect duties, examine imports, and process export and import documents;
- Customs investigators who investigate commercial fraud by importers;
- Customs inspectors who collect duties from individuals entering the country and examine carrier records, cargo, and commercial mail; and

Figure II.1

GAO **Costs Recovered Through The Merchandise Processing Fee**

- Estimated costs paid by the fee totaled $584 million in FY 1989
- Costs recovered are those associated with all commercial activities
- Costs are estimated based on data in Customs' accounting and personnel systems

- Customs management and administrative staff, including data processing and international affairs personnel, who support commercial work.

Customs calculates the cost of commercial activities using its accounting and personnel systems. It assigns 100 percent of direct salary and expense costs for its trade, legal, audit, and technical staff recorded in the accounting system to the costs of commercial activities. However, Customs inspector and investigative personnel do both commercial and enforcement work. For example, inspectors do commercial work by examining cargo to determine whether the shipment complies with trade rules, including trademark and copyright requirements. These inspectors also do drug enforcement work by identifying high-risk shipments to detect illegal drugs.

Customs' accounting system generally does not record separate cost data by the type of commercial and enforcement work done. Therefore, Customs estimates these costs by taking the total positions recorded in the personnel system and asking its program managers to estimate the number of full-time equivalent positions doing (a) commercial work and (b) enforcement work. Customs uses these personnel estimates to distribute direct costs recorded in the accounting system to the cost of commercial activities and other enforcement work. After distributing direct costs on the basis of these personnel estimates, Customs generally distributes management and administrative support costs using the same ratio.

Figure II.2

Complete Evaluation of Costs Not Possible

Customs' accounting system contains commercial activities cost information supporting the direct trade, legal, audit, and technical costs that are to be recovered through the MPF. These costs totaled $126 million, or about 22 percent of total estimated commercial activities costs ($584 million) for fiscal year 1989. However, we were unable to determine whether most of the remaining costs ($458 million) assigned to commercial activities represented an accurate reflection of costs. For example, Customs does not know actual direct inspection costs associated with collecting duties from passengers entering the country and processing commercial cargo. For fiscal year 1989, Customs estimated these inspection costs at $179 million, or about 31 percent of the $584 million in total estimated commercial activity costs.

Customs' inspection and control unit, which collects duties from individuals entering the country and processes commercial cargo, also does enforcement work to detect drugs and other illegal cargo entering the United States. Customs does not know how much time its inspectors spend processing passengers and cargo versus detecting drugs and other illegal cargo because it does not collect this information. Without this information, we were unable to determine whether the amounts assigned to commercial activities accurately reflect costs.

Customs officials said they would need a work measurement system to accurately allot resources between commercial and enforcement work. The last such study was done in 1982 and collected data on a random sampling basis at all ports (see page 18). Customs officials said that they have no plans to redo that study because they support an ad valorem type MPF that would not require the detailed data.

Another way to distinguish the resources used in commercial and enforcement work would be to require inspectors to record time they spend on each of these functions when they fill out their payroll records. Customs is developing a new payroll system, which is scheduled to start operations in the spring of 1992. Customs officials said that the new system can provide work measurement data, such as time spent in processing merchandise and doing enforcement work. In April 1990, Customs officials agreed to use the new system to collect work measurement data so that they could establish accurate cost estimates.

Alternative Fee Proposals Developed by Customs

Transaction Fee

The first proposal, known as a transaction fee, would charge a $47 fee for all formal entries and an $11 fee for informal entries.[1] To reflect higher processing costs, the proposal contains a $3 surcharge for formal and informal entry documents submitted to Customs manually rather than electronically. The proposal also includes six special fees for different services used by importers. For example, importers may have to ship merchandise through several Customs ports before the cargo reaches its final destination where duties must be paid. Customs needs

Figure III.1

GAO Description of Customs' Two Alternative Fee Proposals

- Transaction proposal would establish fees that reflect the cost of services used
- Modified ad valorem would retain a value-based fee but with changes to help reduce under- and overcharging

[1]Entries are documents filed with Customs as a record of importation, description, value, and disposition of a given lot of imported merchandise by an importer or broker. Formal entries are entries of merchandise with a value usually greater than $1,250, and informal entries are entries of merchandise with a value usually less than $1,250.

to track these shipments (known as in-bond shipments) to ensure duties are paid. Importers who use them would pay a higher fee than those who do not.

Customs and USTR officials believe that in their judgment this proposal would address GATT concerns that fees be tied to Customs' costs of processing an importer's individual shipment of merchandise. We also believe transaction fees could represent prices that are related to the costs of processing an importer's individual shipment because importers would be charged for some specific services they use. Customs officials agreed that the services covered in the transaction proposal represent Customs' major merchandise processing services used by importers. Currently, Customs does not have the data to develop transaction fees. (See page 18.)

Modified Ad Valorem Fee

The second proposal, known as a modified ad valorem fee, would still be based on merchandise value but with limits. For formal entries, the ad valorem would be 0.15 percent of merchandise value with a minimum of $20 and a maximum of $400. Like the transaction proposal, the proposal contains an $11 fee for informal entries and a $3 manual submission surcharge for formal and informal entries.

The Bush administration has submitted proposed legislation to Congress recommending adoption of the modified ad valorem. Customs and the USTR believe this proposal addresses GATT concerns that importers of high-value shipments were being overcharged and that these overcharges were subsidizing importers of low-value shipments. Agency officials believe that the upper and lower limits, coupled with informal and manual entry fees, will reduce over- and undercharging and address GATT concerns that the fee approximate the costs of processing an importer's individual shipment. It is unclear to us whether these modified ad valorem fees would approximate the costs of processing an importer's individual shipment because of a lack of cost data.

Figure III.2

GAO **Alternative Proposals Linked to Revenue Needs**

- In redoing the MPF, Customs plans to reduce FY 1991 collections by $110 million
- Customs used an outdated study to develop transaction fees
- Customs did not collect cost data to develop modified ad valorem fees

Alternative Proposals Linked to Revenue Needs

Customs generally designed both proposals to collect enough revenue in fiscal year 1991 to offset its estimate of those commercial activities costs that the GATT panel said could be included in the fee. Because Customs lacks data on commercial activities costs and does not have data to link the proposed fees to the costs of processing an individual merchandise shipment, it estimated the reductions to collections and the individual fees as follows.

Reductions in Collections

To address the GATT panel finding concerning the four cost elements that importers were charged for but did not use, Customs plans to reduce the amount of revenue collected in fiscal year 1991 by $110 million. (See app. V for a list of planned reductions.) Concerning the reduction associated with processing imports exempt from the MPF, Customs estimated that $45 million would have been generated assuming there was no exemption and used the number as a reduction figure. Regarding the remaining three cost elements (passenger processing, export processing, and international affairs), Customs reduced estimated costs recovered through the fee by $65 million.[2] However, in estimating the cost elements that GATT said should not be recovered through the MPF, Customs did not exclude about $14 million in management and administrative support costs related to the commercial services importers did not use. Customs officials attributed the problem to an oversight and agreed to reduce revenue collected by this additional amount.

Methods Used to Estimate Fees

According to Customs officials, the transaction fee proposal is based on a 1982 time study. This study collected data from all ports and included data on the amount of time employees spent in processing different types of shipments. Customs officials recognized that increased automation and new methods for processing shipments had significantly changed Customs' merchandise processing since 1982. However, they used the study because it was the only information available. These officials agreed a new study would be needed to develop reliable data for transaction fees. According to an official who helped design the original study, Customs could collect new data but it would take about 2 years. Because Customs is supporting the modified ad valorem MPF, officials said they have no plans to redo the study.

In developing the modified ad valorem, Customs made a series of calculations using various fees, percentage rates, and data on the value of imports. From these calculations, Customs chose a combination of fees and a percentage rate that yielded the collections needed to recover estimated commercial activities costs minus the costs that the GATT panel said should not be charged to importers. Customs officials said they did not collect cost data because they believed that putting upper and lower limits on the fees would address GATT concerns.

[2]Although the GATT panel finding specifically mentioned airport passenger processing costs, Customs officials said that the estimated costs challenged included cost estimates for processing all passengers. Consequently, Customs included all passenger processing costs in its $65 million estimate.

Figure III.3

GAO **Past Excess Collections Not Addressed**

- Customs did not reduce the fee to offset past excess collections
- For FY 1988 and FY 1989 combined, past excess collections totaled about $235 million

Past Excess Collections Not Addressed

Member nations also complained to the GATT panel that the rate of the existing MPF had been set too high, generating more revenue than needed to cover all the costs of Customs' commercial activities. During the GATT panel hearings, the United States explained that MPF legislation contains a fee reduction mechanism that allows the Secretary of the Treasury to make recommendations to Congress on reducing the MPF in subsequent years to offset past excess collections. For fiscal years 1988 and 1989 combined, Customs estimated that these past excess collections totaled about $235 million.

Agency officials did not address past excess collections in calculating changes to the fee for fiscal year 1991. They said that because the MPF statute is due to expire, their first two priorities were to develop proposed legislation to (1) eliminate from the proposals the costs that should not be charged to importers and (2) address concerns about the MPF exceeding the cost of processing an importer's individual merchandise shipment. Agency officials also noted that adjusting the fee requires congressional action. They said that their proposed legislation to change the MPF gives the Secretary of the Treasury the authority to adjust fees. According to agency officials, if Congress adopts their proposed legislation and extends the law, the Bush administration will probably address excess collections in setting fees for fiscal year 1992.

Figure III.4

Ability to Administer and Control Alternative Proposals

Administering Alternative Fee Proposals

Customs officials and brokers said transaction fees would be more difficult to administer than modified ad valorem fees. Customs officials said they do not have methods and procedures to collect two of the six special transaction fees. For example, they said they would have to develop a method for collecting proposed fees on in-bond shipments. Customs officials also said that because of the larger number of transaction fees, their offices may need more personnel to collect fees. Brokers commented that a schedule of transaction fees would complicate their operations more than a modified ad valorem because of the time required to (1) educate employees and clients on the various fees, (2) develop operating procedures, and (3) program their automated systems. They said they would need about 2 to 6 months to implement transaction fees into their operations.

Potential for Reduced Collections

In discussions with brokers, we learned there are at least two ways in which reduced collections could occur under both alternative fee proposals. First, brokers and importers could reduce the fees they pay by combining information from the entries onto a summary document. Customs' regulations allow this practice. The examples below illustrate how smaller collections could result.

- Under the transaction fee, a broker combines five entries on a summary document. Instead of paying $235 ($47 X 5 entries), the broker would pay $47 for the summary document —a loss of $188 to Customs.
- Under the modified ad valorem, a broker combines 10 entries each valued at $5,000 on a summary document, for a total value of $50,000. Instead of paying $200 ($20 minimum X 10 entries), the broker would pay $75 ($50,000 X 0.15 percent) for the summary value—a loss of $125 to Customs.

Customs now proposes to charge fees based on each entry as opposed to charging a fee on the summary document. This action will correct the first potential revenue loss problem associated with combining entry information onto a summary document. However, it will not prevent the second way in which potential revenue losses could occur.

Under both proposals, brokers and importers could combine different merchandise in a shipment onto one entry document to keep the fee low. Customs officials said that while regulations do not prohibit this practice, there are economic reasons that would discourage it. For example, if an entry is selected for inspection, all the merchandise would be held by Customs until the inspection is completed, thus delaying the importer's ability to fill customer orders. Officials said that under either proposal they will have to monitor import practices to assess whether revenue losses are occurring.

Objectives, Scope, and Methodology

The objectives of our review were to assess

- Customs' methods for estimating commercial activities costs,
- Customs' plans to address international concerns on the MPF,
- alternative fee proposals for recovering costs, and
- problems Customs could face in administering fees and controlling against revenue loss.

To collect information on these issues, we interviewed Customs officials responsible for budgeting and accounting, trade operations, inspection and control, and user fee development. We reviewed documents that dealt with methods Customs used to estimate its commercial activities costs for fiscal year 1989 through 1991 and plans for complying with the GATT panel findings. We spoke with officials from USTR, the Office of Management and Budget, and members of the Treasury Department's Commercial Operations Advisory Committee concerning the fee proposals. This committee was formed by the Omnibus Budget Reconciliation Act of 1987 (P.L. 100-203) to advise the Secretary of the Treasury on issues relating to Customs' commercial activities.

To find out how difficult it would be to administer and control proposals, we spoke with Customs' headquarters officials, Customs officials, and customs brokers at ports in New York City; Los Angeles, California; Laredo, Texas; and Buffalo, New York. These locations were selected in consultation with Customs officials who said these ports represent merchandise processing operations common among all ports. These ports accounted for over $238 million, or 33 percent of the MPF collections during fiscal year 1989. At these locations, we spoke with Customs officials responsible for processing imports and a total of 30 brokers.

We selected a judgmental sample of the 30 brokers from lists of brokers provided by Customs. Brokers were selected based on the size and type of operations as indicated by their annual entry volume. We did not project the views obtained from these interviews because of the small number of brokers interviewed. We also spoke with industry representatives from the National Customs Brokers and Forwarders Association, the American Association of Exporters and Importers, and the Joint Industry Group.

Our work was done from June 1989 through May 1990 and in accordance with generally accepted government auditing standards.

Customs' Commercial Activities Cost Estimates for Fiscal Year 1991 and Planned Reductions to Address International Concerns

Dollars in thousands		
Commercial Activities Costs		**$676,200**
Planned Reductions		
Passenger processing[a]	($62,900)	
Export processing	(1,400)	
International affairs	(1,000)	
MPF exempt imports	(45,000)	
Total adjustments		**($110,300)**

[a] *Includes all costs of processing passengers, including airport passengers.*

Source: U.S. Customs Service

Major Contributors to This Report

General Government Division, Washington, D.C.

Weldon McPhail, Assistant Director, Administration of Justice Issues
John Noto, Evaluator-in-Charge
Scott Derrick, Evaluator
Eric S. Rauch, Writer-Editor
Mary E. Cassady, Social Science Analyst
Anna T. LittleJohn, Secretary/Typist

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