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REPORT TO THE CONGRESS

U.S. Imports Of Watch Movements Duty-Free From Virgin Islands Benefit Islands' Economy B-114898

Departments of the Treasury,
Commerce, and the Interior

BY THE COMPTROLLER GENERAL
OF THE UNITED STATES

MARCH 25, 1970

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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

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To the President of the Senate and the
Speaker of the House of Representatives

This is our report on benefits to the Virgin Islands economy from United States imports of watch movements duty-free from the islands. Our review was made pursuant to the Budget and Accounting Act, 1921 (31 U.S.C. 53), and the Accounting and Auditing Act of 1950 (31 U.S.C. 67).

Copies of this report are being sent to the Director, Bureau of the Budget; the Secretaries of the Treasury, Commerce, and the Interior; the Governor of the Virgin Islands; and the Commissioner of Customs.

A handwritten signature in black ink that reads "James B. Stacks".

Comptroller General
of the United States

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D I G E S T

WHY THE REVIEW WAS MADE

The Tariff Schedules of the United States provide that articles produced in insular possessions may be imported duty-free if the value of foreign-produced materials contained in the articles is no more than 50 percent of the articles' value. The Congress authorized this duty-free feature to stimulate the development of light industry in the insular possessions.

Annual imports of watch movements into the United States from the Virgin Islands increased from about 5,000 units valued at about \$34,000 in 1959 to about 3.8 million valued at about \$23.1 million in 1968. If the watch movements had been subject to duty, the estimated amount of duties would have been about \$8.7 million in 1968.

Because of congressional interest concerning imports of watch movements from the insular possessions, the General Accounting Office (GAO) examined into the extent to which the watch industry, operating under the duty-free provisions of the Tariff Schedules, has stimulated the economy of the islands.

Also, GAO reviewed the need for the Virgin Islands Government to continue tax exemption and subsidy benefits granted some watch companies and the effectiveness of Bureau of Customs administration of the duty-free provisions of the Tariff Schedules.

FINDINGS AND CONCLUSIONS

As a result of certain actions by the Congress and the President, the extent of labor used in assembling watch movements in the Virgin Islands has increased since January 1967, and this has enhanced the economic benefits which the islands have received under the duty-free provisions of the Tariff Schedules. During calendar year 1967, the estimated amount of these direct economic benefits, consisting basically of wages and company taxes, amounted to about \$4.6 million. During calendar year 1968, this amount increased to about \$5.4 million mainly because of increased labor costs incurred by the watch companies. (See p. 8.)

Of the 15 watch companies operating in the Virgin Islands as of June 30, 1968, four had received 10-year grants of tax exemption and subsidy by the Government of the Virgin Islands. The benefits to these four companies were estimated at \$1.5 million for calendar year 1967. On the basis of the profits earned by these four companies and other companies which do not receive such benefits, the need for the continuation of governmental assistance appeared questionable. (See p. 13.)

Discontinuing the tax exemption and subsidy grants would substantially increase funds available to the Government of the Virgin Island. (See p. 13.)

GAO found that the Bureau of Customs should improve its procedures for verifying data furnished by Virgin Islands' watch companies regarding the eligibility of watch movements for duty-free entry into the United States. Also, Customs should make internal audits of the administration of the duty-free provisions of the Tariff Schedules. (See p. 16.)

RECOMMENDATIONS OR SUGGESTIONS

GAO suggested to the Commissioner of Customs certain actions to improve the administration of the duty-free provisions of the Tariff Schedules. (See p. 18.)

AGENCY ACTIONS AND UNRESOLVED ISSUES

The Department of Commerce expressed the view that the watch companies no longer need the stimulus of tax exemption and subsidy by the Virgin Islands Government to continue profitable operations. (See p. 15.)

The Governor of the Virgin Islands is of the view that, when the tax exemption and subsidy grants for the four companies expire, they should not be extended or renewed. (See p. 15.)

The Commissioner of Customs said that, in line with GAO suggestions, actions had been taken to improve procedures for verifying data furnished by the watch companies and to provide for internal audits of the administration of the duty-free provisions of the Tariff Schedules. (See p. 18.)

MATTERS FOR CONSIDERATION BY THE CONGRESS

GAO is reporting these matters to inform the Congress of the impact the watch industry, operating under the duty-free provisions of the Tariff Schedules, has had on the economy of the Virgin Islands.

CHAPTER 1

INTRODUCTION

The Tariff Schedules of the United States provide that articles may be imported duty-free into the customs territory of the United States from the insular possessions when such articles do not contain foreign materials valued at more than 50 percent of the total value of the articles. GAO has made a review to ascertain whether U.S. imports of watch movements duty-free from the Virgin Islands have encouraged the establishment of light industry in the islands and have thereby contributed to the economy of the islands, as intended by the Congress. In our review we considered the need for continuing tax exemption and subsidy benefits granted to watch companies under the industrial incentive program administered by the Government of the Virgin Islands. Also, we examined into the Bureau of Customs administration of the duty-free provisions of the Tariff Schedules of the United States.

Although other articles are imported duty-free into the United States from the Virgin Islands, our review was limited to the importation of watch movements.

Since 1959, when the first watch company was established in the Virgin Islands, the assembly of watch subassemblies and parts obtained chiefly from Japan, West Germany, France, and Russia--into completed watch movements for exportation to the United States--has become one of the largest industries in the insular possessions. As of June 1968 there were 15 watch companies located in the Virgin Islands shipping watch movements to the United States free of duty.

From 1959 through 1968, the number of watch movements imported annually from the Virgin Islands increased from about 5,000 units valued at about \$34,000 to about 3.8 million units valued at about \$23.1 million.

The scope of our review is described more fully on page 20. The principal officials responsible for the activities discussed in this report are listed in appendix IV.

CHAPTER 2

LEGISLATIVE HISTORY

In July 1954 the Revised Organic Act of the Virgin Islands (48 U.S.C. 1541) was enacted to provide a new charter of civil government for the people of the Virgin Islands. The purpose of the 1954 act was to give a greater degree of autonomy, economic as well as political, to the people of the Virgin Islands. This was to be a step toward the day when the Virgin Islands could be self-sustaining and the citizens in the islands could contribute more toward support of their government.

Pursuant to the provisions of General Headnote 3(a) of the Tariff Schedules of the United States (19 U.S.C. 1202), articles which are grown, produced, or manufactured in the Virgin Islands and other insular possessions are to be admitted free of duty into the customs territory of the United States, provided they do not contain foreign materials valued at more than 50 percent of the total value of the articles. If the 50-percent requirement is not met, articles coming from the Virgin Islands and other insular possessions located outside the customs territory of the United States are subject to the rates of duty applicable to like articles imported directly from foreign countries.

The Congress, in enacting the 50-percent requirement, intended that the duty-free treatment of articles imported into the United States from the Virgin Islands would stimulate the establishment of light industry in the Virgin Islands and would, therefore, contribute to the economic development of the islands.

Pursuant to the act of March 3, 1927 (19 U.S.C. 2071-2073), the Bureau of Customs, Department of the Treasury, is charged with the responsibility for assessing and collecting duties, taxes, and fees and for administering laws that regulate the importation and the exportation of merchandise into and from the United States. These activities are carried out by Customs regional and district offices located throughout the United States.

Bureau of Customs regulations provide that, before an article can be imported duty-free from the Virgin Islands into the United States, the manufacturer must file with the Bureau of Customs at the Virgin Islands a certificate of origin (Customs Form 3229). The certificate, according to Customs regulations, must show, among other things, that the imported articles are products of the Virgin Islands and must disclose the landed cost (cost of materials, freight, and insurance) of the foreign materials included in the articles to be imported.

Customs regulations provide also that the certificate must be signed by the Customs agent in the Virgin Islands, certifying that he has investigated the correctness of the data shown on the certificate. The certificate, when compared with other documents evidencing the selling price of the articles to be imported, provide a basis for determining whether the articles are to be imported duty-free in accordance with the requirements of General Headnote 3(a).

The Congress, in order to control the quantity of watch movements imported into the United States from the insular possessions, under the act of November 10, 1966 (19 U.S.C. 1202), placed an annual quota on the quantity of watches and watch movements which may be imported free of duty under the provisions of General Headnote 3(a). The act states that the annual quota for each calendar year shall be one ninth of the apparent U.S. consumption of watch movements during the preceding calendar year, as determined by the Tariff Commission, of which amount 87.5 percent shall be the product of the Virgin Islands, 8.33 percent the product of Guam, and 4.17 percent the product of American Samoa.

The Secretary of Commerce and the Secretary of the Interior are charged with the joint responsibility of allocating the available territorial quotas on a fair and equitable basis among producers of watches and watch movements located in the Virgin Islands, Guam, and American Samoa.

The Senate Committee on Finance, in its report¹ on this legislation, commented that the cost of direct labor involved in the assembly of a watch is a factor which well might be taken into account by the Secretaries in making a fair and equitable allocation of the quotas. According to the report, this factor is a measure of the economic contribution being made by the assembly process.

The calendar year 1968 quota of watches and watch movements allocated to watch companies located in the Virgin Islands totaled about 4.2 million units, and the quantity shipped into customs territory of the United States by the companies, consisting almost exclusively of watch movements, totaled about 3.8 million units.

In July 1957 the Legislature of the Virgin Islands approved Act No. 224 which provided for an industrial incentive program, through the granting of tax exemption and subsidy benefits to new businesses and industries, to promote the economic development of the Virgin Islands. Under this act, the Governor of the Virgin Islands was empowered, upon recommendation by the Virgin Islands Tax Exemption Board, to grant, for a period of 10 years, tax exemption and subsidy benefits to persons, firms, and corporations which established new industries in the Virgin Islands in accordance with the provisions of the act.

The act provided generally that the grantee would be exempt from the payment of all property taxes, all trade and excise taxes related to the construction of any new business or industry, all annual or specific license fees, and all gross receipt taxes. In addition, the grantee was entitled to receive a nontaxable subsidy equal to (1) 100 percent of import duties and other taxes paid to the Virgin Islands Government on raw materials imported into the Virgin Islands, (2) 75 percent of income taxes paid to the insular government, and (3) 50 percent of the income taxes paid to the insular government, by stockholders or partners, on income derived from operations of the grantee.

¹S. Rept. 1679, 89th Cong. 2d sess., p. 8.

Act No. 224, as amended, expired on December 31, 1961, and the Virgin Islands Tax Incentive Act (33 V.I.C. 4001), as amended, became effective January 1, 1962. Pursuant to this act, the Governor of the Virgin Islands may, upon recommendation by the Virgin Islands Industrial Incentive Board, grant 10-year certificates of tax exemption and subsidy benefits to persons, firms, or corporations determined by the Board to qualify for the benefits.

Certificates issued under this act provide for exemption from the payment of any, or all, of the aforementioned taxes and fees, with the exception of gross receipt taxes. Also, the certificates may provide, in addition to or without regard to the granting of tax exemption, for the payment of a nontaxable subsidy equal to (1) 90 percent of import duties and other taxes paid to the insular government on raw materials imported into the Virgin Islands, (2) 75 percent of income taxes paid to the insular government, and (3) 75 percent of the income taxes paid to the insular government by stockholders on income derived as dividends from a corporation holding a certificate.

As of June 1968, three Virgin Islands watch companies were holding 10-year grants of tax exemption and subsidy issued under Act No. 224 and one was holding a 10-year grant issued pursuant to the Virgin Islands Tax Incentive Act. According to records of the Virgin Islands Government, subsidy benefits paid to the four watch companies for fiscal years 1961 through 1968 totaled about \$5.8 million.

CHAPTER 3

ECONOMIC BENEFITS TO THE VIRGIN ISLANDS

AND TAX EXEMPTION AND SUBSIDY BENEFITS

GRANTED TO THE WATCH INDUSTRY

ECONOMIC BENEFITS TO THE VIRGIN ISLANDS

FROM THE WATCH INDUSTRY HAVE INCREASED

SINCE 1967

Prior to January 1967, the cost of labor in the Virgin Islands included in the value of watch movements imported into the United States duty-free was relatively small. However, as a result of certain actions taken by the Congress and the President of the United States, the extent of labor used by the watch companies in the Virgin Islands has increased since January 1967, which has augmented the economic benefits the islands have received under the provisions of the Tariff Schedules.

We made a limited review of the effects on the Virgin Islands watch industry of several factors which have brought about additional economic benefits to the Virgin Islands. Briefly, these factors are:

- A January 1967 reduction of about 30 percent in the rates of duty applicable to watch movements having not more than 17 jewels.
- Allocation, to watch companies in the Virgin Islands and other insular possessions, of annual quotas of watch movements for exportation to the United States. These allocations are made by the Departments of Commerce and the Interior based in part on direct labor costs incurred in assembly operations in the islands.
- Increases in the minimum hourly wage rate to \$1.40 in 1967 and to \$1.60 in 1968.

We found that, in order to establish the selling price of watch movements to customers located in the United States and to comply with the 50-percent value requirement of General Headnote 3(a), watch companies generally doubled the landed costs of foreign materials, which included freight and insurance.

For example, the selling price of an assembled 17-jewel lady's watch movement would be set in the following manner:

Price of foreign materials	\$2.4341
Add: Freight and insurance	<u>.0846</u>
Landed cost of foreign materials	2.5187
Multiplied by two (to meet General Headnote 3(a))	<u>X 2</u>
Total	<u>\$5.0374</u>
Selling price (rounded)	<u>\$5.04</u>

The landed costs of the foreign parts contained in the above example represent 49.97 percent of the selling price or total value, which would meet the 50-percent limitation on the value of foreign materials. The watch movement would therefore be exempt from customs duty upon entry into the United States.

The Virgin Islands companies generally were able to establish selling prices in this manner because their watch movements were competing in the United States with assembled watch movements on which duty had been paid. The duty is significant in relation to the cost of the imported assembled watch movements and in some cases can be greater than the cost of the assembled watch movement.

On January 11, 1967, the President of the United States, by Proclamation No. 3761, reduced by about 30 percent the rates of duty applicable to watch movements containing not more than 17 jewels.

To determine the effect the reduction of duty rates had on watch company operations, we selected for review

eight watch companies operating in the Virgin Islands. In general, we found that the lowering of the duty rates resulted in the watch companies' reducing the selling price of their duty-free watch movements. This action was necessary in order to compete with companies importing, directly from foreign countries, similar watch movements on which duty had been paid.

However, in order to lower their selling prices and also to meet the 50-percent limitation on foreign materials as stated in General Headnote 3(a), the Virgin Islands watch companies had to purchase less completed (unassembled) watch components, rather than watch subassemblies (a partially assembled watch movement), from foreign suppliers and to perform additional assembly work which increased the cost of domestic labor. The additional assembly work has increased the companies' contributions to the economy of the Virgin Islands.

To illustrate, prior to the January 1967 reduction of duty rates, the landed costs of foreign materials, consisting mainly of movement subassemblies used in a particular watch movement, amounted to \$2.57. The watch movement, therefore, had to be priced at \$5.14, or more, in order to meet the 50-percent requirements of General Headnote 3(a) for duty-free entry into the United States. The company, subsequent to January 1967, purchased, at a cost of \$2.29, less-completed watch components, consisting of 90 to 115 parts, for assembly in the Virgin Islands. The company could then lower the selling price from \$5.14 to \$4.58 and still meet the 50-percent requirement of General Headnote 3(a).

Another factor that stimulated the Virgin Islands economy was the method used in allocating quotas to the watch companies. The Departments of Commerce and the Interior announced in March 1967 that, in making allocations of quotas for future years, increased emphasis would be placed on those factors which foster a greater contribution to the economy of the insular possessions.

The 1968 importation quota was allocated to the Virgin Islands watch companies on the basis of (1) their 1967 shipments of watch movements to the United States and (2) the amount of wages subject to social security tax paid by the companies to their local employees. Using wages subject to social security tax as a means of allocating the quota gives added consideration to those companies performing more assembly operations. Generally, the companies with the lower labor costs will experience reductions in their watch quotas, while companies showing higher labor costs will receive increases in their quotas.

A Department of Commerce official told us that the companies, in order to perform additional and more complex assembly work, were expanding their facilities and training their local employees. These actions should result in additional capital investment by the watch industry and additional skills for the local employees.

We found that, during calendar year 1966, prior to the duty reduction and the implementation of the quota, the cost of labor incurred by the eight selected companies ranged from \$0.34 to \$0.76 a movement. With the purchase of unassembled watch movements, the labor costs incurred by these companies during calendar year 1967 ranged from \$0.52 to \$1.04 a movement, or an average increase in the cost of labor of about 40 percent. This increase in labor costs occurred as a result of the 1967 duty rate reduction and the allocation of the importation quotas to the watch companies. Some of the increased labor costs are attributable to the increased minimum hourly wage paid watch company employees.

During hearings held by the Senate Committee on Finance in 1966 concerning the significant increase in the number of watch movements imported from the Virgin Islands,

consideration was given to the economic benefits received by the Virgin Islands under General Headnote 3(a). As a means of measuring the extent of economic benefits provided to the Virgin Islands by the watch industry, comparisons were made during the hearings of the amount of such benefits--wages and taxes--with the loss of customs duty to the United States.

If watch movements imported into the United States from the Virgin Islands during calendar years 1967, and 1968 had been subject to customs duty, we estimate that the amount of such duty would have been about \$7.7 million and \$8.7 million, respectively. The 1968 increase of about \$1 million in estimated duty over that for 1967, was due to an increase of about 400,000 units imported.

The estimated amount of direct economic benefits provided to the Virgin Islands during calendar year 1967, consisting basically of wages and company taxes, amounted to about \$4.6 million. During calendar year 1968, this amount increased to about \$5.4 million, mainly because of increases in labor costs incurred by the watch companies. Certain indirect benefits, such as income taxes on wages of the watch company employees, were also realized by the Virgin Islands. The benefits will be increased further if the certificates of tax exemption and subsidy benefits, granted by the Virgin Islands Government to four companies, are not extended or renewed.

TAX EXEMPTION AND SUBSIDY BENEFITS GRANTED
TO CERTAIN WATCH COMPANIES

As a means of encouraging the establishment of industry in the Virgin Islands, the Legislature of the Virgin Islands enacted legislation under which the Governor of the Virgin Islands was empowered to grant tax exemption and subsidy benefits to new business and industries. (See p.6.) Of the 15 watch companies operating in the Virgin Islands as of June 30, 1968, four received 10-year grants of tax exemption and subsidy benefits. The last of these grants expires in April 1972. The tax exemption and subsidy benefits to the watch companies totaled \$1.5 million in 1967.

As evidenced by the profits earned by the four companies receiving tax exemption and subsidy benefits and by other companies not receiving such benefits, the need for the continuation of tax exemption and subsidy benefits in order to continue profitable operations in the Virgin Islands appeared questionable. Discontinuance of tax exemption and subsidy benefits will further increase the economic benefits to the Virgin Islands.

On the basis of data furnished by the four companies to the Departments of Commerce and the Interior, we estimated that, without these benefits, the four companies would have been liable to the Government of the Virgin Islands for taxes (income, gross receipts, trade, and excise taxes) and customs duties for 1967 amounting to about \$1.8 million. However, their net payments for 1967 amounted to approximately \$0.3 million and the apparent savings in taxes and customs duties of \$1.5 million represent subsidy benefits from the territorial government. In addition, the four companies received other benefits through exemption from the payment of real property taxes, excise taxes, and annual or specific fees related to assembly operations.

At the time of our review, available financial statements submitted to the Government of the Virgin Islands by the four companies receiving tax exemption and subsidy benefits showed that the companies earned a substantial profit from operations for their latest accounting period. On the basis of information presented in the statements and other financial data furnished the Departments of Commerce and the

Interior, we estimated that, even without the exemption and subsidy benefits, the four companies would have conducted profitable operations. We found also that other watch companies operating in the Virgin Islands without tax exemption and subsidy benefits had generally conducted profitable operations. For example, financial statements available to us at the time of our field review, for seven companies not receiving tax exemption and subsidy benefits, showed that five companies reported profits from operations.

Because of the substantial profits earned by the companies receiving tax exemption and subsidy benefits and by other companies in the Virgin Islands not receiving such benefits, the need for the continuation of tax exemption and subsidy benefits for watch companies located in the Virgin Islands appeared questionable.

Fourteen of the applications for tax exemption and subsidy grants, received from watch companies during the period August 1959 through December 1965, received final action. Five of the first six applications received were favorably considered and grants were issued. Grants issued to four companies are still in effect; the remaining company discontinued operations in the Virgin Islands in June 1962 because of financial difficulties. Nine applications were disapproved by the Governor of the Virgin Islands. In commenting on the reason for disapproving the applications, the Governor stated in a letter to each applicant that the company, as evidenced by its substantial profit return, did not require the stimulus of governmental assistance.

In November 1968 the Commissioner of Commerce of the Virgin Islands, who acts as the Chairman of the Virgin Islands Industrial Incentive Board, informed us, in effect, that tax exemption and subsidy benefits would not be granted to watch companies after their current grants expired. He stated that those companies exporting products to the United States free of duty under the provisions of General Headnote 3(a) of the Tariff Schedules had been unable, during recent years, to demonstrate a need for tax exemption and subsidy benefits in order to become established in the Virgin Islands. The Commissioner advised us, therefore, that applications from such companies had been disapproved.

AGENCY COMMENTS AND OUR EVALUATION

In commenting on our draft report, the Acting Administrator, Business and Defense Services Administration, Department of Commerce, by letter dated September 22, 1969 (see app. II), concurred in our observations regarding the economic benefits which the Virgin Islands are receiving from the watch industry. He said, however, that the locally paid wages which the Departments of the Interior and Commerce had emphasized as a factor in allocating watch quotas to the Virgin Islands watch industry, had had at least as great an effect as the reduction in import duties in bringing about the increased contribution of the watch industry to the territory's economy.

The Director of Survey and Review, Department of the Interior, by letter dated September 30, 1969 (see app. III), advised us that it was the view of the Governor of the Virgin Islands that, when the existing grants expire within the next 3 years, none of the grants should be extended or renewed.

The Director of Survey and Review advised us also that, according to the Governor of the Virgin Islands, a study of the Virgin Islands industrial incentive law was under way and when it was complete the recommendations made by the legislature would be reviewed by a committee appointed by the Governor to determine executive policy with respect to that very important area in the development of the economy of the Virgin Islands.

The Acting Administrator, Business and Defense Services Administration, Department of Commerce, expressed the view that watch companies located in the Virgin Islands no longer need the stimulus of tax exemption and subsidy by the Government of the Virgin Islands to continue profitable operations.

CHAPTER 4

IMPROVEMENTS IN THE ADMINISTRATION OF PROVISIONS CONTROLLING THE DUTY-FREE IMPORTATION OF WATCH MOVEMENTS FROM THE VIRGIN ISLANDS

As a result of proposals made by us to Bureau of Customs officials during our review, Customs (1) has established guidelines for use by Customs agents in verifying certain cost data included on certificates of origin and (2) is instituting internal audit reviews of General Headnote 3(a) activities to provide Customs management with objective appraisals of the manner in which these activities are being carried out. We believe that the proper implementation of the guidelines and effective internal audit will improve administration of the statutory provisions controlling the duty-free importation of watch movements from the Virgin Islands.

GUIDELINES FOR VERIFICATION OF CERTIFICATES OF ORIGIN

Our review showed that adequate examinations of watch companies' accounting records and related documents to verify the correctness of cost data shown on certificates of origin were not performed by Customs personnel in the Virgin Islands. Our review showed also that certificates of origin were being routinely signed by district office employees prior to review by the Customs agent and thus without knowledge of whether the data on the certificates were in fact complete and accurate. Although our review did not identify any certificates of origin that were erroneous or improper, it was our opinion that, in view of the substantial value of watch movements imported into the United States duty-free from the Virgin Islands, the procedures for verification of such certificates should be strengthened to provide assurance of their validity.

We found that no written guidelines had been established to assist a Customs agent in the Virgin Islands in carrying out General Headnote 3(a) responsibilities. The Customs agent in the Virgin Islands advised us that verification work under General Headnote 3(a) consisted of examining certificates of origin and certificates of manufacture and comparing such certificates, on a limited test basis, with other company-furnished documents. The Customs agent advised us also that such verification work did not include examining underlying documents, such as canceled checks, letters of credit, and cash receipt and payment records of the watch companies.

In our opinion, the practice of making comparisons between data presented on certificates of origin and/or manufacture with data on related documents, all of which have been furnished by the same company, would not adequately ensure that the certificates accurately show all foreign material costs and could not be relied upon for determining the dutiable status of imported articles. Inasmuch as exporting companies prepare certificates of origin and also furnish supporting documents, it seems reasonable to assume that each company would assure itself that the certificates are in agreement with the related documents. We believe that, to be effective, the verification of such certificates should include appropriate tests of pertinent documents and records of the watch companies concerning the value of foreign materials included in the watch movements.

We believe that the lack of adequate verification of cost data shown on the certificates of origin existed primarily because the Bureau of Customs had not established operating guidelines to be followed by Customs personnel in verifying the correctness of certificates of origin. We therefore suggested that guidelines be established.

INTERNAL AUDITS

We found that the Customs internal audit staff had not made reviews of General Headnote 3(a) activities in the Virgin Islands. Therefore, Customs' management was not provided with objective appraisals of the effectiveness and efficiency with which General Headnote 3(a) responsibilities had been carried out.

From 1959 through 1968, the number of watch movements imported annually from the Virgin Islands increased from about 5,000 units valued at \$34,000 to about 3.8 million units valued at \$23.1 million. If the watch movements imported into the United States in 1968 had been subject to duty, we estimate that the duty could have been as much as \$8.7 million. Customs duty rates that would have been applicable to watch movements imported from the Virgin Islands in 1968 ranged from \$1.80 to \$2.70 for each movement.

Because of the increased number of watch movements imported duty-free into the United States from the Virgin Islands and because of the increasing complexities in the administration of General Headnote 3(a) activities, we suggested that it would be desirable for the Bureau of Customs internal audit staff to make periodic reviews to determine the effectiveness and efficiency with which such activities are carried out.

AGENCY COMMENTS AND OUR EVALUATION

The Commissioner of Customs by letter dated April 22, 1969 (see app. I), advised us that, in line with our suggestions, formal guidelines for verifying certificates of origin had been established for use by Customs officers in the Virgin Islands. The Commissioner advised us also, with respect to the verification of certificates of origin, that:

- Such certificates were no longer being certified by employees of the Virgin Islands Customs district office.
- The Customs agent in the Virgin Islands was now, required to examine, among other things, manufacturers' records, including letters of credit, canceled checks, and other pertinent accounting documents, and had been instructed to request foreign investigations, when warranted.

The Commissioner further informed us that the internal audit staff responsible for field office review would be instructed to routinely audit the procedures followed by the Customs agent in the verification of certificates of

origin and to spot-check verified certificates. In May 1969 the Director, Field Audit, in Miami, Florida, was directed to include in his work program for fiscal year 1970 an audit of pertinent procedures and records related to the importation of products from the Virgin Islands.

We believe that the guidelines and instructions issued by the Bureau of Customs, if properly implemented, should improve the administration of the General Headnote 3(a) program and should provide greater assurance that products entering Customs territory of the United States free of duty satisfy the requirements for duty-free importation set forth in the law.

CHAPTER 5

SCOPE OF REVIEW

Our review consisted primarily of:

- A study of the legislative history of pertinent provisions of Customs laws pertaining to the insular possessions and of legislation enacted by the Government of the Virgin Islands relating to the industrial incentive program.
- An examination of pertinent Bureau of Customs regulations, procedures, and records, including a survey of procedures followed by Customs relating to the entry of articles at the New York and Puerto Rico ports of entry.
- Interviews with responsible officials of the Business and Defense Services Administration, Department of Commerce, Office of Territories, Department of the Interior, and the United States Tariff Commission in Washington, D.C.; the Bureau of Customs, Department of the Treasury, in Washington, D.C., Miami, Florida, and St. Thomas, Virgin Islands; the Government of the Virgin Islands; and eight selected watch companies located in New York or in the Virgin Islands.

We also analyzed pertinent financial and operating data furnished by watch companies located in the Virgin Islands and observed the watch assembly operations of selected watch companies.

APPENDIXES



TREASURY DEPARTMENT
BUREAU OF CUSTOMS
WASHINGTON



Apr. 22, 1969

REFER TO
SP 017.6 o

Mr. Max A. Neuwirth
Associate Director
Civil Division
United States General Accounting Office
Treasury Annex 1, Room 126
Washington, D. C. 20220

Dear Mr. Neuwirth:

This refers to your letter of March 5, 1969, concerning the verification of certificates of origin filed in connection with shipments of merchandise from the Virgin Islands for which duty-free entry into the United States is granted under the provisions of General Headnote 3(a), Tariff Schedules of the United States (TSUS).

You question certain observed practices in the verification of certificates of origin by customs officers in the Virgin Islands, and you request the views and comments of the Bureau on the following points:

1. The extent of verification work in the islands on watch movements [see GAO note, p. 25] under General Headnote 3(a), TSUS.
2. The need for formal guidelines for use by the agents in verifying data on customs Form 3229 (certificate of origin).

[See GAO note, p. 25.]

4. The possible use of internal auditors in the General Headnote 3(a) program.

The procedure formerly utilized in the Virgin Islands whereunder certificates of origin presented by manufacturers were routinely signed by a clerk in the office of the district director of customs at St. Thomas, Virgin Islands, has been abolished. Formal guidelines for the use of customs officers in the islands were established in accordance with instructions issued on February 27, 1969.

REPLY TO: COMMISSIONER OF CUSTOMS, WASHINGTON, D.C. 20226

Under the new guidelines, certificates of origin which are presented by insular manufacturers are no longer certified by employees in the district director's office. Instead, the certificates are stamped "Not verified - copy referred to CAC, St. Thomas, V.I. for verification," and a copy of the form is referred to the customs agent in charge. This notation is easily understandable at any port of entry, and will eliminate the granting of free entry on the basis of signed, but unverified, certificates of origin.

The customs agent in charge is now required to examine (and the manufacturer is required to produce) the documents listed below for the purpose of substantiating the landed cost of raw materials figures appearing on the certificates of origin and certificates of manufacture:

- (a) Virgin Islands consumption entries
- (b) Foreign shippers' invoices
- (c) Airway bills or bills of lading
- (d) Copies of purchase orders
- (e) Letters of credit
- (f) Checks issued for payment of materials
- (g) Disbursement records

In addition to the records examination referred to above, the customs agent in charge is also instructed to request foreign investigations when questionable foreign values are presented.

The selling prices of Virgin Islands products which are sent to the United States are verified by examining the manufacturers' shipping invoices and also documents showing proof of payment by the purchaser. In addition, an agent's verification of shipping invoices at the office of the purchaser in the United States will be requested in some instances.

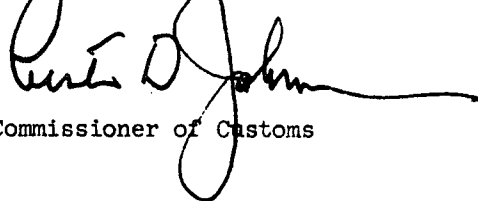
Experience in the verification and examination of manufacturers' records has indicated that adequate control of the General Headnote 3(a) program may be maintained by spot-checking in most cases. Where the manufacturer has in stock several lots of the same foreign parts or materials with different landed costs, however, each certificate of origin will be verified under the new guidelines.

[See GAO note, p. 25.]

[See GAO note.]

The final subject on which you request comments is the possible use of internal auditors in the General Headnote 3(a) program. Such utilization does appear to be desirable, and the Director, Field Audit, will be instructed to routinely audit the procedures followed by the customs agent in charge, St. Thomas, Virgin Islands, in the verification of certificates of origin presented by manufacturers of products intended for entry into the United States under General Headnote 3(a), TSUS. Spotchecks of verified certifications will also be made.

Sincerely yours,

A handwritten signature in black ink, appearing to read "Curtis D. Johnson", with a long horizontal flourish extending to the right.

Commissioner of Customs

GAO note: Comments pertaining to draft report material not contained in the final report have been omitted.



U.S. DEPARTMENT OF COMMERCE
Business and Defense Services Administration
Washington, D.C. 20230

OFFICE OF THE ADMINISTRATOR

September 22, 1969

Mr. Henry Eschwege
Associate Director
Civil Division
General Accounting Office
Washington, D. C. 20548

Dear Mr. Eschwege:

The Secretary has asked us to respond on his behalf to your request for comment on a draft report by the General Accounting Office on a "Review of Duty-Free Importation of Watch Movements From the Virgin Islands" which you sent to him on August 5, 1969. As we have no information on which to base an evaluation of that part of the report concerning the Bureau of Customs, we shall comment only on that portion of the report pertaining to tax exemptions and subsidy benefits granted to watch producers by the Virgin Islands Government and the economic benefits received by the territory from its watch industry.

We agree with the finding of your report that watch companies located in the Virgin Islands no longer need the stimulus of tax exemption and subsidies by the Government of the Virgin Islands in order to continue profitable operations. We also concur with the substance of your report regarding the economic benefits which the Virgin Islands is receiving from its watch industry. In our opinion, however, the emphasis which the Departments of the Interior and Commerce have placed on locally paid FICA wages as a factor in allocating watch quotas, pursuant to Public Law 89-805, has had at least as great an effect as the reduction in U. S. import duties in bringing about the increased contribution of the watch industry to the territory's economy which has been noted since the enactment of the quota law. (page 20, first paragraph).

In order to provide a fuller description of the operation of Public Law 89-805, it is suggested that the following be inserted after the first sentence of the first paragraph on page 6 in lieu of the second sentence of that paragraph: "The Act states that the annual quota for each calendar year shall be one-ninth of the apparent United States consumption of watch movements during the preceding calendar year, as determined by the Tariff Commission, of which amount 87.5 percent shall be the product of the Virgin Islands, 8.33 percent


the product of Guam, and 4.17 percent the product of American Samoa. The Secretary of the Interior and the Secretary of Commerce are charged with the joint responsibility of allocating the available territorial quotas, on a fair and equitable basis, among producers of watches and watch movements located in the Virgin Islands, Guam, and American Samoa."

In the paragraph beginning at the bottom of page 22 and continuing on page 23, it is indicated that four watch firms paid an estimated \$1.8 million in taxes and Customs duties to the Government of the Virgin Islands in 1967, of which amount an estimated \$1.5 million was claimed as refunds. As these firms are exempt from some taxes and are entitled to a refund of part or all of other taxes from which they are not exempt, it is suggested that this paragraph be changed to read as follows: "Of the 15 watch companies in the Virgin Islands, the first four established were granted 10 year certificates of tax exemption and subsidy benefits. Based on data furnished by the four companies to the Department of Commerce and the Department of the Interior, it is estimated that without these benefits the four companies would have been liable for taxes (income, gross receipts, and trade and excise taxes) and Customs duties for 1967 amounting to about \$1.8 million payable to the Government of the Virgin Islands. However, their net payments for 1967 amounted to approximately \$.3 million and the apparent savings in taxes and Customs duties of \$1.5 million represent subsidy benefits from the territorial government."

In the "Scope of Review" on page 27 of the report, no mention is made of interviews with officials of the Business and Defense Services Administration of the Department of Commerce.

Principal officials of the Department of Commerce responsible for joint administration of Public Law 89-805 are not mentioned on page 29 of the report. These officials are shown on the attached list.

Sincerely,



Forrest D. Hockersmith
Acting Administrator

Attachment

APPENDIX III



UNITED STATES
DEPARTMENT OF THE INTERIOR
OFFICE OF THE SECRETARY
WASHINGTON, D.C. 20240

Mr. Allen R. Voss
Associate Director, Civil Division
General Accounting Office
Washington, D. C. 20548

SEP 30 1969

Dear Mr. Voss:

The Department and the Governor of the Virgin Islands have completed their review of the GAO draft report to the Congress entitled "Review of Duty-Free Importations of Watch Movements from the Virgin Islands, Bureau of Customs, Department of the Treasury."

Based upon the Governor's review and ours, we believe the report is accurate with respect to factual matters and we make only the following observations.

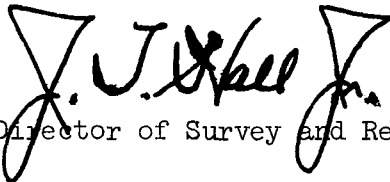
On page six the impression is left that the judgment of the District Court of the Virgin Islands was final. In fact, appeals were taken to the United States Court of Appeals for the Third Circuit, at Philadelphia, resulting in the reversal of the judgments of the District Court and a holding that the statute is valid. This correction to the draft should be made.

Governor Evans advised that his administration concurs in the view that tax exemption for the watch industry in the Virgin Islands should be discontinued. Within three years the existing grants will terminate, and it is his position that none of these grants should be extended or renewed.

Governor Evans advises further that when the Legislature of the Virgin Islands completes the study of the Virgin Islands industrial incentive law now underway, the recommendations made by the legislature will be reviewed by a committee appointed by the Governor to determine executive policy with respect to that very important area in the development of the economy of the Virgin Islands.

We appreciate the opportunity to have reviewed the report in draft.

Sincerely yours,


Director of Survey and Review

PRINCIPAL OFFICIALS RESPONSIBLE FOR THE
ACTIVITIES DISCUSSED IN THIS REPORT

<u>Tenure of office</u>	
<u>From</u>	<u>To</u>

DEPARTMENT OF THE TREASURY

SECRETARY OF THE TREASURY:

David M. Kennedy	Jan. 1969	Present
Joseph W. Barr	Dec. 1968	Jan. 1969
Henry H. Fowler	Apr. 1965	Dec. 1968

COMMISSIONER OF CUSTOMS:

Myles J. Ambrose	Aug. 1969	Present
Lester D. Johnson	Aug. 1965	Aug. 1969

DEPARTMENT OF COMMERCE

SECRETARY OF COMMERCE:

Maurice Stans	Jan. 1969	Present
C. R. Smith	Mar. 1968	Jan. 1969
A. B. Trowbridge	Feb. 1967	Mar. 1968
John T. Connor	Jan. 1965	Feb. 1967

BUSINESS AND DEFENSE SERVICES

ADMINISTRATION:

Forrest D. Hockersmith	Apr. 1969	Present
Rodney L. Borum	Sept. 1966	Apr. 1969

DEPARTMENT OF THE INTERIOR

SECRETARY OF THE INTERIOR:

Walter J. Hickel	Jan. 1969	Present
Stuart L. Udall	Jan. 1961	Jan. 1969

DIRECTOR, OFFICE OF TERRITORIES:

Elizabeth P. Farrington	Mar. 1969	Present
Ruth G. Van Cleve	Apr. 1964	Mar. 1969

PRINCIPAL OFFICIALS RESPONSIBLE FOR THE
ACTIVITIES DISCUSSED IN THIS REPORT (continued)

Tenure of office
From To

DEPARTMENT OF THE INTERIOR (continued)

GOVERNOR OF THE VIRGIN ISLANDS:

Melvin H. Evans	July 1969	Present
Cyril E. King (acting)	Feb. 1969	June 1969
Ralph M. Paiewonsky	Apr. 1961	Feb. 1969