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ENFORCING RULES OF ORIGIN REQUIREMENTS UNDER THE UNITED STATES-CANADA FREE TRADE AGREEMENT

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED SECOND CONGRESS

FIRST SESSION

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ENFORCING RULES OF ORIGIN REQUIREMENTS UNDER THE UNITED STATES-CANADA FREE TRADE AGREEMENT

TUESDAY, JULY 30, 1991

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:10 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Lloyd Bentsen (chairman of the committee) presiding.

Also present: Senators Riegle, Rockefeller, and Grassley.

[The press release announcing the hearing follows:]

[Press Release No. H-32, July 26, 1991]

BENTSEN SCHEDULES HEARING ON ENFORCING RULES OF ORIGIN REQUIREMENTS UNDER U.S.-CANADA FREE TRADE AGREEMENT

WASHINGTON, DC.—Senator Lloyd Bentsen, Chairman of the Senate Finance Committee, announced Friday a hearing next week on enforcing rules of origin requirements under the U.S.-Canada Free Trade Agreement and any future North American agreement.

Bentsen (D., Texas) said the hearing will address a Customs Service audit of Honda on the rules of origin requirement covering autos under the agreement with Canada.

The hearing will be at *10 a.m. Tuesday, July 30, in Room SD-215* of the Dirksen Senate Office Building.

"Rules of origin are essential to the effectiveness of any free trade agreement. They provide the basis for determining whether a product is U.S. or foreign-made. Well-crafted, enforceable rules of origin therefore are an absolutely critical part of our trade laws and our trading system," Bentsen said.

"Recent press reports about the Customs Service's audit of Honda under our free trade agreement with Canada underscore how these rules can have important policy effects. This hearing will enable the Committee to gain a better understanding of the status of that audit. It also will allow us to examine more generally how rules of origin are being enforced under the Canadian agreement and how they may be developed in the North American free trade negotiations with Mexico and Canada," Bentsen said.

OPENING STATEMENT OF HON. LLOYD BENTSEN, A U.S. SENATOR FROM TEXAS, CHAIRMAN, SENATE FINANCE COMMITTEE

The CHAIRMAN. This hearing will come to order. Today's hearing will allow the Finance Committee to examine how the rules of origin requirements are being enforced under the Free Trade Agreement between the United States and Canada. One of the issues that we will address at this hearing will be the question of the Customs Service audit of Honda.

That audit was initiated to determine whether Honda had satisfied the rules of origin requirements for automobiles as set forth in the agreement with Canada.

The Honda audit has generated a great deal of attention in recent weeks. Press reports have indicated that the Customs Service was prepared in March to find Honda in violation of the agreement's rules of origin requirement, which would have resulted in additional duties of some $20 million. We then heard that Treasury put that audit on hold.

Today I want Commissioner Hallett and Mr. Simpson to shed some light on the status of that audit. I hope they will be able to clarify what the role was of the Customs Service and Treasury Department, how it was played out, and how that audit proceeded.

But this hearing is also about more than just the Honda audit, important as that is. This hearing is about how we are enforcing some of the more important provisions of the Free Trade Agreement: those that determine whether a product is made in the U.S.A. or made in Canada and, therefore, deserving of the special tariff treatment that the Free Trade Agreement provides.

The Finance Committee has been charged with the job of overseeing the implementation of the Free Trade Agreement with Canada. And in the months ahead, we will have a major responsibility to ensure that any agreement that is brought about from Free Trade Negotiations with Mexico and Canada is in the economic interests of the United States.

Two months ago I led the fight to give our negotiators 2 more years of fast-track authority, in large part because of my belief that a well-crafted North American agreement can contribute to new jobs and economic growth in the United States. But that is going to happen only if those who benefit from a free trade agreement are firms committed to substantial investment and production in North America, not producers from other countries who would use this agreement as a back door for entry into the U.S. market.

Nothing will do more harm to the cause of closer economic relations with our neighbors than evidence that they are being used as a launching pad, kind of a trampoline, for foreign goods to get into the United States without paying the proper duties. That is why strong and carefully enforced rules of origin requirements are important in a free trade agreement.

The rules of origin requirements in the United States-Canadian Free Trade Agreement can be extremely technical, but the basic principle is still a very simple one. To qualify for duty-free treatment, goods must be made either in the United States or Canada. They still may include parts from all over the world, but enough of their content must be American or Canadian to benefit from the duty-free privileges the agreement provides.

In the case of automobiles, that means at least 50 percent of the direct costs of processing must have occurred in the United States or Canada. That 50 percent has not pleased everyone, and it may not work in an agreement with Mexico. But it is a tougher rule than what we had with Canada before the Free Trade Agreement went into effect, precisely because the FTA was intended to benefit those automakers who do the bulk of their manufacturing in the United States and Canada.

That kind of rule is not unique to the United States or Canada, or to what we are proposing with Mexico. I recall in visiting with the Prime Minister of Great Britain, and talking to her about the Nissan plant in the north of England, asking if they were going to have a domestic content requirement for that. And she advised me, yes, they were going to have 60 percent. Not 50 percent, but 60 percent.

And then I spoke with the Prime Minister of France, and asked him if they were going to accept the cars from the Nissan plant in England, and he said, no, because they only have 60 percent domestic content and France demands 80 percent. I think they finally compromised at 70 percent. So the requirements are unique, but they also are important to us.

We gave our support to this agreement in the Congress with a view that it was going to contribute to jobs here at home, not in Europe, not on the Pacific Rim. But for that to happen, the 50-percent rule of origin requirement has to be enforced, and enforced rigorously. That is the commitment the administration made to us on auto products back in 1988 before we approved the agreement.

The administration said back then that it was committed to rigorous audit and inspection procedures that would ensure that the benefits of the agreement inured to the United States and Canada. Now that is a pretty clear commitment.

Therefore, I am concerned when I hear that the handling of the Honda audit, the first one under the agreement's auto rules, may have been subject to irregularities.

Those press reports I mentioned earlier say that the Customs Service wrote to the Treasury Department last March concerning Customs' findings that Honda had failed to meet the rules of origin requirements under the Free Trade Agreement with Canada.

The report notes further that Customs stated its intent to begin collecting duties that Honda owed. Yet now both Customs and Treasury tell us that the audit is not nearly done, and no decisions have been reached on Honda's action. Apparently more time is needed before Customs and Treasury officials, working together, will be able to determine whether Honda was in violation of the rules.

This audit of Honda began over a year ago. That starting date itself was more than a year after the Free Trade Agreement took effect. How can we, in the Congress, have confidence in the process of enforcing the rules of origin requirements when it is so clouded and it is so slow?

And that is why we have these witnesses here today, because I am hoping they can shed some light on these concerns. What is the status of the Honda audit? If it has not been completed, why is it taking so long? How are the rules of origin requirements on autos being enforced? What are the options for rules covering autos in a free trade agreement with Mexico? This can have a lot of influence on that agreement.

Learning how rules of origin requirements are being enforced can help this committee assess whether free trade with our neighbors can stimulate economic growth at home—as I hope—or, instead, could just speed up the flood of foreign products into our

market. I will be looking forward to hearing from the two witnesses on this very important issue.

I now defer to Senator Riegle, who has a long and continuing interest in this subject.

OPENING STATEMENT OF HON. DONALD W. RIEGLE, JR., A U.S. SENATOR FROM MICHIGAN

Senator RIEGLE. Thank you, Mr. Chairman, and let me thank you for your very important leadership on this issue, like so many others. But this is a key hearing today, and this will be very important testimony. It is important that we have all the facts and that we understand them clearly.

I think it is worth taking a moment to talk about the backdrop against which we meet and weigh this question, and that is that we are suffering major job losses in the United States.

I do not mean temporary layoffs because of the serious recession that we are in and are still struggling with, in my view, but virtually every major company in the United States is announcing permanent job reductions.

IBM recently said 17,000 permanent jobs are disappearing. The ARCO Co., 10,000. Digital Equipment, something on the order of 10,000 jobs. The same with the UNISYS Corp. The big banks that are merging are talking about laying off multiple thousands of employees permanently. So, there is a shrinking job base in the country, and any trade cheating that goes on by Japan, or any other country, further reduces the job base in America and makes our economic problems far more difficult.

In the auto industry, we have had massive continuing quarterly losses now over several quarters. The aggregates of those losses are well over $10 billion. That is an enormous amount of capital to drain out of any one industry, even an industry as large as that one in such a short period of time.

General Motors has just announced recently that it is going to be closing permanently two of its major manufacturing plants in this country, and other permanent plant closings seem to be coming behind it. So, that is the backdrop against which we have to assess this question.

It seems to me we are further injured by the fact that there is no economic plan in place for this country these days. We have an economic plan for every other country in the world, it seems, but not for this one, and this is part and parcel of that problem.

Now, the United States-Canada Free Trade Agreement requires 50 percent North American content in order to qualify for duty-free status. I had argued for 60 percent. I think a higher figure was, in fact, in order, and I would hope at some point we would get to a higher figure.

But if we take what the news reports tell us—and I gather that they are accurate here, and that is what we need to affirm today—the New York Times story that ran on June 17 indicated that the Customs Service had concluded after this 18-month audit that Honda of Canada does not meet the 50 percent North American content required for duty-free status under the Free Trade Agreement, that the actual level was only 38 percent, and that they had

not been truthful about it—they had attempted to deceive the authorities that would otherwise have to examine and make this assessment.

In a memo to the Treasury Department which was given to the New York Times, the Customs Commissioner, who is here today and will be testifying, in that memo, said, Honda's North American content was 25–30 percent less than the company had represented. And as a result, she said the Customs Service "will begin action immediately to collect $20 million in duties from vehicles imported into the United States in 1989 and 1990."

Now, that is $20 million that goes to the government, and properly so under the law. It helps reduce our deficit, and they are monies that need to be collected.

I think, by the way, as an aside, the fact that Honda is assumed to have the highest North American content of any of the transplants suggests that none of them are meeting the 50 percent requirement, and others are probably even in a worse noncompliance and, frankly, illegal situation.

In fact, the Customs audit also turned up evidence of dumping, indicating that Hondas were selling in this market for some $1,500 below their actual cost. That is a clear Trade Law violation.

But then—as we were given to understand later in that very week—Honda apparently set up a meeting with Treasury Secretary Robson through Honda's law firm here in town, which is a law firm by the name of Gibson, Dunn & Crutcher, which, it turns out, employs a former Treasury General Counsel on their legal staff.

And then just 3 days later after that meeting, Customs Commissioner Hallett publicly backed off on this issue saying then "that the audit is not yet complete, and no final decisions have been made." This, despite the fact that the audit had already been under way for 18 months—a year and a half.

Mr. Robson was asked about this—and I have personal regard for him—but he was quoted as saying and admitting that the meeting that he had with Honda was somewhat unusual. He is quoted as saying, "I do not meet with every importer who has a Customs case, but this is not the first time."

In fact, it would not be the first time that the Treasury has reversed a politically sensitive Customs case. In 1989, after heavy foreign lobbying, the Treasury Department reversed a Customs decision to classify certain multi-purpose utility vehicles as trucks, which would thus require them to pay a 25-percent duty.

And when the Treasury refused to accept that determination, it cost the government between $300 and $500 million. And $500 million is a half of a billion; it is a lot of money. And it looks to me as if somebody muscled that decision around with lobbying influence, and it looks to me exactly as if that has happened here in this case.

And so, one of the things I want you to address very specifically is what conversations were had, and with whom. I want to know if there were conversations with Mr. Robson, or representatives of Mr. Robson.

I want to know how this thing got turned around when we were on the track at one point to collect these duties which are due to us because of this sub-par domestic North American content level. How has this thing flipped around?

How do these decisions get undone, especially after these high-powered lawyers in town show up and put the arm on the administrative process? I am upset about it. I think it is wrong. I think it is hurting this country. I think it is hurting workers in this country. I think it is adding to the unemployment, it is adding to the deficit.

Now, obviously somebody is making a lot of money. Somebody is getting fat on these deals, but they are in direct violation of our law. And you folks have an obligation to see that the law is carried out. That is your obligation, and if you do not do that, then you ought to be in another line of work.

So, I want to make sure that we have all the facts here. Not just some of the story, the whole story.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Commissioner Hallett, you can see our concern, and we would like to hear your testimony.

STATEMENT OF HON. CAROL HALLETT, COMMISSIONER, U.S. CUSTOMS SERVICE, ACCOMPANIED BY WILLIAM INCH, DIRECTOR OF REGULATORY AUDIT, U.S. CUSTOMS SERVICE

Commissioner HALLETT. Thank you, Mr. Chairman, Senator Riegle. I appreciate the opportunity to be here today to discuss your interest in Customs regulatory audit activities and Customs enforcement of the Canadian Free Trade Agreement.

I would like to introduce Mr. John Simpson, the Deputy Assistant Secretary for Enforcement at Treasury, and Mr. William Inch, who is the Director of the Office of Regulatory Audit at the Customs Service.

As explanatory background, the Office of Regulatory Audit is part of the Office of Commercial Operations and presently has approximately 300 auditors who operate out of 25 field locations and the Washington headquarters office.

Its mission encompasses auditing a host of international trade programs, such as the Canadian Free Trade Agreement, the Caribbean Basin Initiative, along with the Generalized System of Preference, all of which, of course, provide preferential duties to eligible imported merchandise.

In addition, Regulatory Audit is responsible for auditing the activities of Customs brokers, draw-back claimants, foreign trade zone operators, and other members of the importing community to ensure the protection of the revenue with regard to imported merchandise.

Its focus, therefore, covers a wide range of complex and technical issues involving classification, valuation, and origin.

On average, the Office of Regulatory Audit conducts approximately 500 audits each year, and these audits generally result in a recommended revenue recovery of $66 million in duties, with corresponding penalties of approximately $95 million in 1990.

In the area of planning process, due to the vast number of potential audit candidates, as well as our limited resources, the Office of Regulatory Audit uses an elaborate planning process to develop a national audit plan.

That process includes an analysis of the number of hours necessary to complete an audit, as well as the number of man hours available. And the goal of Regulatory Audit is actually to assess which major importers have the highest risk of violating the law, and then to audit these high-risk importers once every 5 years.

A formal selection process is used to identify audit candidates for inclusion in the national audit plan. The selection of candidates is based upon referrals, suggestions, and other factors that have been developed by Regulatory Audit.

And because of the ever-increasing number of importers, as well as the volume of Customs' entry work load, Regulatory Audit must rely on targeting and selectivity concepts in order to ensure the most effect use of its resources.

The following criteria are used to calculate risks. One, whether the importer is new. Second, whether a large, established importer has been audited in the past. Third, the type of merchandise. Fourth, the country of origin. Fifth, whether changes in existing trade benefits have occurred, or new trade programs have been enacted. Sixth, whether audits or other companies contain evidence which indicate the likelihood of a loss of revenue or violation of the law.

And finally, whether information developed through other Customs disciplines—such as from our import specialists—necessitates an audit of company business documents.

Next is the audit process. And the Office of Regulatory Audit places special emphasis on the professionalism of its audits. Regulatory Audit recognizes that cooperation and coordination with auditees are necessary for both a quick, as well as a successful completion of the audit.

From the pre-audit planning stage to audit completion and report finalization, Regulatory Audit establishes and also maintains a line of open communication with company representatives.

Once a company is selected for an audit, the company officials are notified orally, and then in writing of the audit. Its purpose is presented to them, along with the preliminary requirements for record, as well as document availability.

An opening conference is held with the company officials in which the scope of the audit, its objectives, and methodologies are all articulated; 19 U.S.C. 1508, 1509 and 1510 provide Customs with the authority to review all financial, accounting, as well as inventory records relating to specific Customs transactions.

In accordance with law, it is Customs' policy to safeguard confidential business information obtained in the course of the audit from unauthorized disclosure. At any time during the audit process the company or the Office of Regulatory Audit may seek legal advice.

Upon completion of the audit and the closing conference with company officials, the Office of Regulatory Audit then issues a confidential report. This report is maintained by Customs, and, at the same time, it is provided to the auditee upon request, if no violation of law has been uncovered. If there is a suspected violation, then the Office of Regulatory Audit refers the matter to the Customs Office of Enforcement for investigation.

In general, the entire audit process is one which requires effective coordination between both the disciplines within Customs, and, at times, the Department of Treasury to ensure that the accurate application of Customs laws and regulations are carried out.

Although I have presented a simplified version of our audit process, I hope I have adequately illustrated the areas of responsibility, as well as the uniform procedures employed to ensure compliance with the regulations and laws which govern the activities of the importing community.

I realize that the major focus of this hearing today is Customs' enforcement of the United States-Canada Free Trade Agreement. I would like, however, to briefly discuss the role of Regulatory Audit in enforcing the Free Trade Agreement.

As I know you are aware, the United States-Canada Free Trade Agreement went into effect on January 1 of 1989. The agreement, simply stated, allows merchandise that is wholly produced in the United States or Canada to enter either country under preferential tariffs, such as you mentioned, Mr. Chairman.

In addition, merchandise which incorporates third-country materials may also obtain preferential treatment if the materials have been changed in the United States or Canada in a manner resulting in a specified change in tariff classification under the harmonized tariff schedule.

In certain cases, the agreement requires goods containing third-country materials to contain at least 50 percent North American content in order to qualify for preferential duty treatment.

In other cases, such as automobiles, the FTA rule of origin requires that the merchandise undergo a tariff classification change illustrated by a heading shift in the harmonized code, and that 50 percent of the cost of the merchandise be North American.

In the case of the automotive section of the Free Trade Agreement, the rules of origin were intended to be tougher under the United States-Canada Auto Pact. In fact, the stricter FTA rule of origin for automobiles was intended to benefit United States and Canadian auto parts manufacturers.

The statement of administration action states that the use of the stricter FTA rule "will ensure that importers of third-country parts cannot use the FTA to circumvent our Most-Favored-Nation tariffs."

In addition, the statement of administration action also states that "the administration is committed to effective enforcement of the more rigorous rules of origin in the FTA through rigorous audit, as well as inspection procedures. . ." And it goes on and ends the quote.

With this as a guiding principle, Customs has sought to enforce the agreement. Customs has the responsibility for preparing a multi-year plan for enforcement of the FTA with emphasis on the automotive sector. This plan, Mr. Chairman, augmented by Customs regulations, requires regular cost submissions from Canadian producers of automotive products. Based on these costs and figures contained in the annual vehicle cost reports of the North American content, submissions are then presented.

And Customs is required, by the statement of administrative action of the Canadian Free Trade Agreement, to use its regulatory

audit process to target firms having the greatest likelihood of not meeting the origin requirements.

In the course of pursuing these enforcement efforts, certain technical issues have arisen concerning the application of the FTA rules of origin. Customs is currently working with Treasury officials and our Canadian counterparts to address these issues so that audits which are in process can be completed in an expeditious manner.

I can assure you, Mr. Chairman, that the Customs Service takes very seriously its responsibility to effectively enforce the United States-Canadian Free Trade Agreement.

This concludes my formal presentation, Mr. Chairman. I believe that Mr. Simpson also has a presentation.

[The prepared statement of Commissioner Hallett appears in the appendix.]

The CHAIRMAN. Yes, Commissioner Hallett. Thank you.

Mr. Simpson, if you would proceed, please.

STATEMENT OF JOHN P. SIMPSON, DEPUTY ASSISTANT SECRETARY FOR REGULATORY, TARIFF, AND TRADE ENFORCEMENT, U.S. DEPARTMENT OF THE TREASURY

Secretary SIMPSON. Thank you, Mr. Chairman. I have a short statement which I have presented to the committee and which I would like to ask be included in the record.

The CHAIRMAN. That will be done.

[The prepared statement of Secretary Simpson appears in the appendix.]

Secretary SIMPSON. I agree with you, Mr. Chairman, that it is very timely for the committee to take an interest in this issue, in view of the fact that we are now beginning negotiation of a North American Free Trade Agreement in which this issue is going to be very central.

I am prepared to answer any questions that you, or Senator Riegle, or Senator Grassley may have.

Thank you.

The CHAIRMAN. Well, Commissioner, that was an interesting statement as to the process, but now let us get to the specifics. Let us talk about our concerns.

I have commented, and so has Senator Riegle, about the memorandum you sent in March to Deputy Secretary Robson. In that memorandum, you are quoted as saying, "We have determined that Honda has failed to meet the requirements for free tariff treatment under the Free Trade Agreement with Canada." Why would the Customs Service have made such a determination if the audit was still far from complete, as you and Mr. Simpson have said?

Commissioner HALLETT. Mr. Chairman, in that white paper, the purpose was to raise certain questions on an audit which is not unusual for Customs to do with the Treasury Department and, in fact, I know that Mr. Simpson can discuss a number of different instances where this has occurred.

However, I certainly regret that the paragraph to which you refer would have implied that, indeed, the audit was a fait accompli, because it was rather to raise questions with Treasury to dis-

cuss, because this was the first time such an audit under the Free Trade Agreement was being carried forth, and therefore, I wanted to make sure that we discussed these issues. And at the same time, Mr. Chairman, it is very important to point out that there were still several weeks left on the audit before it could be completed.

I would like to further state that while it is true that the audit commenced in May of 1990, it was interrupted for at least 6 months by the review which took place by the FTC.

They reviewed, in fact, some 18 different companies, and it interrupted the process of this audit going forward. And so, beginning in May and coming to this present time, it would have been—had it been consecutively under audit—14 months, but it was interrupted by some 6 months.

The CHAIRMAN. Well, Commissioner——

Commissioner HALLETT. Excuse me. The FTC.

The CHAIRMAN. Let me get to the first part of that, because it certainly sounds in your memorandum as though you had arrived, and the Customs Department had arrived, at a decision. "We have determined that Honda has failed to meet the requirements for free tariff treatment under the Free Trade Agreements with Canada." We have determined; that is what you say. And the March memorandum also quotes you as stating, "plans to begin action immediately." "To begin action immediately to collect the $20 million from Honda for duties owed for 1989 and 1990." Why would you be ready to collect duties unless you had finished your audit?

Commissioner HALLETT. Well. Mr. Chairman, as I indicated——

The CHAIRMAN. Both of these points on the memorandum certainly lead to the conclusion that you have made up your mind. You think they are in violation, that they ought to be fined. And $20 million is what you are talking about.

Commissioner HALLETT. I think that it is fair to say, Mr. Chairman, that while I indicated to you previously, I regret the implication that the audit was complete; it was not, it is not, and it will be—we would hope—by the end of October.

I would like to say with respect to the white paper, I think that the issues raised were really bigger than those that we wanted to deal with until we had again had conversations with Treasury, and I think that it is really appropriate for us to notify Treasury under such circumstances. It may be that Mr. Simpson——

The CHAIRMAN. Well, let me ask you then on that one, when did Treasury first become aware of the Customs Service audit of Honda? Maybe Mr. Simpson can better answer that one.

Commissioner HALLETT. And I think first of all it is important to point out it is right about that time when we did, in fact, prepare a memorandum for discussion. I would like to certainly ask Mr. Simpson to feel free to respond.

The CHAIRMAN. Yes.

Secretary SIMPSON. Mr. Chairman, we were always aware of the Honda audit as it was ongoing from the very beginning.

The CHAIRMAN. Is it normal for Treasury to be always involved in that kind of an audit from the beginning?

Secretary SIMPSON. Well, at the point it began we were not involved in it, but we were aware of it. I would guess that we became

involved in it at the point that we received Commissioner Hallett's memorandum.

The CHAIRMAN. What made the Honda case special?

Secretary SIMPSON. I think from our point of view—and I am sure Commissioner Hallett can explain why she chose to send a memorandum—but certainly from our point of view it was the first audit of a major industry under the most important trade preference arrangement that we administer. The Canada Free Trade Agreement is very much a new experience for us. It far exceeds, in terms of its scope and complexity, any trade preference arrangement that we have ever had before. And so, I think we were appropriately very much interested in its administration.

Commissioner HALLETT. Mr. Chairman.

The CHAIRMAN. Yes.

Commissioner HALLETT. Might I just follow-up on that? Because I think to put the white paper in context, which, first of all, was an internal document. I did immediately initiative an investigation to try to determine why and how it was leaked, when, in fact, that occurred.

But I think if you were to read through the entire memorandum, you would find that it is, indeed, inconsistent, because the body of the memo clearly—clearly indicates that the audit is still ongoing. That, in other words, we still have issues, and I think that is an important point to raise.

It is true that the last paragraph is misleading. It was written by someone other than myself, and it was, I think, probably intended to be a dramatic ending to ensure that Treasury did, in fact, give attention to this issue and would, indeed, engage in dialogue with us.

The CHAIRMAN. Well, it sure got our attention.

Commissioner HALLETT. Well, I realize that, Mr. Chairman. It got my attention also, believe me.

The CHAIRMAN. And it is not just the one instance, you know. You are talking about starting immediately the collection of the $20 million. That sure sounds like you had made up your mind, and that you had decided your audit was something that had to lead to that.

Commissioner HALLETT. May I just explain the reference to $20 million, and while this is not going into any detail, and Mr. Inch may prefer to, I think it is very important to point out that $20 million would be collected—in this particular case—on an X number of automobiles by any company, whether it was Honda or any other company, if they brought those automobiles into the United States and, in fact, the 50-percent rule did not apply.

And I think it is important to point out that that is a "what if" almost kind of a statement that was made. That is my interpretation of the way in which that particular paragraph was written.

The CHAIRMAN. Well, I must say I would not interpret it that way.

I put a limitation on myself and all of us of 8 minutes, and then we will come around again, because we only have the two witnesses.

The last visit, Mr. Simpson, by the Customs Service auditors was in December 1990. Now, the New York Times report on the leaked

audit came in mid-June of 1991, more than 6 months later. What happened in those 6 months?

Commissioner HALLETT. Mr. Chairman, may I ask Mr. Inch, who is our Director of Regulatory Audit, to respond?

The CHAIRMAN. All right, fine. All right.

Mr. INCH. As has been indicated, Mr. Chairman, this is the first audit covering significant issues. We——

The CHAIRMAN. Would that be why you think it has moved so slowly?

Mr. INCH. Well, we took our time to get the issues together; to bring our thoughts together on these issues.

The CHAIRMAN. I see my time has expired. Senator Riegle.

Senator RIEGLE. Ms. Hallett, do you have the memo with you?

Commissioner HALLETT. I do not, Mr. Riegle.

Senator RIEGLE. Is there a reason why you did not bring it?

Commissioner HALLETT. It is an internal memo. It was not, and is not for distribution. And, in fact, I think it is most inappropriate for me to discuss the memo, because it is not for publication.

Senator RIEGLE. Well, I disagree with you.

Commissioner HALLETT. It is pre-decisional, Senator, and I really feel that it would be most inappropriate for me to discuss something that was surreptitiously shared with the news media, not with authority from myself or anyone else in a position of leadership with the Customs Service.

Senator RIEGLE. Well, you have made several references to it today yourself, and you have described it in some detail how it is inconsistent, that some parts say one thing, and some parts say another.

I think you have an obligation to produce it, under the circumstances, and I would like to read it and be able to ask you about it. So, I am formally asking you for it, and I would like it now. I would like somebody to fax it in here so we can have a way of taking a look at it and understanding exactly what the history is here.

Commissioner HALLETT. Senator, I do not have a copy. I believe that it would have appeared to me that Senator Bentsen was reading from the memo. I am sorry; I do not have a copy.

Senator RIEGLE. Well, I am told we do not have a copy of the memo. But I would assume you do. Would you not normally maintain one in your files?

Commissioner HALLETT. I am sure we have one in the files.

Senator RIEGLE. Well, let us not beat around the bush. I want the memo, and I think you have an obligation to provide it. So, I would either like it from you or from Mr. Simpson. Now, I assume you have got a copy and the Treasury has a copy, and I do not understand what the need is to hide it.

Commissioner HALLETT. This is sensitive information, Senator. It is information that could adversely impact any audit. It would be most inappropriate for us to share an internal, sensitive memo dealing with an audit. And this is standard procedure. It was leaked to the press by someone, and I consider that a violation. And that is why I have initiated an investigation into that violation.

Senator RIEGLE. Well, let me make it very clear that I do not accept that answer. I think that is an unsatisfactory answer. I think we should see it, and I will persist in my request to get it.

Now, let me ask you, Mr. Simpson, can we see your copy of the memo?

Secretary SIMPSON. I am sorry, Senator. I also do not have a copy of the memo today.

Senator RIEGLE. Well, nobody has the memo. I mean, we have heard all these references to the memo, but nobody seems to be able to have one or find one or can produce one. How many people work with you, Mr. Simpson? Do you not have a pretty good-sized staff?

Secretary SIMPSON. There are two persons in the Treasury who have that memorandum.

Senator RIEGLE. Well, than can we not contact one or both and get a copy of it up here?

Secretary SIMPSON. Well, let Commissioner Hallett and me put our heads together and discuss this, and we will get back to you.

Senator RIEGLE. Well, I mean, we are here today.

Secretary SIMPSON. Well, I know that, Senator.

Senator RIEGLE. We are not all here by surprise; you knew you were coming. I would have thought that you would bring the memo with you, quite frankly. It sounds to me like whatever is in this memo you certainly do not want to have see the light of day. But let me go on.

I want to know exactly what happened, Ms. Hallett, after you sent the memo. I want you to go through the chronology of events, and I want to know what your contacts were with the Treasury Department after that memo was sent; who contacted whom, and when.

Commissioner HALLETT. Senator, my contacts were minimal. I did send the memo to Treasury. I had at least one conversation with Mr. Robson who asked about it, and——

Senator RIEGLE. Did he call you?

Commissioner HALLETT. I am sorry, I do not recall, because I talk to him on a regular basis. I see him once a week, and the only discussion that we had was that there would be further discussions. I believe that Mr. Simpson could better address that question.

Senator RIEGLE. No. I do not want to go to Mr. Simpson yet. You were the other half of the conversation. We do not have Robson here; we have you here. You are half of the Robson conversation. I want you to give me all the detail you can as to what was said. What did Mr. Robson say to you?

Commissioner HALLETT. It was less than a 5 minute—less than probably a 3 minute conversation. There was simply no discussion.

Senator RIEGLE. Well, what was said in it? I am not interested in how long it was, I am interested in what the content was.

Commissioner HALLETT. The reason I sent him the memo was to raise the level of interest——

Senator RIEGLE. What did he say to you? Would you tell me what he said to you?

Commissioner HALLETT. I simply told him that we had an issue that we needed to discuss with respect to an audit. I had sent an issue paper and that we should get together and discuss it.

Senator RIEGLE. Did he express his concern about it?

Commissioner HALLETT. He expressed interest. Not necessarily concern, but interest.

Senator RIEGLE. How did he express the interest?

Commissioner HALLETT. Senator, that was back in March, and I really do not recall.

Senator RIEGLE. All right.

Commissioner HALLETT. I can tell you that it was not, "oh, my goodness," or, "what are you talking about?"

Senator RIEGLE. Was it your only conversation with Mr. Robson on this subject?

Commissioner HALLETT. Certainly, it is the only one that I recall. There could have been at least other references, but I never sat down and had a specific meeting just on this issue. I recall bringing it up to him. I recall sending a memo. I could have had one other conversation at the most. I am sure, Senator, that that was the extent of my involvement. There were others who were involved; I was not.

Senator RIEGLE. Mr. Inch, have you read the memo?

Mr. INCH. Yes, sir.

Senator RIEGLE. All right. Do you have a copy?

Mr. INCH. Sir, I have——

Senator RIEGLE. The missing memo. The memo that everybody has seen but no one has.

Mr. INCH. I do have it here in my packet.

Senator RIEGLE. Do you mind sharing it with us, or do you feel that you are under some injunction to hang onto it?

Mr. INCH. I feel as the Commissioner, that it is pre-decisional.

Senator RIEGLE. Now, I am interested in knowing, Mr. Inch, after you had started with your audit, you were coming down the track and you were concerned enough that this material was placed in the memo that we are talking about here. Who spoke to you after that point about this issue? Did anybody talk to you about the audit, and about how it was going, and what it was finding, and so forth and so on?

Mr. INCH. Just in-house people who I work with.

Senator RIEGLE. Yes. Who would that have been?

Mr. INCH. I have had conversations with my boss, Sam Banks.

Senator RIEGLE. Did anybody tell you to speed it up and get it done?

Mr. INCH. Not really, Senator. We were not to speed it up, but to just do a good job.

Senator RIEGLE. No suggestions one way or the other about speeding it up, slowing it down, taking a second look, anything of that kind?

Mr. INCH. No, sir.

Senator RIEGLE. Let me ask you, Mr. Simpson. There is some indication that maybe Mr. Wallison is the person who set up the meeting with Mr. Robson. Do you know if that is correct?

Secretary SIMPSON. I would have to ask Mr. Robson's office, but I believe that may be correct.

Senator RIEGLE. That was after the story appeared in the New York Times. Were you present at the meeting?

Secretary SIMPSON. Yes, I was.

Senator RIEGLE. Could you tell us what was said?

Secretary SIMPSON. Well, generally, the representatives of Honda were very concerned about the fact that the details of a Customs Service audit had appeared in the New York Times.

Senator RIEGLE. Let me just stop you for a minute just so we have it straight. Can you tell me who all was present at that meeting? You were there, of course. Who else was there?

Secretary SIMPSON. I was there, Mr. Robson was there. There were three officials from Honda North America, one from Honda of Canada included in that number. Two representatives of the law firm of Gibson, Dunn & Crutcher.

Senator RIEGLE. Do you remember who they were?

Secretary SIMPSON. Mr. Donald Harrison and Mr. Peter Wallison. And perhaps one or two persons from our Office of General Counsel.

Senator RIEGLE. Now, if you would just give us the details of what went on in that meeting.

Secretary SIMPSON. The Honda people said that they were prepared to address any issues raised by the Customs Service audit. They were prepared to address any accounting issues, or any legal issues, but they expected to do that in a more orthodox context. They did not have to expect to have to respond to Customs audits reprinted in the New York Times.

Senator RIEGLE. Yes. My time is up.

The CHAIRMAN. We will make another round. Senator Grassley.

Senator GRASSLEY. Mr. Chairman, I did not get here in time to give an opening statement.

The CHAIRMAN. Well, you are certainly welcome to make one, if you would like.

Senator GRASSLEY. I would rather insert it in the record.

The CHAIRMAN. That will be done. Thank you.

[The prepared statement of Senator Grassley appears in the appendix.]

Senator GRASSLEY. Let me ask Treasury, is it normal procedure for a company being audited to bypass Customs and seek an immediate meeting with Treasury?

Secretary SIMPSON. Well, Senator, that is not ordinary. I think the Honda folks were seeking the meeting at Treasury not because they were being audited, but because the audit report. had appeared in the New York Times.

Senator GRASSLEY. Do you know if they sought meetings with other agencies, like Commerce, or at the White House?

Secretary SIMPSON. No, sir; I do not.

Senator GRASSLEY. Maybe you do not know for sure, but have you heard any inferences that maybe they sought other meetings or had other meetings?

Secretary SIMPSON. Senator, I do not recall having heard that implied. They very well may have done that.

Senator GRASSLEY. Have the Japanese or any other government intervened in this case in any way?

Secretary SIMPSON. No, sir.

Senator GRASSLEY. The fact that the Japanese are at our window regularly buying part of our National debt, and they own a considerable amount of it; as far as Treasury is concerned, does that have

anything to do with the position you've taken on the Honda problem, the audit, and Treasury's concern about the audit?

Secretary SIMPSON. Senator, we do not make tariff classification decisions based on whether we think they will affect the Japanese interest in buying our Treasury notes.

Senator GRASSLEY. I would like to have some general description of what the criteria is for the Treasury Department's involvement in Custom affairs. And let me tell you the basis for my query.

I recall several years ago that in response to Japanese political pressure, the Treasury Department took it upon themselves to reverse Customs Services' definition of what a truck is, and, in the process, save the Japanese auto industry millions of dollars.

I guess I see a potential for the same scenario, and I want to know what guidelines Treasury has for involvement with Customs on matters like this.

Secretary SIMPSON. Well, Senator, let me begin first by saying that the Treasury Department under took its review of the Customs' decision on sport utility vehicles on its own initiative, not under pressure from the Japanese Government.

To get to the more central question, the Secretary of the Treasury does have responsibility under the law for oversight and supervision of the Customs Service. That responsibility goes back to an act of May 8, 1792, and we have always had it.

The committees of the Congress have consistently expressed an interest in having the Secretary of the Treasury exercise oversight. For example, 2 or 3 years ago this committee created, by law, an advisory committee to advise the Secretary of the Treasury on the commercial operations of the Customs Service, in the expectation that the Secretary's oversight of Customs would be strengthened.

Last year, the Oversight Subcommittee of the House Ways and Means Committee issued a report on the Customs Service management in which it very strongly chastised the Treasury Department for not exercising stronger oversight.

So, I think it is fairly well established that the Congress expects the Treasury Department to oversee the operations of the Customs Service.

Senator GRASSLEY. So, you are saying that their involvement in this particular case is the regular course of doing business?

Secretary SIMPSON. Yes, sir. It is 100 percent of what I do at the Treasury Department.

Senator GRASSLEY. Well, then let me ask you what might come of all this. Is the Treasury Department using the report as a source to develop rules of origin for the North American Free Trade Agreement?

Secretary SIMPSON. Yes, sir. One of the pieces of information that we will use to guide our negotiations in the North American Free Trade Agreement is the reports that we receive from the Customs Service on their audits.

To some extent, the people who write free trade agreements are doing theoretical work. The Customs Service people are the ones who actually determine whether the airplane will fly, and we are very much reliant on the Customs Service to tell us what works in practice and what does not.

Senator GRASSLEY. Well, will this report be used also for the development of trade policy?

Secretary SIMPSON. It is already being used that way.

Senator GRASSLEY. Is it being used in a way that is going to see that the United States does not become a dumping ground for government subsidized products, as is clearly the case here?

Secretary SIMPSON. Yes, sir. Well, I do not know if dumping or subsidies are clearly the case here, but certainly the report is already demonstrating its usefulness in guiding us in our negotiation of a North American Free Trade Agreement.

Senator GRASSLEY. Do you know why I think that is the case here? Because Senator Riegle cannot get a copy of this document.

Secretary SIMPSON. Senator, I will be perfectly happy to sit down with my bosses at the Treasury Department and discuss this issue with them. Frankly, I see no reason why we cannot share this report with the Congress. I would be perfectly happy to.

Senator GRASSLEY. Remember where the sun shines in there is not going to be any mold.

Secretary SIMPSON. I could not agree with you more.

Senator GRASSLEY. Mr. Chairman, I have no further questions.

The CHAIRMAN. Thank you, Senator.

Commissioner Hallett and Mr. Simpson, I would particularly want to see this memorandum, Commissioner, that you sent to Treasury, because you have stated to me that, taken out of context, this can lead to a different conclusion than if I had an opportunity to see the entire memorandum.

When I read these points that "we have determined that Honda has failed to meet the requirements for free tariff treatment . . . we will begin action immediately to collect $20 million because of violations," you tell me that the unfortunate part is I have not seen the entire memorandum, so I am prepared to look at it.

Commissioner HALLETT. Mr. Chairman, I, again, believe it is very important to make the point that this is an internal document and, in fact it was not meant for distribution to the press, or anyone outside of Customs, as well as Treasury. And I think that it would be most inappropriate.

It is clearly an issues paper to discuss with our parent, the Treasury Department, and I believe that to release the information was, in fact, a violation by someone who was either at Customs or Treasury, and that is why I initiated an investigation to determine how it was leaked, because it was totally inappropriate.

The CHAIRMAN. Commissioner, I am not questioning that part of it. What I am talking about is you are telling me that the leaked part, which I have reviewed with you, is really not a correct interpretation if you read the entire memorandum.

Commissioner HALLETT. Well, Mr. Chairman, I am not trying to stone-wall you, but I would like to—

The CHAIRMAN. It is coming pretty close.

Commissioner HALLETT [continuing]. Discuss this with you in private, and the members of the committee, if we might. Because I think that if this is to be shared, it needs to be done in a classified document so that it will not be released to others.

The CHAIRMAN. That does not trouble me at all to share it in that light.

Commissioner HALLETT. Under those circumstances, I would share it with you.

The CHAIRMAN. All right. Fine. Now, let us get to another concern here. Because in approving the United States-Canadian Free Trade Agreement, one of the commitments we had out of the administration was that the resources would be committed, that you would have enough auditors to get the job done, to gain a high level of compliance with the auto rules of origin requirements.

Mr. Inch, you were talking about the problem of putting this together, and the delays. Commissioner Hallett and Mr. Inch, tell me what Customs has done to meet that kind of commitment. How many auditors have you added?

Commissioner HALLETT. Mr. Chairman, we have at the present time—as I mentioned in my opening statement—some 300 auditors working out of 25 different offices. In the 1992 budget, which has fortunately passed with very good support from your committee. We have an additional 50 auditors who will begin working for Customs in 1992.

I am hopeful that that budget will pass quickly so that we can be prepared to hire those people on the 1st of October. In addition to that, we will be making proposals for more hires in future budgets, depending on what we need.

The CHAIRMAN. For Mexico?

Commissioner HALLETT. This would absolutely—and with the advent of the North American Free Trade Agreement for Mexico, we will be assessing all of our needs.

I would like to point out as well that for the 1992 budget, we are also hiring an additional 125 import specialists, which you approved. And the reason I make that point is because they really are working hand-in-hand in terms of trying to make sure that we are able to do the very best job possible with our audits, and they do work together in this area.

So, we have literally doubled our staff for audit in the last 3 or 4 years. That is, I believe, very significant, and certainly we are increasing at a rate where we are able to carry out our responsibilities, and I want to make sure that we are able to absorb all of them properly without having any of their abilities wasted. But Treasury has been very supportive of all of our requests for auditors that we have presented to them.

The CHAIRMAN. All right. One of the other points in seeing compliance was a multi-year plan, as spoken of by the administration at the time, concerning cost submissions from auto producers in Canada. Now, has Customs met that requirement, and have those producers met that requirement?

Commissioner HALLETT. That is correct, Mr. Chairman.

The CHAIRMAN. As you look at the Mexican agreement, do you see any further tightening of the requirements, tightening of the rules for autos, insofar as domestic content?

Commissioner HALLETT. May I make a brief comment, and then ask Mr. Simpson to further comment on this? When the negotiations commenced for the Canadian Free Trade Agreement, the Cus-

toms Service came into the picture at the very end, and we were not involved with input.

Mr. Simpson and Ambassador Hills, as well, have brought us into the picture at the very beginning of discussions so that our input will be taken, and I think it can have a very beneficial impact on the way in which the Customs Service enforces the North American Free Trade Agreement, including Mexico.

The CHAIRMAN. Mr. Simpson.

Secretary SIMPSON. Mr. Chairman, I think it is likely that the origin rule for automotive trade in NAFTA will be tightened a little bit in two ways. As you know, we are on the record as supporting a more rigorous origin requirement under the Canada Free Trade Agreement, so basically we wanted a higher value-content threshold going into the NAFTA negotiations.

But I think the second way in which we want to do some tightening is in terms of greater definition and precision in the law. I think one of the things we are finding as these audits go forward is that there is enough ambiguity in the rules of origin as they are written in the Canada Free Trade Agreement that it is a cause for some concern. So, we want to tighten that up a little.

The CHAIRMAN. Well, let us get to some of the technicalities then, Mr. Inch. I understand that one of the problems is having some really clear cost accounting standards to guide the Customs Service, and that Canada has been able to develop much more specific guidelines than we have on our side of the border.

That, in contrast, U.S. Customs does not have such guidelines, and the Customs Service—the auditors—are forced to rely on some of the vagueness of the Free Trade Agreement itself. How would you respond to that?

Commissioner HALLETT. I think maybe Mr. Simpson would be a more appropriate person to respond, Mr. Chairman.

The CHAIRMAN. Really? That is interesting. All right. Mr. Secretary. I did not realize your talents extended that far.

Secretary SIMPSON. Mr. Chairman, we have interim regulations that we developed to guide both the Customs Service and the public in interpreting the Free Trade Agreement.

The final regulations to be published in the Federal Register have been held up by me, because of a disagreement we have had with the Government of Canada over an interpretive issue involving automobile trade.

We are in the process of resolving that issue, and as soon as we can we shall put final regulations in the Federal Register. But I think there is still going to be enough ambiguity in the Free Trade Agreement that we will need to make some corrections in the law.

The CHAIRMAN. Thank you. I see my time has expired.

Senator Riegle.

Senator RIEGLE. Mr. Chairman, I have here the letter from Ms. Hallett to Mr. Yoshino of Honda, sort of an apologetic letter written on June 24, 1991. I would make that a part of the record here.

The CHAIRMAN. That will be done.

[The letter follows:]

THE COMMISSIONER OF CUSTOMS,
Washington, DC, June 24, 1991.

Dear Mr. Yoshino: Thank you for your letter of June 19 to Deputy Secretary Robson, concerning various newspaper articles regarding a U.S. Customs Service audit of Honda. This audit concerns Honda's eligibility for preferential tariff treatment under the free trade agreement between the United Sstates and Canada. I appreciate the cooperation of your company in the course of this audit.

I can confirm to you that the audit is not yet complete and no final decisions have been made. I can also assure you that the audit process will be fairly conducted, including consideration of any views which you may present to us on particular issues off interpretation. In accordance with our normal practice, you will be informed of final decisions when they are reached.

In order for Customs to carry out its audit responsibilities, it must have access to full and accurate information. We recognize that businesses will only be willing to share sensitive business information if they can rely on the government to adequately protect such information against unauthorized disclosure. I therefore regret that details of this incomplete audit were disclosed to the public media.

Sincerely,

CAROL HALLETT.

Mr. Hiroyuki Hoshino
President
Honda of America Manufacturing Inc.
Marysville, Ohio 43040

Senator RIEGLE. Do you have, Mr. Simpson, the copy of the letter that the Honda person sent to Secretary Robson that is referenced in this letter?

Secretary SIMPSON. I do not have it with me today, Senator.

Senator RIEGLE. Pardon?

Secretary SIMPSON. I do not have it with me today.

Senator RIEGLE. Can you get it faxed up here?

Secretary SIMPSON. I will see if I can find it, yes, sir.

Senator RIEGLE. I mean, I am sure you have staff here. If our staff could provide a fax number, I would like to see the letter that was sent to Mr. Robson from the Honda official to which this apologetic letter appears to be a response.

Now, let us go back to the meeting again——

Senator GRASSLEY. Senator Riegle, while you are on the letter——

Senator RIEGLE. Yes.

Senator GRASSLEY [continuing]. Could I ask a question? I wanted to ask just why she felt compelled to write the letter.

Senator RIEGLE. I think that is a good question.

Commissioner HALLETT. Well, Senators, I believed that an apology was in order. It was certainly inappropriate for anyone to leak that white paper to the press. The audit was still under way; there was sensitive information in that audit; it was an internal document that was never intended for anyone other than officials in the Customs Service and the Treasury Department. And I would apologize to anyone who found information about an ongoing audit of their company released to the press.

Senator RIEGLE. Well, Ms. Hallett, let me say to you, this company has been cheating the United States of America—cheating our country, cheating our taxpayers, and it is your job to find it and put a stop to it.

I think he owes us an apology. I think he owes us an apology for cheating us systematically. That is what your department has found with this audit, that there has been systematic and deliberate cheating going on by this company.

And you happened to find it, and then some lawyers get into the case and contact the Treasury Department. The next thing that happens is that you write this guy an apologetic letter because he has been caught cheating our country. You have got an obligation to track down people like this.

The letter you should have written to him, in my judgment, is that you were deeply disturbed about what you had found to date, and that you were troubled about it and you were going to pursue it to its conclusion, not all this bowing and scraping that is in here. You do not owe him an apology whatsoever; he owes us an apology. You have got to figure out what side you are on, and so does this administration.

Senator GRASSLEY. Senator Riegle——

Senator RIEGLE. If I may, just one moment, then I will be happy to yield, although I do not want to lose all my time. Because I want to know how many other instances there are where Mr. Wallison shows up at the Treasury Department with some client on his arm, such as we had here in the case of Honda. Are you aware of any other instances, Mr. Simpson? And I would like you to really rack your memory.

Secretary SIMPSON. Senator, I have been at the Treasury Department for a long time, and I do not believe I have seen Peter Wallison more than once or twice since he left Treasury from his position as General Counsel.

Senator RIEGLE. So, this would be a rather extraordinary event then, this particular case?

Secretary SIMPSON. Oh, there are always lawyers coming in to see the Treasury Department. I just do not happen to have seen Peter Wallison in a long time.

But Senator, let me tell you something. The Treasury Department, in my view, has a very good record on dealing with cheaters. I have been at the Treasury Department for 12 years, and all of it involved in enforcement of the laws, and I think our record is very good. In this case, I do not think it has been established yet that Honda is cheating.

Senator RIEGLE. Well, let me just say to you I have to dispute that, based on the one that I cited before. Because we had the previous case where the decision was made to overturn the issue on the multi-purpose utility vehicles after there had been a recommendation coming from the Customs Department, and it cost us somewhere between $300 million and $500 million.

And if you are proud of that, then I think your pride is misplaced. I think you do have a problem there, and I think you have a problem in this case. And the fact that you do not see it makes it even a worse problem.

Now, you said earlier that you had some reason to think that Honda may have had other contacts within the Executive Branch. What do you know about that?

Secretary SIMPSON. No. I said they may have; I do not know.

Senator RIEGLE. Have you heard that?

Secretary SIMPSON. No, sir.

Senator RIEGLE. Are you sure, now?

Secretary SIMPSON. Yes, sir. I am not privy to Honda's——

Senator RIEGLE. You have heard no indication——

Secretary SIMPSON. No.

Senator RIEGLE [continuing]. Or no talk around that they were contacting other places within the Executive Branch?

Secretary SIMPSON. Not that I recall, Senator. I certainly may have been told that, but I do not recall it. Honda does not include me in its planning meetings.

Senator RIEGLE. Mr. Inch, let me ask you this. In terms of the findings that you had reached up to the point that they were included in this memorandum that we have not yet been able to see, have your findings changed since that date?

Mr. INCH. No, they have not.

Senator RIEGLE. Would it be fair to say then that the findings of a substantial under-percentage of domestic content and North American content still appears to be the case?

Mr. INCH. Well, some of the legal issues involved are under review.

Senator RIEGLE. Well, what does that mean?

Mr. Inch. Well, some of the——

Senator RIEGLE. Well, let me make it simple. I mean, because the domestic/North American content issue becomes a fairly simple issue in the sense that it is a percentage. And are we up to 50, or are we below 50?

Mr. INCH. Sir, a final determination has just not been made there yet.

Senator RIEGLE. But do I understand your answer a minute ago to be that your assessment today is in line with your assessment back at the time that the memo was generated?

Mr. INCH. Generally, our findings have not changed.

Senator RIEGLE. Well, I take from that that we have got a problem here of a substantial under-performance with respect to North American content. And frankly, I think it is bad practice to be sending these apologetic letters. And I think we ought to be getting some apologetic letters, and you ought to be seeking them, quite frankly, Ms. Hallett. I think you have got an obligation to get this process moving faster.

Now, I realize it may get slowed down when there is a lot of interference in it, because it appears to have been slowed down in this case. But I think it is time to wind it up. And if they are cheating, I want them to start paying, because they are cheating everybody in this country. And if you do not crack down hard on that, you are aiding and abetting it. And frankly, I think this letter is no credit to the department.

Commissioner HALLETT. Senator, may I respectfully respond?

Senator RIEGLE. Yes, please.

Commissioner HALLETT. First of all, I believe this is very incorrect, the implication that we have, in fact, found fraud; we have not found fraud. That is the first statement that needs to be made.

Second, the issues are in dispute. Treasury has not interfered, no one has purposely slowed this down. I think it is most unfortunate, and it is, in fact, really a very serious problem that we are dealing

with. And to have anyone say that someone is interfering or trying to slow it down is simply not the case.

Senator RIEGLE. Well, let me ask you a very direct question then. I want you to list for me—and we will take whatever time it takes—every other Customs case of this kind where you have had to sit down with the Treasury Department, with Mr. Robson, at that level, to go over an audit that is under way on an item of this kind. How many other instances have there been?

Commissioner HALLETT. Certainly, there have been several.

Senator RIEGLE. Well, how many?

Commissioner HALLETT. I have only—well, I could name at least two——

Senator RIEGLE. Is several dozens, or——

Commissioner HALLETT. At least two others since I have been here.

Senator RIEGLE. So, there has maybe been three.

Commissioner HALLETT. There have been three that I can recall.

Senator RIEGLE. All right. Let us hear about those two.

Commissioner HALLETT. They have been audits that deal with IBM, and an issue dealing with Nike.

Senator RIEGLE. So, there have been three, to your knowledge?

Commissioner HALLETT. That I can recall. There may be others.

Senator RIEGLE. All right. Now, how long have you been in this position?

Commissioner HALLETT. And I have been here for a year and a half.

Senator RIEGLE. All right. So, three in a year and a half. That is the universe.

Commissioner HALLETT. There could be more, but I do not recall. But I would say this——

Senator RIEGLE. But those have been initiated by you sending memos to Mr. Robson, is that what would have triggered those off, or not—the other two?

Commissioner HALLETT. One of them was already ongoing when I arrived, and discussions continued. That was with IBM. And on Nike, I initiated that.

Senator RIEGLE. All right. You sent a memo?

Commissioner HALLETT. I believe so.

Senator RIEGLE. Can we see that memo?

Commissioner HALLETT. If we have one, you may certainly see it, yes.

Senator RIEGLE. I would hope you would have it.

Commissioner HALLETT. I would say this. There is a letter. I do not know that there is a memo.

Senator RIEGLE. Well, a letter, fine. Whatever the written communication was.

Commissioner HALLETT. May I just follow up on my comments, because I think it is important. We have a role to audit, and that is what we are doing. And because we audit any company does not necessarily mean that that company is cheating. And I think that we have not found that.

Senator RIEGLE. Well, let me just ask you this. They have asserted the content is above 50 percent. If it turns out that the content is substantially below 50 percent, does that constitute cheating?

Commissioner HALLETT. Well, certainly if it is substantially below, our audit will show that.

Senator RIEGLE. Well, 10 percentage points——

Commissioner HALLETT. And then, obviously, the duty will be owed.

Senator RIEGLE. I know. But is that cheating if they do that? If they make one representation and it turns out to be false, is that cheating?

Commissioner HALLETT. I am simply not going to say whether it is or not, because I do not know all of the facts.

Senator RIEGLE. Well, I just gave you the facts in a hypothetical, and that is they say it is up here and, in fact, you check and it is down here, below the requirement. Is that cheating? That meets my definition of cheating.

Commissioner HALLETT. Well, any case like that we would automatically send investigators in to investigate to determine whether or not—with any company—cheating was, in fact, occurring.

It is our job, and we do it, and we say so if that is the case. I have no evidence at this time to say that that is the case, because our investigators are not even involved in this case. The audit has not been completed.

The CHAIRMAN. Your time has expired.

Senator Grassley.

Senator GRASSLEY. I am not going to use all of my allotted time, so if Senator Riegle wants some of the time back he shared with me earlier. I would like to reciprocate. I just have a question that does not deal specifically with this issue, but it gets into the area of this committee's responsibility of Internal Revenue oversight, as well as Customs Service oversight. It might be more appropriate for you, Mr. Simpson, so let me ask, does the Customs Service ever come upon corporate business practices—such as transfer price manipulation—that appear to be undertaken to avoid taxes?

And then before you answer that, is there any mechanism by which such findings could be brought to the attention of the Internal Revenue Service?

And then additionally, whether or not the Treasury Departments thinks that it would be appropriate for the Customs Service to work with the Internal Revenue Service in areas involving international transactions, perhaps like conducting joint audits and investigations to bring in this money that, quite frankly, I think that we are losing because of how these international corporations structure their corporation. And there is a feeling of a lot of avoidance of taxes as a result of it.

Secretary SIMPSON. Senator, we became of that problem several years ago, and with the cooperation of the Congress, it is now a legal requirement that whatever value is assigned to goods imported into the United States be the same for both income tax purposes and Customs duty purposes, so that we cannot be fiddled on both ends.

We do work with the Internal Revenue Service within certain limits. The Congress, and I think the American public, expects that there will be very tight control maintained over information on tax returns.

And, therefore, the Internal Revenue Service is very careful not to disclose to us information that they think would violate their obligation to protect the confidentiality of tax returns.

But within that limitation, we do work with the Internal Revenue Service, and we are both concerned about the problem with transfer pricing. I know that within the last couple of years, the Internal Revenue Service has increased by about 20 percent its staff of international examiners to get at the transfer pricing issue. So, we are convinced that we are working very well with them.

Senator GRASSLEY. Appreciating the necessity for the confidentiality on the part of the Internal Revenue Service, would the Internal Revenue Service have full access to any of the information that comes out of this audit that might be beneficial in determining tax obligation, or tax fraud, or efforts to avoid paying taxes?

Secretary SIMPSON. Senator, I do not know fully what legal restrictions are imposed on us with respect to sharing that information, but certainly to the extent that we are allowed by law to do that, it is in our interest to do it. And we, as I say, have worked with the Internal Revenue Service to share information and coordinate to the extent that the law allows us to.

Senator GRASSLEY. So, there is no turf problems, no bureaucratic nuances that keep full cooperation between the Customs and the IRS—and the information Customs has is being turned over fully to the IRS?

Secretary SIMPSON. Not that I am aware of, Senator. Other than the concern about not violating legal restrictions on disclosing information, I am not aware of any problems.

Senator GRASSLEY. Thank you Mr. Chairman.

The CHAIRMAN. Thank you.

Commissioner HALLETT. Mr. Chairman?

The CHAIRMAN. Yes.

Commissioner HALLETT. Might I make one correction, please?

The CHAIRMAN. Yes.

Commissioner HALLETT. It occurs to me, Senator Riegle, that when I mentioned to you there had been three different audits that I had discussed with the Treasury Department, one of them was, in fact, a ruling, and not an audit.

The CHAIRMAN. All right. I must say, Commissioner, I am looking forward to seeing that memorandum, because I hear you stating on the one side that the Treasury did not—as I understand it—really interfere in your audit, to the extent of trying to change the results. But from the memorandum I read, it sure sounds like you had a completed audit, and that is why I want to see the rest of it that you refer to.

Mr. Simpson, let me ask you. Senator Grassley was talking about transfer prices from the standpoint of taxes paid, and that is an old problem we have had around here with some multi-national companies. But that, of course, also deals with the question of domestic origin, because they can under-price what they have coming in from the company overseas.

Do the rules of origin allow you to also look into the Keiretsu relationship with a company in Japan that might not be the direct parent or subsidiary of a company dealing here? Do they let you get into that, or not?

Secretary SIMPSON. Yes, sir. The so-called——

The CHAIRMAN. That gets more out on the margin, I understand.

Secretary SIMPSON. But the Keiretsu relationship is the sort of situation in which we are most concerned about transfer prices.

The CHAIRMAN. Yes.

Secretary SIMPSON. We are allowed to examine any document or record that we think is relevant to determining the taxable status of goods coming into the United States. The problem sometimes is in compelling production of those records when they are maintained by a party overseas.

Now, our remedy for that is that if the party with whom we are concerned fails to produce those records for our examination, we simply disallow preferential treatment and impose the full rate of duty.

The CHAIRMAN. Well, that certainly is a means of enforcing it. I have no further questions.

Senator RIEGLE.

Senator RIEGLE. Thank you, Mr. Chairman.

Mr. Simpson, there is a book out called "Agents of Influence," written by a man named Pat Choate, and in that book on page number 5, he recounts a situation where there was a Customs ruling—the one that I referred to earlier on whether we were talking about cars or trucks—and that the Customs Department, in January 1989, had ruled that light trucks could not be classified as cars. And there is a quote here from Von Robb at the time explaining why that ruling was made by the Customs Department. Japan was very angry. And this is what it says. Let me read Von Robb's comments so it is all in context.

He is reported to have said, "The vehicles in question are built on truck bodies; they have truck characteristics; most are built in truck divisions; most are built in truck factories. They are advertised as trucks, off-load vehicles, vans, or vehicles that can carry cargo. For years, the Japanese have certified them as trucks when importing them in the United States. Even my grandmother can go in the parking lot and tell the difference between a passenger car and a truck. These are trucks. Japan reacted swiftly. During a January 1989 meeting of the Finance Ministers of the world's seven leading industrial nations, the Japanese Minister of Finance persuaded his German and British counterparts to approach Treasury Secretary Brady and ask for an official reconsideration. Brady swiftly complied. Within 9 days of the Custom announcement, the ruling was suspended. To kill the ruling altogether, Japan's auto lobbyists and representatives of the Japanese government met with officials from the Office of the U.S. Trade Representative, the White House, and the Department of the Treasury . . ." and it goes on in that vein.

I do not know if you know any of that history, Mr. Simpson, but it sounds to me if this account is accurate—and I take it to be accurate—that issues of Customs classifications, in fact, do get raised at the highest levels.

Normally, these G-7 meetings have to with exchange rates, they have to do with whether other countries do or do not buy our securities, capital flows of that kind.

I thought I had heard you say earlier that those kinds of issues do not get juxtaposed in that setting. It sounds to me as if, in fact, they did very specifically in a case very similar to this one.

Secretary SIMPSON. Senator, Mr. Choate's account is not accurate. I do not know how much time you want to spend discussing this, but I not only know the history of this case, I know it very well. In the first place, the issue had nothing to do with trucks. It had to do with the classification of vehicles as either vehicles principally for the transport of persons, or as vehicles for the transport of goods.

Now, one class of vehicles that the Custom Service classified as vehicles for the transport of goods was mini-vans, like the Plymouth Voyager and the Dodge Caravan. These are built on K-car bodies. They are very much like the other passenger cars that Chrysler builds.

They have never before been classified as cargo vehicles, and to the best of my knowledge—and I am a somewhat experienced car shopper—they are not sold as cargo vehicles; they are sold as substitutes for station wagons.

Now, that is a very limited part of the issue that was raised, but I have discussed it with a number of automobile dealers around the country; ordinary people in Iowa and in other places, and I have yet to find anybody who would classify the Plymouth Voyager or the Dodge Caravan as a cargo vehicle. So, I think, Senator, the issue is a little deeper than Mr. Choate recognizes.

Senator RIEGLE. Well, wait a minute. You, by yourself, have said you are dealing with a part of the problem and part of the issue, and not the whole issue here. It certainly is fair to say, is it not, that Von Robb had a different opinion from the Treasury Department?

Secretary SIMPSON. I have never been able——

Senator RIEGLE. Look, you fellows flipped this decision over. The Customs Department came in, they made a finding, and somebody did not like it, and it got changed. We are right in the middle of another one right here. We are right in the middle of another one.

You have found a situation where there has been—my word—cheating. I think it is cheating when it falls below the standard that has been established, and they misrepresent it as found by Mr. Inch and his people.

It is conveyed in the memo that we cannot see, and now there is an effort, it looks to me, to come around the process, come in at the top and try to change it. Lawyers ask for meetings. The Honda people come in, they get a lovely letter of apology as I have cited here earlier, and presumably, the cheating is still going on. It is going on this very day. I mean, you have just told me your audit results have not changed from when that memo was prepared, so it sounds to me like they are cheating us every single day, and we are just kind of plugging along. We are going to get the audit done one of these days.

Let me ask you this, Mr. Simpson. I want to go back to the meeting. How long did the meeting last in Mr. Robson office, Mr. Simpson?

Secretary SIMPSON. I would say, Senator, around 45 minutes or an hour.

Senator RIEGLE. And who represented the Honda side?

Secretary SIMPSON. Mr. Yushido, Mr. Wallison, Mr. Harrison, and two other executives from Honda.

Senator RIEGLE. What did they ask for?

Secretary SIMPSON. They asked for a public clarification of the fact that the Customs audit was not complete. I am sorry. They asked for a clarification of the fact that the Customs Service audit was not complete, and that there had not been a final determination that Honda owed Customs duties.

Senator RIEGLE. So, is that what then, in turn, caused the Treasury to send the message to Ms. Hallett to write this letter?

Secretary SIMPSON. Yes, sir.

Senator RIEGLE. So, this letter really came at the request of the Treasury Department from this meeting?

Secretary SIMPSON. To be fair to Commissioner Hallett, I think we all believed it was the right thing to do.

Senator RIEGLE. Well, it may have been, or may not have been. But the point is the idea to go ahead and send a letter of some chagrin and apology to the Japanese manufacturers came out of that meeting, is that right?

Secretary SIMPSON. Yes, sir.

Senator RIEGLE. And then do you know who delivered the message to Ms. Hallett to get a letter written, was that you, or somebody else?

Secretary SIMPSON. No, I am sorry, I do not recall. It very well may have been Deputy Secretary Robson.

Senator RIEGLE. Himself.

Secretary SIMPSON. I just cannot recall.

Senator RIEGLE. What other understandings were reached in that meeting?

Secretary SIMPSON. The Honda people asked that a fair and impartial review be undertaken of some of the issues that had been raised by the audit, which, of course, we promised to do, and we would have made that promise in any circumstance. We like to think that is what we always do.

Senator RIEGLE. Why do you suppose they did not go see Ms. Hallett?

Secretary SIMPSON. I think you will have to ask Honda.

Senator RIEGLE. Well, I am asking your opinion, though. Would that not have been the logical place to go? She is in charge of the audit operation.

Secretary SIMPSON. I have no idea, Senator.

Senator RIEGLE. But would that not have been the logical place to go?

Secretary SIMPSON. I——

Senator RIEGLE. Did they ever come to see you, Ms. Hallett? Did Mr. Wallison ever call you and ask to come by and talk, and bring the Honda people in and say that maybe you are being a little too tough on them, or——

Commissioner HALLETT. No, Senator.

Senator RIEGLE. None of that. So, they went around you. They went up a notch, and they went right to the Treasury Under Secretary. They got a meeting with him, and out of that meeting then came an understanding that there would be a letter sent to Honda

to make them feel a little better, and then somebody called you and asked you to write it. Who was it that called and asked you to write the letter?

Commissioner HALLETT. Someone contacted me from the Deputy Secretary's office.

Senator RIEGLE. It was not Mr. Robson, somebody on his behalf?

Commissioner HALLETT. I honestly, Senator, do not recall. But there was a discussion that——

Senator RIEGLE. What was said, do you recall?

Commissioner HALLETT. Simply that it would be appropriate to send a letter of apology, because this is not our normal practice to release this kind of information to the press before an audit is complete. And, in addition to that, that we were unaware of anyone who had released it to the press.

Let me just follow up on that, if I may, Mr. Chairman. I know the time is up, but I think it is important just to point out with respect to the 50 percent rule, and particularly domestic content, that there are a number of different things that are up to interpretation, and often it is a matter of interpretation with respect to, let us say, the interest that is charged, or anything else that can cause the 50 percent to go either way. And that is certainly not construed as cheating, but it is, in fact, an issue that is discussed and, in fact, reviewed in an audit. And then, if we believe that there is an investigation that is necessitated after the audit is complete, that is when we then send our investigators in.

Senator RIEGLE. Well, Ms. Hallett, if I may just proceed just for a minute. Mr. Inch, I take you to be an auditor by background and a financial person by background, and you obviously take your work very seriously.

Mr. Inch has made a representation to the committee today that the work he has done in the months since has not changed his findings. The findings have not varied, is that not correct, Mr. Inch? Did I not hear you say that earlier?

Mr. INCH. Yes, sir.

Senator RIEGLE. Now, in your memo that is quoted, it indicated that you were finding the level to be about 38 percent, is that not accurate? Is that accurate, Mr. Inch?

Mr. INCH. I am concerned about commenting, sir, because of the previous information——

Senator RIEGLE. All right. Well, let me not ask you. Is that what is in the memo? Ms. Hallett, let me ask you. Is that what is in the memo?

Commissioner HALLETT. Senator, I cannot tell you whether that is in the memo, because I did not read the memo today, because I do not feel that it is appropriate for me to discuss it in public. I have indicated to the Senator I will share it in a confidential form with the chairman and the members following the meeting.

Senator RIEGLE. Well, after that is done, it will be my effort to try to persuade the committee to make it public, because I think it ought to be public.

You are public officials, and these are public issues. And they ought to be out in the full public view, particularly given the patterns and the history that we have already talked about today.

You have got a top responsible auditor who sat at this table today and said that the findings that he is generating today are no different than they were at the time this memo was presented. You have not disputed the accuracy of the quote that we do have out of that memo that you were planning to "begin immediate action to collect $20 million in duties for vehicles imported in the United States in 1989 and 1990." Now, that is money that is owed this country, and the taxpayers of this country. And we have certification today from this auditor that his results have not changed since then.

Now, I do not want the results manipulated and altered because some lawyer comes through a side door, a back door, and who talks about reclassification of this or that, or how you change these factors, and so forth. And all of a sudden, magically, 38 percent goes up to 50.1 percent. And these folks are off the hook for the money they owe us for the cheating that has already gone on. I think you have got to understand what your task is here, and that is to enforce these laws vigorously. Vigorously. I do not see you doing that, quite frankly.

Commissioner HALLETT. Senator, I am very proud of my record of enforcing these laws——

Senator RIEGLE. Well, you should not be on this issue.

Commissioner HALLETT. And as soon as this audit is complete, we will share with Honda the outcome. But let me say, let us use Honda or any other company, in this case or in any other case. If, at the end of the audit, an investigation goes forward by our Enforcement Office and they ultimately find that, in fact, they have not met the 50 percent in this case, or any other case, no matter when that is handed down, the full duty—and let us say it was American Motors that was involved—the full duty would still be required. It is not going to change when an amount is paid based on whether it is done today, but certainly it cannot be done before an audit is complete.

Senator RIEGLE. Have you been asked before by Mr. Robson or anybody else over at the Treasury Department to send an apologetic letter to a foreign company? Has this happened before, or is this the only time it has happened?

Commissioner HALLETT. To my knowledge, in the short time that I have been there, this is the only time it has happened.

Senator RIEGLE. Well, you have been there a year and a half, right?

Commissioner HALLETT. Yes.

Senator RIEGLE. All right. So, in the year and a half you have been asked to send one letter, and this is it, is that right?

Commissioner HALLETT. Well, I have never had this happen before where any——

Senator RIEGLE. I understand. I know——

Commissioner HALLETT [continuing]. Internal memo was leaked to the press of this nature with sensitive information.

Senator RIEGLE. So, the only time you have been asked by the Treasury Department to send an apologetic letter was this case, is that correct?

Commissioner HALLETT. In this particular instance.

Senator RIEGLE. Yes. Very good.

The CHAIRMAN. All right. Thank you, Senator.

Senator Rockefeller.

Senator ROCKEFELLER. Mr. Chairman, I do not have any questions to ask, but I do want to say this is an extremely important hearing. I regret that I was at the Commerce Committee at a markup, and the chairman will understand why I was not here.

The CHAIRMAN. Because I had the same problem.

Senator ROCKEFELLER. Right. I do not know what the conclusions of this hearing, or what comes after this hearing will provide, but if there is any sense that the Customs Service has been less than diligent, or a sense that any pressure is being exercised by anyone within the administration, obviously then very swift congressional action is warranted.

This episode certainly makes you question whether the rules of origin established in the Free Trade Agreement with Canada are adequate and appropriate. If we were to have problems like this with Canada, I would think we would certainly have a lot more problems with Mexico.

And then, Mr. Chairman, in conclusion, that if there is anything to this, it cannot help but reflect on our bilateral relations with Japan. Our trade deficit may shrink just a little bit this year; that is yet unclear.

But our exports to Japan that are increasing are those that probably do not reflect our real economic strength, and that is food, wood, and primary products.

On the other hand our trade balances for those that really are important in terms of trends or manufacturing products are growing worse. And, in fact, auto and auto parts is the largest part of that deficit.

The extent to which this is happening is a legitimate trade question, and I will be pursuing it in its after-life, so to speak, as I know the Chairman would want me to do. I thank the Chairman for his indulgence.

The CHAIRMAN. Thank you. Well, Commissioner, the very strong impression from that memorandum is that Treasury exerted influence to try to turn you around, or to stop the imposition of penalties. You make the point in your memorandum that "we have determined that Honda has failed to meet the requirements for free tariff treatment," and then you go on to state, "to begin action immediately to collect the $20 million from Honda for duties owed for 1989 and 1990," and that is why it is critical that I see that memorandum that you offered to provide me.

And the other point that has to be of some concern, it seems to me, is that as I understand it, Canada has laid out the specific standards to be used by its auditors, and our understanding is that the Customs Service still has not clarified how it should measure different costs. Now, where are we on that?

Commissioner HALLETT. Mr. Chairman, we are in the process now of going forward, and I believe, as Mr. Simpson stated, we are now ready to go forward in the Federal Register, and so it has just been a matter for waiting for certain decisions to be reached, and it will be very shortly that that will go forward in the Federal Register.

The CHAIRMAN. But that was what you were referring to, specifically, when you made your comments earlier?

Mr. SIMPSON. Yes, sir.

The CHAIRMAN. All right. If there is nothing further, thank you very much for your attendance.

Commissioner HALLETT. Thank you, Mr. Chairman.

[Whereupon, the hearing was concluded at 12:40 p.m.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED

PREPARED STATEMENT OF SENATOR CHARLES E. GRASSLEY

Thank you Mr. Chairman. Let me begin by commending you for holding this hearing this morning on an issue of vital importance to the economic well being of this nation.

Like most of my colleagues I have had an opportunity to read the New York Times and Wall Street Journal articles highlighting the Customs Service investigation of tariff cheating by the Japanese owned Honda Motor Company. From the article it is apparent that not only was an attempt made to circumvent the country-of-origin rules to avoid making tariff payments, but to add insult to injury we're advised that the auditors have uncovered a pricing policy that has all the earmarks of "dumping" autos and parts into the United States at a sustained loss to gain market share.

Mr. Chairman, to date we have agreed to two free trade agreements . . . . one with Israel and the other with Canada. Just last month we gave the administration fast track approval to enter into a free trade agreement with Mexico. While I do not have a problem entering into any agreement in which both parties obtain mutual benefit . . . . I do have serious reservations when an agreement puts the United States at a disadvantage through loopholes in which third party countries skirt the rules of the game.

We can not afford to lose revenue, jobs, and market share to companies or countries who have no regard for our national well being. Khrushchev as we recall threatened the United States by stating he would bury us. While that threat has diminished from the Soviets, it is more apparent that this threat still exists when we allow other countries to take advantage of our national security by circumventing our trade laws, avoiding the payment of duties owed, threatening our industrial base by targeting certain markets at below cost-to-gain market share, and having total disregard for the American workers who will lose their jobs as a result of such action.

Mr. Chairman, the New York Times article reported Honda owes $20 million dollars in duties for vehicles imported in 1989 and 1990. If this is true, it is criminal and we need to have the full weight of the United States Government behind the Customs and Treasury departments to collect these duties and put a halt to dumping into this country.

I will be most interested in the comments of our witnesses today on this subject. No longer can we tolerate such behavior for the sake of foreign and diplomatic policy. The American taxpayer deserves better, the people in government who are working to insure trade agreements are adhered to deserve better, and clearly the American worker who is trying to make ends meet to take care of his or her family deserves better. American workers and manufactures can compete with anyone on the face of the earth if we are all playing by the rules of the game . . . that Mr. Chairman is fair trade. We can not afford, however, to have our industrial base eroded by those who will use what ever means necessary . . . legal or illegal . . . to gain market share without any concern for the American worker, manufacturer, or our country's economic well being.

Thank you Mr. Chairman.

PREPARED STATEMENT OF CAROL HALLETT

INTRODUCTION

Thank you Mr. Chairman and members of the committee for the invitation to discuss your interest in Customs Regulatory Audit activities and Customs enforcement of the Canadian Free Trade Agreement.

As explanatory background, the Office of Regulatory Audit is part of the Office of Commercial Operations and presently has approximately 300 auditors, who operate out of 25 field locations and the Washington headquarters office. Its mission encompasses auditing a host of international trade programs such as the Canadian Free Trade Agreement, the Caribbean Basin Initiative, and the Generalized System of Preferences—all of which provide preferential duties to eligible imported merchandise. In addition, regulatory audit is responsible for auditing the activities of customs brokers, drawback claimants, foreign trade zone operators, and other members of the importing community, to ensure the protection of the revenue with regard to imported merchandise. Its focus, therefore, covers a wide range of complex and technical issues involving classification, valuation and origin.

On average, the Office of Regulatory Audit conducts approximately 500 audits each year. These audits generally result in a recommended revenue recovery of $66 million in duties with corresponding penalties of approximately $95 million in 1990.

PLANNING PROCESS

Due to the vast number of potential audit candidates and our limited resources, the Office of Regulatory Audit uses an elaborate planning process to develop a national audit plan. That process includes an analysis of the number of hours necessary to complete an audit and the number of man hours available. The goal of regulatory audit is to assess which major importers have the highest risk of violating the law, and to audit these high risk importers once every 5 years.

A formal selection process is used to identify audit candidates for inclusion in the National Audit Plan. The selection of candidates is based upon referrals, suggestions, and other factors developed by Regulatory Audit. Because of the ever-increasing number of importers and the volume of Customs entry workload, Regulatory Audit must rely on targeting and selectivity concepts to ensure the most effective use of its resources. The following criteria are used to calculate risk:

1. Whether the importer is new;
2. Whether a large established importer has been audited in the past;
3. Type of merchandise;
4. Country of origin;
5. Whether changes in existing trade benefits have occurred or new trade programs been enacted;
6. Whether audits of other companies contain evidence which indicate the likelihood of a loss of revenue or violations of law; and
7. Whether information developed through other Customs disciplines (e.g. import specialist) necessitates an audit of company business documents.

THE AUDIT PROCESS

The Office of Regulatory Audit places special emphasis on the professionalism of its audits. Regulatory Audit recognizes that cooperation and coordination with the auditee are necessary for a quick and successful completion of the audit. From the pre-audit planning stage to audit completion and report finalization, Regulatory Audit establishes and maintains a line of open communication with company representatives.

Once a company is selected for an audit, company officials are notified orally and in writing of the audit, its purpose, and preliminary requirements for record and document availability. An opening conference is held with company officials in which the scope of the audit, its objectives, and methodologies are articulated. 19 USC 1508, 1509, and 1510, provide Customs with the authority to review all financial, accounting, and inventory records relating to specific Customs transactions. In accordance with law, it is Customs policy to safeguard confidential business information obtained in the course of its audit activities from unauthorized disclosure. At any time during the audit process the company or the Office of Regulatory Audit may seek legal advice. Upon completion of the audit, and the closing conference with company officials, the office of regulatory audit then issues a confidential audit report. This report is maintained by Customs and provided to the auditee upon request if no violation of law has been uncovered. If there is a suspected violation of

law, then the Office of Regulatory Audit refers the matter to the Customs Office of enforcement for investigation.

In general, the entire audit process is one which requires effective coordination between various disciplines within Customs, and at times the Department of the Treasury, to ensure the accurate application of Customs laws and regulations.

Although I have presented a simplified version of our audit process, I hope that I have adequately illustrated the areas of responsibility and the uniform procedures employed to ensure compliance with the regulations and laws which govern the activities of the importing community.

I realize that the major focus of this hearing today is Customs enforcement of the United States-Canada Free Trade Agreement. I would like to briefly discuss the role of regulatory audit in enforcing the Free Trade Agreement. As you are aware, the United States-Canada Free Trade Agreement went into effect on January 1, 1989. The agreement, simply stated, allows merchandise that is wholly produced in the United States and/or Canada to enter either country under preferential tariffs. In addition, merchandise which incorporates third-country materials may also obtain preferential treatment if the materials have been changed in the United States or Canada in a manner resulting in a specified change in tariff classification under the harmonized tariff schedule. In certain cases, the agreement requires goods containing third country materials to contain at least 50% North American content in order to qualify for preferential duty treatment. In other cases, such as automobiles, the FTA rule of origin requires that the merchandise undergo a tariff classification change illustrated by a heading shift in the harmonized code and that 50% of the cost of the merchandise be North American.

In the case of the automotive section of the Free Trade Agreement, the rules of origin were intended to be tougher than under the United States-Canada Auto Pact. In fact, the stricter FTA rule of origin for automobiles was intended to benefit United States and Canadian auto parts manufacturers. The statement of administrative action states that the use of the stricter FTA rule "will ensure that importers of third-country parts cannot use . . . the FTA to circumvent our most favored nation tariffs." In addition, the statement of administrative action also states that "the administration is committed to effective enforcement of the more rigorous rule of origin in the FTA, through rigorous audit and inspection procedures. . ."

With this as a guiding principle, Customs has sought to enforce the agreement. Customs has the responsibility for preparing a multi-year plan for enforcement of the FTA with emphasis on the automotive sector. This plan, augmented by Customs regulations, requires regular cost submissions from Canadian producers of automotive products. Based on these cost submissions and figures contained in annual vehicle cost reports of North American content, customs is required, by the statement of administrative action of the Canadian Free Trade Agreement, to use its regulatory audit resources to target firms having the greatest likelihood of not meeting the origin requirements.

In the course of pursuing these enforcement efforts, certain technical issues have arisen concerning the application of the FTA rules of origin. Customs is currently working with Treasury officials, and our Canadian counterparts, to address these issues so that audits which are in progress can be completed in an expeditious manner.

I can assure you that the Customs Service takes very seriously its responsibility to effectively enforce the United States-Canada Free Trade Agreement.

PREPARED STATEMENT OF JOHN P. SIMPSON

Mr. Chairman: I am pleased to join my colleagues this morning to discuss with you administration of the United States-Canada Free Trade Agreement. This hearing is particularly timely in that we are now beginning negotiation of a North American Free Trade Agreement that will be based on our free trade agreement with Canada.

In order to discuss how the United States-Canada Free Trade Agreement works with respect to trade in goods, and specifically how rules of origin operate, it may be useful to review briefly some earlier U.S. trade laws. Over the last twenty-five years, Congress has enacted several laws that require goods entering the United States to be treated differently according to their national origin. Some of these laws impose penalties or restrictions, for example, trade and financial sanctions, quotas, or special higher duties. Other laws extend preferential treatment, for example, the Generalized System of Preferences (GSP) the Caribbean Basin Economic Re-

covery Act (commonly referred to as the Caribbean Basin Initiative, or CBI), and the United States-Israel Free Trade Agreement.

Congress has consistently made clear its interest in seeing these laws administered in a manner that achieves the objectives Congress intended. Goods produced in countries on which sanctions have been imposed should not avoid those sanctions. On the other hand, where Congress has extended special benefits to products of certain countries, those benefits should be extended only to goods produced in the countries Congress intended to benefit, and should not slip over to products of nonbeneficiary countries.

Administration of these laws is relatively easy when dealing with goods that originate wholly in a country that is the target of sanctions or the recipient of benefits. An example of this is agricultural products grown in that country's soil or minerals extracted from its mines. However, administrative problems are greater when a target country's products are further manufactured in another country, or when a target country further manufactures the products of a non-target country. We do not want a country subject to sanctions to circumvent those sanctions by having its products subjected to superficial processing in another country. Nor do we wish to see countries to which we have not extended preferential treatment effectively enjoy those benefits by having their products superficially processed in a beneficiary country.

Consequently, in order to achieve these objectives, we have adopted a policy that products of a country *remain* products of that country unless they undergo processing in another country that results in a substantial change in their character, or, as our courts have said, a substantial transformation.

Until enactment of the United States-Canada Free Trade Agreement in 1989, Congress never provided specific rules for defining substantial transformation. Traditionally, substantial transformation has been defined on a case-by-case basis by the U.S. Customs Service, using principles developed in opinions issued by our courts. Such an approach is necessarily highly subjective and the results have been inconsistent. Moreover, the courts have occasionally issued opinions, particularly some involving imports of iron and steel products, that appear to many to be in conflict with the intent of Congress in enacting laws regarding iron and steel trade.

It was apparently in an effort to guard against origin determinations that fail to meet its expectations that Congress, in enacting laws granting tariff preferences, introduced a new criterion for identifying products of a beneficiary country: a value-content requirement. The value-content requirement may set a ceiling on the value of nonbeneficiary-country materials contained in a product—examples of this are found in the insular possessions preference law and in the Automotive Products Trade Agreement with Canada—or the value-content requirement may set a minimum value for beneficiary-country materials and labor contained in a product, as is the case with GSP, CBI, and the United States-Israel Free Trade Agreement.

In 1987, when we began negotiation of a free trade agreement with Canada, we recognized the need to devise a better method for defining the term "substantial transformation" for the purpose of identifying goods qualifying for preference under the FTA. For many reasons that I shall not go into here, we rejected the idea of defining substantial transformation on the basis of value added or value content. Instead, we borrowed and, I believe, improved on, a European idea of defining substantial transformation in terms of change in tariff classification.

Substantial transformation defined by tariff classification change is the primary basis for determining the origin of goods under the United States-Canada Free Trade Agreement. However, for a limited number of product sectors the FTA does require in addition to a change in tariff classification that at least half of the cost of producing goods eligible for preference be attributable to the value of United States and/or Canadian materials and labor. We imposed this requirement only where the Harmonized system was insufficiently detailed to support construction of a rule of origin based on tariff classification, or where a particular industry insisted on having a value-content requirement.

One of the product sectors where we included the supplemental value-content requirement is the automotive sector. Our previous experience with preferential trade in automotive products was the Automotive Products Trade Agreement, or APTA. As implemented by the United States, APTA allowed duty-free access for automobiles and certain automotive parts provided that not more than 50 percent of their value was attributable to foreign materials.

There was fairly widespread dissatisfaction with the APTA rule because it was believed not to require a sufficiently high level of United States or Canadian content. One of the reasons for this was that there was no restriction on what could be counted as United States or Canadian content. Because of this, items such as profit,

advertising and sales promotion, administrative costs, and executive incentives could all be counted as Canadian content. This reduced the need to utilize actual Canadian or United States parts and labor.

Consequently, a primary objective in drafting the free trade agreement with Canada was to strengthen the rule of origin for automotive products. We did this in several ways. First, we scrapped the APTA approach to value-content, which merely places a limit on foreign content, and replaced it with a positive requirement for United States and Canadian materials and actual labor, which was the approach we had used in GSP, CBI, and the United States-Israel FTA. This effectively disallowed counting profit, sales promotion and like costs as qualifying content.

And second, we reduced the inconsistency of results that the GSP/CBI type of value-content requirement produces by substituting total cost of manufactu ring in place of Customs value in the denominator of the equation. This means that regardless of changes in shipping costs or profit levels the denominator stays the same.

Finally, we raised the qualifying threshold from the 35 percent used in GSP/CBI to 50 percent. The result was a value-content requirement that was substantially more rigorous than that provided by APTA. As an aside, I might note that we are seeking to have this requirement increased to 60 percent if the value-content test is left in its current form.

It goes without saying that our experience with GSP and CBI did not adequately prepare us for a free trade agreement involving trade of the magnitude and complexity that we have with Canada. This is particularly true for automotive trade. Many of the principles and procedures that work well in trade with Caribbean countries are inadequate automotive trade between the United States and Canada. We are learning some of these lessons from our audits of companies doing business under the FTA. We are benefitting from this experience and we are applying the lessons we are learning both to seek modifications to our free trade agreement with Canada and to devise improved rules for the NAFTA.

In the meantime, we shall need to sort out problems that we discover, either through our audits or through other means, and take appropriate corrective action. And in doing that we shall need to distinguish between problems that result from a manufacturer's failure to comply and problems that result from shortcomings of the FTA itself.

I know the Committee has a particular interest in Treasury's role in Customs enforcement of the FTA. Treasury has both a policy making and oversight responsibility with respect to Customs issues, including its enforcement activities. We in Treasury are very supportive of Customs enforcement activities, and especially of Customs' efforts to enhance its commercial enforcement capabilities, particularly its audit function. We work collaboratively with Customs on enforcement matters, especially when such matters involve important or precedential policy issues. Because our experience in administering the United States-Canada Free Trade Agreement will undoubtedly influence our negotiation of a North American Free Trade Agreement, we are especially interested in having Customs bring to our attention any audit matters that appear to raise broad issues.

Thank you.

COMMUNICATION

POST-HEARING STATEMENT OF
AMERICAN HONDA MOTOR CO., INC. AND
HONDA OF AMERICA MFG., INC. RELATING TO THE
JULY 30, 1991 HEARING ON ENFORCING RULE OF ORIGIN
REQUIREMENTS UNDER THE U.S.-CANADA FREE TRADE AGREEMENT

This statement is filed on behalf of American Honda Motor Co., Inc. and Honda of America Mfg., Inc. in connection with the Senate Finance Committee's July 30, 1991 hearing on issues relating to the United States Customs Service's determination on "origin" issues under the United States-Canada Free Trade Agreement ("FTA"), and particularly the so-called "Honda FTA audit" issues. The Honda FTA audit involves the FTA qualification of automobiles manufactured by Honda of Canada Mfg. in Alliston, Ontario, and imported into the United States by American Honda. (American Honda, Honda of America Mfg. and Honda of Canada Mfg. are sometimes referred to collectively as "the Company" or as "Honda.")

The Committee's hearing followed a June 17, 1991 New York Times article that quoted statements and information from what was described as a confidential Customs Service memorandum, and which has led to numerous misstatements in the press and elsewhere unfairly damaging Honda. The Committee Chairman raised some of the same questions that Honda has concerning statements quoted in the New York Times article -- for example, how to square the article's quotations with what the Customs Service has told Honda privately and publicly, that is, that the Honda FTA audit is not complete, that the necessary field work has not even been finished, and that no final determinations have been made. Certain other comments at the hearing, however, involved distortions of, or a disregard for, the facts, and unwarranted attacks on the reputation of Honda and its officials. To clarify the record, this statement deals with four points:

(1) The Customs Service has confirmed both publicly and privately that the Honda FTA audit is not complete, and that no decision has been made on whether the Honda cars manufactured in Canada qualify under the FTA.

(2) The leak of the Customs Service confidential memorandum breached both the Service's written commitment to the Company and a confidentiality legend stamped on all Company business confidential information provided to the auditors, and also violated a federal criminal statute.

(3) Honda is concerned about the extent to which it can expect to achieve a fair determination in the FTA audit, particularly given the absence of any substantive guidance on the origin rules in the Customs Service regulations and the continuing prejudicial atmosphere, as reflected by certain comments made at the Committee's July 30, 1991 hearing.

(4) The actions of Honda and its representatives in response to the illegal, unauthorized and highly prejudicial and unfair release of confidential business information reflected in the June 17, 1991 New York Times article were entirely appropriate and reasonable.

Background on Honda's North American Manufacturing Operations and FTA Audit Experience

Before turning to these four points, however, it would be helpful to understand (a) the nature and extent of Honda manufacturing operations in North America, and (b) the FTA origin rules and Honda's experience with FTA audits conducted by the United States and Canadian Customs authorities. Both points were addressed in a brief that was recently filed on Honda's behalf in connection with upcoming hearings by the Trade Policy Staff Committee, which brief also included Honda's recommendations for improvement in tne NAFTA. Accordingly, a copy of this brief is included as Attachment A to this statement. As detailed in this attachment:

1. Honda's North American Manufacturing Operations

-- Honda has major manufacturing operations in North America, involving a total investment exceeding $2.8 billion, and facilities including (1) two automobile manufacturing plants located near Marysville and East Liberty, Ohio, (2) an automobile manufacturing plant in Ontario, Canada, (3) a motorcycle manufacturing plant near Marysville, Ohio, (4) an engine plant in

Anna, Ohio (which plant also manufacturers drive trains, suspensions, and related components), (5) a plant to manufacture lawn mowers and engines in Swepsonville, North Carolina, (6) a plant near Guadalajara, Mexico that produces automobile service parts, motor scooters, and motorcycles, and (7) major research and development and production engineering activities based in the United States.

-- Honda's North American manufacturing operations reflect Honda's longstanding philosophy to manufacture its products in the markets where the products are sold, a philosophy that resulted in Honda's initiation of United States motorcycle manufacturing in 1979, United States automobile manufacturing in 1982, and United States engine manufacturing in 1985.

-- Honda's Ohio and Canadian automobile manufacturing operations are among the most integrated in the world, involving stamping of all major body panels (using American-made steel), injection molding of plastic parts, sophisticated and automated welding operations, and state-of-the-art painting facilities. Similarly, the operations at Honda's Ohio engine plant (involving a total investment of over $600 million) include aluminum casting of the engine blocks, cylinder heads and pistons from aluminum ingot; ferrous casting of other engine parts; and sophisticated aluminum machining and ferrous machining operations.

-- Honda is a major purchaser of OEM parts and materials from United States suppliers, purchasing approximately $3.0 billion in these parts and materials from more than 230 United States/Canadian suppliers in 1990.

-- Honda is a leader in exporting automobiles from the United States; in 1991 a total of approximately 30,000 United States-manufactured cars will be exported to 11 countries, including Japan.

2. The FTA "Origin" Rules and the Honda FTA Audits by the United States and Canadian Customs Authorities

-- After the FTA became effective January 1, 1989, FTA claims were made both for Honda automobiles, motorcycles, and lawn mowers manufactured in the United States and exported to Canada, and for Honda automobiles manufactured in Canada and exported to the United States.

-- The FTA "origin" rule for all of these products is cost based, and basically requires that 50 percent of the total value of the materials and "direct cost of processing" to manufacture the goods originate in the United States or Canada.

-- When the FTA became effective, Revenue Canada had supplemented the FTA origin rule with detailed written administrative guidance on its operation, had centralized authority for origin determinations in a special "Origin Determination Directorate," and had developed a number of detailed "origin questionnaires" and other specific procedures to conduct FTA audits.

-- The Customs Service, by contrast, had provided no substantive guidance to the FTA origin requirements in its regulations, had no special audit procedures or organization to resolve origin issues, and had no standard questionnaire or specific guidance for FTA audits.

-- In 1989 and 1990 Revenue Canada conducted separate FTA audits of Honda motorcycles, Honda automobiles and Honda lawn mowers exported from the United States to Canada. These audits were based on each company's submission of a response to Revenue Canada's detailed origin determination questionnaire. In each case the Honda products were found FTA qualified. The Revenue Canada audits involved an open process with access to the decision makers, the FTA determinations were arrived at in a professional and efficient manner, and none of the Company's business confidential cost and other information was leaked to the press or to the public.

-- The United States Customs Service's FTA audit of Honda automobiles manufactured in Canada during the period January 1989 through March 1990 began in April 1990, as the Service's first FTA audit of an automobile manufacturer and only its second FTA audit of any company. Notwithstanding the Company's full cooperation, the audit has been hampered by the lack of regulations interpreting the FTA origin rules, the auditors' resulting uncertainty on how to interpret these rules, a refusal by Headquarters personnel in Washington to meet with the Company to discuss and resolve these issues, and the June 17, 1991 publication of internal Customs documents including Company confidential information, illegally leaked to the press.

Discussion

1. The Honda FTA Audit is Not Yet Complete, Notwithstanding Honda's Full Cooperation

As the Commissioner of Customs stated at the Committee's July 30, 1991 hearing, the Honda FTA audit is not complete, and no determinations have been made as to whether Honda cars imported from Canada qualify under the FTA. These points were confirmed in a June 24, 1991 letter from the Commissioner of Customs to the President of Honda of America Mfg. (a copy of which letter is included as Attachment B). Indeed, the local Customs auditors have advised that they have not even completed their field work, nor begun to write the report that would be the basis for the audit results.

It should be added that Honda has also provided to the Customs Service 12 major factual submissions, hosted on-site audit visits lasting a total of 31 business days, and committed over 11,000 hours of time by more than 100 Honda personnel.

2. The Leak of the Customs Service Memorandum was a Breach of Law and Confidentiality Commitments Made to the Company

As is apparent, the Honda FTA audit involved sensitive, confidential cost and other business information. Accordingly, at the outset of the audit the Company raised with the auditors its concerns with the protection of this confidential information. The result was a May 10, 1990 letter from the Regional Director of the Regulatory Audit Office in Boston stating that the Customs Service would "to the maximum extent permitted by law, protect the confidentiality of documents submitted to it." Further, pursuant to a recommendation made in the Director's May 10, 1990 letter, each and every page provided to the FTA auditors on which Company business confidential cost or other information appeared was stamped with a confidential legend.

Nonetheless, Customs materials containing confidential cost information were leaked to the New York Times. In addition to breaching the representations in the May 10, 1990 letter, this involved a violation of the federal criminal law in 19 U.S.C. § 1905, which makes it a crime for any officer or employee of the United States to disclose or make known in any manner confidential information obtained during a Customs Service audit. In her June 24, 1991 letter to the Company, the

Commissioner of Customs expressed regret at this illegal and unauthorized disclosure, noting that it was also inconsistent with the Service's interest in obtaining company confidential information during an audit.

The Company remains very concerned about this issue. The Company believes that this situation should also be of great concern to the Committee, not only because of the unfair impact on Honda but also because of the negative implications for the Customs Service's ability to do its job.

3. The Lack of Clear Rules and the Atmosphere Surrounding the Honda FTA Audit Jeopardize the Company's Right to a Fair Determination

The Company is fundamentally concerned about its ability to get a fair determination in the Honda FTA audit, particularly given two circumstances.

The first circumstance, as indicated above, relates to the lack of clear guidance in the Customs Service's regulations on interpretation of the FTA origin rules. The Service's "interim rules" (published on December 24, 1988, one week before the FTA went into effect) do no more than restate the FTA language. This is so notwithstanding Article 2102 of the FTA, which requires the United States (and Canada) to "publish in advance and allow opportunity for comment on any law, regulation, procedure or administrative ruling of general application that it proposes to adopt respecting the matters covered by this agreement." This requirement is consistent with that in the United States Administrative Procedure Act, 5 U.S.C. § 553, which similarly recognizes that those affected should be given reasonable opportunity to comment on and have guidance from federal regulations and practices. The absence of such guidance makes it difficult for companies to determine that their products satisfy the FTA origin rules, and can also permit arbitrary and unfair actions.

A second reason for concern relates to the atmosphere created by the misstatements concerning the Honda FTA audit. Those who may be interested in "penalizing" companies, particularly those that are foreign-affiliated, and who may lack concern for fairness or for the facts can create circumstances in which public officials are pressured to reach a "politically acceptable" result. Such a circumstance would be fundamentally unfair and unjust.

4. The Actions of the Company and of its Representatives have been Appropriate and Reasonable

A final point concerns charges or suggestions at the hearing that the Company and its representatives somehow acted improperly to affect the substance or process of the Customs Service's Honda FTA audit. These charges or suggestions are false.

Honda and its representatives had absolutely no contact with Treasury Department officials on Honda FTA audit issues prior to the published media report of the leak on June 17, 1991.

As indicated above, on June 17, 1991 the New York Times published an article based on an allegedly confidential Customs Service memorandum that discussed the Honda FTA audit. In addition to seriously misstating the status of the audit, the article also included business confidential cost and other information. Subsequent press reports further distorted the facts and made false and damaging statements about Honda's actions and the circumstances of the audit. (Included in Attachment C are headlines that appeared in the world press immediately after June 17, 1991.)

Honda representatives approached Treasury Department officials after June 17, 1991 only after unsuccessful efforts to discuss these very serious matters with Customs Service officials. On June 17, 1991, the day that the New York Times article appeared -- and the first day that Honda or its representatives heard of the documents referred to in that article -- at the request of the Company, the Company's legal representative attempted to discuss these matters with senior Customs Service officials. These efforts included a letter that was hand-delivered to the Commissioner of Customs, and a telephone call to the Commissioner's office. In response, the Company's attorney was called by a regional auditor, who stated that he was responding to those communications to the Commissioner and to any other Customs Service officials, although he could not provide specific information on the documents referred to in the New York Times article.

Only after the refusal of the Customs Service to respond to the New York Times article did the Company's legal representatives seek to meet with Deputy Treasury Secretary Robson. The meeting was not concerned with any substantive issues raised in the Honda FTA audit, but reflected Honda's concerns with (1) the status of the audit, (2) the breaches of Company confidential data, and (3) obtaining a fair determination given the circumstances. The meeting did not involve any discussion of the merits of Honda's FTA claims.

In short, the Company responded to an alarming situation in which misinformation concerning the status of the Honda FTA audit and related issues had resulted in claims in the media and elsewhere that were totally false and damaging to Honda's good reputation. Those questioning the Company's actions in defending its good name should wonder how they would react were the same circumstance to happen to a major American company in Japan or another foreign country. Who would deny the right, indeed the obligation, of the company to act promptly to clarify the record and defend its confidential information and its good name?

* * *

Honda appreciates the opportunity to present this statement to the Committee.

August 19, 1991

9513H

ATTACHMENT A

BEFORE THE
TRADE POLICY STAFF COMMITTEE

Re: Hearings on North American Free Trade Agreement Negotiations

BRIEF OF AMERICAN HONDA MOTOR CO., INC. and HONDA OF AMERICA MFG., Inc.

This brief is filed on behalf of American Honda Motor Co., Inc. and Honda of America Mfg., Inc. (collectively sometimes referred to as "Honda") in response to the July 16, 1991 Federal Register notice of the Trade Policy Staff Committee's ("TPSC's") public hearings concerning the North American Free Trade Agreement ("NAFTA") negotiations. American Honda is the distributor of all Honda products in the United States, including Honda automobiles, motorcycles, and power products. Honda of America Mfg. is an Ohio manufacturer of Honda automobiles, motorcycles, and automobile and motorcycle engines.

As detailed below, American Honda imports a limited number of automobiles manufactured by Honda of Canada Mfg. in Alliston, Ontario, and some of the motorcycles, automobiles and automobile engines that Honda of America Mfg. produces are exported to Canada. In each of these cases, entries have been made under the provisions of the United States-Canada Free Trade Agreement ("FTA"). Based on its experiences with these FTA operations, American Honda and Honda of America Mfg. have comments on one of the five issues as to which the TPSC particularly invited comments, that is, the adequacy of

existing customs measures concerning the determination of the FTA origin of imported goods. As detailed below, American Honda and Honda of America Mfg. believe that these customs procedures are inadequate in the following two respects:

(1) First, the United States customs regulations do not provide reasonable guidance to foreign manufacturers and importers on the FTA origin requirements, a circumstance that appears inconsistent with the requirements in the United States-Canada FTA, unfair to companies seeking to comply with FTA requirements, and at odds with the approach taken by the Canadian customs authorities.

(2) Second, the United States has not developed adequate procedures to protect business confidential cost and related information supplied in an FTA origin audit. This situation can lead to the type of unauthorized and illegal disclosure of confidential business information of which Honda was recently the victim. Such violations can severely damage companies such as American Honda and Honda of America Mfg. that fully cooperate with a Customs Service FTA audit, and will seriously discourage cooperation by other potential auditees.

Before detailing the companies' views on these specific issues, we will provide by way of background (1) a

summary description of Honda's North American operations -- which involve an aggregate investment of over $2.8 billion and employment of over 16,000 people in the manufacture and sale of automobile, motorcycles, lawnmowers, engines, and other component parts, as well as production engineering and research and development -- and (2) a summary of Honda's experience with FTA audits conducted by the Canadian and United States customs authorities.

1. Honda Manufacturing Operations in North America

Honda's manufacturing operations in North America reflect Honda's longstanding philosophy to manufacture its products in the markets where these products are sold. Indeed, the genesis of Honda's North American manufacturing operations dates back to 1974, when a Honda study was initiated to assess the feasibility of building a Honda motorcycle plant, and later a Honda automobile plant, in the United States. By 1977, a decision was made to initiate these manufacturing operations, and in September 1979 Honda of America Mfg. began manufacturing motorcycles at a 260,000 square-foot motorcycle plant near the city of Marysville, Ohio. The motorcycle plant is a fully integrated manufacturing facility, which involves fabrication of the motorcycle frame from steel pipe, welding of the frame and other parts, injection molding of the plastic parts, painting of the frame and plastic parts, subassembly and final assembly operations, quality assurance, and shipping

operations. At present, the motorcycle plant manufactures both the Honda Gold Wing, Honda's top-of-the-line luxury touring motorcycle, and Honda all-terrain vehicles. Products of the motorcycle plant are currently exported to 15 countries, including Canada and Japan.

In 1980, Honda announced plans to construct an automobile plant adjacent to the motorcycle plant. In November 1982, Honda of America Mfg. began manufacturing automobiles at a 1.0-million square foot Marysville automobile plant capable of producing approximately 150,000 automobiles per year. The Marysville automobile plant has since been expanded to 3.1-million square feet, with current production capacity of approximately 360,000 automobiles per year. The operations at the Marysville automobile plant include four stamping lines to produce all major body panels (using United States steel), a state-of-the-art painting facility, sophisticated and automated welding operations, plastic injection molding facilities, two final assembly lines, quality assurance operations, and complete shipping and receiving facilities.

In 1984 Honda Power Equipment Mfg. Inc. began production of lawnmowers at an 87-acre production facility located in Swepsonville, North Carolina. In 1988 the operations were expanded to include the manufacture of lawnmower engines. Currently the company has the capacity to

manufacture 120,000 lawnmowers and engines. These lawnmowers and engines are exported to countries worldwide, including to Canada, Japan, and Europe.

In 1985, Honda of America Mfg. began manufacturing motorcycle engines at a 235,000 square-foot engine plant in Anna, Ohio, located approximately 40 miles from Marysville. Production of automobile engines began the next year, in September 1986.

Also in 1986, Honda of Canada Mfg. Inc. began production of automobiles at its 1 million square-foot plant in Alliston, Ontario, Canada. Today, the plant operations include stamping, welding, painting, sub-assembly and assembly, testing, quality assurance and shipping. The plant's annual capacity is 100,000 units. Its operations involve many United States OEM parts and materials suppliers. In fact, of Honda of Canada's 123 North American suppliers, 98 are from the United States.

In 1987, Honda de Mexico S.A. de C.V. began production of automobile service parts at facilities in El Salto near Guadalajara, Mexico. In 1988, Honda de Mexico began manufacture of motorcycles. Today Honda de Mexico produces a range of stamped automobile service parts, model CH 80 and SA 50 motorscooters, and CBR 100f motorcycles. The facility

represents a total investment of approximately $30 million and a plant of approximately 80,000 square feet.

In September 1987, Honda announced a five-part strategy for establishing in North America a self-reliant motor vehicle company with resources to compete in the world market. This five-part strategy involves:

(1) Addition of a second United States automobile plant and greatly expanded engine and component manufacturing operations;

(2) Expansion of automobile exports;

(3) A substantial increase in the domestic content of the companies' automobiles;

(4) Expansion of Honda Research and Development North America, Inc., to facilitate increased domestic parts sourcing and to permit the design, development and engineering of cars in the United States; and

(5) Expansion of the activities of Honda Engineering North America, Inc., to develop production equipment for Honda's North American manufacturing operations.

The results of this five-part strategy to date include the following:

-- Construction of a second automobile plant in Ohio representing an initial investment of approximately $380 million, and a production capacity of an additional 150,000 automobiles per year.

-- Expansion of the engine plant to 1.0 million square feet, involving a total investment of more than $600 million. As expanded, the engine plant has the capacity to manufacture 500,000 engines per year, as well as drive trains, suspensions, and related components. The manufacturing operations at the engine plant include an aluminum casting department to cast engine blocks, cylinder heads, and pistons from aluminum ingot; an aluminum machining department to process raw castings; a ferrous casting department to cast engine parts (as well as brake drums and brake discs); a ferrous machining department; two engine assembly lines; and quality control and related production support operations.

-- Expansion of the United States research and development and production engineering activities. One indication of the breadth of activities of these operations is that in 1990 the company began producing a new Accord station wagon that was designed, engineered, and manufactured in the United States.

-- Expansion of automobile export operations, so that in 1991 a total of approximately 30,000 United States-manufactured Honda cars will be exported to 11 countries, including Japan, Taiwan, South Korea, Israel, Canada, United Kingdom, France, Germany, Belgium, The Netherlands, and Switzerland.

-- Expansion of the purchase of OEM parts and materials in North America, so that in 1990 these purchases totaled more than $2.8 billion from more than 230 suppliers.

2. Honda FTA Audits by Canadian and United States Customs Authorities

As noted earlier, Honda motorcycles and automobiles produced in Ohio are exported to Canada, and Honda automobiles produced in Alliston, Ontario are exported to the United

States, and in each case the vehicles were entered under the terms of the FTA, which took effect January 1, 1989. The Canadian customs authority, that is, Revenue Canada, conducted and completed FTA audits of the Honda motorcycles and automobiles exported to Canada in 1989-90. In April 1990, the United States Customs Service began an FTA audit of Honda automobiles imported from Canada from January 1989 through March 1990, but this audit has not yet been completed.

In each case, the essential issue was whether the Honda automobiles (and motorcycles for one of the two Revenue Canada audits) qualified as "originating in" the United States or Canada under the FTA origin rules. Simply put, the FTA origin rules provide that for these vehicles to qualify, they must meet a so-called "50-percent test." Pursuant to this "50 percent test", the total value of materials originating in the United States or Canada plus the "direct cost of processing" must equal at least 50 percent of the total of all materials plus the "direct cost of processing."

There are a number of uncertainties and ambiguities in the FTA's "50 percent test." For example, the FTA definition of "direct cost of processing" states that this is to include all costs that are either "directly incurred in" or that "can reasonably be allocated to" production of the goods involved. This FTA definition further provides examples of both costs

that are to be included -- including the costs of "supervision" and "management" where the production takes place -- and costs that are to be excluded -- such as costs of "sales," "advertising," and "marketing." The evident intention was to include most if not all production-related costs, and to exclude selling and marketing expenses. However, no express guidance was given on inclusion of costs such as purchasing department expenses and other production support costs. Similarly, the FTA definition of qualifying "originating" materials includes the cost of so-called "intermediate materials" that is, materials produced by a vertically integrated company that themselves qualify as "originating in" the United States or Canada. The FTA provisions, however, do not provide specific guidance on how these are to be identified and their value calculated.

Honda's views on the two points noted above on page 2 -- the importance of (1) detailed, substantive regulations, and (2) procedures to maintain the confidentiality of information -- are influenced by its experiences with the Revenue Canada and United States Customs Service FTA audits.

A first contrast concerns the substantive guidance to the FTA calculations provided by Revenue Canada and the United States Customs Service. Specifically:

-- Revenue Canada provided centralized authority for origin determinations under the FTA by use of a special Origin Determination Directorate. It published detailed, substantive "guidelines" on the FTA "50-percent" calculations. See United States Tariff Rules of Origin Regulations, Memorandum 011-4-12 (December 1988). It developed a detailed "Territorial Content Questionnaire" to be completed by companies subject to an FTA audit, which provides further guidance as to Revenue Canada's position on the "50-percent test" calculations under the FTA.

-- The United States Customs Service, by contrast, has simply added FTA origin issues to the myriad of issues subject to audit by its Regulatory Audit staff. Regulations published by the Service only one week before the FTA went into effect provide no additional substantive guidance on the "50-percent test" calculations. See 19 C.F.R. 610.301 et seq. 53 Fed Reg. 51762 (Dec. 23, 1988). The Customs Service has provided no specialized questionnaire or specific guidelines to assist either the auditors or the auditee in an FTA audit.

A second contrast involves the actual process of the FTA audits. Specifically:

-- The Revenue Canada authorities in 1989-90 conducted audits of the Honda motorcycles and automobiles produced in Ohio and of the Honda lawnmowers produced in North Carolina, based on the companies' responses to the detailed Territorial Content Questionnaires developed by Revenue Canada. For the motorcycle audit, Revenue Canada also conducted detailed, on-site visits in some cases attended by the Manager of Origin Audits in the Origin Determination Directorate. The auditors provided opportunities for the companies to provide both factual material and their views on interpretative issues to the decision makers both at the audit and in Ottawa. At the conclusion of the process, Revenue Canada confirmed the FTA qualification of the goods. The process in each case was comprehensive, efficient, organized, and timely. Further, Revenue Canada provides protection for confidential information, and Revenue Canada did not breach the confidentiality of the company's cost and related information provided during the audit.

-- By contrast, the United States Customs Service audit of the Honda cars imported from Canada that began in April of 1990 has not yet been completed, notwithstanding the companies' full and complete cooperation, involving over 100 Honda personnel who have together spent more than 11,000 hours to provide information and participate in on-site visits lasting 31 business days. Neither the Customs Service auditors nor Honda has had the benefit of any specific guidance by way of regulations or guidelines, and there is no special "questionnaire" to organize the presentation of company FTA data. Further, there are no express procedures to discuss and resolve substantive FTA interpretation issues with decision makers prior to the decisions; indeed, requests during the audit to meet with Headquarters personnel considering these issues were denied. Finally, the Customs Service does not have adequate procedures to ensure the protection of company confidential information provided during an FTA audit, as evidenced by the fact that confidential data from the Honda FTA audit was disclosed to the New York Times and published June 17, 1991. This disclosure was not only a breach of an express agreement with the

Customs Service auditors, but also a violation of the federal criminal law in 18 U.S.C. § 1905, which makes it a federal crime for a federal official to release company confidential data.1/

3. The NAFTA Must Mandate Express Procedures to Ensure the Protection of Company Confidential Data Supplied During an FTA Audit

As indicated above, one fundamental point that must be addressed in the FTA is the need to protect the confidential information of companies supplying cost and other information to customs authorities reviewing the origin determinations. Simply put, it is not reasonable for a Government to ask companies to cooperate in an FTA audit unless the company can have reasonable confidence that its confidential information will be protected. This protection cannot rely simply upon ad hoc or general procedures. There must be a comprehensive program to safeguard company confidential information, which should include, for example, procedures (1) to identify and

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1/ The June 17, 1991 New York Times article also contained inaccurate information concerning the status of the audit and its results. In fact, as reflected in a subsequent June 27, 1991 New York Times article, the Customs Service has confirmed (1) that the Honda FTA audit is not complete, and (2) that no determinations have been made as to whether the Honda cars involved qualify under the FTA. Further, Customs Service officials have confirmed that there is no indication of any wrongdoing or improper activity by the company, notwithstanding distorted reports in the media and elsewhere following the first June 17, 1991 New York Times article.

mark all company confidential information included in any reports or memoranda, (2) to appoint custodians to regulate access to confidential materials, (3) to limit those to whom such information is available, and (4) to regulate copying of such information. These procedures should also be detailed in a written form available to the auditee as well as to all those at the customs authority. Other United States government agencies have such specific procedures, for example, the Federal Trade Commission and the Internal Revenue Service. See 15 U.S.C. § 57b-2, FTC Operating Manual; 26 U.S.C. § 6103, Tax Information Security Guidelines. Indeed, the Customs Service has adopted express confidentiality procedures for national security information. See Safeguarding Classified Information Handbook, CIS HB 1400-03 (Feb. 1991). The NAFTA should require the customs authorities to adopt such procedures to protect confidential business information.

4. The NAFTA Must Provide More Detailed Substantive Guidance on the FTA "50-Percent Test" Calculations

A second point concerns the need for express, substantive rules to guide importers and foreign producers on origin determination issues, particularly the "50-percent test" calculations noted above. Article 2102 of the United States-Canada FTA expressly provides that the United States (and Canada) "shall publish in advance, and allow opportunity for comment on, any law, regulation, procedure or

administrative ruling of general application that it proposes to adopt respecting the matters covered by this agreement." This requirement is consistent with that of the Administrative Procedure Act, which similarly provides for notice and opportunity for comment on regulations, see 5 U.S.C. § 553, so that parties that are potentially affected will have an opportunity both to be advised of the interpretations of the law and to provide comments before those interpretations are adopted.

As noted above, however, the admonition in Article 2102 of the United States-Canada FTA has not been effective either substantively or procedurally. It is now more than two and one half years since the FTA went into effect, and the United States has not yet adopted regulations clarifying uncertainities and ambiguities in the FTA origin provisions. Further, before it adopts such regulations it should, consistent with Article 2102 of the United States-Canada FTA and the Administrative Procedure Act, publish a proposed version of these regulations for comment by interested parties.2/ To avoid this problem in the NAFTA, the NAFTA

2/ When the United States Customs Service published "interim" FTA regulations on December 23, 1988 (one week before the January 1, 1989 effective date of the FTA), it also invited comments to be received by February 21, 1989. However, as

[Footnote continued on next page]

itself must provide much more specific and detailed guidance on the origin rules, for the benefit both of the manufacturers and importers involved and of the customs authorities who must determine the FTA qualification of goods. Honda suggests as one possible means to this result that a tri-lateral body be established to be responsible on a continuing basis for providing interpretation and guidance on the NAFTA "rule of origin" and related issues.

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American Honda and Honda of America Mfg. appreciate the opportunity to provide these comments.

Respectfully submitted,

Donald Harrison

Counsel to American Honda Motor Co., Inc. and Honda of America Mfg., Inc.

August 12, 1991

2/ [Footnote continued from previous page]

indicated above, the FTA origin rules in the interim regulations do no more than track the FTA language, and particularly given the developments and experience since December 1988, the Service should publish proposed rules and provide a notice and comment period before finalizing the rules.

ATTACHMENT B

THE COMMISSIONER OF CUSTOMS

WASHINGTON, D.C.

June 24, 1991

Dear Mr. Yoshino:

Thank you for your letter of June 19 to Deputy Secretary Robson, concerning various newspaper articles regarding a U.S. Customs Service audit of Honda. This audit concerns Honda's eligibility for preferential tariff treatment under the free trade agreement between the United States and Canada. I appreciate the cooperation of your company in the course of this audit.

I can confirm to you that the audit is not yet complete and no final decisions have been made. I can also assure you that the audit process will be fairly conducted, including consideration of any views which you may present to us on particular issues of interpretation. In accordance with our normal practice, you will be informed of final decisions when they are reached.

In order for Customs to carry out its audit responsibilities, it must have access to full and accurate information. We recognize that businesses will only be willing to share sensitive business information if they can rely on the government to adequately protect such information against unauthorized disclosure. I therefore regret that details of this incomplete audit were disclosed to the public media.

Sincerely,

Carol Hallett

Carol Hallett

Mr. Hiroyuki Yoshino
President
Honda of America Manufacturing Inc.
Marysville, Ohio 43040

ATTACHMENT C

WORLD PRESS HEADLINES FOR STORIES ON THE HONDA FTA AUDIT, WEEK OF JUNE 17, 1991

UNITED STATES:	
"U.S. ASSERTS HONDA ELUDED CAR TARIFF"	New York Times Front Page, 6/17/91
"HONDA DUCKED IMPORT DUTIES . . ." "U.S. CUSTOMS CITES HONDA OVER DUTIES . . ." "U.S. CUSTOMS ACCUSES HONDA OF AVOIDING DUTIES ON IMPORTS"	Wall Street Journal Front Page, 6/18/91
"U.S. FINES HONDA $20 MILLION FOR UNPAID DUTIES"	Investors Daily, 6/18/91
"HONDA PENALIZED"	Detroit News, 6/18/91
"HONDA UNDER FIRE IN CUSTOMS PROBE"	The Columbus Dispatch 6/20/91
CANADA:	
"U.S. MAY SLAP DUTY ON HONDAS FROM CANADA" "HONDA ACCUSED OF TARIFF DODGE"	The Toronto Star Front Page, 6/17/91
"HONDA FACES HEAVY DUTY ON CIVICS EXPORTED TO U.S."	Globe and Mail, 6/18/91
"HONDA DENIES CHEATING U.S."	The Toronto Star Front Page, 6/18/91
"HONDA ACCUSED OF EVADING TARIFFS, MANIPULATING FREE TRADE"	Reuters Business Report 6/17/91
PAN:	
"AMERICAN HONDA ILLEGALLY AVOIDED CUSTOMS DUTY"	Mainichi Shimbun, 6/18/91
"U.S. AGENCY CONFIRMS THEY WILL BE CHARGING HONDA ADDITIONAL DUTY" "U.S. CUSTOMS SERVICE CONFIRMED THAT AMERICAN HONDA HAD AVOIDED $2.8 BILLION DUTY"	Nihon-Keizai Shimbun 6/18/91
"REPORT THAT HONDA ILLEGALLY AVOIDED CUSTOMS DUTY WAS CONFIRMED BY CUSTOMS SERVICE"	Reuters-Jiji Wire Service 6/18/91
"SIX CONGRESSMEN REQUEST PRESIDENT TO INVESTIGATE AMERICAN HONDA'S ILLEGAL AVOIDANCE OF DUTY"	Yomiuri Shimbun 6/20/91
EUROPE:	
"U.S. SAYS HONDA EVADED TARIFFS"	International Herald Tribune, 6/18/91
"HONDA IN CUSTOMS DISPUTE WITH U.S."	Financial Times, 6/20/91
"HONDA CASE IS LATEST SIGN OF HARDER U.S. TRADE STANCE"	European Edition, Wall Street Journal, 6/18/91