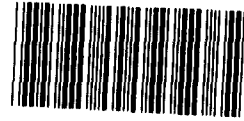


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Status Report on GAO's Review of the Export
Enhancement Program

Statement of

Allan I. Mendelowitz, Director
Trade, Energy and Finance Issues
National Security and International Affairs
Division

Before the
Subcommittee on Wheat, Soybeans and Feed Grains,
Committee on Agriculture
House of Representatives



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Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss with you the status of our ongoing work on the Export Enhancement Program (EEP). Our review is being conducted at the request of the Chairman, House Committee on Agriculture; Congressman Conte, the Ranking Minority member of the House Committee on Appropriations; and Congressman Schumer.

Our current review updates and expands upon the issues addressed in our March 1987 report,¹ which concluded that the EEP had increased exports of wheat and wheat flour in several markets but at that time these increases had been offset by decreased exports to other markets. Importing countries benefitted from purchases of wheat and other agricultural commodities at prices made lower by the increased competition resulting from the EEP. We also concluded that the EEP had increased the cost of the European Community's (EC) Common Agriculture Policy, specifically through increased export subsidy payments, and had contributed to an agreement to include agricultural subsidies in the Uruguay Round of multilateral trade negotiations which were launched in September 1986.

¹Implementation of the Agricultural Export Enhancement Program, (GAO/NSIAD-87-74BR).

During the 2 years since our report, conditions in the world market for wheat have changed. Supply has become relatively tight. This is due not only to adverse weather conditions, including the North American drought in 1988, but also to decisions made by the United States and other governments to reduce production. As a result world wheat prices have increased. As U.S. supplies of wheat become tighter, use of the EEP, or even expectations of its use, could affect the market differently than previously. Whereas in earlier years use of the EEP led to lower commodity prices in the world market, now, given the tighter supply, it could lead to higher prices. Recognizing this, fewer new EEP initiatives have been announced and existing ones have not been extended. While it recognizes that the EEP must be used more selectively, the administration continues to emphasize the program's importance as a trade negotiating tool.

THE EXPORT ENHANCEMENT PROGRAM

The EEP was established in May 1985 by the administration following extensive lobbying by an informal coalition of agricultural trade organizations reacting to continuing decreases in U.S. agricultural exports. Through the Food Security Act of 1985 and subsequent legislation, the Congress made the EEP a mandatory program and has provided over \$2.5 billion in support for the program. For 1989, the program appropriation provided for support up to \$770 million.

The EEP's objectives were to (1) increase U.S. agricultural exports and (2) encourage U.S. trading partners to begin serious negotiations on the liberalization of agricultural trade.

According to guidelines established by the cabinet-level Economic Policy Council in May 1985, each EEP initiative was to meet four criteria.

1. **Additionality:** sales were to increase U.S. agricultural exports above those that would have occurred in the absence of the program.
2. **Targeting:** sales were to be targeted at specific market opportunities, especially those challenging competitors that were subsidizing their exports.
3. **Cost effectiveness:** sales were to result in a net plus to the overall economy.
4. **Budget neutrality:** sales were not to increase budget outlays above those that would have occurred in the absence of the program.

Since its inception, EEP has grown dramatically--as of July 21, 1989, there have been 103 initiatives (i.e., announcements that

specific countries were eligible to purchase specific commodities under EEP). Twelve commodities in 65 countries have been targeted and 73 exporters have participated in the program through the first six months of FY 1989. Four exporters--Cargill, Continental, Louis Dreyfus, and Artfer--received over \$100 million each in bonuses (60% of all bonus awards); Cargill and Continental each received over \$400 million in bonuses.

Total EEP sales are valued at \$8.4 billion, of which wheat represents 82.3 percent. Sales to the Soviet Union and People's Republic of China account for nearly 50 percent of total EEP wheat sales. Sales to Algeria, Egypt, Yemen and Morocco, the first four countries targeted under EEP, represent another 25 percent of total wheat and 60 percent of total wheat flour sales. The remaining EEP commodity sales have been in barley malt, semolina, rice, vegetable oil, sorghum, frozen poultry, table eggs, poultry feed, and dairy cattle.

As of July 21, 1989, the market value of EEP bonuses was nearly \$2.6 billion and approximately half of the \$770 million appropriated for bonuses in fiscal year 1989 had been awarded. To date, about 70 percent of total bonus awards subsidized wheat exports. The top recipients of U.S. agricultural exports under EEP as of March 1989 have been the Soviet Union, China, Egypt, and Algeria. Bonus commodities, either paid or approved, given to U.S. exporters to support sales in these countries were: Soviet Union

\$553 million, China \$344.5 million, Egypt \$310.5 million, and Algeria \$217 million.

DIFFERENT VIEWS ON EEP

There are widely divergent views concerning the need for the EEP today. Some view the program positively, while others are critical. On the positive side, the farm community overall sees the EEP as largely responsible for the increase in wheat exports over the last several years and views it as a valuable export assistance tool.

The administration views the EEP as a valuable trade policy tool which has encouraged the EC to seriously negotiate the liberalization of agricultural trade. It recognizes that the program must be used judiciously, given current market supply conditions, but strongly emphasizes that it must not be dismantled unilaterally. If market conditions were to change, the EEP could be used more aggressively, thereby increasing the costs of the EC export subsidy program. The administration maintains that eliminating the program now would send the wrong signal to the EC and others concerning the political will of the United States to liberalize agricultural trade.

Some critics charge that the program generates only a small, if any, increase in U.S. agriculture exports. They also question

whether subsidies are necessary, given relatively tight wheat supply conditions. Furthermore, some question whether supplies of U.S. commodities are adequate to support aggressive use of the EEP and whether U.S. domestic prices might not increase if the program is used too aggressively.

Critics also note that the EEP is counter to the U.S. position in the Uruguay Round that all support to agriculture which distorts trade be eliminated. Non-subsidizing competitors of the United States complain that they have been caught in the cross-fire of the subsidy war between the United States and the EC and that the EEP has caused world commodity prices to decrease, thereby affecting their revenues.

IMPACT OF EEP ON INCREASING U.S. AGRICULTURAL EXPORTS

In the last several years, U.S. agricultural exports have increased significantly. U.S. wheat exports increased from 25 million metric tons (mmt) in the 1985 crop year to 43.5 mmt in the 1989 crop year. The U.S. market share of world wheat and wheat flour exports increased from 29 percent to 42 percent during the same period. However, as discussed in our March 1987 report, an exact measure of how much of these increases were due to EEP is difficult to determine.

The effect of EEP cannot be isolated from that of other policy and economic variables which have contributed to increased agricultural exports. The Food Security Act of 1985 established lower loan rates as well as increased export assistance which contributed to the expansion of U.S. agricultural exports. Also depreciation of the U.S. dollar against major competitor currencies, production shortfalls, and other changes in global economic conditions contributed to the increase. Furthermore, the fact that the EEP is "targeted" adds more complications in determining its effect. For example, competing suppliers may respond by displacing potential U.S. sales in untargeted markets. Thus, while exports may increase in the targeted markets, the overall effect on U.S. exports worldwide is uncertain. If this happens, the use of targeted subsidies may merely reroute trade flows and total export volume would not necessarily increase. Moreover, when prices decline, it is unclear as to the extent that importers will buy more of the lower priced commodities or use the resources saved to buy other commodities.

With that caveat stated, EEP does appear to have been critical to making sales in certain markets--without it the sales would not have taken place--such as the wheat sales to the Soviet Union and China. During periods of surplus supplies on the world market, these importing countries took advantage of competition among exporters to obtain the best possible price and terms. Without EEP to make U.S. exports competitively priced, it is highly

unlikely that these sales would have taken place. Officials in Algeria, Egypt, Jordan, and Iraq told us that EEP was essential to enable U.S. exporters to make sales because these countries are "price buyers" (i.e. they buy at the best price available regardless of the source). They also noted that the availability of U.S. export credit guarantees was essential to making many EEP sales.

We have reviewed several studies that have attempted to measure the EEP's overall additionality. All of these studies estimate that U.S. agricultural exports have increased due to EEP but they differ on the magnitude. The additionality estimates range from 2 to 30 percent and are greatly influenced by the assumptions made and the time period covered.

THE EEP AND THE MULTILATERAL TRADE NEGOTIATIONS

When it was established, the EEP was viewed not only as a means for increasing U.S. exports but also as a means of encouraging U.S. trading partners, especially the EC, to begin serious negotiations on liberalizing agricultural trade. In our March 1987 testimony before the House Agriculture Subcommittee on Department Operations, Research, and Foreign Agriculture we noted that the EEP had exerted financial pressure on the EC and had reduced its grain sales in the Mediterranean region. We reported that the EEP, combined with the decline of the dollar and lower

loan rates, had increased the financial cost of the EC's export restitution payments and had contributed to realizing agreement to include agricultural subsidies in the Uruguay Round of multilateral trade negotiations.

In our March 1987 report, we concluded that the ultimate impact of the EEP depends, among other things, on how serious and sustained a commitment it represents. A prior U.S. attempt to match foreign export subsidies had not been sustained and the subsidizing competitor regained the market. The United States had countered competitor subsidies for wheat flour exports to Egypt in 1983 and had taken the market away from France. However, the United States did not renew the program in subsequent years and France regained its market share.

European and U.S. officials had contended that this demonstrated U.S. unwillingness to seriously challenge EC agricultural export subsidies. The U.S. approach had been criticized by U.S. agricultural interests as inconsistent and lacking in follow-up commitment. The gain in the U.S. share of the Egyptian wheat flour market proved to be temporary. Had the United States terminated the EEP after 1 or 2 years, the program would have been viewed as yet another indication of the lack of U.S. will to retaliate against unfair trading practices. Hence, abandoning the program could have adversely affected progress in the agricultural trade negotiations.

Most U.S. observers would agree that the program was instrumental in bringing the EC to the negotiating table initially, but there are diverse views as to its present utility in encouraging serious negotiations to liberalize agricultural trade. The outcome of the agricultural trade negotiations remains unclear, with the United States and the EC still disagreeing over the ultimate objectives.

As the market situation has changed with tighter supplies of wheat and other commodities, (i.e., as the price of commodities has increased), the EEP has been used relatively sparingly. Bonus amounts are significantly less than they had been in the early years of the program. EC restitution payments, similarly, have been significantly less than they were during the earlier period. EC officials told us that the EEP has had little effect in recent months in moderating their position on the agricultural trade negotiations. However, U.S. negotiators, including the U.S. Trade Representative and the Secretary of Agriculture, have reaffirmed the U.S. position that U.S. competitors should not expect any unilateral concessions by the United States. The Under Secretary of Agriculture for International Affairs and Commodity Programs stated in May 1989 that there was a continued role for the EEP. Whether the program is useful or not in the current market environment, the U.S. administration has made it clear that it is not going to give up the EEP unilaterally.

We also believe that the EEP's continued existence as a trade policy tool is important. If market conditions change, it could again be used aggressively, potentially increasing the cost of the EC's restitution program. More significantly, abandoning the EEP now would send the wrong signal to U.S. competitors, especially the EC, with whom we are negotiating on the liberalization of agricultural trade. The EEP has significant symbolic value in this regard. In addition to the direct impact it previously had in increasing the costs of the EC's export restitution program and thereby encouraging the EC to negotiate, the EEP appears to have had an indirect impact as well. To the extent that it has had an adverse impact on other competitors, including Argentina, Australia, and Canada, it has probably increased their resolve to push for a GATT agreement on agriculture trade.

IMPACT OF EEP ON COMPETITORS

Officials of Argentina, Australia, and Canada all claim that they have been adversely affected by the EEP, both in terms of lower prices for their commodities and reduced market shares. Australia has been the most vocal in its opposition of the EEP, stating that, contrary to the U.S. Department of Agriculture's stated intention of not harming non-subsidizing competitors, EEP has adversely affected Australian agricultural exports, especially wheat. However, isolating and quantifying the EEP's exact effects

on Australian wheat exports is difficult if not impossible. Australian government and farm industry representatives and U.S. Agriculture officials agree that EEP contributed to the depression of world wheat prices between 1985 and 1988 and, consequently, to the reduction in Australian wheat export earnings. There is no consensus, however, on the extent of repercussions of the EEP's price effects. According to Australian officials, Australia has lost market share and export revenue as a result of EEP, and wheat production declined as a consequence. According to U.S. Agriculture officials, on the other hand, EEP had only a minor effect on Australian export revenue and Australian production cuts were due to the rising profitability of wool production relative to wheat, not to the EEP.

EEP affected Australian wheat prices in two ways: (1) by providing bonuses in-kind from U.S. stocks, EEP increased total supply to the world market, thus reducing average world prices and (2) by providing subsidies on sales to targeted markets, EEP reduced prices in those markets, to the detriment of Australia and other suppliers, who were forced to match the subsidized price or lose market share. Australian wheat export prices fell about 17 percent, from about \$115 a ton in 1984/1985 to about \$95 a ton in 1987/1988.

According to Australian officials, the fall in export prices encouraged producers to move out of wheat production; plantings

fell from about 12 million hectares in 1984/1985 to about 9 million hectares in 1988/1989. Australian resources previously employed in grain production flowed into the livestock sector and into alternative crops, such as grain legumes.

Australian officials acknowledge that the EEP is only one of a number of factors, including declining world demand, reduced U.S. loan rates, and continuing EC subsidies, contributing to the decline in Australian wheat export earnings. In their opinion, however, the EEP has clearly had a significant adverse impact on Australian and other non-subsidized competitors' exports.

U.S. Agriculture officials believe that the EEP's effects on wheat prices were minimal to begin with and were mitigated by the Australian government's guaranteed price mechanism and the devaluation of the Australian dollar in 1985. They said that recent declines in Australian wheat production are more accurately attributed to historically high wool prices than to EEP. During the mid-1980s, wool prices more than doubled, luring farmers out of wheat and into wool production.

EVOLUTION OF EEP TARGETING

The EEP was designed to be targeted and discretionary rather than across the board. Proposals for EEP subsidies were to "target a specific market to challenge only the competitors who

overtly subsidize their exports." Originally the EEP's primary targets were countries that made significant purchases of subsidized EC exports. However, over time the program changed and expanded to include countries that had a small EC presence and then to countries where the EC was only contemplating a presence. As the EEP displaced the EC in one market, the EC turned to another country's market, making that country eligible for EEP benefits as well. The EEP grew from 4 targeted countries to 65 in 4 years, and has included 12 commodities.

Perhaps the most controversial aspects of targeting were the administration's decisions regarding the Soviet Union. That country was initially excluded from the program despite the fact that the EC's share of the Soviet wheat market rose from 5 to 22 percent from the 1981 to the 1985 crop year. Agriculture initially claimed that the Soviet Union was excluded because the non-subsidizing competitors had about a 48 percent share of the market in crop year 1985. Non-subsidizers, however, had equal or greater shares of other markets targeted under the EEP, such as Egypt, Iraq, Jordan, and Sri Lanka. Clearly the Soviet Union had been excluded until August 1, 1986, for foreign policy reasons. The Soviet Union was then made eligible for EEP sales and has since become the largest importer under the program. Critics have complained that U.S. government resources are being used to subsidize a U.S. adversary.

Country and commodity selection starts with a proposal that can come from an importing country, within the U.S. Department of Agriculture, agriculture trade organizations, or other sources. The proposal is submitted to the appropriate commodity division of the Foreign Agriculture Service (FAS) which examines how it meets the program criteria of budget neutrality, additionality, targeting, and cost effectiveness. The proposal is then sent to Agriculture's Under Secretary for International Affairs and Commodity Programs.

If the Under Secretary approves the proposal, the interagency review process begins. The proposal is sent to the Office of the U.S. Trade Representative which coordinates the review process, and then distributed to member agencies of the Trade Policy Review Group (TPRG)². Members of the TPRG informal working group are given a deadline for expressing concerns about the proposal; if the group's chairman does not receive any objections, the proposal is sent back to Agriculture and the initiative is announced.

Each initiative carries a fixed quantity. Once that quantity is filled under the program, additional quantities must be approved through the interagency process.

²The Trade Policy Review Group (TPRG) is chaired by a Deputy U.S. Trade Representative and is made up of Under Secretaries and Assistant Secretaries from the Departments of Agriculture, State, Commerce, Labor, Treasury, and Transportation; the Office of Management and Budget; the Council of Economic Advisors; and other agencies with interest in the topic under discussion.

When concerns or objections to the proposal are raised by members of the TPRG working group, representatives of the TPRG itself meet to discuss the problems. In the event that the TPRG cannot reach consensus on the proposal, it is forwarded to the cabinet-level Economic Policy Council (EPC)³.

PROGRAM OPERATIONS

The EEP's day-to-day operations are managed by FAS. EEP began as a small, focused, and temporary program and grew into a large, broadly applied program requiring more extensive resources to implement necessary management controls. Our ongoing review is examining a full range of operational issues. While our work is ongoing, we have identified some areas of concern.

Once the EEP began to expand to a larger number of countries, problems arose. We have found examples of markets that FAS appeared to have targeted inappropriately. In the case of dairy cattle to Indonesia, Australia and New Zealand were the only two countries to export significant numbers of dairy cattle to Indonesian in the last 40 years. Importers told us they never

³The EPC is chaired by the Secretary of the Treasury and is composed of the Secretaries of the Treasury, Agriculture, State, Commerce, Labor, and Transportation; U.S. Trade Representative; Director of the Office of Management and Budget; Chairman of the Council of Economic Advisors; Vice President; Assistant to the President for National Security Affairs; and White House Chief of Staff

seriously considered importing EC cattle, even though the Dutch were making offers. Bonuses for EEP dairy cattle sales in this country amounted to over \$19 million.

Countries which were traditional markets for U.S. agricultural exports became upset when they were not eligible to buy under EEP. They complained about having to purchase commodities at higher prices while other countries benefitted from subsidized lower prices.

According to the new Under Secretary for International Affairs and Commodity Programs, EEP is being used more selectively to target markets where the EC has a major presence. For example, in June 1989 a proposal went forward for EEP soybean oil sales to the Soviet Union. This proposal was not approved partly because the EC only has a 2-percent market share for soybean oil in the Soviet Union and an EEP sale would not hurt the EC.

Management of the EEP requires efforts in four major areas: (1) qualifying and registering exporters wanting to participate in the program, (2) setting minimum acceptable prices and maximum acceptable bonuses, (3) administering the bidding process, and (4) ensuring exporter performance. We are currently reviewing these four areas.

Our March 1987 report reviewed FAS methodology for determining minimum sales prices and maximum bonus awards for wheat, flour, poultry, and barley. FAS attempted to collect price information but Agriculture Department officials acknowledged that it was often difficult to obtain and verify this information for some commodities. Thus, the price-setting process involved considerable judgement.

We are currently reexamining the price and bonus-setting processes. The data collection efforts and methodology for price-setting can vary by commodity, partially due to the nature of the market and the availability of information and other factors, such as quality, packaging, processing, and transportation rates.

Some methodologies for determining minimum sales price and maximum bonus amounts have been revised during the course of the EEP. FAS has developed written procedures to document price and bonus determinations, but experienced judgement remains a key element in the process.

A concern raised during past GAO and Department of Agriculture Inspector General (IG) reviews was that bonuses exceeded amounts necessary to make sales. For example, the Dairy, Livestock, and Poultry Division was criticized for issuing bonuses often exceeding 50 percent of the value of the sale. FAS suspended the livestock program for several months to determine whether the

bonus levels were too high. Eventually the program was reactivated with bonus levels cut in half, and in early 1989 FAS cancelled the livestock program.

The difficulty in administering a program as complex as the EEP is reflected in the number of procedures required to manage program operations. These procedures range from ensuring conformance with criteria in targeting recipient countries to documenting that exporters deliver commodities according to their contract agreements. Past GAO and IG reviews have criticized the Department of Agriculture for its lack of internal controls over these procedures. FAS has established some procedures to ensure that program requirements are met and that exporters perform according to contract agreements. We are examining these procedures to determine whether they provide adequate internal controls, particularly verification of required documentation.

OVERALL OBSERVATIONS

In summary, EEP remains an important trade policy tool if for no other reason than unilaterally abandoning it would weaken the U.S. negotiating position with the EC. It could have greater importance in the future if market conditions change. The EEP has contributed to increased U.S. agricultural exports, particularly wheat, in many countries, including the Soviet Union, China, and those in the Middle East. The magnitude of the overall

additionality, however, is difficult if not impossible to determine because of the many factors influencing exports. In today's tighter wheat market, the program is appropriately being used more selectively.

Mr. Chairman and Members of the Subcommittee, this completes my statement. I will be happy to answer any questions you may have.