UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

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PROGRAM ANALYSIS DIVISION

B-207221

MAY 7, 1982

The Honorable Nick J. Rahall, II
House of Representatives

Dear Mr. Rahall:

Subject: Effects of Cargo Preference Requirement for Dry Bulk Exports and Imports (GAO/PAD-82-29)

In your letter of January 18, 1982, you asked us to comment on some of the effects of requiring at least 40 percent of the Nation's dry bulk imports and exports to be carried in U.S. flag, U.S.-built vessels. Such a requirement appears in the pending Port Development and Navigation Act of 1981 (H.R. 4627), which was recently reported out of the House Committee on Merchant Marine and Fisheries.

You specifically asked whether such a cargo preference provision would:

--Inhibit U.S. dry bulk export trade;

--Burden U.S. consumers with increased import costs;

--Increase the costs of U.S. coal and other dry bulk exports so that they would not be competitive on the world market;

--Stimulate investment in domestic maritime trades and shipbuilding;

--Erode the concept of free trade among nations by artificially distorting market prices and by dictating source of transportation; and

--Be practical from a regulatory aspect.

You added that you were particularly interested in the effect of the proposed legislation on exports of coal.

It is impossible to provide precise quantitative responses to your questions. Even if a major research study were undertaken, any numerical estimates of the effects of the cargo preference provision of H.R. 4627 would be of doubtful reliability. Since

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the United States has no experience with such a provision, these estimates could be obtained only by creating and solving a complex model of international trade. The reliability of such estimates would still be limited because model formulation and estimation are judgmental processes, and differences of opinion are bound to arise about judgments made.

Therefore, as agreed with your office, we have limited our response to identifying the potential direction of change that we would expect to take place in the prices of and demand for U.S. exports and imports, prices of new ships, investment in shipbuilding facilities, and other economic data following the enactment of a cargo preference provision. Our expectations should not be construed to represent a position on the merits of this cargo preference provision.

We begin by presenting background information about commodity flows in U.S. commerce and about recent efforts to enlarge the share of imports and exports that moves in U.S. vessels. More detailed data on the status of the U.S. merchant fleet and the construction and operating cost difference between the Nation's U.S. flag and foreign flag vessels can be found in our recent report, "Maritime Subsidy Requirements Hinder U.S.-Flag Operators' Competitive Position," CED-82-2, November 30, 1981.

BACKGROUND

The U.S. merchant marine now carries very little of the Nation's oceanborne dry bulk imports and exports--about 1 percent of the total. (See table 1.) Few entrepreneurs appear willing to build ships in U.S. yards, register them under the U.S. flag, and use them to carry more of the Nation's foreign commerce because of the high costs involved. According to the report cited above, the prices of new vessels from U.S. shipyards are at least double those of similar ships from foreign builders. Also, domestic yards take much longer to build and deliver ships. As a result, ship operators have strong incentives not to patronize U.S. builders unless the Government subsidizes ship construction in U.S. shipyards.

Ship operators also have little incentive to register their vessels under the U.S. flag without the promise of an operating subsidy. The payroll costs for the American crews that man U.S. vessels are much higher than the crew costs for foreign vessels. Certain other costs are also higher, but it is the high cost of shipboard labor that accounts for the bulk of the operating cost difference between U.S. flag and foreign flag vessels.

The Federal Government has previously attempted to increase the share of the Nation's bulk imports and exports that move in U.S. vessels. It was one of the principal goals of the maritime

Table 1

Share of Dry Bulk Cargoes Moving in U.S. Foreign Commerce Carried by U.S. Flag Vessels, by Weight and Value, 1971-79

(percentages)

Measure	1971	1972	1973	1974	1975	1976	1977	1978	1979
By weight	2.1	1.6	1.6	1.8	1.4	1.7	2.0	1.5	1.0
By value	3.1	2.4	2.5	2.3	2.8	2.8	2.8	1.8	1.7

Source: The Annual Report of the Maritime Administration for Fiscal Year 1980, p. 19.

program that was inaugurated in 1970 to divert a sizable share of the bulk trades to U.S. vessels. Federal construction subsidies were to be provided for building bulk carriers in U.S. shipyards and the law was amended to permit operating subsidies to be awarded for operating U.S. flag vessels in the bulk trades.

Several bulk carriers were built in the early 1970s, but far fewer than were envisioned when the program began. The high cost of construction, together with limited subsidy funds, is one reason why so few vessels were built; another--and possibly more important--reason was the unwillingness of many bulk carrier operators to enter into operating subsidy contracts with the Maritime Administration. They owned ships that were registered under foreign flags, and they would have been required by U.S. law to divest themselves of those ships in order to receive operating subsidies for their new U.S. flag tonnage. This they were unwilling to do. As a result, the goal in the 1970 program of substantially increasing U.S. participation in the carriage of U.S. bulk commerce was never realized and by the late 1970s had been abandoned.

WILL EXPORTS BE INHIBITED OR BECOME NONCOMPETITIVE?

The first and third of your questions are related and will be discussed together here. The difference between merely inhibiting U.S. dry bulk exports and actually rendering them noncompetitive in world markets is no more than a difference in degree. Because it would require use of more costly U.S. flag ships, a cargo preference requirement like that in H.R. 4627 would increase the costs of transporting U.S. bulk exports to our overseas customers. The increase would be gradual as the requirement was phased in, in increments of 4 percent a year. In addition, implementing this requirement might raise further the cost of shipping commodities on U.S. flag ships. Until the number of U.S. flag vessels can be increased, competition for the few qualifying vessels might be expected to drive up their charter rates, increasing the cost of delivering commodities that are carried aboard them. Of course, if it is impossible to squeeze the legally required fraction of U.S. dry bulk imports and exports aboard available U.S. vessels, something must give. Presumably we would use more foreign flag vessels to carry our commerce than the law strictly permitted, rather than curtail our imports and exports. In any case, upward pressure on charter rates is the most likely outcome--pressure that might persist for many years.

Higher charter rates would mean higher transportation costs for U.S. dry bulk exports. Whether the higher costs would severely, or slightly, impair the competitiveness of U.S. exports depends on circumstances that are particular to each commodity. It is logical to assume that exporters will be able to shift the costs forward to their customers abroad if the price of the delivered commodity inclusive of the additional transportation cost remains lower than the delivered price of a competitor's product. In other words, in those markets in which U.S. exporters already enjoy a substantial price advantage over their foreign competitors, they should be able to shift higher transportation costs forward to their customers. In other markets in which they have little or no price advantage over their competitors, the ability of U.S. exporters to shift costs forward will be constrained and they may have to absorb some or all of the added costs themselves. Whether they can do so depends primarily on their present profit margins. If their margins are large enough, they may be able to do so and still retain an incentive to export.

Much also depends on the size of the share of foreign markets that U.S. exports now claim. The larger the share of the world market for any commodity that U.S. exports supply, the more likely it is that an increase in transportation costs can be shifted forward, in whole or in part, to our customers--at least at first. The United States exports no major commodity of which it is the world's sole supplier, although it is the dominant supplier of several. For example:

--U.S. exports of soybeans totaled 23.7 million metric tons from July 1, 1979, to June 30, 1980; those of Brazil, Argentina, and the European Economic Community (EEC), the three next largest exporters, amounted to less than 4.5 million tons.

--In the same year the United States exported 37.2 million metric tons of wheat and wheat flour, or about 15 percent less than the combined total of wheat exported by Canada, Australia, the EEC, and Argentina, the four next largest exporters.

--Just over 25 percent of world coal exports in 1979 came from the United States. No other nation exported as much, but Australia exported two-thirds as much and South Africa more than one-third as much.

In the longer run, U.S. exporters may have less ability to shift transportation cost increases forward to their customers. Soybeans, wheat, coal, and most of the other commodities that the United States exports are available from other countries. If whatever price advantage the United States now enjoys were eroded, other countries might be expected to gradually increase their exports at the expense of the United States.

WILL IMPORT COSTS INCREASE?

Much of the same reasoning that explains in what circumstances a cargo preference requirement would be likely to reduce U.S. dry bulk exports is relevant also in understanding how dry bulk imports would be affected. As transportation costs rise, pressures would develop to raise the landed costs of dry bulk imports. If the United States were dependent on foreign sources for the bulk of its supplies, and if it were only a small consumer of the commodity in world markets, U.S. consumers would probably have to absorb the higher transportation costs themselves. If the imports competed with domestic supplies, the ability of the foreign suppliers to shift costs forward to the U.S. consumers would probably be diminished.

WILL INVESTMENT IN SHIPBUILDING BE STIMULATED?

The current size of the U.S. dry bulk fleet is small relative to the number of ships that would be needed to carry 40 percent of the Nation's dry bulk exports and imports. Not only does the U.S. merchant marine now carry very little of the Nation's ocean-borne dry bulk imports and exports, but the ability to expand that share with the existing fleet is highly limited. Using assumptions designed to maximize the potential share that the existing U.S. flag vessels can carry, we estimate that even if these vessels were loaded to capacity and in constant use, they would be unable to carry more than 5 percent of current dry bulk exports and imports. Therefore, unless exports and imports were expected to decline substantially, enacting a broadened cargo preference requirement would stimulate investment in U.S. shipping and add to the demand for new vessels from U.S. yards. It would also stimulate investment in new shipbuilding facilities. New vessels would be needed quickly and in large numbers if the statutory requirements are not to be flouted. The pressure on prices might be great, not merely on charter rates but also on the prices of new ships. These pressures may be expected to have a strongly stimulative effect on investment in shipping and shipbuilding. Any expectations, however, that expanding cargo preference will raise transportation costs enough to reduce exports and imports will reduce this investment incentive.

Our remarks should not be interpreted to mean that we believe that the cargo preference provision in H.R. 4627 would be an efficient device for promoting investment, or that the investment that resulted would represent the best use to which resources might be put in the U.S. economy. If resources flow into shipping or shipbuilding, some or all of them may well come from other economic sectors, diminishing output there. Normally there is a presumption that if resource flows occur only in response to a statutory requirement, such as cargo preference, the value of the foregone product probably exceeds the value of the new product, and that the movement of resources is therefore "inefficient." But so many exceptions to this general presumption about efficiency may be cited that we refrain from drawing that conclusion here.

WILL THE CONCEPT OF FREE TRADE BE ERODED?

The cargo preference provision would do little to promote the concept of free trade among nations, since it would impede trade by adding to transportation costs. The provision could have symbolic importance because of the predominant position of the United States in world trade, for it would mark the first major expansion of the U.S. cargo preference laws in more than a quarter century.

The United States could not legitimately be accused of a unique breach of free trade if it adopted the proposed cargo preference provision, because forces are at work today which tend to limit the freedom of shippers to choose the flag of their carrier. For example, a number of "bilateral agreements"--i.e., agreements between pairs of nations--have been signed that provide for a division between the two national fleets of the commerce that moves between the two nations, sometimes allowing a small part to be shared with the ships of other nations. The United States is a party to several such agreements, including one with the Soviet Union and another with the People's Republic of China.

The United Nations Conference on Trade and Development (UNCTAD) has adopted a Code of Liner Conduct that would reserve 40 percent of the cargoes moving aboard liners--general cargo vessels--between two nations to the ships of each national fleet. Carriage of the remaining 20 percent would be open to the ships of other nations. The Code will have to be ratified by countries whose fleets contain a stipulated fraction of the world's commercial tonnage before it can take effect, and it is still unclear when or whether that will happen. But clearly the cargo preference provision in H.R. 4627 is consonant with the spirit of the UNCTAD Code, notwithstanding that one embraces only dry bulk cargoes, the other only liner cargoes.

IS REGULATION OF THIS REQUIREMENT PRACTICAL?

We are unable to say whether the proposed preference requirement would prove practical to administer. The Government has experience in administering other cargo preference requirements that apply to Government-impelled cargoes. The administrative difficulties might be greater for this provision, however, because of the need to coordinate compliance among many commercial enterprises. Presumably, if given enough resources, the Government could administer the provision. But we do not know how much it would cost to administer the provision in a manner that caused a minimum of interference with private decisionmaking and hindered shippers as little as possible.

The cost of the preference requirement may depend in part on where in the Federal Government the responsibility for its administration is located. If the provision is administered by an agency that is responsible for promoting the U.S. merchant marine, the "ship American" requirement is apt to be interpreted more strictly and exceptions allowed more sparingly than if the provision is administered by an agency that is responsible for promoting U.S. commerce. In the former case, the cost of the provision will likely be higher, but its value to the U.S. maritime establishment will be greater.

As arranged with your office, we did not obtain agency comments on the contents of this report. Unless you publicly announce its contents earlier, we plan no further distribution until 30 days from the date of the report. At that time, we will send copies to interested parties and make copies available to others upon request. If you have any questions about this letter or if we can be of further assistance, please call us.

Sincerely yours,

Morton A. Myers

Morton A. Myers
Director