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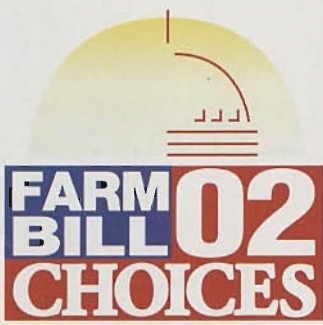
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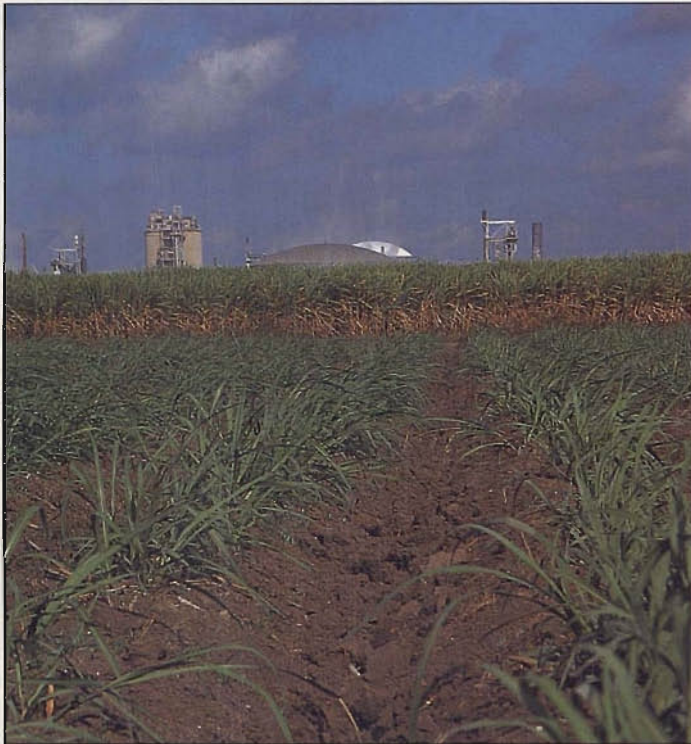
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COLLISION COURSE:

THE LOOMING CONTRADICTIONS OF U.S. SUGAR POLICY



Can't Beet It with a Cane: The U.S. sugar industry, from cane growers in Louisiana to beet producers in Idaho, will feel the effects of the looming collision between U.S. sugar policy and international trade commitments. photos courtesy Clear Window

BY ERIC KNEPPER, DAVID B. SCHWEIKHARDT, KELLEY CORMIER, AND JUAN ESTRADA-VALLE

United States domestic sugar policy is on a collision course with international trade obligations negotiated under the North American Free Trade Agreement (NAFTA) and the Uruguay Round Agreement of the General Agreement on Tariffs and Trade (GATT). As sugar imports increase under the terms of these agreements, the contradictions of high price supports and trade liberalization commitments make existing domestic policy inoperable and leave policy makers with few palatable alternatives.

These contradictions are surfacing as the U.S. provides greater access to sugar imports from Mexico and Canada. The domestic price support program that has long supported the industry faces increased pressure, and policy makers must resolve the conflicting policy objectives that

are becoming evident. Recent government purchases of stocks and limits on domestic production are merely a prelude to the looming collision of domestic and trade policies.

U.S. sugar policy is a combination of a domestic loan rate program and a Tariff Rate Quota (TRQ) designed to support domestic price at a level near the loan rate. The Federal Agricultural Improvement and Reform Act (FAIR) provides recourse or nonrecourse loans, depending on the level of imports, at a rate of 18 cents per pound for raw cane sugar and 22.9 cents per pound for refined beet sugar for crop years 1996-2002.

U.S. sugar production has increased from 7.9 million tons in 1994 to 8.5 million tons in 2000, while U.S. consumption increased from 9.3 million tons to 10.3 million

tons annually during that same period (Figure 1). The viability of the nonrecourse loan program relies on the import protection provided by the TRQ. Recent events and long-term trade obligations are requiring the U.S. to open its borders to more sugar imports, causing the industry's domestic and trade policies to become increasingly contradictory.

Northern Exposure

The contradictions in U.S. sugar policy begin at the U.S.-Canadian border. In 1995, Heartland By-Products Company received a ruling from the U.S. Customs Service (USCS) regarding the import of sugar syrup under subheading 1702.90.40 of the Harmonized Tariff Schedule of the United States. Heartland intended to mix raw granular sugar with molasses and water in Canada and ship the resulting sugar syrup to Michigan under that subheading. The sugar syrup would then be processed to extract a liquid sucrose for sale to U.S. food processors for use in breakfast cereal, ice cream, and candy. This ruling permitted the syrup to be imported at a lower tariff outside the TRQ.

In 1998, shipments of sugar syrup from Canada to the U.S. reached 100,000 tons (Figure 2). The USCS then reversed its earlier ruling and held that Heartland's process was an act of "disguise or artifice" intended to evade the sugar import quota. The USCS declared that the product must enter the U.S. under the TRQ, which would have increased the tariff on the syrup to prohibitive levels.

In February 2000, the U.S. Court of International Trade ruled that the reversal of the original USCS ruling was an "arbitrary, capricious... abuse of discretion" that violated the "plain meaning" of the tariff schedule. Citing the long-standing principle that "a manufacturer has the right to fashion goods to avoid the burden of high duties," the court restored the original ruling allowing Heartland to import syrup outside the TRQ (U.S. Court of International Trade).

This decision leaves the U.S. border open to further increases in sugar syrup imports. In 1999 nearly 140,000 tons of sugar were imported as sugar syrup, making Canada a larger source of sugar imports than all but three countries that ship sugar to the United States under the TRQ. Though the Court's ruling could be appealed, Congressional action may be required to amend the tariff schedule and limit such sugar imports. Such action might be incompatible with U.S. obligations negotiated under the Uruguay Round.

Southern Discomfort

The contradictions in U.S. sugar policy also arise at the U.S.-Mexico border. The liberalization of trade negotiated in NAFTA, combined with the modernization of the Mexi-

can sugar and food processing industries, is causing a transformation of the sugar and sweetener sectors in Mexico. As the implementation of NAFTA nears completion, this transformation will result in greater export capacity for the Mexican sugar industry.

Mexican sugar production reached 5.4 million tons in 2000 (Figure 3). This growth in production has resulted from increased yields, favorable weather conditions, and the addition of 10,000 hectares to sugar cane production. Mexico's sugar consumption hit 4.5 million tons in 2000.

As production of cane sugar increases, Mexico's food processing industry is converting to the use of high fructose corn syrup (HFCS), much as U.S. processors did in the 1970s. The liberalization of corn trade between the United States and Mexico under NAFTA, leading to lower corn prices for Mexican processors, has contributed to the growth in Mexico's use of HFCS. In 1999/2000, Mexico's production of HFCS reached 330,000 tons, while U.S. exports of HFCS reached 210,000 tons (Figure 4). The increased production and use of corn sweeteners in Mexico requires Mexican sugar producers to compete with HFCS processors, particularly in the soft drink market (USDA).

As Mexico's sugar production increases and competing sweeteners expand their role in the Mexican market, Mexico's sugar export capacity is likely to increase. Mexico's total export capacity has been projected to range from as

Figure 1: U.S. Production & Consumption



Figure 2: U.S. Import of Canadian Syrup

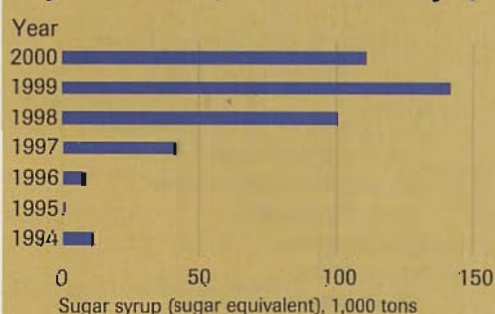
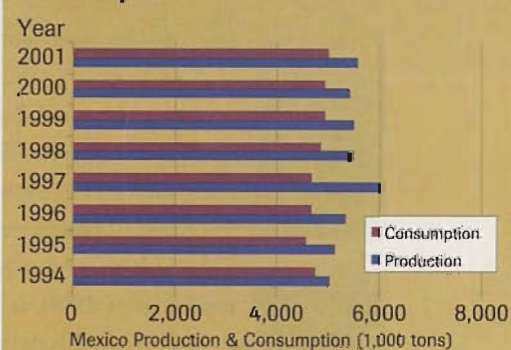


Figure 3: Mexico Production & Consumption



low as 138,000 tons to as high as 2.2 million tons annually for the coming decade, depending on the growth of HFCS use and the financial viability of the Mexican sugar industry

(Haley, 2000b). This increased export capacity, combined with the sugar trade liberalization in NAFTA, creates another contradiction in U.S. sugar policy.

The only remaining question is how rapidly Mexico will gain increased access to the U.S. market. A dispute has arisen over a side-letter to NAFTA, which the U.S. claims should modify the original agreement (Corn Refiners Association). Under the original NAFTA agreement, Mexico was permitted to export 27,557 tons

648,000 tons to the U.S. in 2001, while under the side letter agreement Mexico would have access for only 180,000 to 207,000 tons.

While the resolution of this dispute will determine how quickly the U.S. market will be opened to Mexican sugar exports, the eventual outcome will be the same: By 2009, the United States' commitments under WTO and NAFTA will come into conflict with domestic sugar price supports.

Domestic Intranquility

U.S. sugar policy is already straining under the pressure of lower prices, resulting in short-term measures designed to support domestic prices in the face of increasing imports. Faced with an oversupply, the USDA purchased 141,000 tons of sugar in June 2000. In addition to these purchases, USDA held another 165,000 tons of sugar that had been forfeited under the nonrecourse loan program, giving USDA ownership of 3.3 percent of the total sugar production forecast for the 2000 crop (USDA). Analysts indicate that USDA will buy 500,000–750,000 tons of sugar in 2001.

In August 2000, USDA announced a Payment-In-Kind (PIK) diversion program designed to reduce supply, with sugar producers bidding to indicate how much refined sugar they would accept from the government in exchange for idling a portion of their acreage. The PIK program is a short-term measure intended to stabilize market prices and reduce sugar production, crop loan forfeitures, and government storage costs. Nearly 100,000 acres of the 2000 sugar beet crop, representing 297,000 tons of sugar, were diverted under this program (USDA, 2000).

Bitter Medicine

Under the Uruguay Round Agreement, the U.S. is required to maintain duty-free access for a minimum of 1.256 million tons of raw and refined sugar each year. When the obligation to accept increased sugar imports from Canada and Mexico is added to the WTO obligation, U.S. policy makers are left with few palatable options. They can maintain the U.S. price support program and accommodate Canadian and Mexican exports by reducing imports from other sugar-producing countries, or they can modify the U.S. price support program to accommodate sugar exports above the existing level of the TRQ.

Resolving these contradictions will require compromise among policy objectives, such as controlling budget cost or maintaining producer income. At least five alternatives will be available as Congress considers the future of the U.S. sugar program.

Figure 4. U.S. Exports of HFCS

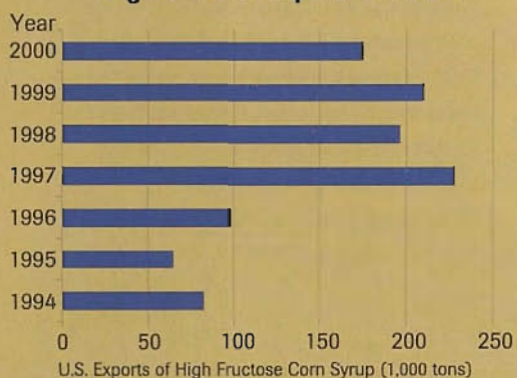


Figure 5. U.S. Sugar Import Allocations, 2001



annually to the U.S. during the first six years of the agreement, increasing to 165,000 tons on October 1, 2000 and thereafter increasing 10 percent annually until 2008. These limits were to be waived, giving Mexico unlimited access to the U.S. market after 2000, if Mexico achieved "net surplus producer" status. All barriers on sugar trade between the U.S. and Mexico will be eliminated in 2008 (Haley, 2000a).

The dispute has arisen over the calculation of Mexico's net surplus producer status and the speed with which Mexico will be permitted access to the U.S. market. The original agreement defined the net surplus producer status based only on Mexico's production and consumption of sugar. It did not account for use of corn sweeteners. In an eleventh-hour attempt to secure votes for the agreement, the U.S. introduced a side letter, which Mexico claims never to have accepted. This letter revised the net surplus calculation to account for Mexico's use of corn sweeteners. Under the original formula, Mexico would have access to export

First, Congress could maintain the existing level of imports by reducing the import quotas of other sugar producers (Figure 5) and increasing access for Mexican and Canadian sugar. Replacing other countries' exports with Canadian and Mexican sugar would be a classic case of trade diversion, with Mexican and Canadian sugar displacing lower cost sugar exporters in the U.S. market.

Second, policy-makers could reduce the loan rate to a level consistent with U.S. import commitments. It is questionable whether any price support above the world level would be operative, however, if Mexico's sugar export capacity reaches the higher end of its potential and sugar syrup imports from Canada continue to increase.

Third, the U.S. could replace the nonrecourse loan with the marketing loan used for other commodities. A marketing loan would decouple domestic price supports from their reliance on import restrictions by paying producers a loan deficiency payment when the market price falls below the loan rate. For each cent by which the market price falls below the loan rate, the budget cost would increase by an estimated \$175 million. Such an approach would increase the budget cost of the sugar program and could face WTO restrictions on the level of subsidies permitted.

Fourth, Congress could institute continually tighter supply controls on domestic sugar production. Given the reduction in U.S. sugar acreage that might be required to support prices at the existing price support level, however, such an alternative might prove unacceptable to U.S. sugar producers, processors, and input suppliers.

A final alternative would be some form of producer buy-out program. Such a program could either permit producers to bid for a lump-sum payment in exchange for their agreement to exit the industry, or it could provide lump-sum payments to all producers as compensation for losses following the termination of the loan program. Our analysis suggests that sugar beet producers would require a payment of \$2,000 to \$3,500 per acre as an incentive to participate in a permanent buyout program. The political viability of such an approach, as well as the ability of Congress to resist the pressure to provide other policy benefits after the buy-out is complete, is highly questionable.

The contradictions of U.S. sugar policy will be felt in 2002 and will be unavoidable during the next decade. The fragile equilibrium of domestic and trade policy that has supported the domestic sugar industry during the past two decades cannot endure as imports increase. The resolution of these contradictions will require policy makers, producers, and processors to make fundamental choices about the industry's future.

For More Information

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Shoesmith, Shannon, and Sherri Lehman. "CRA Presents NAFTA Panel Testimony as Sweetener Dispute Escalates." Corn Refiners Association. September 5, 2000. Available at <http://www.corn.org/web/cc_0900.htm>

Reversal of Heartland By-Products Ruling

On August 30, 2001, the U.S. Court of Appeals reversed the earlier ruling of the U.S. Court of International Trade and upheld the decision the U.S. Customs Service that Heartland By-Products' mixture of sugar, water, and molasses was an attempt to evade the TRQ on sugar. The Appeals Court decision restores the decision by the USCS to impose a prohibitive tariff on Heartland's sugar syrup imports and effectively blocks Heartland's ability to import sugar outside the TRQ. The Appeals Court decision is subject to further appeal by Heartland to the U.S. Supreme Court. See U.S. Court of Appeals. *Heartland By-Products v. United States*. Slip Opinion 00-1287, August 30, 2001, and U.S. Court of International Trade. *Heartland By-Products v. United States*. Slip Opinion 00-10, February 1, 2000.

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