CALIFORNIA ASSOCIATION of WINEGRAPE GROWERS

September 17, 2018

Trade and Commercial Regulations Branch, Regulations and Rulings
Office of Trade
U.S. Customs and Border Protection
90 K Street, NE 10th Floor
Washington, DC 20229-1177

RE: Comments on Modernized Drawback, USCBP-2018-0029, RIN 1515-AE23

To Whom It May Concern:

The California Association of Winegrape Growers (CAWG), a statewide organization representing winegrape growers, submits the following comments regarding a proposed rule, RIN 1515-AE23, to establish a new process for drawback pursuant to the Trade Facilitation and Trade Enforcement Act (TFTEA). These comments will focus on that portion of the proposed rule which would disallow the filing of a substitution drawback claim for internal revenue excise tax paid on imported merchandise where no excise tax was paid upon the substituted merchandise.

In general, CAWG believes substitution drawback for wine, under 19 U.S.C. 1313(j)(2), has produced significant market distortions adversely affecting California winegrape growers.

It is clear the allowance of substitution drawback claims for wine has operated to increase both the import and export of bulk wine, and drawback subsidies flow to those enterprises engaged in the import and export of wine. Research suggests the program, under prevailing market conditions where the volume of wine imports exceed exports, stimulates greater exports of wine than would occur without the program. However, the lack of transparency in how the program operates makes it difficult to determine with confidence which wine industry sectors and operators are helped or harmed by the program.

It is also clear that drawback subsidies have contributed to significant structural changes in the wine industry by enhancing the intrinsic value of imported bulk wine, which in turn confers a competitive advantage in the U.S. marketplace for imported bulk wine over comparable domestically produced bulk wines. Consequently, CAWG believes the proposed changes to substitution drawback claims for wine, as detailed in U.S. Customs and Border Protection (CBP) Notice of Proposed Rulemaking (NRPM) on Modernized Drawback (USCBP-2018-0029), would on balance be beneficial to California's winegrape growers

1121 L Street
Suite 304
Sacramento, CA 95814
PHONE: 916 379 8995
FAX: 916 379 8999
EMAIL: info@cawg.org
WEBSITE: www.cawg.org

Background
The U.S. Treasury offers a drawback subsidy equal to 99-percent of import duties and federal excise taxes on imports of non-sparkling wine of 14 percent alcohol or less whenever firms match imports with qualifying exports of wine of the same color and the price variation between the imported wine and the exported wine does not exceed 50-percent. Firms have until five years after the date of import to claim a drawback subsidy.

Concerned that the substitution drawback program as described above induces bulk wine imports, CAWG commissioned a study, *Economic Implications of the Import Duty and Excise Tax Drawback for Wine Imported into the United States*, published August 20, 2011, by researchers at University of California Agricultural Issues Center, (http://aic.ucdavis.edu/publications/Drawback831.pdf).

Some key conclusions from the study are:

- The drawback program for bulk wine creates large incentives for firms to expand imports or exports to capture additional drawback. The drawback subsidies stimulate the import and export of bulk wine.
- Firms with substantial imports of bulk wine have a strong incentive to match those imports with exports in order to claim drawback subsidies. Conversely, firms with substantial exports of bulk wine have a large incentive to expand imports to match against exports.
- Experience shows under differing market conditions the drawback subsidy program helps to increase domestic winegrape prices and sometimes it helps to weaken domestic prices. Under current market conditions, the net effect of the program is to stimulate greater exports.

However, the report's authors note (page 33):

> "There remains much to learn about the magnitudes of impacts of the drawback program. Unfortunately, without better data on wine exports and imports by color and without more detail on import and export prices, it is difficult to know when imports exceed matching exports or exports exceed matching imports."

The preceding observation concerning limited data and lack of transparency is significant, and a better understanding of which import-export transactions qualify for drawback subsidies is key to gaining and understanding of how the program affects winegrape growers.

<u>Lack of Data Obscures Potentially Significant Adverse Effects</u>
Wine varies greatly based on such attributes as color, grape varietal, origin and quality factors. The substitution drawback program deems wines to be functionally equivalent or commercially interchangeable, when imported wine and exported wine match based on color (i.e., red to red or

white to white) and the variation in price between the imported wine and the exported wine does not exceed 50-percent. This standard for substitutability does not account for the wide variability of differences in wine within broad color categories of red and white.

So, it's reasonable to assume wineries claiming substitution drawback subsidies are importing bulk wines made from grape varietals which are relatively scarce in the California market and are exporting bulk wines made from grape varietals that are relatively abundant. In which case, growers of grapes that are relatively abundant benefit, while growers of grapes defined by market scarcity would be hurt by the program.

The lack of publicly available data on drawback subsidies claimed on the basis of wine varietal (Cabernet Sauvignon, Chardonnay, Merlot, Sauvignon Blanc, etc.), country of origin, destination country, price point and dates make it impossible to accurately assess which communities of growers are helped or hurt by this program. This lack of transparency is highly problematic because imported bulk wines compete with domestic growers of the same wine varietals.

Increased Bulk Wine Imports Hurt California Winegrape Growers

Generally, when bulk wine is imported it competes with domestically produced wine made from the same grape varietal and which is otherwise comparable in quality and price. Consequently, bulk wine imports will depress market prices for California grapes. CAWG believes bulk wine imports, stimulated in significant part by substitution drawback subsidies, accounts for a significant share of the decline in winegrape acreage in California's Central Valley.

The annual California Department of Food and Agriculture's Grape Acreage Report (produced in cooperation with the USDA National Agricultural Statistics Service) reveals a substantial decline in winegrape acreage for California counties most sensitive to bulk wine market pricing. In eight California counties – Fresno, Kern, Madera, Sacramento, San Joaquin, Stanislaus, Tulare and Yolo – total winegrape acreage declined from 217,487 to 125,391 acres over the five-year period from 2012 to 2017. As a point of reference, the reported net loss of more than 92,000 winegrape acres exceeds the total combined winegrape acreage currently in production in Oregon and Washington,

CAWG recognizes that several factors have contributed to declining winegrape acreage in the Central Valley, but we believe depressed winegrape prices attributable to bulk wine imports is a significant factor. Moreover, increased utilization of imported bulk wine contributes to the commodification of winegrapes.

The California winegrowing industry commits substantial resources and effort to marketing and promoting winegrapes and wine on the basis of geographic identity. Many winegrape growers invest heavily to promote consumer awareness of the geographic identity of California winegrapes. Grape origin may be defined by the name of an individual vineyard or the location of the vineyard within an American Viticultural Area, county or regional appellation or state level identity – California.

Origin claims on wine labels are strictly regulated and label claims of origin based in California require that all wine in the container originate from California grapes. The availability of subsidized bulk wine imports encourages California wineries to shift away from California origin claims – an important tool for communicating value and quality to consumers – because the low cost of imported bulk wine outweighs the premium consumers would pay for a wine marketed as originating from California.

CAWG believes the added incentive to import bulk wine due to substitution drawback subsidies is contrary to winegrape growers' interests to market and promote California wine.

<u>Substitution Drawback Subsidies Confer Economic Advantage to Imported Bulk Wine</u>
Many reasons may explain why imports of bulk wine into the U.S. have increased so significantly since 2004, but to understand how substitution drawback subsidies promote bulk wine imports, it's useful to consider a hypothetical example.

A California winery has potentially many choices for sourcing wine for a domestically marketed wine brand. In our hypothetical, the winery has a choice between one of two 1,000-liter lots of wine which are equal in all respects -- cost, color and quality -- but one lot of wine originates from New Zealand and the other originates from California grapes. So, which of the two is most economically attractive?

While both lots lot wine are effectively equivalent in cost and quality, the shipment from New Zealand holds the potential of delivering a drawback subsidy to the winery, equal to 99-percent of the excise tax and duty, provided the winery can export an equal quantity of a like kind of wine sometime within the next five-year period. However, if the winery chooses to utilize wine made from California grapes and later exports California wine, it receives no subsidy.

So, for a period of five years after the date of import, the imported bulk wine transaction has the potential of returning the equivalent of $0.2827 in federal excise tax per liter of wine to the importing winery, provided the winery can find a qualifying export.

<u>Drawback Subsidies Do Not Specifically Promote Exports</u>
The value of the drawback subsidy does not necessarily attach specifically to wine that is imported or exported. Depending upon market conditions, a winery could apply the subsidy to the export transaction, to general domestic marketing activities or to the cost of the imported wine. Money is fungible, and it can flow towards those activities that generate the highest return. However, it's clear that California wineries that rely solely on California winegrapes for domestic and export markets are denied the benefit of a drawback subsidy, which can only be obtained when wine is imported and exported under the drawback program.

Based on the preceding, California wineries relying solely on California winegrapes are at a competitive disadvantage both in the U.S. market and the export market when competing against firms that benefit from drawback subsidies.

Future Policies or Economic Trends Could Market Effects of Substitution Drawback Program

If left unchanged, certain future policy decisions or economic trends could magnify the market distorting effects of the substitution drawback program as it applies to wine, resulting in significant and deleterious consequences for winegrape growers.

The Congressional Budget Office recently reported the U.S. budget deficit widened to $898 billion in the 11 months through August, exceeding CBO's forecast for the first full fiscal year under the current Administration. The nation's debt load is now $21.5 trillion and growing rapidly. In light of our nation's worsening fiscal condition, a future Congress and President may seek to increase alcohol excise taxes.

As CBP noted in its NPRM, excise tax on wine represents about 25-percent of the customs value of bulk wine. In any increase in excise taxes would increase the stimulative effects of drawback subsidies for the import and export of bulk wine. Thus, higher excise taxes create a stronger incentive for U.S. wineries to maximize subsidy benefits by displacing U.S. consumption of domestically produced wine with imported foreign wine and maximizing exports of U.S. wine. Carried to its logical conclusion, wineries seeking to maximize federal subsidies would want imports to satisfy all U.S. wine consumption, while all domestically produced wine is exported. In our judgment, any federal policy that encourages such an outcome fails to meet the standard of good policy.

California winegrowers are strongly committed to growing California wine exports and there are federal programs aimed at supporting foreign market development activities. However, if the U.S. were to regain its status as a net exporter of bulk wine, as it was prior to the start of CBP's policy to approve substitution drawback claims for wine, then the program will operate to promote even greater bulk wine imports as wineries seek to capture additional drawback subsidies. Such an outcome does not benefit California winegrape growers.

Currency exchange rates can have significant effects on imports and exports of bulk wine. In the event the U.S. dollar significantly weakens and U.S. exports become more competitive, we would expect to see bulk U.S. wine exports to grow as a result. However, the drawback subsidy program ensures that any substantial success in growing bulk wine exports will be met with a strong countervailing impulse by wineries to import more bulk wine. We find this problematic.

Conclusion

We recognize the substitution drawback program currently operates to stimulate U.S. exports of bulk wine because imports of bulk wine imports substantially exceed wine exports. To that end, substitution drawback subsidies will stimulate higher prices for certain grape varietals exported as bulk wine. However, for reasons stated previously, CAWG is very concerned by other market distorting effects of the substitution drawback program.

The drawback program does not exclusively promote exports: the program subsidizes both imports and exports. Moreover, the program operates to subsidize a certain category of winery operator that is engaged in both import and export activities. Meaning, as a matter of policy the program operates to the detriment of wineries that rely exclusively on California winegrapes, as these wineries are forced to compete against subsidized wineries who benefit from imported bulk wine.

CAWG believes adoption of CBP’s NPRM may pose short term negative consequences for producers of certain winegrape varietals, but the long terms benefits of eliminating the market distorting effects of drawback subsidies would confer a broad benefit to California’s winegrowers.

Sincerely,

John Aguirre
President, California Association of Winegrape Growers