Agricultural Trade Liberalization and the Developing Countries

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A. Introduction

Agriculture is the most distorted sector in the world economy. During the Uruguay Round of multilateral trade negotiations, a first major step was taken to remove some of these distortions and to open world agricultural markets to more competition. In the current Doha Round this process is to continue and the liberalization of agricultural markets has the highest priority during the negotiation process. In agriculture trade, there is a distinct North-South dimension to the negotiation process and outcome. The European Union (EU), the United States (US) and other developed countries who are major exporters of food and agricultural products will have to open their agricultural markets to more imports. Many least developed countries (LDCs) are currently net food importers but should have great export potential once world agricultural markets are opened up further.¹ Moreover, other developing countries who are currently large agricultural exporters are likely to be among the main beneficiaries of liberalized agricultural trade. Unfortunately, it is far from a clear cut issue to determine who will benefit from further agricultural trade liberalization in the developing world and there are misconceptions about the effects of developed country agricultural policy on LDCs.²

A popular point of view in the public, reinforced by non-governmental organizations (NGOs) and a semi-scientific press is that agricultural subsidies and protectionism exist only in the developed world, that the negative burden of these policies is placed mainly on LDC economies and their poorest rural households which in

¹ Note that as much as 43 out of 63 low income countries are net food importers (Valdes and McCalla, 1999).
² The notion of an LDC in this paper is based on the four UNCTAD criteria: (1) low-income based on 3-year average estimate of gross domestic product per capita with under US$900 for inclusion and above US$1,035 for graduation; (2) human resource weakness involving a composite Augmented Physical Quality of Life Index (APQLI) based on indicators of nutrition, health, education and adult literacy; (3) economic vulnerability involving a composite EVI (Economic Vulnerability Index) based on indicators of instability of agricultural production, instability of exports of goods and services, economic importance of non-traditional activities, merchandise export concentration and economic smallness; (4) population not greater than 75 million people.
turn is a major impediment to the economic development in LDCs. On the other hand, it is suggested that agricultural trade liberalization would be an engine for LDC economic development and prosperity for their poorest rural households and create no significant problems for developing country economies.

The main objective of this paper is to provide a thorough and informed economic analysis to show that agricultural trade liberalization in developed countries (i.e. EU and US) may also hurt LDCs and that current protectionism and agricultural subsidies in the EU and the US may also be helpful to poor rural households in LDCs. Point of departure for this analysis is that a accurate examination must sharply distinguish the agricultural trade interests of three different groups of developing countries: LDCs (e.g. Sub-Saharan Africa, Bangladesh, Cambodia, Nepal, Haiti), Cairns Group developing countries (e.g. Brazil, Chile, Colombia, Indonesia, Malaysia, South Africa) and other developing countries (e.g. India, China).

The following analysis provides economic arguments and examples that support both viewpoints sketched above. Section 2 looks at the nexus between trade liberalization and LDC economic development. In section 3, the paper analyzes links between protectionism, agricultural subsidies and the rural poor in LDCs. In the final section, the paper offers some policy implications for agricultural trade liberalization as well as for economic cooperation and development and the current negotiation process.

B. Trade Liberalization and LDC economic development

This section looks at the nexus between trade liberalization and LDC economic development. It has been argued that agricultural trade liberalization can support but may also hurt LDC economic development. This view is reinforced by NGOs and a semi-scientific press. Currently, agricultural policy in developed countries is protectionist and limits market access. Moreover, export subsidies depress world market prices and domestic support policies distort competition in global markets. These forces will lead to less agricultural exports from developing countries and impede their economic development. But when agricultural trade is liberalized, lower tariffs will lead to better market access conditions for developing countries. Abolishing export subsidies in developed countries will raise the prices of developing countries exports. Moreover, disciplined domestic support policies in developed countries will lead to less distortions and fairer competition in global markets. Combining these forces will lead to more agricultural exports from developing countries and support their economic development.

3 According to the UNCTAD-definition, India (and China) are not least developed countries.
However, there are also arguments to support the contrary point of view, i.e. that agricultural trade liberalization hurts LDC economic development. Why? One reason is that LDC exporters would lose their preferential market access to developed country markets (preference erosion). Moreover, protected markets and export subsidies lead to lower world market prices for many food products which in turn is beneficial to many LDCs which are currently net food importers. As a consequence of trade liberalization there is a case to be made that preference erosion may hurt LDC food exporters while higher world market prices would hurt LDC food importers.

Note that any Generalized System of Preferences (GSP) or Preferential Trade Agreement (PTA) will be beneficial to developing country exporters only if the preferential price exceeds the price that would prevail under free trade. The EU boasts an extensive system of trade preferences. Notably, in 2001, it adopted the "Everything but Arms" (EBA) initiative to grant Least Developed Countries (LDCs) preferential access to EU markets and better export opportunities. Under the EBA, all goods (except arms) from LDCs get duty and quota free access to the EU. Exceptions are rice, sugar and bananas where duties are being phased out over time. In addition to the Cotonou Agreement, which also remains in effect, the EBA initiative expanded EU trade preferences to benefit LDCs. In particular, entry prices for fruits and vegetables and specific duties applicable to flour and sugar are completely eliminated by the EBA, but are still applicable under the Cotonou Agreement, albeit at a reduced rate.

Bhagwati (2005) has argued that the recent spread of PTAs and "Special and Differential" (S&D) arrangements have seriously undermined the principle of non-discrimination or Most Favored Nations (MFN). For imports into the EU, MFN tariffs now apply only to a handful of countries, with all others enjoying politically driven lower-tariff rates under multiple PTAs, differentiated GSP, EBA and other schemes. As a result, the MFN tariff in the EU has become an LFN tariff, sorting out the least favored nations to trade with the EU (i.e. Australia, Japan, USA, New Zealand, Canada, and Taiwan).

Figure 1 illustrates a scenario with a preferential trade agreement for LDCs (e.g. the EBA initiative) in conjunction with distorting trade policy by the granting country (e.g. the EU). In this example, suppose the EU would import the agricultural commodity in question with free trade at prices $P_F$. However, an export subsidy ($P_T - P_S$) together with an equal or higher tariff results in the EU becoming an exporter. The world price would fall to $P_S$. Trade preferences imply that LDCs would face import prices $P_S$ and export prices $P_T$ equal to the internal EU price. Clearly, the lower world price benefits LDCs that are currently net food importers while exporting LDCs would benefit from preferential access to the EU market at the higher internal price $P_F$. In this case, full trade liberalization eliminating tariffs and export subsidies would be raising prices that importers have to pay while lowering prices that exporters will receive from the EU. Welfare losses ensue for both LDC food exporters and importers.
For recipient developing countries, the EBA initiative enhances their ability to be more competitive in the EU market, but it does not necessarily lead to a strong utilization of the program. The benefits accrued by an LDC from preferential access depend on many factors, including the extent of the product coverage, the margin of preference, the complexity of program rules and regulations, the costs to meet eligibility requirements, and the trade-limiting effects of program constraints (OECD, 2004). In addition, many LDCs lack productive or export capacity, which may limit their ability to take full advantage of EBA trade preferences. Under the EBA, LDC exporters are expected to switch their utilization of preferences to EBA-GSP terms, as the latter constitutes a more favorable regime. However, according to OECD estimates, the use of EBA preferences among LDC countries has been meager and most African LDCs have hardly ever used the EBA scheme.

The main reason for the low utilization of EBA is the co-existence of competing preference schemes (e.g. the Cotonou Agreement). This may not change until the Cotonou regime is eventually modified after 2007. Another important reason for the low utilization is that the EBA initiative has stricter rules of origin (RoO) than the Cotonou Agreement, which allows ACP countries to source components from any other ACP country. Currently, the RoO tend to hinder utilization of EBA preferences particularly in manufacturing. Thus, a harmonization of the RoO for trade preference purposes is highly desirable and the EU has initiated activities to simplify the RoO in an effort to enhance preference utilization. A third factor contributing to the low uptake of trade preferences is the capacity of LDC exporters to meet EU quality, certification and traceability requirements, but this is not peculiar to the EBA. Finally, it is important to point out that the EBA is non-contractual, which means that the EU can change it, or rescind it. As such, it offers less predictability than other schemes and this may put-off some ACP states.

In an effort to quantify the factors that contributing to the low uptake of trade preferences, the aforementioned OECD study found that the size of the preferential margin under EBA has a positive effect on the utilization of the scheme, whereas dual eligibility for both Cotonou and EBA appears to have a negative effect, confirming the importance of competing schemes. Note that unlike African LDCs, eligible Asian countries not benefiting from another preference scheme made much greater use of EBA. Moreover, low-value transactions (shipments) seem to have a negative impact on EBA utilization, suggesting that smaller exporters have difficulties in taking advantage of the EBA preferential access.

An argument often cited in the context of agricultural trade liberalization is that LDC importers will gain if they turn into exporters with free trade. However, it is hard to believe that an LDC food importer will suddenly turn into an exporter when export prices actually decrease. In the context of Figure 1, an LDC exporter would receive $P_T$ with duty free/preferential access (e.g. with EBA) prior to trade liberalization and only $P_F$ with free trade. Yet, it still imports at the higher price $P_T$ and will not export at the lower price $P_F$.

Figure 2 illustrates a different scenario. Suppose that a developing country currently importing an agricultural commodity at $P_S$, does not have preferential EU...
market access (i.e. a country that is not eligible for EBA). When will this country gain from trade liberalization when world prices are increasing to $P_F$? The simple answer is that it will only gain when it becomes an exporter and offsets the gains from trade as an importer by obtaining even larger gains from trade as an exporter (i.e. area $b$ must then exceed area $a$). This analysis leads us to conclude that countries that are already competitive in world agricultural markets (i.e. domestic equilibrium price $P_D$ is close to or exceed $P_S$) are likely to gain most from further trade liberalization (e.g. Brazil). This conclusion also points to the apparent conflict of interests between developing countries with respect to trade liberalization.

Sugar serves as an important example here. Under WTO rules, agricultural export subsidies are prohibited unless they are within the annual scheduled WTO limits specified in the export subsidy commitment schedules of each member. In 2003, Brazil, Australia, and Thailand took WTO dispute settlement action against the EU on the basis that it violates its WTO obligations by providing export subsidies in excess of its WTO export subsidy commitment levels for sugar, because the EU fails to apply the required WTO limits to its subsidized exports of the ACP/India equivalent sugar and the C sugar.

The EU's annual scheduled WTO limits for sugar are about US $800 million and 1.27 million tons. In addition to exports consistent with scheduled limits, the EU exports 1.6 million tons which it regards as equivalent to its imports of sugar under special preferential arrangements from certain sugar exporters (so-called "ACP/India equivalent sugar"). It also exports an additional quantity not entitled to EU domestic price support or direct export subsidies (but which is indirectly subsidized by high profits made on domestic sugar sales) which must be exported by law (called "C sugar").

This dispute was heard by a WTO Panel that ruled against the EU in 2004. In a comprehensive appeal to the WTO Appellate Body, the EU argued that its WTO Schedule actually allows for direct export subsidies for ACP/India equivalent sugar and that its C sugar exports do not receive export subsidies. However, the WTO Panel and Appellate Body ruled that the EU still violates the WTO Agreement on Agriculture (requiring that all export subsidies as defined in Article 9 of that Agreement to be reduced and that the internal EU sugar market provides both the finance and incentive for C sugar exports to be made at below cost prices which constitutes an "export subsidy") and dismissed the appeal.

It is interesting to note is that the case was brought up by Brazil and Thailand against the interests of ACP and other developing countries who sided with the EU. There is an apparent conflict of interest between countries that are very competitive in world sugar markets and others that are not. A similar situation is found in world banana markets. Here, the conflict of interests exists between ACP countries (importing into the EU under a quota system with referential tariff) and the so-called dollar-zone countries (e.g. Ecuador, Costa Rica, or Colombia without preferential EU access). With respect to bananas, the WTO has ruled that the EU must eliminate all import quotas by 2006 to be replaced with a preferential tariff which will favor low-cost dollar-zone producers at the expense of high-cost ACP countries.
With respect to cotton, the situation is somewhat different. The EU has no major production interests and internal EU prices are more close to world prices. Therefore, utilization of EBA preferences will not have much of an impact on LDCs. Cotton was the main issue for the failure of the Cancun summit in December 2003 where the some of the poorest LDCs in West Africa demanded an end for the cotton subsidies in developed countries. High subsidies given to cotton farmers in richer countries (particularly in the US) induce overproduction which is dumped in the international market at an artificially low prices. This has severe adverse effects for certain West African countries (i.e. Benin, Burkina Faso, Chad, Mali) where cotton is the main cash crop and the most important source of export revenue.

A fundamental justification for granting trade preferences is to encourage economic development in the recipient countries. However, critics of trade preferences remain skeptical and mount strong arguments against them. Perhaps the most damaging aspect of the major preferential trade agreements such as the Cotonou Agreement is the extent to which countries have become preference dependent diverting resources towards industries that obtain the greatest degree of preference. Even though EBA preferences cover all goods, there is still an incentive to divert resources to products that receive the greatest preference margin, which are often agricultural products. As a result, the production base becomes narrow, with a disproportionately high share of resources being directed towards preference receiving industries which in turn may also reduce the competitive pressures on them. A lack of diversification and the failure to expand into other competitive industries can make countries more vulnerable to external shocks. Many of the poorest countries are characterized by a very narrow production/export base, which are at least to some degree attributable to preference-related distortions. Another problem is that preference-receiving industries frequently end up being high-cost producers. When trade preferences raise the average price received, more resources than optimal are attracted into the receiving industry raising average costs.

There are numerous empirical studies evaluating the effects of agricultural trade liberalization.

For example, Yu and Jensen (2003) find that LDC gains from EBA decline or even reverse with further agricultural trade liberalization by the EU. Results as such highlight the difficulties that LDCs face in WTO negotiations. Peters and Vanzetti (2004) find that most benefits from further trade liberalization in agriculture accrue to developed countries while the gains are small and unevenly distributed among developing countries. Because of higher world prices, producers in developing countries tend to gain at the expense of consumers and welfare losses ensue for net-food importers (i.e. African LDCs). Hertel (2004c) calculates that agricultural trade liberalization in OECD countries largely benefits Brazil and Argentina while the welfare effects on sub-Saharan Africa, the Middle East and North Africa are negative. Anderson et al. (2005) suggest that moving to free global merchandise trade would boost real incomes in sub-Saharan Africa proportionately more than in other developing or in high-income countries, despite a terms of trade loss in parts of the region.
This section analyzes linkages between protectionism, agricultural subsidies and the rural poor in LDCs. Hertel (2004c) argues that in most LDCs, agriculture-specialized households are disproportionately poor and that this is true even in Brazil where self-employed agricultural households comprise a large share of the poor.

It has been argued that protectionism and agricultural subsidies by developed countries hurts poor rural households in developing countries. Current market access limitations and export subsidies depress market prices and distort competition in global markets. This discriminates against farmers and the rural poor in LDCs who must compete against subsidized agricultural imports from developed countries. Lower world market prices imply a lower marginal value product from farming and thus lower rural wages which in turn hurts the rural poor. But when world agricultural trade is liberalized, subsidized imports will vanish from developing country markets. Moreover, disciplined domestic support policy in developed countries implies fewer distortions and fairer competition in global markets. As a result, prices will increase which then raises rural wages and benefits poor rural communities in LDCs.

On the other hand, there are also arguments to support the contrary point of view, i.e. that protectionism and agricultural subsidies helps poor rural households in developing countries. Why? As outlined above, many EU trade policies grant preferential market access and benefit LDCs through higher prices for producers of exportable agricultural goods which in turn increases the marginal value product from farming (and rural wages helping poor rural households). In contrast, trade liberalization would lead to a loss of preferential market access and, as a consequence, when an LDC specializes in exportable agricultural goods this would result in lower export and higher import prices which hurts many LDCs which are net food importers (Valdes and McCalla, 1999).

Figure 3 is a simplified labor market analysis of an LDC specialized in exporting an agricultural good (e.g. sugar). The size of the labor market is measured by the length of the horizontal axis. The distance OM is the amount of labor employed in manufacturing and OA the amount of labor employed in agriculture. The vertical axes depict the value of marginal products from manufacturing WM and agriculture WA. The value of marginal product is defined as the additional output of the last unit of labor employed (e.g. MPLA) in a sector times the product price (e.g. PA). In an equilibrium, this is equivalent to the ongoing wage rate (WM = WA). A loss of preferential market access would result in lower export prices which in turn lowers the marginal value product from agriculture shifting it downward from PA\(\cdot\)MPLA to PA\(\cdot\)MPLA. This leads to a decline in rural wage rates to WM. As a result, rural labor will leave agricultural employment and move towards manufacturing where wages also decline without a counteracting improvement in productivity (MPLM) or the terms of trade (PM). Declining rural employment also means additional pressures on large cities coping with the problems of urban migration.
LDCs dependent on sugar exports serve as examples here. According to The Economist (2005), Mauritius owes an estimated 30% of total export earnings to sugar that is exported into the EU under preferential trade access at 3-times the world market price. Yu and Jensen (2003) estimate that Malawi and Zambia would more than double sugar output in response to EBA while smaller gains are possible for Mozambique and Tanzania. In these countries, a complete loss of preferential market access might lead to a displacement of rural labor and necessitate some large-scale economic adjustments. The situation is similar in ACP countries dependent on banana exports. Preferential access to EU markets will cease in 2006 and high-cost producers are likely to lose out and a resulting displacement of rural labor. However, in the long run, the poor in many LDCs are still likely to gain from trade liberalization in agriculture. Anderson et al. (2005) simulate a full liberalization scenario and suggest that it would alleviate poverty in sub-Saharan Africa as real net farm income, the real value of agricultural and food exports, farm employment, and the real returns to farm land and unskilled labor would all rise. Hertel (2004a) takes a more differentiated approach and argues that definitive assessments of poverty-trade links require detailed single country case studies as trade can have a strong impact (positive or negative) on subgroups within a society.

D. Policy Implications and Conclusions

The final section of this paper offers some policy implications for agricultural trade liberalization as well as for economic cooperation and development. In the current WTO trade negotiation process, it will be crucial to assure that the LDCs are not the losers of agricultural trade liberalization. At the beginning of the paper, we argued that an accurate examination of the issues must sharply distinguish the agricultural trade interests of different groups of developing countries: LDCs (e.g. sub-Saharan Africa, Bangladesh, Haiti), Cairns Group developing countries (e.g. Brazil, Colombia, Indonesia) and other developing countries (e.g. India, China). There are apparent conflict of interests between these groups of countries especially with respect to the system of trade preferences and what an elimination of the current trade regime would imply for them. Cairns Group developing countries who are already competitive in world agricultural markets are likely to gain most from further trade liberalization (e.g. Brazil). Unfortunately, this view is enhanced by several other factors including more stringent quality standards in response to food quality scares or the increasing importance of non-tariff import barriers (e.g. SPS measures) put in place by developed countries – some might argue in anticipation of further trade liberalization. Relative to the Cairns Group developing countries, many LDCs are at a disadvantage to meet more stringent SPS measures or quality standards and are likely to lose further market share.

On the other hand, the more advanced developing countries within the Cairns Group are better prepared to overcome more stringent non-tariff barriers or food quality standards and are likely to become the clear winners of further agricultural
trade liberalization. Moreover, because they are the most frustrated by the lack of liberalized agricultural trade, they may also find it politically opportune to argue that agricultural protectionism harms LDCs and their poor knowing that this is also an argument in their favor.

However, there are also important historical implications with respect to the current and any future trade negotiations. In past negotiation rounds, LDCs were mostly ambivalent to trade. Many of them made no liberalization commitments and therefore got no returns in terms of commitments by rich countries for products of their imminent interest. Instead, many LDCs have stressed import-substitution and repressed agriculture. Rich countries on the other hand, have been liberalizing trade of mutual interest mostly in manufacturing. Now with agriculture being on the trade negotiation table, LDCs fear that this process may end up harming them. Therefore, it is be even more crucial to ensure that the LDCs are not the losers of this process. Otherwise, there would be the risk to disenchant them with the trade liberalization process altogether such that they continue to loose ground which would compromise the goal of free trade in the long run. It is important to ensure that LDCs can adjust to freer trade.

This argument leads to some important policy implications for economic cooperation. Compensation mechanisms and safety nets must be in place to stop the dependency of LDCs on trade preferences such they can move forward and also prosper from further trade liberalization in agriculture. Development assistance measures must smooth LDC transition to freer trade and foster their supply capacity to help those temporarily displaced. However, liberalized trade will also open up additional resources for aid and development assistance in developed countries because granting trade preferences is very costly. According to an estimate by the World Bank (2005), it costs preference granting countries 6 US$ for every 1 US$ gained by the preference receiving country.
Figure 1: Analysis of PTA (EBA): EU would import with free trade

Figure 2: Analysis of developing country currently importing (e.g. wheat)
Figure 3: Analysis of Labor market: LDC currently exports (e.g. sugar)

References:


