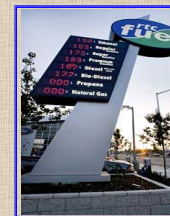# THE EFFECTS OF TRADE DISTORTIONS: THE CASE OF THE SUGARCANE-ETHANOL INDUSTRY IN BRAZIL VERSUS THE CORN-ETHANOL INDUSTRY IN THE U.S.

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ABSTRACT: In order to compensate for the gap in price competitiveness derived from fossil fuel production still being more price-competitive than production of biofuels, the ethanol industry is heavily subsidized inside and protected from the outside in both the U.S. and Brazil. In this paper we assess the impact of the elimination of trade distortions, in particular, the 2.5 percent ad valorem tax, and a secondary tariff of 54 cents-per-gallon on imports from Brazil the U.S., imposed to offset the 51 cents-per-gallon domestic subsidy to corn-ethanol production. For this purpose, we estimate a partial equilibrium trade model – an ethanol export supply curve for Brazil and an ethanol import demand curve for the U.S.-, based on annual data from 1975 to 2005. Two-stage least squares is used to estimate both curves, the world price of ethanol being treated as endogenous. The results show Brazilian export supply to very sensitive to changes in prices, thus it is very likely that elimination of trade distortions in the ethanol market will result in a more than proportionate increase in ethanol exports from Brazil due to the rise in the world price. Moreover, according to this model, if the U.S. increases its demand for imports from Brazil, there will be a positive impact of the U.S. in driving the world price up. Therefore, this paper supports the idea that the U.S. and Brazil reaping gains from trade when trade distortions are eliminated.

INTRODUCTION

Since the oil crisis of the 1970's, countries around the world, specifically those highly dependent on the movement of oil prices, have begun a quest for alternative sources of energy. Biofuels is one of the main sources; specifically ethanol and biodiesel dominate the market. Brazil took steps some thirty years ago to reduce its dependency on oil, by building the necessary infrastructure for becoming the leader in the sugar cane-based ethanol industry:

The U.S. has decided to move towards reducing its oil dependence too:

Government mandate requiring that ethanol be used instead of methyl-tert-butylether (MTBE) for blending in reformulated gasoline

Energy Policy Act of 2005 requiring doubling the U.S.'s use of alternative fuels by 2012 to 7.5 billion gallons

Heavily subsidized inside → Ethanol Industry (U.S. and Brazil) → Protected from the outside

OBJECTIVE: assess the impact of the elimination of those trade distortions which prevent both the U.S. and Brazil reaping the gains from trade due to their comparative advantage.

•U.S. imports of ethanol from Brazil face high tariffs: a 2.5 percent ad valorem tax, and a secondary tariff of 54 cents-per-gallon, imposed to offset the 51 cents-per-gallon domestic subsidy to corn-ethanol production (Kopp, 2006).

METHODOLOGY

We estimate a partial equilibrium trade model:
- an ethanol export supply curve for Brazil
- an ethanol import demand curve for the U.S
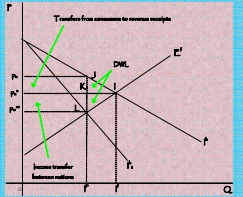
Method: Two-stage least squares (the world price of ethanol being treated as endogenous)

$$(1)\ E_{Br,t} = \alpha_0 + \alpha_1 P_{eth,t} + \alpha_2 E_{Br,t-1} + \alpha_3 P_{oil,t} + \alpha_4 P_{sugBr,t} + \alpha_5 Pop_{Br,t} + \alpha_6 RGDP_{Br,t} + \varepsilon_t$$

$$(2)\ P_{eth,t} = \beta_0 + \beta_1 I_{US,t} + \beta_2 P_{oil,t} + \beta_3 Pop_{US,t} + \beta_4 RGDP_{US,t} + \upsilon_t$$

$$(3)\ E_{US,t} = I_{US,t}$$

$P_{eth,t}$ = world price of ethanol; $E_{Br,t}$ = Brazil's exports of ethanol; $P_{oil,t}$ = world price of oil; $P_{sugBr,t}$ = the price of sugar in Brazil; Pop = population in Brazil or U.S., respectively; $RGDP$ = real gross domestic product in each country; and $I_{US,t}$ are U.S.' imports of ethanol.

Sources: USDA's historical database, ERS-USDA database, FAO, Nebraska Ethanol Board, CEPEA and Unica.

Based on annual data from 1975 to 2005

RESULTS

$$(1)\ E_{Br,t} = -1083.59 + 572.62 P_{eth,hat,t} + 0.41 E_{Br,t-1} - 12.13 P_{oil} - 821.96 P_{sugBr,t} - 0.41 Pop_{Br,t} + 1.77 RGDP_{Br,t}$$
$$(-2.7211)\quad(2.6593)\quad(2.0071)\quad(-2.6519)\quad(-2.3865)\quad(-0.2183)\quad(2.6689)$$

$$(2)\ P_{eth,t} = -6.43 + 0.0028 I_{US,t} + 0.026 P_{oil,t} + 0.037 POP_{USA,t} - 8.98e{-005} RGDP_{USA,t} - 0.105 trend +$$
$$(-3.4205)\quad(1.8811)\quad(10.0563)\quad(3.7099)\quad(-1.1949)\quad(-5.6724)$$

$$[AR(1){=}0.44, AR(2){=}{-}0.37, AR(3){=}{-}0.26]$$
$$(-2.0098)\quad(-1.6270)\quad(-1.2150)$$

NOTE: t-statistics in parenthesis.

Price elasticity evaluated at the mean is 3.51 → Brazilian export supply is very sensitive to changes in prices → **the reduction in the tariff on Brazil's ethanol imports of 54 cents per gallon would cause an approximate increase of 1.35 percent in the total exports of Brazil.**

If the U.S. increases its demand for imports from Brazil, there will be a positive impact of the U.S. in driving the world price up (this is because the value of the flexibility of the world price of ethanol given an increase in U.S. imports of that product is 0.0028, which means that an increase in imports of ethanol from Brazil in 1 percent will increase world price by 0.08 percent).

MAIN FINDINGS FROM THE SIDE OF THE EXPORT SUPPLY CURVE:

(i) there is a positive relation between exports and the world price, this is in accordance with the trade model used in the analysis;

(ii) a negative effect on exports if the price of sugar rises, this might be caused because there is a substitution between sugar and ethanol production at the firms' plants so if they see a higher price of sugar they will shift to this product and reduce their production of ethanol available to export;

(iii) a positive effect of real GDP of Brazil, as the economy grows in real terms there is more potential for this economy to support profitable industries such as ethanol;

(iv) a negative effect of a rise in oil prices on the export supply, this is because there is a substitution effect in Brazil between oil and ethanol, i.e., the domestic demand for ethanol rises if the price of oil increases such that available production for exports is reduced in order to satisfy domestic needs; and

(v) the lag of exports is between 0 and 1 in absolute terms, meaning that the model is not explosive.

MAIN FINDINGS FROM THE SIDE OF THE IMPORT DEMAND CURVE:

(i) there is a positive relation between imports and the world price, which again is in accordance with the trade model;

(ii) a positive effect on the price of ethanol when the price of oil rises is totally in accordance with empirical evidence because in the U.S. the price of ethanol goes hand in hand with movements of the price of oil;

(iii) the lag of the price level is between 0 and 1 in absolute terms, meaning that the model is not explosive.

CONCLUSIONS/ DISCUSSIONS

This paper contributes to the discussion of whether or not the U.S. should reduce tariffs/taxes imposed on the imports of Brazilian sugar-cane ethanol.

In order to put these results in perspective three other papers in the literature can mentioned: Elobeid and Tokgoz [2006], Gallagher et al. [2006], and Koizumi [2003]. In general these papers conclude that **elimination of trade distortions will lead to an increase in world price of ethanol**, which coincides with the results of this study though the size of impact differs (this is particularly true for our analysis which finds a very small impact increase in imports on the price of ethanol).

Political arrangements that must be set so that the tariff imposed on ethanol imported from Brazil is reduced are very difficult and costly to reach because there are vested interests on the industries affected by these decisions.

There is a great deal of research in the U.S. for alternative energy sources besides ethanol, this includes either developments in the biodiesel industry or other substitute inputs (switchgrass, sugar beets, peach pits, etc).

Issues that should be taken into account in future studies:

Brazil's analysis of social and land costs is also critical in determining the possible impacts of a policy causing an increase in the demand for sugar-cane ethanol in Brazil. There are environmental, health and labor costs involved in this decision such that only taking into account the market impacts will not give an accurate solution to the problem.

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