WPS 1386

POLICY RESEARCH WORKING PAPER 1386

EU Bananarama III

Brent Borrell

New European Union banana policy extends protection, favors inefficient producers, and is a costly way to provide aid. The European Union and the favored Caribbean countries could all gain much by shifting from banana aid to formalized, targeted general development aid.

The World Bank
International Economics Department
International Trade Division
and
Latin America and the Caribbean Regional Office
Office of the Chief Economist
December 1994

Summary findings

On July 1, 1993, the European Union (EU) adopted a unified banana policy that is even more distortionary and costly than some of the disparate national policies it replaced. Before, some EU countries gave preferred market access and high prices to banana producers from selected developing countries in Africa, the Caribbean, and the Pacific, and from EU territorial suppliers. This preferential status was regarded as a form of aid to countries with historical ties to certain EU countries (France, Great Britain, Italy, Portugal, and Spain). Other EU countries (Belgium, Denmark, Germany, Ireland, Luxembourg, and the Netherlands) granted no preferences and either had free trade policies or imposed only low tariffs.

The earlier quota-based national policies were inefficient because the main benefits of the quotas and high prices were enjoyed by importers, wholesalers, and retailers in the quota-restricted countries. Under the unified EU policy, quotas, high prices, and preferential access provide aid to preferred suppliers, but cost EU consumers dearly and the quota restrictions hurt nonpreferred suppliers (mainly Latin American countries). But the main problem with the new policy is that it extends protection (and consequent ineffiencies) to countries where it didn't exist before .

As the costs of the new EU policy become better understood, new forces are emerging that will probably create pressure for change over the next decade. Banana producers who now receive aid through preferential access to the EU banana market are likely to lose those preferences. This could deal a hefty blow to several small Caribbean island economies and some African countries. But much more efficient alternative mechanisms exist through which the European Union could grant aid to these economies.

The European Union and the favored Caribbean countries could all gain much by shifting from *banana* aid to formalized, targeted general development aid.

This paper — the third "bananarama" paper and a joint product of the International Trade Division, International Economics Department, and the Office of the Chief Economist, Latin America and the Caribbean Regional Office — is part of a larger effort in the Bank to analyze international commodity policies. Copies of the paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Grace Ilogon, room R2-072, extension 33732 (33 pages). December 1994.

EU Bananarama III*

New EU banana policy extends protection, favors inefficient producers, and is a costly way to give aid. Pressures for change could necessitate major adjustments in the smaller ACP countries. **A program of transition to foster economic diversification is urgently needed in these countries.**

by

Brent Borrell**

* This work was jointly funded by the International Trade Division, International Economics Department, and the Office of the Chief Economist in the LAC region of the World Bank.

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Abstract

The new EU banana policy is highly inefficient. As its costs become better understood, many new politico-economic forces are emerging which are likely to cause the policy to be changed over the next decade. For banana producers who receive aid through preferential access to the EU banana market, the changes are likely to result in eventual loss of preferences. This could deal a hefty blow to several small island economies of the Caribbean and some African countries. However, alternative much more efficient mechanisms exist for the EU to grant aid to these economies. The EU and the Caribbean countries involved could all gain a great deal by formalising and targeting aid in place of general development *banana* aid.

Contents

1 New EU banana policy is highly protectionist: introduction and background

On July 1, 1993, the European Union (EU) replaced individual member countries' trade regimes governing imports of bananas with a unified EU banana policy. In adopting this policy the European Union has made a step backward. The new policy is even more distortionary and costly than some of the disparate national policies it replaces.

Traditionally some EU countries have given preferential market access

Previously some EU countries gave preferred market access and high prices to banana producers from select developing countries (African, Caribbean, Pacific (ACP) countries) and EU territorial suppliers. This preferential status was regarded as a form of aid to these countries. The preferences had grown out of historical ties of various EU member countries (Great Britain, France, Spain, Italy and Portugal) with banana supply regions (Belize, Jamaica, Suriname, Windward Islands, Somalia, Cameroon, Ivory Coast, Guadeloupe, Martinique, Madeira and the Canary Islands) — see box 1.1. Complex and highly distortionary trade regimes based on quota restrictions to imports from non-preferred suppliers had been developed in various EC member countries to protect the preferences offered to preferred suppliers. Other countries, Germany, Netherlands, Belgium, Denmark, Luxembourg and Ireland, provided virtually no preferences and operated either free trade policies or imposed relatively small tariffs.

The findings of two earlier "bananarama" papers (Borrell and Yang 1990 and 1992) and Borrell and Cuthbertson (1991) were that while quotas, high prices and the preferential access given provided some aid to preferred suppliers (see box 1.1) of certain developing countries, they cost EU consumers dearly and the quota restrictions hurt non-preferred suppliers (mainly Latin American countries) which are also developing country banana exporters. A major conclusion of these studies was that the previous quota based national policies were highly inefficient because the main advantage of the quotas and high prices was captured by importers, wholesalers and retailers in those quota restricted countries.

The new policy also gives preferences and is even more inefficient

The main problem with the new policy is that it extends across the entire European Union the most protectionist and costly of the former national policies. It relies on quotas to restrict supply and raise internal EU prices. Prohibitive over-quota tariffs make the quota effective. A tariff also applies to quota imports.

In the main, the new policy continues to protect the vested interests established under the earlier policies. The monopoly profits of EU marketers have been at least maintained and possibly increased — traditional EU marketers of ACP fruit have been given special privileges backed by a system of licenses which has allowed them to take market shares from traditional marketers of Latin American fruit. The protection afforded banana producers in EU territories has been guaranteed. Preferential access, or aid, for ACP producers (see box 1.1) has to some extent been retained. That said, it is not guaranteed as securely; the aid it confers is less specifically targeted and prices for ACP fruit have fallen since July last year. This fall in price may reflect the lesser quality of ACP fruit and afforded to traditional EU marketers to now import Latin American fruit under privileged licence conditions.

The main difference arising from the adoption of the new policy is that the costs of the policy are borne by consumers in all EU countries rather than consumers in only some EU countries. Consumers who formerly benefited from mostly open and competitive marketing, such as those in Germany, now face closed and uncompetitive conditions with higher prices. Moreover, import restrictions applying against non-preferred supplying countries (see box 1.1) have been tightened. This has imposed extra costs on efficient export suppliers in Latin America. Costs have also been imposed on companies which traditionally marketed Latin American bananas in the relatively open and contestable markets of the European Union, such as Germany where a third of all EU bananas were consumed. The restrictive quota and allocation of import licenses have discriminated strongly against these companies by directly reducing the overall size of the market as well as transferring some of their market shares to traditional EU marketing companies. Banana marketing in the European Union has become more restrictive and considerably less competitive.

The opportunity for an efficient, virtual free trade outcome was missed

The European Union missed an opportunity to greatly rationalize and reduce the cost of its previously distortionary policies. Borrell and Yang (1990 and 1992) and Borrell and Cuthbertson (1991) estimated that the efficiency of providing aid to preferred suppliers could have been increased greatly by pursuing virtually free trade policies and targeted direct aid. Indeed, in terms of the policies open to it, the European Union appears to have adopted one of the most costly and distortionary options.

There are strong pressures to change the new policy

Despite the missed opportunity, the new policy has unleashed some new pressures for change. For the rest of this century these pressures are likely to mount and lead to large changes in the world banana market. Such changes could greatly alter the welfare of many Central American countries and some African countries. Among these countries are the world's most efficient banana exporters — Colombia, Costa Rica, Guatemala, Honduras, Panama, and Ecuador — and some of the less efficient and protected producers — Belize, Jamaica, Suriname, Windward Islands, Somalia, Cameroon and Ivory Coast. This latter group of countries (ACP countries) has long been protected by preferential access to uncompetitive markets of the European Union. Each of these countries will be affected differently. But all will need to make adjustments.

Foremost among the new pressures for change is the emergence of a well focused debate on the inefficiencies of EU banana policy. Groups with well articulated arguments are now pressing for reforms of the EU policy. Pressures are being exerted through GATT. Other forums will also be used. This debate could well eventually culminate in a substantial liberalization of EU policy. Already this process has resulted in a 17 January 1994 GATT panel ruling calling upon the European Union to dismantle the new policy. This has forced an EU compromise response which could result in a small increase in the quota and a lowering of the in-quota tariff, albeit that some Latin American countries could be drawn into the

EU web of distortionary preferences. At this stage (June 1994), the EU compromise has not been ratified by the EU Council and possible legal actions in Europe and the United States are likely to delay or even overthrow the compromise. Whatever the eventual outcome, the compromises, blockages and positioning all reflect the very strong pressures for reform.

Another pressure for change will be the expiry of the ACP Lomé agreement under which the European Union agreed to uphold the ACP countries' preferential access. This expires in 2002.

Reform would bring big changes for some developing countries

Eventual liberalization of the EU market would be good for the efficient exporters of Latin America who would gain more market access and higher world prices. However, it would also threaten the preferred market access and the aid that flows from that access to less efficient ACP exporting countries.

Whether the EU market is eventually liberalized or not, there is another pressure for change emerging. Access preferences and therefore aid to ACP countries under the new policy are not as directly targeted as before. This reduced focus has raised doubts about the reliability of access preferences and the aid they convey continuing in the long term. Even if preferential access continues, questions about the efficiency of providing aid by distorting banana prices are sure to be raised.

Whatever the eventual outcome the implications seem to be much the same. The inefficiencies of EU policy need to be better and more widely known to promote awareness and debate and to hasten the move to more sensible EU policy. At the very least there are complex aid, development and adjustment problems for ACP countries which will need to be tackled. There is also considerable uncertainty about what will happen which has big implications for the macroeconomic outlook for many small island economies. What would help to reduce this uncertainty and help in the development of such economies is a known timetable for change with transparent objectives and rules, transition arrangements and economic support for adjustment, social support and diversification.

This paper documents how changes in EU policy could affect banana exporting countries and draws out the policy implications for these countries.

Box 1.1 Preferred and non-preferred suppliers of EU banana imports

Preferred suppliers	*Country giving special preference*	*Non-preferred suppliers*
African, Caribbean and Pacific (ACP) countries [a]		*Latin America or so-called 'dollar' area countries of Central and South America*
Belize	United Kingdom	Colombia
Jamaica	United Kingdom	Costa Rica
Suriname	United Kingdom	Guatemala
Windward Islands	United Kingdom	Honduras
Somalia	Italy	Panama
Cameroon	France	Ecuador
Ivory Coast	France	Brazil
EU overseas territories		
Guadeloupe	France	
Martinique	France	
Madeira	Portugal	
Canary Islands	Spain	

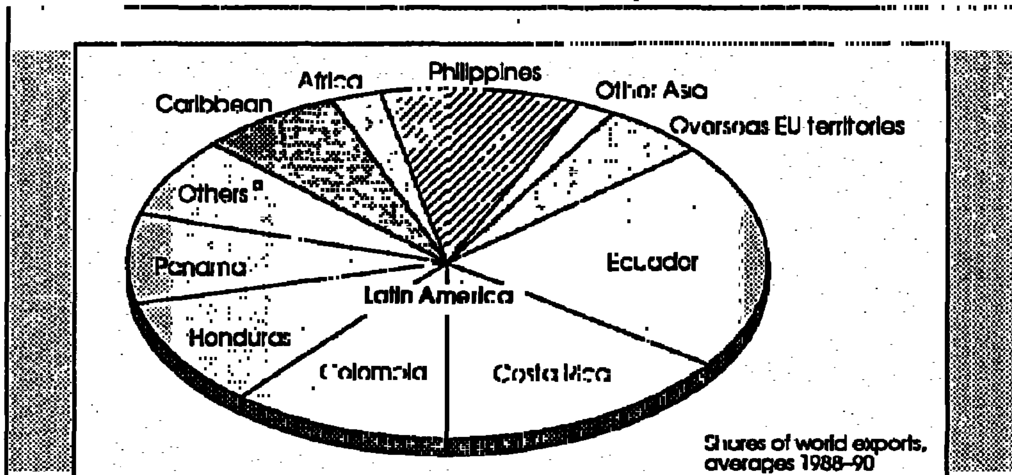
[a] Under the Lomé Convention all ACP countries have duty free access to protected EU markets. Germany is virtually a free market, so gives no preference to ACP suppliers.

2 The EU and the world banana market

The European Union is the world's largest importer of bananas. It imports around 40 per cent of world trade. Bananas are the most traded of all fruits.

Banana exports are important sources of foreign exchange for many small developing economies, a large number of which are small island economies. Latin America exports most of the world's bananas, accounting for almost 75 per cent of world exports (chart 2.1). ACP countries and overseas EU territories account for 15 per cent of world exports only.

Chart 2.1 **Latin America dominates banana exports**



[a] Belize, Brazil, Guatemala, Mexico, Nicaragua, Surinam and Venezuela.

Data source: FAO (1991).

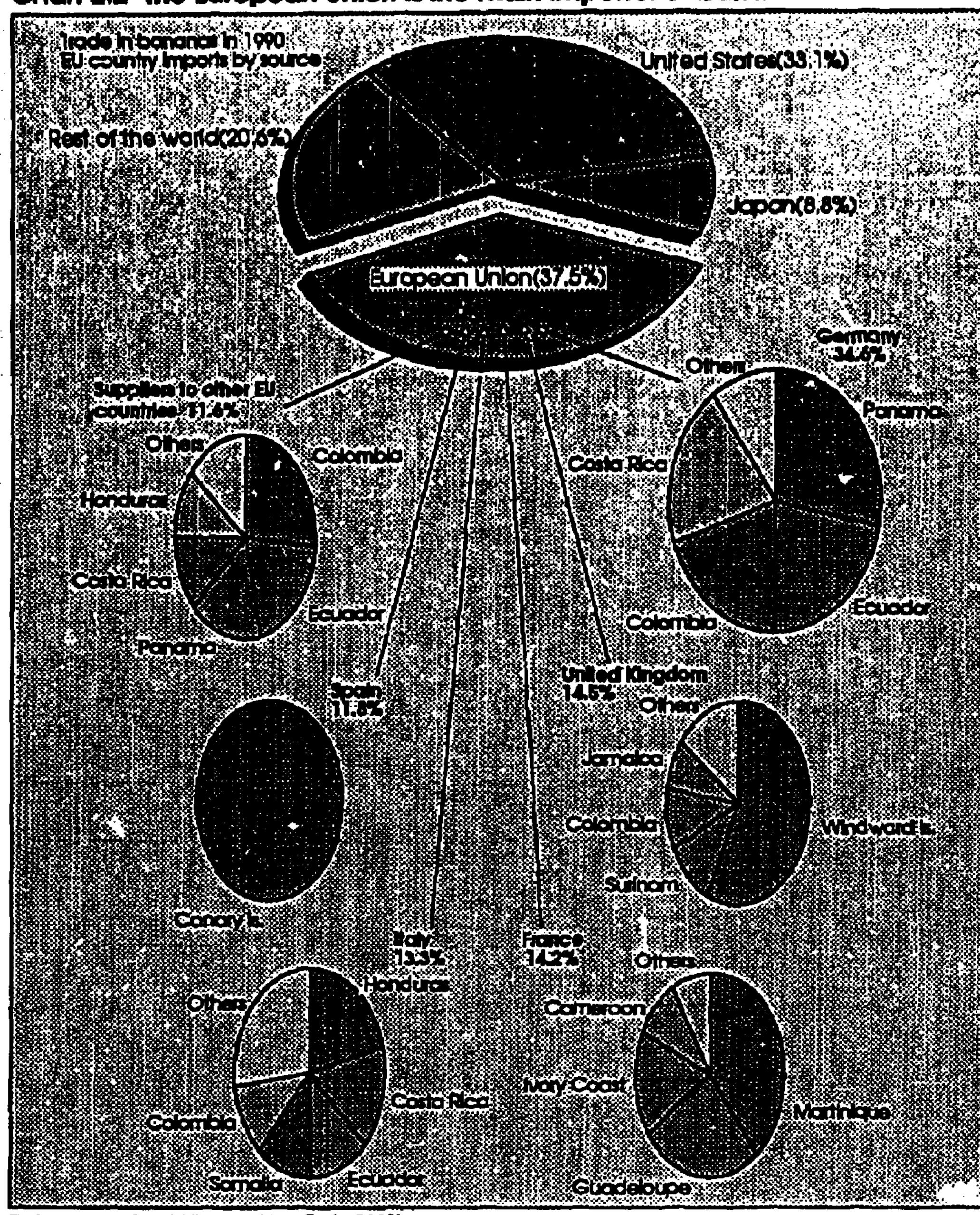
The patterns of trade between banana exporters and the EU have been long established (see chart 2.2) and have shown only minor changes since the EU was established in 1957. They have been tightly defined by import policies and preferences granted by separate national governments, notwithstanding the EU's common commercial policy. It imports from African, Caribbean and Latin-American sources but does not import from big Asian countries such as the Philippines.

Efficiency of export suppliers varies widely

Latin American exporters are efficient, low cost suppliers with the potential to expand output. The ACP countries and the overseas EU territories are less efficient than Latin American suppliers (see chart 2.3).

Climate, topography and soils favor Latin American countries over ACP countries and EU territories. The result, productivity in Latin America is up to double that of other producing countries and non-labor production costs are less than half of those in other countries. Quality in Latin America is more reliable.

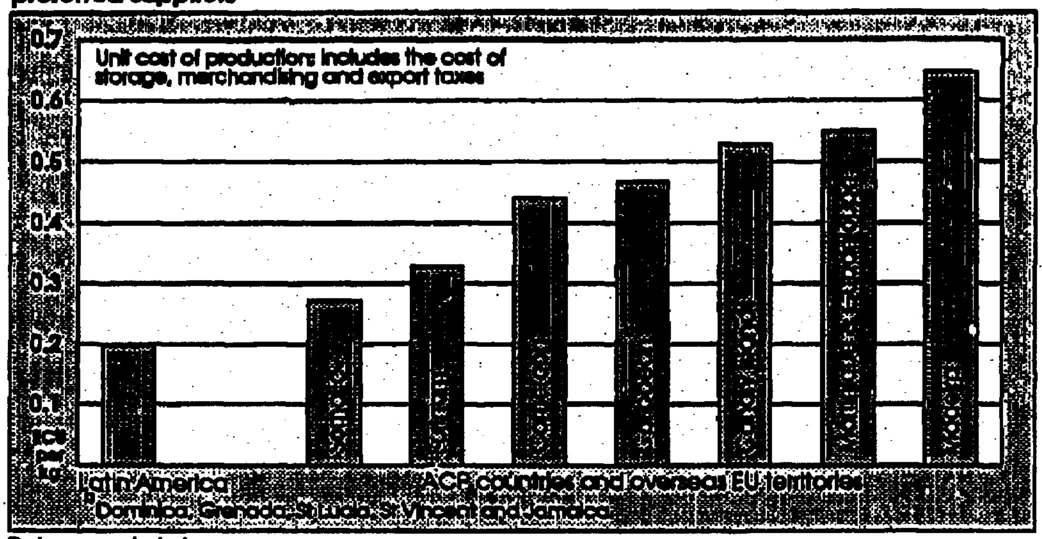
Chart 2.2 **The European Union is the main importer of bananas**



Data sources: World Bank (1990); FAO (1991).

Competitive production and marketing arrangements also favor Latin American countries over ACP countries and EU territories in the productivity stakes. Competitive conditions have attracted considerable investment in productivity and quality improving technology and infrastructure in Latin America. Lack of competitive production and marketing arrangements in the ACP countries and EU territories have reduced incentives for similar investment and technology transfer.

Chart 2.3 Banana producers in Latin America are much more efficient than preferred suppliers



Data source: Industry.

The lower productivity of ACP countries and territories means they are highly dependent on the special access and high prices provided by the EU market to maintain existing levels of production.

EU policies have changed but preferences remain for now

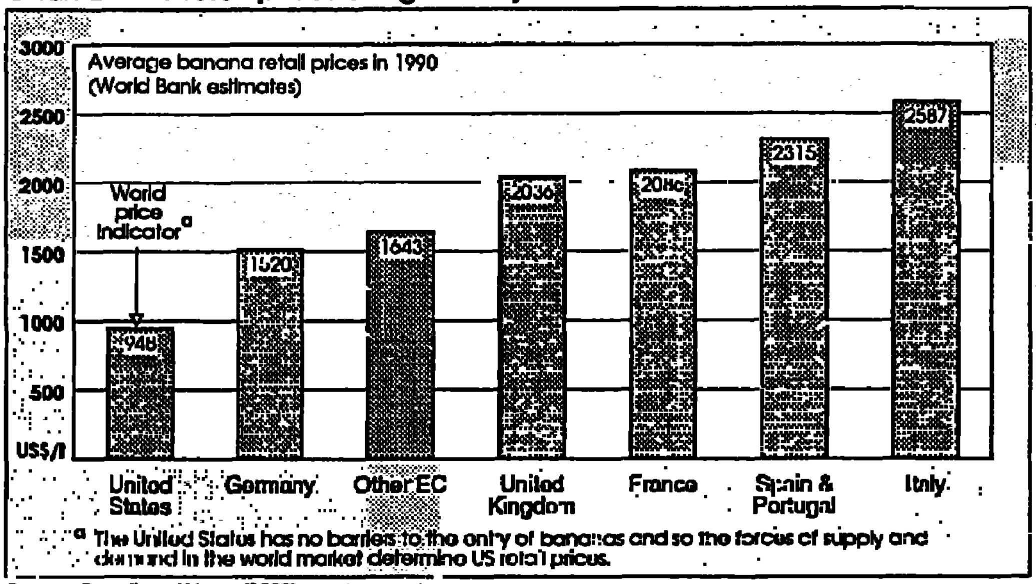
On 1 July 1993, as part of continued EU commercial integration, the EU unified banana policy came into effect. It replaced the three main types of national policies which had applied in various EU countries. These included the highly protectionist quota policies of France, Great Britain, Spain, Portugal, Italy and Greece, the free market of Germany and the mildly tariffied markets of the Netherlands, Belgium, Denmark, Ireland, and Luxembourg.

Because of its great importance as an importer, EU policy decisions potentially have a large economic effect on the world banana market.

The old policies: separate national policies before 1 July 1993

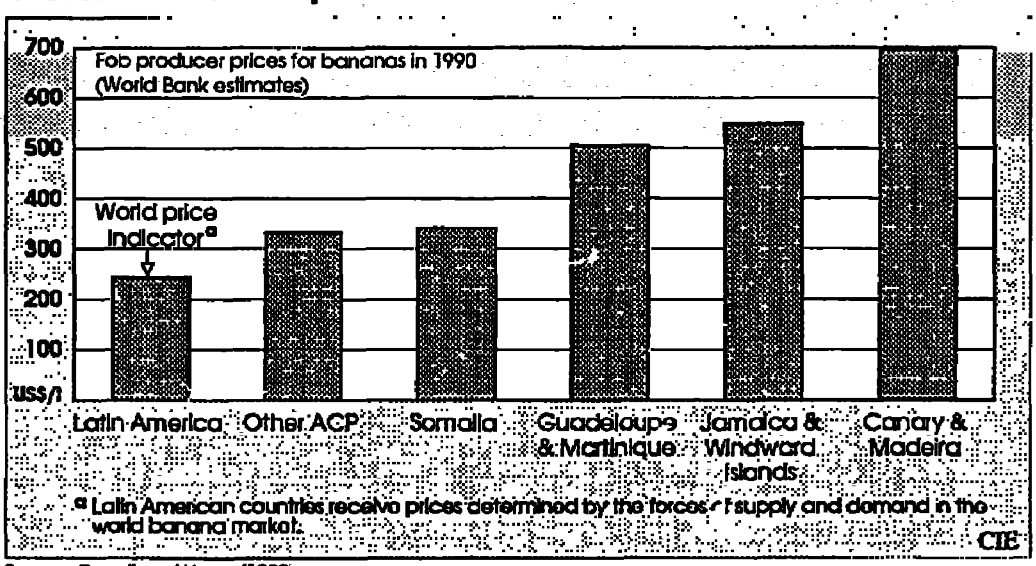
EU countries operating quota based policies used import restrictions to limit supplies and raise prices to consumers (see chart 2.4). They also allowed for part of the high consumer prices to be channeled back to selected developing countries/territories — preferred suppliers — by giving them preferential market access to raise producers' *fob* prices (chart 2.5). The part of the high consumer prices not passed back to preferred producers was captured by EU marketers in the form of excess profits. The preferred status and high prices received by preferred suppliers was intended as a form of aid to the select countries/territories. For ACP countries, these preferences are recognized under the 1986 Lomé IV convention (signed in 1989).

Chart 2.4 **EU retail prices are generally well above those of the United States**



Source: Borrell and Yang (1992).

Chart 2.5 **Most producer prices of preferred suppliers to EU markets are over double the world price indicator**



Source: Borrell and Yang (1992).

Under a special protocol of the Treaty of Rome, Germany was permitted to increase its quota in line with domestic demand. It therefore did not restrict supply and maintained a virtually free market. It had the lowest retail prices in the EU. The German price was higher than the US price shown in chart 2.4 because transport costs and other non-traded inputs affecting wholesaling and retailing margins are higher due to the high value of the Deutschmark. Prices in tariff-only countries were higher than in Germany due to the 20 per cent tariff on imports levied c.i.f.

The new single policy greatly impedes the functioning of an efficient market

The new unified EU policy maintains preference to ACP countries and EU territories. A system of EU-wide quotas has been implemented to restrict supplies and maintain consumer prices at levels high enough to broadly maintain benefits to select EU marketers, EU territories and in general terms to ACP producers. The way quotas are allocated helps to maintain existing preferences in broad terms in the immediate future. The method of allocation determines how *quota rents* (from consumers) are allocated to producers and others in the marketing chain. Quotas are allocated through the use of a licensing system, although how the *quota rents* are allocated depends on the nature of supply and demand as well.

Separate quotas apply either implicitly or explicitly to bananas from EU territories, ACP producers and other suppliers — mainly the efficient Latin American exporters. Quotas on EU territory and ACP bananas are set at levels equal to or higher than the highest level of shipment over the past five years (1.7 million) and are non-transferable. The quota on Latin American supplies (2 million tons) is the residual quota and it is transferable. It is determined in order to fix the end price; it has been set at about 6 per cent below Latin American supplies to the EU in 1992 according to World Bank data, but could be further below 1992 levels based on adjusted Eurostat data. Moreover, one third of the Latin American quota is allocated to marketers of territorial and ACP bananas. As well as helping to guarantee *quota rents* to traditionally protected EU marketers of bananas, this provision directly transfers market shares from traditional marketers of Latin American fruit to marketers of territorial and ACP fruit.

ACP and Latin American quotas are explicit and quantitative. EU territorial quotas are implicit. Provision exists for deficiency payments or compensation for loss of producers' incomes which might arise as a result of the change to a single market. Because compensation applies to a maximum quantity of bananas produced (0.854 million tons), in effect EU territorial producers are guaranteed prices similar to what they received previously for a fixed amount of fruit. Certainly there is no upper limit to EU territorial supply to the EU market and no penalty above the limit, however without compensation under the new single policy EU entails that territorial suppliers' prices could decline compared to before the single policy came into force. Previously, EU territorial suppliers received prices higher than the average. And so, EU territorial producers' guaranteed price is limited to a maximum quantity. They may face lower effective prices above the quota. This amounts to an implicit quota.

Allocation of import quotas and licenses discriminates strongly against those involved in the production and marketing of Latin American fruit and any non-traditional quantities of ACP fruit. At the same time the arrangements distinctly favor those involved in the marketing of traditional ACP and EU territorial fruit. As well as some of the traditional market share of firms marketing Latin American fruit being directly transferred, by EU sanction, to firms who traditionally market ACP and EU territorial fruit, the access for Latin American fruit has been reduced compared to what it had been. No similar reciprocal arrangement has been enacted affecting ACP and EU territorial fruit. One explanation of these arrangements is that they are designed to force the margins earned on the imports of Latin American fruit to be used to cross-subsidize the imports of expensive ACP and EU territorial fruit.

Just how the market will operate in the long term remains unclear. The system provides room for considerable administrative discretion. A management committee on bananas has been established consisting of representatives of the member states whose votes will be weighted. The quota on Latin American bananas is subject to annual review and will be adjusted based on the opinion of the committee and, more importantly, the approval of the

Commission, in line with forecasts of: performance the previous year in general; EU territorial and ACP production trends; and consumption trends in the EU. Under 'exceptional circumstances' (undefined) the quota may be adjusted during the year as well.

Tariffs also apply and are imposed discriminatory. EU territory and ACP producers pay no tariff on entry of quota bananas. Latin American producers must pay a tariff of *green* ECU100/ton on quota bananas (to be reduced to ECU75/tonne if the EU compromise agreement with Latin American countries is ratified). This tariff is equal to *commercial* ECU121/ton. A prohibitive over-quota tariff applies: *green* ECU850/ton (*commercial* ECU1025/ton) on Latin American fruit and *green* ECU 750/ton on ACP fruit. This tariff makes the quota binding.

The licensing system extends to allocate preferences to primary importers, secondary importers and ripeners through a weighting system. This has the effect of allocating *quota rents* according to the specified weightings among those involved in marketing bananas. Licenses are allocated based on a three year moving average and other discriminatory rules. These preferences apply only to imports from Latin America and non-traditional quantities from ACP countries. No similar or symmetrical set of allocative preferences apply to importers and ripeners of traditional ACP and EU territorial fruit, which adds to the discriminatory and uncompetitive nature of the arrangements.

Under the new regime there are also schemes to provide specific assistance to producers in EU territories. There is a minimum income support scheme, a banana tree pull scheme to assist growers out of banana production and for five years, assistance to encourage the establishment of producer organizations for the purposes of marketing. Such assistance further extends the privileges available to EU based marketing firms and discriminates against firms marketing Latin American fruit. Regulations to control quality and standards also apply.

Although no specific provisions are made for assistance to producers in ACP countries under the EU regulations defining the EU banana policy, there exists a proposal to provide direct aid to improve the quality of ACP producers' bananas, linked in with provisions for marketing and vertical integration and temporary compensation for declining revenues caused by lower prices. However this proposal has not been ratified by the EU council and it is likely that several of the member states will oppose the granting of direct aid to ACP countries while the existing distortionary policy prevails.

In summary, the new unified policy greatly limits the workings of the market in allocating resources associated with the growing, distributing, handling and selling of bananas. A raft of mechanisms exists which limit competition, restrict trade and which require officials far removed from the market to make resource allocation decisions. The policy is complicated and is designed to allow tightly managed trade.

With lower prices demand would increase

The demand for bananas has grown strongly in recent years in many EU countries. The discrepancy between banana consumption per person in Germany (14 kg a year previously with the lowest consumer prices) and consumption in the United Kingdom (8 kg a year) suggests that the EU market for bananas has the potential to expand. However, the prices determined by the new policy will have a big bearing on this (see Borrell and Yang 1992).

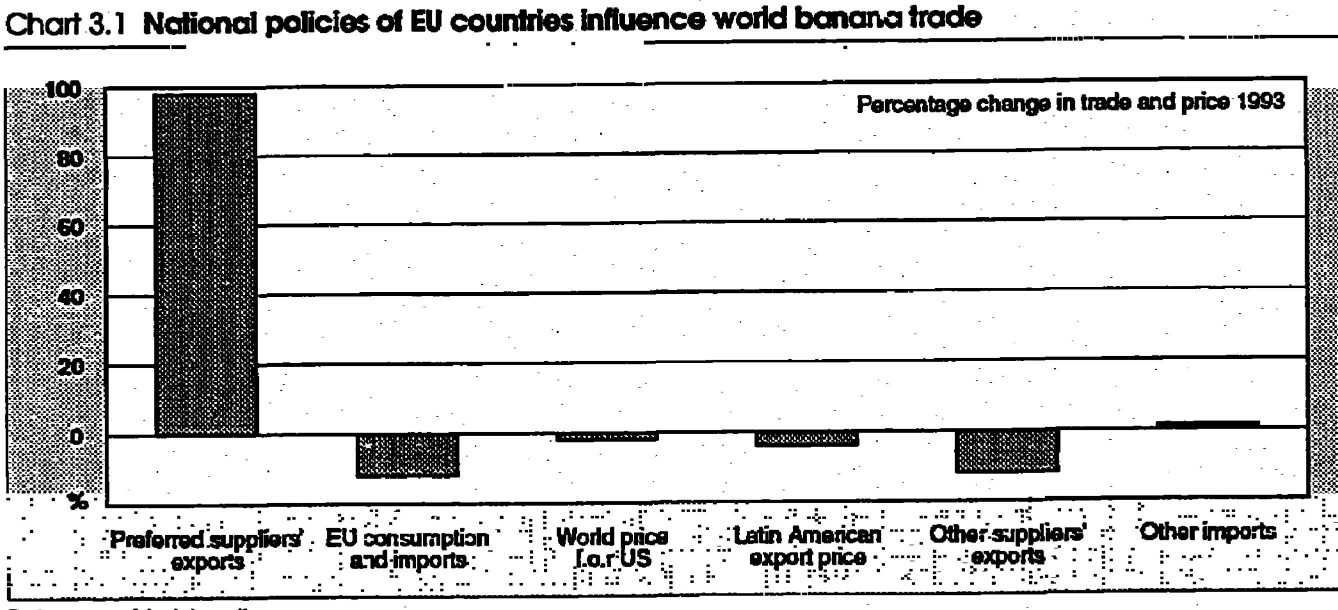
3 How EU policy distorts world banana trade

Three earlier papers document the large inefficiencies of the previous national EU banana policies — Borrell and Yang (1990), Borrell and Cuthbertson (1991) and Borrell and Yang (1992). The economic effects of the new policy can be interpreted from the results of Borrell and Yang (1992). The economic effects of both the old and new policies are presented here. Presentation of the effects of earlier policies provides a point of reference.

The previous policies were extremely inefficient

Borrell and Yang (1992) found that previous EU policies greatly altered imports, exports, prices and welfare compared to a free trade situation. Using a world trade model, they found that the policies caused preferred suppliers' exports to be nearly double what they would be under free trade, and caused EU consumption, the world price, the Latin American export price and other suppliers' exports to all be lower (see chart 3.1). The policies cost EU consumers about $1.6 billion annually to transfer a net benefit of $0.3 billion a year to preferred suppliers — EU territorial and ACP producer (see chart 3.2). This was an extremely inefficient transmission of aid. It cost EU consumers about $5.30 to transfer $1.00 of aid to select developing countries or regions. Additionally, every dollar of aid reaching preferred suppliers cost other developing country suppliers — the Latin Americans — $0.32 or $98 million annually in total.

Chart 3.1 National policies of EU countries influence world banana trade



Data source: Model results.

EU marketers were the main beneficiaries. Of the estimated $5.30 it cost EU consumers to transfer $1.00 of aid (or $1.6 billion in total cost to EU consumers) over $3.00 (or $917 million in total) was siphoned-off as excessive marketing margins and transferred to protected importers and wholesalers. About $0.30 was collected as tariff revenue. About $1.90 (or $575 million in total) was the net cost to the European Union after allowing for the excessive margin and tariff transfers. And about $1.00 (or $304 million in total) was lost in outright waste to the world economy. Waste occurred because more resources were used up in producing bananas than was necessary. At least some of the bananas produced at high cost by preferred suppliers could have been produced with fewer and cheaper resources in the more efficient, non-preferred suppliers of Latin America.

The incidence of the costs and benefits of the policies on various countries and regions are summarized in chart 3.2. Borrell and Yang show that more efficient policies could have been used to achieve the EU's aid commitment. Through the use of a small tariff of about 17 per cent used to fund a system of well targeted deficiency payments or direct aid, the costs of the policies could have been virtually eliminated while the aid benefits could have been retained or improved. The inefficiency of transferring aid could have been reduced enormously. The cost to EU consumers of transferring one dollar of aid could have been reduced from $5.30 to just over $1.00.

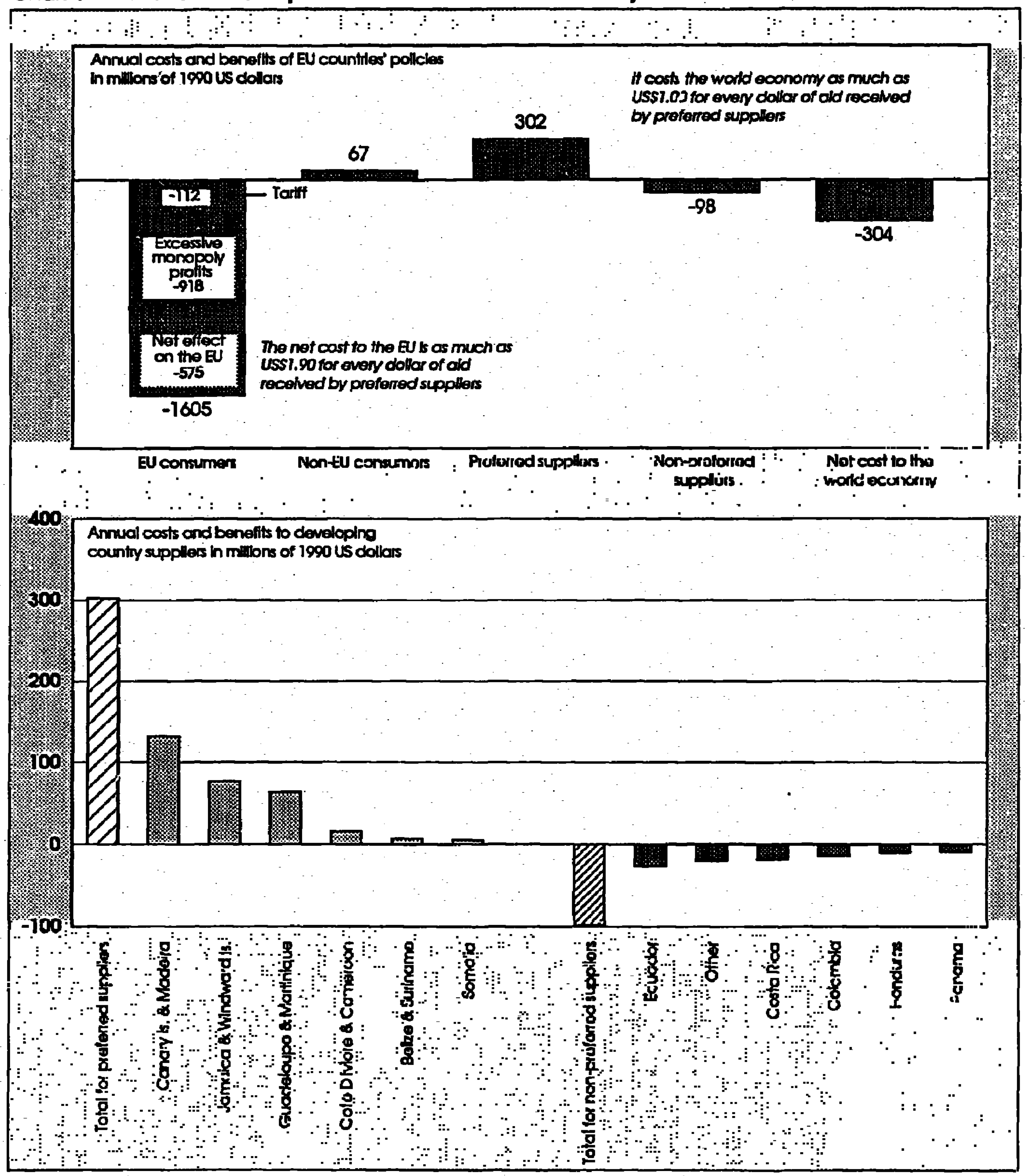
Read (1994) takes issue with the Borrell and Yang estimates. He argues that the estimates of the cost of previous policies may be overestimated. He argues Borrell and Yang have assumed that a perfectly competitive market would prevail if free market policies were adopted in place of previous national policies. This he argues is incorrect and that the market would be an oligopoly. However, Borrell and Yang did not assumed a perfectly competitive market. Simply they assumed that the market would be as contestable and at least as competitive as the German market was and as the US market currently is. These are not necessarily perfectly competitive markets, but there is no reason for believing that an open EU market would be any less contestable and open than the German market was or than the US market is. Read (1994) rightly points out that, if anything, the German market prices assumed by Borrell and Yang to prevail in an open EU market underestimates the price falls which might occur in other member countries because of their preferences for lower quality bananas than the Germans. If so, the Borrell and Yang estimates would underestimate the gains from replacing previously distortionary trade with open trade. That is, the cost of distortionary policies may be higher than estimated by Borrell and Yang.

The new policy is more costly than the old

Because the new policy restricts aggregate imports of bananas to the EU more than the total of separate national policies, the new policy is more costly than the old policies. Chart 3.3 summarizes the comparative costs. The single EU banana price is estimated to be 12 per cent higher than the weighted average of previous separate national prices. This increase allows excessive monopoly profits to marketers to be higher than previously. Aid to preferred suppliers is likely to be much the same in aggregate though possibly different to individual supplying regions. The cost to consumers is estimated to have shifted considerably toward Germany, the Netherlands, Belgium, Denmark and Ireland and away from other EU consuming countries and has gone up from around $1.6 billion annually to $2.3 billion.

Although the EU Commission appears to be arguing that under its tariff-quota arrangements over-quota bananas can and will enter the EU, the evidence is that the over-quota tariff is clearly prohibitive (see chart 3.4). Based on model results of Borrell and Yang, with a 2 million ton quota on Latin American fruit, EU retail prices will settle at around US$2100/ton or ECU1809/ton. To sell over quota fruit, retail prices will have to fall below this level. But the over-quota tariff will be set at *commercial* ECU1025/ton which will force up the price of over-quota bananas to an estimated ECU2332/ton — see Borrell (1993). This price is clearly far above EU consumers' willingness to pay and they will switch to other fruit.

Chart 3.2 National banana policies of EU countries were costly

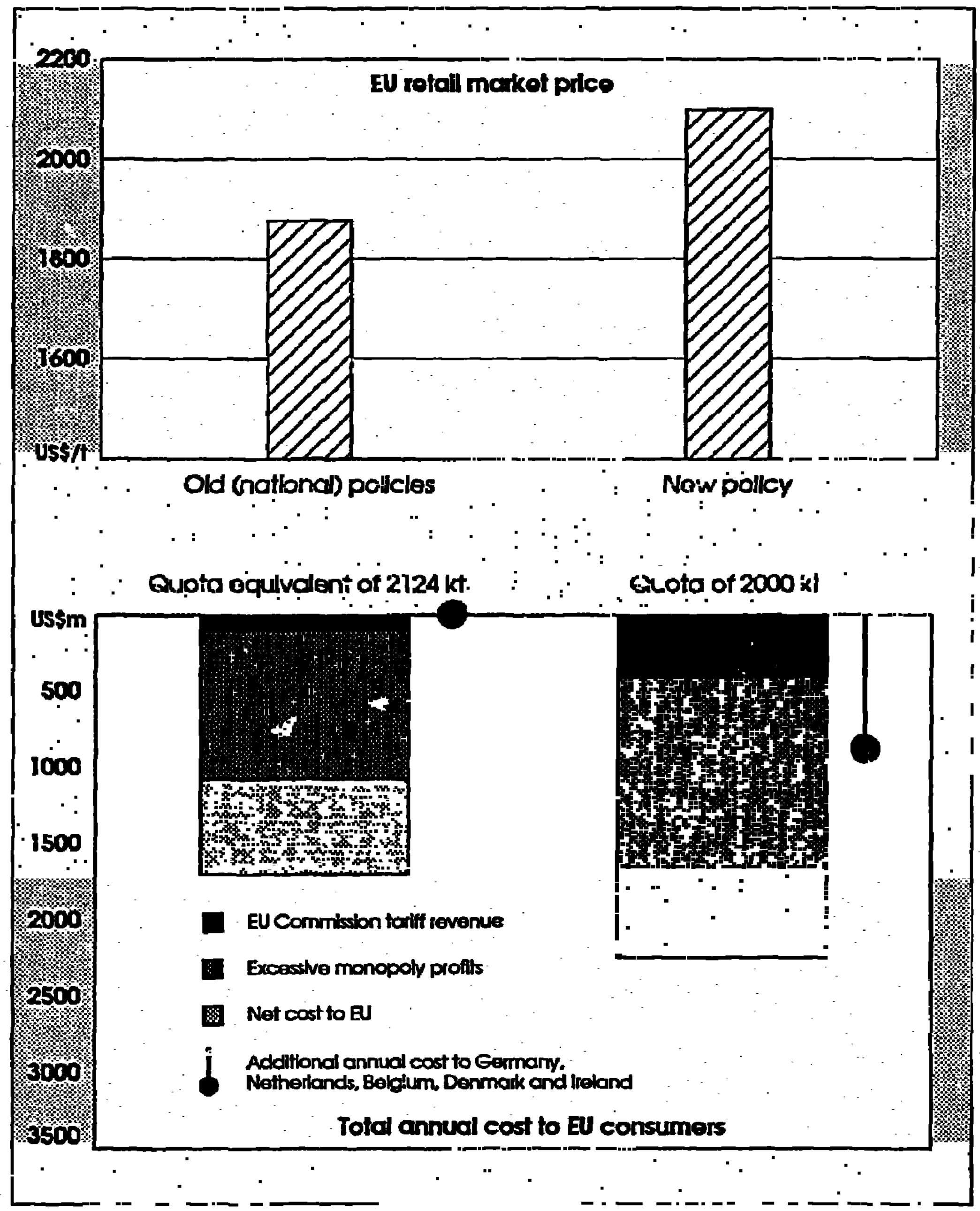


Data source: Model results

Managing the quotas and licenses is already proving difficult and will continue to be so. The welfare of many groups involved in supplying bananas will become sensitive to decisions made by the management committee on bananas. This will make the setting of quotas vulnerable to political interference. Political objectives are likely to override commercial ones. Already the market has been made uncompetitive.

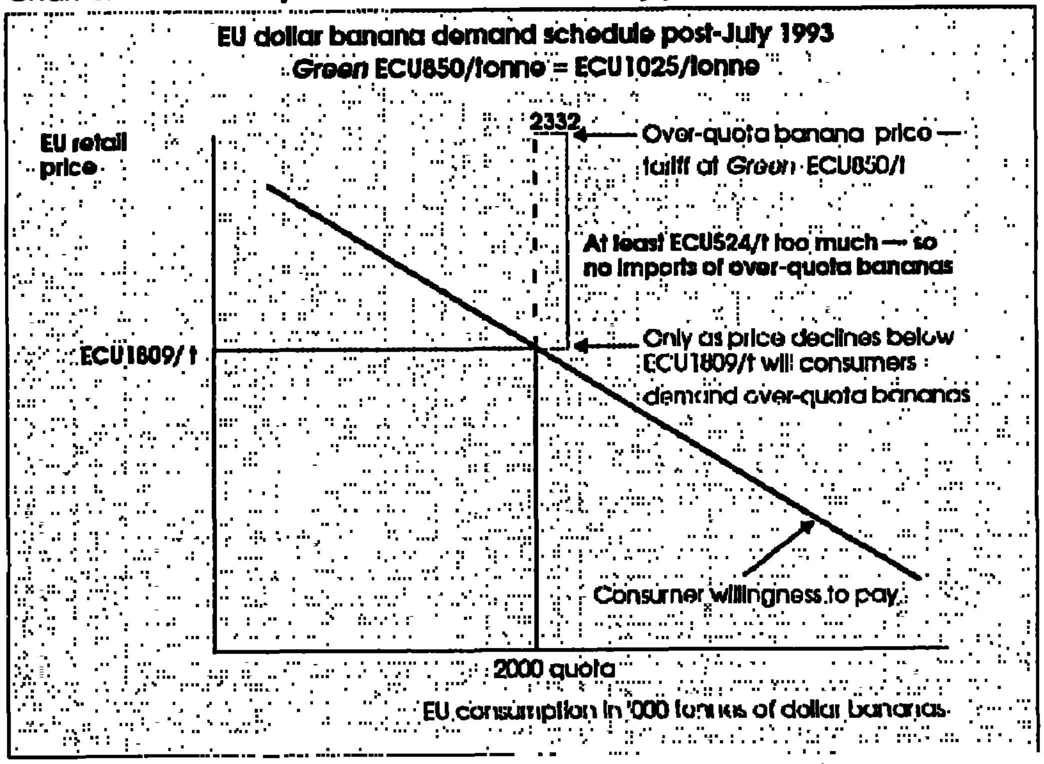
The volume of trade by firms which previously marketed Latin American bananas competitively in the European Union has been reduced by around 50 per cent since the introduction of the new policy. This is due to the restrictive 2.0 million ton quota and to discriminatory nature of how quota and licensing are allocated. The reduced trade of these firms has also reduced their economies of scale and increased their costs.

Chart 3.3 **The new EU policy is even more costly than the national policies it replaces**



Data source: Model results

Chart 3.4 **The over-quota banana tariff is clearly prohibitive**



Data source: Model results.

The new policy is a big step backwards

In moving to adopt a new unified policy the European Union missed an opportunity to rationalize and improve its distortionary banana policies. Of options open to it, the European Union chose one of the most discriminatory and distortionary. There are two possible explanations for not choosing simpler and much more efficient policies. One is to protect (and expand) the vested interests of EU based marketing companies. This group is clearly the main beneficiaries of the policy. EU consumers, other marketers and Latin American suppliers are clearly big losers. If so, the main objective of the policy does not appear to be to provide aid to ACP and EC territorial producers. The other possible explanation is that policy makers still do not fully understand the effects of their policies. Either way, proper analysis and measurement appears to be essential.

For EU territorial suppliers the policy seems to offer assured protection, but for ACP suppliers, the policy introduces considerable uncertainty and confusion about the level of support they will receive. Support is provided in a completely indirect way and is not well targeted, although the proposal to provide additional aid to assist in increasing productivity and quality in ACP countries may be an acknowledgment by the European Union of a need for a different form of aid. But as it stands now, in part the provision of support relies on margins collected on the sale of Latin American fruit to be handed to ACP producers and in some cases it relies on one marketer earning the margin and then transferring it to another before it is passed on. The mechanism is by no means transparent and there is, as of yet, no specific commitment to ACP suppliers as there is to EU territorial suppliers. The policy creates huge incentives for *rent* *seeking* and political interference. And there are many grey areas about how quotas will be adjusted in the future, about how import licenses will be allocated and about how marketers may use the powers afforded them under the legislation to manipulate supplies. All this makes the market less predictable than previously and introduces considerable, and costly, business risk. And for small island economies it creates considerable uncertainty for the entire economy.

The new policy limits normal commercial operations and competition. It does not encourage open, expansionary practices, efficiency, innovation, risk taking, quality and consumer–oriented marketing. The German market for instance has gone from being an open, rapidly expanding, contestable market with low consumer prices to a closed one, with reduced supplies, regulated control over expansion and higher consumer prices. The commitment of some marketers in previously contestable EU markets to expanding the market by improving efficiency and quality has been greatly impeded. Higher consumer prices and restrictions on supply make this difficult. The growth potential of the EU market has probably been greatly restricted.

Indeed, the perverse incentives and obvious inefficiencies created under the policy may well turn out to be the seeds of its own destruction. When policies are costly in subtle hidden ways quite powerful analysis is necessary to drive the message home in a persuasive way. But when policies are so manifestly bad public awareness of the problems is more or less automatically generated. Groups adversely affected by the policy will have a strong incentive to lobby against its continuation — already there are many expensive legal and other resources being devoted (on both sides of the Atlantic) to lobbying for reform of the policy. Meanwhile, there is a real possibility that increasingly restrictive regulations and controls may be introduced to combat the sorts of problems which often emerge in tightly managed, closed and uncompetitive markets. But as more controls are put in place they will attract increasing criticism and opposition, and eventually public opinion will force the policy to be reformed. Nonetheless, the evolution of an efficient policy and outcome may be highly unpredictable and a long way off.

4 Why the new EU policy is unsustainable

The costs and inefficiencies of EU banana policy have become increasingly transparent through the process of formulating a unified policy. The process has spawned a number of studies which have focused attention on the adverse economic and welfare effects of the old and new regimes. It is now becoming increasingly transparent to governments in EU states and the EU public that the policy is inconsistent with many EU objectives relating to GATT, competition law, aid to developing countries, increased consumer welfare, equity and justice. Groups adversely affected by the policy are now vigorously pressing for reforms to the policy. Chief among them are the Latin American producers, marketers of Latin American bananas in the EU, the US Government, various governments concerned about the implementation of the Uruguay Round and the governments of Germany, the Netherlands, Belgium, Denmark, Luxembourg and to a lesser extent Ireland, and Italy.

Many groups are pressing for reform: Scenario 1 — liberalization

Through GATT, Latin American countries have exerted considerable pressure on the European Union to reform its policy. And in January 1994, the GATT called for the European Union to dismantle its new policy. The panel decision has given considerable publicity to the GATT illegality of the new policy. In response the European Union is trying to ratify an agreement with four Latin American countries — Colombia, Costa Rica, Venezuela and Nicaragua — not to pursue the adoption of the GATT panel report in exchange for increases in the quota, a reduction of the in-quota tariff and additional access and licensing privileges. However, although the four Latin American countries have agreed to the compromise, at this stage it has not been ratified by the EU Council. On both sides of the Atlantic legal attempts are being made to delay and overturn the compromise. And opposition to the compromise could increase by four when the EFTA countries accede to the European Union. So it is unclear when and whether the compromise will be ratified or, if it is, how long it will last. Further, several of the Latin American suppliers (importantly, Ecuador, Honduras, Panama, Guatemala and Mexico) are insisting that they will continue to fight for a liberalized market. Further, under new dispute settlement procedures agreed under the Uruguay GATT round, the consequences of GATT/WTO panel findings are likely to be more difficult to defy. At the very least the new '*consensus to reject*' dispute panel reports instead of the old '*consensus to accept*' rule will mean good reports are guaranteed to be adopted by the new WTO. This will make it more embarrassing and make the pressures for compliance more enduring for governments who try to defy the findings.

Six actions have been taken to the European Court of Justice by marketers of Latin American bananas in the EU and one by the German Government itself. They have sought to have the regulations suspended on a number of grounds relating to the discriminatory and disproportionate nature of the regime. Although the court has dismissed some of these actions, others are still pending. The ruling on the German Government action is expected in October 1994.

The US Government's interest in the issues are many and varied. The United States is no doubt concerned about the economic and political stability of countries in their region, the trade policy precedents set by the banana policy and what it considers to be the discrimination of EU policy against American banana marketing companies operating in the European Union. Although US incentives to see reform of the EU policy are clear the means for achieving that reform are not. Nonetheless, the US Government has the capability and opportunities to concentrate on the policy debate and is becoming involved. It also has the Section 301 provisions in its trade legislation to take action against unfair trading practices in foreign countries.

Other governments monitoring the completion and implementation of the GATT Uruguay Round are aware of the GATT dispute on bananas. They too can be expected to participate in the debate on EU banana policy and to point it in the direction of reform.

The groups agitating for change of the EU policy do so mainly because they see some potential to bring about reform. With so many groups vigorously pursuing this objective, success is a realistic possibility. Liberalization of the EU market should be considered as one scenario.

Should it occur, liberalization would have obvious benefits for the Latin American countries but would reduce the size and profitability of the banana industries of ACP countries. Because of the small size of these countries, it could also have wider macroeconomic effects.

Scenario 2: muddling along

Without reform of the policy, *rent seeking* and political interference are likely to determine how the market evolves. The effects of this are difficult to predict but without informed debate the strongest vested interests are likely to prevail. The mechanisms established under the policy are especially vulnerable to political interference and the demands of strong vested interests. Between them, the Management Committee, the Commission and the Council have great powers to change the quota but this will be extremely difficult to do efficiently. Bearing in mind the political structure and nature of the Committee, the Commission and the Council it is not hard to imagine political targets being set in place of economic ones.

Model results demonstrate the difficulty of managing the quota to achieve specific economic targets. A one per cent decrease in the size of the Latin American quota will change the cost of the program by an estimated ten per cent. Small changes in world supply conditions also have a large affect on the cost of the program. By implication small changes in world supply conditions will require large changes in quotas to maintain price targets within the EC. Quality differences in fruit from different regions will also add to the complexity of setting and achieving price targets (Borrell and Yang 1992).

The reported results of Borrell and Yang demonstrate that decisions flowing from the Management Committee on bananas will have the potential to greatly affect the livelihoods of those involved in supplying bananas to the EC. For instance, a one per cent reduction in the quota could yield preferred producers and marketers an estimated additional $50 million in excess profits. So there is a great deal of scope and incentive for *rent seeking* and *black marketeering*. These practices increase business risk and costs and reduces the consumer orientation of the market.

EU Commission intervention in the market discourages legitimate commercial and competitive market solutions to many problems and establishes (or maintains) vested interests. With legitimate commercial channels closed off in some areas, market participants will turn to alternative channels — political, black market and under-the-table means — to respond to changing economic pressures. But alternative channels are not transparent and open to all participants. To operate through them entails taking of legal and personal risks. So the best ideas and practices are less likely to surface. Many potential participants may have too much at stake — an international brand name — to risk using illegitimate commercial avenues to bring about needed change. If so, the best operators may be discouraged from the market. What is more, emphasis on protecting vested interests will detract from efforts to increase quality, service and economy; the things that enhance the competitiveness of the market. This weakens the commercial focus and user orientation of the market. Efficiency and predictability of the market will suffer.

The long term economic effects of quotas and how they are managed are not readily apparent. The advantages they establish for particular groups in the first instance create incentives which distort economic behavior over the long term. Although this behavior is difficult to predict, what does seem certain, and is borne out by history, is that through time the advantages (preferences) that quotas provide for various groups can be greatly manipulated and be captured by groups other than those for whom they were intended.

The possibility of this scenario raises the concern that the *quota rents* arising from preferences established under the policy will be increasingly captured by protected EU marketers at the expense of EU territorial producers and ACP producers. Model results reveal EU marketers are already by far the major recipients of the *quota rents* made possible due to restrictions on competition.

At the same time, under this scenario the possibility of developing the full potential of the EU banana market for the benefit of efficient Latin American countries will be greatly inhibited. Bananas will not be competitively marketed in the EU. Alternative fruits will be more competitive. Latin American suppliers will miss an important growth opportunity in the world's largest banana market.

An additional political concern as to why ACP producers may lose their preferences relates to the eventual expiry of the ACP Lomé agreement. This expires in 2002. One view of the EU Commission is that development and assistance initiatives for the Caribbean should be the responsibility of the United States rather than the EU given its proximity. The EU long ago agreed to honor its 1986 Lomé IV banana commitments in developing its unified banana policy. In essence it has largely done this, albeit inefficiently. But these commitments expire in 2002. And it is instructive to note that under the new policy the EU has put in place a guaranteed minimum income support scheme for territorial producers but not for ACP producers. This perhaps reflects its perception of a lesser responsibility toward the ACP producers. And the EU proposal to provide additional aid for research into productivity and quality improvements in the ACP countries may be a reflection of an increasing awareness to alter the focus of how aid is given to ACP countries.

5 Coherent policy responses for banana exporters

Both efficient Latin American and high cost Caribbean banana exporters have good reason to be disappointed with the new EU banana policy. It introduces considerable uncertainties into the production and marketing of bananas and introduces further confusion about the aims to provide aid to ACP producers. It reduces the competitiveness of banana marketing in the European Union which in the long term is likely to reduce the options for all banana exporting countries. Overall it reduces access to the EU market and makes bananas a less competitive, higher priced fruit to EU consumers. But above all, the apparent objectives of the policy have little to do with the welfare of banana exporting countries. The main objective appears to be to protect and expand the monopoly marketing profits of EU banana marketeers.

Although over the long-term it seems inevitable that the inefficiencies of EU banana policy will be unsustainable, it nonetheless is likely to cause much disruption and waste in the interim. This is a good time for both groups of countries to consider their positions and the policy responses they might follow.

What seems important is to reduce the uncertainties created by the policy. What would help to reduce this uncertainty and help in the development of the ACP economies at least, is a known timetable of change with transparent objectives and rules, transition arrangements and economic support for adjustment, social support and diversification

Policy considerations for ACP countries

The economic difficulties of small island states need special recognition. The Windward Islands, for instance, have become dependent on banana exports for most of their export earnings. Loss of that income without some form of compensation or support would impose great hardship. The social impacts of the loss of income could be costly to ACP countries. Studies of small island states show that trade and aid often represent large proportions of their gross national product (OECD 1989; World Bank 1989).

Many small island states are likely to remain dependent on aid for a some time to come. But how aid is delivered will determine the extent of future reliance. Therefore the efficiency with which that aid is transferred is very important.

Why a better form of aid for ACP countries is needed

The banana market with its artificially high prices provides a seemingly convenient mechanism for the EU to transfer economic assistance to small economies. But to qualify for the aid these small economies must produce bananas. They must therefore use up valuable resources — fertilizer, pesticides, shipping space, land, labor and capital — to obtain the aid. The net value of aid is therefore substantially below the gross value because the costs of production of preferred suppliers are higher than the efficient Latin American suppliers.

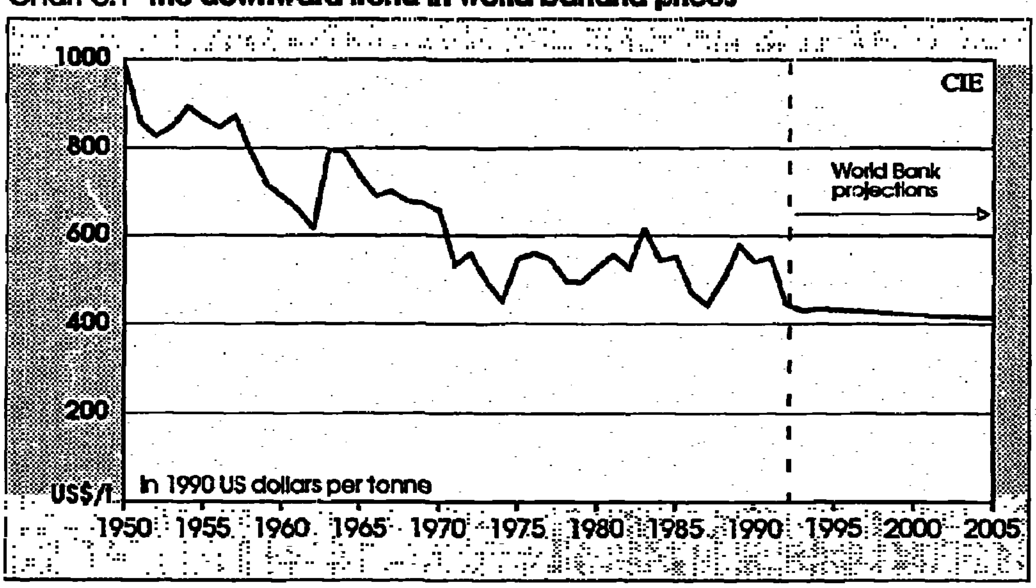
The 'aid' component of the prices paid to preferred suppliers for their bananas encourages inefficient banana cultivation, marketing and discourages diversification of production. Without pressure to be internationally competitive in production and marketing, marketers of ACP fruit have not needed to emphasize the need for productivity gains and new technology to the extent of competitive marketers of bananas in the European Union. In competitive exporting countries big productivity gains have been achieved through technology transfer and highly integrated production and marketing systems. By some accounts, the same banana marketing companies operating in both protected and unprotected markets have been much more active in investing in productivity enhancing technology in the unprotected markets than in the protected ones.

In as much as the 'aid' component of banana prices is captured by landowners in the preferred supplying countries the distribution of the aid is inefficient too. Far better would be to use aid for infrastructure development that will assist in long term development of efficient industries upon which small island economies can stage their own development.

Further, to the extent that aid is transferred through *quota rents* it is unreliable. The aid is not transparent, and it could be captured by others. So long as it is not delivered directly it cannot be guaranteed or channelled to most productive uses. When looking ahead twenty to thirty years, the futility of protecting inefficient industries seems more apparent. Over such a period, something is bound to occur to jeopardize specific product assistance — as occurred with US sugar aid.

Chart 5.1 reinforces the eventual futility of granting aid through prices. EU national policies fix the prices to preferred suppliers, yet real banana prices have been on a downward trend. As efficient producers become more efficient in a competitive market and world prices fall, EU and ACP producers receiving assured and higher real prices become less competitive and more dependent on aid. They are under little pressure to adjust and resources are increasingly being locked into an industry which has no long term hope of being competitive.

Chart 5.1 **The downward trend in world banana prices**



Data source: World Bank (1992).

Currently the ACP countries have a short term incentive to increase banana production to ensure they have sufficient quantities to fill their quotas in bad years. Failure to fill them may give EU officials reason to reallocate the quota. Further, the requirement that 30 per cent of the Latin American quota be given to marketers of EU and ACP fruit means some EU and ACP fruit could substitute for Latin American fruit. To establish such trade flows EU and ACP producers need more fruit. And by implication, Latin American producers need to grow less. However, the more ACP producers increase production the more vulnerable they make their economies to cuts in preferences if and when they occur.

The EU proposal to provide ACP countries with aid aimed at improving quality and productivity and compensation for declining revenues caused by lower prices, if eventually ratified and successful, may also encourage increases in production in ACP countries. This type of aid does not encourage economic diversification.

Asking for direct aid in place of banana aid is a sensible policy objective for ACP countries

EU banana policies currently cost EU consumers an estimated $2.3 billion annually. The policy and its costs are justified in terms of the aid objective being pursued. One interpretation of this situation is that EU consumers are willing to part with $2.3 billion to support various small island economies. But currently only $0.3 billion of that wealth reaches these economies. How much wealthier these economies could be if more efficient mechanisms could be used to transfer even half the $2.3 billion.

Direct aid, instead of that tied to banana prices, would permit this to happen. The EU proposal to grant ACP countries aid for quality, productivity and marketing improvements and compensation for loss of income may reflect the growing receptiveness of the EU toward alternative forms of aid. Although as stated earlier, several of the member states are likely to oppose the granting of additional or more direct forms of aid to ACP countries until the existing distortionary policy are reformed, and the type of additional aid proposed still locks ACP countries into banana production to qualify for aid. Moreover, to the extent that quality, productivity and marketing problems have a lot to do with uncompetitive structures in production and marketing partly sustained by distortions created by EU policy, the objectives of granting this type of aid may be difficult to achieve.

It seems that a major imperative of ACP countries should be to ask donors to decouple aid from banana prices and formalize the transfer of aid. That way aid could be used to support rational, well targeted investments which help support economic diversification. Indeed, such targeting and focusing of direct aid from the European Union could become an imperative of the development programs in these countries. And part of such programs could involve making approaches to EU donors to formalize direct aid commitments.

A move to direct aid would require initiative for structural adjustment in ACP countries

A move to direct aid would result in banana prices in ACP countries dropping to world price levels. Certainly ACP prices have already sustained some drop. But at world prices, ACP prices would be about half of what they were before the implementation of the new EU policy. It seems almost inevitable that this would result in reduced production. However, the extent to which this would occur would differ from country to country and would depend on how the real exchange rate, wage rates and land prices change as a result of no banana aid, and on the potential for each country to achieve productivity gains.

Decoupling aid from banana prices may force ACP countries to seek more competitive production and marketing arrangements. This could provide big incentives for technology transfer and adoption of best practices in marketing and growing. Productivity gains would follow. Nonetheless, considerable structural adjustment, economic diversification and investment in infrastructure may be required.

Specific policy initiatives may be required to ensure productivity gains can be taken up quickly. Any domestic market regulations applying to production and marketing which were designed to underpin preferential access would need to be reviewed. Laws which previously required producers to sell to a national association which in turn made long-term contracts with EU marketers would no longer be required. Indeed they could act as a hindrance to better production and more competitive marketing arrangements.

A starting point for any specific policy initiative to increase productivity should be a detailed study of marketing arrangements and infrastructure needs. There may be certain infrastructure requirements — such as better port facilities or roads — which is best provided by governments and direct aid money could be used for this purpose.

In devising policies to improve productivity, it would seem sensible to seek means which would allow the most efficient producers and those with the most scope for productivity increases to do so, but not to develop policies aimed at increasing productivity for all farmers. The EU's current ACP quality, productivity and income support aid proposal would tend to create the possibility of all producers to increase production. Even with productivity gains, some diversification into other activities will be essential. It may be necessary for less efficient farmers to move out of the industry. To facilitate such a process, direct aid could be used to offer farmers assistance to move out, and infrastructural support could be given to help them diversify into other activities. Direct income support might be considered to facilitate the process but there would be many problems. These have to do with the administrative costs of arranging that support, the incentives provided for people to make themselves eligible for it, and the inequities arising in these countries where many people in other sectors may have suffered even greater uncompensated misfortunes. Therefore, having considered income support with all its attendant political problems, the best way of helping adjustment may be to introduce the policy changes in a clean and predictable fashion and to design some sort of social safety net without a specific income guarantee. Once new activities begin to develop, the government could provide infrastructural support in the form of transport facilities, research, extension, and international marketing information and expertise.

What if the European Union will not agree to direct aid?

If the ACP quotas were vested directly with the ACP government and could be filled with non-ACP bananas, they could effectively be converted to direct aid. Non-ACP bananas purchased at the world price could be on-sold into the EU market at high prices to realize big premiums. The premiums would be worth more than current aid because the cost of bananas used to fill the quota would be cheaper than the value of resources currently used in ACP countries to fill those quotas. So costs of filling the quota would be less while revenue would be unchanged.

To achieve this outcome would require changing current EU regulations specifying that the specific ACP country quota must be filled with fruit originating in that country. In effect the European Union would have to accept the transferability of the quota. Although this outcome would have several advantages over the current situation, changes in EU policy toward a more liberal market in the future would see premiums and therefore aid to ACP countries diminish. In this regard direct aid not linked to the banana market at all would be superior. To convince the European Union to undertake such changes would require a formal and considered approach.

Were the European Union to accept a proposal to make quotas transferable, specific policy initiatives would still be required to facilitate productivity gains in what remained of smaller ACP industries and to help some farmers adjust out of the industry into other activities.

What if the European Union will not accept transferability?

Without direct aid or transferability, the ACP countries face a dilemma. They wish to maintain production to qualify for banana aid from the European Union. At the same time, they wish to prepare for the eventuality of losing preferential access. This implies shifting resources out of banana production and using some of the aid resources provided by EU banana policy to finance infrastructure and new industry development. The only real solution to this dilemma is to increase productivity in the banana industry and to attempt to tax back some of those gains to reallocate the aid resources and finance other developments.

Again an important first step toward achieving productivity gains will be to increase competition in marketing and to increasingly expose producers to world market price conditions. Various policy initiatives could be followed to accomplish the objectives identified within the constraints outlined.

A study to identify how to open the industries to international competition

A study examining production and marketing regulations should be a high priority. The study should be aimed at identifying and making recommendations to remove any barriers to international competition. Ensuring the industries of ACP countries are open to international competition in the marketing of their bananas will ensure bidding for ACP fruit is as high as possible. Part of this will involve ensuring no barriers stand in the way of foreign direct investment. This could be crucial to attracting international companies to invest in the banana industries of these countries. Such foreign direct investment has been important in facilitating important technology transfers which have enhanced productivity and development in Latin American countries.

Ensuring flexibility in marketing and production to promote integration of the production and marketing systems is also important and any study should aim to investigate this too. Currently, contractual arrangements appear to made in a way which separates production and marketing. This is a major difference between the marketing of ACP and Latin American fruit. Yet integration can be important to ensure efficiency in shipping and to provide total quality control. Integration does not necessarily require vertical integration by ownership, but commercial contractual flexibility needs to be adequate to facilitate a wide variety of business arrangements between firms.

Expose producers to world price by using taxes: variant 1

One possibility for achieving these objectives is to make prices received by banana producers subject to an annually larger tax over a specified period. The tax would need to be designed to absorb part or all of the productivity gains achieved but not to discourage producers from filling the quota. This would effectively transfer the 'rent' component of high banana prices from the European Union to the particular ACP government.

However, there are many problems with this approach. Removal of EU preferences may cause the price to decline to world prices before the specified period and determining the rate of tax increases would require great insights about what productivity gains are possible. Setting the tax too high would mean not filling the quota and setting it too low might result in over filling it and having to pay subsidizes for over production.

Put out marketing and policy management to competitive bids: variant 2

Another variant on how to achieve a similar outcome to the above would be to invite international banana marketing companies to put in competitive bids to manage such a marketing and policy program as outlined in variant 1. The objectives would be to maximize filling of the quota and to achieve maximum productivity gains so as to maximize the collection of taxes. And the competitiveness of each bid could be assessed in terms of these targets. A fixed term contract could be awarded to the most competitive bidder.

Such an approach would encourage the international banana marketing companies with the scope for achieving the greatest productivity gains to bring their know-how to the ACP countries. The competitive bidding process would also force each bidder to identify what policy, regulatory or other changes might be required to improve the efficiency of marketing and production. The governments of the ACP countries could assess proposals for change in terms of their political acceptability as well as their competitiveness as a bid. Indeed, ACP governments would be in a position to negotiate with the bidders to find politically acceptable solutions if political constraints needed to be taken into account.

Still this approach centralizes marketing and although contracts could be put out for competitive tender periodically, competition in marketing would be limited to the tendering process.

Sell quotas to the highest bidder: variant 3

Given the great uncertainty about productivity gains, setting the level of tax incorrectly and the restrictiveness of appointing one marketer, selling quotas to the highest bidder within the country would have several advantages. Once sold, the buyer would have an incentive to fill the quota provided it paid to do so. If quotas were made transferable within the country (this would not concern the European Union) a buyer who could not economically produce to fill the quota would have an incentive to sell to someone who could. At the same time, upon initial sale of the quota the government would collect a tax based on producers' collective assessments of the *rent* component in the banana price. The tax would be set based on capacity of the industry to pay and yet still continue to fill quota.

If auctioned off annually, as productivity gains occurred competitive bidding would encourage producers to pay increasingly higher prices (or taxes) for their quotas. If eventually the European Union withdrew preferences, the price producers would be willing to pay for quota would drop to zero. If the European Union does not withdraw the preference, the ACP governments go on collecting increasingly higher taxes in line with productivity gains until such point as producers become competitive at world prices — which is exactly the position aimed for. And the ACP governments would go on capturing the EU banana aid which can be redirected toward broader development.

Competitive annual auctions of the quota also give government the incentive to create a production and marketing environment which is conducive to promoting the uptake of productivity gains. This is because, the higher the productivity gains, the higher is the price it will receive for quota. The more open and competitive it makes this environment the more likely it is to attract the most efficient producers and marketers.

Although the above may sound reasonably straight forward, the auctioning of quotas for export purposes may be GATT illegal under article 8. More important, government annual on-going intervention in the market may become a major disincentive to efficient producers and consumers making a long term commitment to productivity increase and investment since they would anticipate the increasing taxes. On-going government intervention also makes the industry and market vulnerable to political interferences which adds to business risk.

Allocate once and for all but make quotas fully transferable domestically: variant 4

One way to encourage efficiency but at the same time reduce government involvement in the industry would be to simply make quotas freely transferable among producers. They would trade among themselves and more efficient producers would have incentives to buy out less efficient producers. The government would not get to collect a tax directly from auctioning the quota but to the extent that efficiency was improved, producers would increase profits, a proportion of which they would plough back as investment in the economy anyway, and a proportion of which they would pay as income tax.

In selling their quotas inefficient growers would automatically receive a form of compensation for leaving the industry. Inefficient growers would only face incentives to sell if the price received from selling quotas made them better off than if they filled the quota themselves. This way, transferability would provide an automatic safety net against hardship.

For many ACP governments this variant may be the most efficient outcome. Still, to maximize productivity gains, profits and taxes, the government may have a special responsibility to ensure the production and marketing environment is as efficient as possible. Also, creating the expectation among producers that preferences may not be extended beyond the current Lomé convention (beyond 2002) may also be important. This way producers will be encouraged to at least begin thinking about how to adjust to lower prices.

Consideration should be given to supporting research

Under all variants research into banana production and quality should be undertaken, possibly on a region-wide basis. This will support banana production in those countries where it is economic. As other agricultural activities develop, research and extension should be undertaken to support the new activities. Initial studies could be carried out at an early stage to see which agricultural or other activities are likely to develop. However, it is difficult to forecast which activities will develop under different real exchange rates.

Other infrastructural support should also be undertaken as new activities develop, both on and off the farm, including transport and marketing.

Policy considerations for Latin American exporters

Decoupling aid from banana prices will improve the trading environment of efficient Latin American exporters. Therefore these countries also face incentive to try and persuade the European Union to pay aid directly or allow transferability of quotas. Latin American countries gain most by seeing distortions to the world market and reduced access to the EU market eliminated. It appears that a major policy objective for these countries should be to coordinate and reinforce their efforts to fuel the debate on reform of EU policies. Further development of arguments challenging EU policy are important for keeping up pressure for change. This would require further analysis, measurement and debate to help inform many other groups indirectly hurt by EU policy.

The recent EU attempts to persuade some Latin American countries to drop their GATT action against the Union in exchange for larger preferential access suggest another policy priority for this group of countries. They need to closely research the long-term problems of foregoing competitive trading conditions for the promise of short-term yet small concessions. The fact that the European Union is willing to compromise, in response to the GATT panel finding, reflects how sensitive it is to GATT actions and the publicity it creates. This helps emphasize the need to keep up pressures on the European Union through GATT as a means of stimulating debate. And the inefficiencies in production and marketing in ACP countries and other protected agricultural producers around the world helps to emphasize the serious long-term problems which can arise by responding to distorted price signals and having to allocate preferential access using quotas.

6 Where to next?

The cost and inefficiencies of the new EU single banana policy are not in dispute. They are large and extreme however they are measured. Furthermore, there are indirect costs that are not measured such as the uncertainty created by the policy. The fact that the European Union chose to implement such a distortionary policy when faced with the option of implementing far more efficient alternatives is testimony to the unpredictability of policy making in the European Union. The obvious course of action was not followed. What steps the European Union will follow next must also be regarded as highly uncertain.

Some elements of political interference are predictable and in this light the EU banana policy may be seen as reinforcing the concern that regionalism, political interference and the adoption of a common policy lead to lowest common denominator solutions and an averaging down of the quality of policy. And although we might predict from this that the policy is vulnerable to being degraded further, it tells us nothing of *how* and only adds to the uncertainty of *when*. But also it tells us nothing of the other vested interests which may emerge. That said, we can be sure there is plenty of potential for new groups to emerge as the costs and waste of the policy becomes better known, and that the groups hurt by the policy will press ever more strenuously for reforming. This is starting to happen. Indeed, the enormity of the inefficiencies of the policy and the wide range of groups now positioning themselves for reforming the policy makes a strong case that inevitably the policy will be reformed. But again *when* remains highly uncertain, and there could still be plenty of time for waste and disruption to occur in the interim.

The uncertainty, waste and disruption imposed on banana exporting countries while they wait for the European Union to rationalize its policy, represents a policy challenge itself. For ACP producers who currently receive aid from preferential (but quota restricted) access to the high priced EU banana market, the best policy response to the uncertainty waste and disruption would appear to be to seek direct aid from the European Union in place of that tied to banana prices. With direct aid more aid could be received without making the European Union any worse off and indeed it could be made better off, that aid could be targeted to infrastructure development which would support the development of sustainable industries rather than an industry which requires assistance and adjustment to the banana industries of these countries could be made to put them on a more sustainable basis.

Of course, given the unpredictability of European Union policy, there can be no certainty of the European Union accepting such a proposal despite the economic rationale for doing so. If the European Union will not agree to direct aid, were it to agree to allow import quotas to be transferable between countries, with a little more effort, a similar result to direct aid could be achieved.

If the European Union will not accept transferability, the ACP countries face the dilemma of wishing to maintain production to qualify for the aid, but at the same time they must prepare for the eventual loss of preferential access. In this paper four variants to achieving these objectives are outlined. The fourth is probably the simplest and cleanest alternative. It involves allocation import quotas of a particular country among its producers and then allowing those quota allocations to be fully transferable within the country. This should help encourage the most efficient producers to take up quota and for less efficient producers to leave the industry. Fewer resources would then be used to produce bananas, making the profits (and therefore the aid component) from preferential access greater for the economy of these countries. Profitable quota holders will pay taxes which can be used for infrastructure investment and profitable quotas holder will tend to invest some of their profits elsewhere in the economy anyway.

Under all four variants proposed, government may have a special responsibility to ensure that the production and marketing environment is as efficient as possible and that realistic expectations about the eventual loss of preferences are established. Preferences which insulate producers from market forces and international competition often lessen the urgency to adopt international best practices. This leads to featherbedding and technological stagnation. If government can succeed in establishing an efficient commercial environment, this would increase the value of preferences to the economy and increase the robustness of the industry for when it must face international prices for bananas. Part of ensuring a healthy commercial environment is established, may require support for policy, marketing and productivity research

For Latin American exports hurt by the policies, direct aid in place of tied banana aid to ACP countries would be to their advantage. So, they too have an incentive to support ACP countries in any effort in this direction. But Latin American countries also have an incentive to keep up pressure on the European Union to fundamentally reform its distortionary policy. To this end, the Latin American countries need to keep up their pressures for reform by making transparent the costs of the policy and by forming coalitions of interest with other disaffected groups. An emerging concern is that the European Union will keep trying to *buy off* Latin American countries by also offering them limited preferential access. In this regard the Latin American countries should familiarize themselves with the many long term problems which have emerged in ACP countries as a result of preferences and with protectionist, quotas based policy elsewhere in the world.

Summary

In adopting its new unified banana policy the European Union chose some of the worst features of previous EU member countries' policies. The policy essentially maintains the trade access preferences which some EU member countries previously granted to banana suppliers in former colonies and territories as a form of aid.

Earlier research (Bananarama I and II) has shown that the previous systems of preferences, and the import quotas used to underpin them, were highly inefficient as mechanisms for granting aid. They cost EU consumers dearly while providing only very small advantages to banana suppliers in former colonies and territorial — mainly ACP (African, Caribbean and Pacific) countries. At the same time the preferences imposed costs on efficient banana exporting countries of Latin America which are also developing countries. The main beneficiaries of the policies turned out to be marketers of fruit coming from countries with preferences

The EU missed a good opportunity to greatly rationalize and reduce the cost of its previously distortionary policies. Earlier research indicates that the efficiency of providing aid to preferred suppliers could have been increased greatly by pursuing virtual free trade policies involving a relatively small tariff and through targeted, direct aid.

The new policy relies on EU-wide quotas to restrict supply and raise internal EU prices. Prohibitive over-quota tariffs make the quota effective. A tariff also applies to quota imports.

The main difference arising from the adoption of the new policy is that the costs of the policy are borne by consumers in all EU countries rather than consumers in only some EU countries. Moreover, import restrictions applying against non-preferred supplying countries have been tightened. This has imposed extra costs on efficient export suppliers in Latin America.

Despite the opportunities missed, the new policy has unleashed some new pressures for change. Foremost among these is the emergence of a well focused debate on the inefficiencies of EU banana policy. Groups with well articulated arguments are now pressing for reforms of the EU policy. Pressures are being exerted through GATT. Other forums will also be used. This debate could well culminate in a substantial liberalization of EU policy.

Whatever the eventual outcome the new policy and the pressures for change create considerable uncertainty about what will happen. This has big implications for the macroeconomic outlook for many small island economies. Loss of the aid without compensation could have a big economic and social impact on ACP countries. What would help to reduce this uncertainty and help in the development of such economies is a known timetable for change with transparent objectives and rules, transition arrangements and economic support for adjustment, social support and diversification .

This paper builds on the previous Banarama papers and documents how changes in EU policy could affect banana exporting countries and draws out the policy implications for these countries. One of the main policy implications drawn out here is that ACP countries

should ask for direct aid in place of banana aid. This would allow for economic diversification and infrastructure development, which would give much more flexibility to develop the economies of the ACP countries than restrictive banana aid does.

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