A Trade Regime for Sub-National Exports Under the Agreement on the Application of Sanitary and Phytosanitary Measures

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Laura J. Loppacher
Research Associate
Estey Centre for Law and Economics in International Trade
Saskatoon, Canada

William A. Kerr
Van Vliet Professor
Senior Associate, Estey Centre for Law and Economics in International Trade
University of Saskatchewan
Saskatoon, Canada

Richard R. Barichello
Associate Professor
Faculty of Land and Food Systems
University of British Columbia, Canada

http://www.catrade.org

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1.0 Introduction

Regulations relating to disease management have traditionally been an important component of the overall environment in which international trade in agriculture products occurs. The World Trade Organization (WTO) Agreement on the Application of Sanitary and Phytosanitary Measures (SPS Agreement) allows members to restrict or prohibit imports from a country when imported products present a risk to human, animal or plant health or life. As the Bovine Spongiform Encephalopathy (BSE, also commonly called Mad Cow disease in the media) outbreak in Canada showed, the disease status of a country is a major competitive advantage and losing disease-free status can impose significant costs on an industry. The risks associated with SPS-based border closures were not well anticipated by the Canadian industry and government, and little was done in preparation for the potential change in the trading environment and the ensuing losses. This is a mistake many stakeholders in the industry plan to avoid making again.

2.0 Regionalization

One possible option for reducing the costs associated with losing the freedom to export is to create internationally recognized sub-national zones with differing disease status within a country. In international trade law, this practice is known as regionalization. Traditionally, regionalization has been used as a disease management tool by veterinarians/plant scientists and has not been used to facilitate international trade. However, when the SPS Agreement was negotiated, the possibility of allowing exports from regions that could be considered disease-free or having a lower incidence of disease was included as “Article 6 – Regionalization”.

3.0 Benefits and Costs of Regionalization

Regionalization was included in the SPS Agreement because of its potential economic benefits. When a trade embargo or restriction is put in place because of a disease outbreak in the exporting country, the welfare gains from trade are eliminated or reduced. If an exporting country can segregate the disease to a particular region or regions and maintain exports from the disease-free area(s), these losses can be reduced. This is particularly relevant for geographically large countries which are export oriented such as Canada. One of the most important issues that requires better designed policy responses, however, is that segregation of disease-free areas and infected areas will create a price differential between the regions; the price in the disease-free area will be higher than in the infected area. This creates an incentive to smuggle product from the infected area to the disease-free area. Economic studies show that if there is an incentive to smuggle, it is almost impossible to completely eliminate. Given the highly contagious nature of many of the diseases that countries are trying to manage, such as avian flu or foot and mouth disease (FMD), even one infected animal being smuggled could spread the disease to the previously disease-free area and efforts to implement a regionalization strategy will be rendered useless. Thus, it is of critical importance to eliminate the incentive to smuggle which has largely been

unaddressed thus far. As discussed later, this could be accomplished through a well designed compensation policy.

In Canada, the benefits of regionalization have been estimated to be as high as $20 billion in the event of a large scale FMD outbreak. There are many costs associated with regionalization systems such as implementation and monitoring costs, efficiency losses from domestic trade restrictions and compensation costs to producers in the infected area. Benefits are maximized and costs minimized when the infected region is as small as possible. Hence, creating zones that minimize the area impacted should be a priority. Existing administrative boundaries (such as provincial borders) are unlikely to coincide with economically optimal disease management areas. The overall net benefit or loss from regionalization will depend on the nature and location of a disease outbreak and the subsequent size of the infected area. Significant overall benefits may be possible but are not guaranteed.

4.0 Regionalization and the WTO

While the potential for regional exports was included in the SPS in 1995, widespread application of the principle has not been easily achieved as countries struggle to balance obtaining the benefits of increased trade with reducing the associated risks. As a result, importing countries frequently fail to recognize exporting countries' sub-national disease-free areas.

Implementation of Article 6 was first identified as a major issue requiring further work in 1999 and it has been an agenda item at every meeting of the SPS Committee since 2003. There has been little progress made since that time. The main complaint has been the difficulty exporting countries have had when trying to obtain recognition for disease-free regions from importing countries. Administrative procedures have been identified as the most significant impediment. An important question to ponder is: If importing countries are willing to accept an exporting country's assertion of disease-free status on a national basis, why are they unwilling to accept it on a sub-national basis? The answer to that may be the incentives to smuggle that were mentioned above.

Negotiations at the WTO SPS Committee have focused on the possible creation of guidelines governing the administrative procedures that have been identified as a major impediment. Many countries, most notably the South American countries, are strongly advocating that these administrative guidelines be created in the SPS Committee. Other countries, most notably Canada, the US and Japan, argue they should be created at the relevant scientific standards setting bodies (the International Plant Protection Convention (IPPC) for plant diseases and the World Animal Health Organization (known by the acronym OIE from its original name, Office International des Epizooties) for animal diseases). Despite three years of discussing the issue, no progress in improving implementation of the regionalization article has been made. Recent amendments to OIE regionalization standards failed to address the concerns raised at the SPS Committee regarding lack of transparency and predictability.

5.0 Canada's Experience with Regionalization

Canada has recognized various countries' efforts to create disease-free areas. This has applied primarily to the US and Mexico with respect to diseases such as anaplasmosis brucellosis, bluetongue, avian flu, pseudorabies and classical swine fever. This is an important show of goodwill when Canada makes requests of others to recognize domestic regionalization efforts. There are cases, however, in which countries have complained they have not obtained recognition when they should, such as Argentina's FMD free region which is officially recognized by the OIE but not recognized by Canada.

Canadian efforts at creating a regionalization system that could be implemented in the event of a major disease outbreak have focused primarily on the possibility of an incursion of FMD due to the devastatingly high costs that would result from an outbreak. These efforts fall mostly under the purview of the Canadian Food Inspection Agency (CFIA) and were initiated in 2000. The CFIA has worked in conjunction with industry to identify major deficiencies in their existing scientific systems and in the examination of effective systems. The CFIA would use regionalization as a "fallback" strategy, preferring to eliminate the disease on a national basis and implementing regionalization only if that is not feasible. They are also following a post-outbreak strategy and would implement controls only after a disease was detected to avoid impeding domestic trade before it is necessary.

Currently, the CFIA plan focuses on controlling domestic animal movements. Efforts have focused almost entirely on a crossing at the Manitoba-Ontario border that sub-divides Canada into two extremely large regions. The strategy is based on the ease of controlling animal movements rather than removing the economic incentive to smuggle. Significant potential net benefits from having smaller infected zones may be sacrificed.

6.0 Advice for Implementing Regionalization in Canada

The most important issue that needs to be dealt with is eliminating the incentive to smuggle. A compensation program must be designed *ex ante* and communicated to industry to avoid premature movement of animals in the event of a rumored outbreak and to control smuggling during the entire outbreak. Without this, any efforts to create sub-national zones could be wasted. Policy makers should avoid creating zones based only on administratively convenient borders or enforcement efforts and should focus on containing the disease to the smallest geographical area possible.

Second, Canada must be aware of the implications of attempting to implement regionalization on a post-outbreak basis. This may be the optimal choice given Canada's current disease status. It will take time, however, to demonstrate the effectiveness of the regionalization systems to trading partners after it is implemented. Policy makers must be aware of this and ensure a proper plan is in place for this transitory period.

Finally, at the WTO SPS Committee, Canada should consider altering its negotiating position. As the significant delays in regaining access to the US market for live cattle exports after the BSE outbreak shows, administrative delays can be a serious issue and better rules would favour a heavily export dependent country such as Canada. Canada should ensure these rules are fair, transparent, predictable and decided in a timely fashion while still allowing countries to accept imports only when the risk is acceptably low. Explicitly including the issue of economic incentives to smuggle may be critical to breaking the stalemate that has existed for the past three years in the SPS negotiations.

7.0 Conclusion

Many countries, including Canada, stand to benefit considerably from sub-national zones that are allowed to export in the event of a major disease incursion. Work in the last six years has advanced Canada's knowledge of what needs to be done but there are still major deficiencies in these plans. Addressing economic incentives is one of the most important issues if implementation is to be successful; e.g. by using policies to equalize prices between sub-national regions. Canada needs to develop a strategy for international negotiations that is built on the assumption that the country could experience another major disease outbreak. A central component of this strategy is resolving the ongoing negotiations in a timely manner. Finally, government agencies need to ensure that they design regionalization programs that are feasible for industry to implement and to continue working with industry to obtain their input and gain support for initiatives in this area.