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Why unwinding preferences is not the same as liberalisation: the case of sugar

Christopher Stevens
Institute of Development Studies at the University of Sussex, Brighton, UK

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Abstract

Many of the changes to developed country trade policy that affect developing countries do not fit neatly into the category of 'liberalisation' yet they are frequently assessed as if they did. The recent changes to the EU's regimes for production and imports of sugar fall into this group: both production and trade policies were highly distorted before the change and will remain so after it, but the distribution of the effects of these distortions will be altered. This will affect three of the six Development Cooperation Ireland programme countries in Africa: Mozambique, Tanzania and Zambia. Returns from sugar exports to the EU will be less than otherwise would have been. How much lower depends critically on how the sugar market develops after 2009.

JEL: Q18, Q12

Key words:

Sugar, liberalisation, value chains

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Introduction

Much discourse on the WTO, other areas of liberalisation or CAP reform seems to assume implicitly that there are just two states – protectionism or liberal trade - and that they apply equally to all parties. Whilst a moment's reflection is sufficient to dispel such illusions, the implications arising from the subtleties of actual policy change are nonetheless overlooked. The case of sugar illustrates very clearly how the overall effects of a policy change may be very different from those assumed to arise from headline captions such as 'reform' and 'liberalisation' that are used to describe them.

Sugar throws the issues into particularly sharp relief because it accounts for the greatest single static gain for beneficiaries from EU (and probably global) trade preferences and does so in a variety of ways which produce different distributions of gains. The current changes to the EU regime will alter substantially both the value and the distribution of gains for preference recipients whilst assisting non-recipient producers outside Europe only to the extent of reduced competition in third markets. Achieving the same third market effect in a different way could have resulted in greater gains for the lowest-cost global producers along the lines of those expected from 'liberalisation'.

Sugar is also of particular interest since it concerns three of the six programme countries for the Development Cooperation Ireland (DCI) development cooperation programme. These are Mozambique, Tanzania, and Zambia. It is important to think through the broad potential effects of the EU sugar changes on these countries since these cannot necessarily be inferred from what is known about the typical effects of liberalisation.

The first two sections describe the ways in which preferences confer benefits on countries receiving them and, specifically, how ACP sugar exporters have gained from the *status quo ante*. The gains are complex because preferential sugar enters the EU through several schemes that confer different gains on the exporting states and are vulnerable to change. The third section completes the picture by describing the three most direct sources of change. Having set the scene, the paper sets out an analytical framework relevant to assessing any trade policy changes that fall short of multilateral liberalisation. This is then used to assess the potential implications for the ACP of the CAP changes agreed in November 2005 and the Economic Partnership Agreements currently under negotiation.

The paper concludes that net effects of the recent changes in EU sugar policy are likely to be different in these three countries, although there exist so many uncertainties that it is not prudent to be too categorical. Overall, though, imports by the EU from the three sugar exporting DCI programme countries will be smaller than would otherwise have been the case.

The value of preferences

Trade preferences can exist only if there is protection: if supply to a market is restricted then the possibility arises to reduce some barriers for some external suppliers. All of the OECD states offer some form of preferential market access to certain developing countries. One of the fundamental mechanisms whereby protection supports domestic producers is by restricting supply in order to maintain prices at higher levels than would otherwise apply. In some cases these restrictions (and their price effects) are substantial. They create what may be termed trade policy rents: policy artificially restricts supply resulting in economic rents for some operators.

The principal intention of the distortions is normally to confer the rents on producers in the distorting state, but there is leakage. For a variety of reasons, some of the rent accrues to value chains that link producers in developing countries to developed country markets. So long as the volume or price of the 'preferential supply' is insufficient to depress prices in the importer to the level that would obtain under a liberal trade regime, there is a double gain for elements in the supply chain of the 'preferred exporter': not only are goods sourced from them rather than from less preferred suppliers, but also the final price is artificially inflated.

The existence of rents may alter the power relations within the value chain that supplies the imported goods. If, for example, the dominant buyer *needs* particular suppliers in order to acquire or perpetuate the rent, the latter's power within the chain may be much greater than it would be in a market that is regulated less or in a different way. This may influence the distribution of the rent between actors in the chain.

Hence, the gain for any given group of preferred producers will depend on three conditions:

- **condition 1:** the extent to which demand for their goods is increased;
- **condition 2:** the extent to which final prices are inflated;
- **condition 3:** the architecture of the protection/preference institutional framework and the characteristics of the market.

The first two conditions will determine the absolute scale of the rent. Any impact will be most substantial for product markets that face protectionism so severe that it restricts sharply the possibility of importing from non-preferred sources. It is in these cases that the price difference between the internal price and the world price is likely to be greatest. In such heavily protected sectors preferences typically take the form of special quotas allowing some third parties to supply the high-priced market without paying the substantial import duties that either exclude other imports or drastically reduce their profitability.

The effect is most easy to plot where there are special quotas. In such cases they are most favourable for those third parties that receive preferences and would not be able to sell larger volumes on the protected market even if it were unrestricted. The most adversely affected third parties are competitive producers that do not receive preferences. In the middle are countries that are preferred but are also competitive producers. In such cases, it is uncertain without a detailed analysis whether they gain more on the 'swings' of high prices than they lose on the 'roundabouts' of volume limitation.

The distribution of these gains and costs may be heavily influenced by condition 3: the architecture of the regimes conferring both the underlying protection and the preferences. Depending upon the power distribution within a value chain trade policy rents may:

- accrue to the producers in the preferred states, increasing the profitability of production and allowing them to:
  - increase supply relative to that of non-preferred states; or
  - compensate for production, storage or transport inefficiency relative to that of non-preferred states; or
  - invest in the human and physical capital required for upgrading;
- accrue to the buyers, increasing the profitability of importing from preferred states relative to non-preferred ones leading to:

- increased imports from the former;
- a need/willingness to shift value-adding processes to the producing state.

Because the distributional possibilities for any given absolute level of rent are so wide ranging, changes to the architecture of a regime may produce effects as (or more) profound than those resulting from changes to conditions 1 and 2. It is insufficient, therefore, to consider changes to protectionist regimes only in terms of whether or not they reduce excess supply. As explained below, it is possible to envisage situations in which measures to reduce excess supply in a protected domestic market have external effects that are the opposite of the ones normally expected from liberalisation.

The case of sugar

The EU regime of sugar protection and preferences not only scores high on conditions 1 and 2 but also provides different preferential regimes, each with their own architecture, that result in different distribution patterns for the rent. The EU's import tariffs are between €339 and €419 per tonne (equivalent to an *ad valorem* tariff of 108–133 percent) which is sufficient to exclude most non-preferential imports.[1] Moreover, preference beneficiaries include states with the range of supply characteristics noted above. There are those for which volume constraints are irrelevant as they could not increase supply at the prices available (with the high-price Caribbean sugar producers as the main examples). Others could increase supply were volume restrictions lifted (notably the Southern African preference recipients). And in others the situation is uncertain in that volumes might be increased but only on certain assumptions about future productivity gains and price levels.

In the sugar case, the losers from EU protection/preference include the Philippines, Cuba and especially Brazil. Not only do they gain no advantage from the high EU prices (because they cannot export to Europe) but they also face lower world prices as a result both of surplus EU exports and of the perpetuation of uncompetitive production, *inter alia* in the Caribbean.

There are five main avenues for sugar imports to enter the EU, four of which are preferential, and in addition there are cane supplies from the OCT which, whilst technically not imports, are nonetheless very different from the beet sourced in the core of Europe.[2] Three of the regimes cover developing countries; the other two relate to 0.3 million tonnes of sugar which is imported preferentially from the Western Balkans under the Stabilisation and Association process and an MFN tariff quota for Finland that pre-dates its entry into the EU.

The Sugar Protocol

The longest-standing regime is the EU–ACP Sugar Protocol which provides a tariff quota of 1.3 million tonnes to a sub-group of the African, Caribbean and Pacific (ACP) states (plus India). The architecture of the Sugar Protocol has provided the most extreme example of condition 3. Under the Protocol the EU guarantees to purchase ACP sugar at a price 'negotiated annually' that is within the 'range obtained in the Community'.

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[1] The tariffs given are for raw cane sugar (Combined Nomenclature – CN – codes 17011110 and 17011190) The *ad valorem* equivalents are those given in UNCTAD's *Trade Analysis and Information System*, which were calculated using 2001 data.

[2] See Chaplin and Matthews 2005 for more detail on these regimes.

The countries supplying under the Sugar Protocol have changed over time as some have lost their exportable surplus whilst others have taken their place. There are currently eighteen ACP states that export sugar to the EU under the Protocol: Barbados, Belize, Guyana, Jamaica, Trinidad and Tobago, St Kitts and Nevis, Fiji, Republic of Congo, Ivory Coast, Kenya, Madagascar, Malawi, Mauritius, Mozambique, Swaziland, Tanzania, Zambia and Zimbabwe. Because quotas are set partly in relation to historic supplies, the distribution of the gains is very uneven.

Special Preferential Sugar

Special Preferential Sugar (SPS) has been significant historically because it was the next avenue created for imports (following the Iberian enlargement of the EU), but its importance has been much reduced by the third route, Everything But Arms, which is described below. SPS covers additional quotas made available to some Protocol signatories to supply an extra quantity of sugar to feed the cane refining capacity in Portugal (currently around 220,000 tons). Conditions 1 and 2 are fulfilled with SPS just as much as with the Sugar Protocol. Condition 3 has also applied to a substantial extent. But this is less because of the legal text of the regime (which does not repeat the Protocol requirement that the price be linked to the EU level) than a consequence of the characteristics of the trade and of the EU sugar regime. In order to ensure 'orderly marketing' SPS suppliers have generally received a price that is below the Protocol level but far higher than a 'free market price'.

Everything but Arms (EBA)

The EBA regime of 2001 has introduced further diversity. Access to the EU sugar market is now open to all least developed countries (LDCs) although as of 2003 only eight were exporting to the EU under EBA, all but one of which (Nepal) are ACP states. Of these, four (Madagascar, Malawi, Tanzania and Zambia) also have access under the Sugar Protocol.[3] Unlimited free access is being phased in over the period to 2009/10, but the size of the tariff-free quotas available during the transition period is comfortably sufficient for *current* LDC exports.

EBA clearly fulfils condition 1; indeed, as the only import regime that will be unrestricted by quota from 2009/10 it offers the greatest potential increase in demand for LDC exports. So long as EU prices remain above 'undistorted market levels', condition 2 will also be met. So far, the organisation of the EU sugar market has been such that condition 3 is also fulfilled in the sense that the price paid to LDC exporters for EBA sugar is related to, though lower than, Protocol levels. But this arrangement is not required by the EBA text. It has come about because it is perceived to be in the mutual interest of the EU and LDCs during the current period when the latter's supplies are limited by a TQ. Council Reg 1381/2002, which lays down that a minimum price should be fixed for EBA sugar, covers the period up to 2005/06 and the new sugar regime agreed in November 2005 (see below) will extend the price support whilst the TQs are in operation.

It is not certain that this 'export restraint' will continue to be perceived as mutually advantageous after it becomes 'voluntary' in 2009 or, even if it is so perceived, whether it will be enforceable. From 2009/10, LDCs will have unlimited access (without any specific national 'allocations'). Unless new EU regulations are introduced regulating private sector

[3] The other EBA suppliers were (in declining order of export value) Sudan, Burkina Faso and Ethiopia.

transactions some LDCs might decide that they could gain by selling more sugar than can be accommodated at the administered price. If they were to start selling to beet refineries it might be difficult to police a system of voluntary export restraint in return for set prices. A free rider problem, familiar to students of commodity agreements, could emerge. It is conceivable that, as a result, the price could become one that is negotiated between actors in the value chain, with the proportion accruing to exporters determined by supply and demand. This would have consequences that are taken up below.

Thus far, EBA sugar has been accommodated in the EU market largely by cutting SPS supplies in order not to alter substantially the pre-existing supply–demand relationship. The possible knock-on effect of increased LDC supplies on the prices received by EU producers is a major reason why the EBA prices are administered in the way that they are. If increases in EBA imports began to exceed cuts in SPS or reductions in Protocol imports it is also possible that the EU market price might move towards an 'undistorted' level. It would be unlikely to reach this level unless sufficient LDCs develop a capacity to supply a large part of the market at prices similar to those of, say, Brazil. None the less, to the extent that EU prices move down there will be a weakening to condition 2 as well as to condition 3.

The refiners

Because production and trade involve a small number of large players, it has been easier to administer the supply and price controls for sugar (and ensure that a significant proportion of the final price remains in the producing country) than would have been the case with a good that has the characteristics of, say, horticulture. One EU processor/distributor, Tate and Lyle, is substantially dependent for its supplies on preferential sugar imports and, in turn, is the monopoly buyer of developing country preferential exports to the EU. It is a relationship of mutual dependence.

As a cane sugar refiner, the company needs access to imports since domestic European sugar production is of beet. And, because of the high EU tariff, the financial viability of its operations depends upon the continuation of supplies from preferred sources. Although the Caribbean is not the only source of preferential sugar (and others, such as Southern Africa, are cheaper) the country-specific quotas under the Sugar Protocol constrain severely its ability to switch.

At the same time, as the owner of the main cane sugar refineries in Europe, Tate and Lyle is the only feasible 'full time' purchaser of African and Caribbean exports to the EU. Since the option of exporting already refined sugar to the EU is not considered to be commercially viable on a substantial scale, the only alternative would be to sell outside the European harvesting season to EU beet refineries. But the beet and cane industries are in competition for market share.

The buyer, producers, and exporting governments therefore have a certain overlap of interests. Tate and Lyle, for instance, have persisted in buying from the Caribbean despite a history of production problems. Both the company and the preferred states lobby vigorously to protect their overlapping (but not identical) interests. And, from time to time, they are joined by the EU sugar beet lobby. But the relationship is a vulnerable one that could easily be upset by change. And change is occurring on three fronts.

The three sources of change

This section analyses sources of change already agreed or sufficiently certain to allow conclusions to be drawn. There is at least one other source of potential change: the WTO's Doha Round. Were this to result in significant agricultural liberalisation and/or in a change of the rules affecting the way in which European sugar is supported it could alter the options available to the EU or the ACP, not least by requiring further change to the measures already agreed or in prospect. However, the failure of the Hong Kong ministerial to agree the formula for liberalisation (the 'modalities' in the jargon) means that it is not yet possible to determine whether or not sugar (or any other sensitive product) could be shielded from substantial liberalisation *if there were a deal*. Moreover, the Hong Kong failure to make sufficient progress either on the modalities or on many other important elements of Doha raises serious doubt over the italicised words. If a package is not agreed by mid-2006, it will be difficult to get the resulting legislation passed by the US Congress before the President's fast track authority expires. Given both the absence of detailed guidance and the distinct possibility that Doha will not be concluded this decade, the working assumption for the present must be that it is the changes already agreed or in prospect that will determine the environment for the ACP. Should this prove to be too pessimistic about Doha, the analysis can always be revised when the detail is known.

Common Agricultural Policy (CAP) reform

Until recently the sugar sector stayed outside the CAP reform process initiated in 1992. The pre-existing regime was extended in 2001 until 30 June 2006, but on the proviso that proposals for reform be submitted by the beginning of 2003.[4] In fact, the Commission did not initially submit proposals as such; rather, it argued that, given the nascent state of sugar policy reform, it should first initiate a debate within Europe on alternative approaches to reform. This was done as part of the Commission's Communication on further CAP reform in September 2003. Whilst the Commission made specific proposals for the other three crops included in the Communication (cotton, tobacco and olive oil), for sugar it simply set out four options for reform together with a summary of an Extended Impact Assessment.

In July 2004 the Commission issued a further Communication which indicated that it had chosen the option allowing EU market prices (supported by tariffs) to fall to the point where internal EU consumption is met by EU and preferential supplies. This proposal foresaw the current intervention price being replaced by a 'reference price' which would serve both to establish the minimum sugar price for producers (and the trigger level for private storage) and to provide the basis for calculating import protection and the guaranteed price for preferential imports.

The Communication proposed that the reference price be set at €506 per tonne for 2005/6 and 2006/7 and then cut to €421 per tonne from 2007/8 – a fall of 33 percent from its prevailing level of €632 per tonne. Implicit in the proposal was that high-cost producers within member states would exit the market – as would high-cost ACP countries, although their supplies would be substituted by other ACP states. EU beet farmers would be compensated by an increase in the single farm payment.

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4 See Chaplin and Matthews 2005 for an authoritative review of the reform process.

In June 2005 the Commission made a revised proposal to cut prices by 39 percent over two years.[5] Following intense discussion the changes finally agreed in November 2005 are broadly along the same lines but with important differences in detail.[6] The EU price cut will be 36% implemented over the four years 2006/7 – 2009/10 and will result in a raw sugar reference price for the Sugar Protocol of €335.2 per tonne. The June 2005 proposal calculated that the compensatory increase in the single farm payment to beet producers would be equivalent to 60% of the estimated revenue loss. The November 2005 agreement leaves unchanged the amount of compensation, even though the price cut has been reduced, which means that it has increased proportionately.

Another innovation is that a safeguard clause has been introduced that could result in curbs on EBA imports after 2009. An increase in imports from one year to the next of over 25% will trigger automatically a Commission enquiry.[7] The November agreement text makes clear that an increase from any LDC will trigger the enquiry although in subsequent correspondence with the LDC Sugar Group the Commissioner for Agriculture has stated that safeguard measures will not be implemented if total EBA imports do not exceed the forecast level.[8]

It appears that the EU is concerned primarily to cover itself in cases where the rise in LDC exports is due to a rapid increase imports of sugar from the world market up to (or even in excess of) the level of their domestic demand. However, without information on the likely output of each unit of the new capacity being planned in some LDCs (in order to make their exports competitive) it is not possible to know whether genuine increases in domestic supply could trigger the safeguards.

The WTO dispute

The combination of the EBA TQs and offsetting cuts in SPS have avoided any increase in the 'surplus' sugar that the EU has to export, but a ruling from the WTO that the EU's subsidised exports of sugar exceeded the levels permitted by its commitments under the Uruguay Round means that exports now have to be cut radically. The ruling, which was one of the stimuli for the 2005 sugar reforms, had its origins in a panel set up in July 2003 by the WTO to consider the complaint brought by Australia, Brazil and Thailand. It reported in October 2004 supporting the core of the challenge and, in January 2005, the EU appealed. The following April the Appellate Body published its report, finding in favour of the complainants.

The core of the complaint was that the EU was exporting some 4.1 million tonnes of sugar under subsidy (within the meaning of the Agreement on Agriculture) whilst its commitments allowed it to export just under 1.3 million tonnes. In other words, it has permitted exports of 1.3 million tonnes and a further 2.8 million tonnes of questionable exports. The EU has long portrayed 1.3 million tons out of the latter category as somehow 'offsetting' imports under the Sugar Protocol, and included a footnote in its Uruguay Round schedules to this effect. But in both factual and analytical terms there is no such link. The exports are not exclusively refined cane sugar, nor are imports from the ACP necessarily the least competitive that come onto the EU market and, hence, a 'surplus' in economic terms. The only sense in which there

5 CEC 2005b.

6 EU Council 2005.

7 EU Council 2005: 9.1. The document does not specify whether the increase will be measured in value or volume terms.

8 EU Council 2005: 9.1.

is any clear link between preferential imports and the permitted exports is that EU policy has sought ‘autarchy plus’; it has set production quotas that exceed self-sufficiency. This has necessarily resulted in exports in excess of the level of imports

With both the WTO panel and the Appellate Body finding against the EU, these exports have to be reduced by 2.8 million tonnes. This is not to achieve an efficient domestic market but simply to comply with the Agreement on Agriculture which permits the EU to continue to subsidise exports of up to 1.3 million tonnes. Removing subsidised exports altogether, as the EU has promised to do by 2013 in the Hong Kong Ministerial Declaration, would require a further 1.3 million tonnes of cuts to supply, and if this were achieved through price cuts that were not offset (wholly or partly) by increased subsidies to EU producers through other means, part of the cut would probably fall to imports and part to domestic production according to their relative costs of production.

Economic Partnership Agreements (EPAs)

The Cotonou trade regime expires in 2007 and the current plan is to replace it with a set of EPAs negotiated with ACP sub-regions. At present six regional negotiations are under way. Neither the Sugar Protocol nor SPS are formally part of the Cotonou trade regime (and EBA is completely separate). None the less it seems likely that some change will be needed to the Protocol (which is included in the text of Cotonou despite its legally separate identity) in order to adapt it to a post-2007 system in which signatories are spread between several EPAs. some of which may also include sugar-producing LDCs eligible for EBA.

The Commission has proposed that the ‘Sugar Protocol be integrated into EPAs in such a way that does not prejudice the EU’s commitment to LDCs for full market access for sugar from 2009 and that ensures full compatibility with WTO rules’.[9] This will be covered by the review of the Sugar Protocol, to be negotiated jointly with the ACP in the framework of EPA negotiations.

Three questions need to be asked concerning the volume and price of allowable ACP exports. There is a strong expectation that the EU will offer ‘EBA-style’ unlimited free access to its market for all the exports of EPA members; will this also apply to sugar? If it does, will any price guarantees still apply?

If some supplies are made through the Protocol, its price provisions would remain effective (unless all parties agreed to change). But it is not certain that any exports will be made via the Protocol – or at least not for ever. Whilst the Protocol is of ‘indefinite’ duration this is not necessarily the same as ‘unlimited duration’; the term means merely that neither a minimum nor a maximum duration are specified. In other words, the Protocol might cease to exist.

There is no logical reason why ‘EBA equivalence’ should offer Protocol guarantees to exports from non-signatories or, if the Protocol continues, to its signatories for amounts in excess of their quota. It might be considered mutually advantageous for guarantees to be offered (and there is nothing in the Protocol to prohibit this); as noted above, EBA has operated so far in a way that confers similar (although slightly lower) price benefits to LDC exporters. But it is hard to see how the EU could make such an offer for an unlimited volume of ACP exports.

[9] CEC 2005a: 8

In other words, the ACP may have to balance a continuation of export volume restrictions in return for administered prices. This is the bargain at present: but it is one in which the ACP have limited choice. If EPAs were to offer unlimited access for all ACP sugar exports, the non-LDC states would face the same choices that, under EBA, the LDCs will face from 2009. The outcome will be determined both by their initial choices and by the practicalities of policing volume restrictions (given an underlying EU trade law that offers unlimited access, not least in order to meet the requirement of WTO Article 24).[10] An increase in the number of countries eligible to export unlimited volumes, and the absence of TQs enforceable at the border may make an extension of the current regime unworkable (especially if there is a parallel proliferation of buyers).

There is also an open question of what will happen to any non-LDC sugar exporter that chooses not to enter an EPA. Since neither the Sugar Protocol nor SPS are formally part of Cotonou there is no obvious legal problem with a continuation of their access under current arrangements (always assuming of course that these are not successfully challenged within the WTO). But there remains uncertainty.

These are unanswerable questions at present as no EPA negotiation has yet moved sufficiently far to have begun addressing the issues in a serious way. But, when they emerge, the answers will have a strong impact on the likely impact of the current CAP reforms on the EU sugar price and the gains derived by preference recipients.

The potential effect of change

How these changes may affect ACP and LDC suppliers is covered in the next section, but this one sets the scene by considering how changes to complex preference regimes such as the EU's may affect domestic producers and consumers and actual or potential exporters. Any sub-multilateral liberalisation scheme will tend to produce a combination of trade creation and diversion**.** But in a reshuffling of the EU's 'pyramid of privilege' many cases will not fall neatly into either category.

Adding two additional classification categories of positive and negative diversion reversal ('positive DR' and 'negative DR') to the standard tools of trade creation and diversion helps to understand the range of likely effects. Trade creation is a straightforward concept: if liberalisation removes significant tariff barriers imports may increase, displacing less competitive domestic European production. So, too, is trade diversion: if the EU liberalises towards some sources but not others existing imports may be diverted from a source that is more efficient but is now less preferred to one with the opposite characteristics. Diversion reversal occurs when a policy change removes or reduces the commercial advantage acquired in the past by the less efficient supplier. This can occur either through a reduction in the tariff payable by the more efficient supplier (positive DR) or by increasing the tariff paid by the less efficient supplier (negative DR).

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[10] At present, imports from LDCs are controlled through regulations that specify a two-tier tariff regime for 'in' and 'out' of quota supplies. EPAs will need to satisfy WTO Article 24's requirement that they liberalise 'substantially all' trade. The EU has interpreted this requirement in such a way that the degree to which the ACP have to liberalise is dependent upon the extent of the EU's liberalisation (see Stevens and Kennan 2006). If, as expected, the EU agrees to liberalise on 100% of imports (and the ACP's liberalisation effort takes this into account), its regulations will not be able to impose TQs on a 'liberalised product' such as sugar without bringing conformity with Article XXIV into question.

Although both positive and negative DR are simply specific cases of trade creation/diversion, there are two reasons why it is helpful to distinguish them separately. One is that the overall impact of any given trade policy change will be determined by the relative importance of 'diversion reversal' effects. The second is that this relative importance will be influenced by the number of countries that are covered by any particular regime.

To illustrate these differences Table 1 sets out in simplified form the effects of each relative to the others on the level of imports, the location of the producers who will have to adjust to increased competition, and the effects on consumers in the importing countries. The effect on the level of imports is the determining change – the others flow from it.

Table 1: Trade creation, trade diversion and diversion reversal

Reshuffling effect	Level of imports	Adjustment impact	Consumer impact
Trade creation	Large increase	Domestic producers	Significant gain
Trade diversion	No change	Efficient exporters [a]	Small gain or nil [b]
Positive diversion reversal	Small increase	Inefficient exporters [a]	Small gain
Negative diversion reversal	Reduction or no change	Inefficient exporters	Nil or lossl [b]

Note:
(a) And, possibly, domestic producers. (b) Depending on how government replaces lost tariff revenue.

A policy change that results only in trade creation will result in the largest relative increase in imports for any given level of tariff cut and price elasticity of supply and demand. By definition trade diversion will result in no increase in imports; if the relative costs of supply are such that the tariff cut allows an increase in imports from the preferred suppliers that exceeds the fall in those from the non-preferred the net increase will be classified as trade creation. It is possible that consumers may gain from trade diversion if prices fall as a result of the tax cut, but that partly depends on whether the government seeks to offset the tariff reduction by increasing other taxes (or by reducing expenditure that benefits certain consumer groups). In either case there are likely to be distributional effects.

Positive DR can be thought of as a sub-category of trade creation. Imports are likely to increase but only in proportion to the preference margin that is eroded and in relation to the supply capacity of the beneficiaries. The only element of any constraints on imports that will have been removed is the tariff disadvantage of those competitive suppliers that have been granted improved access *vis à vis* less efficient preferred states. For many products the pre-existing margin of preference is quite small – typically less than 10% for horticulture. An extension of preferences may not fully remove this margin and, unlike multilateral liberalisation, it may not apply to all suppliers. If the 'newly preferred' states are not globally the most efficient (merely more efficient that the previously preferred ones) the effect will be smaller than the 'pure' trade creation envisaged in the literature.

This is why the table shows a small consumer gain *relative* to the entry for trade creation. There will be a need for adjustment by formerly preferred, less efficient exporters. Whether or not domestic producers also have to adjust depends on the extent to which the new preferences remove import taxes and the number of suppliers that they affect. Whereas trade creation affects domestic producers by definition, the extent of positive DR is a matter for empirical observation. It is possible to envisage cases in which the increase in imports is so small as to avoid any significant displacement of domestic production.

Negative DR will normally result in a fall in imports: the exports of the inefficient supplier can be expected to decline but no change would have happened to cause an offsetting rise in exports from the efficient supplier. It is possible that, if the cost difference between the efficient and inefficient supplier is very close to the tariff rate that they will both now pay, the former may be able to supply the same level of imports as used to come from the latter without the price rising sufficiently to reduce demand. In such a case imports would remain unchanged. But by definition there can be no increase in imports: if the more efficient supplier had been able to supply at the post-tariff price additional imports beyond those sourced in the less efficient one, it would already be doing this.

The less efficient suppliers lose from negative DR – a loss that is offset by gains accruing either wholly to EU producers (if imports fall) or partly to efficient sources of imports (to the extent that they do not). For consumers there will be either no change or a loss as a result of negative DR. The former would occur only if the more efficient suppliers are able to replace the imports lost from the less-efficient suppliers without increasing the price (i.e. by cutting their prices to the extent of the tariff) and/or if the government uses any increased tariff revenue in a way that benefits a consumer group. But if imports from the previously preferred countries are not wholly offset by same-price imports from the more efficient suppliers either the level of imports will fall or the price of imports will increase (or both) and government revenue may not increase.

Consequences for ACP countries

With these subtleties in mind we can assess the likely consequences of the sugar regime changes on the ACP countries, non-ACP sugar producers and EU consumers. Some effects are already clear but those on African ACP states, in particular, will be influenced strongly by what happens next.

Among the clearest effects are those on non-ACP producers: the EU's plans allow for no new trade creation (above what is implicit in EBA) and no scope for positive DR. Only to the extent that the changes are essential to allow the EU to comply with its 1994 commitments under the Agreement on Agriculture (as interpreted by the WTO Appellate Body) will non-ACP exporters benefit – through reduced competition in third markets. But to argue this is effectively to say that, without the reforms, the EU would default on its 1994 commitments.

Also clear is the effect~~s~~ on the high-cost ACP which will be analogous to negative DR. By making the EU a relatively less attractive market the level of imports will tend to be lower than it otherwise would have been.

For lower-cost non-LDC ACP states much depends on whether volume limits on their exports are removed and on what happens to the prices they receive. If volume curbs are reduced or removed (and this gain is not wholly offset by price falls), they would experience effects analogous to positive DR (although whether the consumer welfare effect is the same will depend on what happens to prices). If there are any external adjustment costs arising from this positive DR it will be felt by the LDC ACP states which, alone at present, have a promise of unlimited market access.

Broadly the effect on imports (and on ACP returns from their exports) depends on three things:

1. the supply response of the select group of states permitted to export to the EU;
2. the preference regime to which permitted exporters are a party; and

3. the relationship between EU and world market prices

Point 3 arises because preference recipients have the opportunity to ‘swap’ imports from the world market for exports to the EU up to the limit of their domestic production. If, for example, their domestic consumption is 1 million tonnes and their production 1.5 million tonnes their strategic choices range between supplying the domestic market wholly with local supply and exporting 0.5 million tonnes or satisfying domestic demand exclusively from imports and exporting 1.5 million tonnes.

Because these three factors vary between the ACP and the effective terms of future preference agreements is uncertain, this section deals with the potential impact in two steps. The first assesses what is known about the aggregate effect on the volume of ACP sugar exports. The second sub-section considers how this aggregate effect will affect different ACP sub-groups according to alternative assumptions about what may happen to the distribution of any remaining economic rent within the relevant value chains.

Aggregate effect

When in June 2005 the Commission was proposing a cut of 39 percent in the white sugar guide price it forecast that there would be no fall in imports from the Sugar Protocol states and an increase in imports under EBA resulting in a net increase in imports of 1.6 million tonnes to 3.9 million tonnes by 2012/13.[11] This assumed that any falls in imports from the high-cost ACP producers would be replaced by increased exports from the lower-cost producers, with Malawi, Mozambique, Swaziland, Zambia and Zimbabwe specifically mentioned as potential beneficiaries. Imports under EBA were forecast to reach 2.2 million tonnes (as against the level of 3.5 million tonnes that they would have reached without any price cut).

It is far from clear whether these levels will be attained for three reasons. Partly it is because the information required to judge is complex (depending as it does on the relativities between the EU price, the costs of production in each ACP state, and the world price – all three of which have to be projected into the future). Related to this, it is also partly because there are only a few, closely guarded, sources of technical expertise on comparative production costs. Third, the nature of the ACP’s post-2007 preference regime is uncertain; of critical importance is whether or not there will be any quantitative or price constraints on lower-cost Protocol beneficiaries taking over (or exceeding) any fall in supplies from high-cost producers. The effect of these uncertainties may be magnified by their impact on investment decisions. Sugar production and investment is a typically lumpy activity. With uncertainty on all these points it is hard to judge whether the new investment foreseen in some LDCs after EBA was unveiled will actually be forthcoming.

Information available from one industry specialist suggests that the EU figures may be at the higher end of likely import volumes. It assumed a slightly larger cut in prices than has finally been agreed with the reference price for raw sugar under the Sugar Protocol being reduced to €325 per tonne (as against the €335.2 that will apply under the November 2005 agreement).[12] It then made two different assumptions about quantitative restrictions under the preferential regimes. If the current non-LDC preference recipients obtain unlimited access, it forecast an

[11] CEC 2005a: 8

[12] EU Council 2005: 2.

increase (over 2000-02 levels) in total ACP exports under all preferential regimes of just over 1 million tonnes by 2010 (as against the Commission's forecast of 1.6 million tonnes by 2012). The alternative assumption is that non-LDC suppliers are limited to their current quotas (i.e. that Protocol quotas can be reallocated between signatories but only LDCs have unlimited access outside the Protocol). In this case the forecast increase in exports is only 78,543 tonnes. These figures imply total EU imports between a high of 3.1 million tonnes (assuming no change to the Commission's estimates for supplies from the Balkans and under MFN), and a low of 1.7 million tonnes (just 5 percent higher than in 2000–02).

As the actual cut in prices is slightly less severe than assumed, import levels may be somewhat higher, but it still seems likely that the effect of sugar 'reform' will be lower imports than would otherwise have occurred. At the high end these figures suggest that imports will be 2.1 million tonnes lower in 2012/13 than the 5.2 million tonnes forecast by the Commission in the absence of CAP change.[13] At the other end of the scale they would be 3.5 million tonnes lower.

EU consumers will tend to benefit from lower prices. However, the cuts will be offset (to the extent of over 60%) by increases in the single farm payment. This, in turn, will mean a combination of higher taxes than would otherwise have occurred and a redirection of expenditure away from non-sugar uses.[14]

Distribution of effects

Although there will be no increase in imports from non-preferential suppliers, some preference recipients will see their exports grow. Although the aggregate growth will be less than forecast in the absence of the sugar policy change, it is possible that some non-LDC ACP states could achieve higher growth (through reallocated Protocol quotas) than they could otherwise have expected. Indeed, it will be the distributional changes arising from the reduction in the internal market price will be the most significant.

The impact on individual countries will vary, depending on:

- the regime(s) under which they export to the EU market;
- the extent to which the regimes allow exports to increase;
- their underlying costs of production;
- the relative importance of sugar for their economy.

The effect of the changes on the proportion of the final price received by the exporting state will depend on what happens to the Sugar Protocol and SPS. If the post-2007 Cotonou regime allows non-LDC Protocol beneficiaries to export unlimited quantities those countries with low production costs will be able to increase their exports. If the regime also offers a guaranteed price, the reduction in their revenue per unit exported may be smaller than if they have to sell at whatever the market will bear. For LDCs much will depend on whether they continue to sell at an administered price or if there is a free for all. Given that quotas have

[13] CEC 2005b: Table 4.

[14] The choice between lower taxes or redirected expenditure is predetermined to 2013 by decisions already taken – but it will become a practical option (as well as an analytical one) after the expiry of the EU Financial Perspective 2007-2013 agreed in December 2005 – or before then if further CAP reform is brought forward. Given that the total expenditure on CAP Pillar 1 expenditure is now fixed to 2013 this implies a redirection of expenditure away from non-sugar enterprises.

been ruled out, post 2009 price levels may depend, as explained above, on the agreement and enforceability of voluntary export restraint.

Central to all this is the continuation of an EU cane refining capacity, which is currently owned by a single company. This depends, in turn, on how competition between cane and beet refiners is 'managed' in the EU market. The worst outcome from a developing country perspective would be a closure of all or a large part of the cane refining capacity.[15] For the Protocol beneficiaries, if the price guarantees remain in force, this could turn the trade into a cash transfer operation which would make a reality of the current fiction that 1.3 million tonnes of EU subsidised exports are accounted for by its imports: the EU would have to re-export onto the world market the deliveries of cane that it receives. For LDCs it offers the prospect of sales being made to refiners at prices determined by competition between the EBA beneficiaries (and possibly with EU producers as well).

Industry sources suggest that even after any feasible restructuring to reduce production costs, a cut in the reference price for raw sugar under the Protocol to €325 per tonne would cause production to cease in Barbados, Belize, Côte d'Ivoire, Jamaica, Madagascar, St Kitts and Trinidad.[16] Without restructuring, production would also cease in Mauritius. The potential 'beneficiaries' that could see production increase significantly if allowed are Malawi, Swaziland, Zambia and Zimbabwe; there could also be significant increases from Guyana and Tanzania if production costs are reduced. Congo and Fiji would continue to produce, but at current levels.

The combined effect of the price and volume changes would see countries falling into one of three categories in terms of earnings from sugar exports. On the 'slightly worse than actual' assumption of €325 per tonne and assuming both that the industry restructures and that all ACP states are able to increase export volumes, the categories and their membership are as follows.

1. **Total loss of forex revenue:** the countries in which production ceases – Barbados, Belize, Côte d'Ivoire, Jamaica, Madagascar, St Kitts and Trinidad – plus Tanzania which is forecast to re-direct supplies to the domestic market.
2. **Substantial loss of forex revenue:** Congo, Fiji, Malawi, Mauritius, and also Zambia (which, like Tanzania, is forecast to redirect its current exports, partly to the regional market).
3. **Modest increase in forex revenue:** Guyana, Swaziland, Zimbabwe.

The economic impact of these losses will depend on the relative importance of sugar to the economy and the possibilities for diversification. It has been estimated by industry sources that in 2000–02 the Sugar Protocol accounted for over 10 percent of GDP in Guyana, for about 5 percent in Swaziland, Mauritius and Fiji, for between 1 and 2.5 percent in Belize, St Kitts, Barbados and Malawi, and for under 1 percent in the rest. This implies that the outcome forecast would benefit the two countries with the greatest dependence on the Protocol even though it would adversely affect the rest.

[15] Or its continuation in business only at the cost of slashing the prices its pays for cane imports.

[16] The analysis does not include Mozambique.

Conclusion

EU sugar policy (through the CAP and trade preferences) has resulted in substantial forex transfers to a select group of developing countries. Some, such as Mauritius, have used this transfer very prudently to help support diversification, first, into another product attracting trade policy rents (clothing) and then into services. Others, such as most Caribbean states, have allowed production costs to escalate so that the sector fails to make a surplus, let alone invests in diversification. For those DCI focus countries with significant sugar potential - Mozambique, Tanzania, and Zambia – the effects have been mixed. As a result of domestic economic policy mistakes, Tanzania failed to reap the gains that it could have obtained as an original signatory of the Sugar Protocol. As ‘late arrivals’ Mozambique and Zambia fear that the gains are being reduced just as they become eligible to receive them on a significant scale – as does Tanzania now that its domestic problems have been overcome.

How is one to view their concerns? In cases where preferences are eroded by multilateral liberalisation the losses of previously-preferred but less competitive producers must be set against the broader gains of more competitive suppliers and consumers. The gains are expected usually to exceed the losses so that the most appropriate response is to provide adjustment support for those countries no longer able to export (and, perhaps, to phase in the change over a period sufficiently long that borderline producers can restructure). But as the sugar case demonstrates, liberalisation is not the only cause or preference erosion.

The net effect of the EU sugar regime changes agreed in November 2005 is likely to be, in the view of most parties (including the European Commission), a fall in imports from the levels that they would otherwise have reached. Only a small number of developing countries are expected to experience an increase in their earnings from exports to the EU. Hence, there are few external ‘gains’ to set off against the external ‘losses’. For no ACP state is the impact of the change forecast to be worse than full liberalisation, and for those that remain able to export to the EU it will be better. But the main welfare gains expected to arise from liberalisation will not occur.

Given the starting point (of a highly distorted domestic and import regime) it is not obvious what else the EU could do that would have a superior impact for the ACP suppliers other than the imposition of smaller quotas on European production (which was one of the options discussed in the Commission’s 2004 report). Clearly, domestic production has to be cut in order to reduce subsidised exports. The method adopted to achieve this spreads the cuts between EU and non-EU producers. But whereas the former are being compensated for over 60% of their loss, the latter have been promised a small increase in aid to be paid not to producers but to governments. The burden of adjustment, net of these payments, will be greatest therefore on developing country suppliers.

It is assumed that the longer term goal is genuine liberalisation, with tariffs being cut to a level that imports can determine the actual price levels in Europe. One way to use the current *dirigiste* system to prepare for such a market-driven future is to provide support to those ACP states that are potentially competitive at future prices to scale-up their production. The three sugar producing DCI focus countries would certainly fall into this category. Support (either through price supplements or by investment subsidies) over the period during which MFN tariffs are gradually reduced would help them to prepare for the day on which they will have to compete directly with Brazil.

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Institute for International Integration Studies
The Sutherland Centre, Trinity College Dublin, Dublin 2, Ireland