IPC Position Paper No. 9

State Trading and the WTO: Reforming the Rules for Agriculture

Published by the
International Policy Council
on Agriculture, Food and Trade
Washington, D.C.
September, 1999

The work of the International Policy Council on Agriculture, Food and Trade is done by consensus. The views and positions expressed are therefore the product of group deliberations and not every IPC member is always in agreement with every position or view expressed.

To order hard copies of *State Trading and the WTO: Reforming the Rules for Agriculture* contact the IPC at:

International Policy Council
1616 P Street, NW, Suite 100
Washington, DC 20036
Tel: (202)328-5056
Fax: (202)328-5133
email: nsmith@rff.org

Preface

The International Policy Council first began to address the issue of state trading in agriculture in 1990 when it launched a study to examine the effects of trading institutions on world markets in order to develop recommendations on how to bring them under international trade law. The result of that study was the IPC Task Force report, *State Trading in International Agricultural Markets: Institutional Dimensions and Select Cases*, which was issued in 1991.

The present IPC position paper was written with the same objectives in mind and has for its focus the start of the WTO trade negotiations scheduled to begin in late 1999. A draft of the paper was initially discussed at the time of the 22nd IPC Plenary Meeting in October, 1998 in the Hague. The final draft received the approval of the IPC membership at the 23rd IPC Plenary Meeting in June 13-15, 1999 in Florence, Italy. The paper is designed to provide insight into options for the Seattle Round that the IPC thinks will be useful for trade negotiators.

The IPC would like to thank Rob Johnson for authoring the paper and Peter Lacy for providing editorial support. The paper reflects the views of the IPC on state trading and should not be attributed to any other organization or individual.

Overview

With agricultural trade reform talks preparing to resume by the end of 1999 under the auspices of the World Trade Organization, it is time for the activities of state trading enterprises (STEs) to come under the purview of the multilateral trade rules system. This is because the same reasons for liberalizing borders and reforming policies also apply to reform of STEs: Measures that favor one type of commerce over another invite abuse, encourage waste and stifle innovation, with the costs falling most heavily on farmers and consumers.

The aim of the present paper by the International Policy Council on Agriculture, Food and Trade (IPC) therefore is to provide negotiators in the WTO with policy recommendations for how to liberalize this aspect of agricultural trade in the context of the 1999 trade round. The paper describes the various types of STEs—from public export monopolies to market promotion agencies and cooperatives—and suggests individual remedies for their trade-distorting effects. Where monopolies exist, the IPC contends that effective competition must be put into place, and where other distortions arise because of STEs, appropriate disciplines should be imposed.

The IPC argues that if progress is made on state trading in agriculture based on the framework outlined in the paper, then the 1999 WTO round will have taken a significant step forward in removing a major obstacle to the free flow of agricultural and food products.

Introduction

Agricultural markets can be distorted or prevented from working efficiently in many ways. One obvious hindrance are national or regional borders, including tariff and non-tariff barriers which discourage imports, and subsidies or other aids which encourage exports. Another form of hindrance are domestic policies, including price supports, production-distorting income supports, production quotas or restraints, and input subsidies, all of which can distort production or marketing patterns.

Such interference with agricultural markets represents heavy costs for global commerce, national economic growth, farmers, consumers and the environment. Recognizing this, trade negotiators addressed both border measures and domestic supports directly in the Uruguay Round of GATT trade negotiations concluded in 1993. They also committed to move ahead with negotiations to further reform these areas in the next round of global agricultural trade negotiations beginning in late 1999 under the auspices of the World Trade Organization.

Another important mechanism that distorts agricultural markets, but one that was not addressed in the Uruguay Round, is that of state trading. State trading enterprises are established for many purposes, but they are typically aimed at providing insulation from market fluctuations or facilitating exports. For example, in some countries, their aim is to provide a system to facilitate the reliable supply of imports or the stabilization of trade relations. Regardless of its objectives, state trading in agriculture invariably affects the realms of market access and export competition, and it has become recognized as a means to circumvent the impact of tariffication. The failure to recognize and directly address the role of institutions involved in state trading has hindered the GATT/WTO's ability to increase the free flow of agricultural trade. In particular, the entry of new countries, particularly China and Russia, could pose real problems for the WTO if they are not brought in under a rules system that covers state trading. State trading is also of major interest to developing countries, whose food security questions will be a major issue in the next round. As a result of all these concerns, a number of countries have recently expressed their desire to deal with this important issue in the upcoming agricultural negotiations.

One problem is that a number of different practices have been grouped under the heading of state-trading. The aim of the present paper by the International Policy Council on Agriculture, Food and Trade (IPC) is to help negotiators in the WTO better understand how to develop mechanisms to address state trading in agriculture. To this end, the paper distinguishes amongst the different kinds of state trading entities (STEs), and then concludes with recommendations for liberalizing this aspect of agricultural trade in the context of the 1999 trade round.

Reforming STEs will produce broadly shared benefits. By replacing marketing monopolies with competitive markets, the WTO round can:

1. create greater scope for innovation in product and service offerings;

2. bring consumers and producers closer together;

3. eliminate some of the price distortions that undermine the capacity of global markets to match supply with demand;

4. enhance trade-based food security while shifting to more environmentally sustainable production patterns; and

5. intensify pressures to lower marketing and handling costs.

In other words, reform of STEs will help foster a global food system that rewards efficient producers, responds to shifting consumer demands, expands trade flows and accommodates change in the industry.

Reform of STEs must by necessity and for maximum effect be coordinated with other trade-liberalizing steps. For example: all trade distorting activities in export markets need to be addressed in tandem; attention needs to be focused on the linkages between reform of importing STEs and reductions in barriers to market access; and reform of domestic marketing STEs and domestic support regimes must go hand-in-hand. Moreover, while these various distortions should be addressed in a coordinated or linked manner, there are also benefits from STE reform in reforming countries that justify the accelerated implementation of reforms these countries have already committed to make.

Types of State Trading Enterprises

State trading enterprises can be classified in a variety of ways. If the purpose is to bring disciplines to bear on their potential market-distorting effects, it is useful to divide STEs into two separate categories. The first category involves their field of operations, the second their mode of operations.

Fields of operation

An STE may be involved in one or more of the following operations: importing, exporting, marketing products domestically, or a combination of two or more of these activities. The field of operations determines where the primary potential for market distortion exists. The primary market distortions of an STE are likely to be found in the field in which it operates. For example, an import monopoly primarily will distort competition between domestic and imported goods. The effects of this market distortion can extend to other fields of operation. For example, an import STE that keeps domestic prices high can also impair the export competitiveness of products using the protected item as an input.

If an STE operates in several fields—import, export and/or domestic marketing—it is possible for it to distort several markets at once. It may even shift the primary effects of its market distortions across these fields over time as market conditions evolve and change. Obviously, dealing with STEs that have multiple fields of operation can pose a complex policy challenge.

Modes of operation

State trading entities also have different modes of operation. For purposes of gauging and disciplining their potential to distort markets, four different types of STEs should be considered:

1. Monopoly backed by public resources

This sort of STE (typically called a public monopoly) has the exclusive right to market a product plus the ability to transfer resources from taxpayers to a preferred beneficiary. It can for example pay farmers more than it charges consumers and make up the difference by transferring wealth from taxpayers or by skimming off gains from imports.

2. Monopoly relying on its own resources

In this case, the STE still has monopoly marketing power, but it does not have access to taxpayer resources. This type of STE (typically called a parastatal monopoly) can still distort markets. If it has multiple fields of operation, it can transfer resources from one segment of society to another. For example, it can overcharge domestic consumers in order to pay farmers more or in order to sell into export channels for less.

Even if this type of monopoly only operates within a single field, it can still distort markets. For example, it can pay some producers more than it pays other producers, although the most overt form of this price discrimination is usually avoided by requiring a "pooling" of returns that are then shared out among producers on a pro rata basis. Other discriminatory effects on production can still exist, such as ignoring quality or location differentials, favoring one class or type over another or one stage of processing over another.

Discriminatory effects are also felt on the sales side. The monopoly can discriminate between buyers, or it can choose to price products below the market price for a period of time in order to expedite sales. If this results in a misreading of market prospects, such under-pricing has the effect of transferring resources from farmers to favored customers.

3. Marketing promotion

A third type of STE in terms of mode of operation is a collective that can impose an assessment on the domestic production of a commodity or tap public resources to fund the promotion of that commodity. This type of STE is typically called a market promotion agency.

Here the principal market distortion involves how assessments are made and how promotional activities are undertaken. While an assessment to fund promotional activity may appear fair and non-distorting, it can have trade distorting effects if applied to imports. Importers are unable to pass the assessment back to producers in the exporting country. Since importers have to absorb the cost of such an assessment directly, it has the same effect as an import tax.

4. Chartered marketing combine

A fourth type of STE enjoys various marketing privileges. It may, for example, be empowered to enforce certain product standards to preserve a reputation for quality. It may also be permitted to restrict production or marketing of a product, usually with the goal of capturing a premium or at least of stabilizing producer returns.

In effect, marketing combines often permit producers to come together to engage in practices that otherwise would be regarded as anti-competitive. Such collective action often is justified as necessary to offset market power elsewhere in the distribution chain or because of specific market characteristics (e.g., perishability).

When these combines get exclusive marketing or bargaining rights they function much like a parastatal monopoly. If, however, a marketing combine is exempted from enforcement of anti-competitive laws but is not a monopoly, it poses different kinds of trade issues. Lastly, this type of STE is typically called a voluntary collective marketer, or a cooperative.

Remedies for Market Distortions

Some observers have suggested that greater transparency—more openness and information about how they operate—could remedy the major market-distorting effects of STEs. However, the issue is much more complicated than that. Different remedies are needed to protect against the various kinds of market distortions caused by different types of STEs. The table on page 10 provides a simplified grid illustrating possible STEs as defined by their fields and modes of operation.

The table identifies the most likely forms of market distortion arising in each category. "Subsidy" refers to an infusion of external resources that has a distorting effect. A "cross-subsidy" means distorting effects across multiple fields of operation. That adds a dimension of complexity, in part because cross-subsidy effects can be larger than the transfer of any direct taxpayer resources. "Discourage" and "encourage" are weaker distorting effects than "discriminate." Discrimination can be planned and controlled, whereas discouraging or encouraging trade flows are secondary effects of actions likely taken for some other purpose. Lastly, "uncertain" reflects the fact that evaluation depends on whether a cooperative becomes so large as to exert market power and eliminate effective competition. A more detailed discussion of some of the boxes in this grid will illustrate the trade-distorting issues.

Graph

Public export monopoly

A public export monopoly has enormous potential to distort markets. One way to address the distortion in trade negotiations is to treat the transfer of taxpayer resources to the monopoly the same as an export subsidy applied to a product. While identi-fying such transfers as export subsidies would be a helpful way to rein in market distortions, other problems would remain. The average per-unit subsidy would not necessarily be the actual subsidy granted to a particular business, so there would remain the possibility, indeed the likelihood, of discrimination among buyers. As with export subsidies in general, this particularly objectionable form of market distortion cannot be curbed unless the transfer of taxpayer resources is stopped.

Public import monopoly

With a public import monopoly, the source of market distortion is less likely to be in the form of taxpayer resources than in charging more for the product internally than is paid in the world market. In this case, governments direct these resources into their general coffers, or use them to support other activities in the agri-food chain. At its extreme, an import monopoly can limit trade, much as an import quota does.

In any event, the differences between world and domestic prices, and open versus restricted trade flows, function like a tariff rate quota, since the public monopoly importer can determine not only the price spread but also the quantity imported. Remedying this kind of market distortion requires reducing the market price gap as well as opening and then enlarging a market for imports to compete with the monopoly. This free trade component at a low or zero duty is necessary to ensure that domestic producers and consumers begin to feel the pull of effective competition.

Public export/import/domestic monopoly

An STE with import, export and domestic monopoly powers has enormous capacity to distort production, consumption and trade flows. Alongside the previous two remedies already mentioned—a subsidy discipline similar to export subsidy restraints and a free trade component involving expanding import competition—must be imposed a third remedy: the right of domestic and foreign investors to compete for the purchase, handling and sale of the domestically produced commodity. In effect, the trade-distorting impacts cannot be curbed without allowing effective competition in each market.

Parastatal export monopoly

A parastatal export monopoly has no access to taxpayer resources but does have the capacity to distort trade through price discrimination. One way it does this is to under-price exports by, in effect, paying producers less than market value. This is harmful to local producers and disruptive to global markets. It is far from clear that simply requiring more trans-parent conduct of this type of STE will end such distortion, however, since it does not bear any risk of loss from the “prices” it charges.

A parastatal export monopoly has other tools that can distort markets. It may control the quantities of the commodity that can enter the marketing stream at any point in time through devices such as marketing allotments. It may control the allocation of transportation equipment, by commodity, by region or even by elevator. These powers may distort both absolute price levels and price relationships between commodities, among locations or over time.

A parastatal export monopoly can also distort markets in more subtle ways. Because its services are not tested by competition in the marketplace its costs can exceed competitive norms, or its services can become outdated. Because such parastatals are typically organized by commodity, they can prevent a country’s comparative advantage from adjusting, as it should when market or technological changes occur. Perhaps the most subtle yet important market distortion here is the power to limit access to supplies. A single selling desk can refuse to do business with a buyer, thereby denying that buyer the grain or other commodities it handles.

The only effective protection against such market-distorting practices is choice. An effective marketing alternative must be made available, with bidding conducted on a daily basis. Only open competition will ensure that parastatal export monopolies do not capture export business at the expense of farmers, distort price and service responses, or interfere with effective access to supplies.

Parastatal import monopoly

The potential for distorting markets has many of the same characteristics with imports as with exports. Consumer prices can be raised artificially, and available quantities can be restricted artificially. The timing of deliveries can be out of step with market needs, and the qualities or types of products can be out of line with consumer preferences.

In other words, there are many ways in which a parastatal import monopoly can suppress demand, distort markets, prevent imports and protect domestic production. Again, the only effective remedy is to open an alternative, competitive channel that gives foreign suppliers direct access to users.

Parastatal export/import/domestic monopoly

In addition to the above mentioned distortions, a monopoly operating across all marketing channels has the capacity to cross-subsidize its activities. It can restrain imports in ways that inflate domestic prices to consumers, then divert some of those artificial gains into export sales at or below lower world market prices. It can also provide cheap inputs to domestic processing industries to facilitate the export of their finished products, thus shifting the optimal location of that processing activity and distorting trade flows.

The only reliable means to avoid these trade or market distortions is to abolish the monopoly. Because the monopoly spans internal and external markets, both domestic and foreign investors need to be given the opportunity to procure, handle, process and distribute the commodities involved. Unless markets are open to new entrants, the capacity to distort markets, in the short term and over time, will remain unchallenged. Without the risk of losing market share, without the opportunity to expand market share through innovation, or without the challenge of investors shifting their capital to better opportunities, a parastatal monopoly will behave differently than a competitive business. And many of these behavioral differences will manifest themselves in market distortions.

Market promotion agency

A market promotion agency differs from the monopolies described above in that its purpose is to promote products, not to market them. The marketing is done separately. The principal market distortion issues involve the way the promotional activities are funded and performed.

The funding can be through assessments on products sold or through public funding. If the funding is through an assessment imposed at the first point of sale by a producer, the producer in effect bears the cost of that assessment. Any attempt to transfer the assessment to imported products places the “tax” on the importer rather than the producer in the exporting country. This can function as a disincentive to import, especially in products with low margins. If funding is from public resources, the promotional activities require careful scrutiny in order to ensure that discriminatory practices are not employed.

Promotional activities can also distort markets. Promotions intended only to increase overall usage do not discriminate on the basis of origin. And promotions designed to create brand preference for the products made by those who are funding the promotions also fall within the realm of standard advertising practices. However, using promotional funds to require labeling on the basis of origin, to lobby governments for preferential treatment, or to urge consumers to avoid a competitor’s product because of where it was produced can be a discriminatory and market-distorting practice.

In other words, market promotion activities are not inherently market distorting. But any objectionable or discriminatory promotional activities should be easy to identify and discipline.

Cooperative marketing

In a variety of countries and commodity sectors, producers are allowed or even encouraged to band together to market their products. Often these cooperatives are given antitrust immunity and other public benefits such as specialized tax treatment not shared by their investor-owned competitors. Even so, these powers and incentives are not market distorting as long as the right to associate with the cooperative is voluntary and the share of production accounted for by the cooperative is not excessive.

When association becomes mandatory rather than voluntary, the marketing cooperative then takes on the characteristics of a parastatal monopoly. In that case, the remedies for its potential market-distorting effects should resemble those for parastatals mentioned above. If a mandatory marketing cooperative receives public benefits, such as special tax treatment, it takes on the characteristics of a public monopoly, and therefore requires the remedies appropriate to such an STE.

However, most cooperative marketing agencies are in fact voluntary. Most are granted limited exceptions to the normal rules of competition, and those exceptions are usually fairly balanced against the disadvantages that come with cooperative marketing efforts, such as higher costs, less expertise or limited product and service offerings. Moreover, competition between cooperative and investor-owned firms benefits farmers and customers by giving them additional choices.

Recommendations for Liberalizing STEs

The IPC believes the goal should be the dismantling of state trading entities or, at least, the re-interpretation of Article XVII of the WTO so that it does not allow international agricultural trade to be distorted. In addition, the IPC recognizes that the Seattle Round negotiations must take into account certain non-trade concerns—such as international development, rural development, food security and the preservation of the environment—and that these concerns may affect the direction reform of STEs may take. Obviously, given their array of divergent functions and goals, the different types of state trading entities will require different types of reform. The IPC believes that in order to allow for greater competition and to reduce or eliminate their trade-distorting effects, reform of STEs should take the following form in the coming round:

1. Comprehensive public monopolies

Such STEs are typically vestiges of state-controlled economies, with a state or state-chartered entity given exclusive marketing rights for exports, imports and domestic sales, backed by access to taxpayer resources. Because the potential for market distortion is the greatest, the array of remedies must be the most comprehensive. Here, reforms should focus on:

- constraining, and eventually eliminating, the use of taxpayer funds (similar to restrictions placed on the use of export subsidies);

- disciplining import controls and (as with tariff rate quotas) progressively reducing the levels of protection and increasing the volume of business open to market competition; and

- commitments to end both the monopoly on marketing rights and any discrimination against foreign investors in order to create an open, competitive marketplace by the end of the implementation period of the next round, if not sooner.

2. Limited public monopolies

Simply limiting a public monopoly to one field of operation or to a narrower geography will not by itself generate enough rivalry amongst the various public monopolies to create competitive markets. The potential for market distortions remains essentially the same, and the same remedies outlined above for comprehensive public monopolies are also required with limited public monopolies in order for markets to function effectively.

3. Parastatal monopolies

Even though parastatal monopolies receive no resources directly from government treasuries, their power to exploit farmers or consumers by paying low prices or charging high prices gives many parastatal monopolies substantial financial resources. Monopolies that are created by governments but are not funded by them still have the ability to distort domestic markets and international trade flows. As long as they enjoy exclusive powers or advantages not shared by their competitors, monopolies will not behave like "at risk" enterprises. To end the resulting market distortions, the monopolies themselves must be eliminated, preferably by the end of the implementation period of the next round. These monopolies are designed to provide stability or insulation from market fluctuations, however such goals need to be pursued in less market-distorting ways.

4. Market promotion agencies

Since promotional agencies are not inherently distorting in their own right, their potential for market distortion arises from specific actions or functions that can be addressed on a case-by-case basis.

5. Cooperative marketing associations

Cooperatives are often a useful marketing alternative. Market distortion issues are likely to arise only when association with the cooperative is mandatory rather than voluntary, or when the incentives for membership or antitrust exemptions become excessive. While such distortions should be avoided, and removed where identified, more comprehensive remedies to this sort of STE are not required.

The same reasons nations seek to liberalize borders and reform domestic policies apply to the reform of state trading entities. Measures that favor one type of commerce over another inevitably invite abuse, encourage waste and stifle innovation. And these costs fall most heavily on farmers and consumers. Where public subsidies are employed, whether in the form of export assistance or state trading support, the IPC believes they should be progressively eliminated. Where monopolies exist, effective competition must be put into place, and where other distortions arise from STEs, appropriate disciplines should be imposed.

It is hoped that the preceding recommendations will illustrate how WTO rules and regulations must be re-drafted in order to address the issue of institutional trading in the context of multilateral trade negotiations. The time is right for the global agricultural rules system to cover this important issue. The IPC believes if progress is made on state trading in agriculture based on the framework outlined in this paper, the 1999 WTO round will have taken a significant step forward in removing a major obstacle to the free flow of agricultural and food products.

International Policy Council Members (1999)

Lord Plumb of Coleshill
Chairman, International Policy Council
Member and Former President of European Parliament (United Kingdom)

Allen Andreas
Chief Executive Officer, Archer Daniels Midland Company (United States)

Bernard Auxenfans
Chief Operating Officer & Executive Vice-President, Agricultural Sector and President, Europe/Africa – Global Team, Monsanto Life Sciences Company (France)

Brian Chamberlin
Chairman and Managing Director, Euroa Farms, Ltd. Former Agriculture Counselor, New Zealand High Commission in London and Special Agricultural Trade Envoy (New Zealand)

Csába Csáki
Senior Agricultural Advisor, Europe and Central Division, Agricultural Industry and Finance, The World Bank. Professor, Budapest University of Economic Sciences (Hungary)

Pedro de Camargo Neto
Vice President and Former President, Sociedade Rural Brasileira (Brazil)

Aart de Zeeuw
Former Chairman, Agricultural Negotiations Committee, GATT
(The Netherlands)

Martial Genthon
Corporate Head of Agriculture, Nestlé
Former General Manager Agrosuisse LTDA Brazil (Switzerland)

Dale Hathaway
Former Undersecretary for International Affairs and Commodity Programs, USDA. Executive Director, National Center for Food and Agricultural Policy (United States)

Wilhelm Henrichsmeyer
Professor and Director, Institute for Economics and Agricultural Policy, University of Bonn (Germany)

Rob Johnson

Corporate Vice President, Public Affairs, Cargill, Inc., and member of the Council on Foreign Relations and the Agricultural Policy Advisory Committee (United States)

Tim Josling
Professor, Institute for International Studies, Stanford University (United States)

Ke Bingsheng
Vice President of China Agricultural University (China)

Dean Kleckner
President, American Farm Bureau Federation (United States)

Georges-Pierre Malpel
Director General, Unigrains (France)

Donald McGauchie
President, National Farmers' Federation (Australia)

Liberty Mhlanga
Former General Manager and Director, Agricultural and Rural Development Authority (Zimbabwe)

Rolf Moehler
Former Deputy Director General, European Commission, DG VI (Germany)

Joachim Rathke
Former Group Managing Director, N.V. Vandemoortele International, Belgium (Germany)

Alberto Santos de Hoyos
Federal Senator from Nuevo León State and Chairman of Empresas Santos (Mexico)

Hiroshi Shiraiwa
Director and Deputy General Manager, Mitsui & Co. (Japan)

Jiro Shiwaku
President, Livestock Industry Promotion Council (Japan)

I. P. Singh
President, National Institute of Agriculture (India)

Rob Tazelaar
Chairman and President, Products Boards for Livestock, Meat and Eggs. Former Member, Parliament and European Commission DG VI (The Netherlands)

Bob Thompson

Sector Strategy and Policy Specialist, Rural Development Department (United States)

Ann Veneman
Secretary of the California Department of Agriculture. Former Deputy Secretary of the US Department of Agriculture (United States)

Claude Villain
Inspector General, Ministry of Finance (France)

Anthony Wylie
Director General, Fundación Chile (Chile)

Jorge Zorreguieta
Former Secretary of Agriculture. President, Argentine Sugar Producers Council (Argentina)

The Mission of the International Policy Council on Agriculture, Food and Trade

The International Policy Council on Agriculture, Food and Trade (IPC) is dedicated to developing and advocating policies that support an efficient and open global food and agricultural system—one that promotes the production and distribution of food supplies adequate to meet the needs of the world's growing population, while supporting sound environmental standards.

◊ ◊ ◊

Founded in 1987, the IPC is an independent group of 35 leaders in food and agriculture from over 20 developed and developing countries, including formerly centrally planned countries. Members are chosen to ensure the Council's credible and impartial approach, and include influential leaders with extensive experience in farming, agribusiness, government and academia. The IPC meets twice annually to develop policy recommendations to address the critical issues facing the world's agricultural system. It then conveys its recommendations directly to policymakers through its personal contacts and through a variety of papers and studies. The IPC also convenes task forces and holds conferences and seminars.