Export Subsidies: Agricultural Policy Reform and Developing Countries

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The WTO's July 2004 Framework Agreement calls for the elimination—by a credible date certain—of all forms of export subsidy in agriculture and for disciplines on export measures that have the effect of a subsidy, including the subsidy components of export credits and state trading enterprises (STEs). Food aid is to be disciplined to avoid disruption of commercial trade flows, while export taxes and restrictions are to be subject to tighter rules. The elimination of export subsidies and their equivalents will finally put agriculture on an equal footing with manufacturing products, for which export subsidies were banned many years ago.[1]

So-called implicit export subsidies in many forms are disbursed indirectly and nontransparently through food aid programs, STEs (low-interest loans and government underwriting of losses), publicly underwritten export credits (long maturities and below-market interest rates), export promotion activities, and domestic policy levers that can, in combination, function as an export subsidy. Such nontransparent mechanisms were subject to few disciplines in the Uruguay Round Agreement on Agriculture (URAA) and so are key issues for the current negotiations, despite the complexity of calculating their subsidizing effect.

Export taxes, used in periods of high world prices to keep domestic prices low, are not constrained by the URAA. Because they increase the cost of food for net importers, some countries are pressing in the current negotiations for constraints on such taxes and for greater flexibility to protect their own food-crop sectors and so increase self-sufficiency.

This note evaluates the effectiveness of the disciplines imposed on export subsidies in the URAA and presents options for new multilateral rules. We show how countries have circumvented their commitments on explicit export subsidies and explore issues related to indirect export subsidies, as well as some omissions and improper measures associated with commitments to reduce export competition.

Explicit export subsidies in the URAA

Commitments on export competition in the URAA focused mostly on explicit, taxpayer-financed export subsidies. Twenty-five countries agreed to reduce both the volume and value of their export subsidies and to prohibit new subsidies for 23 product categories. Each country committed to reduce the volume of subsidized exports by 21 percent over six years from the level in the 1986–90 base period (14 percent over a 10-year period for developing countries), and to reduce the value of

Table 1. Summary of provisions of the WTO Framework Agreement on export competition, July 2004

Export subsidies	• Eliminate export subsidies by a credible end date. • Agree on schedule and modalities of reductions.
Export credits	• Eliminate export credits, guarantees, and insurance programs with repayment period of more than 180 days.
Food aid	• Eliminate food aid that is not in conformity with disciplines to be agreed. Disciplines will be aimed at preventing commercial displacement. • Negotiate other food aid issues (role of international organizations, humanitarian and development issues, aid in grant form).
State trading enterprises	• Eliminate trade-distorting practices of state trading enterprises. • Negotiate use of monopoly powers.
Special and differential treatment for developing countries	• Allow longer implementation periods for reductions and elimination. • Permit developing countries to continue to benefit from Article 9.4 exceptions. • Make appropriate provisions for export credits in line with Decision on Least Developed and Net Food-Importing Countries. • Accord developing countries special consideration in negotiation of disciplines on STEs. • Allow, in exceptional circumstances, ad hoc temporary financing arrangements relating to exports to developing countries.
Export restrictions	• Strengthen disciplines on export prohibitions and restrictions.

Source: Josling (2005).

export subsidies by 36 percent (24 percent for developing countries). Temporary exemptions for developing countries allow subsidies for marketing, handling, cost reduction, and international transport, while the least developed countries are not subject to reduction commitments at all.

Following adoption of the URAA, the European Union (EU) accounted for more than 90 percent of explicit export subsidies worldwide, which averaged about $5 billion per annum, well below the aggregate limit of approximately $10 billion. Apart from some isolated instances of limit breaches and the addition of export subsidies for some developing countries, the commitments were met. But this was primarily because the base period from which reductions were made was one of low world prices and high levels of export subsidy, making the targets easy to achieve. Abnormally high world prices in 1997–98, exchange rate developments, and domestic policy reforms all contributed to the ease with which countries fulfilled their commitments. Finally, loopholes in the URAA (described below) were amply exploited.

Circumventing explicit export subsidy commitments

The experience of the Uruguay Round has important implications for the current negotiations. Several loopholes in the URAA made commitments to reduce direct export subsidies less effective than they appear to have been.

- Countries were allowed to designate a different base period (1991–92) other than the initial 1986–90 average. In anticipation of this option, some countries actually increased subsidies in the 1991–92 period, a practice known as front-loading.
- Subsidy commitments could be banked across years if unused, a practice known as rollover, or shielded under commodity-group aggregates. Rollover allowed countries to increase subsidies when world prices were low, further depressing the world price to the detriment of producers in developing countries. Because reduction commitments were tied to commodity groups, countries could avoid reductions on selected products while meeting their aggregate commitment by reducing subsidies on other lines in the same group.
- As opposed to the discipline on tariffs, where per unit or *ad valorem* duties are bound, only the total amount spent on export subsidies (or the volume exported) is regulated. This implies less control over the trade distortions caused by export subsidies, because the same value of export subsidy allocated to a commodity can have different effects on the quantities exported, and therefore on world price. The data on export subsidy equivalents confirm that these differences are significant across countries, commodities, and over time (Ruiz 2000).
- Failure to restrict per unit subsidies also allows seasonal subsidies, whereby exports receive high subsidies for part of the year without causing the total of the period to exceed the constraint. During the season of high subsidy, the impact on world price can be substantial.

The objective of eliminating all forms of export subsidies must necessarily close opportunities for avoidance of and delay in implementing trade liberalization.

Issues related to implicit export subsidies

Indirect export subsidies not only are more difficult to measure than direct subsidies, but also involve programs that under some circumstances are beneficial or crucial, such as food aid. Hence, any rules to discipline their use must be carefully designed and will involve more disciplines on reporting and monitoring than will those on more explicit forms of subsidy.

Food aid

Although food aid can have market effects similar to those of export subsidies, it was not included in the URAA schedule of reductions. Crucial in cases of national disaster, food aid has been used by developed countries to dispose of surpluses,

provide budget support for the recipient government, and underpin foreign policy. Such uses have created serious problems. When given in kind, food aid may be detrimental to local producers by lowering prices and altering traditional dietary preferences. When distributed outside normal commercial distribution channels—as it usually is—in-kind food aid also disrupts the development of those channels and interrupts the movement of food to the deficit areas from surplus regions in the country and from neighboring countries. Disruption increases the likelihood and severity of future famine. Hence, food aid should be purchased from other developing countries and from food surplus areas of the country assisted, as a first priority. Also, food aid should never be used by industrial countries as a way of disposing of surpluses.

To avoid these risks, food aid in full grant form such as cash or vouchers should be directed to meet the needs of well-defined vulnerable groups or in response to an emergency as determined by the United Nations. This will also support local producers and traders. For these reasons, cash aid is often preferable to in-kind distribution. The exceptions are crisis situations where transportation is severely disrupted or markets are not functioning, or when there are good reasons to believe that in-kind food distribution can be better targeted to those with the greatest need.

Export credits

Officially supported export credit programs average about $6.5 billion per annum, with the United States providing around 50 percent of the world total. The programs involve credit guarantees, public assumption of risk, and subsidization of interest and insurance. It is very difficult to measure the value of the export subsidy associated with these programs because the value of the risk reduction they provide is difficult to estimate. At the same time, export credit programs enhance food security for countries suffering from financial or food crisis, thereby expanding exports to everyone's benefit. However, only about 20 percent of agricultural export credit is extended to poor developing countries. Although the subsidy component of these credit programs is found to be small, disciplines are required for all such public expenditures (with exemptions for poor country importers in emergency situations).

State trading enterprises

STEs and domestic policies that allow for market segmentation and protection of domestic markets can subsidize exports through price discrimination, that is, by using revenues from high domestic prices to subsidize fixed costs for the rest of production, which is then exported (box 1). STEs and domestic marketing arrange-

Box 1. Price discrimination and pooling can combine to create an export subsidy

Export subsidies based on price pooling and price discrimination are quite complex and can occur in different settings. Extra revenues derived from price discrimination are "pooled" and then "averaged" to farmers, thereby acting as a production subsidy, while higher prices to consumers act like a consumption tax. No tax revenues are involved, but the outcome is identical to that of a standard taxpayer-financed export subsidy: supply is increased and demand is reduced at the same time. Such practices are often referred to as "consumer-financed" export subsidies.

Price discrimination with pooling can be carried out by an STE or through legislation fixing domestic prices. Nontraded domestic products (fluid milk, for example) can be used to support implicit export subsidies. Although the milk itself is not traded internationally, its high domestic price can be used to cross-subsidize exports of related products such as cheese or milk powder. If an STE practices price discrimination only in world market segments, without taxing domestic consumers, but pools the revenues, the resulting subsidy is not disciplined in the URAA.

The Dispute Settlement Body of the WTO ruled in 2003 and 2004 for the Canadian dairy and EU sugar sectors, respectively, that price discrimination alone with production quotas have the effect of cross-subsidizing exports and so violate commitments made under the URAA to reduce export subsidies. The WTO panel agreed with Brazil's argument that higher domestic prices for quota production have allowed farmers to expand output and sell the extra output at lower world prices below total average costs of production. The practice constitutes a subsidy because losses in one market (the export market) are offset by profits in another (the domestic quota market).

Why should farmers accept a loss on exports? Because the unit-cost savings they realize from higher output are greater than the marginal losses they incur. Exploiting economies of scale under these circumstances constitutes cross-subsidization, according to the WTO panel. Output is also distorted because some farmers limit their production to the quota amount and would have exited the industry were it not for high domestic prices on the quota. This is output distortion due to "exit deterrence" as opposed to distortions that are due to cross-subsidization (where some farmers produce beyond the quota amount at lower world prices but are able to do so because of higher domestic prices).

Box 1 ***(continued)***

These rulings have implications for all production subsidies on limited output (known as "infra-marginal" subsidies), whether financed by taxpayers or consumers. Subsidies on a limited amount of output have been increasing since the URAA was adopted. It is therefore possible that other commodity sectors and countries are in contravention of their export subsidy reduction commitments.

Source: Kropp and de Gorter (2005).

ments can also be used to pool revenues to farmers, a practice that constitutes an export subsidy if domestic consumer prices are higher than world prices. Domestic production expands with pooling, and consumption declines, as in the case of a taxpayer-financed export subsidy. Pooling can occur over time and across markets and commodities.

Some export STEs may counter the power of multinational trading firms and hence may improve competitive conditions in the market. But disciplines are needed to ensure that STEs are more transparent and subject to the same general rules as private firms. In particular, disciplines should be placed on price pooling and on taxpayer support to STEs (for credit guarantees or promotion, for example), with targets for their eventual phasing out. More stringent requirements for reporting acquisition costs and prices are required to ensure that any price discrimination by the STE is within normal business practices and that no product is sold on world markets consistently below domestic prices. There should be no discrimination against private firms' participation in the market; nondiscrimination discourages STEs from using discriminatory practices. Special financing privileges should be also disciplined, with exemptions for poor countries dealing with inadequate institutional infrastructure.

Objectives for negotiators

Some lessons can be drawn regarding the general principles of an effective agreement on export subsidies, and some specific holes can be identified that need to be eliminated.

General principles

- Because countries have committed to eliminate all forms of export subsidy, a firm deadline for phasing them out should be agreed upon. Five years may be reasonable.
- Countries are encouraged to make a gesture of good faith when signing the

agreement by offering a down payment in the form of an across the board cut in export subsidies immediately.

- *Ad valorem* (percentage) limits on the per unit subsidy (as a percentage of the world price) should be introduced on a commodity-by-commodity basis, combined with a ceiling on the total value of exports that may be subsidized. The *ad valorem* limit will place a constraint on the difference between domestic and world prices, while the value limit will constrain the impact of export subsidies on world markets.
- Monitoring of export subsidies should be strengthened by coordinating data collection among organizations (including the OECD and the WTO). One possibility is to consider mandating the WTO Trade Policy Review Mechanism to provide an annual evaluation of the effects of export subsidies, focusing in particular on developing countries.
- The banking of export subsidies, whereby they are rolled over to subsequent years, should be banned.
- All commitments should be made on a per product basis, accompanied by a uniform system of classifying products.
- Delaying or avoiding reductions through practices like front-loading should be anticipated and prevented.
- Special and differential treatment for developing countries should not go beyond Article 9.4 of the URAA, which specifies exclusions for subsidies on marketing, handling and transportation only.

Plugging holes in the URAA

- The URAA lacks rules that directly govern export credits, payment guarantees, and direct financing. As these policies have the effect of subsidizing exports, such rules are needed as part of the disciplines on export subsidies. The methodology developed by the OECD (2001) should be adopted to include the export-subsidy component of such measures; that component would be counted against reduction commitments.
- Specific disciplines on export credits should be established, such as a maximum repayment term, a minimum cash payment by the importer, and premiums based on risk.
- All expenditures involving direct, in-kind disposal of public food stocks in export markets should be subjected to the same rules as normal export subsidies.
- URAA provisions on food aid should be tightened to facilitate genuine food aid while preventing the abuse of aid to circumvent export subsidy restrictions. Proposals include limiting food aid to the form of grants only, and to provision in-kind only in response to appeals from the United Nations or other appropriate international bodies. Donations in cash or channeled through international

agencies should be preferred (WTO 2002).

- Stronger disciplines on STEs are needed. At a minimum, STEs should be subjected to the same export-subsidy rules as private sector enterprises. Notification and transparency requirements must be tightened to prevent disguised export subsidies. Government financing and underwriting of losses should be eliminated, as well as any associated direct export subsidies. One option would be to strengthen and extend the disciplines of GATT Article XVII and Article II on state-trading exports to include limits on *ad valorem* subsidies. Another option is to mandate coexistence with private companies to eliminate the monopoly element of the market.
- Rules are needed to constrain consumer-financed export subsidies, especially revenue-pooling arrangements or cross-subsidization through price discrimination.
- Export taxes should be constrained and eventually phased out. For any developing countries that still depend on these taxes as an important source of government revenue, the phaseout period could be prolonged.

Notes

1. This note was prepared by Harry de Gorter who is an Assistant Professor of Agricultural Economics at Cornell University in Ithaca, New York.

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