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Between Protectionism, Poverty Orientation, and Market Efficiency: Reform of the EU Sugar Market Organization

The reform of the European sugar market organization (SMO), which has until now been excepted from the general restructuring of the EU Common Agricultural Policy, must be seen as an important building block in the project of liberalizing the international agricultural markets. The reform will have substantial impacts on developing countries. However, it is not as radical as it is often made out to be: Its principle aim is to cut subsidized exports by lowering administrative prices. Some other important elements of the existing market regime will continue in place, including production quotas and heavily restricted market access.

Without tariff protection, no more than a small proportion of the EU's sugar production would be likely to survive for long, and most of the EU's demand for sugar would be covered by a number of larger, competitive developing countries. For this reason alone, pressure to reform the EU sugar sector is likely to continue over the long term. Alternative reform proposals that would have left prices at their present, high levels and used quotas to manage production and imports must for this reason be viewed with a critical eye. While these proposals hold promise of short-term gains for certain developing countries, they would at the same time set major incentives for these countries to develop inefficient production structures that would not prove economically sustainable in the long run. The consequence would be later crises entailing high economic and social costs.

Under the current reform not all developing countries will turn out to be winners. The decline in prices it entails will substantially curtail the exports and export chances of some developing countries that presently enjoy preferential access to the EU market. These include some especially poor countries that have virtually no other production and export alternatives. It is essential to provide compensation for these losers of the reform – for one thing to cushion negative impacts, but for another to avoid the impression that agricultural liberalization is a factor that contributes to exacerbating poverty. The EU should mobilize the funds needed to compensate these countries.

The sugar market's importance for developing countries

The reform of the EU sugar market organization is at once highly important for developing countries and of major symbolic value for the ongoing general liberalization of the agricultural policies of industrialized countries, a highly contentious issue.

For several centuries the sugar trade was a central element of South-North trade, and it is accordingly bound up with a number of deeply rooted economic, social, political, and cultural structures. Even today the volume of the international sugar trade amounts to some US $ 9–11 billion, a figure which accounts roughly for a 2–3 % share of world agricultural markets. Sugar, accounting as it does for a share of up to 38 % of their overall exports (Cuba), is an extremely relevant good for many developing countries.

Worldwide, the sugar market is one of the agricultural sectors most heavily affected by political interventions. In 2003, averaged across the OECD countries, producer supports accounted for 49 % of the value of gross sugar output. Most developing countries also intervene in their sugar markets; for the most part, pointing to distorted world market prices, they argue that such measures are needed to protect their producers from imports. At the same time, sugar is, in terms of value, the most important instance of EU trade preferences granted to developing countries. And the final outcome is a complex system of interdependent markets and interventions.

The European sugar market organization and its reform

With its output volume of some 20 million t (EU-25), the European Union is the world's most important sugar producer; and with its worldwide shares of 5 % of imports and 15 % of exports, it is also a significant actor in the world market. Production, processing, and marketing are in large part codified in the sugar market organization (see Box 1).

Those who profit from this complex market regime include some 330,000 EU sugar producers, most of them above-average earners, the EU sugar industry, and a select circle of producers in developing countries that have access to the EU market (see Box 2). The EU's

Box 1: Essential features of the European sugar market organization

- An intervention price is used to determine the minimum price that triggers official sugar purchases. This intervention price in turn is used as a basis to set prices at various processing stages.
- Specific tariffs of, at present, over 400 €/t of white sugar (roughly € 320 for raw sugar), a figure amounting to 130–260 % of the world market price (which has in recent years ranged between 160–300 US $/t), and the permanent use of special agricultural safeguard measures have until now served to shield the market against imports.
- To contain overproduction, quantitative target output quotas are set and allocated to the member countries. A distinction is made between regular A-quota sugar and B-quota sugar, which is roughly 40 % cheaper.
- Surpluses (so-called C-sugar) are sold on the world market, i.e. exported in the form of sugar and sugar products manufactured by the sugar-processing industry; part of these transactions profit explicitly from official export subsidies (in particular the reexport of preferential imports; see Box 3), another share benefits implicitly from high administrative prices, with mandatory charges levied on the sugar industry used to finance exports.

direct expenditures for the SMO amount to an annual € 1–2 billion, roughly one third of which is raised through charges levied on the sugar industry. The reexport of preferential sugar from developing countries accounts for an average of 75 % of these expenditures. The lion's share of the economic costs involved – estimates speak of a figure of up to € 8 billion per annum – is borne by consumers in the EU.

This arrangement was due to expire in mid-2006. The pressure to reform the SMO had grown in recent years, both for internal reasons and for reasons rooted in trade policy (see Box 3). Following years of preparatory work, the EU Commission finally tabled its reform proposals in June, 2005, and it was agreed upon by EU agricultural ministers on November 24.

Box 2: The most important EU sugar preferences for developing countries

- Under the sugar protocol, a present total of 20 African, Caribbean, and Pacific (ACP) countries enjoy irrevocable duty-free import quotas amounting to a total of roughly 1.3 million t of white-sugar equivalents per year. Mauritius alone accounts for 38 % of this quota, and Fiji, Guyana, Jamaica, and Swaziland together account for another 43 %. For India there is a similar arrangement in place for 10,000 t.
- The Special Preferential Sugar (SPS) arrangement is a nonbinding EU commitment that allows further duty-free exports of raw sugar to cover the specific needs of certain sugar refineries. In recent years this has meant a volume of some 150,000-300,000 t/year. The beneficiaries of this agreement too are mainly the ACP countries and India.
- Under the Everything-But Arms (EBA) initiative, the EU grants to the 50 least developed countries (LDCs) duty- and quota-free access to the EU market for nearly all of their goods. The total value of these EBA preferences is dominated by sugar exports, although there is a transition arrangement in place involving import quotas: in 2001/02 EBA countries were allowed to import 74,000 t duty-free, with the quota then rising by 15 % per year. Beginning in 2006, nonquota tariffs are set to be reduced to zero in three stages. From 2009 on, there will be no more barriers to market access. At present ten LDCs export sugar to the EU. But only six of them are net sugar exporters. Other LDCs export their own sugar to the EU at high prices and then cover their own demand with cheap sugar bought in the world market (so-called swap transactions).

The core elements of the reform, which have been slightly softened compared to the initial proposal, are to abolish the differentiated quota system and to reduce the price of sugar by 36 % (from € 632 to € 404/t of white sugar) over four years. This means that the reference price will continue to be considerably higher than the world market price, which was below € 200/t during the past decade, although it has in recent months experienced exponential growth. The intervention price will be replaced by a reference price, and this in turn will mean abolishing official intervention buying, a practice that in any case was rare. As a replacement, supports will be provided for private storage for the case that the sugar should fall short of the reference price. Tariff reductions are not (yet) decided upon, they will mainly depend on ongoing WTO negotiations. Direct farm premiums will be used to compensate EU sugar producers for 64 % of their losses.

As a consequence of the reform, the EU Commission anticipates (for a slightly higher price decrease of 39 %) a decline in European sugar output from the current level of 19.7 t to 12.2 million t and a drop in exports from today's 5.4 t to 0.5 t by the year 2012.

Impacts of the SMO reform on developing countries

On the whole, developing countries are certain to profit from the reform. But for individual countries the impacts will differ substantially, depending on their sugar trade balance, their EU preference status, their own trade policies, and their production structures and costs. One important parameter for the distributional effects of the reform is the change in world market prices that emerge when the EU discontinues its subsidized exports – various studies anticipate price increases between 5 and 20 %. We can clearly distinguish four country groups here:

1. The large net sugar-exporting developing countries, including in particular Brazil, will be the clear-cut winners of the reform. While they will not be granted improved access to the EU market, the mere absence in the future of some 5 million t of subsidized EU sugar in the world market will open up new markets for them. These additional exports – as well as present exports of some 20 million t – will profit from higher world market prices. Some of these benefits will be cancelled out by rising consumer prices for sugar.
2. Rising world market prices will lead to higher import expenditures for net importers. This group includes the majority of developing countries, which import a total of some 17 million t of sugar. But it must be noted that these losses will be far lower than the additional revenues achieved by the net exporters, and most probably some net importers will experience production increases.

Box 3: Reasons for the reform of the European sugar market organization

- Since general reforms of the EU's Common Agricultural Policy have, since 1992, had a thrust toward lower prices and a decoupling of subsidies from production, the SMO is no longer in line with the EU's general market organization.
- According to the final ruling handed down by the World Trade Organization (WTO) in April 2005, a large proportion of the EU's sugar exports are in violation of obligations assumed under existing WTO agreements. This situation must now be corrected within 15 months. The WTO has explicitly called on the EU to respect its international obligations, including its import obligations vis-à-vis developing countries.
- A general improvement of market access in connection with the ongoing WTO Doha Round is likely to require the EU to reduce its agricultural tariffs, including those on sugar. If this should cause prices to decline below internal prices, the SMO would in any case have to be adjusted.
- The most important reason is without doubt the EBA initiative. The EU is forced to compensate for these imports by reducing imports and/or production. Thus far this has mainly affected SPS imports, but any massive expansion of such imports would force the EU to cut European production quotas. In view of the high rents that accrue in the sugar sector, it would be politically more than difficult to push through any meaningful selective production cuts in weak regions, and uniform reductions would only serve to further undercut the international competitiveness of EU sugar.

3. Given data on production costs, it is relatively easy to calculate the export losses that the ACP countries will face due to the cancellation of their import quotas. These losses are estimated at US $ 400–500 million per year.
4. The export losses faced by the EBA countries are more difficult to estimate, the reason being that they will mainly affect potential export chances. In 2002/2003 the value of the EBA import quotas actually realized was just above € 40 million. For 2012, and without the reform, the EU Commission anticipates EBA imports amounting to an annual 3.5 million t; with reform, the estimated figure is 2.2 million t, with a depreciation of roughly € 1.1 billion. The higher world market price for sugar will be able to compensate only in part for these downsides; in fact, it will even prove to be an additional burden for the net importers among them.

These export losses do not necessarily reflect the actual losses faced by the countries affected; often enough, sizable rents are pocketed by importers in industrialized countries. Another aspect that plays a role in assessing the reform in terms of its development-related impacts is the way in which the revenues are broken down in developing countries into profits, wages, other factor earnings, and rents. While these distributional effects are by no means fully known, the polemics concerning them, in particular the diatribes on the low social standards in place in the Brazilian sugar sector, could hardly be more vociferous.

It is as good as undisputed that higher prices for importing countries and consumers do not constitute a serious argument in favour of retaining the present EU subsidies, since subsidies are in fact unreliable, unfair, and unsustainable. The actual development-related controversy surrounding the EU reform is concerned with the situation of the developing countries with preferential access to the EU market (see Box 3). When EU prices decrease, the value of preferential exports will decline with them (preference erosion).

Recommendations for a reform effective in terms of development

The abolition of export subsidies must generally be seen as a positive development. On top of improved export chances, higher prices in the world market will contribute to eliminating market distortions in many countries and in the end foster the development of more efficient agricultural sectors, bringing benefits for most producers and many consumers.

Viewed from the perspective of the developing world, the two most contentious – and at the same time closely interlinked – issues concerning the reform are a) whether the projected reduction in exports could be better effected through price cuts or by lower quotas (as the preference losers had proposed) and b) whether the losers of the reform should be compensated and what form such compensation should be given. The potentially explosive nature of these issues is clearly indicated by an alternative proposal advanced in April 2005 by the sugar-producing LDCs, and by threats that during the Hongkong WTO ministerial meeting in November 2005 the sugar case could reduce support for EU positions. The LDC proposal had found the support of many nongovernmental organizations, which have otherwise come out strongly in favour of a dismantling of the protectionist tariffs in place in the industrialized countries. The proposal envisioned a reduction of internal EU prices amounting to no more than 20 %. As a means of limiting EBA imports, these countries had proposed a quota system and a more gradual reduction of tariffs on nonquota sugar. Despite this offer of voluntary restraint, the LDCs anticipated exports far higher than under the EU proposal.

Even though the agreed price cuts will, compared with the alternative proposal on reduced quotas, initially entail adverse impacts on the poorest countries, for a number of reasons it is the more recommendable way.

- The pressure to reduce EU tariff protection, and with it EU sugar prices, will persist. The reasons for this must be sought on the one hand in the export interests of the large developing countries, with their more marked bargaining power, in a potential export market for over 10 million t of sugar and on the other in the interests of the EU sugar-processing industry, whose international export competitiveness is, without export subsidies, endangered by overly high prices for a key raw material. In view of this long-run perspective of falling EU sugar protection and prices, it is important not to set any incentives for preference countries to develop structures that would prove economically unsustainable in the long run. This would entail the risk of later crises, with their inevitably high economic and social costs.

- In cases of very great disparities between domestic and world market prices, import quotas tend to give rise to very high rents. These in turn encourage the development of political and administrative structures that are quite prone to clientelism and corruption. It is precisely the weaker market participants that often see themselves at a disadvantage in settings of this kind. This risk is an especially real one in the sugar sectors of the developing countries, dominated as they tend to be by a small number of powerful actors. The agreed price adjustments constitute a powerful inducement to reform inefficient sugar industries, laying the groundwork for a dynamization of the sugar sector, or at least for viable alternatives.
- The high rents made possible by a high EU sugar price would constitute an incentive for developing countries to set their sights on maintaining this specific, albeit important, market distortion, in this way obstructing the overall process of agricultural-policy reform in the industrialized countries.

The development-related motive behind the call for compensation for preference erosion is to reduce revenue losses and ease adjustment problems. The LDCs in particular are unable to finance these adjustments on their own. Furthermore, compensation would serve to reduce fears, resistance, and retaliatory actions related to the reform.

The types of compensation conceivable would include alternative preferences, e.g. in the service sector, and above all financial assistance. It would be essential to determine through careful analysis what funds might best be provided for what sectors and population groups, the aim being both to reach out directly to losers of the reform and to build future competitiveness in the sugar or other sectors.

In allocating compensation payments, it would be important to distinguish between the ACP countries and the EBA countries. For the established sugar-supplying ACP countries, the EU will provide an initial € 40 million in aids for the year 2006. Additional funds, of unspecified volume, are promised for the period from 2007–2013.Thus far, however, no compensation is envisioned for the EBA countries, even though they will be the actual losers of the reform – and they are considerably poorer than the ACP countries. These countries too should therefore be provided compensation.

The level of compensation payments and the mechanism used to calculate them should be laid down in binding form. In view of the fact that the lion's share of SMO subsidies are designed to support the reexport of sugar, i.e. are at least in principle conceived as a means of support for developing countries, abolishing these subsidies should make sufficient funds available.

Prospects for further steps toward agricultural liberalization

The present reform of the SMO may be seen an important building block for liberalization of the international agricultural markets, e.g. in connection with the ongoing WTO agricultural negotiations. The reform will provide the EU some leeway for the talks. And in view of the fact that it is targeted to one of the world's most distorted subsectors, it furthermore sets important signals for the liberalization of other markets.

Moreover, adequate compensation for the losers of the reform would contribute to defusing the general problem of preference erosion. Improved market access in sectors in which they have comparative advantages is often an unattractive proposition for LDCs. Financial compensation would be one option that would give such countries a share of the gains stemming from liberalization and help win their support for reforms. While sugar is the most important case of compensation for preference erosion, the approach could very well prove reasonable for other products as well or as a means of cushioning the impacts of higher food prices for net food-importing countries. While measures of this kind were promised the developing countries at the conclusion of the last WTO trade round, many questions still remain to be answered as regards the conditions and the binding nature of the commitments made.

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