

## **Proposed Reform of the EU Sugar Regime: More Market, Consumer and Trade Friendly?**

*by Chris Milner and Wyn Morgan<sup>1</sup>*

### **1. Introduction**

On 14th July of this year the European Commission tabled proposals for the major reform and liberalisation of the EU Sugar Regime, starting in 2005, and for completion in 2008. A substantial reduction in sugar exports and support for exports, reduction of domestic price support and production are proposed. Franz Fischler, EU Agriculture Commissioner says:

“This reform gives the EU sugar sector and developing countries a realistic prospective. Our customers will see more market orientation, developing countries much less trade distortion”

Certainly the current EU Sugar Regime has been fiercely criticised for not being market, consumer, and developing country trade friendly. In this brief we explore how friendly the reforms are, in particular to the developing country countries. In so doing, we give particular attention to the implications for the Sugar Protocol exporters within the ACP sugar producing countries, and the least developed countries with preferential access to the EU under the “Everything But Arms” Agreement.

### **2. Nature and consequences of the Current EU Sugar Regime**

There has been a common market organisation (CMO) for sugar in the EU since 1968 during which time the main aim has been to ensure that EU producers of sugar should be given protection from world market forces in order to ensure they receive a reasonable income from production. As part of this, is the preferential trade arrangements drawn up under the Lomé Agreement that provide access to EU markets for sugar producers in signatory ACP countries (and India for which a special bilateral preferential arrangement exists) at the protected EU intervention price. In essence, the EU’s Sugar Regime protects domestic producers at the expense of domestic consumers and non- Lomé producing countries.

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A number of instruments are used to make the policy operational. First, production quotas are established by the Council of Ministers and allocated to member states, which limits the amount of refined sugar that can be produced and in effect also limits the output of sugar beet. Second, an intervention price is set that is maintained in surplus years by the purchasing of surplus production to take sugar off the EU market. Finally, there are specific trade arrangements to support EU prices. Specific volumes of sugar can be exported with the aid of export refunds. The effect of this subsidised exporting is to depress prices on world markets. Imports into the EU are subject to a variable levy unless they are part of the provision of the Lomé Agreement. Under Lomé, signatory ACP countries are given export quotas to the EU for their sugar and for which they receive the EU's intervention price.

There are clear consequences arising from the workings of the Sugar Regime. Sugar production levels are higher than those that might obtain under a free market regime and the geographical spread of sugar production is different both inside and outside the EU. Specifically, production in the EU is not concentrated in lower cost producing countries and instead occurs in a number of countries that would not be able to compete in a free market environment. Outside the EU, the Protocol arrangements could be viewed as ossifying the structure of sugar production and exporting in many ACP countries, as well as limiting production and potential exports from low cost producing countries not in the Protocol. In short, the EU's Sugar Regime has a significant distortionary effect on world production of sugar.

Clearly there are gainers and losers within and outside the EU. Consumers in the EU have to pay higher prices for their sugar as a result of the constraint on competition from imports from low cost producing countries such as Brazil and Australia. Producers within the EU by contrast gain from higher prices and protected markets. For countries outside the EU, the net effects differ. The non-Lomé sugar producers clearly lose. Their access to the EU market is restricted and the price they receive for their exports are depressed by the EU's subsidised exports. Unsurprisingly, it is these features that have given rise to the fiercest challenges to the EU's Sugar Regime at the WTO. By contrast, the Lomé Sugar Protocol producing countries are interested in retaining the benefits of the Agreement, although, as we argue below, it is the larger producers within the group who export mainly to the EU, such as Mauritius, Fiji and Guyana that have the strongest interest in the maintenance of the current policy (see Milner and Morgan, 2003).

Under the reform of trade in agricultural products encompassed by the Uruguay Round of the GATT in 1986, much attention was paid to policies that distorted market prices and trade flows. The EU Sugar Regime came within that remit. Under the agreed outcome, the EU had to fix and then reduce the levy on imports by 2000/1. In effect this meant that the import tariff on white sugar was introduced at 507 ECU/tonne in 1995/6 and had to be reduced gradually to 419 ECU/tonne by 2000/1. In addition, the EU had to alter its policy of export subsidisation by limiting both the value and the volume of such exports by 2000/1.

While the EU believes it has achieved these targets, Australia and Brazil have challenged the policy at the WTO by suggesting that the continued support of EU production via quotas is tantamount to subsidising any exports that arise, whether they actually have a formal subsidy paid or not. Pressure in support of this position has grown. Further budgetary concerns and the expansion of the EU to include countries such as Poland that produce substantial volumes of sugar, have encouraged the European Commission to propose radical reform of the regime.

### **3. The Proposed Reforms**

The major thrust of the reforms is to reduce greatly the degree of intervention and support on the EU sugar market. The main reforms are as follows:

- support prices falling by a third over three years from 632 Euros/tonne to 421 Euros/tonne;
- production quotas to become transferable between member states;
- quotas being cut by 2.8 million tonnes or 16% over four years from 17.4 million tonnes to 14.6 million tonnes;

- public intervention being replaced by a private storage scheme;
- sugar producers in the EU receiving a de-coupled payment of 60% of their losses;
- a 2 million tonne reduction in subsidised exports from 2.4 million tonnes to 0.4 million tonnes; and,
- guaranteeing export volumes for sugar Protocol countries under the Lomé Agreement but at a lower intervention price

It is intended that the reform process would begin in July 2005 and would be subject to further review in 2008.

#### **4. Implications for EU and world Prices and Trade for Sugar**

The EU's Sugar Regime has a distorting effect on EU and world prices and in turn affects international trade flows (see Milner and Morgan, 2003). However, it is not the only trading bloc or country to engage in such protection, with other OECD countries also protecting domestic markets and producers in similar ways. A critical question then arises: to what extent will the EU reform (liberalisation) of its policies affect EU and world prices for sugar? This can be answered either in a context of wider OECD liberalisation of all sugar policies or more narrowly by the EU only.

Milner and Morgan (2003) argue that liberalisation of all OECD sugar policies could lead to EU prices falling by as much as 52% from their current level, while world prices would rise by around 38%, both substantial changes. However, the current debate is couched within consideration of EU reform only with current proposals suggesting that EU intervention prices will fall by 33.4% and that subsidised exports will be eliminated. In simple pro-rata terms, this suggests that the current EU proposals may, if implemented in full, raise world prices by about 25-30%. These would constitute significant changes from the present levels.

Equally, when trade flows are considered the effects of reform could also be expected to be large. It would be expected that as the volume of production in the EU is cut via quota reductions and there is also removal of the export subsidy then EU exports onto world markets would decline. Additionally, as EU tariffs fall in line with the support price, there would appear to be greater market opportunities for exporting countries. However, the response of exporting countries will depend on whether they are signatories to the Lomé Agreement or not, and on whether they are least developed countries and benefit from the preferential access to the EU under the "Everything But Arms" (EBA) arrangements. (We consider these issues in more detail in the next section).

#### ***Implications for EU Producers and Consumers***

EU producers would see the 'ring fence' of support prices and import levies reduced thus exposing them to greater competition from lower cost producers such as Australia and Brazil. They would also see their domestic production levels reduced as quotas are restricted and production moved closer to the market-determined level. Clearly, income from sugar production would fall significantly in the EU though this will be partially covered by the compensatory de-coupled payments. The transfer of quota between members states implies that those countries with lower costs of production could acquire quota from high cost countries and thus EU output is likely to be concentrated in fewer, larger and more efficient farms. Ultimately, such a structure should help engender a more competitive sugar sector within the EU.

Consumers in the EU will gain from lower EU raw sugar prices providing that there is transmission of these lower prices into final sugar products and lower refined sugar prices. As taxpayers, they will see a reduction in expenditure on sugar support and hence some, albeit a relatively modest reduction in CAP expenditure as a whole.

#### **5. Implications for the Sugar Protocol and other Developing Countries**

The EU has stated that it is willing to continue to guarantee the volume of sugar imports outlined in the Lomé Agreement at 1.3 million tonnes. However, it will only buy these exports at the new (lower)

intervention price. These countries therefore could maintain export volumes at the agreed level to the EU but receive a lower price.

If the production costs are high and they are unable to absorb the reduced price, some production at least may be driven out. Indeed, it is suggested by some commentators that some protocol exporters would cease exporting sugar if the EU guaranteed price were to fall significantly. With the under-filling of some quotas, there may be some scope for redistributing quota from higher to lower cost producers. The more efficient protocol exporters would also have an increased incentive to supply beyond quota production to the world markets as world prices rise following EU liberalisation.

Milner and Morgan (2003) estimated that the total income transfer to the Sugar Protocol ACP Countries, associated with the total protocol quota and the excess of the guaranteed EU price over the world price, was about (US) \$500 million (at 2001 prices) or about 60% of the total value of these countries' sugar exports to the EU. Mauritius receives the largest share (c. 36%) and Mauritius plus Fiji, Guyana, Jamaica and Swaziland receive about 80% of the total transfer. This concentration means that the proposed EU sugar reforms are likely to have rather different implications across the protocol countries. Indeed the protocol quotas and the importance of sugar in total exports and of the EU markets for their sugar exports varies significantly across the protocol countries. In 2001 the income transfer element of the Sugar Protocol constituted more than 15% of Mauritius and Guyana's total exports and over 5% of Barbados, Belize, Fiji and Swaziland's exports. By contrast it contributed less than 1% of the value of total exports in the case of the Republic of Congo, Cote d'Ivoire, Kenya, Madagascar, Tanzania, Trinidad & Tobago and Zambia. Similarly, the impact of the protocol arrangements for production, incomes and employment vary markedly across the countries involved. The most vulnerable countries in terms of potential direct production and job losses are Guyana, Mauritius, Swaziland, Fiji and Belize. These countries would be the clear major losers from the proposed EU Sugar Reform.

There are other protocol countries for which the picture is less clear. Of course all the protocol exporters would lose on their protocol quota exports to the EU, with the EU guaranteed price falling. But there are some African protocol countries (e.g. Republic of Congo, Cote d'Ivoire and Zambia) with sufficient sugar exports to non-EU markets for which the EU reform-induced rise in the world price of sugar may well more than offset the effect of the decline in the EU guaranteed price. These protocol countries are in fact potential gainers from EU sugar reform, at least relative to their present position. These countries may well have benefited, however, in future as least developed countries, from unrestricted duty-free access to the EU market under the "Everything But Arms" (EBA) Agreement. In which case high EU prices would have provided opportunities to gain from quota and non-quota sugar exports to the EU market. EU sugar reform may well therefore make them better off than they had been, but worse off than they might have been!

The implications for developing countries other than the Sugar Protocol countries (and India) are mixed, depending upon whether they are (net) sugar exporters or importers and whether they have specific trade relations with the EU. Ignoring the latter complication for a moment, then it is clear that the exporting countries (such as Brazil and the Dominican Republic) should tend to gain from the reforms that tend to push up world prices, reduce competition in third markets from subsidised EU sugar, and may in the longer term improve access to the EU market (and other OECD markets if further liberalisation is induced). By contrast the much larger group of net importing countries would tend to lose as a result of rising sugar and sugar product prices. Though in this case it should be recognised that in the longer term the liberalisation of world sugar markets may allow for changes in the international pattern of comparative advantage and specialisation, and for the shift from net importing to net exporting status for some developing countries. Further, note that although the EU sugar liberalisation would tend in the absence of other changes in market conditions to drive world prices up, the actual changes in world market prices may be affected by other market developments. If production and export capacity of developing countries increases significantly, it may mean that in the longer term world prices are actually driven down.

For some of the sugar exporting developing countries (outside the Sugar Protocol), the implications of EU Sugar Reform depends not totally on what happens to world prices but also on what happens to the EU price and their terms of access to the EU market. As mentioned above, EBA provides for unrestricted access to the EU after 2009 for the least developed countries at zero tariff. The lowering of the EU domestic sugar prices will tend to lower the preferential terms of access and benefits to the EBA countries of their agreement. There are still potential benefits for the EBA countries, but smaller than they would have been. In the case of another group of developing countries, namely the Western Balkan countries, the European Commission is specifically proposing to maintain the benefits of their current EU Sugar Import Regime by introducing a tariff rate quota at levels that would preserve their present export levels to the EU.

## **6. Development Assistance Measures for the Sugar Protocol Countries**

The EU Commission has indicated that it will be proposing specific measures to help the Sugar Protocol countries (and India) to adapt to the market conditions that will apply post-reform. There are in principle three (not mutually exclusive) options available to the EU in trying to safeguard these ACP countries against the erosion of sugar preferences:

- compensation for their lost income transfer;
- support for increasing the competitiveness of their sugar industries; and
- support with contraction of sugar and diversification into non-sugar activities.

For the higher cost producers the greater emphasis may be on contraction and diversification with transitional support for the sugar sector, while for some countries there may be greater scope for improving productivity and competitiveness through production rationalisation and product diversification within the sugar sector itself.

Given that the income transfers associated with the protocol arrangements are easily calculable (and have been calculated) it would be relatively easy to identify the cash transfers (or equivalent trade preferences for other sectors) that would need to be given to the protocol countries. There may be resistance to this type of assistance from the EU and bilateral donors, especially if it were not conditioned on actions and measures aimed at transformation and/or diversification in these ACP countries. Indeed they are likely to want to see their assistance targeted on broader development strategies. This might involve some mixture of direct budget support for public reform programmes to improve administration, institutional arrangements or infrastructure, tied funds for labour retraining and increased mobility required for industrial restructuring, and of soft loans programmes for industrial restructuring that cannot be supported by the market. An emphasis on market-based transformation and diversification is likely to mean that direct subsidies and cash grants to the sugar industries are likely to be eschewed. There is work that has been done on the nature and scale of the support required by the ACP countries arising from reform of the EU Sugar Regime (e.g. LMC International, 2004) that can be drawn upon in designing development assistance packages for these countries.

## **7. Overall Evaluation**

Agricultural trade reforms invariably involve a complex array of gainers and losers, even though the net welfare effects are unambiguously clear cut and positive. This is certainly the case for the proposed reforms of the EU sugar sector and trade. Indeed these effects on other countries' trade are particularly complicated in this case by the existence of special preferential trade arrangements with some developing countries relating to sugar trade. But this complexity of effects and the possibility of losers should not be allowed to de-rail agricultural trade liberalisation. More efficient use of resources within the EU is in the EU (and its citizens') interest, and less distorted international prices and markets for agricultural products is in the long-run interest of the developing countries overall (Milner and Morgan, 2004). The EU should be encouraged to make this specific, unilateral reform. Hopefully, it will encourage further agricultural reforms within the EU and elsewhere, and contribute to fostering an environment conducive to further negotiated, multilateral reforms. If implemented, the EU sugar sector

would be more market friendly and friendly to EU consumers. It would also be more friendly to the trade of those countries outside the EU with a current or potential comparative advantage in sugar production. Inevitably it will be less friendly to those countries whose sugar trade has or would be driven by preferential treatment only. For these countries appropriate assistance will be required to reduce or eliminate this reliance on preferential treatment.

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