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POLICY SPACE IN AGRICULTURAL MARKETS

by

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Abstract

As an outcome of the Uruguay Round Agreement on Agriculture, all agricultural products now have a bound tariff rate on their imports. This system of bound tariffs combines the rigidity of an upper limit that is independent of future economic conditions but discretion as governments have a whole array of choices in terms of applied tariffs as long as they are set below the bound rate. One recurring argument is that bound rates may limit countries' policy flexibility, or policy space, in response to particular economic circumstances. This paper looks at the use and availability of this policy space in agricultural markets. This is first done in a descriptive setting, then by assessing what plays a role in determining this space using an empirical analysis. A general finding is that policy space in agricultural products is generally available, and only limited for developed countries. Many developing countries have ample room to raise tariffs in most agricultural imports without infringing binding commitments. For LDCs there is virtually no imports for which policy space is not available. The findings indicate that four specific factors are related to the use of policy space, which are the elasticity of import demand, the fact that the goods are being used as intermediates, food security and protection of local producers. The results suggest that policy space tends to be used relatively less for products with lower elasticity of demand and for intermediate products. In regard of products relevant for food security, the results suggest that policy space is larger. In regard to products that face domestic competitors, the results indicate lower tariff water and more use of policy space, suggesting that producer protection is an issue related to the level of policy space to use and the level of market protection to set.

Keywords: International trade, policy space, WTO, tariffs.

JEL Classification: F10, F13

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1. INTRODUCTION

Trade in agri-food products is governed by a set of rules influencing market access conditions by limiting the level of protection countries can legitimately apply. At the multilateral level, the rules governing the trade of agricultural products are those agreed in the Uruguay Round Agreement on Agriculture (URAA). The URAA was concluded in 1994 and became fully implemented by 2005. As an outcome of the URAA each WTO member replaced border barriers with an equivalent tariff. This tariff is known as the "bound rate" and refers to the highest rate the country could then apply without infringing the agreement.[1] The rationale behind setting tariff ceilings was to increase policy certainty and limit negative spillovers of domestic policies on international markets. As noted in Horn et al. (2010), the system of bound tariffs combines the rigidity of an upper limit that is independent of future economic conditions but discretion as governments have a whole array of choices in terms of applied tariffs as long as it stays below the bound rate. Still, one recurring argument is that bound rates may limit countries' policy flexibility (or policy space) in response to particular economic circumstances.

In reality, countries often choose to apply a tariff that is well below the bound rate, and thus generally maintain significant flexibility in raising the tariffs of many agricultural products. This flexibility can be measured by the difference between the bound and the "most favoured nation" tariff rate (MFN) and is referred to as *tariff water* or *binding overhang*. In order to understand the use that developing countries do, or don't do, of such flexibility, this paper examines the availability and use of policy space related to agricultural trade.[2]

There are a certain number of reasons for which the desired MFN is often set below the bound rate and thus policy space remains available. Theoretical work by Amador and Bagwell (2012) considers that governments set tariffs so as to maximize a weighted average of consumer surplus, tariff revenue and profits in the import-competing sector. They will be influenced by many economic factors, some of which will affect several of them simultaneously. This paper investigates some of the most relevant factors that can influence the use of policy space. In particular, the paper examines the relationship between policy space and the elasticity of import demand, the fact that the goods are being used as intermediates, food security and protection of local producers.

The elasticity of import demand will have a direct impact on consumer surplus and will influence the amount of tariff revenue through changes in import volumes. For example, if a government's objective is to reduce demand of imports, small changes in tariffs on products with elastic demand would be rather effective, while any raise in tariff would not substantially impact imports of products with inelastic demand which lack of domestic substitutes. In contrast, tariff setting would be quite different if the government's objective is to increase tariff revenues. In practice, governments under fiscal constraints may be willing to use their policy space on products with inelastic demand. The use of policy space may also be related to whether the good is used as an intermediate product. In such cases policymakers may be inclined to keep the MFN applied relatively low thus favoring local processing