



**State Trading and
International Trade
Negotiations**

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STATE TRADING AND INTERNATIONAL TRADE NEGOTIATIONS

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Preface

This report is part of the Trade Research Series that Agriculture and Agri-Food Canada (AAFC) is undertaking to support discussions in connection with multilateral and bilateral trade negotiations. The purpose of the series is to create an inventory of research that will make it easier for stakeholders to identify concerns, issues and opportunities associated with such discussions. Any policy views, whether explicitly stated, inferred or interpreted from the contents of this report, should not be represented as reflecting the views of AAFC. The research is for the most part directed to areas in which little or no information has been circulated rather than to areas in which a broad base of literature already exists. More information on the Trade Research Series is available on the AAFC website at www.agr.ca/policy/epad, or by contacting Brian Paddock, Director, Policy Analysis Division, Policy Branch (e-mail: Paddobr@em.agr.ca, phone: (613) 759-7439).

In order to prepare for upcoming negotiations, an in-depth understanding is needed of the characteristics of the emerging trade policy environment, and how Canada's negotiating partners may establish their priorities and pursue them. This report is a qualitative analysis of several specific elements that influence the emerging trade policy environment. It is based on the experiences of past negotiations, recent developments, published papers, public commentary and discussions with policy analysts. The time horizon for the review is the next decade.

This paper was presented at the 1998 Annual Meeting of the Canadian Agricultural Economics Society in Vancouver as part of a session on International Trade.

State Trading and International Trade Negotiations

INTRODUCTION

State trading is a topic which evokes radically different reactions from different people. Some see state trading as inconsistent with a liberalized trading environment. For example, Sir Leon Brittan commented:

I should at this point raise a related issue concerning state trading, in other words, where a government has a special right to a designated corporation to import or export or to distribute certain goods . . . I think that, if we are to look at international competition rules seriously, the time is ripe to consider whether this antiquated form of monopoly trading can be phased out altogether.¹

At the other end of the spectrum are those who feel that such institutions are essential for producers in markets dominated by a small number of multi-national traders. Representative of these views are two Australian wheat producers who writing in *The Land*, an Australian periodical claimed:

If the export market were deregulated, we would lose a great deal of our clout. The world market is not a level playing field and without a single desk we would be depowering a valuable marketing arm . . . export market deregulation would give a dangerous amount of market influence to large multi-national traders. They could force down the market price to suit their own mean.²

1. "Competition Policy and the Trading System: Toward International Rules in the WTO." Speech presented to the Institute for International Economics, Washington, D.C., November 1997.

2. *The Land*, November 27, 1997.

The structure of the remainder of the paper is as follows. Section 2 presents a brief history of state trading and international trade negotiations. Section 3 provides definitions and rules. The analytical framework is Section 4 and some concerns regarding state trading are in Section 5. Finally, Section 6 elaborates some thoughts on how to advance issue in the future.

HISTORIC CONTEXT

With the advent of another round of multilateral trade negotiations, there is a renewed interest in state trading. The issue has existed as long as the GATT itself. The Havana Conference on Trade and Employment on March 24, 1948 was to have established the International Trade Organization (ITO). At that time state trading had expanded as a result of the war and there were efforts in the drafting of the Havana Charter to include provisions relating to state trading enterprises (STEs). Those drafting the GATT-ITO also recognized that a private firm may have significant market power and that power may be abused. Therefore, they put into the ITO Draft Charter a whole chapter on “restrictive trade practices”. However by 1950, U.S. President Truman withdrew the Havana Charter from congressional consideration and the ITO died as a result. The GATT which had been adopted as a temporary interim agreement in 1947 survived. Although the chapter on restrictive trade practices died with the ITO, most of the provisions on state trading survived as Article XVII (paragraphs I and II) and Article II:4 of the GATT. In 1957, Article XVII was amended to introduce requirements for reporting specified activities and a provision that the contracting parties “recognize” the importance of negotiations aimed toward lessening the level of protection provided by state trading.¹

DEFINITIONS, RULES AND THE MOTIVATION TO RENEGOTIATE

Article XVII defines state trading as occurring where a WTO member “establishes or maintains a state enterprise . . . or grants to any enterprise . . . exclusive or special privileges.” The article however, does not define either “state enterprise” or “privileges”. One result of the Uruguay Round included the Understanding on the Interpretation of Article XVII which provides the following working definition for state enterprises:

. . . governmental and non-governmental enterprises, including marketing boards, which have been granted exclusive or special rights or privileges, including statutory or constitutional powers, in the exercise of which they influence through their purchases or sales the level or direction of imports or exports.

The provisions provide that each member must notify the WTO of any state trading enterprise within its jurisdiction. The notification provides:

- an enumeration of STEs;
- the reason and purpose of introducing and maintaining the STE;

1. See Jackson (1969) for a discussion of early concerns surrounding international competitive practices.

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- a description of the functioning of the STE (including whether the STE imports or exports, whether private traders are allowed, criteria determining quantities traded, how export prices are determined, how import mark-ups are determined, and whether long term contracts are negotiated); and
 - data on production, imports and exports and the proportion of exports and imports traded by the STE.

The lack of precision in the definition combined with the reliance on self-notification has allowed countries to interpret the definition to suit their own purposes. Not surprisingly, there are a number of noteworthy omissions from the list of STEs that are notified. For example:

- Canada has notified the activities of the Canadian Wheat Board, the Canadian Dairy Commission, the Freshwater Fish Marketing Corporation, the Ontario Bean Producers' Marketing Board and the provincial liquor board but the Ontario wheat Producers' Marketing board has been left out, apparently on the grounds that their export activities are undertaken under licenses issued by the Canadian Wheat Board.
- The United States has notified the activities of the Commodity Credit Corporation but excluded the activities of the various marketing orders for horticulture and dairy products.
- The European Union has not notified the activities of the commodity management committees of the European Commission or the activities of the member state intervention agencies.
- Finally, although the notification does provide detailed information on the activities of the STEs, it provides no information on the markets in which the STEs operate. This information is essential to assess the impact of STEs on market performance.

While there is a recognized concern over the inconsistency of the notifications, the practical effect may be minor because the disciplines imposed on STEs are rather modest. The rules on state trading, contained in the GATT, include the main provisions of Article XVII plus provisions in other articles which relate directly or indirectly to STEs. These rules cover:

- non-discrimination (Article XVII:1),
- market access (Articles II:4 and XVII:4),
- transparency and notification (Article XVII:4), and
- prohibitions on quantitative restrictions (Articles XI, XIII).

The requirement for non-discriminatory treatment is tempered by an interpretive note to Article XVII:1 which allows a state trading enterprise to charge different prices for sales in different markets provided this practice is done for commercial reasons and to meet the market conditions in the export market. Some have argued that, in the end, the GATT provisions succeeded only in establishing a place holder for future negotiations.

While the members of the WTO have largely been willing to ignore the issue of STEs, this no longer appears to be the case. The United States Trade Representative has been particularly forceful in insisting upon dealing with this issue in the next round of negotiations on agriculture. (It should be noted that existing WTO rules governing STEs are general in nature and are not agriculture specific-there are a number of non-agricultural STEs.) Some other members of the WTO, such as, Argentina appear to support this effort.

Josling (1997) suggests three reasons for the resurgence in interest in state trading.

- The removal of other government interventions has exposed new players to competition from state traders. In a number of cases, tariffs or quotas previously precluded STEs and other traders from entering certain markets. With the elimination of these barriers and the creation of tariff rate quotas, traders, including STEs have acted upon the new opportunity and begun to participate in these markets. Faced with new competition from imports, existing players have sometimes suggested that the activities of STEs constituted unfair competition.¹
- STEs may provide a means of circumventing WTO disciplines. In some countries STEs are the sole import buyer; they may also administer tariff rate quotas. In such an environment, one may question whether increased access provided by lower tariffs or granting of tariff rate quota may be offset largely by internal decisions taken by the STE.
- The concern over circumvention of WTO disciplines is accentuated by the anticipated entry into the WTO of a number of (formerly) centrally planned economies such as China and Russia. Not only will their entry will bring some important new STEs, but they will be in countries where because the “market economy” is in a rather rudimentary stage, the potential for STEs to circumvent WTO disciplines is even more significant.

Canada has an interest in the resolution of this issue. On one hand, since the agri-food sector depends on exports for its well-being, Canada has an interest in ensuring that disciplines negotiated in the Uruguay Round are respected. On the other hand, Canada has utilized STEs as an instrument to achieve domestic and international policy objectives. Thus, it would not wish to see disciplines placed on these entities which would put STEs at a competitive disadvantage relative to their private sector competitors.

ANALYTICAL FRAMEWORK

The conventional approach to the analysis of STEs is to assume that the rest of the market is composed of atomistic firms which act as perfect competitors. The quotation by Sir Leon Brittan is consistent with this assumption. Dixit and Josling (1996) focus only on the potential abuses of state trading without any recognition of (perceived) distortions in the international market place, which are the rationale for the creation of many STEs. The assumption of a competitive alternative inevitably leads to the conclusion that elimination of STEs would lead to improved market performance.

1. Witness for example the concern over the activities of the Canadian Wheat Board and the New Zealand Dairy Board in the US market.

In fact, markets are rarely competitive. While primary production is typically characterized by many small firms, the processing and trading sectors are frequently composed of a few large firms. Moreover these firms deal with a number of countries with a broad spectrum of products and with a number of vertically related activities (e.g. trading, processing, transportation). This structure raises the possibility that these firms may exercise significant market power. The assumption that replacing a STE with a private firm(s) in this market structure will necessarily lead to improved economic performance is misleading. For example, given the high degree of concentration in international grain trading, it is quite reasonable to expect that these traders possess a degree of market power and are therefore able to generate excess profits. The view expressed by Smith and Scriven reflects this. A framework which assumes a perfectly competitive market structure would conclude that an STE with a degree of market power would reduce market performance. A framework which takes into account imperfect competition in the market may conclude that by capturing and distributing those excess profits, the STE could enhance overall market performance. It is therefore necessary to consider the actual market conditions in a particular case and the potential market distortions that would exist in the absence of a particular STE in order to draw appropriate policy conclusions.

CONCERNS OVER STATE TRADING

The conventional idea of the problem associated with market power is that the offending firms restrict sales in order to increase profits by increasing selling prices and/or reducing purchase prices. While this concern may be relevant for importing STEs, it is not the focus of concern over exporting STEs. Rather the concern centres around their potential to increase sales and decrease prices. The basis of this concern is that STEs may provide a channel for explicit or implicit subsidies which could provide an advantage to domestic producers at the expense of foreign competitors.

While STEs may indeed be used to provide subsidies to domestic producers, these subsidies should, in principle, be covered under the disciplines for domestic support and export subsidies. There is no reason to assume that support provided through STEs is any more distorting than similar support provided by other mechanisms.¹ It is possible that the close relationship between STEs and government may make such support more difficult to detect.

Critics of STEs see transparency as a general issue, rather than just the ability to detect subsidies from government. Their criticism focuses on a lack of information about the general operations of STEs. Specifically, because of insufficient information regarding its purchase or selling prices, an STE may have an unfair advantage vis-a-vis its competitors. Two comments are relevant with respect to this criticism. First, even in the absence of STEs, markets generate less market information than one expects. For many commodities spot and futures markets do not exist. Moreover even for many commodities where they do exist, an increasing portion of production is priced using alternative valuation markets to the point that some analysts question both the relevance and reliability of these markets. Second, many of the private firms are not publicly traded and they release even less information

1. Dixit and Josling for example cite access to favourable interest rates, tax benefits, preferential foreign exchange rates and access to capital expansion funds. However, all of these instruments are used by governments without channelling them through STEs. There seems little reason for focussing on the provision of such benefits through STEs while ignoring similar benefits provided by other means.

concerning their financial dealings than do most STEs. Moreover, given their transnational nature and the wide scope of their operations, it is by no means clear that such companies are, in fact, more transparent than the exporting STEs.

The status as a single desk sales agent may allow an STE to undertake some transactions which independent firms would find difficult. For example, the absence of futures markets for some commodities may make it difficult for (small) private traders to price as far into the future as an STE. Until recently durum wheat was an example of this type of situation. While this capability may be viewed as an advantage it would not be appropriate to describe the advantage as unfair because it stems from correcting the market failure of the absence of a futures market.

A third concern is that state traders do not face the same risks as private firms and that this allows them to engage in practices which are not available to other firms.¹ The validity of this concern depends upon the nature of the STE. Where the STE is trading “on its own account”, such a criticism may have some validity. However, many exporting STEs pass all revenues (less selling expenses) to producers. In such cases it is ultimately the producer who bears the risk not the STE. The status of the STE is more like that of a commission seller or cooperative than that of an independent entity. In this situation, the concept of purchase price is meaningless since the STE does not possess all the normal attributes of an owner of the product.

The ability of exporting STEs to practice price discrimination is also a concern. The ability of STEs to extract high prices from some markets combined with a price pooling system may enhance producer prices, leading to increased production to the detriment of competing producers. In principle the alleged premiums could be extracted from any market with an inelastic demand provided that arbitrage between markets can not occur. However the high degree of substitutability between commodities of different origins probably limits the possibility of such premiums except where the price discriminating exporter has preferential access through special arrangements. Given the relatively small size of most tariff rate quotas any advantage derived from preferential access is quite limited. In any case, such preferential access to tariff rate quota may be conferred to either an STE or a private trader from a favoured supplier. One potential high priced market is the domestic market where the STE operates. If this market is effectively insulated from external competition and if it is sufficiently large, then the price premiums derived from the domestic market could be used to “cross subsidize” sales to other markets.

1. See for example Canada-United States Joint Commission on Grains, Final Report, Vol. 1, pp. 88-89.

It is worth drawing attention to the implicit assumption of critics of price discrimination. If one exporter can enhance its market returns by practising price discrimination, then it follows that competing exporters are necessarily worse off. This may in fact not be the case. Price discrimination allows sellers to enhance their joint market returns. If the products of competing exporters are sufficiently substitutable, the seller practising price discrimination, raises the price in the inelastic market and gives up market share to competitors. This potential loss of market share limits the degree to which price discrimination is possible. Moreover the distribution of the increased market returns may be such that both exporters are better off.¹

Price discrimination is sometimes condemned because it is symptomatic of market power and the exploitation of market power implies a misallocation of resources. However, this criticism is not appropriate if imperfect markets exist whether or not price discrimination is practised. Price discrimination can improve the performance of industries that are unavoidable monopolies by reducing the inefficiencies that arise from output restriction. Price discrimination can enhance competition by facilitating experimentation in pricing. Unsystematic price discrimination can have an important pro-competitive effect by undermining oligopoly discipline. In some circumstances, such as when a firm faces increasing returns to scale over a large range, certain types of systematic price discrimination, such as “Ramsey pricing”, can enhance economic efficiency.² For these reasons the Hilmer Commission (Hilmer 1993), which reviewed Australia’s competition policy, concluded that price discrimination enhances competition.

FUTURE DIRECTIONS

On the basis of the discussion above, the author suggests future directions for negotiations and for economic analysis. With respect to future negotiations, the author suggests that emphasis be placed on ensuring that STEs are not used to circumvent negotiated disciplines on access, domestic support and export subsidies. Given that disciplines are already in place, emphasis might be placed on providing more detail on the relationship between STEs and their governments. In this way potential support can be identified and dealt with in the same manner that similar support is dealt with when provided by other means.

Second, when considering differentiating STEs for purposes of identifying situations where more stringent monitoring and possible further disciplines might be imposed, the degree to which foreign traders can access the STEs home market should be considered crucial. Open access should be taken to signal minimal potential for abuse.

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1. A small model with three markets and two suppliers, one with price discrimination capability, was developed to test this hypothesis. Over a relatively wide range of elasticities of substitution, the impact on the competing exporter was minimal and in some cases was positive. However, the presence of a tariff on one of the markets, the domestic market most plausibly, greatly reduced the likelihood that price discrimination practised by one party would benefit both suppliers.
 2. Ramsey pricing is a second-best solution to social optimal prices when marginal cost pricing is not feasible. The resulting prices, as with price discrimination, vary across markets in inverse proportion with price elasticities. However, Ramsey pricing uses monopoly pricing principles just enough to meet the social constraints which are imposed. See Sherman (1989 pp. 124–157) for a more detailed description.

Finally, the more general concern over the competitive impacts of STEs should be considered under the more general heading of international competition policy. Under this rubric all potential threats to competitive markets could be addressed. Such an approach would be in keeping with the original intentions behind the Havana Declaration to have international trade agreements address the activities of private firms as well as those of government.

With respect to future analysis, frameworks are needed which can be used to assess the impacts of STEs in the context of imperfect markets. As we have seen, applying assumptions of perfect competition can lead to misleading conclusions and inappropriate policy conclusions.

On a more general note, one can only hope that future initiatives related to STEs are grounded on logical analysis rather than political rhetoric. In this day and age, it is easy to minimize the value of institutions of or connected to government. However in some circumstances, such institutions may be the most appropriate way of dealing with market imperfections. It is essential then that criticisms of such approaches be subjected to the same requirements of analytical rigour as are other policy analyses.

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