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Policy-making in the EU: the *bananarama* story, the WTO and policy transparency

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The EU banana policy is manifestly bad. But despite a healthy policy transparency process and comprehensive public criticisms of its extreme inefficiencies, its costs have been growing progressively worse and more disruptive of international commerce. This raises serious doubts about the WTO process, and the policy transparency process itself. At the very least, the *EU bananarama* story told here means we should not be complacent about either.

This is a true story. Import restrictions apply to a particular product which costs consumers $1.6 billion a year. Ostensibly, these restrictions are to support a foreign aid program which works by raising the prices developing country exporters receive for their product. But it turns out that only $300 million of the $1.6 billion a year cost to consumers is delivered to the intended recipients in developing countries. At the same time, the restrictions impose collateral economic damage of $100 million a year on other developing countries. These outcomes have been documented by several independent pieces of economic analysis. These studies also show that there are half a dozen alternative policy options which could deliver more aid, for a fraction of the cost to consumers, and deliver virtually no collateral damage to other nations.

The story continues when a once-in-a-decade opportunity to reform the program comes up. But rather than reform it, a new program is devised with even tighter import restrictions, even greater costs to consumers — 25 per cent greater — a halving of aid delivered to intended recipients and a 50 per cent increase in collateral damage. All of this happens with a program which relies on an import quota scheme which discriminates against foreign-based product marketers in favour of local marketers. It sounds like a banana republic story and it is indeed about bananas. But it is the European Union *bananarama* story. It is partly about modern policy-making in the EU and it is partly about a test for the World Trade Organization (WTO) and economic analysis and policy transparency.

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Consider the following. The policy was twice declared illegal under the General Agreement on Tariffs and Trade. The German government and others have taken cases to the European Court of Justice, which seriously criticised the policy. The Hamburg Financial Court has moved to override the policy. There has been a wave of critical press articles and editorials. The governments of Germany, Italy, Sweden, Belgium, Austria, Finland and Luxembourg have publicly opposed the policy. The United States Trade Representative (USTR) has found that it contravenes US trade law. The United States with Guatemala, Honduras, Mexico and Ecuador have filed complaints through the WTO and a new international challenge has just started (October 1996). Yet still the program remains in place.

If the European Union can do this to itself with bananas, what is to stop it adopting similar policies elsewhere? How does that affect business expectations and EU policy credibility? What does it say about expectations for further trade reform from the European Union? What pressure does it put on new WTO trade rules?

In this article I do not offer answers to these questions. The task I have set myself is to tell the *bananarama* story so far. I do this by drawing on the evidence of four earlier *bananarama* papers and others (Borrell and Yang 1990 and 1992; Borrell 1993, 1994 and 1996; Borrell and Cuthbertson 1991). As the story unfolds over the next few months, the new WTO process will be tested. The value (or otherwise) of conventional economic analysis and policy transparency, and the policy behaviour of the European Union itself will also be seen. Time will tell the story, but here I document the plot, the crime, the players and the motives.

1. EU policies have a big effect on the world banana market

As a big rich trading bloc, with little banana production of its own, the European Union is an important player on the world market, importing around 40 per cent of all internationally traded bananas. Its policy decisions therefore have the potential to have a big impact on world trade, especially given the interventionist nature of policies pursued. And with single market unification in 1992–1993, big policy decisions were required, because until that time the policies operated by separate member states varied widely.

France, the United Kingdom, Spain, Italy, Portugal and Greece had long used quota-based import restrictions to provide preferential access and aid to high cost growers (preferred suppliers) in four territories and seven small African, Caribbean and Pacific (ACP) countries. Only Germany had a completely free market in bananas, although trade interference in the Netherlands, Belgium, Luxembourg, Denmark and Ireland was relatively mild tariff intervention. The countries with little or no intervention in the

Table 1 Preferred and non-preferred suppliers of EC banana imports

Preferred suppliers: African, Caribbean and Pacific (ACP) countries[a]	Country giving special preference	Non-preferred suppliers: Latin America or so-called 'dollar' area countries of Central and South America
Belize	United Kingdom	Colombia
Jamaica	United Kingdom	Costa Rica
Surinam	United Kingdom	Guatemala
Windward Islands	United Kingdom	Honduras
Somalia	Italy	Panama
Cameroon	France	Ecuador
Ivory Coast	France	Brazil
EC overseas territories		
Guadeloupe	France	
Martinique	France	
Madeira	Portugal	
Canary Islands	Spain	

Note: [a] Under the Lomé Convention all ACP countries have duty-free access to protected EC markets. Germany is virtually a free market, so gives no preference to ACP suppliers.

market typically imported their bananas from efficient growers in Latin America (non-preferred suppliers) (see table 1).

Consumers in EU import-restricted markets paid much more for bananas, ate fewer of them — 8 kilos UK versus 14 kilos per year in Germany — and ate lower quality bananas. Quota restrictions created high prices and the scope for *rent seeking*. The quotas were intended to raise the price received by preferred suppliers, but they also enabled others in the marketing chain to seek benefits, due to the way import quotas were allocated.

Preferential access resulted in preferred suppliers receiving *fob* prices about double the prices received by non-preferred suppliers. But restricted import rights (quotas) resulted in marketing margins in import-restricted markets being double those in the United States and up to 50 per cent higher than in the European Union's only free market, Germany (see figure 1). For further details of the national policies see Borrell and Yang (1990) and Borrell and Cuthbertson (1991).

1.1 A model of EU banana policies

To estimate the economic cost of the EU banana policy, an economic model of the EU and world banana market has been constructed (see Borrell and Yang 1990; Borrell and Yang 1992). The model is a simple

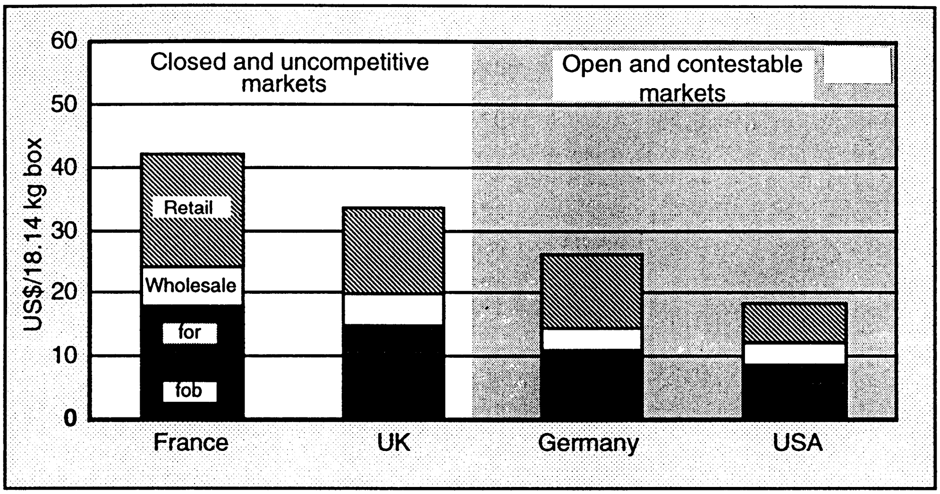

Figure 1 Marketing margins in closed, uncompetitive and open, contestable markets: prices and marketing margins (1992)

Source: FAO (1994)

static, partial equilibrium, global net trade, homogenous product simulation model. It represents export supply from favoured and non-favoured regions and import demand by EU quota-protected markets, EU tariff-protected markets, EU free markets and the rest of the world. There are eight exporting and eight importing regions.

Export supply from favoured nations is a function of the internal EU quota raised price less marketing margins and transport costs applying in the EU country of destination. There are seven favoured suppliers represented. Export supply from non-favoured nations is a function of the world price (US landed free on rail price) less transport costs. Only one rest of world region is represented.

Import demand in EU quota-protected markets is a function of the representative EU internal price in that region. Five EU countries are separately identified. Import demand in tariff-protected markets is a function of the world price plus transport costs, plus the tariff, plus the marketing margin (one region). Import demand in free markets is the world price plus transport costs and the marketing margin (one EU country, Germany, plus a rest of world region). The world price adjusts to ensure exports and imports equate. Price elasticities of export supply range from 1 to 3. Price elasticities of import demand range from –0.4 to –1.0. Marketing and transport margins are exogenous.

Alternative policies are simulated by replacing quota-set internal prices with the world price plus marketing margins in open markets, or the world price plus a tariff plus marketing margins in open markets. Welfare measurements are based on consumer and producer surpluses. Data are from FAO and World Bank sources.

1.2 Model estimates revealed the costs of old quota-based policies were excessive

The cost to consumers of paying preferred suppliers double the world price for bananas was estimated using the model to be $576 million a year, but the cost to consumers of paying excessive marketing margins in import-restricted markets, instead of paying the marketing margins faced by German consumers, was estimated at $917 million a year. Consumers also paid an estimated $112 million a year extra due to tariff revenue collected on imports. But more worrying still, of the $576 million being paid by consumers for preferred suppliers, this was only worth an estimated $302 million a year to preferred suppliers. This was because they had to use up and pay for resources to grow bananas to qualify for the aid.

In summary, it was estimated that before the introduction of the current policies consumers in import-restricted EU markets incurred excess costs of $1.6 billion a year to deliver $300 million a year to the eleven developing economies of the preferred suppliers. Put another way, it cost EU consumers an estimated $5.30 to deliver $1.00 of net banana aid to eleven developing country economies. Of the $5.30, over $3.00 was estimated to be siphoned off in excessive marketing margins to EU marketeers. About $0.30 was collected as tariff revenue. After allowing for the excessive margins and tariffs which are just internal EU transfers, the net cost to the European Union was estimated at about $2.00 ($1.90). About $1.00 of this was estimated as outright waste to the world economy, while the other $1.00 was the one reaching its target as aid. By any measure of performance, these estimates revealed the old quota-based policies operating in the European Union were highly inefficient.

The outright waste of $1.00 per $5.30 cost to consumers occurred because more resources than necessary were used to produce bananas — at least some of the bananas produced at high cost by preferred suppliers could have been produced with fewer and cheaper resources by the more efficient, non-preferred suppliers of Latin America. Waste was also highlighted by the fact that to qualify for aid, preferred suppliers had to grow bananas inefficiently and so use up land, labour and capital that could have been used in other more productive ways such as is occurring in the export processing zones in the Dominican Republic and Jamaica, see World Bank (1993).

1.3 While giving some aid, the quota policies hurt other developing countries

For every dollar of aid reaching preferred suppliers, a cost of $0.32 (or $98 million a year) was estimated to be incurred by other developing country suppliers, namely, Latin American suppliers, due to lost export opportunities.

2. With market unification, the EU adopted a new policy in 1993

On 1 July 1993 the European Union replaced the disparate import policies of its member states with a unified policy. The European Union had many alternative efficient options placed before it (see, for example Borrell and Yang 1990 and 1992; Borrell and Cuthbertson 1991; and Jim Fitzpatrick and Associates 1990). With an estimated cost to consumers of $1.6 billion extra for bananas to provide support to the eleven small developing economies involved, it was not difficult to come up with schemes which provided benefits far in excess of the $300 million reaching its target under the old schemes, and which would cost consumers less. In particular, this would involve shifting from cross-subsidy aid tied to trade in bananas to direct, well-targeted aid and virtual free trade in bananas as occurred in Germany.

However, instead of adopting the efficient policies of Germany, the European Union chose to extend across the entire European Union the most protectionist and costly of the former national policies. It chose policies which do not make economic sense over those that do. The new policy:

- relies on a prohibitive tariff-quota on Latin American imports, to restrict supply and raise internal EU prices;
- applies a tariff to quota imports from Latin America to raise revenue;
- greatly limits competition in the marketing of bananas through a system of import licences and export certificates which divide up market shares and quota rents;
- restricts trade and supply for Latin American bananas to below the aggregate level previously held under national policies;
- allows EU territorial bananas free and open access and a deficiency payment; and
- allows duty-free, but quota-restricted, access for (ACP) bananas.

2.1 Normal commercial conditions do not apply, and much commercial uncertainty is added

The policy interferes with the normal commercial workings of the market. Many resource allocation decisions in production and marketing are made centrally and bureaucratically rather than commercially. As a result, political and bureaucratic objectives get in the way of commercial ones. Costly red tape and politically induced uncertainty are introduced to the marketing of Latin American bananas in the European Union.

Allocation of quotas leads to favouritism and discrimination in marketing

The policy favours those EU marketing companies (mostly EU-owned) that benefited previously under the various national policies. It does this through allocating these companies special licences (category B — see below). This hands to them, by bureaucratic fiat, a third of the Latin American trade. Previously these companies were not competitive enough to command this trade. Only through the special privilege conferred on them by their special licences are they able to participate.

The companies which traditionally marketed Latin American bananas (mostly US-owned) suffer from this restriction. They previously marketed bananas in the relatively open and contestable EU markets such as Germany, the Netherlands, Belgium, Luxembourg, Denmark and Ireland and in the three recent entrants to the European Union — Austria, Sweden and Finland. They have had the overall size of their markets reduced directly, first through quotas and then through the allocation of licences (category A) which directly restricts their share of this market to around two-thirds of the total. It also restricts growth. This was further restricted with the 57, 28, 15 per cent allocation between importer, customs clearers and ripeners respectively. The other third is the share that has been handed to favoured EU marketing companies as B licences. There is also a small amount (C licence) that has been handed to non-traditional marketers.

Higher prices are no compensation

It may be argued that the higher prices received due to the quota is some compensation to the marketers of Latin American fruit but this ignores the complexity of modern business. Reduced volume reduces economies of scale and scope and so raises costs. Compliance with the red tape of complex quota and licensing arrangements raises costs. The arbitrary nature of the policy, how it is administered, how licences are allocated and how it could change due to political and bureaucratic interference, all introduce huge investment risks which add greatly to costs. The arbitrary nature by which market shares are allocated denies competitive companies their main security and comparative advantage, that is, their right to compete. It imposes an opportunity cost on them because it denies them the right to compete for future profit streams through good current commercial performance, and delivering what the consumer wants. Under quotas and licences, winning market share requires extensive and expensive lobbying. But even then this guarantees no favour. This is one reason why competitive growth-oriented companies continue to resist quotas.

2.2 The new policy appears to be twice as inefficient as the old

The stated objective of the EU banana policy is to provide support (aid) to EU territorial producers and those banana exporters of the Lomé ACP countries, while ensuring consumers are adequately supplied with good quality bananas (The Commission of the European Communities 1995a). Quotas on imports raise consumer prices for bananas above what they would be in a free and open market. The allocation of B licences to companies marketing bananas from preferred suppliers is intended to increase the demand for bananas from EU territories and ACP countries. Increased demand is intended to raise the prices for fruit from these sources, bidding it up above the world price. In this way it is intended to provide support or aid through a cross-subsidy to these exporters.

However, the cross-subsidy aid does not appear to be getting through to intended recipients. On average the aid component of the support price dropped 50 per cent in the first 18 months of operation of the new policy (see figure 2), suggesting the net annual benefit of the banana aid (from the cross-subsidy) dropped to $151 million from an estimated $302 million under the old policies, see Borrell (1996).

The policy also appears to be failing to achieve its other objective. Availability to consumers declined 11.5 per cent between 1992 and 1994 and retail prices rose by at least 42 per cent in Germany (the biggest sector with 30 per cent of consumption) and by at least 7 per cent across the entire European Union (twelve members). Quality may also have dropped, see Borrell (1996).

On this basis the cost to consumers appears to have risen $400 million a year to $2 billion a year. And there has been a major redistribution of cost, away from the French and British to the Germans. German consumers who previously paid no cost, appear to be paying about $0.8 billion a year now. Deadweight losses to the EU economy appear to be in excess of $600 million annually. EU marketers remain the main beneficiaries, receiving windfall gains of just over a billion dollars annually — seven times what preferred suppliers receive. Marketing margins are about double what they are in the United States. Estimated tariff revenue of around $300 million a year was raised in 1994, see Borrell (1996).

The collateral damage imposed on other exporters went up because reduced EU import demand caused the world price to dip. It fell 3.5 per

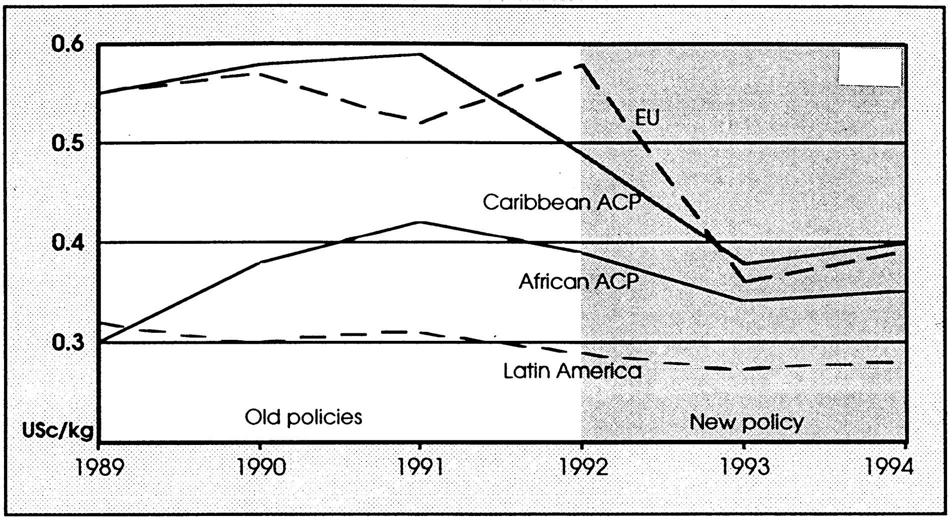

Figure 2 Convergence of EU and Caribbean ACP fob prices towards African ACP fob prices (real 1994 prices, weighted averages)

Source: FAO (1995)

cent between 1992 and 1994. This is consistent with expected impacts shown in Borrell (1994). The collateral damage of the EU policy on Latin American producers is conservatively estimated to have increased by 50 per cent over the old national policies, from an estimated $98 million previously to $147 million in 1994. If so, this offsets the net benefit of banana aid to preferred suppliers (see figure 3) and see Borrell (1996).

If it costs EU consumers $2.0 billion to transfer $151 million a year to preferred suppliers in the form of banana aid (the cross-subsidy), this implies the new policy is more than twice as inefficient as the old policy in achieving its objective. It costs consumers $13.25 to transfer $1.00 of benefit to preferred banana suppliers. Under the old policies it was estimated to cost consumers $5.30 to transfer each $1.00 of banana aid. Most of the increase in cost is due to the fact that windfall gains on the sale of bananas have been deliberately raised by the policy but, more important, even less of these windfall gains is being passed back to preferred suppliers in the form of higher prices than occurred previously.

The policy is also out of kilter with EU competition policy

Table 2 sets out some of the key points about EU competition law and how the EU banana policy appears to contravene that. On an economic

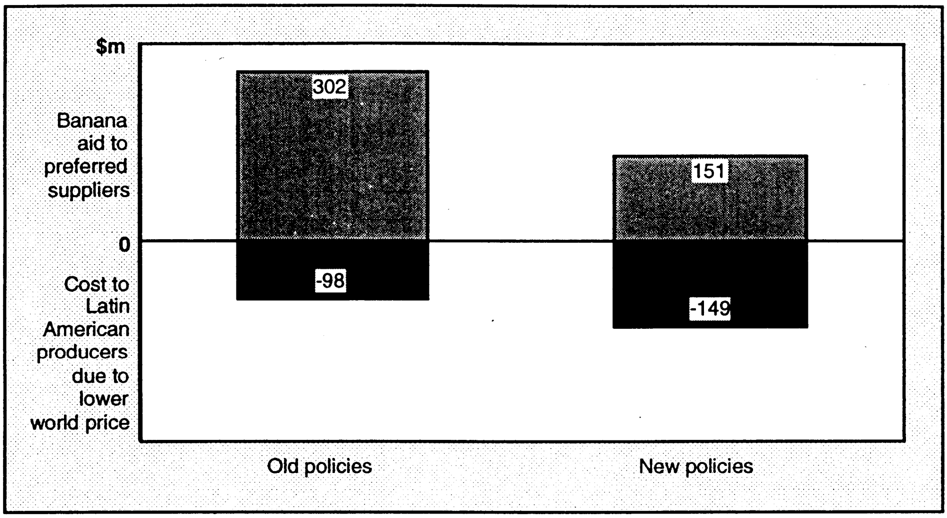

Figure 3 The net aid effect for developing countries may be zero

Source: Borrell (1994)

interpretation of this law, the banana policy would appear to fall down on every category.

The policy flouts WTO trade rules

In 1992 when GATT explicitly condemned the European Union's old restrictive national policies, the European Union blocked GATT approval of that ruling and ignored its content in structuring the new policy. In 1994 when GATT, for a second time, ruled against the EU banana policies and called for a restructuring of their new policy, the European Union again blocked the ruling.

3. Direct aid is available, negating need for indirect banana aid

Large transfers of direct aid are being paid to compensate for shortfalls in the intended cross-subsidy of banana aid. For example, in 1994 about $120 million was committed to African and Caribbean ACP producers in the form of STABEX (a deficiency payment arrangement) and special adjustment assistance, while the Canary Islands alone received around $240 million in 1995. The numbers suggest direct aid is now truly dominating aid transferred by the cross-subsidy.

Further, the European Union is committed to direct aid (under Lomé IV). It provides an additional $200 million to $300 million a year in this

Table 2 How EU banana policy contravenes EU competition policy

Key features of EU competition law	An economic interpretation of this law as it applies to EU banana policy
Article 3(g) of the Treaty of Rome provides that the activities of the European Union shall include *a system ensuring that competition in the internal market is not distorted.*	Quotas and licensing guarantee that competition in internal markets is distorted.
Articles 85 and 86 of the Treaty of Rome further lay out the basis of European Union competition policy. *The following shall be prohibited as incompatible with the common market: all agreements between undertakings; decisions by associations of undertakings and concerted practices which may affect trade between member states and which have as their object or effect the prevention, restriction or distortion of competition within the common market; and, in particular, those which:*	The stated object is to deliberately prevent, restrict and distort competition to orchestrate an indirect monetary transfer to a small group of banana producers.
(a) *directly or indirectly fix purchase or selling prices or any other trading conditions*;	Quotas and licences directly fix trading conditions and indirectly fix the selling price.
(b) *limit or control production, markets, technical development, or investment;*	Quotas and licences limit production, investment and technical development and blatantly control markets.
(c) *share markets or sources of supply;*	Licences mean there is blatant market sharing.
(d) *apply dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage; and*	Conditions applying to licences mean there is blatant discrimination against one type of marketing company over another.
(e) *make the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts (Martin 1994).*	Category A, B and C licences have supplementary obligations attached to them.
Exemptions may apply if the action promotes technical or economic progress and consumers share in the benefits.	The policy would appear to cause the exact opposite and so there are no grounds for exemptions.

form to ACP banana-producing countries. The European Union has a large program in place to deliver direct aid. The benefits of the program are that financial aid has a high degree of predictability and accountability and can be directly targeted to deal with economic problems such as low productivity and competitiveness. Indirect banana aid through an unreliable cross-subsidy is by comparison haphazard, unaccounted for, is not targeted and promotes inefficiencies.

According to a Cargill Technical Services Ltd study (1995), banana aid has created complacency and reduced the competitiveness of the banana industry of the Windward Islands. The study points out:

- the industry has the capacity to function competitively in a free market if the necessary organisational and technical changes are made;
- poor management at all levels is a bigger problem for the industry than inherent climatic, topographical or structural weaknesses;
- Windward Island bananas are perceived to be low yielding, high cost and of inconsistent quality relative to Latin American fruit;
- costs of production are twice those of Latin American producers;
- guaranteed access to the UK market up to 1993 was a disincentive to solving fundamental quality and cost inefficiencies (a common occurrence);
- despite good support prices and conditions between 1989 and 1992, the industry's marketing bodies were accumulating debt ;
- when prices fell in 1993, debt of marketing bodies blew out to ECU 113 million, putting the industry in an unsustainable financial/debt position; and
- the industry is financially unsustainable without massive increases in productivity and competitiveness, substantial debt write-offs and infusions of equity.

Indirect aid would appear to be the problem, not the solution and appears to be inconsistent with the EU direct aid program.

4. What's next and implications for the policy transparency process

The cost of the latest policy is so high because its main instrument (discretionary quotas–licences) is one of the most market-distorting instruments that it is possible to have. Such intervention chokes commercial and competitive behaviour by discouraging open expansion and sound consumer-oriented marketing. It stifles innovation, quality and market dynamism. No market can be expected to function efficiently under such circumstances. To continue with such mechanisms even if the policy were achieving its objective would be highly inefficient because the same objective could be achieved using alternative mechanisms which do not involve disrupting the market. The alternative mechanisms simply involve using direct aid in place of indirect banana price aid and the many options have been discussed in earlier *bananarama* papers. The cost of direct aid could even be raised through a tariff (around 20 per cent *ad valorem*) on all banana imports. But the ultimate irony is that the failure of the current instrument is leading to direct aid by default, while the market is being left the legacy of one of a very intrusive piece of intervention which imposes serious costs.

It was never a big step to shift from banana aid (through cross-subsidy) to direct aid. But because this is occurring by default, that leaves just two important steps to complete. The first would be to dismantle the discredited EU banana quota-licensing system and to establish instead the biggest, most sophisticated free banana market in the world — one to rival the efficiency of the US market. The other would be to formalise direct aid in place of banana aid.

The combination of direct aid to target recipient countries and a free market for bananas in the European Union would see lower prices and more bananas consumed throughout Europe, better quality bananas supplied, greater efficiency in banana production in producing countries and resources in inefficient banana-producing areas being used more productively. Everybody would stand to gain, except protected marketers. By one interpretation it might seem that it is only a matter of time before such manifestly bad policies are dismantled. There is little disagreement now that the policies are extremely inefficient in meeting their targets and that better policies could be easily crafted.

The policy transparency process seems to be alive and well. As well as the six studies referred to earlier there have been at least half a dozen others coming out with broadly consistent quantitative findings and similar policy conclusion (see, for example, Fitzpatrick and Associates 1990; McInerney and Peston 1992; Mathews 1992; Read 1994; Kersten 1995). But the interesting question is, will it bring about reform?

That such policies have grown progressively more costly and trade-disruptive despite the well-published evidence against them is an indication of the strong political forces standing in the way of reform in the European Union. Nonetheless, while the policy remains, it seems to be creating a big demand for ongoing analysis and more publicity of the issues. The up-coming WTO case will be a big test of the effectiveness of the new trade rules and the capacity of the WTO to be drawn by analysis of the public interest.

Certainly the continuing flurry of studies and publicity will make it more difficult to maintain the status quo. If this fails, this must raise serious doubts about the power of the WTO and the policy transparency process itself. Much is at stake and further developments in the EU *bananarama* story are well worth monitoring as indicators of what we can expect from the EU policy-making in the future. It will also be a good pointer to the value of the WTO.

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