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# The Economics and Potential Protectionism of Food Safety Standards and Inspections: An Application to the U.S. Shrimp Market

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The Economics and Potential Protectionism of Food Safety Standards and Inspections: An  
Application to the U.S. Shrimp Market

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**Running head:** Economics and Protectionism of Food Safety Standards and Inspections

**Abstract:** We formally investigate the effects of an inspection system influencing safety of foreign and domestic food products in the domestic market. Consumers purchase domestic and imported food and value safety. Potential protectionism à la Fisher and Serra (2000) can arise: inspection frequency imposed on foreign producers set by a domestic social planner would be higher than the corresponding policy set by a global social planner treating all producers as domestic. The domestic social planner tends to impose most if not all of the inspection on foreign producers, which improves food safety for consumers and limits the production loss for domestic producers. Despite this protectionist component, inspections address a potential consumption externality such as health hazard in the domestic country when unsafe food can enter the country undetected. We then calibrate the analytical framework to the U.S. shrimp market incorporating key stylized facts of this market. Identifying protectionist inspection requires much information on inspection, safety, damages, and costs. We also investigate how to finance the inspection policy from a social-planner perspective. Financing instruments differ between the domestic and international welfare-maximizing objectives.

**Keywords:** Food safety, non-tariff measures, inspection, protectionism, HACCP, seafood, shrimp.

**JEL code:** Q17, Q18, Q22, F14

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## **Introduction**

This chapter formally explores the potential protectionism and effects of an inspection system to enforce a food safety standard on domestic and foreign producers. The chapter delineates the role of inspection as discriminatory trade barrier through foreign producers' difficulties to enter a market but also their legitimate role to internalize potential external effects from risk of illness.

Food safety regulations are a contentious issue in the context of North-South trade with contrasting views on safety regulations either as a barrier (Henson and Loader, 2001; Otsuki, Wilson and Sewadeh, 2001a and 2001b; Wilson and Otsuki, 2004) or catalyst driven by consumer concerns (Anders and Caswell, 2009; Jaffee and Henson, 2005). Most of these analyses have focused on standards rather than inspections. Inspections turn standards into implemented standards and determine the effective quality available on the market. Different inspection levels at the border and in domestic plants allow to effectively discriminate between foreign and domestic food producers and to impose differentiated implemented standard via different inspection rates even though the "official" uniform food standard applies to all producers. We focus on the economics of these inspections and analyze their role in trade as protectionist barrier but also as a way to internalize external health effects on consumers. Identifying protectionist inspections is more daunting than one would presume in presence of asymmetric safety levels between foreign and domestic firms.

We assume that a social planner chooses an optimum inspection level to enforce food safety that maximizes domestic welfare (surplus of consumers and domestic producers net of potential health externalities). The standard itself is assumed to have been fixed at a safe level, that is, at which no sickness or negative external effect occurs. Potential protectionism à la Fisher and Serra (2000) arises: inspection frequency imposed on foreign producers set by a domestic social planner would be higher than the corresponding policies set by a global planner treating all

producers as domestic.

The domestic social planner tends to impose the total or a large part of the inspection on foreign producers to shift cost abroad. Food safety improves (especially for imported food), and domestic producers' losses are limited. Despite this protectionist component, the inspection addresses a consumption externality such as health hazard in the domestic country when unsafe food can enter the country undetected.

The chapter then applies the conceptual framework to the American seafood market and more specifically to shrimp. The United States (U.S.) is a significant producer and importer of seafood products. Seafood imports are seldom inspected at the border, raising the issue of unsafe food being imported. Cases of contaminated and unsafe seafood imports have been reported despite extensive food safety standards in existence (Southern Shrimp Alliance, 2007; U.S. Government Accountability Office – GAO, 2001, 2004, and 2009). When inspections occur, they often reveal imported products failing U.S. food safety standards (GAO, 2001 and 2004). Safety problems also affect domestic production, where many products are not processed following existing food safety regulation (GAO, 2001 and 2004). Hence, our set-up and approach fully apply to the U.S. seafood market with its safety standards and inspections at the border and in domestic plants.

Using recent econometric estimates of consumer and producer price responses, cost of production data, and information on the cost of meeting food safety standards for seafood exporting countries, we calibrate a partial equilibrium model of the U.S. shrimp market including imports to derive the socially optimum inspection levels conditioned on a food safety standard. Consumers in the U.S. and other advanced countries have repeatedly expressed their willingness to pay for better and safer seafood products in the market place and in laboratory experiments. We show that even though the optimal policy is protectionist (as defined in the previous

paragraph), it is optimal for an importing country to impose differential implemented standards via tighter inspections on foreign producers.

We also determine the optimum way to finance the inspection policy from a social-planner's perspective. Financing instruments are different under the domestic welfare-maximizing objective as opposed to the case of the international welfare-maximizing objective inclusive of foreign profits.

### **Related literature**

The results of this chapter differ from the previous literature on standards and protectionism (Fisher and Serra, 2000; Marette and Beghin, 2010) by focusing on inspections to implement discriminatory effective standards, rather than the standard itself. We also depart from the existing literature on borders inspection, by providing a complete welfare analysis with both conceptual and empirical contributions. From an empirical point of view, the results of this study contribute to the literature on food safety inspection by providing a complete welfare analysis with calibrated estimations. Previous papers by Mayer, Nickerson and Owan (2004), Starbird (2005, 2007), and Starbird and Amanor-Boadu (2006) restricted their analyses to the supply chain organization and the determination of inspection policy without explicitly considering consumers' welfare.

In addition, our results extend the literature on how to finance inspections to an open-economy context. In particular, Crespi and Marette (2001) study different types of financing instruments without considering trade issues with foreign producers. We show the consequences of considering foreign welfare rather than just domestic welfare on financing options.

Regarding the shrimp market, our approach differs from previous seafood studies which focus only on the ex post evaluation of past measures and imports (Cato and Lima dos Santos,

1998; Debaere, 2005; Anders and Caswell, 2009, among others). Our analysis evaluates future potential, i.e. ex ante, policy with a simulation integrating welfare measure, market imperfections, and consumers' valuation of food safety attributes, which can assist decision makers and inform the public policy debate. Our analysis follows the approach proposed by Beghin et al. in chapter 1 but with the added focus on inspection rather than the standard itself.

Among the ex post analyzes of food safety issues with seafood imports, Anders and Caswell (2009) evaluate the trade impact of the 1997 Hazard Analysis and Critical Control Point regulation (HACCP) on U.S. seafood imports. They use a gravity model and panel data for 1990-2004 and 33 seafood exporters. Results show a negative and significant effect of the HACCP's introduction on aggregate U.S. seafood imports but with a composition effect penalizing developing countries' products and favouring developed countries' exports. Further, country-level analysis shows that the introduction of HACCP had a positive impact on exports of larger seafood exporters and a negative one on exports of small exporters, independently of the development level of a country. A similar gravity equation investigation of French seafood imports by Peridy, Guillotreau, and Bernard (2000) shows a significantly small impact (elasticity of  $-0.092$ ) of trade barriers on aggregate seafood imports for the period 1988-1994.

Cato and Lima dos Santos (1998) suggest that the 1997 European ban on shrimp imports originating from Bangladesh pushed the same shrimps to be exported to Japan and the United States, raising the issue of differential standards and inspection levels across importing countries. More recently, Nguyen and Wilson (2009) estimate a panel gravity model on U.S., European, and Japanese imports of seafood products. The trade impact of food safety standards is negative and significant but differentiated across seafood products. Shrimps appear to be the most sensitive to changing food safety policies, while fish is the least sensitive.

Using data on shrimp trade, Debaere (2005) empirically investigates the effect of trade



policy on international prices and countries' welfare. He shows that European Union (EU) trade policy (especially strict standards on antibiotic residues compared to the ones applied by the U.S.) significantly impacted the world shrimp market and shifted exports away from Europe towards the U.S. in the late 1990s and early 2000s with the added consequence of depressing U.S. prices for shrimp.

Hudson, Hite, Jaffar and Kari (2003) examine ex ante the effects of a potential ban on shrimp imports by the United States from countries non-complying with the Turtle Excluder Device system. They estimate a linear expenditure system to obtain the own-price elasticity of demand for shrimp imports. They find that such a ban will generate a welfare loss for U.S. consumers. The magnitude of the effect will depend on whether lost imports from banned countries are reallocated to other countries.

Alberini, Lichtenberg, Mancini and Galinato (2008) propose a theoretical model of enforcement and compliance in a regulatory environment similar to the one created by HACCP in the seafood industry. Predictions on optimal Food and Drug Administration (FDA) monitoring strategy and firms' compliance efforts are derived. Using FDA seafood inspection data, the authors show that, contrary to the predictions of the model, FDA inspections are based on product risk but not on past compliance. On the other hand, firms' compliance efforts do not increase with the threat of an inspection.

Lastly, Disdier and Marette (2010) combine the results of a gravity equation with a partial equilibrium model to determine the welfare impact of a standard capping residues of chloramphenicol, a toxic antibiotic. Their empirical analysis of crustacean imports in the U.S., EU, Canada and Japan suggests that both trade and welfare effects do not necessarily go in the same direction. However, they do not investigate the issue of inspections.

## **Background on seafood inspections by the FDA**

Food safety in many advanced countries, including the U.S., is implemented through HACCP, a preventive approach to food safety. This approach imposes food safety standards at critical junctures of food processing susceptible of contamination and health hazards to reduce health risk. The standard enforcement and the suppliers' compliance directly depend on the inspection policy.

The U.S. HACCP program for seafood is managed by the U.S. FDA. The FDA is supposed to inspect plants and products to make sure that they meet health standards included in and implied by the HACCP system. HACCP was initiated in 1997. The program has been repeatedly criticized as insufficient (GAO, 2001 and 2004). Several papers analyze FDA's seafood inspections, detentions and refusal decisions for products not meeting standards (Ababouch, Gandini and Ryder, 2005; Allshouse, Buzby, Harvey and Zorn, 2003; Buzby, Unnevehr and Roberts, 2008). Allshouse et al. (2003) provide the most detailed description. There are two types of detentions: "Regular" detentions of shipments for which physical analysis shows that FDA standards are violated, and detentions without physical analysis. The latter are based on past history and/or other information leading to the resumption that the product (and further shipments) may not meet standard. In this case, the shipper or importer should prove that the product satisfies FDA standards.

These investigations convey some key stylized facts. The FDA inspects only a small percentage of imports. Detentions occur seldom. On average, from 1999 to 2001, less than 1% of shipments were detained, and 78% of detained shipments were eventually released for import into the U.S. Detentions for fishery/seafood represented 27% of total FDA import detentions (2<sup>nd</sup> behind vegetables). The major reasons for seafood detentions were (i) adulteration (safety, packaging, sanitary problems – 83.6% of violations), and (ii) misbranding (untruthful or missing

labelling – 14.3% of violations). Among exporters, 80 out of 130 exporting countries had violations for adulteration. The number of detentions (for adulteration) per U.S. dollar (USD) of import value is low (0.46 detention per USD 1 million of imports). The top three countries in terms of number of violations for adulteration in 2001 were Vietnam, Thailand, and Indonesia. Salmonella was the most common violation for adulteration (34% of the cases). Shrimp and prawns accounted for more than 25% of the detentions for adulteration.

Buzby et al. (2008) provide some statistics of U.S. import refusals from 1998 to 2004 using data from FDA Import Refusal Reports. They reach similar conclusions as the investigations of detention data did. More interestingly, Buzby et al. (2008) describe import alerts. They can be informational or can call for intensified surveillance of a particular food product from a particular exporter but can also place an exporter/product on detention without physical examination. Shipments are refused entry into the U.S., unless the exporter provides evidence (such as test results) to the FDA that its product meets FDA standards. These facts suggest that import inspections and refusals are not a result of a random sampling of imports but rather of some kind of Bayesian process. The U.S. policy initially involves random sampling at the border. Importers with a previous nonconformity record are supposed to be classified into the Automatic Detention List, with their next five consecutive shipments subject to inspection. If requirements are satisfied by the 5 shipments, the importer is moved back to the random sampling list. In reality, inspections may not work as described above (Alberini et al., 2008; GAO, 2001 and 2004).

GAO (2001, and 2004) found a myriad of problems with the HACCP program implemented since 1997 by the FDA. With imported products, the FDA does not have equivalence or compliance agreements with any exporting country. U.S. importers are required but not able to demonstrate that imported seafood is produced in accordance with the U.S.

HACCP regulation. When the FDA identifies problems in inspected foreign seafood firms it does not follow up with automatic detention and inspection of products. Few inspections take place: In 1999, less than 1% of imported seafood was subject to laboratory examination. Regarding domestic production, many seafood products are not processed under HACCP because the FDA cannot identify all seafood-processing firms (no registry exists); only the subset of the commercial fishing fleet processing fish on board is subject to HACCP requirements. About 1/3 of seafood products are not required to have a HACCP plan because seafood firms can determine, with FDA acquiescing, that food safety hazards are unlikely. When firms have a HACCP plan, more than half of FDA inspections found violations and the FDA did not issue warning letters in a timely manner. Finally, the FDA does not have objective data to assess the effectiveness of HACCP.

U.S. consumers have recently expressed concerns about FDA inspections. In a recent survey realised by Consumer Reports, two-thirds of respondents said “the FDA should inspect domestic and foreign food-processing facilities at least once a month, more in line with meat inspection practices by USDA” (Consumer Reports, 2008, p.1). While this fact clearly indicates a strong concern by U.S. consumers, no details are given about the willingness to pay (WTP) elicitation or the way to finance such an ambitious inspection program. This void explains why we pay attention to financing aspects.

### **Externality and health cost**

The externality is twofold. First, there is health risk exposure associated with consuming unsafe food, which is not internalized or known by the consumers. A major concern in that regard is the presence of bacteria (such as salmonella, E-coli, or *Listeria monocytogenes*) and the widespread use of chemical products and antibiotics to address this sanitary problem. In developing

countries, seafood producers often use chloramphenicol to fight against bacteria, which leads to traceable residues in consumer products. There is a well established link between aplastic anemia, carcinogenicity, reproductive toxicity, and exposure to chloramphenicol. The science has not established a threshold for low levels of exposure to chloramphenicol. The use of chloramphenicol mitigates unsafe production but provides another risk of its own.

The second externality is the potential development of bacterial resistance to antibiotics associated with excessive use of antibiotics in seafood farms (Duran and Marshall, 2005). The link of chloramphenicol to antibiotic resistance is tedious (World Health Organization, 2001). Although the science is still being established, a precautionary principle would be legitimate.

Consumers have expressed their WTP for safer food and avoid bacteria such as salmonella (Hayes, Shogren, Shin and Kliebenstein, 1995). Roheim Wessells and Anderson (1995) undertake an experimental study to elicit the WTP of Rhode-Island consumers for various seafood safety inspection and assurance programs using contingent valuation methods. Ten safety alternatives were considered. Respondents value specific information the most, such as date caught, catch site, and temperature since caught. The most valued characteristic was date caught valued at 47 cents above the price of USD 4.5 per pound, roughly, a 10% premium. Inspections by retailers and processors were the least valued forms of assurance of seafood safety. The authors also note the limited use of branding in seafood retailing and the lack of incentives to provide information for seafood harvesters. Holland and Roheim Wessells (1998) undertake a similar conjoint analysis for salmon. Strong preferences are elicited for U.S. Department of Agriculture or FDA inspected products relative to non-inspected salmon. The WTP for inspection is much stronger than for production method and price.

The health cost associated with seafood consumption is hard to pin down. The greater ignorance is on the number of seafood-borne illnesses. There is underreporting of cases and

outbreaks, and consumers cannot attribute illness to a specific consumption. The lack of inspection and testing of seafood and long term impact of excessive residues of toxic substances and banned antibiotics contribute to the difficulty to estimate health cost. As noted before, FDA only inspects a small share of seafood imports and detains about 2% of inspected seafood imports and actively tests a subset of these detained goods. Hence, less than 1% of seafood imports are formally tested (GAO, 2009; Allhouse et al., 2003). Domestically, the FDA does better but still relies extensively on self-reporting by producers and processors and only inspects a fraction of domestic seafood output.

### **Cost of HACCP implementation for foreign and domestic producers**

The literature suggests that the implementation cost of food safety standards by foreign producers in developing countries, are initially high. While the fixed cost of doing so is high, the marginal cost of maintaining these standards is small. This marginal cost is even smaller for U.S. domestic seafood producers. Cato and Subasinge (2003) analyze these costs in the shrimp industry in Bangladesh. The EU banned shrimp imports from Bangladesh for sanitary reasons. The ban was costly, representing about USD 15 million in lost revenues from August to December 1997. Some exports resumed in 1998. Bangladesh made significant investments in food safety via HACCP plans. By 1997 the Bangladesh shrimp industry had invested USD 17.6 million in plant upgrades; its government had invested USD 382,000 in laboratory and personnel upgrades and had received a small assistance from FAO (USD 72,000) in training programs. The annual recurring costs to maintain HACCP programs and meet international standards would be about USD 2.2 million for the industry and USD 225,000 for the government.

Cato and Lima dos Santos (2000) conduct a survey of 19 Bangladesh shrimp processing plants in 1998. The average investment per plant to be in compliance with minimum technical

and sanitary standards was USD 277,155. The annual invested amount to maintain a HACCP plan was USD 34,875 per plant. The cost per kilogram for plant upgrades was USD 0.7141 or 6.72% of the 1997 average price received. The marginal cost per kilogram to maintain a HACCP plan was between USD 0.0327 and USD 0.0899, representing between 0.31 and 0.85% of the 1997 average price received. The authors also report moderate investments by the Bangladesh government in laboratories and personnel to monitor HACCP in the shrimp plants of roughly USD 200,000 per year since 1997. The total investments (industry, government and foreign institutions) to upgrade Bangladesh shrimp plants to meet minimum HACCP standards represented 9.4% of export sales for one year. The annual marginal cost to maintain the HACCP plan represents 1.26% of export sales per year. The Government's estimated that USD 14.9 millions were needed to implement the highest levels of HACCP monitoring, which is several orders of magnitude larger than the previously cited figures.

The World Bank (2005) provides a review of the cost in the shrimp industry in Thailand to meet tightened standards on antibiotics (such as the zero tolerance ban applied by the EU). The compliance costs to Thai shrimp farmers are reported as follows. The use of alternative chemicals increases the average cost of production of black tiger shrimp by 5.7% from the conventional chemical-supplemented shrimp farming method. By shifting to probiotic<sup>1</sup> farming, this cost will decrease by 33%. Moving on to compliance of shrimp processors, their costs would be much higher, at USD 328 per ton. As highlighted by the World Bank (2005), the government of Thailand allocates a substantial budget to the shrimp industry. Between 1998 and 2002, 56% of the whole budget for fisheries was devoted to the shrimp industry or USD 5.35 million in 1998 and USD 0.73 million in 2002. The cost of laboratory services is not included in these

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<sup>1</sup> Probiotic supplements are a microbial formulation that maintains water quality.

figures and represents a bit less than USD 10 per ton of shrimp exports. The additional fixed costs to comply with EU requirements on drug residues amount to USD 4,301,790. Finally, International Finance Cooperation (2006) provides numerous examples of programs for improving shrimp quality adopted by various countries but without cost estimations.

Cato (1998) reviews the available estimates on the cost of implementing and complying with HACCP in various U.S. fish and seafood industries. The cost, annualized typically represents less than 0.5% of the price received by producers and processors. The initial cost of implementing HACCP can be high for small plants, but overall the annualized cost is low, past the first year of implementation. For example, the annualized cost of HACCP for the U.S. shrimp processing industry was USD 0.009 per pound, or about 0.3% of the price charged by processors with a pass-through to consumers of USD 0.025 per pound. Similarly, HACCP cost estimates for U.S. blue crab plants hover around USD 0.02 per pound, or 0.33% of processor price. For breaded products, added cost per pound of product for compliance was USD 0.01 for small plants and USD 0.0002 for large plants with no effects on consumer prices. Cost per pound of molluscan shellfish and other products produced were estimated at USD 0.05 for small plants and USD 0.003 for larger plants. Although it is difficult to find more recent estimates of the cost of HACCP, these older figures suggest that these costs are small and smaller than for compliance of a foreign producer.

### **A simple conceptual model**

We consider a parsimonious framework to highlight the essence of forces at work and then to calibrate simulations. A representative foreign producer offers a proportion  $0 \leq \lambda_f \leq 1$  of non-contaminated products meeting the safety standard and a proportion  $(1 - \lambda_f)$  of contaminated



products failing the standard and entailing damage for the importing country.<sup>2</sup> Similarly, a representative domestic producer offers proportions of non-contaminated products meeting the standard and of contaminated products failing the standard and entailing consumer damage as described later.

A foreign producer has a probability  $\gamma_f$  of being inspected when its product reaches the border (the same analysis is developed with probability of being inspected for the domestic producer). When products are inspected, the inspection provides perfect information about the product's safety at a marginal inspection cost  $H$  for the importing country. The inspection procedure is not subject to diagnostic errors for simplicity.<sup>3</sup>

With probability  $(1-\gamma_f)$  the foreign producer is not inspected. This producer is able to sell all products and to benefit from a per unit price for the sold shrimps. A proportion of the products are non-contaminated, that is, there is no health damage for the importing country. A proportion of the foreign products are contaminated and there is a per unit external damage  $e$  for the consumer of the importing country. The proportion is exogenously given, which corresponds to a short-term situation for which producers cannot improve the safety of their products for reacting to an inspection policy. A similar assumption holds for domestic producers.

With probability  $\gamma_f$ , imported shrimps are inspected and a proportion of them pass the standard test and the producer receives the same per unit price  $p$ . A proportion fails the test and the producer loses this proportion of products. In this case, for simplicity we assume there is no

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<sup>2</sup> The proportion  $\lambda_f$  could be interpreted as probability of having non-contaminated products and sell the products on the domestic market. It is assumed predetermined to the policy implementation. Making the proportion endogenous significantly complicates the computation of the optimum inspection rates without offering additional insight on the protectionist potential of the inspection policy under the domestic regulator.

<sup>3</sup> The inspection procedure could be subject to a diagnostic error (false positive test) in an extension.

way to sell and divest the rejected product elsewhere.<sup>4</sup> Other punishment schemes could be conceived. Foreign producers' profits are now briefly discussed.

For a foreign producer with output  $q_f$ , the cost function is  $\frac{1}{2}c_f q_f^2 + k_f(\lambda_f)q_f + K_f(\lambda_f)$  where  $c_f$  is a variable cost parameter.  $k_f(\lambda_f)$  and  $K_f(\lambda_f)$  are respectively the marginal cost and the sunk cost linked to proportion  $\lambda_f$  of safe products. For a same proportion  $\lambda_f$ , these costs may differ from the respective domestic costs,  $k_d(\lambda_d)$  and  $K_d(\lambda_d)$ , to express heterogeneous access to food safety technology and ease of implementation.

We assume that the price received by the foreign producer is parametric (price-taker). For a foreign producer the expected profit is:

$$\pi_f(p, \lambda_f, \gamma_f) = [(1 - \gamma_f) + \gamma_f \lambda_f] p q_f - \frac{1}{2} c_f q_f^2 - k_f(\lambda_f) q_f - K_f(\lambda_f) \quad (1)$$

Profit maximization yields individual firm supply functions before the inspection equal to:

$$q_f^s(p, \lambda_f, \gamma_f) = \frac{[(1 - \gamma_f) + \gamma_f \lambda_f] p - k_f(\lambda_f)}{c_f} \quad (2)$$

By taking into account the probability of inspection and the proportion of safe products, the foreign supply effectively sold by the foreign producer (after the inspection) is:

$$Q_f^s(p, \lambda_f, \gamma_f) = [(1 - \gamma_f) + \gamma_f \lambda_f] q_f^s(p) = [(1 - \gamma_f) + \gamma_f \lambda_f] \frac{[(1 - \gamma_f) + \gamma_f \lambda_f] p - k_f(\lambda_f)}{c_f} \quad (3)$$

Using a similar approach for domestic producers, we assume that their expected profit is:

$$\pi_d(p, \lambda_d, \gamma_d) = [(1 - \gamma_d) + \gamma_d \lambda_d] p q_d - \frac{1}{2} c_d q_d^2 - k_d(\lambda_d) q_d - K_d(\lambda_d) \quad (4)$$

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<sup>4</sup> A drastic sanction is assumed in this chapter, since a rejected shipment is not necessarily destroyed and could be used for animal feeding or redirected to other markets. It is also possible to consider less drastic sanctions as monetary penalties. However the lower monetary penalty, the higher is the number of inspections necessary for maintaining incentives.

where notations linked to subscript  $d$  have a similar interpretation to the one detailed for foreign producers. The domestic supply effectively sold by domestic producers (after the inspection) is:

$$Q_d^s(p, \lambda_d, \gamma_d) = [(1 - \gamma_d) + \gamma_d \lambda_d] \frac{[(1 - \gamma_d) + \gamma_d \lambda_d]p - k_d(\lambda_d)}{c_d} \quad (5)$$

The demand of a representative consumer is derived from a quasi-linear utility function that consists of quadratic preferences for the market good of interest and an additive numéraire:

$$U(q, v) = aq - Irq - bq^2 / 2 + v \quad (6)$$

Where  $q$  is the consumer's consumption of shrimps and  $v$  is the numéraire. The terms  $a, b > 0$  allow capturing the immediate satisfaction of the consumer from consuming shrimps.

The effects of externalities are captured by the term  $-Irq$ . The binary parameter  $I$  represents the consumer knowledge regarding the specific characteristic brought by the bad shrimps; the aversion brought by bad products is captured by the negative sign and by parameter  $r$ , the overall damage per unit consumed. If consumers are unaware of the specific characteristic or if there is an unaccounted externality linked to the specific characteristic, then  $I=0$ . Conversely,  $I=1$  means that consumers are aware of the specific characteristic and internalize the externality and reduce their consumption. We assume that consumers are not aware of the specific characteristic ( $I=0$ ).<sup>5</sup> The maximization of the consumer utility under budget constraint ( $v + pq = R$ ) leads to the demand  $Q^d(p) = (a - p) / b$ . The consumer surplus is then  $U(Q^d(p), R - pQ^d(p))$ .

The expected damage per unit of consumption  $r$  is not internalized by consumers and is

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<sup>5</sup> This assumption can be relaxed particularly with intense press coverage or by the effect of the country-of-origin labeling (COOL) program that may lead to product differentiation based on the origin, when safety levels differ according to the origin.

defined as following. Recall that if foreign products are not inspected with a probability  $(1 - \gamma_f)$ , contaminated foreign products enter the market in a proportion  $(1 - \lambda_f)$ . Foreign supplies are inspected with a probability  $\gamma_f$  under which no contaminated products enter the market. With a per unit damage  $e$ , the expected per unit damage linked to foreign products (after the inspection stage) is given by  $r_f = [(1 - \gamma_f)(1 - \lambda_f)]e$  and the expected per unit damage linked to domestic products (after the inspection) is given by  $r_d = [(1 - \gamma_d)(1 - \lambda_d)]e$ . The expected damage per sold unit is defined by  $r = [r_f Q_f^s(p) + r_d Q_d^s(p)] / [Q_f^s(p) + Q_d^s(p)]$ .

For a situation with given values of  $\gamma_d$  and  $\gamma_f$ , the equilibrium price clears the market by equalizing demand and overall supply leading to an equilibrium quantity  $Q_A$ . Fig. 1 shows domestic demand ( $D$ ), foreign supply ( $S_F$ ) and the total supply ( $S$ ) (the domestic supply is omitted for clarity). The price,  $p$ , is located on the vertical axis and the quantity,  $q$ , is shown along the horizontal axis.

Take in Fig. 1

In Fig. 1,  $Q_A^f$  is the foreign output and  $Q_A$  is total output (local plus foreign). The gross profits correspond to area  $0wvp^A$  for foreign producers (since sunk costs are zero) and area  $wzAv$  for domestic producers. The usual surplus of domestic consumers corresponds to area  $p^A Aa$ . The damage linked to contaminated products does not impact the demand since  $I=0$ . However, the cost of ignorance from the external health cost should be accounted for in the welfare calculations and is represented by the area  $0rtQ_A$ . Domestic welfare is the sum of domestic profits, consumer surplus, cost of ignorance, and overall cost of inspection. This welfare is given by area  $p^A vwzAa - 0rtQ_A$  when the cost of inspection is zero. International welfare is the sum of domestic welfare and foreign producer surplus and is given by area  $0zAa - 0rtQ_A$  when the cost of

inspection is zero. Reinforcing the inspection policy leads to a shift of supply functions to the left, since it reduces the possibility for dangerous products to enter the market. However, this reduces the expected per unit damage  $r$  influencing the cost of ignorance. The regulatory choice balances the negative and positive marginal impacts of inspection policies on welfare.

With both domestic and foreign products having some probability of being inspected at a marginal cost  $H$ , the overall cost of inspection to the policy maker is  $H[\gamma_d q_d^S(p, \lambda_d, \gamma_d) + \gamma_f q_f^S(p, \lambda_f, \gamma_f)]$ . For an equilibrium price  $p^A$ , the domestic welfare is:

$$W_d(\gamma_d, \gamma_f) = \pi_d(p^A, \lambda_d, \gamma_d) + U(Q^d(p^A), R - p^A Q^d(p^A)) - Q_f^S(p^A) r_f - Q_d^S(p^A) r_d - H[\gamma_d q_d^S(p, \lambda_d, \gamma_d) + \gamma_f q_f^S(p, \lambda_f, \gamma_f)] \quad (7)$$

Recall that  $r_f = [(1 - \gamma_f)(1 - \lambda_f)]e$  and  $r_d = [(1 - \gamma_d)(1 - \lambda_d)]e$ . The domestic regulator abstracts from the foreign producers' profit for determining its policy. The international global welfare includes foreign producers and is defined by:

$$W_i(\gamma_d, \gamma_f) = \pi_f(p^A, \lambda_f, \gamma_f) + W_d(\gamma_d, \gamma_f) \quad (8)$$

The “domestic” regulator maximizes the domestic welfare given by (7), while the regulator caring about global welfare maximizes the international welfare given by (8).

We now turn to the determination of the optimal frequencies of inspection  $\gamma_d$  and  $\gamma_f$ . For the domestic regulator, the first-order conditions are given by:

$$\begin{cases} \frac{\partial W_d(\gamma_d^*, \gamma_f^*)}{\partial \gamma_d} = 0 \\ \frac{\partial W_d(\gamma_d^*, \gamma_f^*)}{\partial \gamma_f} = 0 \end{cases} \quad (9)$$

and with the second-order conditions for concavity being satisfied. For the “international” regulator, the first-order conditions are given by:

$$\begin{cases} \frac{\partial W_i(\gamma_d^{**}, \gamma_f^{**})}{\partial \gamma_d} = 0 \\ \frac{\partial W_i(\gamma_d^{**}, \gamma_f^{**})}{\partial \gamma_f} = 0 \end{cases} \quad (10)$$

with a similar check on second order conditions.

Despite the simple setup, the social planners' problems cannot be solved analytically and we resort to simulations. Before introducing the calibration linked to the shrimp market in the U.S., we introduce basic simulations to highlight underlining important mechanisms.

One simple but illuminating case consists in assuming symmetric producers and no cost for food safety, implying  $\lambda_f = \lambda_d$ ,  $c_f = c_d$ ,  $K_f(\lambda) = K_d(\lambda) = 0$ , and  $k_f(\lambda) = k_d(\lambda) = 0$ . For a heuristic purpose, we fix exogenous proportions  $\lambda_f = \lambda_d = 0.5$ , demand intercept  $a=25$ , cost  $c_f = c_d = 2$ , per unit damage  $e=15$ , and marginal cost of inspection  $H=2$ .

Fig. 2 clearly shows that the inspection policies crucially differ when the objectives to maximize are domestic or global as defined by (7) and (8). When the domestic welfare is maximized the inspection processes differ with a frequency of control  $\gamma_f^* = 1$  imposed on foreign producers and a frequency of control  $\gamma_d^* = 0$  imposed on domestic producers, despite the strict similarity between producers (see the left chart).<sup>6</sup> By imposing all the controls on the foreign producers the regulator limits the externality coming from the consumption and foreign producers profit decreases because of the complete elimination of the proportion  $(1 - \lambda_f)$  of tainted products. Domestic producers benefit from this elimination since the equilibrium price

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<sup>6</sup> Exclusion of foreign producers could occur when proportion  $(1 - \lambda_f)$  of tainted products is relatively high leading to a negative profit in (1). Marette (2007) and Marette and Beghin (2010) detail the producers' exclusion/exit linked to regulation.

increases after the elimination of foreign-tainted products.

Take in Fig. 2

Conversely, when international welfare is maximized the optimum inspection rates  $\gamma_d^{**} = \gamma_f^{**} = 0.31$  are similar for all producers because of the strict similarity between producers (see the right chart). By imposing similar controls on domestic and foreign producers, the international regulator limits the externality by equally sharing the effort induced by the partial elimination of tainted products. Note that  $\gamma_d^{**} + \gamma_f^{**} < \gamma_f^* = 1$ , which means that the effort imposed by the domestic regulator is higher than the cumulated effort imposed by the international regulator taking into account the foreign profits. To sum up, there is a distortion in the domestic choice compared to the international choice. This result was not underlined by the previous literature.

Compared to Fig. 2, we may consider numerous situations with different parameters. For instance, when health risks differ with safer domestic food ( $\lambda_f < \lambda_d$ ), the optimal controls maximizing the international welfare are such that  $\gamma_d^{**} < \gamma_f^{**}$ . The global planner would seemingly be protectionist. More controls are imposed on foreign producers compared to domestic producers because foreign products are not as safe as domestic products. With everything else equal, the change of the foreign proportion  $\lambda_f = 0.3$  leads to a policy maximizing the international welfare and defined by the inspection frequencies  $\gamma_f^{**} = 0.64$  and  $\gamma_d^{**} = 0.09$ , while inspection frequencies  $\gamma_f^* = 1$  and  $\gamma_d^* = 0$  still maximize domestic welfare. From the international welfare defined by (8), it is legitimate to differentiate the inspection policy with  $\gamma_f^{**} > \gamma_d^{**}$  since  $\lambda_f < \lambda_d$ . This is an interesting result since the possibility of legitimate discrimination readily arises from the difference in the proportions of safe products  $\lambda_f$

and  $\lambda_d$ . The evaluation of the inspection policy maximizing the international welfare is crucial to characterize policies as protectionist or not, with  $\gamma_f^{**} < \gamma_f^*$  in the sense of Fisher and Serra (2000).

### The shrimp application

The model previously described is calibrated to estimate welfare effects linked to welfare-maximizing inspection rates which are implemented as inspection reinforcements over some initial arbitrary pre-existing levels. Prior to the reinforcement of the inspection, parameters of the model are initially calibrated such as to replicate prices and quantities of the U.S. shrimp market for 2006 (see Table 1).

With the observed quantity sold  $\hat{Q}$ , the observed price  $\hat{p}$ , and the direct price elasticity  $\mathcal{E} (= p \cdot dQ^D / (Q^D \cdot dp))$  obtained from econometric estimates whose sources are indicated in Table 1, the calibration leads to estimated values for the demand parameters equal to  $1/\beta = -\hat{Q}/\hat{p}$ ,  $\alpha = \beta\hat{Q} + \hat{p}$ . For the supply side, both domestic and foreign supplies are calibrated with the same price elasticity of supply. With the baseline scenario for 2006 (before the reinforcement of the policy), the calibration of (3) and (5) is made for an initial inspection equal to  $\gamma = 0.01$ .<sup>7</sup> The parameters used for the calibration are presented in Table 1.

**Table 1. Values of parameters in 2006 for the calibrated model of the U.S. shrimp market**

Variable	Value
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<sup>7</sup> With the baseline scenario (before the reinforcement of the policy), it could be assumed that the initial inspection rate is equal to 0.01 or  $\gamma = 0.01$  (close to the official statistics reported in Southern Shrimp Alliance, 2007 or in GAO, 2001).



Consumption in 2006 (thousands of tons)	732.6
Imports in 2006 ( thousands of tons)	593.7
Domestic production for the domestic market in 2006 ( thousands of tons)	138.9
Price <sup>1</sup> in 2006 (USD)	6.97
Own-price elasticity of demand <sup>2</sup>	-1.01
Own-price elasticity of supply <sup>3</sup>	0.77

Notes: Quantities and prices in 2006 come from FAO (2009).

<sup>1</sup> The domestic price is estimated by dividing the value of imports by the quantity of imports (FAO, 2009), since the import price is equal to the domestic price by arbitrage.

<sup>2</sup> Hudson et al. (2003) for shrimps in the U.S. by taking the average of own prices elasticities of demand over the 4 destinations in Table 4 (p.236).

<sup>3</sup> International Institute for Fisheries Economics and Trade (2004) for the aquaculture of shrimps by taking the average of own prices elasticities of demand over the top 5 world producers of shrimps in Table 3 (p.5).

The following simulations provide useful information in a context where data linked to border inspections are difficult to collect. Ababouch et al. (2005) in their exhaustive study of border cases mention these difficulties arising from complex access to and treatment of data. The parameters selected for the simulation show diverse plausible situations that could emerge.

Several cases for the value of the per unit damage  $e$  are presented in the simulations. For ease of interpretation, this damage can be expressed as a percentage of the initial-equilibrium price  $p$  used in the baseline scenario. We now turn to the results.

Table 2 presents surplus variation between different situations. Four cases are presented to account for potential sensitivity to some parameters. The first column details the surplus variation for different agents coming from maximizing the *domestic* welfare with  $\gamma_f^*$  and  $\gamma_d^*$  (optimal values given parameters in Table 1) compared to the baseline calibration with  $\gamma_f = \gamma_d = 0.01$ . A positive variation for an agent means a gain coming from the optimal domestic policy. The second column details the surplus variation coming from maximizing the *international* welfare with  $\gamma_f^{**}$  and  $\gamma_d^{**}$  (optimal values given parameters in Table 1) compared to the baseline scenario with  $\gamma_f = \gamma_d = 0.01$ . The third column presents surplus differences under the maximized international and domestic welfares. For each row, the value in column 3 is the

difference between column 2 and column 1. All the scenarios assume a relative low cost of inspection ( $H=0.1$ )

**Table 2. Surplus variation between different scenarios for 2006 (million USD and %)**

<b>Case 1:</b> High per unit damage $e$ . Equal foreign and domestic shares of safe food $H=0.1$ , $\lambda_f = \lambda_d = 0.6$ , $e=p$	<b>Domestic vs. baseline</b>	<b>International vs. baseline</b>	<b>International vs. domestic</b>
Optimum probabilities of inspection	$\gamma_f^* = 1, \gamma_d^* = 0$	$\gamma_f^{**} = 0.29, \gamma_d^{**} = 0.29$	$\gamma_f^{**} = 0.29, \gamma_d^{**} = 0.29$
Reference probabilities of inspection	$\gamma_f = \gamma_d = 0.01$	$\gamma_f = \gamma_d = 0.01$	$\gamma_f^* = 1, \gamma_d^* = 0$
Domestic consumers and cost of ignorance (surplus variation)	822.3 (162%)	403.5 (79%)	-418.8 (-82%)
Domestic producers (profit variation)	171.8 (29%)	-64.9 (-11%)	-236.6 (-40%)
Domestic welfare (with cost of controls)	948.5 (86%)	317.8 (29%)	-630.7 (-57%)
Foreign exporters (profit variation)	-1,091.0 (-43%)	-277.4 (-11%)	813.6 (32%)
International welfare (variation)	-142.5 (-3%)	40.4 (1%)	182.9 (5%)
<b>Case 2:</b> High per unit damage $e$ . Safer domestic food (higher domestic share). $H=0.1$ , $\lambda_f = 0.6$ , $\lambda_d = 0.7$ , $e=p$	<b>Domestic vs. baseline</b>	<b>International vs. baseline</b>	<b>International vs. domestic</b>
Optimum probabilities of inspection	$\gamma_f^* = 1, \gamma_d^* = 0$	$\gamma_f^{**} = 0.33, \gamma_d^{**} = 0.01$	$\gamma_f^{**} = 0.33, \gamma_d^{**} = 0.01$
Reference probabilities of inspection	$\gamma_f = \gamma_d = 0.01$	$\gamma_f = \gamma_d = 0.01$	$\gamma_f^* = 1, \gamma_d^* = 0$
Domestic consumers and cost of ignorance (surplus variation)	835.6 (138%)	368.7 (61%)	-467.0 (-77%)
Domestic producers (profit variation)	170.8 (28%)	46.3 (7%)	-124.5 (-21%)
Domestic welfare (with cost of controls)	960.9 (80%)	396.0 (33%)	-564.9 (-47%)
Foreign exporters (profit variation)	-1,090.8 (-43%)	-357.0 (-14%)	733.8 (29%)
International welfare (variation)	-129.9 (-3%)	39.0 (1%)	168.9 (4%)
<b>Case 3:</b> Very high damage per unit $e$ . Equal foreign and domestic shares of safe food. $H=0.1$ , $\lambda_f = \lambda_d = 0.6$ , $e=2p$	<b>Domestic versus baseline</b>	<b>International vs. baseline</b>	<b>International vs. domestic</b>
Optimum probabilities of inspection	$\gamma_f^* = 1, \gamma_d^* = 1$	$\gamma_f^{**} = 1, \gamma_d^{**} = 1$	$\gamma_f^{**} = 1, \gamma_d^{**} = 1$
Reference probabilities of inspection	$\gamma_f = \gamma_d = 0.01$	$\gamma_f = \gamma_d = 0.01$	$\gamma_f^* = 1, \gamma_d^* = 1$
Domestic consumers and cost of ignorance (surplus variation)	3,088.8 (203%)	3,088.8 (203%)	0 (0%)
Domestic producers (profit variation)	-234.1 (-39%)	-234.1 (-39%)	0 (0%)
Domestic welfare (with cost of controls)	2,796.8 (301%)	2,796.8 (301%)	0 (0%)
Foreign exporters (profit variation)	-1,001.1 (-39%)	-1,001.1 (-39%)	0 (0%)
International welfare (variation)	1,795.8 (112%)	1,795.8 (112%)	0 (0%)
<b>Case 4:</b> Very low damage per unit $e$ .	<b>Domestic vs.</b>	<b>International vs.</b>	<b>International</b>

Equal foreign and domestic shares of safe food. $H=0.1$ , $\lambda_f=\lambda_d=0.6$ , $e=0.3p$	baseline	baseline	vs. domestic
Optimum probabilities of inspection	$\gamma_f^* = \gamma_d^* = 0$	$\gamma_f^{**} = \gamma_d^{**} = 0$	$\gamma_f^{**} = \gamma_d^{**} = 0$
Reference probabilities of inspection	$\gamma_f = \gamma_d = 0.01$	$\gamma_f = \gamma_d = 0.01$	$\gamma_f^* = \gamma_d^* = 0$
Domestic consumers and cost of ignorance (surplus variation)	1.7 (0.08%)	1.7 (0.08%)	0 (0%)
Domestic producers (profit variation)	2.2 (0.3%)	2.2 (0.3%)	0 (0%)
Domestic welfare (with cost of controls)	3.9 (0.1%)	3.9 (0.1%)	0 (0%)
Foreign exporters (profit variation)	9.3 (0.3%)	9.3 (0.3%)	0 (0%)
International Welfare (variation)	13.2 (0.2%)	13.2 (0.2%)	0 (0%)

Note: Relative variation (%) compared to the baseline scenario (in columns 1 and 2) and to the domestic welfare (in column 3) in parentheses.

We first discuss case 1 of Table 2, for which the per unit damage  $e$  is high and equal to the initial price  $p$  of the baseline scenario. Recall from Fig. 1, that the higher the inspection policy, the higher is the price increase and the related distortions. Domestic consumers and producers prefer the domestic policy defined by  $\gamma_f^*, \gamma_d^*$  (first column) compared to the international policy defined by  $\gamma_f^{**}, \gamma_d^{**}$  (second column), which explains a negative third column. Under the domestic policy, consumers benefit from the high-domestic controls  $\gamma_f^*=1$  imposed on foreign producers and reducing the expected damage per sold unit. The overall damage reduction coming from the higher inspection relative to what it would be under the international policy outweighs the consumer loss linked to the greatest price distortion. Domestic producers also benefit from the high-domestic control  $\gamma_f^*=1$  imposed on foreign producers compared to what it would be under international controls. They benefit from a price increase without any quantity reduction because of  $\gamma_d^*=0$ . However, for foreign producers who lose under both schemes, the international policy defined by  $\gamma_f^{**}, \gamma_d^{**}$  (second column) is less distortive than the domestic policy defined by  $\gamma_f^*, \gamma_d^*$  (first column) with  $\gamma_f^* > \gamma_f^{**} + \gamma_d^{**}$ , which explains a positive third column. Aggregate international welfare decreases relative to the baseline scenario

when the domestic policy menu  $(\gamma_f^*, \gamma_d^*)$  is selected (first column), whereas international welfare increases when the international policy is selected (second column). The domestic policy is deemed protectionist since  $\gamma_f^* > \gamma_f^{**}$  and  $\gamma_d^* < \gamma_d^{**}$ , in the spirit of Fisher and Serra (2000). Note that the variations of the international welfare are low while the variations for domestic agents or foreign producers are large, that is, transfers among agents are large. In the first column, the negative variation of the international welfare when the domestic policy is imposed means that the foreign-producers' loss offsets the gains of domestic producers and consumers.

Case 2 keeps the high per unit damage and introduces a larger domestic share of safe output. The case shows it is legitimate (non protectionist) from the international point of view to impose a higher level of control on foreign producers compared to domestic producers, with  $\gamma_f^{**} > \gamma_d^{**}$ , because of a higher risk for foreign products with  $\lambda_f = 0.6$  and  $\lambda_d = 0.7$ . Foreign exporters, especially from developing countries, tend to have a lower expected quality because meeting the standard is relatively more costly and inspections are uncertain, two documented stylized facts for shrimps. As case 1 does, case 2 shows that the domestic regulator imposes an excessive level of inspection because of the relationship  $\gamma_f^* > \gamma_f^{**} + \gamma_d^{**}$ . The inspection rates are protectionist because  $\gamma_f^* > \gamma_f^{**}$  and  $\gamma_d^* < \gamma_d^{**}$ . Observing the inspection level for domestic firms lower than the inspection level for foreign firms is not the appropriate criteria, but rather one should compare their respective levels under domestic and international regulators.

Case 3 assumes a very high value of the per-unit damage  $e$  and similar foreign and domestic safety levels. In this case the optimum domestic policy corresponds to the foreign policy since the relatively high damage requires a systematic control of all products. Indeed both probabilities under both welfare maximizations reach the maximum equal to one, while the

expected damage  $r$  completely disappears since no tainted products are consumed.

In case 4, there is no protectionism since the controls would be counterproductive and they are equal to zero under both “maximized” domestic and international welfare.<sup>8</sup> Domestic consumers slightly benefit from the reduction of inspections compared to the baseline scenario because of relatively low damage  $e$  and savings from not implementing costly inspections and the absence of price distortion through inspections.

Making  $\lambda_f, \lambda_d, \gamma_f, \gamma_d$  jointly endogenous leads to complex computations with multiple roots. However, the choice of  $\lambda_f, \lambda_d$  is subject to the same differences when domestic welfare and international welfare are taken into account. In the following example using parameters of Table 1, we restrict our attention to a situation with an inspection policy  $\gamma_d = \gamma_f = 0.3$ , marginal costs  $k_f(\lambda_f) = k_d(\lambda_d) = 0$  and fixed safety costs  $K_f(\lambda_f) = 1000000000(\lambda_f)^2$  and  $K_d(\lambda_d) = 500000000(\lambda_d)^2$ . These values guarantee concavity of profits functions and positive profits with  $0 \leq \lambda_d \leq 1, 0 \leq \lambda_f \leq 1$ .

As firms face a probability of being controlled, the maximization of the firms' profits leads to the selection of  $\lambda_d' = 0.25, \lambda_f' = 0.42$ . Despite the cost differences, the effort by foreign producers is higher than the one by domestic producers, since the higher market share for foreign

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<sup>8</sup> The value of  $e$  for case 4 is likely to correspond to the one provided by experimental studies or by consumers' surveys. The percent price premium for safe products over conventional product is equal to 30%. We draw on the value suggested by Hayes et al. (1995) for the U.S. They found respondents willing to pay 15% to 30% more for food safe from five pathogens in the U.S., including salmonella. We could retain a value equal to  $w=0.3$ . We apply the price  $p$  used for the initial calibration, which means that the per-unit damage is equal to  $e=0.3p$  (as in case 4 of table 2) for each country and leads to the cost of ignorance.

producers allow them to bear a larger sunk cost. We now turn to decisions taken by a regulator maximizing the domestic welfare or the international welfare and imposing the same standard on foreign and domestic producers. The regulator maximizing the domestic welfare would select a standard  $\lambda^* = 1$  imposed to all firms. The regulator maximizing the international welfare would select a standard  $\lambda^{**} = 0.85$ . As for the inspection policy, the domestic regulator will try to impose a higher standard since the fixed cost  $K_f(\lambda_f)$  is only incurred by the foreign producers and not passed on to the domestic consumers. Note that the characterization of the protectionism is based on the comparison between  $\lambda^* = 1$  (namely, the domestic choice) and  $\lambda^{**} = 0.85$  (the international choice) and not on the comparison between  $\lambda^* = 1$  (the domestic choice) and  $\lambda_f' = 0.42$ , that is, the private choice by the foreign firms reacting to the inspection policy  $\gamma_d = \gamma_f = 0.3$ . The comparison between a policy maximizing the domestic welfare and a policy maximizing the international welfare is necessary for delineating the frontier between the legitimate regulation reducing the consumer's damage and the protectionism injuring foreign producers.

Protectionist, discriminatory pressures and possible distortions imposed on foreign producers are not limited to the probabilities of inspection or phyto-sanitary standards. Another important regulatory decision considered here deals with alternative ways to finance controls and their implications for welfare and potential protectionism. This problem has been overlooked by the previous literature.

### **How to finance inspections?**

This section complements the previous one, since it also shows that the way to finance the inspection may also have protectionist consequences. For selected levels of inspection decided

by the regulator (as in the previous section), alternative ways to finance inspection could be selected. Two fiscal instruments can be considered, namely, a fixed fee (whatever the quantity sold) and a per-unit fee imposed on firms. For simplifying the analysis, those fees are the same for foreign and domestic producers, which differs from the previous section where discriminations were possible.

To further simplify the analytical expressions, we keep the previous notations and we assume a symmetric configuration for producers with  $\lambda_f = \lambda_d = \lambda$ ,  $c_f = c_d = c$ ,  $\gamma_f = \gamma_d = \gamma$ . Moreover, we assume  $k(\lambda) = K(\lambda) = 0$  and  $b = 1$  for the demand parameter in (6). Obviously, the results of this section could be combined with the previous results defining different probabilities  $\gamma_f$  and  $\gamma_d$ . We can rewrite the profit previously defined by (1), as:

$$\pi_f(p, \lambda, \gamma, g, G) = [(1 - \gamma) + \gamma\lambda]pq_f - \frac{1}{2}c_fq_f^2 - g[(1 - \gamma) + \gamma\lambda]q_f - G \quad (11)$$

with a fixed fee  $G$  paid by the producer and a per-unit fee  $g$  paid per sold unit. These fees account for refused goods as showed in (13) below. Note that, after the inspection, the sold units are  $[(1 - \gamma) + \gamma\lambda]q_f$  for foreign producers. The profit maximization yields individual firm supply function before the inspection equal to:

$$q_f^s(p) = \frac{[(1 - \gamma) + \gamma\lambda]p - \gamma g}{c} \quad (12)$$

with  $[(1 - \gamma) + \gamma\lambda]q_f^s(p)$  corresponding to the supply function after the inspection (the same can be done for domestic producers). Note that the fixed fee  $G$  does not influence the chosen output but only impacts the profit. It is chosen such that the budget constraint of the regulator is satisfied. Similarly to the previous section, the equilibrium price is  $p^A$ . With the per-unit fee  $g$  paid for each sold unit and the fixed fee  $G$ , the budget constraint linked to the inspection and the fees is:

$$H\gamma[q_d^S(p^A) + q_f^S(p^A)] = g[(1-\gamma) + \gamma\lambda][q_d^S(p^A) + q_f^S(p^A)] + 2G \quad (13)$$

where  $\gamma$  is the probability of inspection applied to output and  $H$  is the marginal cost of inspection.

The per-unit fee  $g$  paid per sold units accounts for all inspected units including the withdrawn units. With an expected damage per sold unit  $r_f = r_d = r$  and with sold products

$Q(p^A) = [(1-\gamma) + \gamma\lambda][q_d^S(p^A) + q_f^S(p^A)]$ , the domestic welfare previously given by (7) is defined

by:

$$W_d = \pi_d(p^A, \lambda, \gamma, g, G) + U(Q(p^A), R - p^A Q(p^A)) - rQ(p^A) \quad (14)$$

with  $r = [(1-\gamma)(1-\lambda)]e$ . The international welfare is defined by:

$$W_f = \pi_f(p^A, \lambda, \gamma, g, G) + W_d \quad (15)$$

For given values of  $\lambda$  and  $\gamma$ , the domestic regulator maximizes the domestic welfare given by (14) subject to (13), while the international regulator maximizes the international welfare given by (15) subject to (13). Result 1 and Fig. 3 are useful to illustrate the financing choices by a regulator balancing the budget defined by (13). The per-unit fee  $g$  is located along the horizontal axis and the welfare along the vertical axis.

**Result 1.** *When domestic welfare is maximized, the per-unit fee paid by all producers is:*

$$g^* = \frac{[c + 2(1 + \gamma(1 - \lambda))^2][\gamma H + 2e(1 - \gamma)[(1 - \gamma) + \gamma\lambda](1 - \lambda)] - 2a[(1 - \gamma) + \gamma\lambda]^3}{c[(1 - \gamma) + \gamma\lambda]}, \text{ linked to a}$$

$$\text{fixed fee } G^* = \frac{(a - g^*)[\gamma H - g^*(1 - \gamma(1 - \lambda))](1 - \gamma(1 - \lambda))}{c + 2(1 - \gamma(1 - \lambda))^2}.$$

*When the international welfare is maximized, the per-unit fee paid by all producers: is*

$$g^{**} = \frac{\gamma H + e(1 - \gamma)(1 - \lambda)[(1 - \gamma) + \gamma\lambda]}{(1 - \gamma) + \gamma\lambda}, \text{ and with fixed fee}$$

$$G^{**} = \frac{(a - g^{**})[\gamma H - g^{**}(1 - \gamma(1 - \lambda))](1 - \gamma(1 - \lambda))}{c + 2(1 - \gamma(1 - \lambda))^2}.$$



Result 1 shows that the selected fees are completely different because of different welfare criteria. When the international welfare is maximized, the per-unit fee  $g^*$  is positive and greater than the fee  $x = \gamma H / [(1 - \gamma) + \gamma \lambda]$  that would satisfy (13) with  $G=0$  (see  $x$  in Fig. 3). It is socially optimal to internalize the cost of inspection into the price, as well as the per unit damage  $r = e(1 - \gamma)(1 - \lambda)$  as a Pigouvian tax. As  $g^{**} > \gamma H / [(1 - \gamma) + \gamma \lambda]$ , the corresponding fixed fee  $G^{**}$  is negative to balance the budget, which means that firms receive a fixed subsidy that partially compensates the incurred cost linked to the per-unit fee  $g^{**}$ . This is an interesting result since it rationalizes having HACCP bankrolled by the domestic regulator (see the previous section on HACCP). Note that with this mechanism, consumers and firms finance the inspection since the per-unit fee  $g^*$  is passed onto consumers via the equilibrium price.

Take in Fig. 3

When the domestic welfare is maximized, the per-unit fee  $g^*$  is negative for relatively medium-values of  $H$  and the corresponding fixed fee  $G^*$  is positive to balance budget constraint (13). It means that both firms mainly finance the inspection with a fixed fee that is not passed on to consumers into the price. This allows the domestic regulator to finance the inspection policy via the fixed fee that is incurred by domestic and foreign firms. One part of the financing is passed onto foreign firms (and countries) and not passed onto domestic consumers. The domestic choice is distorted compared to international one because the foreign country bears a larger share of the financing. As foreign producers are not considered in the domestic welfare, it is optimal to use the fixed fee not passed on to consumers. This result was overlooked in the previous literature on inspection that does not broach international trade *per se*. When  $H$  is relatively large, the fee  $g^*$  is positive.

The domestic mechanism  $(g^*, G^*)$  can be judged protectionist compared to the international mechanism  $(g^{**}, G^{**})$  since the domestic mechanism decreases the foreign profit, compared to a situation maximizing the international welfare.

This simple model of financing may lead to extensions. In particular, the exclusion of foreign producers could be studied. The financing instruments could be different between foreign and domestic producers, which would re-enforce the discrimination and the protectionism with higher positive fees imposed on foreign producers compared to domestic producers. The domestic regulator could be tempted to select fees such that the foreign profit is negative leading to foreign producers' exit ( $\pi_f(p^A, \lambda, \gamma, g, G) < 0$ ). This possibility would reinforce the distortion of the domestic choice compared to the international choice. Eventually, another extension could restrict the analysis to welfare maximization for which both  $g$  and  $G$  are positive. This additional constraint can be added as the positive values of the fees for limiting the firms' transfers. In this case, choices are the following. When the international welfare is maximized, the per-unit fee paid by all producers is  $x = \gamma H / [(1 - \gamma) + \gamma \lambda]$ , linked to a fixed fee  $G$  equal to 0 as implied by the budget constraint (13) (see  $x$  on Fig. 3). When domestic welfare is maximized, the per-unit fee paid by all producers is zero, linked to a fixed fee  $G^{**} > 0$  to balance the budget. The interpretation of this result is similar to the one given after result 1.

## Conclusion

This chapter explores the potential protectionism of food safety inspection system to implement a standard and its influence on safety choices by foreign and domestic producers selling food in the domestic market. Inspections play a key role to turn safety standards into a discriminatory implementation of the food standard, leading de facto to discriminatory effective or implemented

standards, often raising the average quality of imports above that of domestic goods. The way these inspections are financed can also re-enforce the protectionist nature of the inspections. All these effects occur in absence of any rent seeking by firms. Even when considering global welfare, discriminatory non protectionist inspections can arise if domestic and foreign firms have heterogeneous cost structures.

This chapter suggests that more attention should be given to the way domestic and foreign products are inspected and the way these inspections are financed. Whatever the instrument (inspection, standard or fees for financing the regulation), we show the comparison between a policy maximizing the domestic welfare and a policy maximizing the international welfare is necessary for delineating legitimate regulation reducing the consumer' damage from protectionism injuring foreign producers. A larger question is what should policy maker do in light of non discriminatory principles in trade agreements? For example, domestic treatment under the World Trade Organization would suggest that these differences in inspection rates and their financing may be inconsistent with the Agreement.

The empirical analysis raise interesting issues related to the actual U.S. policy. It seems to be neither a protectionist policy nor a catalyst, given its very low frequency of inspections. Despite some shortcomings, welfare measures developed in this chapter help streamline the amount of money earmarked to public-inspection programs. In essence, more attention should be given to the economic analysis of food safety of shrimps and to the optimal inspection policy at the border and in domestic plants and its welfare effects.

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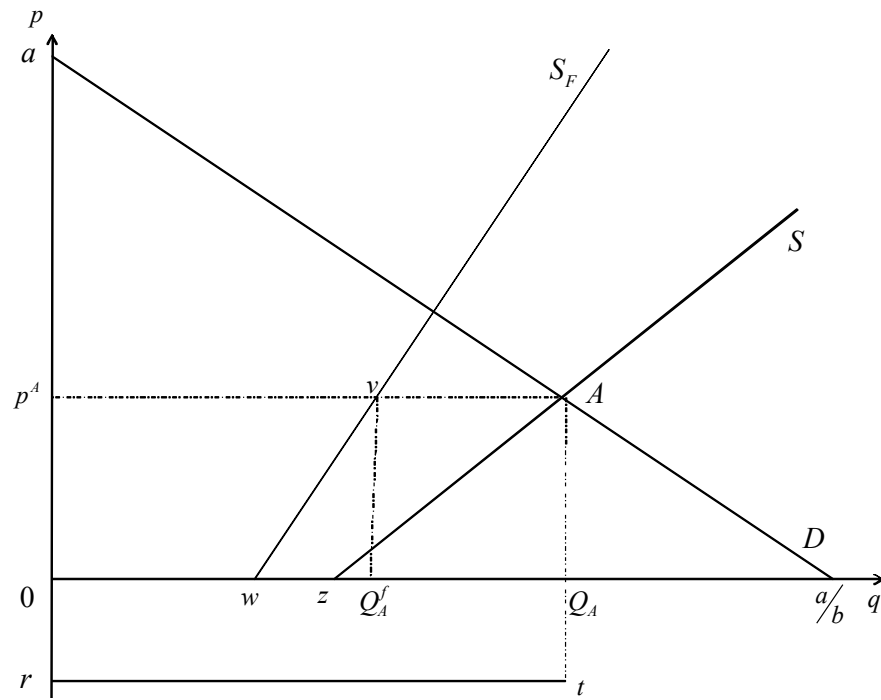
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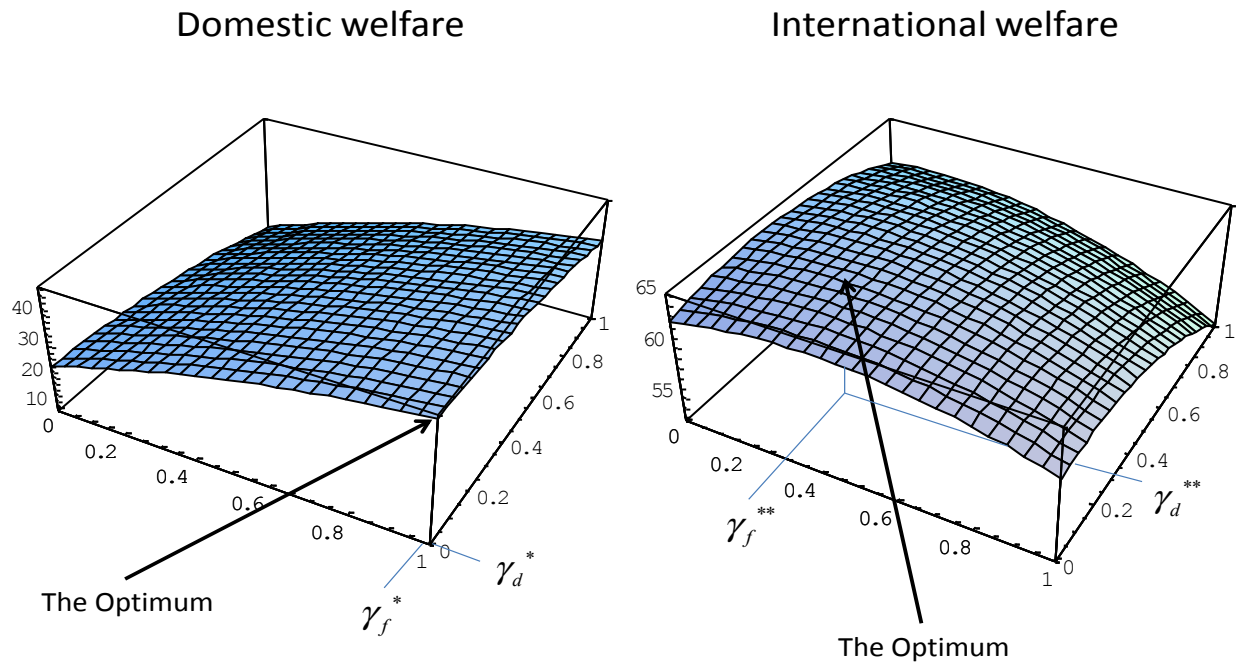
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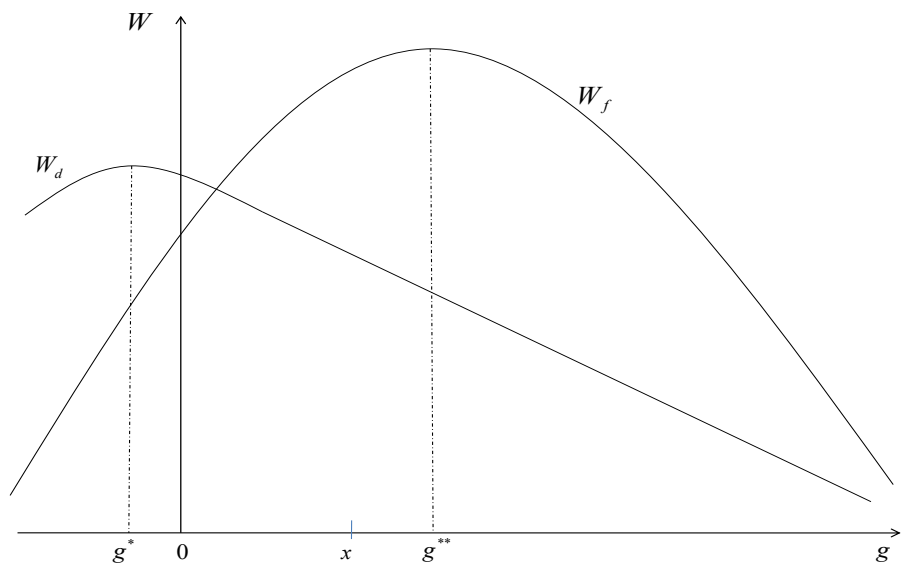
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**Fig. 1. Market Equilibrium**



**Fig. 2. Numerical illustration of optimal inspection policies**



**Fig. 3. Per-unit fees  $g$  under different scenarios**