MAP - Brief
Monitoring Agri-trade Policy

European Commission

Directorate-General for Agriculture and Rural Development

The European Union's agricultural market is often portrayed as an impenetrable 'fortress', built on a system of very high tariffs. Clearly the EU has certain high tariffs, but it is also a <u>fact</u> that it is the largest importer of agricultural goods in the world. Such an analogy is therefore both misleading and unhelpful in the current context of international trade negotiations.

This brief aims to set the record straight and detail some of the key elements of our complex tariff structure.

From different tariffs…

The first important element is that EU agricultural products are currently defined in a very detailed way, amounting to a tariff structure of more than 2 000 different tariff lines. This detailed product description reflects consumer preferences and historical tariff structures at the same time as differentiating between different products belonging to the same category. For example, when we say "cheese" we are referring to about 50 different tariffs that reflect the different quality and types of cheese.

A second important point is that tariffs can be expressed in different ways. An "ad valorem" tariff is a duty paid as <u>a percentage of the import price</u> when the good crosses the border. So, if a certain type of cheese had an ad valorem tariff of 10 %, and we imported € 100 worth, we would have to pay a € 10 import tax on it.

"Specific" duties on the other hand are a <u>fixed</u> amount paid per physical unit i.e. kilos, litres, % of alcohol content, etc. For certain types of cheese we import for processing for example, the 'specific' tariff that has to be paid is € 10 per 100 kg.

Specific tariffs, together with those where specific and ad valorem duties are mixed are widely used, mainly by developed countries, but they cannot be directly compared, or summed up, or averaged as is the case for ad valorem tariffs.

…to the significance of the AVE

The ad valorem equivalent or AVE, is the equivalent in an "ad valorem" form of a tariff originally expressed as a "specific" or mixed duty. Expressing all tariffs in their AVE form was considered a necessary step because of the tariff reduction option (the so-called tiered approach) adopted in the context of this round of WTO talks and the Doha Development Agenda (DDA). But, experts and negotiators are still discussing which of the different methodologies should be used to convert specific and mixed tariffs into their ad valorem equivalent. Each has very different and very significant implications for the negotiations.

How are AVEs calculated?

To convert a specific tariff into its AVE should, in principle, be simple: it is enough to divide the tariff by the import unit value. For example, if we import 1 kg of cheese for which the import unit value is € 28, and the specific tariff is € 7 /kg, the ad valorem equivalent is 25 % of the import price.

However, this apparent simplicity can be complicated by several factors, the most fundamental of which is the price used to make the conversion.

The most logical choice would be to use, as in the example above, the import unit value recorded by each country, which reflects the quality standards and true type of product actually imported in that country.

However, exporting countries have developed the argument that the level of protection should be measured not against the import values of an importing country, but against the world average import value as recorded by a database of United Nations (UN) statistics - a method which, not surprisingly, affords disproportionate benefits to the exporter.

This is because the database concerned only provides price indications at a broad level of product aggregation and so tends not to provide a clear indication of the prices of high quality products within these broad groups. This is a particular problem when it comes to reflecting accurately the import flows into the EU.

As a result the import unit value calculated on the basis of the world imports is often much lower than that recorded for EU imports. This is because if an AVE is calculated by dividing the tariff by the aggregate "world price", it will result in a much higher figure than an AVE calculated by dividing the tariff by the high EU import price.

For example, imports of fresh sausages into the EU total more than € 40 million every year and the import price paid per kg at the border is about € 8. In contrast, the average world import price used as a reference for this group of products is less than € 2 per kg, largely due to the lower average quality of imports realised in other world regions. The EU tariff on this product is expressed as a specific duty – € 1.5 per kg. The resulting AVE is very different depending on which of the different import values is used:

EU import value	World import value
€ 1.5 / kg	€ 1.5 / kg
€ 8 / kg	€ 2 / kg
AVE = 19 %	AVE = 75 %

Extending this example of the AVE calculation to in excess of another 900 tariff lines of specific tariffs explains why the EU has sometimes been accused of being a fortress.

A simple formula but an increasingly complex problem

In the context of the ongoing negotiations however, it emerged that in certain cases EU import values were inflated, either as a result of preferential import arrangements or because of the high guaranteed prices paid to preferential suppliers (as in the case of sugar). Recognising the existence of this potential distortion, the EU agreed to treat such prices separately.

So a proposal emerged to "filter out" any cases where there was a significant difference (of more than 40 %) between values based on world import prices and those based on EU prices, and a significant difference (of more than 20%) between the AVE calculated according to the world price and the one calculated using the EU price.

Having identified these products (whose tariff lines were imaginatively called 'blips') the debate then moved on to the more important question of what adjustments should be made to the relevant prices.

Establishing the correct price was at the centre of discussions that kept negotiators and analysts occupied for over a month. Whilst it was clear that a suitable mid-way point should be found between the two values, the difficulty was how to do so in such a way that correctly reflected the true value of a product. In other words, in such a way that reflects the distortion that preferential import arrangements might create, but still demonstratedsthe high quality of EU imports.

Around mid-April, two main proposals lay on the table:

1. To take a 50/50 weighting of EU and world prices

2. To take a 20/80 weighting of EU/world prices.

In the spirit of compromise, the EU accepted 25/75 and further conceded to a 10/90 weighting for a limited number of tariff lines that posed particular problems. And so with the 'golden' price combination now established, calculating AVEs for the "blips" could finally begin.

The end? Apparently not. Having spent weeks searching for, and achieving, the correct balance, these efforts were rendered void when it was suggested that a new calculation be done, applying the agreed weighting scheme (25/75) directly to AVEs, instead of the prices.

Of course, political agreements are always open to interpretation, but it is quite blatant that, from and economic and an analytical point of view, to adopt this new methodology would simply be wrong. It is a basic economic concept that possible distortions and/or differences in quality are directly related to prices and only indirectly related (and inaccurately reflected) to the various indicators built on prices - such as the AVEs.

The box on the next page shows in detail the difference between the two systems of calculation and how price – the most important factor in the calculation – is simply overlooked in an approach that directly applies the 25/75 weighting to the AVEs.

Why does all this matter?

Given the current state of play in the WTO negotiations, the conversion of all tariffs into their ad valorem equivalent is clearly important. However, some basic elements should not be forgotten:

1. That basing the AVE calculation on a per unit value which does not reflect the quality differentials of an agricultural import implies an incorrect assessment of the level of protection.

2. That AVEs calculated on such a per unit value would not reflect the specific commitments in the EU tariff structure as agreed in the Uruguay Round Agreement on Agriculture (URAA), nor the specific preferences of its consumers.

To provide a realistic and meaningful assessment of import protection, AVEs must be calculated in a manner that is consistent with the current tariff structure. It should remain a technical exercise and not be confused with the substance of the negotiations themselves. And at the end of the day WTO members must be allowed to keep the type of tariff structure that they consider appropriate.

For the EU, this means essentially keeping the present structure, including specific duties, bound under the previous negotiating round (Uruguay Round).

Alternative formulae and their implications:

The formula for calculating the AVE on the basis of the corrected price is the following:

(1) $AVE_{25/75} = \dfrac{\text{Specific Duty}}{0.25* P_{EU} + 0.75* P_{world}}$

which can also be expressed as:

(1bis) $AVE_{25/75} = \left[\left(\dfrac{0.25* \text{Spec. Duty}}{P_{EU}}\right)*\left(\dfrac{P_{EU}}{0.25* P_{EU} + 0.75* P_{world}}\right)\right]+\left[\left(\dfrac{0.75* \text{Spec. Duty}}{P_{world}}\right)*\left(\dfrac{P_{world}}{0.25* P_{EU} + 0.75* P_{world}}\right)\right]$

In contrast, a formula that directly applies the weighting to the AVEs is simply written as follows:

(2) $AVE_{25/75} = \left[\dfrac{0.25* \text{Spec. Duty}}{P_{EU}}\right]+\left[\dfrac{0.75* \text{Spec. Duty}}{P_{world}}\right]$

In both cases the EU price (P_{EU}) is derived from EU import statistics and the world price (P_{world}) from UN import statistics.

It is therefore evident from this illustration that formula (2) omits the relative weighting of the prices themselves in that it drops the second factors in each of the square brackets of (1bis). This systematically inflates the AVE when the EU price (P_{EU}) is greater than the UN database's world price (P_{world}).

In fact, the second formula takes no account of the scale of difference between P_{EU} and P_{world}, but simply takes a weighted average, 25 %:75 %, of the two AVE calculations. This is a purely arbitrary method of trying to take account of possible quota rents or quality differences in products.

$\left[\left(\dfrac{P_{EU}}{0.25* P_{EU} + 0.75* P_{world}}\right)\right] > 1$ and increasing as the difference between P_{EU} and P_{world} increases.

$\left[\left(\dfrac{P_{world}}{0.25* P_{EU} + 0.75* P_{world}}\right)\right] < 1$ and diminishing as the difference between P_{EU} and P_{world} increases.