

A PROPERTY RIGHTS APPROACH TO (LACK OF) TRADE LIBERALIZATION

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Abstract: Traditional studies on international trade have neglected the role of institutions and institutional change. The present study departs from the role that different social groups play in the demand for changes in trade protectionism, and considers that the institutional environment defines property rights of valuable assets (land, knowledge, national markets). The study considers both public and private interests in explaining the slow rate in the reallocation of property rights. The paper revisits the traditional analysis of the effect institutional changes have on organizations and adds the possibility that strategies change even before the actual change in the institutional environment occurs. Several cases are presented to demonstrate that private strategies change in the presence of expected institutional movements.

Key words: Institutional analysis of trade, Property rights and trade liberalization, New institutional analysis of agricultural trade.

Jel Classification: Q17, F13

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1. Introduction

Traditional studies of trade barriers in agriculture have failed to convince policy makers to move towards trade liberalization. There are several understandable motives for this failure, none of which are related to the findings of the studies that show basically that there are at least the traditional deadweight losses resulting from the intervention in addition to the transference of income. The first motive for failure is the assumption that governments act based on benevolent and unbiased criteria of rational choice. Several authors have pointed to agency and capture problems, and the rent seeking theory (Krueger,1974)¹ has shown that interest groups will spend resources magnifying the figures based only on triangle losses. The second reason for failure has to do with the mistaken assumption that efficiency enhancement is the real target of policy makers. Sub efficient goals are the rule instead of the exception in the case of trade barriers. Optimal institutional arrangements frequently proposed are frequently unfeasible solutions. Williamson (1996)² presents the concept of “inefficiency by design” to demonstrate that when sub optimal goals are the target then traditional remedies will have negligible effects. And the third cause of failure to move forward with trade liberalization programs is the predominant choice of theoretical approaches that bound the policy makers, which neglect the role of institutions and institutional change. By and large the understanding of how institutions evolve and how they affect the organizations in the society is the keystone to finding new ways to deal with old problems such as protectionism. The importance of institutions has been stressed by North (1990)³ and even authors that are not strictly committed to the new institutional economics agenda have become aware of their importance, as stated by Krueger (1996)⁴ studying the U.S. sugar program.

The theme of international intervention in agricultural markets is relevant to international and domestic policy formulation at the beginning of the decade. Such importance is magnified especially for developing countries that are showing increasing capacity to compete in the global markets of soybean, cotton, and meat, but are unable to compete with the high level of subsidies embodied in the local farm policies both in the U.S. and Europe. The relevance is stressed in the presence of growing demands of developing countries with regard the capacity of the international

¹ Krueger,A.O. 1974. The Political Economy of the Rent Seeking Society. American Economic Review 64(n.3, June):291-303.

² Williamson.O.E.1996. The politics and economics of redistribution and inefficiency. In The mechanisms of governance. Oxford University Press.

³ North,D.C.1990. Institutions, Institutional Change and Economic Performance. Cambridge University Press.

⁴ Krueger,A.O.1996. The political economy of controls: American sugar. In Alston,L.J.,Eggertsson,T.,North,D.C..Empirical studies in institutional change. Cambridge University Press.

institutions created to promote trade liberalization - especially the World Trade Organization - to enforce adaptations in domestic policies in USA and EU.

The present essay presents an analysis of trade liberalization of agricultural products, from the institutional viewpoint, especially adopting the theory of property rights. The study examines the problem considering first that institutional change - i.e. trade liberalization rules - can be seen as changes in bundles of property rights over the access to domestic markets. Second, it emphasizes the relationship between the institutional environment (laws, regulations, norms) and the institutional organization (firms, contracts), especially the impacts of trade intervention on private strategy of agents operating in food markets on a global scale.

The study stresses two points. First, the theoretical development in linking international institutional change and property rights is still very crude and undeveloped. Most studies are based on the state monopoly to supply property rights. Second the study explores the effects that expected (instead of actual) institutional changes have on the redefinition of institutional arrangements. In other words, the study maintains that organizations shape the strategies already as if the trade barriers had been released, while keeping the support to the existing institutional setting. This second point indicates that organizations anticipate institutional changes and define their strategies in such a way that reinforces the vectors that promote changes in the definition of property rights of access to markets, but at the same time will enjoy the benefits of the existing rules as much as possible.

The essay is structured in five parts. The second part presents the property rights approach and introduces the institutional environment that shapes the structure of property rights. The third part explores the macro institutional environment defining the interest groups affected by eventual institutional changes. Part four explores the strategic behavior of firms – institutional arrangements – presenting anecdotal evidence of anticipatory accommodations of private strategies. Finally, part five presents concluding remarks.

2. Institutions and Property Rights: Theory

This chapter introduces the concept of institutions and discusses how property rights evolve. It then presents the international dimension of property rights and formulates hypotheses based on the theory.

North (op. cit., p. 3) defines institutions as “ *[The] rules of the game in a society or, more formally,... the humanly devised constraints that shape human interaction.*” Bundles of property rights are defined and enforced by the institutions, providing agents with signals to cooperate in production. As proposed by Eggertsson(1990)⁵, property rights are defined by social norms and formal rules and their relevance depends on how well the rights are recognized and enforced by other members of the society.

Thus, the logical influence of institutions works through properly defined and enforced property rights, providing long-term incentives for investments and commitments among agents. It is expected that strategic decisions of private organizations will be influenced by how institutions are shaped. Therefore, institutions can reduce the transaction costs in society, especially the costs of defining and guaranteeing property rights. Governments enjoy scale advantages in supplying property rights, but informal social arrangements also play an important role.

There are at least three different time horizons to consider in dealing with effects of institutional change. First, the short-run movements of organizations responding to the institutional environment changes. Responses motivated by efficiency gains will drive the organizations to adopt transaction cost-saving forms of governance. Second, long-run movements that are typical of the process of institutional change. Here it is important to understand the driving forces that change institutions, considering this process of changing property rights over valuable resources. And third, informal norms usually take longer than formal rules to adapt, increasing the costs of changes and partially explaining the slow rate of macro institutional adaptations. Here economists must search for support in related sciences, especially sociology.

<place figure 1>

⁵ Eggertsson,T.1990. Economic Behavior and institutions. Cambridge University Press.

Relevance of institutional changes: To study the slow institutional movement towards free trade, this study chooses one of several competing explanatory models. Alston (1996)⁶ presents a model of institutional change based on demand pressures of social groups and the capacity of society to supply property rights. Therefore, from this viewpoint, institutional change is an endogenous process and becomes relevant to knowing who the demanders are, their relative power, and the incentives for change. Since changes in institutions always mean a new bundle of property rights, the relative power of the interest groups becomes important. The first dimension of analysis considers that there is a potential growth rate based on the stock of knowledge and (less so) on the endowment of natural resources, and the proper allocation of property rights will result in the position of society in terms of the closeness of the potential economic frontier.

Institutions are the result of a political process and therefore cannot be taken as exogenous. We should know more about how governments make decisions and how informal rules evolve over time in order to explain sub optimal political arrangements. The second important dimension is to understand how property rights are delivered and guaranteed in the international setting. Studies of organizations usually consider institutions to be exogenous, focusing on how the structure of economic organizations and contractual arrangements adapts efficiently. Authors such as Eggertsson (1996)⁷ and Williamson (1996)⁸ explain how individual agents, institutional arrangement, and the institutional environment interact in a dynamic way. Departing from the stock of available institutions, their effect on the shape of organizations is considered in this study, as well as the feedback effect from organizations, through political organizations, on the shape of existing institutions.

The traditional analysis based on Williamson's proposition that in the short run institutions must be taken as exogenous is challenged in face of the effects of expectations shaping institutional arrangements.

Related theories such as rent seeking and interest group theory of property rights complement the basic approach defined by Alston. The work of Olson (1965)⁹ related to the logic of collective

⁶ Alston, L.J.1996.Empirical work in institutional economics: an overview. In Alston, Eggertsson and North (op. cit.)

⁷ Eggertsson,T.1996. A note on economics of institutions. In Alston, Eggertsson and North, op. cit.

⁸ Williamson,O.E.1996. Institutions and Governance of Economic Development and Reform. In Mechanisms of Governance, op. cit.

⁹ Olson,M. 1965. The Logic of Collective Action: Public goods and the theory of groups. Harvard University Press.

action and the interest group theory of property rights described by Eggertsson (op. cit.) also complement the analysis. Both consider the effect of a political market, and therefore the logic of an unbiased government delivering property rights efficiently is not adopted. The role of small and homogeneous groups is relevant to explaining the bias of the appropriation of rents derived from trade intervention programs that are not always its initial target. This view is important to understanding the large benefits carried to large North American farmers by the policies prevailing in the 80s, 90s, and at present.

Sources of inefficiency are represented by the existence of transaction costs between the different interest groups in the presence of asymmetrical information, which brings the possibility of social output losses departing from the potential frontier of efficiency.

For the purpose of the present study, a simplified version of Alston's model will be adopted, considering the structures that supply and demand property rights. The basic model demands an adaptation to enable the analysis of the international environment, as shown in figure 2. The foundation of the model is based on the understanding of how certain social groups are able to affect the supply and/or the demand for changes in laws and regulations to their benefit. Players will choose collective strategies, sharing their costs.

Chapters three and four will focus on two levels of analysis. First the institutional environment will be discussed in chapter three, especially how players can be grouped in terms of common interests towards protectionism. Chapter four will discuss how organizations will adapt to existing expectations of rules bounding international trade.

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International Dimensions: Not many institutional models consider explicitly the international dimensions involved in institutional change. In the model proposed by Alston (op. cit.), the motivation departs from the existence of a stable state government whose basic role is to be the sole supplier and enforcer of property rights. Therefore the national focus is the relevant one. On the side of demand, the logic is also based on the existence of constituents that are able to use democratic (or barely democratic) ways to press for keeping or changing the existing structure of property rights.

Similarly, Eggertsson (op. cit), presents a digression on international property rights, pointing to, but not exploring, elements that must be adapted to expand the theory. The author states that: “ *The structure of international property rights affects the behavior of agents in foreign transactions and the wealth of interrelated nations.*”

He suggests three level of analysis to embrace the complex structure of decision-making present in the international arena. First is the behavior of economic players as a function of the existing international system of property rights. Second is the logic of economic organizations and contractual transaction cost-economizing arrangements. Third, and most difficult, is the logic of political institutions of the international order.

This paper adds still other challenges, related to the third level seen above, to provide an adequate theoretical foundation for property rights in an international setting. The first has to do with who has the capacity to supply property rights in a way that all international community will consider relevant to individual decision-making. This will depend on the development of international bilateral or multilateral agreements. The second point is related to the problem of enforcement capacity, whose costs must be higher than usual for local purposes. Third is the definition of reliable and unbiased third parties to deal with disputes. The fourth point has to do with the MNF (multinational firms), which operates globally, demanding property rights from different governments, but not necessarily aligned with their individual interests. The MNF might develop strategies based on their own supra national interests. Still a fifth point must be considered, related to time constraints, which are different from the public and private viewpoints. Finally, the decision makers do not necessarily bear full costs related to their decisions as posed by Krueger (op. cit.), therefore the issue of agency applies.

3. International Institutional Environment: Unfinished Liberalization in the Agribusiness Sector?¹⁰

We now review the key aspects related to trade protectionism in agricultural products, especially the interest groups affected by the existing definition of property rights.

¹⁰. This section is based on the forthcoming paper by Jank, M. and R. Finch. (2002) “*Perspectives for Agriculture in Multilateral and Regional Negotiations*”, prepared by the Integration, Trade and Hemispheric Issues Division of the Inter-American Development Bank (IDB). The section will also be included in the Background Paper “*Market Access In The Americas: An Unfinished Agenda*”, to be presented at the IDB

3.1. The Political Economy of Agricultural Protection

Within international trade, agribusiness is the sector in which market globalization and regional integration have been mediocre and full of faults when contrasted with the traditional proposed remedies. Despite efforts to implement the first multilateral agreement in this area -- the Uruguay Round Agreement on Agriculture (URAA) -- and the signing of several preferential trade agreements benefiting mainly smaller and poorer countries, developed countries continue to use all sorts of tariff and non-tariff barriers in agricultural trade. They also offer heavy subsidies that over-stimulate internal production and exports.

However, it is interesting to note that the resistance to opening agricultural markets has not blocked an impressive increase in foreign direct investments and mergers and acquisitions in agribusiness worldwide. Ironically, while American, European, and Japanese farmers fight to maintain subsidies by building powerful lobbying groups to influence both their Legislative and Executive branches, the largest agribusiness corporations from these same countries rapidly expand their operations abroad in the regions most impacted by protectionism.

Such a dichotomy presents the need to treat the issue of agricultural protectionism in a realistic and pragmatic way and to identify with clarity the main parties in favor of and resistant to change. The following section will identify the economic, social, and political forces that are fighting to maintain status quo protectionism from those fighting to change current conditions both within their countries and abroad.

This section will discuss who the players are that demand property rights of access to agribusiness markets.

3.2. Interest Groups and Agricultural Reform: Pressures for Protectionism (inefficient by design)

The following factors lead to the growth (or at least the continuance) of agricultural protectionism in the developed world, acting in the direction of keeping and increasing the specific property rights of access to specific markets and the related institutional design:

a) Intense Lobbying by Agricultural Interest Groups

This is the main factor explaining the persistence of high levels of agricultural protection in the world. Farmers and their allies (the machinery and agriculture equipment industry, the agricultural supplies industry, the transportation industry, the warehousing industry, and the supporting banks) form powerful political lobbies in Europe, the US, and Japan. Because this lobbying is concentrated and focused, the pressure exerted by this small group of beneficiaries is politically more efficient than the less focused and dispersed actions of the main losers, namely the consumers and the taxpayers. Within the small group, a still smaller sub group is organized by large US farmers, which receives the larger share of transfers related to the program.

b) The Argument for Food Security

War, hunger, and xenophobia are the main reasons explaining the historical treatment of agriculture as an "exception" in the multilateral processes for market liberalization. These were the reasons Europe and Japan developed policies to "protect" their consumers from free trade uncertainties. Such arguments lost their importance after a long period of technological and logistical improvements that spread agricultural surpluses worldwide. Although these arguments have lost strength in the developed world, the main arguments for food security remain powerful in highly populated countries like India, China, and Russia. It is very difficult to distinguish between social norms that result from the history of wars and food shortages and just arguments for protectionism.

c) Quality Standards and Food Safety

At the end of the 1990s, Europe faced successive crises related to sanitary measures and quality standards of foods. The most important of these were the dioxin contamination in Belgium, the successive epidemics of "mad cow " and "foot and mouth" diseases, and the growing consumer aversion to genetically modified foods. Food safety is growing in importance in all developed countries. The issue of food safety and quality is occupying a growing space in developed countries'

agricultural budgets and policies and eventually will substitute the traditional tariff-based protectionism.

d) Intrinsic Characteristics of Agriculture in Developed Countries

The aging of the rural population in developed countries, the low opportunity cost, and high cost of professional relocation are some of the factors explaining the resistance by producers and policymakers to reduce agricultural subsidies in wealthy countries. The main argument (although not scientifically proven) is that subsidies are cheaper than the social cost of agriculture unemployment. The same logic can be provided by developing countries in terms of policies to keep employment opportunities in farming areas as a way to deal with the uncontrolled growth of urban areas.

e) Agricultural Non-Trade Concerns (NTC)

In recent years, most European countries and even some Asian countries (e.g. Japan and Korea) have tried to promote a “fourth pillar” in the international agricultural negotiations, adding to the three traditional ones – market access, export subsidies, and domestic support. The most popular expression of the NTCs is the still-obscure and ill-defined concept of the “multifunctionality” of agriculture. This concept provides an excuse for the concession of new subsidies to farmers because they perform roles that extrapolate commercial production of foods and fibers. In those countries’ point of view, farmers, as opposed to other economic agents, perform roles that produce positive externalities to society. Among them are the occupation and management of national territory, the survival of small towns (important factor in rural Europe), preservation of the rural landscape and eco-tourism, maintenance of peasants’ culture and way of life, and, more importantly, preservation of the environment. Of these roles-- - and most of them are difficult to properly define and measure-- - environmental preservation is the central element of this new concept of “rurality”. Trade and environment enjoyed much attention in the WTO Development Agenda in Doha and, more recently, in the preliminary position of Germany with regard to the upcoming round of reform of the Common Agricultural Policy. Trends seem to indicate that environmental preservation will be the main issue to be introduced in the regional and multilateral trade agreements, justifying new (and even old) forms of subsidy and/or protection.

These are the five primary factors that explain the continuance of agricultural protectionism in the developed world. Now, if agricultural protectionism were to be justified and implemented only by the first-world countries, third-world countries likely already would have vehemently questioned these five factors.

However, closer to the truth is that the reduction of agricultural protection is still an unpopular cause of less than twenty countries in the world today. The great majority of the underdeveloped world supports the continuity of agricultural protectionism because of one or more of the following three reasons:

f) Intrinsic Characteristics of Agricultural in Underdeveloped Countries

Agriculture is an important component of the GDP, employment, and export agenda of the majority of the underdeveloped world. Most of these countries concentrate their most competitive agricultural production in a very small group of commodities, usually of tropical origin, and therefore very little or not at all protected in the developed world (but not for tobacco, sugar, cotton among others, also protected in developed countries). The majority of these countries view protectionism with a certain sympathy for the following reasons: food security (as already mentioned), maintenance of subsistence agriculture, government support for exports, creation of rural development and land reform programs, and, most of all, due to a strong concentration of voters in the rural area. The majority of poor countries tend to offer subsidies and protectionism to the agriculture sector, in general with very little success. They are, however, always appealing to the idea of “special and differential treatment” in the multilateral system of trade.

g) Food Dependence

Developed countries have the practice of setting prices above the equilibrium, which generates over-production. Such over-production is released in the world markets through direct incentives to exports (e.g. E.U. export refunds), government credits (e.g. GSM 102 and 103 programs in the US), and food aid programs. This process allows the possibility of acquiring cheap foods in the world market, and in turn creates a strong dependency from the so-called Net Food Importers, which depend on the eternal existence of subsidies in the developed world.

h) Trade Preferences

Preferential tariff schemes are probably the most important factor explaining the international alliances among wealthy and poor countries to support the agricultural “waiver” to free trade. The great majority of third-world countries depend directly on the preferential or even duty-free access of the few commodities that are the bulk of their export schedule. Coffee, cocoa, sugar, and bananas are the most notorious examples of products for which a completely free market would sweep away a large part of the underdeveloped world from the market, unable to survive without its preferential state of trade diversion. Agreements like the GSP, ACP, AGOA, CBERA, ATPA, and others are fundamental to the survival of many exports from the poorest countries of the world, which establish alliances with the wealthier countries to maintain the tariff advantages of the former and subsidies of the latter.

These are the eight great forces, with emphasis on the first five in the case of wealthier countries and the last three in the case of poorer countries, which explain the continuance of protectionism in the world. Following is the analysis of more recent changes impacting this scenario, and the identification of the forces that challenge this long history of agriculture protectionism.

g) Complexity and Specialists:

The argument has been raised by Kruger (op. cit.) and is based on the existence of a large group of technocrats with strong ties with the protectionist rules. Being complex and difficult to decode, many governments maintain sizable groups of experts dedicated full time to the transmission of information, creating another social group interested in keeping things as they are. There are rents to be collected from the capacity to understand the complex system of international rules of protection and consult governments and private companies.

3.3. Pressures against Protection

Six main factors help to explain the pressures on public policy reforms toward the reduction of agricultural protection, i.e. the revision of the structure of property rights embodied in the prevailing institutional environment. A review of each follows.

a) The Uruguay Round Agreement on Agriculture and the Cairns Group

The GATT Uruguay Round (1986-1994) brought the first multilateral agreement for agricultural trade, with rules and regulations in three basic areas: market access, domestic support, and export subsidies. There was also an agreement for a 9-year Peace Clause¹¹, and those negotiations resumed at the beginning of 2000. In addition, in 1986 a group of 15 countries that were exporters of commodities met in the Australian city of Cairns, forming a solid free-trade alliance that acted as a third force in the negotiations, facing strong resistance from Europe, Japan, and the traditional “ambiguity” of the US. Under Australia’s leadership, the Cairns Group remains active today, with 18 members. The 4th Ministerial Meeting of the WTO in Doha finally established the track of agriculture negotiations, which should be concluded by January of 2005.

b) Agricultural Policy Inconsistencies in the Developed World

In wealthy countries, the group of farmers that truly benefit from subsidies and protection is continuously getting smaller while at the same time representing a larger portion of assets, including land, and the value of production. Literature points to the fact that the current models of US and European Union agricultural policies - which have persisted since the 1930s and 1950s, respectively - do not have economic support. Currently, only one-third of American farmers receive payments from the government, which in 2000 reached the equivalent of 50% of the agricultural net farm income. The bulk of subsidies essentially benefit the top 7% producers, who are responsible for almost 70% of the value of the production and receive approximately half of government payments (an average of US\$ 61,000 per farmer in 1999). 75% of U.S. farmers are systematically losing money from agriculture and survive only from non-agriculture income (retirement, urban jobs, hobby farms, etc.). In much the same way, the Common Agricultural Policy (CAP) consumes one-half of the European Union budget, and the high prices to support CAP mainly benefit the largest farmers. Suffice it to say that less than 20% of European farmers benefit from the incentives to exports, which Europe has been systematically postponing phasing out.

Besides the problem of subsidy concentration in the hands of a small group of beneficiaries, other indicators show the current inconsistencies of the agricultural policies in the developed countries,

¹¹ Article 13 (“due restraint”) of the Agriculture Agreement protects countries using subsidies that comply with the agreement from being challenged under other WTO agreements. Without this “peace clause”, countries would have greater freedom to take action against each other’s subsidies, under the Subsidies and Countervailing Measures Agreement and related provisions. The peace clause is due to expire at the end of 2003 (WTO 2002).

such as (a) in all those countries, agriculture has been losing relative importance as a percentage of GDP and employment, which means that its capacity of political attraction will be reduced over time; (b) despite the increasing incentives, two thirds of European and American farmers have abandoned agricultural activities since the end of the World War II, and the exodus is still advancing; (c) there is increased aging of the rural population, since the descendents of small farmers do not want to continue in the agriculture activity; (d) a transfer of subsidies via the support of market prices over the land price in Europe and US. Recent studies in the US show that 37% of the benefits of the commodities programs (market support prices and other payments per ton or hectare) go to the landlords. In other words, the policy ends up stimulating an undesirable rent-seeking behavior in the agricultural society.

c) New Domestic Pressures

The inconsistencies mentioned above have moved important sectors to favor a broader reform in trade and agricultural policies. On the one hand, organizations of industrial and final consumers and an important part of the American and European media are showing stronger support for agricultural policy reforms. On the other hand, in some countries there is increased pressure for a more “extensive” agricultural policy model, with less use of modern inputs (by stimulating organic production, for instance) and more respect for environmental preservation. This new orientation, already discussed, is reflected very clearly in the recent position paper of the German Ministry of Consumer Protection, Food, and Agriculture, “EU Agricultural Policy for the Future”. In reality, there is a conflict of interest between political and budgetary forces. Politically, the preservation interests of the environmentalists (represented mainly by non-governmental organizations) tend to be in conflict with the farmers’ trade interests mainly through a strong opposition to the traditional systems of agriculture. Consequently, there is a growing competition between the allocation of resources for traditional policies of price support and for conservation policies. This appropriations conflict has already emerged with some strength in the 2002 Farm Bill debates of the US Congress.

d) Growing International Pressures

Along with the pressures that resulted from the new WTO multilateral trade round, where it seems that countries from the Cairns Group and others will have a stronger voice, the agricultural debate also tends to play a central role for many countries in regional forums as well. Such is the case of the FTAA, where the countries from Mercosur will certainly be more demanding than Mexico was

in the NAFTA negotiations. At the same time, 10 countries from Eastern Europe will pressure the European Union to expand their agricultural policy to their integration policy, which will entail a significant change to the current model. Similarly, the European Union tends to face a new assemblage of forces with the United Kingdom and Germany now fighting for a broader CAP reform. Internationally, several presidents of multilateral organizations, leaders of large private corporations and non-governmental organizations have increased pressure for change. The recent communiqué by the World Economic Forum shows an increased discontent with agricultural protection. It was signed by representatives of WTO, OECD, World Bank, and FAO, and by non-governmental organizations such as Consumers International and Catholic Agency for Overseas Development as well as by presidents of corporations like Cargill, Unilever, Coca-Cola, General Mills, Kraft, Nestlé, Royal Ahold, A.T. Kearney, and Sara Lee.

e) Internationalization of Large Agribusiness Corporations

There are strong movements towards the internationalization of agribusiness firms. Behind traditional commodities like soy and chicken there are about a half-dozen global players acting at the same time in the main producing regions in the world. In general, transnational corporations try to take advantage of cost gaps, tariffs, and national incentives. Most of the time, these enterprises fight to maintain their “market reserves” in their headquarter countries, leaving the production and exploration of new markets abroad. Such firms understand the cost differences and competitiveness and know that they can operate in a much more efficient way with production and export bases abroad, to supply the local and third markets. While this internationalization grows in investment terms and mergers and acquisitions, the interests of these firms converge more and more with the interests of countries involved against protection, especially because the long-term value of the assets of these enterprises abroad is in question. This topic will be further discussed in the next section.

f) International Migration of Farmers

In a very preliminary way, a growing movement of commercial farmers can be noticed worldwide, pushed by one or more of the following factors: (a) large differences in land prices and labor costs between countries with similar production conditions; (b) strong differences in the rigor of environmental laws, which makes the cost of production much higher in some regions (Netherlands

and Denmark are good examples); and (c) difficulty to expand agriculture horizontally by exploring economies of scale, due to supply-control mechanisms (quotas, set-aside, etc.)

As the current model of agricultural policy of the US and Europe is maintained, these differences become stronger. Therefore, Dutch farmers migrate to Eastern Europe (pork) and Spain (flowers), the U.S. Mid-west, Mercosur, and Australia, and American and Portuguese farmers buy cheap land in the Brazilian Mid-west region. It is quite possible that the “farmer globalization” will become a much faster process than the “agricultural globalization”.

The following table summarizes the first part of this Chapter with a synthesis of the main pressures for and against agricultural protectionist policies and subsidies in the modern world.

Table 3.1. Pressures For and Against Agricultural Protectionism

For	Against
<ul style="list-style-type: none"> • Intense Lobbying by Agricultural Interest Groups • The Argument for Food Security • Quality Standards and Food Safety • Intrinsic Characteristics of Agriculture • Agricultural Non-Trade Concerns (NTC) • Food Dependence (Net Food Importers) • Preferential Trade Agreements 	<ul style="list-style-type: none"> • The Uruguay Round Agreement on Agriculture and the Cairns Group • Agricultural Policy Inconsistencies in the Developed World • New Domestic Pressures • Growing International Pressures • Internationalization of Agribusiness Corporations • International Migration of Farmers

4. Strategic Behavior of Firms: The Institutional Arrangements

The objective of this section is to discuss the evidence of the capacity of MNFs to anticipate institutional changes in the case of international trade. Examples of MNFs operating in the Brazilian food and agribusiness market will be presented. Contrary to the traditional view, which argues that institutional change determines strategies of organizations, the idea of this section is to present anecdotal evidence of anticipatory strategic commitments before the implementation of a trade bloc.

Moreover, the movement of international agribusiness firms to Brazil is a fertile example of how institutional arrangements and environment interact in a dynamic way, which includes the formation of expectations. The dynamics of corporations active in trade consider the national institutional barriers to trade but at the same time search for opportunities to change the property rights structure. Private incentives are (i) to seek new opportunities, (ii) to minimize the risks, and (iii) to diversify the business.

The previous section showed the importance of the institutional scenario of trade barriers to developing countries. Countries like Brazil and Argentina are engaged in complex bilateral negotiations in the Free Trade Area of Americas as well as with the EU-Mercosur agreement. At the same time the multilateral WTO negotiations are in place. The bilateral negotiations may open a new reality in market access to developed countries.

This section discusses some credible signals provided by private companies that reveal the expectations with regard to changes in the protectionist scenario. The most important point is that the discussion intends to raise the issue of the rigidity of the theoretical treatment that assumes the institutional arrangement follows changes in the institutional environment in the short run. On the contrary, we support the proposal that organizations will anticipate institutional changes, adapting ex-ante.

4.1. Evidence of Institutional Movement

During the 90s, Brazil saw a significant inflow of foreign direct investments where the food, beverage, and tobacco industries were among the most important hosts of these investments. From 1994 to 2000 about 269 mergers and acquisitions in the food, beverage, and tobacco industries were reported, of which 57% were driven by direct foreign investments¹². The same study shows that in the agro-food industry, 81% of the foreign direct investments from 1994 to 1998 were directed to the acquisition of existing firms, 13.2% were directed at creating new firms, and 5.8% at expansion and modernization of already existing firms.

In spite of the international protectionist policies, the strategy of international companies provided clear signals of commitment to Brazilian production, especially in export products. Direct foreign investments soared in the 90s in sectors like tobacco, (from 82 to 90%); soy crushing, (from 30 to

48%); pork, (from 11 to 40%); poultry, (from 8 to 34%) and sugar mills (from 0 to 8%) (Jank, 2001)¹³.

On the other hand, the agro-industrial production and exports did not increase at the same rate as M&A operations and foreign direct investments - FDI. According to Jank (2001), only 5.8% of the total (FDI) from 1994 to 1998 was allocated to the food and beverages industry, mostly directed to the expansion and modernization of already existing firms. Rodrigues (1999)¹⁴ analyzed the beginning of the internationalization process in the Brazilian food and beverages industry (1992 to 1996). In a sample of 38 M&A cases, the author observed that foreign investments were not aimed at upgrading productive capacity.

The same study classified the strategies of the foreign firm investors in five groups, namely: diversification strategies, vertical strategies, domestic market (domestic consumption increasing due to the macroeconomic stabilization), financial strategies, and Mercosur effect. Rodrigues discussed the possibility of export strategies but did not find any case in the sample. This study indicates that exports were not the focus of M&A in the period. However the 90s can be considered the first wave of M&A in food and agribusiness sectors. The second wave is characteristic of the end of 90s and beginning of 2000 decade, where the focus of foreign investments changed. The firms' strategies in the second wave have taken into account exports to third markets.

The basic question is to explain the incentives for multinational firms to invest in the Brazilian export-oriented agribusiness sector considering the barriers to reach the protected developed countries. Besides the relevance of the Brazilian domestic market, which was important in the mid-nineties, one of the explanations may be associated to the firms' perceptions about the growing significance of the international market based on the expectations of changes in the institutional barriers. The ongoing MNF movement to Brazilian food and agribusiness, could be, in part, explained by the potential growth of international transactions when the free trade areas (FTAA and UE-Mercosur agreement) are implemented. The hypothesis is that MNFs are anticipating the effects of international negotiations considering that institutional change moves slowly and anticipatory

¹² KPMG Corporate Finance (2001). *Mergers & Acquisitions in Brazil: An analysis of the 90's*.

¹³ Jank, M. S.; Leme, M. F. P.; Nassar, A. M.; Faveret Filho, P. (2001). Concentration and Internationalization of Brazilian Agribusiness Exporters. *International Food and Agribusiness Management Review*, Vol. 2(3/4): 359-374.

¹⁴ Rodrigues, R. I. (1999). *Empresas Estrangeiras e Fusões e Aquisições: Os Casos dos Ramos de Autopeças e de Alimentação/Bebidas em Meados dos Anos 90*. IPEA, TD no 622.

strategic positioning might be important. Organizations move faster than institutions and anticipate the direction of institutional change.

4.2. Incentives for Institutional Arrangements:

The anticipatory strategic effects in face of implementation of new trade agreements have become a hot topic of studies in the literature of international trade. Freund and McLaren (1999, p. 3)¹⁵ studied the dynamics of trade reorientation experienced when a country joins a regional trade bloc. The paper pointed out two important arguments to our own paper:

- i) “When a country joins a regional bloc, the share of its trade that is accounted for by bloc naturally rises, with a path that is typically characterized, roughly, by an “S” shape. The same pattern is exhibited by trade intensity indices, which control growth of total bloc relative to world trade”. The “S” shape patterns mean an acceleration of the trade around the formation of a trade agreement. According to Devlin and Estevadeordal (2001, p. 15), “when the initiative is credible, as the date of accession looms near, a country and its private sector will accelerate trade with its future partner countries (...)”.
- ii) The results of the paper provide evidence of sunk investments made in anticipation of the changes in property rights, which are important to determining the reallocation of resources after the formation of a free trade area. The authors interpret these findings through a non-traditional approach: trade flows react to institutional change, even if the change has not yet been accomplished. They explain the anticipatory investments as a set of reallocations caused by the institutional change. On the other hand, they argue: “the anticipatory investment has been important in shaping the adjustments to trade agreements” (Freund and McLaren, 1999, p. 18). The adjustments may be interpreted as adaptation in the institutional arrangements produced by the anticipatory multinational investments. When the anticipatory investments hit MNFs, it could be interpreted as a strategy of risk minimization. If the MNFs have operations in both countries that are going to be integrated by a free trade area, they are minimizing the risks when the integration becomes complete.

The anticipatory effects are an important argument to the followers of “New Regionalism” (Devlin and Estevadeordal, 2001, p. 15)¹⁶: “given the different scope, modalities and credibility of the older

¹⁵ Freund, C. L.; McLaren, J. (1999). On the Dynamics of Trade Diversion: Evidence from four Trade Blocs. Board of Governors of the Federal Reserve System. International Finance Discussion Paper number 637.

¹⁶ Devlin, R.; Estevadeordal, A. (2001). What’s New in the New Regionalism in the Americas. INTAL-ITD-STA, Working Paper 6.

versus new agreements, those effects may be of different magnitude, much stronger in the case of the new agreements, partly because of the greater credibility and domestic receptiveness to the openness of the New Regionalism". The new arrangements are related to enhancing trade among partners, rather than old arrangements, which were used as a means of extending the domestic import substitution industrialization. There are two distinct situations. First if the private sector believes that the signals of changes in institutions are credible, it will accelerate trade and investments with its future partners countries. Second, if the firms feel harmed by the institutional changes they are also expected to take new strategic positions elsewhere. However it is expected that firms will take the best advantages they can from the status quo while simultaneously adapting their strategies to the expected changes.

The published papers (Freund and McLaren, 1999; Devlin and Estevadeordal, 2001), however, discuss the anticipatory effects on the level of trade but not on the level of firms. Although these papers provide the first insight into the private sector dynamic in the face of an institutional change, namely the implementation of a free trade area, they discuss only the trade flow intensification. The authors have not analyzed the flow of FDI among firms intended to anticipate the institutional change.

Most traditional studies consider the effects of trade liberalization in cases of Mercosur, NAFTA, and EU after trade barriers were phased out. The traditional models may not explain the direct investments observed in Brazil since the change in the exchange regime in 1999, if these investments are oriented to the international market. Alternatively a possible explanation might be due to the incentives triggered by anticipatory effects. Foreign direct investments have been made in some agricultural commodity sectors, especially in those where the international market is protected, showing that direct investments have been made expecting changes in the structure of property rights. In such cases, these firms comprise the Brazilian market as a production and origination base, aiming at the international market.

Being global players, multinational firms can assert their rights based on incentives provided by the local markets, risk management, and international markets. As interested agents they will lobby locally for institutional changes in their interest, but with a global perspective. Assuming that the free trade area will become a reality in the long run, the strategies of anticipation will depend on (i) the importance of each market to the firm, (ii) the competitiveness in each market, (iii) the local institutional environment, and (iv) the governance structure in each market. The firms with most

incentives will be those whose parent and subsidiaries have complementary activities. On the other hand, if parent or affiliates have competitive activities, they face a strategic dilemma. A multinational originator in Brazil, for example, could be an important source of pressure to open the home market since its parent company, which is an originator and processor, has a global supply strategy.

4.3. Cases of Anticipatory Strategies

The cases of anticipatory strategies may be observed in four sectors in Brazil: poultry industry, sugar cane mills and refineries, soybean crushers, and orange juice industry. The conditions to the occurrence of anticipatory investments in Brazil are (i) high export potential in the industry, (ii) protected international market, and (iii) ongoing negotiations to open the international markets. These three conditions may be seen in the four sectors mentioned.

The soybean industry was one of the first to be internationalized in Brazilian agribusiness. The top 4 crushers (Bunge, Louis Dreyfus, ADM, and Cargill) have 45% of the total crushing capacity. The tax exemption made in 1996 and the demanding international markets have promoted the rapid growth of grain exports, from 3,6 to 14 million tons. The competitiveness of soybean production attracted new international companies besides Cargill and Louis Dreyfus, which were Bunge and ADM. In a few years, Bunge became the first exporter of soybean, increasing its market share year by year. Bunge is now the leader of the market, being the biggest crusher (24% of the crushing capacity) and grain exporter. The international market of soybean is open but soybean meal and oil face tariff escalation in many countries and US farmers receive sizeable subsidies. The anticipatory strategies of firms like Bunge and ADM may be associated to the phasing out of tariff escalation that bilateral negotiations can further.

The poultry industry has been headed towards internationalization since the Brazilian exporters expanded their operations in third markets. The high competitiveness and differentiation (the chicken cuts and whole chicken are tailored to the clients) of the Brazilian products in the international markets attracted the attention of European companies. The French company Doux, who came to Brazil by acquiring the Brazilian Frangosul, is one more case of anticipatory strategy¹⁷. Frangosul is the third producer and fourth exporter of chicken. The Doux-Frangosul

¹⁷ Valor Econômico. 2002. Doux Frangosul Pode Instalar Nova Unidade em Apucarana, no Paraná. Year 3, issue 418.

executives declare that the firm came to Brazil to target the international market, especially the European market when trade barriers become more flexible. The same may be said about the international company OSI, which just acquired the operations of chicken meat production of the Brazilian Predileto¹⁸. The OSI CEO, who is a former executive of Bunge, asserts that the new firm will increase the exports.

The sugar and ethanol (fuel alcohol) industry is one of the most important sectors in the Brazilian agribusiness exports. Brazil is the world's most competitive producer of sugar and ethanol, with the highest world sugar exports. Brazil is also one of only a few countries that produce ethanol from sugarcane. The balance between ethanol and sugar production in Brazil immediately affects international sugar prices. The sugar market may be considered the most protected agribusiness market. United States and European Union have their programs to support the domestic production (trade barriers and subsidies), which are recognizably less efficient than Brazilian production. Because of the protectionism of these countries, the size of the international market of sugar and ethanol is smaller than it would be if the market were open. On the other hand, the international firms seem to believe that the protectionist reality should change soon. It is because of the international market that French sugar beet companies have acquired 6 Brazilian companies in the last 4 years. Cosan coordinated three of them and the other three were coordinated by a joint venture among Cosan, Union SDA, and Sucden, namely FDA Group (Franco Brasileira Açúcar e Álcool)¹⁹. The FDA Group is the biggest producer of sugar and alcohol in Brazil. It has 10% of the total mill capacity of sugar cane. Like the other companies in this industry, the FDA Group is directing their operations towards the international market of traditional commodity products (sugar) and towards developing new products and distribution channels in international clients²⁰.

The anticipatory strategies in the orange juice industry have different characteristics from the three already described. Brazil is the largest FCOJ (from concentrated orange juice) exporter in the world, holding 80% of the market. During the last decade, after the consolidation process in Brazil, the larger exporting companies decided to go abroad. The American orange juice market is changing because the consumption of FCOJ has been replaced by NFC (not from concentrate), which is the dynamic market. Similarly, exporting companies face a tariff peak on the exports to USA (about 55% of ad-valorem equivalent). It is estimated that 30% of Florida's processing capacity is

¹⁸ Valor Econômico. 2002. OSI Compra Fábricas da Predileto. Year 3, number 438.

¹⁹ Pasin, R. M.; Neves, M. F. 2001. Fusões, Aquisições e Internacionalização da Agroindústria Sucro-Alcooleira (no prelo).

²⁰ Valor Econômico. 2001. Cosan Fecha Compra da Univalem. Year 2, number 248.

controlled by the same top four companies that command the market in Brazil: CARGILL Citro America (EUA), S.A. LOUIS DREYFUS (French), CUTRALE Citrus Juice U.S. (Sucocítrico Cutrale subsidiary and Minute Maid supplier) and CITROSUCO Paulista S.A.²¹. The acquisition of processing capacity in Florida led to the appearance of linkage companies, which are firms that link Brazil and Florida in case of raw material supply, orange juice production, and distribution to the consumer USA market. In this case, the anticipatory strategies are focusing on the supply chain, rather than on exportation, as the other cases described.

The present chapter shows evidence of strategic movements of companies towards countries that are efficient in production, but have limited access to international markets due to subsidies or tariffs. The explanation is that they are anticipating institutional changes and considering ex-ante those changes to design their short-term strategies.

5. Conclusions

The present paper discusses critically the dynamics of interaction between institutional environment and institutional arrangements. It adds that an important but little discussed effect exists in the short run, motivating new strategic arrangements with incentives entirely based on expectations of institutional changes.

The demand for property rights motivated by the new arrangements can reinforce the rate of institutional changes. The supply of property rights is based on local governments; therefore constituents continue to play a role in that matter, even if we are considering international agreements. The lack of enforcement capacity of international institutions that promote free trade shows that power aspects also matter. Recently, countries like Brazil have been starting to learn how to deal with the international agencies, also pressing for the enforcement of the multilateral and bilateral treaties.

Third parties and mechanisms to solve disputes are relevant to deepening the understanding of the institutional change in the international arena. Different time constraints found between firms and bureaucrats are at the center of the discussion.

²¹. "The Agribusiness Examiner," edição 72, 2 de maio de 2000

This paper has shown that there are unexplored motives to consider in dealing with institutional change related to property rights over valuable resources, expectations being among them, deserving further attention.

Figure 1: Private Strategies in relations to property rights

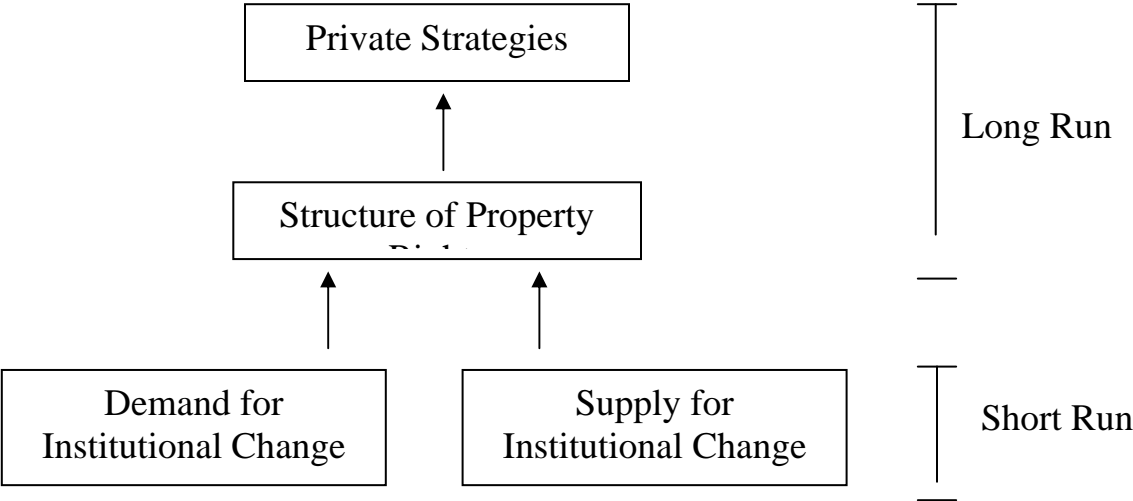


Figure 2: Expectation effect on private strategies

