BUILDING AN EFFECTIVE DOMESTIC EDIBLE OIL INDUSTRY THROUGH STRONG PRICE LINKAGES WITH THE INTERNATIONAL MARKET

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I. Introduction

A. The Need for a New Policy Instrument

The "Edible Oils Stock and Trade Management" (STM) Study represents a major departure from most analyses of Pakistan's edible oils sector because it places major emphasis on the price linkages between world and domestic oil prices [1]. The study found that many of the current problems have arisen precisely because the domestic market languishes in isolation from the world market.

Many of the present policies have been based on the argument that periodic high world prices create an intolerable burden for consumers. Unfortunately, little mention is ever made of the great damage done to the nation's oilseeds sector by artifically low oil procurement prices and periodic low world oil prices. In fact, Pakistan's food security has declined, not because of increasingly volatile world prices, but due to price policies that fail to exploit the world market. Current oil importing and pricing policies fail to link oilseed and oil markets in a manner that is consistent with Pakistan's comparative advantage.

The STM Study concluded that a simple, unified policy instrument is needed to realign Pakistan's domestic oil market with the world market. The transition from current policies to a policy based on strong linkages between domestic and world markets would be difficult, but the long term net benefits would be substantial.

B. The Plan of This Paper

The following sections summarize the main features of a proposed new edible oil import tax model and discuss the implications of the tax for the wholesale oil market, the retail vegetable ghee market and the oilseed market.

II. A Summary of the Proposed Import Tax Model

The STM Study found major shortcomings in the current policy of importing most oil through a government agency, then selling the imported oil to domestic processors at a fixed procurement price. The most basic difficulty with this policy is the lack of a price linkage mechanism to permit the domestic oil market to adjust to international market conditions. Price incentives are not transmitted to as incentives to producers and limited domestic supplies are not effeciently allocated among consumers. The STM Study concluded that the long term trend in imported oil prices offers an effective tool for rationalizing the domestic market with the world market.

A. The Importance of the Import Price Trend

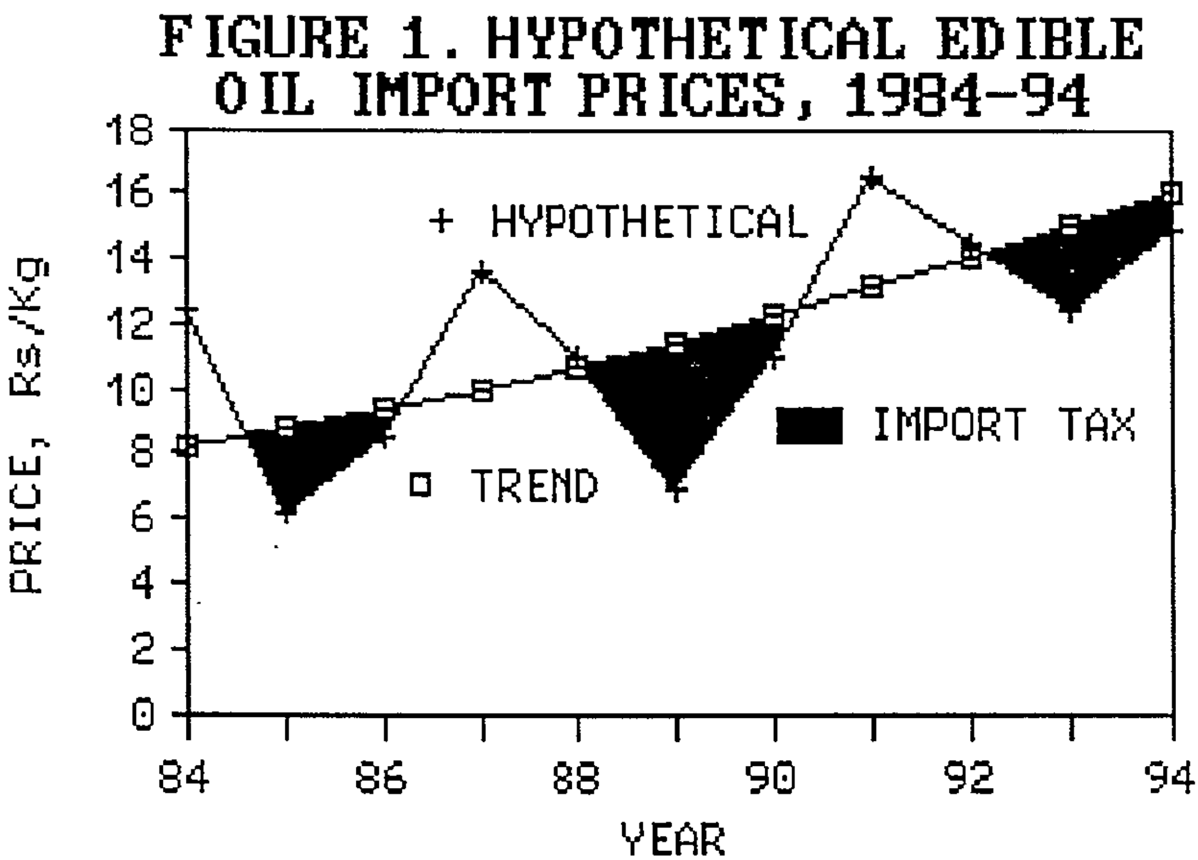
The price Pakistan pays for imported edible oil reflects both domestic and international market conditions. However, because Pakistan is a major oil importer, it generally faces a "seller's" international market since there are no domestic alternatives for about 80 percent of total consumption requirements.

A trend model was used to establish the trend price for the 1971-82 period, and forecast prices over the 1983-94 period (Table 1, column B). According to the model, annual average import prices have been increasing at about 6.7 percent per annum. This model reflects the long term structural change in the international edible oil market and suggests an historical trend toward heavy demand pressure. If this pattern applies to the international market, it will be increasingly difficult for Pakistan to afford the extra foreign exchange costs and trade deficits that will result from a lower domestic price ceiling.

B. The Import Tax Mechanism

The STM Study recommended using the import price trend line from Table 1 as a long term import price floor. Figure 1 shows how a hypothetical future distribution of import prices would be taxed under the new policy. During periods of abnormally low import prices, the price floor would be maintained by levying a variable tax on imported oil. The tax would equal the difference between the import trend line and the relatively lower landed import price. Import tax revenues would vary inversely with world oil prices, up to the the annual trend price.

During periods of abnormally high import prices, the import price would exceed the trend price, but neither import taxes nor subsidies would be applied. Consumers would bear much of the burden of the price increase, but the increased derived demand for oilseeds would lead to increased domestic oil supplies.



Projected retail vegetable ghee prices based on the two scenarios and the import trend are summarized in Table 2. It is very difficult to accurately predict price changes at the outset of a price decontrol program, particularly when price controls have been enforced for many years and the price of the commodity in question has been held below most other commodities in its industrial group. In the case of vegetable ghee, the 10 percent growth rate assumed under the price decontrol scenario would probably be an upper limit.

TABLE 2. ALTERNATIVE PROJECTED VEGETABLE GHEE PRICES

	----Retail Veg. Ghee Price----			
	Trend Import Price	Implied by Trend Import Price	"SS" Scenario	"PD" Scenario
	----------Rs/Kg----------			
	(a)	(b)	(c)	(d)
1984	8.21	13.15	13.32	13.75
1985	8.79	13.71	14.20	15.12
1986	9.40	14.33	15.14	16.64
1987	10.06	14.97	16.14	18.30
1988	10.76	15.67	17.21	20.13
1989	11.51	16.42	18.34	22.14
1990	12.31	17.22	19.55	24.36
1991	13.17	18.11	20.84	26.79
1992	14.09	19.02	22.22	29.47
1993	15.07	19.98	23.69	32.42
1994	16.12	21.06	25.25	35.66

NOTES:
SOURCE: STM Study.

(a) Annex E, Table E-6, page 91.
(b) Table 6-1, page 52.
(c,d) Annex B, Table B-4, page 62.

The import price trend would serve as a strong moderating force on the retail market. In Table 2, a fixed marketing margin of 4.93 rupees was added to the trend import price to estimate the implied retail price. By comparing the price implied by the import trend with the "SS" price, it would appear that the margin will have to increase over time. However, increased competition would produce market cost savings that would tend to reduce upward pressure on retail prices. It is doubtful that the marketing margin would increase enough to push the retail price above the "PD" upper boundary.

TABLE 3. PROJECTED MINIMUM MARKET OILSEED PRICES

	Import Oil Price Floor	Oilseeds			
		Cotton	Sunflower	Soybean	Safflower
	Rs per Maund				
	(a)	(b)	(c)	(d)	(e)
1984	307	75	135	87	112
1985	328	78	143	90	118
1986	351	80	152	94	125
1987	375	83	161	98	131
1988	401	86	171	103	139
1989	429	90	182	107	146
1990	459	93	193	113	155
1991	492	97	206	118	164
1992	526	101	219	124	174
1993	562	106	232	130	184
1994	602	110	248	137	195

NOTES:

SOURCE: STM Study, Table 6-1, page 52.

(a) Prices are the 1971-82 average import price trend (STM Study, Annex E, Table E-6, page 91).

(b-e) Major oilseed price assumptions are:

1) An oilseed salvage value of Rs. 2 per kg.
2) Oil extract. costs Rs. 20 per maund of seed.
3) Seed waste/loss rate is 10%.
4) Oil extraction rates are: Cotton, 12%; Sunflower, 38%; Soybean, 17%; and Safflower, 28%.

VI. Conclusion

A. Need for Consistent Tax Rules

The proposed edible oil import price floor mechanism will not be effective if the operating rules are not applied consistently. Both consumers and producers will act with greater regard for national interests if they are confident the government will levy import taxes according to clearly established rules.

B. Need for Equal Treatment of All Firms

The new import price floor mechanism will not be effective if all edible oil importing firms are not treated equally. When import prices fall below the import price floor or trend price, the government must insure that all oil is taxed fairly, whether it is imported by private or public firms. If public firms are given tax breaks, the floor price mechanism is short-circuited and farmers are penalized by low priced imports. When im-

References

1. U.S. Agency for International Development. *Pakistan Edible Oils Stock and Trade Management* Islamabad, Pakistan: United States Agency for International Development, January 1985.