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AN OVERVIEW OF THE GOP/USAID EDIBLE OILS STUDIES

by

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I. Introduction

Pakistan has a serious edible vegetable oils problem. Each year, dozens of newspaper articles chronicle the government's growing concern about a seemingly insoluble problem. Reviews of Pakistan's economy usually include edible oils in the problem areas. Against this background, the U.S. Agency for International Development joined the Government of Pakistan in a cooperative effort to analyze the problem.

A. The Mandate for the Edible Oil Studies

More than 20 consultants were directed to prepare a comprehensive analysis of the technical, social and economic dimensions of the edible oils sector and recommend appropriate solutions. At every step of the analyses, the consultants were required to consider the sector's interdependence with agriculture's crops and livestock subsectors. Above all, the consultants were asked to recommend activities that would exploit Pakistan's comparative advantage, in concert with world markets, without resorting to overly complex new programs or regulations. The consultants reviewed a wide range of policy options and chose a package of new policies that would best serve their perceptions of Pakistan's overall economic policy goals.

The first study, *Pakistan's Edible Oilseeds Industry*, better known as the "Oilseeds Study," was conducted for the Government of Pakistan and USAID by the U.S. Department of Agriculture [2]. The Oilseeds Study included technical reports on crops, processing and relationships to the livestock subsectors. These studies found major shortcomings in oilseed productivity, but the overall perspective concluded that the main problem involves economic policy issues, rather than a lack of production technology.

As a follow-up to the Oilseeds Study, a second study was conducted in conjunction with Pakistan's participation in the PL-480 program. The report, *Pakistan Edible Oils Stock and Trade Management*, is also known as the "STM Study" [1]. The STM Study elaborated on the economic policy issues raised in the Oilseeds Study and is the primary subject of this paper.

B. Rationale of the Recommended Policy Approach

The two studies make clear that the complexities of the edible oils sector do not make its problems amenable to piecemeal solutions. The consultants were not engaged to serve as staff policy analysts to the GOP. Their recommendations were restricted to those modifications that appeared to have the best overall chance of meeting Pakistan's avowed goal of reducing its dependence on imported edible oil. The recommendations were therefore not prepared as an advocacy position, but as a set of professional analyses that GOP policy analysts may find useful in assisting the government to develop a successful edible oils policy. The policy changes that have been recommended were designed to:

- o Draw valid, relevant conclusions and applications from economic theory;
- o Make the best possible use of available agricultural resources and market institutions;
- o Strengthen Pakistan's food security status; and
- o Recognize the intricate interdependence of most economic policies affecting the edible oils sector.

about 20 percent of consumption requirements, but future production is estimated to decrease at an annual rate of about one percent, falling to about 183 thousand tons by 1994. The projected gap between consumption and production implies future edible oil imports will increase at an annual rate of about 13 percent, rising to about 2.6 million tons by 1994.

The financial consequences of future import trends are even more disturbing. If past imported oil price trends and the projected import levels continue over the next decade, annual edible oil import costs will increase at an annual rate of 21 percent, amounting to an annual cost of about 2.9 billion dollars by 1994. Based on these trends, Pakistan's cumulative import bill for the 1984-1994 period would be about \$15 billion.

The current high level of edible oil imports is a major threat to Pakistan's food security and balance of payments, but the projected future trends present an even more dismal situation. The country's high import dependence is even more paradoxical in view of the Oilseed Study's conclusion that substantially more oil could be produced without disrupting current production of other major crops.

B. The Causes

Figure 1 suggests that the import dependence problem is due to either stagnating production or sharply rising consumption, or a combination of both production and consumption problems. The USAID studies conclude that the root causes of the import problem are in four areas of market policy.

1. Inadequate Competition in Processing

In the edible oils processing subsector, the Ghee Corporation of Pakistan, a public enterprise, dominates the market. It behaves like a monopolist by restricting entry of private sector firms into the industry. The government's practice of restricting the size of new private ghee mills through the sanctioning process serves to protect the GCP's monopoly position, but it also increases average costs of oil processing. Preferential treatment for the GCP on transportation, imported oil and canning costs and the absence of profit incentives in the GCP have eliminated adequate incentives to the industry to minimize production costs and invest in modern processing technology.

2. Inadequate Competition in Wholesale Oil Trading

The GCP's monopoly role in wholesale oil trading is another major example of weak competition giving rise to increased marketing costs at the consumer's and the government's expense. Since most of the oil required by the processors must be imported, it would be to their advantage to have an open, competitive import market to minimize the importers' offered prices. Unfortunately, the wholesale oil trade has been restricted to buy imported oil from a very concentrated market which has been dominated at various times by either the Trading Corporation of Pakistan or the GCP.

On the domestic side, the oilseed crushing industry has stagnated under the GCP's past monopoly control of cottonseed oil. As a result of this market arrangement, private processors were again placed at the mercy of the GCP in buying wholesale oil and cottonseed crushers found it relatively more profitable to sell oil in cake form than to the oil market. Recently, the government announced a new policy of open competition among

B. Major Economic Policy Goals

Pakistan's most fundamental economic policy goal is a steady increase in per capita purchasing power. This goal is reflected through the government's well publicised aims to achieve: food security; adequate farm income; low price inflation; full employment; and balanced external trade accounts.

C. The Role of Tradeoffs in Resolving Policy Conflicts

The formulation of a successful edible oils policy will require compromises among conflicting values, beliefs and economic policy goals. Decisionmakers will be able to make more informed judgements about the political, social, administrative and economic consequences of each policy option if the compromises are posed as policy tradeoffs.

The edible oil studies identified four major policy target groups that should be considered in any discussion of tradeoffs: the Government Treasury; oilseed farmers; edible oil processors; and consumers. The recommendations presented in the STM Study were designed to address these target groups with policy changes that can be viewed as economic tradeoffs.

IV. Recommendations for a New Policy Approach

During the past 15 years, market performance in Pakistan's edible oils sector has deteriorated steadily. The STM Study concluded that the edible oils sector can benefit from three major policy changes: increased competition in edible oil trading and processing; complete decontrol of retail vegetable ghee prices; and new import and tax policies to rationalize domestic edible oil prices with the international market.

A. Increase Competition in Processing

The main barrier to entry into the edible oils processing industry is the government's sanctioning procedure, which limits private sector firms to low, high-cost operating capacities and requires unnecessary administrative authority. The STM Study recommended increasing competition in the industry by removing all edible oils sanctioning requirements.

B. Increase Competition in Wholesale Oil Trading

Competition in the processing industry is also severely restricted by the government's key role in wholesale oil trading. Most imported oil is purchased by one buyer, the GCP (formerly, the TCP had the same role). Because it is a government entity, the GCP is prohibited from buying forward contracts to hedge against international oil price fluctuations. The STM Study concluded that Pakistan's oil import costs are unnecessarily high because futures trading is not used and the major importer is a government organization without adequate incentives to minimize import costs. The STM Study recommended that all edible oil processors and traders be allowed to import oil directly. The study also strongly recommended the establishment of an edible oils futures market to allow the industry to minimize price risk in the international market and strengthen domestic oilseed production.

TABLE 1. ESTIMATED PRODUCTION, CONSUMPTION AND IMPORT EFFECTS OF NEW EDIBLE OIL POLICY. (THOUSAND TONS)

	----"Steady State" Assumptions----			----"Price Decontrol" Assumptions----			-----Effects of New Policy-----		
	Production	Consumption	Imports	Production	Consumption	Imports	Production	Consumption	Imports
	(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)
1984	205	965	760	214	950	736	9	-15	-24
1985	203	1,067	864	221	1,036	815	18	-31	-49
1986	200	1,182	982	228	1,128	900	28	-54	-82
1987	199	1,310	1,111	237	1,230	993	38	-80	-118
1988	196	1,454	1,258	246	1,343	1,097	50	-111	-161
1989	194	1,615	1,421	254	1,466	1,212	60	-149	-209
1990	192	1,794	1,602	264	1,602	1,338	72	-192	-264
1991	189	1,995	1,806	274	1,751	1,477	85	-244	-329
1992	187	2,220	2,033	284	1,916	1,632	97	-304	-401
1993	184	2,472	2,288	295	2,096	1,801	111	-376	-487
1994	183	2,753	2,570	308	2,294	1,986	125	-459	-584

SOURCE: STM Study, Table 2-2, page 8,

The year 1984 is included because the STM Study assumed the new policies would begin then.

while consumption would increase at about 11 percent per annum. Imports would increase at about 13 percent per annum to meet the growing gap between consumption and production. A key element of this scenario is the assumption that retail vegetable ghee prices continue to rise at about 6.6 percent per annum.

2. "Price Decontrol" Policy Scenario

An alternative, "Price Decontrol", scenario was designed to estimate the market effects of the major policy changes recommended by the STM Study. In this scenario, future production would increase at an annual rate of almost four percent. Consumption would continue to increase, but at a slower rate (nine percent per annum). The combined production and consumption effects would slow the annual import growth rate from 13 percent to 10 percent. The price decontrol scenario assumes major market reforms are implemented to allow farmgate oilseed prices to vary directly with the interaction between the prices of retail oil and landed imported oil. Oilseed producers would respond to the new policy by increasing oilseed acreages and yields. Under a price decontrol policy, retail vegetable ghee prices are assumed to rise at an annual rate of up to 10 percent as the market realigns oil prices with all other food prices.

3. Differences Between Policy Scenarios

The estimated net market effects of the new policy are presented in Table 1 as the difference between the two scenarios. By 1994, the new policy would produce an extra 125,000 tons of oil above the "Steady State" level. The slower consumption growth rate would result in 459,000 fewer tons consumed in 1994, compared to predicted consumption under current policies. Imports would continue to rise, but the slower growth rate would save about 584,000 tons annually by 1994.

Nor is the edible oil policy question confined only to tradeoffs between foreign exchange savings/costs and consumer losses/benefits. The Ministry of Finance should also consider the benefits of releasing valuable public funds that are currently tied up by the GCP as working capital for its oil import buying operations. If the GCP's importing operations are assumed by the private sector under the proposed new policy, the savings in operating capital to the government would amount to at least \$2.2 billion over the 1984-1994 period (Table 3).

TABLE 3. ESTIMATED TAX, GOP OPERATING CAPITAL AND MARKET COST EFFECTS OF NEW POLICY.

	'PD' Ghee Demand -1,000 Tons-	Net Farm Income Gain	Import Tax Gain	GOP Oper. Capital Saving	Market. Cost Saving
	(a)	(b)	(c)	(d)	(e)
1984	834	5	57	64	36
1985	917	10	67	78	43
1986	1,008	16	79	95	52
1987	1,108	24	94	115	63
1988	1,217	34	111	139	77
1989	1,337	43	131	168	93
1990	1,469	55	154	203	112
1991	1,614	70	182	244	135
1992	1,773	85	216	294	163
1993	1,947	105	254	354	197
1994	2,139	126	300	426	238
TOTAL:		573	1,645	2,180	1,210

NOTES: (Totals may not sum properly due to rounding.)

Exchange rate of Rs.16=1\$US is used for the 1984-94 period.

- (a) Projected vegetable ghee demand under "Steady State" scenario (STH Study, Annex B, Table B-4, page 62).
- (b) Assumes returns to farm land, labor and capital are 40% of import price per ton of domestically produced oil.
- (c) Assumes 15% of import price (Table 2, column b), per ton of "PD" import demand (Table 1, column f).
- (d) Assumes 60 day supply at import price per ton of annual "SS" import demand (Table 1, column c).
- (e) Assumes 5% saving on "PD" ghee price (Table 2, column g), per kilogram of "PD" ghee demand (column a).

The edible oil processing industry would also realize important benefits from increased competition under the new policy. The edible oils studies concluded that private sector oil mills are much more efficient, even under existing restrictive policies, than the typical GCP plant. It is conservatively estimated that vegetable ghee production costs could be reduced by at least one rupee per kilogram under the competitive marketing

TABLE 4. SUMMARY OF ESTIMATED EFFECTS OF NEW EDIBLE OILS POLICY

	-----GAINS-----				-LOSSES-		Net Gain
	Foreign Exchange	GOP Capital	Oper. Tax	Import Market. Costs	Farm Income	Consumer Surplus	
-----Million Dollars-----							
1984	12	64	57	36	5	26	148
1985	27	78	67	43	10	60	165
1986	48	95	79	52	16	108	183
1987	74	115	94	63	24	171	198
1988	108	139	111	77	34	255	213
1989	150	168	131	93	43	366	219
1990	203	203	154	112	55	510	217
1991	271	244	182	135	70	697	206
1992	353	294	216	163	85	937	175
1993	459	354	254	197	105	1,246	123
1994	588	426	300	238	126	1,642	37
TOTAL:	2,295	2,180	1,645	1,210	573	6,019	1,884

NOTE: Totals may not sum properly due to rounding.
SOURCE: Tables 2 and 3.

A. A Comprehensive Approach to the Edible Oil Problem

The edible oils sector involves many interdependent technical and economic relationships that indirectly affect an even wider portion of the economy. The proposed new policy should be evaluated on its comprehensive treatment of these interdependences and its potential to create new problems as the old problems are solved.

B. Need for Stronger Private Sector Role in Edible Oils

Any decision on a new edible oils policy should not ignore the major benefits that can be gained by strengthening the private sector's role in edible oils. The Sixth Five Year Plan stresses the government's determination to give the private sector greater responsibility for national economic growth. The edible oils sector offers the government an excellent opportunity to fulfill that commitment.

C. Need to Eliminate Counterproductive Regulations

Any change in edible oils policy should reflect a major commitment to remove counterproductive regulations. Many of the regulations on sanctioning procedures may have been implemented with good intentions, but the cumulative effects have meant higher marketing costs and serious disincentives to technological innovation. Retail price controls undoubtedly reflect the government's strong concern for the welfare of poor consumers, but the resulting rapid increase in consumption has compromised the nation's balance of payments and overall food security.

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.
2. U.S. Department of Agriculture. *Pakistan's Edible Oilseeds Industry*. Islamabad, Pakistan: United States Department of Agriculture, Office of International Cooperation and Development, March 1984.