Toward Free Trade

A European Union Perspective

by Seamus J. Sheehy

The Uruguay Round Trade Agreement (URTA), which has replaced the GATT, was implemented in July 1995 under the auspices of the World Trade Organization. The URTA as it relates to agriculture spans a six-year period to June 2001, and the parties involved are committed to reopen negotiations in 1999 to reach a new agreement to succeed it.

It is therefore appropriate at this time to review the genesis of the URTA and, in particular, the crucial role played by the European Union (EU) in that saga. It is argued that the next trade agreement is likely to be much more radical than the URTA, mainly because of changing political circumstances in the EU.

The URTA

Negotiations in the Uruguay Round began in 1986 and extended over eight years to April 1994. The negotiations covered trade in a wide range of goods and services in addition to agricultural commodities, but it was agriculture that posed the greatest barrier to progress. So from being a peripheral player in the seven previous rounds of trade negotiations under the GATT, agriculture had now moved center stage.

The orientation of countries in the negotiations ranged from those advocating a rapid dismantling of all protection—led by the United States—to those seeking minimal changes—led by the EU. Therefore, each of the critical hurdles which had to be surmounted culminated in a show-down between the United States and the European Union.

After some four years of negotiations—which were largely spent shadow boxing—the shape of the ultimate agreement emerged. It had four dimensions, namely, *(i)* a reduction in the level of domestic support, *(ii)* a reduction in the degree of protection of domestic markets, *(iii)* a reduction in the extent of export subsidization, and *(iv)* the introduction of sanitary and phytosanitary regulation. Most of the subsequent argument then concerned the quantification of the first three of these headings.

The final agreement was much closer to the EU position than to that of the U.S. It was therefore a bitter disappointment to all free traders, including most agricultural economists. Nevertheless, it was a historic achievement because for the first time agricultural trade was brought under global discipline.

Price reduction

The main reduction in prices occurred in cereal and protein crops where, for example, the support price of cereals was reduced by 29 percent over three years to some $130 per ton. This was still well above world trading prices at that time. Direct payments were introduced to compensate for the price reduction, and these rose over the three years to some $175 per acre, varying according to average yields by region. A similar system of direct payments had already been introduced in 1991 for oilseeds.

The new support system for cereal, protein, and oilseed crops requires arable farmers to return details of their cropping program each year as a basis for claiming their entitlements. In theory, participation is voluntary, but in practice no grower would forego the attractive direct payments offered.

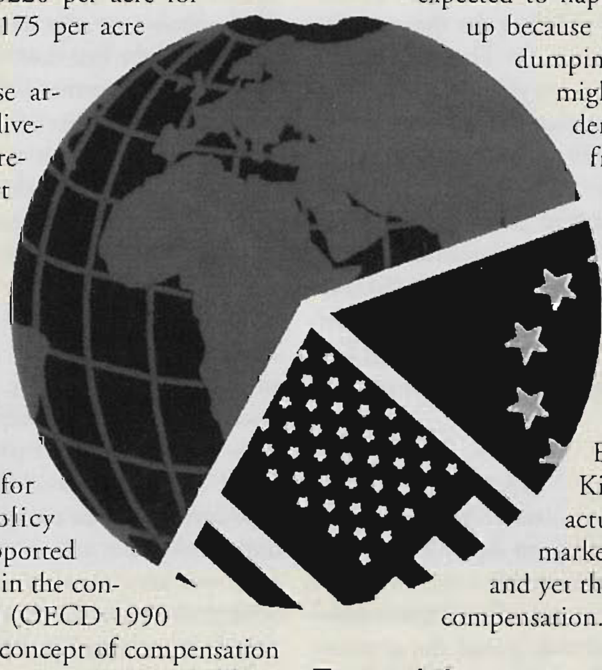
The other price reduction involved was for beef where the intervention price was cut by 15 percent and offset by a complicated set of payments per head on beef cattle. A similar approach was proposed by the commission for milk, but was rejected by the council. However, the commission proposes to return to this formula in the years ahead as a way of dismantling the milk quota regime.

Supply control extended

The supply control content of the MacSharry reforms has two aspects: partial decoupling of the new payments and introduction of land set-aside.

The new compensatory payments are restricted to the crop areas and yields and to the herd sizes prevailing at the time the reforms were proposed. So they are still coupled with current production up to these limits, but any expansion above this does not qualify for the payments. This quasi-decoupling was a critical condition for subsequently getting the U.S. to agree to exempt such payments from curtailment under the URTA.

The land set-aside introduced is essentially an import from the United States. There is a compulsory set-aside requirement for participation in the case of all but the smallest growers. In addition, there is provision for voluntary set-aside by all growers should they wish to exceed the mandatory area. All set-aside land attracts a payment in excess of the planted area payment; for cereals in 1995–96 this amounted to some $220 per acre for set-aside in contrast to $175 per acre for planted area.



The net effect of these arrangements for crops and livestock is to continue the previous high level of support for EU farmers, but to prevent it from increasing. This was sufficient to meet the requirements of the URTA.

Generosity bias in compensation

Compensating farmers for losses arising from policy change has long been supported by agricultural economists in the context of trade liberalization (OECD 1990 and 1994). However, the concept of compensation advocated has always been payments decoupled from current production and so based on some historic criteria of output, income, etc. Also such payments would be phased down over time to ultimately disappear as agricultural resources adjusted to free-trade prices.

This is not the concept introduced by MacSharry. The European Commission (1991a, b) made it quite clear that the new compensatory payments it proposed were designed to "fully compensate" all but the largest farmers, and the Council of Ministers increased the proposed payments to ensure that most of the larger farmers also received full compensation. Furthermore, any suggestion of reducing the payments over time was rejected out of hand.

The commission has never spelled out in detail its definition of "full compensation." Agricultural economists would have in mind compensating for *income* loss, but the commission calculations were based on *revenue* loss. Now since income equals revenue minus costs, there is a great possibility of the new payments actually overcompensating rather than just fully compensating for income loss. This possibility becomes a probability if the level of payments are not adjusted down over the years. Any reduction in unit cost of output, either by a lower volume of inputs or falling input prices, would translate into overcompensation, all things being equal. Of particular importance here is the ongoing reduction in labor.

The generosity bias does not end at this. The level of compensatory payments was calculated in relation to the fall in support prices rather than in market prices. Therefore, if market prices do not fall in line with the reduced support levels, income will also increase, all things being equal. This is expected to happen as world prices firm up because of reduced EU and U.S. dumping under the URTA. It might also happen for regular demand/supply reasons and from currency realignments. In fact, since 1992 when the payments were calculated there have been many such market price changes, including the international rise in cereal prices in 1995–96. Some EU countries, the United Kingdom for example, have actually experienced a rise in market prices rather than a fall, and yet they receive the full level of compensation.

Toward the next trade agreement

Superficially the reduction in protection agreed upon in the URTA appears significant, with, for example, a 20 percent reduction in the domestic support level, a 36 percent reduction in tariffs, and a 21 percent reduction in the volume of subsidized exports. But most countries, including the EU, have contrived formulae in calculating these sums to minimize the impact at farm level. As a consequence, now in the second year of the agreement, EU farmers are scarcely aware of its existence.

Yet by the end of the current agreement and the beginning of its successor in July 2001, reductions in protection will have progressed to a degree which will begin to affect trade. This will vary by commodity and by country. In the EU tariffs will have fallen enough to begin to affect milk and sugar beet prices, if EU prices remain at their current levels and if world prices are low. Restrictions on subsidized exports will also be hurting in the cases of cereals, dairy products, and beef. Any further reductions in protection in the next trade agreement will progressively force down farmgate prices.

Within the EU debate has already begun on the approach to the next agreement. It is expected that external pressure for further trade liberalization will intensify, and internally there will be a new concern, namely, the expected enlargement of the EU to the east to take in up to ten Central European Countries (CECs). This will probably begin with Poland, Hungary, and the Czech Republic and subsequently extend to other CECs. Negotiations are to begin with those countries toward the end of next year and will undoubtedly continue and overlap with the new trade negotiations. Further CAP reforms must then both satisfy the EU's trading partners and facilitate enlargement.

Agriculture in the CECs is still emerging from its communist past (European Commission 1995). At this stage most countries are operating close to international trading price levels. While there are pressures to push up prices, they are not likely to succeed for at least two reasons: these countries are too poor to afford the luxury of high agricultural protection, and their consumers will resist high prices since they still spend some 40 percent of their income on food in contrast to 10 percent in the United States.

More radical reform ahead

The CAP reforms needed to satisfy the two EU goals—namely, a new trade agreement and enlargement—must therefore bring price levels down toward world trading levels. This may even begin before the next trade negotiations are completed. The EU farm lobby will again resist, and while the strength of that lobby is slowly weakening over time, it will still be strong enough to have to be placated. Therefore, further compensatory payments will be required. But these cannot be as generous as the MacSharry payments. Internal EU pressures will force a redefinition of the concept of compensation toward the transitional payments advocated by agricultural economists. At the same time external pressures will lead to fuller decoupling of such payments to minimize their trade distortions. The decoupling of similar payments in the 1996 U.S. "Freedom to Farm" bill will then be consolidated in the next trade agreement.

For more information

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