Staff Papers Series

Staff Paper P90-2

January 1990

AGRICULTURE IN THE URUGUAY ROUND:
A EUROPEAN PERSPECTIVE

by

Ken A. Ingersent

Department of Agricultural and Applied Economics

University of Minnesota
Institute of Agriculture, Forestry and Home Economics
St. Paul, Minnesota 55108

Staff Paper P90-2

January 1990

AGRICULTURE IN THE URUGUAY ROUND: A EUROPEAN PERSPECTIVE

by

Ken A. Ingersent*

*Visiting Professor, Department of Agricultural and Applied Economics, University of Minnesota, St. Paul, MN 55108. This paper was written when Professor Ingersent was on leave from the Department of Economics, University of Nottingham, England.

AGRICULTURE IN THE URUGUAY ROUND: A EUROPEAN PERSPECTIVE

Introduction

The European Community's stance in the Uruguay Round Agricultural negotiations needs to be seen against the background of an ongoing process of economic integration which is still far from complete. It also needs to be seen in a historical perspective, particularly that of the Common Agricultural Policy (CAP).

The Community is characterized by the persistence of substantial regional disparities in per capita income, unemployment, the relative importance of agriculture in the economy and other economic indicators (Table 1). These disparities suggest that the EC (12) still has a long way to go before attaining the degree of economic and social integration already achieved in North America. Community decision makers appear to take the view that such disparities justify continuing to afford EC agriculture some measure of protection from the vagaries of unstable world prices and exchange rates. This interpretation of the basic reason for the continued protectiveness of the CAP does not, of course, deny that substantial differences of view exist amongst economists on the relative merits of "openness" and "protection" in the pursuit of long-term economic growth. A further reason for the adoption of a protective stance is the pervasiveness of political constraints upon trade liberalization.

The nature and origins of the CAP

Turning from the present to the past, the formulation of the CAP was the major "achievement" of the six foundation members of the EC in

Table 1

BASIC ECONOMIC INDICATORS WITHIN THE EC (EUR 12) AND IN NORTH AMERICA

Country	GDP/cap (a) current market prices (1988) PPS[1]	Total population (1986) millions	Unemployment rate (1987) percent	Percent employed in agriculture forestry and fishing (1987)	Av. holding size (1985) ha
Bel.	13,883	9.9	12.1	2.8	14.1
Den.	16,025	5.1	7.5	6.5	30.7
W.G.	15,702	61.1	8.1	5.2	16.0
Greece	7,670	10.0	2.8	27.0	4.3
Spain	9,893	38.7	20.4	15.1	12.9
France	15,042	55.4	11.1	7.1	27.0
Ir.	8,537	3.5	19.1	15.4	22.7
Italy	14,527	57.2	14.1	10.5	5.6
Lux.	17,326	0.37	1.7	3.7	28.6
Ned.	14,527	14.6	11.8	4.7	14.9
Port.	7,196	10.2	7.0	22.2	4.3
U.K.	14,158	56.8	10.7	2.4	65.1
EUR (12)	13,639	322.8	11.6	8.0	12.9
CANADA	17,428	25.4 (1985)	6.9 (1986)	5.1 (1986)	n.a.
U.S.A.	21,307	239.3 (1985)	9.5 (1986)	3.1 (1986)	180.2

Sources: Eurostat, Basic Statistics of the Community, European Commission, The Agricultural Situation in the Community, World Bank, World Development Report.

[1]PPS–purchasing power standard ($U.S.)

its early days. The CAP is based upon the three mutually supporting principles of common prices, common financing and Community preference. The task of harmonizing six very diverse systems of national agricultural support and protection to accord with the application of these principles was inherently difficult. Several years of hard work were needed to achieve success interspersed by numerous internal disputes and disagreements, including the celebrated episode in 1965 when France withdrew from the Community for six months, ostensibly on the question of agricultural financing, but really on the issue of the ability of individual member states to veto council decisions. Having resolved this dispute (with the "Luxembourg Compromise") and many others, the architects of the CAP were justly proud of their achievement in completing the edifice.

The protectiveness of the CAP is enshrined in the principle of Community preference, whereby third country suppliers are deliberately placed at a competitive disadvantage compared with community suppliers on community markets. The emphasis given to this principle by the architects of the CAP is explained by the long tradition of agricultural protectionism in EC (6) member states, especially France and Germany, both before and after the Second World War. It is essential to view the nature of the CAP in this context. Thus, if the UK and Denmark had been founder members of the EC, the CAP might well have been less protective. But, in the event, those countries did not join the Community until after the nature and form of the CAP had already been decided by the EC (6) member states. A major reason why the UK and Denmark delayed their applications for membership was basic disagreements with the EC (6) on agricultural policy. But once they decided to seek accession to the Community, acceptance of the CAP, as it stood, became a condition of admission.

Problems of the CAP and internal pressures for reform

The common prices of regulated commodities (i.e., commodities covered by CAP regulations) tended to be set at a high level. This was a virtually inevitable result of harmonizing a wide range of national price levels which initially prevailed in member states. With the benefit of hindsight, it is easy to see that setting CAP prices high relative both to world prices and to the costs of low-cost EC producers was bound to lead to serious problems of over-production and structural surplus accumulation. But there is little or no evidence that when the CAP was formed during the early and mid-1960s, its architects anticipated such problems. The Community was then considerably less than self-sufficient in nearly all agricultural commodities. However, the EC Commission did come to recognize over-production as a major problem of the CAP, even before the first enlargement from EC (6) to EC (9) in 1973. Thus the Mansholt Plan (1968) advocated major farm structural reform to create larger and more efficient farms to enable prices to be lowered nearer to market clearing levels.

The Mansholt Plan encountered fierce political opposition, especially from farm representative organizations who dubbed Mansholt the "peasant killer." Although, in 1971, the Council agreed to a much watered down scheme of farm structural reform, the pressure to apply the brakes to rising agricultural production especially through price policy, was temporarily relieved by the world-wide agricultural crisis of 1972-73 when the prices of grains and other commodities rose to unprecedented levels. However, the Commission returned to the task of formulating proposals for the reform of the CAP, and especially to contain expenditures in the guarantee section of FEOGA (the Agricultural Budget) as early as 1973, with the publication of "Memorandum Agriculture, 1973-1978." But, apart from a few cosmetic measures, such as the co-responsibility levy imposed on milk producers in 1977, the Council failed to take the need for reform seriously until the 1980 "Mandate," under which the Commission was required to come forward with proposals for curbing the budget. But the pressure for fundamental CAP reform was again abated by a temporary improvement in world agricultural prices in the early 1980s. Action on the Mandate was also held up by the delay in finding a solution to the contemporaneous problem of the British budget contribution. However, a package deal was finally agreed by the European Council in March 1984. The package included a solution to the British problem combined with the introduction of milk quotas to curb agricultural expenditure. This is now recognized as the first significant and substantial measure of CAP reform.

A substantial volume of independent academic critiques of the CAP, including radical proposals for reform, appeared almost from the time of its formation. So for example, as early as 1971, two British critics proposed that the EC should abandon agricultural price support -- apart from a low "safety net" -- in favor of direct budgetary compensation for existing farmers (Marsh and Ritson, 1971).

External pressures for reform

During the early 1950s the movement towards European integration, and the formation of the EC, were encouraged by the United States and other Western countries, mainly for strategic reasons. The possibility of an economic backlash, including international trading problems, may have been foreseen, but was not viewed then as being paramount.

The Dillon Round of multilateral trade negotiations in GATT, during 1960-61, coincided with an early stage of CAP formation, though not before the Variable Import Levy (VIL) had been adopted as the major protective instrument. The United States then tried but failed to obtain from the European Community guaranteed access for its existing level of agricultural exports. With the benefit of hindsight, it is now clear that, from the point of view of the EC's competitors, the major achievement of the Dillon Round was the binding of duty rates on oilseeds, oilseed products and cereal substitutes at low or zero levels. At the time the EC was far from self-sufficient in these commodities and probably failed to realize the importance of this concession.

The Kennedy Round of MTNs (1964-67) coincided with a later but still unfinished stage of establishing the CAP. So the Kennedy Round was the final opportunity for the GATT to influence the CAP before its completion. During the Kennedy Round the EC proposed that all measures of agricultural support might be reduced to a common denominator termed the margin of support or "montant de soutien." Moreover, having agreed upon the common denominator, it might also be feasible to agree to bind the margin of support. With the benefit of hindsight, this appears to have been a somewhat remarkable offer by the EC anticipating by some 20 to 25 years the current PSE approach to agricultural policy and trade reform. However, at the time, this and other EC proposals were rejected by the United States and other temperate agricultural product exporters, ostensibly because the EC failed to offer any reduction in margins of support, but possibly also for other reasons such as unwillingness to accept domestic policy constraints.

By the time of the Tokyo Round of MTNs (1973-79) the edifice of the CAP was complete and the EC's negotiating mandate was quite explicit in insisting that since the principles and mechanisms of the CAP could not be called into question, they were strictly non-negotiable. The montant de soutien proposal was not repeated. The Tokyo Round ended in 1979 without making any significant impact on the CAP or achieving other major advances in lowering agricultural protection.

Reforms actually achieved

The milk quota scheme, adopted in 1984, has been effective in "capping" EC milk production. The total quota has in fact been reduced since the start of the scheme, by 6 percent in 1987-88 and 2.5 percent after 1988-89. The Brussels Summit of February 1988, extended the life of the scheme until 1992, but most informed observers expect it to continue indefinitely. Existing milk producers who hold quotas are generally in favor of the scheme. Intervention stocks of butter, skimmed milk, and other dairy projects have virtually disappeared. But, the prices received by producers and paid by consumers remain high compared with world market levels.

In the case of milk, the Council chose quotas, a non-market instrument, in preference to a price cut large enough to counter or reduce production by the required amount. But in February 1988, the Brussels Summit adopted "stabilizers" to limit budgetary expenditure on most other CAP regulated commodities. Commodity stabilizers consist of two related elements:

1) an aggregate production threshold (or MGQ), and

2) a punitive "co-responsibility" levy to penalize producers for exceeding the threshold.

In the case of cereals, two levies apply. A <u>basic</u> levy, amounting to 3 percent of the intervention price is augmented by a <u>supplementary</u> levy of the same magnitude (i.e., 3 percent). Both levies are collected from individual producers at the first point of sale, but the supplementary levy is refundable if the MGQ is <u>not</u> exceeded. If the MGQ is exceeded, there is also a deferred price penalty in that the following year's intervention price is automatically reduced by the amount of the supplementary levy.

Commodity stabilizers are complemented by overall budgetary discipline. The rate of growth of FEOGA guarantee expenditure cannot exceed 74 percent of the Community's annual GDP growth rate. This "agricultural guideline" effectively imposes an absolute ceiling on each year's FEOGA guarantee expenditure.

The Commission has set up an "early warning system" to monitor FEOGA expenditure and compliance with the agricultural guideline. Should an overshoot threaten, the Commission is obliged to table proposals for strengthening stabilizers, and the Council must act within two months.

2. <u>The EC's attitude to the Uruguay Round and negotiating stance on agriculture</u>

The Uruguay Round was launched in 1986 with the Punte del Este Declaration which committed GATT member countries to a new round of MTN's emphasizing the reform of agricultural trade. The European Community's attitude to the launching of the Uruguay Round was ambivalent. On the one hand, like other countries with highly protected domestic agricultures and growing burdens of agricultural support expenditure, the EC could perceive the potential benefits of relieving budgetary pressure through international agreement to limit and reduce agricultural support and protection. The EC also had motives for safeguarding wider, non-agricultural trading interests, especially with the United States, which refusal to negotiate on agriculture might have compromised. On the other hand, the EC's attitude to a new round of MTNs, with agriculture at the center of the stage, was tempered by a continued unwillingness to allow the CAP to be the subject of international negotiations. The internal political costs of giving ground on this issue were still considered to be too high.

Unlike the EC, the United States and the Cairns Group countries were wholeheartedly in favor of agricultural trade liberalization. So the EC's major agricultural market competitors were probably more influential than the EC itself in launching the Uruguay Round. However, the absence from the Punte del Este Declaration of any explicit mention of export subsidies may reflect the EC's influence.

The EC's 1987 position paper on agriculture

The EC's initial position paper on agriculture was tabled in Geneva after the US had presented its "zero-option" proposal. Thus the stance adopted by the EC was, in part, a reaction to the US proposal.

The EC condemned the US proposal as "unrealistic," but also accepted the desirability of reaching international agreement on measures of agricultural trade reform, both short-term and long-term. Short-term measures of two types were proposed:

(1) Action to reduce instability in particular commodity markets like cereals (and cereal substitutes), sugar and dairy products through market management, and

(2) Action to reduce excess commodity supplies overhanging international markets through negotiations to lower levels of producer support and protection.

For the long-term, the EC proposed a concerted move towards reduced domestic support over a wide range of commodities, allied with lower external protection, but not their phasing out.

The EC attitude to PSEs

The EC also advanced a proposal similar to the "montant de soutien" proposal it had put forward during the Kennedy Round. In its 1987 position paper, the EC again offered to contemplate binding and reducing levels of protection in GATT, using the PSE[1] or similar device, but with two provisos:

1) Any agreement on binding overall levels of protection must be

---

[1]Like alternative AMSs, the producer's subsidy equivalent (PSE) is a summary measure of the impact of all forms of government support and protection on farm incomes.

sufficiently flexible to permit protection of particular commodities to be increased -- termed the "re-balancing" proposal.

2) The fundamental principles of the CAP, including the principle of community preference maintained by means of the variable import levy (VIL) and variable export subsidy (VES), must continue to remain off the negotiating table.

In October 1988, the EC tabled a further paper proposing progressive reductions in support over five years from a 1984 baseline (1984 was a year of peak production in the EC, immediately preceding the introduction of milk quotas). However, the proposed reductions in agricultural support were not quantified. The same paper also included details of the EC's proposal for a modified AMS, termed the "support measurement unit" (SMU). The SMU differs importantly from the PSE in two respects:

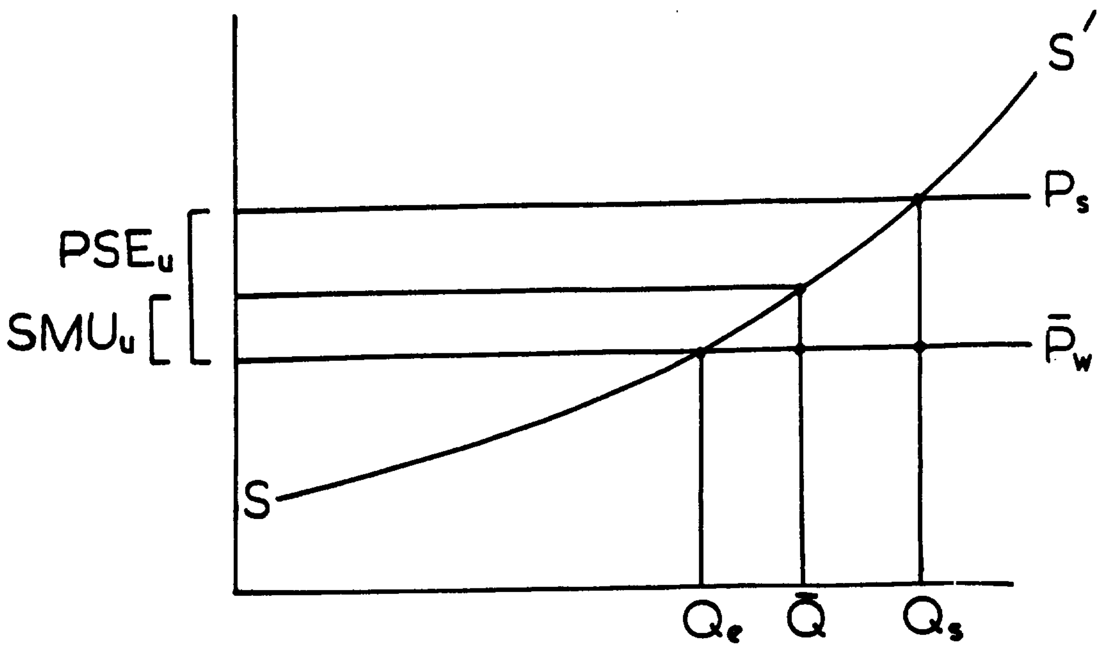
1) It gives credit for government imposed supply control.

2) It measures the difference between the domestic support price (P_s) and a fixed external reference price expressed in national currency, instead of an unstable world price (P_w).

A diagram will serve to clarify the first mentioned of these differences.

In Figure 1, price support without supply control produces equilibrium at output level Q_s. At this output, the unit PSE is P_s-$\overline{P}_w$, where $\overline{P}_w$ is the external reference price. P_s-$\overline{P}_w$ also represents the marginal economic rent which producers derive from price support at output level Q_s. Now suppose that a government imposed quota limits aggregate supply to output level $\overline{Q}$. An effect of supply control is to

Figure 1



Comparison of PSE with SMU: the EC proposal for allowing a PSE 'credit' for supply control reduce the marginal economic rent from P_s-$\overline{P}_w$ to a lower level represented by the vertical distance between the supply curve and $\overline{P}_w$ at output level $\overline{Q}$. This distance also represents the unit SMU with output constrained at $\overline{Q}$. Just as the aggregate PSE at Q_s is $(PSE_u)(Q_s)$ where PSE_u is the unit PSE, so the aggregate SMU at $\overline{Q}$ is $(SMU_u)(\overline{Q})$ where SMU_u is the unit SMU.

The SMU also makes a clear distinction between trade-distorting and non-trade-distorting levels of domestic output. Output level Q_e, which equilibriates the supply price with $\overline{P}_w$, is considered to be non-trade-distorting. Q_e also defines the output level where SMU=0.

The SMU is similar in conception to the Canadian "trade distortion equivalent" (TDE)[1].

3. EC's position at Montreal mid-term review, December 1988

At the mid-term review of the Uruguay Round held in Montreal in December 1988, the United States refused to budge from its insistence that any negotiations on lowering agricultural support levels in the short-term must be preceded by a prior commitment to the elimination of support within 10 years.

The European Community not only refused to subscribe to the zero-option but also either to quantify the reductions in farm support it was prepared to make, or the time period over which it was prepared to make them.

---

[1]The author's analysis of the difference between the PSE and the SMU derives from the work of Don McClatchy at Agriculture Canada and in particular from the Government of Canada (1988).

In his report to the Montreal meeting, the Chairman of the Negotiating Group on Agriculture (NGA) worked hard, but in vain, to find enough common ground between the U.S. and the EC for some agreement to be reached. Ministers were invited to decide "whether the ultimate goal should be the elimination or the substantial reduction of trade distortive support and protection" (author's emphases).

The Uruguay Round might have collapsed as a consequence of the impasse reached at Montreal. But the negotiations were saved by an agreement to adjourn until a re-convened meeting of agricultural officials to be held in Geneva in April 1989. In the meantime, the Secretary-General of the GATT was instructed to seek a means to escape from the impasse.

Concessions made and gained at Geneva, April 1989

The cooling off period between Montreal and the date of the re-convened meeting in Geneva appears to have produced a change of heart on both sides, especially in the U.S. where the change of President apparently gave negotiators a better sense of what might be politically feasible, not only abroad but also at home, in dealing with Congress and various farm lobbies.

The change of heart enabled the GATT Secretary-General to succeed where the Chairman of the NGA had failed. The Dunkel Text, forming the basis of the agreement reached at Geneva, termed the "Geneva Accord," turned out to be remarkably similar in most respects to the Chairman's Report at Montreal. However, the Dunkel Text contained no reference to the possible elimination of trade distorting support and protection, but only to the possibility of substantial progressive reductions in them, giving credit for measures taken since the Punte del Este Declaration (i.e., since 1986). This compromise reflected concessions made both by the U.S. on the zero-option, and by the EC, which wanted credit for measures taken since 1984.

The Geneva Accord was, in its turn, notable for its similarity to the Dunkel Text. However, a notable feature of the Accord was the omission of any reference to supply control. This could be interpreted as a victory for the United States, since Dunkel had proposed there should be no short-term relaxation of supply control measures. There were also some differences in wording between the Dunkel Text and the Accord on both long-term and short-term measures to promote export competition. However, these differences do not appear to be of decisive importance.

4. Current state of play: where do we go from here?

This section opens with a brief assessment of the "achievements" marked by the Geneva Accord. This is followed by a review of the European Community's possible response to the call for short-term cuts in agricultural support and protection. This leads on to a consideration of the Community's likely stance in negotiations on long-term measures of agricultural policy and trade reform, including both the role of PSEs and the alternative option of extending or tightening GATT rules and disciplines.

Geneva Accord "achievements"

Study of the Geneva Accord points to three principal achievements.

First, agreement was reached that there should be an immediate short-term freeze and standstill on the application of measures of agricultural support and protection, subject to existing law. Second, it was agreed in principle that initial cuts in support and protection should be made, starting in 1990, as a "down payment" towards larger long-term reductions. But the down payments were not quantified at Geneva, although contracting parties were required to table 'statements of intent' by October 1989. Third, the Geneva Accord entailed for the contracting parties a commitment in principle to substantial progressive long-term reductions in support and protection over an agreed but as yet unspecified period of time.

Which of those three Geneva Accord achievements was the most crucial? Opinions differ, but the writer is inclined to think that the very short-term freeze and standstill agreement was critically important as a pre-condition for embarking on negotiations for the long-term.

The EC response to the call for short-term cuts and likely stance in negotiations on long-term reform measures.

Dealing first with the question of short-term cuts in support and protection, the United States is still implementing planned cuts in the budget prices of grains in 1989 and 1990. Likewise, the EC hopes that support price cuts resulting from existing and on-going reforms, including the 'stabilizers' agreed early in 1988, will obviate the need for additional CAP reform measures to be devised and implemented at least until 1991.

Turning from short-term "down payments" to the likely EC stance in negotiations on long-term measures of reform, the declared objectives of these negotiations are:

1) Substantial progressive reductions in agricultural support and protection over an agreed period" (as stipulated by the Geneva Accord), and

2) "Strengthened and more operationally effective GATT rules and disciplines" for agricultural trade (as stipulated by the Uruguay Round Declaration of 1986).

Two general points can be made on the EC's likely response to these objectives, before moving on to more technical considerations. One of these points seems to be favorable to successful MTNs on agriculture, but the other less so.

The favorable argument is that CAP decision makers are now firmly committed to reducing price incentives, even more than has already occurred, in order to reconcile farm budget spending with fiscal realities. The long-term momentum towards lower support is reinforced by a growing awareness that, due to the impact of continual productivity growth caused by technical progress, budget expenditure cannot be capped merely by freezing prices.

The less favorable argument is that current CAP reforms have been prompted primarily, not by international obligations but by <u>domestic</u> considerations such as:

1) the fiscal necessity of controlling the Community budget,

2) the political necessity of attempting to resolve conflict amongst member states with respect to sharing the costs and benefits of budget expenditure,

3) the political imperative of resolving problems of Community enlargement, and

4) the newest priority of ensuring that intra-Community agricultural trade is fully consistent with the requirements of the single European market as required by the Single European Act of 1985.

External political pressure for CAP reform, such as those exerted via the GATT, do not appear to have had much influence in the past. The main impetus has come from within the Community. But economic pressures, such as competitive export subsidies, may have had some effect.

Having dealt with these two general points with a bearing on the EC stance in multilateral trade negotiations directed at long-term agricultural reforms, we now turn to more technical issues. Two major issues appear to be:

1) the role of PSEs (or other AMS), compared with commitments on specific policy measures, in lowering agricultural support and protection, and

2) the implications of the Geneva Accord commitment to extending the ambit of and otherwise tightening GATT rules and disciplines.

These issues are briefly discussed below.

The role of PSEs

The EC appears to be favorably disposed to the use of PSEs, both to monitor and to bind support levels, subject to other parties to the negotiations adopting an acceptable definition of the PSE (or other AMS). As explained above, the critical issues for the EC in this context are: 1) adjustment for short-term price and exchange rate fluctuations, and 2) obtaining credit for domestic supply control.

Specific reasons for expecting the EC to favor the PSE approach to policy and trade reform include:

1) Current (i.e., Uruguay Round) and post (i.e., Kennedy Round) offers to negotiate on the basis of using a comprehensive indicator both to measure and bind support levels.

2) The PSE approach might permit more flexibility in complying with the requirements of any agreement than commitments on specific policies, especially with respect to the protection of particular commodities. The Community is known to be keen to gain acceptance of the principle of "re-balancing" commodity support levels. It may therefore be more likely to accept a progressive reduction in support and protection, measured in terms of an overall AMS, than a program requiring individual commodity AMSs to be lowered at a uniform rate.

3) The EC proposal that PSEs should allow credit for domestic supply control implies that, if forced to yield ground on the issue of 'overall' versus 'individual commodity' PSEs, the Community is likely to favor an aggregate rather than a per unit commodity PSE measure. Consider the example of the milk quota scheme. Because the support price remains high relative to the world price, the PSE per unit of production is correspondingly high. But, ceteris paribus, the effect of the quota is to lower the aggregate PSE attributable to the milk support regime.

Prior to the Geneva Accord, the United States was adamantly opposed to the adoption of PSEs as an instrument of agricultural trade reform, except possibly as a policy monitoring instrument. The U.S.

seems to have given considerable weight to the argument that the use of the PSE to bind levels of protection affords too much scope for cheating. Recent U.S. emphasis on the merits of converting all measures of agricultural trade protection to the form of tariffs (so-called "tariffication") suggests that, despite abandoning the "zero-option," the attitude to PSEs has not changed. Thus a major battle seems likely between the EC and the US on the role of PSEs in any final agreement.

Extending and tightening GATT rules and disciplines

The main areas of contention on this issue are:

1) Non-tariff barriers (NTBs), including VILs and VERs, as well as import quotas, and

2) Export subsidies.

NTBs

On this issue, the principle objective for the EC is to retain the continued use of the VIL providing absolute protection from imports. In the writer's view the EC is very unlikely to relax agricultural import restrictions significantly in the foreseeable future. The reason for this judgement is the paramountcy of Community preference. It is pertinent here to recall Josling's observation that "without Community preference we don't have a common market" (Josling, 1984). Proposals for capping VILs, or converting them to tariffs, are likely to be strongly resisted by the EC due to the relative weakness of these as alternative protective instruments. Surrendering the VIL, and the variable export levy (VEL) would expose the internal Community market to the vagaries of the world market, the very danger which the CAP is explicitly designed to prevent.

A simple diagrammatic presentation of the mechanics of CAP price support serves to show:

1) How the VIL provides absolute protection, as well as

2) Why VIL > VES

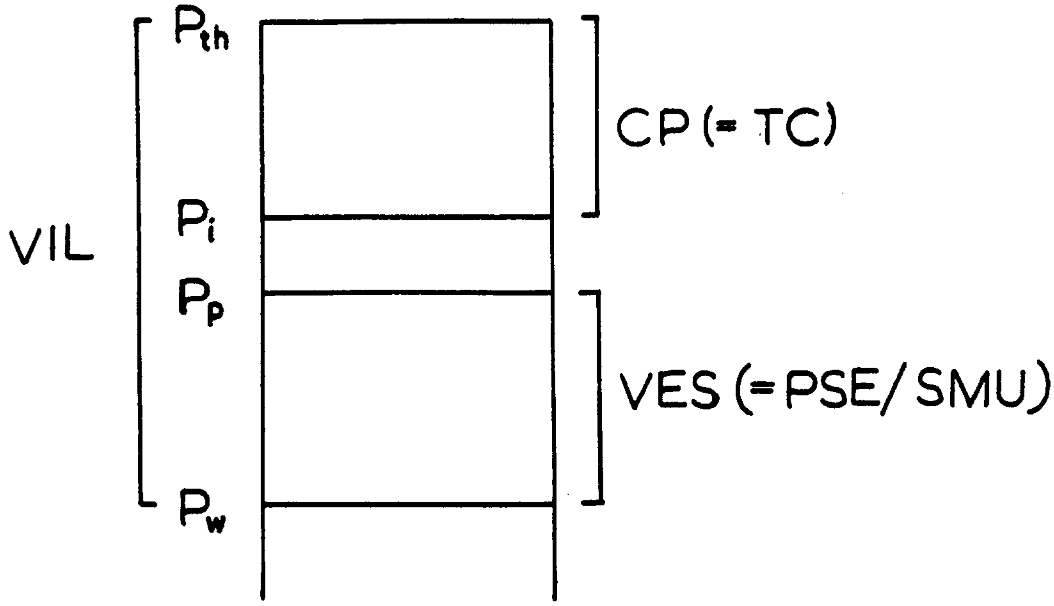
3) Why VES = PSE_u (or SMU_u)

4) Why PSE_u (or SMU_u) fails to reflect the nominal rate of protection (NPR) afforded by VIL.

The analysis which follows is based on the CAP cereals support regime. In Figure 2, P_{th}, P_i, P_p, P_w respectively signify the threshold price, the intervention price, the producer price and the world price of cereals. The following definitions then apply: VIL = P_{th} - P_w, and VES = P_p - P_w. The reason why VIL > VES is that, due to Community preference, $P_{th} > P_p$. Officially, the discrepancy between P_{th} and P_i (denoted by TC in Figure 2) is accounted for by the cost of unloading imported grain at Rotterdam and transporting it to the point within the EC domestic market with the largest local grain surplus (Duisburg, in Germany). In practice, however, the gap between P_{th} and P_i is fixed generously so as also to provide a "safe" margin of Community preference.

In principle, and occasionally in practice, $P_p>P_i$. However, $P_p<P_i$ is increasingly the norm due to deliberate CAP price policy adjustments to weaken the downside link between P_p and P_i. For cereals, the minimum producer price has officially been reduced to only about 90 percent of P_i. In addition, the conditions surrounding intervention purchases of most commodities, including minimum quality

Figure 2



Mechanics of CAP price support

standards, the duration of intervention periods and other market conditions, have been progressively tightened. Thus, while relative to a given P_w, VIL remains unchanged, VES and PSE_u become progressively smaller.

Since the definitions of VES and PSE_u are identical, it is clear why VES=PSE_u (or SMU_u). More importantly, because VIL>VES and VES=PSE_u, VIL>PSE_u and PSE_u (or SMU_u) must inevitably fail to reflect the full nominal rate of protection (NPR) afforded by VIL.

It is difficult to see how, short of banning its use, the GATT could be extended to deal with the VIL. But the EC is very unlikely to agree to such a ban. It might therefore be more fruitful to negotiate reductions in threshold prices to reduce the VIL's margin of protection (or Community preference). A willingness on the part of the U.S. and other GATT negotiators to show flexibility on the issue of re-balancing might further enhance prospects of success in this direction.[1]

---

[1]In its latest GATT paper tabled in Geneva (September, 1989), the EC apparently offers to negotiate on the method used to determine the VIL. A "transparent method of calculation" is offered "to ensure that the amount of the variable levy is strictly limited to the difference between the external [world] price and the entry [threshold] price as defined in advance." The main conditions governing the EC's willingness to reduce the entry price appears to be (a) reciprocal reductions of domestic prices by other contracting parties, and (b) flexibility on re-balancing. The main condition concerning the EC's willingness to move on the definition of the external price used to determine the VIL appears to be that other negotiating parties agree to accept some concept resembling the EC's proposed fixed reference price (see page 10 above). For further details of the latest EC paper, see Inside U.S. Trade: Special Report, Sept. 29, 1989.

Export subsidies

It would appear that the main objective of the EC on this issue is to retain the use of the VES as an export marketing "weapon," subject only to budgetary constraints. The Community is therefore unlikely to yield easily to international pressure on this issue as, for example, by consenting to re-negotiate Article XVI:3 of the General Agreement either to "cap" the subsidy per unit of exports, or to limit the quantity subsidized. However, due to budget constraints, the EC might yield more easily upon this issue than upon NTBs.

In a paper tabled in Geneva in July 1989 entitled "The EC Approach on Aggregate Measurement of Support" (MTN.GNG/NGS/W/96), the Community offered to bind and freeze the SMU for an agreed period provided, of course, that other parties to the negotiations agree to adopting the SMU as the common AMS. This offer appears to go some way towards agreeing to bind unit export subsidies.

In its most recent September 1989 paper entitled "Improving the GATT Rules and Disciplines," as reported in Inside U.S. Trade: Special Report, September 29, 1989, the Community appears to accept the proposal that in Article XVI:3 the reference period used to determine "equitable" market shares should be defined quite explicitly as "the average of three to five most recent calendar years." This appears to signify that the EC may also be prepared to accept the quantitative limitation of subsidized exports.

It may be surmised that the EC's preferred solution to the problem of export competition is still a market sharing agreement amongst the major agricultural exporting countries, including an agreement to fix export prices. Failing this, the Community might agree to further policy adjustments effectively transferring a growing proportion of the costs of surplus disposal from the budget to producers themselves. Two-tier pricing is a policy instrument which could be more widely adopted and applied to this end. Two-tier pricing already exists in the EC for sugar and could be extended to other commodities, either by the EC acting unilaterally, or through international negotiations.

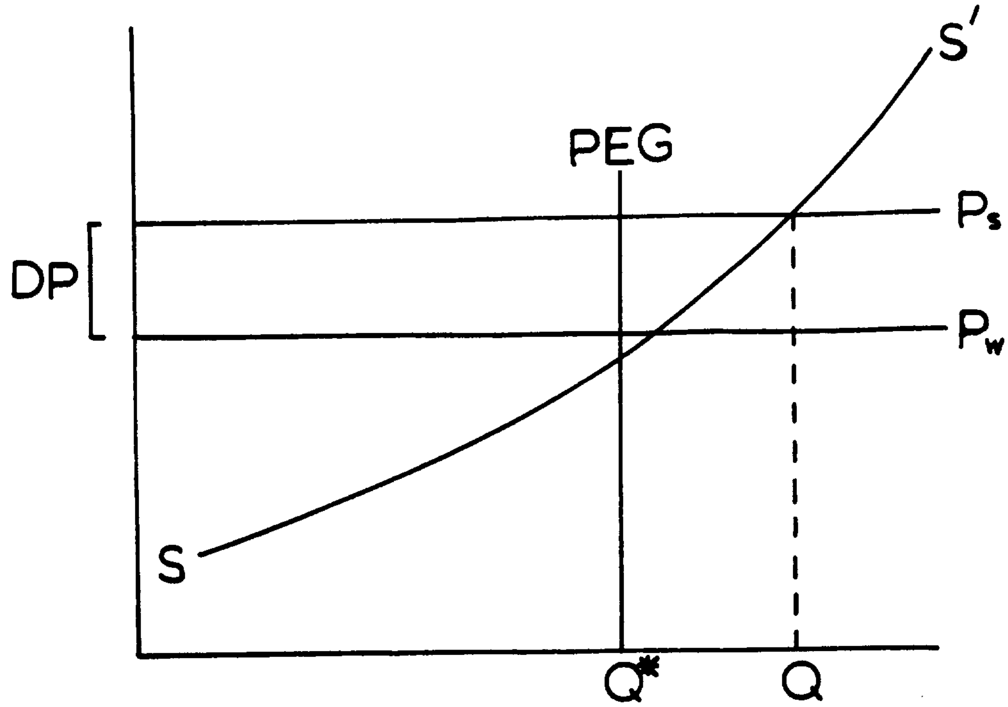
The scheme of Production Entitlement Guarantees (PEGs) as recently advocated by members of the International Agricultural Trade Research Consortium (IATRC) is an example of the application of the concept of two-tier pricing.

PEGs

A PEG program would "limit the quantity of production of individual farmers eligible to receive support payments and therefore on the total quantity that receive payments" (Blandford, et al., 1989). A PEG is not a quota, but a two-tier pricing instrument with the lower-tier price at the free market level and involving the use of deficiency payments.

Figure 3 shows the difference between a conventional deficiency payment scheme without supply control, and a PEG scheme of two-tier pricing. The unit deficiency payment is P_S-P_W and, without a PEG scheme, aggregate production equilibrium is at Q and the aggregate PSE (or budget cost of support) is $Q(P_S-P_W)$. To avoid distorting trade, the PEG quantity Q*, is set to the left of the level of output corresponding with the intersection of the domestic supply curve, S,

Figure 3



PEG system of farm income support

with world supply, P_w. That is the PEG which attracts the higher tier price, P_s, <u>does not distort trade</u>. Producers are free to expand output beyond Q*, but only at the lower-tier, world price. Thus the adoption of PEG-type two-tier pricing obviates trade distortion and implies the complete abandonment of subsidized exports. A further advantage is that the support budget (and PSE) is reduced from $Q(P_s-P_w)$ to $Q^*(P_s-P_w)$.

Existing U.S. cereal and cotton support programs bear some resemblance to the PEG scheme, but ARP restrictions would have to be removed to permit producers to expand production without limit at the world price. But if U.S. export supplies of grains and other commodities are as elastic as some analysts have suggested, the rapid removal of supply control could have serious international repercussions and even provoke retaliation by competing exporters.

Some U.S. policy analysts take the view that the current grain support program already exposes participating producers to two-tier pricing at the margin of production because the program payment yield is frozen at a historic (pre-1985) level (e.g., Thompson, 1988). But other analysts taking a different view of whether or not farmers equate marginal costs and revenues, disagree.

More importantly, a recently announced change in the 1990 wheat program permits producers to expand their wheat acreage beyond the 95 percent of wheat base, up to a maximum of 105 percent, provided they give up their entitlement to deficiency payment support below the 95 percent level, on an acre for acre basis, appears to be a further move in the direction of two-tier pricing (USDA, 1989).

Until now, the EC has adopted the deficiency payment system of support only for oil seeds and some minor crops like durum wheat: so the community would have further to go than the U.S. in changing over to a PEG system of farm income support. However, production levies -- a form of "stabilizer" -- are already collected from individual EC producer through grain merchants. Thus, even in the EC, a system of deficiency payments linked to a limited output quantity may not be beyond the bounds of administrative or budget feasibility. However, the budgetary implications of changing from the existing system of farm income support in the EC, which imposes most of the costs of support on consumers, to a system which transfers the whole cost to taxpayers, remains as a serious obstacle to the adoption of PEGs in the current fiscal climate.

If PEGs were ever considered seriously as a policy reform option in international negotiations, certain technical problems would have to be resolved such as each country's aggregate PEG quantity entitlement. Although current domestic consumption might be acceptable as a proxy measure, this and related issues could be contentious and difficult to resolve.

The PEG proposal is similar in conception to some recently canvassed schemes of <u>de-coupled payments</u> to replace farm commodity price support. So, for example, it has been proposed that for an indefinite period existing farmers should be entitled to receive annual payments of constant nominal value based on historic levels of direct income payments. Apart from such payments, they would have to rely solely on open market prices for their income (Agricultural Policy

Working Group, 1989). However, de-coupling is likely to be resisted by producers, and may encounter taxpayer opposition too, if it is felt that farmers should not be entitled to payments for "doing nothing." The advocates of PEGs argue that if de-coupling failed to gain political acceptance for this or other reasons, "the value of the PEG is that it provides a minimally distorting alternative when the complete elimination of support is not politically possible" (Blanford, et al., 1989).

Domestic production subsidies

It has been suggested that Art. XVI:3 might be extended to include domestic as well as export subsidies. It seems unlikely that the EC would agree to rules limiting the amounts of per unit production subsidies. But since it does favor giving PSE credits for domestic supply control measures, the Community might agree to quantitative limits on aggregate domestic production subsidy payments. Some recent CAP reforms already point in this direction. For example, the beef support regime has recently been modified to limit "headage payments" to a maximum of 90 steers. The sheep regime has similarly been modified to limit the full headage payment to either 500 or 1,000 ewes, depending upon the breed and/or region. Above these limits, "surplus" ewes attract only a half headage payment. The primary objective of these and similar schemes is to target income support where it is most needed, as well as making a budget saving. Such schemes are clearly open to abuse and manipulation, like "large" producers subdividing their herds/flocks into smaller units through collusion with "smaller" relatives or neighbors.

5. Summary and conclusions

This paper points to four major conclusions on the stance taken by the European Community in the Uruguay Round agricultural negotiations.

First, because the Community is interested in CAP reform primarily for internal, mainly budgetary reasons, it would be unwise to expect major concessions to be made to trade competitors. External pressures for reform have been relatively unimportant in the past and appear likely to remain so in the future.

Second, the EC seems to be quite well disposed to PSEs and has offered to bind and lower support measured in this way. Progress seems more likely via this route than by the alternative route of trying to make the CAP conform to tighter GATT rules and disciplines.

Third, despite some recent signs of greater flexibility on the issue, the Community is likely to be especially resistant to attempt to whittle away its margin of Community preference, or seriously interfere with the absolute protection afforded by the VIL.

Finally, due to the primacy of budget control and the heavy burden of export subsidies, the EC may be responsive to proposals for reducing or limiting export subsidies by multilateral agreement, provided the incomes of the most vulnerable producers can be protected. It may also be willing to consider limiting domestic production subsidies along the same lines.

BIBLIOGRAPHY

Agricultural Policy Working Group, Agricultural Policy for the 1990's, APWG, Washington DC, June 1989.

Blandford, David, Harry de Gorter, Bruce Gardner and David Harvey. "There is a Way to Support Farm Income with Minimal Trade Distortions," Choices, First Quarter 1989.

Josling, Tim. Agricultural Trade Among Friends: The Parlous State of U.S. Trade Relationships with the Industrialized West, in Hillman, Jimmye S. (ed.), United States Agricultural Policy 1985 and Beyond, Dept. of Agricultural Economics, University of Arizona and Resources for the Future, undated.

Government of Canada, The Trade Distortion Equivalent (TDE): An Aggregate Indicator of Adverse Trade Effects of Measures of Support and Protection for Agriculture (Technical Discussion Paper tabled in GATT), February 1988.

Hine, R.C., K.A. Ingersent and A.J. Rayner. The Agricultural Negotiations in the Uruguay Round, University of Nottingham, Center for Research in Economic Development and International Trade, Research paper 89/3, 1989.

Hine, R.C., K.A. Ingersent and A.J. Rayner. Agriculture in the Uruguay Round: From the Punte del Este Declaration to the Geneva Accord, Journal of Agricultural Economics, 40(3), 1989.

Marsh, J. and C. Ritson. Agricultural Policy and the Common Market, Chatham House/PEP, London, 1971.

Thompson, Robert. Agricultural Policy Under a Republican Administration, American Journal of Agricultural Economics, 70(5), 1988.

United States Department of Agriculture, Yeutter Announces Changes in 1990 Wheat Program, Press Notice, Washington, D.C. 13 September 1989.