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**THE CAP REFORM AND EC-US RELATIONS:
THE GATT AS A "CAP" ON THE CAP**

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ABSTRACT

Reform of the Common Agricultural Policy has entailed the substitution of new income support instruments for the former price based instruments, mainly in the cash crop sector. Our first point is that the domestic political balance was unable to generate such a large change in policy design, in spite of inefficiencies and imbalances. The pressure of the US has been a major factor in the design of the reform. We argue that trade interests have been crucial to catalyze international collective action in order to counterbalance domestic pressure groups. The pursuit of an agreement in the GATT is therefore a means to place a cap on the CAP and foster some reform and control over sectors such as sugar and dairy in other countries. We do not foresee the disappearance of sources of tensions between the two countries, as EC animal products become more competitive and as the working of the CAP in the vicinity of world prices will make trade flows sensitive to world macro-economic and agricultural shocks. The Uruguay Round, should not be considered as fully satisfactory, and the long-run objective of further decoupling of payments from production incentives should be pursued.

1. INTRODUCTION

The last ten years have witnessed a substantial reevaluation of agricultural policies in developed countries. The launching of the Uruguay Round and the insistence that agricultural issues be dealt with, under the pressure of the United States (US) and other net exporters of temperate zone products, has created an environment for debate and action. The European Community's (EC) Common Agricultural Policy (CAP) has been the main target of attack that has resulted in EC-US conflict with hot and cool moments according to the stages of the GATT (General Agreement on Tariffs and Trade) negotiations and to the various negotiation tactics employed in the Uruguay Round.

The present paper focuses on the interpretation of the CAP reform in the context of the Uruguay Round and the EC-US agricultural trade conflict. The questions addressed are first to explain why agriculture has, for the first time, been given such a central role and why the CAP reform has developed in the way we have witnessed, tackling firmly the cash crop programs and leaving nearly untouched the most protected dairy and sugar sectors. Our main point is that changes in comparative advantages and the existence of big trade interests in cash crops, organized by the main player, i.e., the United States, was the main force to circumvent the otherwise dominant special interest forces in favor of the status quo. This explains convincingly the actual design of the CAP reform and even the changes brought to the Commission projects by the EC Council.

The second point is that the GATT framework provides to the competitive exporters a means to constrain the CAP in the future. But, because the GATT is based on **general** principles and should not be commodity specific, the accord has to be stated more generally and should accordingly force all countries to reform their own highly protected and less competitive subsectors. The GATT would therefore put a cap on the CAP and on other protectionist farm policies, as well.

However, all countries try to minimize the political cost of adjustment, and reforms of the CAP and of other policies still leave a lot of room for payments to be too tied to production incentives, at the expense of environmental amenities. Will the GATT be able to tame and reorient farm policies in the socially desirable directions?

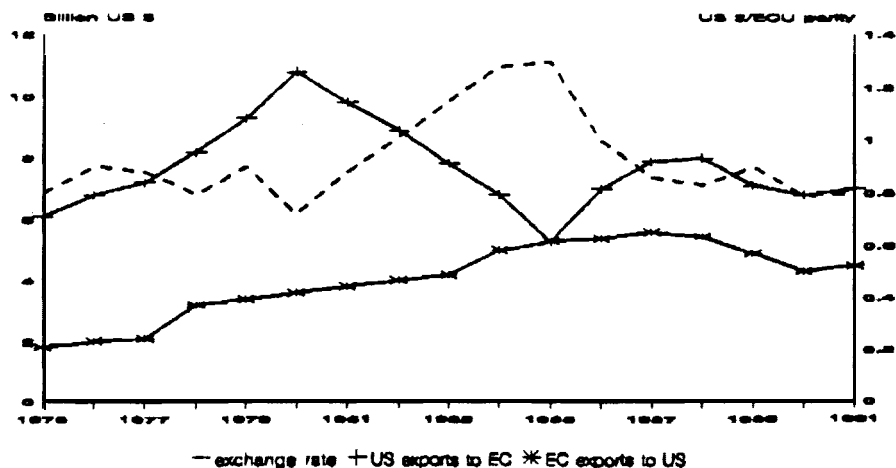
Section 2 briefly reviews the historical EC-US trade debate. Section 3 deals with the EC-US special interests and trade conflicts, Section 4 analyses the CAP reform implications on the EC-US relations and relates it to the expected GATT treaty. Section 5 addresses more long-run issues, stressing the shortcomings of the CAP reform and future prospects for the GATT as a framework to discipline domestic and trade farm policies, including their environmental dimensions.

2. THE EC-US AGRICULTURAL CONFLICT

The history and the role of agriculture in the GATT shows that the successive Rounds of negotiations were dominated by EC-US disputes. Several issues in the EC-US agricultural trade conflict emerged soon after the creation of the Common Market and the implementation of the CAP. This conflict reached a new stage with the economic growth of EC agriculture, and it became the focus of negotiations in Uruguay Round.

The trade balance in agricultural products between the EC and the US has traditionally been in favor of the US. US exports to the EC reached about 10 billion US \$ at the end of the seventies, but fell to nearly 6 billion in 1985. It has slowly recovered over the rest of the decade (Figure 2.1).

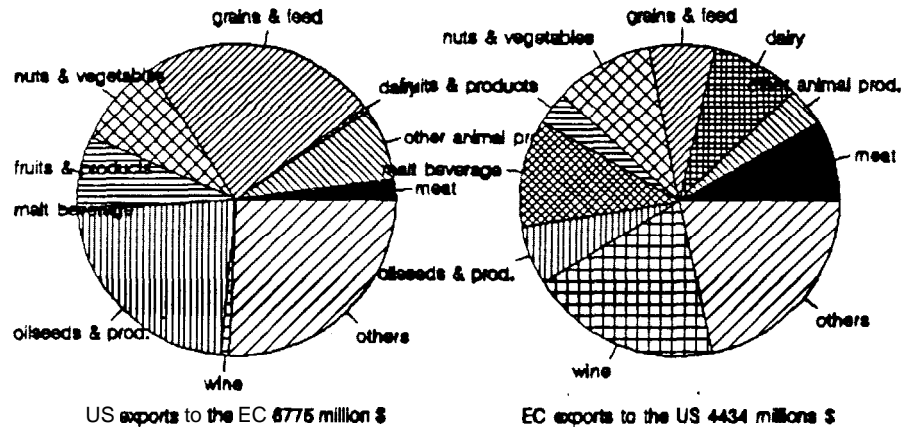
Figure 2.1. EC-US bilateral agricultural trade



Sources: USDA Agricultural Statistics (US exports to the EC) USDA World Agricultural Trends and Indicators (EC exports to the US), La situation de l'Agriculture dans La Communauté, various issues (exchange rate).

The composition of bilateral trade flows in agricultural products is however quite different (Figure 2.2). The US exports to the EC essentially basic commodities (grains, oilseeds products and corn by-products) which are heavily regulated in both the EC and the US with a generally higher level of protection granted in the EC, except for corn by-products. EC exports to the US include more processed food products with a high value added per ton. For the most part, they are non-CAP commodities, such as wine and beer. Meat and dairy products are also exported. The latter are supported in the EC, but they are also subject to strict trade barriers in the US.

Figure 2.2. Structure of bilateral agricultural trade between the US and the EC (year 1990)



Sources: from USDA, Foreign Agricultural Trade of the United States, 1992.

The sources of the trade tensions between the EC and the US have originated in both the bilateral trade interests and in the competition for outlets in third countries. The latter source has taken momentum with the increasingly net exporting position of the EC.

The major concern of the US has always been to alleviate or reverse the consequences of the CAP on trade, in cereals and related feed stuffs. The US was in favor of European Integration, but has never really accepted the creation of the customs union and the subsequent principles of the CAP. The issue at stake is the high protection in the EC for grains which first reduced

potential US outlets for these products in the EC and made it necessary for the EC to protect other sectors too. Moreover, the use of the variable levy • restitution system, compared to a "gate on a dam" by the US Agriculture Secretary Freeman, was constantly criticized by the US and other exporters as being in contradiction with the GATT principles. In the Kennedy Round, the US wanted to modify the variable levy system, and in the Tokyo Round she wanted levies considered as non-tariff measures and treated accordingly. The US did not get preferential access to the EC for grains in negotiations following the first enlargement of the EC, but did so in 1986 after the accession of Spain and Portugal.

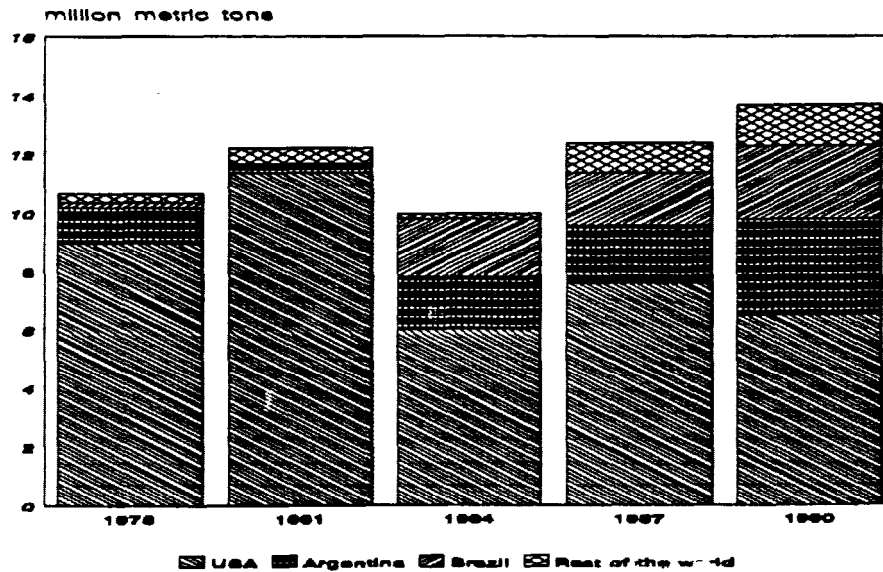
Tensions increased when the EC turned to a net exporting position in grains in the early eighties. Variable restitutions, the major EC protecting device, have been under constant pressure from the US (the share of restitutions in EC agricultural expenditures has increased from 20 % in 1975 to 35 % in 1990). This new situation has launched a creeping trade war on the world grain market, with the US developing a permanent program of export subsidies. In the Tokyo Round, the code for subsidies attempted to reinforce Article XVI with the "concept of an equitable share of world export", but the implementation of this vague limit did not prevent a rapid growth of EC grain exports. The US has become increasingly frustrated by these developments which explain its insistence on a separate negotiation on export subsidies in the Uruguay Round.

Two other major trade concerns of the US, namely oilseeds and corn by-products, are indirectly determined by the EC grain policy. The EC conceded a bound zero tariff on oilseeds products in the XXIV-6 Negotiation, on corn germ meal in 1962 and on corn gluten feed in the Kennedy Round in 1967. These concessions have proved over time to make it increasingly difficult for the EC to pursue its high grain price policy. First, the EC wanted to increase its capacity to produce oilseeds in order to reduce dependence on imports, a policy triggered by the US soybean embargo and the peak world prices of 1972-74. Oilseeds production in the EC has been stimulated by a price support and by a crushing subsidy mechanism (which works broadly as deficiency payments). This mechanism has proved to be very costly as production increased sharply. Increased production was further enhanced by the slowly diminishing support given to grains as a reaction to excess supply. As a result, the cost of the

oilseeds program has risen to 3.4 billion ECU in 1990.

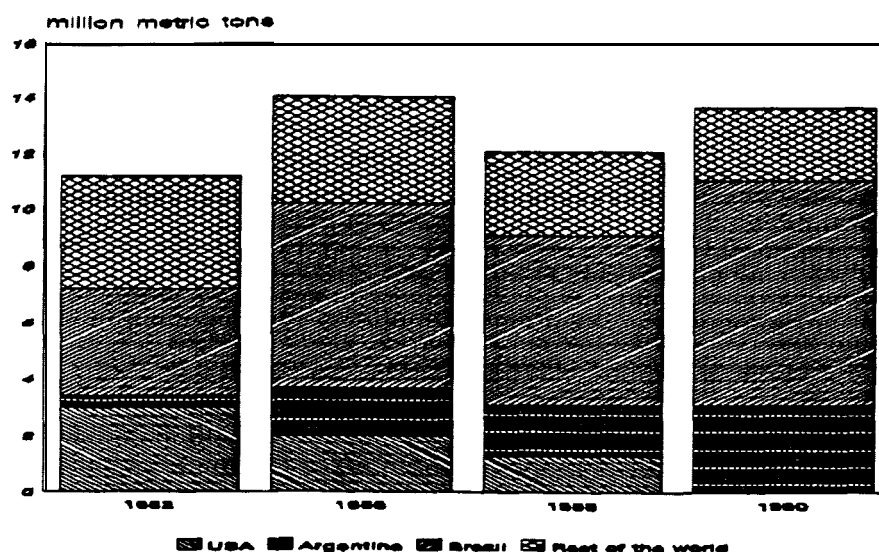
Meanwhile, imports of by-products used in compound feeds have soared due to the price differential with domestic grains. This increased demand has created an attractive outlet for US corn by-products that accounted for more than 1 billion US \$ of imports in 1990. Because of the trade interests in soybean and corn gluten feed, the US has resisted vigorously attempts by the EC to "rebalance" its external protection either by placing a tax on vegetable fats or by voluntary export restraint on grain substitutes. In the early eighties, the strong dollar and the emerging competition from Brazil and Argentina caused a general reduction in US exports to the EC (Figure 2.1), particularly in US trade shares of EC soybean imports (Figures 2.3 and 2.4). Pushed by the American Soybean Association, the US filed a GATT complaint in 1988 alleging that the EC discriminated against the imports of US soybeans. The appointed panel concluded in 1989 this was indeed the case. The Commission of the European Communities (CEC) accepted the conclusions, with some reservations, and implemented a subsidy per hectare of oilseeds produced.

Figure 2.3. EC-12 soybean imports by source



Sources: from USDA, World Agriculture, March 1988, and ISTA, Oil World Annual, various years.

Figure 2.4. EC-12 soybean meal imports by source



Sources : from ISTA, Oil World Annual, various years.

These trade interests and the US competitive advantage in crops explain its emphasis on reducing border protection first. The trap in which the EC has put itself is due to its long standing grain policy and its direct (restitutions) and indirect (feed imports) consequences. This situation has recently given the US a formidable leverage to press the EC toward reforming the CAP. The various recent skirmishes on other trade disputes (definition of corn gluten feed, delisting of US beef and pork packing plants, the procymidone case, the EC sugar complaint....) can be considered as minor avatars to the central conflict. In contrast, the EC's attitude in relation to the US is not so much dictated by trade interests as it is by a continuous attempt to cope with the adverse consequences of earlier made decisions in the framework of the CAP. The EC exports to the US are mainly non-CAP products (Figure 2.2) which sell competitively and are designated targets for occasional retaliation. As a consequence, the behavior of the EC has been mainly passive or reactive to US pressures. From the beginning, the EC considered the CAP as nonnegotiable, variable levies and restitutions being viewed as logical consequences of domestic policies emanating from domestic pressures. In the early stages of the Round, the EC constantly refused to negotiate separately on border measures.

Another distinctive feature in the EC approach to trade policy has been its desire to "organize world markets" through International Commodity Agreements (ICA's). These ICA's have not really worked and the US has always been reluctant to manage world trade or to indulge in implicit cartellization of agricultural trade.

The so-called harmonization of border protection in the EC is another example where trade policy changes are dictated by the EC's feeling the need to tackle the consequences of domestic policies. The cost of the grain and oilseeds regimes has led to a recurrent debate in the EC about fat taxation, which evolved into the concept of harmonization of border protection (CEC, 1989) whereby domestic support would be reduced as a concession for import taxation of animal feeds. Hence, the inclusion of rebalancing in all of the EC GATT proposals, a demand that the US was never willing to consider as a possible concession in the Round.

In sum, the recent reform of the CAP reflects the typical lagged response of the EC to the adverse effects of pressures created by past policies, except the extent of this reform seems to be in excess of that which would come about from domestic pressures alone.

3. THE EC-US AGRICULTURAL TRADE GAME AND THE DESIGN OF THE CAP REFORM

3.1. Sources of domestic pressures for a reform of the CAP

In its introduction to the July 1991 "Communication to the Council" (CEC, COM(91) 258 final), the EC Commission repeats the conclusions of its previous reflections (CEC, COM(91) 100 final) on the current state of the CAP and on the need for fundamental changes. Quoted arguments include, i) price guarantees lead to growing output, ii) extra output can be accommodated only by adding to stocks or by exports to already oversupplied world markets, iii) built-in incentives for high input intensity places the environment at risk, and iv) rising budgetary expenditures, devoted in large part to a small minority of farms, provides no solution to the problems of farm incomes in general.

These reasons for CAP reform are well known. They reflect the outcome of policies which cannot be adjusted for various political reasons in the familiar agricultural context of rapid technical change - partly induced by the support - and of sluggish demand due to the staple nature of the products

of the industry. The inefficiencies and market imbalances which result are also known, as well as the regressive distributional effects of the considerable and steadily rising budget expenditures. It is more difficult and conjectural to point out the actual causes for the recent reform which, although not comprehensive, is the most drastic since the inception of the caap.

Given the magnitude of the protests triggered by Commission pronouncements on reform and of the subsequent modification of the reform by the Council, one can only be surprised that a significant reform still took place in a manner so central to the EC agriculture, and in such a market-oriented manner. One can also be surprised at the large price cut decided for grains and oilseeds while, in a similar domestic context, the course of action adopted in the dairy sector in 1984 was the other extreme, i.e., production quotas. Actually, the latter solution was highly supported by large producer groups and even by countries. So, in the current reform program, what prevented this idea from being applied to the crop sector?

It is our conviction that domestic forces were unable to generate the current extent of reform even though it was eventually circumscribed to the main cash crops, a lesser extent to beef, and accompanied by sizeable compensation payments, which have become increasingly tied to the endowments of the farmers. The final package of CAP reform appears to be more the result of external pressures¹. This view is supported by the observation that the dairy and sugar sectors, where trade conflicts do not concern trade interests of the big players, only experienced a cap on current policies. This view is also supported by the land set aside program in the reformed CAP, which is mainly for purposes of reducing excess supply, and thus exports with little attention to environmental concerns.

3.2. EC, US and the international game

Our focus here is on how international pressure influenced the nature of CAP reform. Our general theme is that the legitimacy of the GATT rests on its principles, and that the broad based rejection of these principles for

¹The prospect for increased feed demand in the EC did however help the Commission in reaching an agreement among members for a more market oriented approach to the 1992 reform of the CAP.

agriculture would continue to perpetuate shocks to international markets of magnitudes greater than the collective interests of either the US or the EC were willing to accept. The role of special interests within each country, and the extent of interdependencies among exporting and importing countries, influenced the actual direction and magnitude of the CAP reform and the GATT compromise.

3.2.1. The nature of special interests in agriculture

The plethora of papers on the formation of special interests and their motivation to seek, through economic policy, income transfers that are not easily undone has clearly sharpened our understanding of their influence in forestalling and directing policy reform in agriculture. To suggest how international pressures influenced the nature and extent of CAP reform, it is useful to briefly mention several factors that strengthen the capacity of narrow based interest groups to influence agricultural policy to a degree greater than would otherwise be suggested by their representation in the polity². We group these factors into two broad categories: institutional and economic.

Institutional structures that are part of the policy making-policy implementation process cause an inertia to reform. Agriculture in many of the industrialized market economies tends to typify the extensiveness of these structures relative to the other traded goods sectors of their economies, and particularly so for the CAP. They tend to make reform more difficult because of the various channels of political connections, legislative committees, legal statues and other organizations at the regional and local levels that support, implement and provide communication mechanisms to agriculture. Policy reform that entails a dismantling of this structure, particularly after it has been in place for an extended period of time, is often questioned on the grounds that it will expose the sector to the vagaries of the market without mechanisms in place to help farmers insure against future contingencies. This structure too has a vested interest in sustaining the status

²Petit provides an insightful discussion of some of the earlier determinants of agricultural policies in the US and the EC while Josling et al discuss some of the more current factors influencing the direction of policy.

quo, while at the same time it has strong control over the public decision making process. Consequently, it and its vested interests tend to dampen internal motivation for reform, while at the same time, increasing the difficulty from those outside the structure to induce reforms³.

Several economic factors also provide agricultural interests with political influence beyond their relative number in the population.

First, the cost of policy that supports incomes in agriculture tends to be dispersed over the entire economy while the benefits are concentrated on a few. As Olson (1965) has suggested, because farmers are small in number relative to a country's population, they have two major advantages. Their small number decreases their individual costs of arranging a group consensus to seek legislation in their favor and their specialization in one or two major activities allows them to earn per capita benefits from support which far exceed the per capita costs incurred by consumers and taxpayers. Hence, since food accounts for a small proportion of total household expenditures, producer groups tend to be more motivated to expend resources to achieve their more narrow political interests than consumers and taxpayers are in general willing to countervail these forces.

Second, due to the uncertain and cyclical nature of agricultural markets caused by climatic, macroeconomic and world trade shocks, agricultural support is often introduced in the presence of upturns in the macroeconomic business cycle. But, it tends to be only marginally withdrawn during downturns in the cycle and its is generally increased during periods of macroeconomic uncertainty (Paarlberg, 1989). Part of the reason is that agricultural production is characterized by sector specific resources such as land, buildings and equipment that cannot be easily reallocated to other sectors during cyclical downturns in the agricultural economy. Consequently, the value of these resources can fall precipitously during decreasing cycles or lag behind the upturns in the macroeconomic economy, all of which places the welfare of rural households, financial institutions supplying credit to the sector and variable input suppliers at some, risk relative to the overall economy. This risk invariably induces support for agriculture (Orden, 1990). Part of the

³See Munk (1989) for a further discussion of the public finance pressures for reform in the context of the current GATT round of negotiations.

reason that support is only partially withdrawn appears to lie in the fact that just as cyclical downturns affect the value of these resources, so do too the very economic policies designed to avert these effects on their value. That is, the value of agriculture's sector specific assets embody the implicit value bestowed upon them by the instruments themselves⁴. Hence, when economic conditions improve, policies tend to remain in place. Producers are aware of the linkage between the value of sector specific resources and economic support. They are aware of the potential decline in value if support is withdrawn and therefore they have an incentive to engage in political actions to avert this eventuality. Hence, policies designed to offset the effects of uncertainty and cycles in the economy tend to turn into permanent support.

A third closely related incentive to maintain support after a cyclical downturn is that the increased value of the sector specific resources that support causes also provide incentives for capital deepening in land improvements, buildings, equipment and so on. Since this capital deepening is induced by support, the returns to this new capital is dependent on maintaining support. Together, these two effects provide incentives for the ratcheting up of economic support for agriculture.

Fourth, agriculture is often associated with environmental amenities, rural development and to natural resources. It appears that the economic support to the producers of agricultural commodities is easily confused with support for rural development, support for the country life in general and the environment in particular, the more so as these amenities are public goods without a collectively organized constituency to promote their supply at the socially desirable level.

And fifth, food is closely associated with security (an alleged reason for Japan's support of her rice producers), and health, particularly in the form of food safety. Food safety can easily serve as a justification for non-tariff barriers and extensive regulation.

The culmination of these various factors tends to provide some sectors

⁴See Goodwin and Ortalo-Magne for a recent empirical study of the influence of commodity programs on the prices of land in Canada, France and the US.

in agriculture with more political power to influence policy in their favor than others. Johnson et al. (1993) obtained empirical estimates of these relative influences for the US and the EC based on data from 1986, while another study has reaffirmed these approximate magnitudes using data from 1990. Sugar and dairy interests in both the US and the EC exhibited the most influence, followed by producers of animal feeds and grains. Taxpayers (as reflected by the budget costs of agricultural programs) and consumers had the least influence. The influence of beef, pork and poultry producers tended to rank higher in the EC than in the US. Hence, from an interest group perspective alone, it is not surprising that, i) reform is likely to be more difficult to obtain in the sugar and dairy sectors of either the EC or the US relative to the grain sector and, ii) if reform is to be obtained, some form of compensatory payments will surely be required. It is also apparent that acceptance of the GATT principles for agriculture, even if reform is modest, will be an important disciplinary cap to the influence of these interest groups.

3.2.2. The nature of interdependencies between the agricultural economies of the major players

The interdependent effects of EC-US agricultural policies are fairly well known. Effectively, the various studies are in general agreement that the own effects of policy reform are greater than the indirect effects of reform in the EC (US) on the agricultural economy of the US (EC). For example, the results of Johnson et al. (1993) suggest that if the US reforms while the EC follows the status quo, the world prices of wheat and coarse grains, milk and milk by-products, and sugar rise while the prices of animal feed concentrates (oil cakes and vegetable proteins), pork and poultry tend to fall. If the EC reforms while the US follows the status quo, the world prices of wheat and coarse grains, milk and milk by-products, and sugar also tend to rise, as do the prices of beef. The prices of animal feed concentrates, and pork and poultry tend to fall. However, changes in domestic prices and quantities produced always tend to be greater from own reform than from indirect effects of reform in the other country. As a consequence, federal budget savings, the decline in producer quasi rents, the increase in consumer surplus and the net social gains in either the US or the EC are always greater

for own policy reform than from the indirect effects of EC (US) reform on the US (EC). Since grains are the major traded commodities for the US and for many members of the Cairns Group of countries, the greatest interdependence lies in the grain sector which in turn impacts on animal feeds, beef and pork and poultry. To exporters, this interdependence in grains has of course been the major cause for frustration with the CAP's variable levies, export subsidies and other policies that distorted the EC grain sector. In turn, the EC's commitment in the Dillon Round to bound tariffs on soybeans and meals at zero caused a large divergence in the relative feed grain - protein concentrate price ratios faced in the Community relative to the US, and hence a disadvantageous cost structure for her livestock sector.

In another study, Mahe and Roe (1993) evaluated the importance of reforms in other industrialized agricultural importers on the willingness for the US and the EC to compromise. The results suggested that concessions by these other countries had the effect of increasing their import demand and raising world market prices. In the context of a Nash game where budget savings are used to compensate the losers from reform, these effects in turn increased the domain of policy choice over which the US and the EC could find agreement that made neither country worse off than the status quo. The domain was enlarged because the increase in demand for US and EC exports caused smaller losses to US and EC producers in the export competing sectors for an increased range of US and EC concessions. Moreover, the smaller losses allowed the budget savings from reform to more adequately compensate the losers. While free trade was not obtained, freer trade appeared to be a real possibility. Thus, the extent of reform in the Round, and reform of the CAP, may be strongly influenced by the willingness of the other mentioned countries to make concessions; and it is in the mutual interests of the US and the EC to encourage this outcome.

Collective action at the international level also helps to explain why and how the various and often contradictory forces, channelled into the agricultural trade game of the Uruguay Round, contribute to delineating the contour of the final agreement and the nature of the reform of the CAP. Whether the incentives for reform are sufficient to trigger action at the national level depends in part on the prospects that a country can internalize the gains from reform. The Most Favored Nation principle that the benefit of a

concession made by any country must be extended to all other contracting parties is akin to a concession being a public good. When a large number of countries are involved, and/or when they have approximately equal world market shares of the traded good, the incentive is reduced for an individual country to make a concession in return for a concession from another since the benefits of such concessions must be shared by all, i.e., the free-rider problem. This may be a partial explanation for the failure of the group of small and numerous countries that are low cost producers of sugar to obtain reform of US and EC sugar policies.

The proliferation of Free Trade Areas, bilateral trade agreements (e.g., NAFTA) and trade blocs may be seen as attempts to circumvent this external problem, as well as to circumvent the pressures of domestic interest groups (Paarlberg, 1987, p. 44). The existence of big players in the international game helps to safeguard the principle of multilateral trade agreements on which the GATT is based. Large players have incentives to negotiate concessions (i.e., to incur costs) because, even though they will need to share the "reformed market" with others, their relative size allows them to capture sizeable benefits and to express credible threats that can force other reluctant players to move as well. It appears that the US and other large agricultural exporters have such an incentive, particularly in the form of terms of trade gains in the grain sector. Hence, their active role as a catalyst for collective action in the game of negotiations. A positive externality in this case is the extension of the pressure to others to reform this sector too, such as Japan, Korea, and the Nordic countries.

3.2.3. Summary

The major conclusion is that domestic and international forces appear sufficiently strong to explain why reform under the GATT and the CAP is to occur primarily in the grain sector and to some extent in the livestock sector through the feed grain-concentrate linkage. While there is more to the story, note that the domestic forces for reform of the CAP discussed above, the mentioned political influence in the grains being small relative to sugar and dairy, the major interdependencies between US and EC policies occurring

in grains, and lower incentives for countries to free ride in making mutual concessions, together point to trade reform in the grain sector.

The GATT process has therefore been supported by countries with vested interests in the widely traded commodities (namely grains). While the EC was motivated to undertake reform, the approach is notable because the instruments chosen permit market forces to operate more effectively which is in sharp contrast to the choice of production quotas for dairy in the 1984 reform of the CAP. The large cut in EC market prices in grains and oilseeds would have been unlikely if the domestic forces alone were the major motivating force for change. Discrepancies between the initial Commission proposals and the decisions of the Council support this view. The Council has constantly modified the reform effort - and is still doing it - so as to attenuate price adjustments and to increase the level of compensation. Furthermore, the progressive drop of the measures to reform dairy and sugar envisaged by the Commission, and the relatively smaller shift toward direct payments in the beef sector, reflect, in our view, the lack of foreign pressure from big countries having trade interests in these areas. New Zealand interests in dairy products and developing countries interests in sugar cane have not been able to develop a coalition in support of their interests as have the grain and oilseeds exporting countries. In sum, the changes in economic conditions and the resulting imbalances and inefficiencies in European agricultural policy developed sufficient pressure to induce reform of the CAP. However, these pressures were not sufficient to counter those seeking to maintain or increase protection so as to produce a reform of the magnitude and of the market-oriented type we have witnessed.

4. EC-US AGRICULTURAL RELATIONS AND THE GATT ROUND:

A "CAP" ON THE CAP

Within Commission circles, the CAP reform was officially presented as a separate process from the GATT negotiations. We have argued that the eventual features included in the reform package reveal a major effort to soothe anticipated international pressures on specific trade issues. This is illustrated by the sizeable positive effects of the CAP reform on US agricultural policy objectives. Our analysis (Table 4.2) suggests that the strict implementation of the Dunkel compromise in the EC would not have provided

larger benefits to the US than those from the CAP reform. In this light, the continuing conflict to conclude the Round can be seen as an effort by the grain exporters to bring the CAP under the discipline of the GATT as a guarantee that future CAP developments be constrained more than in the past and as an assurance that the CAP reform would be more effective, i.e., a cap on the CAP. Moreover, as mentioned in the previous section, applying the discipline of the GATT to agriculture on a multilateral basis would also serve to countervail those interests in sectors of agriculture, such as sugar and dairy in the US and to reform these sectors as well.

4.1. CAP reforms, world prices and implications for future EC-US Trade Conflicts

The implications of the CAP reforms on the US arise from at least three sources : i) changes in US exports to the EC, ii) expected US gains in export volume to the Rest of the World as a result of reduced EC competition, and iii) some terms of trade gains on grain exports. The analyses of these linkages are based on MISS (Guyomard and Mahe, 1993). MISS is a price equilibrium model that focuses in detail on the structure of US and EC agriculture and agricultural policy, extended to include a simplified "Rest of the Economy" supplying inputs to the farm sector at near infinitely elastic supply so that prices of inputs supplied by the non farm sector are led by the inflation rate. Technological change, growth trends in population and per capita incomes, and other variables exogenous to the agricultural sector are factored into the analysis.

4.1.1. World Prices

The base-run scenario corresponds to a "continuation of the pre-reform" CAP. The results suggest that nearly all prices decline moderately in real terms. Prices of grains, of oilseeds and particularly of grain substitutes decrease most. The only significant exception is beef which exhibits price increases in nominal and real terms due to a lower rate of technical change and a higher income elasticity than other food products. These results depend on the assumptions made regarding the evolution of the mentioned exogenous variables. They also depend on the changes in EC price support policies in the base-run. There is room for debate here, and alternative assumptions could be

made on exogenous variables depending on world economic growth in the next decade with different results for the trends in world prices.

The main effect of the CAP reform is to reduce grain exports by stimulating domestic demand for feed and by controlling production growth. World grain prices are 5.3 % higher in 1996 and 6.4 % higher in 1999 with respect to the base-run scenario. Corn gluten feed price falls sharply and is 14% smaller than in the base-run. Prices of manioc and other grain substitutes fall less because their implicit protection is adjusted down and their supply elasticity is larger. From 1993 to 1999, the world price ratio of corn gluten feed to grains falls by about 5 % in the base-run and by 22.5 % in the CAP reform scenario. World prices of animal products are less affected by the CAP reform save for beef and, to a much smaller extent, milk prices which would be respectively 5.2 and 2.7% higher than in the base-run.

In a decoupled CAP reform scenario⁵, world prices are not much different from their levels under the actual CAP. The slight difference, mainly visible until 1996, originates from a further contraction of EC output of crops and beef due to the complete decoupling of payments. The magnitude, however, is limited as the set-aside requirement, according to our interpretation and our parameters, partly offsets the incentives to produce created by acreage payments. World prices of grain fed animal products and of grain substitutes would be slightly lower in a fully decoupled CAP reform because of the increased price competitiveness of grains. Sugar prices are basically unaffected since no policy change is expected. Sugar is otherwise little affected by the price of other crops because of its quota restriction. The same reason explains why world dairy prices are the same in the two CAP reform scenarios. It is also noticeable that the discrepancies in world prices between the actual and the decoupled CAP reforms fade over time and almost disappear at the end of the decade.

In the "Blair House" or GATT scenario, where the pre-agreement is implemented in the EC only, the picture of world price effects is generally not much different, except for grains and feeds. World prices are lower in this GATT

⁵ This scenario is run assuming that acreage and headage payments introduced by the reform are granted in a fully decoupled way, e.g., on the basis of past criteria only. Furthermore, there is no set aside in this scenario.

scenario because no set aside is imposed on the arable land in the EC and only a limited cut in producer price is mandatory to meet the 20 % reduction in AMS and the 36 % tariff equivalent cut. The user price of grains in the EC has to be fully aligned on the world price since exports overshoot the allowed quantity of subsidized exports. Consequently, the EC is running large deficiency payments in grains, exporting at world prices but much more than under the actual CAP reform scenario and, of course, much more than under the nearly free trade decoupled CAP reform scenario. Lower cereal and feed grain prices also drive world prices of proteins and grain by-products further down, but only to a small extent.

To sum up, the overall picture of world price changes due to the three EC scenarios is that the major impact of the decoupled reform is to moderately improve world grain prices. In the CAP reform scenario, prices of oilseeds are a little below the level of the base-run scenario, but it is not the case in the decoupled reform. Corn gluten feed prices are driven down sharply in the two reform scenarios, and more so in the actual reform simulation. The prices of animal products are also raised by the reform projects, but only in 1996 for pork and poultry prices which are thereafter heavily influenced by EC and world grain prices.

Table 4.1. Effects of EC reform scenarios on world prices (ratio of 1996 world prices in the EC reform scenarios relative to the base-run)

| | Reform | Decoupled reform | Blair House |
|--------------------------------|--------|---------------------|----------------|
| Grains | 1.05 | 1.07 | 1.03 |
| Protein cakes | 0.98 | 1.01 | 0.97 |
| Oil | 1.02 | 1.05 | 1.02 |
| Corn gluten feed | 0.86 | 0.84 | 0.84 |
| Manioc | 1.00 | 1.00 | 1.00 |
| Other grain substitutes | 1.01 | 0.99 | 1.00 |
| Beef | 1.05 | 1.06 | 1.01 |
| Pork, poultry and eggs | 1.01 | 1.01 | 1.01 |
| Milk | 1.03 | 1.03 | 1.03 |
| Sugar | 1.00 | 1.00 | 1.01 |

4.1.2. Implications for the US

It is difficult to model **correctly** the complex US farm programs. Our quantitative assessment meets clear limitations in that respect and will have to be supplemented by verbal comments based on the economic rationale of the policy instruments introduced in the Farm Act of 1990.

In our representation, target prices of grains are exogenous but loan rates follow the trends of world prices. The loan rate on soybeans is treated in the same way⁶. Market prices of pork and poultry, and of corn gluten feed also follow world prices. For dairy⁷, beef and sugar, domestic prices are pegged in nominal terms, and therefore they decrease by the rate of inflation in real terms.

The effects of the three EC reform scenarios on the US are summarized in Table 4.2. The main observation is that, except for budget costs and trade balance on grains, the difference between the various EC reform scenarios is significant, but not huge in spite of the noticeable discrepancies in world prices highlighted previously.

Under the base-run scenario in the EC, terms of trade for US exports would deteriorate. The export value of grains would be 1.5 billion ECU (in 1993 ECU) lower in 1999 than in 1990. Net exports of oilseeds (and products) and of corn gluten feed would continue to grow slightly in value.

As expected, the actual CAP reform appears attractive to the US. With respect to the base-run, better world prices for grains reduce the US budget costs for grains by 1.2 billion ECU (in 1996) and net exports of grains are

⁶ An alternative solution could be to peg the loan rates according to the principle of marketing loans, but the loan rates themselves may be adjusted by policy makers.

⁷ This is also a debatable representation as there is an extensive discretionary power given to the administration to adjust the policies if program cost increase. The cost associated with dairy policy must be considered as "potential" rather than automatic.

0.6 billion higher in value. The only minor adverse effects are due to the loss of oilseeds (and products) and corn gluten feed export value because of the declining feed demand from the EC animal sector.

The consequences of the EC reform scenarios on US agricultural incomes are small in relative terms, although they may be less reliable because of the way policy programs are expressed in the model⁸. World prices of grains affect the feed cost of US livestock producers, and higher grain prices, as a result of the two CAP reform scenarios for example, translate into an income loss for the US farm sector as a whole. This is the reason why the CAP reform looks better than the decoupled alternative from the US farm income point of view. Because of the absence of an adequate representation of non participants in the US crop programs who would benefit directly from higher world prices, the result in table 4.2 is probably too pessimistic for the US.

Table 4.2 Main effects of EC reform scenarios on US in 1999
(in billion 1993 ECU)

| | 1993 | | 1996 | | | | 1999 | | | |
|----------------------|------|----------|--------|---------------|--------|----------|--------|---------------|--------|--|
| | | Base Run | Reform | Decoup Reform | Dunkel | Base Run | Reform | Decoup Reform | Dunkel | |
| Farm Income | 77.5 | 76.0 | 76.0 | 75.7 | 76.0 | 74.8 | 74.1 | 73.7 | 74.9 | |
| Budget costs | | | | | | | | | | |
| -grains | 7.1 | 6.1 | 4.9 | 4.4 | 5.4 | 5.0 | 3.5 | 3.1 | 4.0 | |
| -dairy | 0.72 | 0.76 | 0.76 | 0.7 | 0.8 | 0.83 | 0.8 | 0.8 | 0.8 | |
| Trade Balance | | | | | | | | | | |
| -grains | 7.1 | 6.4 | 7.1 | 7.4 | 6.8 | 5.6 | 6.5 | 6.7 | 6.1 | |
| -oilseeds | 4.15 | 4.3 | 4.1 | 4.54 | 4.1 | 4.4 | 4.7 | 4.6 | 4.4 | |
| -CGF | 0.7 | 0.7 | 0.6 | 0.6 | 0.59 | 0.8 | 0.6 | 0.6 | 0.65 | |

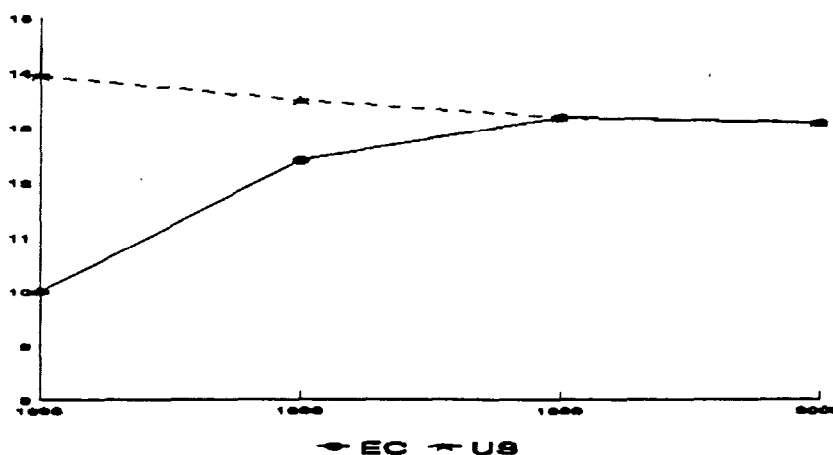
⁸ The US income indicator mainly reacts to world prices of grains, oilseeds and pork and poultry. There is no distinction between participants and nonparticipants in the US grain program, and therefore, no benefit from higher world prices on US grain producers is represented in the model. Incomes are negatively affected by higher world grain prices. Thus, the positive effect of the CAP reform on US incomes is probably underestimated.

4.1.3. Trade in commodities, trade in livestock products on a more competitive basis

The CAP reform has clearly been designed to solve the problems of EC cash crops. The global benefits to the US in terms of budget or trade are clear cut. The reform will also have drastic effects on price ratios in the livestock sector which could potentially shift the contested EC-US issues from the grains and feeds to livestock products.

Figure 4.1 shows the dramatic changes in the price ratio between grain fed animals and grains in both the EC and the US. Similar patterns of evolution would be observed for other animal products and other feeds. Over the next decade, this price ratio will increase by about 30 % in the EC and decrease by about 10 % in the US. By the end of the decade, both countries should export these products on a nearly competitive basis.

Figure 4.1. Price ratio between grain fed animals (pork and poultry) and grains in the EC and the US under the CAP reform scenario



Sources : Guyomard and Mahe (1993).

Trade in animal products and particularly in poultry and even in pork and dairy has increased more than in the basic commodities. The prospects for trade expansion in this area are good because these products are income elastic and consumption should grow, as the upturn in the world economy gathers momentum. It should particularly be the case in the fast growing Newly Industrial Countries (NIC's) of East Asia, where land is scarce and where

environmental concerns will develop and increasingly constrain domestic production.

As the basic price-cost ratios turn in favor of the EC, one should expect that trade conflicts in livestock products, either on bilateral trade flows between the EC and US or on third market outlets might arise. The use of limited but targeted subsidies to capture market shares in this area are not an unrealistic scenario. EC dairy products also can potentially become competitive, as the general movement to lower opportunity cost of land in the EC, dampened however by the acreage payments, and lower feed costs will drive the shadow price of milk in the EC in the vicinity of world prices. The EC will therefore be in a position to develop a more competitive position on cheese and other dairy products if the market organization is adjusted in an appropriate manner.

It is to be expected that non-tariff barriers, new technologies (hormones) and sanitary regulations will become even more important issues in this area than they are now. The GATT should play an increased role in this area, and adequate surveillance procedures by the Secretariat will become a major stake as it is clear that few countries can resist the temptation to use non-tariff barriers on such sensitive products.

4.1.4. The operation of the CAP with market prices in the vicinity of world prices

The assessment of the implications on EC-US relations based on the model has focused on long-term issues and basic trends. The major changes in EC market prices for grains and feeds do, however, raise short-run issues related to the operation of the CAP with domestic price support close to unstable world prices.

First, the considerable reduction in exports is likely to change the self-sufficiency position in wheat and feed grains. It is probable that corn supplies, at some stage in the transition period at least, fall short of domestic demand while net wheat exports would remain positive. In such a case, the operation of the CAP would certainly create a wedge between wheat and corn prices because of Community preference. As Surry (1992) has shown, market prices are driven up to the threshold price in a net importing situation and

driven down to the intervention price in a net exporting case. Higher prices for corn than for wheat in the EC would trigger outlets for US corn, but also make Community preference (45 ECU/tonne, which is much larger than the target-intervention price wedge of 10 ECU/tonne) more dissuasive. Skirmishes on the implementation of the minimum access as specified in the GATT Draft Final Act are therefore likely.

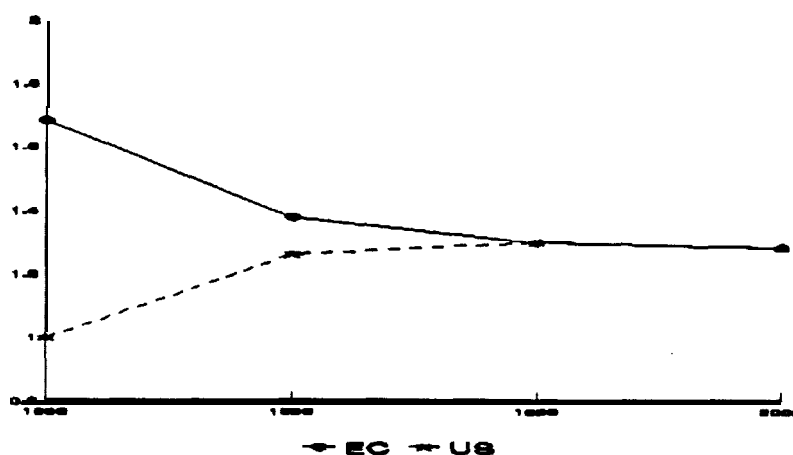
Such circumstances would also affect the issues on grain substitutes, and particularly trade in corn gluten feed (CGF). First, the continuation of unabated US flows of CGF exports to the EC, as projected by the model, calls for some qualifications. This outcome is probable as long as EC market prices for grains are significantly above US and world prices. However, with world prices rising in nominal terms, our scenario of alignment of EC on world prices is likely. It would of course be even more likely if the dollar approached its purchasing power parity value, if world economic growth accelerates, and if the EC set aside is not adjusted quickly enough to changes in market or weather conditions. Such optimistic or booming prospects on world markets, which cannot be discarded, would drastically change the prospects for feed substitutes in the EC. Even in the absence of rebalancing, transportation costs should provide some wedge between US and EC values of CGF, both led by similar world prices. The use of CGF in the US compound feed sector should take place under these circumstances because the EC price premium would disappear, potentially leading to a dramatic fall in exports of CGF to the EC. A dollar appreciation would clearly enhance the probability of this course of events, but the rise of corn and feed grain prices in the EC, due to low self sufficiency after the CAP reform, would for some time retard this process.

The trend in world grain prices would also change the fundamentals of EC grain exports. The management of restitutions will be more subject to world price shocks as the necessary level of subsidization becomes low or zero. The EC could then target more precisely her restitutions, as the US does now, on specific markets to be contested or preserved.

Altogether, the likely picture of EC imports and exports in the grain and feed area is clearly moving toward more instability in prices, subsidies and trade flows. The macroeconomic factors worldwide, and in both the EC (through the working of the European Monetary System and the switch over) and in the US

(exchange rates), will be essential elements of agricultural trade. Because of the likely shocks and ratchet effects on flows due to changing price relations, conditions are prepared for a pursuit of conflicts between the two big players. Even the signing of a Peace Clause is not likely to overcome the potential trade conflicts created by the fundamentals.

Figure 4.2. Price ratio between grains and corn gluten feed in the EC and the US under the CAP reform scenario



Sources: Guyomard and Mahe (1993).

4.2 The GATT as a cap on the CAP

The US and the so-called fair traders have obtained, with the CAP reform, a considerable reduction in EC competition in third markets by the cut in price incentives and by a freeze of resources in the cash crop sectors. Still, they are not satisfied with this unilateral reform because past experiences seem to have taught them that the EC is unable to timely adjust price support levels to technical change and world market conditions in a manner that precludes a loss in their market shares. Hence, their response to this reform suggests that it does not provide the guarantees that the disciplines of the GATT will apply. This is likely why the US and the Cairns Group firmly rejected the EC negotiating position that specific commitments on trade policies were unnecessary because they would result automatically from the cut in internal support.

This is one of the reasons for the US proposals to have included specific

and often different commitments on various trade barriers⁹. Therefore, two areas of negotiation were added to the PSE-AMS approach which had a more central role in the early than in the later stages of the Round. This is at variance with the expectation that the AMS would play an important role, when for the first time, domestic policies were supposed to be scrutinised in the negotiation process and then disciplined by the GATT.

The post mid-term US proposals (1989, 1990) focused on tariffication and export competition, insisting that export subsidies should be reduced at a faster pace than import barriers. Moreover, the concept of tariffication was also aiming at the elimination of the long denounced variable levy-restitution system.

These elements are in fact consistent with the GATT philosophy which promotes transparency of trade barriers, bound tariffs and which does not allow dumping practices. The GATT Secretariat and the President of the Trade Negotiation Group on Agriculture supported this line, as reflected in the De Zeeuw paper (1990) and more systematically in the Dunkel compromise (1991). The discrimination against export subsidization was justified by the GATT general principles but put a disproportionate burden of adjustment on the EC as compared to the US for example (Guyomard and Mahe, 1991).

The lack of confidence among the more competitive exporters in the unilateral CAP reform is further illustrated by the introduction of a new concept in commitments, i.e., the obligation of results in trade liberalization. Hence, the introduction of the concept of minimum access to imports and the specified reduction in subsidized export quantities included in the Dunkel compromise. These elements are clearly aimed at countering the temptation of the EC to maintain a sizeable exporting activity based on subsidization and to further enhance self-sufficiency in the remaining importing sectors. In other words, the GATT Round was seen as an opportunity to discipline the EC decision making and to "put a cap on the CAP".

Even if the Uruguay Round has often appeared as a "combat des chefs" between the two economic giants, it is also true that multilateralization of the reform process was a way to promote positive-externalities in the reform

⁹Another reason includes the attempt to minimize adjustment in the protected sectors (CARD, 1991).

process. Most studies (e.g. OECD, 1987, Johnson et al., . . .) suggest that joint liberalization increases world prices. For most developed countries, this would reduce the cost of adjustment or increase the benefits of net exporters due to further improvements in terms of trade. Hence, the efforts of the US and the Cairns countries to continue the multilateral process.

4.3. The GATT is also a means to help so-called fair traders do some housekeeping at home

The process of negotiating a treaty for agriculture under GATT principles requires that negotiators reach agreement on rules. These rules, however, cannot be commodity specific even if strategies were clearly designed so as to maximize other countries concessions while minimizing own concessions.¹⁰ The rules, tailored according to this strategy, must be in line with the GATT philosophy of reducing import barriers and especially the reduction of subsidies to exports that up to now were tolerated under article XVI.

Rules, as they are specified in the Draft Final Act, are complex and their differences according to instruments reflect the strategies of the various countries to capture trade gains at minimum political cost. Still, the protected sectors (sugar, dairy) should not escape the obligation of adjustment in the future. This is how the compromise will impose a revision of the CAP reform in a direction more consistent with the first Commission proposals and will help to reduce price support in the dairy and sugar sectors. Eventually enlarging the cap on the CAP. This change in the political balance of domestic forces between reform supporters and opponents will also extend to the countries who have a tendency to present themselves as free traders, but who nonetheless have highly protected sectors that they have been unable to reform. Again, the US is probably the best example of this case as illustrated by the

¹⁰ There is ample evidence that most delegations have followed that route. Canada is an example when it strived to get production quotas treated in a more lenient fashion than other price support policies without supply control. The US is another case in point when the choice of the reference period for the AMS reduction is clearly designed to minimize support cuts under this rule. Japan is the extreme case in that respect, but the EC's reluctance to accept specific commitments on subsidized exports is another example of this general attitude.

commodities which are sheltered by the 1955 waiver in the GATT.

Whether these factors were an intended positive spill-over effect of the US Administration in the early stages of the Round or a reflection of the economic philosophy of the Republican Administration is difficult to determine. The latter is doubtful, however, since otherwise the sugar policy in the US would have been liberalized to the benefit of sugar cane producers from developing countries independently from the GATT process.

4.4 Summary

Our interpretation of the course of events observed in the agricultural component of the Round is therefore that expected trade gains in key sectors of key countries were the necessary circumstances to promote collective action at the international level. This action also served to counter collective action at the domestic level which would otherwise have likely resulted in the status quo. Highly protectionist countries like Japan and the EC (for even further reasons due to her super-national nature) almost surely would not have promoted the discipline of agricultural policies under GATT rules, in spite of their general trade interest in sectors other than agriculture. The role the US played in the early stages of the GATT treaty such as insisting that agriculture be given special treatment, and its efforts to obtain the waiver are ample pieces of evidence to suggest that it would not have pursued free trade on philosophic grounds alone. The changed economic conditions, particularly in comparative advantage, and the threats from the EC on trade interests in specific commodities were sufficient to induce it to seek an effective result in this Round.

5. LONG TERM PERSPECTIVES OF EC-US TRADE

The CAP remains on the whole inefficient and inequitable to consumers and taxpayers, and to selected farmers whose incomes are supported unevenly. The main motivation for farm support in the EC is the existing low remuneration to resources, labor in particular, invested in farming. Consequently, in the long term, intersectoral mobility of resources is the natural remedy for low agricultural incomes, and policy makers should find ways of facilitating this transfer at the least social cost. A proper long-term policy favoring resource mobility and structural adjustment in agriculture is then essential to reduce in the future justified claims for public support. Consequently, long-term

perspectives on the EC-US agricultural trade will be largely dependent on the impact of CAP reform on the farm structure.

5.1 Conflicting Objectives:

Structural impact of EC common and national policies

The traditional CAP has been focusing on price support, without a strategy for structural adjustment. The Guidance section of EAGGF has always accounted for less than 5% of the fund, even though, according to the initial views of EC policy makers, its size should have been at least one third of common expenditure in agriculture. Structural policy has been left to the initiative of member states, whose main concerns were focused on safeguarding farm incomes and adequate levels of agricultural employment.

As a result, farm structure in the EC, which was quite uneven before the institution of the EC, has failed to become more homogeneous. In northern countries, farm structures have moderately improved along with labor productivity. In southern countries, farm structures have improved at a much lower rate and labor productivity is still very low. Notwithstanding considerable rates of labor out migration (e.g., in Italy and Spain), farm structure did not change substantially, and a large number of inefficient farms are still present together with a smaller number of larger and more competitive farms. In fact, the declared objective of some national policies has been to keep a large number of working people in agriculture. For example, the objectives of the Italian "Piano Agricolo Nazionale" are, i) to support and increase farm incomes, and ii) to safeguard agricultural employment especially for young people, and in less developed regions.

These objectives of the Italian agricultural policy are clearly hindering the intersectoral mobility of resources, and of labor in particular. This may help to explain why Italy, although importing almost one fifth of its food needs, accounts for a labor share in total employment in terms of Annual Work Units (AWU's) which is still double or triple that of other EC countries enjoying approximately the same level of economic development, such as The Netherlands and Belgium.

Unfortunately, in the EC as a whole, the distribution of farms per class of farmer's income is more similar to Italy than to the Dutch. Family farm income per AWU in half of EC farms is still less than 5000 ECU per year, notwithstanding the substantial price and income support granted by the CAP. This

may explain, to a certain extent, the more liberal approach of Dutch policy makers and farmers unions regarding the GATT negotiations as compared to the more conservative positions held by some other member states.

This excess labor retained in agriculture, especially in the less developed regions, is likely to be the combined effect of both the EC price support policy and the pseudo-structural policies implemented at the national level. The invisible nature of most income transfers to farmers was disguising the real contribution of agricultural employment to social welfare¹¹.

The 1992 CAP reform, by substituting explicit direct subsidies for invisible market transfers, substantially increased the transparency of the social productivity of farm labor, not only as perceived by consumers and tax payers but also as understood by farmers. To the contrary, in the dairy sub-sector where production quotas were introduced in 1984, the existing level of transparency has been further reduced, hindering the intersectoral mobility of resources and structural adjustment.

5.2 Long-term effects of the CAP reform

The long-term effects of the CAP reform are obviously very important in order to understand whether it will effectively contribute to solving the farm problems and favor a more efficient international allocation of resources, or whether it will be a palliative aiming at maintaining present economic rents in some farms and regions together with inefficient farm structures in other regions. "Gattopardismo" has been very frequent in past CAP reforms.

The EC Council of Ministers on May 1992 decided that the compensation of farmers for income losses due to reduced price support should be paid on a year to year basis. This decision is likely to have the following consequences:

i) The administrative costs of computing compensations and validating farmer's annual declarations will be a major burden on EC and national budgets, with wider possibilities for fraud.

¹¹ Social security invisible transfers were substantial, accounting for more than 50% of public expenditure in agriculture in early eighties. Altogether, income transfer to agriculture was approximately equal to the sectoral value added (Tarditi and Croci-Angelini, 1988, p. 28 and 70). Unfortunately, the survey on national expenditure in agriculture (CEC, 1982) initiated by the EC Commission in the early eighties, and providing extremely interesting information, was never updated.

ii) It would not be advisable to modulate compensation according to farm size in the case where they are paid yearly without running the risk of hindering structural adjustment while they install incentives to meet the conditions to maximize payments. Maintaining smaller and less efficient farms would mean receiving every year higher compensations.

iii) Farmers running small holdings will be encouraged to remain in the agricultural sector in order to receive their payments, thus limiting the intersectoral and intersectoral labor mobility.

iv) Farmers are continually uncertain of their future payments. This could encourage them to take a conservative approach in making structural improvements, and induce them to spend time and money convincing the political sector to guarantee their compensation.

v) Employment in farming will decrease less and some extra, employment will be created in the public sector in order to implement the new administrative practices and controls. However, the marginal contribution of this extra employment to social welfare is likely to be negative.

The newly born reform of the CAP is likely to show its advantages in the upcoming years, but its intrinsic contradictions will be more apparent as well.

5.3. Long-term benefits of a more decoupled CAP reform

Society may be justified in granting direct payments to farmers for the conservation of natural resources and other environmentally saving practices. Positive externalities are currently produced by agriculture, but as they are public goods, they are not valued by market prices. On the other hand, compensations for income losses due to reduced price support after the CAP reform may be paid as a lump sum, allowing farmers to accumulate future payments for a number of years¹². In order to avoid sudden budgetary problems, lump-sum payments could be financed by the EC budget in the form of bonds, saleable on the financial markets, as recently proposed by the Land Use and Food Policy Inter Group (LUFPIG) of the European Parliament. (Marsh et al., 1991)

If a lump-sum compensation, for the reduction in incomes is computed for

¹² The LUFPIG proposal at the European Parliament envisioned a 15 year period. The same period has been assumed for a simulation of the impact of a decoupled CAP reform on markets and prices (Folmer et al., 1993).

a number of years and, for example, offered to farmers as bonds saleable on the financial markets, farmers would have the choice to cash annually the payment or to sell the bonds and cash, at any time, their discounted cumulative compensation for future payments.

The long-term effects on structural adjustment of this more decoupled feature of the CAP reform are quite interesting, they include:

i) Bureaucratic costs would be reduced and the possibility of fraud decreased as the administrative work of calculating and analyzing payments would only have to be done once.

ii) Compensation could be modulated according to farm size, or to other parameters, without generating inefficient resource allocation in the future. Investment decisions could then be based mainly on market conditions and there will be less public incentive for owning a smaller farm instead of a more efficient and viable one.

iii) Proper environmental standards could be targeted by means of regulation, incentives for positive externalities and disincentives on negative externalities, without directly hindering a more efficient allocation of resources. Land set aside could be encouraged on the basis of conservation objectives, and not to manage supply control for reasons of complacency towards foreign competitors.

iv) Labor mobility out of agriculture would not be hindered.

v) Farmers' incomes would not be tied directly to policy makers. The spending for lobbying would be reduced and farmers would be more reliant on actual market prices.

Although accepting its economic advantages, these decoupled aspects of a bolder CAP reform may be considered too risky by policy makers whose concerns are focused on possible demographic and territorial problems. Lump-sum compensations could then be tested on a specific section of the agricultural sector, e.g., providing this extra choice only to smaller, economically nonviable farms, or limiting lump sum compensations to specific EC regions where agricultural employment is clearly excessive. Such a scheme would favor the needed structural adjustment. Complementary measures for restructuring farms in these areas and fostering economic development in other economic sectors are also clearly necessary to promote regional and rural development on a wider economic basis than the agricultural sector alone.

6. CONCLUSION

The reform of the Common Agricultural Policy has amounted to the substitution of new income support instruments for the usual price policy, essentially in the cash crop sector. Our first point is that the domestic political balance was unable to generate such a large change in policy design, in spite of inefficiencies and imbalances due to the traditional CAP. The pressure of the US has been a major factor in the evolution of the reform. We argue that trade interests have been crucial to catalyze international collective action in order to counteract domestic pressure groups. Apparently, the reform satisfies the US objectives as well as the GATT compromise. The US gains from the CAP reform are noticeable, but we do not foresee the disappearance of sources of tension between the EC and the US, as EC animal products become more competitive and as the working of the CAP in the vicinity of world prices will make trade flows sensitive to agricultural and macro-economics shocks.

According to some quantitative estimates¹³, which are consistent with ours, the expected effect of a decoupled CAP reform on trade flows between the EC and the US should not be too dramatic as a whole. The increased extensification related to a larger number of economically viable farms will likely be balanced by reduced land set-aside, improving the allocation of resources.

The most interesting effects should be apparent in the changing perspectives for further trade liberalization, as intersectoral labor mobility and lower farm production costs are essential conditions for allowing a further reduction in farm support and for developing a freer international trade for agricultural products without excessive burden on consumers and taxpayers. Improved structural adjustment, generating lower production costs and lower demand for protection, is likely to be the best safeguard against continuing requests for protectionist measures both in the EC and the US. A less interventionist policy by the EC and the US is likely to be followed by other developed countries and favor a more efficient international allocation of resources.

The CAP could then concentrate more on providing incentives for environmental conservation and improvement, subsidizing farmers in less

¹³For example, Folmer et al., 1993.

developed regions where depopulation could occur and favoring a better income distribution through decoupled policy instruments. However, as domestic special interests, both in the EC and the US, are still very strong, such a completion of the CAP reform is likely to be possible only if external pressures for reform are joined by domestic political pressures from consumers and by a more socially oriented attitude of policy makers (Tarditi, 1993).

The pursuit of an agreement in the GATT is therefore a means to keep further developments in the CAP under control and to promote the positive externalities from multilateral reform. Hence, the search for a package dressed up along the principles of the GATT and based on trade barriers rather than on effective support reduction. This package has the further benefits of fostering the capability of the proponents of action to actually reform their most protected sectors like sugar and dairy which they were unable to adjust in isolation. The magnitude of changes in these sectors will be limited, but the GATT will put a cap not only on the CAP but also on the support of the protected industries in otherwise agricultural export oriented countries.

It appears that the Uruguay Round will succeed in placing agriculture partly under the GATT. This success is not satisfactory however, and the long-run objective of further decoupling of payments from production incentives should be pursued in order to promote agricultural trade on a more competitive basis and to reserve intervention of the State to the promotion of public goods.

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