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The Treatment of National Agricultural Policies in Free Trade Areas

by

Tim Josling*

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*Tim Josling is a Professor, Food Research Institute, Stanford University.

Correspondence or requests for additional copies of this paper should be addressed to:

Tim Josling
Stanford University
Food Research Institute
Stanford, CA 94305

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Revised

THE TREATMENT OF NATIONAL AGRICULTURAL POLICIES IN FREE TRADE AREAS

Tim Josling
Food Research Institute
Stanford University

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The Treatment of National Agricultural Policies in Free Trade Areas

Tim Josling
Food Research Institute
Stanford University

I. Introduction

Post-war trade policy has emphasized multilateral trade rules and the principle of non-discrimination among GATT members. In reality, the majority of GATT members are associated with some regional or other trading bloc, within which conditions of market access show a degree of preference. Whether or not the current Uruguay Round strengthens and extends the GATT rules, there is likely to be a continued interest in regional trade arrangements. The issue of the treatment of domestic economic and sectoral policies within free-trade areas will be an important facet of such trade groupings.

In agriculture the pervasive effect of domestic agricultural policies, in particular those that regulate markets and support prices, poses special problems for free trade areas (FTAs). These problems are of two types: the impact of the policies themselves on market access within the FTA; and the impact of free-trade area rules, such as tariff reductions and other trade policy adjustments, on the ability of the domestic agricultural programs to achieve their objectives. The issues of the compatibility of national farm policies and free-trade areas is also of importance to outsiders. This study addresses these problems as they relate to the current negotiations on regional trade arrangements in both the EC and North America.

It is convenient to start with the main agricultural trade and policy issues facing countries contemplating the creation of FTAs.[1] Such countries face several choices. These include the following:

i) the extent to which agricultural trade should be included in the provisions of the FTA,

ii) the treatment of domestic policies as potential non-tariff barriers to trade within the FTA,

iii) the impact of freer intra-bloc trade on the efficacy of domestic instruments of price and income

[1] The emphasis in this paper is on the impact of free trade in agricultural commodities on the product price support policies of the participating countries. There are important implications for agriculture and agricultural policy of freer factor movements and greater flows of investment among countries. In some cases these other aspects of market liberalization go along with freer trade. These factor flow issues are not addressed in this paper.

support,

(iv) the harmonization of regulatory systems and standards as a way of reducing artificial trade impediments, and

v) the implications for third countries of the choices made by participants in an FTA.

These questions are used as the structure of the study, with a section devoted to each issue. The implications of this analysis for European and North American free-trade talks are then discussed. A final section summarises the main conclusions.

II. Inclusion of Agriculture in FTAs

There are four main reasons to include agriculture in the provisions of an FTA. First, one of the countries may be an exporter of agricultural goods and insist on gaining market access for those products. The other countries may be forced reluctantly to grant such access even at political cost. Secondly, to omit an important sector from trade liberalization implies possible intra-bloc distortions from different price levels for food, different raw material costs for agro-based industries, and different rural employment conditions. The potential for conflict exists when such obvious disparities are perpetuated. Thirdly, the need to track and examine all agricultural and food products at the border, to protect national price level differences, will eventually become an administrative anomaly. And fourthly, the GATT article that allows a departure from the general principle for non-discrimination in trade (Article XXIV) states that "essentially all trade" must be covered. Though not strictly enforced, this provision at least gives a presumptive argument for inclusion of agriculture.

There is essentially only one argument for excluding agriculture from an FTA. Domestic agricultural price support policies rely on import controls and export assistance to regulate the domestic market. Entrenched political and economic interests make it difficult to contemplate the negotiation of free regional trade in the presence of such policies. It maybe deemed not worth the trouble. There are a number of examples, as discussed below, which illustrate this unwillingness to tackle agricultural policy issues within an FTA.

The question of the inclusion or exclusion of agriculture from an FTA is illuminated by consideration of both the European and the North American experiences. This section will examine the arguments for and against the inclusion of agricultural trade in free trade areas, through a discussion of the treatment of agriculture in the European Community (EC), in the European Free Trade Association (EFTA), the EC/EFTA bilateral free-trade agreements, the European Economic Area (EEA) accord just concluded between the EC and EFTA, and the Canada-United States Free-Trade Agreement (CUSTA) of 1989.

a) Agriculture in European Integration

The issue of the place of agriculture in European integration goes back at least to the inter-war period. The farming sector posed a problem for the Economic Union between Belgium and Luxembourg (BLEU), negotiated in 1922. Luxembourg's poor farming structure and history of high protection made it difficult to contemplate a level playing field in agriculture. A series of payments were made to Luxembourg farmers (out of customs receipts from the Union) to keep their prices above those in Belgium.[2] Later, Luxembourg began to impose import restrictions to protect their market. When the Benelux union was formed in 1948, Belgian agriculture faced competition from the Netherlands. The solution on this occasion was to allow countries to fix minimum prices and control imports, though giving a degree of preference to partner supplies. The Dutch were never happy with this arrangement and tried on several occasions to renegotiate the agricultural provisions of the Benelux agreement. It was made abundantly clear by the Dutch that no such illiberal internal trade restrictions would be allowed in a wider European Economic Community (EEC).

In the event, the Treaty of Rome, which set up the EEC, made no distinction between agricultural and other foods as regards internal trade. The Dutch view prevailed over those (led by the French) who argued for quantitative controls. Subsequent politicians showed less good sense than the drafters of the Treaty. Internal free trade in the Community has been distorted since 1969 by the monetary adjustments (MCAs) made at the borders to relieve farmers from the impact of currency movements. Nevertheless, it is generally true that internal agricultural trade is free of restrictions, as evidenced by the fact that no agricultural policy measures were

[2] For details of this and other early attempts at dealing with agricultural policy in European integration, see Michael Tracy, Government and Agriculture in Western Europe, 1880-1988, Harvester Wheatsheaf, 1990.

included in the 1992 internal market program.[3] Because the Community chose to go beyond a free trade area, by instituting a common external policy, free factor movements, and a common agricultural policy, the EC experience has less direct relevance to the topic of agriculture in FTAs, and it will not be discussed in detail.

By contrast to the EC, the countries that negotiated the EFTA decided to exclude agriculture from the terms of its free trade provision. The recently concluded discussions between EFTA and the EC, on the formation of a European Economic Area (EEA), highlighted this difference. In the event, agriculture was omitted from the free-trade provisions of the EEA.

The reasons for the exclusion of agriculture from the EFTA were broadly historical. In July 1956, at a time of intensive negotiations on the future trade relations in post-war Europe, the UK suggested the formation of a free-trade area for all the OEEC countries -- including the six initial EEC members. The Six were not convinced that a mere free-trade area would be satisfactory: it did not hold out the promise of closer political relationships. Moreover, they distrusted the UK's insistence that such an FTA exclude agriculture (to preserve the practice of Commonwealth Preference) and chose to continue on their way toward the Rome Treaty.[4] The UK and six other countries (The Outer Seven) pursued the FTA option, leading to the creation of the EFTA in the Stockholm Treaty of 1960. This Treaty, heavily influenced by British trade policy, contained an agreement that the trade liberalisation provisions would not apply to agriculture and fisheries (Articles 21 and 26).

The legacy of the decision still remains. EFTA is an incomplete free-trade area because it omits these two important sectors of the economy. Some bilateral arrangements were made between Denmark, when an EFTA member, and the other members, particularily the UK, to ease the export of farm products. The UK also agreed to allow the import of some fish products from EFTA partners, subject to a minimum-import price, in the late 1960s. Some duties on agricultural products were bound in 1966, and market access was improved in

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[3] For a fuller discussion of EC trade policy in agriculture, see T. Josling, "European Community Policies Towards Trade in Agricultural Products," and for a detailed discussion of the links between agricultural policy and 1992 see D.R. Kelch (ed) EC 1992: Implications for World Food and Agricultural Trade, USDA. Staff Report Number AGES 9133, October 1991.

[4] For a discussion of this period, see Michael Tracy, (op. cit).

1971, but EFTA essentially failed to tackle the agricultural anomaly in its thirty years of existence.

The same decision, to exclude agriculture, was made at the time of the series of bilateral trade pacts among the EFTA countries and the EC, following the desertion of the UK and Denmark from EFTA in 1973. Countries were agreed that trade barriers should not be re-erected among former EFTA partners: free trade agreements between the EFTA countries and the EC looked to be the answer. But in agriculture and fisheries, the issue did not arise. No new barriers were erected on farm products as no preferences were eroded. Swiss farm exports, for example, were not allowed free access into the UK market under EFTA rules, so they suffered no loss of preference with UK accession to the EC. It was the UK's Commonwealth Preference system that had to take most of the adjustment to UK membership in the area of agricultural trade.

Whether the EC-EFTA bilaterals could have included agriculture is uncertain. The EC had by that time developed the Common Agricultural Policy, a heavy-handed approach, which involved rules on free trade within the EC coupled with an overly-restrictive system for controlling third country imports. The protectionist face of the CAP toward third countries, however, was not the main problem for the EFTA-EC agreements. Austria, Sweden, Norway, Switzerland, Finland (made a full EFTA member in 1969) and Iceland (which joined in 1970) and Portugal all had restrictive regimes for farm trade. The issue was trade within the EC-EFTA bloc. EFTA countries could hardly have been expected to have adopted the CAP: the loss of control of rural policy, seen as crucial to national security and social policy in several of these countries, was too much to expect of non-members. The supranational nature of the EC was (and is) much more evident in the case of agriculture than in most other areas of economic activity. The full set of regulations governing agricultural marketing together with a sharing of the financial burden and the need to harmonise prices would have been too much to impose on the EFTA countries. Without extensive revision of EFTA policies in this area, free trade in farm products was out of the question.

The talks aimed at establishing a European Economic Area have taken the same approach to agriculture. Rather than open up the question of trade in agricultural products, both the EC and EFTA agreed that it be left off the table. This decision was questioned by Spain, perhaps not so impressed with the historical precedents in this matter, which requested better access into the affluent nations of EFTA for Meditteranean products. Rather than open up the whole "can of worms", it was decided to avoid this issue.

The question remains whether this is a satisfactory or indeed a stable state of affairs. Agriculture is a small and diminishing part of these economies. It is quite possible, from an administrative perspective, to rule all farm trade beyond the scope of an EEA.[5] But the long-term viability of such a decision is doubtful. As the impact of integration is felt, one can imagine anomalies arising which would call into question the decision. These problems are likely to arise most clearly through developments in the food industry. Unlike the small size of the farm sector, the food industry is one of the largest in the European economy. People spend between 25 and 30 percent of their income on food, either prepared at home or eaten out. This industry is undergoing a process of rapid adjustment, including internal structural change and rationalisation and closer integration among countries. The end result will be an inevitable blurring of the national divisions of this sector. Some of the largest firms are located in EFTA countries. One would expect increasing pressure to remove anomalies that prevented these firms from seeking the cheapest source of supply for raw materials in a competitive European food market. This industry will also need to maintain its competitiveness in world markets. In spite of these concerns, one would expect that agriculture will be kept formally out of the EEA arrangements for some time to come, with issues being dealt with on an ad hoc basis.

Whether this exclusion of agriculture weakens the prospects for the EEA has been rendered largely moot by the application of Sweden and Austria to join the EC and the expected application of Finland next year. Switzerland and Norway are presently discussing their own applications. New members will not have the luxury of exempting agriculture from the arrangements: they will be expected to adopt the CAP in its entirety. Poland, Hungary, and Czechoslovakia have all expressed a desire to join the EC, and the Community can ill afford to rebuff their overtures. The prospect of extending the CAP to over 20 countries worries politicians and bureaucrats both within and outside the EC.

b) Agriculture in North American Integration

Agricultural trade liberalization was not a major focus of the CUSTA. At least three reasons can be

[5] This does, however, raise again the position of EFTA and the EEA within the GATT. Article XXIV states that a free trade area must cover essentially all trade. No one bothered to make an issue of the EFTA arrangement, but the same might not be true of an EEA treaty.

advanced to explain this omission. First, as major exporters, neither Canada nor the US think of the other as a large potential market for future sales. In spite of considerable trade in US fruits and vegetables exported to Canada and in Canadian livestock products moving to the US, the main export possibilities are perceived to be elsewhere. Many import restrictions in the two countries are in place to protect against dumping or to support some domestic program of market regulation or supply control. The blatant protection of an inefficient domestic sector, as illustrated by the farm policies of Japan and the European Community, is less common in the US and Canada, though the dairy (in both countries) and sugar (in the US) sectors stand out as exceptions.

Allied to this was the fact that agricultural policy and trade issues were a major focus of the Uruguay Round of trade negotiations. At the time of negotiation of the Canada-US FTA, there was still hope that the Uruguay Round would severely curb agricultural protection and impose new rules on global agricultural trade. This made the task of negotiating bilateral rules both less urgent and more complicated: it seemed obvious that such matters were best left to the GATT talks, and yet the outcome of the GATT talks would not be known until after the bilateral agreement had been negotiated. An attempt to prejudge that outcome would have been resisted.

A third reason lay just below the surface. In Canada, many of the agricultural trade regulations are legislated and administered at the Provincial level. The federal government runs its own set of farm programs often in parallel with those of the provinces. The FTA was negotiated at the federal level and did not directly involve negotiation on provincial legislation: the federal government was assumed to be able to bring the provinces into line at the implementation stage. This assumption may not have been warranted in all cases. Not only have provinces been able to resist the pressure from Ottawa to make changes consistent with the FTA, there has been evidence of some new initiatives at the provincial level to replace federal protection given up in the bilateral agreement.

For whatever reasons, agriculture was treated lightly in the Canada-US FTA. In Lipsey's terminology, contentious farm trade and policy issues were consigned to the "penumbra" of the Agreement, reflecting "carefully crafted compromises relating to points of bilateral friction," rather than the "core" of liberal trade principles.[6] Michael Hart concludes that the "obligations in the agricultural sector [are] significantly less onerous than obligations for trade in industrial goods." [7] The agricultural provisions included, along with scheduled reductions in trade barriers, specific agreements on beef quotas, wine marketing, and cereal import licenses. In addition, there was some attempt to avoid trade problems resulting from different sanitary and phytosanitary regulations. But the dairy sector was largely excluded from consideration, out of deference to sectoral sensitivities.

c) Other FTAs and their treatments of agriculture

The decision to exclude agricultural trade either in whole, as with EFTA, or in part, as with CUSTA, has been common on other continents. Latin American trade pacts in the past generally have not tackled the issue of agricultural trade within their region. This may change in the future, as countries in that region move to the use of tariffs, as discussed below. Recent discussions among the ASEAN countries for an ASEAN Free Trade Area (AFTA) which would bring down barriers to trade in that region also chose to avoid agriculture. Only the Closer Economic Relations (CER) agreement between Australia and New Zealand has really come to grips with the issue. Agricultural trade, as well as trade in other products, is now free between these countries. This development was no doubt helped by the drastic reduction in government intervention in these two countries in the past five years, particularly in New Zealand, which paved the way for the removal of market distorting policies.

III. Domestic Policies as Non-tariff Barriers

Perhaps the most obvious problem with excluding agriculture from the provisions of a free-trade area is that domestic policies often act as trade impediments. The FTA cannot fully develop along the lines of regional specialisation if a major sector is excluded. The issue of domestic policies as non-tariff barriers (NTBs)

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[6] Richard Lipsey, "The Case for Trilateralism," in Steven Globerman (ed) Continental Accord: North American Economic Integration, the Fraser Institute, Vancouver, 1991, pp. 114.

[7] Michael Hart, A North American Free Trade Agreement: The Strategic Implications for Canada, Institute for Research on Public Policy, Ottawa, 1990, p. 113.

in a free trade area is essentially the same as that being faced in the Uruguay Round of the GATT with respect to multilateral trade. Trade frictions will exist so long as domestic policies give incentives to domestic producers.

In the context of the GATT round, the emphasis has been on the reduction of protection and the reinstrumentation of domestic and trade policies. In FTAs, members could attempt to reduce producer incentives, but may have difficulty in doing so without corresponding multilateral action by non-member countries. Reinstrumentation of policies may also be desirable for intra-bloc trade policy, but once again this runs into the problem of "getting ahead" of multilateral rule changes. Regional problems are undoubtedly complicated by the existence of parallel negotiations at the GATT level. On the other hand, successful GATT negotiations would make the inclusion of agriculture in FTAs much easier. This section explores both the analytical issue of the consistency of domestic policies with free market access within the FTA and the issue of the links between regional and bilateral talks and the GATT negotiations.

a) Free trade and domestic policies

Free trade is an imprecise concept. It certainly implies the absence of deliberate tariff barriers and such non-tariff barriers as quotas and parafiscal taxes. It usually means the absence of discriminatory policies that treat imported goods less favorably than those of domestic origin. In its strictest sense it would also include the removal of all policies that give any form of assistance to domestic firms, on the principle that the playing field was not truly level. Taken to its extreme, provision of most public goods would be effected, as the quantity, quality, and method of financing of such government activities undoubtedly influence competition.[8] Governments, however, are not likely to buy the argument that a free-trade commercial policy involves giving up all domestic sectoral, regional and industrial policies. In practice, the question is how to constrain policies that give a marked incentive to expand the production, or reduce the consumption, of a product of export interest to a trading partner.

b) Policy instruments and market access

[8] If one adds free trade in services, another set of government regulations could be considered contrary to free trade. Barriers to service trade are generally of the form of regulations on labor mobility, rules of establishment, fiduciary control of financial services, and other types of regulations usually deemed "domestic."

A classification of policy instruments permits identification of those likely to be of particular relevance in free-trade area talks. For this purpose it is useful to start with a distinction between "coupled" and "decoupled" policy instruments. In this context, a "coupled" policy rewards (or taxes) producers or consumers on the marginal unit of production or consumption. Output or use decisions, therefore, are directly impacted by the policy.[9]

Four combinations of producer and consumer policy types are possible, as shown in Figure 1. Policies that are coupled on the producer side are likely to cause the most problems for intra-block trade. These include primarily the set of policies that operate at the border, which are coupled to both production and consumption decisions. Policies decoupled on the consumer side include various producer subsidies paid in a way that allows market prices to find their own level. These will be somewhat less contentious, but still raise issues of competition among producers. Producer-decoupled programs include coupled consumer taxes and subsidies, which are unlikely to be of major concern in an FTA, and those fully decoupled instruments that do not directly affect market price and hence are likely to be broadly acceptable to all of the trading partners. The main policy instruments that fall under these four headings are considered below.

i) Border measures

One would expect the issue of direct trade policies to be the most immediate concern in FTAs. The problem will be apparent as a conflict between protected domestic producers and those wishing to gain access to that market through the provisions of the FTA. .

The natural focus of negotiations in the case of tariff protection is to agree on a reduction on such tariffs on intra-bloc trade, leaving members to run their own external commercial policy. The tariff reductions can be subject to safeguard provisions, which can act to "snap-back" tariffs if imports rise too fast. In the case of import quotas one would expect the relaxation of quantitative restrictions on partner trade over a period of time. Domestic pressures will try to influence the time period allowed for adjustment, though this may be unrelated to the actual time needed for such adjustment. Firms will be keen to protect the value of their capital

[9] This definition of a coupled policy is less rigorous than others that can be suggested. For instance, lump sum payments do not affect marginal decisions directly but may be enough to keep a producer in business, borrow to finance expansion, and choose one product over another. Too strict a definition of decoupled policies is probably unconstructive in the context of FTAs: too few policies would qualify, and the attempt to modify national policies could be abandoned.

Figure 1: Classification of Instruments According to

Degree of Coupling

	Producer Coupled	Producer Decoupled
Consumer coupled	Incompatible with FTA Allowed on third-country trade -Import taxes, levies -Import quotas -Export subsidies -Voluntary export restraints -Home market schemes -Producer-financed export subsidies State trading	Likely to be tolerated in FTAs -Consumer subsidies -Storage subsidies (consumer level)
Consumer decoupled	Likely to be challenged in FTAs as distortion of competition -Producer subsidies -Deficiency payments -Storage subsidies (producer level) Set-aside payments $(P_i - P_w) . Q$	Allowable under FTAs -Food stamps (general) -Crop insurance -Hectarage payments -Set-aside payments $(P_s - P_i) . Q$

$(P_i - P_w). Q$ refers to the part of set-aside payments that stimulate output above world prices, and $(P_s - P_i). Q$ is that part which has no effect on output. See text for an explanation of these terms.

investment; a long transition period preserves for a time the stream of protected receipts and hence presents a free fall in asset values.

Export subsidies are also likely to be objectionable to producer interests in an FTA, on grounds that competition is distorted. Governments in general will have less difficulty reducing export subsidies on internal FTA trade, despite the fact that such subsidies offer protection to producers. [10]It is somewhat easier for an industry to claim protection against imports than to argue for export assistance. Quantitative controls on exports within the bloc, such as might be used to keep prices down in times of shortage, can also be outlawed with relative ease. Voluntary Export Restraints (VERs) have become a part of the commercial armory of a number of countries: it would seem natural that FTA partners remove all VER arrangements between them, perhaps after a transition period.

Among other export-related policies that are likely to cause problems for FTAs are home-market schemes (where a higher domestic price gives an implicit export subsidy as a result of revenue pooling) and "producer-financed" export subsidies, paid from a producer levy rather than from the taxpayer.[11] Such policies distort competition and will be targets for negotiation. However, in so far as they are run by marketing boards there could be considerable resistance to change.

This problem of what to do with institutions that run policies counter to an FTA arises also in the case of state trading. A parastatal importer can offer protection without the need for a tariff or explicit quota. The effective quota is the amount imported, which can be less than would have come in under free trade, and the implicit tariff revenue is the profit made by reselling on the domestic market. Export agencies also can influence traded quantities, often giving an effective subsidy through trading losses. A country may be reluctant to give up its cherished institutions on account of an FTA: in practice, some accommodation will have to be found to

[10] On occassions an importing country may wish to keep the advantage of subsidized imports from the partner, at the expenses of domestic producer interests. This could be true, for instance, in the case of Mexican attitudes toward US government credit guarantees on sales of dairy and grain products to Mexico.

[11] This instrument should be more properly called a consumer-financed export subsidy, as it can only be profitable for the producer to sell more cheaply abroad if the domestic price is raised above the world market price. As with the home market scheme, such producer-controlled policies require import restrictions to operate and are usually associated with parastatal marketing boards.

prevent conflicts arising within the FTA from state trading activity.

ii) Producer subsidies

Producer subsidies raise problems for FTAs only slightly less serious than direct trade barriers. Competitors in other countries are likely to challenge producer subsidies as distortive of competition. The economic case for the removal of such subsidies is not clearcut: the policies may be desirable responses to divergences of a specific national character. In terms of political economy, the success of the FTA may hinge on the willingness of governments to give up the right to distort competition even when national conditions might warrant such policies.

Deficiency payments are a special breed of producer subsidy, triggered by the relationship between market prices and a pre-set guaranteed price. They add stability to farm prices (if not incomes) and are generally considered by recipients to be the next best thing to adequate market prices. To give up these policies in an FTA may prove difficult. It is more likely that attempts would be made to "decouple" such payments, as has been done for the purposes of control of domestic spending.

Storage subsidies (at the producer level) pose similar problems, but are in general likely to be less provocative: they act to remove surpluses when prices are low and may be deemed helpful to the partner country in the FTA. The subsidy element in set-aside programs is, however, likely to be contentious. Set-asides are usually ways of restraining the quantity of output that can benefit from support prices. They should, therefore, be judged as a part of a producer subsidy program. One can conceptually distinguish between that part of a set-aside payment that is production-neutral and that which is in effect a production-stimulating subsidy.[12] The US-Canada Free Trade Agreement attempted to deal with this issue in the context of opening up Canadian markets to US grain.

iii) Consumer subsidies and decoupled programs

Consumer subsidies are unlikely to generate significant problems within an FTA, even though they may

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[12] If P_s is the (marginal) support price, P_w the world price, and P_i the price at which the actual output would be the same as that with the policy (the "incentive" price), then $(P_i - P_w)$ is the price incentive and $(P_s - P_i)$ is a production-neutral subsidy. See Carol Bray, Tim Josling and Jay Cherlow "Adjustments for Set-Aside Acres in Agricultural Trade Agreements: An Example from the Canada-US Trade Agreement," Canadian Journal of Agricultural Economics (forthcoming).

distort competition. There is enough of a mercantilist flavor to most FTAs to welcome any trade-expanding measure. Schemes that encourage storage (at the wholesale level) in general will also be found unobjectionable. Stability from such storage will benefit all partners.

Similarly benign are programs that are effectively decoupled from output and consumption decisions, such as food stamps (which act much as an income supplement) and crop insurance (so long as it is not commodity specific). Payments per hectare, such as is envisaged in the MacSharry proposal for the EC, may raise some questions in an FTA, but if truly decoupled from current output decisions they may have a minimal impact on competition. The decoupled element of set-aside payments could also be deemed to be non-distorting within an FTA.

IV. Free Intra-Bloc Trade and Domestic Policy Choice

The problem of domestic instruments as barriers to market access for FTA partners is the focus of most attention in free-trade negotiations. But an equally important issue that has received remarkably little attention is the impact of freer intra-bloc trade on the effectiveness of domestic policy instruments that might be used by member countries. What national policies can survive in an FTA? On the face of it, members can remove those policies that cause the most trade friction within the FTA and still maintain their individual policies against non-members. Figure 2 shows the range of policy instruments where the trade measures apply only to third-country trade. But even if only the less disruptive policies were allowed to stay, significant changes in their effectiveness are apparent. The feasible policy set in an FTA is much smaller once protection against partner trade is removed. The loss of policy effectiveness can be illustrated by considering the various instruments in the presence of free partner trade (Figure 2).[13]

i) Third country border instruments

The problem of disparate tariffs on third country trade among FTA members is well known. Trade can be "deflected" through the country with the lowest border protection and dilute the protection in the other

[13] See the Annex for a more analytical exposition of the impact of partner free trade on the effectiveness of policy instruments.

Figure 2: Impact of FTA on Effectiveness of Policy Instruments

Policy	Impact of FTA
Tariff on 3rd country imports	tariffs above lowest partner level become ineffective
Quota on 3rd country imports	quotas become ineffective
Export subsidy on 3rd country trade	subsidies become more expensive
Voluntary export restraint on 3rd country trade	restraint becomes ineffective
Variable import levy on 3rd country trade	stability property lost
Government financed storage scheme	storage scheme becomes less effective
Quantitative limit on domestic marketing or production	quota becomes ineffective as price raising device
Deficiency payments	not directly affected: cost may be raised or lowered
Consumer subsidies	not directly affected: cost may be raised or lowered
Crop insurance	not affected
Hectarage payments	not affected
Food stamps	not affected

countries. It is normal in FTAs to deal with trade deflection by means of rules of origin. To qualify as "internal" a product must have undergone a substantial transformation (or acquired a particular value added) in the partner country. Unfortunately, this remedy is of limited use for agricultural products. Rules of origin are meaningless for a homogenous good: even if one could trace the origin of a particular bushel of wheat, national supplies are fungible. The low-priced country would import its consumption needs to free up exports to the high-priced market. Such arbitrage could only be stopped by interfering with intra-bloc trade.

Similar problems apply in the case of import quotas on third country trade. One country cannot effectively maintain such quotas if its partner with free access does not. Import quotas can be fully effective only if "regionalized" to apply to both markets--in effect the introduction of a "common policy"--just as tariffs will only be fully effective if harmonized. Third-country import policy can still be nominally independent in an FTA, but in practice pressures will mount for coordination in the case of homogenous products.

Export policy fares no better. An export subsidy (on third country trade) may survive the negotiation of an FTA. But if there is free access into the market of the subsidizing country and supplies are fungible, production from the non-subsidizing country will flow to the subsidizing partner and cause the policy to collapse. Voluntary export restraints suffer the same fate: there is little point in negotiating such restraints with third country suppliers at the front door if the back door is open. Once again, the solution is either common policies or the abandonment of the instruments. Home-market schemes and "producer-financed" export subsidies also lose their efficacy in a situation of free partner access, even if restricted to third countries. The ability of the marketing board to operate such schemes is impaired by lack of control of all sources of supply. Consumers can in effect choose not to subsidize exports: they merely buy partner products.

Also influenced by the operation of an FTA, as market access within the area is improved, is the mechanism of the variable levy. If one member of the FTA has a fixed tariff and another a variable levy, the fixed tariff will come to dominate the levy. Prices in the country previously protected by the levy will follow the world price plus the fixed tariffs, with arbitrage among the markets. Other stability devices (such as variable export subsidies) suffer the same fate. It is difficult for one country to stabilize its market if it has free trade with a less stable partner. Instability will flow accross the border. This will tend to lead to either a departure from the FTA principles or a common stability policy.[14] It follows that storage policies will also either become unmanageable (as are partner attempts to stabilize the whole FTA internal market) or coordinated. Independent stability policies will not survive a regional free trade regime.

ii) Quantitative controls on production

The countries within an FTA may accept that their powers to run independent policies on third country trade are de facto restricted: surely they can run domestic supply control policies to maintain farm incomes. Free partner trade will not in itself prevent such production quotas from operating. The effectiveness of such quotas, however, will be significantly limited. It is clear both from economic analysis and trade policy practice that domestic supply controls need trade measures as support. If substitute production can be freely imported from an FTA partner, the production control will be ineffective in maintaining price.[15] This is the reason behind the exception in the GATT to the rule of "tariffs only" (Article XI), which allows quantitative restrictions when domestic production is controlled. It also lies behind the use of import quotas under Section 22 of the US Agricultural Adjustment Act (as amended) which mandates such action in support of domestic policies. FTAs put to the test the issue of import barriers in support of domestic quotas.

iii) Producer and consumer subsidies

The relationship between FTA rules on internal trade and the ability to run domestic subsidy programs is less clearcut. Such subsidies could be ruled out on competition grounds, as indicated above. But those that survive might be weakened by the free access provisions of the FTA. Essentially, the impact on such policies depends upon the trend in market prices. If freer trade with partners reduces market prices, the cost of deficiency payments could increase. But free trade could also increase market prices, if export opportunities are opened up. In this case the cost of deficiency payments in an importing country could go down. Less stable market prices, following from the greater market access, will also cause the cost of such policies to fluctuate.

[14] To the extent that production fluctuations within the FTA offset each other, stability may be increased with free trade among partners.

[15] One could still control production to limit government expenditure. Political support for such limits could erode, however, if it was clear that no price enhancement was being achieved.

But the market price in the FTA could also be more stable as a result of freer trade. Consumer policies could benefit from more open access to partner supplies: food stamp programs and those that fix maximum prices for consumer foods will be less costly to run with lower cost supplies. In general, if the consumer and producer subsidies survive the "competition" test of the FTA, they probably can survive the arbitrage that would follow the opening up of market access.

Decoupling such policies from output decisions was suggested as the response to the competition issue, and this would tend to free farm incomes from market prices. The set of decoupled policies discussed above will generally be left unaffected by freer intra-bloc trade. Crop insurance, hectarage payments (for the reduction in price support, tending the land, or abstaining from chemical dependency) and food stamps can all thrive in an environment of free trade. In some cases, there might be higher costs, if market prices fell or were more unstable, but such extra costs in effect would be compensation for the beneficial impact of lower cost supplies. It is no coincidence that the same set of policies are being proposed for the "green box" in the GATT negotiations. Policies that are consistent with free regional trade are also likely to be acceptable at the international level. This section has argued that they are not only consistent with market access and competition needs of an FTA, but also they, almost alone among existing policies, can be run effectively in the presence of free trade among partners. The reinstrumentation of policies towards decoupling and targetting may be the only way for farm groups to preserve benefits without facing head-on the movement to regional free trade.

V. Free-trade and Environmental Policies

A special case of the impact of freer trade on domestic policy is in the area of environmental, health and safety standards (EHS), including the subcategory of sanitary and phytosanitary regulations (SPR). To some groups the existence of trade itself poses a threat to the working of these EHS policies. These groups assume that government control is weakened by the movement to regional free trade and that harmonized rules for such trade remove the accountability for environmental policy to international bodies. To others, these same environmental policies can represent undesirable trade impediments, posing a challenge for intra-bloc trade relations as well as for multilateral rules.

The issue can be treated analytically as involving the aims of policy, the choice of regulatory mechanisms to use, and the point at which the regulations are applied. Government EHS regulations in the agricultural area can be thought of as meeting four needs: a) protection of consumers from unsafe food; b) protection of workers from unhealthy working conditions; c) protection of the environment from contamination; and d) protection of plants and animals from disease. Assessment of risks in each of these areas will differ in different countries: the challenge for an FTA agricultural market is to respect these differences and even to lower the cost of providing such protection.

a) The compatibility of different EHS standards with free trade

Freer trade holds out the promise of wider choice and less expensive farm produce for consumers. It also allows food producers to sell to the most remunerative markets. This will generally lead to an increase in trade in agricultural and food commodities. But free trade does not imply no domestic regulations on the production and sale of foodstuffs. Consumers will still demand that their food supply, from whatever source, meet certain standards of quality and safety. It is no violation of free trade to insist on these standards. Similarly, countries and states can legislate the method of production of agricultural goods within their jurisdiction. Free trade does not imply any loss of control over the regulation of worker health or of the rate of depletion of natural resources. Nor does it imply that countries cannot collaborate to prevent or offset some global environmental hazard. The fact that each of these legitimate actions has an impact on the pattern of trade, and may in certain cases lower the volume of trade, does not mean that trade is thereby distorted. Indeed, it would be a distortion to deny consumers or farm workers their desired health protection, or to overexploit natural resources, merely for the sake of expanding trade.

Not all consumers will demand the same level of government protection from health hazards. In some cases adequate information through labelling and consumer education may be preferred to the prohibition of particular ingredients. The task of policy is to choose some combination of labelling and the regulation of particular substances which will maintain consumer choice while preserving public confidence in the food system. The combination chosen can well differ by country, or by state or locality, wherever a level of government has an obligation to legislate in this area. Such differences do not in themselves conflict with freer trade. In the same way, countries can have different standards for worker health and different resource depletion policies. To the international economy these need to be no more troublesome than different consumer tastes and different national production costs. Indeed, trade in itself can be a valuable response to such national difference, reducing the consumer cost of resource-depletion and worker-protection policies and giving producers opportunities to meet specific consumer demands.

If different health and environmental laws are consistent with liberal trade, why are they a potential source of conflict in international affairs? The answer lies in the way in which these laws are commonly formulated and administered. They become trade barriers when they are administered as border restrictions. Economic motives for protection become linked with the operation of the health and environmental standards. The objectives of public policy become confused and the instruments become abused. Mercantilist and xenophobic political arguments masquerade as sound common sense.

b) Health standards and FTAs

Two trading partners might differ on the issue of the acceptability of a particular chemical residue level in food. The country with the stricter standard will undoubtedly seek to institute controls over imports. If that country chooses to regulate its own producers, it will have to test goods from abroad to ensure compliance with the same standards. The act of inspecting goods at the border is the cause of most complaints arising from different national consumer standards. Producers in other countries feel that they have no say in the way in which the regulations are imposed. They fear discrimination with good cause: there are countless examples of the use of health standards to keep a little more of the domestic market for local producers. The consumer gets some protection, but pays in higher costs for the produce, to the net disadvantage of the economy as a whole.

But the same two trading partners, instead might differ on the health hazards of particular farming practices, such as the use of pesticides, on farm workers. In this case the regulations may put the producers in the stricter country at a disadvantage in the marketplace. Their ability to compete on both domestic and international markets will be impaired. Similar effects may be felt from different policies on resource depletion and on animal welfare. Producers will often be tempted to argue for economic protection to counter their cost disadvantage. In this way a trade barrier may arise as a result of different production standards. The producer protection from the economic implications of stricter production standards will again come at a cost to the consumer and to the economy as a whole.

c) Is there a way of reducing this cause of trade tensions?

The best hope for removing the temptation to use health standards as trade restrictions is to de-emphasize action at the border. Enforcement of any particular pesticide-residue limit should be carried out on all foodstuffs regardless of origin. In general, this would imply testing at the wholesale level, where imported and domestic goods merge. Control over method of production would no longer be an appropriate way of enforcing this consumer standard, though there might still be controls to comply with worker-health and environmental regulations. Production methods would in effect become self-regulated: all producers (domestic and foreign) would have an incentive to produce goods that would pass the test at the wholesale level. And domestic producers would be free to use different production methods for other, less regulated, consumer markets. Most importantly, the absence of any border controls would reduce the possibility of granting an economic advantage to domestic producers and remove the possibility of challenges from trading partners. The GATT principle of "national treatment" for imports (i.e., no discrimination within the country on the basis of origin) would be applied, and as no border intervention would be needed, there would be no need for recourse to the Article XX exemption.

Does the same hold true for different production standards, designed to protect worker-health or animal welfare, or different policies to control resource depletion? If no border restrictions apply, it is much less likely that such policies will be viewed as trade issues. Other countries will reach their own decisions on the use of their resources and the standards they set for worker safety. The removal of the temptation to use trade policy instruments to influence such decisions will improve conditions in international trade.

Many regulations governing standards and grading practices are incorporated in marketing orders and other devices operated under national or state (provincial) legislation. These marketing orders often appear to those excluded to be instruments of protection. Designed to encourage "orderly" marketing, they are often easy to transform into a way to favor domestic producers. Free trade based on national treatment must include equal access to decisions taken on grading and quality standards. The existence of marketing orders is not inconsistent with free bilateral (or multilateral) trade; their practices may have to be changed to remove the opportunity for rent seeking.

Under what conditions might it be necessary to retain border controls? Some health problems arise directly from the transmission of goods across borders. In particular, plant and animal diseases are often spread through trade. In this case, intervention at the border is often the best way to prevent the spread of disease. Free trade will always be subject to the qualification that unwanted pathogens should not accompany the traded products. It may not be possible to avoid all cases of economic protectionism taking advantage of such sanitary and phytosanitary import restrictions. But the problem will be minimized if the regulations are clearly cast in terms of the objective of disease control. This will normally imply differentiation of the regulation by place of origin, as areas of endemic disease do not always correspond to national boundaries.

d) International talks on EHS standards

If different standards are compatible with free trade, is there any point in trying to harmonize them? The answer depends on how different the standards are and on why they are different. Many national standards for health and safety developed in a period when trade was much less widespread. Differences in the standards among countries have often arisen not from different risk assessment but from different ways of doing the same thing. Under these circumstances, the cost of production and marketing could be reduced with no loss of consumer safety by harmonization of standards. The use of international standards, such as those from the Codex Alimentarius, the International Office of Epizootics and the International Plant Protection Convention, seems appropriate for this purpose. But acceptance of such standards should not imply that additional regulations cannot be enforced in particular markets, so long as the rule of "national treatment" was applied.

In the same way, regulatory authorities often differ in the way they test for safety and in the stage of the production and marketing chain at which the regulations apply. There may be considerable savings (in retesting) and a greater transparency in the market if regulatory authorities could establish the "equivalence" of different tests. An attempt to ensure equivalence of different tests is a part of the agenda in the GATT discussions, and the concept of "mutual recognition of testing systems" (as opposed to mutual recognition of standards) has long been a feature of OECD industry agreements on standards. But this issue itself would be

Figure 3: Appropriate Type of Control for Meeting EHS Concerns

Concern	Production Externality	Consumption Externality	Trading Externality
Water Pollution Worker Safety Countryside Amenity	PPM - taxes/subsidies PPM - training PPM - taxes/subsidies		
Food Safety		Product Standards Recipes Labeling	
Plant Disease Animal Health Animal Welfare	PPM PPM PPM		Border Tests: quarantine Border Tests: quarantine

PPM = "Production and Processing Method" Regulation less important if the instruments of control were moved from the border: one would no longer be dependent upon knowledge of other the testing proceedure in other countries. If testing for consumer safety were done at the wholesale level, for instance, the equivalency of tests at earlier stages in the production/marketing process would no longer be an issue. Tests for worker health and environmental impacts will remain the responsibility of local and national authorities. If the distinction between worker-health and consumer-safety issues is properly established, "equivalency" of tests designed to control these different externalities is no longer a meaningful concept. Border inspection becomes necessarily only in the case where animal and plant pests and diseases can cross phytosanitary and sanitary boundaries.

e) How might such policies work in practice?

This dilemma is at the crux of the discussion on sanitary and phytosanitary measures in the GATT negotiations. The GATT is not a body that sets health and environmental standards. Instead, it tries to promote more liberal trade by agreeing to a set of rules on the conduct of trade policy that will avoid costly conflicts. The GATT articles recognize the validity of national standards and health regulations. Article XX is specific in exempting such national regulations from challenge as trade barriers. The issue under discussion in Geneva is not whether such an exemption exists but under what circumstances can one claim such an exemption. If there are no limits on the ability of governments to claim exemption on the grounds of health and safety, arbitrary and unfair acts of protection will continue.

These matters can be illustrated with reference to European and US-Canada experiences. The problem of disparate health and safety standards in food and agricultural production is one of the most contentious facing the negotiators in the NAFTA talks. Some limited attempts have been made in the Canada-US FTA to reduce trade frictions, but the issue was essentially left to discussions in the GATT. Earlier talks between the US and Mexico, under the framework approach, have progressed on questions of plant health. But many sticky issues remain. As US opposition to the NAFTA negotiations has highlighted food standards and environmental pollution as key issues, they will have to be addressed in even a modest agreement. The formulation of such an agreement is likely to focus on the need to improve adherence to existing regulations in Mexico and making those regulations conform with practices in the US.

The issue is broader than that posed by the formation of FTAs. The GATT negotiations have raised the same question and are moving toward a closer definition of the appropriate conditions under which trade barriers may be used in support of health and safety standards. The European Community has dealt with these problems in its quest for a border-free internal market. And bilateral discussions between the EC and the US have also tried to resolve trade conflicts such as that arising from EC legislation banning the use of hormones in animal feed. The US and other countries are engaged in a process of revising several aspects of domestic policy to accord with the realities of the global marketplace. Adjustment of health and safety standards and of environmental and resource depletion policies are examples of this process. The European Community has had to face up to these issues in the framework of its "1992" program for a single internal market. The tight timetable and the political imperative to make compromises have forced the pace of legislation. The prospect of a border-free Community by 1993 has made it essential to decide on ways in which individual country preferences could be kept without giving scope to national protectionism. The way in which the EC is going about this process has lessons for other countries.

The treaty establishing the European Community left the issue of protecting health and safety in the hands of national governments. It was recognized, however, that the operation of national legislation could distort trade. For years the Commission, the body charged with initiating legislation, sought to harmonize such national regulations, with little success. The breakthrough came in the late 1970s, when the European Court, whose job it is to enforce the Treaty, ruled that arbitrary use of standards to give economic advantage was not legal. The notion that countries had to practice "mutual recognition" of each others standards, when no danger to health was involved, has been a powerful one in freeing up intra-EC trade. Harmonization of legislation _per se_ is no longer a focus of attention. In a borderless European Community, a producer will no longer have to meet a dozen different sets of standards to sell into the markets of other member states. Only for the control of animal and plant disease will produce movement across internal borders be monitored, and that will be limited to movement between regions with different disease incidence. Even this latter program is under the control of the Commission, rather than the individual countries, and is temporary until certain diseases can be eradicated.

It is unlikely that other countries will be able to move at the speed of the Community to the de-emphasis of border controls, but the experiment does have useful lessons. Local control over health and safety issues is not incompatible with a border-free internal market. Negotiations on harmonization of legislation need not be the focus of improving trade relations. Mutual recognition of the standards of others could improve trade opportunities without undermining essential public health controls. And policies that require international action, such as those to avoid the spread of disease and those that relate to cross-border pollution, are more appropriately taken at the international level.

f) Summary

Disparate health and safety standards in different countries (or states) do not of themselves distort trade: the way in which they are operated, however, tends to lead to discrimination and trade conflicts. Such trade conflicts can be minimized by the appropriate type of policy well-focused on the problem area.

Consumer food safety standards should be applied within the border and without discrimination as to source. If other countries followed this procedure, domestic produce would be able to compete in a number of overseas markets. Some countries might choose a less restrictive standards than others: in these markets, domestic producers would not be hampered by having to meet the higher standards they face on the domestic market. Negotiations to remove arbitrary differences and hence to permit lower-cost marketing would continue.

Production and processing methods should be regulated according to the needs and standards of the country in which the production or processing takes place. This should not be tied to the consumer standards, nor be differentiated by destination. Strict regulations may seem to inhibit economic opportunities for producers. But if they are deemed to be necessary, that opportunity is only an illusion. Regulation of business in one country to correct a "global" problem does, however, represent lost income: such problems can only be solved by cooperative policies among groups of countries. Unilateral action usually involves a heavy loss with little or no gain.

It follows that any legislation attempting to cover production methods, environmental pollution, and consumer safety issues needs very careful crafting. In political terms there may be some links between these topics: sound public policy would recognize the very different objectives involved. This might imply that they be addressed by separate instruments and even that they be negotiated in separate places. Unless such an issue separation can be achieved, conflicts will continue to arise from the clash of national health and safety regulations.

VI. Free-trade Areas and World Markets

The final set of issues relates to the links between the intra-bloc treatment of agricultural trade and policies and the situation on world markets. Among the analytical issues in this context are the impact of regional free trade on world market price levels and stability; the conditions under which trade diversion may impact countries not part of trade blocs; the extent to which regional solutions assist in the negotiation of multilateral rules; and the importance of multilateral rules for guiding the conduct of inter-bloc trade in agriculture.

These questions do not have a straightforward answer. The significance of the treatment of agriculture within an FTA on outsiders depends on a number of factors. Paramount among these are protection levels in the FTA countries and the trade balances of the participants. Before looking at the issue of actual trade blocs and their impact, some clarification of the expected direction of that impact is useful. At the risk of some tiresome taxonomy, this is attempted below.

a) Different types of FTAs

The range of different trade outcomes can be seen by imagining four typical countries, each a candidate for a two-country FTA (see Figure 4).[16] Countries A and B are protectionist, one an exporter and the other an importer, while Countries C and D are a liberal importer and exporter, respectively.[17] One can therefore

[16] The discussion of this section is limited to two-country FTAs, ie. bilateral trade agreements. The taxonomy would quickly get tedious if all possible multilateral arrangements were to be included. However, the results from the two-country examples are illustrative of the range of possibilities in the multicountry cases. It is additionally assumed that all partners have roughly equal weight in the formation of the FTA. Obviously, a dominant partner could impose the agenda and define the trade concerns of an unbalanced FTA. A particular form of bilateral agreement is the "hub-and-spoke" model, where a large "hub" country (say the US, the EC or Japan) negotiates individual bilateral agreements with a number of smaller countries, which may or may not have any preferential access to each other's markets. It is tempting to see the hub-and-spoke system as merely a series of independent bilaterals, but as seen from the hub the arrangements are more like a multicountry FTA.

[17] The terms exporter and importer refer to the trade balance for a particular commodity. The comments on internal and external problems should be interpreted accordingly.

Figure 4: Categorization of Possible FTAs by Trade Regime and Trade Balance

Type of Country	Trade Regime	Trade Balance	Examples
A	Protectionist	Importer	Japan, ROK
B	Protectionist	Exporter	EC, US, Canada
C	Liberal	Importer	Mexico, Chile
D	Liberal	Exporter	New Zealand, Australia
Type of FTA	Internal Problems	Trade Creation	Trade Diversion
a) Likeminded FTAs			
AA	concern over deflection	no	no
BB	concern over subsidies	no	no
AB	conflicts over access	yes	yes
CC	no internal problems	no	no
DD	no internal problems	no	no
CD	no internal problems	no	no
b) Contrarian FTAs			
AC	concern over deflection	yes	no
AD	conflicts over access	yes	no
BC	concern over subsidies	no	yes
BD	no conflicts	no	yes

define six "likeminded" FTAs, which match either protectionist countries together or involve only those with liberal trade policies. In each case one can ask what internal problems are likely and what might be the outside interest. Internal problems are most likely among the protectionist FTAs. Two high-priced importers (an AA FTA in Figure 4) will tend to have conflicts over trade deflection, each cautious about weakening their own internal market price. One would expect the protection levels in these countries to move together over time as a way to avoid such problems. It is also likely that pressures will mount to free up internal trade. This could cause the bloc as a whole to move toward lower levels of protection, and some trade creation could occur. Significant trade diversion is inherently unlikely in markets where both countries are importers, but the lowering of support levels could have some beneficial impact on third countries.[18] An alliance between two high-priced exporters (a BB FTA in Figure 4) may also lead to internal conflicts, this time over the level of subsidies in each member, and there might be pressures to reduce such subsidies. However, there is no clear presumption that any significant trade creation or diversion will occur as a result of pressures within the FTA.

Trade impacts on the rest of the world are more likely if the partners have different trade interests and commodity balances. A protectionist importer and a high-cost exporter (an AB FTA) will undoubtedly try to expand internal trade, at the behest of the exporter, though the importer will try to resist this pressure. Trade expansion will tend to be positive for agricultural markets, but the main benefits will be captured by the exporting partner. Trade diversion is likely to swamp any positive impacts from freer FTA access. Free trade agreements among "liberal" countries (CC,DD and CD FTAs) are likely to be relatively benign. With low trade barriers and few export subsidies, and with price levels close to world market levels, the internal improvement in market access will have little effect on collective balances with the rest of the world.

A different set of responses can be expected if protectionist and liberal countries are thrown together in an FTA. These "contrarian" FTAs are likely to have somewhat different approaches to the inclusion of

[18] The analytics of trade creation and trade diversion, and its interpretation in non-tariff situations, is discussed in the Annex. Trade creation is usually defined as an increase in imports in the importing partner: trade diversion refers to the switch in the source of supplies away from third country trade. In the present context, trade creation can be taken to mean a reduction in protection levels as a result of the FTA and trade diversion as a reduction in demand by the FTA from the rest of the world (or an increase in supplies). Thus trade creation raises "world" prices and trade diversion lowers them.

agriculture in intra-bloc free trade. A protectionist importer paired with a liberal importer (an AC FTA) will be primarily concerned with trade deflection through the liberal partner's markets. Agriculture may well be left out of the agreement, as a way of avoiding this problem. A protectionist importer paired with a liberal exporter (an AD FTA) will be more likely to include agriculture in the FTA agreement. The exporting partner will argue for more liberal access and lower prices in the importer as a condition of membership.[19] Trade creation is likely, but third countries may gain little: the improved access would go to the exporting partner, as envisaged in the intra-bloc trade deal. A liberal importer paired with a protectionist exporter (a BC FTA) will be concerned over the level of subsidies employed by its high-priced partner. Competition rules are likely to be high on the internal agenda. However, internal trade may not increase, and the main impact could be on third country trade, if the liberal importer becomes a "trojan horse" for reduction in internal prices in the exporter. In this case there would be negative trade "diversion" which would be positive for world markets as subsidized exports were reduced. Protectionist exporters paired with liberal exporters (a BD FTA) also could catch a dose of liberalism, as the process of arbitrage weakens the ability of the high cost producer to dump on world markets.

b) Regional trade and world markets

This set of possibilities would suggest that the impact on any third country is crucially dependent on the nature of the countries forming the FTA. It is useful to consider some of the major commodity markets and the situation in existing trade blocs and regions discussing such arrangements. This is attempted in Figure 5, which indicates in summary form the net balance of some of the major (mainly developed country) trade groups. The major trade problems of agricultural markets are represented in this matrix. The EC, North and South America, and Australasia are net exporters of wheat, seeking access into somewhat protected markets in East Asia (and in other regions not in the Figure). It follows that the wheat market is not likely to be benefited by alliances between low-cost exporters (as in NAFTA) and only somewhat indirectly by an FTA between the EC

[19] The issue of a liberal exporter joining an already established union between protectionist importers is of some interest. Will the exporter be able to change the trade stance of the importers? Or will the exporter be content to turn protectionist, knowing that the size of the "home" market will be increased by such a policy? The Netherlands faced this dilemma when it joined the Belgium Luxembourg Economic Union (to form the BENELUX Union) in the immediate post war period.

Figure 5: Commodity Balance and Regional Trade Blocs

Commodity	South America	North America	European Community	EFTA and EE	East Asia (inc Japan)	Australia & New Zeal.
Wheat	+	+	+	=	-	+
Rice	=	+	=	-	+/-	=
Corn	+	+	+/-	-	-	=
Oilseeds	+	+	-	-	-	=
Dairy	=	=/-	+	+	-	+
Meat	+	=	+/-	+	-	+
Sugar	+	-	+	=	-	+
Fruits and Vegetables	+	+	-	-	-	+

Key: + indicates export surplus

- indicates import deficit

= indicates approximate self-sufficiency

/- indicates import possibility with lower protection and other European countries.[20] If East Asia joined with either Australasia or North America (or even South America), one might expect some net liberalization of world trade. But most of the improved access into protected importer markets would be reserved for partner suppliers. The key relationship between the competitive exporters and those who export with large subsidies looks unlikely to be resolved in the context of an FTA.[21]

The situation for rice is somewhat similar, since the East Asian market holds the key. In this case, the key relationship would be between the US and Japan. If free trade were proposed between the two, the issue of rice would have to be faced. Any liberal solution to this problem would have world market benefits, even if the US rice producers get the major benefit. Corn trade into Asia is less restricted. In this case only a US-EC free trade compact is likely to have major impacts on world markets, although internal impacts of FTA arrangements could be significant for corn-consuming economies.[22] Oilseed markets are also likely to be only affected by free trade agreements between the US and the EC, although freer trade in oilseeds between South America and the EC would have an impact on world prices.

The situation is somewhat different for dairy products and meats, where the US is not a major exporter. In the case of dairy, it is not easy to see an FTA putting significant pressure on dairy protection in the EC, except as a result of some EFTA surpluses. Australia and New Zealand once had an FTA with the UK, which stimulated beef, sheep, and dairy exports to that country. New Zealand has special access still in that market. But nothing like a free-trade pact between the EC and Australasia is likely to bring relief to the dairy market. The beef and sheepmeat markets could be helped by regional free trade agreements, as between Australasia and East Asia.

Sugar is one of the few commodities in which regional free trade could take significant pressures off the

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[20] An exception could be increases in wheat exports from Argentina to Brazil, as a result of a bilateral between those twop countries. See Barry Krissoff and Jerry Sharples "Preferential Trading Arrangements: Wheat Trade in Western Hemisphere Countries," (mimeo) 1992.

[21] It seems safe to assume that in any FTA between the US and the EC, the Community would ask for an exclusion of agricultural trade. Inclusion of such trade would have major repercussions for other countries.

[22] This is particularily true of Mexico in the context of the NAFTA, where inclusion of corn as an item to be liberalized will have major impacts on the rural economy .

international market. In particular, the US market could expand to absorb exports from the Caribbean, Central and South America. At present, trade policy is designed to protect the workings of domestic price support systems. If this protection were removed in regional negotiations (or in the GATT), there would be benefits to world markets.[23] Similar benefits could be achieved in some fruit and vegetable markets, where regional trade flows are both complementary and significant in terms of world trade. The trade relationships between the EC and Eastern Europe and the Mediterranean, and between the US and Central and South America, each have the potential for impacting the world markets for certain fresh fruits and vegetables.

Beyond these commodity-specific effects, the most important link between FTAs and world agricultural markets is the impact on national domestic policies. At present the trade implication of such policies is being discussed in the GATT Uruguay Round. The relationship between the regional trade talks and the GATT Round is discussed in the next section.

VII. Current Negotiations on FTAs and the Place of Agriculture

a) Prospects for further agricultural integration in Europe

The roadblock to the incorporation of agricultural trade in the general liberalization of internal European markets is not so much the existence as the form of the CAP. So long as the internal market is characterised by high prices, supported by variable levies and export subsidies, it is difficult to see any way of granting liberal access to Eastern Europe. The extension of the protective wall of the variable levy, and the assurance of open-ended export subsidies, to EFTA and Eastern Europe would encourage massive investment in the Community directed towards products which are already in surplus. High stable prices may look attractive to farmers in the new member states, but they exacerbate the resource allocation problems already serious in the EC. It is doubtful whether the Community can afford to admit new members at the high price levels currently achieved by the CAP.

The CAP might be transformed into a series of regionally-differentiated compensation payments,

[23] See Steven Neff and Timothy Josling, Economic Effects of Removing US Dairy and Sugar Import Quotas, NCFAP Discussion Paper No FAP 92-01, Resources for the Future, Washington, D.C., 1991.

shielded by a modest and declining external tariff. The situation then would look vastly different. EFTA countries will come in with their own set of compensation payments, with a straightforward transitional period to Community financing. Tariffs on third-country trade can easily be harmonised over the same transition period. Eastern European countries need not erect trade barriers as a part of joining the Community: they could benefit at once from lower food prices and open access to EC markets. Compensation payments might still be necessary, in cases where farm prices are now high, but no market-rigging intervention systems would have to be introduced.

A year ago, such a prospect would have seemed a pipe-dream. The CAP has sucessfully resisted radical reform for twenty-five years. But the recent proposals from the European Commission for a drastic reform of the CAP go precisely along these lines. Under the MacSharry plan, significant price cuts (55 percent, over three years, in the case of cereals) would be offset by compensation payments to farmers.[24] Support payments per ton, the implied basis of support under present policies, would in effect be replaced by payments per hectare, by the subtle device of paying compensation for prices cuts on the basis of an average yield. There is still lively debate on the precise method of calculating the payments, but any basis other than current yield and acreage (as is implied, say, by a deficiency payment program) would partially decouple payments from output. The stated objective of the MacSharry plan is to reduce surpluses and to encourage more extensive farming systems, while keeping up incomes in rural areas.[25] The most significant effect may be to make the CAP, and hence the Community, expandible.

b) NAFTA and agricultural integration

Against this backdrop, it is possible to pose the main questions faced by those responsible for the

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[24] See Commission of the European Communities, The Development and Future of the Common Agricultural Policy, COM(91)258, July 1991. The plan also calls for acreage set-asides for larger farmers, with limited compensation for lost output. This set-aside scheme has more political than economic significance.

[25] One implication of the per-hectare compensation scheme based on average regional yield is that support is redistributed from the high-yield farmers to those with lower-than-average yields. This has led many to argue that the plan would reward inefficiency. Of course, it is an empirical question whether the high- or the low-yield farmers use resources more efficiently. See T.Josling and A.Mariani, "The Distributional and Efficiency Implications of the MacSharry Proposals," (mimeo) 1991.

agricultural component of the NAFTA talks.[26] One can identify various stages on the way toward the full integration of agricultural markets in North America. These stages indicate the nature of the choice facing the negotiators: how far to proceed down the path toward a true common market. At the risk of oversimplification, three such steps can be distinguished along the road to regional trade liberalization. These include a modest first step, which would tackle a limited number of trade issues brought up by the participants; a somewhat more imaginative stage designed to encourage sectoral integration in North American agriculture; and an even more ambitious venture into the realm of free trade, free investment, and a degree of policy coordination. These three stages are discussed before taking a look at the relationship between the agricultural part of the NAFTA talks and the process of multilateral and unilateral trade liberalization.

i. Removing Trade Irritants

The first step is to negotiate a modest agreement that includes a reduction of tariff barriers and focusses primarily on trade irritants, those aspects of each country's policy to which others particularly object. Unfortunately, such solutions to these trade problems are likely to be somewhat ad hoc. As many of the irritants arise from the rapid growth of trade rather than its absence, the solutions may on occasions lead away from liberalization and market integration.

Agricultural trade would be partially liberalized by such an agreement. Tariff barrier reduction would occur, subject to snapbacks and other safeguards, but non-tariff measures would be reduced by negotiation rather than by rule or as a matter of principal. The negotiation mode would be "request and offer" rather than agreements on rules. This is essentially the procedure being undertaken at the moment in the NAFTA talks. The three countries have exchanged lists of tariffs and identified non-tariff measures in partner countries that can be negotiated down. There is reason to believe that an agreement can be reached on the basis of such a process. Though apparently modest, such a step would still go further than the European Free Trade Association (EFTA), which has chosen for thirty years to exclude agriculture, fish, and forestry products altogether from its free trade provisions.

[26] These questions are described in more detail in Timothy E. Josling, "Agriculture in the NAFTA: Issues and Options," (mimeo), 1991.

ii. Moving Toward Sectoral Integration

The tariffs-plus-trade-irritants model for NAFTA would, however, fall some way short of a progressive integration of the agricultural markets in the three countries. More in keeping with the longer run objectives of liberal trade policy is to take a second step, that of sectoral integration in agriculture. This move would include an agreement to open the border for farm products; an attempt to ensure harmonized, compatible or mutually recognized safety and quality standards; and a movement toward domestic policies to take advantage of complementarities rather than perpetuating the segmentation of the market. Inevitably this would mean in many cases the adaptation of Mexican policies and procedures to accord with US and Canadian practices.

Private sector integration in agriculture across the US-Mexico border has proceeded apace for many years. Labor flows and capital investments have accompanied goods movements. The chief characteristic of a "sectoral integration" stage in the development of the North American market is that governments attempt to make such private sector activities easier. This, of course, implies the reduction of tariff barriers in the initial stage, but a different approach would need to be taken for the other trade impediments. Trade barriers would be identified that impeded market access and cross-border investment. If overriding political considerations precluded quick liberalization, a timetable would be set out for eventual implementation. Trade remedy provisions, that allow for contingent protection from imports, would be similarily circumscribed. The aim would be to create a climate where businesses could make investments and satisfy markets without the fear that their success would be penalised by the introduction of restrictions. Negotiations would also have to address directly the issues posed by domestic policy differences, not least in the agricultural area. There is little indication that the negotiators are contemplating taking this second step at this time.

iii. Moving toward Common Policies

A third stage would imply sectoral integration in goods and factor markets and supplementing the integrated market with the development of common policies for the agricultural sector. These policies need not be of an interventionist nature. They would include the adoption of single regulations and standards where appropriate. It is likely that closer integration of markets will over time increase the need for common policy instruments, common support levels, and common external policies. Although it is doubtful whether the political and institutional basis for such policies exists at present, it is still useful to define this step to clarify the choices open to negotiators. Moreover, under certain conditions it may be possible to gain the benefits of common approaches to policy issues without the need for political integration or common institutions. The process of negotiation itself may open up possibilities to push beyond the "free trade area" stage in economic integration.

This third stage of integration for the agricultural sector needs to be identified not so much for its immediate practicability but to provide a conceptual framework into which to place more limited agreements. Both for those who would welcome a true North American Common Market and others who would shrink from such a prospect, there is the need to know how far down that road the NAFTA talks are travelling. The move from independent sectoral economic policies to commonly articulated policies is a landmark on that road.

The European Community is presently the only regional trade grouping that has explored this territory. Driven by visions of political union and facilitated by common institutions, EC member states have shifted responsibility for both foreign commercial policy and domestic market regulation to the Community level.[27] At present the EC is attempting the feat of accumulating economic policy controls at the center while retaining cultural, social, health, education, and internal security responsibilities at the national level. These affluent and sovereign countries seem prepared to explore the sharing of responsibilities for economic policy: it is not impossible that common economic policies might eventually reach the North American agenda.

c) The GATT and FTAs

The significance of a GATT deal for regional free-trade talks is that it addresses the same set of issues, focussing on the distortive impact on trade flows of instruments designed for domestic farm price support. Within global trade as in a free trade area, export subsidies pose particular problems. Non-tariff barriers and coupled domestic subsidies are at the root of international trade problems. The currently proposed GATT solution to such problems would make life a whole lot easier for free-trade areas. Moving to tariffs as the main import barrier makes the issue of freer internal trade much more tractable. Of course, there will still be losers

[27] This process has undoubtedly been helped by the relative homogeneity of economic conditions in much of the EC, allowing common policies to operate across the Community. The poorer southern countries were enabled to join in part by generous financial transfers and long transition periods. It remains to be seen whether the same conditions will apply if the Community is expanded to include some of the eastern european countries.

from internal trade liberalization, but a long transition period with safeguards can always be negotiated if necessary. A global agreement to phase down export subsidies immediately removes the pressure from the need to negotiate on these matters regionally. And a series of GATT-acceptable decoupled payments in lieu of present high price supports gives a neat way to avoid the issue of different support prices within regional trade blocs. The payment of such trade-neutral subsidies could be allowed to continue on a national basis, to reflect the "divergent social economic and environmental conditions" among the members of the free-trade area. The GATT formula of tariffs and decoupled payments is the only way (short of total liberalization) to make agricultural policies consistent with the development of regional trade blocs without common policies.

The timing of an agreement in the parallel discussions in the Uruguay Round on new rules to govern agricultural trade in the GATT, however, is crucial to both the NAFTA talks and to discussions in Europe. Many of the objectives of freer North American trade in agricultural products would have been assisted by a more speedy resolution of the GATT talks. But the US, Canada and Mexico have had to proceed without the certainty of a firm GATT pact. This uncertainty translates into a shifting agenda for the NAFTA talks and changes the probabilities of the outcomes described above.

A favorable outcome to the GATT Round would doubtless provide some momentum for a more ambitious NAFTA. Under these conditions, plans for sectoral integration would appear to be more realistic. A good GATT outcome on agriculture that included a commitment for steady reductions of support levels, combined with a movement toward tariffs for import protection and the elimination of export subsidies, would make the integration of North American agricultural markets much easier. Mexico could continue to tariffy its import regime under the GATT agreement, avoiding the impression of being forced to do so by the US. The US could drop its export subsidies on farm products to Mexico, thus reducing the potential for market disruption without appearing to be acting to reduce trade. If the GATT pact included minimum access guarantees, new trade opportunities in all three countries would be opened up. Making domestic price support policies less trade distorting, through the traffic-light system, would reduce regional as well as global trade tensions. And as support levels came down over a transition period, a raft of smaller trade problems would be eased.

A weak GATT outcome could signal a more limited approach to regional problems. The "modest"

NAFTA option, with an emphasis on solving bilateral problems, requires little in the way of a successful GATT Round outcome or any further degree of liberalization on the domestic front. Indeed, it would have been possible even if the US Congress were to have denied the administration an extension of fast-track authority. A slow-track negotiation would almost certainly have led to a piece-meal approach to trade liberalization. It is possible that even with the fast-track authority, congressional sensitivities will force the US administration to negotiate along these lines. High-level trade-offs, necessary for a commitment to liberalization, are hampered by the need to consult Congress at every turn. A poor GATT outcome would cause Congressional scrutiny of a NAFTA pact to be even more exhaustive.

An outright failure in the GATT could cause a burst of enthusiasm for bilateral trade processes and might seem to make a more ambitious NAFTA possible. But such an outcome, even though it might give a rhetorical boost to bilateral ideas, will pose significant additional problems for agriculture in the NAFTA talks. In effect, all the desirable developments under discussion in Geneva would have to be translated to the NAFTA agenda. Though it might seem to be much easier to find common ground on farm trade policy improvements among the US, Canada, and Mexico -- in particular, now that Mexico broadly supports the GATT position of the Cairns Group -- than with the EC and Japan, it is not clear that this could easily be put into a NAFTA agreement. Objectives that look desirable at a multilateral level may lose some appeal on a regional basis. Without the promise of higher sales to Japan and the EC, the US and Canada may rapidly lose enthusiasm for tariffication and export subsidy reductions in the more limited context of regional trade.

Much has been made of the political difficulties facing the Community in responding to the pressures from the US and the Cairns Group in agriculture. But a strong GATT agreement would be of enormous benefit to the EC's future commercial agricultural arrangements. The absence of such an agreement is at present hampering the further development of trading relationships with other parts of Europe. This is particularily true in the thorny issue of the incorporation of the potential new members, both in EFTA and Eastern Europe, into the Community.

This leads to the conclusion that a successful outcome to the GATT talks is probably a prerequisite for any serious moves towards a true common market in North American agriculture and in Europe. A strong

GATT agreement promising real and sustained agricultural trade liberalization at a multilateral level could also be a springboard for further cooperation in policy making at a regional level.

VIII. Conclusions

The examination of the role of agricultural policy in free-trade areas leads to the following conclusions:

i) There is a temptation to leave agriculture out of the free-trade rules for an FTA. The main problems reflect the different support systems and protection levels in the participating countries. Omitting agriculture from the internal free trade arrangement is likely to lead to problems at a later date.

ii) The problems are caused by both the differences in the level of support and the types of policies used. Support levels in principle can be harmonised, but the process will be resisted by domestic interest groups and lawmakers.

iii) In addition, countries will have to rethink policies that remove resources from production and those that aim at market price stability. These programs will be inherently less effective in a regional free-trade environment. Domestic policy instruments tend to require trade controls to be operative. An FTA weakens the ability of those policies to support farm incomes.

iv) Changes in the type of policy used could be the best approach to resolving these problems. The needed changes go in the same direction as those under consideration in the GATT Round. The conversion to tariffs of non-tariff import barriers; the reduction of export subsidies; the decoupling of domestic programs; and the clearer definition of when sanitary and phytosanitary rules become barriers to trade will all help.

v) The implications of FTAs for third countries depend upon the particular countries involved in the FTA and their trade balance for various commodities.

In general, the major commodity conflicts in world trade cannot be solved by free trade agreements on a regional basis.

vi) Success in the Uruguay Round will make the formation of regional free trade areas much easier. Similarly, if such negotiations proceed at a regional level, the agricultural trade relations among blocs may also be modified over time.

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