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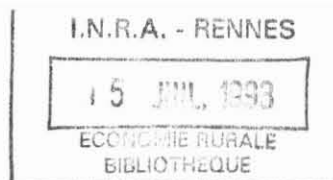
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INTERNATIONAL AGRICULTURAL TRADE CONSORTIUM INTERNATIONAL CONFERENCE

NEW DIMENSIONS IN NORTH AMERICAN - EUROPEAN AGRICULTURAL TRADE RELATIONS

LE CASTELLA, ISOLA CAPO RIZZUTO, CALABRIA, ITALIA

THE CAP REFORM AND EC-US RELATIONS

THE GATT AS A cap ON THE CAP

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SUMMARY

The reform of the Common Agricultural Policy has consisted in the substitution of new income support instruments to the usual price policy, essentially in the cash crop sector. The payments are based on factors currently used which set entitlements for the future. Our first point is that the domestic political balance was unable to generate such a large change in policy design, in spite of inefficiencies and unbalances due to the traditional CAP. The pressure of the US has been a major factor in the elaboration of the reform. We argue that trade interests have been crucial to catalyse international collective action in order to countervail domestic pressure groups. In fact, the reform satisfies the US objectives as well as the GATT compromise. The US gains from the CAP reform are noticeable, but we do not foresee the disappearance of sources of tensions between the two countries, as EC animal products become more competitive and as the working of the CAP in the vicinity of world prices will make trade flows sensitive to world macro-economic and agricultural shocks.

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

This achievement of the Uruguay Round, while it has to be considered as a success, should not be considered as satisfactory, and the long-run objective of further decoupling of payments from production incentives should be pursued in order to promote agricultural trade on a more competitive basis and to reserve intervention of the State to the promotion of the positive externalities of agriculture in developed countries.

1. INTRODUCTION

The last ten years have witnessed exceptional events with regards to agricultural policies in developed countries. After the boom on market prices of the early seventies, the deep slack of the eighties has triggered considerable debate and some action.

First, a considerable amount of work was done world-wide to assess the international impact of protectionist policies in developed countries and, to a lesser extent, of urban-biased farm policies in the developing world. The OECD (Organisation of Economic Cooperation and Development) major task of assessing the support on a comparable basis between its member countries has provided a costly information which the political debate, normally biased under the influence of special interests, could not avoid taking into account.

The launching of the Uruguay Round and the insistence that agricultural issues be dealt with, under the pressure of the United States (US) and other net exporters of temperate zone products, has laid the ground for some action to take place. The European Community (EC) Common Agricultural Policy (CAP) has been the familiar target for attacks during this period, and the EC-US conflict has developed with hot and cool moments according to the stages of the GATT (General Agreement on Tariffs and Trade) negotiations and to the tactics of the GATT supporters.

The present paper focuses on the interpretation of the CAP reform in the context of the Uruguay Round and in the perspective of the EC-US traditional agricultural trade conflict.

The questions addressed are first to explain why agriculture has, for the first time, been given such a central role and why the CAP reform has developed in the way we have witnessed, tackling firmly the cash crop programmes and leaving nearly untouched the most protected dairy and sugar sectors. Our main point is that changes in comparative advantages and the existence of big trade interests in cash crops, organised by the main player, i.e., the United States, was the force necessary to circumvent the otherwise dominant forces in favour of the status quo exerted by the domestic pressure groups. This explains convincingly the actual design of the CAP reform and even the changes brought to the Commission projects by the EC Council.

The second point is that the GATT framework provides to the competitive exporters a means to constrain the CAP in the future. But, because the GATT is based on general principles and should not be commodity specific, the accord has to be dressed according to general lines and should accordingly force the countries openly in favour of trade to reform own highly protected sub-sectors. The GATT would therefore put a cap on the CAP and on other protectionist farm policies, as well.

However, all countries try to minimise the political cost of adjustment, and reforms of the CAP and of other policies still leave a lot of room to payments too tied to production incentives and not enough to environmental amenities produced by the agricultural sector. Will the GATT be

able to tame and reorient farm policies in the socially desirable directions ?

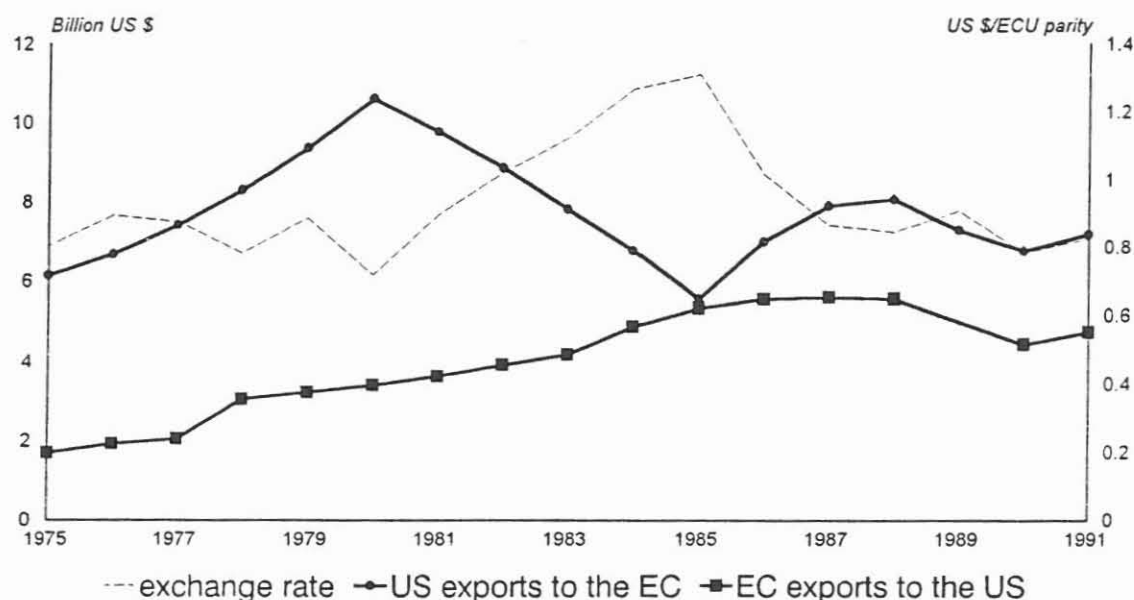
Section 2 briefly reviews the historical EC-US trade debate. Section 3 deals with the theory of the EC-US and international games. Section 4 analyses the CAP reform implications on the EC-US relations and relates it to the GATT expected deal. Section 5 addresses more long-run issues, stressing the shortcomings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

2. THE EC-US AGRICULTURAL CONFLICT

The history and the role of agriculture in the GATT shows that the successive Rounds of negotiations were dominated by EC-US disputes. Several issues in the EC-US agricultural trade conflict have emerged soon after the creation of the Common Market and the implementation of the CAP. This conflict has reached a new stage with the recent development in EC's agriculture and has been at the heart of the Uruguay Round Negotiation.

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

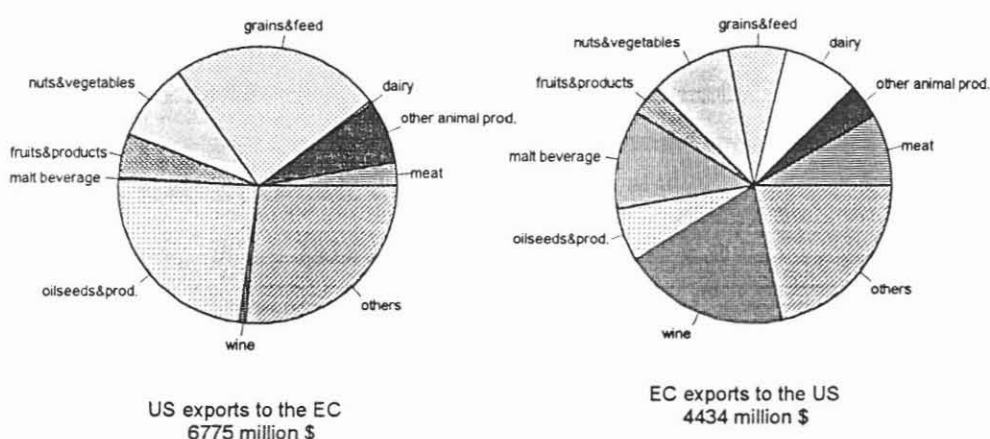
Figure 2.1. EC-US bilateral agricultural trade



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

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

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



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

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

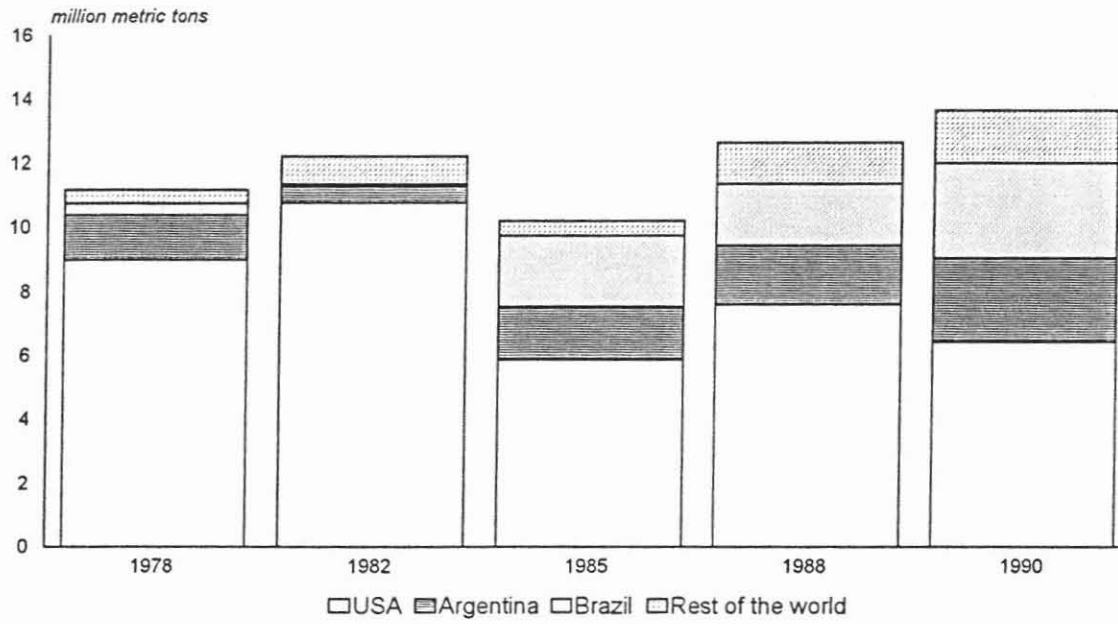
The major concerns of the US have always been to alleviate or reverse the consequences of the CAP on trade in cereals and related feed stuffs. The US was in favour of European Integration but has never really accepted the creation of the custom union and the subsequent principles of the CAP. The issue at stake is the high protection in the EC for grains which first reduced potential US outlets for these products in the EC and made it necessary for the EC to protect other sectors as well. Moreover, the use of the variable levy - restitution system, compared to a "gate on a dam" by the US Secretary Freeman, was constantly criticised by the US and other exporters as being a contradiction with the GATT principles. In the Kennedy Round, the US wanted to modify the variable levy system, and in the Tokyo Round she wanted levies considered as non-tariff measures and treated accordingly. The US did not get preferential access to the EC for grains

negotiations following the first enlargement of the EC, but did so in 1986 after the accession of Spain and Portugal.

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

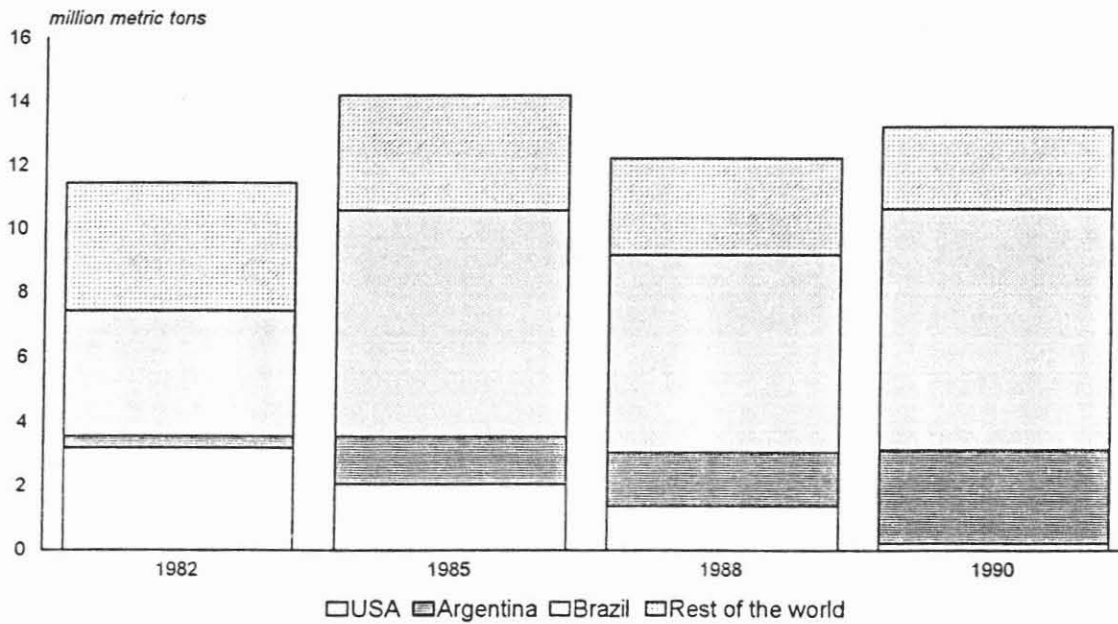
Two other major trade concerns of the US, namely oilseeds and corn by-products, are indirectly determined by the EC grain policy. The EC conceded a bound zero tariff on oilseeds products in the XXIV-6 Negotiation, on corn germ meal in 1962 and on corn gluten feed in the Kennedy Round in 1967. These concessions have proved over time to make it increasingly difficult for the EC to pursue her high grain price policy. First, the EC wanted to increase her capacity to produce oilseeds in order to reduce her dependence on imports (a situation which the US soybean embargo and the peak world prices of 1972-73 revealed to be destabilizing for the European animal sector). Oilseeds production in the EC has been stimulated by a price support and by a crushing subsidy mechanism (which works broadly as deficiency payments). This mechanism has proved to be very costly as production increased sharply. Increased production was further enhanced by the slowly diminishing support given to grains as a reaction to excess supply. As a result, the cost of the oilseeds programme has risen to 3.4 billion ECU in 1990. Meanwhile, imports of by-products used in compound feeds have soared due to the price differential with domestic grains. This increased demand has created an attractive outlet for US corn by-products that accounted for more than 1 billion US \$ of imports in 1990. Because of the trade interests in soybean and corn gluten feed, the US has resisted vigorously attempts by the EC to "rebalance" its external protection either by placing a tax on vegetal fats or by voluntary export restraint on grain substitutes. In the early eighties, the strong dollar and the emerging competition from Brazil and Argentina caused a general reduction in US exports to the EC (Figure 2.1), and more precisely of US trade shares in EC soybean imports (Figures 2.3 and 2.4). Pushed by the American Soybean Association, the US filed a GATT complaint in 1988 alleging that the EC discriminated against the imports of US soybean. The appointed panel concluded in 1989 this was indeed the case. The Commission of the European Communities (CEC) accepted the conclusions, with some reservations, and implemented a subsidy per hectare of oilseeds produced.

Figure 2.3. EC-12 soybean imports by source



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

Figure 2.4. EC-12 soybean meal imports by source



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

These trade interests and the US competitive advantage in crops explain her emphasis on reducing border protection first. The trap in which the EC has put herself is due to her long

standing grain policy and its direct (restitutions) and indirect (feed imports) consequences. This situation has recently given to the US a formidable leverage to press the EC toward reforming the CAP. The various recent skirmishes on other trade disputes (definition of corn gluten feed, delisting of US beef and pork packing plants, the procymidone case, the EC sugar complaint,) can be considered as minor avatars to the central conflict.

On the contrary, the EC's attitude in relation to the US is not so much dictated by trade interests than by a continuous attempt to cope with the adverse consequences of earlier made decisions in the framework of the CAP, a policy designed in response to domestic pressures. The EC exports to the US are mainly non-CAP products (Figure 2.2) which sell competitively and are designated targets for occasional retaliation (see, for example, the procymidone case).

As a consequence, the behaviour of the EC has been mainly passive or reactive to US pressures. From the beginning, the EC considered the CAP as non negotiable, variable levies and restitutions being viewed as logical consequences of domestic policies. The EC has constantly refused to negotiate separately on border measures and always considered that reductions in border protection and export subsidies would follow suit as a result of lower domestic support.

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

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

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

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

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

The economic reasons for the CAP reform are well known and will not be repeated. It is more difficult and conjectural to point out the actual causes for the recent reform which, although not comprehensive, is the most drastic one since the inception of the CAP.

In its introduction to the July 1991 "Communication to the Council" (CEC, COM(91) 258

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

These statements speak for themselves and reflect the outcome of policies which cannot be adjusted for various political reasons in the familiar agricultural context of rapid technical change - partly induced by the support - and of sluggish demand due to the staple nature of the products of the industry. The inefficiencies and market unbalances which result in these cases are well known, as well as the regressive distributional effects of the enormous and steadily rising budget expenditures.

In the face of the magnitude of the protests triggered by the Commission projects and of the subsequent edulcoration of the reform by the Council, one can only be surprised that a significant reform still took place in a market organisation so central to the EC agriculture and in such a market-oriented manner. One can also be surprised at the large price cut decided for grains and oilseeds while, in a similar domestic context, the course of action adopted in the dairy sector in 1984 was the other extreme, i.e., production quotas. Actually, the latter solution was highly supported by large producer groups and even countries, and one wonders what actually prevented this idea to go through.

It is our conviction that domestic forces were unable to generate this drastic move which was eventually circumscribed to the main cash crops and to a lesser extent to beef, and accompanied by sizeable compensation payments. Along the reform process, these new payments have become increasingly tied to the endowments of the farmers currently in activity as can be expected from the operating defence of special interests, increasingly regressive regarding their distributional effects and growing in magnitude so as to make the change at last acceptable.

It is patent, in view of the left-out dairy and sugar sectors where international trade conflicts do not concern big trade interests nor big countries, and in view of the role played by the set aside of land, implemented with the only purpose to reduce excess supply and therefore exports and without close environmental purposes, that the final package of the reform is more the result of external pressures than of domestic forces.

As most developed countries are also protecting their agricultural sector and have up to now lived with the special status granted to agriculture in the GATT, one must wonder what is the peculiarity of the current circumstances, which appear to ensure that a significant step is being made this time toward reforming agricultural policies in developed countries, in the context of the

Uruguay Round Negotiation.

3.2. EC, US and the international game

Our focus here is on how international pressure influenced the nature of CAP reform. Our general theme is that the legitimacy of the GATT rests on its principles and that the broad based rejection of these principles for agriculture risked more turmoil to international markets than the collective interests of either the US or the EC were willing to accept. The role of special interests within each country, and the extent of interdependencies among export and importing countries influenced the actual direction and magnitude of the CAP reform and the GATT compromise.

3.2.1. *The nature of special interests in agriculture*

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

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

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

First, the cost of policy that supports incomes in agriculture tends to be dispersed over the entire economy while the benefits are concentrated on a few. As Olson (1965) has suggested,

because farmers are small in number relative to a country's population, they have two major advantages. Their small number decreases their individual costs of arranging a group consensus to seek legislation in their favour and their specialisation in one or two major activities causes their per capita benefits from support to be much higher than the per capita costs incurred by consumers and tax payers. Hence, since food accounts for a small proportion of total household expenditures, producer groups tend to be more motivated to expend resources to achieve their more narrow political interests than are consumers and tax payers in general willing to countervail these forces.

Second, due to the uncertain and cyclical nature of agricultural markets caused by climatic, macroeconomic and world trade shocks, agricultural support is often introduced in the presence of up turns in the macroeconomic business cycle. But, it tends to be only marginally withdrawn during down turns in the cycle and its is generally increased during periods of macroeconomic uncertainty (Paarlberg, 1989). Part of the reason is that agricultural production is characterised by sector specific resources such as land, buildings and equipment that cannot be easily reallocated to other sectors during cyclical down turns in the agricultural economy. Consequently, the value of these resources can fall precipitously during down turns in the agricultural economy or lag behind the up turns in the macroeconomic economy, all of which places the welfare of rural households, financial institutions supplying credit to the sector and variable input suppliers at some risk relative to the overall economy. This risk invariably induces support for agriculture (Orden, 19??). Part of the reason that support is only partially withdrawn appears to lie in the fact that just as cyclical down turns affect the value of these resources, so do too the very economic policies designed to avert these effects on their value. That is, the value of agriculture's sector specific assets embody the implicit value bestowed upon them by instruments themselves. Hence, when economic conditions improve, policies tend to remain in place. Producers are aware of the linkage between the value of sector specific resources and economic support. They are aware of the potential decline in value if support is withdrawn and therefore they have an incentive to engage in political actions to avert this eventuality. Hence, policies designed to offset the effects of uncertainty and cyclical in the economy tend to turn into permanent support.

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

Fourth, agriculture is often associated with environmental amenities, rural development

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

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

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

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

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

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

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

Collective action at the international level also helps to explain why and how the various and often contradictory forces, channelled into the agricultural trade game of the Uruguay Round, contribute to delineating the contour of the final agreement and the nature of the reform of the CAP. Whether the incentives for reform are sufficient to trigger action at the national level depends in part on the prospects that a country can internalise the gains from reform. The Most Favoured Nation principle that the benefit of a concession made by any country must be extended to all other contracting parties is akin to a concession being a public good. When a large number of countries are involved, and/or when they have approximately equal world market shares of the traded good, the incentive is reduced for an individual country to make a concession in return for a concession from another since the benefits of such concessions must be shared by all, i.e., the free-rider problem. This may be a partial explanation for the failure of the competitive sugar exporting countries to obtain reform of US and EC sugar policies.

The proliferation of Free Trade Areas, bilateral trade agreements (e.g., NAFTA) and trade blocs may be seen as attempts to circumvent this externality problem, as well as to circumvent the

pressures of domestic interest groups (Paarlberg, 1987, p. 44). The existence of big players in the international game helps to safeguard the principle of multilateral trade agreements on which the GATT is based. Large players have incentives to negotiate concessions because even though they will need to share the "reformed market" with others, their relative size allows them to capture sizeable benefits with the cost of international action and also to express credible threats to force other reluctant players to move as well. It appears that the US and other large agricultural exporters have such an incentive, particularly in the form of terms of trade gains in the grain sector. A positive externality in this case is the extension of the pressure to reform this sector on to others too, such as Japan, Korea, and the Nordic countries.

3.2.3. *Summary*

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

The large distortions in the sugar sector of both the EC and the US reflect off budget instruments, both countries are not competitive in sugar, and there exists no single sufficiently large sugar exporter that appears motivated to accept the costs of pressing US and EC negotiators for reform. The institutional structure of dairy policy, dairy's sector specific resources, and the relatively modest trade in dairy between the major players in the GATT make dairy an unlikely candidate for major reform. Or, put another way, the compensatory payments required to induce reform in this sector may be extraordinarily high in terms of any budget savings from reform. Even though the US advanced a zero option in the early stages of the Uruguay Round, the counterfactual evidence is of course not available to indicate whether she could have actually obtained congressional support for this level of reform in the sugar and dairy sectors (Paarlberg, 19??).

Of course, even though reform of any real magnitude among the major players is less likely in sugar and dairy, this does not imply that governments cannot foresee the potential welfare gains that reform would yield. Actions to mitigate further distortions in these sectors could be considered a victory, i.e., bringing agriculture under the principles of the GATT in itself should be considered a major achievement in light of the difficulty of inducing reform or preventing further distortions in these sectors.

The GATT process has therefore been supported by countries with vested interests in the widely traded commodities (namely grains). While the EC was motivated to tackle reform primarily in the CAP, the approach is notable because the instruments chosen permit market forces to operate more effectively. This is notably in contrast for instance to the choice of production quotas for dairy in the 1984 reform of the CAP. The large cut in EC market prices in grains and oilseeds would have been unthinkable if the domestic forces alone have been the major motivating force for change. This view is supported by the discrepancies between the initial Commission proposals and the decisions of the Council. The Council has constantly edulcorated the reform effort - and is still doing it - so as to attenuate structural adjustment and to increase the level of compensation. Furthermore, the progressive drop of the measures to reform dairy and sugar envisaged by the Commission, and the relatively smaller shift toward direct payments in the beef sector, reflect, in our view, the lack of foreign pressure from big countries having trade interests in these areas. New-Zealand interests in dairy products and developing countries interests in sugar cane have not been able to develop a coalition in support of their interests as have the grain and oilseeds exporting countries.

In sum, the changes in economic conditions and the resulting unbalances and inefficiencies in European agricultural policy developed sufficient pressure to induce reform of the CAP. But, these pressures were not sufficient to counter those seeking to maintain or increase protection so as to produce a reform of the magnitude and of the market-oriented type as we have witnessed. An alternative scenario along the lines of the introduction of dairy quotas in 1984, or at least, more geared to a shorter run solution with inward looking tendencies, could have been as likely.

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

Within Commission circles, the CAP reform was officially presented as a separate process from the GATT negotiations. We have argued that the eventual features included in the reform package reveal a major effort to soothe anticipated international pressures on specific trade issues. This is illustrated by the sizeable positive effects of the CAP reform on US agricultural policy objectives. Our analysis (Table 4.2) suggests that the strict implementation of the Dunkel compromise in the EC would not have provided larger benefits to the US than those from the CAP reform. In this light, the continuing conflict to conclude the Round can be seen as an effort by the grain exporters to bring the CAP under the discipline of the GATT as a guarantee that future CAP developments be constrained more than in the past and as an assurance that the CAP reform would be more effective, i.e., a cap on the CAP. Moreover, as mentioned in the previous section, applying the discipline of the GATT to agriculture on a multilateral basis would also serve to constrain those interests in sectors of agriculture, such as sugar and dairy in the US, from

further distortions as well as promoting reform processes in developing countries.

4.1. CAP reforms, world prices and implications for the US

The implications of the CAP reforms on the US arise from at least three sources : i) changes in US exports to the EC, ii) expected US gains in exports to the Rest of the World as a result of reduced EC competition, and iii) some terms of trade gains to the major grain exporters. The analyses of these linkages are based on MISS (Guyomard and Mahé, 1993). MISS is a price equilibrium model that focuses in detail on the structure of US and EC agriculture and agricultural policy, and extended to include a simplified "Rest of the Economy" supplying inputs to the farm sector at near infinitely elastic supply so that prices of inputs supplied by the non farm sector are led by the inflation rate. Technological change, growth trends in population and in per capita incomes, and other variables exogenous to the agricultural sector are factored into the analysis. The framework tends to constrain the interactions between the US and the EC to world price effects as opposed to the diversion of trade flows to particular countries. However, the price effects of the CAP reform on the US are expected to dominate in the long run since it is the nature and level of relative support provided to the farm sector in competing countries which determines the international location of production, excess demand, relative prices, farm incomes and/or budget costs, depending on the degree to which policy instruments isolate domestic from world markets.

4.1.1. World Prices

In the base-run scenario corresponding to a "continuation of the pre-reform" CAP, nearly all prices decline moderately in real terms. Prices of grains, of oilseeds and particularly of grain substitutes decrease most. The only significant exception is beef meat which exhibits price increases in nominal and real terms due to a lower rate of technical change and a higher income elasticity than other food products. These developments in world prices highly depend on the assumptions made on technical change and on world demand prospects. They also depend on the changes in EC price support policies in the base-run. There is room for debate here, and alternative assumptions could be made on exogenous variables depending on world economic growth in the next decade with different results for the trends in world prices.

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

5 % in the base-run and by 22.5 % in the CAP reform scenario. World prices of animal products are less affected by the CAP reform save for beef and, to a much smaller extent, milk prices which would be respectively 5.2 and 2.7% higher than in the base-run.

In a decoupled CAP reform scenario¹, world prices are not much different from their levels under the actual CAP. The slight difference, mainly visible until 1996, originates from a further contraction of EC output of crops and beef due to the complete decoupling of payments. The magnitude, however, is limited as the set-aside requirement, according to our interpretation and our parameters, partly offsets the incentives to produce created by acreage payments. World prices of grain fed animal products and of grain substitutes would be slightly lower in a fully decoupled CAP reform because of the increased price competitiveness of grains. Sugar prices are basically unaffected since no policy change is conducted on that commodity which is otherwise little affected by the price of other crops because of the quota restriction. The same reason explains why world dairy prices are the same in the two CAP reform scenarios. It is also noticeable that the discrepancies in world prices between the actual and the decoupled CAP reforms fade over time and almost disappear at the end of the decade.

In the "Blair House" or GATT scenario, where the pre-agreement is implemented in the EC only, the picture of world price effects is generally not much different, except for grains and feeds. World prices are lower in this GATT scenario because no set aside is imposed on the arable land in the EC and only a limited cut in producer price is mandatory to meet the 20 % reduction in AMS and the 36 % tariff equivalent cut. The user price of grains in the EC has to be fully aligned on the world price since exports overshoot the allowed quantity of subsidised exports. Consequently, the EC is running large deficiency payments in grains, exporting at world prices but much more than under the actual CAP reform scenario and, of course, much more than under the nearly free trade decoupled CAP reform scenario. Lower grain prices also drive world prices of proteins and grain by-products further down, but only to a small extent.

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

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

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

4.1.2. Implications for the US

It is difficult to model correctly the complex US farm programmes. Our quantitative assessment meets clear limitations in that respect and will have to be supplemented by verbal comments based on the economic rationale of the policy instruments introduced in the Farm Act of 1990. In our representation, target prices of grains are exogenous but loan rates follow the trends of world prices. The loan rate on soybeans is treated in the same way². Market prices of pork and poultry, and of corn gluten feed also follow world prices. For dairy³, beef and sugar, domestic prices are pegged in nominal terms.

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

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

As expected, the actual CAP reform appears attractive to the US. With respect to the base-run, better world prices for grains reduce the US budget costs for grains by 1.2 billion ECU (in 1996) and net exports of grains are 0.6 billion higher in value. The only minor adverse effects are due to the loss of oilseeds (and products) and corn gluten feed export value because of the declining feed demand from the EC animal sector.

The consequences of the EC reform scenarios on US agricultural incomes are, i) small in relative terms, and ii) probably less reliable because of the way policy programmes are

expressed. The US income indicator mainly reacts to world prices of grains, oilseeds and pork and poultry. There is no distinction between participants and non participants into the US grain programme and no benefit from better world prices on US grain producers is represented in the model. Therefore the adverse effect of the CAP reform on US incomes is probably underestimated. Moreover, world prices of grains affect the feed cost of US livestock producers and better grain prices on the market, as a result of the two CAP reform scenarios for example, translate into an income loss for the US farm sector as a whole. This is the reason why the CAP reform looks better than the decoupled alternative from the US farm income point of view. Because of the absence of an adequate representation of non participants in the US crop programmes who would benefit directly from higher world prices, the result in table 4.2 is probably too pessimistic for the US.

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

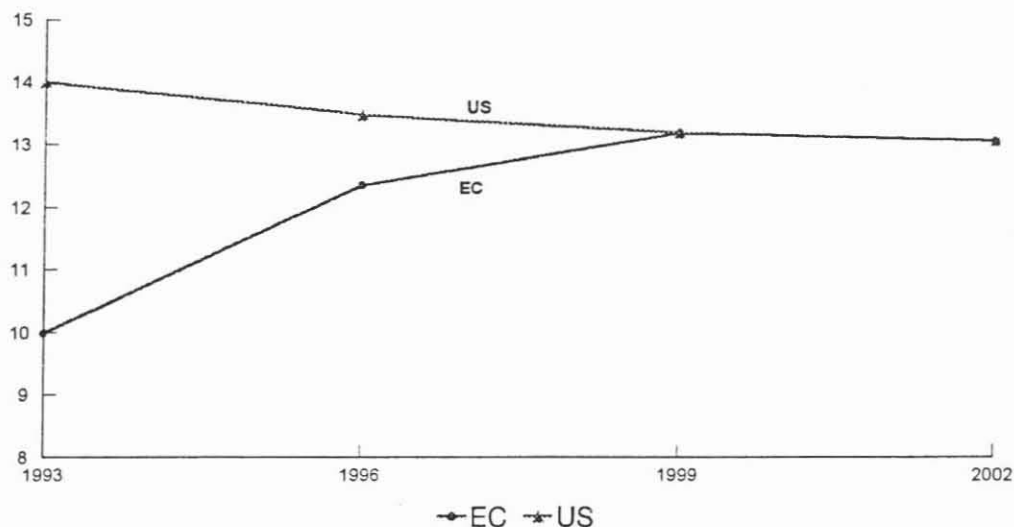
	1993	1966				1999			
		Base Run	Reform	Decoupl. Reform	Dunkel	Base Run	Reform	Decoupl. Reform	Dunkel
Farm income	77.5	76.0	76.0	75.7	76.0	74.8	74.1	73.7	74.9
Budget costs									
- grains	7.1	6.1	4.9	4.4	5.4	5.0	3.5	3.1	4.0
- dairy	0.72	0.76	0.76	0.7	0.8	0.83	0.8	0.8	0.8
Trade balance									
- grains	7.1	6.4	7.1	7.4	6.8	5.6	6.5	6.7	6.1
- oilseeds	4.15	4.3	4.1	4.54	4.1	4.4	4.7	4.8	4.4
- CGF	0.7	0.7	0.6	0.6	0.59	0.8	0.6	0.6	0.65

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

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

Figure 41 shows the dramatic changes in the price ratio between grain fed animals and grains in both the EC and the US. Similar patterns of evolution would be observed as regards other animal products and other feeds. Over the next decade, this price ratio will increase by about 30 % in the EC and decrease by about 10 % in the US. By the end of the decade, both countries should export these products on a nearly competitive basis, at least price and cost wise.

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



Sources : Guyomard and Mahé (1993).

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

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

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

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

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

First, the considerable reduction in exports is likely to change the self-sufficiency position in wheat and feed grains. It is probable that corn supplies, at some stage in the transition period at least, fall short of domestic demand while wheat net exports would keep positive. In such a case, the operation of the CAP would certainly create a wedge between wheat and corn prices because of Community preference. As Surry (1992) has shown, market prices are driven up to the threshold price in a net importing situation and driven down to the intervention price in a net exporting case. Higher prices for corn than for wheat in the EC would trigger outlets for US corn, but also make Community preference (45 ECU/tonne, which is much larger than the target-intervention price wedge of 10 ECU/tonne) more dissuasive. Skirmishes on the implementation of the minimum access as specified in the GATT Draft Final Act are therefore likely.

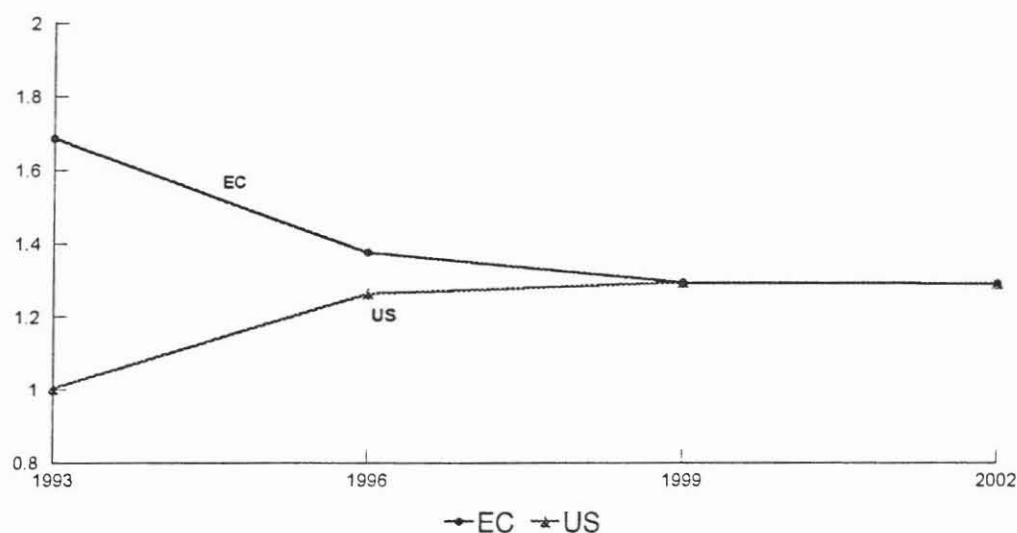
Such circumstances would also affect the issues on grain substitutes, and particularly trade in corn gluten feed (CGF). First, the continuation of unabated US flows of CGF exports to the EC, as projected by the model, calls for some qualifications. This outcome is probable as long as EC market prices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

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

Altogether, the likely picture of EC imports and exports in the grain and feed area is clearly moving toward more instability in prices, subsidies and trade flows. The macro-economic factors world wide, and in both the EC (through the working of the EMS and the switchover) and in the

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

Figure 42. Price ratio between grains and corn gluten feed in the EC and the US under the CAP reform scenario



Sources : Guyomard and Mahé (1993).

4.2. The GATT as a cap on the CAP

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

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

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

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

The lack of confidence among the more competitive exporters in the unilateral CAP reform is further illustrated by the introduction of a new concept in commitments, i.e., the obligation of results in trade liberalisation. Hence, the introduction of the concept of minimum access to imports and the specified reduction in subsidised export quantities⁴ included in the Dunkel compromise. These elements are clearly aimed at countervailing the temptation of the EC to maintain a sizeable exporting activity based on subsidisation and to further enhance self sufficiency in the remaining importing sectors. In other words, the GATT Round was seen as an opportunity to discipline the EC decision making and to "put a cap on the CAP".

Even if the Uruguay Round has often appeared as a "combat des chefs" between the two economic giants, it is also true that multilateralisation of the reform process was a way to promote positive externalities in the reform process. Many pieces of work (Roningen, 19?? ; OECD, 1987, Johnson et al., ...) have shown that joint liberalisation increases world prices more than single country liberalisation by the EC or the US. For most developed countries, this would reduce the cost of adjustment or increase the benefits of net exporters due to further improvements in terms of trade.

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

In the process of seeking an insurance in the trade game to more fully guarantee cooperation in the long run instead of leaving open the alternative route of distorting world trade when domestic conditions would require to do so and therefore to prevent free riding, the negotiators had to agree on rules. These rules, however, cannot be commodity specific even if strategies were clearly designed so as to maximise other countries concessions while minimising own concessions⁵. These rules, tailored according to this strategy, had however to be in line with the GATT philosophy of reducing import barriers and more especially subsidies to exports up to now tolerated under article XVI.

These rules, as they are specified in the Draft Final Act, are complex and their differences according to instruments are reflecting the strategies of the various countries to capture trade gains at minimum political cost. These differences however do not allow protected sectors to fully escape the obligation of adjustment in the future.

This is how the compromise, while not doing more than the CAP reform in the cash crops, the actual targets of the GATT pushers, will impose a revision of the CAP reform in a direction more consistent with the first Commission proposals and will help in the up to now impossible reduction in price support in the dairy and sugar sectors, eventually enlarging the cap on the CAP.

This change in the political balance of domestic forces between reform supporters and opponents will also extend to the countries who have a tendency to present themselves as free traders, but who nonetheless have highly protected sectors they have been unable to reform unilaterally at this stage. Again, the US is probably the best example of this situation, regarding the commodities which are sheltered by the 1955 waiver in the GATT.

Whether this was an intended positive spill-over effect of the US Administration in the early stages of the Round or a reflection of the economic philosophy of the Republican Administration may be difficult to demonstrate. The latter is doubtful, however, since otherwise the sugar policy in the US would have been unilaterally liberalised to the benefit of sugar cane producers from developing countries.

Our interpretation of the course of events observed in the Round, as far as agriculture is concerned, is therefore that expected trade gains in key sectors of key countries were the necessary circumstances to promote collective action at the international level to countervail collective action at the domestic level which results in the status quo. Highly protectionist countries for all commodities like Japan and the EC (for even further reasons due to her supra-national nature) would not have promoted the discipline of agricultural policies under GATT rules, in spite of their general trade interest in sectors other than agriculture.

The US herself would have done it under pure free trade philosophic grounds without these trade incentives. The role she played in the early stages of the GATT treaty in insisting that agriculture be given a special treatment and the efforts to obtain the waiver are ample pieces of evidence. The changed economic conditions, particularly in comparative advantage, and the threats from the EC on trade interests in specific commodities were necessary to trigger momentum to seek an effective result in this particular Round of negotiations.

5. LONG TERM PERSPECTIVES OF EC-US TRADE

The CAP reform is still partial and unfinished. Some basic agricultural sub-sectors (grains, oilseeds, beef) are undergoing a radical reform process while others (dairy and sugar) are subject to production quotas and others (fruits, vegetables, wine, olive oil) are still supported at different

degrees in the traditional way.

The CAP remains on the whole inefficient and inequitable not only with reference to consumers and tax payers, but also with reference to farmers themselves whose incomes are supported unevenly. The existing differences in levels of support are more tied to the strength of the lobbying organisations than to any rational or common sense parameter related to the general interests of the society as a whole.

The main motivation for farm support in the EC is the existing low remuneration of resources, labour in particular, invested in farming. Consequently, in the long term, intersectoral mobility of resources is the natural remedy for low agricultural incomes and policy makers should favour resource mobility whenever and wherever possible provided it does not create specific negative externalities. These externalities (depopulation, desertification, ...) usually affect specific areas and in principle should be dealt with by means of local policy measures.

A proper long-term policy favouring structural adjustment in agriculture is then essential to reduce in the future justified claims for public support. Consequently, long-term perspectives on the EC-US agricultural trade will be largely dependent on the domestic impact of the CAP reform on the farm structure.

5.1. Structural impact of EC common and national policies

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

As a result, the farm structure in EC member states, which was quite uneven before the institution of the EC, has failed to become more homogeneous. In northern countries, farm structures have moderately improved along with labour productivity. In southern countries, farm structures have improved at a much lower rate and labour productivity is still very low. Notwithstanding considerable rates of labour out migration (e.g., in Italy and Spain), the farm structure did not change substantially and a large number of inefficient farms are still surviving together with a smaller number of larger and more competitive farms.

In fact, the objective of some national policies has been to keep a large number of working people in agriculture. The objectives of the Italian "Piano Agricolo Nazionale", for example, are, i) to support and increase farm incomes, and ii) to safeguard agricultural employment especially for young people and in less developed regions. It is not specified if the Italian agricultural policy should support per capita or total agricultural income. However, if agricultural employment is to

be safeguarded, total sectoral income is likely to be the real objective.

Applied to the whole country, without a specific reference to special areas where agricultural employment could fall short of minimum levels and create serious social and possibly environmental problems, these objectives of the Italian agricultural policy are clearly hindering the intersectoral mobility of resources, and of labour in particular. This may help to explain why Italy, although importing almost one fifth of her food needs, accounts for a labour share in total employment in terms of Annual Work Units (AWU's) which is still double or triple that of other EC countries enjoying approximately the same level of economic development, as The Netherlands and Belgium

Unfortunately, in the EC as a whole, the distribution of farms per class of farmer's income is more similar to the Italian than to the Dutch. Family farm income per AWU in half of EC farms is still less than 5000 ECU per year, notwithstanding the substantial price and income support granted by the CAP entailing large income transfers from consumers and tax payers. This may explain, to a certain extent, the more liberal approach of Dutch policy makers and farm unions towards problems discussed in GATT negotiations as compared to the more conservative positions held by some other members states.

This excess labour retained in agriculture, especially in less developed regions, is likely to be the combined effect of both the EC price support policy and the pseudo-structural policies implemented at the national level. The invisible nature of most income transfers to farmers was disguising the real contribution of agricultural employment to social welfare⁶ not only to consumers, but also to farmers themselves. Some farm unions maintain that it is much better for farmers to "earn" their own income from sales on the (domestic) market than receiving direct income subsidies.

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

5.2. Long-term effects of the CAP reform

Notwithstanding the manifest average and marginal low productivity of farm employment, the first objective of the reform mentioned in the reflection paper of the Commission (CEC, COM(91) 100 final) is "sufficient numbers of farmers must be kept on the land". In fact, the first unofficial "leaked" version of the document was referring to a "large" number of farmers.

As labour productivity in EC agriculture is much lower than in other sectors of EC

economy, the objective of limiting the intersectoral labour mobility by means of subsidies or indirect income transfers is advisable only exceptionally in areas where environmental or demographic problems may arise, not in areas where such problems do not exist or as a general goal to be reached in all EC regions.

In fact, in a number of areas and especially in southern Europe, workforce levels in farming are still patently excessive. In some labour intensive areas, farming is also more capital intensive per hectare of land and more polluting than in areas where farm sizes are larger and family farms are economically viable.

The goal of retaining farmers in all EC regions may be useful for electing a large number of MP's, which would allow for larger income transfers to the sector. However, as these income transfers usually involve high social costs and benefit mostly rich farmers, such vested interest cannot be spelled out openly as they would not be widely accepted on ethical grounds.

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

Society may be justified in granting direct payments to farmers for two distinct types of motivations : subsidies for positive externalities created by the conservation of natural resources and other pro-environment practices, and compensations for income losses due to reduced market prices. The different nature of these motivations should be considered carefully.

Positive externalities are currently produced by agriculture but, as they are public goods, are not valued by market prices. It is up to the farmers to decide if they want to practice environmentally safe methods and have a positive impact on the environment. Because the results of each farmer behaviour can be seen and judged on a year to year basis, an annual reimbursement payment would be logical.

On the other hand, compensations for income losses due to reduced price support after the CAP reform may be paid as a lump sum, allowing farmers to cumulate future payments for a number of years⁷. In order to avoid sudden budgetary problems, lump-sum payments could be financed by the EC budget in the form of bonds, saleable on the financial market, as recently proposed by the Land Use and Food Policy Inter Group (LUFPIG) of the European Parliament. (Marsh et al., 1991).

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

i) The bureaucratic work needed for computing compensations and controlling farmer's

declarations will be annual as well, requiring large administrative costs born by EC and national budgets, wider possibilities of fraud, and implying private costs also for farmers engaged more and more in bureaucratic practices.

- ii) It would not be advisable to modulate compensation according to farm size without running the risk of hindering structural adjustment. Maintaining smaller and less efficient farms would mean to receive every year higher compensations.
- iii) Farmers running small holdings will be encouraged to remain in the agricultural sector in order to receive their payments. The intersectoral and intrasectoral labour mobility will be limited. Ultimately, this would hinder the natural economic adjustment and have an adverse effect on the EC economy.
- iv) Farmers are continually uncertain of their future payments. This would cause them to take a conservative approach in making structural improvements, and instead force them to spend time and money convincing the political sector to guarantee their compensation.
- v) Employment in farming will decrease less and some extra employment will be created in the public sector in order to implement the new administrative practices and controls. However, the marginal contribution of this extra employment to social welfare is likely to be negative.

The newly born reform of the CAP is likely to show its advantages in the upcoming years, but its intrinsic contradictions will be more apparent as well. Hopefully, these new problems will be reconsidered by policy makers and the appropriate changes made.

5.3. Long-term effects of a decoupled CAP reform

If a lump-sum compensation for the reduction in incomes is computed for a number of years and, for example, offered to farmers as bonds saleable on the financial market, farmers would have the choice to cash annually the payment or to sell the bonds and cash at any time the discounted cumulated compensation for future payments.

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

- i) Bureaucratic costs would be reduced and the possibility of fraud decreased as the administrative work of calculating and analysing payments would only have to be done once.
- ii) Compensation could be modulated according to farm size, or to other parameters, without generating inefficient resource allocation in the future. Investment decisions will be taken mainly on the base of market prices and there will be no public incentive for owning a smaller farm instead of a more efficient and viable one.
- iii) Proper environmental standards could be targeted by means of regulation, incentives for positive externalities and disincentives on negative externalities, without directly hindering a more efficient allocation of resources. Land set aside could be encouraged on the basis of conservation

objectives, and not to manage supply control for reason of complacency towards foreign competitors.

iv) Labour mobility would not be hindered and unsuccessful farmers would feel freer in changing job where available. This would have an overall positive affect on the long-term EC economy.

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

Although accepting its economic advantages, these decoupled aspects of CAP reform may be considered too risky by policy makers whose concerns are focused on possible demographic and territorial problems. Lump-sum compensations could then be tested on a specific section of the agricultural sector, e.g., providing this extra choice only to smaller, not economically viable farms, or limiting it to specific EC regions where agricultural employment is excessive under all points of view. Such a scheme would favour the needed structural adjustment. Complementary measures for restructuring farms in these areas and fostering economic development in other economic sectors are also clearly necessary to promote regional and rural development on a wider economic basis than the sole agricultural sector.

5.4. Likely impact on EC-US trade relations

Improved structural adjustment generating lower production costs and lower demand for protection is likely to be the best safeguard against continuing requests for protectionist measures both in the EC and US.

According to some quantitative estimates⁸ which are consistent with ours, the expected effect of a decoupled CAP reform on trade flows between the EC and the US should not be too dramatic as a whole. The increased extensification related to a larger number of economically viable farms would be balanced by reduced land set-aside, improving altogether the allocation of available resources.

The most interesting effects should be apparent in the changing perspectives for further trade liberalisation, as intersectoral labour mobility and lower farm production costs are essential conditions for allowing a further reduction in farm support and for developing a freer international trade for agricultural products without excessive burden on consumers and tax payers. Improved structural adjustment, generating lower production costs and lower demand for protection, is likely to be the best safeguard against continuing requests for protectionist measures both in the EC and the US.

A less interventionist policy by the EC and the US is likely to be followed by other developed countries and favour a more efficient international allocation of resources.

The CAP could then concentrate more on providing incentives for environment conservation and improvement, subsidising farmers in less developed regions where depopulation

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

6. CONCLUSION

The reform of the Common Agricultural Policy has consisted in the substitution of new income support instruments to the usual price policy, essentially in the cash crop sector. The payments are based on factors currently used which set entitlements for the future. Our first point is that the domestic political balance was unable to generate such a large change in policy design, in spite of inefficiencies and unbalances due to the traditional CAP. The pressure of the US has been a major factor in the elaboration of the reform. We argue that trade interests have been crucial to catalyse international collective action in order to countervail domestic pressure groups. In fact, the reform satisfies the US objectives as well as the GATT compromise. The US gains from the CAP reform are noticeable, but we do not foresee the disappearance of sources of tensions between the two countries, as EC animal products become more competitive and as the working of the CAP in the vicinity of world prices will make trade flows sensitive to world macro-economic and agricultural shocks.

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

This achievement of the Uruguay Round, while it has to be considered as a success, should not be considered as satisfactory, and the long-run objective of further decoupling of payments from production incentives should be pursued in order to promote agricultural trade on a more competitive basis and to reserve intervention of the State to the promotion of the positive externalities of agriculture in developed countries.

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Outline

Summary	2
1. Introduction.....	3
2. The EC-US agricultural conflict.....	4
3. The EC-US agricultural trade game and the design of the CAP reform.....	8
3.1. Sources of domestic pressures for a reform of the CAP	8
3.2. EC, US and the international game	10
3.2.1. The nature of special interests in agriculture	10
3.2.2. The nature of interdependencies between the agricultural economies of the major players.....	12
3.2.3. Summary	14
4. EC-US agricultural relations and the GATT Round : a cap on the CAP	15
4.1. CAP reforms, world prices and implications for the US	16
4.1.1. World Prices	16
4.1.2. Implications for the US.....	18
4.1.3. Trade in commodities, trade in livestock products on a more competitive basis.....	19
4.1.4. The operation of the CAP with market prices in the vicinity of world prices	21
4.2. The GATT as a cap on the CAP	22
4.3. The GATT is also a means to help so-called fair traders to do some house keeping at home	23
5. Long-term perspectives of EC-US trade	25
5.1. Structural impact of EC common and national policies.....	25
5.2. Long-term effects of the CAP reform	27
5.3. Long-term effects of a decoupled CAP reform	28
5.4. Likely impact on EC-US trade relations	29

6. Conclusion	30
Bibliography	32

¹ This scenario is run assuming that acreage and headage payments introduced by the reform are granted in a fully decoupled way, e.g., on the basis of past criteria only. Furthermore, there is no set aside in this scenario.

² An alternative solution could be to peg the loan rates according to the principle of marketing loans, but the loan rates themselves may be adjusted by policy makers.

³ This is also a debatable representation as there is an extensive discretionary power given to the administration to adjust the policies if programme costs increase. The cost associated with dairy policy must be considered as "potential" rather than automatic.

⁴ Respectively 5 % of domestic consumption of the reference and 24 % of subsidised exports in the reference.

⁵ There is ample evidence that most delegations have followed that route. Canada is an example when she tried to get production quotas treated in a more lenient fashion than other price support policies without supply control. The US is an other case in point when the choice of the reference period for the AMS reduction was clearly designed to minimise support cut under this rule. Japan is the extreme case in that respect, but the EC's reluctance to accept specific commitments on subsidised exports is an other example of this general attitude.

⁶ Social security invisible transfers were substantial, accounting for more than 50 % of public expenditure in agriculture in early eighties. Altogether, income transfers to agriculture were approximately equal to the sectoral value added (Tarditi and Croci-Angelini, 1988, p. 28 and 70). Unfortunately, the survey on national expenditure in agriculture (CEC, 1982) decided by the EC Commission in early eighties and providing extremely interesting information was never updated.

⁷ The LUFPIG proposal at the European Parliament was envisaging a 15 year period. The same period has been assumed for a simulation of the impact of a decoupled CAP reform on markets and prices (Folmer et al., 1993).

⁸ For example, Folmer et al., 1993.