

The CAP and the GATT/WTO: a story of mutual influence and antipathy

Abstract

The Common Agricultural Policy, in 2008, reached its fiftieth birthday. It has been a constant presence in directing resources to the EU agricultural sector, but the means of channelling these resources have changed considerably in that time. This article charts the evolution in the principal policy instruments used and analyses the welfare effects of the major reforms implemented. It also analyses these changes in terms of the institutional context of the principal reform pressures, of international trade obligations and EU budget concerns. Both pressures are linked to the dominant policy instruments adopted initially – price support. The initial institutions, however, meant that whilst trade concerns did not lead to significant CAP reform, budget concerns did. During the late 1980s and early 1990s, however, changes to the institutional context of both trade and budget policies resulted in joint pressures forcing the EU to change fundamentally the way in which it delivered financial resources to farmers. Throughout, however, this process was never one of simple determinism: those same policy instruments established patterns of transfers that created vested interests in the *status quo*. The CAP must therefore be seen in the light of its institutional context and of endogenous vested interests to the policy.

The Birth of the Behemoth: an introduction to the CAP

2008 marks the fiftieth birthday of the Common Agricultural Policy (CAP). Although the policy did not begin operating until 1962, it was in 1958 that Ministers of Agriculture, along with representatives of farmers and the food industry met at Stresa in order to lay the groundwork and begin preparations for the new common policy.

The Treaty of Rome had, in Article 39.1¹, set out five objectives for the CAP:

- to increase agricultural productivity by promoting technical progress and by ensuring the rational development of agricultural production and the optimum utilisation of the factors of production, in particular labour;
- thus to ensure a fair standard of living for the agricultural community, in particular by increasing the individual earnings of persons engaged in agriculture;
- to stabilise markets;
- to ensure the availability of supplies;
- to ensure that supplies reach consumers at reasonable prices.

Three principles emerged at Stresa, which became known as the three pillars of the CAP: a *single market*, enabling EC-produced goods to circulate freely between EC members; *community preference*, giving this trade priority over imports from third countries; and *financial solidarity*, providing a financial structure that shared the cost of the CAP across all member states.

The CAP would deploy many policy instruments, but even at Stresa the primacy of price support was acknowledged; as was its likely external impact (Neville-Rolfe 1984; Stead 2008). In the period between Stresa and the start of operation of the CAP,

the members² of the General Agreement on Tariffs and Trade (GATT) had the opportunity to address the nascent policy during the Dillon Round (1960-62). Despite concerns over the consequences of high support prices, the US accepted the principle of price support. In return, it negotiated the side-payment of duty-free access to the EU market for oilseeds – CAP commodities for which EC self-sufficiency was by far the lowest (typically below 40% until well into the 1970s), for which the EC would have an ongoing import need.

Price support implied the possible use of export subsidies, but these had been confirmed as GATT compliant (subject to limits) in 1955. The EC system of price support would also involve variable import levies rather than fixed tariffs. These were not covered by the GATT and their legality would not be challenged until the Uruguay Round. Ultimately, with support prices not yet set, GATT members were unable to determine if the CAP would leave the EC in violation of its obligations under the General Agreement (see also Josling *et al* 1996, 40).

Subsequently, fears over the trade effects of the CAP would be justified, as discussed below. Indeed, it would be this central policy instrument of price support that would generate two distinct sources of pressure for reform – the EC budget and international trade concerns – as well as distinct beneficiaries resistant to CAP reform: landowners and agribusinesses. It would, however, be the institutional context of the reform pressures that would determine whether the interests in the *status quo* would be overcome. First, we consider the simple economics of price support to establish its role in the evolution of the CAP and emergence of reform pressures.

APPROXIMATE LOCATION OF FIGURE 1

Figure 1 shows the dynamics of price support. The system turns the EC market into an economic island, wherein prices are maintained at levels above those prevailing on world markets: P_w is that world price, initially. P_{th} is the Threshold Price, a minimum import price maintained by the application of a variable import levy, VIL: P_{th} is fixed, but the levy varies with world price movements. The lightly shaded area 'a' represents the revenues generated by that levy, which pass to the EC budget. Over time, supply increases. Technological developments will contribute to this, but partly because of price support. Farm income support is achieved via raised prices: the more that can be produced and sold, the more support received. Farmers' higher demand for output-enhancing technologies (fertilisers, pesticides, more efficient harvesting equipment, etc) and, where possible, land (but see below) is partly policy-induced. Agribusinesses controlling productivity-enhancing technologies thus benefit indirectly from the price support system and have an interest in preserving that system.

As supply rises from S_{EC0} to S_{EC1} , the market price falls. As supply approaches S_{EC2} , a second mechanism of price support is activated. The fall in market price undermines the goal of income support. A system of intervention buying puts a floor in the market: if market prices fall too low, farmers can sell to the government at the intervention price, P_i . At P_i demand is perfectly elastic and support is 'open-ended': subject to minimum standards, the authorities were committed to buying whatever was offered for sale. Intervention was central to the output growth seen through the 1970s and 1980s, as it guaranteed farmers both a buyer for their output and a minimum purchase price, regardless of market conditions.

Price support imposes a cost on consumers regardless of whether the domestic market is in deficit or surplus, as EC prices are above world market levels. The EC budget faces costs through disposal of surpluses. If surplus quantities are to be exported to third countries but the price paid to farmers not undermined, a subsidy is needed to bridge the gap to P_w . The total cost of export subsidies at P_i/S_{EC2} is shown as the dark-shaded area 'b', with the unit export subsidy X_{sub} . With some surplus quantities bought into intervention initially rather than exported immediately storage costs, not shown on the diagram, will also be incurred.

As output continues to rise, to S_{EC3} , surplus production and EC exports grow. These exports reduce the world price, to P_w' , as the EC is now a 'large' exporter (in just a few years, the EC became the second largest agricultural exporter in the world). Moreover at the annual price-fixing, EC Farm Ministers increased institutional prices, seen here as an increase in the intervention price from P_i to P_i' . The large shaded rectangle shows two factors driving up export subsidy costs – larger surplus quantities and a larger per unit export subsidy, X_{sub}' . Storage costs also rise as more is also sold into intervention. The VIL gives an indication of the degree of 'community preference' built into the CAP. Even with an unchanged threshold price, rising EC exports depress world prices and increase the degree of preference. In practice the threshold price was raised as well, increasing 'community preference' further.

What Makes a Reform Pressure Binding?

Price support generated two sets of policy problems directly: budgetary and trade-related. We discuss below how problems emerged in the context of Figure 1. Before

that, we outline the institutional contexts that help define a policy ‘problem’ and which first led to the possibility of reform being needed. We then explore how these contexts varied in the extent to which they created *binding* pressures for reform. We distinguish in the next two sections between two periods, as reforms were agreed to both EC budgetary and international trade institutions through the late 1980s and early 1990s which were to affect fundamentally the impact of both on the CAP.

The Initial Institutions of International Agricultural Trade Policy

The place of agriculture in the GATT is discussed in detail in many places (see, *inter alia*, Ingersent *et al* 1994; Josling *et al* 1996). The focus here is on the institutions of trade policy and their enforceability (see also Kay and Ackrill 2008). Under the GATT, several provisions allowed challenges against domestic policies. The key agriculture-specific measures were Article XI – quantitative restrictions; and, most relevant to the CAP, Article XVI – subsidisation, especially export subsidies. There were also general obligations applying to all trade. Measures could be challenged that ‘nullified or impaired’ a country’s expected benefits from its membership of GATT; or which caused ‘serious prejudice’ to other countries. Export subsidies were permitted so long as they did not give a country “more than an equitable share of world export trade in that product”. Fundamental problems were faced, however, in enforcing Article XVI, notably defining equitable market share. As a result, in the fifty years of the GATT Article XVI only featured in five cases. One, brought in 1958 by Australia against France, pre-dated the CAP (it was also the only successful action). The other four cases were all brought against the EC and all failed to force policy reform (see GATT 1983; Josling and Tangermann 2003).

In the two cases brought against the EC sugar regime in 1978, by Australia and Brazil, the Panels felt unable to rule on whether EC export shares were equitable or not (see GATT 1979; GATT 1980). They did, however, rule against the EC on serious prejudice. What followed was two years of discussion, ultimately fruitless, between the EC and the injured parties over what needed to be done to remove the serious prejudice (see Ackrill and Kay 2008). In the US action against EC wheat flour subsidies, the Panel failed to rule on ‘equitable share’, nullification and serious injury. The US case against EC pasta export subsidies saw a 3-1 Panel decision against EC policy, but the EC blocked the adoption of the report (Josling and Tangermann 2003, 216-218), at the height of the “Farm Wars” (Wolfe 1998).

Josling and Tangermann (2003, 210-214), however, identify two Transatlantic trade disputes where EC policy did change – but both were concerned with domestic rather than export subsidies. On canned fruit (a sensitive issue, if not a core part of the CAP) the EC again blocked the GATT Panel report, but still agreed to make changes to the domestic subsidy regime. The other case, oilseeds, is discussed below. Overall, the institutional structures of the GATT prior to the Uruguay Round proved inadequate to address the concerns of other countries about the trade effects of price support by forcing its fundamental reform. Thus although budget crisis emerged later, it would be the first to force CAP reform.

The Initial Institutions of the EC Budget

It is beyond the scope of the present article to discuss in detail the complexities of the EC budget (see, *inter alia*, Ackrill 2000b; Laffan 2000). We highlight here the two elements most relevant to the emergence of budget problems for the CAP. The first is

a balanced budget rule (BBR) , introduced in the Treaty of Rome, applied to the budget as a whole. A ceiling is placed on total revenues available in any year, which defines total spending in that year. The second, dating from the 1970 Treaty revision, distinguishes between two types of expenditure. Compulsory Expenditure (CE) is “expenditure necessarily resulting from this Treaty or from acts adopted in accordance therewith” Article 203 (now 272); Non-Compulsory Expenditure (NCE) is everything else. CE is dominated by CAP guarantees.

A key part of this distinction concerned expenditure control. In essence, with NCE the budget was set first and then allocated between competing claims. Moreover, annual growth was limited by Treaty mandate. With CE, once the expenditure-generating policy instruments were in place all resulting expenditure claims had to be met. Were this not the case, policy goals could be undermined. For example, limiting spending on intervention storage or export subsidies would see ‘excessive’ quantities retained on the EC market, the EC market price fall and the income-support goal of price support compromised.

Under price support, as production and thus surpluses rose so did spending on export subsidies and intervention storage, pushing total CAP and EC spending towards the BBR ceiling. Given the definition of CE, the only way to alter the upward trajectory of CAP spending was to change the expenditure-generating policy instruments – that is, to reform the CAP. By the early 1980s the dairy sector accounted for almost a third of CAP spending and a quarter of total EU expenditure: it thus provided the setting for the first substantive CAP reform in 1984.

APPROXIMATE LOCATION OF FIGURE 2

Figure 2 shows the economic impact of a production quota, introduced into a policy of price support. The high support (intervention) price results in excess supply. Export subsidy expenditures are shown as $P_i P_w q_d q_s$. A production quota is now introduced. Even with excess supply built in and neither a reduction in intervention price nor rise in world price, expenditure on export subsidies falls, to $P_i P_w q_d q_s'$. Quotas had a direct impact on production; important, given the budget situation. They also helped resolve possibly contradictory positions across member states. Countries such as Germany opposed reductions in support prices whereas, for example, the UK sought to contain budget costs. Also, no country strongly opposed quotas. The comparative static budget savings from a price cut would be $d+e+i+f+g+j+b$,³ but ongoing production growth – which price cuts alone could not stem – would see area a grow over time.

To understand interest-group pressures over the reform process, compare the welfare effects of a quota and a price cut. Cutting the intervention price to P_i' would increase consumer surplus by $c+d$. At the time, however, there was insufficient support for the price cuts which would benefit consumers. In contrast, price cuts would see producer surplus fall by $c+d+e+i+f$ – a much larger effect on a smaller and better-organised lobby. Quotas would reduce producer surplus by at least f but, if quotas were allocated on the basis of past production and quota-trading was not allowed, this fall would be $f+h+i$ (still considerably less than the loss with price cuts). Area $h+i$ arises because this method of quota allocation cuts production by efficient producers and maintains some production by inefficient producers. Allowing quota transfer between producers (as happened from 1992) could eliminate the loss $h+i$ (see Burrell 1989).

Production quotas also had to be a practical solution. Virtually all milk produced on farms passes through dairies for processing, offering a channel for quota enforcement. The one regime established with production quotas *ab initio*, sugar, shares this feature: a farm-level product (sugar beet) requiring processing to obtain the principal consumed commodities. This makes quotas a reform option that is limited in its wider applicability. With dairy production and budget growth contained, attention turned to other commodities which were now moving into surplus and driving expenditure-growth (as shown in Figure 3); but the specific implementation issues of production quotas did not see their widespread adoption for other commodities.

APPROXIMATE LOCATION OF FIGURE 3

Most reforms thus involved modest tweaks to the instruments in Figure 1 (see, *inter alia*, Ackrill 2000a for a detailed discussion). The fundamental problem with price support is the inherent conflict between the price levels deemed necessary to deliver income support and technical progress as in Article 39, and their consequences for output, surpluses and budget costs. Thus, given the overbearing presence of Article 39 on policy-makers, such 'reforms' as were undertaken (such as 'guarantee thresholds' in 1982 and 'stabilisers' in 1988) adjusted prices by, typically, 3% at most. As a result there was no fundamental change to the production incentives offered to farmers, given that EC prices were far enough above world prices for cuts of 3% to do nothing to reduce the production incentives.⁴

Institutional Changes and Fundamental CAP Reform

Budget concerns resulted in policy changes, but income concerns limited the extent of the reforms and thus their effectiveness in containing budget pressures: a new direction was needed for the CAP.⁵ Dairy quotas represented the first reform to alter a core element of price support (the commitment to support unlimited production). The period from this reform to the 1992 CAP reform, below, marks a key evolutionary phase in the CAP: Article 39 ensured financial transfers to farmers would remain, but changes to budget and trade policy institutions resulted in simultaneous budget and trade pressures that saw a shift to fundamentally different instruments of support.

Institutional Change in International Agricultural Trade Policy

The Uruguay Round was significant for the multiple changes made to the treatment of agriculture within the GATT. Whilst agriculture continues to be treated differently to other sectors, notably in permitting (for now) the use of export subsidies, the constraints on agriculture have changed fundamentally. In particular, there are explicit quantitative limits on the use of export subsidies and on domestic support. This makes breaches much easier to establish. If, for example, the limit on export subsidies is exceeded, this constitutes a “*prima facie*...case of nullification or impairment” (Dispute Settlement Understanding, Article 3.8, emphasis in original). Problematic terms like “equitable share” have thus been removed.

The oilseeds case noted earlier benefited from having agriculture included in the trade liberalisation talks. The GATT case raised two issues – national treatment (EC producer payments, paid via processors, put domestically produced oilseeds at an advantage over imports) and nullification and impairment (the expected benefit to the

US from the EC's zero tariff-binding was thus reduced). Domestic reform dealt only with the first concern. The second was brought into the wider Uruguay Round talks and, in a bilateral meeting between the US and EC at Blair House in November 1992, the EC agreed to limit the arable area planted to oilseeds. This followed the May 1992 CAP reform (see below) which brought cereals and oilseeds into a new arable regime. In this new policy context, placing a limit on oilseeds area was less threatening to EC arable producers, who could trade off different crops without affecting adversely the overall arable payments received (see also Kay and Ackrill 2008).

The quantification of spending limits on domestic support was accompanied by a move towards its de-coupling, weakening the link between levels of production and support received. Cuts were required to spending on trade-distorting domestic policies (Amber Box policies), such as price support. Other, less trade-distorting policies, were grouped into either the Blue Box or the Green Box (the origins of the Blue Box are considered below). These differed in the extent to which they were judged to be trade distorting. The Green Box contains policies felt to be no more than minimally trade distorting, with payments not related to production or prices. Blue Box policies represent partial de-coupling (based on, for example, fixed areas and yields, rather than current values); and/or involve payments limited in total quantity (and thus value); and/or include measures designed to limit production (such as land set-aside).

These distinctions are crucial, as agricultural support can be maintained overall, with Amber Box policies replaced in part or whole by less trade-distorting measures compatible with the Blue and/or Green Box. In the Uruguay Round, in the wake of the Farm Wars, other countries were putting pressure on the EC to agree a deal that

could only be achieved if the CAP was reformed. The grouping of policies into different 'Boxes', with spending on each treated differently, effectively pushed the CAP towards particular policy instruments.

Institutional Change in the EU Budget Process

1984 saw the start of an ongoing programme of policy change: Budgetary Discipline. The first CAP-related measure introduced was the 'agricultural guideline', which sought to limit the growth in CAP spending to the rate of growth in EC GNP. There was, however, no binding pressure on the Council of Agriculture Ministers (CoAM) to achieve this. In 1988, further reforms were agreed (see, *inter alia*, Ackrill 2000b; Laffan 2000). Notably spending plans were presented in multi-annual Financial Perspectives (the first was for five years; each since has been for seven). Planned CAP spending embedded an amended agricultural guideline which limited growth in CAP guarantees to no more than 74% of the growth in EC GNP. This made the budget process more transparent, but there remained no credible enforcement mechanism for CAP spending. Thus by 1992 the BBR was again threatened (Kay 1998), a binding budgetary constraint was again faced and CAP reform was needed in order to alleviate budgetary pressures.

The 1992 'MacSharry Reform: balancing trade and budget concerns

The foregoing established how two pressures, distinct but linked intimately to the structures of price support, simultaneously put the CAP under pressure. Could a reform be found that addressed both concerns? The solution to the trade pressure came through the development of direct payments compensating price cuts of a depth previously thought infeasible – about 30% for cereals, for example. These were paid

per-hectare and fixed in value, calculated with reference not to current yields but a yield figure based on an earlier representative period (the “Olympic average” of the middle three values for the five years 1986-1990). A similar reform was agreed for beef, where fixed headage payments were agreed.

However the new payments did not conform to the definition of the Green Box (a problem also faced by the US). As things stood, they would thus go into the Amber Box and be subject to further cuts, an unacceptable option especially given the efforts required to achieve CAP reform. Thus at Blair House the EC sought a solution that could form the basis of a GATT agreement and which was consistent with the new CAP. The resulting Accord (see Josling *et al* 1996; Kay 1998; Wolfe 1998) avoided changing the definition of Green Box policies and kept the payments out of the Amber Box by creating a new, Blue, Box . This was thus defined by existing policies, rather than it be defined and policies conform to it. The Blue Box was then placed inside the Green Box to protect it from cuts imposed on Amber Box policies, with ‘credit’ given for partial de-coupling and production constraints such as set-aside.

The 1992 CAP reform was thus influenced fundamentally in both its timing and shape by trade pressures. As already noted, however, the BBR was again under threat and thus budgetary factors were also important. Consider Figure 4. There are substantial cuts in institutional prices, but a constant world price is assumed, for simplicity.. As the intervention price is reduced, the EC market price falls. Offsetting this are direct payments. The unit value of the direct payments, 45 ECU per tonne is based on the new target price, P_t , and converted to a per-hectare payment in the manner described above. Large farmers – those who, at base yields, could produce 92 tonnes or more of

cereals – also had to set aside a percentage of their land (initially 15%) in order to qualify for the payments. This shifts the supply curve S to S' .

APPROXIMATE LOCATION OF FIGURE 4

Export subsidy costs, initially, are $P_i P_w q_d q_s$. After the reform they fall to $P_i' P_w q_d' q_s'$. Comparing actual expenditure in 1992 and 1996, as the reform was phased-in, arable export subsidies fell from 3.14 billion ECU to 313 million ECU – with intervention costs falling from 2.5 billion ECU to -46.5 million ECU.⁶ Total grains self sufficiency fell from 120% in 1990/91 to 105% in 1995/96, with total grains intervention stocks falling from 20.9 million tonnes in January 1993 to 1 million tonnes in January 1997.

Two types of direct payment gave compensation for lower support prices and, for large farmers, compensation for having to set aside land. The first is shown as $a+b+c+e+f$, whilst the second is shown as $g+h+j$. The set-aside payment was initially also based on 45 ECU per tonne ($P_i - P_t$). During internal negotiations over the oilseeds deal with the US, described earlier, the member states agreed to increase the per unit compensation for setting aside land, to 57 ECU per tonne, for accepting the limit on oilseeds area: hence area j .

The fall in price results in a significant rise in consumer surplus, of $a+b+k+l$ (see also McCorrison and Morgan, 1998). There is also a significant fall in producer surplus, of $a+b+c+e+g+k+l+m+n$. Within this, $k+l+m+n$ represents lost revenue from lower prices that is not covered by direct payments, although this is balanced against $f+h+j$ – direct payments not associated with a loss in producer surplus, but which arise

because of the per-hectare nature of the payments. Overall, budget spending on the arable sector rose from about 10.4 billion ECU in 1992 to 16.4 billion ECU in 1996.

What explains this apparently contradictory response to budget pressures?

Price support costs, as seen earlier, are under constant upward pressure, with high prices encouraging farmers to produce more and with intervention guaranteeing a buyer. Direct payments, however, are fixed in value. Indeed, not only is their per-unit value fixed, as described above, there are aggregate eligibility limits imposed on both: thus total spending on direct payments is capped. Potential problems arising from the definition of Compulsory Expenditure are circumvented by building spending limits into the policy instruments. Total spending rose over the three years the payments were phased in, since when further growth in CAP spending has been more controlled, occurring as a result of further reforms or of EU enlargements. The period 1988 to 1992 revealed the partial nature of institutional reform – the Financial Perspective helped the budget process, but it was only with the embedding of spending limits into the new CAP payments in 1992 that a credible compliance mechanism for the CAP spending set out therein was achieved.

Agenda 2000 – a mix of old and new

1997 marked the start of the detailed process of preparing applicants, mainly former Communist countries from central and eastern Europe, for membership – and also preparing the EU⁷ for this large-scale expansion. The programme, “Agenda 2000”, took two distinct approaches to reforming CAP support. The first continued the reform of 1992, reducing price support levels further and increasing direct payments in compensation – albeit by only 50% of the price cut (see Ackrill 2000a, 126),

The second element saw significant changes made to ‘guidance’ measures. The CAP has long devoted funds (albeit typically less than 5%) to restructuring measures, such as efficiency-enhancing ‘development plans’, early retirement for older farmers, training and re-training (for those wishing, respectively, to remain in or leave farming). In 1988 the Commission published “The Future of Rural Society” followed up, in 1996, by the “Cork Declaration for a Living Countryside”. This spoke, for example, of prioritising integrated and inter-disciplinary policies to enhance wider rural development and the sustainability of landscapes, through a coherent and simple approach to policy programming.

Agenda 2000 thus established a new strand of measures – Rural Development – that soon became known as Pillar II (Pillar I being price and income support: CAP ‘guarantees’). This embodied two broad concepts: the ‘European Model of Agriculture’ (EMA), recognising the ‘multifunctionality’ of the sector. The measures covered investment in farm businesses, human resources, support for less favoured areas and areas subject to environmental constraints, forestry, processing and marketing of products, agri-environmental measures, and the general development of rural areas. Novel features included member states choosing which measures to implement. Furthermore, along with an increase in the share of total CAP spending devoted to these measures, to about 10%, they also entailed national co-funding. This enabled higher total spending without imposing the full burden on the EU budget.

The creation of Pillar II was not solely budget-driven,. Issues such as BSE increased awareness of a policy and sector that did not always deliver either production systems

or food of the expected safety and quality. Also, the Uruguay Round Agreement required that further negotiations should start on agriculture by 1999. Developing Pillar II meant the EU could provide resources to agriculture that reflected wider policy concerns and which could go into the Green Box of de-coupled measures. This would protect these transfers from future reductions and would allow it to take more of a leadership role in talks, compared with the Uruguay Round, when it was typically having to respond to policy initiatives led by other countries.

This reform again raised budgetary concerns, in particular given the changes to Pillar I and with forthcoming enlargement. A new Financial Perspective (for 2000-2006) was also negotiated as part of Agenda 2000 wherein, for the first time, the overall ceiling on the EU budget remained unchanged, at 1.27% of GNP, enlargement notwithstanding. This marks the point when the net contributors to the EU budget became more assertive in EU budget negotiations. Prior to 1999, some member states even argued that since the post-1992 payments represented 'compensation' for price cuts not faced by the applicants, they should not receive those payments. The 1999 reform, however, embedded direct payments as a key basis of CAP support. Denying new members these payments was thus infeasible politically.

That said, a radical CAP reform that reduced individual EU15 countries' receipts and distributed more money to the new member states was unpalatable. Thus detailed discussions over accommodating CAP spending in the new members – especially the direct payments – was deferred until October 2002, when the accession package was finalised. No adjustment was made to the Financial Perspective, despite an actual enlargement of ten countries rather than the planned six, but one part of the solution to

the direct payments problem was in-built: the per hectare value of arable payments would generally be lower in the new members because most had lower yields. It was also decided (by the EU15) that the payments would be phased in over ten years, starting at 25% of their full values. Although enlargement could have seen the budget again force CAP reform, reformed budgetary institutions and the more aggressive negotiating stance of the net contributors saw established budget constraints respected and any necessary financial accommodation borne by the new members.

The Mid-Term Review – Anticipating Trade Pressures

Agenda 2000 required the reformed CAP to be reviewed in 2002. Despite opposition from some quarters Commissioner Franz Fischler produced reform proposals, primarily trade-driven, that sought significant change. The post-1992 payments would, subject to limited exceptions available to member states, be replaced by a 'single payment system'. Eligibility would be independent of current activities, decoupling further the post-1992 payments and making them Green Box-compatible. This, as with Pillar II, would strengthen the EU negotiating position in the ongoing Doha talks. This reform is analysed by Alan Swinbank (see this volume) and is not discussed further here. In conclusion, however, Figure 5 indicates how far the CAP reforms described here have restructured overall CAP spending by policy instrument.

APPROXIMATE LOCATION OF FIGURE 5

The Making of CAP Reforms

The foregoing reveals both the Council (the member states) and Commission as key players in CAP reforms. This section considers this further, although a full analysis of

theories of policy-making is beyond the scope of the present article (see, *inter alia*, Swinnen 1994; Van der Zee 1997; Wallace, Wallace and Pollack 2005; Pokrivcak *et al* 2006) It is a feature of EU decision-making that only the Commission can formally propose legislation, although the genesis of policy ideas may be elsewhere (see Princen 2007).

CAP reforms tend to occur at times of budget or trade pressures. Article 211 of the Treaty (formerly 155) gives the Commission the task of ensuring the provisions of the Treaty are applied; including the balanced budget rule (Article 268, formerly 199). Moreover, in trade talks, the Commission negotiates on behalf of the member states, albeit to a mandate determined by the latter. This makes the Commission uniquely well placed to understand the pressures, budget or trade, that the CAP may face. Indeed, even if a reform appears to occur without immediate trade pressure, such as in 1999 and 2003, the reforms agreed offer two advantages: greater EU control over the reform agenda, rather than responding to external pressures; and shaping the CAP to allow the EU to take more of a leadership role in trade talks.

Subsequent to the Blair House Accord, some member states sought the 'renegotiation' of an agreement they said went beyond the Commission's negotiating mandate, when they reached agreement on export subsidisation, domestic subsidisation and market access separately. The revised agreement, agreed immediately prior to the conclusion of the Uruguay Round talks, tweaked elements of the earlier deal but left this central element unaffected. This outcome can be understood in the light of two factors. First, the move was primarily about re-imposing Council (ie member state) authority over the Commission. Second, the external constraints on the EU prevented reversal of this

element without collapsing the entire Uruguay Round. Indeed, this helps explain why member states have limited scope to amend the Commission's CAP reform proposals generally, if reform occurs under specific pressures.

Vahl (1997) analyses the policy leadership role of the Commission during the Uruguay Round, but his conclusions apply generally (pages 286-291). "The Commission can play a leading role in EC decision-making only if": "it has exclusive powers at its disposal"; "Commission disunity is limited"; "it has the support of at least two large member states"; and "external pressure undermines the position of the most reluctant member state". Not all cases fit exactly into these terms – the 1992 CAP reform proposals were prepared in secret in the agriculture Directorate General partly to limit negative influence from within the Commission (Kay 1998); whilst some factors may be inter-linked – for example the position of France, the 'most reluctant state' on the 1992 reform, was undermined when Germany joined the other 'large member state', the UK.

Vahl provides a useful starting-point for understanding the balance of power between Commission and member states in different reform negotiation contexts. In addition there is also the debate within and between member states. This will be influenced by many factors, of which we focus in this paper on two endogenous to the CAP and related to the distribution of the benefits from price support. As noted above, price support gives farmers an incentive to increase output. This affects their demand for inputs which will, in turn, affect their price. This is seen most clearly in the land market, where supply is inelastic and where not all farmers own the land they farm.

APPROXIMATE LOCATION OF FIGURE 6

In a simple Ricardian model land is fixed in supply and has no value other than for agricultural production. The opportunity cost is zero and any return to land is simply rent. As Figure 6 shows, with fixed supply of land Q and demand for land D_1 , the equilibrium price of land is P_1 . Price support increases the demand for land, to D_2 , as the returns to agricultural production rise. The price of land thus rises to P_2 and landowners have gained from price support. through an increase in wealth, simply by owning land. The rent they earn rises from area $aqbP_1$ to $aqcP_2$.

If farmers are also landowners their wealth will have risen as the value of their assets rises along with the prices for their output. If, however, farmers are not landowners but tenants, they have to pay the landowner rent to farm the land; and rent is directly related to the price of land. As the later rises so does the former. Farmers appear to gain from higher product prices under price support, but they pay higher prices for their inputs – most dramatically so with land. *In extremis*, they might be no better off after the policy is enacted than before because of the impact of price support on input markets. It has been suggested that only 10% of price support goes to farmers in their capacity as farmers (OECD data, quoted in HM Treasury-DEFRA 2005, 12). The HM Treasury-DEFRA paper goes on to argue that direct payments are not much better, quoting studies that suggest only between 10% and 20% of coupled area payments were reaching farmers; the rest was getting capitalised into land prices which then also presents a barrier to entry for new entrants to farming.

One general observation is that extremely little empirical work has actually been done to determine the distribution of the benefits of CAP support from different policy instruments. In this regard the observations of Hill (2008, 14-17) are pertinent. Writing on the dearth of detailed statistics on the incomes of farming households, including incomes earned either off-farm or from non-farming activities, Hill offers several arguments why the demand for such data, seemingly central to the CAP in the light of Article 39, might be lacking. In particular Hill argues (page 16) that a clearer statistical picture might “undermine the general case for agricultural support.”

Price support resulted in all farmers receiving support through high prices. Some countries received greater budgetary transfers as surpluses rose, driven by an increase in output from only some producers (the Commission estimated, in 1991, that 20% of farmers received 80% of support). This, in turn, established interests for and against the *status quo*. Unlike the general question of whether or not the CAP should be reformed this debate, constrained also by the pressures discussed in earlier sections, allowed the CAP to be reformed whilst CAP spending was maintained. Could the CAP be reformed, however, without undermining fundamentally the distribution of transfers? The reform described in Figure 4 managed largely to achieve this, as the value of the direct payments were based the depth of the price cuts. The distributional effects for most countries were, given the extent of the reform, remarkably modest (Ackrill *et al* 1998).

As noted in the introduction to the paper, technical progress is an extant objective of the CAP along with farm income support. Figure 1 shows that price support increases the demand for productivity-improving technologies, and thus returns to innovation in

agribusiness. as Figure 6 describes, however, it is the owners of land (who may or may not farm) who benefit from the CAP price support system's incentives to increase production. These distributional characteristics of the CAP created over time a constituency of landowners and agribusiness opposed to price cuts, alongside certain farmers and member states. Moreover even with changes to policy instruments, there has been continuity in the distribution of policy transfers.

The paper identifies key shifts in the external and internal institutional context which mediates the budgetary and trade consequences of the CAP. In particular, the spillovers from the price support system come into conflict with the trade institutions introduced after the Uruguay Round and new EU budget management procedures after 1984. The conflicts and tensions between the trade and budget effects of the CAP and these new institutions have resulted in episodic EU crises, characterised by a widespread sense that 'something had to be done'. This is one way of understanding the notion of binding pressures used in this paper. Importantly, however, we should avoid labelling these pressures as mechanical and deterministic. As set out in historical detail, even at the moments when the consequences of the CAP were creating grand pieces of political theatre in Brussels and elsewhere, reforms, though accommodating binding pressures, were still influenced by interests heavily invested in a CAP support system that has its roots in price support.

Conclusions

2008 marked fifty years of the Common Agricultural Policy. In the latter part of its first half-century, however, it has undergone significant change, in response to pressures largely endogenous to the principal support instrument chosen in 1958 –

price support. This created a policy that distorted trade and generated ever-growing budget costs. This paper has charted the development of these pressures for change alongside the institutional context of international trade and EU budgetary policies, for it is in the interaction of policy instruments and policy institutions that the timing of policy reforms is best understood.

This is, however, only part of the story. Those same policy instruments also established a particular distribution of financial transfers that, in turn, created vested interests amongst both individuals and member states, for and against subsequent reform. Indeed, with price support affecting farmers' demand for production and productivity-enhancing inputs, both the producers and owners of those inputs gained indirectly from the CAP. CAP reform is not, therefore, a simple deterministic process. The institutional context of different policy instruments was key to determining whether or not a reform pressure was binding, whilst the distribution of transfers and the interests vested in those transfers would result in bitter battles fought over the direction taken by the CAP. Indeed member states, individually and collectively, were central to the reform of the institutions of trade and budgetary policies during the late 1980s and early 1990s.

Reforms to the EU budget placed an ever-tighter ceiling on total CAP spending, whilst reforms in the GATT constrained policies that distorted trade. Since 1992, CAP reforms have reflected these distinct pressures. Constraints have been imposed on the growth in CAP spending, whilst the distribution of that spending across farms of different sizes and activities has remained relatively stable: only the accession of ten new member states in 2004 has threatened the cross-member state distribution of

transfers. Furthermore, transfers are increasingly delivered through policy instruments that have de-coupled support from production. The CAP is increasingly targeting not only measures that reflect growing concerns over quality and safety, but supporting measures that go beyond agriculture to sustain the wider rural economy. The CAP has come a long way in its first fifty years. Ongoing budget and, especially, trade concerns suggest the story of mutual influence and antipathy is far from over, as reflected in the other papers in this Special Edition.

Notes

¹ Since the entry into force of the Amsterdam Treaty, this is now Article 33.1.

² Strictly speaking the GATT had 'Contracting Parties' rather than 'members'.

³ Where a is the full rectangle between j and b.

⁴ In 1988, for example, EC wheat and barley prices were 184% of the world price, for maize it was 170%, for milk 215%, beef 203% and sugar 144%.

⁵ Williams (1997) shows that after the dairy reform, the number of dairy farms dipped only in 1984/85 and 1985/86, whilst income per farm rose throughout the 1980s, measured both in terms of net value added per farm at factor cost and net value added per annual work unit per farm at factor cost.

⁶ The negative number reflects how the valuation of intervention stocks is accounted for. Stocks are sold onto third country markets at P_w – and the book value must be written-down to the expected sale price by the end of the year of purchase into intervention (with that sum paid from the EC budget to the member states). If the final selling price is above this the cost shows as a negative, as the member states must reimburse the EC budget the amount of the excess write-down.

⁷ We now use this term as subsequent events occurred after the enactment of the Maastricht Treaty.

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Figure 1: The Dynamic Effects of Price Support

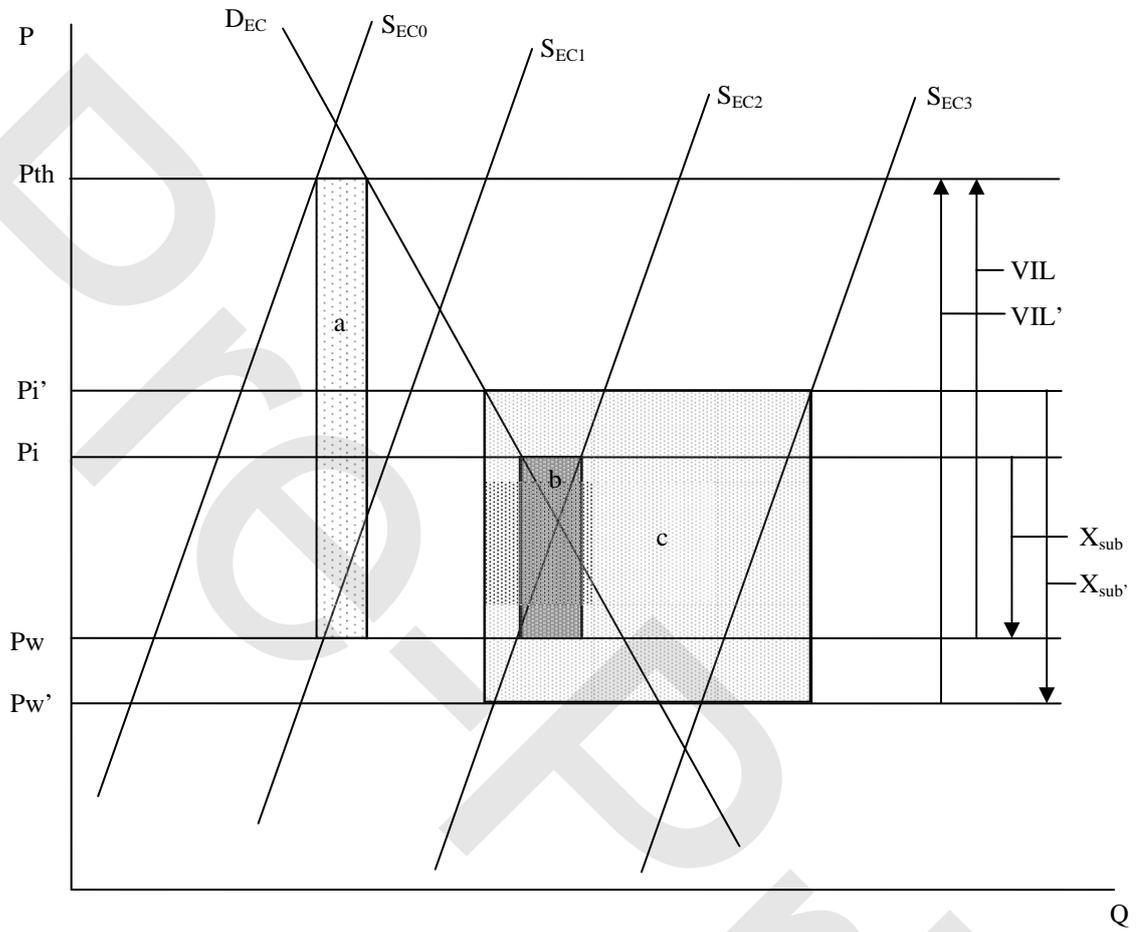


Figure 2: Price Support With Production Quota

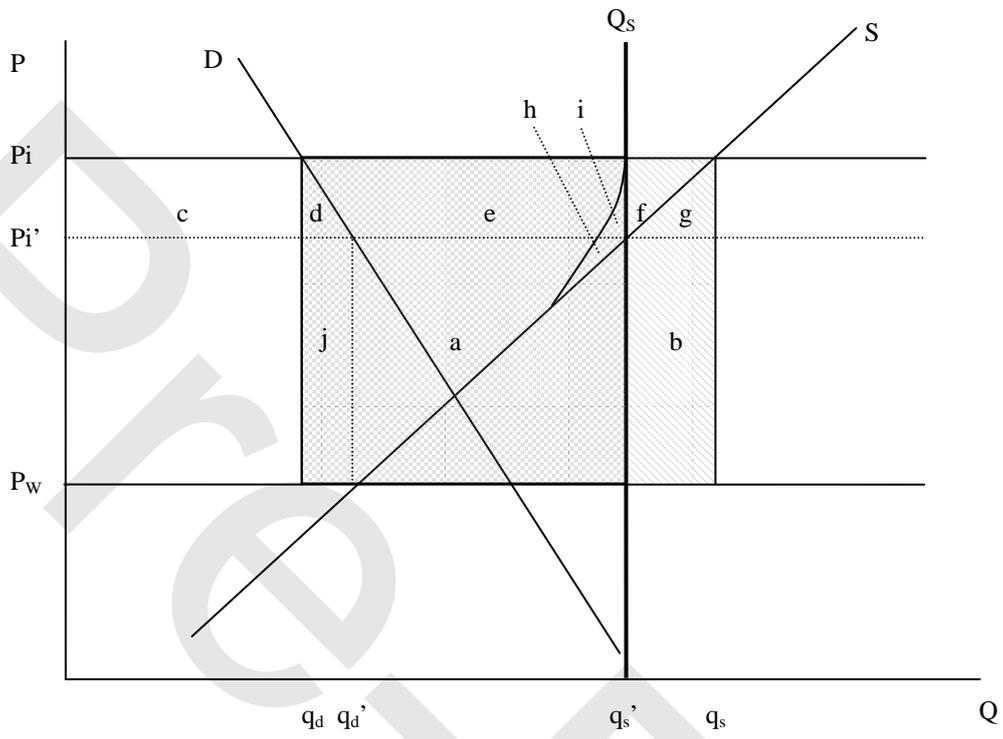
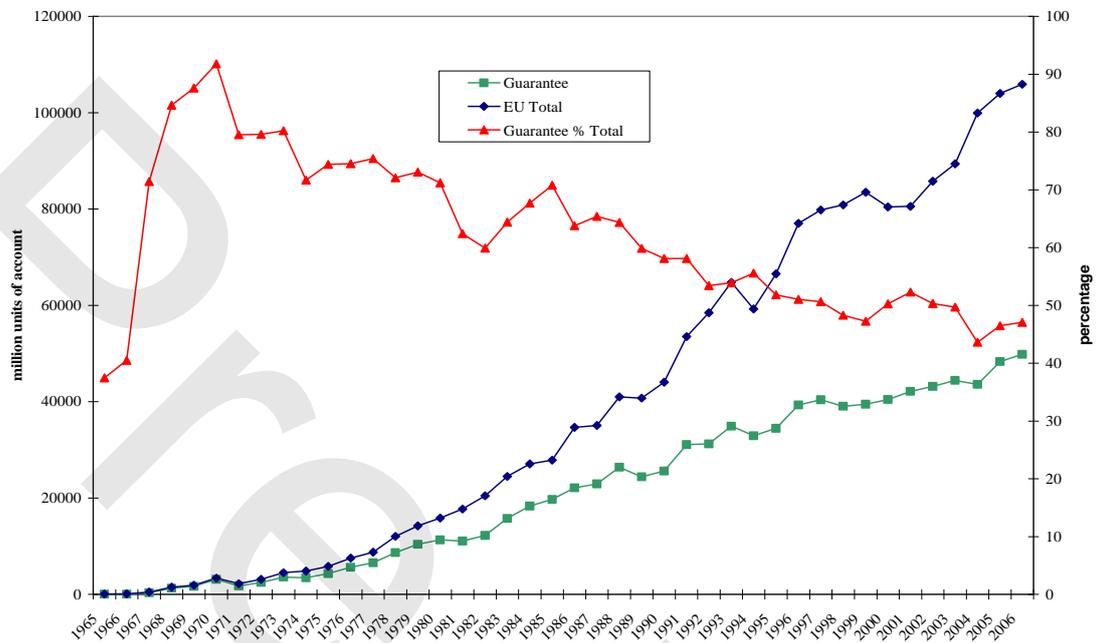


Figure 3: Total EU spending and CAP Guarantee spending, 1965-2006 (million units of common currency; percentage share)



Source: European Commission, 2006; own calculations.

Note: Guarantee expenditures traditionally focused on income support measures.

Since the 1999 reform, some rural development measures also fall under this heading.

Figure 4: Price Support and Direct Payments Compared

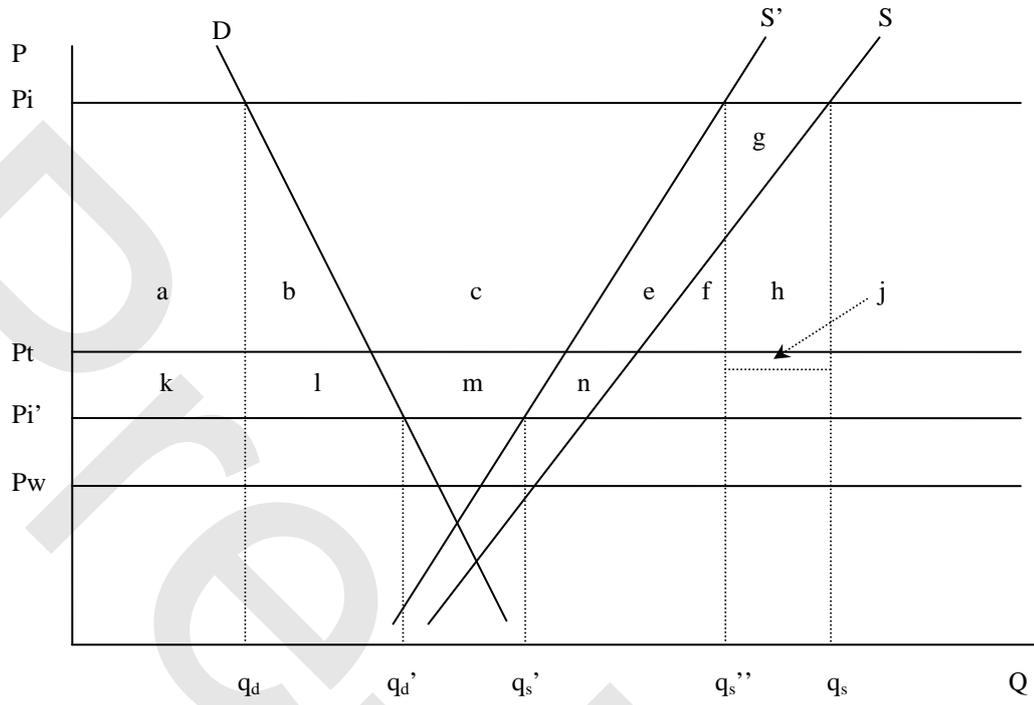
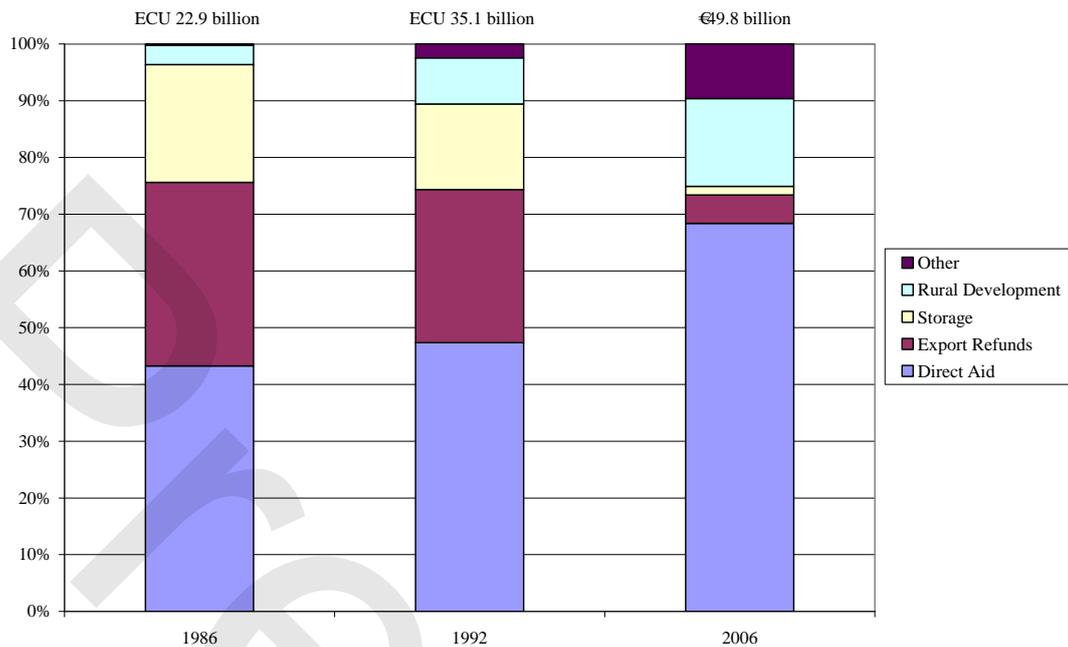


Figure 5: The Changing Structure of Total CAP Spending,



Sources:

1986 – Court of Auditors Annual Report for 1986, OJC336, 15 December 1987, except ‘rural development’, from European Commission, Financial Report 2006;

1992 – Court of Auditors Annual Report for 1992, OJC309, 16 November 1993, except ‘rural development’, from European Commission, Financial Report 2006;

2006 – European Commission, Financial Report 2006.

Note: 1986 and 1992 ‘Rural Development’ spending is actually agricultural ‘structural’ expenditure, included for approximate comparative purposes.

Figure 6: A Simple Ricardian Model of the Land Market

