11

THE COMMON AGRICULTURAL POLICY

Its Operation and Reform

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INTRODUCTION

For a variety of reasons, the European Union (EU) has in recent years become an important focus for economic analysis. The most important development has been the movement towards closer economic integration between the member states of the EU, known as the 1992 programme (see Chapters 7 and 8), and subsequently the debate over even closer links in the future under the Maastricht Treaty (see Chapters 4–6). There has, however, been one policy operated by the EU for a number of years that has continually put the EU in the public eye – that is, the operation and effects of the Common Agricultural Policy (CAP). This is the means by which the EU provides financial support for its farmers. It has been popularly associated with massive budgetary expenditures and the infamous mountains and lakes of surplus products as diverse as cereals, skimmed milk powder, beef and alcohol.

These problems have, of themselves, caused great consternation and have brought forth a number of attempts to correct imbalances in agricultural production and the resulting rising expenditures. However, these problems have had wider implications. For the success of the 1992 programme, a larger EU budget was necessary to fund larger and new policies (for example, greater regional spending and the expansion of the EU's activities into areas like research and development and new high-technology industries – see, for example, Chapter 14). This had to be accompanied by an effective reform of the CAP in order to ensure the larger budget was not simply swallowed up by ever-expanding support costs for agriculture.

In this chapter, simple microeconomic theory is used to consider the principles underlying the operation of the CAP, the reasons why the levels of surpluses and budgetary expenditures have risen over time as a result and how the reforms implemented to try and control the growth of agricultural output and expenditures have actually operated. The system of support operating up to 1993 will receive particular attention, in order to understand how the problems of the CAP came about and why the reforms implemented prior to the MacSharry reforms agreed in 1992 proved ineffective. Although reference will be made to a number of the different products supported under the CAP, the main reference will be to cereals, because of its importance to farmers across the EU, both as a final product and as an input into other production processes, notably as a feed input into livestock production.

WHY SUPPORT AGRICULTURE?

Most developed economies' governments intervene in agriculture to some degree, with a variety of aims in mind. The two principal motives conventionally stated are: (i) to counter unstable market prices; and (ii) to support farmers' incomes. Taking the question of price stability first, the nature of the agricultural production process means that for most products, arable and livestock, one production cycle lasts several months. Thus, *ceteris paribus*, supply is relatively price-inelastic in the short run.

Moreover, there is a relatively low income elasticity of demand for food, so that in the high-income western economies, a relatively low proportion of income spent goes on food. Thus food takes a smaller and smaller proportion of total consumer expenditure over time. This, coupled with the fact that unprocessed farm products face relatively price-inelastic demand (even when a processed form of the food may face relatively elastic demand), as well as the more obvious point that 'food' in total has no close substitutes, results in farmers facing a relatively price inelastic demand schedule. It therefore follows that, given inelastic demand and supply, changes in either demand or supply will result in proportionately greater changes in the equilibrium price. Moreover, whilst demand tends to be relatively stable over time, supply can fluctuate quite significantly, given its reliance on such external factors as the climate (witness, for example, the high potato prices in Britain in 1976 when the drought of that year cut harvests significantly).

The second point, that of supporting farmers' incomes, stems (at least in part) from the argument stated above, namely that in developed economies demand for food rises more slowly than general demand in the economy as a whole. In addition to this, whilst consumers' expenditure on food is rising over time, this in no way guarantees a rising return to farmers, with the food bought by consumers increasingly being processed (e.g., convenience foods, 'TV dinners', etc.). Thus a larger and larger fraction of total expenditure on food goes on the marketing margin – processing, etc. Moreover, technological progress acts to increase supply over time, by developing higher-yielding varieties of seeds and improved inputs. Coupled to relatively static demand for farmers' products, if not for food in total, the price *faced by farmers* will be driven down over time.

SUPPORT UNDER THE CAP PRIOR TO 1993

During the period under consideration, the EU has used a number of different methods of support, all aimed at fulfilling the aims of the CAP as laid down in Article 39 of the Treaty of Rome. These were and remain (author's emphases):

1 to increase agricultural productivity;
2 to promote the optimum utilisation of factors especially labour;
3 to ensure *thereby* a fair standard of living for the agricultural community;
4 to stabilise markets; to ensure certain supplies; and
5 to ensure supplies to consumers at *reasonable* prices.

The principal method of support involved maintaining a market price for each commodity within the EU which was normally higher than the price in the rest of the world and, moreover, above the equilibrium price. Simple microeconomics suggests that, without further intervention, this policy would result in the price charged being driven down to the equilibrium level. In the particular case of the CAP, there were two ways in which this high price could be undermined and thus there were two distinct, but closely related, policies operated by the EU to protect this higher price.

First, the EU had to protect against cheap imports from the rest

of the world entering the EU and undermining the high EU price (see Chapters 1 and 7 for a discussion of the welfare effects of trade protection). It achieved this by applying variable import levies (VILs) to all imports coming into the EU. These were set by reference to the 'target price'. This was defined as the market price at Duisburg in the Ruhr, assumed to be the place of greatest cereals deficit in the EU and therefore the place with the highest market price. From this were deducted transport costs from Rotterdam (the main point of import into the EU) to Duisburg. This then gave the 'threshold price'; that is to say, the minimum price at which imports were allowed into the EU. Thus the VIL was calculated as the difference between the price of the cereals landing at Rotterdam and the threshold price.

Second, to prevent domestic over-supply from putting excessive downward pressure on the EU price, a system of intervention buying was available for most products. This acted to put a floor in the market, so that when the market price fell below this level, the member states, on behalf of the EU, were obliged to buy in what farmers decide to offer to them for sale, subject to certain requirements such as minimum quality and current stock levels. When the products were sold out of intervention, they normally went for export to third countries. Resale onto the EU market would have undermined the reason for the intervention buying in the first place, namely that of domestic over-supply, by simply adding to that over-supply. This, like all exports to third countries, required a payment to cover the difference between the EU price and the world price – the export restitution payment (though more commonly called the export refund or subsidy, funding the process popularly known as 'dumping'). Note that, for a number of reasons, the unit export refund was generally lower than the unit VIL. This system of protection operated by the EU can be seen in Figure 11.1.

The target price, P_t, is above the threshold price, P_{th}, by the transport costs from Rotterdam to Duisburg. P_{in} is the 'intervention' or buying-in price and P_W is the world price. S_{EU} and D_{EU} are the EU's supply and demand curves for this particular commodity. What these show is that at the institutional prices set by the EU, the EU is a net exporter; i.e., supply is greater than demand at those prices. At the world price, however, the EU is assumed to be a net importer. Because the intervention price theoretically put a

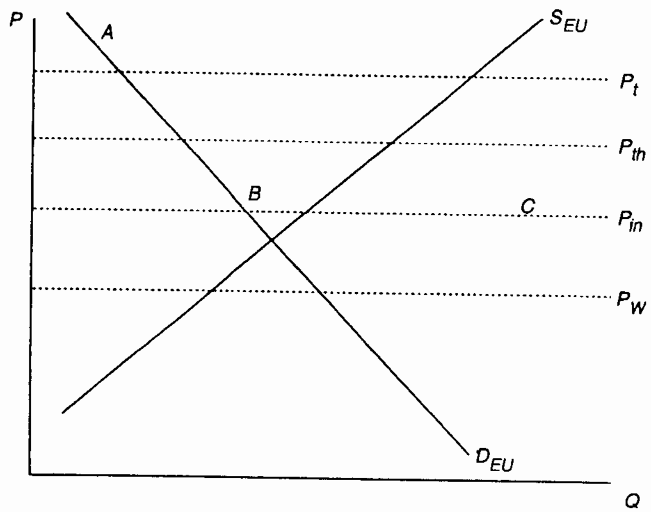

Figure 11.1 The price regime of the CAP

floor in the market, the effective demand curve facing producers is given by *ABC*.

Over time, the EU moved from being a net importer to being a net exporter. Demand for many agricultural products remained fairly stable over time, but technological advances, encouraged by high support prices, continually increased supply. Given a higher unit VIL than export refund, being a net importer meant that this system of supporting agriculture was originally a net income generator for the EU. More recently however, as the EU moved from being a net importer for most products to being a net exporter (the situation shown in Figure 11.1), the cost of supporting agriculture rose. Although the unit VIL was still greater than the unit export refund, a far greater quantity of many products was exported than imported.

This last point also demonstrates that whilst small cereals farmers are often cited as an example of perfectly competitive producers (even ignoring the impact of government intervention on this point), this example is highly questionable. The output of small cereals farmers can be highly differentiated. Thus the EU imports large quantities of 'hard' wheats suitable for milling, whilst simultaneously exporting larger quantities of 'soft' non-milling

wheats – all basically wheats, but very different in consumption and trading at very different price levels on international markets.

As production rose, not only were greater quantities of the surplus products exported, requiring greater expenditure on export refunds, but for most products, greater quantities were also sold into intervention. Thus expenditures rose here as well, to cover the operations involved in moving the products into and out of store, as well as the costs of keeping them there. Therefore, as surplus production rose over time for the reasons set out above, so too did the level of stocks (the 'mountains' and 'lakes' the media have always been so ready to highlight) with the costs of the CAP threatening, *inter alia*, the progress of the EU towards the completion of the internal market in 1992 – a danger highlighted by the Commission president when the Single European Act (SEA) was first agreed upon. We have now established the principles that underpinned EU support to agriculture until 1993 and showed how this led to the emergence of surpluses. By considering the financial implications of dealing with these surpluses, we have also seen how the EU's expenditure on agricultural support has risen over time.

THE ATTEMPTS AT REFORM

Because of the market developments outlined above and the consequent rise in expenditure, by 1984 the EU was, in a technical sense, bankrupt, though the member states provided sufficient short-term injections to ensure the continued functioning of both the EU and the CAP. The fact that these additional payments were made reflected the value placed by the member states on the EU. Rather than let this imbalance in agriculture risk the future of the entire EU, as some commentators suggested a budgetary crisis would, the EU was able to continue functioning. It was apparent, however, that this situation could not continue indefinitely and that, moreover, simply providing more money would not solve the problem, since if the CAP were left unchanged, the extra money provided would simply go straight into agricultural support.

Thus in 1984 an attempt was made to secure both extra funds for the EU budget as a whole, while at the same time trying to control the amount spent on agricultural support via rules on 'budgetary discipline'. The formula agreed was one which set an informal limit equating the growth of agricultural expenditure to total EU expenditure. The agricultural price decisions (i.e., the setting of the target price, the threshold price and the intervention price) were to be taken so as to respect this lower growth in agricultural expenditure, but there was no legally binding mechanism to guarantee that the expenditure guidelines were respected. In practice, the measures simply failed, as the price decisions taken left no chance of total expenditures falling below total revenues. The lower real prices paid to farmers were intended to slow or halt the growth in agricultural production, but the decisions taken were insufficient to outweigh the effects of steadily improving technologies and so extra payments were needed from the member states in 1984 to 1987 as production, and hence costs, kept rising.

THE 1988 REFORMS

In February 1988, the European Council took the decisions that tightened the budgetary discipline guidelines referred to earlier and made them legally binding. It was, however, a time when certain external (and internal) factors were also coming to the aid of the EU. Principally, there was a drought in the United States during the summer of 1988. International cereals prices tend to be determined by US domestic policy, since it is the dominant supplier to the world market. Thus the large fall in US output caused by the drought led to a sharp rise in world cereal prices and so savings by the EU on unit export refunds. Also, the seemingly inexorable rise in nominal EU support prices began to slow. Support prices had been increased very dramatically during 1980–81. Indeed, for the first (and only) time, the prices increased in real as well as nominal terms. Since then, however, the real price had fallen. Indeed, the automatic increase in the nominal price every year had become a thing of the past, with the target price and the intervention price being frozen in nominal terms during the mid- and late-1980s.

Increases in production have been driven by yields, rather than area planted, for some time now. Thus the effect of measures such as 'set-aside', whereby farmers receive a financial inducement to take land out of the production of certain surplus crops, was always going to be debatable (especially as only around 1% of the total arable area was set aside each year). For example, with cereals the area planted has been in secular decline for many years, but rising yields have outweighed this effect, resulting in steadily rising production.

In addition, reform measures known as 'stabilisers' were passed at this Brussels summit. The principal weapon was an automatic cut in the intervention price whenever production exceeded a particular level, known as the Maximum Guaranteed Quantity (MGQ). This, *ceteris paribus*, also cut the per-unit export refund. This price cut to farmers, it was also hoped, would slow down the rate of growth of agricultural production – i.e., slow down the rate at which the supply schedule shifted to the right over time. Coupled to this agreement was an increase in the EU's 'own-resources' (i.e., total revenues), which was felt necessary to fund the policies needed to achieve a single market by December 31, 1992, and extend the number of common policies operated by the EU.

AN ASSESSMENT OF THE REFORMS OF THE 1980s

The foregoing discussion of policy reforms suggests that, although the EU introduced a number of ways of trying to control agricultural production and resultant expenditure, perhaps the most significant feature to note is that the underlying principle of high prices (i.e., prices maintained well above their world levels) remained unaltered. Reform simply consisted of a gradual lowering of this price, in the hope that farmers would respond by producing less, therefore yielding savings to the EU budget. If one considers the experience of the EU's cereals sector, however, it can be seen that this path would prove to be ineffective. Calculations by this author suggest that between the early 1970s and 1989, the real price paid to cereals farmers in the EU roughly halved. During this same period, the total area planted to cereals in the EU fell by around 4–5%. Yet despite these two effects, total cereals production in the twelve member states rose by approximately 33%.

These figures show that the EU's reform policy of gradually cutting support prices paid to farmers in order to correct market and financial imbalances would not work. The reason can be seen quite clearly in Figure 11.1. Whilst the levels of the different support prices were changed over time, those changes were too small to have any significant effect on production and expenditure levels. The intervention price *was* cut, but it was always chasing a moving target, as the steady increase in excess supply pushed down the world equilibrium price.

This point is further evidenced by the market events of late 1990 and early 1991. Following the reforms of 1988, CAP expenditures did fall, but this was against the background of the drought in the United States. Most commentators felt that the cause of the expenditure cut was the drought, rather than the stabiliser reforms. Their prediction was, therefore, that once world production rose (with production in the United States returning to 'normal' levels and production elsewhere responding to the higher world prices realised in 1988), CAP expenditures would once again rise. This process started in earnest in 1990, with rising surpluses in a number of sectors and increasing quantities of products going into store and for export. Official stock figures (taken at the end of the accounting year) indicate that the previous highest level of cereals intervention stocks in the EU occurred at the end of 1985, when the figure was 18.5m tonnes. The data indicate that, by mid-1993, cereals stocks had risen to about 29m tonnes – i.e., *considerably* above the level of the mid-1980s.

In addition to the cereals sector, a number of other sectors faced major difficulties. Among those was the beef sector. Here, however, the causes of the problems were somewhat different. First, there were large quantities of cheaper beef 'entering' the EU from the former East Germany, resulting in more producers in the rest of the EU trying to sell their beef into intervention. Second, in Britain in particular, demand was affected by the BSE 'mad-cow disease' scare, causing producers to increase their 'demand' for intervention, as 'market' demand fell.

From all of this, it can be seen that attempts at reform failed *de facto*, because they in no serious way altered that fundamental underlying method of support under the CAP. Those 'adjustments' that were made can be seen to have failed to address the imbalances in both the product markets and also in the budgetary expenditures incurred.

A RADICAL REFORM OF THE CAP

The discussion so far therefore begs the question of what sort of reforms could be implemented that would succeed in containing the growth in production and support expenditure. What is set out now is a consideration of the MacSharry Reforms agreed upon in May 1992. The MacSharry Reforms represent the most radical changes in the CAP ever undertaken. The reason for this is that,

for the first time, the basis for support has been changed fundamentally. Over a three-year transition period, the selling price of farmers' output will fall, with farmers being compensated for this with direct government payments. Additionally, all who produce more than 92 tonnes of cereals (calculated at average historical regional yields rather than actual yields, *ex post*) must set aside 15% of their arable land (defined as the area of land on which they grow cereals, oilseeds and protein crops – peas, beans and lupins – and also land that was set aside under the schemes agreed upon in 1988).

The larger farmers are not compelled to set aside their land, but if they do not, they will not be eligible for the compensatory payments which offset the lowering of the selling price of their output. This is the first time 'cross-compliance' (i.e., having to satisfy a pre-condition before being eligible to receive support) has played a major role in the operation of the CAP. By setting aside land, these larger farmers then also become entitled to claim compensation for that obligation as well. In all cases, the per-unit level of compensation is initially stated as a sum per tonne of production. The *actual* payment, however, is now based on area, so the per-unit or per-tonne compensatory payment must be multiplied by the average regional yield figure, in order to establish the sum paid. It must also be noted that this 'base' yield figure is not the actual current yield, but the average of the yields over the period 1986–90, excluding the highest and lowest figures. Thus support is now based on area planted rather than the level of production, unlike the old system of support. The principle is best illustrated by a simple example.

The new versus the old regime

To illustrate the difference between the two regimes, suppose a farmer has 100 hectares planted to different cereals, oilseeds and protein crops. He must now set aside 15% of this area (i.e., fifteen hectares) and farm only 85 hectares. Suppose also his average base yield is five tonnes per hectare. With a per-unit compensatory payment of ECU 45 per tonne, he is eligible for a per-hectare payment of (ECU 45 × 5 =) ECU 225. This is payable on the 85 hectares that he is allowed to plant and thus he receives, for this area of his farm, a total compensatory payment of (ECU 225 × 85 =) ECU 19,125. In addition, he can claim compensation for having to set aside 15 hectares of his land. This is compensated at a rate of ECU 57 per tonne. Thus, he also receives a per-hectare set-aside compensatory payment of (ECU 57 × 5 =) ECU 285, giving total set-aside compensation of (ECU 285 × 15 =) ECU 4,275. The farmer thus receives total compensatory and set-aside payments of ECU 23,400. In addition, he will also receive the revenue from selling his crop at the (lower) market price. Assuming the producer price continues to follow the level of the intervention or buying-in price, this will be ECU 100 per tonne. He is producing on 85 hectares at five tonnes per hectare, which gives him a total revenue of ECU 42,500. Thus, he has a total income of (ECU 42,500 + ECU 23,400 =) ECU 65,900.

Under the old system, in contrast, the price received by farmers also tended towards the level of the intervention or buying-in price. This was approximately ECU 155 per tonne. He would, however, be producing on all his 100 hectares. Thus, the same farmer under the old regime would sell his crop for (ECU 155 × 5 × 100 =) ECU 77,500. The hypothetical farmer is therefore worse off under the new system by ECU 11,600. This calculation, however, only looks at income and thus excludes costs incurred in production. One way in which a farmer could make savings is via the lower use of variable inputs such as fertilisers and pesticides. Under the new system, the yield figure (here taken as five tonnes per hectare) is based on past yields, *not* current levels. Thus, whilst a lower use of such inputs may cut current yields, this would not affect the calculation set out above. Hence, savings on purchased inputs may be made.

In terms of the effect on production, economists predict that the growth in output will be affected. The large fall in crop selling prices will be most influential in this. Over the space of the three-year transition period, the drop in nominal selling price will be about ten times the average annual price cut under the stabiliser mechanism. Moreover, there will be a much larger area of land taken out as set-aside. Under the schemes agreed in 1988, the area came to approximately 1% of all arable land. Under MacSharry, however, allowing for small farmers who are exempt from set-aside requirements, about 9% of all arable land will be removed from production. One forecast (see Ackrill *et al.*, 1993) suggests that by 1999 production may be at least 15–16m tonnes per annum lower under MacSharry than had the old stabiliser system continued.

Regarding the control of production, therefore, it appears that

the new policy could be relatively successful. The main grey area surrounding this forecast remains 'slippage'. This occurs when the cut in area planted is not fully represented in the cut in production. Whilst it has been suggested that farmers could cut the use of inputs and therefore cut production more than proportionately, it is also conceivable (based on years of experience in the United States) that farmers could farm their remaining 85% of land more intensively. This would push up average yields and reduce the effects of set-aside on cuts in production. Thus a net 9% cut in area may only result in perhaps a 6–7% cut in production.

For consumers, there is generally modest and qualified good news. As noted earlier, there is an increasing element of processing going into food nowadays and it is unlikely that the price cuts under MacSharry will make any serious difference to the marketing margin. Thus whilst food processors will be paying less for their raw material inputs, their other costs are unlikely to change and so the net effect on the price of food in the shops is likely to be modest at best.

The third main group in the analysis – i.e., the taxpayers who pay for the EU budget via their domestic tax contributions – are also likely to suffer. The costs incurred in paying for export refunds and intervention storage are expected to fall significantly under MacSharry. Estimates put the savings at about ECU 2.4bn by 1999 (see Ackrill *et al.*, 1993). The problem, however, is that the budget must now pay for the difference between the price paid by consumers of the farmers' production and the final sum received by producers; i.e., the total compensatory payments. Ackrill *et al.* (1993) estimate that this figure could exceed ECU 7bn by 1999. Other estimates have put the figure even higher.

There are, however, two possible gains for the EU with the expenditure under the new system, even though total expenditure is likely to rise. First, the bulk of the expenditures (the two forms of compensation payments) will be much more stable and predictable than the expenditures on export refunds and intervention storage. This gives an advantage to the EU in trying to predict the level of own resources needed in any year to cover total expenditure plans. Second, the total expenditure arising from CAP support will now be much more directly under the control of the EU. It was shown earlier how cutting support prices had no significant effect on production and budget costs. Now, however, by cutting the per-tonne level of the compensation payment and/

or set-aside payment, the EU can realise immediate and significant savings. Estimates suggest that, for 1997, a one-off cut on the levels of the two compensatory payments of ECU 5 per tonne would result in budget savings of between ECU 750m and ECU 800m (Ackrill *et al.*, 1993).

THE CAP AND GATT

It is also worth referring in this discussion to the international pressures that have helped, albeit only indirectly, in shaping the new CAP. The EU and its member states are all members of the General Agreement on Tariffs and Trade (GATT). Within the recently concluded 'Uruguay Round' of trade negotiations sponsored by GATT (1986–93), there was great pressure on the EU from the United States and the 'Cairns Group' of agricultural free-traders, which all want the EU to reduce its support for agriculture because of the trade-distorting effects such intervention has – notably the use of export refunds, which depress the world price and permit the EU to compete, unfairly as these other countries perceive it, in export markets.

Considering the MacSharry Reforms detailed above, it can be seen that these will reduce the trade distortion resulting from the CAP since they will cut the market prices of agricultural products within the EU to levels much closer to world prices, thereby requiring much lower export refunds on trade. Indeed, if world prices were to rise by about 15–20% for whatever reason, then such a strong market would mean that the EU would be able to export without subsidy. It is, however, worth examining the commitments that might be asked of the EU in more detail. If the CAP reforms outlined above do not achieve these requirements, further changes to agricultural support in the EU will be necessary. Ingersent *et al.* (1993) sets out in detail both the proposals contained in the 'Dunkel Draft' paper of 1991 and also the amendments contained in the bilateral Blair House Accord, agreed between the EU and the United States late in 1992. In brief, the key issues as outlined in the Dunkel Paper are:

1 to improve market access by tariff reductions. These were to be reinforced by specific minimum import figures for each year;
2 to reduce domestic support by 20%, this to be applied to all supported commodities. In this process, credit is given where

reductions in support for a commodity have occurred since 1986. In addition, support policies that create little or no trade distortion (so-called 'green-box' policies) are to be exempt; and
3 export volumes are to be cut by 24%, with budgetary expenditure on exports being cut by 36%. Both requirements relate to each commodity individually.

The CAP reforms of 1992 unquestionably made the possibility of a multilateral GATT agreement more likely and the purpose of the subsequent bilateral talks was to try to iron out specific concerns between the EU and the United States. Included in this was an attempt to finally resolve the long-standing disagreements between the EU and United States over the EU's support policy for oilseeds (now incorporated into a broader 'arable' regime under the MacSharry Reforms). The Blair House Accord amended the issues outlined above in a number of ways:

1 on market access, the EU was permitted to retain 10% Community Preference. Community Preference has always been a key pillar of the CAP and in practice this now means that the EU would be able to retain a tariff on imports of 10%;
2 on domestic support, the EU got the United States to recognise the new area and headage payments as 'green-box' support instruments, even though they are not fully 'decoupled' (i.e., not fully independent of the level of production);
3 on exports, the 24% volume reduction figure was lowered to 21%. This applies to *all* exporters; and
4 on oilseeds, the EU agreed to a minimum figure of the 15% set-aside requirement that should come from areas planted to oilseeds. The purpose of this is to contain oilseed production within the EU to 10m tonnes.

In the end, an agreement was reached between the EU and the United States in early December that permitted a full GATT agreement to be completed on December 15, 1993, the deadline date for the Uruguay Round. To a great extent, the final deal accepts the proposals from the Blair House Accord, although with a few noteworthy amendments. In accordance with the earlier proposals, domestic support is to be cut by 20%, with the agreed exemptions for 'green-box' policies. In addition, subsidised exports are to be cut by 36% in value and 21% in volume.

There is, however, an important change to the base against which this cut is judged. As agreed between the EU and the United States immediately prior to the conclusion of the Uruguay Round, the base period is to be changed from the average of the period 1986–90, to the average of 1991–92. In practical terms this means that over a six-year period, the EU will be able to export an additional 8m tonnes beyond the limit had the earlier base period applied. Finally, it was agreed that all import barriers are to be converted to tariffs or tariff equivalents and reduced by 36%. This relates to the simple mathematical average of all tariffs – each individual tariff must be reduced by a minimum of 15% over the six-year period. It is estimated that world prices will rise by up to 10%, resulting in gains to the EU in terms of lower unit export refunds (important in terms of the required 36% reduction in export refund expenditures).

One feature of this reform package is that it asks countries to reduce domestic support and address trade issues (notably, market access and export competition). Both the EU and the United States have now made significant changes to their domestic policies and further major cuts would be politically very difficult. It needs to be considered, however, if further changes to the CAP will be needed in order to meet the requirements of the GATT agreement. Considering first the 20% reduction in domestic support required, this has already been met, aided by the classification of new EU support measures as 'green box'.

With regard to the trade measures, things are rather less clear-cut. A number of studies have been carried out to see if the MacSharry Reforms of the CAP would actually result in the EU being able to meet the requirements of the GATT agreement without further changes. The results are dependent on the assumptions made about the affects of price cuts on, *inter alia*, production and consumption and hence on the exportable surplus. Some studies feel that for cereals, the new EU regime will lead to the GATT commitment being met, whilst others feel further change would be necessary. For beef, however, there appears to be more general agreement that further changes would be needed. Work by Rayner *et al.* (1993) perhaps summarises the work best by showing that, for cereals, the result is very much on a knife-edge. It is suggested that for the period 1998 to 2000, the EU may well breach the subsidised export volume limit. If, however, the world price were to rise, it may be feasible to export some cereals without refund, thus meeting the requirement concerning *subsidised* exports.

A few straightforward ways in which the EU could, if necessary, match the GATT obligations are:

1 to increase the set-aside requirement, by either or both of increasing the set-aside percentage for farmers already setting aside land and reducing the exemptions for small farmers (either by reducing the ceiling for a farmer to be exempt, or requiring all 'small' farmers to set aside a low percentage of land); and/or
2 to cut intervention price, thus lowering the internal price. This would reduce the per-unit export refund and could ultimately lead to the abandonment of subsidised exports; and/or
3 to subsidise exports up to the ceiling permitted and export the rest without subsidy (such as occurs in the EU's sugar sector currently); and/or
4 to store the extra quantities if, for 1998–2000, the EU is unable to meet its GATT obligations by the above means. Given the budgetary reforms implemented since 1988, however, this could only ever be a short-term palliative.

One point here is that an implicit assumption is made about the conditions in the rest of the world remaining unchanged. As was seen in 1988 with a drought in the US mid-West, changed circumstances elsewhere in the world could affect the EU's position quite dramatically, for the good in the case of such a drought with budget savings and greater export opportunities. It could be negative, however, if, for example, a major grain importer were to purchase less grain and the supplies they would have bought then needed to find a new market elsewhere. This has often meant larger subsidies being used, driving down the world price and increasing the EU's unit export refund.

Overall, therefore, it can be seen that the various reforms implemented unilaterally by the EU and multilaterally by GATT are to a large extent compatible. For the key cereals sector, some of the support reductions asked for by GATT have already been met by the EU. Other reductions meeting the GATT obligations will, to a large extent, depend on variables outside the control of the EU. Even if these work against the EU, it is suggested that it would be straightforward to amend the CAP as it now stands ('reform' is perhaps too strong a word) so that it will become compatible with GATT.

CONCLUSIONS

Since its inception, the CAP has been a cornerstone of the operations of the EU. The policy has, however, generated much political and economic discussion over the way in which it operates. It has been shown that the method of support used under the CAP since its inception was instrumental in generating the much publicised surpluses of agricultural products and also creating financial crises for the EU. Both outcomes are shown to be entirely consistent with simple microeconomic theory.

Although it was 'reformed' throughout the 1980s, the policy was, in essence, the same as when it was instituted over 30 years ago. It has also been shown that the 'radical' reform of the CAP agreed upon in 1992 will help to contain production and therefore intervention storage and export refund expenditures. The EU budget will, however, have to face the significant added burden of the compensatory payments agreed in 1992. These are effectively comparable to the 'hidden' transfers from consumers that occurred under the old support system, but now, coming from taxpayers, they are quite 'visible'. Consumers may be a little better off, although only marginally, and it is suggested that producers may be better or worse off, depending on specific circumstances, although it is also indicated that larger farmers, like many in Britain, may well be worse off. Taxpayers, it is suggested, will also be worse off, because of the extra cost incurred with the compensation payments.

Future further changes to the policy will depend to a great extent on whether or not the reformed CAP is able to meet the EU's international obligations determined during the Uruguay Round of the GATT. It has been suggested here that even if the new CAP cannot meet these without further change, for some sectors at least, notably cereals, the additional changes needed will not be significant and could be met by simple adjustments to the policy variables under the reformed CAP.

12

JAPANESE FOREIGN DIRECT INVESTMENT

The Impact on the European Union

George Norman

INTRODUCTION

The past decade has seen a remarkable transformation in trade and direct investment flows, particularly between the developed economies, but also between the developed economies and the newly industrialising nations. This transformation has been characterised by a particularly rapid growth in foreign direct investment (FDI). Over the period 1983–89, the outflows of FDI grew at an annual rate of approximately 29%, more than twice as fast as the previous decade and three times faster than the growth of world exports and the growth of world output (see Table 12.1). There is an intensified effort on the part of most countries to attract this investment. Transnational companies are emerging from the developing countries as well as the developed economies and they are increasingly adopting an explicitly global strategy in many of their business activities.

This implies: (i) that FDI is likely to become the dominant method for international economic integration; and (ii) that multinational firms will produce an increasing share of world output. It

Table 12.1 Growth of foreign direct investment, exports and gross domestic product, 1973–89

	1973–83 compound annual growth rate (%)	*1983–89 compound annual growth rate (%)*
World FDI	13	29
World exports	12	9
World GDP	8	8

Source: Dunning (1988), United Nations (1991), OECD.