

# Rural Policy Lessons for the CEEC from Other Regional Integration Agreements

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## *Introduction*

The aim of this paper is to identify lessons from Regional Integration Agreements (RIAs) that might be useful for the formulation of rural policies in the Central and Eastern European Countries (CEEC) as they develop their own regional trade groupings, the Central European Free Trade Area (CEFTA) and the Baltic Free Trade Area (BFTA), and prepare themselves to join the European Union (EU). The intention is (a) to flag particular problems that other countries have found in the incorporation of agriculture in free trade areas and customs unions, so as to assist the CEEC in avoiding such problems and (b) to identify areas where regional integration in agricultural markets has been beneficial to the countries concerned, so as to promote similar benefits in the CEEC. The specific RIAs discussed in the paper include six from the Americas, the Andean Pact, the Common Market of the South (MERCOSUR), the Central American Common Market (CACM), the Caribbean Community (CARICOM), the Canada-US Free Trade Area, and the North American Free Trade Area (NAFTA), and two from Europe, the European Union and the European Free Trade Association (EFTA).

The main policy objective of the countries in the region is that of accession to the EU and full integration into the European single market. But this path has a few twists in it which make it unique. One is the trade relationship among the CEEC themselves. This gives rise to a set of issues concern the treatment of agriculture in the Central European Free Trade

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Area and the Baltic Free Trade Area. To the extent that these free trade arrangements are temporary devices to prepare the way for EU membership these issues could of course be subsumed under the heading accession policy. But they can also be seen as policies in their own right which can be judged regardless of the date of EU entry or even of whether such entry will take place. For this reason the paper will focus on the lessons from other RIAs which relate to the treatment of agriculture in these two CEEC trade agreements, as well as touching on the issue of regional agreements as a prelude to EU membership.

The paper does not however attempt to judge whether CEFTA and BFTA are desirable in themselves. This question involves much more than agricultural trade and rural policy. It is assumed that the formation of these free trade areas is an accepted part of the strategy of these countries. The emphasis is on the impact on rural policy of integrating sub-regional agricultural markets in advance of or as a temporary alternative to full EU membership. Similarly, the paper does not attempt to assess the desirability of EU membership *per se* nor does it purport to lay out elements for a negotiating position for the CEEC in their discussions with the EU.

The structure of the paper is as follows. The first section deals with the general issue of the treatment of agriculture in regional trade and integration agreements. The experience of the main RIAs in this regard is summarized. Differences as well as similarities are noted, and the linkage between trade agreements and domestic policy is explored. The second section focuses on the steps that the CEEC have taken toward regional trade agreements and the incorporation of agriculture. A third section discusses the individual issue facing the CEEC in developing these regional agreements, and applies lessons where appropriate from the other agreements. A fourth section brings together some conclusions. Details of the agricultural content of the existing regional agreements are given in two Annexes, the first dealing with the Americas and the second with Europe.

## **1. Treatment of Agriculture in RIAs**

Agriculture is treated in various ways in regional trading blocs and free-trade areas. In a few cases it is ignored, as if not really subject to the same political and economic pressures as other sectors. In a few cases it is treated as a regular sector of the economy, and subject to the same rules. In most cases, agricultural trade is partially included, as countries have trodden carefully in framing free-trade areas so as to preserve as much as possible of the domestic autonomy of farm and food policies. Nevertheless the agricultural sector is profoundly affected by the existence of free trade with neighboring countries. There will be opportunities for as well as additional pressures for change and adjustment in the sector. Countries can choose to allow national rural policies to change to take advantage of possibilities that freer regional trade brings, or can resist such change until those policies are modified by market pressures or collapse under their own weight.

There are four major reasons to include agricultural commodities in the provisions of an FTA. Firstly, exporter members within the region will want improved access to importer markets for their agricultural goods. An alliance among food-importing countries may be able to ignore intra-bloc agricultural trade for some time, but even in this case there will be some sub-sectors who wish to export to the partner country. Secondly, food cost differences among countries within the RIA, arising from different agricultural prices, will both distort trade and investment patterns and cause problems of wage comparability. Such cost differences will eventually become a cause of contention between the partners. Thirdly, if agriculture is excluded from the free trade provisions the food sector will tend to remain national in scope, as a result of different raw material costs and regulations, and may not be internationally competitive. And lastly, to exclude agriculture from free-trade agreements leaves countries open to challenge under the WTO. Article XXIV of the GATT (incorporated in the WTO) requires that such agreements cover essentially all trade among the partners. Though this requirement has never yet been defined, one can assume that omitting an important sector of the economy would make the RIA vulnerable

to challenge. Moreover the trend is towards more strict interpretation of this provision to prevent the fragmentation of the trade system.

There is in essence only one reason why governments have sought to exclude agriculture from the provisions of a free-trade area. Most domestic agricultural price policies require protection at the border in order to be effective. As a consequence, free trade poses a threat to the operation of such programs. One would expect import-competing sectors to resist the spread of free trade areas as providing more competition on the domestic market. However regional trade pacts tend (with the partial exception of the early Latin American agreements) to cover all goods except those specifically excluded as a policy decision. This obviates the need for the government to convince each individual sector that they should be included. But when the market is largely determined by government regulations the issues cannot be so easily ignored. Negotiations on freer trade are indeed likely to be complicated by domestic farm policy considerations. Politicians are often tempted to take the easy way out when faced with negotiating improved regional access to domestic agricultural markets controlled by policies. However, the changes in domestic policy in recent years away from the management of agricultural commodity markets in favor of direct payments to farmers has removed many of the obstacles to the incorporation of agriculture in RIAs. This has been reinforced by the decision in the Uruguay Round of trade negotiations to convert non-tariff import barriers to tariffs.

The dilemma facing policy makers when faced with the question of the treatment of agriculture in RIAs is well illustrated by the European experience. When the European Economic Community was established, agriculture was included fully in the aim of free internal trade. The exporting countries insisted on this, as a part of the bargain that allowed them to open up their industrial markets. In the treaty establishing the European Free Trade Association (EFTA) in 1960, however, agriculture was left out. With the exception of Denmark, which got some bilateral concessions in the British market, no member was an agricultural exporter. The EFTA-EC bilateral trade agreements (1973), again left agriculture out, as no EFTA preferences were being eroded by accession of

Denmark and the UK to the EC. In the more recent negotiations leading to the creation of the European Economic Area (EEA) in 1992, agriculture was also largely left out of the free trade area between the EU and EFTA. With membership of the EU by three EFTA countries in 1994 the integration of their agricultural sectors could no longer be ignored.

The various Latin American free-trade agreements in the past focused mainly on industrial products, and agricultural trade was not considered an engine of growth. In contrast the new generation of more open agreements include provisions for agricultural trade liberalization. Thus MERCOSUR, the Andean Pact, the Central American Common Market (CACM) and CARICOM all have free trade in agricultural goods, with relatively minor restrictions, as a part of their principles.

In Asia, regional groupings are less common, and hence have less direct influence on agricultural policy. ASEAN has operated a collective agreement on food security, involving the sharing of rice stocks at times of shortage, but otherwise has had little agricultural content. Agricultural products are largely excluded from the recently negotiated ASEAN free trade area. Among the free-trade areas that exist in the Pacific region, only the Closer Economic Relations (CER) Treaty between Australia and New Zealand fully incorporates agriculture. This was made easier by the sharp reduction in the level of protection of the sector in New Zealand in late 1980s, and by the deregulation of marketing systems in the two countries in the last few years.

African free trade agreements have generally included provision for freer trade in agricultural goods, as these cover a large share of trade for the countries involved. However a variety of revenue duties, coupled with the para-statal control over many of the export commodities, have made agricultural trade less than free, even when no tariff restrictions apply.

In North America, the US-Canadian Free Trade Agreement (1990) included agriculture in the tariff-cutting activity, but not in the provisions for non-tariff barrier removal.<sup>1</sup> Neither the US nor Canada thought of the other as a big potential market, and the GATT Round seemed at that time to be taking care of agricultural trade issues. The NAFTA negotiations (1992) also were overshadowed by the Uruguay Round. Market access has been improved by the provisions of two bilateral (US-Mexico and Canada-Mexico) access agreements for agricultural products (to supplement the US-Canada bilateral that already existed in the earlier agreement). Some substantial liberalization will be achieved by these bilaterals, as a schedule of tariff reductions over the next decade will give Mexico better access into the US and Canadian agricultural markets, and vice versa. Non-tariff barriers were also phased out on US-Mexico trade, leading to a relatively free internal market in at least a large part of the continent. Canadian-US farm trade however remains governed largely by the pre-existing, and less liberal, Canada-US FTA.

#### **A. Benefits to the Incorporation of Agriculture in an RIA**

In many respects, agricultural trade might not seem to be a major component of regional trade pacts. Neighboring countries will often produce a similar range of agricultural products. Differences in resource endowments underpin much of agricultural trade, and ensure that there will always be profitable trade between areas which have ample arable land in relation to population and those that have less. This will however often be across regions rather than within region trade. Similarly, trade in crops which require particular climatic conditions will tend to be among rather than within regions. On the other hand, regional flows of agricultural products might still improve the food security of the area by allowing a de-linking of consumption in each country from production fluctuations.

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<sup>1</sup> The exception to this was the liberalization of Canadian cereal import licensing, conditional on US protection levels being less than those in Canada. This condition was met soon after the implementation of the agreement. The discrimination against sales of foreign wine in Provincial retail outlets in Canada was also curbed by the US-Canada agreement.

However, this pattern of trade across regions is rapidly changing. More agricultural trade is taking on the nature of industrial trade patterns, including two-way trade within the same sector. Intra-industry specialization owes its justification to economies of scale in particular processes, and the search for cheap and reliable components and materials. Under such a system, trade grows among countries with rather similar resource endowments and at similar stages of development. Trade in processed foodstuffs already moves among countries each of which produces similar products. This type of trade may be much more likely to be generated either within a region, or among countries that could form natural markets in the absence of political and infrastructure obstacles. This implies a growing significance for certain types of agricultural trade of the movement towards free trade areas.

What are the benefits of including agriculture in a regional trade bloc? Where production costs differ, and efficient suppliers are to be found in the same region, trade creation will take place. But even where such clear-cut advantage are absent, some benefits can occur. One such benefit stems from the additional competition created within a free trade area. <sup>2</sup>Competition within a bloc may be thought of as “toe in the water” liberalization. Firms and farms learn to compete with a few neighbors first before having to face the overseas efficient producers.

Regional trade schemes have other advantages, including the possible exploitation of economies of scale in the larger market. This is clearly one of the motives for Mexico and other countries in the region to have a free trade agreement with the US. Similarly the large market in Brazil attracts others in Latin America. However access to an even larger market would be possible through multilateral liberalization. Thus a country can join a RIA and still work for global liberalization as the best possible outcome.

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<sup>2</sup> This is allied to the problem of the clash between domestic policies and free trade. If the domestic policies are there to shelter farmers from external competition then any trade policy which increases competition is antagonistic to these policies.

A further advantage of a regional scheme for agriculture is that it gives some scope for a common commercial policy and common diplomacy. This is true in particular when export patterns are similar. The CARICOM countries are presently coordinating their trade policies through a single secretariat. The EC has of course made trade policy a matter of collective competence, though the export policy has relied too heavily on export subsidies and not enough on encouraging other countries to lower trade barriers.

This problem of export subsidies is in fact a manifestation of another feature of the EU. As a result of the decision to have a common budget the export subsidies are paid from EU "own resources". No single country has a strong incentive to impose financial constraints, as the cost is shared with others. This has been perhaps the most important single reason why the CAP has been so difficult to control. The incentives to take tough decisions were absent, at least until the budget agreement of 1988 put a firm limit on agricultural spending. It may also be a reason why other groups have not had the same problem. No other group pools tariff revenue, even when they employ a common tariff. No other group has a common budget which pays for agricultural expenditure. Perhaps the lesson from Europe is already understood.

Regional trade arrangements have a number of other dimensions which have an impact on the agricultural sector. These include investment policies, which may make it easier or more difficult to attract foreign capital; an enhanced dispute settlement process which aims to resolve regional disputes; and labor mobility policies which directly relate to the flow of people off the land. Often the health of the agricultural sector is a major factor in determining such flows, and agricultural policy is indirectly connected with migration regulations. In recent years another aspect of regional trade policy has emerged which may be of increasing importance. This is the tendency to negotiate standards and technical regulations at the regional level. As these regulations become more important in trade disputes the place of regional standards may increase.

## **B. Problems in Incorporating Agriculture in a RIA**

The treatment of agriculture in the RIAs of the Americas and Europe stands as a record of the achievements of governments in this difficult area but also highlights the problems.

The problems that individual RIAs have had with the incorporation of agriculture in the preferential trade agreements have not been unexpected. Difficulties in running independent domestic price support policies are the most obvious of such problems. The problems the Andean Pact had with different price band policies in different countries is a case in point. Only when the burden of support can be taken over by the RIA itself, as in the case of the EU, does this problem get resolved. But this then leads to a different problem, that of disparate views of the appropriate level of support, and a consequent drift to higher levels of protection. This drift is compounded by any arrangement to share support costs, as this reduces the incentive for each individual country to contain spending. The story of the CAP is a vivid illustration of the sensible policy of joint financial responsibility falling foul of the natural tendency for countries to spend money which is not theirs.

One would expect that potential clashes with domestic policy would be a major disincentive to include agriculture in the regional free trade plans. This is well illustrated by the EFTA decision to omit agriculture. However, this brings its own problems. One could also have predicted that the agricultural sectors of the EFTA countries would have developed independently without the constraints of free trade within EFTA, and be in effect isolated from outside competition. This was the situation in the Nordic countries, and to a lesser extent the Alpine countries at the time of the latest enlargement. One might also have predicted that the food industries in these countries would be high cost and relatively inefficient as a result of being tied to high cost inputs.

Other predictions could be made, many of which are illustrated by the experience discussed above. First we would expect problems with trade diversion, the trade in high cost goods within the RIA. Certainly this has been the defining nature of the CAP over

the years. Those inside exchange high cost goods: low cost suppliers outside are displaced. Denmark felt the effect immediately the European Economic Community was formed, as it lost the growing German market to Dutch and French competitors. This has significantly reduced the benefits of the free internal market for the members.

However one would also expect in cases where there was no common support policy that the level of intra-bloc trade in agricultural goods would tend to be low, although processed food trade within the bloc could be higher. This has been the experience of the smaller RIAs in Central America and the Caribbean, where flows of agricultural raw materials are small. One would also expect to see some policy convergence even in those RIAs which chose not to go for a common policy. The degree of policy convergence in NAFTA is striking, given the assurances that the free trade treaty did not impose harmonization on domestic policies.

Other lessons show through the experience of agriculture in RIAs. One is that it may be impracticable to control commodity trade among neighboring countries. The rules of origin are crucial in any free trade area, i.e. to prevent trade deflection where there is no common external tariff. But rules of origin are legal devices which may not be totally effective in the marketplace. And the country of origin of raw materials is much less easy to trace than that of a specialized automobile part.

## **2. CEEC Agriculture and Regional Integration**

The countries of Central and Eastern Europe are not unacquainted with the issues of regional integration agreements or even closer economic and political arrangements. The three Baltic nations need no reminder that they were a part of the same country, the USSR, for many years. As such they had no (conventional) trade barriers or restrictions to the movement of goods and services among themselves, though most of the trade was with other parts of the Soviet Union. These countries were also part of the same labor “market”, though there were considerable restrictions on movement of factors. Capital moved through the planning system, but again no major differences existed between the Baltic countries. Under such conditions the creation of a Baltic Free trade Area (BFTA) was much less of a leap in the dark, or a reversal of years of national trade policy, than many other trade agreements. Instead it is largely a question of keeping some degree of integration in the face of pressures to fragment the Baltic region through newly minted trade restrictions and other protectionist policies.<sup>3</sup>

To a lesser extent the same motive was behind the creation of CEFTA. Each of the countries of Central and Eastern Europe (with the exception of the former Yugoslavia) was a member of the Council for Mutual Economic Assistance (CMEA or COMECON). This grouping was both much more and much less than a free trade area. It incorporated deliberate trade and investment plans to a degree not dreamt of in the most *dirigiste* FTA in Latin America, including agriculture, but it had no provision for “free” trade by private firms in the western sense. At the start of the transition period most countries in the region adopted relatively modest tariff protection for both manufactured as well as agricultural trade. As the individual sectors ran into economic difficulties so they naturally

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<sup>3</sup> This phenomenon of previously integrated areas seeking to use free trade agreements to keep some semblance of the former regional market unity is quite common. It occurred in Africa and the Caribbean with the breakup of the British and French preference systems and later in the EU bilaterals with the EFTA countries that did not join the EU. It is also manifest in the Czech and Slovak Republics free trade agreement and the CIS arrangements between some of the FSU countries.

requested protection against imports. Trade among these countries was thus threatened by the return of substantial trade impediments in an area where trade had flowed before, albeit under different institutional arrangements. The decision to form free trade areas was in part a response to this protectionist pressure.

The original decision to form CEFTA came from a summit meeting of the heads of government of Czechoslovakia, Hungary and Poland at Visegrad in February 1991. This meeting pledged mutual cooperation and the formation of a free trade area among the countries of the “Visegrad triangle”. The specific agreement which set up CEFTA was signed in Krakow on December 21, 1992. The Czech and Slovak Republics split into two countries on January 1, 1993, but preserved their trade access with a mutual customs union. The CEFTA countries, which became known as the Visegrad Four, were also widely considered as the front-runners for EU membership. Slovenia joined CEFTA in January 1996 as did Romania in July 1997. The six countries will probably be joined by Bulgaria within the next few months, and several other countries have made overtures to the group about eventual accession (including Lithuania, Latvia, Macedonia, Croatia and the Ukraine).<sup>4</sup>

The original CEFTA timetable called for free trade for all products, including agricultural goods, by the year 2001 (Kiss, 1997). Tariff reductions were to be phased in over time on the basis of bilateral offers. These offers were to be reciprocal and broadly symmetrical. Few institutions were formed, and the CEFTA was deliberately kept to the economic arena of trade policy. A series of Amendments to the CEFTA timetable accelerated the process of trade barrier reduction. By 1997, 90 percent of industrial trade moved without tariffs in the region. Trade concessions existed on 80 percent of the agricultural trade, but a smaller proportion of this was duty-free. Goods which were deemed not to compete with local agriculture (List A) are freely traded among the countries. Those that are

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<sup>4</sup> Conditions of membership to CEFTA include being members of the WTO and having “Europe Agreements” with the EU. This in fact makes these prospective applicants technically ineligible.

produced locally but not deemed “sensitive” (List B) are traded at reduced tariffs. A further group of products (List C) are covered by bilateral tariff reductions often limited by quotas (see Annex II for a fuller description of the CEFTA agricultural schedules).

Three Baltic countries, Estonia, Latvia and Lithuania, made the decision to set up the Baltic Free Trade Area (BFTA) in 1994, initially leaving agriculture out of the free trade arrangements. This omission was repaired in 1996 when the three governments agreed to set up an agricultural free trade area. The agricultural agreement came into effect in January 1997. No import or export restrictions are allowed on trade within the BFTA countries on goods of Baltic origin. Each country keeps its own external trade policy, and there are no plans for a common agricultural policy. Differences in national price support systems have caused problems for the implementation of the agricultural agreement.

### **3. Issues facing CEFTA and BFTA**

This brief introduction to the issues of agriculture in the CEFTA and BFTA regionals suggests a number of questions which have already arisen or will arise in the context of their agricultural arrangements. These questions address issues of sectoral policy (market access, export subsidies, and domestic policies) which relate specifically to the agricultural sector; issues of cross-sector policy (regulatory competition, financial arrangements, inter-sector links) which are shared with other parts of the economy; and questions of external policy (commercial policy, institutions, membership changes). Each helps to shape the trade environment for the rural sector.

#### **A. Sectoral Policy Issues**

##### ***Market Access***

Questions to do with market access are at the heart of issues facing regional integration arrangements. The market access issues that arise in the case of agriculture have to do with the extent to which the sector is included in the integration arrangements, the mechanisms for exclusion of certain products and the timetable for achieving free trade within the region.

inclusion of agriculture and the Article XXIV issue

The range of solutions that others have found to the problem of the inclusion of agriculture in an RIA range from the EU, which decided on full implementation with the help of a common policy, to the EFTA which excluded the sector altogether. The CEFTA countries and the BFTA countries have faced the question of the inclusion of agriculture in different ways. In BFTA, agriculture is fully included, with no exceptions. In CEFTA the solution was to include fully only those goods that were not competitive with local production (the List A). For those that were “sensitive” the decision was to establish two more categories (List B and the bilateral agreements), as described above, so that at least

some parts of agriculture would be subject to free-trade area rules, even if others “escaped” for the immediate future.

This raises the question of the conformity of CEFTA with Article XXIV of the GATT, that “substantially all trade be covered”. Unfortunately the meaning of this restriction has not been clarified. EFTA seemed to get away with the exclusion of agriculture altogether, but the panel report on EFTA was never adopted. Could one argue that in the case of CEFTA the lists are not exclusions in principle but merely arrangements during a transition period?<sup>5</sup> CEFTA ministers originally agreed to omit agriculture from the target of free internal trade and then decided later that it would be included. They tried again to get agreement at their last meeting to phase out the lists over time, but without success. The accession of Slovenia complicates the matter, as it has more protection for agriculture than the original “Visegrad Four”. With Romania now a member and Bulgaria knocking on the door the chance of all the countries agreeing to a rapid freeing of agricultural trade must diminish.

The issue of GATT conformity does not arise in the case of BFTA, as the three member countries are not yet WTO members.<sup>6</sup> But it is likely that the decision to include agricultural trade in the tariff-free arrangement for intra-BFTA trade makes it acceptable under WTO rules.

the use of specific lists of products afforded different treatment

The use of specified lists for liberalization has parallels in other RIAs. LAFTA drew up lists of products which would be able to trade freely within the area. Not many sensitive products ever made it to the lists. More recently, NAFTA included schedules for trade liberalization for each country, specifying alternative tariff reduction regimes by

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<sup>5</sup> Under the Uruguay Round Agreement, which went a little way towards clarifying the criteria for creating a WTO consistent RIA, a transition period of ten years is suggested as permissible.

<sup>6</sup> Estonia is currently in the process of joining the WTO and Lithuania has asked for membership discussions.

commodity. The bilateral agreements that made up a part of the agreement specify which products are to be subject to free trade arrangements and which are reserved.<sup>7</sup>

Lists have several negative consequences. First they divide the agricultural sector itself into those for which there is protection in the national market and those which have to compete on regional markets. If the former are also the products which have high degrees of protection from third country imports then the distortion is likely to be greater. Over time the agricultural sector becomes divided into a competitive and a non-competitive part. Secondly they become a magnet for political opposition to liberalization. The lists themselves become the focus of pressure, necessitating hours of debate over commodities that have little economic significance. Slovenia found problems with the lists as they existed in CEFTA and has tried to have them redefined. Romania likewise expected to be able to remove commodities from the list that was due for most rapid liberalization. But if each country can choose the commodities to include and each new country can add to that list the benefits of trade liberalization in the sector soon erode. Thirdly the food industry in the region is likely to be hampered by different raw material prices for basic commodities depending on whether they are on the liberalization list or not. This will distort investment plans, deny the benefits of scale economies and keep processing activities tied to national production.

the use of quantitative limits on intra-group trade

One way of making it more feasible to include agriculture in regional liberalization is to put quantitative limits on the extent or growth of cross-border trade in particular commodities. This is the main technique used in the Europe Agreements for agricultural goods as well as for other “sensitive” products such as textiles and steel. Quotas in the context of regional trade liberalization have not been so extensively used in the Americas,

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<sup>7</sup> The different tariff reduction schedules for different groups of products are included as a part of the trilateral agreement (i.e. are part of the implementation of the free trade regime). The bilaterals deal with exceptions to free trade which are not just a transitional arrangement. Thus, for instance, sugar is eventually to flow freely between the US and Mexico but not between the US and Canada.

though there are a number of examples. Quotas can of course be combined with lists, with quantitative limits on trade flows of goods from a certain list.<sup>8</sup>

For the CEFTA countries the use of quotas has been central to the process of the inclusion of agriculture. The commodities for which trade restrictions will be removed quickly (i.e. the goods which compete less with domestic production) have no quantitative limits. The goods on the second multilateral schedule and those on the bilaterals in general are restricted by quota. This “belt and braces” policy was no doubt thought necessary to get agreement, but it puts considerable strain on the management of the agreement in the next few years.

The use of quotas as a way of opening up markets brings with it certain problems. Unlike unconstrained tariff reductions, trade creation is inherently unlikely so long as the quota is binding. The above-quota tariff will determine the price on the domestic market, and the quota holders will (unless the quotas are auctioned) make a profit, called the quota “rent”, as a result of the reduced within-quota tariff. As the domestic price does not decline, no pressure is put on the domestic producer. The main effect is to transfer revenue from the taxing authorities to the quota holders.

In the longer run, quantitative limits can either be a way of opening up a previously restricted market or can be a way of keeping a degree of protection with only a token amount of trade. It all depends on the way in which the quota is changed over time relative to the amount of trade that would happen in the absence of the quota. If a quota is increased at a faster rate than the “frustrated” trade then over time the quota will become redundant and trade will move freely (or at the tariff level that operated within

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<sup>8</sup> Quantitative restrictions on imports of a commodity from all sources are no longer acceptable under the WTO. But quantitative restrictions on goods coming from another country under preference schemes are permissible, at least as a part of a transition to free access or as a way of giving assistance to other countries (under certain circumstances). Moreover the Uruguay Round set up a large number of Tariff Rate Quotas (TRQs) in the process of opening up markets previously restricted by non-tariff barriers. The administration of TRQs has created significant problems and will be rationalized at the next trade round. The issue of preferences will probably be addressed at that time. To the extent that the CEFTA quantity limits on bilateral access are strictly temporary they are probably safe from challenge.

the quota). If however the quota grows more slowly than the “frustrated” trade then the distortion gets worse over time and the quota has in effect become a way of avoiding trade liberalization.<sup>9</sup> Unfortunately the incentives once a quota system are in place tend to militate against expansion. The quota itself becomes a political focus, for the agriculture minister to defend as a matter of national honor. And firms that are lucky enough to fill the quota get the “rent” to the extent of the amount of the preference. They will therefore have an incentive to keep the quotas in place.

Quotas in the case of the CEFTA seem likely to become more restrictive over time unless a decision is taken to expand them at a reasonable rate. The appropriate rate is itself difficult to calculate, as it depends on the development of the market. But one could devise mechanisms to limit the rents from the quotas and to decide on future quotas on the basis of the magnitude of the rent. Additionally, the restrictiveness of the quota can be ameliorated by reducing the above quota tariff until the quota no longer has any value.

the problem of rules of origin and accumulation rules

One issue which arises inevitably in the consideration of free trade areas is that of rules of origin. If external trade barriers differ there is always the possibility of trade deflection, the importation of products through the lowest-tariff country. Rules of origin are designed to identify those goods coming from other member countries and those that originate from outside the region. For consumer-ready imports the notion is relatively clear-cut. But many products now are themselves made from imported inputs and then resold. This implies that some “domestic content” rules are needed as well to distinguish between goods made from local inputs and those assembled from imported parts. In practice there is usually some minimum acceptable domestic content requirement that will

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<sup>9</sup> A good example of this phenomenon is the Multi-Fiber Agreement, where trade in textiles was increasingly limited by the quotas. The original notion of the Agreement was to liberalize this trade over time. The Uruguay Round has instituted a number of tariff rate quotas (TRQs) for agricultural goods. The question arises now as to whether these TRQs will be an instrument for further opening or a vehicle for continued protection.

allow the good to qualify as being regionally produced and hence satisfy the rules of origin. This can either be a test of substantial transformation in the domestic country (say by a change of tariff heading) or a particular value-added contribution. Such rules sometimes differ by industry and add to the complexity of trade rules.<sup>10</sup> The complexity of the rules both encourages circumvention and ties up trade with customs procedures and paperwork. To avoid the need for such rules would seem to be a major administrative goal.<sup>11</sup>

Two important points can be made about rules of origin, both significant for CEFTA and BFTA. First the problem is much less significant when countries form a customs union. If each country knows that the inputs, if imported, have paid the same tariff then they can afford to be more relaxed about knowing their point of origin. The same effect can be had in an FTA by agreeing to treat certain inputs alike.<sup>12</sup> Thus rules of origin are only likely to be a major problem if protection levels on inputs differ markedly. This implies that agricultural products, where levels of protection are divergent, may well be candidates for trade deflection. This would show up in the market for food products, where the different raw material prices might encourage, say, a Lithuanian food manufacturer to use inputs imported free from Estonia under BFTA which in turn might have come in from another country under Estonia's liberal external trade regime.

Secondly, the impact of rules of origin is modified by the operation of cumulation.

Contribution to value added in any qualifying country can be added together to determine the status of the good. Cumulation therefore helps to avoid rules of origin problems, by

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<sup>10</sup> A significant part of the NAFTA treaty is made up of detailed agreements on the rules of origin for automobiles, textiles and a few other sectors where the industry had insisted on protection from trade deflection, in particular from Asian imports into Mexico being sold into the US market with little "local content". By contrast, rules of origin are relatively lax for the EU's Overseas Countries and Territories (OCT) which has allowed producers in the Caribbean to ship agricultural products such as rice to the OCT in the region and have these products resold in Europe free of duty after some minor processing.

<sup>11</sup> The customs authorities may have conflicting interests however, as with the removal of trade barriers themselves.

<sup>12</sup> If all CEFTA countries were to allow animal feed to be imported without tariffs then no-one has to keep track of whether the poultry of the Czech Republic has had enough value added to call it a CEFTA product.

increasing the number of sources of inputs which count as “domestic”. In practice, cumulation also adds to the complexity of trade arrangements between the CEECs. Each of the BFTA and CEFTA countries participates in the Pan-European Cumulation of Preferences agreement, implying that as far as the EU is concerned inputs coming from any such country qualify as domestic content. But CEFTA and BFTA have their own cumulation rules for qualification for free intra-bloc trade. Thus there could be circumstances when a good can enter the EU free but not the market of another CEEC as it does not qualify as a regional good.

In spite of all the elaborate administrative superstructure surrounding rules of origin they have a fundamental weakness. They rely for their effectiveness on the premise that the imported and the domestic goods are in practice rather imperfect substitutes. Thus in a manufacturing process the assumption is that an imported part cannot just be replaced by a domestic part without some significant loss in functionality or appeal. But if domestic and imported goods are perfect substitutes in the eyes of consumers then one would expect both more fraudulent labeling of goods and perfectly legal “substitution deflection”. This is quite likely in the case of homogeneous agricultural commodities. Fraudulent trade might include changing the label on a consignment of sugar to indicate that it came from a source eligible for preferential access. This is the bread-and-butter of customs officers, whose task is made more difficult by multiple trade agreements. But the more interesting case is the legal sale of the product of a partner country which then imports it’s own requirements from other countries. This is already widespread in such commodities as sugar where preferential export quotas are worth filling even when domestic requirements have to met by imports.

It is difficult to know in advance the extent to which Baltic trade patterns or those in the CEFTA countries will be distorted by substitution deflection. The problem is easier to describe than to detect or to solve. The fact that a country is both an importer and an exporter of the same product happens all the time as a result of transport costs, natural markets, imprecise customs classifications, etc.. If a surge in such trade was noticed then

one might suspect the presence of substitution deflection. But even then there is little one can do to prevent it without harmonization of external protection. So long as this is in a downward direction this represents a beneficial movement towards a more open regional system. If protection levels remain high then such deflected trade is less desirable. Although it does not divert trade, it imposes unnecessary transaction costs and it generates rents in the exporting member in place of tariffs in the importing country.

#### safeguards and snapbacks

One aspect of RIAs is the provision that is made for action to be taken if there is a surge of imports as trade barriers are removed. The import surge often triggers some safeguard mechanism which gives some relief to the struggling importer. Both CEFTA and BFTA have such provisions for temporary relief. In the case of CEFTA the countries can also use WTO safeguards to guard against injury from import surges.

NAFTA has incorporated a “snapback” provision for a number of agricultural commodities in addition to the more general safeguards under both the NAFTA and the WTO. The snapback allows countries to revert to a higher level of tariff when imports grow by more than a particular percentage (a trigger). The extra duties allowed are temporary, and correspond to the tariff in place in the previous year of the transition. This mechanism gives some assurance to producers without disrupting too much the phased reduction of tariffs under the agreement.

#### market size and economies of scale

One major incentive for any regional trade agreement is to expand the size of the “home” market to allow firms to spread fixed costs over a larger production volume. In one sense this was behind the “import substitution” model that drove the Latin American integration experiments. It reappears in the more recent discussions of “strategic” trade policy, where capturing larger markets is the main driving force. Agriculture typically has less scope for scale economies than manufacturing sectors: the optimum size of

production activity is small relative to the size of local markets, let alone national and international ones. But there are examples of economies of scale even in agricultural production. One clear example is poultry and egg production, where the scale of modern technology may be such that a large plant can service an area that crosses borders.

A similar argument can be made that processing sectors need a large “catchment area” for raw materials to achieve economies in processing. The scale of processing industries is generally increasing but rarely outgrows a national raw material base. Dairy and meat processing are not particularly scale responsive, nor are grain milling, oilseed processing or sugar beet crushing. Processing activities for fruit and vegetables can however benefit from scale economies which could lead to firms wishing to purchase from more than one country.

For the CEFTA countries these scale economies are probably not major arguments for freer trade in agricultural products. For BFTA, on the other hand, the size of the home market for foodstuffs is probably too small for efficient production, and duplication of processing activities in the Baltics could lead to higher costs.

#### tariffication of non-tariff barriers

Non-tariff trade barriers between countries in a regional trade bloc are likely to politically unacceptable, as well as thwarting the economic purposes of the agreement. It is common for RIAs to deal with the problem of non-tariff import barriers maintained by individual members by converting them to tariffs. This process has received a considerable boost from the outcome of the Uruguay Round which transformed (almost) all such non-tariff trade barriers in agriculture to tariffs. If countries follow strictly the WTO rules there should no longer be a problem for RIAs. However, to be realistic, non-tariff barriers still persist in agriculture as elsewhere. Converting them to tariffs in a regional agreement may still be useful.

#### harmonization of tariff levels and the move to a customs union

The process of harmonization of tariff levels can occur in two different contexts. First, within the plans for a customs union countries can agree to move over time their own tariffs toward the common level. Secondly, the national tariffs can converge over time as an outcome of decisions which are technically unrelated but which might be driven by similar pressures. In Latin America the tendency has been toward customs unions, with NAFTA, Andean Pact, the CACM and CARICOM all having a common external tariff, though in some cases the exceptions belie the commonality of the tariff.<sup>13</sup> North America has made a point of preserving the tariff-making autonomy of each country, and any talk of a CET has been discouraged.

Nevertheless tariffs do tend to harmonize over time, not least because they have all fallen as a result of successive GATT rounds. Moreover there will be a tendency to harmonize to avoid the problems of trade deflection, as discussed above. Problems both economic and political are more likely where there is a major discrepancy between protection levels in neighboring countries. It is probably constructive to have some form of “tariff commission” which can recommend tariff changes (presumably downward, and respecting WTO obligations) for the RIA. NAFTA has such a body which is empowered to consider the tariff changes during the transition with an eye to suggesting ways to speed up the liberalization. CEFTA has a good record of accelerating its internal tariff reductions: the prospect of joining the EU within five years makes it relatively easy to keep to the timetable. In the normal way one might expect the CEFTA countries to begin to harmonize third-country tariffs toward the EU CET. However, in the case of agriculture this would imply higher protection and hence trade diversion.

transition periods for free internal trade

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<sup>13</sup> In the Andean Pact, only Colombia and Venezuela apply the CET fully: Ecuador has negotiated a number of exceptions, Peru has suspended its membership in the economic provisions of the Pact and Bolivia has been allowed to keep its own much lower tariffs. In CARICOM, exceptions to the CET are commonplace, as countries merely have to request derogations from the Secretariat and these have rarely been denied. MERCOSUR so far has been more faithful to the notion of a CET, though several products have yet to be included in the scheme.

The device of a transition period helps to surmount domestic opposition to trade liberalization. However the longer the transition period the more uncertainty is created among investors and the slower the adoption of competitive technologies and the adjustment of structures. The question is ultimately whether the political and economic prospects are deemed to be positive, and hence to be gained as quickly as possible, or negative, and hence to be delayed as long as possible. Unfortunately, in the case of agriculture, the assumption is made that regional market integration is not beneficial in itself but is an inevitable side-effect of industrial market integration. Under these circumstances it is obvious that long transition periods will be requested. But if one takes the view that the economy will be stronger with a competitive rural sector producing the right mix of products and finding profitable markets in a new regional economy then the quicker one can get to that position the better. There will be adjustment costs, but even these may be reduced by speedy rather than slow adjustment.

In the case of the CEFTA countries the issue is circumscribed by the likely date of EU accession. A transition period which lasts beyond the date of accession has less significance, as entry to the EU will make the question of internal access moot. The first likely accession date seems to be about 2002, on the assumption of relatively rapid negotiations and ratification by existing members. The current CEFTA timetable for industrial goods seems geared to this. Whether one could get to totally free agricultural trade within CEFTA by that time is somewhat doubtful, but it is worth attempting. The shock to the agricultural sectors of the acceding countries would be less. BFTA countries chose a short adjustment period and have therefore already faced many of the adjustments in the first year of the existence of the agreement. But as the BFTA countries themselves move closer to the CEFTA group there will be transition issues for these countries also. How rapidly, for instance, should Polish - Lithuanian agricultural trade be liberalized?

## *Export Subsidies*

treatment of export subsidies on intra-group trade

The key to any politically stable market integration agreement is to persuade producers within the integrating area that conditions of internal competition are “fair.” If one part of the region uses export subsidies on goods flowing to other members this task is likely to prove impossible. The regional market will not long survive such subsidies. Pressures will build up for countervailing measures and the political climate will deteriorate rapidly. In this respect it is somewhat surprising that the banning of export subsidies is not more prominently a part of all RIAs. The reason has more to do with the fact that not many countries engage in explicit export subsidies, and therefore may assume that the issue will never arise.

The Canada-US FTA included a ban on export subsidies on intra-CUSTA trade. Canada, which at that time did not recognize its transport subsidies as assistance to exports, was concerned that the US Export Enhancement Program and other such subsidies should not be used to lower grain prices on the Canadian market. The US also did not want subsidized exports from Canada on its own home market.<sup>14</sup> In the NAFTA the provision against US-Canada export subsidies was retained, but no such prohibition was included in the US-Mexico bilateral. This was apparently due to the benefits that the Mexican parastatal agency CONASUPO derived from below-market imports of US butter and skimmed milk powder when these goods were resold on the Mexican market. The wording of the bilateral indicates that the importer can choose not to ask the exporter to refrain from the export subsidy. In addition, the US was concerned not to be at a disadvantage in Mexican markets from the export subsidies of the EU. Thus export subsidies are allowed in cases where similar subsidies from third countries need to be

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<sup>14</sup> The irony is that, as was discussed above, if the US gives export subsidies on third country exports then Canadian grain will come in to the US market to fill the gap. Thus an exporter within an FTA has an incentive for other exporters to give up their internal export subsidies but not their external subsidy programs.

“matched”. For these reasons the prohibition against “internal” export subsidies was not possible in NAFTA at the time of its negotiation, though this situation could change..

At present CEFTA does not have a ban on internal export subsidies. Hungarian export subsidies in particular have been the source of a good deal of tension as one would expect. The Hungarian counter to charges that they are distorting competition on the CEFTA market is that other members have subsidies which have a similar effect. Clearly the issue of subsidies and anti-competitive policies needs to be faced within CEFTA, but it should be possible to deal with export subsidies as a particularly egregious way of distorting competition. More problematic is the fact that regional suppliers would still have to face competition from dumped farm products from the EU. One way to deal with this is to put a surcharge on the products from the EU which benefit from a subsidy (e.g. by putting on a tax at the border equal to the amount of subsidy granted by the EU). But this would in effect raise the domestic price in the importing country, which may cause concern on the part of consumers and food-industry users of the product. BFTA does have a restriction on export subsidies within the region, and thus should be immune from this problem.

effect on export subsidies to third countries

Though NAFTA contains an exhortation to avoid the use of export subsidies in third markets, there was no obligation to do so. The Uruguay Round was still going on at the time of the NAFTA talks and the US did not want to make “unilateral” concessions. But subsidies on exports to third country markets so obviously change the balance on the internal market that RIAs can hardly ignore totally the issue. Canadian grain clearly moves into the US market to displace the US grain which is exported under the EEP. This export version of the “substitution deflection” described above will have the effect of making export subsidy programs more expensive.

CEFTA and BFTA have no restrictions against the use of export subsidies in third markets. Hungary is the only country to use such subsidies widely, though Poland also

has made use of the instrument on occasions. Such subsidies are rarely if ever sound policies for the exporting country, and represent a failure of rural marketing strategy. But if Hungary should be unable to move away from policies which benefit foreign consumers at the expense of those at home then other CEFTA countries might as well share in the benefits of Hungarian generosity and sell goods to Hungary that replace those it sells to others.

The export subsidy issue is among the main items for the next round of trade talks on agriculture, due to start in a couple of years. However it is conceivable that one could make progress at a regional level before this time. The EU and the CEEC could mutually agree that the twenty five country zone (if EFTA countries would join it would be the same as the pan-european cumulation zone) be free of all export subsidies.

### ***Domestic Policies***

It is a hallmark of regional trade agreements in the Americas that they do not involve changes in domestic agricultural policy. In Europe, the same was true of EFTA by dint of leaving the sector out of the free trade regime. Only the EU started out explicitly to change totally the range of domestic policy measures, through the instrumentality of the Common Agricultural Policy. One might be tempted to think that domestic policies in the CEFTA and BFTA countries can continue without taking heed of the trade agreements. In fact the trade rules have several very important effects on domestic policy, as was mentioned in the last section. The result is a process of convergence which can have the same effect as a formal agreement on a common path for policies. Moreover, if the issue of domestic policies is not tackled in a fairly open way the conditions will develop for mutual distrust and disillusionment.

different support levels and internal trade

The first issue is that of different support levels. Clearly there is likely to be some unease about the fact that, say, Lithuanian farmers receive more for a gallon of milk than do their

counterparts in Estonia. Besides the political fallout from the public knowledge, the economic impact is significant. First of all it encourages Lithuanian farmers to attempt to deliver milk in Estonia. Since the border has no trade barriers it may be difficult or costly to prevent this trade. In this case one could regulate border trade by means of access to processing facilities, but for many commodities that would not be so effective. Even if the direct shipping of milk to Estonia could be restrained, one could imagine firms setting up near the border to compete.

The feasibility of maintaining different support prices depends crucially on the way in which the prices are maintained. If a country maintains its domestic price levels through border protection alone then the reduction of tariffs against imports from the partner country will help to determine domestic price.<sup>15</sup> The earlier discussion of tariff changes applies to this case. But if the prices are maintained by fixed purchase prices operated by parastatals then the border price will be less important. However the parastatal will have to buy the domestic output, or compel the private sector to do so, as the imported product becomes cheaper. In this case there will have to be some implicit or explicit subsidy to offset the higher cost of using the domestic good. This can either be an export subsidy, which raises other problems as discussed above, or some assistance to the domestic user of the good, which raises issues of competitiveness. In other words the internal price policies will come under indirect pressure from the opening up of regional trade.

Somewhat less pressure will be put on input cost policies by the opening up of internal trade within the region. If one country maintains a fertilizer subsidy then the product can be sold freely in competition with that of regional partners. But two problems will eventually arise. One is that there would be a tendency for fertilizer itself to be traded from the country where the purchase of it is subsidized. This could be controlled by

rationing, but it is symptomatic of the tendency for arbitrage whenever a price difference exists in a free trade area. Similarly, fertilizer-intensive products will be favored in those countries where subsidies exist. This will lead to the second problem, that of protests from governments which do not use such subsidies. They will either have to adopt similar practices themselves or seek to have them banned within the region.

#### quantitative restrictions on supply

One of the more interesting implications of free trade within a region is its effect on supply control policies. Clearly the policies themselves are not likely to run afoul of any provision in a free trade agreement. Indeed in most such RIAs the partners would be only too pleased to see output being restrained. But the effectiveness of supply control is clearly undermined if goods can come in from partner countries free of tariffs and quantitative restrictions. The result is that most cases of supply control will either be associated with quantitative limits to imports or be relaxed once free trade has become established in the region. The former option is more problematic now that the WTO has ostensibly removed all non-tariff trade barriers (with the limited exception of the “rice clause” for Japan, Korea and the Philippines). If quantitative restrictions still exist they can be challenged in the WTO. One must conclude that quantitative restrictions on output are difficult to maintain in countries which are members of regional associations where agricultural goods are freely traded. As they are increasingly unpopular with farmers these instruments are likely to be put back on the policy shelf.

#### stabilization policies and stocks

Many countries like to manage stocks of primary commodities in an attempt to stabilize domestic markets. Free regional trade may alter the practicality of such schemes. It is intrinsically more difficult to stabilize the domestic market against *external* shocks if the

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<sup>15</sup> If the product is imported from third countries, and external protection does not change, the price effect may be small. Pressure on prices in this case will not be felt unless the intra-trade displaces the imports from the third country supplier.

borders are open to imports (and exports). The attempt by one country within an RIA to build up stocks (to prevent a price fall) will merely encourage imports in from the partners. Similarly, the release of stocks to keep down domestic prices is less effective if those released stocks find their way onto export markets. On the other hand instability from *internal* instability is reduced by opening up to trade, as imports can come in at times of shortage and exports flow out with local surpluses. For this reason one cannot say in general whether an RIA will increase or decrease domestic price stability.

If stability of markets was to be a problem, say in the Baltics, the tendency would be to coordinate stocks policies among the three countries. A joint effort to manage stocks could be successful as a guard against external shocks. But it should be remembered that most such schemes have ended up supporting prices above sustainable levels, either through “capture” by interest groups or misreading of trends in world markets, and financial compensation for sudden income loss may be a much better way of dealing with instability of production.

reinstrumentation and green box policies

The fact that several of the “old style” rural policies such as supply control and fixed domestic prices have been shown to be incompatible with the operation of an open regional food and agricultural market suggests that there is likely to be a period of reinstrumentation in regional groups. This parallels the move in the WTO away from non-tariff trade barriers, export subsidies and trade-distorting domestic price policies towards “decoupled” policies and non-commodity-specific subsidies that fit into the “green box” of allowable domestic instruments. Each RIA has in effect to define a “green box” of policies that it will allow individual members to pursue and take steps to counter those that fall outside.

As with the issues of export subsidies, quantitative trade restrictions and the definition of non-trade-distorting subsidies, the WTO has made it much easier for RIAs to go the next step. But so far there has been little overt attempt to meet these problems face-to-face.

Countries within regional groups are reinstrumenting their policies at a rapid rate. The passage of the 1996 Farm Bill in the US, beside giving that country a good platform for the next round of trade talks, has made it easier to contemplate free agricultural trade over the continent. The reinstrumentation of the CAP, which started with the 1992 MacSharry Reform and continues with Agenda 2000, allows expansion of the EU at a much lower budget cost.<sup>16</sup> Within BFTA the willingness of Lithuania to move to more trade-friendly domestic support measures has defused what could have been a troublesome issue for the group. Similarly, the intention of Slovenia to switch to more acceptable support methods has made the issue of their hesitant entry into CEFTA (at least from an agricultural trade perspective) more tractable.

marketing structures and state trading

One issue which has received scant attention is the possibility of pressures on different marketing systems within an RIA. This has arisen in the case of grain marketing in North American specifically in respect to the Canadian Wheat Board (CWB). However the problem is much broader than that, and the CEECs are by no means unaffected by the issue. At the heart of the issue is the compatibility of State Trading Enterprises (STEs) and private firms when they operate in the same market. Under what conditions do they compete with each other and when does the state firm have an advantage? Will countries that have privatized their food chains always protest the existence of state enterprises in regional trade partners? Can one separate out the domestic activities of the parastatals from their trade actions?

The evidence from other RIAs is mixed. The EU in its early years managed to remove the exclusive marketing powers of the majority of STEs in member countries, giving them in

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<sup>16</sup> Compensation payments for price cuts clearly should not have to be paid to countries that had low prices before accession and therefore benefit from price increases. However that logic did not prevent the EU from doing precisely that in the case of Sweden. By the time the CEFTA and Baltic countries join, the compensation payments may have been passed to the individual member states for administration and financing.

many cases a role in the organization of markets. They often became “intervention agencies” which had the role of buying up excess products at a fixed price. Coupled with the tight control of imports through the variable levy system, which gave a generous cover of protection for parastatals and private firms alike, and the export subsidy system which removed the overhang of surpluses from the market, the newly reorganized agencies became reconciled to lack of control over internal trade. For the two “quota” commodities, dairy and sugar, the adjustment was even less as the marketing of these commodities was aided by restrictions on cross-border movement of the raw material and fixed processing margins. Nevertheless the UK had eventually to modify its Milk Marketing Board which was the sole buyer of milk and controlled the activities of the private creameries. Now, as Milk Marque, it is reduced to a role as a promoter of milk with limited market powers.

In the Americas the issue has been subsumed largely by the widespread privatization of the marketing of agricultural goods. The grain juntas of South America are gone, at least in function, as are the monopoly import agencies which operated in much of the region. The remaining STEs are mainly in Canada, where the Provinces hang on to them in part as a way of resisting a free *internal* market in Canada, and where wheat farmers far from the market support the CWB as a way of getting a higher price for their more costly product. Tariffication of the non-tariff barriers of the Provincial marketing boards will eventually erode their market control: in the mean time the high protection means that they can continue as before. The CWB will at some stage lose its exclusive position on export markets and become a competitor with the US firms in the marketing of Canadian grain.

Both CEFTA and BFTA have residual agencies from the time when the market was tightly controlled. Privatization has gone at different speeds in the various countries. This implies that the conditions of competition are likely to be uneven in the region for a few years to come. However the introduction of improved market access will hasten the changes in the institutions themselves.

## **B. Cross-Sector Policy Issues**

The issues of agricultural market policy discussed above are complemented by a set of problem areas which involve other sectors. These include the regulatory apparatus of the modern state which has to be modified to take account of regional trade pacts; the financial arrangements within the regional agreement, if any, which influence the incentives to produce and to trade; and the links between agriculture and other sectors which often can be as significant for the sector as more specific rural policies.

### ***Regulatory Compatibility***

similar standards and regulations

One issue which emerges in the operation of RIAs is that of disparate national standards and health and safety regulations. These are often used to impede trade, even within regional markets. The benefits of harmonization of standards has to be weighed against the disadvantage of “one-size-fits-all” regulations not well suited to all parts of the region and the suspicion of firms and consumers about the unresponsiveness of centralization. The EU has been through this argument for decades, with periods of attempted harmonization leading to nationalistic reactions and calls for “subsidiarity”.<sup>17</sup> In the mid-1980s the concept of mutual recognition was applied to regulations as a way of avoiding the problem of trade barriers within the EU as a result of different products.<sup>18</sup>

In the case of the CEFTA and the BFTA countries the issue is made somewhat easier by the fact that they are all aspiring to join the EU and trade freely with Western Europe. It would seem therefore superfluous to develop standards materially different from those in

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<sup>17</sup> Subsidiarity is an ecclesiastical term for the sharing of power downward to bishops and below. In modern political parlance it refers to the taking of decisions at a level lower than that of the EU whenever it is in the broad public interest to do so.

<sup>18</sup> The stimulus came from the European Court of Justice, who had ruled in the case of Cassis de Dijon that German regulations could not be applied to the imports of the French liquor since it had already satisfied French health and safety standards. The incentives set up by mutual recognition of each others regulations can of course lead to a “race to the bottom” as each partner tries to give its own firms an advantage.

use in the EU. Where the EU has no common standards the CEEC could choose those of the larger markets (in many cases this will be Germany). This process will be helped by the fact that much of the investment coming into the CEEC in the food and agricultural area will be from the EU and hence be able to bring with it the appropriate technology. As credibility and public confidence are key aspects of any regulatory system, particularly in the food industry, some new regional agencies may need to be created to ensure that standards on the books are in practice followed.

### ***Financial Solidarity***

An important adjunct to the market access and export subsidy provisions of a trade regime is the fiscal provisions. The question as to who collects government revenue from tariffs and how it is used are central to the economic impacts of the policies. They can under certain circumstances lead to incentives which detract from the regional integration that is the objective of the trade agreement.

common budgetary resources

The question of whether to collect and disburse any common budgetary resources raises some very fundamental issues of national taxation, fiscal control, accountability. Only those RIAs which have serious aspirations toward political union have faced up to these issues. The EU has a fully-developed system of “own resources” which constitute the proceeds of tariffs and certain other taxes (such as the sugar levies) supplemented by a payment loosely based on GDP shares. These funds are spent on the agricultural policy (export subsidies, compensation payments, intervention costs etc.), on regional policies and on administrative costs. Some degree of redistribution among regions and countries is possible, in particular the regional aid payments made toward the southern countries known as “cohesion” subsidies. But the redistribution among sectors is also considerable, with the payments to agriculture (50-75 percent of the budget over the years) being out of

proportion to its contribution to the economy (less than ten percent overall, much less for the few most favored commodities such as dairy and wheat).

No other RIA has approached this scale of common spending or redistribution. EFTA has a minuscule budget to cover meetings, though it did coordinate some EFTA bilateral aid first to Finland and then to Portugal. NAFTA has a fund set up to finance environmental projects along the border between the US and Mexico. So far the NADBank has yet to make a loan, and the funding is too small to meet the significant problems of years of environmental neglect by the *maquiladora* industries. None of the other RIAs in the Americas has instituted common funds. CEFTA and BFTA likewise have no common financing institutions.

The absence of funds to finance common policies is either a cause or a consequence of the absence of common policies themselves. It is difficult to think of much outside the realm of tariffs and market regulations that would not involve funds and once financing is needed the issues of control and accountability arise. It seems that few RIAs wish to risk that step. Common policies bring benefits but also entail costs. The benefits come from the fact that the problems of policy harmonization mentioned above are avoided. From coordinated stock and stability measures and research and development programs to common negotiations with other countries, the advantages are clear. But the costs are in the control that is needed and the profligate incentives which arise from common financial “responsibility” for policies. In short, the incentives are for overspending as a result of lax constraints. Many policies which benefit one country’s farmers but which would be too expensive for that country to undertake look more attractive when the cost is shared. Since every country will have its own programs that generate attractive domestic political benefits, the effect is to generate fiscal “irresponsibility”. These lessons would be worth remembering if BFTA or CEFTA are tempted to drift in the direction of common policies with fiscal implications.

common project financing

As the scope of the common policies expands the benefits from commonality are likely to increase and the dangers of irresponsible action are reduced. Infrastructure projects and market intelligence activities are good candidates for collective policies. If the BFTA countries were to set up a fund to facilitate joint action in these areas it would both strengthen the economic case for free trade in the region and give some public visibility to the trade initiative.

One variant of the common financing issue is that of collaborative management of external funds. Here some of the problems of collective profligacy are less likely to occur. The total amount of funds available are limited by the external agency, and the issue is the most effective and efficient way of disbursing them. Benefits of coordination include scale economies, non-duplication, and administrative economies.

#### trade bias and financial pooling

What does the financial decision have to do with the pattern of trade? When a country keeps control of its own tariffs, as happens in a free trade area, the revenue does not go to a common budget but is retained by the importing government as fiscal income. Even in customs unions, such as MERCOSUR, CACM and CARICOM, the revenue from the CET is kept by the importing countries. This distinguishes these cases from the CET of the European Union. In Europe the revenue collected from the tariff on imports is centrally collected and then disbursed in the form of program finance. The difference is important for three reasons. First, the pooling of revenue from the common tariff gives the regional group some funds to disburse to assist disadvantaged regions or sectors. Thus it helps the cohesion of the region and the willingness of the countries to liberalize trade. Secondly, it cements the notion of a common tariff as an obligation of membership rather than a guideline for harmonizing national tariff levels. And thirdly it removes the temptation to import from third countries as a way of gaining tariff revenue. This third aspect is potentially of considerable importance. A country importing from a non-CEFTA source pays the world price and the government gains tariff revenue. The same

imports from a CEFTA source cost more in foreign exchange, as those goods compete at the tariff-inclusive price, and no tariff revenue is collected. The tariff revenue is in effect included in the price paid to the regional supplier. From the exporter's perspective such regional sales are more profitable (the regional market gives preferences for regional goods) but the importing government gains more when the product is imported from third countries. Therefore *to the extent that governments have any control over the source of imports* there will be a tendency to import from third countries at lower foreign exchange prices and keep the tariff revenue. To prevent this "third country bias" in trade patterns CEFTA and BFTA would have to find a way to ensure that governments have no control over the sources of imports. This at the very least requires the abandonment of parastatals and the usual forms of import licensing.

### ***Links with other sectors***

How agriculture is treated in an RIA has implications for other sectors, in particular the food and agricultural processing sectors. In addition, agriculture itself is impacted by the arrangements made for other sectors, in particular those providing agricultural inputs and small business services. The more competition in other sectors the more likely it is that the rural sector will be able to withstand competition.

market access for other goods - e.g. food

The market access for foodstuffs is likely to be an important factor in the development of the agricultural industry. Experience with other RIAs suggest that better import access for foods will have the effect of driving the domestic farming industry toward greater competitiveness. The food industry has traditionally relied heavily on local raw materials, with processing close to the production point. Recently there has been a growing trend toward a food industry which shops around for raw materials in other areas and is sensitive to price as well as quality. Under these conditions farmers are competing directly with those in other regions for the chance to supply this processing industry.

Farm returns will generally improve from this trend, as some degree of market differentiation is often possible. CEFTA countries have experienced considerable inward investment in the food and beverage sector, and this has given an opportunity for farmers who supply these firms with the raw materials. BFTA also should find that firms will be more attracted to an integrated region, and the improved market access for food products will be a further inducement.

#### liberalization in the services market

Another key area which could have a major impact on agricultural and rural development is liberalization of the market for services. Though for many years considered a poor relation to trade in goods, trade in services has expanded until it is now a significant aspect of open trade relations, both regionally and multilaterally. The EU has free trade in services explicitly as a goal for the internal market, and this is true for NAFTA, which was quite innovative in this regard. Other RIAs have generally followed this trend, though less completely.

For rural policy, free service trade opens up two different types of possibilities. One is to exploit the complementarity between some service activities, particularly tourism and the restaurant trade, and agriculture. This is sometimes accompanied by the formation of regional service enterprises, such as hotel chains, which in turn might exploit local attractions such as traditional foods. The other possibility is additional employment and income in the rural area from such service activities which help to keep the balance in the farming sector.<sup>19</sup>

Other services help the rural sector by reducing the traditionally high transactions cost relative to urban areas, as well as correcting the common bias towards better educational opportunities in towns and cities. Modern telecommunication systems combined with a

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<sup>19</sup> Farms at the level of development of those in the CEEC tend to have too much labor and too little capital relative to their land area. Thus an additional outlet for the labor is crucial to these areas and the income earned is often reinvested in the agricultural enterprises.

good road network will attract investment into rural areas: improved schools and technical education will ensure that the jobs that this investment brings will go to local people. Investment clearly can be attracted without forming regional agreements, as Chile has demonstrated, but if a regional agreement makes political sense then the benefits should include a more integrated service sector and better conditions for foreign firms to set up activities.

#### capital movement and right of establishment

Movement of capital and the right of persons to set up in another member country were a part of the foundation of the EU. Other RIAs have followed somewhat hesitantly.

Capital movement was for instance excluded from the original objectives of CARICOM, as impairing the ability of individual governments to control capital flows. However, capital markets are not global in scope and the issue of capital mobility within RIAs is largely moot. Capital mobility is the underpinning of much of the service trade and the flow of foreign direct investment. As such it has an indirect effect on rural policy.

The freedom of establishment is often included in RIAs as an adjunct to liberalizing capital movements. Once again it is the key to the international provision of services, in particular those that require the seller to move to the buyer.<sup>20</sup> Rural service activities could be greatly benefited by the freedom to establish businesses in other RIA members. Regulatory reform also assist in this process.

#### labor movement, pension mobility, and qualification recognition

The fourth economic “freedom” in the single market area in the EU is that of movement of labor. There are several aspects to this, including the ability of skilled workers to move to other member countries to the movement of unemployed workers in search of work. The

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<sup>20</sup> Service trade is often divided into those transactions where the buyer goes to the seller (e.g. tourism); those where the seller goes to the buyer (e.g. construction work); and those where no physical movement is needed (financial advice). The second of these types often requires both capital and labor movement and the right of establishment in the “host” country.

EU is the only RIA to have an explicit goal of free labor movement and have enacted the regulations to bring it into fruition. This no doubt reflects the political goals of the EU in its early days, though the commitment to free labor movement may be dwindling.

NAFTA took great pains to avoid any commitment on labor movement. Other RIAs have made limited attempts to allow skilled workers to move but have been wary about allowing those without jobs to migrate freely in search of work.

Among the important issues governing labor mobility are the portability of pensions, the eligibility for social security and health benefits, and the mutual recognition of professional qualifications and university degrees. The EU is in the lead in tackling these issues, with a high degree of mobility possible. Some RIAs have addressed some of the issues. CARICOM has a unified university system (The University of the West Indies) with its three campuses open to students from any CARICOM country. Though apparently remote from rural policy, the conditions under which families and workers can move may well have very profound impacts in the CEEC where there has been a considerable history of movement but several decades of tight restrictions.

### **C. Cross-Country Issues**

#### ***External Policies***

coordination of WTO schedules and positions

It is a curious fact that although most of the members of the WTO now belong to regional trade agreements, very few of these countries coordinated their WTO tariff schedules.

The notable exception, of course, is the EU, where competence for trade policy resides at the Union level (though individual member states are still members of the WTO). One would expect members of FTAs to have independent trade policies, but even the so-called Customs Unions reported different tariff bindings to the WTO.

There is however a strong reason for small countries to coordinate their position within the WTO and it may help to consolidate tariff schedules as well for domestic reasons. In

the case of CEFTA and BFTA there is no talk of a common external tariff (though as mentioned above, tariff differences might be expected to be reduced over time). Indeed the tariff to which all aspire is the CET of the EU. This may give a strategy for informal convergence which could ease the problems which arise from disparate tariff levels.

#### common negotiating bodies

The benefit of coordinating external negotiations rests on the notion that small countries (as most of the CEEC are) and even medium sized countries (such as Poland) have little negotiating power alone. They rarely put forward ideas for rule changes, and are not often consulted by the large trading powers. Collective action means that a group of countries can get some attention on issues that particularly concern them. CARICOM has recently set up a common negotiating body to coordinate the trade position of the region with respect to upcoming talks with the EU, the US, MERCOSUR, and the WTO. Many of the countries in Latin America are members of the Cairns Group, the group of small and medium sized agricultural importers that made sure that agriculture remained on the agenda in the Uruguay Round. MERCOSUR itself has plans to coordinate its position in trade talks, and this is helped by the creation of a Secretariat.

It is unlikely that the CEECs will be able to negotiate as a bloc with the EU, on agriculture or on any other area. The tendency will be to split between the first tier and the second tier countries. This could cause problems for CEFTA and BFTA, each of which would have members in each camp. But in other external negotiations there could be some benefit in coherence and coordination. And there could be significant saving of scarce resources if the CEFTA countries coordinated their activities in Geneva, as indeed there could be also for the BFTA countries.

#### trade information and market promotion

On a more mundane level there are likely to be benefits from sharing of information on markets and trends among the agencies that assist farmers and agricultural processors.

This could on occasions go beyond the “pure” information to include coordination of anti-dumping actions and the monitoring of trade agreements such as the Europe Agreements. Other RIAs are contemplating such collective actions though not much has happened so far.

“preparation” for joining larger blocs

One particular manifestation of the advantage of coordinating negotiating positions is that of defining strategies for joining other trade blocs. In the case of MERCOSUR this has taken the form of planning the expansion to become a South American Free Trade Area, to negotiate on more even terms with the NAFTA. For the CACM the issue was whether to join NAFTA, though that possibility now looks remote. The CARICOM countries see their own RIA as in part preparing them for participating in a larger bloc. CEFTA is certainly seen as a step towards EU membership.

One can ask how effective is this “preparation”? Some opening up of a previously closed economy is no doubt beneficial, but why should it be done regionally? For industrial goods there is some merit in the argument that unilateral opening of the economies of the CEEC, along the Chilean lines, would have been as beneficial. For agriculture there is perhaps less of a case for unilateral action. The existence of the Common Agricultural Policy means that the CEEC will become part of a relatively integrated agricultural sector with common rules and protection levels within a few years. The opening up of trade in agricultural goods within the applicant countries will assist those countries to get ready for “competition” within the EU. Orientation to world markets would normally be more constructive but could imply two periods of adjustment to different conditions within a few years.

avoidance of “hub and spoke”

At the time when Mexico approached the US to discuss a free trade area, along the lines that the US had recently signed with Canada, it was uncertain whether there would

develop a series of bilateral trade deals or one trilateral agreement. Canada argued for a trilateral agreement to avoid the problem of a “hub-and-spoke” configuration. With the US as the hub, and the bilaterals as the spokes radiating from it, trade and investment would favor the hub.<sup>21</sup>

CEFTA and BFTA are useful if for no other reason than to avoid the hub-and-spoke problem. No longer is a Hungarian manufacturer at a disadvantage selling into the Czech market relative to a German manufacturer. The same is true as between Latvian and Finnish suppliers on the Lithuanian market. Does this have any implications for agriculture? The effect will be limited by both the quantitative restrictions built into the Europe Agreements and to the limits of CEFTA in the area of agriculture, but the principle still holds.

### ***Institutional Issues***

central decision making

The extent to which the RIAs considered in this paper have central decision making bodies differs widely. At one extreme one has the EU with defined competencies and the supranational powers to carry out its obligations. The NAFTA, and the Canada-US FTA before it, does not even have a secretariat, though there is a NAFTA Council and a series of quasi-judicial bodies.

As important as how central decisions are made is that of who makes the decisions. Will it be trade ministers or agricultural ministers that make decisions on, say, removing a product from the “sheltered” list in CEFTA. Agricultural ministers know the detail of agricultural policies and the special problems of the sector. However they have had difficulty in the past being objective about the agricultural trade situation, often assuming

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<sup>21</sup> Lomé is in many ways a hub-and-spoke arrangement, with the EU at the hub, whereas the (British) Commonwealth Preference system at least implied that all member countries accorded each other preferences.

that world market conditions will turn to rescue past policy mistakes and needing the constraint of finance and trade ministers before taking tough reform decisions. In this respect the forum in which decisions are taken in agriculture may be the most important of all.

#### parliamentary cooperation

One simple means of promoting cooperation and avoiding conflict is through the parliamentary bodies of each country. This has the benefit of focusing public opinion on some of the regional issues, but it carries with it a danger of allowing confrontation and a spill-over of national concerns into regional politics. One could expect that agricultural issues would take up more time in such debates than proportional to the sectors share in national income. Parliamentary collaboration is already promoted through several regional bodies. To date there does not seem to be new administrative initiatives in this area among the CEFTA and BFTA countries.

#### dispute settlement and legal process

Perhaps more important than the parliamentary links are the institutions which deal with disputes in the trade area. Once again agricultural issues are likely to be over-represented in the area of trade disputes. NAFTA has perhaps the most elaborate dispute settlement mechanism of the American FTAs. Several agricultural disputes, mainly between Canada and the US, have been adjudicated in this way. The EU, by contrast, goes much further by setting up legal institutions at the multilateral level. This changes the nature of dispute settlement from intergovernmental intermediation to interpretation of established Treaty articles by a judiciary process. CEFTA and BFTA have not included any such legal apparatus as yet, and as their aim is to join the EU they are unlikely to make the effort to do so in the future.

#### private sector collaboration

The private sector can have a direct influence on the direction and path of integration. Often the politician makes the first move, by announcing a regional initiative, and the businessman takes him at his word. When the pace of political action slows the private sector applies pressure to complete the task. Once business starts to think of a region as constituting an integrated market then they are impatient of impediments to the movement of goods, services, labor and capital. Politicians often find themselves following this trend by removing barriers to regional trade and factor movement as requested by the private sector.

One lesson from the early days of the European Union is that the political and the economic motives are in any case closely aligned. Economic integration was undertaken as a way of advancing the political agenda in post-war Western Europe. Investors and businesses began to think of Europe as integrated, and the combination of commercial and political arguments proved irresistible. Integration in EFTA did not proceed far beyond a modest industrial free trade area in part because of a lack of any political rationale. Businesses were more interested in the developments in the EU, and never were able to push the free trade area much beyond its initial goals. NAFTA has some political justification, including the benefits to the US of having friendly neighbors, but in general the public debate has emphasized economic issues, along with those of the environment. US business interests are generally in favor of further integration in the hemisphere but there is no long term political agenda which excites public interest and justifies short term sacrifices. MERCOSUR started with a strong political incentive to defuse bilateral tensions between Brazil and Argentina: it has sparked the interest of the private sector and seems to be developing a momentum which other RIAs in the region lack. The Europe Agreements would be much less viable in the absence of strong political and security motives for entry into the EU.

The question therefore is whether CEFTA and BFTA have a strong political rationale which will drive the economic agenda, and whether the private sector is sufficiently interested in the economic agenda to back the politicians. In the case of CEFTA there

does not seem to be a political rationale separate from that of EU entry. It is unlikely that one could make a strong case for economic integration among these economies, as opposed to their independent participation in an open economy, if they were not lining up for membership of the EU. For this reason it is likely that the private sector will continue to look to Western Europe and leave the development of the CEFTA market to the politicians. For BFTA the economic case must rest on the advantages of scale economies, but the centrifugal tendency for the Baltic Three to assert their independence at the expense of solidarity will be difficult to resist. Once again the private sector may not be able to keep the regional show on the tracks.

This issue is important for agriculture for two reasons. First, without the political commitment it may be difficult to make the modifications to domestic agricultural policies to make a success of the regional agricultural market. There has to be some broad political benefits to allow rural legislators to confront those who favor the status quo. Secondly, the agricultural processing sector and the food sector can be key actors in the politics of regional integration. If they shift from a national orientation to a regional (or international) view of their production base and market then they will exert pressure on politicians. Otherwise they will tend to support policies which maximize domestic production.<sup>22</sup>

### ***Membership Changes***

new member accession and schedule adjustment

Successful RIAs grow in size, at the expense of those that fulfill less of a need. The EU has been enlarged on four occasions as countries which were previously outside decided that they would rather be in.<sup>23</sup> Both CARICOM and MERCOSUR have expanded, and

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<sup>22</sup> The fact that so much of the investment for the food industry in the CEEC is coming from foreign firms suggests that they will be outward looking. On the other hand anecdotal evidence suggests that when a foreign firm buys into a protected national market they can turn protectionist in outlook.

<sup>23</sup> The economics of the process of growth by RIAs is itself a fascinating topic. For the existing members, the additional benefits are likely to decrease with the size of the membership, and the costs of administration increase with more members. On the other hand the benefits of joining a RIA increase with

have countries lined up to join. The Andean Pact is shrinking as its members come to terms with MERCOSUR and the CACM already includes almost all of the obvious countries.<sup>24</sup> The issues involved in accession are therefore well known.

The issue of new membership brings out the difference between RIAs that are driven by strong political motives and those that are there because of commercial convenience. The former engender strong passions. It is not surprising that the UK has not fitted well into the EU, given its different views on the desirability of political union: it was kept out for many years on these same grounds. But membership of EFTA hardly makes the front page of the newspapers. One would not expect the EFTA-CEEC agreements to cause any political problems for the countries concerned: they are marginally useful commercial treaties. If CEFTA is seen in the capitals as similarly politically innocuous then joining it will imply no great commitment other than a change in tariff schedules. If CEFTA membership brings not only greater readiness to join the EU but also expanded investment, common standards, joint bargaining, and political representation then it will be attractive to others in the region. The fact that Croatia, Macedonia and the Ukraine have shown an interest does not settle the matter: they may be after some market access, investment credibility and political legitimacy.

One issue which has already come up in the expansion of CEFTA is that of the agricultural commodity schedules. First Slovenia and later Romania wanted to be able to modify the list of goods to reflect their own sensitivities. This has caused some tension,

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its size and the cost of exclusion tends to increase. This suggests that there will eventually be a limit to the size of the RIA and that others may spring up to absorb the disappointed applicants. Several countries wanted to join NAFTA, but the resistance in the US is considerable. MERCOSUR is proving an attractive alternative for the smaller countries in the region. If the EU were to put the conditions of membership out of reach of CEFTA members it is not impossible for an alternative bloc to form in Europe. Of course this alternative would not be discussed during the negotiations for membership of the EU.

<sup>24</sup> Belize is a member of CARICOM as a consequence of its British heritage, but has recently shown a desire to have closer trade ties with its Spanish-speaking neighbors if it can do this without casting itself adrift from the other CARICOM countries. The larger Caribbean islands, Cuba and Hispaniola (Haiti and the Dominican Republic), are looking for affiliations and are interested in CARICOM. The umbrella group, the Association of Caribbean States (ACS), has not yet found a role in the economic integration process.

but if the schedules are seen as temporary ways of defining the transition to free intra-regional trade it should matter little if latecomers are using somewhat different transition arrangements.

#### timetable for accession

The timetable for accession is both an economic and a political issue which new members have to face, and often the two considerations clash. For the existing members the faster the new member adjusts the less disruption - unless the new member is a particular threat to the stability of the internal market. For the new member a slower transition for sectors in which there are likely to be adjustment problems would seem better. Transition arrangements are therefore heavily dominated by agricultural arrangements, as one of the sectors where adjustment to internal free trade could be painful. However, every new member wants to be a full member of all decision-making bodies from the start. Thus the EU has usually offered new members a voice in decision making at once but a lengthy transition period in which to align agricultural prices with those in the existing members.

More recently, with the accession of the three EFTA countries, the pattern has changed. The emphasis was on the immediate entry into the single market, with compensation payments to ensure that particular farm groups did not suffer income collapse. There would seem to be some uncertainty as to whether this model will be applicable to the CEEC entrants. On the one hand there should not be the same problem of farm income falls in the CEECs: on the contrary, income is likely to rise. But the agriculture of the existing EU could be adversely affected by produce coming in from the new members and diluting market prices.

#### exit decisions and access preservation

One issue that is likely to be relevant for countries in CEFTA and perhaps BFTA is that of exit. Suppose one or more countries gain admission to the EU in advance of the rest. How the exit is handed may be important to preserve the benefits for the remainder. The

precedents are favorable for an arrangement which does not involve increases in tariffs. When Chile left the Andean Pact there were bilateral agreements to soften the impact on the most affected sectors. Peru suspended its membership of the same group more recently, but signed bilaterals with the other members to preserve most of the advantages of free trade. When two of the EFTA members defected in 1973 to join the EU there were bilateral free trade agreements (excluding agriculture) between the EU and each EFTA member. It would seem likely that similar agreements could be worked out if some of the CEFTA and BFTA countries joined before the others. The easiest way would be to incorporate the relation into the respective Europe Agreements of the excluded member. With respect to CEFTA, the terms of access for (say) Romanian and Bulgarian goods into Hungary and Poland (assuming they were in the first wave) would not have to be changed. They would merely be covered by the Europe Agreement rather than CEFTA. Clearly the closer are the terms of access incorporated into the Europe Agreements to those in CEFTA the easier such a transition would be. For the BFTA countries the same provisions should hold. Entry by one country could have little impact if the Europe Agreements matched the previous BFTA access.<sup>25</sup>

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<sup>25</sup> The new members would of course have to change more policies, as a result of adopting the CAP, but in terms of market access for agricultural goods the Europe Agreements are already aiming for free trade by the year 2000. Agricultural provisions include quotas on access to the EU market, which would need to be liberalized or expanded with membership changes. In turn the access of the EU to the CEEC would be liberalized with membership, but then there would be no export subsidies paid on such exports.

#### **4. Conclusions**

The advantages and disadvantages of incorporating agriculture in a free trade area such as CEFTA and BFTA can be related to the dominant objective of rural policy. If the policy goal is to fully integrate the rural sector with the world market then regional or preferential trade liberalization is rarely the best way of opening up the agricultural sector. Unilateral reduction of protection is more likely to give the best results, as this will allow third country suppliers to compete for the domestic market, along with domestic producers. (This is essentially the Chile model, with Estonia being the only European country to follow a similar path). Regional liberalization will be less efficient than unilateral action in that some suppliers will get preferred access. If these are not the most efficient suppliers then the agricultural market will not be truly competitive (this is Chile's problem with adopting the MERCOSUR CET). On the other hand the "first best" policy may not be available, either because it is a political non-starter or because the regional route has political rationale. In this case the policy issue is to keep trade diversion costs to a minimum. In a free trade area this should be possible through a low external tariff for each member. In a customs union one country could be forced into a more protectionist position than would be preferred by that country (the UK problem with joining the European Community in 1973). Then the institutional process for changing the CET becomes crucial.

If the policy goal is eventual liberalization, perhaps a little ahead of global liberalization in the WTO, but there are real problems in the short run about imposing too much pressure on certain sectors which need time to be globally competitive, then a case could be made for regional liberalization of agriculture under certain conditions. One would be that the country with which one was entering into a preferential agreement should ideally be a more efficient producer of agricultural import items. In other words the price should tend to go down with regional liberation. That way the regional agreement would not be used to support high cost agriculture. (For export products it is in a country's commercial

interest to have preferential access to an otherwise highly protected market in a partner country: it is up to the importing country to worry about the inefficiencies of such a policy).

If, however, the main goal is to preserve agriculture from outside competition then any form of trade liberalization should be resisted. This was the Scandinavian model before entry into the EU. Even limited opening to trade from a partner country will lead down a slippery path to liberalization, hence the need to exclude agriculture from EFTA.

Domestic policies will become more difficult to manage. Program costs will increase.

Trade tensions will be exacerbated. Goods will find their way in through partner countries, as rules of origin don't work well for agriculture. One would hope, however, that few governments in the present era of expanding global markets still want to insulate their agricultural sector in this way. Slovenia has recently made it clear that they wish to reform and modernize their agriculture and farm policy, and Lithuania has made significant strides in the same direction.<sup>26</sup>

If for reasons other than agricultural policy a free trade area was to be set up then agriculture should normally be included. To leave it out would be to risk isolating that sector from competitive pressures, as happened in EFTA. But if agriculture is included then it is important that the level of protection against external sources of agricultural products be as low as possible, to avoid the EU problem of trade diversion. In a free trade area one could even imagine one country having a zero tariff on third country imports (Estonia within BFTA?), implying that other member states would have to rely on the enforcement of rules of origin to avoid losing all protection of their own markets.

If the other members of a customs union do not agree to a strategy of following a low protection policy for the agricultural products which one imports then it could be best to

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<sup>26</sup> Both Romania and Bulgaria started with the opposite problem, taxing their agricultures and in particular restricting exports. Under such conditions the opening up of these sectors to the world market (i.e. removing the "protection" that the rest of the world enjoyed from Romanian and Bulgarian goods) should pose few political problems.

request that some of those commodities be excluded (as Canada did with sugar, though NAFTA is not a customs union). In that way a more liberal policy can be continued in at least one country. Other countries may wish to exclude commodities when they wish to maintain *inefficient* production: this is a reasonable solution only if the alternative was to have higher protection throughout the RIA. However, there are limits to the exclusion strategy since under WTO rules the free trade area has to cover “substantially all trade” (Article XXIV). One can do the same thing by having flexibility in the operation of the CET and the rules of origin (the CARICOM solution).

If one joins a RIA, and agriculture is included, one crucial question is whether to move toward a common agricultural policy or to allow each country to run its own rural policy. If a customs union arrangement is favored, the level of common protection is crucial in determining whether the incentives are there for efficient agriculture. It may be difficult to influence this common level, as interests in other countries will tend to focus on keeping prices high. Without a common policy the level of protection is that which can be sustained by the market arrangements, which will reflect third country access agreements, internal trade flows, arbitrage and different production conditions.

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# **Rural Policy Lessons for the CEEC from Other Regional Integration Agreements**

by

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