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Will Eastern Enlargement Force the EU to Fundamentally Reform its Common Agricultural Policy (CAP)?

Andreas Knorr

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Abstract

With a share of almost 50 per cent in the EU's budget the Common Agricultural Policy (CAP) is clearly the single most important EU policy. From its inception in the late 1950ies it has also been its most controversial for being hugely protectionist and essentially command-and-control in nature (in the words of *The Economist*: “An expensive way to create surpluses, high food prices, environmental damage and harm to poor third-world farmers“). Neither intense international pressure nor several internal attempts to reform it (the CAP had triggered several severe budgetary crises in the EU), however, were successful so far.

On May 1, 2004, eight central and eastern European countries (CEC-8) plus Cyprus and Malta, will join the EU; by 2008, Bulgaria and Romania are scheduled to follow. Their accession will present the CAP with its biggest challenge yet. While in the 15 current member states (EU-15) agriculture is a quantité négligeable (GNP share: 2.0 per cent; employment share: 4.3 per cent), it is of major economic importance to the newcomers (GNP share: 5.1. per cent; employment share: 21.4 (!) per cent). As a result, Eastern enlargement will create both a poorer and more agriculturally oriented EU. Against this backdrop we will estimate whether Eastern enlargement is likely to increase the pressure for a fundamental CAP reform.

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Andreas Knorr*

> "…We give subsidies for a lot of reasons. The question is not do we give subsidies, but how we give them"
>
> *Franz Fischler* (January 2003)[1]

Introduction

The outstanding political importance of the Common Agricultural Policy (CAP) in the process of European integration can be observed when its share of the EU budget is considered – currently it accounts for 45 percent of EU's expenditure; during the 1980ies (*Ardy* 2000) its share even accounted for almost three quarters of the EU budget. Moreover, CAP's share of the 80,000 page Acquis communautaire – the Union's body of primary and secondary law – reached approximately 50 percent. Anyhow, regardless of some minor reforms CAP was not spared of fundamental economic criticism, firstly due to financing problems and secondly due to the reluctance of the EU to fully integrate agriculture into the GATT/WTO framework. *The Economist* (*The Economist* 2002) recently described the CAP as "an expensive way to create surpluses, high food prices, environmental damage and harm to poor third-world farmers". However, European Union enlargement on 1 May 2004 poses a major challenge for the CAP. This is because agriculture has a far larger economic relevance in the new member states than in EU-15 (*OECD* 2002a and 2002b). The agricultural sector merely reaches a share of 2 percent of the gross national product (GNP) and 4.3 percent of employees in the current 15 EU member states (EU-15), whereas it reaches a 5.1 percent share of GNP and 21.4 percent of employees in the European Union Acceding Countries (EUAC) in Eastern and Central Europe. Furthermore, the agricultural area will increase by 45 percent and the number of employees in the agricultural sector will even increase by 120 percent in the wake of this enlargement (*European Commission* 2002a, 75) – with the EU's overall population increasing by merely 28 percent and its GNP (calculated on the basis of purchasing power parities) by just 11 percent. This paper analyses the future prospects of the of CAP in the enlarged EU which, on average, will both be poorer and far more agriculturally oriented then the existing EU-15.

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[1] *Fischler* is the EU's Commissioner for Agriculture.

Basic Elements of the Common Agricultural Policy (CAP)

Principles and Objectives

The basic principles of CAP are the unity of the single market, i.e. free movement of goods within the EU, the joint financing (solidarity) and the so-called community preference, which directly led to the EU's extreme protectionism in the agricultural sector. The precise design of the CAP, which has been introduced to the European Economic Community (EEC) – the EU's economic pillar – from July 1964 onwards, is regulated in articles 32-38 (ex-articles 38-46) of the Treaty of Rome (as amended in the Treaty of Amsterdam). Article 33 (ex-article 39) mentions the following objectives :

- To enhance agricultural productivity by encouraging technical progress, rationalisation in agricultural production and best possible input of production factors, in particular considering the workforce;
- To guarantee the farming population an adequate standard of living, in particular by increasing income per head of farmers and other agricultural workers;
- To stabilise (agricultural) markets;
- To guarantee supply; and
- To provide adequate prices for consumers.

Instruments

The aforementioned objectives were traditionally achieved by means of so-called common market organisations respectively market regulations against the background that most world prices of agricultural products are (substantially) lower than average production costs within the EU (*Koester* 1996). These regulations currently still include about 90 percent of the common agricultural production, strictly regulating their production and/or trade flows. Four basic types of market regulations can be distinguished (table 1).

Table 1: Classification of CAP market regulations

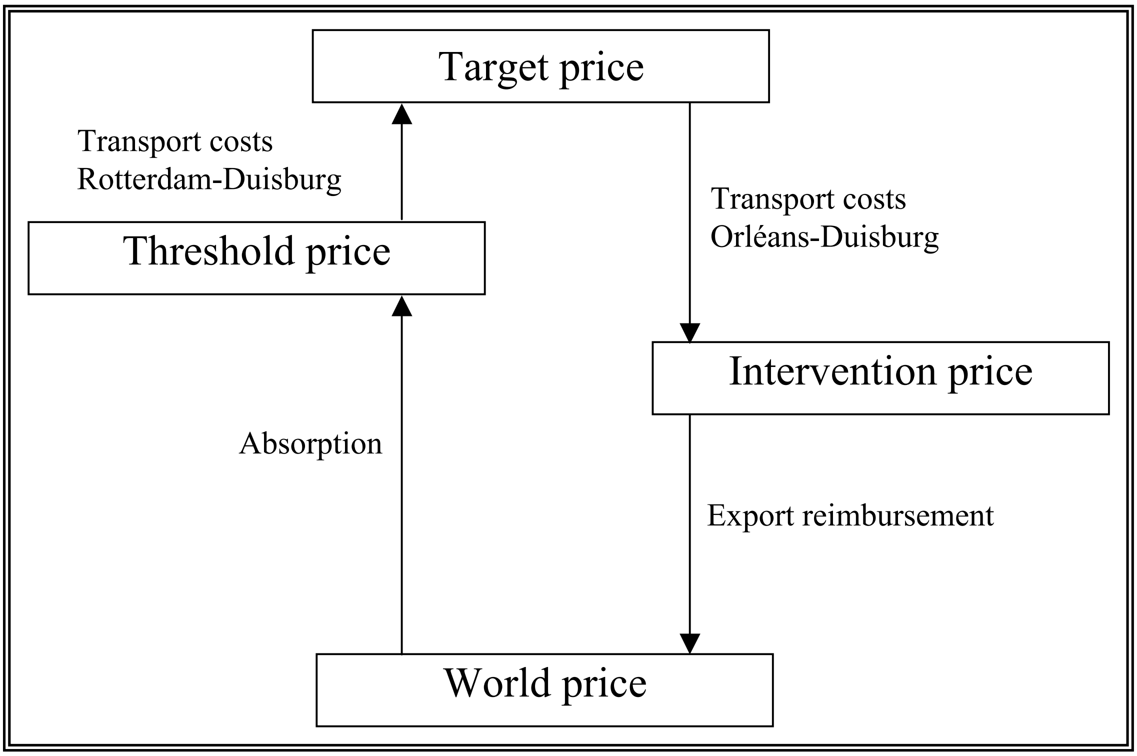
Type of market regulation	Included products
Intervention (=minimum prices) *plus* production subsidies *plus* protectionism	Grain, milk and milk products (from 2005), beef, rice, olive oil, sheep meat, oil seeds, dried grapes
Intervention *plus* protectionism	Sugar, milk and milk products, pork, wine, fruit and vegetables
Production subsidies *plus* protectionism	Flax and hemp, fodder, processed produce of fruit and vegetables, tobacco, hops, seeds, goat meat, bananas
Protectionism	Poultry, eggs, other fats than olive oil, alive plants and goods of flower retailing, products, which do not fall in one of the other categories[2]

Source: Based upon *European Commission* (2003a).

[2] These are basically substitutes for certain domestic products, which are cultivated outside the EU, e.g. manioc and soy.

The functionality of the CAP's agricultural support system is imaginably simple (table 2 describes it for the grain market regulation).

Table 2: The traditional CAP price support mechanism (grain market regulation)



Source: *Bartling* (1984, 34) and *Swinbank* (1996, 134).

The *target price*, which is yearly set by the European Council of Agricultural Ministers, i.e. representatives of the member states, reflects the politically desired price level of the concerning product for the following year. The so-called *threshold price* for imports is calculated by subtracting transport costs between the main port of imports Rotterdam (Netherlands) and the principal intra-community subsidy area[3] Duisburg (Germany) from the target price. The difference between this price and the world price, which is much more volatile than the former, is fully eliminated by a variable tariff, which is also known as absorption. A minimum price for agricultural imports is hence fixed by this procedure. This minimum price ensures that foreign producers are not in a position to offer their products in the EU below the EU's target price. The *intervention price* marks a price floor for the affected agricultural products, which are produced within the EU, in case the degree of self-sufficiency of the community surpasses 100 percent. Farmers and distributors could initially sell their whole crop at this guaranteed minimum price per output unit at so-called intervention centers (in the meantime, some quota were introduced). The intervention price is calculated by adjusting the target price by the transport costs between the main area of surplus and the main area of subsidy. Therefore, the market price can only swing between the target price and the intervention

3 This means that any farmer in the Duisburg area is entitled to the highest subsidy amount per output unit throughout the entire EU.

price. Export subsidies (named export reimbursements) fully balance the difference between the higher production costs of the community and the lower world price in order to be able to sell at least part of the surplus production by exporting it to other states.

The Economic Case Against the CAP

The underlying problem of CAP – apart from the enormous and well-documented incentives to subsidy fraud inherent to the system (*Angres*, *Hutter* and *Ribbe* 1999) – is its almost sole orientation at the suppliers' interest. By contrast, consumers, which are only mentioned once in the catalogue of the CAP's objectives, are solely entitled to adequate – as opposed to low –prices for agricultural products (*Messerlin* 2001, 80). Therefore, it is not surprising that merely two of the four objectives could be achieved: security of supply and a sufficient income for employees of the agricultural sector. These apparent successes have been bought not only for a financially high price, as will be extensively argued below, since the CAP still accounts for more than 50 percent of the EU's budget. Furthermore, the huge indirect costs of CAP have to be added to these direct costs – with most of the indirect costs having spilled over upon third countries. The economic critique of CAP substantially focuses on the four aspects which will be discussed now.

Huge Welfare Losses Due to Autarky

The politically intended autarky for important agricultural products had been achieved fairly rapid, partially already at the end of the 1960ies. Degrees of self-sufficiency of 116 percent in case of grain, 98 percent in case of potatoes, 128 percent in case of sugar, 109 percent in case of wine, 123 percent in case of milk (370 percent in case of milk powder), 103 percent in case of eggs and 107 percent in case of meat are reached at present according to official estimates (*European Commission* 2002b). The high necessary expenditures for the storage, elimination or the subsidized export of the resulting surpluses are not only the main cause behind the CAP-induced budgetary crises the EU has suffered regularly since its inception. Even worse, they also create considerable welfare losses due to the abdication of the welfare increasing effects of free(r) trade in agricultural products. The latter point does not just refer to the agricultural sector itself, but also in all those sectors where the trade partners of the EU refused to agree to (further) liberalization due to the EU's agricultural protectionism. Furthermore, the negative consequences (following overpriced inputs) for the competitiveness of the food processing industry within the EU and the below described substantial decrease in the consumer surplus also have to be added to the indirect costs of the CAP.

Perverse Redistributional Effects

With the help of the CAP politicians were very successful in redistributing income to the employees of the agriculture sector. In this regard it is not only remarkable that public net allowances, i.e. the balance of EU and member state grants minus all direct taxes paid by the farming community, account for 47 percent of the income[4] of agricultural employees in the EU-15 (*European Commission* 2001, 24). On a per capita basis, this translates into additional costs of approximately 370 Euros in terms of higher taxes and food prices for every EU-citizen and year – incidentally an especially serious strain on poorer household which spend a higher share of their income for food. But contrast, the household income of agricultural employees have – largely unnoticed by the public or even economists – continuously exceeded the average income of all households in almost all the EU's member states (*OECD* 1999, 12; *OECD* 2002c, 12; *OECD* 2003) – in the case of Belgium by a margin of approximately 25 percent, in Denmark and France[5] by approximately 40 to 50 percent and in the Netherlands by more than 150 (!) percent.[6] Furthermore, these statistics conceal the fact that the major share of agricultural subsidies flows to the major agricultural producers (their proxies are also spearheading the national farmers' unions of the EU member states), because the absolute output quantity still is the primary calculation base. This means that the Top 20 percent of the agricultural businesses, which account for more than 70 percent of the common agricultural production, also receive nearly 80 percent of the subsidies granted by the EU and its member states, even though the income of their employees significantly lies above the average income of the sector and most notably above the average income of EU-citizens (*The Scottish Parliament* 2001, 6). Finally, CAP not only favours farmers to an extremely high degree, but also the owners of inputs, which cannot be easily replaced, in particular the lessors of land, which are in case of Germany in their majority neither active farmers nor residents of the rural areas nor in need of state aid for social policy reasons (*Schrader* 2000, 17; *OECD* 2002d).[7]

CAP-induced Environmental Damages

Like every other human activity agricultural production inescapably leads to environmental degradation. The principal areas for concern are the contamination of groundwater with fertilizers, pesticides and fungicides, the irrigation-induced salinization of land, erosion in case of extensive cultivation, pollutant emissions, the destruction of habitats, and, inseparably connected, a reduction of biodiversity. A considerable share of these damages can be ascribed to the already mentioned CAP-immanent perverse incentives which foster overproduction in general. The problem is exacerbated by considerable state subsidies for important inputs (water, fertiliser, diesel, heat energy etc.), also encouraging environmentally damaging waste, so that they ultimately can be ascribed to political failure to a substantial degree (*Stiftung Europäisches Naturerbe EURONATUR, Arbeitsgemeinschaft bäuerliche Landwirtschaft* 2002). Finally, indirect subsidies in the shape of price ceilings or laxer standards for pollutant

4 In this regard the EU speaks of a family farm business income.

5 *Messerlin* (2001, 93) notes that France subsidised every employee in the agricultural sector with 17,000 € in 1999 on average – the legal minimum wage in France is only 10,000 € per year.

6 This is all the more noteworthy, because from the point of view of marginal farmers, the CAP's subsidy regime ultimately acts as a market exit barrier, i.e. the CAP effectively <u>decreases</u> the average agricultural income!

7 90 percent of the agricultural area in former East Germany are leased as compared to only 60 percent in the West (*Koester* 2003, 154).

emissions of agricultural origin in comparison to standards for industry and private households are another crucial factor in this context (*Knorr* 1997, 47).

Destabilisation of World Agricultural Markets and Trade Conflicts

The EU and USA enjoy a world agricultural market share of about 20 percent each and, therefore, are the two biggest exporters of agricultural products. However, by adopting the CAP the EU transformed itself within a few years from a net importer to a net exporter (although the EU also is the world's biggest importer of agricultural products with a world market share of 20 percent). Admittedly, the USA accounted for merely 1.5 percent of export subsidies for agricultural products of the OECD member states between 1995 and 1998, but the EU accounted for 90.2 percent (*Diakosavvas* 2003, 46). This fact is considerably problematic insofar as the EU exerts considerable pressure on world market prices and, furthermore, ultimately externalizes a substantial share of the economic costs of the CAP; *Borrel* and *Hubbard* (2000) estimate that the EU shifts nearly a third of these on third countries. Moreover, the EU displaces competitive suppliers from third countries respectively considerably decreases their income, because re-imports of the highly subsidised surpluses fail to the greatest extent due to the EU's comprehensive import restrictions. In addition, as the EU's surpluses underlie significant annual variations, which ultimately and inevitably lead to increased volatility of world market prices of agricultural products – this also implies negative allocative and redistributive impacts in the affected countries. Finally, CAP is the main cause of numerous trade political controversies and it also nearly caused the failure of the Uruguay Round.

Previous CAP Reforms

The aforementioned CAP-immanent problems became quickly manifest in high surpluses – the sufficiently well-known milk and wine lakes, butter and grain mountains, which were a logical consequence of achieving self-sufficiency from the late 1960ies for most products. Initially the guaranteed minimum prices (without any limitation of the maximum allowable output per farmer per year) were the key cause for this development. These guaranteed prices also freed farmers of economic risks of any kind. In return the CAP quickly reached funding limitations in the face of a EU budget which is (currently) capped at 1.27 percent of the member states common GDP. Since CAP-induced expenditures increased six-fold in nominal terms and by more than 160 percent in real terms between 1975 and 1988, the CAP gave rise to a significant budgetary crisis in the EU from the mid-1980ies (during the same period, the EU's real GDP had increased by merely 32 percent and even agricultural production by only 25 percent; *Watzek* 2001, 16). Instead of tackling the root of the problem, the economically flawed intervention and subsidy mechanism, the EU at first lapsed into a downright interventionist spiral by trying to fine-tune output through command-and-control means – an approach which was both economically counterproductive and ethically problematic (*Schmitt* 1998, 190; *Howarth* 2000, 8); for example: it was tried to correct the production surplus of milk by introducing slaughtering bonuses for calves (the so-called *Herodes*-bonus). In 1977, after that initiative predictably had remained widely unsuccessful, aside from – obviously – increasing supply on the beef market noticeably, a so-called co-responsibility fee was imposed on farmers. This meant that farmers from now on did not receive the full intervention price per liter, but rather a rate which was curtailed by the joint-responsibility duty. Finally, production quota for milk were introduced as a temporary measure in 1984 after the preceding intervention also missed the desired effects. Anyhow, these quotas have been repeatedly prolonged (and are currently in force until 2005).

In fact, with the help of later corrective measures the EU succeeded in reducing the share of CAP-expenditure of the EU's budget, in particular due to the two reform packages of 1984 and 1988. Inter alia, they led to the reduction of intervention and guarantee prices, the introduction of a so-called guarantee threshold, a land set-aside and the decision to cap the share of CAP-expenditure of the EU's budget to 0.71 percent, later to 0.74 percent, of GDP-growth have to be mentioned. Nevertheless the surplus problem could not be fully solved up to now and the rise of the subsidy volume in absolute terms has continued (*European Commission* 2000, 32).

The three most fundamental reforms, the so-called *MacSharry* reform of 1992, the Agenda 2000 and the recent decisions taken by the Council of Agricultural Ministers in late June 2003 in preparation of the enlargement process were also not capable of radically changing the aforementioned developments. However, these reforms changed the focus of the CAP from the traditional market intervention approach to a system of direct subsidies to individual farmers. The guarantee prices for the agricultural key products grain and beef had been further reduced in 1992, but all attempts of the then agricultural commissioner *MacSharry* and the European Commission to also implement similar reductions in case of milk, wine, fruit and vegetables failed due to the fierce resistance of member states and the farmers' lobby. Nevertheless, the direct bureaucratic control on production capacity has been substantially expanded at the same time. Moreover, farmers received full compensation payments for their income losses due to the reduction of the guarantee prices. These so-called direct payments (*Swinbank* 1996, 137; *European Commission* 2003b), however are still in some way related to output figures, because they are calculated on the basis of historic average yields per acre and only farmers who really produce the product in question will receive them. As a result, the stated aim to uncouple agricultural (subsidy-)income and agricultural production has merely conditionally been reached, particularly since production-dependent subsidies of up to 25 respectively 40 percent are still allowed for some important agricultural products like grain and beef. Furthermore, member states agreed upon

- a downright limitation of agricultural expenditure for the time between 2000 and 2006 to 40.5 bn. € per annum and the introduction of a budget discipline mechanism, which shall prevent CAP-caused budgetary crises until 2013;
- the reinvigoration of structural agriculture policy as the second pillar of CAP in order to support "rural development" by means of the so-called modulation approach, i.e. the (subsidised) creation of alternative jobs in e.g. landscape conversation, animal and environmental protection and tourism by support programs which are funded by reducing direct payments; and
- the introduction of the so-called cross-compliance mechanism. It means that a farmer only receives full direct payments if he fulfils the legally required environment, animal protection and safety at work obligations; deductions of up to 25 percent are possible in case of contempt.

Post-Enlargement Perspectives of the CAP

The necessity of a fundamental reform of CAP, or better its total abolishment, has been extensively accounted for in this paper. This conclusion independently applies, if the EU will be enlarged by the EUAC or not. However, the *MacSharry* reform, the Agenda 2000 and the recent reform decisions of the Council of Agricultural Ministers brought forward some innovations, which are in principal suited for correcting the most serious aberrations of the CAP, i.e.

- the gradual change from direct market subsidies and price interventions to direct payments in 1992;
- the introduction of modulation enables to end the grotesque system-immanent redistributions in favor of larger companies, which have not been revised by the change to direct payments and which cannot be justified in their current form on social policy grounds either; and
- the attempts by the European Commission to draw member states on substantially co-financing CAP as it already has done in the case of the EU's regional policy; all new member states will have to take part in co-financing direct payments within the first pillar of CAP immediately after joining the EU. Not only the group of the current net contributors to the EU's budget, in particular Germany, would profit by this move. Furthermore, the new member states are above all not economically able to financially support farmers to the same degree as the richer current member states. This could possibly motivate both groups to form a coalition in order to reach the gradual abolition of the subsidy regime.

However, the aforementioned scenario is not quite realistic, because experience teaches that the accession of more agriculturally-oriented poorer economies to the EEC/EU – Greece in 1981, Spain and Portugal in 1986 – was always accompanied by a downright increase in agricultural expenditure (*Field* 1998). Furthermore, the weight of the agricultural lobbies has always gained importance in the process. This can be easily explained using rent-seeking theory, because the number of agricultural employees understates the real relevance of the farming community substantially. If family members, retirees, land owners and former farmers, which now work in other sectors, are added to the number of active employees the figure accords nearly one sixth of eligible voters in France, compared to just 4.4 percent of the employees who really work in the primary sector (*Elliott* and *Heath* 2000, 44). The comparative figure for the EUAC, in particular in Poland and Romania (which is likely to join the EU by 2008), is even higher, because of the still widely spread subsitence and semi-subsistence farming (proof of this is the existence of powerful farmers' parties in some parliaments of the EUAC, in particular in Poland). Furthermore, the inevitable structural change in the new member states' agricultural sector to larger units will reduce the organisational costs of the agricultural lobby and will, therefore, further increase its punch.
Furthermore, the decision making modalities in the Council of Agricultural Ministers prove to be a first-rate institutional barrier to reform[8], even though the relevant legal document – the Treaty establishing the European Community (EC-Treaty) ever since

[8] Not to mention that farmers traditionally occupy the position of the agricultural minister and many other key positions of the public administration in nearly all current EU member states and in the EUAC.

provided for decision making by qualified majority in case of CAP. This policy is practised until today and favours the gainers of the status-quo – including the vast majority of the Eastern European farmers (and their relatives) – after enlargement.

Conclusions and Outlook

According to *Koester* (2000, 194), the development of the common agricultural policy of the EU impressively documents how difficult it is to change an institution once it has been created. While the EU's Eastern enlargement did not, as many economists had predicted, fail because of insurmountable controversy about quotas for fruit, vegetables, sugar or grain, the historically unique opportunity to overcome the anachronism CAP, which can be considered as the last sector-specific centrally planned economy within the common market of the EU, has also been disgracefully ignored. Only massive pressure from other states could produce relief, in particular from EU trading partners on the basis of the WTO framework, the more so as article 20 of the WTO-agriculture accord explicitly calls for further liberalisation measures. So far, first indications are noticeable, as e.g. Argentina and Brazil have staged a complaint before the WTO against the EU-sugar market regulations – the most protectionist market regulation of common market organisation ever (*Haupt* 2003). Furthermore, the EU will have to offer compensation measures to its WTO-trade partners after the execution of enlargement, because the average import tariff for agricultural products levied by the EUAC is well lower than the tariffs of EU-15. The attempt to further liberalize agricultural markets in due time until March 2003 during the Doha Round failed due to opposition of the EU (and Switzerland), although the European Council – i.e. the heads of all the EU's member states – unanimously approved the negotiation proposal of the European Commission in January 2003. This proposal envisaged the reduction of import tariffs by 36 percent, a reduction of export subsidies by 45 percent and a reduction of competition-restraining internal agricultural support by 55 percent, inasmuch as the burden could be equally distributed between the developed countries (*European Commission* 2003c). However, this proposal did not go to such lengths as the USA and the countries of the Cairns-group had expected. The suggestion for a compromise by WTO-mediator *Stuart Harbinson* – reduction of agricultural tariffs by 60 percent and abolishment of all export subsidies within 10 years – was dismissed by both sides: the EU thought of it as being far too radical and the USA and the countries of the Cairns-group wanted far further measures (*Rademaker/Koch* 2003). Therefore, the worst has to be feared, implying that the last promising opportunity in the foreseeable future for fundamental reform of CAP has again be missed.

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