The Common Agricultural Policy

I intend in this essay to investigate the reasoning behind the reforms introduced in the Common Agricultural Policy (CAP) during the 1980s. I also wish to evaluate the reforms which have been introduced and outline more radical policies which could possibly be put into effect. Firstly I shall list the aims of CAP and with these in mind explore the above issues.

The aims of the CAP are outlined in article 39(1) of the Treaty establishing the European Economic Community. These are

(a) To increase agricultural productivity by promoting technical progress and by ensuring the national development of agricultural production and the optimum utilisation of the factors of production, in particular labour;

(b) Thus to ensure a fair standard of living for the agricultural community, in particular by increasing the individual earnings of persons engaged in agriculture;

(c) To stabilise markets;

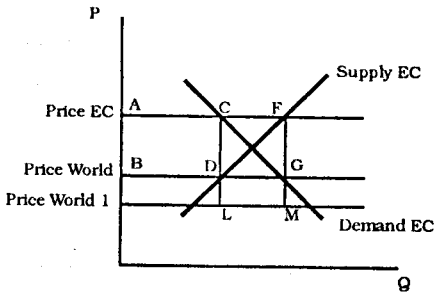
(d) To ensure the availability of supplies;

(e) To ensure that supplies reach consumers at reasonable prices.

An evident need for reform can be seen from an examination of production, cost and other agricultural statistics from the 1980s. I shall discuss these later. However as I wish to criticise the mechanisms of CAP during the decade in the context of possible alternative systems of achieving the above aims, it is important to provide some rationale for the agricultural experience under the CAP. Thus I am outlining a very simple model of how the CAP operated for many commodities during the 1980s. For example what I describe below is a reasonable description of the cereals regime over this period.

The Council of Ministers fixes target, threshold and intervention prices each year. The target price is a benchmark price from which CAP support prices are derived. The intervention price, a fixed fraction of the target price, is the price at which stocks are purchased from producers by intervention authorities, thus setting a floor price to the market. Because this domestic EC floor price tends to be above the world market price, external protection is required to maintain it. The threshold price is a notional EC permitted entry price, set equal to the EC target price less transport costs between the reference point for the target price and the main port of entry. A variable levy is imposed on imports to the Community equal to the differential between the world price and the threshold price. Prices are also supported by sales outside the Community, for which exporters may receive export refunds in order to bridge the gap between EC market prices and the world price.

Thus the CAP relied on internal support and external protection with the objective being to inflate prices to farmers above the world price level. The type of system described above is formalised in diagram(1). Examination of the diagram allows the partial equilibrium welfare effects of a transfer to this system from a free market system to be seen. Producer surplus is increased by the areas ABCD and DCF. Consumer surplus is reduced by the areas ABCD and CDG. Taxpayers lose the areas CFDG and DGLM. BY adding these gains and losses one arives at a deadweight loss of areas CDG, DGLM and FDG due to the policy.



I have modeled the EC so as to be a net importer of agricultural products at free market prices but to be a net exporter at the higher supported prices. Since the EC is a large trading bloc, it

cannot significantly change its level of exports without affecting the world price. Therefore I have portrayed the world price as falling from a free trade level (Pw)to Pw' due to the existence of the EC price support programme. From examining producer and consumer surpluses it is seen that farmers gain from supported prices and that consumers lose out. There is also a financial cost to EC taxpayers and of course a decrease in welfare for other food-exporting countries due to the fall in the world price level. Significantly the policy has a large deadweight loss due to the misallocation of resources it encourages.

I now want to discuss why reform was necessary during the 1980s both by examing how successfully CAP has achieved those aims outlined in 1957 and also in light of other considerations that have become increasingly relevent lately. One would imagine that if the aims of the CAP were not being achieved that this would lead to pressure for reform.

Firstly the aims of increased productivity and security of supply would appear to have become rather irrelevant lately. Productivity increases have been quite startling in European agriculture. In 1986 the EC was a net importer of all main agricultural products, by 1987 it was a net exporter of most. For example in 1968 the EC was 86% self- sufficient in cereals, by 1987 this figure was 119% (A Common agricultural policy for the 1990s, p54). This output increase was accompanied by a large fall in agricultural employment so productivity gains were enormous. Ironically while security of supply is an aim of policy, now the expansion of output was running into a wall of inelastic demand. The OECD estimate that demand for food grows at 0.5% per annum in Europe (OECD p193) so extra production could not be consumed domestically. Security of supply and productivity growth can no longer be considered as practical objectives of the CAP.

Secondly there was the aim of stable prices for consumers. Obviously this aim is quite incompatible with the aim of raising farm incomes when a price support mechanism is in place. In practice legislators have treated the farm incomes aim as being more crucial so the large welfare losses borne by consumers due to the CAP were not a big issue in any debate on reform.

Finally there appears to have been a manifest failure in the aim of maintaining farm incomes. The average real income of a European farmer in 1988 was below the level of the mid 1970s. One possible explanation is that a substantial part of the benefits of support packages has been capitalised into land prices. Another criticism of the policy with regard to incomes is that price support is more beneficial to larger farmers than their poorer counterparts. For instance a simulation exercise presented by OECD on German agriculture showed that the long-run impact of maintaining agricultural prices 10% above their equilibrium level is to increase the index of intra-sectoral inequality by nearly 40% (OECD p191 1987). Thus the CAP appears to have both failed to narrow the income gap between farmers and non-farm workers and also to have increased inequality amongst farmers. However it is doubtful that this depressing result generated the pressure that led to reform in the late 1980s. It is more likely that it was the combination of a financial crisis and some serious negotiations with the EC's trading partners which finlly brought the Community to it's senses.

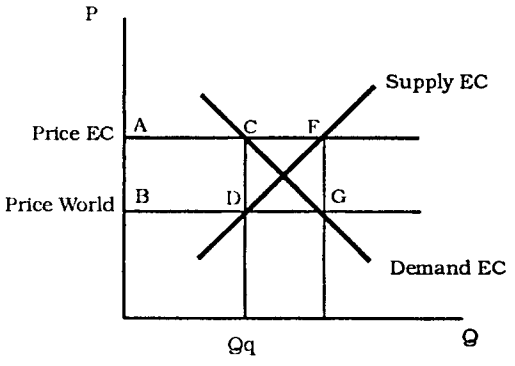
The combination of high guaranteed support prices with increases in yields resulted in Community agricultural support expenditure growing rapidly, exceeding available budgetary funds. Spending on the CAP has risen from 11,300 ECU in 1980 to over 26,000 ECU in 1988. The price-supporting policy swallowed 66% of the total EC budget in1987 (Australian Bureau of Agricultural Economics p4).

The financial cost paid by EC taxpayers is only part of the total cost of the CAP. The deadweight costs visible in diagram(1) affect the citizens of the EC adversely. Winters argues that market interference in agriculture diverts resources from industry and services, reduces EC competitiveness in manufactures and reduces aggregate employment. He feels that deadweight losses of up to 1% of GNP are plausible in the EC (Winters p47).) In 1987 an inevitable financial crisis arose. This crisis was precipitated by rising agricultural

expenditure, the enlargement of the EC to include Spain and Portugal (two relatively poor agriculturally-based countries) and the inability of member countries to agree on a method of raising their contributions to the EC budget. In February 1988 the financial problem was resolved- extra funding was agreed for the EC budget and a parallel agreement was that the agricultural budget would be stabilised. Thus reform of the CAP became mandatory.

A final influence which has prompted reform and will continue to do so to a larger extent in the future, is the effects of the CAP on world food markets and on other food-exporting countries. Due to the costs of intervention storage the Community has tried to reduce surpluses by exporting them to non-member countries. Increases in exports have been quite phenomenal, for instance between 1973 and 1985 cereal exports increased by 150% (A common agricultural policy for the 1990s p56). As modelled in diagram (1) large export increases exert downward pressures on world prices. World prices reached an all-time low in 1987. It is to be remembered that other industrialised countries (such as the US and Japan) contributed to this fall by their agricultural support policies. By the mid-1980s the world markets for food products had become totally destabilised. It is hardly surprising then that the current round of GATT negotiations are centred on agricultural trade. This round must end this year and the EC will come under very strong pressure from the US and the Cairns group(Australia, New Zealand and other food-exporting countries) to make significant reductions in it's level of price support.

I now shall outline the broad thrust of the reforms which have been introduced up to now. The first major indication that costs would not be allowed to veer completely out of control was the introduction of a milk quota scheme in 1984. The Community had reached self-sufficiency in this area in 1974, supply growth over the next ten years was 2.6% per annum as against a 0.6% growth in demand for dairy products annually (A common agricultural policy for the 1990s p62). The guaranteed quantity was initially set at 99M tonnes for the EC, 5M tonnes less than production volume in the previous year. The quantity was then apportioned among the member states, which assigned quotas to their farmers. Production in excess of quota is subject to a large cut in price, making the excess production uneconomical. As a result of the quota system, milk production since April 1986 has declined by some 5% and intervention purchases of dairy products were reduced by nearly 10% in 1988 alone. Since originally quotas were at levels that exceeded EC demand, the Community has bought back a portion of them. Diagram (2) shows how a quota can be used to reduce production to the level of demand at a particular price. If this price is the same as in the intervention-type system of diagram(1), Producer surplus has now increased by area ABCD over it's free market level while consumer surplus has declined by ACGDB. Thus there is a deadweight loss of area CDG. Therefore farmers do not gain as much, consumers are unaffected but large cost savings accrue to the EC taxpayer. In this way a quota can effectively tackle an oversupply problem but a deadweight efficiency loss still remains.



In February 1988 a group of measures were introduced and known collectively as the 'stabilisers' package. The effects on the price support policy are outlined below. Since 1988 guarantee thresholds have been set for many

commodities. These are maximum levels of production for which 'normal' EC support prices prevail. Budget stabilisers have been put in place whereby if production exceeds the guarantee threshold, the level of support, and hence the price, are reduced automatically. Furthermore for some commodities, such as cereals, a co-responsibility levy is raised from producers to cover some or all of the costs resulting from production of a commodity in excess of a specified quantity. In general maximum guaranteed quantities reflect current EC output. For example, in the case of cereals, the choice was 160 tonnes- a figure below the production level in 1988 but above that of the previous two years. If this figure is exceeded, intervention prices are cut by 3% in the following year irrespective of the extent of overproduction. If production remains above the maximum guarenteed quantity for several years, the price cuts become cumulative. Similar arrangements were adopted for oilseeds and protein crops and variations have since been introduced for most commodities. These measures then aim to reduce price as well as quantity. If price reductions are cumulative then overproduction in one year leads to cost savings in future years. Farmers are less well off than in the past because price has fallen. Consumers of course are better off. Since the measures may reduce price and quantity, taxpayers will be richer. There are also positive benefits for food-exporting countries.

Implemented to complement the stabilisers package has been a programme of set-aside. Set-aside involves payment of an aid per hectare by the Commission as compensation to farmers who take arable land out of production for a minimum period of five years. To qualify a farmer must leave at least 20% of his land fallow, plant it with forestry or make use of it for non-agricultural purposes. Set-aside has been unambiguously introduced as a method of reducing surplus production. The savings from the guarantee section of the CAP should more than offset the cost of the payments to participating farmers. Low takeup rates will probably mean that the effects of the scheme will be marginal.

The main criticism of all these reforms is that they have been based mainly on administrative rather than market mechanisms. Price support continues at levels far above international prices. Any reduction in output due to the reforms has been small. The efficient way of reducing production is to reduce prices significantly. This option has been ignored in favour of more roundabout supply constraint schemes.

Secondly most of the maximum guaranteed quantities are a reflection of current EC production levels and therefore will consolidate the present EC trade pattern. Thus the agricultural trade issue has yet to be seriously addressed and it is likely that more far-reaching reforms will be necessary once the present Uruguay GATT round is completed.

Finally there are possible alternative systems of achieving the aims of CAP which I will now outline briefly- these being direct income support for farmers and the extension of the structural funds. Either one or both together could replace entirely the current price support system. Structural funding is used to modernise agricultural production in the Community. As a system it could be much more equitable than price support in that it would be concentrated on the poor, backward farms of Spain, Portugal, Greece and Ireland. Structural policy need not create any new incentives to production. Aid to individual farms can be granted mainly for investments which help reduce production costs, improve living and working conditions and direct agricultural production along new lines. As such it would aid those poorer farmers who have failed to gain significantly from price support. As production would be at free market levels the costs generated by EC surpluses both domestically and internationally would not arise.

A second possible system is that of direct income aids to farmers. In 1973 the Commission put forward proposals for the reform of the CAP in which direct income support was considered, and rejected, on three grounds. Firstly it was argued that it would impose substantial administrative costs for member governments. Secondly it would involve too heavy expenditure of public funds and thirdly that it would hold up structural improvements. These arguments are not really valid because all governments have social assistance programmes in place anyway which could be used for administration and while direct income

aids would call for increased public funds, the welfare costs in terms of higher costs to consumers would not then occur. ie consumers would gain but taxpayers would lose. Farmers would also gain in that the deadweight costs associated with price support would not exist and resources would be allocated more efficiently. However the farming community does not like direct income supports. Politically they are difficult to justify as the transfer from taxpayers is visible. It all may have the appearance of charity and that many farmers would be loathe to accept. Finally larger farmers would not do as well under this scheme and they tend to dominate the farm lobby. However this distributional impact is an advantage of the strategy. Direct income support could have a varying effect on output but it is unlikely that output would be radically different from it's free market level.

An important point about both these possible systems is that because interference in the workings of the market is minimised efficiency losses would be so much lower than they are at present.

A further point is that losses to farmers would not be as great as it may appear. It must be remembered that if the EC liberalised its agricultural markets it would have a positive effect on the world price. What is more likely is that the EC would liberalise it's markets as a result of GATT agreements and so all countries would liberalise simultaneously. If this eventually was to come to pass, the world price would rise by more than if only the EC was to liberalise. Tyers and Anderson estimate that if all countries did liberalise that this would lead to a 33% increase in the international price in the medium term (Tyers and Anderson p201). Therefore phasing out price support would have positive benefits both domestically and internationally.

My conclusion is that the administration of the CAP has been somewhat shortsighted. The CAP remained largely unchanged while it manifestly failed to achieve its aims and while its costs ,both in terms of finance and welfare ,spiraled. Real reform wasn't introduced until it was forced due to financial crises and external pressure. Further more radical change may yet be necessary. With these considerations in mind, more research is needed into alternative means of achieving the aims of CAP other than price support. The potential benefits which could arise from change makes the survival of price support into the future rather unlikely.

Paul Devereux

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