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Economics Case Study

European Common Agricultural Policy

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This tutor2u case study examines the background and current status of the Common Agricultural Policy. It covers a wide range of topics relevant to anyone studying Economics in a European context.

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Online Learning Resource of the Year 2003

1 INTRODUCTION

> "A common agricultural policy that encourages surpluses which then have to be disposed of — at considerable costs — is no longer acceptable or sustainable"
>
> Franz Fischler, European Agricultural Commissioner

This case study considers the Common Agricultural Policy ("CAP") of the European Union. It focuses on the welfare effects of farm support under CAP and the difficult and protracted issue of CAP reform.

Here are some questions you might want to consider whilst working through this case study include:

- Is the CAP the root cause of an unsustainable future for European agriculture?
- Are the original aims of the CAP any longer relevant to the needs of European consumers and producers?
- What are the economic and social costs arising from the CAP
- What reforms are thought to be appropriate and effective for Europe's farmers?
- Is there a case for abandoning all forms of price support and over time exposing the European farming industry to free market forces?
- Is there a case for government intervention to encourage farming as a public good on the grounds of environmental benefits?
- What lessons might be drawn from reforms to farm support in other countries?
- If you were an economist advising the National Farmer's Union would you support fundamental reforms of the CAP? How would you advise that the British farming industry might adjust to such reforms in order to remain competitive?

The **CAP** has shaped European Agriculture for the last thirty five years but reform has been slow and protracted. In the last couple of years, more radical proposals such as **de-coupling** farming payments away from food production and re-directing them into environment schemes have been put on the table but not everyone has embraced the changes and even European Farm Ministers are split. The Germans and the UK want to see fundamental reform whereas the French and the Irish are more fearful of what change may bring to their countryside and rural livelihoods.

It is important to realise that CAP has wide-ranging and far-reaching effects on many **different sectors** of both the UK and European and International economy. Decisions on the future of CAP will impact on millions of individual consumers and households.

The CAP also affects industries that supply and support farmers, food manufacturers and the environment, as well as farmers and exporters of food in other countries trading with the EU. This demonstrates clearly the **inter-relationships** between domestic sectors and the global implications of future policy changes on farm support to the European Union

It is worth remembering **that all countries subsidise their farming sectors to a greater or lesser degree**. Data from economists at the OECD finds that

- Prices received by farmers in 2001 were on average 31% above world prices, shielding farmers in many countries from world prices
- Total support to agriculture in 2001 came to US$311 billion, or 1.3% of GDP
- Producer support is 21% of farm income in the USA and 35% in the EU

BACKGROUND TO THE CAP

2.1 Original Aims

The CAP was introduced in 1960. It aimed to provide a reasonable standard of living for farmers and reasonably priced food for all. But many people now question whether the original aims of the CAP are relevant to the future of European farming.

Original Aims of the CAP	**Evaluative Comment**
Improving production yields to guarantee farm supplies	The CAP is no longer needed to achieve this aim. Freely competitive agricultural markets and **technological innovation** in agriculture guarantee increase farm production and higher yields. In a competitive market system, farmers would have to produce efficiently to remain profitable in the long run
Ensuring a fair standard of living for EU farmers	There are major doubts as to the **equity** of the CAP in delivering this objective. There is a wide and growing division between **large-scale** and **small-scale farmers** within the EU and the accession of ten new countries into the EU as part of **enlargement** has exposed the extent to which farm support affects farmers of different size
To stabilise agricultural markets	This original objective has been largely achieved - but at great economic and environmental cost - and there is a limit to which any form of government intervention can and should seek market stability in terms of prices and incomes
Ensuring availability of farm supplies	Climactic variations in farm output are now much reduced by developments in **agricultural technology** and **biotechnology**. The **globalisation** of agricultural markets makes fears of food shortages less of an issue. Geo-political factors are not particularly relevant any more to the question of maintaining food supplies within the European Union
Ensuring food supplies are available to consumers at reasonable prices	The CAP system has increased European food prices not reduced them leading to a long-term loss in economic welfare for consumers. Many economists believe that competitive market disciplines are the best route to achieve lower prices in the long run

2.2 Agriculture in the UK and Europe

- In the EU the agricultural sector as a whole contributes about 1.8 per cent of GDP
- In the United Kingdom the figure is low, below 1 per cent, although the total **agro-industrial complex** has a much bigger share in national income.
- Including agricultural merchants and distribution, wholesalers, food and drink manufacturers, retailers and caterers, the contribution is around 9 per cent or £55 billion to UK GDP
- Agriculture also accounts for a small and declining proportion of EU employment
- The CAP still absorbs about 45% of the total EU budget
- The EU is a key producer of food in the world market and it also represents the largest single import market in the world
- The CAP is **not a single comprehensive or uniform policy**, but a collection of separate regimes or packages of policy instruments applied to different commodities and sectors.
- For example, EU wheat production is currently relatively unsupported by market intervention and EU wheat prices are little different from world prices, whereas some other grains, oilseeds, protein crops and beef have all remained more heavily supported by these mechanisms.

3 THE CAP – A STUDY IN MARKET AND GOVERNMENT FAILURE

What are the main arguments against the current system of farm support within the EU?

- **Inefficiency and Surplus:** CAP intervention prices have encouraged **excess production** and permitted production inefficiencies and **dependency on farm subsidies** (like all forms of dependency - these can be difficult to break) – all of which leads to a **mis-allocation of scarce resources**
- **Loss of allocative efficiency:** The CAP is seen by much of the public as failing to deliver what society wants from agriculture in terms of food safety, animal health and rural environment. It is neither consistent with emerging policies on sustainable development, nor with consumer demands for high quality, local and regional foods
- **Fiscal Costs:** The financial (budgetary) cost of EU farm support policies has been huge and involves a large opportunity cost in terms of the financial resources that might be channelled instead into greater funding for EU regional assistance or development programmes
- **Fraud and Government Failure:** The cost of maintaining the CAP is magnified by fraud within the system and the ever-rising costs of administration and compliance. The CAP is a hideously complex system of farm support
- **Damage to Consumer Welfare:** Farm support imposes higher food prices for EU consumers – the cost hits low income families most because they spend a higher proportion of their income on food (implying a regressive effect on the distribution of income)
- **Environmental Concerns:** The CAP has encouraged intensive farming prompting growing concern about the long-term environmental impact of CAP. The CAP at present takes only limited account of sustainability and environmental objectives.
- Agriculture is a significant source of greenhouse gases and of ammonia emissions to air. One study of olive growers showed they used more than 400 times the recommended level of pesticides. Reforms to the CAP are increasingly focusing on the need to reward those farmers who engage in agricultural practices that are sustainable and environmentally friendly
- **Global Market Distortions:** The CAP is anti-competitive and distorts domestic, European and international markets threatening the development potential of many low-income countries. The EU spent £2.14 billion on export subsidies in 2001
- **A Barrier to the completion of the Single Market:** The CAP remains a major barrier to the final completion of the European Single Market and is a key cause of tension between the EU and the rest of the world in **global trade negotiations**. The Single Market is one of the final stages of economic integration within the EU and is built on the principles of **free movement** of goods, services, labour and capital.

3.1 Budgetary Costs of the CAP

The scale of the CAP - even after many attempts at reform spread over fifteen years - is huge. According to information released by the UK government Ministry **DEFRA** the annual cost of the CAP was about €40bn in 2000, of which

- €10.8bn went on market price support
- €25.5bn on direct payments
- €4.2bn on rural development and agri-environment schemes
- In other words, 90% of CAP spending goes on payments to producers, whereas only 10% is allocated to schemes designed to change the structure of the farming industry

The latest estimate of the cost of the CAP in the EU15 stands at **€92 billion for 2001**. This is made up of a **cost to EU consumers of €53 billion**, resulting from the difference between EU and world price levels, and **taxpayers a further €39 billion**.

70 per cent of the current CAP budget goes on direct payments to farmers of cereals, other arable crops, sheep and beef, and only 10 per cent to rural development.

Of total EU expenditure in 2001, just under half was budgeted to be spent in support of agriculture in the form of Agricultural Guarantee. Although still substantial, this proportion has fallen by 15 percentage points since 1981

Table 1: Contributions to and receipts from the EU budget in 2000

€ billion

	Contributions	Receipts	Net Receipts
Germany	21.8	10.1	-11.7
United Kingdom	**13.9**	**7.7**	**-6.2**
Netherlands	5.5	2.2	-3.3
France	14.5	12.1	-2.4
Sweden	2.6	1.2	-1.5
Belgium	3.4	1.9	-1.5
Austria	2.1	1.4	-0.7
Italy	11.0	10.7	-0.3
Luxembourg	0.2	0.1	-0.1
Denmark	1.7	1.6	-0.1
Finland	1.2	1.4	0.1
Irish Republic	1.1	2.6	1.5
Portugal	1.3	3.2	1.9
Greece	1.3	5.5	4.1
Spain	6.4	10.8	4.3

Source: European Commission and European Court of Auditors

3.2 Equity Considerations: Winners and Losers under CAP

The CAP raises fundamental issues of **efficiency** and **equity** arising from different forms of intervention in markets for specific agricultural products

The distributional effects of the CAP are complex and often very difficult to measure

(i) **Transfer of welfare from consumers to producers**: There is a transfer of welfare away from consumers towards the EU farming sector because consumers must pay **higher retail prices** and they also have a restricted access to cheaper imports from overseas. There is also a transfer of welfare from consumers to the government in the form of **higher taxes** needed to finance the CAP each year – this is estimated to be of the order of 200 Euros per person per year

(ii) **Transfer of welfare from one country to another**: CAP payments are not allocated equitably across each member nation of the EU. Some countries receive a larger share of expenditure under the CAP budget than they contribute to the EU budget as a whole. Countries with a large share of output of more heavily subsidised commodities emerge as winners, including France and Denmark. Because many 'southern' commodities, such as fruit and vegetables are relatively lightly subsidised, there is generally held to be a 'northern' bias in the CAP. Nonetheless, certain southern products including olive oil, tobacco, rice and cotton receive a very high level of support per unit of output benefiting countries such as Spain and Portugal

(iii) **Distribution of gains between large and small scale farmers within the EU -** The distribution of direct support (direct payments) under the CAP is skewed heavily in favour of larger farmers because it is based to a large degree on the **scale of production** – either farms' present capacity or output (in land area or livestock numbers) or their output in the relatively recent past. Thus the more is produced, the more aid is received. EU farms with the **highest gross margins** earn the highest income. Not surprisingly, there is a strong link between farm size and farm income in the EU. On average, the EU farms with the highest gross (profit) margins have the largest farm area and receive the greatest CAP support

3.3 CAP and Consumer Welfare

CAP imposes a **cost on EU consumers** through **higher food prices** – which has a direct effect on their economic welfare and real incomes. The burden of the CAP on the price consumers pay for food within the EU varies according to fluctuations in world prices, but in 2000 was estimated by the Organisation for Economic Development (OECD) at around €48bn. According to the Consumers' Association, it has been estimated that the cost of EU agricultural policies, in terms of both taxation and higher prices, for an average family of four in the European Union is around £16 per week. The current annual cost to UK taxpayers is around £5 billion – the equivalent of 2p on the standard rate of income tax.

The UK receives some 9 per cent of available CAP funds (some £3bn in 2000-2001), but we are a significant net contributor to the policy. The Germans are also a significant net contributor to the CAP whereas France receives nearly £2bn a year in net incomes from CAP payments). Table 1 on the previous page shows that in 2000, the UK paid over six billion euros in net contributions to the total EU budget.

3.4 Environmental Costs of the CAP

What of the **external costs** of farm support?

Many economists and environmentalists argue that in promoting quantity, not quality, the CAP has encouraged EU farmers to ignore many of the **environmental impacts** of their farming methods. The ecological critique against the CAP argues that **intensive farming** has destroyed much of the countryside, turning once traditional landscapes into stretches of tightly packed rows. The disincentive to follow normal crop rotation strategies ruins the soil. In markets where price supports still exist there remains a direct link between production and profit. Naturally, they then make maximizing production their first priority.

Research by economists at DEFRA finds that CAP has both n. Although **measuring the effects of these are difficult**, estimates of the economic value of these impacts in the UK range from £1 billion to £1.5 billion for negative impacts; and just under £1 billion per year for positive impacts.

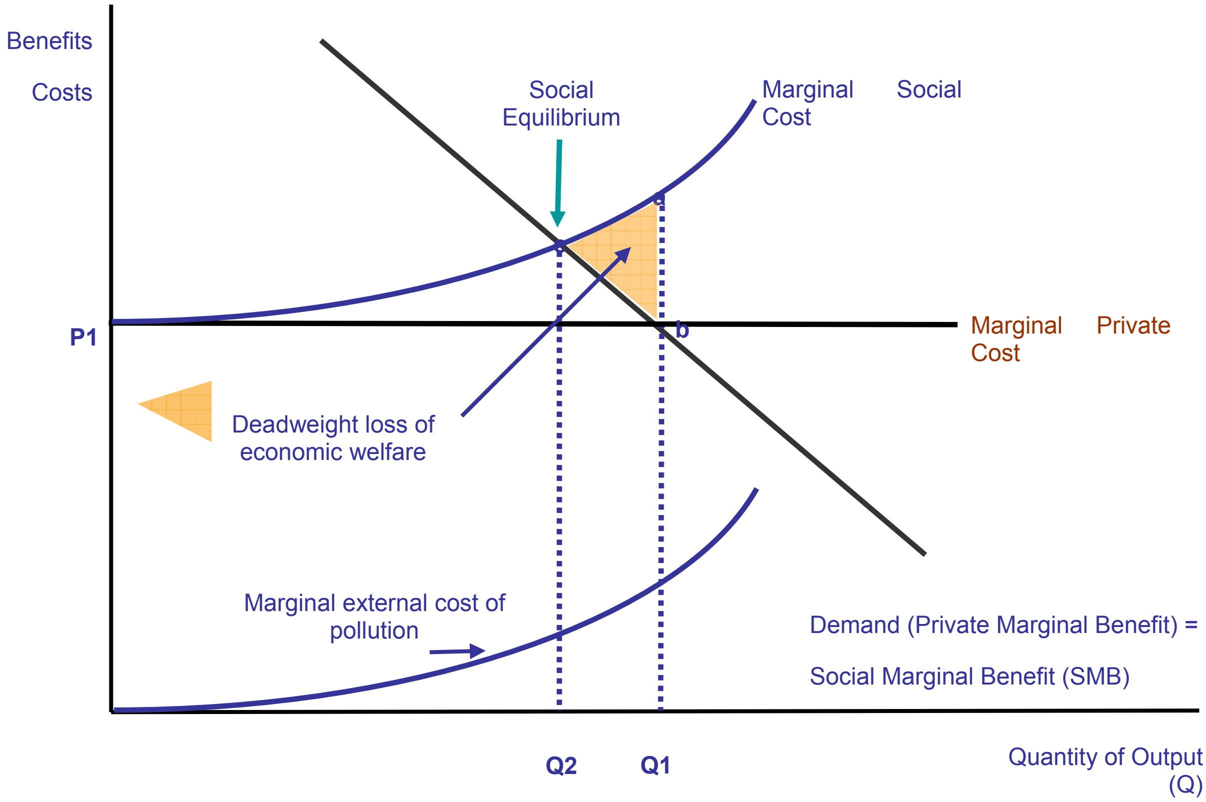
Agricultural economist Jules Pretty from the University of Essex has argued that the external costs of farming are far greater than official estimates suggest. He estimates that the **social cost of farming** in Britain is more than £2.3 billion each year (equivalent to over £200 per hectare). This bill, which includes the cost of cleaning up pollution, repairing habitats and coping with sickness caused by farming, almost equals the industry's income.

> "Agriculture does more than just produce food. It has a profound impact on many other aspects of local, national and global economies and ecosystems, and these impacts can be positive or negative. Farming can erode soils, reduce biodiversity and poison rivers as well as adding to global warming"

3.5 Externalities and Market Failure in Farming

An **externality** occurs when an activity generates unintended effects on third parties on others for which no payment or compensation is made. Externalities arise because of the **absence of private property rights** – if they existed payment/compensation would occur. In the absence of a corrective policy, the level of an activity that gives rise to external costs (which affect people outside of the market) will be too high leading to **market failure**

If the production of food generates external costs (negative externalities) then the free market is **under-pricing** and **over-consuming products** leading to a loss of economic and social welfare. The effect of externalities arising from production is shown in the diagram below. The shaded area represents the deadweight loss of economic welfare arising from the over-production of products that generate external costs

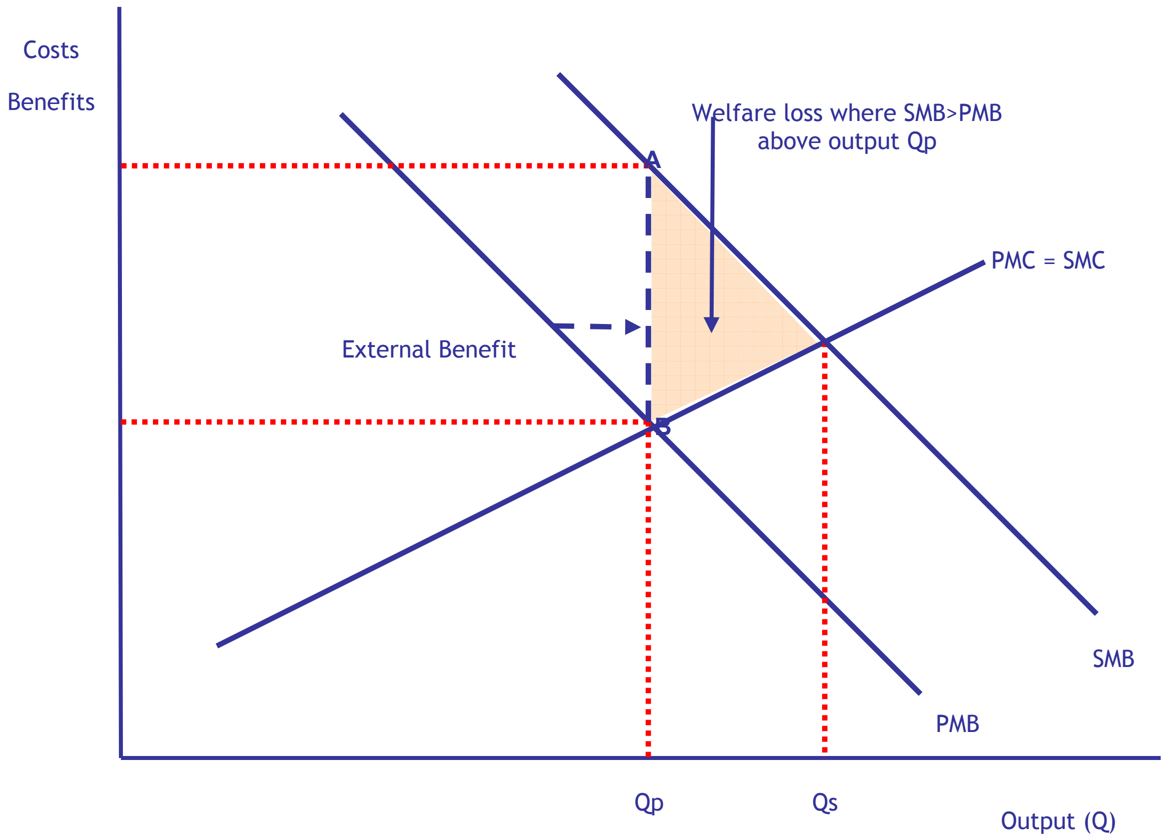


On the other hand, it is often claimed that management and protection of the environment by farmers and maintenance of rural traditions, culture and communities brings about positive **external benefits** not only for people directly involved in farming but for millions of people who enjoy the opportunity to spend time in rural areas.

If there are substantial **positive externalities** from these environmental activities, there is a risk that they would be under-valued and under-provided by the free market, because they are not included in factor and retail farm prices.

Is there a case for direct government intervention to support rural environmental management – regarding protection of rural heritage and natural habitat as a **quasi public good** that ought to be financed directly in the form of **income payments**?

The next diagram illustrates the economics of an activity that creates positive externalities such that the social benefit exceeds private benefit. Measuring these external benefits is difficult.



3.6 Agricultural Support – An Example of Government Failure

Normally, a failure of the free market is justification for some form of **government intervention**. This intervention is designed to correct for market failure and thereby achieve an improvement in economic and social welfare. Likewise, a government may choose to intervene to achieve a more equitable distribution of income and wealth. But intervention can have the effect of **deepening existing market failures** and worsening the original perceived mis-allocation of resources - leading to **government failure**.

There are several ways in which the CAP can be said to have led to government failure

- **The pursuit of self-interest** in protecting the farming industry has over-ridden economic concerns, in part because of political influence and pressure that the farming lobby in many Western European countries can bring to bear. One might argue that some Governments have been "captured" by the farming industry in blocking proposed reforms

- **A failure of governments to appreciate the longer term economic and environmental consequences of farm support policies** - including the effects of dependency on farm subsidies and the very high costs arising from structural surpluses and waste in many agricultural markets which have been the direct result of CAP

- A failure of CAP itself to target financial support to those farmers most in need of help (see the supporting article drawn from research by OECD economists)

Agricultural Support Fails to Target Farmers Most in Need, Says New OECD Study (Jan 2003)

A large proportion of government support to agriculture does not go to the farmers who need it most, according to a new OECD report. Moreover, such support is inefficient in providing increased income for farmers and distorts production and international trade.

The OECD study shows that because most support is production-based, the bulk of it goes to the larger, often the richer, farms who are able to exploit economies of scale. In the case of support to the market price of a commodity, the study estimates that only 25% of the funding ends up as a net income gain for the farmers.

Farm incomes are on average close to those of other households, but increasingly it is through non-agricultural wages and salaries, investments and social welfare payments that those working in agriculture are able to maintain such income levels. Similarly, although large income disparities remain among farmers, they are being reduced by non-agricultural revenues.

At a cost to consumers and taxpayers of more than $300 billion a year, agricultural support in OECD countries is inefficient. There is no evidence that the majority of programmes are efficient at protecting the environment, strengthening the viability of rural areas or contributing to food security. In most cases it is more efficient to pay directly for a public service such as maintaining an agreeable countryside, and to charge those whose activities pollute the environment. Payments for a public service would contribute to raising farmers' incomes.

(Source: www.oecd.org)

Government failure is often the result of the **law of unintended consequences** – so that the effects of a particular form of intervention are far removed from their original aims and objectives. I have argued in this case study that the original aims of the CAP have lost their relevance to the modern EU economy of 2003 and that fundamental reforms of the system are now required.

4 ECONOMICS OF FARM SUPPORT

4.1 Introduction

Traditionally in Western-European countries, **price support** and **intervention schemes** have been at the heart of government policies protecting domestic farming industries.

Market price support policies include

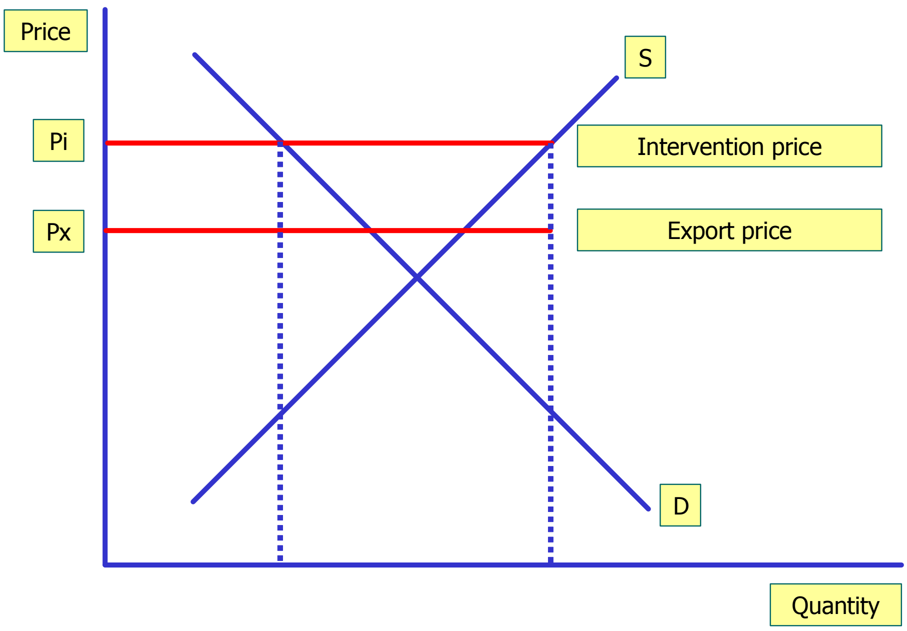
- Import duties and levies
- Anti-dumping taxes
- Export subsidies
- Price and buying guarantees
- Production quotas

CAP has provided financial support to farmers through several important channels

- Guaranteed minimum prices (with production surpluses bought up by the EU and put into intervention storage)
- Export subsidies (to encourage farm surpluses to be exported outside the EU rather than stored)
- A common external tariff on food imports from non-EU countries
- Set-aside payments – i.e. payments for leaving a percentage of arable land fallow
- Subsidies for switching to organic farming

The basics of price support are shown in the following diagrams

4.2 Guaranteed Minimum Prices and Export Refunds



The effect of a **guaranteed minimum price** in a market is shown in the diagram above. The intervention price is normally set well above normal world price levels. It encourages an expansion of supply but a contraction of demand. Under “old-style” intervention purchases, the excess supply was bought up and put into storage adding to the costs of the system.

Intervention remains an integral part of the CAP system – for example in the milk sector, intervention includes public intervention of butter and skimmed milk powder and private storage aid for butter, skimmed milk powder and certain cheeses when EU market prices fall below a pre-determined level (known as the intervention price) for a representative period. Butter Intervention is opened or closed in an EU Member State when national prices have dropped below or have risen above the intervention level of 92% of the target price for two consecutive weeks.

The intervention agency then buy in butter using a tender system at a price, set by the Commission that cannot be less than 90% of the intervention price.

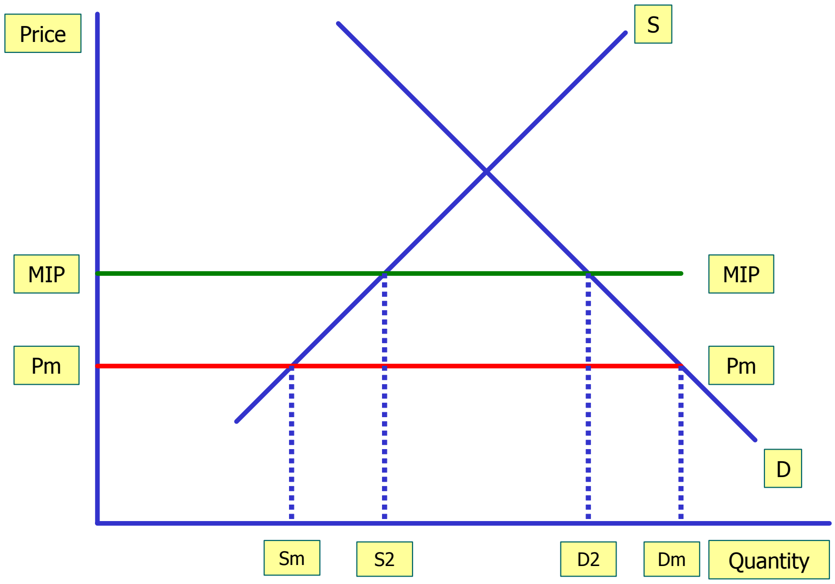
Reforms to the CAP have gradually reduced the scale of intervention purchases but the cost of storage is still a major issue as is the system of **export refunds** of EU farm output to a third (non-EU) country.

Export refunds are paid to an exporter of goods from the European Union to Third Countries in order to compensate for the difference between Community and World prices.

The CAP system keeps food prices higher than they would otherwise be, but the EU also funds producers to offload their surplus production onto world markets by providing a compensatory payment (the refund) to adjust EU prices back down to prevailing world levels.

This strategy is highly controversial in terms of the effect it has on developing countries because at times of falling world food prices, generous export subsidies can take European export prices well below the production costs of farmers in developing nations.

4.3 Import Tariffs – Minimum Import Prices

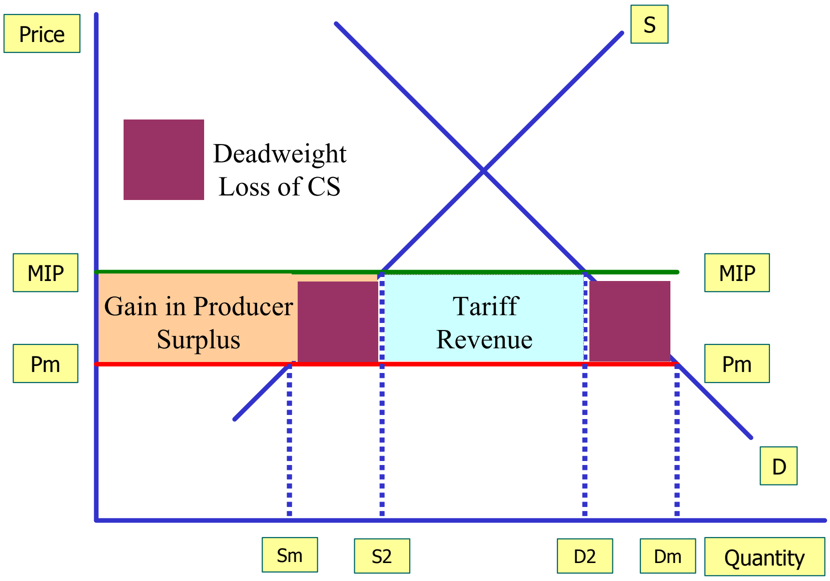


The effects of a tariff are shown in the diagram above. The EU sets Minimum Import Prices (MIPs) achieved through a variable import levy on foods coming into the EU. The MIP is now referred to as the EU reference price.

The tariff leads to an expansion of EU farm output from Sm to S2 but higher prices cause a contraction of demand (Dm to D2). Therefore the volume of imports into the EU declines. If world food prices fell, the EU variable import levy would increase to maintain the minimum import price - insulating the EU from falls in real price levels around the world

Tariffs inevitably have welfare consequences. The standard analysis of a tariff on consumer and producer welfare is shown in the diagram below. To the extent that the tariff raises prices above the prevailing world level, consumer welfare is reduced - shown by the deadweight loss of consumer surplus indicated by the shaded areas.

Tariffs provide protection for EU farmers and thereby boost output and protect employment and incomes - but there are other means of providing financial support for farmers other than using tariffs.



CAP AND DEVELOPING COUNTRIES

5.1 Introduction

CAP has always been a highly contentious issue with international trade partners, and it will continue to be as such until fundamental reform is achieved.

Consider the arguments put forward in this extract from a recent CAFOD report.

Distorting the Market and Development Potential

The CAP isn't working for consumers, for EU farmers, for the environment, and certainly not for farmers in developing countries: they are hit by a double whammy - cheap food dumped in their home markets by the EU's massively subsidised farmers and exporters and unfair competition in their export markets, most of all in Europe. As things stand, the average European cow receives more money in subsidies than the half of the world's population that has to live on £1.30 a day - or less.

Farmers and farm workers represent only one per cent of the working population in the UK, the lowest in the EU. Greece, with 20 per cent, has the highest proportion of the working population in agriculture; then comes Spain with 10 per cent. All other countries are in single figures. For some African countries this proportion can be as high as 80 per cent. Farm subsidies to this minority group are stifling the development prospects of the poor majority all over the developing world

(CAFOD's CAP Policy Analyst Matt Griffith, November 2002)

According to Oxfam, three quarters of the world's 1.2 billion extremely poor people live and work in rural areas: agriculture is crucial to their survival and the global fight against poverty. Nearly 3 billion people - half the world - live on less than $2 a day. This is less than the support received by the average European cow. Oxfam argues that CAP damages producers in developing countries in two main ways. First, it undermines producers in developing countries by **dumping subsidised goods** on their local markets. An Oxfam study published in 2002 found that the EU's wheat export prices are 34 per cent below typical costs of production.

Secondly CAP reduces the potential for developing countries to **exploit their natural comparative advantage** in food production by exporting farm produce to richer European and other international markets. This has important implications for the scale of rural poverty in developing countries.

Milking the CAP – Oxfam Report (2003)

How Europe's dairy regime is devastating livelihoods in the developing world

European citizens are supporting the dairy industry to the tune of €16 billion a year. This is equivalent to more than $2 per cow per day – half the world's people live on less than this amount. EU surpluses of milk and milk products are dumped on world markets using costly export subsidies, which destroy people's livelihoods in some of the world's poorest countries. Dairy processing and trading companies are the direct beneficiaries of these subsidies.

Meanwhile, many small-scale European dairy farmers are struggling to make ends meet. Oxfam is calling for an immediate end to EU dairy export dumping and for agricultural support to target small-scale farmers.

The EU is committed to reforming the CAP and addressing some of the concerns of developing countries about the effects of CAP on their export and domestic farming sectors. The relative impact of the CAP upon developing countries depends in part upon their current and future strategies for economic development. Countries that have geared themselves up to exporting food products currently produced within the EU are at greatest risk of the system of export refunds and EU import tariffs. However many developing countries do have **preferential trade agreements** with the EU which offers them the prospect of a guaranteed market opportunity at prices closer to EU levels.

Type of Effect	Positive Impact	Negative Impact	Possible Implications
Increased world supply	Lowers cost of importing food	Reduces export prices for farmers (deterioration in the terms of trade) Disincentive to invest in agricultural Greater risk of rural poverty	May undermine agricultural development strategies
Artificially high EU prices	Beneficial to those developing countries able to export because of preferential access to EU markets	Exports only viable if high prices continue (fundamental reform of CAP may change this)	Might support export diversification among developing countries
EU export refunds (subsidies)	Reduces import costs	Undermines domestic agriculture and distorts the principles of free trade	Long term undermining of domestic farming sector - damaging to growth and development

6 REFORMING FARM POLICY – LESSONS FROM NEW ZEALAND

6.1 Introduction

New Zealand is one of a handful of countries which have embarked on free trade for agriculture and some say it should be used as a model for changes in Europe.

When price supports were suddenly and unexpectedly abolished in the 1980s, New Zealand farmers went through a period of painful and rapid structural adjustment and many of them had to abandon their businesses.

But the story of how the New Zealand farming sector responded may offer ideas to the EU as it considers further changes to the CAP.

6.2 Background

Prior to the end of farm subsidies, 40% of the average New Zealand sheep and beef farmer's gross income came from subsidies. By 1985 this financial support had virtually come to an end. Real output in the farm industry has expanded by 40% over the last fifteen years and the sector now contributes nearly 17% of GDP (14% in 1986-87). Annual productivity growth since 1986 has averaged 6.0%, a stark contrast to productivity growth languishing close to 1% in the period before the subsidy bonfire.

Real farm incomes have not yet recovered to their pre-subsidy levels and there has been a modest reduction in total sheep stock numbers (although cattle numbers have expanded by 35%). But a growing share of farm income comes from rural tourism and payments for management of the rural environment.

6.3 Transition in the New Zealand Farming Industry after the Removal of Subsidies:

- Loss of financial subsidy on farm profits worsened by sharp appreciation in the New Zealand dollar which damaged the competitiveness of the farm sector and hit exports
- Falling incomes and rising farm debts led to some forced sales of farms which depressed land prices
- Forced sales were not as high as forecast – and one of the benefits of lower land prices was that it encouraged younger farmers to enter farming
- Structural transition in the farming industry began to gather momentum in late 1980s – farm diversification, more rigorous attempts to cost control
- Farmers helped by fall in prices of farm inputs (including labour and components) because these suppliers knew that farmers' purchasing power had declined
- Welfare system provided baseline support for low-income farmers and one off "exit grants" to those who wanted to leave their farms

By 2001, only 1% of the value of New Zealand farm output is attributable directly to government financial support – the lowest of any country inside the European Union where the OECD average is closer to 30%.

The success of the New Zealand farming industry in adjusting to a world without government financial support is valuable evidence in support of the arguments for reforming the CAP. No reform process is without risks and costs. Reform is likely to be more effective when

- The farming industry is sufficiently flexible to diversify into new markets (such as rural tourism, light industry)
- There is a degree of geographical and occupational mobility of labour within the farming industry (e.g. for those who decide to leave their farms and move elsewhere)
- The welfare system is prepared to cover the cost of transitional fiscal transfers to the farming sector to alleviate the risk of rural poverty arising from unemployment

REFORM PROPOSALS FOR THE CAP

7.1 Introduction

There have been three major attempts to reform the workings of the CAP. Of these the current proposals are the most radical although it remains to be seen whether they are implemented in full and lead to further structural change in the way the CAP operates

The main reforms have been:

- The McSharry Reforms (1992)
- Agenda 2000 Reforms
- Mid-term Review (Fischler Reforms) 2003

7.2 McSharry Reforms

The main aim of McSharry was to de-couple the link between support given to farmers and output produced. There were cuts in farm support prices, lower milk quotas and a reduction in intervention purchases of beef. McSharry also introduced the principle of direct income payments rather than guaranteed prices and (most famously of all) brought in a system of obligatory set aside payments.

There were also initial moves towards encouraging less intensive farming techniques, afforestation subsidies to encourage the planting of more trees and financial support to encourage the early retirement of farmers. McSharry was an important phase in CAP reform affecting in the main production of cereals. But it began the process of fundamentally questioning the efficiency and equity of CAP support for EU farmers.

7.3 Agenda 2000 Reforms

Agenda 2000 represented further progress along the long road to reforming the CAP. Again it was a series of incremental changes to the system. It includes further cuts in intervention prices for cereals and beef and an extension of the milk quota regime.

The Agenda 2000 reforms emphasised the desire to move away from direct payments for production towards direct subsidies for farming and stronger environmental targets for direct income payments.

7.4 Mid Term Review - The Fischer Reform Proposals

The key elements of the Mid Term Review announced in January 2003 are as follows:

- A single farm payment independent from production (this is a principle known as "decoupling")
- Income payments if EU farmers meet agreed standards of environmental care, food safety and animal welfare (known as cross compliance payments)
- A reduction in payments to bigger farms (known as "modulation" and "degression") from 2007 to help fund EU rural development programmes (eg specific grants for marketing and processing local foods) and further reforms
- Incentives to help farmers improve the quality of agricultural products
- The essence of the new system is to change the focus from production to farm management for social / environmental reasons

Announcing the reforms, Fischer argued that

> "Farmers will no longer be forced to produce at a loss in order to receive support. They will have the opportunity to maximise their income on the market. Studies show that farm incomes would improve with the reforms. Society is ready to support farming provided farmers give people what they want – safe food, animal welfare and a healthy environment. The new single farm payment will not distort international trade and hence not harm developing countries."

One of the most important aspects of the Mid Term (Fischler) 2003 reforms is the concept of de-coupling. There are strong economic and social arguments for breaking the link between production and farm support payments. It should help to reduce farm surpluses and the costs of administering the system will fall.

It also gives farmers an incentive to **optimise** rather than **maximise** their production. In other words, it is designed to change the pattern of production as farmers alter their production to areas where free-market demand and prices are highest rather than where government financial support is greatest.

7.5 UK Government Policy towards the CAP and Reform

UK Government policy supports the issue of CAP reform. Consider this policy statement from DEFRA and the Minister responsible, Margaret Beckett

> The current CAP is not delivering what farmers, the rural economy or the environment need. Also it is an extremely expensive policy and is insufficient to meet the challenges posed by the World Trade Organization (WTO) and enlargement of the EU.
>
> Our goal is to reduce the overall burden of the CAP, delivering better value for money to taxpayers and consumers; greater reflection of animal welfare concerns; a better deal for the environment; and a better deal for farmers. We want to see market price support and production controls phased out, with transitional support payments to help farmers to adjust.
>
> This should be complemented by a shift towards the "second pillar" of the CAP, thus expanding the resources available for targeted support for rural development and agri-environment schemes.

7.6 Potential Costs and Benefits of CAP Reform

Evaluating the likely effects of fundamental reform of the CAP is a difficult process. We can take into account how reform has affected farming industries in other countries but the effects of reform in the short to medium term will vary from nation to nation within the EU and there are likely to be significant regional implications for individual countries

Some of the main issues to consider are as follows:

- Will reductions in direct payments for production stimulate increases in farm productivity arising from **a switch to larger-scale production**?
- Trends in the Danish pig industry which is now a sector free of all farm support are illustrative of what is likely to happen. In 1991 only 9.5% of pigs were reared from suppliers with herds of 5,000 or more. By 2001 that percentage had grown to 34.1%.
- Will reforms to the CAP stimulate improvements in the **dynamic efficiency** of the UK and European farming industry? Supporters of reform believe that cutting dependency on financial support will encourage farmers to diversify the use of their land including breaking into rural tourism and focusing resources on supplying niche products to local markets
- Will there be sufficient **geographical and occupational mobility** in the farming industry to offset many of the inevitable tensions and problems that structural change will cause? The main risk is a sharp rise in **structural unemployment** and associated problems of **rural poverty**. That said, the British farming industry has suffered greatly in recent years even without fundamental reforms to the CAP
- Will there be massed **forced sales of land** leading to a collapse in farm land prices?
- How **will smaller farms survive**? Should governments target financial assistance on poorer farmers?

- **Will food prices fall**? Standard textbook analysis would suggest that dismantling import tariffs for food coming into the UK and reducing farm support prices should lead to an increase in non-EU food supplies into the Single market, and increased competitive pressures should in the medium term cause higher productivity and lower food prices in real terms.
- However the extent to which lower costs passes through the supply chain to lower prices for consumers at retail level is dependent on several factors. Will food processors and food manufacturers (who should benefit from lower input costs) pass these savings onto final consumers? What of the **monopsony power** of supermarkets? The degree of competition at retail level is also a key factor
- **There will be losers and gainers** throughout the EU – a fundamental shift from market support to direct payments alters the distribution of national gains and losses under CAP depending on the relative shares of each country's consumption of CAP products and its share of EU budget financing

EU ENLARGEMENT AND PRESSURES FOR CAP REFORM

The enlargement of the European Union has accelerated demand for an overhaul of the CAP system. 10 new member states from Eastern Europe - most with large, poor agricultural sectors would qualify for billions of euros in subsidies under an unreformed CAP.

The agricultural sectors of the ten accession countries contribute over 3% of total GDP – nearly double the relative contribution of agriculture in existing EU member countries. And whereas agriculture accounts for just over 4% of total employment in the current fifteen member nations of the EU, that figure rises to 13.2% for the ten accession nations.

These countries have a greater dependency on farming as a source of income and jobs. Many of the farms in accession countries are much smaller and poorer than their Western European counterparts – a major problem given the bias within the CAP to offer disproportionately more financial support to larger more efficient farms. Poland has the largest agricultural sector of the ten new countries joining the EU.

As one might expect given the huge differences in per capita GDP of accession economies compared with EU15 nations, there is a massive difference in the proportion of household spending on food. The average for EU15 is 16.1% contrasted with nearly 29% for those countries about to join the EU in 2004.

Reform of the CAP will inevitably affect (a) the scale of financial assistance to individual farmers and (b) medium term changes to retail food prices.

Table 2: Basic European Data: Key General Statistics for EU(15) and Accession Countries

	GDP Per Capita inhabitants	Share of Agricultural in GDP	Employment	Household Spending on Food
	$ PPP adjusted	Per Cent	Per Cent of Employed Labour Force	Per Cent of Total Spending
EU-15	**23 180**	**1.7**	**4.2**	**16.1**
Belgium	24 690	1.1	1.4	16.8
Denmark	27 530	2.3	3.5	17.4
Germany	24 140	0.9	2.6	15.8
Greece	15 780	6.7	16	21.4
Spain	19 100	3.6	6.5	18.5
France	23 620	2.2	4.1	17.6
Ireland	27 470	2.5	7	17.2
Italy	24 270	2.4	5.2	16.9
Luxembourg	45 750	0.6	1.5	:
Netherlands	26 020	2.2	3.1	10.5
Austria	26 320	1.3	5.8	15.6
Portugal	16 920	2.4	12.9	22.5
Finland	24 280	0.9	5.8	18.1
Sweden	23 130	0.6	2.6	16.7
UK	23 160	0.6	1.4	13.9
Accession Countries (10)	**10 477**	**3.1**	**13.2**	**28.8**
Czech republic	13 280	1.7	4.9	29.7
Estonia	9 800	3.2	7.1	34.0
Cyprus	17 800	3.9	4.9	25.2
Latvia	7 720	3.0	15.1	34.3
Lithuania	8 730	3.1	16.5	39.0
Hungary	11 840	3.8	6.1	27.0
Malta	11 920	2.2	2.1	26.2
Poland	9 210	3.1	19.2	28.8
Slovenia	15 970	2.0	9.9	31.5
Slovakian Republic	11 060	1.9	6.3	18.9
Bulgaria	6 510	11.5	9.7	31.8
Romania	5 860	12.9	44.4	39.3

9 STATISTICAL APPENDIX

9.1 Breakdown of EU Agricultural Spending in 2000

BREAKDOWN OF EU AGRICULTURE SPENDING – YEAR 2000	
Arable crops:	16,641 million Euro
Other plant products:	9,226 million Euro
Milk/milk products:	2,735 million Euro
Beef/Veal sector:	4,465 million Euro
Sheep/goat sector:	1,832 million Euro
Other animal products:	489 million Euro
Rural Development:	4,084 million Euro
Other (ancillary, Reserves)	1,997 million Euro
Total CAP spending:	41,469 million Euro

9.2 Top 15 Agricultural Exporters and Importers, 2001

	Value $bn	**Share in world** %		**Value** $bn	**Share in world** %
Exporters			**Importers**		
EU members	213.53	39.0	EU members	235.51	39.7
EU to rest of world	57.81	10.6	EU from rest of world	79.78	13.5
United States	70.02	12.8	United States	68.40	11.5
Canada	33.57	6.1	Japan	56.94	9.6
Brazil	18.43	3.4	China	20.12	3.4
China	16.63	3.0	Canada	15.55	2.6
Australia	16.56	3.0	Mexico	12.79	2.2
Argentina	12.20	2.2	Korea, Rep. of	12.50	2.1
Thailand	12.06	2.2	Russian Fed	11.40	1.9
Mexico	9.07	1.7	Hong Kong, China	11.06	–
Russian Fed	8.17	1.5	retained imports	6.43	1.1
			Taipei, Chinese	6.99	1.2
New Zealand	7.97	1.5	Switzerland	5.65	1.0
Malaysia	7.19	1.3	Indonesia	5.35	0.9
Indonesia	7.02	1.3	Saudi Arabia	5.01	0.8
Chile	6.97	1.3	Malaysia	4.83	0.8
India	6.41	1.2	Thailand	4.83	0.8
Above 15	445.80	81.4	Above 15	472.32	79.6

Source: WTO International Trade Statistics 2002, table IV.8. "EU members" includes trade between EU members

9.3 Agricultural Products' Share in Trade, by Region, 2001

	Exports	Imports		Exports	Imports
Share in total **merchandise** trade, %			Share in **primary products** trade, %		
World	9.1	9.1	World	40.9	40.9
North America	10.5	6.0	North America	58.3	32.7
Latin America	18.1	9.3	Latin America	45.6	45.7
Western Europe	9.2	9.9	Western Europe	56.0	46.6
C./E. Europe/Baltic States/CIS	8.7	10.5	C./E. Europe/Baltic States/CIS	21.0	43.1
Africa	14.7	15.3	Africa	20.5	56.9
Middle East	3.3	13.4	Middle East	4.3	62.2
Asia	6.7	9.7	Asia	46.7	35.0

Source: WTO International Trade Statistics 2002

10 FOUR VIEWPOINTS ON THE REFORM OF THE CAP

10.1 The National Farmers Union (NFU)

The NFU has always had some reservations about many elements of the CAP. Enlargement of the EU, the requirement to reduce Europe's reliance on export subsidies and price support as part of the liberalisation of world trade, and surplus problems means changes must be made.

The NFU wants these changes to end reliance on price support, deal with environment and rural economy issues and leave EU agriculture better placed to compete on world markets.

10.2 The Economist: "Towards a System of Efficient Farm Support"

Most support measures offered by governments—payments to farmers, price subsidies, intervention purchases and so on—are justified by appealing to broader social benefits including environmental protection, food security, sustaining poor rural communities and the preservation of cultural traditions. Yet most such external benefits could be achieved more directly and at lower cost. To protect the environment, for instance, governments could set aside nature reserves; to sustain rural communities, they could use redistributive direct taxation; to enhance food security, they could buy up stockpiles on world markets.

Other benefits, such as the preservation of rural traditions and the satisfaction of having farms to look at, cannot be derived from anything other than local, non-intensive farming. But these benefits are not factored into farm prices. Left to its own devices, therefore, the market will not deliver enough non-intensively farmed acres.

The economics of externalities argue for enhancing this type of farming so as to maximise society's well-being. That is the case for public support for farmers. But even on this basis the way that governments have chosen to deliver it distorts prices, trade and behaviour, at huge cost.

10.3 Green Party

The CAP has been the policy of the madhouse, and has accomplished the remarkable feat of achieving both environmental destruction and social disaster. In the UK, the average farm income last year was only £5000, and over 20,000 farmers are leaving the land each year. At the same time, industrial farming, promoted by the CAP, has led to increasing degradation of the countryside, and pollution of our waterways.

If we genuinely want to achieve the vision of a sustainable, diverse, and thriving rural economy, then we need a radically different approach based on the re-localisation of our food supply.

Key elements of this approach would be policies designed to give priority to shorter supply routes and regional markets; the introduction of eco-taxation to internalise some of the environmental costs of damaging and unsustainable production methods; more support to farmers to enable them to shift from intensive to extensive systems, including organic agriculture; restriction of the market power of the major food retailers, and an end to the export of live animals.

10.4 Consumers Association

The Consumers' Association (CA) believes that the CAP is failing to meet even the limited objectives laid down in the 1950s which are increasingly out of touch with the needs of society today. The CA is proposing the elimination of all support for production. This will reduce incentives to farm intensively, and should have beneficial effects on the production of high quality food.

The market distortions and false incentives that the CAP imposes will be removed, leaving farmers free to produce what manufacturers, retailers and most crucially, consumers want.

In place of production subsidies, new specific targeted food, environmental and rural policies are needed to promote safe and sustainable production, and encourage diversification. There must be incentives to farmers who act as stewards of the countryside, and thus contribute to our enjoyment of the countryside and wildlife.

11 WEB LINKS FOR FURTHER RESEARCH

- Agra-Europe www.agra-europe.com
- BBC Radio 4 Farming Today www.bbc.co.uk/radio4/news/farmingtoday/index.shtml
- CAP (Background and Evolution) http://econserv2.bess.tcd.ie/amtthews/FoodCourse/LectureTopics/CommonAgriculturalPolicy/PageOne.html
- Catholic Agency for Overseas Development (CAFOD) www.cafod.org.uk/
- Country Land and Business Organization www.cla.org.uk
- Curry Commission (Future of Farming and Food) www.cabinet-office.gov.uk/farming/index/CommissionReport.htm
- Danish Pig Industry www.danskeslagterier.dk/smcms/Danske_Slagterier_UK/Index.htm?ID=141
- EU Budget http://news.bbc.co.uk/hi/english/static/in_depth/europe/2001/inside_europe/budget/
- EU Commission Representative in the UK www.cec.org.uk/info/pubs/bbriefs/bb01.htm
- EU Commissioner for Agriculture http://europa.eu.int/comm/agriculture/index_en.htm
- EU's Farm Deal (BBC October 2002) http://news.bbc.co.uk/1/hi/business/2360541.stm
- Europe's Farm Reform Plans (BBC) http://news.bbc.co.uk/1/hi/world/europe/2685065.stm
- European Commission in Ireland www.euireland.ie/news/agri/index.htm
- Franz Fischler Home Page http://europa.eu.int/comm/commissioners/fischler/index_en.htm
- Friends of the Earth www.foe.org.uk/campaigns/real_food/resource/farmers.html
- Green Party www.greenparty.org.uk
- National Farmers Union www.nfu.org.uk
- New Zealand Farming "Life after Subsidies" http://www.fedfarm.org.nz/
- OECD (select agriculture policy) www.oecd.org
- Oxfam (select policy briefing papers) www.oxfam.org.uk/
- Rough Guide to the CAP www.cafod.org.uk/POLICY/roughguidetothecap200209.shtml
- Rural Development in the EU http://europa.eu.int/comm/agriculture/rur/index_en.htm
- Rural Development in UK Farming www.defra.gov.uk/erdp/default.htm
- Sustain (Alliance for better Food and Farming) www.sustainweb.org/agtrad_index.asp
- World Trade Organization (WTO) www.wto.org/english/tratop_e/agric_e/agric_e.htm

12 KEY CONCEPTS USED IN THIS CASE STUDY

Allocative Efficiency
CAP
Common External Tariff
Deadweight Loss of Welfare
De-coupling
Deficiency Payments
Diversification
Dumping
Dynamic Efficiency
Economic Welfare
Economies of Scale
Efficiency
Enlargement
Environmental Management
Equity
EU Budget
Export Refunds (Subsidies)
External Benefits
External Costs
Factor Immobility
Fiscal Costs
Fischler Reforms
Free Market Forces
Globalisation
Government Failure
Guaranteed Prices
Intensive Farming
Law of Unintended Consequences
Market Failure
McSharry Reforms
Organic Farming
Poverty
Preferential Trade Agreements
Price Support
Productive Efficiency
Regressive Taxes
Rural Development
Rural Poverty
Set Aside
Single European Market
Structural Change
Subsidy
Trade Liberalisation
Transfer Payments
World Trade Organisation