Common Agricultural Policy

Petr Hedbávný
Luboš Komárek

FACULTY
OF SOCIAL SCIENCES
Charles University

OUTLINE

- I. Introduction to CAP
- II. Economics behind CAP
- III. Problems of CAP
- VI. Reforms of CAP
- V. Enlargement of EU and recent trends in CAP

- Readings: **R. Baldwin – Ch. Wyplosz**: “The Economics of European Integration”, 4th edition. (Chapter 9, pp. 239-267).




What is your favourite food?

pictures on slides 3-7 and the slide 38 from (c) http://maxpixel.freegreatpicture.com

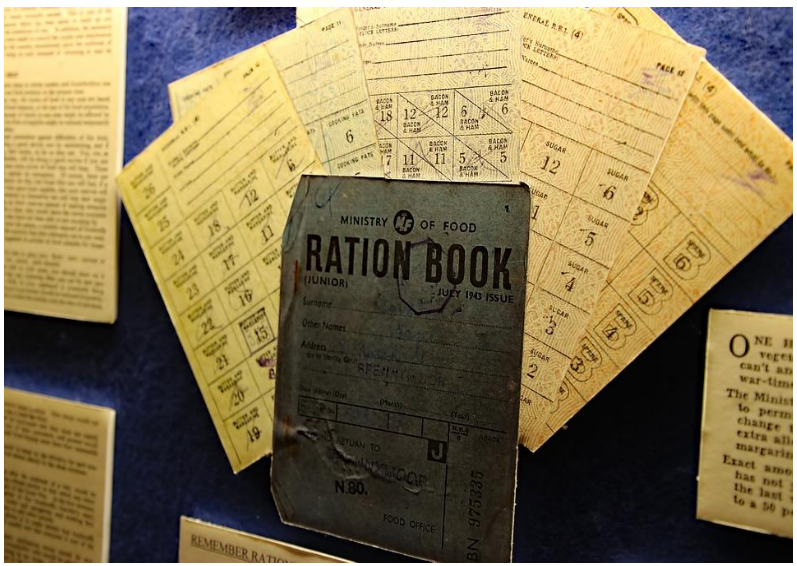
What is your favourite **imported** food?

Uncertainty

Unavoidability

Externalities

Social cohesion



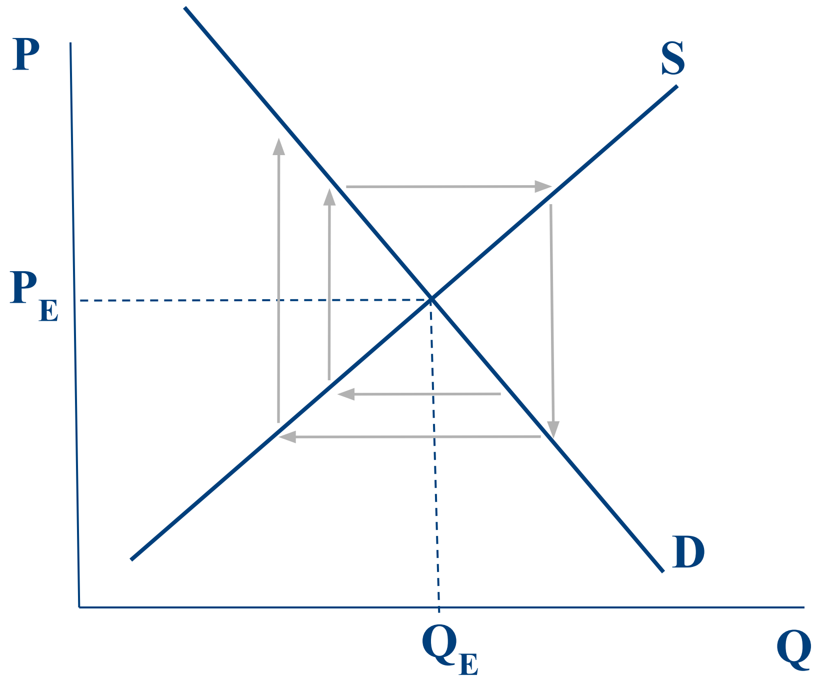
Should farmers be protected (in 1960)?

I. Introduction to CAP

Rationale for public intervention in agriculture

- **Income vulnerability as a result of specifics of production processes**
  - Strong influence of weather conditions (good and bad crops)
  - High share of mutually dependent processes (beef and milk, links between plant and animal products, etc.)
  - Autonomous production cycles (biologically determined reproduction of herd, annual cycle of plant production, etc.)
  - High share of single purpose machinery (combine harvesters, etc.)
  - Impossibility to reverse some output decisions in a changed market situation
- **Farming is a long-term declining industry**
  - Relative drop in household expenditure on food as incomes rise in wealthier societies (Engel's law)
  - Declining demand as a result of stagnant population
- **Social cohesion**
  - Farming is highly competitive industry with a large number of small producers
  - Social tensions caused by income differentiation between rural and urban areas
- **Externalities**
  - Impact of agriculture on the environment (soil and water pollution, elimination of biodiversity)
  - Care of landscape, protection of animal welfare, preservation of endangered breeds

Cobweb theorem



Price elasticity

$\eta = (\Delta Q/Q)/(\Delta P/P)$

$\eta_S > \eta_D$ ➪ explosive cycle

Limit values

horizontal line ➪ $\eta = \infty$

vertical line ➪ $\eta = 0$

- How small economic shocks can become amplified by the behaviour of producers:: decision on agricultural production is made before its realisation (**adaptive expectations**), leading to a **short-run** inelastic supply

- Non-agricultural industries
  - Supplied quantity Q_E adjusts smoothly to equilibrium price P_E and market tends to stay in equilibrium
- Agriculture
  - Divergence from equilibrium in case of lower elasticity of demand than supply
  - Initial positive demand shock (excess demand) ➪ shortage pushes the price up ➪ with a time lag farmers adjust production to a higher price ➪ production decision based on higher price leads to excess supply ➪ surplus pushes the price down ➪ with a time lag farmers adjust production to a lower price ➪ lower price leads to excess demand
- Suggested reading: See Christophe Gouel. Agricultural price instability: a survey of competing explanations and remedies. *Journal of Economic Surveys*, Wiley, 2012, 26 (1), pp.129-156.

Formation of CAP – historical circumstances

- Traditional high share of protection of farmers in continental Europe (France, Germany); also common outside Europe (USA, Japan)
- High diversity of intervention measures called for a kind of common policy
- High share of European labour force working in agriculture (cca. 20 % when CAP was founded)
- High dependency (thus vulnerability) of post-war Europe on food imports ⇨ self-sufficiency among policy priorities

Agriculture in the Treaty of Rome

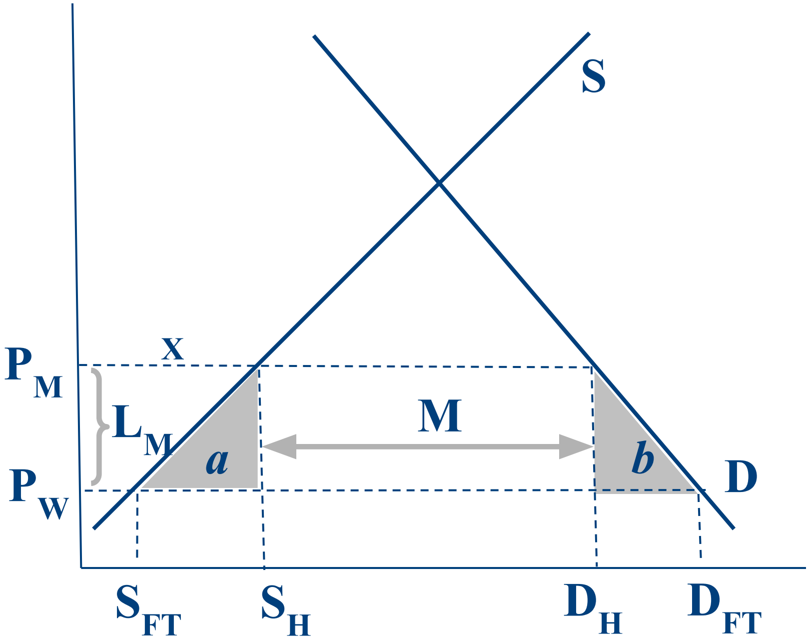
- Treaty of Rome (1958) envisaged the agriculture being part of integration process
- Objectives
  - Raising productivity of agricultural production
  - Assuring appropriate living standards for farmers
  - Stabilisation of markets in farm products
  - General availability of farm products
  - Affordable prices for consumers
- Implicit contradictions in objectives
  - Reconciliation of improving efficiency with the support of small size family farms (as opposed to post-war collectivization in the Eastern bloc)
  - Reconciliation of the support for agricultural prices with reasonable prices for consumers
  - Reconciliation of available supplies with already emerging surpluses of certain products by the late of 1950s

Formation of CAP

- Foundation of CAP in 1962
  - Agreement reached after difficult negotiations (23-day marathon of Council of Ministers meetings)
  - Insufficient progress on CAP jeopardized transition to the second stage of forming customs union (conflicting interests of Germany and France)
- Fundamental principles of CAP
  - **Unity of markets**: progressive liberalisation of trade with farm products among MS, common prices for main agricultural products throughout Community markets
  - **Community preference**: advantage given to EC farmers over producers from third countries in a form of levies on agricultural products
  - **Financial solidarity**: creation of a special fund for financing market interventions and structural measures in agriculture (Agricultural Guidance and Guarantee Fund)

II. Economics behind CAP

CAP instruments - type 1: import levy

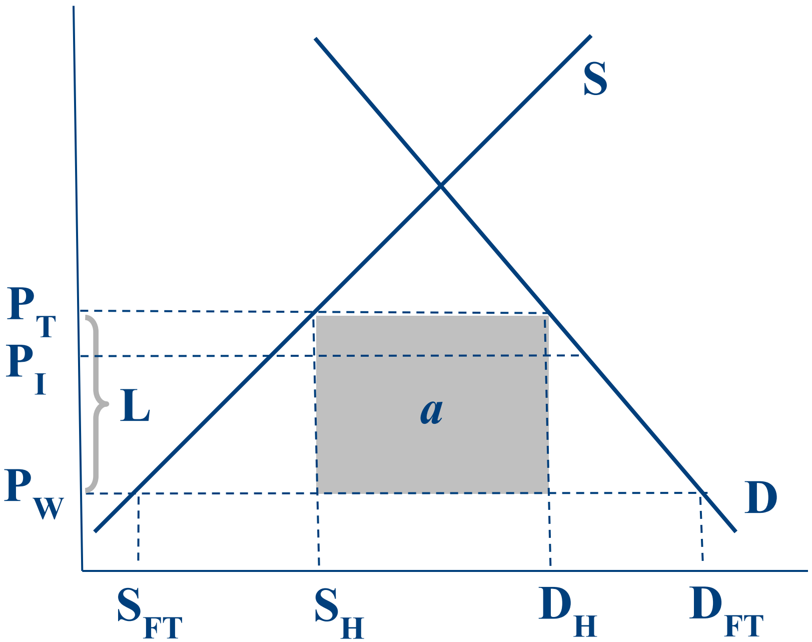


P_W … world price
L_M … import levy (tariff)
P_M … import price ($P_W + L_M$)
M … imports
***a* + *b* … total welfare loss**

- Fixed import prices, variable levies (VL)
  - VL used until 1995, abolished during Uruguay round
  - VL were adjusted on daily basis (in line with world price fluctuations) in order to keep unchanged an agreed level of price protection (fixed import price P_M)
  - Internal prices may undergo substantial fluctuations but home-country producers cannot be exposed to cheaper imports

- Flexible import prices, fixed levies
  - Internal prices copy the movement of world prices
  - Competitive pressure can be eliminated by high tariffs

CAP instruments – type 1: import levy (cont.)



P_T … threshold price

P_I … intervention price

P_W … world price

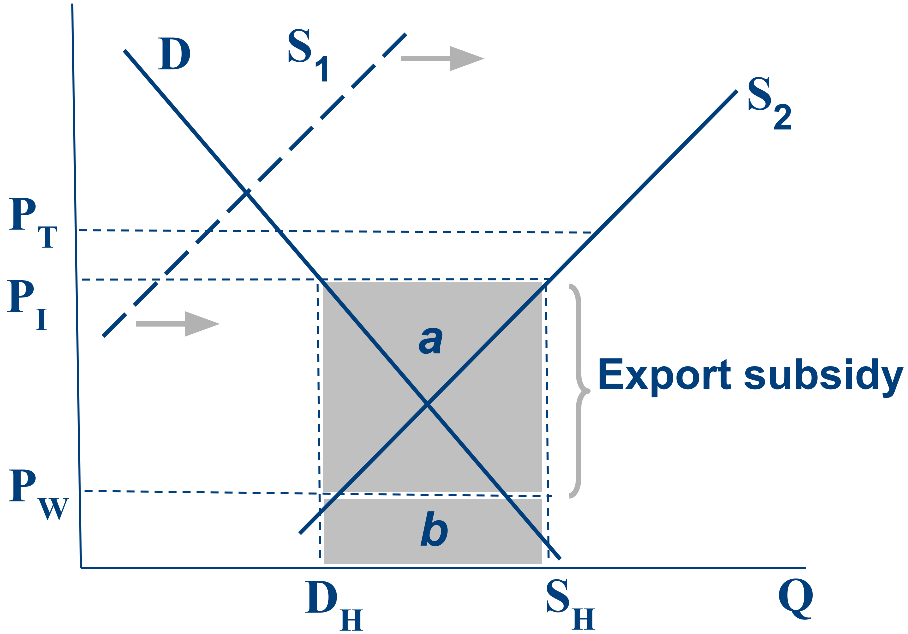
L … import levy

a … tariff revenue

P_I < EC market price < P_T

- **Threshold price** is minimum price applied on imports from the rest of the world at the point of entry to the EU
- **World price** is price of the cheapest imports of a given commodity on EU market
- **Intervention price** is minimum guaranteed price at which farmers can sell any quantity of given commodity of specified quality to intervention agencies (see the next sllide)

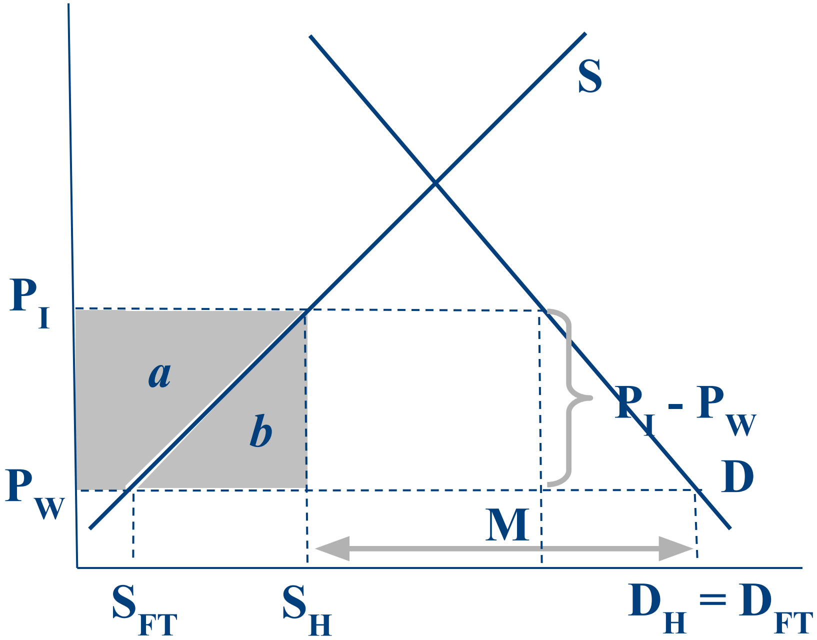
CAP instruments – type 2: intervention purchases;resulting in production surpluses



P_T … threshold price
P_I … intervention price
P_W … world price

- Rising productivity of agricultural production shifted supply curve to the right (development of chemical and machine-intensive technologies called green revolution)
- Political commitment to preserve farmers' incomes shifted the intervention price up
- Agricultural surpluses can be disposed of in two distinct ways
  - liquidation of stored products (loss: ***a* +*b***)
  - subsidised exports *called* dumping (loss: ***a***)

CAP instruments – type 3: producer subsidies



P_W … world price

P_I … guaranteed price

***a* … increase in producer surplus**

***b* … total welfare loss**

- Producer subsidies consist in paying farmers the difference between world price and guaranteed price (volume of subsidy is *a* + *b*)
- Consumers pay lower world price while farmers receive higher subsidized price
- Less distortive income policy (welfare loss is *b*)

Green currencies

- Rationale
  - Their object was to protect agricultural production prices in member countries from wide variations caused by fluctuations in the real exchange rates.

- Definition
  - It a is currency whose value is adjusted in accordance with fluctuations between the currencies of the EU nations
  - The currencies of EU members used artificial rates of exchange for the purposes of the Common Agricultural Policy.

- Evaluation
  - The existence of distortive dual exchange rate regimes was administratively extremely costly and cumbersome, abandoned with the emergence of euro

CAP instruments – direct payments

- Direct payments are payments **granted directly to farmers** under certain support scheme
- Key CAP support policy introduced in the MacSharry reform in 1992
- Construction: usually linked to the acreage of agricultural land, other possible titles are DP per farm, DP per animal head

- Advantages
  - Less controversial instrument,
    - compared with intervention purchases:no direct interference with the price system
    - compared with export subsidies:no direct interference with world trade flows
  - Greater exposure of farmers to market signals

- Disadvantages
  - Leakages of the support to landowners through higher land prices and rents (DP per hectare) ⇨ barrier to entry for new entrants
  - High red tape (reporting duties of farmers, different implementation standards in MS, costly monitoring of compliance with criteria)
  - Development of farmers‘ dependency on income from DP

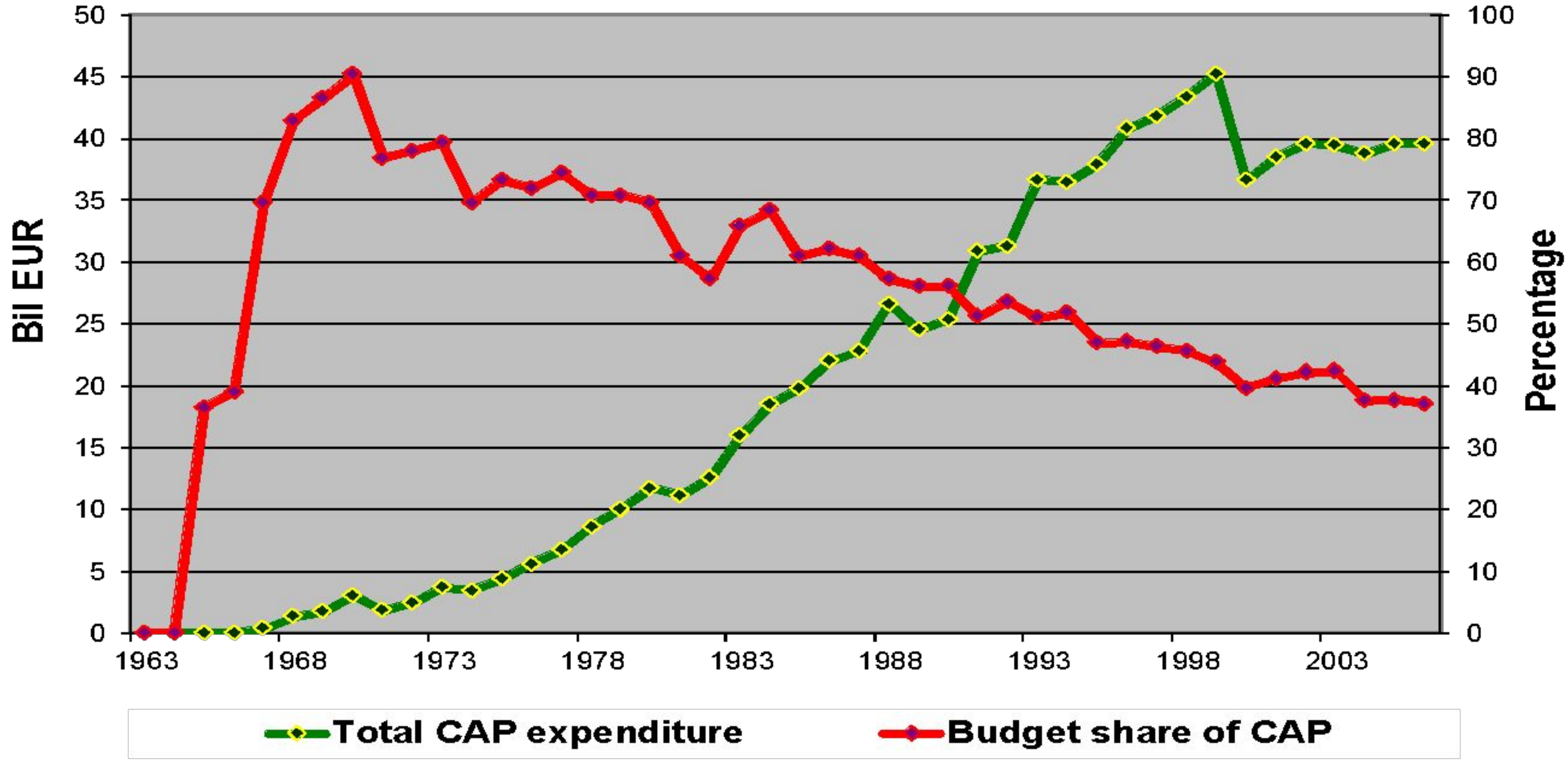
- Cross-compliance
  - Farmers have to meet certain requirements to receive direct payments in full
  - Greening: reorientation of payments on using practices beneficial for the climate and the environment (permanent grassland, crop diversification, ecological focus)

III. Problems of CAP

Problems of CAP – subsidized exports

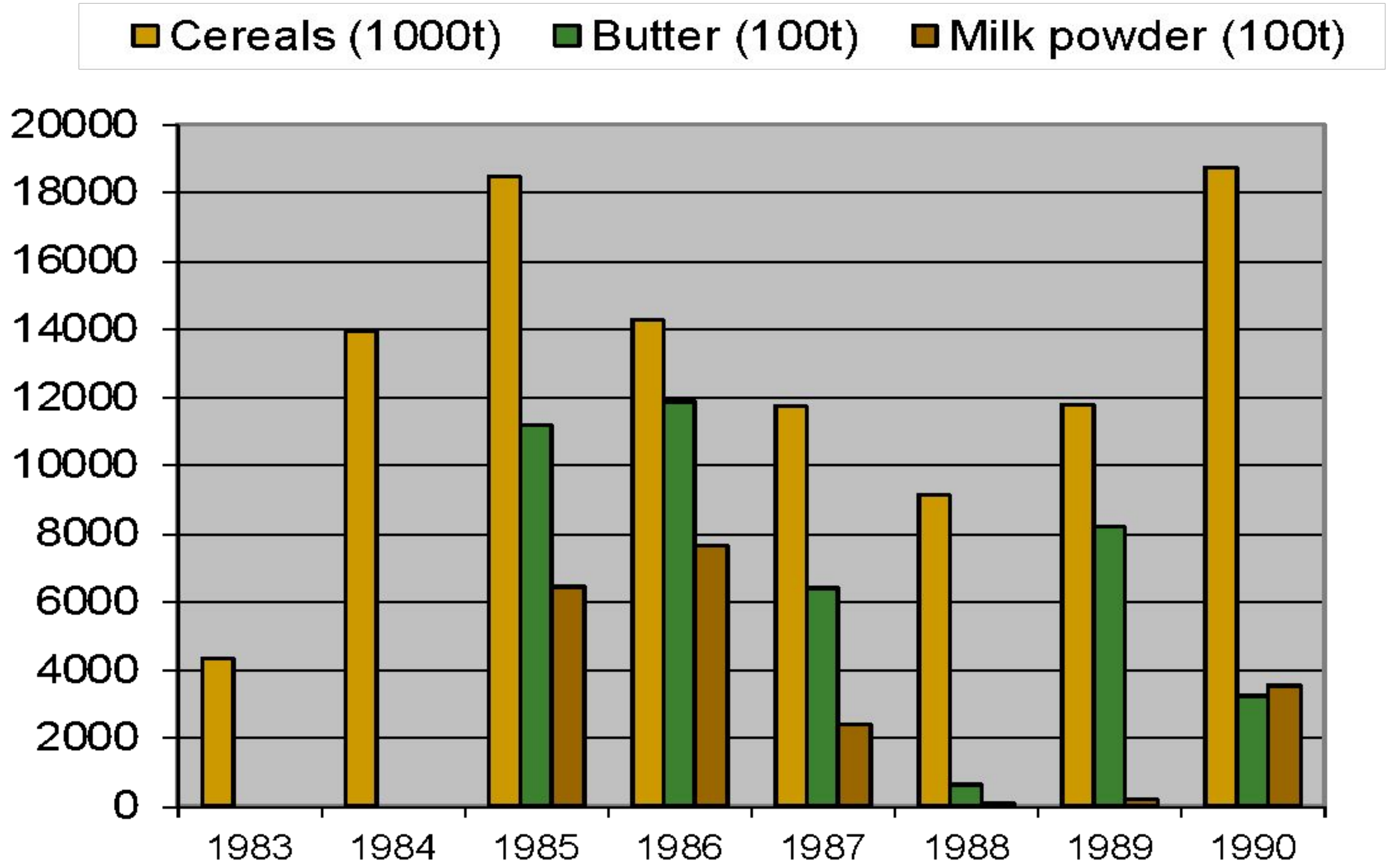
- Negative consequences
  - **Downward pressure on world prices** (lower demand for imports from the rest of the world and higher supply of exports)
  - **Harmful impact on less developed countries** whose agriculture products represent their dominant export articles
  - **Accusation of dumping**: practice of exporting goods at a price that is below cost (not permitted under WTO rules)
  - Tensions and **trade conflicts** with other important exporters of farm products (USA, Canada, Cairns Group)
  - Chicken War (first conflict arising from CAP): 25% tariff on potato starch, dextrin, brandy and light trucks imposed in 1963 by the United States in response to tariffs placed by France and West Germany on importation of US chicken
- Countervailing arguments
  - Protectionist practices in agriculture were a typical norm outside EU
  - Support per farmer in EU was comparable with the one in USA and Japan, half of that in Switzerland and Norway (OECD 2004)
  - Preferential treatment of former colonies (ACP countries) and GSP programmes

Problems of CAP – costs to EC budget



European Commission: Financial Perspective 1993-1999, Financial Perspective 2000-2006

Butter mountains and wine lakes



Source: Baldwin, Wyplosz: The Economics of European Integration, p. 222

Organisation of financing

- European Agricultural Guidance and Guarantee Fund (EAGGF)
  - Set up in 1962, one of the four structural funds
  - Guarantee section financed income policies of CAP (intervention purchases, export and producer subsidies, direct payments, etc.)
  - Guidance section financed structural reforms in agriculture and programmes for rural development
  - Ratio of expenditures in guidance section to guarantee section in 2000–2004 approx. 3-6%
- New arrangement since 2007
  - European Agricultural Guarantee Fund (EAGF): replaced the guarantee section of EAGGF
  - European Agricultural Fund for Rural Development (EAFRD): replaced the guidance section of EAGGF
  - Spending on EAFRD measures account around 10 % of agricultural budget
- Fund management
  - Fund Committee consists of the Commission and representatives of MS

Problems of CAP – inequitable support

- Paradox of CAP
  - Despite massive budgetary costs farm incomes were not keeping up with those in the rest of economy ⇨ feeling of many farmers that CAP was not providing sufficient support
  - **Declining number of family farms** and rising share of farming as second job, negative social impacts were mitigated by a generous social welfare system
  - **Supported the farmers in Northern Europe rather than Mediterranean farmers** (for individual commodities, measured as the difference between the share in production value and the share in CAP spending)

- Explanation
  - CAP instruments that were linked to **efficiency indicators preferred limited number of large producer units mostly owned by rich people**

  EC (1993): in pre-reformed CAP approx. 20 % of farmers got approx. 80 % of CAP assistance

  OECD (2003): approx. 25 % of farmers got approx. 70% of CAP assistance
  - CAP instruments linked to acreage of cultivated land caused **leakages to land owners via higher rents**

  OECD (2003): approx. 40% of farmers are not owners of cultivated land

Problems of CAP – industrialization of farming

- Negative environmental impact
  - Intensive chemical fertilisation and use of pesticides ⇨ nitrates and phosphate in soil, water pollution, damage to atmosphere, decline in natural fertility of land, reduced biodiversity
  - Mechanisation ⇨ large fields, land erosion, reduction in wildlife
- Factory farming
  - Animal diseases: mad cow disease, foot and mouth disease
  - Animal suffering: overcrowded buildings, cage breeding, transport over long distances, etc.)
  - Treaty of Amsterdam: EU should pay full regard to the welfare requirements of animals
- Worldwide problems, in EU encouraged by generous CAP policies

Attempts to limit spending on agriculture (1)

- Co-responsibility levies
  - Excess production over agreed fixed limit are excluded (totally or partially) from support scheme
  - Positive impact on budget but failure to resolve the problem of surpluses (limits are subject to political negotiations)
  - Introduced for milk from 1977 and for cereals from 1986
- Production quotas
  - Introduced for milk since 1983 as a lesser evil compared to cuts in intervention price
  - Price intervention is restricted to predetermined quantity of production, production over the quota is penalize by a fine
  - Fines can be paid or by single farmers (system A) or by milk processors (system B), unused quotas were later permitted to sell to other producers
  - Contentious allocation of quotas by country and then by single farmers
  - Italian milk quotas is blatant case of long delays in applying Community legislation, huge fines, fraudulent activity and violent protests of farmers

Attempts to limit spending on agriculture (2)

- Set-asides
  - Compensation of farmers for withdrawing arable land from production of subsidised products
  - Alternative use of land: totally idle, non-food production, pasture, special production (chickpeas, lentils, vetches)
  - Slippage: only marginal land tends to be removed from production, more intensified methods of production are used on cultivated land
- Budget stabilisers
  - Automatic checks on agricultural spending
  - Maximum guaranteed quantities for individual products, cuts in prices and subsidies in the following year if limits are exceeded
  - Control undermined by high levels of guaranteed quantities and small price cuts relative to the level of price support
- Accompanying measures
  - Incentives for early retirement
  - Incentives for using more extensive production methods
  - Reforestation

IV. Reforms of CAP

Reforms of CAP – Mansholt plan

- Objectives
  - Presented by European Commission in 1968
  - One of the most controversial proposals to resolve the problem of agricultural surpluses and inadequate farm incomes
  - Central concept: modern farm enterprise comparable with those in other sectors (including working hours and holidays)
  - Creation of co-operatives should be encouraged in order to concentrate supply and ensure the use of modern technologies
  - Quantitative objectives: 5 million people to leave farming (4 million to be persuaded to retire), 5 million hectares to release from agricultural production, reduce the number of cows by 3 million
- Strong reaction of the farming community
  - **Proposal perceived as radical, as an attack on family farms**
- CAP relied on exclusive reliance on price support for many subsequent years

Reforms of CAP – MacSharry reform

- Pressures to reform CAP at the beginning of 1990s
  - Previous failed attempts to solve the problem of surpluses of main CAP products
  - Imminent collapse of the Uruguay round (started in 1986): US backed farm trade liberalization, EU concessions were enforced under the threat to paralyse trade in industrial products (80 % of EU exports)
  - Manageable extension of CAP with Eastern enlargement
- Reform package was adopted in mid 1992 under the Agriculture Commissioner Ray MacSharry
- Major elements
  - **Cuts in intervention prices for certain products**: cereal prices lowered by 35 %, beef prices by 15 %, butter price by 5 %
  - **Reduction in the price support was compensated by direct payments** (EU budget devoted to agriculture remained very high)
  - **Compulsory set-asides and other accompanying measures** (environmental programmes, afforestation, early retirement)
  - Concessions in Uruguay round: transformation of variable levies and import quotas into fixed tariff (neutralised by high tariffs 40-150 %), commitment to phase out subsidised exports

V. Enlargement of EU and trends in CAP

CAP and Eastern enlargement

	Acreage (mil ha)	Number of farmers (millions)	Average size of farm (hectares)	Agricultural share in GDP (%)
New members	38	23.9	1.6	3.1
EU -15	128	6.8	18.7	1.7
USA	376	2.2	174.4	1.4

Baldwin, Wyplosz: The Economics of European Integration, p. 237 (Data for new members and EU-15 in 2001)
Wallace et al.: Policy-making in the European Union, p. 182 (data for USA in 2002)

- **Dilemmas of Eastern enlargement**
  - Unsustainable CAP under existing rules (too much new land for products covered by CAP, too many new farmers eligible for aid)
  - Aggravated problems between small and large farms
  - Absence of administrative capacity in new members

Key issues of Eastern enlargement

- Extension of direct payments
  - Commission position
    - Farmers in CEEC will not experience price cuts so they should not benefit from direct payments
    - Full direct payments would be too high for CEEC farmers that would create social distortions and inequalities
    - Leakages of support to non-rural beneficiaries as a result of privatization processes in agriculture
  - Position of new members: differential treatment between rich Western farmers and poorer Eastern farmers
  - Agreement in Copenhagen European Council (December 2002)
    - **Gradual convergence of direct payments spread over 10 years starting from 25 % level**
    - Possibility for new members to top up the assistance from national funds
- Distribution of quotas for milk and sugar
  - Strict conditions for new member states upon EU entry
  - Non-representative reference period for quota determination due to sharp output decline at the beginning of economic transition
- Land ownership by non-residents
  - Fear of selling off land as a result of its low price
  - **Derogation granted on foreign land ownership**

Trends in CAP in the 2010s and 2020s

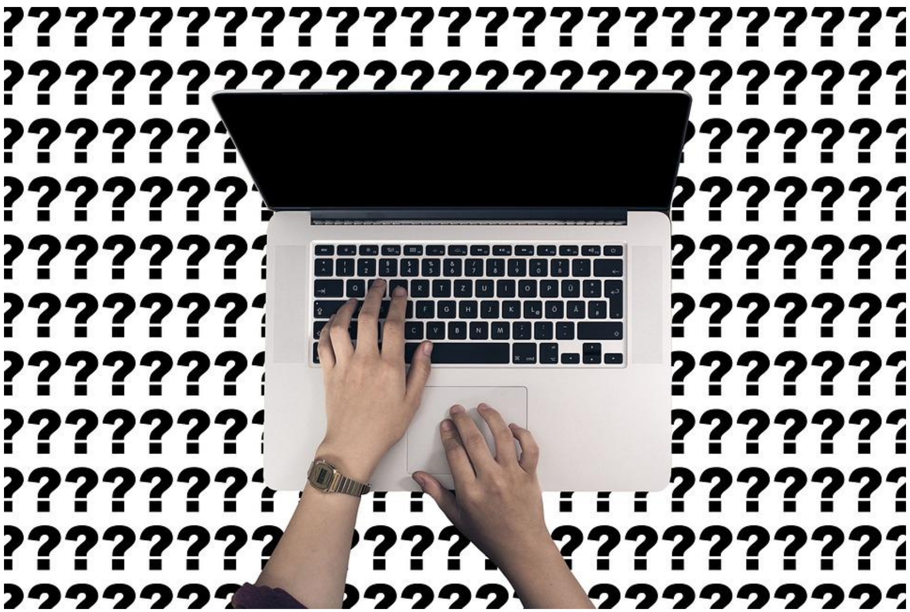
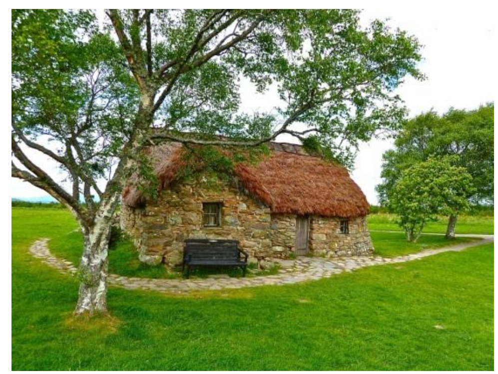
- Leading ideas: **orientation towards more cost-efficient and less distorting forms of farm support**, resistance towards the return of old costly price support schemes and distortions on international markets
- First pillar of CAP: income support for farmers
  - Support policy is now entirely based on direct payments
  - **Decoupling (removal of links between direct payments granted to farmers and agricultural production), strong cross-compliance**
  - Direct payments should serve as a safety net for farmers, not as a large-scale subsidy programmes
  - Elimination of discrimination between old and new members (orientation on phasing out benefits rather than achieving equally generous benefits)
  - Measures in Pillar 1 are fully financed by EU
- Second pillar of CAP: rural development
  - **Agriculture provides public goods and positive externalities that deserve to be funded**
  - Wide range of measures aimed at improving competitiveness, land managements and development of rural areas
  - Measures in Pillar 2 are co-financed by MS to ensure good supervision and control by local authorities ⇨ high administrative costs
- Further liberalisation of world trade in agricultural products
  - **Easier access to EU markets for agricultural products from developing countries**
- Lack of manpower in farming due to covid-19 and other factors ⟶ **increasing price of agric. products in 2020-2021** (FAO site)

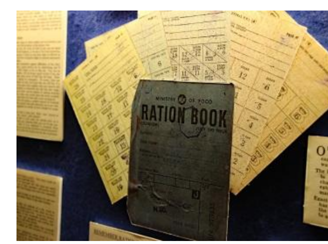
2021 CAP reform

- Adopted on 2 December 2021
- Key aspects of the approved reform include (source):
  - "Member states will be obliged to ensure that at least 35% of the rural development budget and at least 25% of direct payments will be dedicated to environmental and climate measures.
  - A minimum of 10% of direct payments will be used to support small and medium-sized farms.
  - At least 3% of the CAP budget will go to young farmers.
  - A crisis reserve with an annual budget of €450 million (in current prices) will be permanently ready to help farmers with price or market instability.
  - EU labour rules in agricultural sectors will be better monitored and infringements penalised
  - Information about final beneficiaries of EU support will be more transparent thanks to an EU data mining tool, which member states will get access to and which helps to identify the risk of fraud occurring by cross-checking information in public databases." (www.agriland.ie)
- An official presentation of 2021 CAP reform is available on the European Commission site; a piece of journalism with arguments against the reform.







How would you (re-)design agric. policy?

Thank you for your attention.

Merry Christmas
and a Happy New Year 2024!