Reform of the Common Agricultural Policy
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Introduction
The Common Agricultural Policy (CAP) has undergone major changes over time. At times when the most significant changes were undertaken – the Mac Sharry reform and the Agenda 2000 – policy makers, especially from Germany, tended to claim that a long time solution had finally been found and that farmers could rely on a stable and predictable policy for a longer period. In contrast, many economists, among them the advisory council to the German Ministry of Agriculture, called for a more comprehensive reform even beyond the Agenda 2000 decisions. So far their suggestions were neglected in the official policy arena. The BSE crisis and the personal changes in the German ministry of agriculture seem to have changed the thinking. The new Minister and also the German Chancellor ask for a drastic change of the CAP. It should be praised that the status quo is finally questioned and new ideas are put forward. However, the public discussion appears to be partly distorted by beliefs and unreflected opinions. Some clarification and structuring of the discussion might be helpful in the political process of agricultural reform. This short note is structured as follows: first, the need for additional reform will be reconsidered. This diagnosis is important for assessing the reform proposal by the German government, which is analysed in the second section. The key principles for a genuine reform are laid out in the third section. The fourth and final section presents some reflections on the chances for a genuine reform given the present political market in the EU.

Strong needs for reform
Agricultural policy is subject to the same principles and guidelines as general economic policy. Hence, the CAP should be reformed if

- the money spent on agriculture at the European and national level does not serve the generally accepted objectives in a ‘social market economy’,
- the present policy leads to inefficient use of factors of production, and, therefore, continues the wastage of resources, even after taking into account external effects,
the CAP in its present form jeopardises the success of Eastern enlargement

a continuation of the CAP with or without enlargement will be in conflict with international commitments.

**Inefficient use of public expenditure**

It is often complained that EU expenditure on agriculture is too high, as it consumes about 45 percent of the total EU budget. However, this concern should not be based on the magnitude of this expenditure, but rather on the economic and social effects and on the underlying justification of the expenditure. The main share of budget outlays for agriculture is for direct payments tied to the use of land, to the number of beef cattle or to land set-aside. These forms of payments has been introduced with the Mac Sharry reform in 1992; the rationale was either to compensate farmers for the reduction of intervention prices for grain or to curtail production by idling land. The permanent continuation of these payments is not in line with the principles of a 'social market economy'. It is not at all secured that those who receive the payments – which are above 1Mill. DM in specific cases annually – are in real need. Moreover, the recipients are only qualified for payments if they use their land in line with the current policy straightjacket, thus grow grains or oilseeds or keep certain types of cattle. Hence, these payments distort the pattern of production. Oilseed rape and wheat are grown on fields which could be more suitable for other agricultural products at given market prices. Thus, farmers may actually grow crops for which production costs are not covered by the prevailing market prices, but payments may make production profitable to them. Hence, the transfer efficiency of the direct payments is less than one. (Money spent by the EU is less than additional farm income). Transfers made for idling land are even less efficient. Certainly, there is no social rationale for these transfers; a person idling land is not necessarily in social need. Moreover, linking the payments to not using an available factor of production for inefficient use of domestic resources. It is in sharp contrast with the principles of a ‘social market economy’ to provide for incentives to not using factors of production, these factors could surely contribute to a net gain in GDP, even after taking into account possible positive and negative external effects.
**Inefficient use of resources**

The present form of direct payments, as discussed above, is one of the determinants of the inefficient use of agricultural resources. Unfortunately, there are a couple of other determinants which even additionally conflict with the main principles of the ‘Single Market’ in the European Union (EU). The quota systems are a special case in point. There are quotas for production, the most important ones are those for milk and sugar, but there are also quotas for the production of tobacco, potato starch and cotton. Quotas were allocated to individual farms, frequently based on historical production patterns, and are, thus, the conflict with the best use of factors of production in a European Union is obvious. This conflict even holds if quotas were tradable on a Community wide base. In addition to these production quotas, the EU provides quotas for areas planted of certain crops. Entitlement for direct payments for areas used in grain or oilseed production is restricted on the national or even the regional level. Hence, competition among regions is restricted and production costs in the EU are higher than they could be with a more liberal market regime.

**The CAP and Eastern Enlargement**

The CAP causes significant problems for Eastern enlargement. The current discussion focuses on the question whether the present system of direct transfers should be granted to the new member countries and whether sufficient funds were available. The discussion misses at least three important points: First, what would be the economic effects if the new member countries had to accept the CAP as it stands, second, what were the resulting distributional effects, and third, could these countries implement these policies in an acceptable way.

In contrast to former enlargements, the central and eastern European countries are still in a transition stage from a planned to a market economy. Experience has shown that the agricultural sector is one of the lagging sectors in the transition process, mainly due to the strong need for adjusting the farm structure and the mal-functioning markets for land and rural finance. Economic cost would be high for these countries if the future transformation of the agricultural sector were constrained by quota systems. It should be noted that the present share of quota production in total agricultural production is not at all
negligible. Milk and beef, which are largely joint products, already made up for 42 percent of the value of agricultural production in Germany.

Transfer of the present CAP would imply a high burden for consumers in the new member countries. Consumer prices in these countries would go up significantly, reducing real income of poor households, that spend already a high share of their income on food.

It can be questioned whether the new member countries have the administrative capacity to implement the CAP regime in an acceptable way. It is known that the CAP provides significant incentives for fraud. The reports of the European Court of Auditors support the view that fraud is more pervasive in countries with a weak administrative capacity and in countries in which corruption is widespread. The corruption perception index, which ranks countries according to perceived corruption, shows that all applicant countries rank far below than 13 of the 15 present EU member countries. Obviously, these countries are not yet functioning market economies where income is mainly generated by functioning markets. It can be taken for granted that the transfer of the present CAP with highly regulated markets will even widen corruption in the new member countries, questioning the rational of the CAP even more and weakening the acceptance of the CAP in all societies of the member states.

The CAP and international commitments

Changes of the CAP in the past were partly driven by budgetary pressure (up to 1992), but since the last GATT-Round such changes were increasingly driven by constraints imposed by international commitments. These commitments will ask for further reforms.

First, according to the outcome of the Uruguay Round, the EU is most constrained by the limits accepted for subsidized export quantities and by the limits imposed on the amount of export subsidies paid for processed agricultural products. The relevance of the export quantity constraints can be highlighted with only a few figures. Subsidized export quantities in the year 2000/2001 have to be lower than actual export quantities in 1999/2000 for wheat by 15 percent, for coarse grain by 77, for skimmed milk powder by 53, for ‘other dairy products’ by 16, for pork by 58, for poultry by 11 and for eggs by 1.6 percent. If EU prices continue to be higher than world market prices, the EU will have to build up
stocks or has to cut production in order to meet the WTO limits. The problem will even be aggravated by enlargement as most of the new member countries have committed themselves in the WTO to not paying export subsidies.

The problems on exports for non Annex 1 products (processed food products) will be the most pronounced. The food processing industry will receive for export restitutions in 2000/2001 60.4 Mill EUR or 12.7% less than in 1999/2000. It should be noted that the world trade in agricultural products is mainly expanding in processed products. If protection for agricultural products remains high in the EU, and the EU food processing industry is not receiving export restitutions to compensate for the higher raw material prices, then the EU processing industry cannot be internationally competitive.

Second, the EU has signed some trade agreements which allow for preferential access to EU markets. The agreement with the 48 least developed countries is one, which will become most binding. Others are Free Trade Agreements with South Africa, the Mercosur Customs Union and Mexico. Recently, the southern and eastern European countries received a special gift, allowing them free access to nearly all EU agricultural markets. These agreements pose further pressure on the CAP. The exportable surplus will grow and measures to curtail domestic production or to lower internal Community protection will gain more prominence.

**The new official German view**

The official view of the German Government has changed completely over the last few months. Germany had gained a strong reputation as a defender of the CAP, being very reluctant to any changes. Due to BSE, the Germans got a new minister with a broader portfolio, including consumer protection. Mrs. Künast demands a radical change of the CAP and the Chancellor is a strong supporter of these claims. Food safety, environmental effects of agriculture and animal welfare rank high on the agenda. Past policies and ‘conventional agriculture,’ that is considered as ‘industrial production’, are seen as the cause of BSE, foot and mouth disease, and former food scandals. In contrast, organic farming and small scale farming are considered as the solution to the present crisis.

It should be praised that the German government is finally open to a reform of the CAP. Indeed, an open discussion, which may provide new or not yet
disseminated information, may improve policy decisions needed to improve the
efficiency of the CAP. It is hardly questionable that the CAP as it has been
determined by serving mainly the interest of the farming population and has
partly neglected economy–wide spill-over effects, including consumer protection,
environmental effects and animal welfare. However, the official German
diagnosis cannot be supported by the present state of scientific knowledge.

The problem of food safety

There is no scientific support for the belief that small farms or organic farms
contribute to a higher degree of food safety. “The "organic" label is a process
claim rather than a product claim. It should not necessarily be interpreted to
mean that the foods produced are healthier, safer, or "all natural" (FAO). The
White Paper of the European Commission on Food safety states that food safety
standards have to protect and to promote the health of the consumers. It is
emphasised in that paper that food safety is not related to a specific method of
production, but depends on the attributes of the products. It should be secured
for all products on the markets. In contrast to these statements, German officials
convey the impression that food products produced from conventional farming
cause a hazard for health, whereas organic food is without any risk for health.
This impression concerning relative food safety related to conventional and
organic farming is neither supported by scientific research, nor is the promoted
perception of consumption without risk scientifically correct: Food can never be
proven to be entirely safe or entirely hazardous. It can only be proven to be
hazardous to some extent under certain conditions. Although demanding
completely safe food is unrealistic, it is possible to have food in which potential
hazards have been reduced. If the risk of being harmed by a potential food
hazard produced by conventional farming were high, then it should be forbidden
to remain on offer on the markets. According to the present state of knowledge, a
high degree of food safety is guaranteed by both food produced through organic
and conventional agriculture. However, it cannot be denied that the level of risk
of food hazards can occasionally be high and may thus cause a health problem.
BSE is a special case in point. A high level of health risk may arise, because new
methods of production are applied and producers are not aware of a high level of
health risk of the food hazard (ignorance). Such a situation prevailed up to 1994
when animal meal was fed to cows. A high level of health risk may also arise because producers and/or manufacturers offend laws and use inputs which are forbidden (offence against law). Such a situation prevailed after 1994 when meat and bone meal was forbidden to be feed to bovine animals.

As organic producers and conventional producers may introduce new production methods over time, the first cause of a high level of health risk, ignorance, may emerge under both methods of production from time to time. Indeed, some cases were reported from organically produced food. The second case of health risk is also likely to be present for both production methods. If we can assume that organic food producers and conventional food producers are mainly guided by their personal interests, then it would largely depend on the incentive system who will be found to offend the law. If this view is accepted, then the emerging issue is: What method of production is more efficiently controlled and what are the sanctions? There is no evidence that organic farming can be more efficiently controlled than conventional farming.

**Organic farming and the environment**

It can hardly be denied that organic farming leads, on average, to less negative environmental effects than the present methods applied in conventional farming. However, it would be premature to support organic farming due to this reason. First, it is proven that conventional farming exerts less negative environmental effects if it uses less purchased inputs, i.e. produces more extensively. An overall shift to more extensive farming would follow if the CAP were to reduce production tied payments as well as price protection. If less intensive conventional farming were still exerting negative environmental effects, the obvious response of the government should be either to impose prohibition for specific methods of production, or to provide for incentives to produce in a manner more friendly for the environment. Second, if society desires an expansion of the public good “environment”, it has to provide incentives to farmers to produce these goods. It is unlikely that organic farming could produce the environmental good linked to agricultural production cheaper than some conventional farms.

Third, some consumer concerns could remain, despite the above differences in production costs. Some consumers may continue to prefer that organic
farmers, rather than conventional farmers, should supply the same (amount of) public good to society. These consumers do not care about efficiency, but they care about the ‘ethical aspects’ of production. However, if incentives are permitted to work properly in the market, and farmers are paid for, then conventional farmers would equally be willing to supply public goods with those desired ‘ethical attributes’. But in contrast to the traditional organic farmers, those new conventional farmers are now likely, under a reformed CAP with a more extensive overall production, to supply these ‘ethical attributes’ at lower economic costs to society.

**Organic farming and animal welfare**

Unfortunately, it is difficult to clearly quantify animal welfare (EU Commission, 2000, p.7). Nevertheless, there is a widely held agreement that some methods of conventional farming are negative for the well-being of animals. Cases in point are hens held in cages or calves held in small boxes and dark stables. However, the obvious reaction of the government should not be to support organic farming per se, but to define and enforce regulations for keeping animals that apply to the entire market. There is strong evidence that welfare of animals on organic farms can be much more impaired than of animals held on conventional farms. Cows are a special case in point. Whereas cows on organic farms are mostly tied in chains, they are held in open stables on larger conventional farms.

Based on this reasoning there is hardly a rationale for the single minded German view on policy reform related to organic farming. Moving in this direction would have some major negative effects. Government expenditure would go up due to the promotion of organic farms. Prices for organic food would almost certainly decline as most consumers still prefer the cheaper conventional food. The latter will still be offered on the markets and if not produced domestically, it has to be imported in line with WTO commitments. Profitability of organic farms would decline unless the government were to provide higher support. Higher support for organic farming would imply an indirect taxation of conventional farms, impairing their international competitiveness.
**Guidelines for a genuine policy reform**

The CAP suffered severe policy failures from the very beginning. Hence, a reform should first of all address the problem of policy failure and second, should take care of market failure.

Policy failure has been pointed out above in detail. Market signals are distorted due to price protection, direct payments tied to factors of production, land set-aside programs and due to quotas for production. As these instruments lower the efficiency of resource use in the EU, and do not address the agricultural income problem in a most efficient way, they should be abolished in the medium term. It might be useful to define a transparent strategy for withdrawal of these instruments over time.

The agricultural income problem could be solved by introducing more targeted measures. The present direct payments could be fully decoupled and paid in the future to the past recipient digressively over time.

Environmental effects should be tackled by special programs which reward farmers for the production of environmental products. However, two notes are in order: There is no rational to produce environmental goods on all farms and in the same quantity in every region. Hence, these programs should be selective and cannot be just a substitute for the present farm income policy. Second, most environmental goods are regional goods. It would conflict with the principle of subsidiarity if the EU were to determine how much of these products should be produced and if the EU were to finance production of these goods. A co-financing or a nationalization of this type of policy is advisable.

The EU Commission suggest to strengthen the CAP by building up the second pillar, which includes, apart from the subsidization of the production of environmental products, the support of rural development projects. There is certainly a rationale for such an evolution, however, there are also some inherent dangers. The present EU environmental policy links the production of environmental effects with contributing to the agricultural income objective. Therefore, the efficiency of these policy instruments is hard to disprove. Hence, co-financing will most likely lead to inefficient use of funds. Again, it is questionable whether such policies should be in the domain of the EU.
What are the prospects for a genuine policy reform?

Past experience is not at all encouraging. The intensity of internal market regulation has increased significantly, even after the Mac Sharry reform which came up with a 30 percent decline in intervention prices for grains. The political market does hardly allow a market liberalization and/or the implementation of the subsidiary principle in the field of agricultural and environmental policy. It could be argued that the present members should be aware that a reform is needed and that this cannot be postponed. It is likely that after enlargement, it will be even more difficult to find a consensus for a market oriented reform. However, individual countries know that their bargaining power is the strongest in periods before an enlargement. They may threaten to deny approval for enlargement and in doing so, endanger the prospect of enlargement. Thus, the EU is in danger of being blackmailed, in particular in periods before enlargement. One may wonder whether such a period is well chosen for major policy reforms. However, following the arguments from the above, it is even less likely that the EU is prepared for a genuine reform after enlargement, even if the need for reform is compelling. So what options remain? Muddling through or the exodus!