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Ulrich Koester and Heinrich Terwitte*

Breakthrough in Agricultural Policy, or Another Policy Failure?

Before the European summit in February 1988, EC agricultural policy was being criticized by almost all those affected. Farmers complained about low incomes and the lack of prospects, consumers and taxpayers about the high cost of agricultural support, politicians about spending commitments that could no longer be financed, agricultural economists about the waste of economic resources and trading partners about disruption of the world market. Have the decisions taken at the European summit set the Community on a fundamentally new course?

It will be recalled that until 1985 the EC had to finance expenditure mainly from its 1% share of the harmonised value added tax revenue of member countries. The Community had been facing financial collapse since 1982, however, so that its share was raised to 1.4% in 1986, an increase in revenue of 26%. With the financial crisis continuing to simmer, the Community's budgetary resources were increased further by the decisions of the recent Brussels summit, to an implicit level of 2.2% of VAT revenues.¹ This represents a further increase of around 25% in the Community's finances. This year the EC budget will total ECU 43.38 billion, 20.1% more than in 1987.

Agricultural expenditure will also continue to rise. According to official pronouncements, the new financial guidelines for agriculture provide for expenditure of ECU 27.5 billion, against ECU 24.2 billion in 1987. An increase of 13.6% has therefore been approved. It is this increased level that will serve as the basis for limiting the growth in farm spending to 74% of the growth in gross national product. The latest budget estimates for the period 1988-92 accordingly provide for an annual increase of 1.86% in agricultural expenditure. These ceilings are misleading, however, since in future certain expenditure will be financed through newly created budget items or directly via national budgets:

□ The reduction in present stockpiles, which have not even had an impact on the budget yet owing to the nature of the EC system of financing, will be financed from funds that do not count towards the agricultural ceiling. The budget estimate allocates around ECU 1.3 billion a year for this purpose.

□ A newly created exchange risk provision of ECU 1 billion will likewise not form part of capped agricultural expenditure, despite the fact that the exchange rate risk relates almost entirely to the export of agricultural surpluses.

□ The period for EC repayments to national governments for prefinancing will be extended by two weeks. According to calculations by the EC Commission, this will save the Community budget ECU 1.2 billion a year.²

□ The land set-aside programme entails a hidden transfer of around ECU 0.9 billion from national budgets to the EC budget.³

A total of up to ECU 4.4 billion in budgetary expenditure is being masked in this way. Adding these hidden amounts to the expenditure officially planned under the agricultural ceiling gives an annual increase in expenditure of 5.5% between now and 1992. This would be an improvement on the annual increase of 11.5% recorded between 1983 and 1988, but one must ask whether budget discipline can be maintained; in the light of past experience, there is reason to doubt that it can.

Firstly, decisions regarding budget discipline have been taken before. At the end of 1984, for example, the Council of Ministers agreed on new budget guidelines

¹ Cf. *Agra-Europe* (English edition), 15th February 1988, p. 1.

² Cf. *Agra-Europe* (German edition), 22nd February 1988, *Europa-Nachrichten*, p. 9.

³ The amount depends on a number of factors. The figure given was reached on the assumption that the sum of premiums equals the savings on the cost of surpluses and that the approved premium payments of ECU 600 million from the EC budget will be supplemented by national premium payments of ECU 900 million.

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whereby the agricultural budget was to grow more slowly than the Community's own resources. Any unplanned additional expenditure was to be recouped the following year, mainly by making savings in the market organisations concerned. Despite these good intentions, the EC is again on the brink of financial collapse and in need of additional injections of funds from national governments.

Secondly, the latest decision makes no provision for measures to enforce the announced limit. The present agricultural market organisations make it well-nigh impossible to abide by the set expenditure limits. Expenditure arises mainly as a result of market regulation; it is difficult to estimate expenditure commitments in advance, since the Community has no control over important variables such as the level of production and developments in world market prices and exchange rates. Hence if the EC wants to abide by expenditure limits it must modify its commitments arising out of market regulation. Except with regard to the "stabilisers", the Brussels decisions do not indicate that such a change has been made.

In short, it can be concluded that in future the Common Agricultural Policy will cost more, not less. The decisions regarding "stabilisers" and land set-aside schemes discussed below will probably have little impact in this respect. For example, stabilisers have only been approved for cereals, oilseeds and pulses, products that account for only around 27 % of budget expenditure. At best, land set-aside schemes can reduce EC budgetary expenditure only by shifting the burden to national budgets.

The Concept of Stabilisers

The principle behind stabilisers is that price reductions will be triggered within the EC if production exceeds a predetermined volume. Here too it is worth remembering that the idea is not new. The regulation of guaranteed production volumes for cereals officially came into force during the 1982/83 crop year. It would have become effective in 1983/84 for the first time if the EC-10's grain harvest had exceeded the average for the three years from 1980 to 1982, namely 119.5 million tonnes. For example, grain prices for the 1985/86 crop year should have been reduced by 5 %, since the previous year's production had exceeded the threshold by more than 5 %. However, it emerged that this supposedly automatic mechanism did not lead to automatic price reductions, for the Community had omitted to specify clearly the level from which grain prices were to be reduced. It was therefore possible first to decide a normal "price increase" as part of the farm

price review and then to make the 5 % reduction. With an eye to political feasibility, the EC Commission argued in its price proposals that the normal increase would probably be 1.5 % and that a 5 % cut was to be made from this new level. However, even price reductions of this size were politically unacceptable, as was the Commission's second proposal entailing a reduction of only 1.8 %. The 1985/86 price round ended without a decision on grain prices, but the Commission then invoked its powers under the Treaty to reduce intervention prices by 1.8 % in accordance with its last proposal.

In the light of past experience with production thresholds, observers are sceptical about the implementation of the "new" concept approved at the Brussels summit. Even now, it has not been specified whether the 3 % co-responsibility levy will be applied to last year's intervention prices if production exceeds the threshold, or whether a new intervention price, perhaps one which has been negotiated with the levy in mind, will be used. Two examples of loopholes can be cited. First, intervention agencies are currently buying in at 94 % of the nominal intervention price. The Ministers of Agriculture could increase this percentage if nominal intervention prices had to be reduced. Secondly, the Ministers could increase the monthly supplements to the intervention price. The end result might therefore be that prices behave exactly as they would have without the production threshold.

The level of the production threshold – 160 million tonnes – also supports this argument. This year's harvest is already expected to be higher, so that either the agreed mechanism is a shamefaced plan to reduce prices without compensating farmers for loss of income, or it is a worthless sham.

It should also be borne in mind that in its present form the production threshold entails not just a price reduction but double price differentiation. The revenue authorities have to impose and collect the so-called co-responsibility levy, leading to the price cut, but it is only the price to the producer that is reduced, not that to the consumer or purchaser of cereals. The co-responsibility levy is therefore no more and no less than a specific consumption tax and a self-service source of finance for a failed agricultural policy.

The arrangement is particularly detrimental to many small and medium-sized farmers. The price disparity, which may widen as time goes on, means that farmers using cereals they have grown themselves can enjoy lower feed costs than those who have to buy grain. It will therefore harm precisely those small and medium-sized

farms that have to buy feed if they wish to make optimum use of their labour in raising livestock. There are also relatively strong incentives to circumvent the regulations. Since it would probably be difficult to monitor all movements of grain, what is there to prevent a livestock farmer who does not produce enough cereal on his own farm from buying his requirements from his neighbours, thereby evading the co-responsibility levy?

A further price disparity stems from the fact that farmers producing less than 20 tonnes of cereals are to be exempted from the co-responsibility levy. This is clearly based on the assumption that farmers producing little grain are poor and that they can best be helped by giving them a better price than their competitors. It is astonishing that such a fallacy should have taken hold. Farmers who produce small quantities of grain are not necessarily poor. First, part-time farmers may indeed produce little grain but nevertheless achieve a household income well above the average; secondly, specialised market gardeners and livestock farmers can earn high incomes despite producing only small quantities of grain. Need can certainly not be assessed on the basis of the volume of a particular commodity produced.

It may be noted in passing that this provision too creates incentives for circumvention. For example, the volumes produced by individual farmers can be reduced by dividing farms. Moreover, it is impossible to check who actually produced a particular delivery of grain. In extreme cases farmers who do not themselves produce grain could market part of a neighbour's harvest and share the small-producer's premium with him.

In short, the production threshold arrangement gives little reason to hope that it will curb further production growth; and it will certainly not open up any new prospects for farmers.

The Land Set-Aside Programme

It was agreed at the EC summit that member countries are obligated to offer land set-aside programmes. However, farmers will decide whether or not to take up the offer. A farmer can receive the premium only if he takes at least 20 % of his arable land used for growing market organisation products out of production for at least five years. Those who set aside at least 30 % of their eligible land will also be exempted from paying the co-responsibility levy on 20 tonnes of the grain they market.

A number of fundamental comments regarding the new instruments are called for before examining the details of the scheme:

□ Farmers will take land out of production if the premium at least offsets the entire resultant loss of income. They are therefore being asked to reduce their production base and hence their working hours, while continuing to receive equivalent, if not higher, wages. What is denied trade unions for good macroeconomic reasons is being granted at a stroke to workers in a special sector, namely agriculture. The consequence can only be that the prosperity of society in general declines as a result of the reduced exploitation of land, a scarce factor of production.

□ The increased scarcity of land will lead to more intensive cultivation of the remaining area. This may have an additional adverse ecological impact and agricultural production will be reduced by far less than the set-aside acreage might lead one to expect.

□ It is obvious that only less productive land which generates a relatively low income will be taken out of production; this has been confirmed by a pilot scheme in Lower Saxony. Hence not only will the reduction in

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output be less than anticipated, the effects of the scheme will differ widely from one region to another. The regional yield per hectare depends on the level of development of the economy and the intensity of agricultural production. Statistics show that yields per hectare also rise in direct proportion to the size of farm. Land set-aside will be most prevalent in regions with a poor agricultural structure, thus impeding the structural change that is particularly needed in such regions. The remaining farms will be denied the opportunity to grow by renting or buying additional land. This instrument will therefore eventually make regional income disparities even more pronounced, thus working against an equalisation of the level of development.

□ Since land set-aside necessarily leads to a shortage of land, land prices will obviously rise. This effect on rents for agricultural land is important because the proportion of rented land is relatively high in certain regions (in Belgium, for example, 70 % of the cultivated area is rented, in Schleswig-Holstein 45 %). Because farm expansion comes about primarily through renting, it follows that farms with growth potential, which must buy or rent additional land, will have less chance to expand. Land set-aside schemes therefore have an especially restrictive effect on dynamic farmers with growth potential. The vocational prospects of young farmers in particular will be drastically reduced. It is particularly damaging that this effect will be strongest in

the regions with the greatest need for structural adjustment.

□ It should also be noted that the farmers who will take advantage of the scheme will be primarily those with an opportunity to use their working time profitably in another way, such as part-time farmers. This means that the programme will mainly benefit persons leaving agriculture and earning higher incomes by leasing out or setting aside land rather than those actively engaged in farming.

□ There should be no mistaking the administrative effort associated with land set-aside schemes. How do the authorities intend to check the information provided by farmers? It is a known fact that the sequence of crops on individual farms changes over time, so that it is impossible to ascertain exactly how much land was under cultivation on the reference date. There will doubtless be a fairly strong temptation to exploit the system illegally for personal gain. Signs of this are already evident in the fact that in the past year the arable area in some regions has been increased by ploughing up pasture in anticipation of the measure.

International Effects

Furthermore, land set-aside programmes in the EC will not help achieve a better integration of agriculture worldwide. Politicians may favour such programmes in

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the mistaken belief that they are a way of easing the fundamental problem of EC agricultural markets, namely product surpluses. From an economic point of view, however, the problem stems only indirectly from overproduction. Surpluses in themselves pose no problem if production costs are covered by export earnings. This is not the case at present, since agricultural prices in the EC and in the majority of other industrialised countries are well above world market prices.

It is true that current world market prices have only limited validity as a benchmark for domestic agricultural policies, since they have been seriously distorted by domestic policies which are divorced from world markets. It would therefore be desirable if changes in domestic policies throughout the world contributed to improving the operation of world agricultural markets. The world's resources can only be used efficiently if production and consumption decisions are co-ordinated worldwide. Equally, national policies and individual decisions in the various countries can only contribute towards an optimum worldwide utilisation of resources if all decision-makers act on the basis of an identical set of adequate indicators. Current and expected world market prices could serve as the main indicator if they reflected the relative scarcities generated by largely undistorted market forces.

The EC as a superpower in world agricultural trade could make an important contribution to the integration of world agriculture if it moved resolutely towards liberalising EC agricultural policy. This would greatly improve the chances of a successful conclusion to the current GATT round.

Land set-aside schemes, by contrast, create an additional instrument that isolates domestic markets from world markets. They are not aimed at improving domestic resource utilisation but at continuing the policy of price support.

Terms of the Scheme

At best, the land set-aside programme approved by the EC will ease the burden on the Community budget and increase expenditure overall at the national level, since most of the premium will be paid from national budgets whereas the saving due to the decrease in production will accrue entirely to the EC budget. The additional burden at national level will depend not only on the level of premium paid but also on the extent to which the national budget benefits from the reduction in the cost of EC surpluses. The larger a country's contribution to the EC budget, the greater the relief; the

Federal Republic of Germany bears a relatively large share of the financing, around 25%. Under favourable circumstances, a Community-wide land set-aside scheme could even produce a net saving in the German budget; this presupposes that the premiums broadly offset foregone profits on the land in question and are no higher than the savings on the cost of surpluses. Even so, other countries with a large area under cultivation would have to bear an additional budgetary burden.

Given the cost that introduction of the measure would entail at the national level, some countries would be well advised for budgetary reasons to implement the programme as agreed but to offer farmers such a low premium that they will not take it up. In that case, the positive effect on the German budget would also fail to materialise. In general, the measure can be regarded as especially beneficial from the point of view of a particular country's budget if partner countries offer sufficient incentives to take land out of production but the country itself offers only marginal incentives. Hence this measure does not help harmonise the interests of member countries; on the contrary, it will further accentuate national divergences.⁴

From the welfare point of view, an individual member country is also well advised to reduce production as little as possible through land set-aside. In extreme cases, fallow land could be set aside officially, with the result that the country would receive a transfer of national product from fellow members. By contrast, the loss of national product will be particularly high if productive land is taken out of production as a result of the payment of a high premium, combined with a high national contribution to financing this premium. Consequently, there are strong incentives for countries not to behave in accordance with the Community objectives. This programme can therefore do little to foster European integration.

An Alternative

The overall assessment of the decisions taken at the Brussels agricultural summit can only be that farmers' hopes are being raised falsely if it is claimed that they are being offered new opportunities. Consumers and taxpayers will pay even more for a failed agricultural policy. The waste of economic resources will increase, not decrease. Trading partners will continue to complain that the EC is not contributing towards a harmonisation

⁴ The Dutch Minister of Agriculture has already stated that his country has no interest in taking land out of production. Cf. Ernährungsdienst – Deutsche Getreidezeitung, 1st March 1988, p. 1.

of world agricultural trade, as required by Article 110 of the EEC Treaty. Was there really no better alternative?

Of course, it cannot be expected that all the decision-makers and parties involved will be unanimous in judging alternative proposals to be better or worse. For one thing, they have different objectives or attach different weight to individual goals. For another, unequivocal information on the detailed effects of alternative proposals is rarely available. The following proposal is intended to incorporate, as far as possible, both the revealed and the officially declared objectives, such as those expressed in the EEC Treaty.

Practical politicians concerned with agriculture obviously attach particularly great importance to the objective of raising farm incomes and incurring the least possible cost to the national budget. It has been demonstrated above that the Brussels decisions have a negative impact on both these objectives. At best, production thresholds can help slow the rise in expenditure, but they will reduce farmers' incomes. Land set-aside schemes are supposed to have a neutral budgetary effect, but in all probability they will give rise to additional expenditure and will also cut the incomes of tenant farmers and all farmers eager to grow. These adverse effects will occur without any concurrent reduction in the burden which high prices place on EC consumers.

Politicians would have contributed more towards achieving the above objectives, and at the same time would have generated beneficial macroeconomic and trade effects, if they had enacted a gradual annual reduction in producer prices and offset any reductions in income by means of direct transfers instead of introducing land set-aside schemes and production thresholds. Such a policy could be financed without affecting the budget if consumer prices were not reduced, and hence if a co-responsibility levy were collected, as in the case of the production threshold arrangement and the land set-aside programme. Together with the saving in market organisation costs (and especially export subsidies) that the reduction in producer prices would produce, the revenue from the co-responsibility levy would be greater than the compensation to be paid to farmers for lost income.

Shape of the Proposal

This alternative would also be more attractive to politicians than the package of measures approved in Brussels, because it would have no budgetary impact and would cause smaller, if any, losses in farm income. An advantage of the proposal from the macroeconomic

point of view is that prices would gradually regain their signalling function as regards resource utilisation and the wastage of economic resources would be reduced. The potential for international trade conflicts would diminish because EC agricultural prices would move increasingly into line with world market prices. Farmers eager to expand could do so more easily, since land prices and rents would be lower. The following points might be important as regards the arrangements for direct income transfers:

- The use of transfers to meet the agricultural income objective would take care of the social aspect of our economic system. It follows that such transfers could be linked to the need of the income recipient and at all events would have to be limited to the present generation and granted on a personal basis. There can be no social justification for farmers receiving direct income transfers from the first days of their working lives.
- The transfer system would have to be shaped completely differently if its objective were to safeguard farm assets. Such an objective might be justified on the grounds of maintaining social harmony, for example. Since a fundamental change in the agricultural system appears desirable from both the macroeconomic and European viewpoints, especially the latter, it might be argued that farmers should be spared most of the pressure of adjustment. In the same way as the Federal Republic of Germany introduced the equalisation of burdens as solidarity aid for German refugees and war victims, present-day society could jointly bear the cost of macroeconomically desirable change in the agricultural policy system. Since the main effect of farm price support so far has been to raise land values, a change in the system would primarily harm landowners. Compensation would therefore also have to be paid to offset the losses sustained by landowners, some of whom are no longer farmers. As a general principle, it can be argued that all those who lost as a result of the change would have to receive a high degree of compensation, regardless of their income level.
- Direct transfer incomes can also be justified on ecological grounds. In this case the transfers would have to be coupled with requirements regarding methods of farming, and there might be grounds for not restricting transfers to the present generation.

The actual configuration of the policy alternative outlined here would depend on the relative political importance attached to the various objectives. Public discussion of this fundamental change in agricultural policy remains topical, since the decisions taken at the recent summit will soon prove inadequate.