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Ulrich Koester and Stephan von Cramon-Taubadel\*

## EC Agricultural Reform Ad Infinitum?

*After protracted negotiations, the EC Ministers of Agriculture agreed on a reform of the Common Agricultural Policy on July 1st. Will this reform solve the fundamental problems plaguing the common agricultural market? Is it compatible with the GATT?*

When the European Community's agricultural policy was formulated, it was hoped that this common approach would carry the process of European integration forward. The willingness of the member countries to surrender national autonomy in one specific policy area was expected to lead to closer integration in others. Agricultural policy was therefore seen as the locomotive of European integration. However, it had been overlooked that dirigistic intervention in individual agricultural markets would serve to highlight divergences in national interests. It is therefore not surprising that the clash of interests in the EC was especially acute in agricultural policy and that the measures that had to be agreed often intensified state intervention.

From the very outset, academics continually criticised both the conception of the EC's Common Agricultural Policy (CAP) and its further development, and presented a multitude of reform proposals. For some years politicians and even officials of farmers' organisations have realised that the CAP is in need of reform. Indeed, the last decade has seen a steady stream of new measures to reform the policy. Hitherto it was primarily the German Minister of Agriculture who pushed through specific reforms.

As early as 1984, a year after taking office, he managed to force through the introduction of a quota system for milk at the EC level. The aim was supposedly to stem the rise in expenditure on the milk market and at the same time to provide better prospects for farmers. In fact, it proved impossible to bring milk surpluses and expenditure under control. EC expenditures grew less rapidly for milk than for other products, but in 1991 they nevertheless reached ECU 5.6 billion, almost 30% above the 1983 level.<sup>1</sup> At the same time, national expenditure rose considerably; between 1983 and 1990 German spending on national

market organisations increased more than sixfold, from DM 111 to 801 million.<sup>2</sup> Hence, expenditures were also shifted from the EC level to the member states. The milk quota system did not improve long-term prospects for farmers either, as successful milk producers who wanted to expand were prevented from doing so by the high cost of purchasing additional quotas. Measured against the objectives declared before the quota system was introduced, this reform can certainly not be judged a success.

### The 1988 Agricultural Reform

The quota arrangements for milk greatly exacerbated problems in other markets. For example, the reduction in dairy herds as a result of milk quotas led to an increase in the supply of beef and consequently to a collapse in beef and pork prices. It was therefore no surprise that in 1988 the EC announced a further "fundamental" reform of the CAP. This package of measures consisted essentially of three components:

- ☐ an agricultural spending guideline aimed at curbing the annual rate of increase in expenditure for agricultural market intervention;
- ☐ stabilisers that provided for automatic reductions in the prices paid for grain, oil-seeds and pulses if production in a particular year exceeded the so-called guarantee threshold, and
- ☐ an acreage set-aside scheme.

The spending guideline, which is to be regarded as an absolute ceiling, was not reached in 1991, but agricultural expenditure nevertheless rose by 36% between 1987 and 1991. Hence, the budgetary discipline announced in 1988

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<sup>1</sup> Bundesministerium für Ernährung, Landwirtschaft und Forsten: Agrarbericht, Bonn, various years.

<sup>2</sup> Bundesministerium für Ernährung, Landwirtschaft und Forsten: Statistisches Jahrbuch über Ernährung, Landwirtschaft und Forsten, Bonn, various years.

did not impose very binding constraints. It should be borne in mind that part of this rise in expenditure was financed directly by the so-called co-responsibility levies and therefore does not show up in the official figures, and also that expenditure was shifted from the EC to the national level, as mentioned above.

The automatic stabilisers were designed to limit increases in the production of specified products. However, grain harvests rose from an average of 156 billion tonnes in the years 1985-87 to more than 164 billion in 1989-91. Oil-seed harvests also rose by 33% over the same period. These increases in production show that the stabilisers and the acreage set-aside schemes did not curb production as much as had been intended.

### **Dilemma of EC Agricultural Policy**

Clearly, the reforms of the eighties failed to resolve the dilemma of the EC's agricultural policy. Instead, they exacerbated the problems. The reform programmes attempted to tackle the main symptoms of a failed agricultural policy, namely surpluses and state expenditure. However, surpluses only pose a problem on agricultural markets if domestic prices are higher than world market prices. High price supports give producers false signals about the market opportunities for their products. Whereas in macro-economic terms it cannot make sense to expand production if production costs are not covered by world market prices, for the individual farmer it is sufficient if his production costs are covered by domestic prices. False price signals therefore encourage him continually to expand production at society's expense. Initially, this flaw in the CAP did not have such a serious effect, because agricultural production was limited by the availability of land, but technological advances have made it possible to increase production steadily on a given area of land.

Of course, it is not only farmers who profit from an expansion in production but also suppliers of intermediate products, such as feed producers and manufacturers of

pesticides, fertilisers and farm machinery, not to mention storage companies and the foreign exporters of animal feed. The CAP resulted in a distortion in the co-ordination of decision-making in an economy based on the division of labour. This placed increasing responsibilities on the state through increases in public expenditure. The agricultural reforms of the eighties did not take this underlying cause of the symptoms of policy failure into account. Will the reforms of 1992 now cure the fundamental ills of the EC's agricultural policy?

### **The New Parameters**

Agricultural negotiations in Brussels have proved increasingly difficult and protracted. Decisions are frequently reached at the break of dawn after hours of deliberation. It is therefore no surprise that these decisions often only set the bare framework, leaving detailed questions to be resolved later. The agricultural reform of 1992 is no exception. The new parameters will first be outlined below, followed by a discussion of detailed problems. In the present instance this appears to be particularly necessary, as the impact of the overall package may depend essentially on the solutions to particular issues.

### **Drastic Price Reductions for Cereals and Beef**

In accordance with long-standing tradition, the Council of Agricultural Ministers did not deal with the fundamental design of the CAP but rather with those agricultural markets which it perceived to be plagued with the worst problems. This time it was the turn of the common cereals market – now 25 years old and hence the oldest CAP market – and the beef market. For the first time in the history of the CAP the Council of Ministers decided to implement a drastic reduction in prices. It will be recalled that the German Minister of Agriculture opposed a 1.8% reduction in German grain prices in 1985/86, symbolically refusing to go along with the Community decision. Until the mid-eighties there was an unwritten rule that farm price negotiations should not lead to negative price changes for

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any member state. Developments on agricultural markets since then have clearly helped make politicians change their minds.

The decision to reduce grain prices by 30% within three years and beef prices by a total of 15% could in principle be suited to dealing with the root of the CAP's fundamental problem. However, the desired macro-economic effects will not be fully realised, because the Ministers essentially concentrated on only two products and retained the existing arrangements for other products, especially quota-restricted milk and sugar. Any positive macro-economic impact will be further weakened by the other elements in the new package, namely direct transfer payments and acreage set-aside.

### **Acreage Based Direct Transfer Payments**

The decision provides for transfer payments to offset losses of income due to the price reductions. There can be little economic objection in principle to compensation. The scale of compensation for losses of income due to officially imposed price reductions is primarily a political question. Temporary transfer payments to resolve social problems or ease adjustment can be entirely compatible with market principles, but it is questionable whether all EC farmers affected by the price reductions are truly in need of social assistance.

Payments to alleviate social hardship should be arranged so as to be as production neutral (so-called decoupled) as possible.

The payments for grain producers agreed upon by the Council of Agricultural Ministers, by contrast, have a strong impact on production. Farmers can obtain the payments only if they grow eligible produce (grain, pulses, oil-seeds and feed maize). It is therefore possible that individual farmers will plant the products in question at the new reduced support prices, even though without transfer payments the (still falsified) market proceeds would not cover their variable production costs. These transfer payments therefore continue to provide signals that induce incorrect behaviour on the part of the individual farmer from a macro-economic point of view. In the beef market, payments are linked to the number of bulls or dairy cows; hence, here too false signals are given for micro-economic profit/loss calculations.

### **Compulsory Acreage Set-Aside**

Acreage set-aside occupies a particularly important place in the reform programme. Whereas in the past farmers could decide whether to take advantage of set-aside schemes on the basis of the incentives offered, the

new agricultural policy requires all farmers with farms above a certain size to set aside 15% of their arable land in order to be eligible for transfer payments. This measure significantly raises the level of regulation. By state ordinance, a factor of production that is clearly in relatively short supply in our economies will artificially be made even scarcer. The politicians obviously hope in this way to curb further increases in production, but in fact they are exacerbating the real problem of the CAP. From an economic point of view, the objective of agricultural policy should not be to curb state expenditure and surpluses but rather to raise the efficiency of the farm sector and hence to make it internationally competitive. Government-imposed acreage set-aside, by contrast, indisputably raises domestic production costs in agriculture and also makes it more difficult for farmers with small farms to expand, hence undermining agriculture's international competitiveness. It should also be remembered that land and the other production factors used in agriculture are to some extent complementary. Acreage set-aside will therefore lead to a reduction in the use of other production factors on individual farms; this applies in particular to farm machinery, but also to agricultural labour. It can therefore be expected that farmers with excess capacity will try to produce more intensively on their remaining land than would have been the case without the set-aside requirement. This is certainly not in harmony with ecological demands for less intensive forms of agriculture.

### **Treatment of Small Producers**

So-called small producers are exempt from the set-aside requirement. They are defined as producers growing a maximum of 92 tonnes of grain a year, which in Germany corresponds to an area of 16.4 hectares, or 40.5 acres. Small producers will therefore receive transfer payments without taking land out of production. In this regard the Council of Agricultural Ministers is clearly working on the unjustifiable assumption that the owners of small farms need more state support than the owners of large farms. In reality, however, the majority of small farm owners in Germany are part-time farmers, many of whom earn in total a far higher average income than full-time farmers.

This arrangement for small producers may lead to special problems if the total acreage for which applications for direct transfer payments are submitted is greater than a region's "basic area", defined as the area under grain in the past. In this case a two-stage sanctions mechanism comes into operation that affects producers differently:

□ First, in the current year each farm's acreage eligible for transfer payments is reduced by the percentage by which the region's basic area has been exceeded. All producers are affected equally by this rule;

□ Second, in the following crop year an additional area equal to the entire excess must be set aside without any compensation. This affects only producers subject to compulsory set-aside, in other words not small producers.

In theory it is therefore possible that in some regions a small number of fairly large farms will be forced to take a considerable area of land out of production because a large number of small producers have increased their cultivation of products eligible for assistance.

Coupled with restrictions on the total arable area eligible for payments in a particular region, the linking of transfer payments to the acreage currently being cultivated by individual farms is particularly detrimental in macro-economic terms. Moreover, these restrictions fly in the face of the realisation of the internal market in the EC. In economic terms it makes sense for production to move to the most favourable locations, a continuous process of adjustment to market forces. However, the present configuration of the direct transfer payments will impede such migration. It is therefore easy to imagine the disadvantages that will arise for individual regions of the Community.

From Figure 1a) it is clear that individual EC member states' shares of the total acreage under oil-seeds have changed considerably over time. For example, Italy's share has more than quadrupled since 1975. Figure 1b) shows that quotas prevented similar shifts from occurring

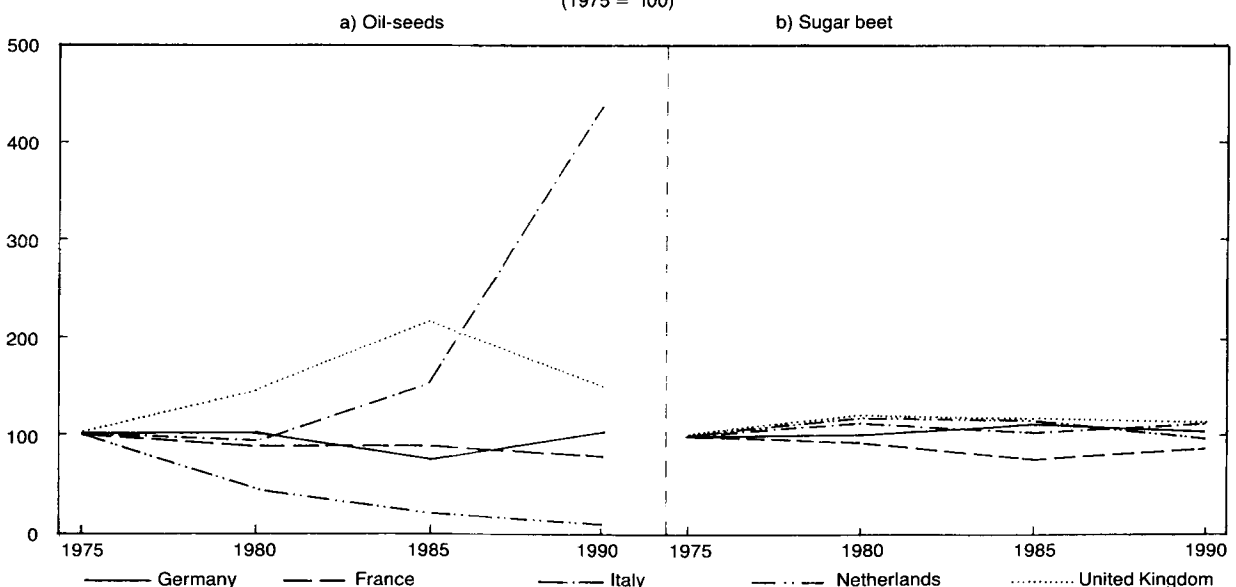
in the sugar beet acreage. That the distribution of the sugar beet acreage would also change if there were no system of quotas is evident from a comparison of the prices for sugar beet quotas in Germany, which vary from DM 15,000 to over 40,000 per hectare, depending on location. These differences indicate that the profitability of sugar beet production differs widely between regions and that the present production structure must be economically suboptimal. The new area-related transfer payments will ossify the present structure of oil-seed production in the EC, precluding potential efficiency gains as a result of future shifts in production in accordance with differences in regional comparative costs.

### Problems of Detail

The differentiation of acreage based assistance according to type of product will lead to particular problems in future. There will be at least three different subsidies; for cereals, oil-seeds and pulses. The cereals category may be further subdivided into maize and other cereals. Hence farmers will not only have to concentrate on producing and marketing their crops, they will also have to sharpen their skills in filling out forms. At the same time they will have to learn to get along with inspectors.

It is obvious that individual farmers will not be able to obtain transfer payments simply by applying for them; their entitlements must, of course, be checked. The agricultural

**Figure 1**  
**Changes in EC Countries' Shares of Acreage under Oil-seeds and Sugar Beet, 1975-90**  
(1975 = 100)



Sources: Commission of the European Communities: The Agricultural Situation in the Community, various years; ZMP: Bilanz Getreide, 1990/91.

reform will therefore spawn a substantial verification apparatus. Hitherto, the agricultural bureaucracy has been able to concentrate mainly on regulating product markets, but now it will be given additional duties. Each and every farm will have to be inspected. This will place widely differing demands on the various member countries, as Table 1 shows. If the administrative burden is related to the number of farms, countries with such different bureaucratic capacities as Germany and Portugal will face comparable administrative and inspection problems. It is doubtful whether the bureaucratic apparatus in southern countries, such as Spain and Italy, will be able to carry out adequate checks.

Additional checks will also have to be carried out because of the accompanying measures that have been decided upon. For example, more extensive agricultural production will be encouraged. Farmers will receive direct payments if they can prove that they have reduced their farming intensity (i. e. fertilisation and chemical use). Here too, of course, it will be necessary to verify whether the information supplied by farmers corresponds to reality. Checks carried out in one German state have shown, for example, that only 10% of farmers fully complied with the terms of an extensification programme, despite having all applied for the available premium. Further inspections will be necessary to implement the programme to promote ecological land use. The overall expenditure on verification will therefore increase substantially.

## Macro-economic Evaluation

The 1992 agricultural reform represents yet another missed opportunity. Reductions in farm prices could help raise the macro-economic efficiency of the agricultural sector and release farmers from the fetters of agricultural

*dirigisme*. However, the price reductions decided upon by the EC are accompanied by measures that will counteract these otherwise positive effects. From an economic point of view, it is incomprehensible that transfer payments should be linked to the acreage under cultivation. If the transfer payments were decoupled, the price reductions would make set-aside unnecessary as a means of avoiding surpluses, especially if the prices of other products were cut as well. Even under present circumstances, acreage set-aside is a particularly inefficient instrument from a macro-economic point of view.

Given these conflicting effects of the reform package, it is difficult to judge whether the latest decisions have actually taken European agricultural policy further in the direction of a market solution. It is to be feared that the opposite is the case. The considerable inspection effort will require an expansion of the agricultural bureaucracy, and it is nevertheless likely that abuse and fraud will increase. In addition, it is questionable whether it will be possible to dismantle this bureaucratic apparatus in future. Experience with the realisation of the EC's internal market suggests that institutions survive the elimination of their original responsibilities by seeking new tasks. It is to be expected that the bloated agricultural bureaucracy will attempt to maintain the demand for its services in agriculture, which would mean the continuation of increased *dirigisme* in farming.

## Assessment from the Viewpoint of Farmers

It is all too understandable that the present reform of the CAP has left many farmers feeling uncertain and betrayed. Until very recently, German agricultural policymakers denied any possibility of drastic price reductions. Under the farm promotion programme, German farmers have

**Table 1**  
**Number and Average Size of Farms in Selected EC Countries, 1987**

Member country	Farms		Average farm size (hectares)	Area	
	Number in 1000	% of total		Hectares in 1000	% of total
Denmark	87	1	32.2	2798	2
Germany	705	8	16.8	11843	10
Greece	953	11	4	3842	3
Spain	1792	21	13.8	24797	21
France	982	11	28.6	28058	24
Ireland	217	3	22.7	4915	4
Italy	2784	32	5.6	15545	13
Netherlands	132	2	15.3	2024	2
Portugal	636	7	5.2	3331	3
United Kingdom	260	3	64.4	16751	15
EC 12	8644	100	13.4	115401	100

Source : Bundesminister für Ernährung, Landwirtschaft und Forsten : Agrarbericht 1992.

received investment grants and subsidies on the basis of individual development plans, which were understandably based on the assumption that agricultural policy would remain unchanged. Given the reforms, however, it is clear that in many cases past decisions at the micro-economic level have led to poor investments.

A more important point, however, is whether the agricultural reform offers farmers clear prospects for the survival of their farms. Can farmers really be confident that they will receive acreage based transfer payments totalling billions of German marks for decades to come? Only if they are incorrigible optimists. Future agricultural policy remains uncertain, and decisions from Brussels will continue to be a greater source of anxiety than the weather.

The agricultural reform also does not offer farmers a chance to practise operating under market conditions without state intervention. The acreage set-aside scheme severely limits the opportunities for many farmers to expand. Particularly in regions that are heavily dependent on agriculture, such as Schleswig-Holstein, compulsory set-aside means that more than 14% of the cultivated area will be taken out of production. In regions with small farms, such as Bavaria and Baden-Württemberg, on the other hand, only about 5% of the land will be set aside. As a result, the process of structural adjustment will be seriously weakened, especially in farming areas with few alternative employment opportunities.

Finally, the psychological effects of the agricultural reform on the next generation of potential farmers should not be overlooked. If a farmer can easily calculate that the proceeds of marketing his produce no longer cover his variable costs and that he remains economically viable only because of state payments, he will realise how heavily dependent he is on government decisions. It must therefore be expected that many farmers' sons and daughters who are at present waiting their turn while undergoing education or training outside agriculture will decide not to step into their parents' shoes. This would not be a bad thing in itself if it did not entail a special selection process. It is probably mainly the more dynamic and innovative young successors to today's farmers who will decide to turn to other activities; agriculture will therefore lose sorely needed human capital.

### **Assessment from the International Viewpoint**

Despite repeated claims by leading EC agricultural policymakers that there is no linkage between the current GATT Round and reform of the CAP, this reform has undoubtedly been greatly accelerated by the Community's international obligations under the GATT. The question

therefore arises whether or not the EC has met these obligations.

The solution formulated for the cereals market is identical to the one applied to the oil-seed market in the 1992/93 crop year. In the early sixties the EC bound itself under the GATT to import oil-seeds and other grain substitutes duty-free. However, the Community's subsidisation of oil-seed production, which was clearly aimed at boosting output, reduced the advantages that other GATT members – first and foremost the USA – had expected to derive from this undertaking. The EC was arraigned before a GATT panel and in December 1989 the oil-seed market organisation was found to be discriminatory. In response, the EC therefore replaced its earlier production based transfer payments with acreage based supports. This arrangement too was less than satisfactory in the eyes of the USA which demanded a further examination by the GATT. The panel again ruled against the EC. The EC is therefore obliged to open negotiations with the USA, which will lead either to an amendment of the present oil-seed market organisation or to an agreement regarding compensation payments. If this does not happen, the USA can be expected to take retaliatory measures.

It is therefore clear that the EC's reformed agricultural policy does not conform with the GATT, at least as far as oil-seeds are concerned. However, the new arrangements for the cereals market are analogous to those for the oil-seed market. It is true that the EC does not have comparable obligations towards other GATT members in the area of cereals, but according to the present status of the current negotiations the new acreage based transfer payments would not fall into the production-neutral "green box" but rather into the "yellow box" of subsidies which must be eliminated over time. The EC nevertheless insists that its new transfer payments are not subject to these subsidy reduction disciplines. It is undoubtedly true that the Community's trading partners regard the present arrangements as better than those that preceded them. The USA, in particular, now finds itself in difficulties, in an election year, because it has long operated a cereals market policy based on acreage based transfer payments (so-called deficiency payments). If the new EC payments were to fall into the "yellow box", these US payments would have to as well. For this reason, discussions about a so-called "blue box" for transitional measures that would have to be eliminated only after a few years are currently being held. The EC may have become more respectable by international standards by agreeing to change the agricultural policy instruments it uses, but it has not kept the promises it made at the beginning of the Uruguay Round to contribute to an on-going and substantial reduction in support and protection in agriculture.