

Koester, Ulrich

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- ☐ improving framework conditions for the cultivation of protein crops,
- ☐ broader application of modulation by Member States,
- ☐ safeguarding European Union food standards in the WTO framework.

We can base the necessary further development of the common agricultural policy towards a consumer-oriented sustainable agriculture on the experience of earlier reforms. The planned mid-term review of Agenda 2000 provides a good starting-point for further steps in this direction.

This means that the funds available to agricultural policy will be used in the medium and long term primarily for more organic land management, more welfare-oriented animal husbandry and for safeguarding jobs in rural areas. We must continue and deepen the reform initiated by Agenda 2000 with

new emphases in view of WTO negotiations and EU enlargement towards the East, by

- ☐ strengthening the environment-related green-box measures,
- ☐ transferring Community funds from the market sector to rural development and the environment as well as
- ☐ by tying compensatory payments to ecological and social criteria to a greater extent.

The options of Agenda 2000 to use modulation to generate a sustainable and ecologically sound development of agriculture and rural areas should also be used in Germany. The environmental and animal-oriented production of high-quality produce must be taken as a chance to strengthen the competitiveness of EU agricultural products on the world market, thus enabling European agriculture to actively share in the forecast growth of global agricultural markets.

Ulrich Koester*

How Good Are the Prospects for a Genuine Policy Reform?

The Common Agricultural Policy (CAP) has undergone major changes over time. At the 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-term 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 have been 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 favour a drastic change of the CAP. It should be commended that the status quo is finally being questioned and new ideas 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 the assessment of the reform proposal by the German government which follows. The key principles for a genuine reform are then laid out, and finally some reflections on the chances for a genuine reform given the present political market in the EU are presented.

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 levels does not serve the generally accepted objectives in a "social market economy",
- ☐ the present policy leads to the 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, or
- ☐ a continuation of the CAP with or without

* Professor, Dept. of Agricultural Economics, University of Kiel, Germany.

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 per cent of the total EU budget. However, 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 were 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 setting land aside. The permanent continuation of these payments is not in line with the principles of a "social market economy". It is not at all guaranteed that those who receive the payments – which are above DM 1 million 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 straight-jacket, i.e. 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 setting land aside are even less efficient. Certainly, there is no social rationale for these transfers; a person setting land aside is not necessarily in social need. Moreover, linking the payments to not using an available factor of production makes for inefficient use of domestic resources. It is in sharp contrast with the principles of a "social market economy" to provide incentives for not using factors of production, since 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. The quota systems are a special case in point. The most important quotas are those for the production of 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, 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 with certain crops. Entitlement to direct payments for areas used in grain or oilseed production is restricted at 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 would be 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 would be 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 sectors which lags behind in the transition process, mainly due to the strong need for adjusting the farm structure and the malfunctioning markets for land and rural finance. The economic costs 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 make up 42 per cent 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 the real income of poor households that already spend 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 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 would even widen the spread of corruption in the new member countries, questioning the rationale 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 in 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 require further reforms.

First, according to the outcome of the Uruguay Round, the EU is most constrained by the limits accepted for subsidised 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. Subsidised export quantities in the year 2000/2001 have to be lower than actual export quantities in 1999/2000 for wheat by 15 per cent, 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 per cent. If EU prices continue to be higher than world market prices, the EU will have to build up stocks or 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 I products (processed food products) will be the most pronounced. In 2000/2001 the food processing industry will receive € 60.4 million for export restitutions or 12.7% less than in 1999/2000. It should be noted that world trade in agricultural products is

expanding mainly in processed products. If protection for agricultural products remains high in the EU, and the EU food-processing industry does not receive 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 put 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 towards any changes. Due to BSE, the Germans got a new minister with a broader portfolio, including consumer protection. Ms. Künast demands a radical change in the CAP and the Chancellor is a strong supporter of these claims. Food safety, the environmental effects of agriculture and animal welfare rank high on the agenda. Past policies and "conventional agriculture," which is considered to be "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 the solution to the present crisis.

The German government should be commended for finally opening itself to a reform of the CAP. Indeed, an open discussion, which may provide new or not yet disseminated information, may assist the policy decisions needed to improve the efficiency of the CAP. It is hardly questionable that the CAP as it is has been determined mainly by a desire to serve the interests of the farming population and has partly neglected economy-wide spillover effects, including consumer protection, environmental effects and animal welfare. However, there is presently no scientific support for the official German diagnosis.

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 neces-

sarily be interpreted to mean that the foods produced are healthier, safer, or "all natural".

The Problem of Food Safety

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 guaranteed for all products on the markets. In contrast to these statements, German officials convey the impression that food products produced by conventional farming cause a hazard to 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 is high, then the food should not be allowed to remain on offer on the markets. According to the present state of knowledge, a high degree of food safety is guaranteed by food produced both by organic and by 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 the food hazard. 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 against laws and use inputs which are forbidden. Such a situation prevailed after 1994 when it was forbidden to feed meat and bone meal to bovine animals.

As both 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 fewer negative environmental effects than the present methods applied in conventional farming. However, it would be premature to support organic farming for this reason. First, it is proven that conventional farming leads to fewer negative environmental effects if it uses fewer 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 producing negative environmental effects, the obvious response of the government should be either to prohibit specific methods of production, or to provide incentives to produce in a manner more friendly to the environment. Second, if society desires an expansion of the public good "environment", it has to provide incentives to farmers to produce this good. It is unlikely that organic farming could produce the environmental good linked to agricultural production more cheaply 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, 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 accordingly, then conventional farmers would be equally willing to supply public goods with those desired "ethical attributes". 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 quantify animal welfare clearly. 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 the welfare of animals on organic farms *can* be much more impaired than that 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 undifferentiated 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 would still prefer the cheaper conventional food. The latter would still be offered on the markets and if not produced domestically, it would have to be imported in line with WTO commitments. The 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 programmes and 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 the 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 programmes which reward farmers for the production of environmental products. However, two notes are in

order. First, there is no rationale for producing environmental goods on all farms and in the same quantity in every region. Hence, these programmes 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 the production of these goods. A co-financing of this type of policy, or its delegation to the national level, is advisable.

The EU Commission has suggested strengthening the CAP by building up the second pillar, which includes, apart from the subsidisation 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 the 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 led to a 30 per cent decline in intervention prices for grains. The political market hardly allows a market liberalisation and/or the implementation of the subsidiarity 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 strongest in the period 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 will be prepared for a genuine reform after enlargement, even if the need for reform is compelling. So what options remain? Muddling through or the collapse of the CAP!