A NEW AGENDA FOR EUROPEAN AGRICULTURE

A RADICAL PROPOSAL

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TIMBRO

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EXECUTIVE SUMMARY

- Ever since the framing of the Treaty of Rome, agriculture has been a central policy field within the European Community and, more recently, the European Union. The Common Agricultural Policy, CAP, now embraces approximately 90 per cent of all agricultural output within the EU. According to OECD calculations, agricultural production in 1998 totalled roughly EUR 128 bn. Subsidies made up 49 per cent of this value. Something like half the EU's annual budget – EUR 42.5 bn – goes on payments to agriculture, the largest item of EU expenditure. Agriculture contributes between 3 and 4 per cent of the EU's combined GDP.

- The CAP is beset with many problems. EU consumers are forced to pay a high price for their provisions, partly because large amounts of taxation revenue are spent on farm subsidies and also because competition from foreign producers is hampered by important barriers – tariffs, for example. EU consumers are therefore having to pay roughly twice as much for their food as would be the case without the CAP. In terms of distribution policy, households on low incomes are worst hit because a larger proportion of their income goes on food bills.

- CAP is impeding the economic growth of the developing countries. For one thing, farmers in the developing countries are unable to sell their produce in the EU at competitive prices, because their products come up against tariffs, and for another, CAP provides EU farmers with export subsidies enabling them to dump world market prices. These tends to obstruct the economic dynamic which could give the developing countries the capital to finance agricultural productivity improvements and industrialisation.

- Everyone versed in agricultural policy is familiar with the problems CAP entails. Attempts have been made, through the Agenda 2000 reform and the MacSharry reform earlier in the 1990s, to alleviate the worst consequences, but most often this has merely shifted problems to other areas. The present report sketches a strategy for swiftly reforming the CAP so as, within five years, to provide scope for a free food market in which producers from all over the world will be allowed to compete without being burdened with customs duties.

- The export subsidy to agriculture will be abolished immediately, so as not to destroy the world market for Third World farmers. Import duties should be reduced immediately and then abolished completely within the short term. This process, however, will have to be combined with a reduction of farm subsidies. This can be achieved over a five-year period, with 20 per cent of the subsidies disappearing annually.

- The phase-out of farm subsidies will be made a national issue. At the common EU level the customs union will still apply, with a common trade policy and a single market. Re-nationalisation of agricultural policy will reduce the effect of lobbying by agricultural interests, because it will now be forced onto a level where voters and taxpayers have more control over what happens.

PREFACE

During the past 15 years we have seen a fantastic growth of world prosperity. GDP in the affluent OECD countries has risen by 50 per cent on average. There are still terribly many people living in poverty in the Third World and in the former communist countries, but even in most of those countries there have been improvements. In Southeast Asia, for example, more countries have stepped over the poverty threshold and in the past decade more people than ever before have left the state which the UN calls absolute poverty. A growing proportion of people in these countries are today being given the opportunity of a life of dignity. Developments in China and India have not attained the same levels of prosperity as, for example, in Thailand, but it is quite clear that material living conditions in these countries have improved considerably. This applies not only to prosperity measured in terms of per capita GDP, but also in a broader sense. The annual Human Development Index compiled by the UN Development Programme (UNDP), for instance, shows that the proportion of undernourished children below the age of 5 is diminishing and that people are living longer.

It is neither luck nor chance that has moved developments in the right direction, so that today, in the first decade of the 21st century, we expect another few hundred million people to depart from absolute poverty. In the majority of cases, what we have instead is a deliberate policy whereby the institutions of the market economy have been established and allowed to take root and greater scope has been given to the elementary principles of free trade and specialisation which Adam Smith in 1776 noted down in *The Wealth of Nations*. Markets have grown and have been substantially boosted by measures to facilitate trade. For this and other reasons, markets have become more efficient and contributed towards greater prosperity by making possible a better utilisation of resources.

But there are a good many blemishes to this picture of good economic development throughout the world. The most important, and the most appalling, of course, is that many people are still living in grinding poverty. In its annual report, *Attacking Poverty*, the World Bank estimates that roughly 1.2 billion people have less than a dollar a day to live on and 2.8 billion less than two dollars.

There are many different explanations for so many people not having extricated themselves from the vicious circles of poverty. One explanation is political régimes with elements of dictatorship and with a corrupt political élite lining its own pockets. The kleptocracies have effectively eliminated people's changes of growing by their own unaided efforts. Absence of market-economic institutions, such as rights of ownership, is another explanation. Bad macro-economic management is a third. Decades of an insane economic policy, not infrequently bolstered by the dependence school and airy Marxist theories, have clearly stood in the way of development. Common to all these countries is also the deliberate choice of an isolationist economic policy. When the degree of openness is measured in *Economic freedom of the year. 2000 Annual report*, we find that the most closed economies come in the group which is poorest.

But there is yet another explanation. Most people in the western world live with a notion of economic development and modernisation which says that, as the economies of the industrialised nations become more advanced, labour intense output can be left to poorer countries. This argument also ties in with the economic history of the western world. We westerners created our prosperity by becoming industrialised. This was done with capital from agriculture and its exports. Our agriculture today, compared with the alternative use of resources, has a low output value per unit of production and we should therefore allow scope for the spontaneous economic structural transformation from agriculture to more sophisticated production. Labour-intensive production – meaning above all agriculture and textile manufacturing – can be left to countries where it is less expensive.

This notion omits important elements of the reasons for economic growth and prosperity, but it incorporates a number of vital statements. Both the affluent part of the world and the poor countries gain in terms of welfare by utilising their comparative advantages and trading with each other. Agriculture, which in the Third World employs about 70 per cent of the labour force, an the upgrading of agricultural produce (foodstuffs and textiles), are a crucial sector for development and, given the right institutional setting, can inject considerable wealth into the economies of poor countries. Capital formation in agriculture augments the prospects of developing and diversifying agricultural output and of financing the investments needed for industrialisation.

There is, however, one problem about this notion: it doesn't quite tally with the realities of trade between different countries. This is not because the notion is wrong, because there are broken links in its chain of proof, but because large parts of the affluent world protect their agriculture from foreign competition and persist in producing their own provisions.

Of course, there is nothing new about countries and regions protecting their agriculture. Supporting food production, for reasons of contingency preparedness, is a long-established principle, and it was only with the Uruguay round that agricultural produce became a subject of multilateral trade negotiations.

There is today an anomaly about this argument. Contingency planning can no longer justify massive intervention in the market. The EU no longer faces any threat which, if realised, would necessitate food production within its own borders, the reason being that world markets for agricultural products have developed and today are better able to cope with production disturbances. But, added to this, the powerful unifying force of trade has brought about a general reduction of the risk of countries trading with each other abandoning that relationship, based on mutual benefit, and instead going to war with each other.

Some will find this argument unhistorical, saying that we know what has happened before, after times when we have taken peace for granted. But a cautionary principle of that kind would be economically impossible to live by, because it would mean other production also have to be protected and supported for the same reason. Nor is it justified by considerations of security policy. Whatever our standpoint on this question, let us at all events be clear about the costs – both economic and social – which agricultural protectionism entails.

It is no secret that the Common Agricultural Policy (CAP) of the European Union comes high on the ranking list of agricultural regulation. The present report shows the basic framework of that policy – its objectives, the perspectives by which it is governed and the tools at the bureaucrats' disposal.

This is no elevating reading. Quite clearly, EU consumers are among the big losers. Partly because, as taxpayers, we contribute large sums of money, in subsidy form, to agriculture, and also because we are forced to pay higher prices for our foodstuffs, cheaper produce from other countries being debarred from price competition.

In 1999 the EU doled out something like USD bn 50 in agricultural support. Various attempts have been made to estimate the total amount paid by EU consumers in excess prices (compared with market prices) for their food, but most of the calculations are shaky and beset with numerous problems of measurement. Several estimates, however, come to the conclusion that EU consumers are paying roughly twice as much for their food as they would have to if we were allowed to shop at world market prices. Estimating the loss of welfare sustained by high income countries due to their protectionist trade policy, the report *Attacking Poverty* arrives at a total of USD 63 bn annually.

The big losers also include the countries, especially those in the Third World and Eastern Europe, which are prevented from competing with their products in EU markets. They come up against tariffs and quotas, but also against an export subsidy to EU farmers enabling them to sell their surpluses on the world market below the equilibrium price. It is hard to say how much farmers in the poor countries lose by this policy. In one estimate the World Bank has worked out that the protectionism applied by the high income countries to agricultural produce causes the developing countries a welfare loss of something like USD 20 bn dollars annually, which is roughly equal to the 1998 GDP of Kenya and the Ivory Coast – combined.

The CAP is not only economically inefficient, it is also moral disaster. At a time when world trade is growing rapidly and helping us westerners to grow ever wealthier, the CAP is contributing to the poverty-entrapment of large parts of the agrarian population of the Third World. We continue with our protectionist policy when we ought to be relieving the developing countries of a heavy burden in their labours – heavy enough as it is – to achieve greater prosperity.

This is also a profoundly cynical policy, as was shown in the autumn of 2000 when the European Commission took the initiative towards abolishing tariffs on "Everything But Arms" (EBA) from the world's 49 poorest countries. The proposal was a cautious one, addressed exclusively to the countries which, generally speaking, are not net exporters of agricultural produce. Several, it is true, would be able to increase their agricultural exports, above all by exporting a larger proportion of their total output to the EU's high price market, but the level of exports would remain comparatively low.

The EU and the governments of its Member States announced at the same time that the proposal was not intended to bring about any great changes in trade with these countries but was primarily to be viewed as a friendly gesture. That gesture came at a very opportune moment, with new talks (the Millennium Round) within the WTO due to begin during 2001, prior to which the EU has already signalled its rejection of several demands from the developing countries.

In February 2001 the General Council of the EU resolved to accept this proposal, but in the event not even this gesture proved feasible. Opposition to the proposal, partly from agricultural interests, led to drastic modifications and a watered-down decision. The goods which these countries were capable of exporting to the EU on a large scale – rice, sugar and bananas – were deleted from the proposal. Liberalisation of trade in these commodities can, at best, come towards the end of the present decade.

The ins and outs of the EBA initiative, and not least the EU's meat production crisis due to the BSE disease, have again highlighted the negative consequences of the CAP. Looking at the reform attempts of recent years, however, one finds little cause to hope for vigorous changes. As the MacSharry reform of 1992 and Agenda 2000 later in the 1990s demonstrated an absence of the political courage needed to stand up to farmers' lobbying, above all in France and Germany. Those reforms have not brought any clear improvement for consumers or Third World farmers. In principle they have merely shifted problems from one area to another, added to which, they have done nothing to curb the growth of EU agricultural spending. Farm subsidies in 1999 accounted for more than 45 per cent of the EU's total budget. That increase, consequently, has also raised subsidies in proportion to the total value of the EU's agricultural output, referred to be the OECD as PSE (Producer Subsidy Estimate).

It was against this background that the liberal think-tank Timbro commissioned PhD Kurt Wickman, an economist at Univ. of Gävle, Sweden, and Chulalongkorn University, Bangkok, with many years' experience of studying food policies, to study the trade consequences of the CAP and sketch the outlines of a radical reform of that policy. The impact description endorses the conclusions which many others have arrived at previously, but this report presents a new proposal for actually accomplishing the CAP reform which so many believe to be impossible.

There is no need to beat about the bush regarding the consequences of the reform presented here. It will undoubtedly result in a large part of the EU's agricultural production being unable to survive. An estimated 50 per cent of that production will have to be discontinued owing to the growth of competition.

The beneficiaries of the reform are consumers and the developing countries. The losers, quite clearly, are the farmers whose production today is buoyed up by subsidies and sheltered by trade barriers. A policy will therefore have to be framed for helping these farmers to switch over to other activities. During a transitional period, some of the savings on agricultural policy will therefore have to be devoted to a policy of readjustment, but that is a price worth paying – several times over.

Stockholm, March 2001

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INTRODUCTION

Agriculture is a leading policy area in the European Union. It is somewhat surprising to find one of the technologically leading regions in the world organising a common agricultural policy (CAP) that absorbs around half of its budget. Moreover, most EU member countries run a technologically advanced agriculture employing no more than 3–5 % of their population. The contribution from agriculture to the GDP of the EU is of the same magnitude, 3–4 %.

The CAP has many aspects. Its aims have been somewhat redefined over time, but there are some long-term intentions behind the policy that have been present all the time. They can be summarised in four points:

- Self-sufficiency in food production, "the union should be able to feed itself"
- Preference for home production, "food imports should be kept at a minimum necessary level"
- Stabilisation of food prices, in the interest of producers (and EU consumers) – also to make it possible for agricultural firms to plan for long-term investments and growth.
- Support for farmers if there are supply swings around the long-term consumption trend – in case of overproduction, union authorities are to buy the excess supply or give financial support for exporting it.

Most countries and regional groups of countries promote an agricultural policy that tends to favour domestic producers. A certain "agricultural mystique" often seems to accompany both political theory and practice. At the heart of this mystique is the notion that agriculture – for various reasons, some more cogently argued than others – cannot easily adjust to a normal market régime. Once this idea is accepted, it follows that some kind of ambitious agricultural policy should be established. More often than not, this policy takes on protectionist features.

No agricultural policy except Japan's – and perhaps also those of Iceland, Norway and Switzerland –is as explicitly protectionist as the CAP. The protectionist problem in the EU as such is compounded by two main points:
1) the EU is a large market, which means that closed agricultural markets will be especially noticeable and problematic for exporters in developing countries. Subtropical countries have potential advantages as exporters to the EU of agricultural goods, now blocked through CAP regulations;
2) through export subsidies EU producers are at times dumping the excess

supply in different places – generating swings in world prices that above all affect the incomes of farm producers in the developing world.

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After a brief description of how CAP is set up and how it works, we will mainly discuss the aspects of importance for EU external economic relations. Some of these are trade-related, but some also affect other parts of the EU's external political or economic relations.

I

HOW DOES THE CAP WORK?

CAP is an EU-wide policy, comprising/encompassing around 90 % of all agricultural products. It replaces national agricultural policies in order to guarantee free trade in agricultural products within the Union. It is also constructed to diminish imports of most agricultural products into the Union. There are a number of preference agreements with some developing countries – mostly former EU colonies – that allow some imports, but they are too insignificant to alter the general restrictive character of EU farm import policy.

The import-restricting characteristics are normally regarded by the outside world as an outright protectionist measure, going against the general free trade orientation of the EU "common commercial policy". Political criticism is not only voiced by large agricultural export countries, like USA and Australia, but is often also heard from countries in the developing world. During the last worldwide trade agreement (the Uruguay round, 1986–1994) developing countries were especially active in demanding that the EU open up its agricultural markets.

The support system of the CAP is based partly on a) import price regulations, partly on b) a variety of subsidies to EU farmers. The price regulations and their impact on the EU agricultural markets can best be described with the help of a diagram. Regulation details differ somewhat between different products – a practical way of getting around that problem is to consider a typical price intervention scheme, like that for cereals, which was the first to be put in practice (in 1967) and whose structure was transferred to other farm products.
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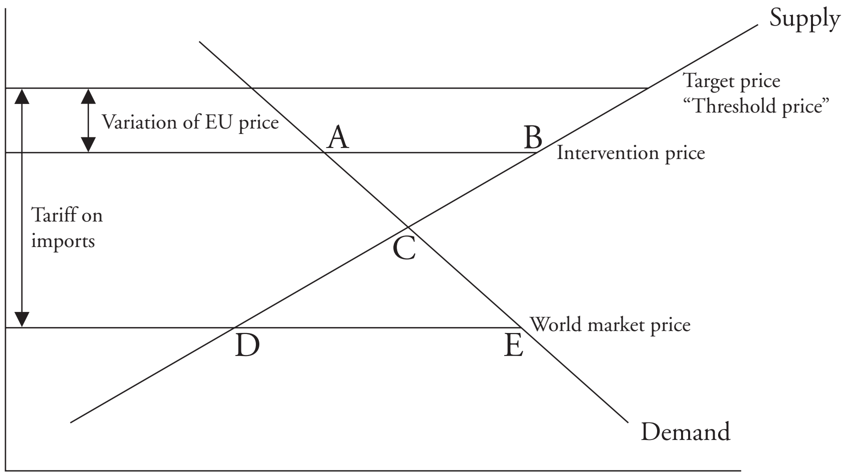
Diagram 1
Construction of the CAP – the case of cereals



The mechanism of Diagram 1 is based on three different price levels: "World market price" is the price at which most exchanges for cereals take place outside the EU, and the price at which foreign farmers are prepared to sell their output to EU consumers. A free-trade regime in the EU would see consumer demand at point E in the diagram. Imports would be D–E, and consumers would pay the world market price. The world market price is significantly lower than actual/current consumer price in the EU. The free market régime would represent the best position for EU food consumers.

However, cereals may not be offered at world market price in the EU. Instead a substantial tariff (the arrow "tariff on imports") is added to imported cereals. The tariff makes final import prices equal to the "target price" (sometimes also referred to as the "threshold price"). The import tariffs are normally set sufficiently high to block all imports from outsiders. To outside agricultural export countries – many of them in the developing world – the arrangement constitutes a highly visible impression of "Fortress Europe".

"Intervention price" is price guaranteed to EU farmers – this is the lowest price that any EU seller of cereals will have to accept. As soon as he is offered a lower price, EU agricultural authorities (EAGGF, European Agricultural Guarantee and Guidance Fund) will step in and buy the surplus at the level of the intervention price. It is below the target price, which shields EU farmers from foreign competition. In passing, it can be noted that falling world market prices for cereals will mean more subsidy, i e higher costs for EU taxpayers.

The intervention price is also well above the domestic equilibrium price in EU, which can be read off at C in the diagram. The deal between farmers and EU politicians then generates *more* than a closed market, namely *a closed market that produces a surplus*: at the intervention price level, consumers are willing to pay for an amount of goods at A, but producers supply at B. The excess supply (B – A) creates serious problems which we will be returning to.

The actual choice of "intervention price" has historically tended to maximise producer interests. Designing the policy has meant choosing between different national levels of protection. Choosing the level of the most protected country has turned out to be normal procedure to . In the case of cereals, the high German protection levels were chosen, not the lower French ones. A former EU Commissioner – the German Ralf Dahrendorf – commented critically upon this property in the CAP setup: "[The CAP] is little more than an instrument for Ministers of Agriculture to get for their farmers in Brussels and in the name of Europe what they would not get at their national Cabinet tables".[1]

The price regulation policy is backed by a subsidy policy. There are producer subsidies, export subsidies and, recently, a number of environmentally motivated subsidies. The excess supply further gives rise to storage costs that should be added to the total cost of the CAP. In the subsidy case, EU consumers compensate EU farmers through taxes, adding to the cost of food consumption.

Diagram 1 can be very straightforwardly interpreted as indicating the strength of economic incentives, such as are assumed behind the normal diagram technique in economics. The price incentive in the CAP transformed the EU in less than two decades from a food-importing to a food-exporting country group. This transformation was behind the expansion of EU export subsidies in the 1980s. And there was a visible "CAP contagion" into the world market: a number of other countries started to lobby their governments for subsidies of the same kind, "to level the competitive playing field".

[1] Quoted from R Howarth, "The CAP: History and attempts at reform", Economic Affairs, Vol 20, No 2, June 2000, p. 9–10.

II

WHAT CAP AIMS TO ACCOMPLISH

CAP wants to support agricultural producers in the EU, to make it possible for farmers to keep incomes at or close to the level of other social groups in the union. Through support measures productivity growth in agricultural production would be improved: by promoting technical progress and a rational use of production factors (especially labour), earnings for all farming groups in the union would be enhanced, partly compensating for the trend towards a long-term relative fall in agricultural incomes.

A certain equalisation of incomes for different types of farmers is also present in the basic political philosophy of the CAP. Especially critical conditions (arctic climate, for instance) are to be compensated through special types of support. Effects of natural conditions that tend to create income differences between distinctive kinds of farmers are to be softened by a subsidy policy.

EU consumers are also to be protected through the CAP. The fundamental idea is to shield consumers from large swings in world market food prices that may sometimes occur. By operating on the "intervention price" agricultural authorities in the union can settle consumer expectations on food prices, on a long-term basis.

III

SPECIFIC CAP PROBLEMS

EU CONSUMERS PAY HIGH FOOD PRICES. Compared to a free-market regime – with no regulations on imports of food – consumers are carrying massive extra costs to support the agricultural sector of the union. The OECD has estimated that in 1998 EU agriculture produced goods to a total value of 128 billions Euro. 49 % of this production value was explained by political support measures. Direct costs in the form of producer and export subsidies were estimated to be around 37 billion Euro. Transfer of resources from consumers to producers through price regulations (Diagram 1) was estimated to be 43 billion Euro. (Secondary costs, like storage costs for the excess supply, were not considered in these estimates.) It is not easy to see the rationality of a policy with such a strong anti-consumer bias.

Present extra costs (over free-market prices) to consumers (December 2000) for agricultural goods in the EU can on average be estimated to be in the interval 80–100 %. The anti-consumer property of the CAP, then, means EU consumers paying on average about double the price for food that they would pay in a free market régime. This has created a growing pressure on EU politicians to reform the CAP. But in spite of a string of reform proposals since the late 1960s, policy changes have come to very little. Instead the reasonable verdict must be that support levels and price regulations have shifted successively upwards, aggravating the problem instead of solving it. The producer bias in the policy seems to be triggered and take over as soon as a reform movement starts.

THE SUPPORT SYSTEM DOES NOT MAINLY PROMOTE SELF-SUFFICIENCY, BUT EXCLUSION OF EFFICIENT OUTSIDE PRODUCERS. The protectionist policy goes against the main orientation of EU trade policy. Most of the important external economic relations for the EU lie outside of agriculture – for instance, EU is the largest manufacturing exporter in the world. EU is also a fast growing service producer for other economies – being well "plugged into" the direction that world trade has been moving in for at least two decades now. In both these – quite central – respects, EU interests are towards open markets and further liberalisation of world trade.

Yet agricultural protectionism blocks an efficient overall management of the major external economic interests. EU authorities get bogged down in losing battles on imports of bananas and hormone-treated beef from the US. In both these recent cases, the conflicts have been supervised by the WTO and their judgments have come down in favour of the USA. When EU authorities have not accepted the WTO decisions, two different types of reactions are visible: 1) US authorities respond by blocking EU agricultural exports, causing the traditionally deep "Atlantic" political relations to deteriorate in quality; 2) It becomes harder for the EU to engage in promoting world trade in other, more important, areas. Suspicion will surround EU initiatives – especially from the developing countries, which suffer most from the closure of EU agricultural markets. The leadership that is sometimes expected from EU delegates cannot be easily accepted in an atmosphere of scepticism regarding EU ulterior motives.

CAP CONTRADICTS THE AIM OF PROMOTING GROWTH IN DEVELOPING COUNTRIES. Even if present conflicts with the US are the most visible, the deepest and by far most numerous are those with the developing countries. Many developing countries have the capacity to produce exportable food products (at "world market price" in Diagram 1). With a free market régime in the EU, developing countries would export more into the EU.

The reason why CAP is especially problematic in this respect is that the EU promotes a "social element" in its foreign policy: the crucial social ingredient is a wish to help developing countries to grow. One efficient way of providing such support is to give developing countries access to the domestic markets for products that can compete successfully. Foremost among such products are agricultural and light industrial goods. But CAP protectionism rules out any such practical solution. However, it makes little sense to deprive developing countries of a sustainable way to generate economic growth, through trade, and at the same time to compensate protectionism through non-sustainable international interventions, namely foreign aid.

Some basic industrialisation patterns from economic history aggravate the non-productivity of the "CAP approach" to the problem: the first one is that there seems to be a unique road to industrialisation. An economy that industrialises, normally finances significant parts of its industrialisation drive by exporting its agricultural surplus. It needs to import industrial goods and hi-tech equipment to use as inputs in its new industrial sectors. Agricultural exports pay for these imports .

The second is that the introduction of an export pattern into a backward economy helps it "plug into" the world economy, making the move towards division of labour (specialisation) faster. In this way, the developing economy can speed up its industrialisation drive and receive international price signals – allowing the growth rates to be higher and the build-up of the economic structure to adjust to the world market (not to regional markets, with other low- or semi-developed economies). In both these respects, living standards in developing countries will rise faster and do so long-term, in a "sustainable" way, if they are allowed to trade freely with industrially developed economies.

CAP MAKES ENLARGEMENT OF THE EU HARDER. The most important task confronting the EU for the moment is to successively integrate former "East European bloc" countries into the Union. Integration will be made more difficult by the CAP, since a) the entire support system will be established in a number of poorer countries, all with large agricultural sectors. It is doubtful whether tax payers in Western Europe are willing to transfer quite substantial sums in support to the newcomers, just because they run inefficient farms.

Recent subsidy estimates suggest that pre-accession transfers alone might be around 520 million Euros annually for the period 2000–2006 – the largest takers being Poland and Romania; and b) there is an incentive for Western European farming interests to block an entry for new producers into an already over-crowded market. It is not easy to see how EU politicians could smoothly integrate low-cost countries with a large agricultural sector, without some kind of "agricultural deal" for farmers in Western Europe. One indication is that political hints in discussions of entry dates are already postponing it from 2003 to 2005 – and the practical measures to make 2005 a reality for entry have so far (December, 2000) been less than energetic.

It seems as if there is also a "CAP contagion" involved in the integration process. Several of the East European countries that are to be members have moved towards an agricultural policy with protectionist features. Some of these features bear a suspiciously close resemblance to those of the CAP. The impression is that future Eastern members are anticipating membership in the CAP and on this basis adjusting through agricultural protectionism.

CAP CREATES POLITICAL CONFLICTS. Several recent EU political conflicts with the "outside world" have had at least one foot on the political axis between far-reaching environmental policies and agricultural interests. The "banana conflict", where Latin American and US export interests were blocked by traditional CAP protectionism, is one example. Another one is the holding back of US exports of genetically controlled cereals and hormone-treated beef. In both these cases the WTO has ruled against the EU, though with little practical effect.

US authorities have in a number of such cases retaliated against CAP protectionism, employing a variant of the so-called "Super-301 rule". The rule is based on a theoretical estimate of the volume of exports being diverted by the EU and then blocking that same amount of agricultural imports from the EU into the USA. US authorities have picked a number of agricultural goods from the EU export menu and declared them "unwanted" in the American market.

These developments tend to produce two kinds of related problems. The first is that the EU loses political goodwill in the world. Its agricultural policy is seen as the root cause of a deep trade conflict. The second is that the traditionally harmonious relations between Western Europe and the USA – the "Western world" or "the Atlantic alliance" – are being poisoned. The image of the EU as a free-trade-oriented and rule-based organisation is being blurred. Since major trade interests of the EU are connected with not only upholding this image, but giving it real substance, the long-term costs of questions marks in this respect might be considerable.

But the CAP also creates "internal" political conflict. This is best seen in the recurring discussions around the common budget. Some countries (Britain and Germany among them) have at times expressed concern over their citizens paying more into the budget than they are getting back in the form of "EU-financed" services. Such discussions tend to destabilise the union (along national lines) and make the attainment of common goals harder.

CAP SUPPORTS MAINLY FARMING THAT COULD COMPETE ON ITS OWN. Farm production in the EU is highly centralised. A statistical rule-of-thumb is that 20 per cent of the farms in the Union produce 70 per cent of the food. On the other side, the 40 per cent smallest farms produce only 5 per cent of all food. The trend has for a long time been towards a higher ratio of concentration – since 1970 the number of people engaged in farming EU-wide has fallen by two-thirds, a trend that still seems unbroken today.

Present experience generates doubts about the efficiency of the CAP in at least two respects. The first is how well it redistributes farm incomes, one of its explicit political goals. Product subsidies are overwhelmingly based on production levels and/or cultivated area. Large farms will capture more subsidy than small farms. But large farms are also more productive than small farms. There seem to be scale effects over a substantial interval for most agricultural production.

This implies that large farms will generate the highest incomes and also receive the largest subsidies. Many of the large farms in the EU would probably be able to compete in world (and domestic) markets without political support, which means that they will use subsidies for "external" purposes: for instance to expand land holdings or buy up production quotas from small farms. Several studies suggest that this happens and subsidies help in this case to artificially speed up the concentration process. The tariff schedule also transforms massive consumer surplus to producer surplus, most of which is picked up by the large farms.

A second implicit goal of the CAP is to guarantee farm incomes. Statistical information shows that it has been unsuccessful in this respect. Even if large farms are doing well, averages for agriculture show a long-term falling income level for the farming community. Over time, income levels have been falling in relation to other industries all over the Union. Subsidies help a larger number of farms to survive (at some income level), which will mean that there are more farms than can be supported by basic market mechanisms. In an overcrowded market the poorest farms will always suffer.

Small farmers will have to supplement their incomes by work in other industries, since incomes from their farms are low. These low farm incomes will enter the statistical picture and can be interpreted in two different ways: 1) rationally, as proof that CAP can't guarantee farm incomes. In spite of continually rising subsidies from union tax-payers, farm incomes have been deteriorating over time; 2) for farm lobbies, the low average incomes serve as an argument for even more subsidies. These lobbies disregard the counter-productive nature of subsidies – most of them end up in the richest farms, where they tend to slow down the introduction of efficiency-raising investments. Another well-known aspect of large subsidy programmes is that they affect suppliers of inputs to the subsidised industry – subsidy effects tend to go in unforeseen directions and are capitalised in places that cannot be controlled by subsidy-supplying authorities.

In the longer run, union consumers and tax-payers are not interested in upholding a larger farming sector than a free market régime would generate in any case. Heavy subsidies are slowing down the process and taking agricultural development in the Union on a costly detour to this end. One of the long-lasting costs of the CAP policy will probably be the Union getting a distorted production structure of the industry as a result.

IV

A RADICAL REFORM PROPOSAL

The Common Agricultural Policy goes back in history, to the basic Rome Treaty from 1958. Its basic construction was erected during the 1960s, and it has stayed remarkably unchanged in spite of extensive political changes. One conclusion is that the CAP has proven to be hard to reform, in spite of ambitious attempts at times to do just that. Yet, this is what has to happen – to finally give EU consumers what they see as a fair deal and restore international credibility to the EU project.

Future moves will go towards a free market regime. It is not easy to see how a specific sector like agriculture could manage to stay out of the general drive towards globalisation. Agricultural reforms to that effect are presently being considered in a large number of countries. Only a few of those policies are aiming for a total reversal of earlier protectionism, but they all move in that direction. It will probably mean agricultural reform being an essential part of the next round of WTO talks, where the EU has other deep interests, in freeing trade in manufactured goods and services. A free market régime for agricultural goods implies directly that EU agriculture will depart from both price regulations and subsidies, as New Zealand, for instance, did already in the 1980s.

PRESENT REFORMS – AGENDA 2000

Pressures for reform are coming from three sources – EU consumers and taxpayers, the logic of the further development of the Union and EU interest in its international relations. They are all quite intensive and they have led to a recent reform attempt, reform of the CAP in relation to the so-called Agenda 2000.

The aim of Agenda 2000 was to meet heavy international criticism of the CAP and to prepare the Union for incorporating former Eastern bloc countries as members without causing a budget crisis. It was realised that the CAP had acquired irritating international properties. Union farmers had since the mid-1980s developed into huge exporters, but based on massive export subsidies. In the mid-1980s the EU countries were world leading exporters of beef and wheat: the level of export subsidy for wheat was in 1987 double that of the currrent world market price.

This experience led, among other things, to the creation of the so-called "Cairns group". The core of this group was Canada, New Zealand, Hungary and Australia plus a number of developing countries. The CAP export pattern had destabilised international trade through the dumping practice that the export subsidies allowed – prices for agricultural goods in the world markets fell to unprofitable levels for non-EU exporters. The Cairns group advocated substantial worldwide reduction of farm protection and they pushed this agenda in the Uruguay Round negotiations. They were supported by the US that suggested a so-called "Zero Option" under which all agricultural policies that distort international trade should be prevented.

The results of the Uruguay Round did not meet the expectations raised by the Cairns group and the US Zero Option. One side-effect of the outcome was to keep pressure on CAP reform up from other countries. During the 1990s US has lowered its farm tariffs substantially – the Nominal Tariff Equivalent (a form of "tariffication" of political support) was in 1998 around 28% of final price, compared to around 82 % for CAP. Agricultural products are now on the agenda of international trade talks, and the trade-offs between agricultural protectionism and free trade in manufactured goods will be made more explicit to EU trade negotiators.

Agenda 2000 meant moving agriculture by a number of large steps towards a much more open market, with tariff and subsidy reductions. A number of interesting attempts at real reform were introduced in the first drafts, drawn up by the Commission. One general idea – already in the US agricultural reforms – was to "decouple" support from production level, and instead re-direct it towards farm income and (maximised) area. In "Eurospeak", it is called "modulation": either a maximum payment per farm or progressive subsidy reductions for area of large farms.

Substantial price reductions were also suggested in the first drafts. The falling incomes for farmers because of a lower "intervention price" were to be compensated by subsidies. But an interesting new concept in this respect was "degressivity", actually an interesting "Eurospeak" innovation: the idea behind it is a gradual phasing out of the subsidies.

For international trade, the drafts addressed the most pressing problem, that of export subsidies. It was vaguely suggested that EU agriculture should take part in a growing world market. The implications are obviously that Agenda 2000 followed the same dismal road as earlier reform proposals.

The agricultural ministers watered the proposals down, but interestingly enough, not in any radical way. The final blow came instead at the Berlin Summit in 1999 – the heads of states reversed many of the suggestions in the drafts. Reductions in intervention price were made smaller and adjustment periods for farmers made longer.

The politician in the Berlin negotiations most active in reversing the suggestions was French President Jacques Chirac. It is not far-fetched to sense the influence of the French farm lobby behind his endeavours. French politicians seem to have a distinct "fear of the street", probably based on the circumstance that it is never far to the next election. Opinion polls in France balance the small number of active farmers (4 per cent of the population) with a larger group, having "strong agricultural attributes" (13 per cent of the population: retired farmers, children of farmers and so forth). The active farmers can probably activate most of the support they have in the larger group by taking to the streets. When this happens – and most of the "attribute group" sides with the active farmers – this group is large enough to decide whether there will be a left- or right-majority in the next election.

Strong French resistance to reform might imply that any attempt at reform is wasted energy. But that conclusion is not as safe as it was only a decade ago. Especially the larger EU interests in the upcoming WTO talks mean that there is a stronger international pressure than there ever was to change. One indication of this is that a fairly far-reaching reform proposal could pass the farm ministers' council: with watering-down results in some respects, but in other respects they were surprisingly small.

All this might indicate a possibly new climate for reform. The reforms to be considered should probably follow two parallel paths. The first is to dismantle all price-rigging schedules (intervention and target prices); the second is to take away the subsidy programmes as well, but possibly to accept an adjustment period for those farmers who are not able to compete when prices shift to the world price level. These farmers should be allowed to change their activity in an orderly way. One way of doing this is to target and set a time-limit for future subsidies, maybe in accordance with the new "degressivity" concept. And during the phasing-out period to re-nationalise the subsidy programs surrounding agriculture. Allow me to comment upon each.

TAKE AWAY IMPORT BARRIERS

Import barriers of the EU type (see Diagram 1) are rare in economic history – their unique and remarkable property is, of course, that target prices are set above intervention prices, which themselves are set above what would entirely close the domestic market to outside suppliers. In this way, the CAP not only comes into conflict with EU consumers and outsiders trying to specialise in exporting to the EU market, it also comes into conflict with the entire world trading community – since occasional dumping of agricultural surplus production (made possible through export subsidies) upsets price formation on food products world-wide.

The cost in good-will for the entire EU project is probably maximised because of the CAP structure. EU citizens can observe that EU politics has pushed prices for one of the basic commodities – food – up to double what they would be without politics. Citizens in poor countries with a competitive agriculture cannot earn much-needed hard currencies by exporting to the EU market. On top of that, they are also at times experiencing a rupture in exports to non-EU markets because of the price swings generated by EU dumping.

The sort of (agricultural) trade philosophy that, for the moment, has deep roots in the Brussels bureaucracy, tends to regard trade in a traditionally mercantilist manner: export is a victory and import is a concession. It is a tradition in trade policy that is represented in political circles in many parts of Europe, maybe most notably in France. The Commission is modelled on French political traditions and it is interventionist in a large number of political areas. The most vocal supporters of such trade theory are, however, the special interest groups that are favoured the most: the powerful French and German farming lobbies.

In modern economic trade theory, on the other hand, exports are mainly seen as a way of financing necessary imports. Imports play an essential role for long-term growth and higher living standards in a country. Exports/imports make it possible for a national economy to specialise – and raise economic growth beyond what would be possible with little or no international trade. One implication is that there is normally no special advantage in having a full "domestic" set-up of any one particular industry. If capital and labour have a higher productivity elsewhere in the economy, it is rather a disadvantage to foster industries for "nationalistic" reasons. There always exists a reliable world market where goods and services not produced domestically can be traded for goods that are.

This elementary principle also goes for agriculture. The political mystique that tends to surround agriculture is mainly composed of shallow thinking. If there were a permanent threat of too low production in relation to demand, the case for political intervention might be there, or could at least be argued with more force than today. But one characteristic will probably strike future economic historians more than anything else when they look at the 1900s: an exceptional long-term rise in farm productivity. At the end of the century, the bigger problem is not too little production, but too much.

The long-term trend for agricultural prices (all the way since the mid-1800s) is a falling one, and at the same time supply has been rising. The recurrent technological shifts that explain this economic pattern, also inform us that the world market for food is very different from what it was only 3–4 decades ago. The technological innovations that are responsible for the pivotal change are not random events, so they will not go away. World population curves are flattening out – an effect of higher world per capita income – which means that the growth of agricultural production will not run out of land.

If there is a stability in world supply of food – albeit with temporary price swings for individual food items at times – there is no better argument for fostering a domestic agricultural industry at high costthan there is for fostering a domestic nuts and bolts industry. All countries ultimately rely on the world market when it comes to nuts and bolts – and there are no known reports of any national "nuts and bolts crisis" because of this.

The unnecessary costs that the CAP puts on EU consumers can then safely be taken away. All import tariffs can be taken away in a short time. No agricultural goods or services should be provided only by licence – every exporter should be free at will to offer his products to European consumers at his own chosen supply price. Likewise, EU consumers should be allowed to import any food item they want from anywhere in the world, without having first to ask permission from someone in the EU farm bureaucracy. The judicial technique of writing such a free trade law is well known and tested since 150 years. The British repeal of the Corn Laws in 1848 might be regarded as a model.

For health and sanitary conditions, EU citizens should be expected to form their own opinion as to what they should consume or not consume. It is hard to see how EU authorities are particularly well qualified for controlling and recommending what individuals should eat or not eat. Information as to health (or not) of different food products is best left to the citizens themselves. Media coverage of such problems has always been intense – and it is private media that have exposed most of the health hazards in food that have been observed and discussed during latter decades. The incentives for authorities are not always the same as for private media – individuals in office might make a number of complicated "policy considerations" before revealing any information that might harm subsidised producers.

SUBSIDIES FOR A SHORT-TERM ADJUSTMENT PERIOD

The subsidy system surrounding the CAP is more complicated. In a strictly straightforward way, it is the EU tax-payers that are paying them. When governments promise more subsidies to farmers, they are at the same time sending a signal to EU citizens that they will raise their taxes to finance the policy. But fro a long time now, EU citizens have been getting very little in return – safety of food supply can be guaranteed by trading in the world market. This implies that there is no great desire among EU citizens to pay a premium for such a "food insurance" to EU farmers. And it also implies that subsidies will have to be abolished at the same time as import barriers.

But there is also a partly different problem concerning those subsidies. They are direct payments to farmers (or farmers' organisations) and have come to represent a government obligation to the farmers. Farmers have come to base their income plans on these subsidies. And they have adjusted their production plans to conditions stipulated in the subsidy policies – no matter whether they have regarded these stipulations as wise or foolish. In this way, farmers have organised their farms in accordance with what politicians have told them is "in the public interest". A case can probably be made that farmers have invested in what they have regard as "a public good" – which makes it possible for them to regard subsidies as a payment for producing it.

When open markets make it clear to farmers that they are producing a good with the same "public significance" as, for instance, nuts and bolts, then obviously they will not be able to claim payments for something they are not delivering to the consumers. In that situation, it seems fair to give them an adjustment period to move their farms back from "subsidy-organised" to "market-organised" production units. Since a readjustment takes time and entails costs, this is an argument fro reducing subsidies successively.

The Commission idea of "degressivity" in subsidy policy is probably applicable. But it should be qualified in at least two ways, to guarantee that it will not come to nothing: 1) a strict timetable over five years for those subsidies that are not tied to production levels, but are intended to guarantee a certain level for farmers' incomes; and 2) a decentralisation (re-nationalisation) of the payment of subsidies and control of the dismantling of the subsidy program.

Subsidies for export and for expanding production further should be abolished immediately. Income-oriented subsidies should be put into a five-year plan and be reduced by 20 percentage units per year. They will act as a kind of "shock absorber" during that time: efficient EU farms will have to reorganise so they will produce at world marginal cost, and the fall in land prices that will accompany deregulation will make it harder for them to finance the reorganisation. Inefficient farms – farms that can only produce above world marginal cost – will have to close shop, and the subsidies will make their transition process smoother.

A re-nationalisation of subsidy programs during the "degressivity period" redresses the balance between farmers' special interest groups and political accountancy/accountability?. EU farmers have concentrated massive lobbying power on the EU level, where political accountancy/accountability? is weak. The explanation for this pattern is that the best position for a lobbying group is probably to operate against a huge and politically/culturally divided bureaucracy – like the one in Brussels – with only indirect links to national political decision-making.

With re-nationalisation, two different and unrelated properties appear. The first is that there emerges an evening-out of negotiating power between taxpayers and farm lobbies: an elected parliament is directly responsible to its citizens for budgetary provisions. The control of and resistance to further expand farm subsidies is stricter. Sweden is a case in point: before entry into the Union in 1995, the long-standing special status of farm subsidies was taken away – subsidies were being cut and import barriers (for a number of agricultural goods) lowered. Consumer aspects started to play a bigger role in policy decisions. After EU entry, the CAP reintroduced some barriers and subsidies – in themselves, some even more far-reaching protectionist than the Swedish agricultural market had experienced for a long time.

The second problem is that re-nationalisation might (and probably will) give rise to national differences in applying the subsidy policy. One implication is that the "internal free market" for farm products in the Union will be undermined. However, this problem is probably both short-term and self-correcting. If, for instance, French politicians choose to subsidise their farmers' marginal costs down to world market prices, French taxpayers will transfer wealth to the rest of the world. It is highly probable that French tax-payers will not wish to uphold such a policy. And even a very impulsive national behaviour during the transition period would not jeopardise the stability of the EU food markets: the broader connection to the world market would act as a stabiliser.

A POLITICAL (PUBLIC CHOICE) CONSIDERATION

It is not easy to understand why CAP has developed in a mainly harmful way. Several of the most interesting attempts at explanation have recently been presented by public choice economists. They regard farmers and politicians as special interest groups – and apply basic economic methods in their discussions – and come up with analytical results that predict much of what we see. One aspect, however, is missing when we discuss the CAP, namely the EU super-national level. It is, however, possible to add more realism to the CAP discussion by introducing some basic perspectives from the economic theories on imperfect markets.

In one central aspect, the EU can be regarded as a political cartel. In modern economic theory, cartels are seen as price-rigging coalitions of producers: firms or, if production is organised along public lines, as for instance with the oil cartel OPEC, countries. To be able to control prices, the cartel must assume the power to control (reduce or eliminate) competition between members.

Instead of competition, a cartel distributes production quotas and other "planning" measures to the respective members. The advantage to the members is that they will have higher total revenue as a group in comparison to the total revenue they would have acquired in a competitive market. If any member would suffer – and on this ground "cheat on quotas", or even break out of the cartel – he can always be compensated ("bribed") by the others, through the higher total revenue.

As a political cartel, the EU attempts to control institutional competition between member countries. By institutional competition is meant varying political institutions in different member countries – and they act as attractors or anti-attractors for freely moving production factors, like capital and skilled labour. The key-word for control of institutional competition in union political circles has come to be "harmonisation".

One of the foremost examples of the EU harmonisation principle has been the CAP. Harmonisation has carried with it – something only too normal in European political thinking – a "producer perspective". And this perspective makes political decision-making in CAP similar to the way in which a private "cartel board for EU agriculture" would have operated. But it would be strictly illegal – contrary to EU competition rules, to start with – to run the CAP policy on a private basis.

It is also likely that total revenue (including subsidies) to EU agriculture is higher with the CAP than would be the case with a free trade régime. CAP subsidies might be interpreted as a way to compensate those groups that could most easily (with little or no loss compared to a non-subsidy regime) move over into a free market régime. It would explain the peculiar situation of the most efficient farms getting most subsidies. This has happened in spite of the "redistribution ideas" that have followed the CAP for a long time – originally, it was even constructed as a social/redistributive policy to help farmers' incomes keep reasonable pace with those of industrial workers. Those ideas would make us expect the subsidy policy to have a different, indeed a contrary outcome.

The existence and growth of agricultural policy has given rise to a vast amount of literature and sometimes heated discussions between scholars, scholars-politicians, scholars-politicians-farming lobbies, seemingly without any final resolution of the crucial issues in sight. But no matter how these discussions will develop in the future, the specific architecture of the CAP and its practical effects challenge the idea of economic common sense in such a fundamental way that it is not easy to understand how a long-term defence could be arranged:

1. EU consumers pay roughly double as much for food as they would pay in a free trade régime.

2. CAP has not been able to defend farmers' incomes – since the modern pattern of economic growth makes that practically impossible. Most of the actual subsidies are capitalised by large farms.

3. CAP has poisoned EU external relations: export subsidies that allow "EU dumping" of surplus production, at times disrupt world markets by creating large price swings.

4. Trade conflicts with USA (bananas, maize, beef) and the developing world (general protectionist interpretation of CAP rules) have made EU obstruct WTO rulings, undermining trust and "voice" in the more important free-trade interests in manufactured goods and services, not to mention the over-all interest in a rule-based world trade scene.

5. General CAP protectionism towards developing countries deprives these countries of their best chance of a sustainable way to finance their economic growth. Compensating CAP protectionism by international aid programs is always a second-best solution.

6. CAP makes the important enlargement issue harder. By including low-cost, highly agrarian, former Eastern bloc countries as members into the union, CAP will contribute to a budget crisis (of some kind). This expectation has already visibly slowed expectations of a "fast track" membership for East European countries.

7. Budgetary allocations surrounding the CAP have created political frictions within the EU – important political energies are tied into recurring discussions whether a country is "over-paying" or not. Non-agricultural groups in EU countries are paying practically all of the tax that finances the CAP. They are not compensated at all for these taxes, which is an incentive that the budgetary frictions will go on.

It is quite probable that the effects of the CAP have materialised differently from what its original architects had in mind. But the basic seven misallocations are there. And they call for political reform.

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