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CAP Reform, the Berlin Summit, and EU Enlargement

The planned enlargement of the EU necessitates major changes in the EU's agricultural policy. The decisions of the Berlin summit in 1999 have been rated as a major breakthrough towards a liberalization of the CAP by the EU Commission and the ministers of agriculture, but are seen considerably more critically by others. The consequences of the compromises reached in Berlin will be distortions both in the allocation of land to agriculture, forestry and environmental purposes, and in the distribution of sectoral income, leading to excessive budget outlays and high economic rents for landowners who are increasingly themselves not active farmers. A fundamental reform of the CAP is still required. What elements should it contain? How could its chances of implementation be increased?

On April 26, 1999, the European Council – among other things – reached an agreement in Berlin on the Agenda 2000, a reform package containing, basically, 3 elements:[1]

☐ the reform of the CAP

☐ the reform of the structural funds

☐ decisions on own resources and imbalanced budgets.

The following will mainly concentrate on the reform of the CAP and touch the reform of the structural funds only in as far as there are close links to the CAP.

The summit decisions are embedded in a new financial framework[2] (financial perspective) covering the period 2000-2006. The total appropriations for commitments for the EU-15 will decrease slightly from Euro 92,025 million in 2000 to Euro 90,660 million in 2006. This includes pre-accession aid of Euro 3,120 million per year for the six applicant countries. With an assumed accession in 2002 the totals will increase by Euro 4,140 million to Euro 98,360 million in 2002 and by Euro 14,220 million to Euro 103,840 million in 2006. The own resources ceiling shall remain at the current level of 1.27% of EU GNP.

The planned expenditure for agriculture, which besides the CAP (market and price policy) now includes rural development and accompanying measures, will reach a peak in 2002 and later on decrease to Euro 41.7 billion slightly above the 2000 level. For the EU-21, the expenditure will be higher by an amount which increases from Euro 1.6 billion to Euro 3.4 billion. The agricultural guideline as a limit to expenditure on agriculture will remain unchanged (0.74% of real GNP) and will be valid for the agricultural expenditure in the pre-accession period as well as after the accession. Rural development policies have been given more political weight and an explicit position in the financial outline for the period up to 2006. The financial allocations will centre around Euro 4,350 million for the EU-15. In contrast to previous regulations these also include all financial means for the agricultural sector, e.g. investment aid, which were previously allocated in the guidance section of the EAGGF.[3] However, in the newly defined objective-1 regions, these measures will be financed by the guidance section, which – as before – is a part of the structural funds.[4] In contrast to the general

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[1] Presidency conclusions – Berlin European Council, 24 and 25 March 1999. Internet: europa.eu.int/rapid/start/agi/gu on.ge/txt=???=DOC/99/1(0).

[2] For details see Official Journal (1999/C 172/01): Interinstitutional agreement of 6 May (Annex I + II).

[3] For details see the new comprehensive Regulation for rural areas No. 1257 (17 May, 1999) which substitutes or includes several former regulations.

[4] For details see the new comprehensive Regulation on the structural funds No. 1260/99 (21 June 1999).

objective of concentrating the financial resources on regions most in need – particularly stressed in the context of the reform of the structural funds – the instruments within the regulation on rural areas are applied area-wide.

Market and Price Policy

In the area of market and price policy the policy change initiated with the agricultural reform of 1992 is continued. The shift from price support to direct (support) payments is extended for the "grand culture" crops and will also be introduced to the beef and later (in 2005/06) to the milk market. The main elements of the decisions are summarized in Table 1.

There is one new element in the summit decisions: some freedom is given to the national governments with respect to compensation payments (modulation). These could be cut by up to 20% for specific reasons such as, for example, a below-average employment intensity, an above-average profit level or the absolute payments per farm. The financial resources saved have to be spent in one or the other way for rural areas, for example, as part of programmes for rural development or as the compliance with environmental standards (cross compliance). Distortions in competition between member countries have to be excluded.

Table 1
Main Elements of the Agenda 2000 Decisions, Prices and Payments
(in Euro/t, rounded)

	1999/2000	2000/01	2001/02	after 2002/03
Grain				
Intervention price	119.2	110.3	101.3	101.3
Compensation	54.3	58.7	63.0	63.0
Set-aside				
Compulsory	68.8	58.7	63.0	63.0
Voluntary	48.3	58.7	63.0	63.0
Oilseeds				
Compensation	94.2	81.7	72.4	63.0
Protein seeds				
Compensation	78.5	72.5	72.5	72.5
Beef[1]				
Intervention price	3475	3242	3013	(2780)
Basic price				2224
Milk[2]				
Intervention price				
Butter	328.2	311.8	295.4	279.0
Skim milk powder	205.5	195.2	185.0	174.7

[1] Price cuts are compensated for by a highly differentiated and therefore complicated system of payments per animal. For details see Regulation No. 1254 (Official Journal, L160, 17 May 1999).

[2] Beginning in 2005, price cuts are compensated for by payments per ton milk quota. The premium is set to 5.75 Euro/t in 2005 and increases in the following years. For details see Regulation No.1255 (Official Journal, L160, 17 May 1999).

Source: Agra-Europe, 1999, No. 21 (German Edition).

Compared to the original proposals by the EU Commission, price reductions are smaller and have partly been postponed to a later date. In addition the quota regime on the milk market is now extended until 2006. The regular compulsory set-aside rate is set to 10%, not to zero as proposed by the Commission. As before, it is allowed to grow renewable resources on land which is under the compulsory set-aside regulations and eligible for a premium. The compensation premiums paid for grain, oilseeds and set-aside will be equalized in 2002/03. Due to unpredictable developments on world markets, the WTO commitments (restrictions) on exports and export subsidies and the mentioned budget constraint, the (price) decisions for grain, oilseeds and milk will be under review in 2002/03.

Policies for Rural Areas

The implementation of Regulation No. 1257/99 on the promotion of the development of rural areas is intended to merge the policies which are directed towards rural areas[5] and thereby supplement the other traditional instruments of the CAP, i.e. market and price policy. Whereas the policy elements are basically the same as before, the support from the European Agricultural Guarantee and Guidance Fund (EAGGF) for rural development is now based on a single legal framework. The main objectives and policy areas are listed in Regulation No. 1257, Titles I and II. The policy areas could be classified basically into two groups, which, however, are not mutually exclusive. The first group includes policies which are intended to enhance efficiency in agriculture and downstream activities on the farm or sectoral level whereas the second group aims at the maintenance of the countryside and an improved environment. In addition, forestry (Title II, Article 29) and, finally, a wide variety of measures facilitating the conversion of farming activities to other rural activities are supported (Article 33).

Objectives and New Challenges

The detailed objectives listed in the Agenda 2000, the summit decisions and the respective regulations

[5] Among other former separate regulations, Regulation 2078/92 on agricultural production methods compatible with the requirements of the environment and the maintenance of the countryside are now included. For details see Regulation 1257/99, p. 81 (Official Journal, L 120).

extend the catalogue of basic objectives formulated in Article 33 of the EC treaty in the consolidated version by

☐ environmental goals and

☐ rural development goals, now merged in Regulation 1257/99.

The driving forces for the extension of the objective catalogue were manifold and interlinked. Firstly, there was the increasing external pressure on the EU to liberalize its trade regime. Secondly, this together with negative internal consequences of strong price incentives, i.e. high unsalable stocks and finally high budget costs as well as increasing environmental pollution (in particular ground and surface water) led to the agricultural reform of 1992 and the agreement in the Uruguay Round 1993.

Moreover, the environmental problems caused by intensive farming not only triggered administrative regulations to avoid environmental damage, i.e. negative externalities (fertilizer regulation, nitrate regulation etc.) but at the same time induced a discussion at all administrative levels on the potential positive externalities of farming. The outcome was twofold. It was postulated that there are positive externalities for which farmers have to be paid. Neither is the first part of this statement generally valid nor is the second part the necessary consequence of the first. Nevertheless, several objectives and financial instruments with respect to the protection of the environment and to the maintenance of the countryside were included in EU Regulation 2078 as well as national and regional programmes, and are now integrated into Regulation 1257/99 (see in particular Title I, Article 2).

The support of rural development seems to be the political reaction to the outmigration of labour from rural areas, which in turn is a consequence of sharp increases in agricultural labour productivity and only slowly increasing revenues. The scope and speed of this development differ widely between regions depending, among other things, on the existence and localization of alternative employment opportunities and the scope of the structural change needed in agriculture to adapt to current technologies and market prices.

With the planned enlargement of the EU and the WTO negotiations on the liberalisation of trade, the dominating objective of the CAP, income support for agriculture, is in permanent conflict with trade liberalisation. Since the negotiated decrease in internal support prices has seemingly been solved by direct (budget) payments, the budget restriction has come to the fore.

This is not only because of the necessity of budget consolidation in most European countries and the Maastricht criteria of 3% but in particular because of the planned enlargement of the EU. That would enlarge the arable area of the EU, which is the main basis for direct payments, by about 45%. The expected budget increase is considered to be politically unacceptable.

The income objective, i.e. pursuing the political objective of increasing the income of persons belonging to a specific sector, will lead to the increased attraction of resources to that sector. In the absence of market failure, this is incompatible with the general efficiency objective. Moreover, to refer in this context to Article 33 EC treaty is incorrect since there the increase in productivity is the vehicle "*thus* to ensure a fair standard of living" (our emphasis).

Although most of the other objectives seem to be compatible with an efficient market solution, their presence in current programmes (Agenda 2000) indicates that these are considered to be unfulfilled at the current level of intervention or that – at least – the current level of intervention is the supposed precondition for the fulfilment of the stated objectives. Therefore, the respective policies, i.e. objectives and instruments, should be evaluated together for efficiency and coherence.

Intensified Competition for Rented Land

As a consequence of the decisions on market and price policy (Table 1) the allocation of resources will generally improve, since the price gap to (lower) world market prices will be narrowed for the most important commodities and therefore the upward biased resource use in agriculture will decrease. However, this general result has to be qualified in several respects. The price cuts are compensated for by direct payments per hectare[6] or animal (beef and sheep) which will be paid in addition to the payments resulting from the 1992 reform. Since these transfer payments are not decoupled from current production and paid only to active farmers, the production incentives discussed above are only partly reduced.

However, the relevant incentive structure depends not only on the relative importance of producer prices

[6] The compensation for grain is about half the expected reduction in revenues. The final outcome for farmers' income depends on possible cost reductions, depending not least on factor ownership, in particular that of land.

versus direct payments but also on the ownership of land. Since land is the only – in total – fixed factor and under full capacity use, the supply is completely inelastic. Assuming that the supply of capital is highly elastic and the supply of labour inelastic only in the short term but elastic in the medium and long term and both factors are priced at their non-agricultural opportunity costs, then variations in farm revenues (producer price or direct payments) will translate to a large extent into variations in land rents and land prices. This mechanism will be the more direct the greater the share of land/animal tied payments in revenues, since these payments alter directly the marginal value product of land and only indirectly the product of the other factors.[7]

Rented land as a share of total cultivated land is already high (Table 2) and still increasing, in particular in those European countries where the farm size structure is not competitive in the face of falling product prices due to accelerated global competition. Moreover, for two reasons it seems plausible to assume that the competition for rented land is intensified. First, it is no longer an "intra-village" market where potential economic rents have been shared between neighbours. Rather farmers, because of the greater mobility of machinery, are renting land at larger distances from their main plot. This often goes together with shorter durations of land rent contracts. Second, the transparency of farm revenues for landowners has increased because of the increasing share of publicly known direct payments which – in case of set-aside payments – often function as a minimum land rent. Therefore, changes in farm revenues which include a growing share of direct payments will increasingly translate to changes in land rents and land prices. This will alter non-agricultural income, but farm income to a lesser extent. Therefore for farmers producing increasingly on rented land the above-mentioned political decisions will continuously lose relevance for their personal income from farming and their production decisions as long as land rents from farming are significantly higher than the opportunity costs. If the

Table 2

Land Ownership[1] of Farms in the EU

(EU Structural Survey 1997)

	Number of farms	Farm area				
	Total	Total	of which			
			Owned		Rented	
	1000	1000 ha	1000 ha	share (%)	1000 ha	share (%)
Germany	534	17160	6354	37.0	10806	63.0
France	680	28331	9879	34.9	18453	65.1
Netherlands	108	2011	1442	71.7	568	28.3
United Kingdom	233	16169	10545	65.2	5624	34.8
EU (15)	6989	128691	75930	59.0	52761	41.0

[1] Including partly rented and other ownerships.

Source: Agra-Europe, No. 48 (1999) IV, pp. 19-20 (German edition).

difference approaches zero, land will go out of production.

However, the current empirical situation in the EU seems in general to be far from one in which land rents are falling and land remains uncultivated because of a lack of profitability.[8] On the contrary, the instrument of compulsory set-aside payments[9] has been reactivated in order to reduce production and resulting budget costs for market interventions and export subsidies (Table 1). Since, at the same time, farmers receive compensation payments per hectare for farming above world market prices and special payments in so-called disadvantaged areas, the set of policies is inconsistent. The consequence is inefficiencies in the allocation of land, of which the most obvious relates to the non-use of productive land. The scarcity of land is increased and so are land rents and land prices.

Another source of inefficiencies is the strongly diverging protection rates for different commodities.[10] These differences, in particular between high rates for milk, beef and sugar on the one hand and relatively low, further decreasing rates for grain and oilseeds on the other hand, cause additional intra-agricultural distortions.

[7] For details see OECD: Adjustment in OECD Countries, Reforming Farmland Policies, Paris 1998, p. 62; J.-V. Schrader: EG-Agrarreform und GATT-Vereinbarungen. Vom Leistungseinkommen zur Quasi-Rente, in: Kiel Discussion Papers, No. 217, Institute of World Economics, Kiel 1993; J.-V. Schrader: Agrarpolitische Irrwege zur Bewahrung von Bodenrenten? Von Butterbergen zu Ökotälern, in: Kiel Discussion Papers, No. 325, Institute of World Economics, Kiel 1998.

[8] OECD, op.cit.

[9] As mentioned above, beginning in 2002/3 farmers have the choice between compensation payments and set-aside. This is a marginal improvement, compared to the prevailing regulation. However, payments are not completely "decoupled" from production since, e.g., in the case of the conversion to grassland this would not be eligible for payments and payments are coupled to the existence of the farm.

[10] This rests on the argument that similar effective protection rates will support a second-best solution. For qualifications with respect to the relevant elasticities see W. M. Corden: The Theory of Protection, Oxford 1971; and W. M. Corden: Trade Policy and Economic Welfare, Oxford 1974.

Rural Development Policies

The financial allocations to rural development measures will amount to slightly more than 10% of the total agricultural budget. According to Regulation 1257/99 the policies intend to accompany and complement the other instruments of the CAP.

The first group of policies, encompassing policies to enhance efficiency, channels financial resources to the agricultural sector in addition to the transfers which are part of the market and price policy. Contrary to what holds for the second group, those policies cannot claim justification because of externalities or other causes of market failure. Coming to investment aid first, the implementation of rules for the efficient allocation of capital to selected activities (commodities, types of farms, regions, etc.) requires information on the administrative level which is hardly available. The intended increase in competitiveness might be accomplished for the few farms chosen but not for the sector as a whole. The intrasectoral allocation of resources will be additionally biased because the supported farms will be privileged compared to farms not supported in the competition for scarce resources, i.e. in particular land.

The policies to support early retirement and at the same time the establishment of young farmers again are intended to improve sectoral efficiency. However, it is hard to conceive that regulating the number of farms (entrepreneurs) by premiums would improve allocation compared to allocation via the market, i.e. the decision of people according to their preferences and the relevant side conditions. On the contrary, given the need for structural change towards larger farms in order to increase labour productivity, which is on the agenda for many regions in the EU, incentives to increase the number of farmers (compared to the situation without premiums) increases the inefficiencies in a broader economic context.

Externalities

The second group of policies is directed towards environmental objectives. Farming can have negative as well as positive externalities.[11] However, the respective classification depends not only on objective criteria but to a large extent on the preferences of citizens. Negative externalities could be seen in emissions to ground and surface water, to the soil and to the air, as well as in the destruction or reduction of natural habitats (biotopes). These negative externalities are positively correlated with the intensity of land use, i.e. the share of land in agricultural use as well as the factor input per hectare, in particular the application of pesticides, herbicides and fungicides. Since the intensity of land use is basically a positive function of production incentives, the continuingly high price protection for most agricultural commodities as well as the obligation for farming to be entitled to compensation payments cause or aggravate negative externalities. Therefore, the first-best choice for the reduction of negative externalities is reducing politically caused production incentives, which cause welfare losses anyway. The internalization of remaining negative externalities will not be discussed here.

Positive externalities of farming can be seen

- in the preservation of certain scenic landscapes,
- in land conservation including landslide and flood prevention and
- in the stabilization of production systems which support a rich variety of flora and fauna.

Since in the current political debate these externalities are associated with both past and prevailing common and national agricultural policies there seems to be no reason for extra payments. Rather, these externalities seem to be the cost-free by-products of conventional agriculture, organized on the basis of private profitability considerations. However, a fundamental reform of the CAP towards liberal principles could endanger the profitability of farming and thereby the first two objectives because these are tied to specific forms of agricultural land use. The effects of a liberalization on the third objective seems to be ambiguous. First of all, the described extensive (low input) production system seems to be rare, given the strong incentives for conventional agricultural use. But if, on the other hand, this land has already to be considered marginal under prevailing economic conditions, it will go out of production and revert back to forest use or to natural succession in case of liberalization. This might serve the general objective of a renaturalization of habitats, but it might miss the preferences of the (local) population with respect to the land use structure and to the present endemic species. This is valid even if in other regions these (extensive) land use structure might develop as a consequence of reduced production incentives. If this description is correct, there should be payments to

[11] For details and an overview of the huge body of literature cf. OECD: The Environmental Effects of Reforming Agricultural Policies, Paris 1998.

the "producer" of a service, which keeps the land use in a condition preferred by the (local) population. This is not necessarily the traditional farmer or landowner.

The same argument holds true for the first two objectives. However, the regional scope of externalities or public goods with respect to natural habitats should be decisive for the allocation of competences for regulating and financing to the respective administrative level. If the public goods have only regional scope, the general joint financing with a share for the EU of 75% (EU Objective 1 regions) and 50% (other regions) respectively[12] causes moral hazard for regional administrations, which are in charge of the design and execution of plans. The consequence would be the excessive and thus inefficient provision of these public goods.

The policy of supporting forestry is to contribute to the economic, ecological and social functions of forests in rural areas. Again, it seems to be important to clarify the reference policy and the corresponding possible externalities of forestry. The prevailing policy is characterized by high protection for agriculture and very low protection for (private) forestry. Accordingly, the land use structure is biased towards agriculture. This could cause an underprovision of forestry and thereby an underprovision of forestry-related environmental social goods. If there were a general liberalization (of the reference system), this bias in the land use structure would be corrected. The opportunity costs for forestry land use would be greatly reduced if price protection for agricultural products, compensation payments and – in particular – payments for agricultural land use in disadvantaged areas were abolished. This would increase the forest area, because even without afforestation in most parts of Europe, the natural succession will develop to forest within 20 years. If this does not meet the preferences of the (local) population with respect to biodiversity or other environmental or social objectives, the preferences with respect to land use could be realized by payments to the supplier of these specific services, as argued above. Therefore the provisions in Regulation 1257/99 (Chapter VIII, Articles 30 and 31), which aim for an increase of forests and allow for annual premiums per hectare afforested to cover maintenance costs and loss of income resulting from afforestation, increase inefficiencies resulting from the massive, area-wide support of agricultural land use and seem to be a waste of taxpayers' money. The major effect will be an increase in land prices and land rents.

Multifunctional Role of Agriculture

The origin of the inefficiencies outlined above seems to be the political proposition of the multifunctional role of agriculture. The latter is defined by the Council as reaching "from production of food and renewable materials to the stewardship of rural landscapes and the protection of the environment. Agriculture's contribution to the viability of rural areas is also indisputable".[13] Or, more precisely, "the role of agriculture in contributing to the maintenance of employment in rural areas" is stressed.[14] Moreover it is argued, the above description is "the model of European agriculture", which is in accordance with the sustainability approach and should be promoted. The basis for the integration of the environment into the CAP is the definition of a reference system which is called "good agriculture practices". If agriculture provides services to the environment beyond the reference system, "these should be adequately remunerated".[15]

As to the integration of the environment into the CAP, the quoted reference system corresponds to the definition of property rights. However, this definition is rather vague: on the one hand it still allows pollution, i.e. negative externalities, whereas on the other hand activities like organic farming, whose positive environmental effects are disputable, or low input agriculture are remunerated.

At the same time, the classification of agriculture as multifunctional is – at best – a description of the activities of farmers all around the world. Therefore, the propagation of "the European farm model" based upon this is not a strategy for the agriculture sector, as stated by the Council.[16] Rather, it seems to be a diffuse political catchword which, however, is inapt to justify all the different interventions in the framework of the CAP.[17]

[12] For details see Regulation 1257/99, Article 47.

[13] European Community, Council of Ministers (Agriculture): Agriculture and Environment. Press Release No. 12917/99 on the 2218th Council meeting (Agriculture) of 15 November 1999 in Brussels, Annex: "Strategy On Environmental Integration And Sustainable Development In The Common Agricultural Policy Established By The Agricultural Council", p. 6. (http://ue.eu.int/newsroom/LoadDoc.cfm?M...C=!!!&BJD=100&DJD=59421&GRP=2089&LANG=1.

[14] Ibid., p.7.

[15] Ibid., p.7.

[16] Ibid., p.7.

[17] A. Swinbank: CAP reform and the WTO: compatibility and developments, in: European Review of Agricultural Economics, Vol. 26 (1999), No. 3, pp. 389-407, here p. 402.

With respect to multifunctionality it is land that allows for different uses such as agriculture, forestry, man-made habitats, wilderness, housing or infrastructure.[18] The role of the state at the different administrative levels should be seen as improving the definition of property rights and overcoming public good problems related to various environmental objectives, but not as the making of payments to traditional sectors.[19]

The other line of argumentation brought forward by the Council and subsumed under the "strategy for agriculture" is founded on the supposedly endangered viability of rural areas and – directly related – the maintenance of rural employment.

Although the share of agricultural employment in total employment is extremely diverse among European regions, the share is uniformly decreasing. The basically economic causes have to be seen in declining real producer prices, rather limited output increases per hectare and increasing opportunity costs because of increasing incomes in non-agricultural employment. The parallel increase in agricultural labour productivity because of new technologies and the related acceleration of structural change towards larger farms has been and still is reducing sectoral employment. This trend dominates in spite of massive subsidies for the agricultural sector from all public budgets and, often unconsciously, from consumers.

As a consequence in many rural areas and villages agriculture no longer dominates, neither in employment nor in GNP shares, and accordingly the viability of these and the social fabric in these areas no longer depend primarily, if at all, on agriculture. Therefore, the Council's perception that "agriculture plays an important role in contributing to the maintenance of employment in rural areas" is misleading in the dynamic perspective. It seems to be a historical view, at best, which is losing relevance even in scarcely populated rural areas. In any case, the Council's perception seems to be backward-looking and not a strategy for the future. If depopulation as a possible consequence of declining agricultural employment is considered a problem, which however is hardly convincing, at least in densely populated countries, the policy should focus on facilitating structural change rather than on subsidizing traditional sectors.[20]

According to the literature[21] the role of the state in rural development should be seen in overcoming the problem of incomplete and missing markets for public goods which – besides the environmental goods – have to be regarded, in particular with respect to transportation and to problems related to supply, as bona fide public goods, which would facilitate the regional development process. Arising out of more recent developments of market failure theory, the "new economic geography" of Krugman further addresses the problem of promoting investments involving external economies, which revived the debate on industrial policy in industrial countries.

Given postwar developments with major reductions in transport costs, and, more recently, the major progress in the availability of efficient information/communication links together with increasingly efficient capital markets, the role of governments should shift away from trying to direct real sector activity towards providing various forms of infrastructure (institutions) that allow private economic agents to interact quickly and efficiently with the increasingly global network of economic agents.[22]

Therefore, the heading of this set of EU policies (rural development) already seems to be inadequate. Even if there is no general unique understanding of what rural policy is about, at least there seems to be agreement in the literature that it is not the lopsided support of the traditional rural sectors, i.e. agriculture and forestry.

Distribution

The CAP has manifold distributional consequences. Two aspects shall be discussed in somewhat more detail. Firstly, there is the general redistribution

[18] David Zilberman, Scott R. Templeton, Madhu Khanna: Agriculture and the environment: an economic perspective with implications for nutrition, in: Food Policy, Vol. 24 (1999), pp. 211-229.

[19] This concerns particularly the estimation of the demand (quantity and quality of respective environmental goods) and the establishment of institutions which could bring about the efficient equalization of supply and demand. Cf. C. Lippert, H. Ahrens and M. Rittershofer: The Significance of Institutions for the Design and Formation of Agro-Environmental Policy, in: Volkswirtschaftliche Diskussionsbeiträge, No. 8, Martin-Luther-University, Wittenberg, Halle 1997; J.-V. Schrader: Agrarpolitische Irrwege ... , op.cit. The allocation of a certain share of the total area to environmental purposes as implemented by the EU directive on flora, fauna, habitat (ffh) in 1992 might be a first approach with low transaction costs, but it fails to achieve an efficient allocation of area for several reasons.

[20] A. Buckwell: Towards A Common Agricultural And Rural Policy For Europe, in: European Commission, Directorate-General for Economic and Financial Affairs (ed.): European Economy: Reports and Studies, Vol. 5, Luxembourg 1997, pp. 75 ff.

[21] For a brief overview on rural development theories cf. W. R. Ward and J. C. Hite: Theory in Rural Development: An Introduction and Overview, in: Growth and Change, 1998, No. 29, pp. 245-258. For a definition of "rurality" and an outline of rural development incentives cf. A. Buckwell, op.cit.

[22] W. R. Ward and J. C. Hite, op. cit., p. 255.

from both taxpayers and consumers to the farm sector. Whereas the share of consumer transfers in total transfers strongly dominated traditionally, it is showing a tendency to shrink because of the substitution of price support by direct payments which was initiated by the agricultural reform of 1992 (Table 3).

This policy shift is hesitantly continued by the Agenda 2000. However, as data for 1998 indicate, this principal tendency is concealed by extremely low world market prices, which increase consumer transfers, since they are calculated on the basis of the difference between world market and EU internal prices.

Beside efficiency gains in resource allocation, the shift in support for agriculture from price protection to budget transfers could be rated positive because the poorer segments of the population, which have a higher expenditure share for food, would be financially relieved. The unassertiveness of policy-makers in this direction could on the one hand be explained by the protests of farmers' organizations, which are afraid of budget cuts due to yearly debates on high spending on the farm sector. On the other hand, a politically predetermined support level for agriculture together with tight budgets at both the EU and the national level gives incentives to politicians to leave a larger share of agricultural support to consumers, since this support via higher prices is basically hidden from the public.

The second aspect to be discussed is more fundamental and touches the total amount of transfers to the sector and the underlying objectives. As has been argued above, the transfers to the agricultural sector cannot be justified by market failure. Moreover,

Table 3
Transfers to the Agricultural Sector from the EU and National/Regional Budgets
(ECU million)

	1986–88	1991–93	1996–98	1997[a]	1998[a]
Transfer					
from consumers	84084	79403	52444	48585	68979
from taxpayers	22555	44517	58542	60018	58558
Budget revenue	-4459	-613	-239	-91	-382
Total	102180	123307	110747	108512	127155

[a] provisional

Source: OECD: Agricultural Policies in OECD countries, 1999, p. 194.

sectoral employment objectives in addition to food production such as for example "the stewardship for the countryside" are hardly convincing. This is because on the one hand this activity is a costless by-product of farming and might in some respects even be in contradiction to environmental objectives. On the other hand, the policy shift towards more direct payments per hectare or animal reduces the support for capital and labour and thereby employment which, however, has to be rated positive with respect to the efficiency objective. But this poses even more emphatically the question as to the beneficiaries of the financial transfers.

Taking into account all the costs of administration (design, enforcement, control) and of fraud, which are the costs of imperfect administration, the net transfers reaching farmers are much lower than the gross transfers (Table 3). Abstracting from these "leakages" the politically declared addressees of transfers, the active farmers, are only to a certain extent the final beneficiaries. The extent primarily depends on factor ownership and the demand and supply elasticities on factor markets. The most important determinant is land ownership. Since the share of cultivated land which is rented surpasses 40% in the EU (15) and 60% in France and Germany (Table 2) with an increasing tendency, it is plausible to assume that – at least in the latter two countries – the greater part of transfers increases primarily – via land rents and land prices – the income/wealth of landowners who are not active farmers. Moreover, if landowners are urban dwellers, the transfers will even not reach rural areas. Empirical evidence is scarce, but in Western Germany, for example, 90% of the land rented is not owned by active farmers.[23]

Coming back to the original CAP objective of supporting farmers' incomes, the policies chosen are inefficient. Since the intended allocational objectives with respect to environment and rural development are also missed or could be achieved with lower costs by applying more specific instruments, the fundamental question on the indigence of farmers or – even more – landowners comes to the fore. There is neither statistical evidence nor convincing political arguments that farmers are *per se* in need of transfers. To poor farmers, according to general national standards and

[23] For more detailed information on the process of shifting agricultural transfers to landowners cf. A. Chatzis: Flächenbezogene Ausgleichszahlungen der EU-Agrarreform – Pachtmarktwirkungen und Quantifizierung der Überwälzungseffekte, in: Agrarwirtschaft, 1997, Sonderheft 154; and OECD, op. cit.

social security systems, direct personal transfers should be paid as for any other person in need.

Enlargement and the WTO

An important aim of the Agenda 2000 and therefore of the Berlin summit decisions has been the preparation of the CAP for the challenges of the next century, i.e. in particular for the EU enlargement and the next WTO Round on trade liberalization.

The EU enlargement, which is politically desired, will also undoubtedly have positive economic (welfare) effects at the aggregate level. However, there are some problem areas in the field of political and economic integration, of which agriculture and the CAP seem to represent a major stumbling block.[24] The reason has to be seen in differences between the two groups of countries with respect to

- economic development and income level,
- agricultural resources and sectoral employment structure, and – closely interlinked –
- agricultural policy.

The CEECs after the market liberalization of the early nineties had relatively low protection for the agricultural sector. Since then, the expected membership in the EU and internal pressure by farmers have led to a progressive adoption of CAP rules and to an increase in producer support in Poland,[25] one of the three largest countries (Czech Republic, Hungary, Poland).

The figures for 1998 are dominated by the low world market prices. However, what can be seen from the negative consumer support[26] is that consumers are strongly taxed in the EU and therefore an enlargement under the prevailing policy conditions, even if further price cuts from the Agenda 2000 are taken into account, would increase food prices in particular in the Czech Republic and Hungary.

These economic costs in addition to the costs related to the implementation of the "acquis communautaire" and the far-reaching agricultural regulations, in the view of candidate countries, seemed to be acceptable under the assumption that they wll benefit from transfers resulting from the CAP. This would be plausible insofar as all candidates, compared to the EU, have lower incomes (and therefore low future budget payments) and – most of them – a relatively large agricultural area per inhabitant. However, the financial framework discussed above hardly has room for expanding the direct payments to the new members since these payments, according to the Berlin summit decisions, will already increase in the old member countries.[27] The rejection of direct payments to accession countries will no doubt trigger other disputes, for example on the allocation of production quotas (milk and sugar). The allocation according to past production as probably proposed by the EU would be ill-founded since politically caused production incentives and – partly interlinked – productivity standards had not been adapted to EU standards. Therefore the exploitation of production potentials, which would be a more reasonable indicator for the allocation of production rights, is lower in accession countries.

Although these problems were debated within the EU for several years, the EU chose that policy option, which is characterized by the reform decision of 1992 and the Agenda 2000, out of three, including price protection, production quota and direct payments. The traditional (before 1992) as well as the liberal policy alternative were neglected.[28] However, direct payments to farmers in only one part of the European Union would be in conflict with the efficiency objective. These payments, as defined and extended in the framework of the Berlin summit decisions, are not neutral with respect to resource allocation. Even if these payments were strictly decoupled from production and paid only for a restricted number of years, a convincing reason would be lacking under allocational and distributional aspects. A strict phasing out of all subsidies has to be considered superior to a subsidy payment compensating older subsidies.[29] If the time span for adaptation is adequately chosen, this policy will also not be in conflict with the trust of entrepreneurs in governmental economic policy.

Strictly differentiated from compensation should be payments for natural habitats, endangered species or cultural landscapes according to the preferences of the (local) population. On the one hand, preferences and willingness to pay differ widely between people, regions and countries, but are positively correlated

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[24] A. Buckwell and S. Tangermann: The CAP and Central and Eastern Europe, in: P. G. Hare (ed.): The transition to the market economy: critical perspectives on the world economy, 1997, No. 4, pp. 32-69.

[25] OECD: Agricultural Policies in OECD Countries, Monitoring and Evaluation, Paris 1999, p. 167.

[26] Ibid., p. 181.

[27] H. Stolwijk and M. Merbis: The Berlin compromise of Agenda 2000, Central Plan Bureau, Report 94/3, 1999, pp. 13-18, here p. 16.

[28] A. Buckwell, op. cit., p. 25.

[29] J.-V. Schrader: Agrarpolitische Irrwege ..., op. cit. p. 18.

with income. On the other hand, supply costs differ depending among other things on land scarcity which, for example, is less pronounced in most CEEC's. Cross-border "markets" for these goods and services could, therefore, even enhance efficiency. A good example might be endangered species where the necessary habitat could be offered at lower costs in an Eastern European country whereas the demand and financing will come from richer and more densely populated areas in western countries. The implementation of institutions which could alleviate these processes should be an urgent task of negotiations on enlargement.

What follows from this discussion is that the CAP and not agriculture is a major stumbling block to the enlargement of the EU. The politically decided budget restrictions would be in conflict with the implementation of the unaltered CAP in the new member countries. Although the budget and in particular the agricultural guideline seem to be arbitrary, the way out should neither be an expansion of the budget nor the limitation of direct payments to "old" members but a market liberalization including the cessation of direct payments which are politically founded on the – disputable – idea of compensation.

WTO Negotiations

Though the WTO opening talks in Seattle in 1999 about an agenda for a new round on trade liberalization were not successful, the negotiations on agricultural trade liberalization were resumed in Geneva in March 2000.[30]

In the field of agriculture, the main topics are again the reduction of export subsidies and the extension of market access. Very low world market prices for most food commodities will make progress difficult to achieve. As far as these topics are under dispute only with respect to quantitative questions and definitional problems (e.g., should food aid be included) but not in principle, the continuation of "blue box" measures (such as the direct payments in the EU) is under attack from EU trade partners, since these measures are obviously not decoupled from production. Other disputes relate to food safety (animal hormones, genetic engineering etc.), environmental and social standards and animal welfare. Moreover the EU position of defending a "European farm model" based on the multifunctionality of agriculture will not alleviate trade talks and will support the sentiments of trade partners who accuse the EU of new forms of protectionism. Therefore the thesis, "If CAP reform is decided before the next round of WTO negotiations, the changes adopted will reflect clearly the international constraints on the EU and will strengthen the EU in the WTO round",[31] which was derived from a game-theoretic analysis, seems to be falsified.

Summing up the problems the EU is facing – the general inefficiencies of the CAP, the planned enlargement, the resumed WTO negotiations, the compliance with former WTO commitments resulting from the Uruguay Round, and the internal budget commitments – the Berlin summit decisions seem to be inapt. This is not only because of insufficient market liberalization but also for reasons of principle. The extension of direct payments and their substantiation with compensation concepts as well as payments for positive externalities and rural development confuses problems which could much better be tackled separately.

Elements of a Fundamental Reform

The CAP is only one element of the European Union's activities. However, not only historically but under budgetary and institutional aspects it is still a core part. Therefore, the fundamental reform of the CAP has to be discussed in close relation to institutional reforms and the resulting distributional consequences.

There seems to be widespread agreement among agricultural policy analysts that the CAP is inefficient and that there is a need for fundamental reform.[32] As discussed above, this judgement still holds after the

[30] For an overview cf. K. Anderson: The WTO Agenda for the New Millenium., in: The Economic Record, Vol. 75 (1999), No. 228, pp. 77-88; A. Swinbank, op. cit.; T. E. Josling and S. Tangermann: Implementation of the WTO Agreement on Agriculture and developments for the next round of negotiations, in: European Review of Agricultural Economics, Vol. 26 (1999), No. 3, pp. 371-388. For a detailed analysis of previous negotiations and remaining tasks cf. T. E. Josling, S. Tangermann and T. K. Warley: Agriculture in the GATT, Houndmills 1996; and S. Tangermann: The European Union Perspective on Agricultural Trade Liberalization in the WTO, University of Guelp, Ontario 1999.

[31] W. D. Coleman and S. Tangermann: The 1992 CAP Reform, the Uruguay Round and the Commission: Conceptualizing Linked Policy Games, in: Journal of Common Market Studies, Vol. 37 (1999), No. 3, pp. 385-405, here p. 403.

[32] For some more recent publications cf. A. Buckwell, op. cit.; F. Heinemann: EU-Finanzreform 1999. Eine Synopse der politischen und wissenschaftlichen Diskussion und eine neue Reformkonzeption, Gütersloh 1998; European Commission, Directorate-General for Economic and Financial Affairs: EC agricultural policy for the 21st century, in: European Economy: Reports and Studies, Vol. 4, Luxembourg 1994; E. Rieger: Agenda 2000. Reform der Gemeinsamen Agrarpolitik, Gütersloh 1999. However, because of the EU policy networks and institutional structures there is scepticism that a fundamental reform of the CAP, i.e. a "Third Order Change", could be brought about. Cf. C. Daugbjerg: Reforming the CAP: Policy Networks and Broader Institutional Structures, in: Journal of Common Market Studies; Vol. 37 (1999), No. 3, pp. 407-428.

Agenda 2000 proposals and the Berlin summit decisions. Although some decisions have to be rated positively central problems of the CAP have not been tackled or have even been worsened:

- the liberalization of markets has been continued only hesitantly; important markets are still exempted, and quantitative production restrictions (production quotas, paid set-aside of land) prevail,
- the political guarantee of income for a sector is continued since price cuts are compensated for by direct payments without time restrictions. This is not only detrimental with respect to incentives for entrepreneurs but could not be justified by distributional or other reasons which are related to environmental or rural development objectives,
- environmental and rural development objectives are increasingly but inadequately confused with farm support.

The superior alternative to the CAP even after Berlin would be complete market liberalization and the cessation of all budget payments to the farm sector which are not related to the supply of public goods. The cessation should include payments in the social sector which sometimes add up to half of the national agricultural budget (Germany) and are often used to hide subsidies to the agricultural sector. After a transition period to adapt differing social systems, the same rules as in other sectors should apply. On the other hand, against the backdrop of the sector's particularities it might be worthwhile analysing the role of governments in the implementation of insurance schemes, for example against natural disasters, if private systems are lacking.[33] Payments for environmental goods should be directed to the suppliers of these goods. Rural development policies should not be confused with farm policy. Competencies with respect to regulation and finance (environment, rural development) should be allocated according to the regional scope of externalities or public goods respectively, whereas state aid control should remain at the EU level.

The doctrine of reliance suggests compensation in the case of an abrupt policy change. However, because adequate compensation is anything but trivial and will generate a bundle of new problems, politicians should abstain from compensation. The policy change should take place within a period of five to seven years. The adaption of prices and budget payments should begin only two years after the announcement and should advance progressively, so that the economic consequences are small at the beginning. This leaves time for personal adaption and for the depreciation of investments. The strain which nevertheless will hit many farmers (families) should be compared to adaption necessities and processes in other sectors and not to agricultural standards, since farmers have traditionally enjoyed privileged treatment.

As far as the final desirability of such a fundamental policy reform is concerned, there seems to be a relatively broad consensus among analysts in general. However, this theoretically efficient solution is frequently criticized as purely academic since its implementation is unlikely because of the opposition of potential losers in the democratic political process. According to these critics, to bring about a transition it is necessary to reduce the incentives and/or opportunities of these losers to block reforms and/or to organize the winners, i.e. interest groups which support the reform. Moreover, to secure the reforms once they are achieved, a credible institutional commitment by governments is necessary.[34]

Coming to the problems of transition and of incentives first, these have to be discussed not only with regard to farmers but also with regard to nations, since France in particular would be a "loser" due to the implicit transfers resulting from the CAP.[35] The incentive problem for farmers to accept a fundamental reform has been debated for more than 20 years and resulted in a great number of scientific recommendations for compensations which differ with respect to the (quantitative) basis (revenue/income foregone, land), time horizon and time dependent modulation (time restricted or unlimited, progressive or degressive, annual payments or a capitalized once and for all lump sum). The suggestions are based on the conviction that some kind of "lubrication" for the transition process is needed.[36] However, with regard to the idea of a buy-out or compensation, the specific outline of the scheme is important. Differentiating only between two schemes, the one preferred by most economists, namely time-restricted personal income

[33] A. Buckwell, op. cit., p. 63.

[34] E. Rieger, op. cit., p. 56.

[35] For details and quantitative assessments cf. J. Begg: Reshaping the EU Budget; Yet Another Missed Opportunity? in: European Urban and Regional Studies, Vol. 7(2000), No. 1, pp. 51-62; F. Heinemann, op. cit.; and Wissenschaftlicher Beirat beim Bundeswirtschaftsministerium: Neuordnung des Finanzierungssystems der Europäischen Gemeinschaft, in: Agra-Europe, No. 3 (18. 01. 1999), Dokumentation.

[36] A. Buckwell, op. cit., p. 83.