WHITHER THE EUROPEAN AGRICULTURAL POLICY?

A viable reform of the CAP in the context of an enlarged EU and the Doha Development Round

KURT WICKMAN

TIMBRO

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PREFACE

The Common Agricultural Policy (CAP) in the European Union is beset with many problems, but two of them are of immediate concern.

Firstly, the CAP is a perpetual blow to the Doha development round. Partly due to disagreements between EU member countries on the future of the CAP, the WTO negotiations have been delayed. Moreover, a new agriculture agreement in the WTO, with substantial improvements in market access for agricultural produce from the developing world, is a centrepiece of the new round, and Europe's inability to reform its deeply flawed agricultural policy is threatening the whole negotiations to derail.

This will not only damage world trade and jeopardise other possible agreements in the new round. It will also render the EU a justified loss of respect in world affairs and, clearly, do much harm to the ambition of the EU to help poor countries to develop.

Secondly, no one truly believes that the Franco-German agreement from last autumn on agricultural subsidies and the up-coming accession of the new member countries – or, for that matter, the recent proposal on the future of CAP by the EU Commissioner for Agriculture and Fisheries, Franz Fischler – are sustainable. On the contrary, none of them addresses the institutional problems that almost have turned the CAP into a farm lobby caucus, and without significant institutional reforms an enlarged EU will arguably lead to an enlarged CAP with even less strength to reform it self. This will probably cause quite severe policy conflicts between different groups of member countries in future. Hence, the EU runs the risk of containing a mechanism that will prevent it from being an efficient organization capable of finding better solutions to problems in European and world affairs.

Most people with insights in the European agricultural policy have recognised the need for a reform that re-arranges the institutional setting of it. However, few (if any) viable proposals on the reform design have been presented. The Swedish government, in theory if not in practice, seems still to be inspired by the liberalization of Swedish agriculture in the late Eighties (before Sweden joined the EU), and has recently suggested that European agricultural policy should be re-nationalised. Since earlier attempts to substantially as well as marginally reduce agricultural subsidies have failed, it arguably makes sense to transfer this policy field to the national arena. Even more so since every member country is aware of the need for a reform, but collectively unable to succeed with one.

The idea of re-nationalization is not new. Such a reform was outlined two years ago in a Timbro study by Dr Kurt Wickman, economist at Gavle University, Sweden, and Chulalongkorn University, Thailand. Due to the latest developments in the EU enlargement process and the Doha round, Dr Wickman has expanded the analysis of a new agricultural regime in Europe, and in this new study describes the nuts and bolts of a re-nationalization.

Dr Wickman's reform proposal is, to my knowledge, the most viable solution to the CAP problems that has so far been presented, even though he is the first to admit that the competition from other proposals has not been strikingly impressive.

The lack of other viable proposals only makes this study even more important.

Stockholm, February 2003
Fredrik Erixon
Chief Economist, Timbro

EXECUTIVE SUMMARY

- Agriculture has for a long time been a central policy field in the European Union. The Common Agricultural Policy, CAP, now embraces approximately 90 % of all agricultural output within the EU. Farms in the EU receives around 35 % of their income from subsidies (in 2001). About half the EU's annual budget – something like € 40 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.
- CAP is beset with problems. EU consumers pay a high price for food. Large amounts of taxes are spent on farm subsidies and competition is hampered by important barriers – tariffs, for example. EU consumers pay roughly 80–100 % more for their food than would be the case in a mature free-market régime.
- CAP slows down economic growth in developing countries. Farmers in developing countries are unable to sell their produce in the EU at competitive prices, because their products come up against tariffs, and CAP provides EU farmers with export subsidies enabling them to dump world market prices. The ensuing swings in prices tend to obstruct the economic flows which could generate the capital to finance agricultural productivity improvements and industrialisation.
- CAP subsidies to agriculture stand in the way of a historic mission for Western Europe (EU-15) – to integrate former communist countries into a United Europe of democracies. An almost Byzantine set of rules has been introduced on "eligibility" for agricultural subsidy. It solves a small problem in the short run but sows the seeds of major long-term problems for the Union.
- The problems of CAP are not new. Attempts have been made, through the recent Fischler reform proposals (2002), the Agenda 2000 reform (1999) and the MacSharry reform earlier in the 1990s, to come to grips with the worst consequences. But most often this has merely shifted problems to other areas. The present report sketches a strategy for swiftly reforming the EU into a free food market where 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, for several reasons but mainly so as not to upset world market conditions 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 percentage units of the subsidies disappearing annually.

- The phase-out of farm subsidies should be made a national policy issue. At the common EU level the customs union will still apply, with a common trade policy and a single market. EU "federal" representatives will guard a set of de-regulation rules, but no longer distribute any subsidy. Re-nationalisation of agricultural policy is expected to reduce the effect of lobbying by agricultural interests, since they will be forced onto a level where voters and taxpayers have more control over what happens. EU-level institutions (the Commission, the Council of Ministers) have proven to be almost surprisingly inefficient at reforming agricultural policy – in spite of widespread support for doing just that. The different EU institutions are even at odds with one another whether to reform or not.

INTRODUCTION

Agriculture is a leading policy area in the European Union. It is perhaps 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. Agriculture's contribution 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 this political theory and practice. At the heart of things we have 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, to be fair, 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 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.

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 (including the enlargement problem) and the recent (1999–2002) reform proposals. Some of these are trade-related, but some also affect other parts of the EU's external political or economic relations. The immediate background to the most recent reform proposals is the East European enlargement of the EU. Several of the 10 prospective new members have a substantial agricultural sector, larger than that of the present EU's 15 members.

I

HOW DOES THE CAP WORK?

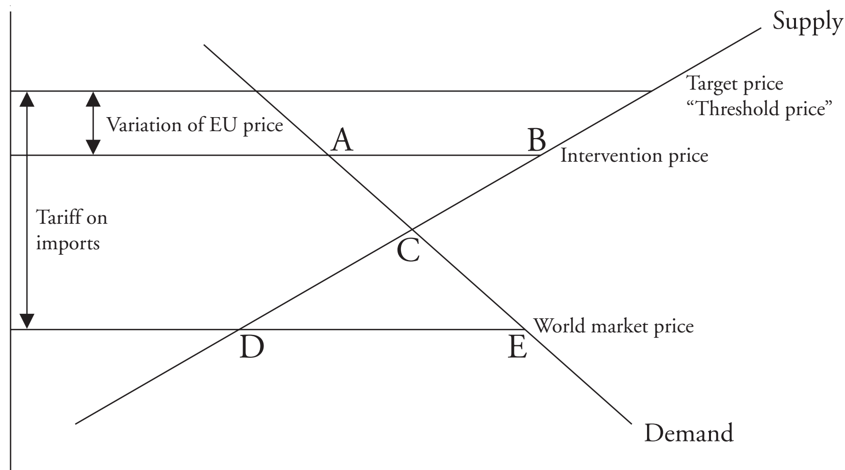
CAP is an EU-wide policy, comprising around 90 % of all agricultural products. It replaces national agricultural policies in order to guarantee free trade in agricultural products within the Union. It is also constructed to diminish imports of most agricultural products into the Union. There are a number 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.

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 régime 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.

But it would not be the best position for producers. All farmers with production costs above that of the world market price would be unable to compete. If EU food markets should move to a pure market regime, the long-term goals of agricultural policy would have to be abandoned. That would especially go for "self-sufficiency" and "preference for home production".

As an adjustment to producer interests, cereals are 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 the 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 ("intervene") and buy the surplus at the level of the intervention price. It is below the target price, which shields EU farmers from foreign competition.

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 return to. The average oversupply in the present EU (2003) is a mighty 25 % – which means that EU is self-sufficient in agriculture at the 125 % level.

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. As these negotiations go, deals seem normally to be rounded off to the *highest* common denominator. 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".

Over time, the relative level of the "intervention price" has been falling somewhat. It is, however, well above the world market price. OECD estimated recently that in the year 2000 food consumers paid around € 48 bn more than they would have paid with a free-market régime in food.

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.

For the year 2000, the (annual) budget cost was around € 40 bn. Of these around € 10.8 bn went on price support, € 25.5 bn on direct payments or income support and € 4.2 bn on rural and environmental support. Such a huge subsidy will in all normal cases substantially influence land use decisions in the EU – and only to a lesser degree be guided by original demand for food and environmental services.

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.

Partly through the subsidy effect, 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”. The contagion factor was especially visible in East European countries with large export ratios. Poland is the most obvious example.

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 offsetting 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.

The observation that world market food prices at time can swing substantially, is often combined with another observation in discussions over CAP philosophy. Demand for food tends to fall as a ratio of total demand when income rises – this is the so-called “inferior-goods problem”. The immediate consequence is that it will create a downward pressure on farm incomes.

SPECIFIC CAP PROBLEMS

EU consumers pay high food prices. Compared to a free-market régime – 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 2000 EU agriculture absorbed the various kinds of political support at a total value of around €90 billions. Direct costs in the form of producer and export subsidies were estimated to be around €50 billion. Transfer of resources from consumers to producers through price regulations (Diagram 1) was estimated to be €40 billion. Secondary costs, like storage costs for the excess supply, or specific tax breaks for food producers are not considered in these estimates. It is not easy to see the rationality of a policy with such a strong producer orientation.

Present extra costs (over free-market prices) to consumers (December 2002) 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 that EU consumers pay on average almost double the input price for food that they would pay in a mature and complete free market régime. The final price difference (what consumers pay in the store) would be smaller, but still substantial.

This has created a growing pressure on EU politicians to reform the CAP. But despite a string of reform proposals since the late 1960s, policy changes have come to very little. Instead the observation reigns supreme that the combined support levels and price regulations have shifted successively upwards, aggravating the problem. The producer bias in the policy seems to be triggered and to take over as soon as a reform movement starts.

The support system promotes not only self-sufficiency, but exclusion of efficient outside producers. If a policy creates more trade than it distorts (for which read: shifts trade away from the most efficient producers), it will stimulate higher incomes. In such cases it should be pursued. If – on the other hand – it distorts more trade than it creates, it is by definition protectionist and should be avoided. CAP is an unusually clear case of the latter.

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, the EU is a centre for manufacturing exports in the

world. It 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. In both these – strategic – respects, EU interests incline 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 adjudicated 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 have been visible: 1) US authorities respond by blocking EU agricultural exports, causing the traditionally deep "Atlantic" political relations to deteriorate; 2) It becomes harder for the EU to engage in promoting world trade in other, more important, areas. Suspicion will surround EU initiatives – also from the developing countries, which suffer most from the closure of EU agricultural markets.

CAP AND THE DEVELOPING WORLD

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.

One reason why CAP is especially problematic – some would say contradictory – in this respect is that the EU wishes to promote a "social element" in its foreign policy: the crucial social ingredient is a wish to help developing countries grow. The most efficient way of providing such support and make it long-term is to give developing countries access to the domestic markets for products where they can compete successfully. Foremost among such products are agricultural and light industrial goods. But CAP protectionism in general rules out such a 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 compensate protectionism through non-sustainable international interventions, namely foreign aid.

Some basic industrialisation patterns from economic history underline the problematic character of the "CAP obstruction" of the problem of development: firstly, 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 .

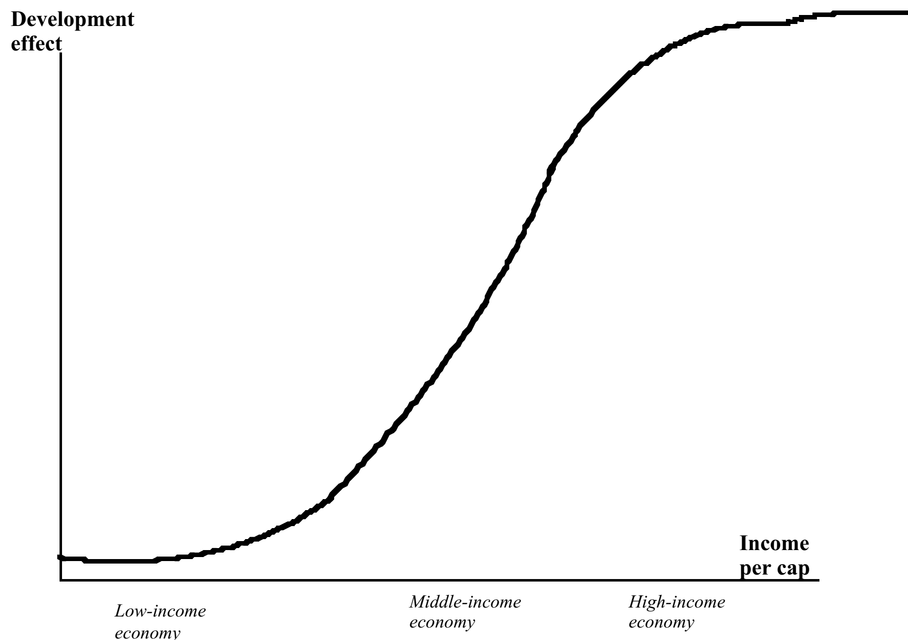
The second is that the introduction of an export pattern into a backward economy helps it “plug into” the world economy, accelerating the move towards division of labour (specialisation). In this way, the developing economy can speed up its industrialisation drive and receive international price signals – 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.

EU authorities have claimed to address this problem by singling out the poorest 49 countries and offering them a wider access to the European market. Even if this measure, in principle, is a reasonable step towards promoting development through trade, it is too half-hearted to merit much praise. In reality, it gives an impression of being negotiated with an eye to traditional producer interests in the region. Important products like sugar and rice are excluded. And import flows from countries with a technically primitive (and mainly self-sustaining) agricultural sector will always be small. As a consequence, the “development effect” of this trade will not be substantial.

To maximise the development effect of trade, the quite general step should be taken to open up the food and light industry markets to all developing countries. This seems to be a general result in development economics, which also can be qualified further. The strength of the effect seems to follow a normal logistic curve: to illustrate this point a logistic curve is drawn in Diagram 2.

Diagram 2

Development effect of a free-trade régime with economies at different income levels



The logistic curve illustrates our point of different effects of trade for developing economies at different income levels. It should be noted that we are only observing developing economies in Diagram 2. The illustration is that a free trade régime will produce different overall growth (or development) effects for economies at different income levels.

- for low-income developing economies it is low and rising. The "low" result is mainly explained by the circumstance that an economy characterised by self-sustaining agriculture can only partly absorb world market price signals.
- for middle-income developing economies it is high and rising. This is where the development effect is highest.
- for high-income developing economies it is high and falling. The reason for the development effect from agricultural trade falling is simply that exports move away from agricultural products. A higher developed economy will rely more on industrial and service exports.

From all this we conclude that the CAP – even with the reform to allow market access for 49 low-income countries – blocks most of the development effect that a free-trade régime would offer.

CAP AND THE ENLARGEMENT PROBLEM

CAP makes enlargement of the EU harder. The most important task confronting the EU for the moment – apart from the currency union problems – is to successively integrate former "East European bloc" countries into the Union. Integration has been made more difficult by the CAP, since 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 for the 10 prospective new member economies suggest that without reform it would increase the EU budget by around € 20 bn.[1] There is, however, a large variation in estimates of these costs. The largest takers are Poland and Hungary.

The decisions so far have been to "phase in" farmers from new member countries by restricting CAP-based payments substantially. The "CAP subsidy rights" for new countries from 2004 will be following this phase-in schedule:

Phase-in scheme for new member countries

Year	Per cent	Estimated Cost, € mn
2004	25	1211
2005	30	1464
2006	35	1743
2007	40	
2008	50	
2009	60	
2010	70	
2011	80	
2012	90	
2013	100	

1 This estimate is made by the Dutch government, reported in The Economist October 5, 2002.

The “estimated cost” column is based on 1999 prices, and it should be noted that it comes into a wide variation of estimates (meaning uncertainty) concerning new member CAP costs. But even if we disregard that, it is not a far-fetched conclusion to believe that this kind of subsidy engineering will integrate deep future contradictions into the union. It is never an easy task to operate a club with very different rights for different groups of members. And if new member politicians are successful in making this 10-year plan more generous, will the Western old members be willing to pay for keeping inefficient (and superfluous) agriculture alive?

It seems as if there is also a “CAP contagion” involved in the wider integration process. Several of the East European countries that are to be members now or later have moved towards an agricultural policy with protectionist features. Some of these features – not only in Poland, but also for instance in Bulgaria and Romania – bear a suspiciously close resemblance to those of the CAP. This at the moment is especially conspicuous in the case of Poland, where the subsidy ratio of farm income has been raised above that of the 1990s – contrary to a general worldwide trend. The impression is that future Eastern members are anticipating membership in the CAP and on this basis adjusting through more agricultural subsidy and protectionism.

CAP BREEDS EXTERNAL…

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 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 could be considerable.

The conflicts with the US has both a deeper and wider world policy background. The world-wide trade agreements in the so-called Uruguay Round (1986–94) meant a commitment for agriculture also to reduce all subsidies and open up domestic markets to exporters from everywhere. Of the 121 members in the WTO a significant number regard liberalization of food trade as one of the most important issues. The Doha agreement – starting the next trade round negotiations – reflects this composition of WTO membership and takes the agricultural trade issue further.

The Doha Development Agenda was negotiated in November 2001 and contained an explicit section on agricultural trade. In its agreed text on agriculture, members are committed "to establish a fair and market-oriented trading system through a programme of fundamental reform encompassing strengthened rules and specific commitments on support and protection in order to correct and prevent restrictions and distortions in world agricultural markets".

This quite far-reaching commitment means "comprehensive negotiations" aimed at: "substantial improvements in market access; reductions of, with a view to phasing out, all forms of export subsidies; and substantial reductions in trade-distorting domestic support".[2] The underdeveloped countries are explicitly given a longer adjustment period to introduce a free-market regime. So the main burden for moving the world market towards openness falls almost entirely on the EU, USA and Japan.

The time table is relatively strict. On March 31st 2003 all the "modalities" (EU-speak for suggested rules and restrictions) to accomplish the free trade target should be presented. They should be (countrywise) advanced at the 5th Ministerial Conference, in Mexico later in 2003. The deadline for signing the new trade treaty is January 1st 2005.

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2 For full texts on current WTO agriculture negotiations, go to http://www.wto.org/english/tratop_e/agric_e/negoti_e.htm.

…AND INTERNAL CONFLICTS

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 mainly supports farming that could compete on its own. Farm production in the EU is highly centralised. A statistical rule-of-thumb is that 20 % of the farms in the Union produce 70 per cent of the food. On the other side, the 40 % smallest farms produce only 5 % 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 inspires doubts concerning 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. This implies that they will use subsidies for "external" purposes, other than those intended: 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 land 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 means 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 too 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 falling 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 is that the Union gets a distorted production structure of the industry as a result.

IV

A RADICAL REFORM PROPOSAL

The history of the Common Agricultural Policy goes back to the basic Rome Treaty of 1958. Its basic structure was formed during the 1960s, and it has stayed remarkably unchanged in spite of other extensive political changes in the European Union. One stable impression is that the CAP has proved hard to reform, in spite of ambitious attempts at times to do just that. It might even be described as a paradox – practically everyone in leading political or administrative circles in the EU thinks that the CAP should be reformed, but it stands unaffected anyway. Yet, reform is what has to happen – to finally give EU consumers (and taxpayers) what they see as a fair deal and restore international credibility to the EU project.

Future moves will be towards a free market régime. It is not easy to see how a specific sector like agriculture could manage to stay out of the general drive towards internationalization. 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, "The Doha Development Agenda", 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. EU negotiations so far have already committed the union politicians to move significantly towards free trade in agricultural products. The "Doha agreed text on agriculture" reflects mainly the interests of developing countries to get access to the rich countries' markets.

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 interests 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 current world market price. CAP was in other words shifting trade towards inefficient producers on a world scale.

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.[3]

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 was to "decouple" support from production level, and instead redirect 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.

3 The US has shifted its policy focus under the new Bush administration. Traditional farming subsidies have been reintroduced large-scale. Even if the level of protection of US agriculture is still well below that of the EU (around half), the Bush subsidies open up for questions as to where this administration is taking the US in coming WTO negotiations on agricultural trade.

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 "Euro-speak" 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.

…AND THE FISCHLER TRIAL

In the recent mid-term revision of the CAP policy, the present Commissioner for Agriculture and Fisheries, Franz Fischler, maintained the line of reform from MacSharry and Agenda 2000:[4]

- Subsidies should be de-coupled from production for strategic goods like cereal, beef, sheep, oil-seed, rice.
- Total budget expenditure should stay at € 40 bn.
- No single farm should get more than € 300,000 in subsidy.
- Direct subsidies should be reduced by 21 %, with some exceptions for small farms.
- Subsidies should be considered with a stronger emphasis on environmental, animal welfare and food safety standards.
- Introduction of a new farm audit system.

From this set of proposals, it is obvious that the Fischler reforms did not aim at a general overhaul of the CAP system. The intention seems rather have been to repeat some of the highlights in Agenda-2000 and adjust CAP a step or two in face of the harshest critical points:

4 Communication from the Commission to the Council and the European Parliament on the Mid-term Review of the Common Agricultural Policy, 10 July 2002. Council Doc 10879/02 COM (02) 394.

- Production to maximise subsidies should be avoided by delinking production and subsidies
- The budget for CAP should not be allowed to expand, which meets the demands of the largest net contributor countries (Germany, Britain, the Netherlands, Sweden)
- The strange redistribution of wealth (to the richest farmers) should be reduced by the cap on what any single farm is allowed to absorb.
- Reduction of subsidy levels is in line with commitments in the Uruguay Round and also in anticipation of the coming world trade negotiations ("The Doha Round")
- EU tax-payers' willingness to finance the CAP has been drastically reduced after a series of scandals on how the money is used. First, the dioxin scandal, the BSE crisis, the foot-and-mouth ordeal have all caused concern of health effects of eating EU food; second, transport subsidies have been over-used, entailing unnecessary and painful travel for animals; third, CAP encourages intensive agriculture with its emphasis on large chemical input, causing environmental problems.
- A better audit system would make it easier to control mis-reporting or direct fraud to absorb CAP subsidies.

RESISTANCE TO REFORM

It seems clear that all known reform proposals are to no avail, at least for the moment. There is no real political reform process underway. Enlargement will happen with a number of agriculture-intensive economies. The public choice logic of this is that the CAP will stay on indefinitely.

The most active politicians to de-activate both the Agenda 2000 and the Fischler CAP reform have been the French, the most determined among them President Jacques Chirac. It is not far-fetched to sense the influence of the French farm lobby behind these endeavours.

In a letter to a number of leading European newspapers in late September 2002 farm ministers actually defended the indefensible. The letter was drafted by the French farm minister Hervé Gaymard and was signed by the farm ministers from Luxembourg, Spain, Portugal, Austria, Ireland and Belgium (the Walloon part). In this letter it was stated that all is well with the CAP, and that the policy actually protects third-world farmers from themselves, trying the folly of moving from subsistence farming to cash crops.

The French political leadership of the pro-CAP movement can be commented upon. French politicians seem to have a distinct "fear of the street", probably based on the circumstance that the next election is never far off. Opinion polls in France balance the small number of active farmers (4 % of the population) with a larger group, having "strong agricultural attributes" (13 % 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 a left- or right-wing majority will be returned 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. In particular, the greater EU interest in the upcoming WTO talks means that there is stronger international pressure for change than ever before . One indication of this is that a fairly far-reaching Agenda 2000 reform proposal could pass the farm ministers' council: with watering-down results in some respects, but surprisingly little in others .

All this might indicate a new climate for reform, sometimes stressed by the reform-inclined Commission. 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 cannot 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 phase-out period to re-nationalise the subsidy programmes. 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 in 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 see that EU politics has pushed prices for food high. 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 price swings generated by EU dumping.

The sort of (agricultural) trade philosophy that, for the moment, has deep roots in the lobbying groups, tends to regard trade in a traditionally mercantilist manner: export is a victory and import is a concession. This trade policy tradition is represented in political circles in many parts of Europe, most notably perhaps in France. The most vocal supporters of such trade theory are, however, the special interest groups that are favoured 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 "under-production", 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 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. If world population curves are flattening out – as an effect of rising world per capita income – growth in 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 cost than 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 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 can still 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 the healthfulness (or otherwise) 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 politically 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 EU tax-payers that are paying them. When governments promise more subsidies to farmers, they are at the same time telling EU citizens that they will raise their taxes to finance the policy. But for 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 regarded 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 for 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 programme.

Subsidies for export and for expanding production further should be abolished immediately and altogether. There is no need for them in a region that is 125 % self-sufficient. Income-based subsidies, on the other hand, 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 programmes during the "degressivity period" redresses the balance between farmers' special interest groups and political accountability. EU farmers have concentrated massive lobbying power on the EU level, where political 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 tax-payers and farm lobbies: an elected parliament is directly responsible to its citizens for budgetary provisions. The control of and farm subsidies resistance to their further expansion are 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, quite a number of them, 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' output 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 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.

The re-nationalisation programme would, third, solve at least one sticky problem in the enlargement puzzle. The new members would never be phased into a "federal" subsidy policy. If the new members should choose to subsidise their agricultural sectors in the future, they would have the right to do so for five years, and direct the subsidies in such a way that they prepare farms to change into normal market economy firms. Because of relatively lower farm labour costs in Eastern Europe, many agricultural firms would probably be competitive after the transition period.

THE DOHA AGREEMENT AND CAP REFORM

A fourth problem – and maybe the most important – that would be solved by our re-nationalisation programme would be that of giving EU negotiators a consistent agenda in the upcoming world trade talks (The Doha agreement).

Already in the Uruguay round, Third World countries wanted to integrate agriculture into the trade talks. They probably felt short-changed when US and EU stalled these talks. The compromise they got as to the CAP was that the EU promised to reduce subsidies by a little more than 20 % over several years. It was an uneasy compromise, but that promise was all the poor countries got.

With a re-nationalisation reform, third World countries would get most of what they have been demanding for at least two decades. In spite of important moves in the wrong direction lately, spokesmen for the Bush administration in the US have promised to take upcoming de-regulation talks seriously. Whatever that promise means, it is nevertheless CAP that poses the decisive problem, because of its magnitude, about double that of the US subsidy programme.

The most important issue for the entire EU economy in the "Doha round" will be to liberalise trade in financial services, secondly in manufacturing products. To be successful in those respects, it seems problematic if the EU representative should run into a "negotiation bottleneck" as to agricultural trade.

A "Doha round" holds a promise for the world to manifest the ongoing globalisation process into a firm set of long-term trade rules. But the political aspect of the process has come to the position, that it can't proceed much further if the EU refuses a deep reform of the CAP.

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. They 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 should 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 – and this is 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 running the CAP policy on a private basis would be strictly illegal – contrary to EU competition rules, for one thing .

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 anomaly of the most efficient farms getting most subsidies. This has happened in spite of the “re-distribution 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 SEVEN MISALLOCATIONS OF THE COMMON AGRICULTURAL POLICY

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 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 up to twice as much for food items 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. The aftermath of such swings seem to linger on – they do not pass of quickly.

4. Trade conflicts with USA (bananas, maize, beef) and the developing world (general protectionist interpretation of CAP rules) have made the 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 programmes is always a second-best solution.

6. CAP makes the important enlargement issue harder. By allowing low-cost, highly agrarian, former Eastern bloc countries as members into the union, CAP contributes to a potential budget crisis (of some kind). New and complicated ad-hoc rules have been introduced, to make enlargement possible in the first place.

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 for the budgetary frictions to go on. Countries are divided politically in negotiations on CAP policy issues, the dividing line drawn by the fine distinction whether a country is a net payer or net taker of agricultural subsidy.

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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