CENTRE FOR EUROPEAN REFORM
policy brief

Why Europe deserves a better farm policy

By Jack Thurston

★ The EU's common agricultural policy (CAP) remains an emblem of inefficiency and inequality, despite substantial past reform. It distorts the EU single market; it fails to increase the efficiency of European farming; and it principally benefits the biggest farms in the richest EU countries.

★ Powerful farm lobbies are likely to prevent a radical overhaul of the CAP in the near future. However, the debate about CAP reform will return with renewed vigour in 2008, when the Commission reviews it.

★ When it comes, CAP reform should include moving payments from trade-distorting subsidies towards supporting national and regional strategies for food policy, rural economic development and conservation.

The prospects for radical CAP reform look bleak. At the time of writing (December 2005) neither the arguments over the EU budget nor pressure from major farm exporters at the world trade negotiations look likely to force the EU to reform The resistance to change is too strong. The French-led coalition of countries defending the status quo is more united than the group that favours reform In theory, EU ministers decide on agricultural issues by qualified majority voting. In practice, however, EU ministers are reluctant to put any country in a minority and consensus is the general rule. This makes it relatively easy for vested interests to block decisions. The farming lobby is better organised and more effective than the loose coalition of consumer groups, Greens and development NGOs which seeks to challenge the CAP.

However, as the battle over the CAP turns into a proxy for a deeper debate about Europe's future, the pressure for change will continue to grow. The battle-lines are being drawn for a major confrontation in 2008, when the European Commission next reviews the CAP. In the forthcoming review, all three aspects of the CAP will be in the spotlight: the CAP's system of artificially fixed prices could face pressure from tariff reductions agreed in the framework of the World Trade Organisation (WTO); the overall size of farm payments will have to shrink if the EU countries are to agree on future EU budgets; and pressure groups will continue to push the EU to place greater emphasis on environmental protection and rural development in the CAP.

In order to win the argument, the British government and other advocates of reform will need to show that they want to improve rather than abolish the CAP. It is a sad reality that agriculture ministers meeting in Brussels are more focused on how much money their country receives than on the CAP as an effective policy. Reformers must work within that reality.

There are currently eight EU countries that receive more from the CAP than they pay into it.[1] At the top of the list is Spain (with a net positive balance of €2.5 billion), France (€2.1 billion), Greece (€2 billion) and Ireland (€1.3 billion). At the other end of the spectrum, the CAP's biggest paymasters are Germany (net negative balance

[1] *Net CAP balances are calculated by deducting each country's CAP receipts from its CAP contribution, assumed to amount to 45 per cent of its total payments to the EU budget (the CAP represents 45 per cent of the EU budget).*

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of €3.2 billion), the UK (€1.3 billion), Italy (€1.3 billion) and the Netherlands (€1.1 billion). The challenge would be to persuade the countries in the middle – in particular the new member-states – that they will be better off with a reformed CAP. This means focusing CAP support on smaller farmers, of which there are a disproportionate number in Central and Eastern Europe.

The core of any CAP reform must be a further shift away from trade-distorting subsidies. Instead, the EU should work with the grain of national and regional strategies for agricultural production, rural economic development and conservation. The EU should also move towards a system that allows the governments to top-up CAP payments out of national budgets (called co-financing in EU jargon). A CAP reformed along these lines would deliver better value for money, solve some of the EU's budget problems and enable the Union to engage more effectively in trade negotiations.

A policy in search of a purpose

Today's CAP is the outcome of historical compromises, not economic logic. Every time the EU has partially reformed the CAP, it has come up with a new reason for continuing the policy. Initially, the CAP was aimed at ending food shortages; then at supporting farmers; and more recently at protecting the environment. So before the EU embarks on new reforms it should analyse the CAP's rationale.

There are three possible reasons why the EU – rather than individual member-states – should formulate, implement or pay for a particular policy. First, doing things at the EU level may be more efficient. Pooling resources on a grander scale can make production more efficient and reduce costs (an effect that economists refer to as economies of scale). A policy or initiative may simply be too expensive to be financed by one country alone. Airbus – the European aircraft maker – is a case in point. Second, the EU can help to shift resources from richer to poorer member-states and so contribute to the EU's avowed objective of cohesion. The 'structural funds' for supporting poorer countries and regions are a mechanism for doing this. Third, the single market requires that all member-states adhere to the same rules in many areas of economics and business. For example, the single market can only function with commonly accepted product standards and competition rules. Is it possible to justify the current CAP in any of these terms? The short answer is: No.

First, there are no economies of scale in farm production that merit EU sponsorship, except perhaps in agricultural research and development. Second, contrary to what advocates of the CAP claim, agricultural subsidies do not promote redistribution from rich urban regions to poorer rural ones. On the contrary, the CAP transfers more money to the wealthy European and Nordic countries than the poorer Mediterranean and East European countries. The main reason why the CAP does not help redistribution is that the highest subsidies still go to those products that are mainly farmed in the EU's six founding members, namely beef, sheep, oats, sugar, milk, durum wheat and rye. None of the new member-states in Central and Eastern Europe is currently a net beneficiary. The EU decided to gradually phase in CAP direct payments to the new members, starting with 25 per cent of what the EU-15 received in 2004 and rising to reach their full entitlement by 2013. But even by 2013, the Central and East European countries will receive less per hectare and per farmer than the old member-states, because their farms yield less and are more labour intensive. Under the current rules, the average payment per hectare would be €183 in the new member-states, compared with €256 in the EU-15.[2] And the average payment per farm worker would be €1,708 in the new member-states, compared with €5,115 in the EU-15.

[2] Calculations based on Annexes VIII and VIIIA of Regulation (EC) No 864/2004 http://europa.eu.int/scadplus/leg/en/lvb/l11089.htm.

Not only does the CAP favour richer member-states, it also disproportionately benefits large, wealthy farms. Some 80 per cent of CAP payments go to the largest 20 per cent of farms. In 2002 (the most recent year for which distribution figures are available), 70 per cent of farms in the EU-15 received less than €1,250. In France, the largest one per cent of farms receive more subsidies than the smallest 40 per cent of farms combined.

The third possible reason for justifying the current CAP – that it supports the EU internal market in food – does not stand up to scrutiny either. The EU needed common farm policies when the CAP mainly consisted of fixing prices at artificially high levels: any attempt to fix prices at different levels in different countries would have been incompatible with the European common market. But now that price fixing is less prevalent, and the CAP is shifting towards direct income support payments (from this year no longer directly linked to farm output), this argument for the CAP is much weaker.

CAP advocates also argue that since every developed country supports its agricultural sector, it is better to have a common EU policy than a free-for-all of national subsidies. However, the EU could ensure fair competition simply by developing tough state aid rules for agricultural payments – this is how the EU regulates subsidies in almost every other area of economic activity. Moreover, even under the current CAP, farmers in the individual member-states are already receiving vastly different levels of agricultural aid.

In spite of all the reforms implemented since the 1990s, the CAP remains largely what it was when it was first created: an EU-administered policy to reward large-scale and resource-intensive agricultural production. Such a policy may have been justified after the Second World War when Europe experienced food shortages, but it is now outdated. That is why each of the three components of the CAP is now under scrutiny: price supports, direct payments to farmers, and the rural development and conservation policy.

Fortress Europe

The most wasteful and pernicious aspect of the CAP is its complex system of artificially high 'support prices'. In the past, high prices encouraged farmers to produce vastly more than consumers wanted. The result was the EU's infamous wine lakes and butter mountains. The EU then had to spend vast amounts to buy up surplus output and either dispose of it or dump it on the world food market with the help of export subsidies. Over the last 15 years, the EU has cut support prices for many products. Prices for wheat, maize and oilseeds are now very close to prevailing world market prices. But in other areas, price fixing is still pervasive. The EU has been paying its sugar producers three times the world price. But a ruling by the World Trade Organisation against the EU led the member-states in November 2005 to agree on a 36 per cent cut in European sugar prices. Beef and poultry farmers receive double the world market price. And EU farmers enjoy a 30 per cent premium for milk and pig meat. Altogether, price supports cost the EU €58 billion a year: half the OECD's estimate of total government support to EU agriculture. Artificially high farm prices create a hidden tax on food which costs an average European family an estimated €500 a year. As the poor spend a high proportion of their income on food, the burden of the CAP falls disproportionately on those who are least able to pay.

Moreover, fixing prices is not an efficient way to support farmers since most of the benefits do not accrue to them. EU subsidies drive up not only food prices, but also the prices of land, farm machinery and so on. The OECD estimates that 36 per cent of the money goes to companies selling farm machinery and chemicals, while a further 26 per cent goes on higher rents and land prices. Only 25 per cent of the €58 billion spent on price supports actually ends up in the hands of farmers.

Last but not least, CAP price fixing is holding up a global trade deal. When the current round of global trade negotiations was launched in Doha, the EU pledged to make "substantial improvements in market access" in agriculture. The condition was that the EU's major trading partners made similar moves in agriculture, and concessions in other sectors like services and manufactured goods. In October 2005, the US made an ambitious offer for cutting farm tariffs. The EU trade commissioner, Peter Mandelson, responded by offering a cut in EU tariffs by an average of 44 per cent, with even bigger cuts on the highest tariff rates. Commissioner Mandelson insisted that these cuts would not endanger the CAP. However, any reduction in tariff levels would increase the amount of agricultural products entering the EU and therefore drive European support prices down towards world prices.

Surprisingly, EU farmers are not the only supporters of CAP price fixing: many developing countries would like to preserve the system too. The EU's 'everything but arms' agreement gives the 50 least developed countries (LDCs) quota-free and tariff-free market access for all their exports bar military hardware. This preferential access allows LDCs' farmers to produce cheaply and then sell to the EU at the artificially high price maintained within the single market. Farm goods from other countries, meanwhile, are kept out by high EU farm tariffs. Any reduction in EU tariff rates would reduce the value of the LDCs' preferential access and thus contradict the declared objective of the Doha Round to help developing countries trade their way out of poverty. So LDCs, and the NGOs that seek to help them, have found themselves in the awkward position of defending 'Fortress Europe' in sectors such as sugar, where significant trade preferences exist.

The challenge for those who advocate CAP reform is to find a way of mitigating the impact of the abolition of price supports on these vulnerable countries. They must show that a development strategy that relies so heavily on narrow trade preferences is ultimately misguided. It locks countries into a dependency on commodity exports and does not stimulate sustainable, market-driven economic growth. The EU's trade preferences are also bad for development in two other ways. First, they entail strict 'country of origin' rules, which means that products containing ingredients from multiple countries do not enjoy trade preferences. These rules cover even the most basic ingredients, such as the packaging materials for salad vegetables. Second, the EU's system relies on 'tariff escalation', which means higher tariffs on processed products than on raw commodities. As a result, developing countries are discouraged from moving up the value chain in agriculture. Rather than becoming coffee-roasters and chocolate-makers, they have to stick with exporting coffee beans and cocoa.

Ironically, the developing world faces many of the same challenges as Europe's own farmers. LDCs must move from aid dependency to market-orientated production – farming the products that consumers will buy rather than those that governments will subsidise. Hence CAP reforms that reduce trade preferences should come with adjustment assistance to help LDCs take advantage of genuine market opportunities.

Social welfare for farmers

While the global trade talks are focused on the EU's tariffs, the big debate within the EU is on the €44 billion of subsidies paid to EU farmers. Most EU countries are facing budgetary constraints. The six biggest contributors to the EU budget are trying to secure tighter spending limits for the EU's next financial perspective (budget) that runs from 2007 to 2013. The British Prime Minister Tony Blair has also tried to deflect attacks on the UK's budget rebate, arguing that it is not appropriate to spend 40 per cent of the EU budget on direct payments to farmers. He claims that the unequal distribution of CAP payments, which favours France above all others, is the only reason the UK needs a rebate at all.

The bulk of CAP payments come in the form of direct income support to farmers. These direct payments were originally meant to compensate EU farmers for the 'losses' they suffered when the EU cut its support prices for farm goods. However, since enlargement, the 'compensation' argument has quietly been dropped.[3] Now CAP defenders talk of two new justifications: income support for farmers, and payments for observing EU regulatory standards.

3 Since farm prices in Central and Eastern Europe were much lower than in the EU, the EU initially said that Eastern European farmers would not receive direct payments upon accession. After hefty protests from the accession countries, however, the EU then agreed to phase in direct payments over a period of ten years. Since farm prices in the new members are rising at the same time, these payments cannot be termed 'compensation'.

If the CAP is about income support, it is quite unlike any other social welfare system. Its payments are not means-tested; there is no upper limit on how much income support can be claimed, nor any maximum time period for eligibility. Payments are not linked to the prevailing income levels in the rest of society. Because many payments are calculated on the basis of past subsidies, it is possible for two identical farms to grow the same products and receive completely different subsidies.

Some CAP defenders have advocated direct payments for farmers as a recognition of their contribution to protecting Europe's pastoral landscape. They claim that Europe's farmers are at a competitive disadvantage because they must meet the high standards of environmental protection and animal welfare required by EU legislation. However, this system of rewards is very crude. The size of payments is not linked to any real measure of environmental management or animal husbandry. In theory, a farm may have all its payments withheld if it is found to be falling short of the required standards. In practice, there is little evidence that member-states have either the administrative capacity or the appetite to withhold payments. More fundamentally, the concept of paying farmers not to pollute or otherwise degrade the environment appears to contradict the 'polluter pays' principle, which is enshrined in the rest of the EU's environmental policies. Despite these problems in justifying direct payments, the shift from price fixing towards direct income support has had a number of positive effects. The overall cost of the CAP to EU citizens has fallen and farmers have become more responsive to market signals. The EU has been able to argue in global trade talks that the bulk of its farm payments are "minimally or non-trade-distorting". Perhaps most importantly, the reforms have opened up a debate about what the direct payments should support.

Conservation and rural development as the new CAP

Since 1999 the EU has sought to give the CAP a new purpose. Faced with growing criticism of the narrow focus on agricultural production, the European Commission bundled the EU's disparate policies on conservation and rural development into a new 'second pillar' of the CAP.

Under the second pillar, the EU and its member-states can pay farmers for specific environmental improvements, or help them diversify into more competitive niches. Member-states are required to co-finance projects out of national budgets, as is the case with the EU's structural fund payments. EU governments are also free to make voluntary top-ups, so the second pillar reflects national policy priorities much better than the first. Austria and the Nordic countries, for example, pay a lot more for rural projects than the UK.

However, in terms of EU funding, the second pillar has continued to lag far behind the first. In 2004, it represented just 12 per cent of all CAP spending financed by the EU. For the 2007 to 2013 financial perspective, the Commission has proposed a 25 per cent increase in spending on the second pillar. However, such an increase can only take place if the overall size of the EU budget increases – something that is staunchly opposed by the big member-states. On the contrary, the 2002 deal on agricultural spending makes it more likely that second pillar payments may even be cut. The deal – worked out between France and Germany and then backed by the other EU countries – freezes the amount of direct payments to farmers throughout the next budget period of 2007 to 2013. The deal, if strictly interpreted, implies that any cuts to the overall CAP budget would be borne by the second pillar.

But even if the EU revisited the 2002 deal and decided to put more money into the second pillar, it would have to think carefully about the different objectives it is trying to achieve, namely environmental protection, rural development and food quality. There is no doubt that environmentally-friendly programmes bring broader benefits for society than old-style farm subsidies. However, they can suffer from the same unintended side effects. If payments for environmental management just serve to inflate land values and rents, they will deliver few direct benefits to farmers. The second objective, rural development, also raises some difficult questions. The economic significance of agriculture is dwindling. Hence it is not clear why rural economic development should fall under the EU's agricultural policy rather than under the existing structural and cohesion policies – or be delegated to the member-states. Although small-scale farming helps to maintain Europe's pastoral landscape, there is no obvious reason why the EU rather than member-states or regional governments should be responsible for small farm policies.

The Commission has set great store by the third objective, that of supporting the production of high-quality food. However, it is questionable whether EU and government intervention can stem existing trends towards mass production of cheap foods. Critics also argue that consumers are able to express their preferences about quality, price and other attributes when they buy their food. The role of governments should be limited to helping farmers adapt to changing consumer tastes and making the case for high-quality or artisan products.

Why is the CAP so resistant to change?

There are three reasons why the CAP has proved so difficult to reform: the delicate balance of power between EU member-states; the rules for taking decisions on agriculture; and the entrenched nature of the farm lobby. The EU's larger member-states are split on the issue of farm reform. France leads the CAP defenders, including Spain, Portugal, Ireland, Austria, Greece and Belgium. The pro-reform camp includes the UK, Sweden, Denmark and, at times, Italy, the Netherlands and Germany.

Germany holds the swing vote in the farm policy debate. As the EU's chief paymaster, Germany has taken the lead in efforts to contain the costs of the CAP. At the same time, Germany has treaded carefully on CAP reform, so as not to undermine its close relationship with France. How Germany's new government will strike this balance is not yet clear. The new chancellor, Angela Merkel, is generally in favour of reform and, unlike the French president, Jacques Chirac, has no historic links to the farm lobby. However, Merkel's farm minister, Horst Seehofer, comes from the CSU, a party with strong links to Bavarian farm interests.

The position of the new member-states from Central and Eastern Europe is similarly uncertain. Although they are not (yet) net beneficiaries from the CAP, they are unlikely to back radical reforms. Farmers are an important political constituency in many of these countries, often represented by their own 'rural' and 'peasant' parties in parliament. Poland, where one-fifth of the population still relies at least partly on income from farming, has the strongest agricultural lobby. Hungary and the Czech Republic have more developed and competitive agricultural sectors and have shown openness to more market-orientated policies.

EU agriculture ministers somehow have to try and reconcile these conflicting positions. Because decision-making in practise is consensual, defenders of the status quo can quite easily threaten to veto reform. As a result, reform packages have aimed to ensure that each farm minister can claim to have won some benefits for his or her rural constituents. The commissioner responsible for making proposals on the CAP tends to be more reform-minded than most national agriculture ministers. But since the Commission is responsible for finding compromises, it must strike a balance between advocating reforms and respecting national interests. The EU's co-decision procedure (whereby the Council and the European Parliament jointly decide) does not apply to agricultural matters. Member-states have thus excluded the European Parliament from decisions on the CAP. It is sometimes argued that if the European Parliament were given more responsibility for agricultural policy, it would help to reform the CAP further. But that is by no means guaranteed: the Parliament's producer-orientated agriculture committee is even less reform-minded than most member-states.

The entrenched position of the farm lobby has probably been the biggest barrier to change. However, its monopoly in the policy process is slowly being challenged. The growing emphasis on conservation, rural development and food quality is evidence of the rising influence of other interest groups, such as environmental activists. Food scares, such as BSE ('mad cow disease'), have drawn attention to the shortcomings of the CAP as a food policy, while development NGOs have raised awareness of the damage that EU policies inflict on the third world.

However, these new lobbies have so far failed to bring about root and branch reform. They have sought to graft new environmental or rural development policies onto the CAP, rather than challenge the core structure of the policy. Yet international development and consumer groups have not managed to win over sufficient public support for their very radical reform proposals, such as ending all farm subsidies. At least for the foreseeable future, it is highly unlikely that interest groups will be strong enough to deliver the kind of change that is needed.

Time for a new approach

Tony Blair has broken with 20 years of British diplomacy, by offering to trade the British budget rebate in exchange for a fundamental rebalancing of the EU budget. This was a sensible move and Blair now needs to win over more EU countries to support his position. The following steps could help him enlarge the pro-reform camp:

★ **Pursue realistic reform objectives**

Some advocates of CAP reform are calling for the complete renationalisation of farm policies in the EU. However, to build a broader coalition, the reformers should start with more modest objectives that elicit support from a wider public. For instance, they should advocate a gradual opening of the EU's markets, and a transfer of money within the EU from richer to poorer farmers and countries, to underpin the EU's cohesion policy.

★ **Widen the coalition of states that would see benefits in CAP reform**

A coalition for reform must include any country which would gain from an EU budget focused on competitiveness and cohesion rather than farm subsidies. Top of this list are the new member-states, all of which would benefit from any EU policy that redistributed from rich to poor EU member-states. Germany, the Netherlands and Italy are large net payers who could be brought on board. Portugal has long felt unfairly treated by the CAP, particularly in comparison with Spain and Greece, which are major beneficiaries. Denmark and Sweden have strongly supported reform in the past and would complete a powerful reform coalition. This coalition must reach beyond farm ministries that are often captured by farm lobbies, building alliances with finance ministries and those responsible for environment and international aid policy.

★ **Agree a strong review clause**

The Commission has already scheduled a review of the CAP for 2008. The scope of this review has not been announced. When an EU budget deal is clinched, reformist member-states should lock in a wide-ranging mandate for the 2008 review.

★ **Launch a debate about co-financing**

Farm sectors across the EU vary widely, as do preferences for farm support policies. It makes sense to allow countries to supplement EU farm payments through co-financing from national budgets. Co-financing should be voluntary, and the EU should initially set strict upper limits. These could then be raised over time, as EU funding is reduced. Eventually, only countries with a per capita GDP below the EU average should be net recipients of CAP funding from Brussels. Although France is currently opposed to any co-financing, it may rethink its position in the long run: projections suggest that it stands to become a net contributor to the CAP after 2013.

★ **Provide more transparency**

Public opinion surveys show that Europeans know little about the objectives of the CAP and care even less. However, recent revelations about massive subsidy payments to blue-blooded land owners and multinational food companies have stimulated a wider debate about what European taxpayers are getting for their money. Under new EU rules on public access to information, requests for information about CAP payments have been made in more than a dozen member-states. The information obtained has been made available on www.farmsubsidy.org, a searchable online database of farm subsidy recipients. More transparency in the operation of the CAP will fuel a better-informed public debate about its future.

★ **Mobilise small farmers**

The majority of Europe's 11 million farms are small and many farmers do not live off farming alone. Some have diversified into tourism by running bed-and-breakfasts, while others treat farming as a hobby. In the new member-states many holdings are subsistence farms that exist mainly to feed their owners. These smaller farms receive nowhere near the level of subsidies of the large 'barley barons'. Winning over this constituency to the case for reform should be a priority. Increasingly, organisations representing small farms (such as the Confédération Paysanne in France and FARM in the UK) are breaking ranks with the mainstream farming unions to become vocal critics of the CAP.

In the long run, the EU's increasing diversity will put intolerable pressure on the one-size-fits-all model of the CAP. An EU of 27 member-states (after the accession of Romania and Bulgaria) will include a vast array of economic, social and environmental conditions in its rural areas. That is why the second pillar of conservation and rural development will continue to grow in importance. It has started to give member-states the opportunity to tailor policies to national and regional needs. It also offers the prospect of a more effective use of public money.

Rather than continue as an outdated, divisive and inefficient entitlement system for large farms, the CAP must evolve into a flexible framework for the countryside – a co-ordinated set of policies covering farming, food, environment and rural development. However, greater autonomy for member-states in choosing policies must bring with it greater national responsibility for funding them. Reform along these lines would at one stroke help to modernise the EU budget, free up more resources for poorer member-states and make it easier for the EU to engage with the global economy.

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