

THE COMMON AGRICULTURAL POLICY AND INTERNATIONAL TRADE IN AGRICULTURAL PRODUCTS¹

This article reviews the structure, operation and effects of the Common Agricultural Policy. First, the objectives and mechanisms of the CAP are outlined, together with the changes in the European Community's trading position. This is followed by an examination of the costs of the CAP to the European Community, a discussion of the international effects of the CAP and the implications of it for New Zealand. The article concludes with a review of the possibilities for reform of the CAP.

Introduction

September 1986 marks the beginning of a new round of talks within the forum of the General Agreement on Tariffs and Trade (GATT). With signs of rising levels of international protectionism, world trade in agricultural products is expected to be a principal focus for discussion. New Zealand and Australia will be among a number of countries arguing for agricultural products to be more fully integrated within the GATT provisions. The aim will be to reduce or at least contain the spread of agricultural trade barriers and export subsidies. This article outlines the basic structure, operation and effects of one of the most significant distortionary influence on world trade in agricultural products — the Common Agricultural Policy (CAP), operated by the European Community (EC).

The Basic Structure and Operation of the CAP

The CAP is a system of policies developed to promote objectives laid down by the Treaty of Rome in 1957 — namely farm income support, technical efficiency in agriculture, price stabilisation and food security (i.e. assured food supplies). The three operational principles on which the CAP is based are free trade within the Community, preference for member countries' products, and joint financial responsibility for the protection and support mechanisms.

Support for EC agricultural producers is provided both by generally maintaining prices for their products

above world market levels, and by protecting domestic producers prices from outside competitors. There are three main instruments of price support, variable levies on imports (to ensure that imports do not undercut the domestic product), intervention purchasing arrangements (under which government agencies purchase and stockpile products to maintain market prices at or above specified intervention prices) and variable export subsidies (to bridge the gap between internal market prices and prices on world markets). Aside from these price support mechanisms, there are other forms of assistance, storage subsidies for producers, subsidies to offset high production costs and 'deficiency payments' to allow high domestic prices for consumers to be reduced, 'voluntary' import restraints negotiated with countries which export to the EC, and minimum import prices. Dairy products, beef, and sheepmeat are mainly supported by a combination of variable levies on imports, intervention agency purchasing and export subsidies. For meat there are also 'headage' payments (payments per animal), and for sheepmeat, voluntary restraints on imports.

The CAP has been in place since 1957, but the marked turnaround in the agricultural trading position of the Community is a more recent development. Initially one of the world's largest importers of agricultural products, it is now the world's second largest exporter. Although a net importer of beef and veal in the early 1970's, the Community is now the world's largest exporter of beef and it presently holds large beef intervention stocks. Sheepmeat is the only meat for which the Community is still a net importer, but the outlook is for sheepmeat imports to decline since EC production is expected to continue to rise faster than consumption. The EC also holds large and growing stocks of other products, including butter, wheat and milk. Although up-to-date numbers are unavailable, Table 1 highlights the shift in EC external trade in agricultural products.

Footnote: The major sources for this article were: The Australian Bureau of Agricultural Economics: *Agricultural Policies in the European Community: Their origins, nature, effects on production and trade.* Policy Monograph No 2 Canberra 1985. Schmitz, G. *The International Repercussions of EC Agricultural Policy*, *Intereconomics* No 6 Vol 20 1985.

Table 1
EC External Trade in Agricultural Products

Product	1976	1977	1978	1979	1980	1981	1982	1983
Net Trade(1)								
Wheat	+2.4	+0.9	-	+3.9	+6.1	+10.7	+10.8	+11.5
Sugar	-0.4	+0.1	+2.0	+1.7	+2.5	+3.3	+3.7	+2.6
Sheepmeat	-0.3	-0.3	-0.3	-0.3	-0.3	-0.2	-0.3	—
Butter	-6.0	+140	+119	+389	+481	+373	+292	+250
Cheese	+47	+84	+106	+151	+200	+213	+276	+292
Beef and Veal	-198	-210	-215	-63	+333	+389	+160	+165

(1) Net imports are denoted by a minus sign and net exports by a plus sign. Units: wheat, sugar and sheepmeat — million tonnes; all others — thousand tonnes.

Source: Bureau of Agricultural Economics, Australia.

The Costs of the CAP

There are three elements to the economic costs of this protection and support, costs to consumers in the form of domestic prices which are above world prices, budgetary costs to taxpayers, and costs to the economy resulting from the misallocation of resources.

Support for producers in the form of artificially high prices represents an implicit tax on EC consumers. This implicit tax, estimated at 30,600m ECU or NZ\$45,000M in 1984, constitutes the largest element in the transfer of resources to the agricultural sector and represents between one-half and two-thirds of the identifiable cost of supporting the CAP.

A more direct but somewhat smaller cost is that to EC taxpayers through the European Agricultural Guidance and Guarantee Fund (the mechanism through which the CAP is financed). For 1984, the Australian Bureau of Agricultural Economics estimates that this cost to taxpayers was 19,000m ECU (NZ\$34,000m), or more than half the total EC expenditure budget of 27,000m ECU. The cost to taxpayers has risen rapidly since 1982, and although export subsidies remain substantial, much of this increase is due to rising storage costs and rapid increases in expenditure on domestic disposal of surpluses.

The costs to the EC economy arising from a misallocation of resources are more difficult to quantify. However, it is clear, given the magnitude of the assistance accorded to the agricultural sector, that the effect on other sectors in the EC economy is likely to have been pervasive and damaging. The import restrictions and export subsidies place an implicit tax on non-agricultural EC exports and an implicit subsidy on imports of manufactured imports. One Australian study suggests that in the absence of the CAP, EC manufactured output (i.e. volume) could have been 4 per cent higher in 1983. This estimate combined with known output/employment responses implies that employment in the manufacturing sector, about 34 million in 1983, could have been between 0.5 and 1 million higher. (EC employment in agriculture in 1983 by contrast was just 7 million.)

Some International Effects of the CAP

EC production and consumption levels are large relative to the world trade in agricultural products. Accordingly, relatively small changes in the balance between EC production and consumption can have a substantial impact on volumes traded internationally

and on world prices. The net effect of changes in this balance in recent years has been to depress world market prices, increase their volatility, and artificially distort the relative price structure for commodities in the world market.

As outlined the CAP imposes levies on imports and subsidises exports of EC agricultural products, and it therefore has the effect of dampening domestic demand while at the same time stimulating production. Restrained growth in domestic consumption combined with the cumulative production responses to the CAP subsidies have meant that world agricultural prices have been significantly depressed — firstly by EC overproduction which has displaced imports, and secondly by the disposal of this surplus on world markets. A 1984 study suggests that in the event of the complete removal of CAP restrictions and subsidies there would be an increase in the order of 13 per cent in the world market price of wheat, an increase of 12 per cent in the world market price of sugar, and particularly large increases in the prices of dairy products, including an increase of 28 per cent in butter prices and a 17 per cent rise in the price of meat. Another study has concluded that the world prices of major temperate products have been depressed by 16 per cent on average as a result of the CAP.

The EC's price stabilisation policy has been very successful in cushioning EC producers against the wide variations that have characterised international agricultural prices since the early 1970s. In part however, the volatility in world prices is a product of the CAP itself. World prices are made more volatile because the large EC market is insulated, thereby preventing it from absorbing part of any variation in demand and supply outside the EC and therefore ensuring sharper price variations in the world market. Within the EC the stabilisation of internal prices also eliminates the incentives for the private sector to hold stocks and engage in futures transactions and other forms of price-stabilising transactions.

More importantly, however, the variability in prices reflects the destabilising way the EC has dealt with its demand and supply fluctuations, by disposing agricultural surpluses onto the world market at irregular intervals.

Effective protection rates for EC farm products were estimated to average around 160 per cent in 1984 (although widely different values were found for different products). This distortion of the internal price structure has diverted factors of production to the highly protected parts of EC agriculture, causing growing surpluses. The counterpart to this on the world

market is that prices of dairy products, sugar, and beef have tended to fall in relative terms while those for other products with low EC protection rates have risen. This distortion in prices has been reflected in world trade flows, and in production and consumption in countries outside the EC, and the resource misallocation implied represents a further cost of the CAP which is borne by non-EC economies.

Implications for New Zealand

For the year ended June 1986, the EC (including the United Kingdom) accounted for 19 per cent of New Zealand's exports. New Zealand exported NZ\$2,058m worth of goods to the EC out of total export earnings of NZ\$10,571 million. The main exports to the EC were butter, lamb and wool. However, access to the EC market for agricultural products has been steadily reduced; butter and lamb for instance are currently exported under special terms of access — and problems with subsidised EC exports are being increasingly encountered on other markets.

In general terms the costs to New Zealand implied by the CAP are those outlined earlier — reduced access to the EC market, lower world prices for agricultural products, the reduced level of EC internal demand arising from higher EC prices, and the price distortions and instability that the EC transmits to world markets. The overall economic costs, while no doubt substantial, are difficult to quantify. On the issue of export receipts only, the Australian university study mentioned earlier concluded that in 1980, if the EC had fully liberalised its agricultural support arrangements, world butter prices would have been about 28 per cent higher, and meat prices about 17 per cent higher. Using 1980 export volumes, this would be the equivalent of an increase in export receipts of about NZ\$300m, on a base level of meat and butter export receipts of about NZ\$1500m.

A further Australian study simulated the impact of a liberalisation of the grain and meat components of the CAP in a dynamic international commodity trade model. Under different model specifications, for 1980, the total gain to New Zealand as a result of higher world prices (the gain in terms of the surplus to producers less the higher costs to domestic consumers) was estimated at between NZ\$260m and NZ\$395m. Of the countries included in the model (the EC, Australia, Canada, New Zealand, the United States, Japan and the Less Developed Countries), the average (over the different model simulations) per capita net benefit was found to be greatest for New Zealand.

Possibilities for Reform of the CAP

The direct budgetary cost of the CAP (which in 1984 totalled 19,000m ECU) has risen rapidly in recent years — growing in real terms at an annual average rate of about 7 per cent over the past ten years. Faced with problems of financing its agricultural support measures, the EC has taken some steps to restrain expenditure. The principal measures have been the application of the guarantee threshold system (under which support prices are discounted if quantities produced exceed certain limits), quotas on milk, more limits on the scope for price intervention and proposed disciplines on future total EC expenditure. There has also been the wider

application of co-responsibility levies, under which agricultural producers contribute to the costs associated with the disposal of surpluses.

However, if the EC is to address its problem of rising surplus agricultural production effectively, it is clear that more steps will be needed. Although most recently (in July 1985) the Community has suggested further possibilities for reform, including a reduction in the role of intervention buying for beef and compensation for milk producers who cease production, these do not represent adjustments to the returns to agriculture on the scale necessary.

While budgetary pressures have not yet proved to be a particularly effective spur for reform, they are not the only consideration which could lead to substantial reform. Despite the magnitude of the resources it has absorbed, the CAP has not been successful in supporting the incomes of the majority of EC farmers. Since most farmers have relatively small farms, and because support given through the price mechanism is in direct proportion to output, the operators of the top 25 per cent of farms, in terms of size, are estimated to receive about 75 per cent of the budgetary support. In 1984 this averaged about 9,700 ECU (NZ\$17,000) per farm per year. The balance of small scale farmers received an average income supplement in 1984 of about 1,100 ECU (NZ\$2,000) per farm a year. Essentially therefore, a principal effect of the CAP has been to increase output by the few producers with large enterprises while giving relatively little support to the large number of producers with small operations.

A more effective and efficient alternative would be to reduce support prices markedly, thereby reducing the propensity to produce surpluses which are expensive to the economy, and to use the funds so released to support the incomes of the majority of farmers directly. In a recent important development, such a strategy of direct income support has been acknowledged by the European Commission (the body charged with administering EC policies) as a primary reform option.

Conclusion

Clearly, the Common Agricultural Policy has reduced New Zealand's export receipts for agricultural products for many years through both reduced access to European markets for butter, cheese, sheepmeat and lamb and lower prices for meat and butter.

There now appears to be at least some prospect that agriculture will be more fully integrated within the GATT framework. It is clear that many of the economic costs associated with the CAP and the adverse effects on other countries could be prevented or markedly reduced if alternative assistance mechanisms were adopted. The recent recognition by the Commission that the objectives laid down in the Treaty of Rome can be met in alternative, more efficient, ways does provide one constructive and potentially productive starting point for negotiations at the impending GATT talks. Nevertheless, it has to be recognised that gains for agriculture within the context of the current GATT negotiations are by no means certain. In any case past experience suggests that the talks are likely to be protracted, extending for a number of years. Even if the talks do result in a change in trend towards freer world trade in agricultural products, the benefits for New Zealand will not accrue in the immediate future.