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THE EFFECTS OF RELATIONS IN FARMING TRADE WITH USA ON EEC AGRICULTURAL POLICIES

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INTRODUCTION

Past and Future

The focus of this paper is prospective rather than retrospective. Thus it concentrates on the future when U.S. policies and exchange rates are likely to exert pressure for change in the Common Agricultural Policy rather than the immediate past when developments in the United States have generally supported rather than threatened the CAP.

In the immediate past U.S. macroeconomic policies, and to a lesser extent farm policies, have I believe held up world commodity prices in terms of ECU (the Community's monetary unit of account). This has in turn allowed the Community to delay adjustments.

Macroeconomic Support

The combination in the United States of a tight monetary policy and an expansionary fiscal stance has bolstered interest rates. This in turn has led to a strong demand for dollars by capital investors and a value of the dollar which has been high in relation to purchasing parity.

The strength of the dollar has raised the prices of commodities in terms of ECU such that export restitutions in the EEC have needed to be less

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and support stocks lower than otherwise. Because expenditure has been eased on both these counts the financial difficulties of the CAP have been lightened. Consequently a pressure for change, indeed probably the main pressure for change, has thus been weakened. In the case of cereals - and it is in the cereals that the conflict in trade will mainly lie - the effect has been reinforced by the Payment in Kind programme. This further bolstered prices at a critical time for the FEOGA budget. A longer established further prop has been a set of loan rates aligned to the boom export conditions of the Seventies rather than the weak demand of the early Eighties.

The Question Posed

Rather than expand on this chain of causation, I propose to consider how EEC policies might react to the opposite situation now emerging where a weaker dollar and greater American exports combine to drive down world prices of cereals as perceived from the EEC. The proper way to pose this question is as follows. How might such a change in world markets force changes in the way trade is used to obtain domestic policy objectives?

This is to emphasize that the EEC does not have a policy for agricultural trade to which domestic interventions might be subjugated. On the contrary, EEC trade policy has little or no independent life. It is an outgrowth of domestic policies. Like most other economic entities, the EEC seeks to export its problems of agricultural adjustment on to the world market. The international market is mainly seen as the residual market - a convenient and comparatively cheap way of getting rid of surpluses. Constraints on trade may well cause changes in domestic policies through the budgetary problems to which they lead. However, specific trade targets, for example in terms of export revenue, market shares of levels of self-sufficiency, are, suggest, unlikely to play much of a role in adjustment to trading conditions.

Normative and Descriptive Aspects

In posing the problem use has been made of the conveniently ambiguous word "might". How might domestic policies adjust to markedly lower cereal prices? This can be interpreted in two ways:

1. How should policies adjust
2. How would policies adjust

Each question is considered in turn but with the emphasis on the positive question.

How should the Common Agricultural Policy Adjust to Lower World Cereal Prices?

A significant fall in cereal prices and one perceived as likely to be long lasting should highlight the basic inefficiency and inequity of the Common Agricultural Policy.

Inefficiency

The inefficiency in resource allocation to which a policy of holding prices above world levels leads has been the main focus of economists' attention. The inefficiencies are of two kinds:

1. There is inefficiency in that the loss of satisfaction by consumers is greater than the increased returns to producers.
2. Resources are retained within agriculture which on certain assumptions could have a greater social product elsewhere.

The size of these "deadweight" losses, as might be expected, is a matter of some controversy, the main uncertainty being the level of world commodity prices if there were no EEC support. Most commentators, however, would agree that they cannot be less than ten billion ECC per annum or approximately nine billion dollars. Politicians, however, are not very impressed by these potential efficiency gains. Perhaps they have doubts, as well they might, about the true social opportunity cost of labor at a time of high structural unemployment. Perhaps they believe similar analyses of other protected sectors (such as steel, transport, coal or housing) would show even greater efficiency losses. Perhaps the gains are too abstract and hypothetical. These doubts have to a degree communicated themselves to economists in the Community. Increasingly our attention is being focussed on income transfers which are of course the meat and drink of politicians.

Inequity and Ineffectiveness

Following this approach, the major defects of the CAP that would be highlighted by a fall in world cereal prices would be the enormous transfer that is made from consumers to producers.

It is not widely recognized that in most years around two thirds, of the support producers receive under the CAP comes from consumers' pockets. The annual transfer is about forty billion dollars. This is certainly a staggeringly large amount. Can one say that this transfer is inequitable? I believe that one can.

The incidence is unfair both among payers and recipients. The burden of what is in effect a tax on food falls most heavily on those who spend a high proportion of their income on food. They are quite clearly the poorer households. The CAP bears rather lightly on higher income households. On the recipients' side there is now, I believe, fairly general agreement among economists that the main effect of such price support is to raise land values. The effect on labour incomes is minimal, the main effect here being to retain some labour that would otherwise have moved out of agriculture. It follows that the main benefit of the price support goes to those farmers, a high proportion of whose income - broadly defined to include capital gains - comes from land holdings. Price supports do very little for small farmers, for tenant farmers or for farm workers. The effect of the policy then is to transfer income from those whose need for income can be assumed to be very urgent, for example State pensioners and single parent families, to land holders and large owner-occupying farmers whom few would consider to be in particular need of support.

The agricultural inequity of this policy within the EEC is reinforced by a strong bias in protection towards cereals and related arable crops and against livestock products (especially those other than dairy products). In continental Europe, incidentally, this bias long predates the formation of the EEC. Broadly speaking, effective protection is much higher for cereals than for livestock products. Many types of livestock production are especially associated with small farms with limited land resources. So the inequity is compounded. This bias towards cereals may also be judged to have had largely negative environmental effects in terms of visual amenity, wildlife variety and pollution.

The policy must therefore be rated ineffective in giving either fair prices to consumers or helping those with low farm incomes. Two of its avowed objectives are therefore not met. Furthermore, its effect on efficiency is largely adverse in terms of both resource allocation and externalities.

The one objective which the policy more clearly satisfies is that of stability and security. By exporting all the need for adjustments in consumption and production due to changes in output and consumer taste to other countries, the EEC gives a high degree of price stability to both producers and consumers. In this respect the EEC system price support differs from that in the United States. It is a two price system.

Most consumers, if properly informed, would consider the price paid for this stability in terms of higher average prices unacceptably high. Security of food supply in many senses has certainly been achieved by the high levels of self-sufficiency to which the policy has led. However, there are almost certainly more cost-effective ways of attaining the same end. The advantages in terms of security and stability are only minor qualifications to the general inequity, inefficiency and ineffectiveness of the CAP, especially as it relates to cereals.

The Preferred Solution

On the broad revision of policy which would make it more efficient, more equitable and more effective, there is I believe fairly wide agreement among economists (including those in the Commission) and indeed among most thinking people without vested interests in agriculture. There should be a marked cut in support prices especially of cereals combined with more direct income support for the needy in agriculture. Needless to say on the nature of this support there is less agreement. Among the schemes touted are income insurance, differential payments, marketing quotas subsequently repurchased by the State, education and retaining grants. The relative merits of these alternatives is not our immediate concern. What needs to be pointed out is that all these schemes would per se involve increases in direct public expenditure. Even more exchequer outlays would be required if, as is likely, it were politically necessary to make some once and for all compensation to those vested interests most directly affected by a cut in intervention prices.

How Would Policies Adjust?

The implications for public expenditure of programmes of direct income support largely rule them out as likely adjustments to a fall in world cereals prices. The problem of the Common Agricultural Policy - insofar as it is viewed in anything but purely national terms - is seen both by governments and electorates as principally one of exchequer cost.

The cost of the policy to consumers is not well appreciated. Furthermore, farm pressure groups are adept at pointing to food shortages like those seen in Poland or the Soviet Union as the alternative to mercantilist agricultural policies. Also, interest in food prices as a political issue has tended to decline with the rate of inflation. No doubt there are other explanations but whatever the full range of reasons, the consumer interest has simply not yet been mobilized. Consumer pressure, therefore, whatever the lure of world prices, cannot be relied upon to bring about radical change in the Common Agricultural Policy. Any change which does arise from lower world cereal prices will come rather through the effect of public expenditure. The need to obtain essentially unanimous agreement among ten countries whose interests widely diverge will mean any change is unlikely to be radical. This factor is often not well appreciated in the United States, where the Commission is commonly seen to be much more firmly in the driving seat than it is in reality. However, past experience indicates that even small changes in the CAP will arise not from concern about efficient resource allocation or the ineffectiveness of price support as a means of incomes support or the inequity to which it leads in both agriculture and society, but only through EEC revenue falling short of expenditure.

The EEC Budgetary Question

The EEC budgetary question is a fairly involved issue but its essential features in the barest of terms are as follows.

For most major agricultural commodities the basic guarantee of producer prices in the Community is the commitment by public agencies to buy up at a predetermined intervention price and in unlimited quantity such supplies as are offered to them. Normally, however, the Commission keeps the price above the intervention level by intervention at the borders of the Community. For commodities in which the Community is in deficit the main instrument is a levy which varies according to the difference between CIF prices of imported commodities and a predetermined minimum import price. For commodities in surplus a similarly, though less rigidly determined, variable export restitution is used.

The revenue of the EEC exchequer comes in part from agricultural import levies and also duties on non-agricultural imports. (Since 1970 these have been designated as the Community's own resources). The deficiency between this income and expenditure is made up as necessary from direct contributions by member governments, assessed as the yield of a standard value-added tax. These direct payments are not, however, unlimited. From

1970 until 1985 the limit was the yield of a one per cent VAT. The main expenditure commitments of the EEC is for the Common Agricultural Policy which has taken from two thirds to three quarters of the total budget. Part of these payments are for structural improvement but, contrary to earlier intentions, the so-called guidance section has remained a small part of the commitment. The bulk of the payment is for price support. In the early days of the CAP following price harmonization in the Sixties and early Seventies, there was absolutely no budgetary problem because the EEC was in deficit in most major commodities. Hence, the CAP was a revenue earner. Lots of import levies were generated and there was little need for export subsidies. This situation, however, changed more rapidly than was expected. Soaring production and stagnant, in some cases declining, consumption made the EEC increasingly a net exporter of dairy products, sugar, beef, wheat and then all cereals. Even the entry of the United Kingdom, the major importer, provided only a temporary respite. Soon the UK too was visibly busily contributing to the surplus and is now indeed a substantial cereal exporter. The broad pattern since 1967 has been that production has been rising at two per cent a year but consumption only at .5 per cent.

The consequent pressure on the budget for increased exports was temporarily alleviated by the commodity boom of 1973 to 1975 and then by the headroom given by the one per cent VAT entitlement. By the end of the Nineteen Seventies, however, this headroom was getting uncomfortably low and for three years, between 1979 and 1981, there was a period of prudent price setting. In real terms, that is to say relative to input prices, prices were cut by three per cent a year as compared to the more normal trend cut of 1.5 per cent a year. This austerity, however, could not be maintained, and in 1982 there was an explosion in prices. The effect of this on the budget was for a time delayed by unusually high world prices but the crunch came in 1983 when projected spending became greater than projected income. Since that time FEOGA, the agricultural section of the Treasury, has staggered from crisis to crisis. It has remained solvent only by rolling back expenditure from year to year, obtaining supplementary payments (at great cost to the power and prestige of the Commission), under the counter price cuts, for example by restricting the availability of intervention, and by the providential strengthening of the dollar.

This period of financial difficulty has produced several changes in CAP arrangements. Some of these, for example the threshold controls on price, have been much trumpeted, but are probably not very important in practice. Others, in particular the reduction of effective prices by administrative limits on intervention, though less publicized, have been quite important in reducing prices. There has also, of course, been one change of considerable importance both politically and in its practical effects, that is the introduction of dairy quotas in 1984. This meant that the commitment to dairying support, always the most expensive of commodities, was no longer open ended. Sugar, another expensive commodity, was already subject to quota. This leaves cereals as the main problem commodity from a budgetary viewpoint. By 1990 the export surplus of cereals is likely to reach sixty million tonnes. A common view is that the maximum it will be politically possible to export is twenty five million tonnes. So unless there is some curtailment of production there will be an expensive growth stockpile.

In 1985, after considerable and protracted negotiation, the VAT ceiling has been lifted from one to 1.4 per cent. This however has not taken the budgetary pressure off the Commission and Council of Ministers as much as it might at first sight appear. Part of this extra revenue is intended to accommodate the need of Spain and Portugal who joined the Community in January 1986. A further part is intended to allow some expansion of EEC non-agricultural policies. Finally, as a quid pro quo, the Council of Agricultural Ministers will be subject to closer scrutiny from the Council of Financial Ministers than was previously the case. The broad intention of new control mechanisms introduced is that EEC expenditure shall not grow faster than GNP.

The Likely Response to Continued Budgetary Pressure

In my view more restrictive pricing of cereals will be forces on the Community. This is likely to happen even in the absence of much lower world prices. In the presence of these it will be unavoidable although the difficulties experienced in obtaining even modest cuts at the last two price reviews indicate that this will not be achieved without struggle. A cut in the price of cereals would be not only financially helpful but good from equity and efficiency viewpoints. There are, however, other possible budgetary solutions.

Perhaps the most likely alternative would be to seek to increase the revenue of the Community by imposing a tax on oilseeds and products. This was mooted in 1983.

From a purely budgetary point of view this route has a number of attractions. It would not only bring in much needed revenue but would also curtail expenditure under other heads. By making the use of soya bean meal as a direct energy source and as a compliment to cassava less attractive, it would reduce the need to subsidize cereal exports; beef, poultry and pigmeat production would also be curtailed, with again some saving in export restitution, via the effect on oil prices, consumption of butter would be stimulated (an important advantage given the quotas have built in a 15 per cent production surplus); the prospective cost of the Spanish olive oil surplus would be reduced.

The efficiency effects of such a move are not clear cut. On second best arguments one might make a case for equal restraints on cereals and oilseed meals (and also incidentally cereal substitutes). In terms of equity, however, the results would be largely bad. However, it will be neither of these considerations that will prevent such a move but rather that too many national interests would be adversely affected. This option one may expect therefore to be raised and discussed at some length, but not implemented.

SUMMARY

In the recent past, U.S. policies, especially as they affect exchange rates, have reinforced rather than threatened the Common Agricultural Policy.

The desirable effect of possible future lower world cereal prices brought by changed U.S. policies should be to combine a large cut in cereal prices with a switch to more direct forms of income support. This is justified on the grounds of both equity and efficiency.

This is unlikely to happen since budgetary problems rather than considerations of equity, efficiency or effectiveness are what have induced change in the CAP.

The budgetary problems which have emerged in the Nineteen Eighties largely through the expansion of exports relative to imports, will continue to plague the Community. They will increasingly centre on cereals. The likely result will be a harsher cereal pricing policy but one unlikely to be harsh enough to avoid further financial crises or confrontations with more traditional exporters.

A possible alternative budgetary solution would be a tax on oilseeds. Despite the broad exchequer advantages of such a move it will be prevented because too many national interests would be adversely affected.