

Final Report

Feasibility of an agricultural strategy to prepare the countries of central and eastern Europe for EU accession

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COUNTRIES OF CENTRAL AND EASTERN EUROPE FOR EU ACCESSION**

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Executive Summary

The Problem

1. The European Union (EU) has expressed its intention to offer membership of the Union to those countries of central and eastern Europe (the PECO's) with which it has Association Agreements. Agriculture is thought to be a problem sector in the accession of the PECO's because of the high level of support given to it within the Union and the potential cost of extending this support to countries in which agriculture is a relatively large part of the economy.
2. The objectives of this study were to examine these problems of accession and to develop options for policies in the PECO's, and, if necessary, in the EU, which would facilitate the integration of the agricultural sectors in the EU and the PECO's.

The Trajectory of the Common Agricultural Policy

3. The accession of the PECO's to the EU will occur at some indeterminate date in the future. It is suggested that this is likely to be nearer 2005 than 2000 because of internal EU debate about the nature and extent of further economic and political union and the disparities in economic development between the EU and the PECO's making lengthy accession negotiations likely.
4. The Common Agricultural Policy (CAP) of the EU is in the process of change. Some reforms were introduced in 1992 and others are currently being considered. Further change is likely over the next decade as a result of the EU's commitments under the Uruguay Round Agreement (URA), irrespective of any Eastern enlargement.
5. Whilst the domestic support and market access commitments are not expected to cause difficulties, it is debatable whether, with current policies and prices, the EU can reduce its exports sufficiently to meet its export volume constraint by the year 2000. By 2005, it appears highly improbable that the constraint could be met and further production restraints are likely to be required.
6. Production cuts can be made by further price cuts or more severe supply controls. Price cuts take longer to work, and would have to be substantial because farmers, through the CAP, are paid a price higher than is necessary to obtain current output levels. Supply controls (such as set-aside and quotas) have a more immediate impact on supply and are likely to be used for short term supply (crisis) management. Our judgement, therefore, is that in the absence of Eastern enlargement, there will not be large nominal price cuts although real prices will be lower by 2005.
7. Given reasonable economic growth in the EU, and therefore increases in the agricultural guideline, the agricultural budget is unlikely to be a constraint. But threats to the budget come from increased direct payments and failure to solve the green ECU problem.

The PECO's

8. Compared with the EU-12, the six associated PECO's (Bulgaria, Czech Republic, Hungary, Poland, Romania and the Slovak Republic) are relatively poor, have large agricultural sectors, have high inflation, depreciating currencies, and some have high levels of external debt and high unemployment. However, important differences exist between the PECO's: the economic indicators are best for the Czech Republic, but worst for Bulgaria and Romania. Although there is considerable doubt about the reliability of the statistics, there is little doubt about the large gap that exists between the EU, on average, and the PECO's, on average.
9. The agricultural sector is extremely important in Romania, Poland and Bulgaria in terms of its contribution to either GDP or employment. For Hungary and Bulgaria, the agricultural sector is an important positive contributor to their foreign trade balances.

10. Agricultural output has declined substantially in the PECO's. Part of this decline was necessary because output was wasted, part is due to the reduction in domestic and foreign demand and part is due to the chaos and dislocation during transition. The decline was also exacerbated by drought during the period.

PECO Agricultural Policy

11. Progress in land reprivatisation and farm restructuring is not yet complete. Different approaches in different countries are resulting in the emergence of two common types of structure. The dominant structure in terms of output will be based on the former large scale farms, with the new owners farming in association. The other form are very small peasant-type holdings, which are unlikely to be viable in the long term. Poland's farm structure has barely altered since it has always been dominated by the small private farm.
12. Privatisation of the food processing and input supply sectors has been slow. Out of date technology, inappropriate scale and location, overmanning, and existing debts have made this sector unattractive to investors, and there is little sign of a solution to their problems.
13. Price and trade policy has been unstable. In the early years of transition, farm gate prices were liberalised, subsidies to farmers reduced, but some control of consumer food prices was retained. There has been a reaction to this approach, partly at least in response to the penetration of PECO markets by subsidised EU exports, and partly because of perceived concerns about food security.
14. A wide range of instruments is now used to influence prices and foreign trade levels, including import levies, minimum import prices, import quotas, export taxes, export bans, export subsidies and intervention buying. However, the level at which these operate is low because of lack of finance, and the overall level of support to the agricultural sector is also low. In the case of Bulgaria, it is believed that agriculture is effectively taxed rather than supported. Producer prices in the PECO's are substantially lower than those in the EU. The main non-CAP policy instrument in wide usage are credit subsidies.

Agricultural development in the PECO's

15. Pre-reform levels of output are not a good guide to the potential output levels in the PECO's because production was centrally planned and not related to real costs.
16. The most important determinant of future agricultural development is the extent of macroeconomic stabilisation. This will stimulate demand, encourage investment in the food chain and accelerate the privatisation and development of competitive markets for agricultural products improving terms of trade for farmers.
17. A modest rate of development will occur pre-accession in all countries perhaps favouring crop production over livestock. Rapid and strong development can be expected only if there is significant investment in the downstream sector.

Effects of PECO's adopting the CAP

18. There are some lessons from the Southern enlargement which had similarities with the proposed Eastern enlargement. Greece, Portugal and Spain were relatively poor with large agricultural populations and agriculture an important contributor to GDP. The State had also played an important role in setting prices and operating market institutions.
19. Although surplus production was expected in a number of commodities following accession and farm size was expected to increase substantially, the outcome was rather different. Farm structure has barely changed, while increases in production have, for the most part, found a market both

domestically or in other EU countries.

20. This suggests that where farming is dominated by small scale peasant or family holdings, restructuring is a slow process, as is adaptation to new technologies. In these cases, the supply response to higher prices is more muted than under commercial farming conditions. In addition, the extra demand for food in a relatively poor country with rising incomes should not be under estimated.
21. The PECO's differ from southern countries in that their agricultural output is more competitive with (rather than complementary to) output from the EU. In addition, despite a sizable peasant farming population, especially in Poland, most land is likely to be farmed in large units albeit under multiple ownership and perhaps cooperative management.
22. Upon accession, PECO producers would enjoy prices considerably higher than those currently received. This, together with the price certainty that the CAP provides, is likely to produce a modest positive supply response. There are many complications surrounding the precise timing of this response - and differences between PECO's - but the outcome is clear. At the same time, higher food prices will restrict the growth in consumption, putting more pressure on the EU support mechanisms.
23. In the long run, farmers in the existing EU would not be affected by these changes, as long as the CAP can continue to provide support at the levels reigning prior to PECO accession. More research is needed on what the cost of such a policy would be.
24. In the short run, PECO producers will have land and labour cost advantages over EU farmers, but as their land and labour are less productive this does not necessarily mean a cost advantage. PECO producers have disadvantages in terms of farm structures, management and marketing experience. Even if average cost advantages do exist and are sizable, there is no necessary threat to the EU market because there is a large range around the average, both in the EU and the PECO's. Only some PECO farmers would be lower cost producers, and the least costly market to supply first would be the domestic market.
25. Notwithstanding the above, any increase in trade between different regions of the EU would be indicative of the market at work, with economic gains to consumers. Reaping these benefits is the main economic argument for further enlargement of the EU. Based on GATT estimates of the benefit of trade liberalisation due to the URA (around 2% of GDP) we calculate that if the Eastern enlargement only gave half the proportional gains, the economic benefit could be around 65 bn ECU per year.

The Implications of the URA on PECO Accession

26. Combining the Aggregate Measures of Support of the PECO's and the EU should not cause any immediate problems because the slack in the EU's AMS can accommodate the tightness in those of the PECO's. However, the new AMS ceiling would be threatened in the event of any production increase by the PECO's after accession. There is also a potential problem with the GATT "due restraint" clause which limits support on a commodity by commodity basis.
27. It will be more difficult to contain EU-21 exports within the new subsidised export ceiling. The EU-12 will have difficulties anyway, and the PECO's are currently exporting more than their ceilings for the year 2000. When the PECO's face EU price incentives, the position can only become more difficult.
28. Harmonising tariff ceilings of the EU and the PECO's will require either a loss of access for the rest of the world (with compensation being payable) or some reduction in protection for EU farmers. However, actual tariffs are sometimes much lower than the maximum tariffs and it may be possible in these cases to harmonise applied tariffs at the higher level without contradicting URA commitments.

The Budgetary Cost of Extending the CAP to the PECO

29. Studies which have included the effect of the 1992 CAP reform suggest that the long term annual cost of extending the CAP to the PECO is between 22-37 bn ecu. In the short term, before any supply response, the cost could be as low as 7.5 bn ecu. Direct payments to farmers are major part of this cost.
30. Because none of these studies take into account the constraints imposed by the URA, both in the EU-12 and on accession, the costs are likely to be over-estimates. In addition, it is by no means clear that direct payments will be available on the present scale to farmers who have not suffered price cuts (ie PECO farmers).
31. Focusing on budget costs is not helpful. Not only are they difficult to estimate, but it is misleading to look at costs without estimating also benefits. As indicated above the benefits could be two or three times larger than the costs.

Alternative Accession Models

32. There are difficulties associated with the accession of all six PECO to the EU, because of the URA and because of the expected budgetary cost (though this appears to have been overestimated). These difficulties might be circumvented if alternative accession models are chosen.
33. Membership of the EU without the CAP could eliminate the agricultural problems of the Eastern enlargement but appears incompatible with the Treaty of Rome and would make nonsense of the move to the single market (and the trade benefits that flow from this).
34. A separate lower price CAP could be designed for the PECO which would operate alongside the existing CAP for the EU-15. Despite lower price levels in the PECO, some production response would still be expected because of the stable climate created for investment. The PECO would also make lower budgetary contributions because they would not have access to the full benefits of membership. A complex system of border controls between the PECO and the EU-15 would be necessary to maintain the price differentials. The outcome would be a suppression of one sector in the PECO, an outcome hardly likely to engender feelings of belonging in the EU's newest members.
35. Different PECO could be admitted to the EU as and when they were deemed ready, without any necessity to wait for other PECO to catch up. For example, in purely agricultural terms, admission of the Czech Republic would create fewest problems and could be undertaken far earlier than the admission of Bulgaria or Romania. However, the agricultural costs are only one part of the equation: the benefits and costs across the economic and political spectrum should be considered. Taking a wider view, an early accession of Poland has merit in view of the size of its economy.
36. Such staged accession would not solve any of the problems outlined in this report, although it would delay facing them. There would also be extra negotiation costs from dealing with each PECO singly.

The CAP after Accession

37. Assuming the six PECO join together towards 2005 and have the same rights and obligations as other members, the CAP, already under significant pressure from the URA commitments and possibly the first WTO round, will face further pressures. An attempt could be made to maintain it, with high supported price levels, or to meet the problems in the simplest way by reducing prices substantially and maintaining support for farmers through other means.

38. A continued high price regime would require severe supply controls in the PECO's (more severe than in the EU-12 today because GATT/WTO constraints will be harder to meet). Such controls would require more administrative interference, would freeze PECO agriculture at an arbitrary level of output while it is still developing, and would raise consumer prices substantially in countries where a high proportion of income is spent on food. High domestic prices in the PECO's coupled with controls would also make PECO produce uncompetitive on third markets, for example the FSU.
39. A 'low' price regime (prices at or close world market levels) would avoid all the problems outlined here because the URA (or subsequent agreement) would no longer be a constraint on production or exports. It would, however, create problems of political acceptability within the EU-15.
40. Loss of income support through reductions in price support could be overcome by substituting direct payments to farmers based on certain qualifying criteria. These criteria should not be linked to current production in any way, as current direct payments are. This could increase the budgetary cost of the CAP compared to the present, depending on the income support criteria used. Part of the cost of raising rural incomes can come directly from national budgets if countries wish to raise incomes above whatever the EU deems necessary (or can afford).
41. A low price regime negates the need for a large administrative structure controlling quotas, set-aside and highly complex subsidy arrangements, with consequent gains to the economy.

Pre-accession Policy Options for the PECO's

42. In view of the uncertain levels of support that the CAP may eventually offer, and the costs to both consumers and taxpayers of any policy offering substantial protection, and the limitations imposed on support anyway by the URA commitments, the most flexible and affordable course to follow is to develop an agricultural sector that will be competitive whether in the EU or outside. This is best achieved by the state doing less, rather than more, directly in the market. Rather, the state should facilitate the operation of the market by correcting existing market failures, by hastening the privatisation process, and by reducing barriers to entry at all levels of the production-marketing system.
43. The option of creating a pre-accession common agricultural policy in the PECO's is rejected. It makes no sense in the absence of a wider PECO common market and operationally it poses large problems of agreeing the common price level, managing such prices in the face of exchange rate instability and financing the common policy.

Pre-accession Policy Actions for the EU

44. Uncertainty about the future nature and level of support under the CAP should be removed if both EU and PECO farmers are to make efficient investment decisions. To this end, a wider public debate on the future of the CAP is desirable, with a clear commitment emerging within two years on the type of CAP that will take the EU well into 21st century. Our own conclusions on this direction are clear, but whatever direction is chosen, it is important for the PECO's to know what they can expect.
45. The Association Agreements provide an opportunity for integrating trade policy prior to accession. As long as preferential quotas remain, then the working arrangements must be improved. Quotas should be auctioned within the PECO's rather than allocated to EU importers. In the longer term, quantitative restrictions on preferential access should be eliminated.

46. Skill levels in the PECO's are still low, notwithstanding the large amount of technical assistance given under the PHARE programme. Administrators, professionals and others in the PECO's cannot be expected to acquire the skills of their western counterparts in a year or two. PHARE projects involving skills and knowledge transfer should be much longer term in outlook, with intermediate stages for assessment and, if necessary, redefinition.
47. Subsidised exports to the PECO's should cease. They have a number of damaging effects, including undermining the PECO market, creating an atmosphere hostile to the EU, and indicating that the EU does not follow the advice it gives to others - to get government out of business and let the market allocate resources. They also encourage the PECO's to erect import protection themselves and to set off on the road to inefficient resource use and higher than necessary food prices.

1 THE PROBLEM TO BE ADDRESSED

The European Union (EU) is a practical expression of the desire of citizens in fifteen European countries to design institutions to enable them together to live in peace and harmony and together develop their living standards. Since the collapse of communism in Europe a strong desire has been expressed by six Central European countries¹ and by the European Union itself to extend the Union border further to the East. The motives in this enlargement are political (in particular, the security of the region) and economic (the gains from free trade in a larger market). This report concerns just one of the aspects of the economic changes consequent to enlargement, namely the implications for agriculture and agricultural policy. The reminder that the major motives for Eastern enlargement are political and economic benefits is given because a negative atmosphere may be generated around the agricultural aspects of Eastern enlargement within the European Community. For example, much of the discussion on the issue contains references to 'fears of' and 'threats to' EU farmers based on unsupported generalisations and assertions. Clearly, it is important to analyse and understand the issues involved so that problems are identified in advance, and costs and benefits are put into perspective.

The underlying concern behind the commissioning of this research² is that current agricultural developments and agricultural policy both in the European Union (EU) and the associated countries of Central and Eastern Europe (PECOs) may be incompatible. If so, this creates an obstacle to the smooth accession of the PECO countries to the EU as envisaged in the Copenhagen and Corfu summits. The research task is to identify the extent to which these developments and policies are incompatible and then to identify and analyze policy options to ease the problems of agricultural integration.

The time horizon for this process is somewhat uncertain. Since the signing of the Europe Agreements and the statements at the two European Council meetings cited above, strong expectations about accession to the Union have been aroused in the PECO countries. In the Visegrad countries in particular there is a strong desire to forge links at every level to prepare the population, businesses, government and officials for entry. However, the indications are that membership may still be some years away for most of Central Europe. It has been said publicly that detailed membership negotiations cannot commence until after the Inter-Governmental Conference (IGC) in 1996 when the European Union has to decide the future path of development of its institutions, the priorities of the Union, the desirability of one, two or multiple speed development and the timetable towards monetary union set out in the Maastricht Treaty. Given the deep differences of view on these issues in and between many member states it is unlikely that such weighty matters can be settled quickly. It therefore seems unlikely that enlargement negotiations could start before 1997. Given the complexity of the negotiations it is improbable they could be conducted within four years. Thus the earliest it is expected that the first of the PECO countries could accede is in about six years time. For the group as a whole towards the end of the period 2000 to 2005 seems a more appropriate

¹ The French acronym for this group PECO - Pays d'Europe Centrale et Orientale will be used as it is easier to say than CEECs - in any language! The countries concerned are those which already have Association Agreements with the EU: Bulgaria, Czech Republic, Hungary, Poland, Romania and Slovakia.

² The terms of reference for the study which, unusually, were discussed amongst several Directorates General in the European Commission are reproduced in Appendix A.

estimate of the likely period during which accession will occur. This is the working hypothesis adopted throughout the study.

Of course, in view of the political objectives, the timetable could be accelerated or retarded if there were political reasons to do so. These points are made in order to clarify two important aspects about PECO accession and adoption of the CAP. Some years will elapse before PECOs join the EU. In the meantime both parties will have time to change and adjust. Changes in agriculture and agricultural policy in the interim period could make accession more difficult or easier. An important task of this study is to help find means of ensuring the latter.

This report commences by examining the likely shape of the CAP at the time of PECO accession. It then provides an outline of the situation in PECO agriculture and agricultural policy and their prospects for recovery pre-accession. Chapter 4 examines the likely response of PECOs to accession and the extent of problems in trade, in meeting URA commitments and with the EU budget. Chapters 5 and 6 then examine options for dealing with these problems, first without changing the CAP for the EU-15, then by changing the CAP. Chapter 7 discusses pre-accession strategies for the EU and the PECOs to ease convergence. Our conclusions are presented in section 8.

2 THE COMMON AGRICULTURAL POLICY: ITS CURRENT TRAJECTORY

Whether or not the CAP is likely to be a constraint on the accession to the EU of some or all of the PECO's will depend upon the type and level of support provided by the CAP at the time of accession, and the extent to which that support is extended to the PECO's. From the CAP, any trade tension which might arise and any difficulties caused in meeting international obligations. From the PECO viewpoint, there may also be costs of adopting the CAP, notably in terms of less efficient resource use and higher consumer prices, but there will also be benefits from the financial transfers to them from EU taxpayers and consumers. Both the CAP and the agricultural policies of the PECO's are evolving in order to meet domestic objectives and international obligations, and an important question is the extent to which these changes alone will bring about convergence, and whether such convergence compounds or eases the problems of accession.

Convergence of policy does not, of course, mean that common industry indicators such as farm size, technical productivity, prices, aggregate output and exports by sector will converge. Whether and how these indicators change will be very much a function of policy. This chapter accordingly examines the probable evolution of agricultural policy within the EU, in the absence of any prophylactic action to prepare for the accession of the PECO's, and within the time frame of feasible accession of one or more of the PECO's. As outlined in section 1, this is likely to be nearer 2005 than 2000. Likely developments in the PECO's are examined in chapter 3. The EU and PECO developments are brought together in chapter 4 where the potential problems of convergence are discussed under the headings: trade tensions, international agreements and the budgetary impact.

2.1 The CAP at present

Historically, the main policy aim has been to raise EC/EU prices above free market levels with the intention of increasing farm income levels. This in turn was thought to contribute to other objectives, such as maintaining the rural population, and increasing the level of production which was perceived to increase food security. Prices for most agricultural products in the EU (cereals, oilseeds, most livestock products) prior to the 1992 MacSharry reforms were approximately double those of world market levels. The traditional policy instruments used to maintain these prices were, first, levies on imported agricultural products, second, intervention buying on the domestic market, and, third, subsidies on exports. The response to the high and stable protection was, predictably, an increase in output. Over the period 1973-1990, output volume in the EU-12 increased by an average of 2 percent per year. While it can be argued about the extent to which this increase was due to the price support system and how much was due to exogenous technical improvements³, it cannot be denied that the growing volume of production gave rise to rapidly expanding budget costs. In real terms, expenditure on price support increased by over 100 percent, a growth rate of over 4 percent per year on average.

³ Many economists would argue that technical change was spurred by the price support system which created the incentives for the agricultural supply sector to invest in research and development.

The steady growth in production (with production increases in all the major commodities in the late 80s unsaleable on the domestic market) gave rise in 1988 to the introduction of quotas or limits on the quantity of production on which subsidies would be paid⁴. A more substantial reform came in 1992 with the adoption of the MacSharry proposals, themselves prompted by the GATT Uruguay Round negotiations. It is these reforms which are currently shaping agricultural production, consumption and farm structures, and which are intended to enable the EU to meet its commitments on levels of domestic support, market access and export subsidies made in the Uruguay Round Agreement (URA).

The reforms of 1992 involved a reorientation of support to farmers away from prices to a limited extent and towards direct aids (that is, payments per hectare of a crop or per animal in the case of beef and sheep). The price reductions, substantial though they were in the arable sector, were not expected to be sufficient in themselves to reduce production to a level where GATT export commitments could be met. The problem of oversupply of certain products was addressed by making receipt of direct aid conditional upon a farmer setting aside land from production. The main reforms were introduced in the 1992-93 production year and are to be completed in 1994-95. Other reforms in the wine, sugar, fruit and vegetable, and milk sectors are currently under consideration.

The view of the agricultural directorate of the European Commission (DGVI) is that the main reforms in the arable sector are complete and no more needs to be done⁵. The new policy instruments in place (livestock 'quotas' and set-aside in conjunction with area payments) can be manipulated to raise or lower output and, in conjunction with the existing instruments (intervention buying, tariffs on imports, and export subsidies), provide sufficient means for the EU to meet its Uruguay Round commitments. Providing the agricultural budget guideline is not exceeded, there is no reason to introduce new instruments of policy until the demands of the next world trade agreement are known. Given the length of time needed for multilateral negotiations, changes needed to comply with the next GATT Round may not be needed until around 2004⁶. The question is whether the MacSharry reforms can stand unchanged until the middle of the next decade or whether either or both URA and budgetary constraints force further changes in the levels at which existing instruments are applied or through the introduction of new instruments. In this chapter these questions are addressed without reference to further enlargement. That issue is the subject of chapter 4.

⁴ In fact sugar quotas were introduced much earlier, and milk quotas were introduced in 1984.

⁵ Speech by Agricultural Commissioner Steichen in London 24/11/1994.

⁶ The Uruguay Round Agreement itself requires contracting parties to continue the process of progressive liberalisation of agricultural markets. It specifies that discussions must commence effectively in 1999 before the end of the application of the Uruguay Round. Assuming the first WTO Round takes the 'normal' four years, the earliest the next reduction commitments could be agreed and ready for implementation is 2004.

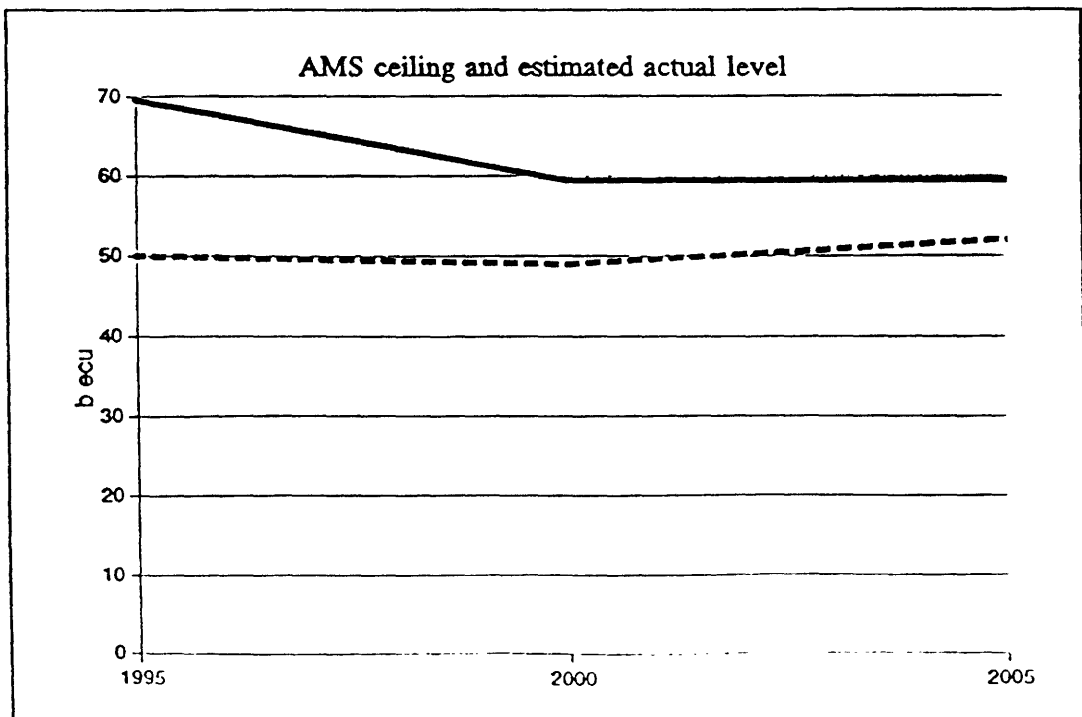
2.2 The EU's agricultural commitments under the Uruguay Round Agreement (URA) of the GATT

The EU faces declining annual ceilings on the aggregate level of domestic support, on the level of tariffs and on the value and volume of export subsidies up to the year 2001. Beyond this, the ceilings remain unchanged, until such time as they are revised in the WTO round. During this period (say, 1995-2004), rising productivity within the EU, with its usual corollary of rising production and extra budgetary costs on the CAP, could threaten to breach the GATT ceilings. Given that many of the technical advances currently in the research pipeline will only be adopted towards the end of this decade and beyond, it is certain that any potential problem will be more severe the later the year considered. This is most important. Most analyses concentrate on the ability of CAP reform to deliver a particular set of requirements by the year 2001 when the presently agreed ceilings are at their lowest. Even if a consensus suggests that the 1992 CAP reform will deliver the production and support constraints that the Uruguay Round requires, this is no reason to believe that compatibility will exist beyond the year 2001. The greatest difficulty in ensuring these ceilings are not breached will come, not at the end of the of this decade, but beyond, even without a further reduction in these ceilings from the next GATT Round. In fact, some analysts have suggested a problem will exist by the year 2000. This suggests that before 2004 (or other putative date for the accession of some or all of the PECO's), policy changes will have had to be introduced to contain rising production and associated support costs. Below we consider the ability of the EU to meet its support level and export subsidy targets.

2.2.1 The Aggregate Measure of Support (AMS)

It is widely concluded that because the commitment is aggregated over all commodities and because the area and headage payments are 'blue box' and therefore excluded from the AMS, the EU will have no trouble in meeting this commitment. Most estimates suggest the EU will be 15-20 percent below the AMS ceiling of 60,000 MECU in the year 2001, provided intervention prices fixed for 1995-96 do not rise in subsequent years. Just as important, the rate at which the AMS could trend upwards (as a result of rising production of supported products) is not expected to threaten the ceiling in the first half of the next decade.

Figure 2.1 The AMS for the EU



There are no foreseeable threats to this conclusion. Although the ceiling is not adjusted in line with internal inflation in the EU, such inflation is (and is expected to remain) low. It would take continuous EU inflation of 3 percent per year over the next five years (or 1.7 percent per year over 10 years), which was fully reflected in EU support prices, to breach the AMS ceiling. Historically, farm support prices have declined in real terms (albeit from very high levels) and it is unlikely that this will change in the future for budgetary and supply constraint reasons. In addition, the level of the AMS is independent of any movements in world prices since it is calculated by reference to a base world price for the period 1986-88.

2.2.2 Volume and value of export subsidies

The EU is required by the year 2001 to have reduced both its volume of subsidised exports by 21 percent and its expenditure on export subsidies by 36 percent, in relation to average 1986-90 levels. While the ceiling value of export subsidies is a constraint, it is unlikely to be the most important limitation facing the EU. The 36 percent reduction in subsidies for most products is likely to be achieved if the volume reduction (of 21 percent) is attained and EU prices are reduced (thus reducing the subsidy per unit of output). In the case of cereals, the price reductions over the period 1992-94 in the EU (without any further changes to the value of the green ECU) will have been approximately 25 percent. Thus, an eleven percent drop in export volume would enable the value reduction commitment to be met. Since the volume reduction has to be greater than this (21 percent), it is the volume commitment which is the real constraint. For virtually all products, if the volume commitment is achieved, then relatively small drops in EU prices (or increases in world prices) enables the value commitment to be met⁷. It is the export volume commitment, therefore, which is the focus of attention here.

There have been a number of analyses on the effects of CAP reform. The majority were undertaken before the Uruguay Round was finalised in December 1993 but when the broad picture was known of what an eventual Agreement would look like. There is broad agreement that the products likely to cause most difficulties are cereals, beef and cheese. These are products where export volumes have been growing, and current export volumes are well in excess of 1986-88 export levels on which the required reductions are based. The case of cereals is discussed here because this product is at the base of the food chain, and it has been subject to greater scrutiny than other products.

There is certainly no consensus on whether the existing CAP reforms will enable URA targets on cereal exports to be met. Different analysts have examined different years (for example, 1996, the last year of the current reform, and 2000/1, the final year for reductions under the GATT) and provide estimates of annual cereal production ranging from 148m to 183m tonnes, (see for example Westhoff P *et al* (1992) and Folmer *et al* (1991)). Given similar variation in the estimates of EU consumption of cereals, it is not surprising that some

⁷ There is a (mistaken) general assumption that as a result of GATT and the reductions in subsidised exports that world prices will generally rise. They would rise, however, only in relation to what they would have been in the absence of the GATT. Prices could still fall while being consistent with the above prediction. Anderson and Tyers (1992) in their model of world food markets show prices under a partially liberalised trade regime being 8 per cent higher than the prices obtaining without any liberalisation by the year 2000. However, absolute world prices are on average virtually the same at the end of the liberalising period as at the beginning.

very different conclusions are derived on the level of export volumes which are calculated as the residual after taking into account production, imports and consumption. It is true that the majority of estimates concluded that the required export reduction was achievable within the MacSharry reforms, but most of these same estimates had future annual production levels below even the current level of 160m tonnes. This output level has been attained despite set-aside and the implementation of most of the planned price reductions, and compares with pre-reform output level of 169m tonnes.

An important reason for the small response to the price cuts in cereals is what might be termed the 'quotarisation' of EU agriculture. Payments are now made to farmers on the basis of historic production patterns: rights to cereal, oilseed and legume payments are limited to what was grown in a base period, just as rights to beef and sheep payments are similarly limited by historic stocking levels⁸. It is because the compensation payments for alternative farm products are limited to those farms that have previously produced them that farmers cannot shift production patterns without financial loss. Thus, cereal output reductions arise only because of less intensive production and set-aside. The normal additional market effect of marginal grain growers transferring cereal area to other uses does not occur because of the loss of arable area payment without any compensating premium for other products. It is not difficult to see why the Commission has organised it so, given the overproduction in most other sectors. However, it demonstrates how the distortions of intervention in one market have a domino-effect on others, and how the resulting system of intervention becomes even more difficult to unravel one sector at a time.

Our own analyses have suggested that across a range of assumptions about lower input use in response to price cuts, technological improvements (mostly through plant breeding) and demand response to lower prices, the required cereal export volume reduction by 2001 can be managed without further reform of the CAP. But it will almost certainly require changes in the level of quantitative restrictions (quotas and set-aside) and prices. In fact, under certain sets of quite feasible assumptions the URA target could require significant increases in the set-aside rate, or further substantial price reductions (or a combination of both). Given a longer time horizon, the solution would have to be even more drastic.

This is the crux. There is no certainty either way that URA export commitments can or cannot be met. But the probability that they will not be met increases the longer the time period considered, because annual productivity growth will increase supply at a greater rate than the increase in domestic demand. In the context of PECO accession during the first decade of the 21st century, it seems almost inevitable that further changes will have had to have been made to price or supply control levels, whether or not further enlargement occurs. Given the political difficulties associated with increasing set-aside, not to mention the economic inefficiency of enforcing resources to remain idle, it might be thought that the solution would lie in having EU prices close to or at world levels. This would also remove any ceiling on exports, since it is only subsidised exports which are limited. Indeed, the purpose of the URA and the GATT is to encourage undistorted trade.

⁸ As with any complex policy like the CAP, there are qualifications. Limitations are also imposed based on current stocking rates, and a small percentage of the aggregate 'rights' to sheep premia are given to farmers without historic claims.

Paradoxically, it can be argued that the introduction of quantitative limits in the URA have made it more likely that supply controls will be used rather than price cuts in the event of trouble in meeting the export commitments. This is because the very existence of supply controls implies that there are economic rents being earned. In other words, producers are receiving a price in excess of the level necessary to induce the restricted output. Thus price reductions may have little effect on production decisions until this slack is taken up. Quite a large price cut may therefore be necessary to get any discernible production effect and even that may take some time to show up. This is particularly so in the case of milk (and milk products) and sugar where farm level quotas exist. The argument is less applicable in the case of cereals where the quota is effectively on area rather than output. However, because supply is inelastic in the short term even price cuts in cereals would have little immediate effect on output. If the EU is perilously close to its export volume commitment the Commission will almost certainly want to take action which deals directly with the problem by the next season at the latest. This almost certainly points in the direction of tighter supply control.

It is a contentious point whether price cuts or more supply control will be preferred. Efficiency arguments, and the interests of larger farmers, who already have to set land aside and who farm the majority of land, point towards price cuts. However, because small farmers are exempt from set-aside and the number of member states with smaller farmers and a tradition of high prices has increased, this indicates that it may be even harder in the future than the past to agree price cuts⁹.

2.3 The Agricultural Budget

The maximum size of the EU's Agricultural Budget is determined by the aggregate own resources of the Union and the agricultural guideline. Aggregate own resources are obtained from customs duties, agricultural import levies, VAT and direct, GDP based, government contributions. Under the 1992 Edinburgh Agreement, the maximum own resources of the EU are set to rise progressively from 1.20 percent of EU GNP currently to 1.27 percent in 1999.

The agricultural guideline for price and income support (the Guarantee Fund) was fixed at 27.5 billion ECU in 1988, and annual increases thereafter were limited to 74 percent of the rate of increase in real EU GDP, with full allowance for inflation. However, following the 1992 reforms and the disturbances in the currency markets that year, it was recognised that the calls on the budget were likely to exceed the guideline as so defined. Accordingly, the budgetary reserve of 1000 MECU was added to the guideline for 1993 and 1994. For subsequent years, fifty percent of the reserve is to be added to the guideline. The guideline for 1993 was 36.66 billion ECU and the estimated margin above expenditure was 1300 MECU. Given a 2 percent annual increase in EU GDP, the ceiling on Guarantee expenditure by 1999 will be just 6 percent higher than the current level.

⁹ It is interesting to observe the recent decision to lower the set-aside rate from 15 to 12 per cent for the year 1994-95. This seems to signal that the Commission sees set-aside rates as the principal policy tool for achieving production targets. But, of course, it is easier to lower set-aside than to raise it.

The Commission view is that this level of resources will be sufficient to finance the CAP. The explicit budgetary assumption is that compensation payments will continue at current levels for the foreseeable future. However, any increases in set-aside or compensation rates (with or without price reductions) could undermine this view. Even without changes in the level of compensation, the budget is potentially fragile: the still unresolved questions over the use of the green ECU, and the tendency for national constituencies to obtain concessions in specific areas in return for agreement on EU-wide proposals will both place strains on any budget. The problem is typical of any common property resource (which the budget is). Every country stands to gain from a narrow perspective by extracting as much as possible from the budget because it only contributes a fraction of the extra resources required. But when every country pursues its narrow interest, the calls upon the resource increase beyond its capacity. In the past, this has resulted in expenditures increasing to meet these demands.

In two ways, however, the budget may be more manageable in the future. The importance of fixed payments (per hectare and per head) should make budgeting more accurate compared with anticipating world prices and production surpluses and the likely requirement for export subsidies. Budgetary pressure should also be less as a result of the accession of EFTA countries. The three countries recently accepted for membership are expected to be net contributors to the EU budget, with receipts exceeding expenditures by approximately 3-4 billion ECU (CEPR 1992).

2.4 Conclusion on the evolution of the CAP

The main influence on the principal CAP commodities over the next ten years will be the URA subsidised export volume limitation. It seems inconceivable that by the year 2005, production will not have increased in some sectors to levels which are incompatible with URA commitments. Notwithstanding the price cuts of the last three years, the large levels of research and development in plant and livestock breeding and in development of agrochemicals and animal health products over the last decade will result in substantial further improvements in technical performance. Because it can take a decade or more to bring the results of research to the market, the flow of technical developments over the next decade will barely be affected by the present price cuts. It is current research which will be cut back, and this will not be reflected in fewer new commercial technologies for another decade.

Given that oversupply is likely to remain a problem within the foreseeable future under the present policy, the major question is how this would be handled. The current range of instruments could certainly cope with the challenge, and in that sense no further *reform* of the CAP is necessary. What will be needed, though, is a willingness to use the level of incentives (prices, compensatory amounts, headage premiums) and quantitative restrictions (quotas, set-aside and stocking rates) flexibly in order to meet policy objectives.

A number of steps are possible. First, prices (a direct incentive to produce) can be reduced and the level of compensation increased. If the compensation is increased on average by the amount that prices (and average revenue per hectare) decrease, then not only does this

increase budget costs, but it over-compensates farmers for the price reductions¹⁰. Compensation on specific commodities is in any case limited to the 1992 level under the URA due restraint article. For this reason, it is suggested that any price reductions that may occur will not be accompanied by 'full' compensation, as presently understood and implemented in the 1992 reforms. Second, set-aside could be increased (with or without compensation). Third, the link between compensation and production could be ruptured completely so that area and headage payments are based solely on some historic production criterion or social need. This would eliminate the necessity to control individual crop areas which would expand or contract according to their profitability. Price policy would then be a more effective method of influencing output. At the extreme, prices could be freed entirely so that production patterns and levels were determined by economics. In this case, the principal budgetary cost would be the compensatory payments themselves. However, this outcome is unlikely, notwithstanding the economic arguments in its favour (and outlined recently by the External Expert Group (1994)). Some level of intervention buying is likely to remain to place a floor in the market. This will be combined with some level of trade protection, albeit at lower levels than today.

It is therefore concluded that quite apart from the Eastern enlargement, there will be substantial pressures for further changes to the CAP within the next decade. Whilst it may be possible for the present range and level of support to survive unscathed until the turn of the century, it will become progressively more difficult thereafter. In the absence of unforeseeable events, quotas, set-aside and compensatory payments will still exist and EU prices will still be maintained significantly above world market levels although by a smaller margin than in the mid-1990s. Despite all the arguments in favour of market prices the abandonment of supply controls and helping farmers with direct payments, the GATT and budget pressures alone will be insufficient to force the EU to adopt measures which are in its own best general interests.

¹⁰ Farmers are overcompensated because their revenue remains unchanged but they save on the input costs that would formerly have been incurred in earning the extra revenue.

3 PECO AGRICULTURE AND AGRICULTURAL POLICY PRE-ACCESSION

To understand the likely agricultural impacts of PECO accession to the EU it is necessary to consider the current agricultural situation and likely developments in the PECO. This chapter considers the macro-economic background to policy development, the place of agriculture in the different PECO economies (including its importance in trade), current agricultural policy and potential changes, and the likely impact of these factors on changes in agricultural output over the next decade.

There is a general view that the agricultural sectors in the PECO are in disarray as a result of the continuing metamorphosis from a centrally planned to a market economy, and that recovery to pre-transition levels of output will take 10 to 15 years. This is certainly the impression conveyed in the report by Nallet and Van Stolk (1994). It is vital that an accurate assessment of these issues is made, based firmly on fact and not casual observation¹¹. If the base situation is incorrectly characterised, this could lead to inappropriate policy conclusions. However, it should be stressed that discovering the real situation in the PECO macroeconomies and agriculture is not easy: the statistical services in the PECO have not fully adapted to the problems of data collection in a market economy and all quoted statistics should be treated with a degree of caution and verified as far as possible from a different source. In addition, international comparisons between the PECO themselves, and the PECO and the EU are bedeviled by the wide disparity in estimates of the most appropriate exchange rates to use.

3.1 The PECO: macroeconomy and agriculture

The six PECO countries together are, physically and demographically, an important part of Europe. Together, the PECO-6 have a population of about 96 million and a land area of 877,000 square km. This is about 28 per cent of the EU-12 population and 24 per cent of the EU-12 area. As shown in table 3.1, in terms of agricultural area it is even more important (40 per cent of the EU-12 agricultural area)¹².

The combined economic output of the PECO-6 in 1993 was under 200 billion US dollars or 412 billion when calculated at PPP exchange rates. The latter is slightly less than six percent of the EU figure of 7,040 billion dollars. The corresponding national incomes per head shown in the last column of the table indicate that the PECO, on average have incomes one tenth of the EU. There is much debate on how accurate these figures are. Most observers agree that there is substantial under-recording of economic activity, particularly in the private sector, much of which is in the service industries. Another factor which makes a great deal of difference to the income figures is the exchange rate used. The fifth column of the table shows GDP per capita based on purchasing power parity adjusted exchange rates. This raises

¹¹ It has to be noted that so inaccurate are some of the anecdotal references made in the Nallet and Van Stolk report (which contains no referenced tables) that it is hard not to wonder on what factual basis they drew some of their conclusions. (An example is the observation that "in Sofia there is more French cheese, Danish pork, Dutch tomato concentrate and Greek pasta than there is of equivalent Bulgarian products". It simply is not true; it seems a classic case of city-centre shop-window empiricism.)

¹² There are differences in the definitions of rough grazing in these agricultural area statistics. Polish figures include rough grazing, Bulgarian data does not.

the average PECO income to 21 per cent of the EU average. These adjustments affect the rankings of the PECO; Poland falls from 3rd to 5th, while Bulgaria (5th to 4th) and Slovakia (4th to 3rd) each move up a place. Within the group, Romania is lagging substantially behind the other five. Romania was the only country which requested to be classified as developing for the purposes of the URA commitments.

Table 3.1: The economic and geographical importance of the PECO in 1993

	Total area 000 km ²	Agricultural area ¹ 000 ha	Population million	Nominal GDP billion USD	GNP per capita USD (PPP)	GDP per capita USD
BULGARIA	111	4576	8.9	10.3	4772	1226
CZECH REPUBLIC	76	4550	10.3	29.3	6965	2844
HUNGARY	93	6484	10.3	35.2	5141	3417
POLAND	312	18700	38.5	85.2	4265	2213
ROMANIA	238	14790	22.8	24.6	2382	1088
SLOVAK REPUBLIC	47	2877	5.3	11.0	5033	2075
PECO-6	877	51977	96.1	195.6	4291	2044
EU-12	2363	130,340	346.2	7040.0 ¹	20280 ²	20349 ²

Sources: Business Central Europe (September 1994), Planecon, Swinnen (1994), ASIC (1993) Eurostat.

¹ Data for 1992.

² Purchasing power standard, 1992, Eurostat

Apart from Romania, the PPP adjusted income figures place the PECO in the range of low middle-income to middle-income countries. Bruno (1992) included some social indicators like the level of education and health and concluded that all the countries in the region could be defined as middle income. This seems a better description of the situation than that provided by the much lower unadjusted GDP figures. Further references to income in this report will be based on the PPP adjusted figures.

Table 3.2 summarises the macroeconomic situation in the PECO over the last four years. Bearing in mind the caveats regarding the quality of the statistics, it is generally a story of instability and decline. The economy contracted in all the PECO, by most in Romania and least in Poland (row 1). This contraction was caused partly by the necessary adjustment to the removal or reduction of price distortions existing under central planning, and partly by the privatisation process. Not shown in the table is that the rate of decline of GDP has slowed down and, in the case of Poland and Romania, it has been reversed. Indications for

1994 are that all but Bulgaria and the Slovak Republic will achieve zero or positive growth.

Inflation (row 2) continues to be high, particularly in Romania and Bulgaria where current rates are well in excess of what would likely to be acceptable for EU membership. Unemployment (row 3) has risen throughout the region but the rates shown are not outside the range found in the EU. There is some doubt about the usefulness of these figures because they do not reflect the disguised unemployment still present in some state sectors, nor the extent of people registered as unemployed yet economically active in the 'informal' economy.

Table 3.2: Macro-economic indicators for PECO countries

	BULGARIA	CZECH REPUBLIC ¹	HUNGARY	POLAND	ROMANIA	SLOVAK REPUBLIC ¹	EU
GDP Cumulative change 1990-94	-25.9	-19.7	-18.5	-11.8	-33.1	-29.7	2.3
Consumer prices % change 1993 average	72.8	20.8	22.5	35.3	256.1	23	3.3
Unemploy ¹ % labour force 1993	15.3	3.5	12.1	15.7	10.2	14.4	10.6
Gov't balance % GDP 1993	-15.1	1.0	-7.0	-2.9	-0.1	-6.8	-4.5
Current account % GDP 1993	-7.0	1.9	-9.6	-2.7	-6.0	-6.4	-1.0
External Debt Net of Reserves billion USD	12.2	3.8	19.2	48.4	3.5	2.5	na
Debt Service Ratio % of exports of goods & services	9.2	7.4	33.7	9.1	6.4	na	na
Exchange rate (Nat. currency per USD, annual average)							
1989	1.82	15.1	59.1	1446	14.9	15.1	0.907
1993	27.86	29.2	91.9	18145	760.1	30.7	0.854

Sources: Bartholdy (1994), OECD (1994), Business Central Europe, Sept 1994

¹ 1989 and 1990 refer to Czechoslovakia

A deficit in the public finances (row 4) is a serious problem in Bulgaria and a smaller problem in Hungary and the Slovak Republic. All the PECO countries except the Czech Republic have a current account deficit, which is especially large in relation to GDP in the case of Hungary, Bulgaria, Romania and the Slovak Republic. Three countries have high levels of external debt both in absolute and relative terms: Bulgaria, Hungary and Poland. Bulgaria's debt is particularly high in relation to GDP. A large part of PECO debt was accumulated under central planning, but Romania only started to accumulate external debt post-reform; by 1993 this had reached 3.5 billion USD. Servicing the debt in these countries will undoubtedly put pressure on their economies.

Not surprisingly, given the overvaluation of the official exchange rates under central planning, all PECO countries experienced very large devaluations of their currencies. The economic disruption during liberalisation added to this process as the PECO countries moved from fixed exchange rates to pegged or floating rates. The assumption is that the major necessary adjustments in exchange rates have now occurred in most countries, and future declines will become proportionately less. However, where inflation is still very high (Bulgaria and Romania) further substantial devaluations are likely, and with them a high degree of economic uncertainty.

Turning to the place of agriculture in the economy, table 3.3 shows that the agricultural sectors in the PECO countries are relatively more important than in the EU. Romania is the most dependent on agriculture with approximately 24 per cent of GDP derived from agriculture, followed by Bulgaria (9 per cent) and Hungary (8 per cent). The average for the PECO-6 of 9 per cent is three times higher than the average for the EU. The country that is closest to the EU share is the Czech Republic with 4.5 per cent. Agricultural employment is even more important in the PECO countries: more than a quarter of employment in Poland and Romania, and nearly one-fifth in Bulgaria is in agriculture, compared with less than 6 per cent in the EU-12. Notwithstanding its importance and the wider distribution of land ownership as a result of the privatisation process, agriculture has become slightly less significant in the PECO economies: its contribution to GDP and employment has generally declined - as, indeed, it has in the EU.

The last two columns of table 3.3 show FAO estimates of the absolute levels of employment in agriculture. It is most striking that the total number employed in the PECO-6 is not far short of the EU-12 total. It is quite possible that in some countries this number is understated because of the inability to record people engaged in small-scale private agriculture. In all cases the recorded numbers decreased over the period 1985-1993. On average they fell by 24 per cent, but in Hungary they fell by almost a third.

Expenditure on food as a proportion of total expenditure is substantially higher in the PECO countries than in the EU-12, reflecting the differences in income. In Bulgaria and Romania the importance of food expenditure in the household budget has actually risen as a result of the large income decline in those countries.

Table 3.3: Importance of agriculture for PECO

	Share of agriculture in GDP		Share of agriculture in employm ¹		Average share of household income spent on food		No. People employed in agriculture '000	
	1989	1993	1989	1993	1989	1993	1985	1993
BULGARIA	11	9.2 ¹	18.1	17.4	29.5	35.9	670	485
CZECH REPUBLIC	6.3	4.5	9.4	6.5	31.6	31-32	906 ⁷	724 ^{2,7}
HUNGARY	15.6 ³	8.5 ^{2,4,3}	17.9 ³	9.9 ³	25.4 ⁴	25.1 ⁴	752	517
POLAND	8.2	6.8 ²	26.4	25.2	50.0	36.0	4676	3700
ROMANIA	14.4	23.7	28.2 ⁶	32.2	49.2 ⁶	58	2839	2053
SLOVAK REPUBLIC	9.4	5.9 ⁵	12.2	8.6 ⁵	29	27.2		
PECO-6	9.0		19.0		36.1		9843	7479
EU-12 *	2.8		5.8		21.7		8353	

¹ Forestry is included in 1989 and excluded in 1993

² Figure for 1992

³ The share of food in GDP is 1.8 in 1989 and 4.7 in 1992, the share of food in total employment is 4.3 in 1989 and 4.6 in 1992

⁴ Average share of household expenditure spent on food excluding beverage and tobacco

⁵ The sectoral share for food in GDP is 3.4 in 1993 and in total employment 2.4 in 1993.

⁶ Figure for 1985, OECD 1994.

⁷ Czechoslovakia

Source: Report from ad-hoc experts OECD, * ASIC 1993 (figures for 1992, 1991 or 1990), Jackson and Swinnen (1994) FAO 1993.

The size of the contraction in agriculture in the PECO from 1990 to 1993 is shown in table 3.4 in terms of percentage changes in the volume of gross agricultural output. Overall, the contraction was deepest in 1992, but part of this was due to drought which affected much of central Europe. Some of the "recovery" in 1993 was due simply to an improvement in the weather (for example, in Poland) rather than an underlying change in economic fundamentals. This emphasises the difficulties of drawing conclusions from a limited range

of data. The cumulative decline over the period 1990-93 was large (over 20 per cent in four countries) but hardly unexpected, given the transitional problems of introducing private ownership (and private decision-making) and the huge changes in absolute and relative prices that liberalisation has brought about.

Table 3.4: Percentage Change in gross agricultural output in PECO's

	1990	1991	1992	1993	Cumulative change 1990-1993
BULGARIA	-6	-0.3	-12	-20	-34.0
CZECH REPUBLIC	-3.2	-8.9	-11.8	0.6	-21.7
HUNGARY	-4.7	-6.2	-19.9	-8.5	-34.5
POLAND	-2.2	-1.6	-11.9	2.2	-13.3
ROMANIA	2.2	0.8	-13.3	11.0	-2.4
SLOVAK REPUBLIC	-4.4	-8.2	-12.6	-6.6	-28.3

Source: OECD (1994).

The balance of agricultural trade of PECO-6 is shown in table 3.5. For the six countries together there was a major decline in the trade surplus in 1993 compared with 1992. Agricultural exports fell in virtually all PECO countries, while imports tended to rise. In 1993 Poland, Romania and Slovakia were all net food importers. Despite the halving of its positive agricultural trade balance, Hungary remained in 1993 the most significant net exporter. Despite the reductions, agricultural exports remain an important part of total merchandise exports for the PECO's, as shown in the final column of the table.

Table 3.5: Agriculture and food trade balance (USD million) and share of agricultural trade

	Agricultural Exports		Agricultural Imports		Agricultural Trade Balance		Share of agricultural exports in total exports (%) 1992
	1992	1993	1992	1993	1992	1993	
BULGARIA	781	694	267	392	514	228	22.3 ⁴
CZECH REPUBLIC	1069	1005	1050	969	19	36	14 ¹
HUNGARY	2653	1778	660	759	1993	1019	
POLAND	2002	1666	1952	2254	50	-588	15.2 ³
ROMANIA	290	262	988	813	-698	-551	
SLOVAKIA	304	365	203	416	101	-51	6.8 ²
PECO - 6	7099	5770	5120	5603	1979	167	
EU - 12	179392		206304		-26912		8.9

1993 : provisional, based on the trend over the first ten months of 1993

Source: OECD (1994), Country reports from ad-hoc experts OECD

¹ 4.3 in 1989, 10 per cent in 1992 by Kraus and al, 1994; foreign trade is increasing, however at a higher rate for exports than for imports.

² 1993 figure OECD country report Sept.94

³ 12.1 per cent for 1993-1994: Polish agricultural trade is declining in this period following the implementation of regulations for agricultural trade and the increasing protectionism resulting from the pressure of farmers organisations on the government to protect domestic producers and to reduce import of subsidized agricultural goods.

⁴ The share has declined in 1993 to 20.5 per cent (OECD, 1994). Some of the largest declines were policy induced e.g the export ban of wheat and fodder grain. The development of the two major products were in opposite directions: increase for wine exports and decrease for tobacco exports.

3.2 PECO agricultural policy

In order to discover what policy and institutional adjustments may be needed to integrate agricultural policies in the PECO and the EU it is necessary first to summarize the main policy instruments in use. This is not an easy task because in just five years the PECO have switched from central planning, then very briefly to a liberal regime, and later to a more protectionist stance using a wide array of domestic and border measures. The situation is even more complicated because for certain aspects it is impossible to separate agricultural policy from the more general reform measures. This particularly relates to the restoration of private property throughout the economy. In agriculture this refers to land reform and

other measures to restructure collective and state farms.

3.2.1 Structural reform and progress

The restoration of private property rights on land and the transformation of state and collective farms is considered in all the PECO's as a precondition for an efficiently functioning agricultural sector. In most PECO's the land privatisation process has been dominated by the settlement of historic claims on property, land in particular. There is evidence that the two processes (privatisation including the restoration of historic rights and restructuring of farms) have clashed to some extent in all countries (OECD 1994). This contradiction has been less important in Poland where restructuring only applies to a minority of the land (mostly in former German land in the North and West of the country).

As far as land claims are concerned, the approaches differ significantly. Bulgaria is at one extreme undertaking comprehensive restitution of land to the former owners or their heirs prior to the collectivisation. Hungary has used a combination of some land restitution and compensation for former owners in order to leave existing structures intact. Romania chose to distribute land to former members of cooperatives, workers on state farms and other rural residents. On the one hand, this has led to the rapid disappearance of the collective farms, but at the cost of significant farm fragmentation. Given the lack of a land market in Romania, the prospects for land consolidation are remote (OECD 1994).

A more cautious approach to the removal of the former farming structures was followed in some PECO's where collective farms were required to restructure themselves as various forms of business identities such as joint stock or limited liability companies. However, in Hungary and the Czech and Slovak Republics, the vast majority of collective farms registering themselves under new cooperative laws are reported to be little changed from the previous organisations.

In general, the implementation of land reforms in all PECO's has been rather slow, but it is an extremely complex process entailing the restoration of property rights and their distribution to former land owners and cooperative workers.

There are two questions connected with land reform and the restructuring of collective and state farms that are relevant to the enlargement. First, what farming structures will emerge from the restructuring and will they differ in any significant way from the prevailing family farm structures in the EU? Second, what are the potential implications for productivity of current land reforms and restructuring? The second question will be treated in section 3.3.

Farming structures emerging from land reforms and transformation or privatisation of state and collective farms are far from clear or settled yet. The only exception is Poland, where the structure is dominated by small scale privately-owned peasant farms which existed pre-reform. Buckwell (1994) stressed the point that in significant parts of the region (and again with the exception of Poland) there is, initially at least, a desire to farm 'in association', as opposed to in the classic Western family farms because it keeps closely to the status quo and

requires less adaptation and change, and because the resource mix and technologies available and with which the workforce is used to working are based on larger-scale structures.

The other prevailing farming structure that seems to be emerging from the reform process is a peasant type farm. At this stage commercial family farms are emerging, but until land ownership questions are settled and until active land purchase and rental markets come into being, these will not develop rapidly. In the longer run, some argue that the 'climax' structure is the family farm, Hagedorn, (1994) which would provide full-time employment for a number of members of the family. However, in the time horizon covered by this paper it is unlikely that this type of farm will be important. Therefore, the enlargement will bring to the EU, a dual structure of producer cooperatives and peasant type farms, neither of which are likely to prove viable under the conditions of developed markets.

3.2.2 Privatisation of upstream and downstream industries

The pace of privatisation and demonopolisation of input supply, food processing and distribution has been mixed. Two general patterns emerge: the more downstream a particular activity is from the farm, and the smaller its scale of operation, the greater the degree of privatisation achieved. Consequently, in most countries of the region (e.g. Bulgaria, Czech Republic, Poland, Slovak Republic) almost all retail activities were privatised by 1993. On the other hand, large scale enterprises closest to the farm in terms of supplying inputs or processing produce turned out to be the most difficult to privatise. Thus, grain handling and milling, feed compounding and large meat and milk processing plants are still mostly state owned. Small units in these industries have been privatised relatively quickly (eg small scale meat plants in Poland). Also, such industries as vegetable oil, sugar, tobacco, beer and wine, with a better technical base or some established market niches in the West have proven easier to privatise, often and critically with an important role played by foreign capital. The most advanced in this respect is Hungary due to its open (and successful) policy towards foreign capital since the beginning of transition.

Given the slow pace of privatisation, it is reasonable to ask whether the PECO's will have privatised the food chain pre-accession. Or inverting the question, will the existence of fully or partially state-owned enterprises in the upstream and downstream sector create a problem for the accession?

The political commitments in PECO's to privatise are beyond doubt. However, the existing administrative capacity, the sheer size of the task to privatise an almost totally state-owned economy, as well as restricted demand for some industries or factories delay the process. It is assumed that the privatisation in some cases is not a matter of selling the state-owned enterprises as closing them down and encouraging new entries. Many of the existing state-owned enterprises are not of interest to private investors due to their huge capacity, out of date technology, overmanning and distance from markets. In some countries (eg Bulgaria) they are burdened with accumulated debts, which in some cases are still growing. When state owned firms have zero or negative market value, privatisation is not feasible.

With the combination of privatisation and liquidation of state-owned enterprises and new entries, it could be expected that most of the food chain will be in private hands by the time of accession. If this is not the case, it offers the possibility to the EU to make privatisation

a pre-entry condition. However, even if the process is not complete this does not create unbearable problems for accession. Monopolised food processors will be subject to EU competition policy and may find some of their activities restricted by that policy, but the more important consequence is likely to be the lack of quality, efficiency and market awareness of such enterprises and the consequent disadvantage for the development of PECO agriculture and food industry.

3.2.3 Price, trade and credit policies

In the early years of transition, particularly in 1991 there was a general move towards price liberalisation whilst maintaining Government control on prices of some basic foodstuffs. Together with trade liberalisation there was a removal of subsidies channelled through the food chain. Poland started domestic price liberalisation earlier than the other PECO: the link between domestic and world prices was established in 1990 after the liberalisation of trade. Romania still has extensive Government intervention in food prices.

Price liberalisation resulted in a significant deterioration of the internal terms of trade for agriculture. The ratio of agricultural output to input prices (1990 = 100) had decreased by 1993 to between 80 per cent in Hungary and 44 per cent in Bulgaria. Similarly, farm prices increased at slower rate than retail food prices in all countries except Poland and Romania; the index (1990=100) in farm to retail price ratio ranged between 46 in Bulgaria and 116 in Romania for 1993. This means that the farmers share in retail prices has declined. This is a normal tendency in the developed market economies. However in PECO it reflects not so much the increased value added in the downstream sector as the market power of this sector in comparison to farming. The non-typical situation in Romania may result from the deliberate government policy to stimulate production and keep consumer prices relatively low. In Poland there was almost no change in the ratio between producer and retail prices. There, the large change in relative prices occurred in 1989-1990 which is only partially captured by the data in table 3.6.

Table 3.6: Agricultural price and market policy in PECOS

	Price liberalisation	Terms of trade for agriculture in 1993 (1990=100)	Market intervention agency	Price and market intervention mechanisms
BULGARIA	1991 almost all consumer and producer prices liberalised simultaneously. control left on some food prices	producer/input 44 producer/retail 46	No single agency, but intervention by: - Fund Tobacco, and - Fund Zerno (bread wheat) and the - Tax administration (control on profit margins of basic foods)	Control on profit margins of basic food (ceiling prices); administrative price (wholesale price of tobacco); minimum guaranteed price: (bread wheat); intervention (tobacco)
CZECH REPUBLIC	1991 price liberalisation, temporary control on some food prices	producer/input 47 producer/retail 60	State Fund for Market Regulation	Intervention in export subsidies for surplus supply milk Guaranteed prices or state purchases milk bread wheat, beef
HUNGARY	1991 price liberalisation; temporary control on some food prices; 1992 full price liberalisation	producer/input 80 producer/retail 86	1993 Agricultural Market Regime Office (AMRO) and Product Councils Implementation and enforcement of Market regulation act	Target prices; threshold and sluice price; guaranteed prices; intervention storage & purchase limited to quota for cereals; unlimited for pig and poultry Directly regulated markets wheat milk pigmeat beef Indirectly regulated markets sugar sunflower
POLAND	1989 liberalisation of food and agricultural prices; 1990 with liberalisation of foreign trade domestic prices influenced by world prices	producer/input 79 producer/retail 101	1990: Agency for Agricultural Markets - regulation of agric. markets, protection of farm incomes - formulation of organisation & legal proposals for the government	Intervention: purchase and sales; storage; imports-exports. Minimum prices (wheat, rye, milk); AAM can buy with higher prices (15-30%) Intervention in many markets: cereals milk pig meat. Quotas for sugar
ROMANIA	In principal market price setting; in fact strong intervention using food security argument and aiming self-sufficiency. Gradual decrease in intervention 1993	producer/input 73 producer/retail 116	State Agricultural Fund maintaining the previous procurement system which centralise purchases at a guaranteed price. In competition with the market channels Share of the Fund in purchases: <50% most products, >90% for sugar and sunflower	purchase prices guaranteed by the state for basic products: cereals, oilseeds, beans and peas, potatoes, sugar beet, tomatoes, seeds, milk. Control of retail prices bread, milk and products, meat and products. Exemption of VAT for meat, milk, bread, edible oil & butter.

SLOVAKIA	1991 price liberalisation; temporary control on some food prices	producer/input 57 producer/retail 63	1993: Slovak Fund for Market Regulation (SFMR): It recommends guaranteed price levels and may intervene in foreign trade as a measure to stabilise domestic markets.	Guaranteed prices within quota milk. Minimum guaranteed prices, minimum quotas for intervention purchases slaughter cattle, cereals, slaughter pigs, sugar, potatoes. System of guaranteed prices which come into effect if average input prices rise more than 5%. Monitoring of retail prices milk, bread.
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Source: Swinnen (1994); OECD (1994)

Subsequent to the swing towards market prices in 1991, there was a reaction and market support has been progressively introduced. All the PECO's with the exception of Bulgaria have created specialised agencies which cover the whole sector. Bulgaria, exceptionally, has two product oriented state funds for tobacco and grain. Some of the instruments for price support used are those employed in the EU; minimum prices, intervention purchasing, subsidised export of surpluses. However, there are substantial differences between the PECO's. Reflecting their earlier contact with the EU, the Visegrad-4 introduced systems which are strongly influenced by the CAP. Romania is operating policy which still resembles command-economy measures, while Bulgaria has very limited price support for tobacco which is not fully enforced because of lack of funds, and has not built institutional structures for agricultural market support. Because oversupply is not a problem, none of the PECO's have any instruments to restrict supply directly such as individual farm quotas, restrictions on livestock numbers or stocking rates, or set-aside. Likewise, none offer direct payments to farmers and neither do they have schemes of payments for environmental services. However, some have operated special schemes to assist farmers in disadvantaged areas. For example, Bulgaria for a few years arranged higher prices for some livestock products originating in mountainous and semi-mountainous areas.

In the absence of settled property rights and given poor information in the possession of both borrowers and lenders there are significant failures in the rural credit markets (analysed in Bulgaria by Petranov and Roussinov in Schmitz *et al* (1994)). These failures have meant that access to credit has been a significant problem during the transition. This is no doubt another contributory factor in the decline in farm output in the PECO's. The failures are manifest in several ways: an underdeveloped commercial financial system and lack of collateral due to the unfinished process of recognition of titles to land, exacerbated by the lack of experience of applicant farmers and the general uncertainty regarding the rate of inflation of farm prices. The result has been a perceived lack of funds for purchasing current inputs (feeds, fertilisers, fuel) and for long term investment. The failure of the financial system to provide loans to agriculture is understandable, given the risks and the more predictably profitable outlets for the limited capital available. In order to overcome some of these problems most Governments have intervened in credit markets to provide credit guarantees or credit subsidies to farmers. Some countries use credit subsidies for investment credits only (eg Hungary), others for working capital (eg Bulgaria). The country with the largest such scheme for credit subsidies is Romania.

The use of credit subsidies is highly controversial. Despite the agreement that some action is needed to improve farmers' access to credit, it is not clear that the present schemes in operation are solving the problems. The assistance available though large in absolute terms is small in relation to potential demand for cheap capital. It is unclear who get the benefits nor how the cheap credit is used. There are suspicions that it may even slow the development of efficient capital markets. The perception is that once credit subsidies are in place their removal will be difficult. Even though all PECO's claim that they are temporary measures necessary to smooth the transition and to help the restructuring there is a danger that they will stay in place for long period of time.

Border measures were subject to the same evolution as price policies. For the first year or two of transition trade was genuinely liberalised but soon afterwards protection was

increased. In the internal political and public debate the increased border protection was justified by the argument that it was necessary to give some protection against subsidised exports coming from OECD countries.

The range of border measures applied by PECOS varies from country to country, but in general they include customs tariffs that have shown a strong tendency to increase, import licensing and variable levies (applied by Visegrad4). Table 3.7 is an attempt to summarise the main features of the trade instruments used in the PECOs since reform. The table is not comprehensive because of the difficulty of capturing the numerous changes in the border measures employed by the PECOs post reform. Dealing with these changes is one of the extra difficulties that producers and traders have in planning and running their businesses.

Table 3.7 Agricultural trade policy in PECO's

	GENERAL	IMPORT POLICY	EXPORT POLICY	COMMENTS	PSE
BULGARIA	1991, general trade liberalisation Import duties up to 55% (poultry). Export restrictions (export tax and bans) in order to increase the supply or to stimulate export of higher value added products unfermented and unmanufactured tobacco, grain, oilseeds, raw hides live female animals in reproductive age, non-automatic export licensing (meat, live animals)	Automatic licence: alcoholic beverage, tobacco products Non-automatic licence: plant protection chemicals Quotas: ice cream Minimum import price Fruits & Veg, alcohol drinks, cigarettes	Automatic licence: dairy products, quality wines Non-automatic licence: live animals, meat, grain seeds for sowing, tobacco Export tax: oilseeds Minimum export prices: for export to EU Export ban: female livestock for breeding, wheat	Very unstable policy "So many regulations apply to agriculture and food products that the foreign trade turned out to be one of the main generators of distortions in the sector" (Davidova, 1994)	negative
CZECH REPUBLIC	1.01.92: Trade liberalisation; substantially higher tariffs for sensitive commodities (agro-food products) and import levies (agro-food products); licences for registration purposes.	Nov 1994, increased tariffs Import levies: live cattle, live sheep, meat, butter, potatoes	Export subsidies to reduce surpluses on domestic market; use is now reduced to dairy products Non automatic licences for some products to protect domestic supplies.	System roughly similar to the EC, but does not operate to the same extent (OECD, 1994)	slightly positive
HUNGARY	1991: general trade liberalisation except 10% of national imports. The major part of agro-food products remains with restricted licensing rules. Except: breeding animals, seeds, wood, protein feed.	Import Quotas: selected prod. under "Global Quota" Introduction of licences for dairy products and wheat as a result of a surge of imports (1994)	Export subsidies (in percentage) increased in 1993: milk products, meat and meat products, fruits wine	'Hungarian foreign trade policy was strongly influenced by the international trade environment of trade barriers and export subsidies' OECD 1994 Export subsidies are said to respond to EC veterinary ban on animals and animal products in 1993.	slightly positive

HUNGARY	1991: general trade liberalisation except 10% of national imports. The major part of agro-food products remains with restricted licensing rules. Except: breeding animals, seeds, wood, protein feed.	Import Quotas: selected prod. under "Global Quota" Introduction of licences for dairy products and wheat as a result of a surge of imports (1994)	Export subsidies (in percentage) increased in 1993: milk products, meat and meat products, fruits wine	'Hungarian foreign trade policy was strongly influenced by the international trade environment of trade barriers and export subsidies' OECD 1994 Export subsidies are said to respond to EC veterinary ban on animals and animal products in 1993.	slightly positive
POLAND	1990: Trade liberalisation, internal convertibility of Zloty Increasing border protection	Mid 91 & 1993: New customs tariffs with higher duties, 1993: specific rate tariffs (in ECUs per unit) poultry, eggs, potato flour, sugar Border tax: 6 % 06.94: Variable import levies applied: pigmeat, poultry, 1992/93: Suspension of tariffs under specified quotas grain & feedingstuffs Veterinary licensing syst. dairy prod. Temporary bans possible	1992/93: temporary export ban on rapeseed and some feedstuffs, Occasionally, export subsidies on sugar, butter, milk powder	The EU is the main trading partner in agric. products with 55% share of total Polish agric. trade., increasing exports to the NIS countries	positive

ROMANIA	1990: in theory, trade is liberalised. In practice the government still plays an important role in foreign trade. The liberalisation of agricultural trade depends on the interpretation of the domestic market situation from the Romanian gov'. Situation difficult to assess.	Imports generally financed by external credits and special govT credits. 12.93: Many food and some agricultural products or inputs made free of customs duty No import quota. Renunciation to cereals imports for 1994-95.	Export bans in response to perceived domestic shortages for cereals, wheat (seeds), rice, sugar, butter, other milk products.	In 1993, agricultural trade policies were largely determined by the level of domestic supplies. OECD 1994	not available
SLOVAKIA	Export and import of agricultural products are regulated by a system of import and export licenses. Alteration of the system in 1994: range of products to be exported	1992: general increase in customs tariffs; Variable import levies; import subsidies; Preparation of law of protection against low-quality imports and stricter vet & phyto measures. Temporary import surcharge for selected commodities (consumer goods, foodstuffs)	Export subsidies: sugar dairy beef pigs poultry eggs Enhancing-exports measures (which are not direct export subsidies).	Customs Union between CR and SR requires mandatory coordination of the licensing policy in both states. Some trade disputes between the two. Import protection measures in response to the use of export subsidies by OECD countries.	not available

Source: Swinnen 1994 and OECD 1994

Due to variation in domestic supplies and perceptions of possible food shortages, some of the PECO, particularly Bulgaria, Poland and Romania have imposed obstacles on exports, namely export taxes, quotas, or in some cases outright export bans. Such measures have been used for critical crops like bread wheat to achieve food security. There is little grasp that the consequence is a depressed price and a threat to longer term food supply. The presumption is that with stabilisation of agricultural sector, and as PECO policy makers gain increased trust of market forces, these measures will disappear.

The overall effect of all the measures identified in table 3.7 is to provide a low (or sometimes negative) level of protection to PECO farmers, and a level of support which is considerably below that pertaining in the EU. The most widely available method of measuring the extent of support of agricultural commodity markets is using Producer Subsidy Equivalent (PSEs). These calculations are now emerging for PECOs, but they have not yet been done comprehensively for all PECOS to a standard methodology. There are particular concerns over the choice of exchange rates used in the calculations, (see Jackson and Swinnen 1994 and Tangermann, 1993). According to the OECD estimates for Hungary and Poland there are roughly three phases over the last 6-8 years; positive PSEs before transition, negative ones during the large changes in price, trade and foreign exchange policies in the early years of transition, and afterwards increasingly positive. The calculations for Bulgaria, which has not introduced market support policies yet, show that protection is still negative. However, even in countries with the highest PSEs (Poland, Czech Republic, Hungary) they are within the range from 8 per cent to 16 per cent in 1992-93 compared with 45-48 per cent for the EU over the same period.

In conclusion, PECO agricultural policy makers found themselves in a difficult position. They had responsibility for presiding over an agricultural sector which is struggling to cope with the triple shock of macroeconomic instability, farm restructuring and declining terms of trade. Production seemed to be falling alarmingly, and the agricultural trade balance reversed as export markets in the old CMEA area vanished and there was a surge of imports from the West. Given the central planning mentality with its desire for physical control of food supplies coupled with perceptions of food shortages and the strong influence of the rural constituency, it was not surprising that a patchwork quilt of domestic and border measures was developed, the combined effects of which will take much more careful analysis to unravel. Although the range of protectionist measures employed is wide, the extent of their use is still far short of the levels of protection in the European Union. Quite simply the PECOs have neither the budgetary nor consumer spending power to match EU farm support.

The case of Bulgaria provides an instructive example. The understandable government response to the rapidly worsening situation in agriculture over the period 1991 to 1994 was to try to contain consumer food price rises using a (weak) system of price and margin controls, to prevent a feared grain shortage by taxing or banning exports and to try and help farmers through credit subsidies. Ivanova (1994) traced through the economic transfers arising from this combination of measures and found that in 1990 the system did indeed protect consumers to some extent, but at the expense of farmers who were effectively taxed. In the succeeding years the taxation of grain and meat producers continued, but the beneficiaries of the transfers have increasingly been the processing/distribution sectors where competitive markets do not exist. The real assistance provided to farmers from the state

budget has shrunk dramatically, and is overshadowed by the effects of high nominal interest rates, higher input prices due to a depreciating currency and declining real farm gate prices caused in part by the inefficiencies and, one suspects, excess profits earned in some parts of the processing and distribution chain.

Overall, a clear pattern has emerged in the evolution of policy in the Visegrad-4. They have explicitly moved to adopt what they call "CAP-like" policies, even to the extent of using export subsidies and variable import levies but not yet supply controls. Of course the Visegrad-4 cannot afford to implement these policy instruments at the same level as the EU, but they feel they are acquiring 'some experience' in using them to prepare the way to accession.

Bulgaria and Romania have not followed this path. Bulgaria has yet to define its approach. It has the least intervened-in sector and thus the greatest gap between itself and the EU. Romania is a case on its own because it intervenes strongly in the agricultural sector but with instruments that are more typical of the former central planning system than the market economies.

Alignment of agricultural policy instruments with the EU would be least difficult for the Visegrad-4, would not be such a problem with Bulgaria which at least does not have an elaborate alternative system to replace, but would be more awkward with Romania which has taken a different route. Having said this, considerable institutional development is necessary in all countries to enable implementation of a set of measures as complex as the CAP. By and large, the only area where there is systematic use of support measures not in use in the CAP is the use of subsidised credit. These would have to be phased out by the time of accession.

3.3 PECO agricultural development pre-accession

The collapse in agricultural output in the PECO's has been substantial, and the variety of measures introduced over the past two years has not yet had any discernible effect in reversing that decline. The question addressed in this section is whether and when a sustainable growth in agriculture can be expected and to what extent the growth in output will be absorbed in the region by increased consumption. The timescale in this analysis is the period up to the point of accession, that is the next five to ten years.

In discussions of this subject comparison is invariably made with the pre-reform levels of output. This is a misleading comparison to make. The pre-reform output was the outcome of a completely different system with different goals and prices which bore no relation to real costs of production. These historic output levels therefore are not a useful reference point. The only relevant question is what rate of future growth in production and consumption can be expected.

The potential supply and demand response in the PECO's to their domestic policies pre-accession is of crucial importance. An insight into this can give a firmer view on which of two visions of PECO agricultural development is likely to be nearer the truth. One view is that the contraction in PECO agriculture is almost totally due to the temporary transitional

problems, including the simultaneous reforms of ownership, price and trade policies, the removal of subsidies, and the temporary loss of the market in the former Soviet Union. On this view, once the shock of adjustment is over, with these countries having domestic policies providing stability and some support to farmers, a substantial supply response could be expected. With EU accession would come an injection of investment and managerial input from Western agri-business, which, together with the signal of higher and more stable prices, would enable the PECO's to produce large volumes of high quality agricultural produce.

The alternative view, as exemplified by Nallet and Van Stolk, is that by and large the PECO's are incapable of reversing the collapse in agricultural output for 10 to 15 years. Their agricultural performance will continue to show large annual fluctuations in output and an average level of quality of produce which cannot meet EU standards.

Both adjustment paths are possible. The most important determinant of which one occurs is the extent of macroeconomic stabilisation. The more quickly inflation is controlled, the faster the high nominal interest rates will fall and the currency will stabilise. This will create a better environment for privatisation and the attraction of foreign capital. These developments will do most to create real competition in the food chain and thus better terms of trade for farmers. Compared to these factors the precise market and trade policies for agricultural products are much less important, providing they are not radically different from those currently operating.

Institutions and attitudes are also important. The PECO's have emerged from central planning, under which prices were used mainly as an accountancy instrument serving the fulfilment and control of physical flows set up by the plan. Budget constraints were soft, and the objectives of enterprises were different from those in a market economy. Behaviour and institutions in PECO's are evolving towards those typical for the market economies, but there is still a long way to go. How fast progress is made depends on formal and informal education. One of the best educators is working with Western companies. Thus, the more open economies will undoubtedly make this transition in attitudes faster.

Because there are so many factors which will influence the rate of recovery it is very difficult to predict. The main assumption is that the worse years are over. The macroeconomy is already stabilising in the Czech Republic. Hungary, the Slovak Republic and Poland still have problems but may not be so far behind. Romania and Bulgaria are expected to stabilise at a later date. Thus the preconditions for agricultural development are expected to prevail in the period up to accession.

To investigate the prospects for agricultural recovery further, analysis should be pursued at a lower level: by individual country, by individual reform measures, and by individual commodities.

At the country level, the particularities of reforms underway will determine to a great extent the ability of agriculture to respond to the positive incentives. This is summarised in Table 3.8.

Table 3.0: Pre-reform system and reform pursued in PECO6

	Bulgaria	Czech Republic	Hungary	Poland	Romania	Slovak Republic
Pre-reform	Orthodox socialisation of agriculture, lack of entrepreneurial skills in the generation engaged in agriculture.	Orthodox socialisation of agriculture, lack of entrepreneurial skills in the generation engaged in agriculture.	More flexible and mixed system, not substantial role of state farms, collective farms with more independence from the central authorities, small scale private farms, some responsiveness to prices induced in the centrally planned system	Dual structure, with 80% of land in small scale private farms and 20% in large scale state and collective farms	Orthodox socialisation of agriculture, lack of entrepreneurial skills in the generation engaged in agriculture	Orthodox socialisation of agriculture, lack of entrepreneurial skills in the generation engaged in agriculture
Reform pursued	destruction of the collective farms inherited from the previous system, full restitution of land ownership burdened with long lasting disputes	preservation of 'collective' farming by transformation of collective farms into cooperatives of private owners, large number of members of the co-operatives, large number of absentee owners, no big disruption to the farming system induced by the reforms, future commercial viability of these producer cooperative with hundreds members questionable	partial land ownership restitution combined with voucher compensation, impediments to excessive fragmentation, commercial viability of producer cooperatives based on shared ownership questionable	preservation of the small private farming without explicit schemes for increasing the farm size which in many cases might be an impediment to commercial viability, privatisation of the state farms facing big problems because of the lack of demand, necessity of big investments in infrastructure, and alternative employment for workers in the state farms and in rural areas in general	at the beginning wild, afterwards partially legalised land restitution, destruction of the previous collective structures, fluid farming structures, big fragmentation of ownership and to a great extent of the operation	preservation of 'collective' farming by transformation of the collective farms into cooperatives of private owners, large number of members of the co-operatives, large number of the absentee owners, no big disruption to the farming system induced by the reforms, future commercial viability of these producer cooperative with hundreds members questionable
Likely speed of agricultural recovery	very slow	steady	steady	slow to steady	slow	steady

In the absence of significant foreign investment, table 3.8 suggests that a rapid and strong recovery cannot be expected. However, recovery will occur with some considerable variation between individual countries. An important question concerns the implications of the land reform and farm restructuring for productivity. Discussion of the restructuring problem invariably invokes arguments about scale economies. The conventional argument says that it is foolish to split up the large scale farms in PECO's because this risks losing the benefits of economies of scale. However, the evidence in Western Europe on scale economies suggests that once farms have expanded beyond a fairly modest size most (though by no means all) size economies are exhausted: the long run average cost curve is 'L' shaped. It is equally clear that other factors are more important than scale *per se*, including farmers objectives, the right incentives and management skills. That is to say, there is much greater variation in economic performance amongst farms in a similar farm size due to these other factors than there is between farms of comparable quality of management, but operating at different scales (Dawson and Hubbard (1987)).

Buckwell and Davidova (1993) applied these ideas to the post-reform restructuring in PECO's. They claim that the land reforms and related farm restructuring essentially shifts a bimodal distribution of farm sizes (with a large number of very small plots and relatively low number of large state and collective farms) towards a more conventional unimodal distribution. In this process there may be productivity gains at each end of the spectrum. The expansion of plots to small farms, as owners consolidate newly acquired land with their plots, enables them to exploit whatever scale economies there are. The contraction of the largest units as they are subdivided to form the new private cooperatives or joint stock companies enables the new units to avoid the diseconomies of the very large and unmanageable state and collective farms.

However, these gains in productivity are potential. The extent to which they will be realised in practice pre-accession depends on the incentives and stability created by PECO's domestic policies. To the extent that more coherent policies exist in the Visegrad-4, it seems reasonable to expect gains in productivity there. On the other hand, Polish agriculture is a particular example, where because of different location of private farms and state farms the explained shifts in size, and particularly the increase in size of private farms due to restructuring of state farms will not be always the case. That is why the countries whose agriculture is expected to develop faster in the group are the Czech and Slovak Republics and Hungary. In Bulgaria the pre-reform structures were the largest farming units in the PECO's, the so-called agro-industrial complexes. Potentially there are substantial gains from the restructuring and land reform. However, the delay in the process as well as the continuation of taxation of producers do not give objective signs that these potential gains could soon become real.

At commodity level, in grains, the production recovery could in general be fast and substantial in all PECO's in which there is not an excessive fragmentation of the operation, because in this sector there is not the need for large new investment. This applies mainly to the Czech and Slovak Republics, Hungary and Bulgaria. Polish experts claim that due to the peasant character of Polish agriculture, grain production increases will be very small. In general, in most annual crops more rapid development in productive capacity could be expected which has the potential of creating some problems with excess supply mainly of cereals and oilseeds (sunflower and rape).

Perennial crops (such as orchards and vineyards) are not likely to witness any increases in production for many years. Investment in these crops has been very low for a number of years, and current productivity is also low. Because of recent neglect, replantings are likely to be necessary on a major scale. Given the time horizon of the crop and difficulties in financing any long term agriculture venture in the PECO, such new plantings are likely to be limited in extent and impact in the period prior to likely accession.

In livestock production the story is more complicated. There is a perception across the region that it could recover quickly, particularly in countries with more fragmented operations (Poland, Romania and partially Bulgaria) because small livestock farms can farm more intensively and respond to market signals. However, this will not be very easy. The cattle production cycle is long and the rebuilding of national herds will take several years. Also, as the PECO markets are now open to the world, standards will also have to be raised in order to compete on both export and domestic markets. The gap in food conversion efficiency, in conformation, in animal health and animal welfare provisions between the PECO and the EU is large and will require substantial investment and skill development to close it. It is unlikely that farmers in peasant type agriculture will be very responsive to new technologies which will be restricted to the larger units with professional management. These considerations will prevent the PECO from producing substantial extra output of livestock products of acceptable international standards for several more years.

Before conclusions can be drawn for the implications of the expected production recovery on the EU it is necessary to treat two more questions: to what extent the increased supply could be absorbed by domestic demand and to what extent it could be absorbed by third markets outside the EU.

Domestic demand has dropped in the post-reform period, first, because of the decrease in real incomes of the mass of the population, and, second, due to the emergence of a wider range of consumer goods, durables and services of a quality previously unavailable to the population. The latter suggests that even when incomes return to the level that existed prior to the start of liberalisation, the level of food consumption will not return to its previous level on a per head basis: consumers will have a wider range of goods and services on which to spend their income. Typically, food consumption (especially meat) was higher per person in the centrally planned countries than in the EU. Extending the choice of the market to the PECO is likely to lead to a permanent reduction in the demand for food, compared with the centrally planned period.

It is highly likely that with an increase in the standard of living, demand will shift to higher value, more healthy food. Using developments in the EU as a guide, there is large growth potential as real incomes grow in the consumption of fresh fruit and vegetables and new processed dairy products. Considerable developments are required in the marketing infrastructure for the distribution of fresh produce, as well as dairy processing. At the present low rate of privatisation and reinvestment in the food industry it is likely that some countries will experience a growth in demand before the modernisation of food processing industries can develop the capacity to meet it. In these circumstances the growth in high quality high value consumption may be met with imported rather than local produce. An increasing share of such imports is already coming from the EU, aided by the proximity of available supplies and the easier access following the implementation of the Europe Agreements.

The capacity of the PECO's to export their surpluses to the non-EU markets is rather limited. There are undoubtedly opportunities to increase exports to the former Soviet Union but, following the disintegration of the economic system of the FSU, the capacity to pay for imports is low. During 1993 and 1994 some PECO's, particularly Poland in both years and Bulgaria in 1994, have expanded trade in this region, but it remains to be seen whether these trade developments are sustainable. It appears unlikely until greater signs of recovery appear in the FSU.

The Middle East has been a market for PECO's but mainly when the Soviet bloc had a political influence on some countries in the region. There may be scope for expansion into this market, and PECO's have an obvious locational advantage compared to Western Europe. However, they face competition in increasing their agricultural exports to the Middle East from traditional suppliers to this market.

As far as inter-PECO trade is concerned, there is even less scope. Apart from trade in specific products based on climatic differences (such as Bulgarian wine to Poland), trade between the PECO's has been very limited. Their agricultural industries were (and are) perceived to be more competitive than complementary.

In summary, the PECO's are recovering from the shock to their macroeconomies over the period 1989 to 1992. Their agricultural sectors have had additional shocks arising from privatisation and restructuring. However, there are signs that output declines have either ceased or are very small, and that some recovery in output is beginning. Agricultural policy in the region has been far from stable with many confusing switches in priorities and instruments. There are signs here too that some order is emerging from the chaos. These developments are occurring to different extents in the individual countries. Thus the PECO's differ significantly in their likely rates of recovery and in their readiness both generally and agriculturally to join the European Union. This will be taken up in more detail in chapter 5. In the next chapter the potential difficulties of PECO adoption of the CAP will be scrutinised.

4 EFFECTS OF PECO ADOPTION OF THE CAP

Given the divergent paths of agricultural development in the PECO and the EU (discussed in chapters 2 and 3), it is inevitable that difficulties will arise in any attempt to integrate their respective agricultural sectors. Difficulties though are not necessarily obstacles, and obstacles are not usually insuperable. It is the solving of problems, the overcoming of difficulties and the removal of obstacles that are the hallmarks of development and progress - and, one might add, political skill. Before policy options are offered to assist this development and progress, it is first necessary to assess the magnitude and nature of the problems. This chapter accordingly attempts to identify these problems and their relative importance.

The chapter begins by examining the likely response to PECO adoption of the CAP. The principal variables considered are production, consumption and net trade. This leads naturally to an assessment of possible trade tensions which could arise as PECO agricultural exports have free access to the rest of the EU market, and vice versa. The next problem to be examined is whether PECO adoption of the CAP will cause problems either for them or the EU in respecting the commitments each has made under the Uruguay Round Agreement (URA). This analysis is concerned principally with the immediate consequences of, and problems involved in, harmonising GATT schedules. The other area which can be identified as causing difficulties is the budget cost of PECO adoption of the CAP. A number of estimates of these costs have been made. These will be evaluated in the light of the judgements made here of the prospects for PECO agricultural response and the kind of CAP which will be operating into the next century. Before drawing conclusions on the extent of the difficulty of PECO accession, further evidence about what might occur - based on previous enlargements - is examined for the light it throws on some of these issues.

4.1 PECO response to adoption of the CAP

The extent to which all three of the potential problems (intra-EU trade, URA commitments and budget) might develop is highly dependent on how much PECO production and consumption will change following access to higher CAP prices. There can be little doubt that production would increase because the CAP (through its intervention system) would provide a level of market stability and security that the PECO have not known in recent years, while the market support system would provide an incentive to expand production and curtail consumption. But would these production and consumption responses be large and what would be the time frame for these responses to develop?

The answers depend on the size of the price gap between the PECO and the EU at the time of entry and the response of PECO producers and consumers to the higher prices. Evidence on the current price gap is provided in table 4.1.

Table 4.1: Producer prices for selected agricultural products in 1993 (USD)

	Bulgaria	Czech R	Hungary ¹	Poland	EU ₂	EU ₄
Feed wheat	94	93	44	132	180	200
Feed barley	89	93	82	112	173	192
Maize	117	119	96	120	191	211
Sugar	462	391			621	688
Sugar beet		28	26	24	43	48
Milk	185	200	207	129	527	584
Cattle (lw) ₃	682	873	859	696	1,743	1,933
Pork (lw) ₃	808	892	988	903	1,200	1,331
Poultry (lw) ₃	710	755	914	911	1,126	1,249
Exchange rate used (national currency per 1 USD)	27.65	29.15	79.00	18,145	0.854	0.77

Sources: Research Institute of Agricultural Economics, Prague; PAU, EC PHARE-Ministry of Agriculture, Sofia; APAU Ministry of Agriculture, Warsaw; ASIC, 1993; OECD, 1994.

¹ Prices for 1992


² Prices for 1992/93 using 1992 exchange rate

³ For EU and Hungary dead weight prices converted into live weight prices using the following conversion rates: 0.56 for cattle, 0.72 for pork, 0.74 for poultry

⁴ Prices for 1992/93 using 1993 exchange rate

Caution should be taken in interpreting these figures. For the EU alone there are wide variations between member states in recorded average producer prices. The statistical services in the PECO countries have much catching up to do in developing the ability to gather data from large numbers of private farms. Nonetheless, it is clear that there are 40-50% gaps between EU and PECO prices. Bulgarian and Czech prices are rather similar (except the higher cattle prices in the Czech Republic) and they both are generally about half the EU levels. Hungarian prices are generally a little lower than the Bulgarian and Czech levels (except milk, pork and poultry which are higher) and they are therefore slightly less than half of the EU levels. Apart from milk and cattle, Polish prices are highest amongst the four PECO countries shown, they are around 60 per cent of the EU levels (except for sugar beet which is half the EU level).

How will these gaps develop in the years between now and accession? It has been argued that whilst the EU prices are under continual pressure, significant reductions are not expected before the end of the century. Beyond that, they could, and many will argue they should, fall significantly. But this requires a significant change of mind about agricultural policy. Chapter two concluded that the intricacies of the interaction between the CAP and the URA



agreements make it more likely that the expected increase in pressure on the CAP during the early years of the next century will be accommodated by tighter supply control than price cuts, if an immediate cut back in production is required. It therefore becomes clear that the biggest argument for cutting CAP prices is the size of the price gap between the Union and the PECO's. Given all this pressure, even if the prevailing view is not to further reform the CAP, there are bound to be some reductions in prices in real terms.

Perhaps the PECO prices will rise to close the gap. It should be clear from the information in chapter 3 that this is unlikely. The public deficits and external debts in the PECO's are too great for them to afford protection which makes demands on the state budget, and the proportion of expenditures on food by the population makes food prices too sensitive an issue. However much the important farm populations may desire and campaign for high prices, the only way they can be given them is by macroeconomically destabilising policy. In other words, the direct and indirect inflationary consequences of CAP-like price support would erode the national currencies of these countries and eliminate any benefit to the farm sector at great cost to the economy at large. If this is not a powerful enough force to prevent the PECO's significantly raising their prices pre-accession, their URA commitments will provide the necessary constraint. This issue is considered in the next section.

The conclusion is therefore that, in the absence of a change of policy in the EU it is to be expected that a significant part (say a half) of the gaps in prices will remain up to the point of accession. What would be the supply response to, say, a twenty to twenty five percent rise in prices? Conventional supply elasticities embedded in most of the models used to calculate just these sorts of effects are of the order of 0.3 to 0.6. So the simplistic answer is a production response in the range 6 per cent to 15 per cent. There are many reasons to suspect that the story is rather more complicated than this.

The strict supply response to price change may be less important than the effects of structural and technical changes. The former is in the hands of the applicant states (see section 3.2.1). To the extent that fears of excessive fragmentation are realised, then this will reduce the size of any supply response. Poland provides a ready made example of this. Its small-scale private sector has proved extremely resistant to change over many decades. The attitudes and objectives of the family farm workers and the kind of technology they have at their disposal do not lend themselves to a large response to higher prices under the CAP. Much will depend on the development of the private production cooperative sector. If this is able to shake off the constraints on management by democracy (ie all members having an equal say in how to run the farm), and if good management appears, then these farms could be in a good position to exploit the opportunities of higher prices. But things are just as likely to go the other way. These farms could be condemned by their institutional structure to fail to respond because the members cannot agree and cannot maintain discipline. This would result in a much more muted response.

The rate of technical change will be greatly influenced by the extent of investment and technology transfer from the EU. This in turn will depend on the confidence foreign investors have on the success of accession. Given the uncertainties of the process of

accession which can stall because of problems on either side¹³ there may not be a flood of such investment until it is very clear that the accession will go ahead. For possible early applicants (like the Czech Republic? see section 5.3) the outlook could become clear in one or two years thereby encouraging new investment pre-accession and thus a lively response to the price rises upon accession. For the more difficult applicants (Romania and Bulgaria?) this may not happen until after the PECO has actually joined. Given that the effects of such developments then take some time to work through, these longer run boosts to production may take several years to appear.

The other factor which will determine the magnitude of supply response to a price rise is how quickly the price rise is implemented. Will it be instant and complete as in the EFTA enlargement, or will it be phased in over a long transition period? The longer the adjustment period the more restrained will be the short run response, although the medium term response (ie ultimate production levels) will be independent of the transition phase. The practicality of transition is examined in section 6.3.

Turning to the consumption response, in principle this is easier to predict. If farm gate prices are increased 20-25 per cent, then provided there is some competition in the food chain not all will be passed on to consumers. However, given the poorly developing PECO food industries and distribution, let us assume that all the farm-gate price rise is passed on. If farm prices account for approximately 50 per cent of the retail price (and there is obviously huge variation around this figure, depending on the product), then retail food prices would rise by 10-12 per cent. This reduces real incomes say 4-5 per cent (assuming food is 35 per cent of total expenditures) and reduces food consumption by 1-2 per cent (assuming income elasticities of about 0.4).

Such crude reasoning serves only to indicate the conclusion that PECO adoption of the CAP does have the potential to boost production and curtail consumption thereby intensifying the chronic problem of overproduction in the EU. The events being analysed are so far into the future that this analysis cannot be more definitive. The problem is not working out the consequences of the assumptions, but knowing which assumptions are the most reasonable.

4.2 Intra-EU agricultural trade tensions

There is a deepseated presumption on the part of farmers in the EU that PECO farmers will be lower cost producers of most products and thus will have a competitive advantage when they join the Union. The expectation is that these cheaper products will find their way onto West European markets displacing the output of EU farmers. This in turn could cause three problems: unbearable budgetary costs of surplus disposal; problems in living within URA commitments; or, it could drive some EU farmers out of business. If these fears are felt by EU farmers' groups, they could be the basis of strident opposition to the admission of the PECO into the CAP and the EU. It is therefore important to understand if there is theoretical and empirical basis for the fears, and if there are other ways of looking at this

¹³ Recent examples are the stalemate in Turkish accession caused initially by the decision by the Union that she was not ready, and the late decision by Norwegian voters to reject the advice of their government to join the EU.

issue to achieve a balanced view.

The argument proceeds in two stages, the longer run equilibrium situation when the PECO are in the Union and economic adjustments are complete, and the interim adjustment problem. In the longer run, PECO production poses no threat to EU farmers for two reasons. First, once PECO producers are sheltered under the umbrella of the CAP, their cost structures will adjust to the new situation and eliminate whatever cost advantage they may initially have. Land prices will be the ultimate sink for the benefits of market support in the PECOs just as they have been in the EU. In the single market there is no reason to expect that purchased input prices will be any lower in the PECOs than the rest of the Union. Thus potential sources of lower production costs in the PECOs in the longer run are persistently lower wage costs and any natural advantage they have by virtue of their resource endowments, technology or natural conditions. How soon wages adjust upwards following the general increase in trade following accession is a much broader economy-wide issue. Experience with previous enlargements is that wage adjustment is a very slow process.

Second, in principle, all EU producers will be subject to the same border and domestic protection. Thus if intervention or market withdrawal is available for one country, then by-and-large it will be available on the same basis for all, and it should make no difference to individual producers in the EU whether it is *their* grain or beef or milk which ends up in intervention stocks, or whether it is grain, beef or milk produced by a PECO farmer. To put these arguments another way, if the price of wheat in the EU is set (by the indirect effects of CAP price and trade policy instruments) at 100 ECU/tonne, then all EU wheat producers will produce until their costs at the margin are 100 ECU; that is until the marginal costs are equalised throughout the Union.

These arguments establish that, provided the CAP continues to provide market support close to current levels, the fears of EU farmers about the long run impact of enlargement are groundless. However, it is argued elsewhere (chapter 2) that the sustainability of present levels of support is questionable for reasons quite apart from enlargement. In other words, EU farmers face a more competitive environment in the long run whether or not enlargement proceeds.

The real problem is in the shorter run period as the old and new members adjust to the new situation. There is a fear amongst EU farmers that PECO producers, with their considerably lower wages and land costs, would be able to undercut EU prices and thus displace produce in EU markets. Whether this fear will come about depends on two things. First whether the PECOs can and will deliver lower cost produce to EU buyers at the required quality and consistency. Second, it requires there either to be little or no EU support mechanism, or a collapse in the support.

Superficially, it is hard to avoid the conclusion that the differences in costs of labour and land could enable PECO producers to supply some products at lower cost for some years to come. Whether they will or not depends on many factors discussed in chapter 3. It is worth pointing out that 'costs' are rarely properly defined, and low wage rates do not necessarily translate into low costs of production if labour productivity is low. Labour productivity in the West is substantially higher than in the East as measured by gross output per worker, and so Western labour costs per unit of output can be lower than in the East. This is another

area in which it would be useful to do further research, if only to demonstrate the advantages that EU farmers have, rather than the usual concentration on differences in wage rates, with their dismal and often illogical conclusions.

It is precisely in these circumstances that economists are asked to identify which countries have a potential comparative advantage in which products and thus the extent of possible trade. It is sad to say, but true, that the calculations that are made in response to such questions are invariably poor guides to policy. If for example, given ample data and much intellectual effort, there is little useful quantitative information on what proportion of EU grain production would survive in competition with open borders with say North American and Australian producers, there is little hope in producing useful answers to questions about comparative advantage in PECO agriculture.

International comparisons are bedeviled by problems of accounting appropriately for different resource endowments, factor prices and exchange rates. These can easily outweigh indicators of physical productivities such as yields per hectare or per animal, stocking densities and feed conversion efficiency. The ultimate arbiter of whether a country has a competitive advantage¹⁴ is whether, *at the margin*, it can produce and deliver products abroad at competitive prices without direct or covert government subsidies. This is usually something that can only be discovered through the operation of the market. The experience of the Mediterranean enlargement (see section 4.5 below) is a clear example that simply having *some* lower production costs does not result in a wholesale takeover of the market.

In this situation where no objective information exists, opinions and judgements will abound based usually on gut feelings, scanty anecdotal evidence or partial indicators such as yields. It is hard to resist indulging in such judgements, so it is important to recognise that their value is extremely limited.

The mere existence of lower cost production and potential for expanding production at lower costs does not mean that EU production *will* be displaced. This requires two conditions to be met. First, the market must truly be open and there should be good information. Despite the single market, there are still obstacles to intra-Union trade based on language, culture, and health and hygiene standards. Second, it must be the case that there is either no support mechanism, or that the support mechanism cannot cope with an expansion of production and trade.

It should also be emphasised that even if it can be shown that on average the East has a comparative advantage in certain lines of production, this would not necessarily threaten the majority of EU farmers. There will be a range of cost structures in the East, just as there are in the EU, and only a proportion of Eastern farmers would be able to produce at lower cost than in the West. Given the demands of the domestic market (which is always cheaper to supply than a foreign one), and the limits on supply from even the most economically efficient Eastern farmers, the large EU market is hardly likely to be taken over by Eastern

¹⁴ It should be noted that comparative and competitive advantage are not the same concept, although they are linked. Comparative advantage takes into account the opportunity cost of alternative production activities; in the longer run, resources will be drawn from production activity with higher opportunity costs to those activities with lower ones. Competitive advantage is having a lower cost structure for a given commodity at a given level of output than one's competitors.

produce. In practice the PECO farmers face enormous problems, including completing the land reform, creating efficient farm structures, adopting and becoming familiar with improved crop varieties and animal breeds, building up the necessary links to the input suppliers and farm product processors. Successful completion of these tasks requires production, management and marketing skills of a high order. None of this will be achieved very fast unless Western firms themselves put in a large investment of technical assistance and training. The huge increase in the balance of agricultural and food trade in favour of the EU following the signing of the Association Agreements is testimony to the importance of sophisticated marketing, processing and distribution in gaining market share, and, it must be admitted, the existence of export subsidies.

The main categories of products for which there is only light protection in the EU are intensive livestock products and fruit and vegetables. To the extent that such products are produced to the necessary quality in the PECO's they may indeed displace some EU-15 production. For all other products, protection under the CAP is heavier and the support mechanisms are capable in principle of dealing with growth in surpluses. The instruments and resources for keeping overproduction off the domestic market are available and there is considerable experience in using them. The import displacement fear therefore comes down to the question whether any potential increase in production of cereals, oilseeds, dairy products, ruminant meat, wine and tobacco will cause either contradictions with URA commitments or an unbearable increase in budgetary expenditure. These issues are considered in sections 4.3 and 4.4.

Ultimately, *if* PECO's do have lower cost produce, what is the argument against the proposition that it is in EU society's general interest that products are produced there and imported? This is what trade is for and how it raises living standards. The economic benefits to all the citizens of the enlarged Union can only come about through increased trade between the members. We are not aware of any quantification of these economic benefits from an eastern enlargement, but we are aware of recent studies on the impact of the URA on trade and the benefits that are likely to be generated. The most recent estimate from the GATT secretariat suggests that the gains from the limited trade liberalisation in the URA will be around \$500bn or up to 2 per cent of world GDP. These gains depend on the size of the reductions in protection (which have been relatively modest in the case of agriculture and some other sectors) and the proportion of world production affected. Enlargement of the EU would mean larger tariff reductions than anything obtained under the URA, although the range of trade of trade would be smaller. Even if the prospective proportionate gains per unit of GDP were only half of those recently estimated by the GATT secretariat, the annual economic benefits to the EU as a whole would be around 60bn ecu, a sum several times the estimated budgetary cost of enlargement.

Securing this benefit must involve an increase in exports of something from the PECO's. If this includes food and agricultural exports, then the correct response should be to find ways to help the higher-cost producers, where ever they are, to move their labour and capital into other activities. These issues are explored in more detail in chapters 5 and 6.

4.3 Implications of the Uruguay Round Agreement

The Uruguay Round Agreement binds its signatories to maximum levels of domestic support, to maximum tariff levels, to minimum import access levels, to maximum export subsidies and to maximum volumes of subsidised exports. All the PECO's under scrutiny in this report (except Bulgaria) are GATT signatories and have committed themselves to maximum levels of protection in each of these categories. Bulgaria is currently negotiating its entry to GATT and the Uruguay Round and thus its commitments on levels of agricultural protection.

On accession to the EU, the bindings of each of the PECO's will have to be absorbed into those of the EU, and this will have to be done to the satisfaction of the international trading partners of both. In the case of maximum domestic support levels it is assumed that whatever PECO commitment exists is added to the EU commitment. For maximum export subsidies and maximum quantities of subsidised exports it is presumed that the commitments are aggregated, with allowance for PECO-EU trade in each commodity in the reference period. For market access, where both the PECO and the EU have different maximum tariff levels for the same product (as usually occurs), then harmonisation of tariffs at one level or the other will involve a loss of protection for the PECO or the EU or a loss of market access to the rest of the world. The implications of this harmonisation and integration of GATT commitments are considered below.

4.3.1 The Aggregate measure of support (AMS)

Domestic support commitments for the EU and the PECO's for the year 2001 and onwards are given in table 4.2. It will be noted that all are denominated in different currencies in the GATT schedules and derived from measurements of support in a common base period. On accession, the different currency amounts (Hungarian forints, Czech crowns etc) will have to be converted to ECU to arrive at a new maximum aggregate measure of domestic support.

Table 4.2: AMS levels in 2000 under different exchange rate assumptions

	AMS 2000 (as in GATT schedules)	AMS in m ECU (1986-1988 average exchange rate)	AMS in m ECU (1993 exchange rate)	AMS in m ECU (with projected exchange rate in 2000)	Percent Change: 2000/Base
EU	61,204 m ECU	61,204	61,204	61,204	0
Hungary	33,808 m HF	644	314	148	-77
Czech Republic	13,611 m CKR	859	399	246	-71
Poland	3,329 m USD	2,563	2,843	2843	+10
Slovakia	10,140 m SKr (est)	640	330	178	-72
Romania	0	0	0	0	0
Total		65,910	65,090	64,619	-2

Bulgaria is excluded from the table because its commitment is not yet agreed.

To harmonise these commitments, the first question is, what exchange rate should be used? There are a two possibilities: the exchange rate that pertained in the base period for which

the aggregate measure was calculated, and the exchange rate pertaining for the period immediately prior to accession. The former exchange rate in the PECO's was not market determined and is generally considered to be overvalued. If this rate was used to convert PECO support levels to ECU values then the new AMS for the enlarged EU would be higher than the level obtained using a current market rate (for example, in column 4).

If the market rate just prior to accession is used, then, because of substantial and - in some cases - continuing depreciations of the PECO currencies against the ECU, the individual country AMSs would be substantially lower. For example, since 1989, the Czech and Slovak currencies have depreciated more than 100 percent against the ECU while the Hungarian forint has depreciated over 50 percent. The fact that the Polish zloty depreciated over a 1000 percent is not relevant because the Polish GATT schedules are denominated in US dollars.

Having the AMS denominated in a strong or a weak currency is important for the countries with the weak currencies (ie the PECO's), but less so for the EU. Table 4.2 shows how the total AMS for Hungary, and the Czech and Slovak Republics could be 70 percent lower using a projected exchange rate for the year 2000¹⁵ than that calculated for the base period. Two countries are not affected by any currency depreciations: Romania has an AMS of zero and Poland with its dollar denominated AMS (which over the long term is not expected to move significantly against the ECU).

Potentially, the definition of the AMS in terms of a depreciating currency could seriously limit a country's scope for supporting its agricultural sector. However, much would depend on the interpretation of article 18 (4) in the URA agricultural provisions which refers to allowance for "excessive rates of inflation" which may allow the aggregate measure of support to be increased in national currency terms. Romania has, however, foregone this choice through its zero AMS. With its developing country status, it can provide support (as defined for AMS purposes) up to 10 percent of its agricultural output value only. Presumably, once Romania joins the EU, this status would be lost, and the allowed support would be halved.

Individual PECO problems in meeting AMS commitments because of currency depreciations or bindings at too low a level disappear on entry to the EU because the EU would assume responsibility for commitments at an aggregate level. Initially, at least, the additions of these bindings to that of the EU should not cause too much of a problem. As table 4.2 shows, the extra depreciation of the PECO currencies between 1993 and, say, 2000, would only reduce the combined AMS by a further 470 m ECU, or 0.7 percent. Even the full depreciation between 1986-88 and 2000 only reduces the AMS by 2 percent. As was pointed out in Chapter 2, the EU-12 has plenty of slack in its own AMS ceiling. On the other hand, adoption of CAP prices by the PECO's would, in general, increase domestic support levels, and this would eat rapidly into the slack. Further detailed work should be done in this area to determine how much domestic support in the PECO's would increase as a result of adoption of the CAP but we suspect that the AMS ceiling could be a real constraint rather than a theoretical one in the event of an eastern enlargement.

¹⁵ The projected national currency depreciation was derived from inflation in the latest available year, an assumption that this inflation would be reduced to 5 per cent in equal annual steps over seven years, and an assumption that changes in domestic inflation were fully reflected in changes in the exchange rate.

than a theoretical one in the event of an eastern enlargement.

As an indication of how much the AMS level could change from the adoption of the CAP, data in table 4.3 shows the relative importance of the AMS to gross agricultural domestic product, both currently and ten years hence, on the assumption that AMSs remain unchanged, and agricultural GDP increases at a faster rate in the PECO than in the EU as a result of stabilisation of the macro-economy, the completion of the land reform, and *inter alia* the contribution of the PHARE agricultural programme.

Table 4.3: Potential increases in the AMS of the EU on extension of the CAP to the PECO-5¹

	Actual AMS (1993): Agric GDP 1993	Maximum AMS (1995): Agric GDP 1993	Maximum AMS (2003): Agric GDP 2003
Poland		0.52	0.33
Hungary		0.14	0.09
Czech Rep		0.36	0.23
Slovak Rep		0.63	0.41
Romania		0.00	0.00
TOTAL PECO-5		0.28	0.18
EU-12	0.52	0.75	0.63
New AMS if PECO-5 support level were raised to EU actual level (m ECU)		56,962	59,451
AMS ceiling (m ECU)		76,107	64,619

¹ PECO-6 less Bulgaria which is not yet a member of GATT.

Table 4.3 illustrates that if the PECO adopted the CAP now, when the AMS is equivalent to 52 percent of EU agricultural GDP, the AMS for the new EU would still be substantially below the 1995 ceiling of 76,107 m ECU at current exchange rates. However, ten years on, assuming growth rates in the PECO of 2.5 percent per annum and in the EU of one percent, and with the AMS scheduled to shrink, the adoption of the CAP by the PECO could mean the AMS ceiling being approached. Any production response to higher CAP prices would certainly pose a threat. This model is crude but it supports the logic that the slack in the AMS, while large, could be quickly reduced.

A related issue on which there might be technical problems is the "due restraint" requirement under article 13 of the GATT. This exempts from challenge those measures that provide support at levels no greater than that "decided during the 1992 marketing year", *on a commodity by commodity basis*. It is not very clear what measures the clause refers to (the marketing year differs between and within crops and livestock, and at what stage in the politico-legal process is a measure actually "decided"?). On a strict interpretation, this clause might be held to mean that for any PECO which tries to adopt CAP price supports where it

did not have a corresponding domestic price support policy in operation in 1992, the (enlarged) EU could be subject to a challenge. There is no case law yet to guide how these provisions will be interpreted in practice, but *prima facie* there is a problem here for some countries, especially Romania which has specified no domestic support.

4.3.2 Export subsidies and ceilings

The problems with depreciating currencies discussed above apply equally to the ceilings on export subsidies. In fact, because these subsidy ceilings are commodity specific, there are *more* likely to be problems with the ceiling being breached, especially since the EU-15 might be having difficulties in meeting certain of its own commitments during the early years of the next century. Furthermore, there is no prospect of any allowance for inflation on the value of export subsidies (as in article 18 for the AMS), which puts further pressure on the ceiling.

The PECO's will of course, face these problems whether or not they accede to the EU. However, on accession they become the EU's problems. Whether the PECO commitments on subsidised exports become a problem for the EU will depend on how future PECO exports compare with those in the base period, and how EU prices compare with world and PECO prices. As argued in chapter 3, production in the PECO's has and will become more price-driven over time, and current export patterns (except where there are impediments to exports - such as bans or taxes) are a rough guide to future comparative advantage. At the very least, it can be argued, they are a better guide than historic export patterns under central planning.

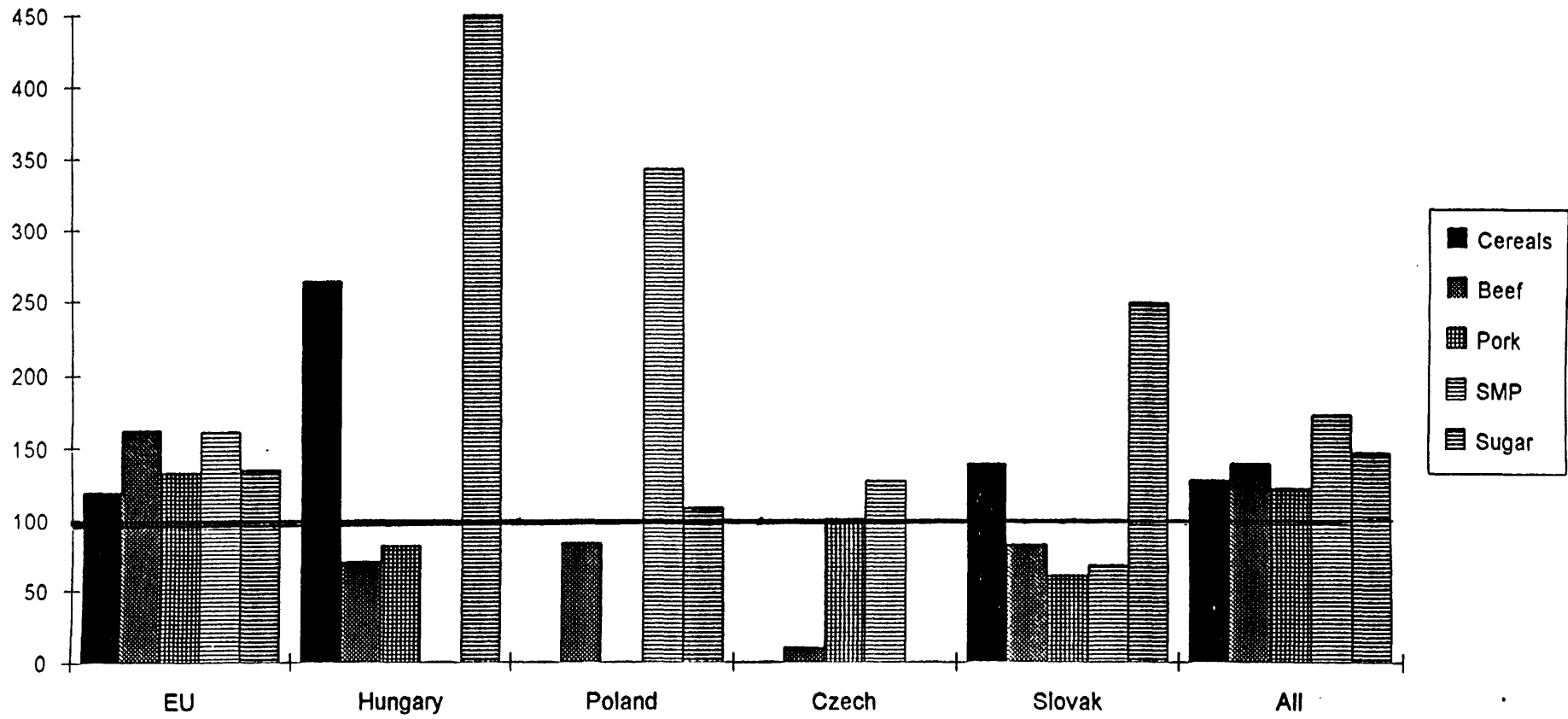
Figure 4.1 (derived from tables B.1 - B.5 in appendix B) shows the relationship between maximum subsidised export commitments (quantities) for the EU and the Visegrad countries for selected products, together with the latest available figures on exports for these countries (whether or not they are subsidised, in the case of the PECO's). The index value of 100 indicates that current exports equal maximum export commitments. Any value above 100 indicates current exports above the future ceiling. For the five products chosen (cereals, beef, pork, milk powder and sugar), the EU's 1993 exports exceeded its target maximum subsidised exports for 2000 in all cases, thus indicating a *prima facie* problem for the EU. Although the export limits of the PECO's are much smaller than those of the EU, many of them are also currently exporting more than their subsidised export targets. Even though they may not be subsidised at the moment, the fact that these exports are possible at prices substantially below EU prices suggests that if EU prices were available then exports would be even greater. In such circumstances they would, of course, have to be subsidised.

Hungary and the Czech Republic currently exceed their commitments on quantities of subsidised exports in three out of the five examples, Poland in four cases, and the Slovak Republic in two instances¹⁶. Aggregated together, the current level of exports for all five products exceeds the 2000 target, usually substantially.

¹⁶ The diagram cannot show in index form every case of current exports exceeding future ceilings because in some cases the future ceiling is zero (as with cereals for Poland and the Czech Republic, sugar for the Czech Republic and skim milk powder for Hungary).

FIG4.1

Index of current exports: future subsidised export ceiling



The conclusion is that PECO's adoption of the CAP is therefore likely to exacerbate existing EU problems in remaining within its export subsidy commitments. The remedy will be either to renegotiate the commitments or take actions to limit the appearance of export surpluses which require subsidies for their disposal.

4.3.3 Market access

Harmonisation of tariffs between the EU and the acceding PECO's at the EU's level would involve either some loss of protection or some loss of market access for the rest of the world. Loss of protection would occur when the PECO tariff rate was higher than the EU's, and loss of market access would occur if the PECO tariff were lower.

It is difficult to generalise about the relative size of EU and PECO tariffs since they vary from product to product and have been set for most countries at the extremely detailed 8-digit level. Furthermore, in many cases both the EU and PECO's have managed to build in a great deal of 'water' in their tariff bindings. That is, maximum tariff levels have been set considerably above the applied tariffs. To give some idea of the problem, table 4.4 summarises the maximum tariff bindings for a range of products for the final year of the URA for the PECO's with GATT bindings and the EU. In order to make the comparisons, tariffs comprising an *ad valorem* and specific element are combined into a single *ad valorem* rate using the base period reference price.

The results are not easily summarised even for this small range of commodities. For example, the Czech and Slovak Republics have lower maximum tariffs on beef than either the EU or fellow PECO's, but for lamb these two countries have the highest rates. Romania has the highest tariff rate of all the PECO's on beef, cereals and sugar, while the EU has the highest rates overall on butter and sugar. The Polish tariff schedules are complex and not always easy to interpret. They were intended to give protection levels equivalent to those of the EU. Hungary appears to have protection levels only a half (or less) those pertaining within the EU across a broad swathe of products. On balance, for the Visegrad countries there are many more tariffs below the EU level than there are above it.

**Table 4.4: Tariff bindings under the GATT for the year 2000;
All expressed ad valorem (%)**

	EU	Czech Republic Slovak Republic	Hungary	Poland	Romania
1. Beef meat carcasses	114.8	34.0	71.7	294 (6.0)	288 (0.5)
2. Beef meat boneless	187.8	34.0	71.7	294 (6.0)	288 (0.5)
3. Frozen beef carcasses	114.8	34.0	71.7	294 (6.0)	315 (0.5)
4. Frozen beef boneless	140.8	34.0	71.7	294 (6.0)	315 (0.5)
5. Pork	61.1	38.5	51.9	102 (6.0)	333 (0.5)
6. Lamb	55.8	110	25.6	64 (6.0)	17 (0.5)
7. Frozen lamb	44.8	125	25.6	64 (6.0)	17 (0.5)
8. Powder milk	183	37.0	51.2	267 (6.0)	96 (0.5)
9. Butter	200	68.0	101.8	245 (6.0)	200 (0.5)
10. Durum Wheat	100	3.0	32.0	25 (6.0)	240 (0.5)
11. Other wheat	107	21.2	32.0	108.5 (6.0)	240 (0.5)
12. Barley	138	21.2	32.8	138 (6.0)	240 (0.5)
13. Maize	102	17.0	32.0	104 (6.0)	240 (0.5)
14. Sugar	216	59.5	68.0	222 (6.0)	180 (0.5)

Notes

- A Duty Tax applies in Romania and Poland and is represented by the figure in brackets.

- The Tariffs for EU and Poland are given as specific amounts in ECUS, the External Reference Prices from the EU Schedule have been used in order to obtain ad valorem tariffs:

Beef: 1729.8 ECU/t; Lamb: 3952.2 ECU/t; Powder Milk: 684.7 ECU/t; Butter: 943.3 ECU/t; Durum Wheat: 148.5; ECU/t; Common Wheat: 88.5 ECU/t; Barley: 67.3 ECU/t; Maize: 91.9 ECU/t; Sugar: 193.8 ECU/t except for Pork where the US Chicago price for 1993 was taken: 877ECU/t.

- Romania being classified as a less developed country under the GATT, its reduction period spans from 1995 to 2004.

- After their partition, the Czech and Slovak Republics have retained a trade and customs union; a common tariff and licensing trade policy is then agreed by the two states.

There are two aspects to the harmonisation of these tariffs: harmonising the maximum tariffs, and harmonising the actual applied tariffs. Bearing in mind that applied tariffs cannot exceed the maximum, there are six combinations of the four variables of interest: EU and PECO maximum and actual tariffs. All six cases are illustrated in Appendix C. If the maximum tariffs of both the EU and PECO are above both actuals, then it could be argued that raising or lowering the PECO maximum should be of little or no importance, since it is what happens to the applied tariffs that affects PECO producers or consumers or third country exporters. However, third countries are likely to pay attention to maximum tariffs even in such cases because that is all they can negotiate about. If either the PECO maximum or applied tariff has to be raised to harmonise with the EU this will cause loss of third country access. There are two possible remedies. Either, injured third countries could be offered

some compensating trade concession in another commodity sector. Or, the EU tariff could be lowered to offset the rise in the PECO tariff and calculated in such a way as to leave overall third country access unimpaired in this commodity. This approach is explored in a little more detail below.

One solution would be to agree on new maximum tariff levels for the enlarged EU which are the trade weighted average tariffs (using third country imports for the period immediately before accession as weights). If the elasticities of supply and demand in the importing PECO's and the EU are identical then there are neither gains nor losses to exporting countries from such changes in tariffs. Because in most instances the EU import levels are considerably greater than those of the PECO's, the resulting weighted tariff would be close to the current bound EU tariff. Table 4.5 below provides an illustrative calculation for the feed wheat tariff. The trade weights should be imports of feed wheat from third countries. These were not available so total cereal imports were used simply to illustrate the calculation. The result shows that the EU maximum tariff would have to fall by just 9 per cent from 107 per cent to 98 per cent to offset the 60 or 70 percent increases in tariffs in Hungary and the Czech and Slovak Republics. The size of the EU tariff reduction which does not make the rest of the world any worse off will generally be small where PECO trade is small in relation to the EU. The losers from this compromise are EU producers who may concede some protection and, of course consumers in the PECO's. This approach to the problem of inconsistent tariff bindings should, in principle, be acceptable to third countries. Of course if harmonisation of the *applied* tariffs involves greater loss of access to imports this solution may not greatly impress third countries.

Table 4.5: Illustrative calculation of harmonising EU and PECO tariff for feed wheat.

Cereals	Import volume cereals latest available year ('000 tonnes)	Max tariff: 2000 Feed wheat %	Weighted max tariff
EU	4847	107	
Hungary	156	32	
Poland	3062	108	
Czech	519	21	
Slovakia	342	21	
Total	8926		98

In principle the cases where third countries lose market access because of PECO accession to the EU could be offset by cases where the PECO tariffs (maximum or applied) are reduced. However, there are fewer such cases, and the relative size of the PECO's and the EU is such that the gains will be rather small¹⁷.

¹⁷ The enlargement in 1995 which embraces the EFTA countries is presumably confronting these problems at the moment. Since most of the EFTA countries have higher tariff barriers than the EU, tariffs can be harmonised at the EU levels without reference to the GATT: the rest of the world would have better access to the EFTA markets, not worse.

In conclusion, unless the rest of GATT contracting parties can be persuaded that PECO accession to the EU is such a political and security gain that it is well worth overlooking the fact that some PECO tariffs have to be raised, harmonising market access commitments could be a very time consuming problem.

4.4 Budgetary cost of the PECOs adopting the CAP

It is widely believed that the budgetary cost of the Eastern enlargement will be extremely high. Contributions to the EU budget from the Eastern countries would be low because these are approximately proportionate to income while calls on both the structural and CAP funds would be substantial. It is not our brief to consider the role of the structural funds, but it is pertinent to point out that, under current criteria, the majority of the PECOs would be designated as objective 1, objective 2 or objective 5b regions and as such would be eligible for substantial EU expenditure, just as the present poorest three countries (Greece, Ireland and Portugal) currently have the highest level of structural funds per head of population. With the growing importance of structural funds in the budget (currently 32 percent of the total budget and intended to double in absolute terms), it may be that their role in the event of any eastern enlargement should be examined just as urgently as that of the CAP.

Current expenditure on the CAP for the EU-12 is around 36 billion ECU annually. However, the increased cost from Eastern enlargement has been estimated to be far greater than the mere proportionate increase in population resulting from accession¹⁸. This budgetary cost will depend on:

- the size of the difference between CAP and world prices
- the extent to which PECOs are eligible for compensatory amounts;
- the volume of the PECOs agricultural output
- the level of PECO demand for agricultural products

The results of studies which estimated these extra costs are summarised in table 4.6. These cost estimates, of course, depend entirely upon the assumptions behind them. They are not forecasts of what the cost will be, but rather what the costs might be in the absence of policy change. Furthermore, some of them do not take into account the effect of the 1992 CAP reform, and none of them include the constraints which the recently concluded Uruguay Round Agreement imposes. For example, the Tyers and Anderson estimate (the highest in the table) arrives at a cost which is based on large levels of export subsidies (which drives down the world price) and increases in domestic support. Because these subsidies are constrained under GATT, policy adjustments would have to be made which would meet GATT commitments and which would reduce costs below the Tyers and Anderson estimate. In two cases (CEPR and Baldwin) the models used are single equations derived from cross sectional data for a single year before CAP reform. Whatever their merits for estimating costs before CAP reform, they are not suitable for extrapolating costs for new members under very different policy conditions.

¹⁸ If FEOGA costs rise in proportion to population (28%) the current extra cost would be about 10 billion ECU.

Table 4.6: Extra CAP expenditure as a result of PECO accession (b ECU)

Source:	Visegrad	Bulgaria Romania	Association Agreement countries	CAP reform included?	URA included?
CEPR (1992)			2.8 - 7.4	No	No
UK MAFF 1 (1994)	5.4 - 13.2			Yes	No
UK MAFF 2 (1994)	4.9 - 14.6	2.6 - 7.9	7.5 - 22.5	Yes	No
Tyers & Anderson	37.6			Yes	No
CEPS (1993)	4-31	1 - 11	5 - 42	No	No
Tyers (1993)	22 - 27			Yes	No
Baldwin (Unpublished)	11.6	11.6	23.2	No	No

Where account has been taken of the 1992 CAP changes, the usual assumption has been that farmers in the Eastern countries would qualify for area or headage payments as their counterparts in the west do. However, this is far from likely on both technical and budgetary grounds. Such support might be challengeable under the "due restraint" clause in the Uruguay Round Agreement (see earlier discussion in section 4.3.1). The UK MAFF, in their calculations, have separated these direct payments from other support payments (intervention buying and export subsidies) and this shows that the direct payments, if paid at the current level, account for between 45 and 95 percent of the total PECO cost to the agricultural budget.

For these reasons, it is necessary to do much more work on the budgetary cost of an Eastern enlargement before a reasonably accurate picture emerges of what these costs might be. At this stage, there are reasons to be cautious before accepting the received wisdom that the cost would necessarily be high. In particular, the conclusion of Chapter 2 was that EU prices in the first decade of the 21st century could be lower than current levels in real terms (and perhaps in nominal terms also). This would have beneficial effects in both the EU and the PECO countries in stimulating consumption above levels commonly assumed, and restricting production to levels lower than would otherwise exist. It was also argued (in section 4.3) that integrating the GATT schedules of the PECO countries with that of the EU will limit the use of subsidies even more than does the EU's current commitment. The CAP budgetary cost may, therefore, not be the barrier that many suppose it to be. It could certainly be much lower than the upper end of the ranges quoted in the estimates shown in table 4.6.

Lessons from the previous enlargements

The offer of future membership of the EU to the PECO countries could potentially bring about the biggest single enlargement that the EC/EU has ever experienced. The word

"biggest" is used here in terms of the additional population numbers, the additional land area and the additional farm population. However, in percentage terms the increase in size is not significantly different from previous enlargements (see table 4.7), except for the 90 percent increase in farm population: the proportionate increase in total population would be less than occurred in 1973 when the UK, Denmark and Ireland joined, while the proportionate increase in agricultural area would be similar to the increases that accompanied the first and the Mediterranean enlargements.

Reflecting the large farm population in the PECO's is the difference in average level of GDP per person between the existing EU and acceding PECO's. This income difference is much larger than for any other previous enlargement, including that of the Mediterranean countries.

Table 4.7 Changes in size in the EC/EU from successive enlargements

Enlargement:	1973 (UK, Ire, Dk)	1980s (Gr, Esp, P)	1995 (A, F & Sw)	Next? (PECOs)
Increase in population (m)	64	58	22	96
Percent pop'n increase	31%	21%	6%	26%
Increase in agric area (m ha)	27	41	10	53
Percent agric area increase	41%	41%	7%	39%
Increase in farm pop'n (m)	1.1	4	0.6	7.5 ¹
Percent farm pop'n increase	16%	50%	7%	90%
Percent difference in GDP per head (compared with EU)	-10%	-33%	+6%	-79 ²

¹ This is the current farm work force, it will almost certainly fall faster than the EU in the next decade.

² Based on GDP calculated using exchange rates calculated at PPP.

Can these previous enlargements provide any insights into how the PECO's and the EU will be affected? The most relevant comparison is with the 1980s enlargement when three relatively poor and agricultural countries (Greece, Spain and Portugal) joined the EC and increased the agricultural area by 41 percent and the farm population by 50 percent¹⁹. These countries had a number of similarities with the PECO's. They had a large agricultural population engaged in what could be described as peasant agriculture. Thus, their average farm size was small, and much smaller than the EC average. The state had played a major role in operating market institutions and setting prices, and agriculture accounted for twice the proportion of GDP as it did in the EC. They also had large regions with poor soils, and

¹⁹ Greece joined five years before Spain and Portugal, but the similar nature of the problems in these countries makes it legitimate to discuss their accession as a single enlargement.

inadequate or uneven rainfall. However, being southern European countries, their agricultural output was for the most part complementary to that of the then EC, where production from the northern European countries dominated EC farm output. In addition, for fruit and vegetables, seasonal differences in availability from different parts of the Community reduced the potential for oversupply. Such is not likely to be the case in future: because the current EU is so large with a diversity of regions and farming types, the pattern of output of the PECO's cannot help but be competitive with that of some regions of the EU, at least. This similarity in commodity range between the PECO's and EU at least offers the comfort of not introducing the need for any new, and potentially expensive, commodity regimes into the CAP.

In agricultural terms, the enlargement which embraced Spain and Portugal was "something of a gamble", to quote from a Commission publication of the time (European Community 1986). Although productivity was low, there was believed to be considerable scope for increased productivity and output from "the extension of irrigation, the consolidation and restructuring of farms", resowing of fallow land (which in Spain totalled 17.5 percent of the total agricultural area), and "increased use of modern production techniques" (*ibidem* p.18). The report envisaged increases in production as a result of higher EC prices, particularly of fruit and vegetables, wine and olive oil²⁰. This forecast tendency would no doubt be aided by the programme of structural reform (land consolidation, farm enlargement, early retirement for elderly farmers, encouragement of young farmers) which was implemented.

What has been the result of this "gamble" after eight years of adjustment to EC/EU support mechanisms (13 years in the case of Greece)? The general conclusion is that the amount of change has been small, and certainly not enough to justify the prognostications of 1986. There has been no dramatic change in the farm structure - an unsurprising fact when one considers the social and economic factors that limit the rate of transfer of land between farmers. Farms over 50 hectares accounted for 0.2 percent of the total in Greece in 1980, and a decade later they accounted for 0.5 percent. In Spain the respective figures are 5.6 and 6.3 percent, while in Portugal they are 1.8 and 2.2 percent. There is a similar very slow rate of change in the other farm size groups in each of the countries. Utilised agricultural area in Spain appears to have fallen slightly since 1985 (rather than the land area increasing).

These observations concerning structure are particularly relevant for the Eastern enlargement. The farm structure in Poland has stubbornly resisted decades of pressure for rationalisation and enlargement including the Soviet inspired collectivisation drive. Undoubtedly, an important part of the structure of farming in the other PECO's will be small scale peasant agriculture. Whilst this poses a vital social question, it significantly limits the power to expand and improve productivity which could 'blow the CAP out of the water'.

Changes in production in Southern Europe since accession also have not confirmed the fears expressed in the Commission report. Olive oil production has not increased in either Spain or Portugal since accession (though there has been a continuation of a long standing trend of increased production in Greece) and wine production over the period 1985-91/92 has trended down. In citrus fruit, the area planted has increased: by 11 percent in Greece, by

²⁰ Although many product prices in Portugal were higher than those in the EC

5 percent in Spain and by 3 percent in Portugal, which coupled with higher yields has increased output by around 16 percent in Greece and over 40 percent in Spain. However, this has for the most part met a market demand: consumption increased by over 40 percent in the same period, and only Greek produce was purchased by intervention authorities to any extent. In vegetables, Greek output has declined, Portuguese has remained static, while Spanish increased by around 13 percent. Very little Spanish production has been purchased by the intervention authorities.

As far as the major EU crops are concerned, neither in grains nor oilseeds has production exceeded its mid-1980 level, although Greek production of sunflower only began on entry to the EC. In fact, the only commodity where production growth has been large and not absorbed by the market is butter, the price of which did not rise on accession. Thomson (1994) has concluded that the CAP has "not provoked major structural changes" that might have been expected prior to accession.

There at least two alternative conclusions which could be drawn from this. First, it takes a longer time for the productive potential in farming to be realised than is usually thought. Or second, the EU supply control measures have been very effective. As far as the latter is concerned, the direct supply control measures used in the EU have not been important for most of the products discussed, and thus the former explanation seems the more likely. It is widely acknowledged that farming as a business has some different characteristics from other businesses because it also provides a place of abode. The responsiveness of farmers (especially small farmers) to restructuring incentives is usually low, and the response to higher prices is often limited by the technology that is known to the farmer and which can be applied on a small farm. In addition, the extra demand for food in the acceding country as a result of rising incomes is often underestimated.

In short, the lesson from the Southern enlargement is that great care should be taken not to confuse what *could* be the response to a protective regime if farming were optimally organised from the *likely* response given actual farm structures. The structure of farms, the management skills and incentives are just as important than natural conditions, soils and climate. Much of PECO agriculture suffers from dislocated structures and an extreme shortage of management skills. These will take much time to rectify.

4.6 Conclusion: does the CAP fit the PECOs?

If all six PECOs adopt the CAP as it is likely to be in the early years of the 21st century there will certainly be problems. The two largest problems appear to be the ability of the enlarged Union to respect its commitments under the Uruguay Round Agreement and the possible budgetary cost of extending the CAP to the PECOs. Of these the URA constraints are perhaps the most difficult to deal with, requiring either renegotiations of certain commitments or changes in internal support in the enlarged Union.

The budget problem may be less than is commonly believed because the impact of the URA has not been taken into account in most calculations. Also it is believed that the ability of the PECOs to respond to the higher EU prices will be limited by managerial, structural and perhaps even cultural constraints. The evidence of the Mediterranean enlargement supports

the view that adjustment to a new set of prices is not necessarily fast when the structure and skills of the industry are, on average, poor.

Trade impacts on the EU of enlargement are probably not negligible, but neither should they demand unacceptable adjustments. PECO farmers operate under a number of handicaps, not just on-farm organisation, but also in the processing and marketing of his output. Most PECO costs are likely to rise to EU levels quite rapidly on entry, and the initial competitive advantage would be eroded. It must also not be forgotten that the PECO market with almost 100 million people would be growing and would be easier for PECO farmers to supply than the rest of the EU.

Where trade does occur this will be beneficial to the Union. The fact that Eastern Europe may be able to produce certain agricultural and food products at lower cost than in Western Europe should be viewed as one part of the economic gains from enlargement. These economic gains greatly exceed the budgetary costs of enlargement under any scenario. Whatever budgetary costs are involved should be seen in the wider context of these economic benefits.

5 ALTERNATIVE ACCESSION MODELS

The conclusion of Chapter 4 is that there are difficulties in the accession of the six PECO's to the EU within the time frame discussed and with current policies. There are significant differences in the URA schedules of the PECO's and the EU which will require either renegotiation with other WTO partners or changes in domestic arrangements. This conclusion applies *a fortiori* if it is judged that there can be a significant production response in the PECO's as they adjust to the generally higher prices in the EU. The budgetary and intra-EU trade problems are less certain because they depend a great deal on the price and support levels in the CAP at the time of enlargement and then on the behaviour of millions of individual farmers and consumers many years from now. However, it is hard to escape the conclusion that, given appropriate incentives, there is some unrealised agricultural potential in the PECO's which could be realised over the period of the next decade.

If full adoption of the CAP by all six PECO's causes these difficulties, what options are there for reducing or eliminating the problems? These will be examined in ascending order of practicality. First, to offer membership of the Union but without adoption of the CAP. A second, less radical, option is to offer a different CAP for the new members. If neither of these seem workable or desirable, a third option is to offer EU membership only to those countries for which the agricultural problems are of a manageable size. Chapter 3 demonstrated large differences between the PECO's and thus the likely impact of each on the EU budget. In itself, this suggests that a phased enlargement may lower the cost of absorption because the more difficult (ie expensive) accessions can be delayed. Other things being equal, costs are always lower in real terms, the further ahead they are. However, if the PECO's waiting on membership are able to expand production at a greater rate than they would within the EU, then the eventual cost could be higher.

A phased enlargement, while quite practical, would not address the fundamental problems identified in chapter 4, and would be only be a temporary solution if accession of the PECO-6 were the ultimate objective. In any case the phasing of enlargement will be taken on much wider, political, grounds. This seems inescapably to lead towards a fourth option which is to reform the CAP for the whole EU-21²¹ to avoid at least some of the obstacles discussed. To put this another way; it may be in the interests of the whole EU-21 to redefine its agricultural policy to take account of the very different circumstances of the next millennium. Discussion of this option is deferred to chapter 6.

5.1 EU membership without the CAP

At first sight this seems a revolutionary concept. After all, the CAP has been the trailblazer for common policy making in the EU for over 30 years, and it has been accepted as a matter of faith that acceptance of EU membership involved acceptance and full application of the CAP²². Throughout the history of the Community the CAP has accounted for a major part of the budget, and for most of this period it was the only really common policy that the EC had. The irony is not that the acceding countries do not want the CAP - they can hardly wait

²¹ That is the EU-12 plus the three EFTANs, Austria, Finland and Sweden plus the six PECO's.

²² It is also an obligation of the Treaty of Rome, A38.

to join it - rather it is the EU which is reluctant to bestow it.

The question is whether it is feasible to allow, or require certain countries to opt out of the CAP in much the same way as the United Kingdom has opted out of the Social Chapter of the Maastricht Treaty and as Denmark and the UK have reserved the right for themselves to opt out of the single currency. If the Union decided that this was the only basis on which certain countries could be admitted, then it would be up to the governments concerned to decide if they wished to accept membership on these terms. If they did, what would it mean and could it be workable?

Any country not operating the CAP would have to decide its own agricultural policy. There would be three constraints on its choice. First, it should not contradict the requirements of the single market. Second it should not run into problems with EU competition policy. Third, it should respect its own and the rest of the EU's URA commitments. The last of these should pose no additional problems to those discussed in section 4.3 above. Indeed, this solution could ease the problems with URA commitments as the individual PECO's would not be obliged to adopt the higher protection and prices of the CAP.

The real problem would be respecting the single market. Different agricultural policies in the EU-15 and some of the PECO's would imply different prices. To avoid trade flows resulting from these policy-determined price differences, there would have to be special agricultural duties on raw and processed products from the low price region. These would seem to be in direct contradiction to the single market and thus infeasible.

However the issue is not as clear cut as it at first appears. It is a political question whether it is possible to have a major exception to the single market. There are precedents. First, for many years, whilst it was moving towards a common market with no internal barriers, the Community operated intra-EC taxes and subsidies, the Monetary Compensatory Amounts under the CAP. Since January 1993 these have been abolished. Second, it can hardly be claimed that there is completely free trade for agricultural products within the EU-12. Trade does indeed pass more or less unimpeded over the Union borders (save the occasional truck load of British lamb or Spanish tomatoes!) but it cannot be doubted that the volume of intra-EU agricultural trade is much smaller under the CAP than it would be in the absence of the plethora of national quantitative restrictions on the production and marketing of cereals, oilseeds, sugar, milk, beef, sheep, and tobacco. If the EU-12 can live with these domestic (rather than border) restrictions on trade, then why not specific intra-EU duties for agricultural produce? It is quite likely that for other reasons (eg sanitary and phytosanitary standards) border controls between the PECO's and the EU-15 will not be abolished on the day of accession. Thus no great matter of principle need be at stake.

Excluded from the benefits of the CAP, the PECO's could not be expected to contribute to the EU on the same basis as other members. Effectively, this would create a two tier EU, with different rights and obligations. This is presumably what two-speed, or variable geometry Europe means. The 1996 Inter Governmental Conference will address precisely these issues. Only after this conference will it become clear what really is a central part of EU membership. Of course, once the precedent for some countries to be excluded from the CAP were accepted, it is not inconceivable that other countries might even volunteer for this status, especially if it was a way of escaping a share of the budgetary costs of the CAP.

When the argument is stretched in this direction it becomes clear why membership without the CAP is really a non-starter. Accession to the European Union means accession to the various Treaties establishing the Union. Article 38 of the Treaty of Rome requires that... "the common market shall extend to agriculture and trade in agricultural products" ...and that this... "must be accompanied by the establishment of a common agricultural policy amongst the Member States". Now that the CAP is such a major part of the EU and that it contains the operational principle of financial solidarity, it really would seem to be stretching the concept of two-tier membership too far to envisage membership of the Union without membership of the CAP.

5.2 A Different CAP for the PECO's

Could the problems of PECO accession be solved by having two agricultural policies one for the EU-15 and one for the PECO-6? At the outset it has to be accepted that such an approach would require an amendment to the Treaty of Rome, but it is worth examining some of the practical challenges of making such an arrangement work.

It seems sensible to define the double-barrel CAP approach as having the same objectives and instruments for both barrels. The two parts would be different only in the *extent* of support between the two regions²³. Broadly speaking, there are two ways in which support levels could be different: in the price support levels and in the direct payments for farmers. To suit their own economic circumstances and in order to live within their URA commitments the PECO's would presumably choose lower price levels than the rest of the EU-15. Although it is a far from trivial matter it is assumed that all the PECO's would operate the same lower price support levels. The existence of different prices within a single market would again require some border taxes and subsidies to prevent the policy-induced price differentials leading to massive trade flows. The arguments about the acceptability of such controls were explored above. If the Council of Ministers (and Parliaments) accept them then they are acceptable.

Even though they would have lower price support, farmers in the PECO's might still find the relative stability of the CAP a favourable environment for investment and productivity improvement. This could lead to an expansion in production. To contain the problems with the URA commitments, it is almost certain that the PECO's would have to be subject to similar means of supply control as in the rest of the Union.

Correspondingly, to manage the anticipated budgetary problem, direct payments to farmers in the form of arable payments, set-aside payments and headage payments could be lower in the PECO's compared to the rest of the Union. Such a differential could be justified in two ways. First, the levels of payments introduced or modified in the 1992 CAP reforms were set at rates calculated to compensate average productivity producers for losses incurred by the price cuts introduced in that reform. Because acceding PECO's would generally be experiencing a price rise not a cut, it could be argued that they are not entitled to any compensation. A less extreme approach would be to offer some, but lower, compensation.

²³ This does not preclude member states from pursuing their own domestic support measures financed from their own resources. The main constraint on such measures is that they should not distort competition.

A second way of justifying differential direct payments for PECO's is based on a different view of the purpose of the payments. It can be argued that by the early 2000s the EU payments (if they are still being offered) will be viewed as direct income or social payments and the rates offered will reflect local variables such as average income levels. As income levels in the PECO's are much lower than in the rest of the Union this could justify lower direct payments²⁴.

Differentiated policy would inevitably, and with justice, lead to requests for differentiated payments to the EU Budget. A formula would have to be defined to scale down payments for countries which did not enjoy the full benefits of common policies.

Administering two separate agricultural policies in the enlarged Europe would not be easy, but it could no doubt be attempted. An organisation which can run an agrimonetary system which copes with at least five changes in the European monetary system²⁵ and which can manage individual-farm milk quotas and arable land set-aside for millions of farmers might believe that the extra detail of running a twin-track CAP could be taken in its stride. However, Italian milk producers for one would smile at such a claim. Notwithstanding the practical difficulties of implementing separate policies, there is also the desirability of following such a path.

In operating this differentiated Policy, meetings of the Council of Ministers would take on an air of Alice in Wonderland. Ministers would find themselves discussing adjustments in high prices and generous direct payments for one group of countries who happened to have, on average, large farms and already high incomes, and lower prices and smaller payments for the other group who invariably had smaller farm sizes and incomes. Regressivity in the CAP has long history. Indeed one of the objectives of the 1992 reforms was to redress this problem. It would be very strange indeed to launch the Eastern enlargement with a lurch back to an even more regressive agricultural policy. Twin-track CAP is not a rational way to go.

5.3 Stepwise enlargement

The problems discussed in Chapter 4 are not the same for all the applicant countries. Another approach is therefore to consider phasing enlargement to allow more time for both the 'problem' applicants and, if necessary, the EU to adjust. Thus, if the general conclusion is that full adoption of the CAP by all six PECO's is too difficult, what smaller subset could be managed? What would be the agricultural implications of leaving some out?²⁶

Although the EU has Europe Agreements with six countries and within those agreements there is a commitment to their eventual accession to the EU, there is no specified timetable. Some countries may be 'ready' for accession long before others, and just as importantly, the

²⁴ This same logic would presumably apply also to the existing EU members.

²⁵ Bretton Woods adjustable peg - tunnel - snake within the tunnel - two-band ERM - single wide band ERM.

²⁶ It is acknowledged that the political and general economic implications of deferring entry of some countries may be more important than the agricultural implications, but these are beyond the scope of this study.

EU itself will be more ready to accept certain countries at an earlier date than others. There is no presumption that the next enlargement has to embrace a bloc of countries (as in 1973, 1986 and 1995). Just as Greece was a lone entrant in 1980, so it may be feasible and desirable for the PECO's to join singly or in subsets of the six²⁷. This section accordingly examines some of the features of the PECO's to determine the likely magnitude of the difficulties of accession as far as agricultural developments are concerned and an attempt is made to rank the six countries in terms of entry difficulties.

Apart from solving the inconsistencies in the URA commitments, the main factor affecting ease of entry is likely to be the extent to which an acceding country makes net demands on the agricultural budget. It is hypothesised that this will depend on the absolute size of the agricultural sector in each country (as measured by value added and by employment), the extent to which the output is absorbed by the country or is exported, the relative importance of agriculture in the economy, and the average income level in the economy as a whole (because wealthier countries contribute more to the EU budget). Apart from the latter variable, the more these are complementary to the EU economy, the less costly will accession be. The values of these indicators for the six PECO's are summarised in table 5.1. While the more relevant indicators will be these values at the time of potential accession, the most recent figures are a guide to future developments.

Table 5.1: Indicators of impact on the EU agricultural budget.

	Agric GDP (m USD PPP) 1993 ¹	Agric GDP as % of Total GDP (1993)	Net agric exports (m USD) 1992/93 average	Agric employment as % of total (1992 or 1993)	GDP per caput (USD PPP) (1993)
Poland	11,165 (2)	6.8 (4)	-269 (5)	25.2 (2)	4,265 (2)
Hungary	4,501 (3)	8.5 (3)	1506 (1)	9.9 (4)	5,141 (5)
Czech	3,228 (5)	4.5 (6)	28 (3)	6.5 (6)	6,965 (6)
Slovakia	1,574 (6)	5.9 (5)	-25 (4)	8.6 (5)	5,033 (4)
Bulgaria	3,907 (4)	9.2 (2)	371 (2)	17.4 (3)	4,772 (3)
Romania	12,871 (1)	23.7 (1)	-625 (6)	32.2 (1)	2,382 (1)

nb: numbers in brackets are rankings.

¹ Calculated from columns 3 & 5 together with populations from table 3.1.

In terms of the absolute size of the agricultural sectors (column 1), both Romania and then Poland are the largest and thus would potentially make substantial calls on the agricultural budget. However, these two countries in recent years have been the largest net importers of agricultural produce amongst the PECO's (column 3). Romania has long been a major importer, presumably due to the Ceausescu agrarian revolution which damaged the social and economic fabric of rural areas. Poland was neither a net exporter nor a net importer for most of the 1970s and 1980s, but it briefly became a net exporter after liberalisation, partly

²⁷ One obvious grouping is for the Visegrad-4 to be treated en bloc as they were in the Association Agreement negotiations.

due to the large fall in consumption at that time. Currently, the balance of agricultural trade is negative. The major exporters have been Hungary and Bulgaria. Based on agricultural contribution to GDP, political pressure for the maintenance of support levels in agriculture is likely to be highest in Romania, Bulgaria and Hungary, (column 3). However, based on farm employment shares the largest three are Romania, Poland and Bulgaria, (column 5). Romania, Poland and Bulgaria have the lowest incomes per head in terms of purchasing power parity and would probably make the lowest contribution per person to the budget (and the greatest calls on the structural funds)²⁸.

From the narrow point of view of agricultural strategy and based on the above data, the most feasible early entrants that present fewest agricultural problems to the EU are the Czech and Slovak Republics. Poland, Hungary and Bulgaria form the next tier for consideration while Romania on present performance would present the EU with the greatest problems: it is ranked first on four of the above criteria, and although least difficult as the current largest net food importer, there is a presumption that this could be reversed once recovery from the upheavals of the last few decades takes place.

These characteristics (and rankings) might change over the next decade. Progress in privatisation, land restitution, farm restructuring and the abandonment of regulated prices, all of which would encourage a more efficient agricultural sector, has been greatest - though by no means uniform - in the Visegrad countries, as has been the success in stabilising the macroeconomy. However, external debt in the PECO's is substantial: servicing this debt will limit investment capacity and retard development. External debt per person is highest in Hungary, Bulgaria and Poland. Their difficulty in repaying it can be gauged by the ratio of debt to income (see table 5.2).

Table 5.2: External debt and the ability to pay (1993)

	External Debt (bn USD)	Pop'n (m)	GDP per person (USD PPP)	Debt per person (USD)	Debt:income ratio
Poland	48.4	38.5	4265	1257	0.29
Hungary	19.2	10.3	5141	1864	0.36
Czech	3.8	10.3	6965	369	0.05
Slovakia	2.5	5.3	5033	472	0.09
Bulgaria	12.2	8.9	4772	1379	0.29
Romania	3.5	22.8	2382	156	0.07

There are many other macro economic considerations, but this latter analysis supports the view based on table 5.1 that the Czech and Slovak republics would be easiest to absorb. This conclusion coincides with the views of other analysts (CEPR and Baldwin referred to in

²⁸ Contributions to the budget are based on actual GDP (*inter alia*) rather than PPP, so Poland may well contribute twice as much per caput as either Bulgaria or Romania

section 4.3) that the agricultural cost of the accession of these two countries would together be less than for any other country²⁹. Whether the net benefits are correlated with the agricultural considerations is another issue, which although beyond the scope of this paper, should be noted. It was pointed out in chapters 1 and 4 that economic benefits flow from the creation of larger markets and the exploitation of comparative advantages which allow the supply of goods and services at lower cost. The generation of these benefits depends very much on the size of the increase in the market. Thus, although in agricultural budgetary terms, Poland may be viewed as a potentially large liability, in terms of its contribution to wider market developments, its accession may provide more economic benefits than any other country because of the size of its economy.

Stepwise enlargement offers many advantages. It imposes lower initial cost to the EU. It will generate less opposition from vested interests in the EU. It offers the opportunity to demonstrate that having some PECO's in the EU represents an opportunity rather than a threat. It provides the EU with the chance of testing its policies on a small scale (with less financial and other risks). A small enlargement could also be undertaken earlier than a large one, and would demonstrate to the PECO's the EU's good faith and intentions. A bride who is kept waiting a long time at the church gate begins to wonder whether she has been jilted.

Broader political consideration will, of course, be more important than agricultural matters. For example, there is no doubt that if the Visegrad4 were not admitted in one group the omitted country(ies) might be deeply offended. Also the EU will have its own interests in the issue of enlargement en masse or stepwise. There can be no doubt that the entry negotiations will be complex and long, there is so much to cover given the very different governmental institutions in the PECO's and their recent history. It would obviously be desirable from the EU point of view to establish simultaneous negotiations based on a common approach. There are certainly economies of scale from negotiating with all six PECO's simultaneously, and it would make the imposition of common entry conditions on each PECO easier. To be engaged in piecemeal discussions with several countries all at different stages of the process would place a considerable burden on EU resources. This would especially be so as the later entrants would presumably wish to engage in negotiations on improving the Association agreements all the while they are left out of membership discussions. A further consideration is that at precisely the time entry negotiations are taking place towards the end of this century, the first round of the WTO will be underway. It would make these negotiations even more difficult if the EU has some PECO's in the Union, some about to come in, some who wish soon to come in and some others outside the Union but who wish to improve their preferential access to it. Negotiating at the same time different complex agreements which impinge on each other could result in the implications of each agreement not being fully understood by the negotiators. On the other hand, it is often useful for the waters to be muddied, since this can allow the passage of agreements which on their own might be unacceptable.

However, whatever the decision on stepwise accession or accession of all six PECO's at once,

²⁹ The UK MAFF estimate suggests that under a dynamic scenario there would be greater supply response in the Czech/Slovakian Republics than in Hungary and Bulgaria, and their budgetary cost would be slightly greater than that of the latter two countries. Note that while the estimates of the various authors on the absolute cost of enlargement are disputed (section 4.4), there is no dispute about the relative cost of different countries.

the EU is confronted with the problem of potential further accession of the Baltic states, Slovenia, and perhaps other parts of the former Yugoslavia. Thus, the issue of the sequencing of succession cannot be settled with reference to the PECO-6 alone.

6. POST ACCESSION CAP

From the forgoing arguments it becomes clear that the Eastern enlargement does indeed pose some difficulties for the EU agricultural sector. Surmounting the difficulties will be complex and take time. If for political reasons all six must become members at the same time, this would stimulate the Union to examine its own agricultural policy, to ask if it has reached its 'climax' form, or whether it must further evolve as circumstances change.

Perhaps surprisingly, but most constructively, before the EU was even half-way through implementing the most radical reforms it has undertaken to date, the 1992 MacSharry reforms, an intensive debate about the future of the CAP has already broken out. So far, this has stimulated the production of several reports (External Expert Group (1994) for DGII of the Commission, the UK National Farmers Union's 'Real Choices' document NFU (1994) and a paper by the UK Country Landowners Association, CLA (1994)) with another report shortly on its way (by the Royal Institute of International Affairs in London).

This activity reflects an internal perception³⁰ that the CAP, despite recent reforms, still does not perfectly represent the multiple desires of various groups with an interest in EU agriculture and food. Many farmers throughout the Union are deeply uneasy with the precariousness of the present compensation payments and are not happy with their production decisions being so 'boxed-in' by set-aside, livestock production and stocking limits and marketing quotas. As international competition intensifies, the direct consumers of farm products, the food industry, is not happy that the CAP continues to distort its raw materials market. Taxpayers find it no easier to pay for the continuing growth in budgetary costs of farm support. As more member states become net contributors to the EU budget this will make further increases in the budget harder to agree. Environmentalists are far from satisfied that the reformed CAP, whilst halting the previous trends of ever more intensive agriculture, is providing sufficient incentives for more environmentally friendly farming. None of these pressures are new. The point is that they have not disappeared since the 1992 reforms. The budgetary pressure and GATT pressures have only temporarily subsided. The eastern enlargement is just an additional pressure.

The example of the political process during 1986 to 1992 may be instructive. This was the period during which the CAP was under intense international scrutiny and attack in Uruguay Round. It induced the Community to take stock of how well the CAP was achieving its own internal objectives. The conclusion of this review was that a reformed CAP would better suit its own needs as well as taking the sting out of external criticisms. The new challenge is to repeat this same exercise by the end of the century. That is, to use the challenge of eastern enlargement for the EU to question again the most appropriate set of arrangements for agriculture to best satisfy the aspirations of all with an interest in food, agriculture and the rural environment in the much enlarged Europe. This is not a process of responding to external pressure; it is a rational reappraisal of the best policy for the EU's present and expected citizens.

Broadly, what are the options for adjusting the CAP to suit the new circumstances? It will

³⁰ Is it really a purely British perception?

be argued that there are really only two. First, to pursue a 'high' price regime, that is one in which agricultural prices continue to be supported significantly above world market prices, and the 'low' price regime where much less market protection is given although there could still be other types of support.

It is not unreasonable to ask why the issue has to be polarised in this way. Is there not an intermediate option in which prices could be reduced, but still offering a 'modest' margin of protection against international competition? Paradoxically, it may be the URA which prevents this middle route. It has been argued in Chapter 2 that by the early years of the 21st century the EU-15 may be finding its URA obligations harder and harder to live with (*a fortiori* if the next round further tightens the commitments). It was further argued in Chapter 4 that adding the PECO's (even without their own responses to higher protection) makes it impossible to achieve many of the URA commitments. Would internal price cuts ease the problem? For the AMS and export subsidy commitments, they would. But the real problem is not with these, but with the subsidised export volumes. Unless it is supposed there is a strong and quick production response to price cuts, this is not likely to achieve the necessary control over excess production. The conclusion is therefore that the real choice is between supported prices and very stringent supply controls or unsupported prices (with consequently no need for supply control) and other GATT-acceptable supports to farmers and the rural environment. Something in between just doesn't work. The features of each of these two regimes will now be examined.

6.1 High price regime

This is the status quo option. It represents the application of the *aquis comunitaire* principle, that new members of the Union agree to accept the whole body of existing EU legislation. Such an approach has the great virtue of not requiring any direct adjustment by existing EU producers. They are affected indirectly only to the extent that problems of enlargement mean subsequent revisions of support levels. The principle of this option is that PECO's fully adopt all then-existing support mechanisms and levels but have to agree to whatever production controls are necessary on their own agriculture to ensure that no additional strains are put on URA commitments by the new member states. Thus, for example, if a country has zero permissible export volume for a particular commodity in its own URA schedule, then its production will be limited to no more than its own domestic consumption.

The obvious problem with this option is that as the PECO's adjust to the protection the supply response discussed in section 4.1 will be encouraged. It is in these circumstances that excess supply of farm produce could arise. At the very least it, would necessitate tightly defined and implemented supply controls in the PECO's: milk and sugar quotas, base areas for cereals, oilseeds and proteins, and base numbers for beef and sheep. It is reasonable to ask if such an approach is feasible. Will the PECO's still have the necessary administrative structure and resources to implement such farm-level controls? At one time, they certainly had physical planning and control of all production at the farm level. However such controls were implemented over a much more concentrated farm structure than will be in existence in 6 or 7 years time. If EU controls after many years of experience are less than adequate,

what is the prospect for the PECO's?³¹ It would also be ironic indeed if the EU had to assist the post-communist countries to re-establish and even extend their previous physical control systems over agricultural production. Something along these lines would be implied by a decision to apply a largely unchanged CAP to the PECO's while still trying to respect the URA commitments. Even if such production controls in the PECO's enabled the EU-21 to live within its subsidised export volume commitment, it is not clear that all the other URA commitments could be met.

The view has been expressed that if it is politically necessary to include the PECO's into an unchanged CAP then a way will be found to do this. Is such an approach desirable? Three considerations suggest it is not. First, it does not seem to be in the best interests of the economic development of the PECO's to select a higher food price policy than is absolutely necessary. It was shown in table 3.3 that the proportion of total expenditure spent on food in these countries is, on average, 14 per cent higher than in the EU-12 (36 per cent compared to 22 per cent). Whilst this will surely fall in the pre-accession years given some economic growth, it will still be higher than the EU upon entry. For them to be obliged to inflict higher food prices on the population will raise wages, erode their competitive advantage and thus reduce their growth. The social consequences of high food prices could be even more serious. There is little doubt that low average incomes do not tell the whole story in the PECO's. The distribution of incomes is becoming more unequal in these societies. It is unlikely that their governments will have the resources to reverse this for many years to come. Those at the bottom of the scale, the old, unemployed, sick and handicapped, particularly in the urban areas, would bear the brunt of a high food price policy.

The second consideration in pursuing the 'high-price, tight-production control' route is the sheer economic waste of such a policy in the PECO's. Why should the agriculture sector in those countries be frozen arbitrarily at whatever production levels they have achieved immediately pre-entry? What is the sense of removing agriculture from the application of the general principle of exploiting comparative advantage? It is not a very convincing argument to say that the EU has 'developed' its agriculture under such controls. Supply controls in the EU were introduced only after four decades of post-war development of agriculture. It would seem inequitable to impose such controls on the PECO's only 10 to 15 years into economic reforms. In addition, if the PECO's knew they would be treated in this way their entirely rational response would be to do all they can to increase their production in the pre-accession period. This would give them the most advantageous position from which to negotiate supply controls, but would potentially give the EU greater problems with the accession.

The third argument against this policy concerns the competitiveness of PECO products in third (ie non-EU) markets. Spokesmen for the EU³² often exhort the PECO's to do all they can to re-establish their previous trade links amongst themselves and with the republics of the former Soviet Union (FSU). For many PECO's (but not for example Poland) the majority of their trade was with the former Soviet bloc. There is little doubt that PECO agriculture

³¹ Control, of course, is exercised by the national governments on behalf of the Commission, which explains why there is a great disparity in the effective control of agricultural production and the disbursement of subsidies across the EU.

³² Including the agricultural Commissioner Mr Steichen in a speech in London on 24th November 1994.

is recovering faster than CIS agriculture, especially with the technical assistance and support of the European Union. However, there would be little sense in developing trade with the FSU if the day after accession to the EU all competitive advantage is lost as the PECO's adopt the higher prices under the CAP. The export capacity built up as such trade is developed would instantly become an embarrassment requiring URA volume 'quotas' and budgetary resources which may not be available.

In short, the high-price, tight-supply regime does not fit the economic requirements of the new members. It has already been argued in chapter 2 that it is unlikely to suit the EU-15 by the time of enlargement either, and the results of chapters three and section 4.1 suggest that it will be difficult to contain the production potential of the PECO's if they are offered significantly higher prices.

6.2 Low price regime

To avoid the potential problems of stimulating over-production of high-price produce in the PECO's and the resulting lack of competitiveness with respect to their Eastern neighbours it makes sense to aim for prices at or close to world market levels. Of course, free from the impacts of subsidised exports, the world price itself would not necessarily be so 'low', it might be better to describe this as the 'no' price option to indicate that the EU has no opinion on what the market price should be. The problems with this approach are the political and economic adjustments which would be necessary within the EU-15, and, it has to be admitted, the disappointment of farming interests in the PECO's who dream of joining what they perceive to be the bonanza of the present CAP. The accession in January 1995 of two³³ even higher cost countries will not make the acceptance of this strategy any easier.

This is not the place to spell out in detail all the features of this option, and the necessary adjustment path to reach it from the current CAP. Only the broad outlines of the approach will be described. The essence is that systematic price support significantly above the international market levels is abolished. This does not remove the need for all price intervention mechanisms. It is highly likely that the EU-21 would wish to have an intervention system for market stabilisation reasons only. Market information systems do not operate perfectly, and thus some floor price and minimal intervention system may provide a valuable function of injecting a degree of information and certainty into the market.

The system described will not provide income support. Such support could be justified in many ways: compensation for previous support withdrawn, income parity reasons or social reasons such as maintaining a population in mountainous or remote areas. The payments could be provided in several ways. There could be direct payments linked to land farmed, livestock numbers, individuals working in the sector, income levels, region, or even altitude. An individual farmer might qualify for more than one such payment. The transfers could be offered as income flows, open ended or time limited, or they could be offered in the form of a tradeable capital asset such as a bond. A principle of all such payments is that they should be based on historic income, resource or production levels and payment should not depend on current production levels or even the need to produce. That is they should be

³³ Finland and Austria. Sweden moved away from its very high-price regime a few years ago.

decoupled from production decisions.

An obvious problem with the approach is that if it is judged that farmers must be offered the same degree of support as is currently available through a combination of price support and direct payments, then the budgetary cost could be higher than at present. This would not cause a problem with URA commitments as long as the payments were truly decoupled, but it could cause a budgetary crisis. Direct payments are also considered by recipients to be more vulnerable. They are much more visible than price supports and are subject to regular scrutiny and questioning through the normal processes of budgetary review. From the taxpayers' perspective this is an advantage of course.

To the extent that agricultural payments are seen as part of fiscal transfers to assist the process of convergence and cohesion in the EU, then a share of the expenditures should come from the EU budget. This is correctly part of the income redistribution in the Union. However it is likely that there are special natural, social and political reasons in each country why certain producers are worthy of more support. In such cases it is up to member states to fund the extra costs.

The third dimension of the low-price (or no-price) option are payments for environmental services supplied by farmers. In principle these too should be co-financed. Some environmental benefits (freedom from soil and water pollution, reduction in crop protection residues, wildlife and landscape) may have a public good element which extends beyond national boundaries. Their costs should therefore be shared. Others (and the majority) will be of national concern and should be paid nationally.

The fourth issue in defining this option is the extent of supply control. In principle if EU prices are maintained at international levels there is no further role for quotas, set-aside or livestock limits.

There is no denying that agricultural supports delivered principally through direct transfers for economic, social and environmental reasons will require administrative resources at least as large as exist in running the CAP. Most of the necessary resources will be within member states (as at present). Some degree of uniformity of administration will be necessary to ensure that competitive advantages are not created.

No budget costs are offered for this option. This is for two reasons. First, it is not rational to calculate budgetary costs *in vacuo*. It has been argued for many years (see Buckwell *et al* (1982)) that the size of budget costs are not a good indicator of efficiency of policy. These are just one item in the economic calculus of policy change. The economic costs of present policy are much higher than budgetary costs, thus to calculate the latter without showing the former would be misleading. Second, it is a major exercise to calculate the economic benefits and costs of a given policy for 21 countries ten years from now. In particular, to calculate the income support payments, first requires defining a basis on which they are to be paid. This is a matter of politics as well as economics and requires discussion and study beyond the capacity of this report. That said, there can be no hiding from the conclusion that the approach advocated will involve higher budgetary expenditure than at present for the EU-21.

6.3 Is a transition period necessary for the PECO's?

This depends on the extent of the policy instrument and price differences between the PECO's and the EU at the time of accession. If the PECO's have been unable or unwilling to align their policy instruments with those of the EU pre-accession and if they are still operating, as now, at much lower prices, then it might be too much of a shock for both parties to have full alignment of both instruments and prices on the first day of enlargement. Likewise if the EU is continuing to operate, more-or-less, the present CAP, this will create a larger gap than if it has moved towards the low-price strategy. On the other hand if the Union decides, pre-enlargement, to move to the low-price strategy then the case for a transition period is weaker because price differences (and policy instruments) will be much lower, and may even be zero.

There are precedents for quite long transition periods for some previous enlargements; as much as seven to ten years for the Mediterranean enlargement. In such transition periods prices in the new member state are gradually aligned with those in the Community. Whilst there are still differences in the prices, border taxes or subsidies called Accessionary Compensatory Amounts (ACAs) are applied to prevent the 'artificial' and temporary price gap stimulating trade flows. As the ACAs are gradually phased out prices converge. However, these arrangements were deployed before the so-called completion of the single market in December 1992. On the face of it such border restrictions are a contravention of the single market and would not be permitted. This was one of the reasons the EFTA countries were not offered a transition period with gradual price alignment.

There are three choices available. Either the CAP and PECO agricultural policy converge sufficiently pre-accession so that no unbearable jump is demanded of either side upon accession. Or, the rules of the single market have to be bent to allow temporary use of ACAs. The third choice has already been discussed in section 5.3, namely stepwise enlargement. That is, admit suitably selected countries one at a time or in groups such that they (and the EU) do not have to make too large an adjustment on accession, while giving time to non-acceding countries to adjust policies to make later accommodation easier. Stepwise enlargement is really like a transition period, with the countries in transition staying outside the EU until they are deemed ready for admittance.

It has been argued that the explanation for the success of the 1992 CAP reform was a mix of three ingredients: a workable idea which gave something to everyone (price cuts for some, supply control for others), the machinery of reform was assembled in both the Union and the member states, and the political climate for reform was created (both internally, the desire to abandon the stabilisers, and externally because of the GATT). There is still some way to go on working out the first two ingredients for the next reform. The political ground is prepared over a long period, and it is hoped that reports such as this make some contribution to shaping opinion in the direction of the low-price option described above. This can be demonstrated to be in the best interests both short term and long term for all the countries in or aspiring to join the European Union. The next chapter discusses what can be done in the meantime to prepare the way for a smooth Eastern enlargement.

7 THE PRE-ACCESSION POLICY OPTIONS FOR THE PECOS AND EU

Having identified the problems of PECO accession and two broad strategies for the CAP which deal with these problems, the final stage of the analysis is to define policy options for both 'sides' to follow in the period before accession. The objectives are to avoid or mitigate the problems of accession by easing the convergence both of policy and the two agricultural sectors prior to accession.

7.1 Options for the PECOs

It is clear from the analysis in chapter 4 that the room for manoeuvre in the PECOs is restricted by the schedules they have submitted in the Uruguay Round. This is fortunate in that it achieves the objective of the Uruguay Round of preventing countries from increasing trade distorting farm supports. However it is unfortunate if it inhibits necessary policy adjustments which could be helpful to the long run development of their agriculture. There is little doubt that their schedules were prepared before they had a clear view of their long term agricultural strategy, especially as it relates to the CAP. This is not a criticism of PECO GATT negotiators; such long term strategy cannot be clarified until the EU itself decides where the CAP is going.

Within the confines of the URA commitments the PECO governments have two broad choices. First, they can, as far as possible, move towards the kind of policy instruments and levels of support employed in the EU. Second, they could take the approach of minimising interventions in agriculture, undertaking only stabilisation, institutional development, information provision and other actions justified by the absence of markets or market imperfections and failures.

Justifications for the first strategy are that it would make entry less traumatic, and, on the assumption that the CAP will continue its high-price approach, it ensures that PECO production is as large as possible so that the PECOs can negotiate the greatest quotas and base arable areas upon entry. It also gives the PECO farmers, traders and officials experience in operating CAP-type supports. The second more open strategy is justified on the standard economic grounds that it encourages production which is internationally competitive and it minimises the drain on the rest of the economy. It also gives PECO agriculture the greatest opportunity to penetrate markets in the former Soviet Union and other parts of the world.

Within these broad choices what further actions could the PECOs take? The document by Nallet and Van Stolk 1994 (N&VS) essentially recommended a two prong approach. First, they proposed a common minimum or floor price to be put in place for the major commodities across the region. Second they made concrete suggestions about some institutional arrangements, particularly for credit.

The case for floor or minimum prices is well made. The suggestion that marketing structures are so under-developed and price information is so poor that individual farmers are not obtaining the 'market' value of their product is probably true in many instances. Most of the countries are already trying to deal with this by having some minimum or purchasing

prices for at least the major products. Perhaps there is scope to extend the idea to a wider range of commodities. There are two difficulties with the precise N&VS proposals. First, the definition of the level of minimum prices. There is absolutely no justification for inventing yet another term 'core costs' to justify the price. There is no rational way of defining such a concept. The floor price will always be a political judgement in relation to international prices and the desire not to accumulate unsaleable stocks.

Second, what is the justification for trying to set up a common system of floor prices across the region? Operationally it would be very difficult because of fluctuating exchange rates. Practically it serves no purpose unless the PECO's are going to contribute to a common fund to implement any purchasing at the floor price. It was shown in table 4.1 that there is a wide range of prices in the region, thus agreeing the common price will not be easy. Whatever common price is agreed will have adverse consequences for different groups in different countries: consumers in countries where the price has to be raised, and farmers in the countries where the price has to be lowered. A whole set of intervention and border mechanisms would have to be set up in order to achieve the common price objective, and these costs would not fall evenly across different countries. Financing these interventions are unlikely to be tolerated by the PECO's who would see the beneficiaries as being the inhabitants of another country. Would a group of countries operate a burdensome policy for one sector, without any compensations in increased trade in other areas? For comparison, would anyone seriously expect Germany and the UK (the two largest net contributors to the EU budget) to continue their generosity in the absence of any economic gains from trade in non-agricultural goods?

In short, proposals for a pre-accession Common Agricultural Policy in the PECO's make no sense in the absence of a common market across the wider economy. It is a much bigger issue well beyond this study whether it is in the interests of the PECO's (and the EU) that a PECO common market should precede membership. It is suspected that such an idea, whatever its merits, would be viewed by some of the PECO's as a diversionary and delaying device towards their political goal of EU membership. On the agricultural front, it must be recalled that it took the EU-6 over ten years to negotiate and introduce the CAP (from 1957 to 1968), why should this be a faster and easier task for the PECO-6? To conclude this point, a PECO CAP is an unhelpful idea.

The case for development of the credit system and marketing institutions is well made by N&VS. However caution should be exercised in pushing a single model on all the countries. There are no common credit or marketing institutions in the EU. Institutions develop best when they arise organically from the legal and political culture of a country. The most useful contribution the EU and its member states can perform is to provide information on the various models in operation in the Union, and let the PECO's themselves choose the most appropriate to their circumstances. This is particularly the case with banks and credit institutions. It is far from clear that there is a single optimal model, and the PECO's have each been developing their own existing banking institutions for several years. It would be quite wrong at this stage to try and impose a single agricultural bank model.

What, then, is the best advice that could be given to the PECO's in this pre-accession period? Given that neither the form nor level of support in a future CAP is known, but that all the pressures are for this level of support to be reduced, PECO's should aim for an efficient

agricultural sector that can meet import or export competition without the need for transfers from other sectors of the economy. This objective holds whether or not entry to the EU occurs at an early date or not. The means to achieve this are to allow markets to work, and where markets do not work, to identify the market failures and undertake corrective action. In this context, hastening the privatisation of land, of processing firms, and of the financial sector will be fundamental. Government, in fact, has to do remarkably little itself, but it does have to release the forces of enterprise and initiative which have been suppressed by too much centralised decision-making in the past.

Privatisation in itself will not ensure a competitive market, if a state monopoly merely becomes a private monopoly. Ensuring the market is competitive is best achieved by reducing barriers to entry. This would have the added advantage of encouraging foreign investment which would also add to the impetus of modernisation and increasing of competitiveness of PECO products.

7.2 Options for the EU which would ease PECO accession problems

There are four actions the European Union could take to help convergence.

1. The most helpful step would for the EU itself to *decide and announce the kind of agricultural policy it will be operating post accession.*

Given that the Union has only just emerged from an exhausting round of CAP reform, and international negotiations on three fronts, within the GATT, for the EFTA enlargement and with the PECO's over the Europe agreements, it is not reasonable to expect that it can immediately announce its strategy for the next decade. However, there are three reasons why it would be optimal to hold the debate and make the decision in the next two years. First, the new Commission (with a new agricultural Commissioner from a new member state), commences its work in January 1995 offering an opportunity to start with a clean slate. Second, the 1992 reforms expire by 1996, and Regulations will have to be agreed by then either to renew the set-aside and compensation payments or to set out on a further round of reforms. Third, if the broad strategy can be agreed and announced then the negotiations for PECO entry which commence in, say, 1997 can have a clear target to aim at.

The choices have been widely trailed in numerous publications and, in polarised and summary form, are described in chapter six. Of course no one can expect any political institution to make cast iron commitments about detailed policy years ahead of its date of implementation. What would most help the PECO's is a clear indication whether they can expect to join a CAP which is attempting to continue much as at present, the high-price tight-production-control option, or whether they should base their pre-accession strategy on the assumption that the CAP will be more like the low-price option. It is not of direct concern to the PECO's to know the precise route the CAP will take during the years prior to accession. There could be a gradual process of price cuts, or it could be announced that price cuts will be made after a particular interval, giving farmers time to adjust their businesses accordingly. For the PECO's it is only the expected end point that matters. Uncertainty is a great drain on resources. The EU can offer a great service both to its own farmers and those in the newly developing countries of Central Europe by debating and

deciding its ten year strategy for accession in the next two years.

2. The EU should intensify its efforts in *providing technical assistance to the PECO's to help them complete their adjustment to the market economy.*

This process is, of course, well underway already in the form of the PHARE programme. In the early years of the PHARE programme the emphasis has been on institution building, the transfer of skills, and emergency relief. There is scope for continuation of the first two of these programmes. Information systems, education, training, extension and research are all unglamorous but essential activities. The necessary learning is invariably not a once-off activity. The external input often has to be maintained over many years before sufficient skills have been transferred to the recipients. What has not been acknowledged, on either side, is that administrators, professionals and others in the PECO's cannot be expected to acquire the skills of their western counterparts in a year or two. After all, western experts only attain their expert status after many years of working at different levels, often in a variety of institutions. Projects involving skills and knowledge transfer need to be much longer term in outlook, with intermediate stages for assessment and, if necessary, redefinition. The criticism of some elements of the PHARE programme by the PECO's and corresponding frustration within the PHARE programme at the apparent reluctance of some institutions in the PECO's to make better use of what is on offer has come about partly because so much was expected so quickly. Disappointment on both sides has been inevitable.

In addition to these institutional, informational and human capital development projects there is a great demand for assistance to rebuild the physical infrastructure. This is one of the tasks of the European Bank for Reconstruction and Development. There could perhaps be greater coordination between the PHARE programme and EBRD. It can only help all these efforts to assist agricultural development if the goal was more clearly spelled out. If all concerned knew the broad parameters of policy as the PECO's join the Union this would help define concrete tasks to be achieved to smooth the path to accession.

The technical assistance programme could be grouped around four problems of PECO agriculture:

Improving the operation of the market:

Poor farm structure: assistance in preparation of land and tenancy laws;

Farm input market: help with formation of farmer machinery sharing, input purchasing groups.

Marketing farm products: help/advice in forming and operating food marketing groups.

Lack of management skills and information:

Assistance in management education in farm schools, colleges and universities; training for food industry management; improvements in research and extension systems; market information systems.

Lack of privatisation in the processing sector:

Continued technical assistance in preparing for privatisation; by clarifying the timetable for accession and the nature of the post-accession CAP this will spur both Western investors and PECO governments to pool efforts to complete this process.

Lack of understanding of market and EU operation:

Requires continued preparation of industry representatives, officials and policy makers by training and by shadowing of EU counterparts.

3. The third action is to improve further the detailed arrangements under the Association agreements.

A welcome package of measures has recently been proposed by the Commission which goes in the directions suggested by an earlier (unpublished) report to the Commission, Buckwell and Haines 1994. The main additional line of assistance apart from continuing to increase preference quotas and reduce tariffs, is to improve the detailed working arrangements of these preferential access arrangements. It is partly a matter of information. PECO traders simply find it very difficult to discover at any point in time how much of the quotas are still available. The EU could do more to disseminate this information. Second, and more radically, it really would solve the information problem if the quotas were auctioned within the PECOs rather than allocated to EU importers, this would also transfer the benefits of any price differences to the exporters. There is little doubt that the present arrangements have created bad feeling disproportionate to the importance of the issue.

4. The fourth action is that the EU should cease to subsidise agricultural exports to the PECOs.

Subsidised exports to the PECOs have a number of damaging effects. First, they undermine the fragile market which PECO farmers are trying to operate in and reduce the prospects of agricultural recovery. As such, they are also damaging to long run economic welfare in the PECOs, even though they provide short term benefits to PECO consumers. Second, such subsidies are interpreted as deliberate hostile actions designed to stifle the development of PECO agriculture. Third, they are overt signs that the EU has no intention itself of following the advice if offers PECO politicians (and which we have done in this report) - to get government out of business and let the market allocate resources. Fourth, it directly encourages the PECOs to erect import protection and to set off on the road to inefficient resource use and higher than necessary food prices. To refrain from using export subsidies on trade to the PECOs alone is obviously a discriminatory policy and distinctly not first best. Producers in third countries could reasonably feel affronted by this measure. However as the PECOs are destined to become members and such refunds will disappear in time anyway, this could be interpreted as a preparatory move to smooth accession.

8 CONCLUSIONS AND RECOMMENDATIONS

The European Union is on the threshold of three more significant steps in its development. After absorbing three of the EFTA countries in 1995 and reviewing institutional development and progress to economic and monetary union in the Inter Governmental Conference in 1996, the next biggest step is the Eastern enlargement. That it *can* happen has already been decided at the Copenhagen and Corfu summits. That it *will* happen depends on progress in the countries of Central and Eastern Europe (called PECO's in this report) in further stabilising their economies and on the ability of both parties to resolve some anticipated problems with this accession.

Eastern enlargement will be a landmark simply because of the absolute increase in size of the population and land area (although proportionately the enlargement is not bigger than the Mediterranean enlargement of the 1980s). The other distinguishing features of this enlargement is that the applicant countries are significantly poorer than the EU average, and they may bring with them seven and a half million farmers compared to the present EU number of just over eight million. It is the sheer size of these numbers that has caused many commentators to predict that agriculture poses a significant hurdle for the enlargement.

Although the end of the millennium is widely talked of as the target enlargement year, practicalities and previous experience suggest that accession of the PECO's is more likely in the period 2000-2005, with the later date the more likely if all six PECO's join at the same time. By that time the CAP is likely to be under severe pressure to live within the constraints of the Uruguay Round Agreement commitments on agriculture. It is suggested that whilst price levels may be lowered to help meet these commitments, the only way the EU could meet its subsidised export volume limit is by tightening supply controls. Price reductions will only be effective in reducing supply if they are very large (practically to world price levels), and instituted very early. Thus the set-aside area, milk quota, sugar quota, and ruminant livestock limits may all have to be even more restrictive. This in itself could precipitate a more radical reform of the CAP even without Eastern Enlargement.

Within the PECO's, the farm sector has experienced a severe shock as a result of privatisation and liberalisation. However there are clear signs that all the six countries except Bulgaria are beginning to climb out of their general and agricultural recession. Further progress is hard to predict, partly because it depends on the confidence of potential investors both in Eastern and Western Europe. This will depend partly on whether and on what conditions the PECO's enter the EU. There is certainly expected to be modest recovery throughout the region. However, PECO governments do not have much scope to influence this by protective agricultural policies because they are limited by their own resources and because they are constrained by their Uruguay commitments. The latter bite mostly on the aggregate measures of support and the export subsidy provisions.

Upon entry PECO agricultural prices will be lower than in the EU. This gives the opportunity for response in both production and consumption which can only increase the export potential of the enlarged community. These responses are not automatic: they depends to a great extent on the PECO's successfully completing the farm structuring and

privatising the food industry in such a way that a competitive market exists. They will also depend a great deal on the extent of Western investment and technology transfer.

The potential for increased exports will cause difficulties on three fronts: with EU farmers who feel threatened by lower cost competition, meeting the URA commitments and with the EU budget. It suggested that the first and third of these problems are real, but surmountable with the right policies. Estimates of the budgeted costs currently being circulated are misleading in our view. They are not juxtaposed with economic benefits and in any case as they do not make allowance for the effects of the URA they are likely to be over estimates. These are entirely EU matters. However, the incompatibilities with the URA commitments involve others who will, no doubt, be watching the EU carefully. Simply merging the URA schedules of the EU-15 and the PECO-6 causes difficulties particularly with market access and export subsidies. These can be resolved only by third countries adopting a flexible attitude and allowing some restrictions to be relaxed (no doubt at a price to be paid in some other area of trade) or, if such flexibility is refused, it would require reductions in EU-21 support levels or tightening of supply controls or both.

In the face of these various problems, there are four options:

- PECO accession to the EU but without access to the CAP;
- Two CAPs - Eastern and Western
- Stepwise accession
- Reform the CAP

The first two options appear unworkable. The third option is to delay facing the agricultural problems by admitting first those PECO's which threaten least the tranquillity of the CAP. This means admitting the Czech and Slovak Republics first, followed by Hungary, Poland, Bulgaria and last Romania. However, this approach ignores the potential trade benefits which enlargement is expected to bring. If a staggered accession of the PECO's is desirable it should be based on wider considerations than the budgetary costs of the CAP. No doubt politics will have the strongest impact on this matter. Of course, stepwise enlargement does not solve any problems - it only delays facing them. The extra time may be required to face the fourth option, which is to reform the CAP.

It was concluded that post enlargement there are fundamentally two choices for the CAP, a high-price tight-supply control option and a low-price option. The former could be made to work, but only at the cost of restricting any development of PECO agriculture, and preventing them from being a competitive source of exports for markets in the former Soviet Union. The alternative option is the favoured approach. The EU should commit itself to a minimalist intervention system designed only to provide market stability. Any additional support for income, social, regional or environmental reasons should be based on appropriately defined direct payments which are completely decoupled from production decisions. The higher budgetary costs of such a policy will be outweighed by the economic benefits. The budgetary cost itself should be shared between member states and the Union.

The most helpful step the EU could take for the PECO's in the next two years is to debate these issues thoroughly and to lay down a ten-year strategy for enlargement. The reduction of uncertainty this would achieve would be of enormous value to farmers and agribusiness

in the whole of Europe.

Two more concrete actions that the EU could take are, first, to further liberalise trade under the Association Agreements in particular to make the operation of the trade quotas more attractive to PECO exporters. Second, the EU should eliminate the use of subsidies on exports to the PECO. The cost to the EU of these actions is not great, but they cause disproportionate harm to EU-PECO relations. Finally the PHARE programme and the EBRD have important roles in technology transfer, institutional development, training and infrastructural development to assist the Eastern enlargement.

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APPENDIX A

TERMS OF REFERENCE

Feasibility of an agricultural strategy to prepare the countries of Central and Eastern Europe for accession

INTRODUCTION

These terms of reference are for a series of studies on the agricultural policies in Bulgaria, the Czech Republic, Hungary, Poland, Romania and Slovakia (CEEC), and on alternative systems which could be put in place, having the objective to integrate the European Union's (EU) and the CEEC's agricultural sectors.

The objective of these studies is to develop options for policies in the CEEC's and, as appropriate, in the EU.

The results should aim to help the European Commission in the elaboration of its strategy to prepare the CEEC for accession in the European Union.

OBJECTIVES

The objectives of the studies are listed below. The rationale, the general framework and the hypothesis under which the studies should be undertaken are explained under a separate heading.

- 1. Form an opinion on each country's present agricultural policy, in terms of compatibility with:
 - (i) their future GATT undertakings following the Uruguay Round**
 - (ii) their budgetary possibilities**
 - (iii) their capacity for policy enforcement**
 - (iv) their domestic, political and social pressures including the need for a sustainable level of farm income**
 - (v) the agricultural policies of their neighbours**
 - (vi) the development of efficient and competitive agricultural production, distribution and processing**
 - (vii) the role of agriculture in the economy and in rural and regional development**
 - (viii) the shared goal of integration with the EU and in world markets and of convergence between their agricultural policies with ours, in the light of foreseeable trends in EU support for agriculture.****

2. Recommend a range of agricultural policy options to be developed by the CEEC, which could respond to the above points, with particular relevance to the external constraints (points (i) and (viii)) and which could help to achieve greater convergence of agriculture policies.
3. Identify how could the EU contribute to the best policies in the CEEC's through trade and agriculture policy and financial and technical assistance (Phare programmes and others).

GENERAL FRAMEWORK AND SCOPE OF THE STUDY

Relations between the EU and the CEEC

The EU relations with the CEEC are established by the Europe agreements with the six CEEC and by the related decisions taken by the Heads of States and Governments in Copenhagen (June 1993) and Corfu (June 1994). The Europe agreements foresee the establishment of a free trade area for all industrial goods (with different calendar and arrangements, depending on the goods), with the EU granting access earlier, and the CEEC within a maximum period of 10 years. The agreements also establish a wide range of co-operation in the economic, social, cultural and political field.

The agricultural chapters of the agreements provide benefits to the CEEC by giving them preferential access to the EU market for a selected range of agricultural products, which, in some cases, are restricted in quantity.

These agreements represent a broad mutual desire to develop deeper political and economic relations between the EU and these countries and create the framework through which the shared objective of EU membership could be reached.

Agriculture in the CEEC

Agriculture plays an important role in the CEEC economy, both in terms of share of total GDP and the percentage of work force employed. The agriculture production chain must therefore be oriented towards long-term competitiveness in world markets as well as in the market of Europe as a whole.

Agriculture in these countries has undergone a severe structural adjustment process which has contributed to (i) a decrease in the gross agricultural output of up to 30 per cent between 1989 and 1992 (this trend continued in 1993, with few exceptions) and (ii) a decrease of agricultural exports and farm income level.

Although some work has been undertaken on restructuring CEEC agriculture, existing reports have not studied all aspects in sufficient detail. They have not taken sufficient account of the dynamic elements in the existing framework defined by the Uruguay Round obligations of the CEEC and of the EU, as well as by foreseeable trends in EU agricultural policy.

General Framework for the studies

Some of the most important elements which the experts should take into account are listed below:

The implications of the change from state trading in the Uruguay Round base period (1986-1988) to the current measures of protection at the border, if any, and more importantly to the measures of protection and support now bound in the Uruguay Round and which limit what can be done to improve the situation in the future.

The CEEC's Uruguay Round obligations commit them to limiting their domestic support to a ceiling which they have bound in GATT. The Uruguay Round also commits them to replacing all existing border measures such as levies with bound ad valorem import duties - which they have done. Finally, it prevents them from introducing export refunds for any product not specified in their schedules.

The developments in agricultural trade flows between the EU and CEEC. EU expansion of its exports (with refunds to the EU exporters) and CEEC stagnation and even contraction of exports to the EU have contributed to the current CEEC problems. An analysis of the preferential trade flows in both directions and the correction of any anomalies provoked by the Community policy are essential if the EU wishes to contribute positively towards price stability in the CEEC and towards the development of their concessionary trade flows to the EU.

Questions to be addressed

- (1) Which options will encourage efficient and competitive production able to respond to market signals and to maintain the possibility of exporting to the world market?
- (2) What measures need to be taken in the short term to stabilise farm incomes and production?
- (3) Which options are most consistent with the development of inter-CEEC and CEEC/CIS trade relationships? Given the degree of monetary and economic divergence, how can we best move towards convergent agriculture policies in Europe as a whole?
- (4) Which policy options are most consistent with the CEEC macroeconomic stabilisation plans, IMP standby arrangements and the Uruguay Round commitments?
- (5) What accompanying policies are needed to make the proposed options workable, for example - crop insurance schemes, future markets, input subsidies, private storage aid and marketing assistance.

STUDY ORGANISATION

This study is being commissioned from several experts who shall work independently. Visits to the countries, in particular those that have introduced agricultural support policies will be necessary.

The study shall be implemented in 3 months.

The experts will present a mid-term report and will be available to discuss with the Commission the preliminary finds and recommendations, as necessary.

APPENDIX B: URUGUAY ROUND COMMITMENTS ON SUBSIDISED EXPORTS

TABLE B.1: Cereals export limits and 1993 or 1992 export levels

CEREALS	Max. subsidised exports (2000) ('000 t)	1993 Exports ('000 t)	Producer price (USD/t) - 1993 Wheat for feed
EU	23409	28034	180 ²
Hungary ¹	1305	3443	44
Poland	0	4	132
Czech R.	0	176.8	93
Slovak R.	109	152	83 ³
TOTAL	24823	31810	-

¹ data for 1992

² Intervention prices decrease from 1993/94 to 143 USD/t (115 ECU/t)

³ Intervention price

TABLE B.2: Beef export limits and 1993 or 1992 export levels

BEEF	Max. subsidised exports (2000) ('000 t)	1993 Exports ('000 t)	Producer price (USD/t) - 1993 Cattle LW
EU	817	1323.4	1746 ²
Hungary ¹	83	58	859
Poland*	40.9	34	696
Czech R.	49.8	5.1	873
Slovak R.	28.4	23.5	863.5 ³
TOTAL	1019	1414	-

* includes horse meat, beef meat, pork meat and lamb meat.

¹ data for 1992

² Intervention prices decrease from 3430 ECU/t in 1992/93 to 3216 ECU/t in 1993/94

³ Intervention price

TABLE B.3: Pork export limits and 1993 or 1992 export levels

PORK	Max. subsidised exports (2000) ('000 t)	1993 Exports ('000 t)	Producer price (USD/t) - 1993 Pork LW
EU ¹	402	536	1200
Hungary ¹	126	102	988
Poland	0	13	903
Czech R.	10.1	9.6	892
Slovak R.	4.7	2.8	752 ²
TOTAL	543	663	-

¹ data for 1992² intervention price

TABLE B.4: Powder Milk export limits and 1993 or 1992 export levels

POWDER MILK	Max. subsidised exports (2000) ('000 t)	1993 Exports ('000 t)	Producer price (USD/t) - 1993 Milk
EU ¹	243.3	392	527
Hungary ¹	0	11	207
Poland	37	127	129
Czech R.	66.9	85.1	200
Slovak R.	15	10.4	186.6 ²
TOTAL	362.2	625.5	-

¹ data for 1992² intervention price

TABLE B.5: Sugar export limits and 1993 or 1992 export levels

SUGAR	Max. subsidised exports (2000) ('000 t)	1993 Exports ('000 t)	Producer price (USD/t) - 1993 Sugar Beet
EU ¹	1151	4710	43
Hungary ¹	32	144	26
Poland	104.4	112	24
Czech R.	0	85.4	28
Slovak R.	3.9	9.9	na
TOTAL	1292.3	5061.3	-

¹ data for 1992

APPENDIX C: HARMONISING TARIFFS AND TARIFF BINDINGS

Tariff bindings:

Since the Uruguay Round Agreement, the application of tariffs in agriculture has been binded *i.e* a maximum tariff is committed by this international trade agreement. In no case tariffs applied by the member parts countries can exceed those tariff bindings.

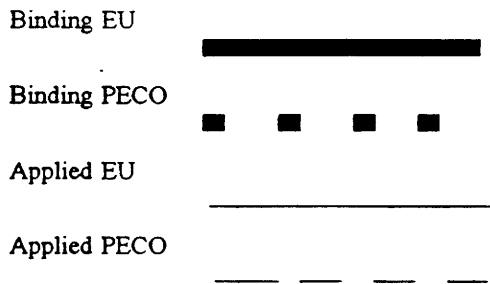
Actual tariffs:

However, the actual tariffs (those applied on a day-to-day basis) may differ from the tariff bindings.

ROW: Rest of the world.

Situation pre-accession 1.

Harmonisation
Common level of binding and applied tariffs
after PECO accession

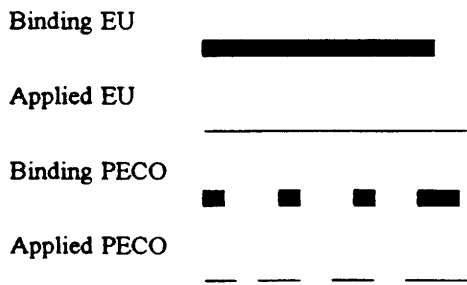


A.

The PECO binding tariff rises to the EU binding tariff
 The PECO applied tariff rises to the EU applied tariff
 Gainers: PECO producers
 Losers: ROW access
 PECO consumers

Situation pre-accession 2:

B.



Weighted average of the PECO and EU binding tariffs
 Weighted average of the PECO and EU applied tariffs
 Gainers: PECO producers
 EU consumers
 Losers: EU producers
 PECO consumers

 ROW Access: no change

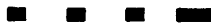
Both situations 1 and 2 can lead to the harmonisations A or B. However the amounts of loss and gain will vary.

Situation pre-accession 3:

Binding EU



Binding PECO



Applied PECO



Applied EU



C.

Harmonisation:
Common level of binding and applied tariffs
after PECO accession

The PECO binding tariff rises to the EU binding tariff.

The PECO applied tariff decreases to the EU applied tariff.

Actual Gainers: PECO consumers
ROW access

Actual Losers: PECO producers

The actual gainers/losers differ from those that would result from the harmonisation of the binding tariffs agreed under the GATT.

D.

Weighted average of the PECO and EU binding tariffs

Weighted average of the PECO and EU applied tariffs

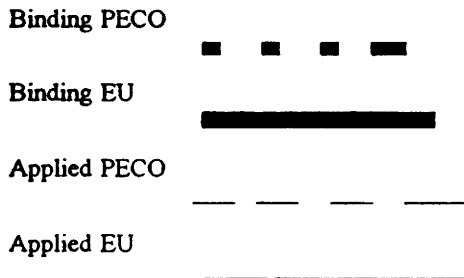
Actual Gainers: EU producers
PECO consumers

Actual Losers: PECO producers
EU consumers

ROW: no change

The situation 3 can lead to the harmonisations C or D.

Situation pre-accession 4:



E.

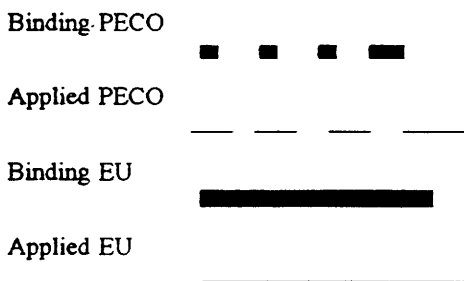
Harmonisation:
Common level of binding and applied tariffs
after PECO accession

The PECO binding tariff decreases to the EU binding tariff.
The PECO applied tariff decreases to the EU applied tariff.

Gainers: PECO consumers
ROW access

Losers: PECO producers

Situation pre-accession 5:



F.

Weighted average of the PECO and EU binding tariffs
Weighted average of the PECO and EU binding tariffs

Gainers: EU producers
PECO consumers

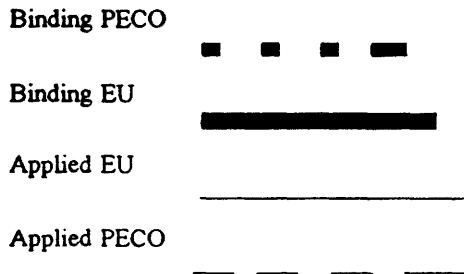
Losers: PECO producers
EU consumers

ROW: No change

Both situations 4 and 5 can lead to the harmonisation E or F. However the amounts of loss and gain will vary.

**Harmonisation:
Common level of binding and applied tariffs
after PECO accession**

Situation pre-accession 6:



G.

The PECO binding tariff rises to the EU binding tariff.

The PECO applied tariff decreases to the EU applied tariff.

Actual Gainers: PECO consumers
ROW access

Actual Losers: PECO producers

The actual gainers/losers differ from those that would result from the harmonisation of the binding tariffs agreed under the GATT.

H.

Weighted average of the PECO and EU binding tariffs

Weighted average of the PECO and EU applied tariffs

Actual Gainers: PECO producers
EU consumers

Actual Losers: EU producers
PECO consumers

ROW: no change

The situation 6 can lead to the harmonisations G or H.