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Can the CAP Survive Enlargement to the East?

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Abstract

The possible enlargement of the European Union to include some of the Central and Eastern Europe countries (CEEC) poses a problem for the Common Agricultural Policy (CAP). Current price levels and subsidy rates, if applied to the CEEC would represent an increase in budget cost of at least 5 billion ECU. Trade frictions with other countries would be exacerbated and the new GATT rules on agricultural export subsidies would be violated. The alternatives presently being considered are a two-tier market in Europe, with prices higher in the current EU than in the CEEC, or further changes in the CAP to allow for a lower market price level. The first requires an elaborate set of border controls to prevent the free flow of agricultural produce into the current EU. It would also have undesirable economic and political implications for the CEEC. The latter option requires reopening the issue of CAP reform, and will cause significant internal tensions.

The paper explores the economic and policy implications of these options and presents empirical estimates on budget cost and trade flows from a multicountry partial-equilibrium agricultural trade model of the EU and the CEEC. It explores the options open to the EU to change the CAP before CEEC accession. It suggests ways in which the transition to full participation in the EU agricultural market can be managed.

Can the CAP Survive Enlargement to the East?

by

Tim Josling and Peter Walkenhorst ¹

Introduction

The European Union faces its most daunting challenge to date in the prospective enlargement to include some of the Central and Eastern Europe countries (CEEC). At the moment it appears that this event will occur by the turn of the decade. This gives the EU five years to get ready for the moment of accession. The ease with which the CEEC can be assimilated into the single market will depend crucially on the development of the Common Agricultural Policy (CAP) over the next five years. This medium term outlook for the CAP is the subject of this paper.

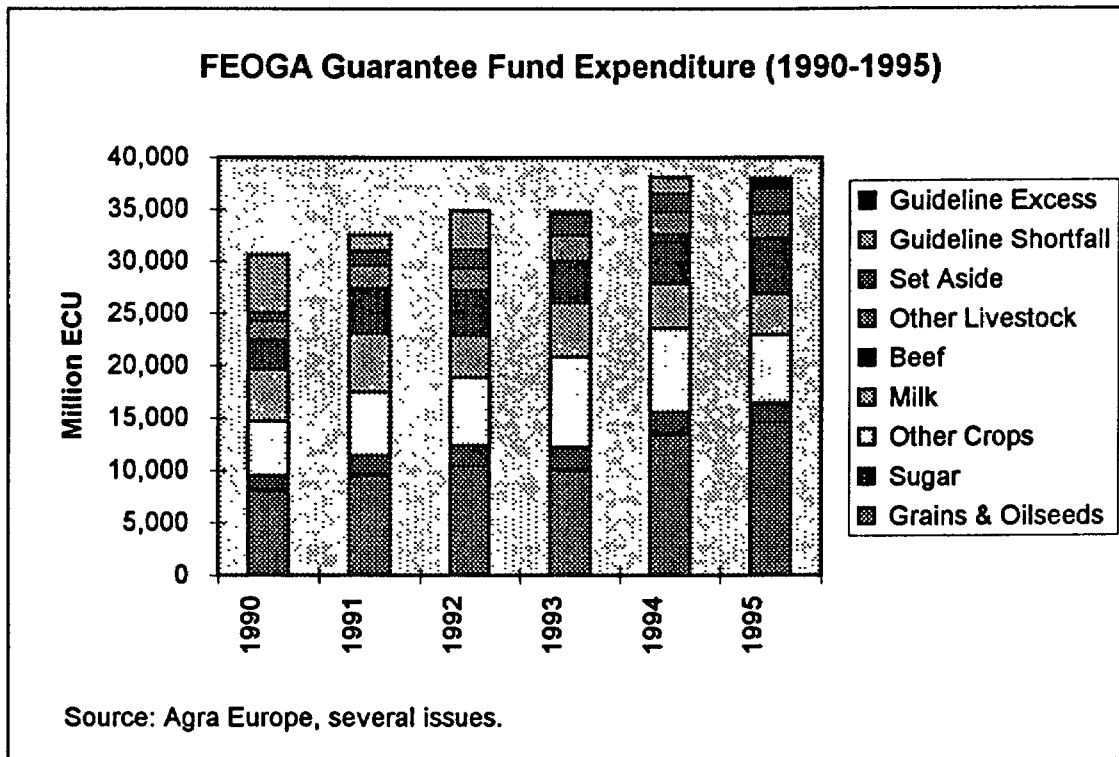
The outlook is likely to be conditioned by four different sets of pressures. First, the budget costs of the CAP will continue to be limited by an overall budget constraint which is unlikely to be relaxed. Secondly, the constraints imposed on the CAP as a result of the Uruguay Round agreement will put strict limits on the price developments under the CAP, and help to shape the instruments used. Thirdly, the CAP will be influenced by broader rural and societal aims such as environmental, health and distributive objectives. And fourthly, the accession of some of the EFTA countries, and the prospective membership of the CEEC will change the market balance for the EU and influence both the budget cost and the political support for the CAP.

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I. Pressures for Change in the CAP

a) Budget Pressures

The EU has experienced a period of five years when budget costs for agriculture have been subject to limits, based on the proportion of total spending. The extra payments needed for CAP reform have strained these limits. Evidence of mounting budget pressures can be seen already. The accompanying chart shows the growth in budget in the past five years. Even without the influence of new members on the budget (see below) it is likely that current policies will exhaust the budget allocation in the near future.



The response of the Union to these budget pressures will determine in large part the CAP that will be in place at the end of the century. If the response is to reduce prices then this would add to the chances of survival and will be consistent with eventual accession of the CEEC: if the reaction of the Union is to tighten supply control and remove productive capacity this will make accession more difficult. Any attempt to shift the burden to consumers will run into problems with the GATT Agreement (see below). One possible way out would be to shift the financial burden back to the individual member-states. Without threatening the unity of the market, it should be

possible for the individual EU-members to take over some part of the compensation payments, properly disconnected from production incentives, as national obligations (see Larsen *et al.*, 1994). This would not only reduce FEOGA spending but make the budget burden easier for new members to accept.

b) GATT Obligations

Even if the limits on budget shares were not to keep the CAP spending within strict limits, there is now for the first time an effective external constraint on the CAP. The Uruguay Round Agreement on Agriculture will have major implications for the CAP from 1995 until 2000. The Agreement calls for a conversion of all non-tariff trade barriers (including variable levies) into tariffs, which would then be reduced on a given schedule. Export subsidy expenditure is constrained, and reduced on a given schedule. The volume of exports benefiting from subsidies is also to be reduced, and export subsidies cannot be introduced on other products. Domestic support in those cases where prices are administered is also reduced by schedule. Though the degree of liberalization incorporated in the Agreement is not dramatic, there will be additional pressures before the end of the decade to negotiate a continuation to the Agreement in order to liberalize agricultural trade further.

The GATT Agreement is unlikely to have a marked impact on price support for EU agriculture in the next two years. Agreement was made possible by the slight decline in farm prices (expressed however in terms of a strengthening "green" ECU) over the years since the Uruguay Round started, and more particularly by the bold Reform of 1993. As a result, the constraints on export subsidies and total support can be met in the short term without immediate policy change. In the medium term, the constraint on the volume of exports which can be subsidized represents the most binding constraint and is likely to impact on CAP price decisions by 1997.

The Agreement also mandates a change to the variable levy system for import protection, replacing it with tariffs. This tariffication is accompanied by a special safeguard mechanism which can be used in cases of import surge or world price collapse. The height of the new bound tariffs are such as to put little pressure on domestic market prices for the next few years. Moreover, for cereals a maximum duty-paid import price has been negotiated as a part of the EU's obligations.

This implies a continuation of a modified threshold price system, at least so long as world prices don't drop to very low levels.

It would however be a mistake to think that the impact of the GATT agreement on the CAP is small. Even though it does not mandate many price and policy changes in the immediate future, it effectively constrains future decisions. Specifically, it makes it difficult if not impossible to revert to the policy price levels that obtained before CAP reform. It makes it difficult to increase the level of compensation to farmers under CAP reform, or to relax set-asides, without incurring the risk of challenge under the GATT. It makes it impossible to expand the use of export subsidies beyond the limits agreed in the Schedules. And it obliges the Union to maintain current access for specified agricultural products. In effect it locks in the policy changes of the past few years, and makes any deviation from that path both politically and economically costly.

c) Environmental and Distributional Pressures on the CAP

In addition to the budget cost and market balance constraints, other forces will be acting on the CAP in the next five years. These include the pressure to make sure that environmental goals are not violated by commercial agriculture. One would expect more concern over groundwater pollution, animal welfare, worker health, and food safety issues. By contrast, broad goals of "rural development" not tied to these essentially urban concerns are unlikely to make much impact on the agricultural policy.

In addition to environmental and health concerns, issues of income distribution are likely to surface over the next few years, as the gap between those who receive large payments from the CAP and those that don't is increased. This could lead to pressures to limit payments, and to put other constraints on the significant amounts of money that now are paid directly to the farmer. This could in turn lead farmers to want to find some other criteria for payment, such as stewardship of natural resources and provision of amenities.

The combination of these two pressures could take the CAP down a path toward the personalisation of policy, and away from the support of commodity prices as a proxy for income maintenance. Some part of the payments would be given for activities undertaken to preserve environmental amenities. But these payments would be in lieu of controls on farming practices, and hence conform both with the trend to using market mechanisms to achieve environmental aims

and also be consistent with the notion of freedom of the farmer to choose his farming pattern and practice. Coupled with the GATT constraints on price policies, and the encouragement to use other methods to achieve income objectives, one could well see a different mix of policies in rural Europe by the end of the century.

d) EU Enlargement

The Entry of the EFTA Three

The quantitative impact on European agricultural markets of the accession to the EU of the three new members is unlikely to be great (Josling, 1993). This is due to three factors. First, the countries themselves are relatively small, both in terms of population and agricultural production. They will not add greatly to the volume of production in the Union. Secondly, the three new members have negotiated the freedom to pay substantial hectareage and headage payments to farmers in remote areas, which will presumably act to keep those farmers from leaving the land idle. Production will no doubt fall over time, with depopulation and extensification, but one would not expect a major migration in the short run. Thirdly, the production in some areas could actually increase as a result of the opening up of markets. Swedish sales to Finland, for instance, could expand. Moreover, not all sectors in closed markets are necessarily inefficient. Even Finland could find that some parts of the agricultural sector develop export markets as well as competing well with imports from the EU.

The influences that can be expected are more subtle. First, the new members will have some influence on the political balance of the Union with respect to agricultural policy. On the surface, this is likely to show up as strong opposition to further price declines, at least if unaccompanied by compensating headage and hectareage payments. But it is also possible that the experience in the new members with such non-price payments, and their acceptance as a part of the CAP, will allow price reductions to be continued with less opposition. Nordic and Alpine influence will also be manifest in a stronger interest in the environmental impacts of intensive agriculture and in the pressure to recompense farmers for the scenic and recreational value of their land. This interest will also show itself in issues of food quality and safety, as well as plant and animal health. The new members are likely to take a more "holistic" view of agriculture, with less concern for individual commodity market conditions and more for the place of rural people in society.

In addition, the accession of the EFTA countries will establish precedents for the further enlargements to the East. First, the fact that the compensation payments under CAP reform were treated as a part of the *acquis communautaire* sets a precedent which other new members may be able to follow. In effect, the Union accepted some part of the financial cost of providing headage and hectare payments for the EFTA countries. These payments would have been needed in any case to bridge the gap between their generally higher price levels (except in the case of Sweden) and those of the CAP. As the net budget contribution expected from the new members was a matter of negotiation, the transfers under the MacSharry payments were unlikely to be a significant net burden on the EU budget. Similarly, the cost of the new programs for Arctic regions are unlikely to be a heavy burden on the budget. They are to be paid for by the individual countries. These payments do however create a precedent for further “nationalisation” of the CAP. If Finland and Sweden can run “Nordic” agricultural programs, why not have a special dispensation for national aids for arid areas, or wetlands, or those areas where high temperatures impede agriculture?

The Prospect of the Visegrad Four

The prospect of the accession of some Central European states with their substantial agricultural production potentials (Jackson/Swinnen, 1994) is much more threatening to the stability of the CAP, and to its ability to live within financial guidelines than the recent integration of the EFTA countries. The immediate impact of the accession of the Visegrad Four¹ on the agricultural budget could be about 5-12 billion ECU if current price levels are maintained and if compensation payments are paid to CEEC farmers at the same rate as to farmers in the EU. The calculations in the table below show an additional cost of 5 billion ECU on export subsidies and compensation payments, including about 3 billion ECU for grains alone, based on a multisector model of the agricultures of the EU, the EFTA countries and the CEEC (see Tangermann and Josling, 1994).² The table shows the modest impact of the EFTA accession on such expenditure,

¹ Czech Republic, Hungary, Poland, and Slovak Republic.

² The higher figure of 12 billion ECU, which comes from Brenton and Gros (1993), includes a number of other programs and is based on the assumptions that the new members will have similar demands on Union structural funds as current members.

the large jump in cereal program costs between 1990 and 1995 arising from the MacSharry compensation payments, and the big jump in costs with CEEC entry, assumed to be by the year 2000. This jump in budget cost is likely to be enough to force significant policy changes on the EU at that time. In addition, the extra net-exports of agricultural products from the CEEC will weaken market prices within the EU relative to policy price levels. Such a dilution of the impact of price support is likely to foster resentment among existing farmers in the Union.

Projected Export Subsidy and Compensation Payment Expenditure on Major Commodities from 1990 to 2000 (in Million ECU)				
		1990	1995	2000
Grains & Oilseeds	EU-12	3,459	10,034	8,946
	EU-15		10,695	9,785
	EU-19			12,925
Beef	EU-12	1,469	(286)	(171)
	EU-15		282	685
	EU-19			1,203
Milk	EU-12	2,099	2,333	1,361
	EU-15		2,656	1,546
	EU-19			2,785
Total	EU-12	7,027	12,081	10,136
	EU-15		13,633	12,016
	EU-19			16,913
Source: Own Calculation.				

II. Options for the CAP during the Pre-Accession Period

The ease with which the CEECs could be assimilated into the EU will depend crucially on the development of the CAP over the next several years. Several alternative policies regarding prices and policy instruments can be imagined. In the following, three medium term policy options will be evaluated: First, a policy of only minimal changes to the present CAP; second, a continuation of CAP reform through extended commodity coverage and adjusted policy instruments; and third, a completion of the reform process to create an agricultural sector competitive under world market conditions.

a) Option 1: Minimal changes to the CAP

One reaction to all the different factors affecting the CAP is to try to preserve the policy as it exists, adapting to pressures in an *ad hoc* way. Such a strategy would avoid taking action to forestall crises. This reactive approach to policy developments has the ring of reality to it: the CAP has usually required a crisis to force change. However, such a passive drift towards the next crisis is not necessarily good policy. Changes in policy which would in any case be in the interest of the Union would be delayed. These changes include the promotion of a competitive agricultural industry that can sell goods on world markets without the need for subsidies, the provision of raw materials for a food industry that also is competitive, and the removal of the artificial incentives to keep land in inefficient activities for the sake of benefiting from support payments. Governments pay lip-service to such objectives, but seem reluctant to take action to bring them about.

That the present state of affairs is undesirable is easily shown. European agriculture at the moment appears to add little or nothing to the GNP of the Union. Net Value Added in the sector as a whole was about 110 billion ECU in 1991 (see table). This was 49 percent of the value of final output. For the same year, the OECD calculated that 68 billion ECU had been transferred to the sector through the CAP, a sum equal to 49 percent of the value of sales for those commodities included (OECD, 1993). The same publication reported total transfers including those by national governments at 120 billion ECU, somewhere in between the net and gross value added. If the transfers through policy are the same order of magnitude as the excess of revenue over costs of inputs from other sectors (i.e. value added), then the cost of inputs must be roughly the same as the

market value (without policy intervention) of output. In other words, no value is being added to the inputs purchased from other sectors, and the industry as a whole contributes nothing to GDP. It is this total waste of good agricultural resources and the skills of the farm community that constitutes the biggest reason not to continue with current policies.

Agricultural Value Added in the EC-12 in 1991		
	Million ECU	Percent
Final Agricultural Output	223,103	100
Gross Value Added (Market Prices)	127,943	57
Gross Value Added (Factor Cost)	138,560	62
Net Value Added	109,664	49
Source: OECD (1994).		

In addition to internal economic considerations, there are other reasons to change policies before forced to by crisis. A strategy of waiting for further crises to develop will inevitably increase the likelihood of a conflict with GATT obligations. It will also maximize the likely political cost of enlargement and of conforming with GATT obligations. By reacting to problems rather than anticipating them, the policy will be in a semi-permanent state of crisis. Those that support the continuation of the CAP as it stands at present will always be seen to be at odds with those that are arguing for EU enlargement, for good trade relations with other OECD countries and with the developing world, and for a competitive EU agriculture which can support a competitive food industry and contribute to the economy.

Casual observation of the political process suggests that this is the option most likely to be followed, i.e. that of relative inaction until provoked by crisis. However that time may not be far away. If yield increases for the major crops continue at 1.5 - 2 percent a year, the inaction strategy will soon prove untenable. Similarly, if world prices are seriously depressed then export subsidy expenditure as allowed under the GATT will be inadequate to remove surpluses off the domestic market. Changes in the CAP will be forced by both the GATT Agreement and the budget. The changes will be either of the type outlined in options 2 and 3 below, in which case the delay will just have been costly, or these changes will be of a much less desirable ad hoc nature.

The most tempting ad hoc strategy for the relief of market surpluses is supply control, through greater set-asides or land retirement schemes. In the case of animal products, herd reduction schemes play the same role. The problem comes in the distortion that such schemes imply for the allocation of resources within the farm sector (even if the total resources in the sector have been reduced by supply control). This distortion is among countries, in that supply control is likely to have differential effects in different member states, and among farms. Total costs will be considerably higher for the same level of output, and hence farm incomes will be less for the same supported level of receipts. Moreover, the further intrusion of bureaucratic controls into the normal farm decisions on what to plant and what stocking density to maintain could cost both political support for the CAP (and for the EU) as well as add to the economic burden of the industry. In short, continuation of the current policy may have appeal but runs the risk of, at the least, costly delay in making needed changes and, at the worst, the promotion of supply control even though it is an undesirable direction for policy to take.

b) Option 2: A Modest Continuation of CAP Reform

An alternative approach is to attempt to continue the reform process started in 1993. This means at least two further stages in the reform process. The first is to complete the reform of sectors other than the cereals and oilseeds complex. Reform of the dairy industry was shelved at the last minute in 1993, in order to get agreement on the cereals sector. At that time, further dairy quota cuts were contemplated, along with price cuts for dairy products. Some price cuts survived, but the dairy sector is still operating with prices far above world market levels. Reform of the dairy sector needs to be restarted. Price reductions could be compensated by the issuance of certificates to farmers, as suggested in the original MacSharry reform paper (see also Tangermann, 1991). In addition to the cereal and dairy sectors, other sectors also are in need of policy modification to become more efficient. The sugar sector, long neglected in reform discussions because of its small budget cost, along with the wine sector and fruits and vegetables could also be improved by inclusion in the reform process.

The second step in this modest completion of CAP reform is to reduce the incentive that currently exists for farmers to continue to farm hectares just in order to get compensation payments. If the farmer cannot make a profit from the production of cereals and oilseeds at the market price, as supported by the threshold price (or maximum duty-paid price under GATT rules,

in the case of cereals) and the intervention price, then it is clearly a waste of resources to insist that the land is used in this way (Josling, 1994). One might wish to suggest other criteria for receiving the payments: use of the land in an inefficient way should surely not be one of them.

This middle-ground option of a continuation of CAP reform is inherently more costly in political capital, but has certain advantages. First, the reduction in the market price for dairy, sugar and other newly reformed commodities offers to those sectors the advantages that the first stage of reform did to grains and oilseeds. Lower consumer prices and lower prices for the processing industry would in effect remove a tax that currently holds back consumption and reduces competitiveness. Compensation payments would preserve for some time the income streams to producers until they were able to switch to alternative commodities. GATT constraints would be more easily met, and the improved international climate would have beneficial consequences for exporters of other products.

Nevertheless, there is a problem to this strategy. It may not prove enough to avoid problems associated with the challenge of membership of the CEEC. Price levels would still be higher than can in the long run be sustained. It would require a long transition period (see below) to avoid the overstimulation of production in the new members.

c) Option 3: Complete Reform Process to Give Competitive Agriculture

The third strategy is to be proactive, anticipating changes and adapting before a crisis occurs. It involves going considerably further than the present reform in lowering market prices and in paying compensation payments only to those that are severely disadvantaged.

In the case of the cereal sector, the next step would be to lower the market price by some significant amount, until close to expected medium-run world market prices levels. The extra compensation payments would be paid in a different way from the current payments for the CAP reform price drop. First, no further use of land would be necessary to receive the payments. They should carry a termination date, say ten years, with a declining payment value, but be fully portable and transferable. Set-asides would be discontinued, as being unnecessary if market prices are close to world market levels. Export subsidies would fall with the drop in market price, and so the level of exports need not be constrained by set-asides. Farmers would make planting decisions based on the best use of their land rather than on the need to satisfy program requirements.

In the case of the dairy sector this option could include a multi-year commitment to move support prices towards those on world markets, compensated where necessary by payments not tied to continued milk production. The system of dairy quotas itself needs to be overhauled, to allow the sale of quota rights across member states. Production of without-quota milk should be allowed by producers who wish to compete with overseas producers. Products made from this non-quota milk would not receive an export subsidy. Over time such milk could replace quota milk on the domestic market, as the quantity of quota milk is reduced by the purchase of quotas from farmers. These quotas would not be reissued: the effect would be to give compensation to the farmer for loss of the quota rents inherent in the supported market.

The more positive policy change would not only complete the MacSharry reforms but to lay the foundation for a competitive agriculture for a Union of about twenty countries. This would include a truly single market over the area of the current Union, which would be offered to new members from the start. It would comprise payments to farmers based on their past production of supported commodities, as an *ex-gratia* compensation for expectations misled by government promises. It would allow farmers to make their own planting and livestock raising decisions. It would remove the artificial incentive to maintain high use of chemical inputs, and hence to put in jeopardy the environment.

The benefits of taking CAP reform to its logical limit would be considerable. First, the wastage of resources that currently go to produce goods that have no commercial markets would be reduced. Secondly, the food industry could develop on a pan-European basis with the lowest raw material costs possible. Third, it would give the EU a position in world trade which it has not had for years, in the forefront of those seeking to improve world markets. Fourth, and most important, the assimilation of the CEEC would be made both easier for the EU and less costly to the entrants.

Such a comprehensive and thorough reform can not be implemented immediately. It would have to be phased in over a medium term time period (Josling/Tangermann, 1995). The rewards of starting early would be considerable, though, since the benefits of a competitive, decentralized, and equitable agriculture could be reaped sooner also.

III. The Task of Assimilating New Members into the CAP

The assimilation of the CEEC into the EU will be the most ambitious project so far undertaken by the EU (or the EC before it). There are however lessons from previous enlargement activities which can be useful. This section looks at the task of incorporation of the Visegrad Four into the CAP in the light of previous enlargements. The changes in the CAP discussed above are put in the context of the timescale of transition. Decisions made on the development of policy in the EU-15 will have implications for the Visegrad Four, and vice-versa. In effect the transition has started. The CAP is in fact already being shaped by the need to effect a smooth docking with the CEEC.

a) Transitional Arrangements in Previous Enlargements

The EU has had considerable experience in assimilating countries with different agricultural policies and price levels into the CAP. The accession of the UK in 1973 posed significant problems of a political and economic nature. On the political side, public opinion labeled the EC as a bastion of high food prices, in contrast to the price levels in the UK which for historic reasons had been governed by the state of world markets. The UK dispensed with the "deficiency payments" which farmers had come to accept as the main instrument of agricultural policy. It was also considered a food policy, in so far as it allowed consumers ready access to supplies at low prices. The reconciliation of this system with the CAP was to have a transition to the higher CAP prices, along with the introduction of import levies and export subsidies. The price gaps over the transition were offset by "accession compensatory amounts", added to or subtracted from the traded price.

On reflection, a golden opportunity was lost at that time to make a radical adjustment to the price level in the EC to which the UK farmers and consumers were adjusting. Had compensation payments been given to the farmers in the Six, the troubles of the CAP in later years may not have been so great. It would have been difficult to do, however, in the climate of the time. An extraordinary rise in world prices in the mid-1970's altered conceptions about the long run state of world markets. As a result, prices rose less fast in the UK than they would have done outside the EC, as they were effectively subsidized by other member states. CAP prices were notched up in

lagged response, and were left high and dry by the receding world market prices. These high prices led directly to the budget and trade problems of the next decade.

Transition arrangements had to be negotiated in the second round of enlargements, as well. Greece was given up to seven years to prepare its own markets for competition with EC produce. Portugal was granted an even longer period when it joined the EC, with a five year initial phase to allow Portuguese authorities to modify the marketing systems to allow implementation of CAP regulations, followed by a further five years to adopt EC price levels. Portugal had prices in many cases higher than the EC, implying some adjustment problem for farmers. A long transition was presumably desirable to allow time for this adjustment. Spain, by contrast was ready to compete immediately, but was deemed to be a threat to the EC market in such areas as wine, olive oil and fruits and vegetables. As a consequence, Spain also had a transition period, though shorter than that for Portugal, which in effect allowed the EC to modify its policies in the area of Mediterranean crops.

The transition arrangements for the EFTA countries were different again. The EFTA countries had a history of price supports higher than in the EC. They also had a history of closed markets, and had resisted attempts to open up agriculture among themselves as a part of EFTA. Agriculture was kept out of the EC-EFTA bilaterals which were negotiated after the UK joined the EC. They were also kept out of the EEA, which in effect gave EFTA countries economic though not political membership of the Community.

When the EFTA countries came to apply for membership, the anomaly of agriculture had to be tackled. The normal assumption would therefore have been a long transition to allow farmers in these countries to adjust over time to the considerably lower farm prices. The exception to this would have been Sweden, where the farm support prices had been reduced (with the payment of some compensation to farmers) in advance of membership application as a part of economic restructuring. But the EFTA countries were applying to join the EU (i.e. post-Maastricht) and hence had to adhere to the principle and to the practicalities of a borderless European Union. Accession compensatory amounts had been traditionally paid or granted at the border. In the spirit of CAP reform, of the GATT talks, and of their own attempts to get away from high market prices, the new members settled for instantaneous adoption of CAP policies and policy prices, with an overlay of compensation payments based on hectareage and headage.

b) Options for the CEEC Transition Period

Transition arrangements for the CEEC could follow one of these models. In the event that the CAP should undergo the completed reform of Option 3 above, the best strategy for the CEEC is to keep prices low. This eliminates any false expectations of highly protected markets. It avoids the pre-accession costs of increased price support. And it reduces tensions arising from GATT obligations which might otherwise constrain policy in the medium term. As important, it minimizes the potential threat as seen by the EU, of the disruption of markets following accession.

If the EU does not manage to reform its agricultural policy completely until the time of CEEC accession, arrangements for the timing of price and policy adjustments in the CEEC have to be found. Policy proposals concerning this time horizon of transition range from perpetual, i.e. keeping the agricultural markets of the EU and the CEEC separate (Nallet/van Stolk, 1994), to instantly. The advantages and disadvantages of these different transition policies can again be illustrated by looking at some representative options.

First one could imagine an agreement for membership which so circumscribed agricultural trade flows that it constituted a de facto exclusion of the sector from the internal market between the existing EU and the new members. The analogy is with the treatment of agriculture within the EEA. This virtual exclusion could take the form of strict quantitative restrictions on imports from the CEEC, or semi-permanent taxes on imports from (and subsidies on imports to) the CEEC. The implication would be that the price levels need not converge, and the policies need not be harmonized. The internal agricultural market in the EU would be protected from competition from the CEEC. Such a situation is more likely to obtain if the CAP has not been reformed further (Option 1 for the EU, above) and if the CEEC have not made a move to EU price levels. Under such circumstances, the price gap could be wide. The temptation to exclude agriculture from the process would be considerable.

This would have a number of serious economic and political implications. It would perpetuate the current imperfect market access of CEEC into the EU. As a result, the CEEC states would be denied benefits that other members enjoyed in the internal market. Politically, this would constitute "second-class citizenship" for the CEEC. From the point of view of European integration, it would imply a breach in the principle that single market legislation applies to all

members. It would in effect represent a move to "Europe à la Carte". Other countries may be tempted to have their own separate agricultural markets and policies. Lastly, it would postpone the removal of border posts between the current EU and the CEEC, and hence represent a further departure from the free internal market.

On the other hand the situation would have potential offsetting benefits for the CEEC: they would not be under any obligation to distort their economies by setting high border taxes for agricultural products and encouraging the production of unwanted surpluses. Indeed, if foods and processed agricultural goods were allowed access into the EU, the CEEC could make use of their cheaper raw materials to develop competitive export industries in these areas. And the CEEC would be better able to establish export markets in other parts of the world, including the states of the Former Soviet Union, Asia and the Americas.

As a way of avoiding the political problems of exclusion of agriculture from the free circulation of goods within the Union, though not obviate the need for border posts, one could imagine a long transition period, say fifteen years, which would have a similar economic effect. This again denies the new members immediate market access, and also gives them the option of keeping prices low in the meantime. A long transition period would inevitably postpone adjustments in CEEC agriculture. The problem with postponing adjustment is that necessary changes are delayed and the costs of being out of adjustment are borne for a longer period. There is a cost to keeping two different price levels for agricultural goods in the EU (or more, if the CEEC have not harmonized their own prices). This cost is a misallocation of resources within the agricultural sector of the enlarged EU, leading to higher production costs and ultimately to lower farm incomes. But there will be benefits to a delayed adjustment if the end-point is itself unsatisfactory. Adjustment to farm prices which are too high has its own costs. Too many resources are kept in agriculture, to the detriment of other sectors and the economy as a whole. Delay in imposing these costs on the economy need not be a bad strategy.

The economic cost of this strategy may well revolve around the budgetary arrangements. If the CEEC are relieved of paying agricultural levies to the EU, and are denied access to export subsidy funds, then the appropriate price level for agricultural products will be close to the expected level on world markets. Higher price levels impose taxes on consumers and necessitate export subsidies. If however the EC does collect revenue, over the long transition period, from the

(lower) level of tariffs applied in the CEEC; if the CEEC receive export subsidies from the EU for their third-country exports; and if there is no artificial ceiling on budget transfers from and to the new members, then this makes the world market price in effect irrelevant. In that case the economic benefits will depend crucially on the market balance for agricultural products. For export products a rapid shift to higher EU prices will be advantageous. For imports it will impose an economic cost. On balance it would seem that a long transition is likely to be against the interests of the CEEC if they have a predominant export interest in agriculture and if they are immediately drawn into the budget process.

The issue of the speed of transition is therefore closely tied to that of the medium term development of the CAP, and to the strategy of the CEEC prior to accession. Put simply, if the CAP is not reformed then much of the urgency to move to full market integration in agriculture is lost. If the CEEC raise their prices before entry, then they will pay a high financial and economic cost for anticipating membership. However, a rapid rise in prices would have the advantage of shortening any transition period, and if they prove to be net exporters of farm products they will benefit after membership from the high internal prices and the availability of export subsidies. A modification of a "rapid price rise" strategy would therefore be to keep prices low until either the CAP is further reformed or until full membership (including open-ended budget participation) is imminent. At that stage, rapid harmonization of prices is the most sensible policy.

If, by the time of accession, the CAP does undergo further reform, the strategy of not moving soon to CAP prices will have been proved sensible. There would be a cost in adopting a price level too high to be maintained. The new members would risk building the expectations of farmers and incurring obligations for compensation if prices had to come down. The strategy of maintaining current price levels below those of the Union until membership is imminent would reduce this risk. In practice, this implies a cautious policy of preparing CEEC agricultural sectors for membership without overstimulation of those sectors which would only be profitable with CAP membership.

c) Trade and Budgetary Arrangements for the Transition

Intra-EU flows after enlargement would be governed by the choice of transition period. If price levels are still different at accession, border tax adjustments such as have been used in the

past would seem to be needed. If the decision has been made to keep quantitative controls on CEEC imports, more extensive monitoring will be needed. This raises the question as to whether there will be commercial borders between the EU and the new members. If the only reason to have such borders is to regulate agricultural markets, there will be considerable pressure to speed up the process of policy and price harmonization. Given the tendency of border controls, in particular those of a quantitative nature, to be used as hidden form of protectionism, there is much to be said for removing such borders as a priority within the enlarged Union. This suggests that any price level differences at the time of accession should be compensated by means of payments directly to farmers (if the price level is higher in the acceding country) so as not to require interference with cross-border commerce. The other aspect of this is that CEEC farmers would benefit immediately from higher prices in the Union.

Trade flows from outside the EU would under such arrangements be immediately subject to the same tariffs as charged on imports into other member states. CEEC goods would be eligible for the same export subsidies as other members. The EU might under these circumstances consider negotiating an increase in the allowed expenditure on export subsidies under the GATT schedule, and the allowable quantities that can benefit from a subsidy. But as the CEEC did not have significant export subsidies in the base period, other countries may take the view that enlargement of the EU is not a reason to create more problems for other exporters. In this case the EU may have to absorb the extra exportable surpluses on the domestic market.

The budget arrangements for new members will no doubt be a matter for negotiation and compromise. The new members, will be expected to contribute to the budget the tariff revenue on imports and be reimbursed for intervention and export subsidy costs. They should be eligible for full participation in EU structural programs. How much additional funding will be forthcoming is for political decision. If there is an effective agreement on the net transfer to the new members, then *at the margin* they will pay for their own export subsidies and keep their own tariff receipts. They will therefore need to calculate benefits and costs of price policies at world market prices, the marginal cost of imports and the marginal value of exports. If there is no effective limit on the net financial contribution or disbursement then the marginal cost of imports and value of exports are the internal policy prices. Under such circumstances, the acceding countries (as with existing members) have no incentive to keep production in check, as the Union membership as a whole

underwrites the disposal of surpluses and taxes any imports which might otherwise be available at world prices.

Conclusion

This paper analyzed the future of the CAP in the face of a prospective Eastward enlargement of the European Union. It was argued that the accession of some of the countries of Central and Eastern Europe with their substantial agricultural production potentials would put severe budgetary and trade policy strains on the current EU policy regime. The basic principles of the CAP, i.e. market unity, community preference, and financial solidarity, are in jeopardy unless further reforms towards a less regulated common agricultural market are undertaken. Such reforms would improve economic efficiency, distributional equity, and international trade relations. The prospect of Eastward enlargement might, therefore, in the end turn out to be the trigger to overcome internal political resistance against another round of CAP reform that is in the interest of the Union anyway.

A reformed CAP would also facilitate the current transformation process from centrally planned to market based economies in the CEEC as well as their later integration into the EU. No expectations about high policy prices would be raised among farmers in the CEEC, thereby avoiding either the substantial financial and economic costs of agricultural support for the CEEC or discomfiting political reactions from disappointed East European farmers. Moreover, a more market oriented CAP would allow for expanded trade in agricultural products between the EU and the CEEC during the pre-accession period already, because the differences in commodity prices and market organization would no longer be that substantial. The integration of the CEEC into the Union could then later be much faster and smoother, avoiding a two-tier Europe and making the CEEC immediately into equal partners.

What then is the answer to the question posed in the title of the paper? The answer appears to be "Yes, the CAP as a common sectoral policy can survive the decade, including budgetary pressures, the GATT and enlargement to the East, but it has to be slimmed down in order to be fit for the challenges that lie ahead." If politicians cannot be persuaded to take such action, then the prospects are for a dismal decade of discord and divisiveness on the agricultural front, and the likely renationalisation of the CAP.

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