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THE IMPACT OF VARIABLE LEVIES: A DISCUSSION OF THE COSTS AND BENEFITS OF THE EUROPEAN COMMUNITY'S COMMON AGRICULTURAL POLICY

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by

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Many studies have attempted to determine how effective the European Community Common Agricultural Policy has been at meeting its stated objectives. However, in trying to estimate the costs associated with certain parts of the program, mnany times the larger overall question is forgotten: Are the benefits justifying the costs? This afternoon, I will outline the apparent benefits of the Common Agricultural Policy (hereafter referred to as CAP) and the costs incurred. I will indicate not only the specific costs and benefits to the European Community, but also how the CAP interacts with world agricultural markets. I will pay particular attention to the current debate among U. S. Farmers about the competition from European farm products. By outlining the costs and benefits of the program, I hope to indicate what major policy problems are facing the CAP.

As outlined in Article 39 of the Treaty of Rome, the CAP of the European Community was formulated to insure a fair standard of living for the agricultural community, to stabilize markets, and to assure the availability of supplies. A major policy tool used to reach these goals is the variable levy system. I will briefly explain how variable levies work, and follow with my analysis of how well this system has achieved its goals.

The mechanics of the variable levy vary across products, but the basic features are similar. A threshold price is set which guarantees producers a level of income support. Producers whose costs exceed this threshold receive a subsidy. Producers whose costs are below the threshold are, in turn, taxed. That is, if the threshold price is above the world price, imports of agricultural products are taxed while high-cost European producers receive subsidies. The variable levy supports the European producers' income by distorting prices of agricultural products inside the European Community.

By affecting agricultural prices in the Community, variable levies have sent a wrong signal to high-cost producers. These producers do not face the lower world price but the higher threshold price. Thus, they are given an incentive to increase their output over and above the quantity they would normally supply at the world price -- to a higher quantity associated with the threshold price. Remember, the threshold price is almost always higher than the world price. The threshold price, with the variable levy, was designed to meet one of the conditions specified in the Treaty of Rome: to stabilize the market for agricultural products. By stabilizing product prices through the threshold price, that is, not allowing agricultural-products prices to move with world prices, an incentive was created for the European producer to overproduce. From a position as a net importer of grains in the early 1970's, the European Community is now roughly self-sufficient in grains, and estimates of future production range as high as a five million ton net export of grains by 1985.[1] The benefits of CAP have been price stability and self-sufficiency in the production of many goods. However, there have been costs associated with these gains.

The major cost of this program has been borne by the consumers of agricultural products in the European Community. They have paid higher market prices resulting from the variable levy system. Many estimates of the magnitude of these costs exist. One, the per family cost of implementation of the policy, has been estimated as high as $175 annually. Other estimates range as high as 3% of Community GNP.[2]

Another problem associated with the variable levy system is funding the subsidies once the Community becomes a net exporter. As a net importer, all grain imported to the European Community was charged a levy equal to the difference between the threshold and world prices. The net importing position of

the EC as a whole allowed it to collect taxes in greater amounts than the subsidies paid out. Thus, the EC continued to collect a surplus as long as it was a net importer and the threshold price remained above the world price. As the EC becomes a net exporter, it will have to pay subsidy amounts greater than the levies collected. There are two ways to cover the increased subsidy payments. One alternative is reallocation of tax revenue from other sources. This is at best a short-run response; the magnitude of the subsidies will continue to increase as European agricultural production increases. Another alternative for the EC is to set the threshold price below the world price. The economics of the situation demand that high-cost European producers be taxed rather than subsidized. The political problems of such a reorientation of policy are, obviously, significant. Also, after sending a subsidy signal to producers for 25 years, a major change in policy would create dislocation in the agricultural sectors of Community countries. There would be underutilization of capacity, increases in unemployment, and most probably agricultural bankruptcies.

Another reason for the CAP to exist is for the support of incomes in the agricultural sector. In general, agricultural incomes are below the industrial average in most countries, although the exact difference is difficult to measure. Given the price supports generated by the variable levy system, wage differentials seem to have narrowed by an insignificant margin. That is, the gains from higher prices are not going to labor. So, where are they going? Rents accrue to the productive factor in the most inelastic supply. The returns to land, fixed in supply, increases while the returns to labor, mobile in supply, stay constant or increase slightly. Between 1973 and 1978, agricultural land values increased 13% per year in France, 30% in the Netherlands,

and 16% as a community average.[3] So, while farm wages increased roughly the same pace as non-farm wages, the value of the land was increasing rapidly.

For countries where the land tenure system is mostly owner-operated, the CAP has indeed increased farmers' wealth. However, it has done little to help their liquidity. That is, the variable levy system has acted to increase the value of one of the farmer's most illiquid assets.

Neither do the effects of the CAP fall evenly on all EC countries. Net exporting countries of agricultural products within the Community are enriched by net importing countries. That is, EC countries supplying grains to other EC countries sell at the threshold price. So, the net importing countries are transferring wealth to the net exporting countries through the artificially high threshold price for goods.

Also, the CAP affects agricultural producers in other parts of the world. Countries outside the EC with agriculturally-based economies must compete in world markets with EC agricultural output. The CAP encourages the EC to become a net exporter, so other exporting countries may be hurt. If the CAP encourages enough exports to significantly affect world prices, other grain exporting countries will lose revenues due to lower world prices. For example, consider a country with an agricultural sector more efficient than the EC. In the absence of CAP, this country may be a major supplier of grains to the EC. But, EC policy forces this country's goods out of EC markets. This loss may have severe impact on the potential supplier to the EC. That is, not only has this country lost agriculture revenue, but it may be more difficult to trade with EC members for other goods. For a developing country, the agricultural trade provides inroads to trade in more modern technology, or at least a supply of hard currency for future transactions. However, the entrance of EC products to the world market, if it depresses world prices, may help net

importing countries. They will pay less for their goods. But, in the long run, depressed world market prices will most likely slow the growth of exportable agricultural products from these countries, and potentially hinder development.

Producers of U.S. farm products are getting a great deal of political mileage and newsprint out of the effects of European surpluses on the world market price for their goods. U.S. farmers are faced with declining world prices due to the increased production in Europe. The declining price is a result of the competition of European agricultural products in markets where the U.S. formerly supplied the majority of goods such as the developing countries of Africa and Asia. The response by U.S. farmers to these conditions has been to call for increased protection from the U.S. government in the form of higher parity prices and the signing of long term trade contracts to guarantee sales to foreign markets.

Clearly, the increased output from European farms has made it more difficult for U.S. farmers to sell their production domestically and abroad, but the call for greater protectionism is counter-productive. As all trade wars in the past have shown, greater protectionism never solves the problem. In fact, a root of the production problem is the agricultural policy of the U.S. and EEC. By protecting their agricultural sectors, both governments have encouraged inefficient production and agricultural surpluses. The economic problem, i.e., surpluses in agriculture due to inefficient production, can be solved by removing the governmentally provided protection. The irony of this situation is that both groups involved in this debate are among the most protected agricultural sectors in the world. Clearly, high degrees of protectionism have only exacerbated the problems.

The political problem is more complex, that is, dismantling the current agricultural subsidy systems while minimising the short run dislocations. Unfortunately, governments tend to respond to short-run problems at the expense of long-run solutions. The EC is currently facing a major crisis in agriculture which is intensified by the current problems in France. Agricultural Ministers are realizing that the CAP must be modified to allow more competition in the agricultural sector. It would be unfortunate if the U.S. did not learn from the European problem. Increasing U.S. price supports and tariffs on agricultural goods will not solve the farm problem domestically. It will only lead to higher market prices for consumers, growing surpluses, and inefficient production. Clearly, a return to competitive agricultural markets would be the best solution but is currently politically infeasible. However, a move by the U.S. to greater protectionism just when the EC is being forced to decrease governmental intervention would be a poorly advised move.

In summary, the CAP does seem to have stabilized community market prices and assured the EC of agricultural self-sufficiency. However, it does not appear to have decreased the agricultural wage differential. So, two of the goals outlined in the Treaty of Rome have been met, but at what cost? Consumers of agricultural products in the EC have paid higher prices. Overproduction has been encouraged by high threshold prices. The threat of the EC becoming a net exporter of many agricultural products is creating a potentially severe budget problem. A net transfer of wealth from agricultural product consumers to landowners has occurred because the rents accruing to the agricultural sector as a result of the CAP have gone toward increasing land values. Other countries with more efficient agricultural sectors than the EC have been closed out of the EC market. Net agricultural product exporting

countries within the EC are expropriating wealth from net importing countries through the threshold price.

At this point two questions come to mind. First, is the success of the CAP in meeting the objectives stated in the Treaty of Rome worth the costs? This question still has not been answered satisfactorily in part because of problems with quantifying the actual benefits. The second and potentially more important question is whether or not the objectives stated in the Treaty of Rome are really an appropriate set of goals for an agricultural program?

Before concluding, I would like to comment on the objectives stated in the Treaty of Rome. The benefit of stable prices is essentially that uncertainty about crop values is decreased. However, with the recent growth of futures markets for most agricultural products, the risk of price variation can be hedged away by both producer and processor. So, while price stability may have been a reasonable objective when the Treaty of Rome was written, its validity as a policy target may have diminished.

The objective of self-sufficiency is a very complex issue. If trade flows cease because of political reasons or warfare, self-sufficiency is clearly worthwhile. Another justification for self-sufficiency is to stop the ability of potential cartels to expropriate the EC's wealth. The possibility of an agriculture cartel forming with the power of OPEC is clearly small, and given the recent history of OPEC, would probably be short-lived. The only real question is how tenuous is the EC's link to major suppliers of agricultural products. Clearly, large reliance on Eastern-bloc producers would be risky, but close alliances with the west, i.e. Canada and the U.S., allow EC access to agricultural products with a high degree of certainty.

Finally, should agricultural policy concern itself with the wage differential between farm and non-farm workers? To give a short answer to this is

difficult, but essentially if farm labor is fairly mobile, workers will migrate to areas and sectors with higher real wages. In fact, the CAP may have hindered the capitalization of agriculture by creating incentives for laborers to remain in agricultural activities. If indeed farm labor is immobile, then policies may be advised to diminish the wage differentials. But, direct transfers would be easier to administer without having the distorting influence of the variable levies.

Granted, the concern with reorienting the objectives of the CAP is evading the short run problem of how to revamp the CAP given its current shortcomings. However, without a consistent and appropriate set of long run objectives, any changes in the CAP will simply add to the problems already in existence.

Endnotes

[1]Johnson, D. Gale, "Outlooks for European Agriculture"

[2]Thorbecke, Erik and Emilio Pagoulatos, "The Effects of European Economic Integration on Agriculture," in European Economic Integration, ed. by Bela Balassa, pp. 301.

[3]Dosser, Gowland and Hartley, The Collaborators of Nations, p. 150.

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