



Of the benefits to the EU of removing the Common Agricultural Policy

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In any debate about reforming the EU budget, the weight of the CAP, which accounts for more than 40 per cent of this budget, is likely to play an important role. On the one hand, the benefits of the CAP must be evaluated in terms of whether it achieves its objectives as set out in Article 39.² On the other hand, the economic costs (those in addition to the direct costs on public finances) of the CAP are numerous, as suggested by the non-exhaustive following list:

- opportunity costs associated with the lack of innovation in the farm and food sectors as assistance maintains marginal agricultural producers in operation,
- equity costs, as assistance is difficult to target and is likely to benefit many operators,
- program operation costs, from the costs related to identifying programs and recipients to program monitoring, assessment and review,
- excess burden associated with the tax revenues collected to finance the CAP,
- economy-wide efficiency and welfare costs within the EU which arise from the reallocation of resources from non-assisted to assisted activities,
- economy-wide efficiency and welfare costs outside the EU, as resources are reallocated in response to distorted price signals.

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The views expressed in this paper do not necessarily reflect those of the Productivity Commission or of the Groupe d'Économie Mondiale at Sciences Po.

² Article 39 of the consolidated version of the Treaty on the Functioning of the European Union as it results from the amendments introduced by the Treaty of Lisbon (ex Article 33 of the Treaty establishing the European Community).

Could there be benefits to eliminating the CAP? How might they come about? What would be their order of magnitude?

A recent study into the effects of the CAP on the EU and world economies provides some answers.³ It shows how the CAP:

- reallocates resources from the non-assisted parts of the economy to the assisted parts of the farm and food sector,
- results in efficiency losses in the form of foregone production, and
- welfare losses in the form of foregone income, and eventually, foregone private and public consumption

These effects are associated with the CAP alone. They abstract from the possible impacts of any farm program that might be in operation in other parts of the world, such as the US Farm Bill. As a result, they ignore the fact that reforming the CAP could open market opportunities for EU farm products, if assistance to agriculture abroad were also reduced as a result of this reform. Such changes in agriculture outside the EU could occur through negotiations, whether bilateral or multilateral, aimed at reducing assistance to the farm and food sector globally. Parties to an agreement to eliminate agricultural support would be able to reduce the fiscal burden associated with assistance to agriculture, and avoid the many economic costs (see list above) that come with the distortions brought about by assistance.

The remainder of this paper provides a short analysis of the effects of eliminating the CAP alone. It is based on:

1. an analysis of expenditure in the farm and food sectors
2. an analysis of the non-budgetary parts of the CAP (border protection), and
3. a ‘counterfactual’ experiment simulating the world economy in which the CAP is assumed to be eliminated.⁴

The results show the difference between the world economy with the CAP and the same economy simulated without the CAP for the year 2007. As in all exercises of this type, there are many caveats to be aware of, and the reader is referred to the more detailed studies for additional details about the analysis.

³ See Costa et al 2009 and Jomini et al 2009.

⁴ The simulation is conducted with the GTAP model – a general equilibrium model of the world economy which has been widely used to estimate the effects of trade and other policies (see Hertel 1994).

Effects on public finances

The CAP can be thought of as composed of two parts:⁵

- a budgetary component, which includes expenditures incurred to support the sector, and
- a border protection component which complements the budgetary part.

The budgetary component

The budgetary components of the CAP are financed through two separate ‘pillars’. In 2007, direct payments to the farm sector accounted for the largest share of pillar 1 expenditures (figure 1). As the year 2007 witnessed very high world prices, export subsidies, which are funded through pillar 1 market interventions, were very low—meaning that what follows concentrates on direct payments and on protection against imports. Figure 2 shows that direct payments are concentrated among the EU15. They are designed to increase in the twelve New Member States (referred to as NMS), meaning that they will contribute to maintaining a large agricultural sector in the NMS – hence probably many inefficient operations.

Expenditures under pillar 2 aim to support ‘rural development’. They are often characterised by very diverse programs that are designed to achieve certain public good objectives.⁶ To the extent that these objectives cannot effectively be achieved through market mechanisms, these expenditures might be considered a legitimate use of public funds.⁷ What follows abstracts from pillar 2 funding, concentrating on the effects of price support and direct payments – that is, pillar 1.

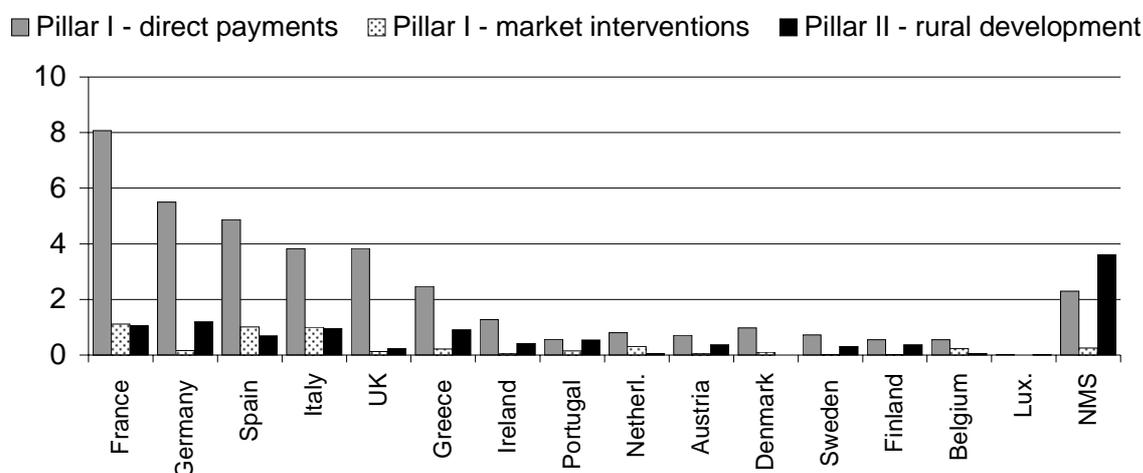
Overall, the CAP budget amounted to some 50 billion euros in 2007. Expenditure on the CAP crowded out other possible uses of the EU budget and prevented the possible allocation of EU funding to other possible European public good activities.

⁵ The two components are intimately linked and cannot be separated in a policy sense. However, it is useful to think of them as two different parts in a purely analytical sense.

⁶ But not exclusively. Pillar 2 can include structural adjustment programs.

⁷ However the link between pillar 2 funding and the public good characteristics of some of the activities it funds can be weak. Another point to note is that it can be argued that EU funding should be used to fund European public goods, whereas national/local funding should be used to finance national/local public goods (see Bureau and Mahé 2008).

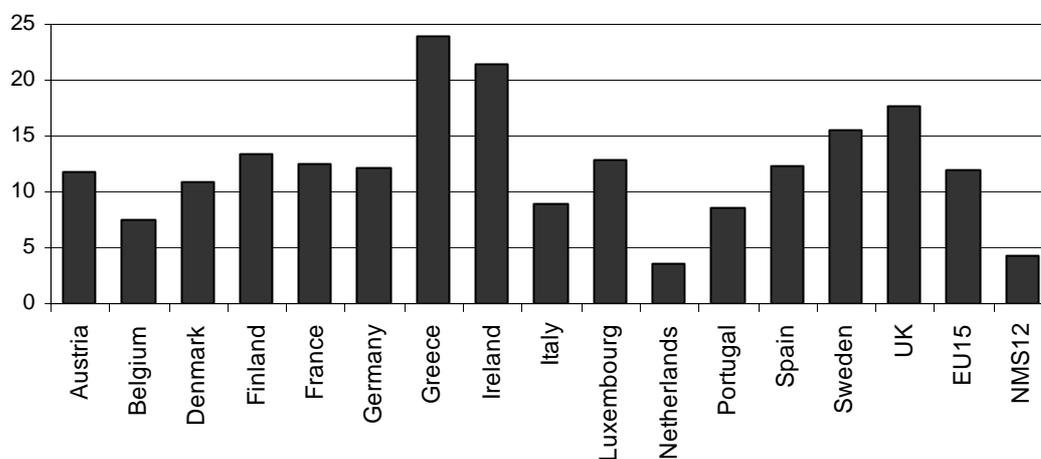
Figure 1 European expenditures by member state: Pillar I and Pillar II
Billion Euros, 2007



NMS: new member states.

Data source: European Commission 2008a

Figure 2 Direct payments as a share of agricultural outputs^a
Per cent, 2006-07



^a Output of assisted sectors within agriculture. NMS12: 12 new member states.

Data source: European Commission 2008b; Eurostat 2009

The year 2007 witnessed very high world prices, hence low storage expenditures. Such expenditures can add up to very large amounts when world prices are low.

The border protection

Border protection (a set of tariffs and quantitative restrictions⁸) is an integral part of price support, and protects many farm products directly. Part of this assistance is supplied to the farm sector by protecting the more tradeable food products (eg refined sugar), rather than less processed products found at the farm gate (eg sugar beet) (see table 1). Although it might give rise to some revenues, tariff protection can also be prohibitive, as illustrated by the highest tariffs shown in table 1, and thus produce no government revenues.

Table 1 **European Union applied MFN tariff rates^a**
Per cent, 2006

<i>Description</i>	<i>Average tariff</i>	<i>Range</i>
Farm ^b	12.4	0-167
Food processing ^c	20.1	0-428
Manufacturing excluding food processing	3.8	0-51

^a Trade weighted averages, which are smaller than simple averages. ^b Agriculture and hunting.
^c Manufacture of food, beverage, tobacco.

Source: WTO 2007

A reform of the CAP, which would eliminate the budgetary expenditures made under pillar 1 shown above would thus free up a substantial amount of public resources for other public good interventions, whether in agriculture or in other parts of the economy. The remainder of this policy brief estimates the economic effects of eliminating pillar 1 expenditure and the associated border protection for 2007.

Economic effects

The studies by Jomini et al. (2009) and Costa et al. (2009) attempt to estimate the effects of the CAP in 2007. The costs of the CAP and its effects in increasing the size of the farm and food sectors in the EU were estimated by creating a ‘counterfactual’ world economy, that is, the world economy that would prevail if the CAP was eliminated. The two situations – with the CAP and without the CAP – were compared to isolate the effect of the CAP.

⁸ Complemented by export subsidies funded by pillar 1, with the contribution of this instrument being very modest in 2007, because of high world food prices.

The economic effects of removing the CAP can be seen just as the reverse of the effects estimated in Jomini et al. (2009) and Costa et al. (2009). These effects have two dimensions – efficiency and equity dimensions.

First, removing the CAP is likely to improve the efficiency of the allocation of resources among the farm and non-farm sectors, and within the farm sector itself (that is, among supported and non-supported farm and food activities). More specifically, removing the CAP is likely to:

- reduce the amount of resources devoted to the farm and food sectors in the EU
- increase the amount of resources devoted to non-supported sectors that compete for resources in the EU. Such sectors include non-supported parts of the farm sector, such as some fruit and vegetable activities. They also include forestry and biodiversity-conserving activities, which compete for land with supported agricultural activities. And of course, they include all the manufacturing and services sectors.
- increase the diversity of agricultural production in the EU as the choices of farmers will not be affected by direct payments that remain coupled and by border protection that is very uneven across commodities
- reduce the cost of land and farm-specific capital (eg dairy herds) and therefore facilitate access to farming by new entrants, hence removing a barrier to succession and generation renewal as young farmers will need to borrow less to buy the farm from their parents (if their parents are farmers) or from other farmers.
- reduce the participation of marginal farms and ‘facilitate’ their decision to exit farming, thus improving the productivity of the farm sector as a whole
- reduce the excessive allocation of marginal land to farming activities.

The elimination of the CAP is also likely to improve equity in the farm sector. Recent work on the recipients of direct payments shows that the detailed distribution of direct payments is very unequal and raises questions about the equity of the payments. In France for example:

- in 2001, the 2530 largest farms – less than one percent of all the French farms – received slightly more direct payments than the 182 270 smallest farms - almost 40 percent of French farms (Boulanger 2005)
- in 2007, 16.5 per cent of French farm holdings received half of all direct payments (Boulanger 2010).⁹

⁹ The release of nominative data on farm subsidy recipients is shedding some light on this unequal redistributive mechanism. The farmsubsidy.org network centralises available data on an

At an aggregate level, the reallocation of resources to sectors that do not benefit from support from the CAP is likely to:

- improve allocative efficiency within each economy within the EU and across the EU¹⁰
- increase production in the EU
- increase economic welfare in the EU, by increasing aggregate income and consumption opportunities.

These economic effects deserve a last – but key – remark. There is no question that some adaptation costs are likely to be incurred. These costs need to be carefully analysed and might give rise to contractual adjustment payments that are well defined and finite over time. While some might argue that these costs could be large, they are likely to be a smaller one-time cost than the multiple-year costs of an on-going CAP.

Inter-sectoral effects: the estimates

The magnitude of the allocative (that is, efficiency) effects mentioned above are illustrated for the year 2007, one of the first times that the 2003 reforms can be taken into account in an *ex post* analysis of this type.¹¹ Given the differences in the application of the CAP between the EU15 and the NMS,¹² the results are presented for both groups in the next few pages.

Overall, eliminating the CAP as it existed in 2007 would reduce the size of agriculture among the EU15 by about 8 per cent (table 2 [1],[2]), less so among the NMS, for two reasons in this simulation (table 2):

1. because by this stage in the NMS, direct payments had only begun to be phased in, and
2. because border protection is higher for products grown in the EU15 than it is for products grown in the NMS.

independent website (www.farmsubsidy.org). Adopted in November 2005 by the European Commission, the European Transparency Initiative led to two waves of public disclosures. In September 2008, beneficiaries of rural development measures were disclosed compulsory. In April 2009, recipients of market support and direct payments followed.

¹⁰ The analysis below abstracts from the effects of any public support to other activities within the EU or outside.

¹¹ There have been several *ex ante* assessments. See for example Francois et al 2003.

¹² Direct payments were small in 2007, but expected to grow as they were phased in. The main effect of this is likely to be the maintenance of a larger agricultural sector in the NMS than otherwise and/or to prevent resources from exiting the sector.

As direct payments increase in the NMS, eliminating the CAP is likely to result in larger decreases in the size of farm sectors among the NMS.

As land exits from farm activities in the EU15, it is reallocated to forestry ([5]), and to a lesser extent, to fruit and vegetable activities ([4]). The reverse occurs in the NMS, because they increase their farm activity as support in the EU15 is diminished.¹³

Within the farm sector, fruit and vegetable activities ([4]) typically do not benefit from direct payments (but many benefit from border protection). For these activities, eliminating direct payments that are targeted to other farm products (whether directly, or through history) would reallocate land (and labour and capital) toward them in the EU15. By contrast, in the NMS, resources would flow from fruit and vegetable activities toward other crops and livestock as the large support for these sectors in the EU 15 is eliminated. Fruit and vegetables in the EU15 and the NMS benefit from some border protection. Eliminating this protection results in a decrease in fruit and vegetables as the EU market opens to cheaper imports. However, this effect may be reduced if EU fruit and vegetable are of better quality than imports.¹⁴

Similar effects can be observed in the food sector, parts of which benefit from substantial direct protection from imports under the CAP (eg dairy and meat products, and sugar). However, many parts of the sector do not benefit from such levels of protection. These latter parts of food processing, which are less assisted are likely to expand with a reduction of the CAP.¹⁵

The main sectoral beneficiaries of resource reallocation caused by CAP reform are manufacturing and services ([6],[7]). Although the percentage changes in services might look small, they correspond to large absolute amounts as this sector accounts for more than 70 per cent of economic activity in the EU.

These estimates deserve a last remark. The relatively high level of aggregation (in terms of products) tends to understate distributional and allocative effects. At regional and individual activity levels, effects are likely to be (much) larger. For

¹³ But as direct payments increase in the NMS, this effect will be reduced – and may disappear in a simulation that uses, say, data for 2011.

¹⁴ Differences in quality could include the extent to which fruit are ripened before picking, or varietal differences, for which consumers are likely to be willing to pay.

¹⁵ In addition to this sub-sectoral effect, Francois et al 2003 identified an increase in market access when the US decreases its agricultural support. In that paper, the increased market access for the EU overwhelmed the decreasing effect of removing EU support to EU food processing, which is illustrated here.

instance, Jomini et al 2009 illustrated this for potatoes in France, indicating that the CAP could be reducing areas devoted to potato farming by at least 10 per cent.

Table 2 Effects of eliminating the CAP on sectoral outputs within the EU^{a,b}

Percentage changes

Sector / CAP component and Region	Crops [1]	Live- stock [2]	Food proces [3]	Fruit vege. [4]	Forest [5]	Manuf [6]	Serv [7]
a. Direct payments							
NMS12	0.49	1.98	0.29	-0.49	-1.12	-0.26	-0.01
EU15	-1.92	-2.52	-0.76	1.21	1.70	0.29	0.05
b. Border protection							
NMS12	-2.48	-2.41	-5.56	-4.64	0.96	1.29	0.20
EU15	-6.23	-4.93	-4.92	-6.66	1.72	1.02	0.10
c. Total CAP							
NMS12	-1.97	-0.64	-5.61	-4.95	-0.04	1.12	0.19
EU15	-8.09	-7.64	-6.02	-5.62	3.35	1.35	0.15

^a Results were generated at the 57 sector level; they are aggregated into broad sectors for presentation purposes. ^b Columns are ordered in approximate decreasing order of assistance from the CAP from, left to right.

Source: Costa et al 2009

Overall effects: the estimates

Eliminating the CAP is projected to improve the allocation of resources among the various sectors of the economy, and thus increases the EU's production potential (its GDP) by nearly 40 billion euros (table 3). This result omits many of the effects listed at the beginning of this paper. This result is also limited by the aggregation of data that was required to obtain the 'counterfactual' economy (without the CAP).

Some of the benefits from eliminating the CAP in terms of production are lost through changes in the prices of EU exports and imports. This is because expenditures (direct payments) and border protection (tariffs) enable the EU to increase the price of its exportables relative to that of its importables.¹⁶ The economic welfare of the EU as measured by gross domestic public and private consumption and investment¹⁷ is projected to be nearly 21.5 billion euros larger

¹⁶ The CAP creates an improvement of the EU's terms of trade at the expense of its trading partners.

¹⁷ The exact term would be 'gross domestic absorption', a demand-side measure of the purchasing power of income.

without the CAP. The bulk of this aggregate effect would occur in the EU15 because:

- they are larger than the NMS and
- many of the effects are skewed toward the EU15, as stressed above.

Table 3 Effects of eliminating the CAP on economic welfare and economic activity

Percentage changes, €million in 2007 prices

<i>Region</i>	<i>Economic welfare</i> <i>Gross Domestic Absorption^a</i>		<i>Production</i> <i>Gross Domestic Product</i>	
	Per cent	Value	Per cent	Value
NMS12	0.32	2882	0.44	3739
EU15	0.16	18666	0.30	34395
EU	0.23	21548	0.31	38134

GDA is sometimes referred to as Gross National Expenditure (GNE); the sum of public and private consumption and investment. Hence, $GDA = GNE = GDP - (X-M)$.

Source: Costa et al 2009

Conclusions and implications

This paper attempts to estimate the benefits of eliminating the CAP to the EU. This assessment was conducted using recent (2007) data on the CAP in a general equilibrium framework, in order to capture the economy-wide effects of reallocating resources across the economy—one of the major sources of benefits to eliminating the CAP.

Not all the dimensions of the CAP could be taken into account. For example, there is not enough information to calculate the effects of Pillar 2 payments. The effects of Pillar 1 were simulated, but without considering negative or positive externalities that could be associated with farming. Pillar 1, which accounted in 2007 for the bulk of EU budgetary expenditure on the CAP, and consisted mainly of direct payments, was included, as well as the main policies that are used in support of price support programs (mostly tariffs and other protection from imports since export subsidies compensating the differences between world prices and support prices were small in 2007).

The main results from this study call for the following remarks:

- given the structure of assistance and the structure of the farm and food sectors in the various parts of the EU, assistance is strongest for farm and food activities in the EU15—hence to the detriment of agriculture in the NMS. However, the

phasing-in of direct payments in the NMS will change this, at the costs of maintaining a large, and in some parts inefficient, farm and food sector in the NMS.

- despite some ‘decoupling’, CAP assistance still biases production toward products and activities that benefit from strong assistance, either through direct payments or through border protection. This is to the detriment of other parts of the economy—not only manufacturing and services, but also forestry and non-supported farm and food activities (such as fruit and vegetable) which compete for land and do not benefit from assistance, as well as non-farm rural activities.
- the costs of misallocating resources within the EU because of the CAP was in the order of 38 billion euros in 2007. This was compensated in part by strong gains to the EU generated by the CAP policies that increased the price of its (non-agricultural) exports and decreased the price of its agricultural imports. These strong price changes contributed some € 16.5 billion to the EU—at the expense of other economies in the world, mostly developing or least developed economies which protect much less than the EU their farm sector.
- some parts of the farm sector (those non-supported) are likely to expand if direct payments are eliminated. For instance, this is probably the case for a wide range of the fruit and vegetable sector.
- last but not least, eliminating the CAP could lead to an elimination of other farm policies around the world such as the US Farm Bill. In such a case, eliminating the CAP should be credited with the additional benefit of increasing market access for EU farmers. The benefits of such a strategy were not assessed in this paper. But they are likely to be substantial, adding to the large efficiency gains measured here.

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