Common Agricultural Policy (CAP)

Lecture 6

18 November 2024

Objectives of Lecture

1. Examine the evolution of CAP
2. Explore the key objectives of CAP
3. Analyze market interventions in the CAP

Common Agricultural Policy

At the start of the European Custom Union in 1958, agriculture was heavily protected with tariffs:

- averaging 14.2%, significantly higher than the overall 7.4% tariff on imports
- It was a result of significant differences in agricultural policies among member countries

Common Agricultural Policy

The importance of agriculture to each economy varied:

- Italy's GDP dependent on agriculture for 23%, while Belgium's was only 8.4%
- French wheat was cheaper than Italian or German wheat, and Italian farms were much smaller on average
- Fertilizer usage varied widely, with Dutch farmers using far more than those in France or Italy.

Common Agricultural Policy

Establishing a common market for agricultural goods required a shared agricultural policy, but reaching agreement on its key features was difficult:

- Countries, which had more efficient agriculture (France and the Netherlands), wanted to quickly remove internal tariffs on agricultural goods
- In contrast, less efficient countries (Italy and Germany) wanted to delay tariff elimination until a common policy was in place.

Common Agricultural Policy

In July 1958, the core principles of the Common Agricultural Policy (CAP) were established, and by December 1960, the Council adopted three key principles based on the European Commission's proposals:

1. A single market was to be established, with the free flow of goods and the harmonization of prices and exchange rates

2. Community preference was extended to European farmers in the form of price supports and export subsidies, but foreign trade would not be eliminated

3. Joint financial responsibility would be accepted by all members through the creation of a common agricultural fund called the European Agricultural Guidance and Guarantee Fund (EAGGF)

Common Agricultural Policy

Common Agricultural Policy (CAP) was implemented in 1962 and aimed to achieve five key objectives:

1. increase agricultural productivity through technical progress and efficient resource use
2. ensure fair living standards for the agricultural community by raising income
3. stabilize agricultural markets
4. assure the availability of supplies
5. ensure reasonable consumer prices

Common Agricultural Policy

Objective of CAP

- It was designed to satisfy the different interests of member states, with future negotiations determining how each would benefit from the promises made.
- The primary goal was agricultural self-sufficiency, a long-standing objective in Europe since World War I, and made even more pressing by the division of Germany.

Common Agricultural Policy

Objective of CAP

- The first four goals of the CAP—boosting productivity, improving living standards for farmers, stabilizing markets, and ensuring food availability—supported this overarching aim of self-sufficiency.

- The fifth goal, ensuring reasonable consumer prices, was intentionally kept vague to avoid conflict, as it was at odds with the first four objectives.

The Importance of CAP

By 1980, EEC had achieved agricultural self-sufficiency, becoming a net exporter of agricultural goods

Agricultural self-sufficiency and export growth in EU were not the result of expanding membership to include countries with large agricultural sectors (Greece, Spain, and Portugal), but rather the constant use of price supports and market interventions in the CAP

Common Agricultural Policy

The Importance of CAP with numbers

1. By the mid-1980s, the share of agricultural exports of EEC in the OECD had increased to 56%, while its share of imports had decreased.

2. By the 1990s, the EU-15 had become a major exporter, with a share of around 18% of world agricultural exports, nearly equal to the United States.
3. This success was driven largely by the use of export subsidies in the EU, which amounted to nearly 6 billion USD in 1999, a stark contrast to the much smaller subsidies in countries such as the US, Norway, and Switzerland.

Common Agricultural Policy

The composition of EU membership affected the distribution of agricultural subsidies over time

- The share of guarantee payments in total CAP spending had decreased from 72% to 45%, as the EU gradually moved from market interventions to direct payments to farmers.
- This change led to a complex array of programs tailored to specific crops, regions, and farmer categories, making it difficult to pinpoint common features of the CAP

Common Agricultural Policy

CAP employs three types of market interventions:

1. *Support prices*, which apply to about two-thirds of CAP products
2. *External protection*, such as tariffs, covering around a quarter of products like wines, poultry, and some fruits and vegetables
3. *Special or flat-rate aid*, aimed at keeping domestic prices low while supplementing farmers' incomes, applied to products like olive oil, durum wheat, cotton, and tobacco

Market Interventions

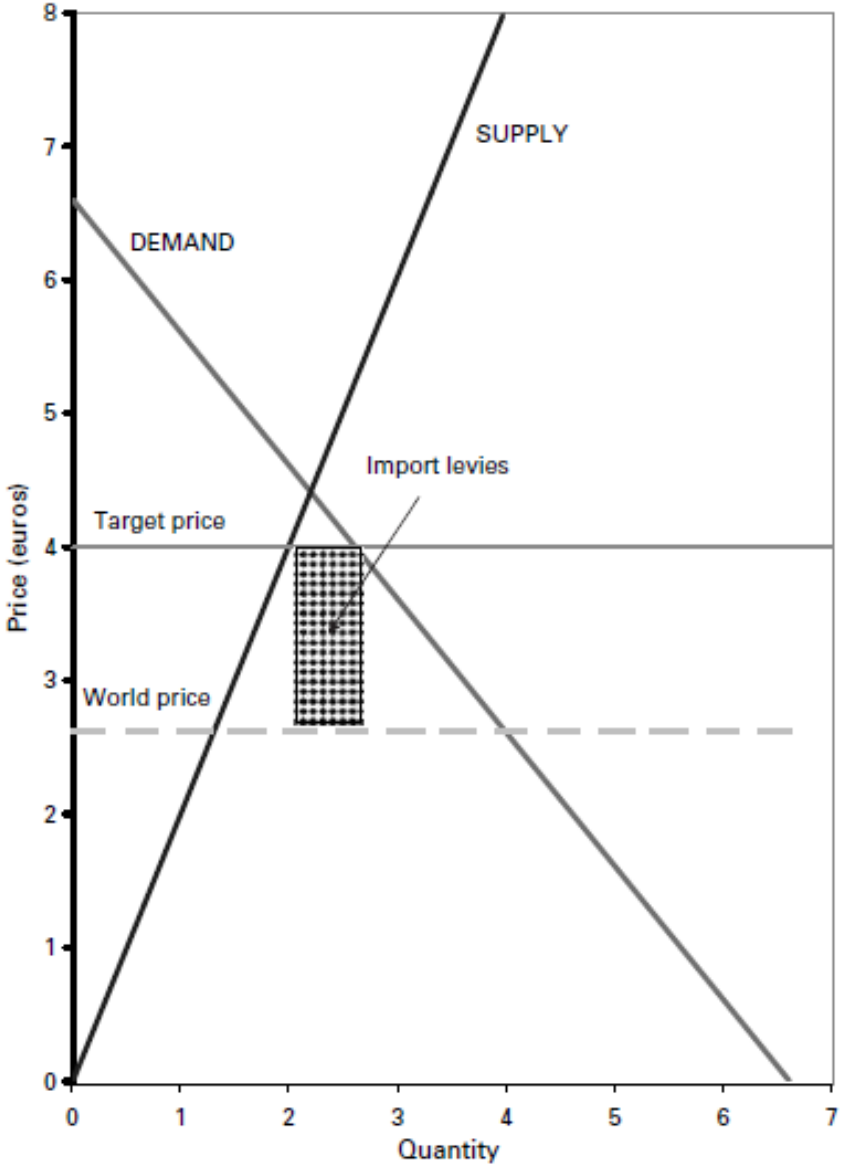


Figure 4.1 Price supports, import

- This figure illustrates the dynamics of supply, demand, and price controls within the context of the European CAP.
- Target price is higher than the world market price to ensure profitability for domestic producers.
- Without policy intervention, domestic farmers would struggle to compete at world price level
- Import levies are imposed on imported goods to elevate the price of imported agricultural products to the level of the target price.

Market Interventions

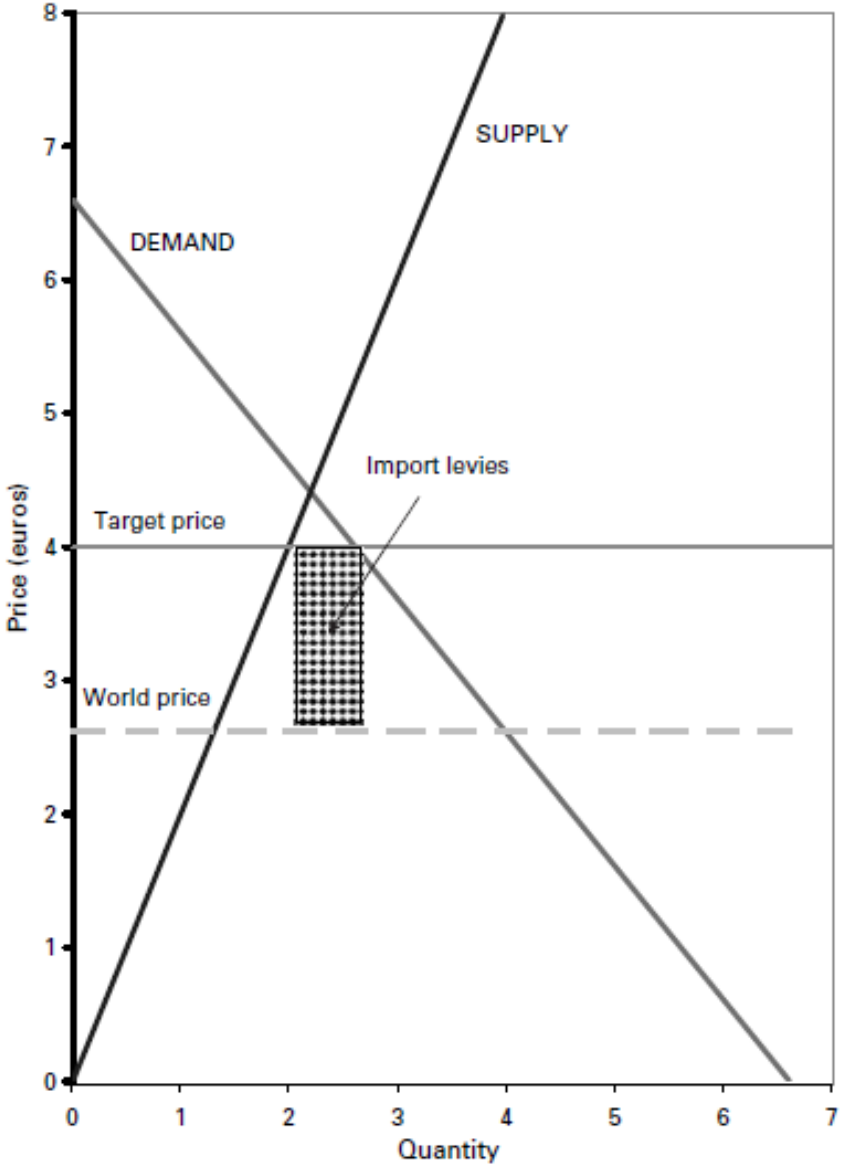


Figure 4.1 Price supports, import

- In the 1960s, European farmers were less productive than farmers in developed countries
- To protect European farmers from competition, the EEC implemented a variable levy on imports.
- **Import Levies** represents the revenue generated from tariffs applied to imports. It is the difference between the target price and world price multiplied by the quantity of imports.
- In the early years, when the EEC was a net importer, the variable levy generated significant revenue, which was used to finance the purchase of surplus domestic production.

Market Interventions

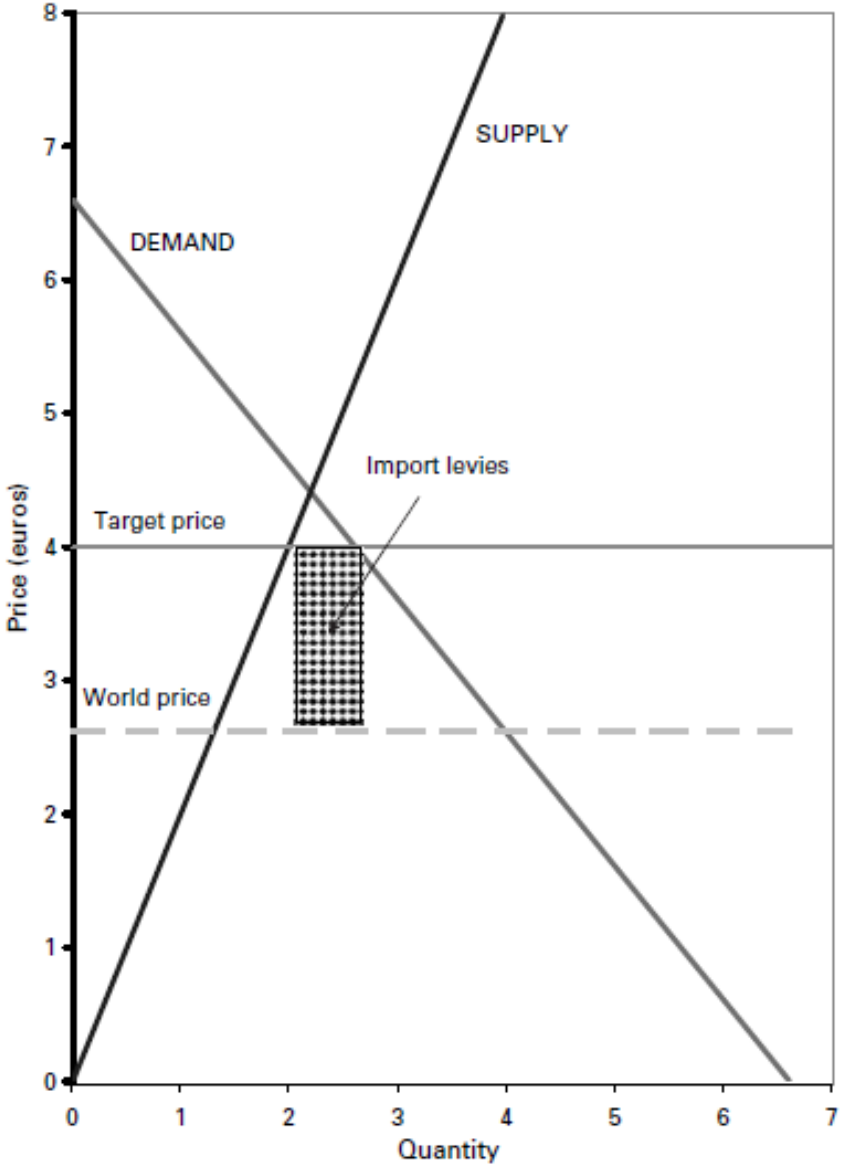


Figure 4.1 Price supports, import

- Figure 4.1 emphasizes how the CAP maintained high domestic prices to protect European farmers.
- By setting a target price above the world market price and applying import levies, the policy ensured higher income for farmers while potentially reducing market efficiency.
- This approach created market distortions, such as reduced competition and incentivized overproduction, which became characteristic challenges of the CAP.

Market Interventions

Features of European Agricultural Guidance and Guarantee Fund

1. To finance its price support schemes, the EEC established the European Agricultural Guidance and Guarantee Fund (EAGGF).

2. *Aim:*The guidance portion was intended to help European farmers modernize and increase productivity, contributing to agricultural self-sufficiency.

Market Interventions

Outcomes of European Agricultural Guidance and Guarantee Fund

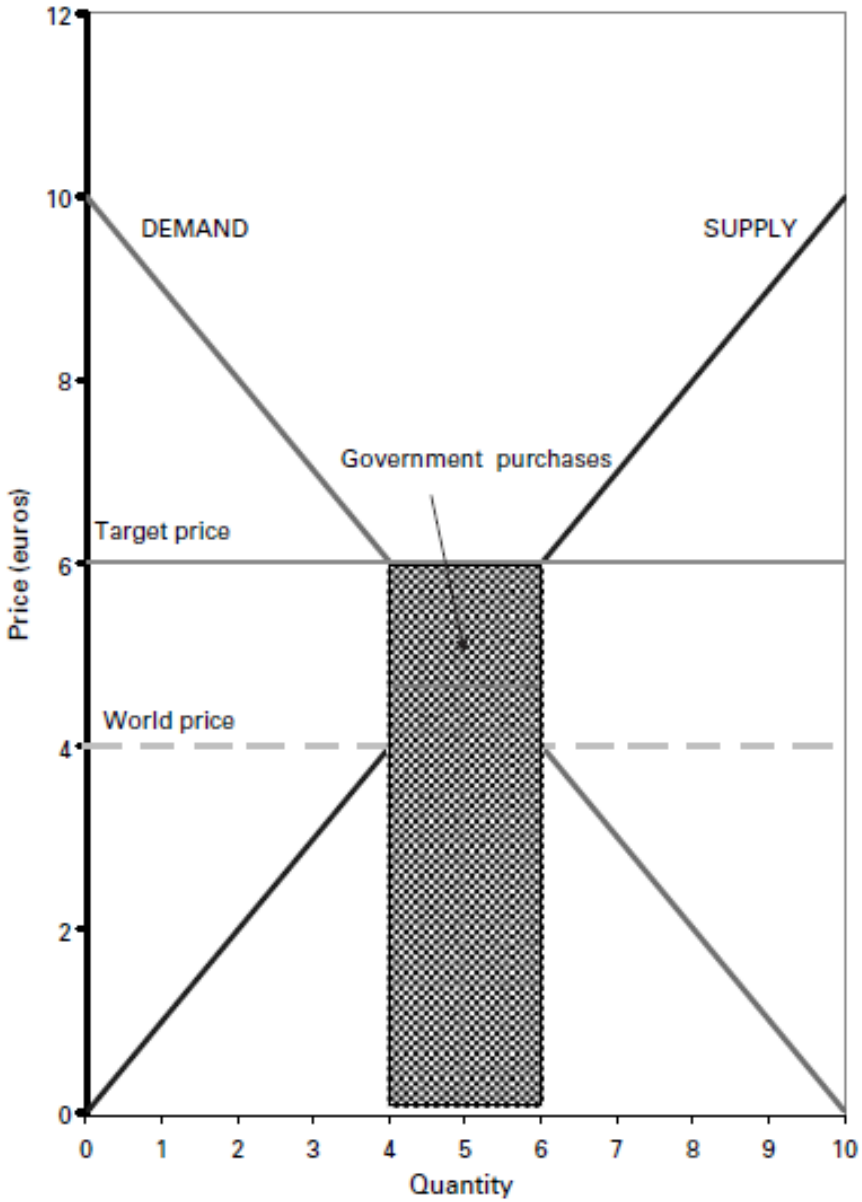
1. Labor productivity in agriculture increased significantly due to the use of fertilizers and machinery, outpacing productivity growth in services and industry.

2. However, despite the growth in agricultural productivity, income in the agricultural sector remained low compared to other sectors.

3. Instead, it created an oversupply of food, which kept prices low.

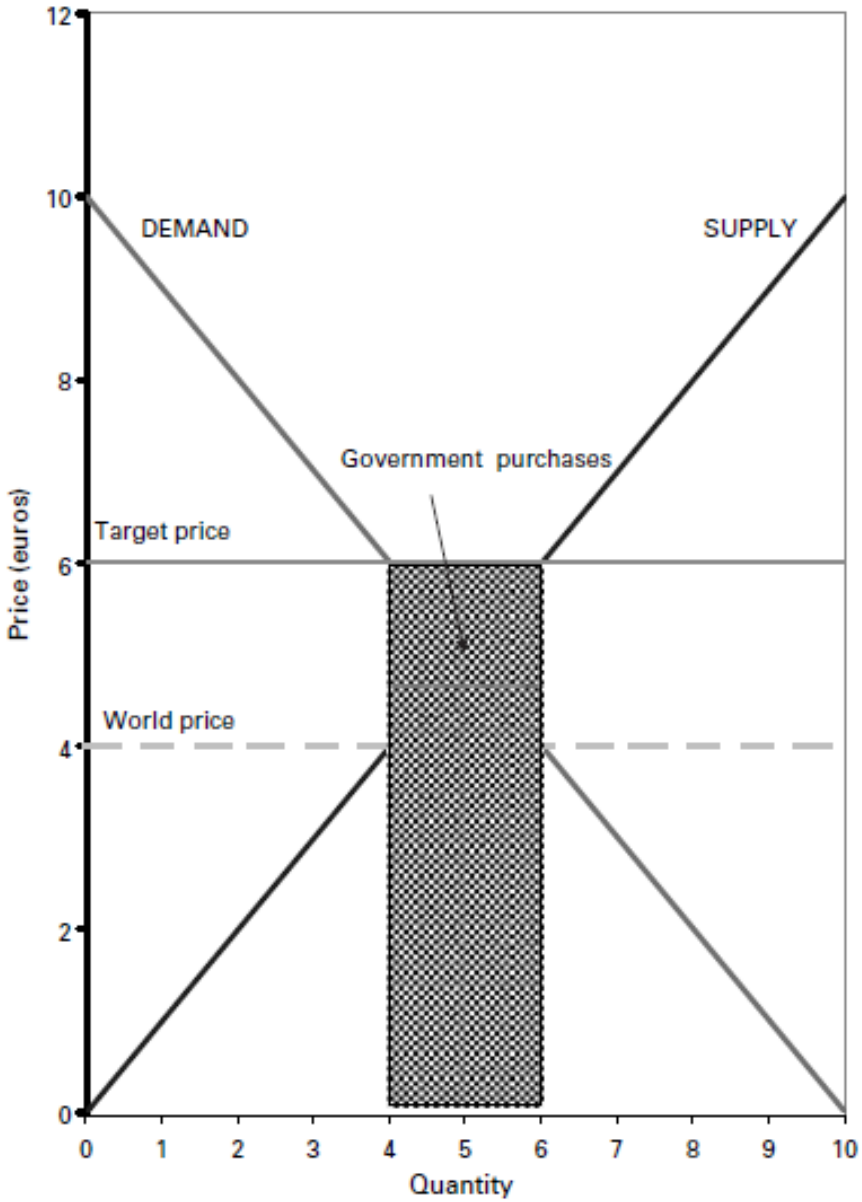
4. This dynamic—driven by price supports and technical progress in farming—was more important than the guidance policies in achieving the EEC's goal of agricultural self-sufficiency.

Market Interventions



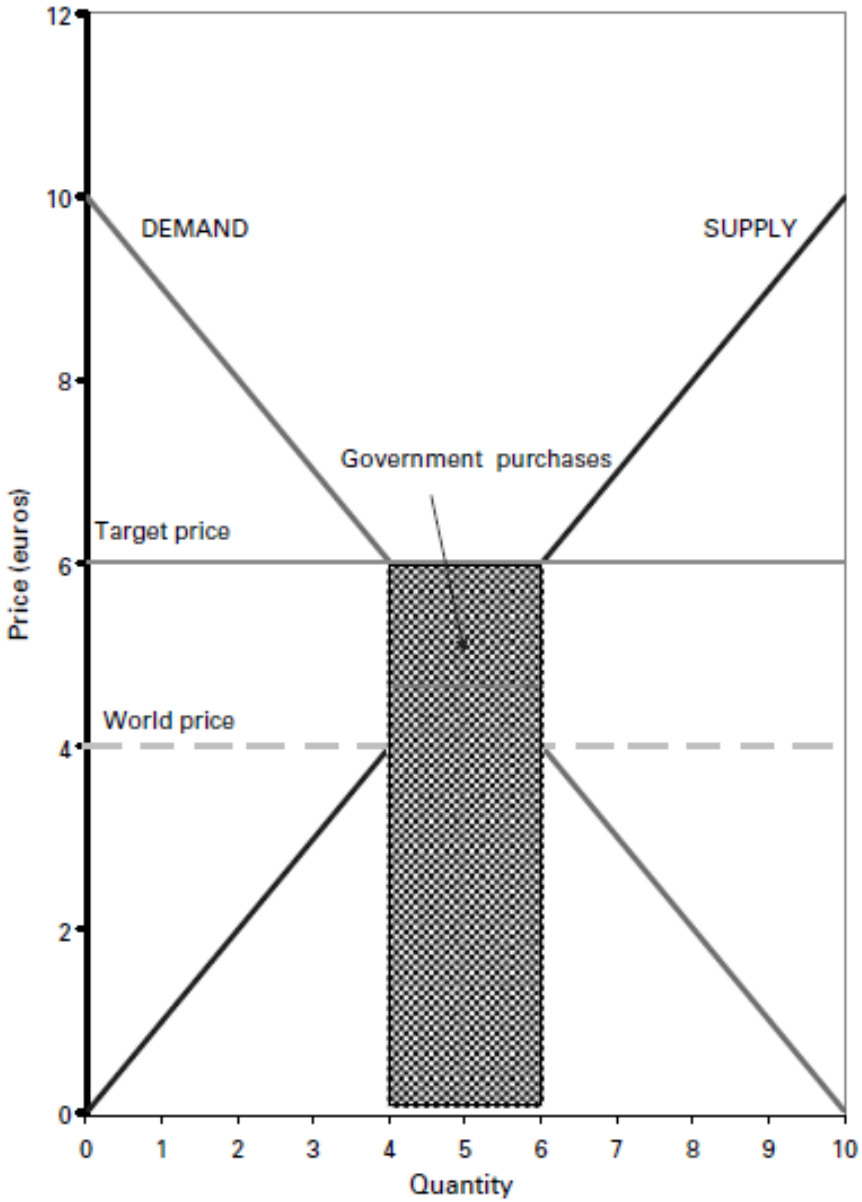
- Figure 4.2 shows the the role of government intervention purchases in managing excess supply in CAP.
- Target price a price floor set by the CAP to ensure that farmers receive a guaranteed minimum price for their products, which is higher than the world market price.
- World price represents the equilibrium price at which the product could be traded internationally, without government intervention.

Market Interventions



- In Figure 4.2, there is an outward shift in the supply curve (to the right). This indicates that production increased, due to incentives created by the guaranteed target price.
- Farmers, encouraged by price supports, produce more than they would at the market equilibrium price (world price). This leads to an oversupply problem, where production exceeds consumer demand at the target price.

Market Interventions



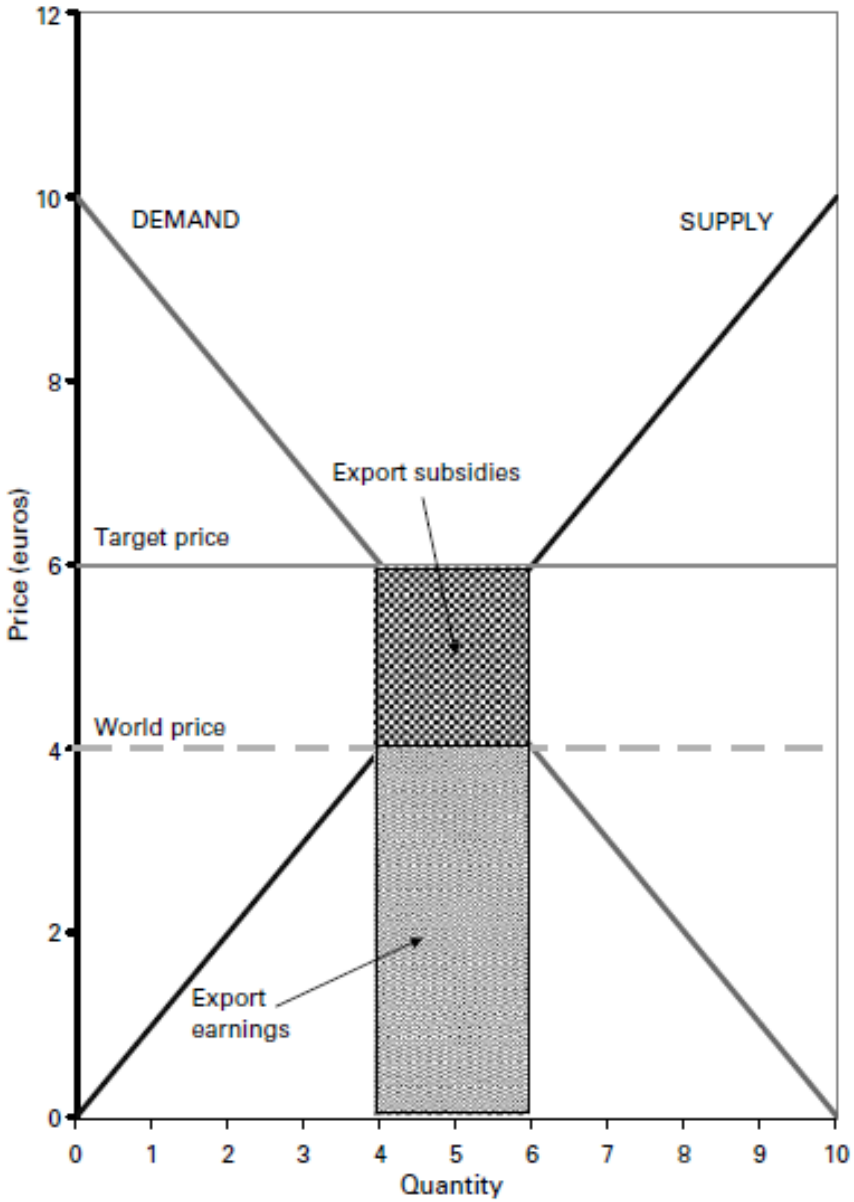
- This surplus pushed CAP expenditures to the limit, as the high target prices prompted farmers to increase production further, exacerbating the oversupply.
- Setting a target price above the world price creates a surplus because producers supply more than consumers demand at this elevated price.

Market Interventions

Government Intervention

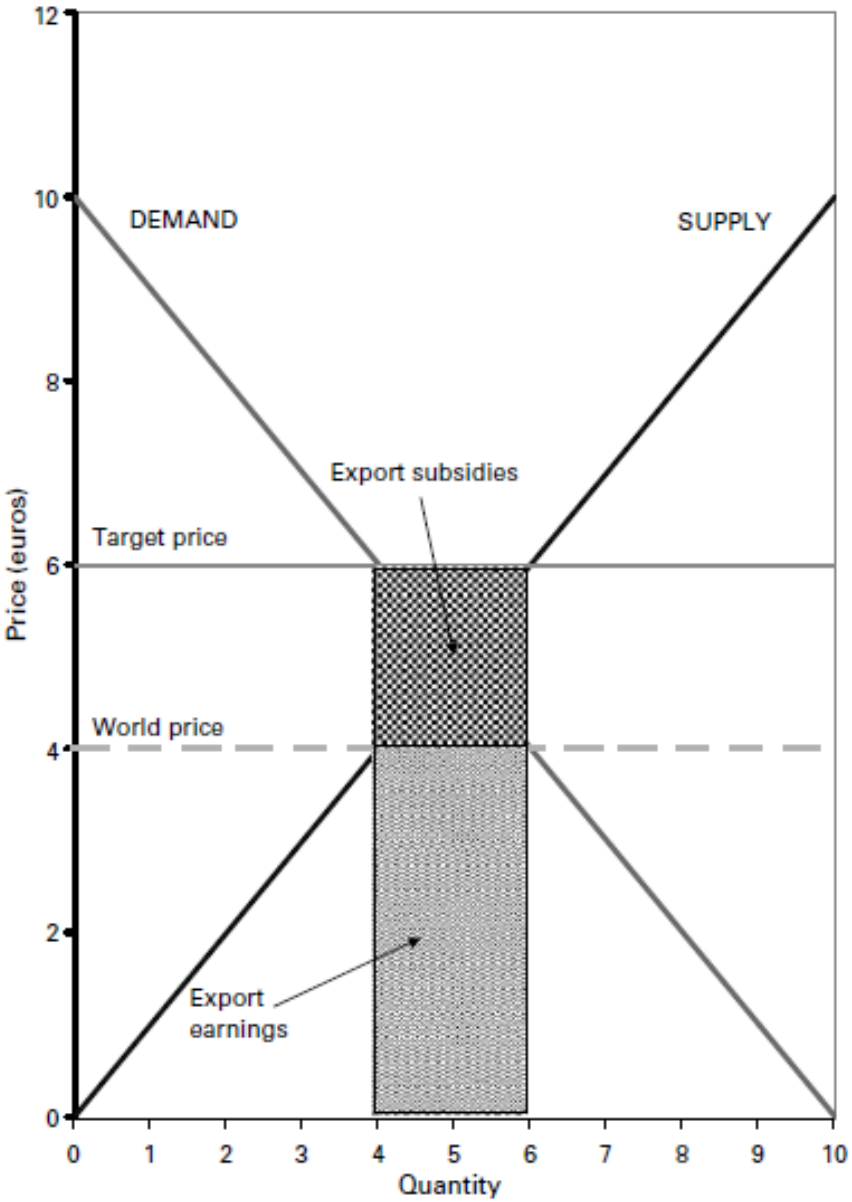
1. The government steps in to purchase this surplus, preventing the price from dropping to the world market level.It keeps prices artificially high
2. This intervention ensures stable incomes and incentivizes production.
3. The cost of purchasing and storing excess production represents a significant financial burden.The figure demonstrates how the CAP's price support system works to stabilize farmers' incomes but leads to overproduction and necessitates costly interventions.

Market Interventions



- Figure 4.3 demonstrates the use of export subsidies as a policy tool under the CAP to manage surplus production and maintain high domestic prices.
- The CAP guarantees a higher target price to support farmers' incomes, which exceeds the world price.
- Then simply paying farmers the difference between the target price and the world price for the excess production.

Market Interventions



- At the target price, domestic supply exceeds demand, creating a surplus. This is due to incentives for higher production under the CAP price supp system.
- The bottom shaded area represents th revenue generated from selling the surplus production on the world mark at the world price.
- The top shaded area represents subsidies paid by the government to farmers/exporters.

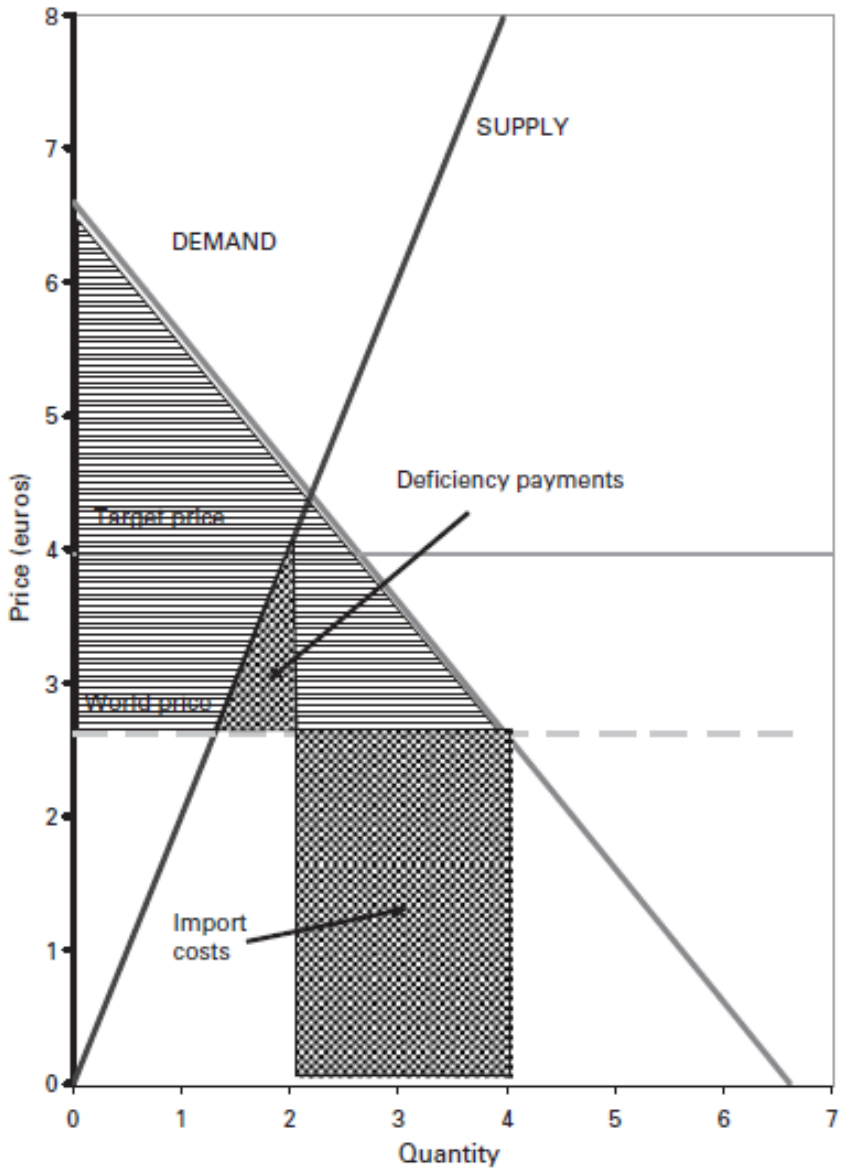
Market Interventions

Export Subsidy

1. Export subsidies are used to deal with surplus production that exceeds domestic demand, a direct result of setting prices higher than market equilibrium.

2. Export subsidies distort international markets by allowing surplus goods from CAP countries to be sold at artificially low prices (world price + subsidy). This can harm producers in other countries who cannot compete with subsidized prices.
3. The government bears the cost of the subsidy, adding to CAP expenditures. Public funds are used to finance overproduction and artificially maintain competitiveness in global markets.

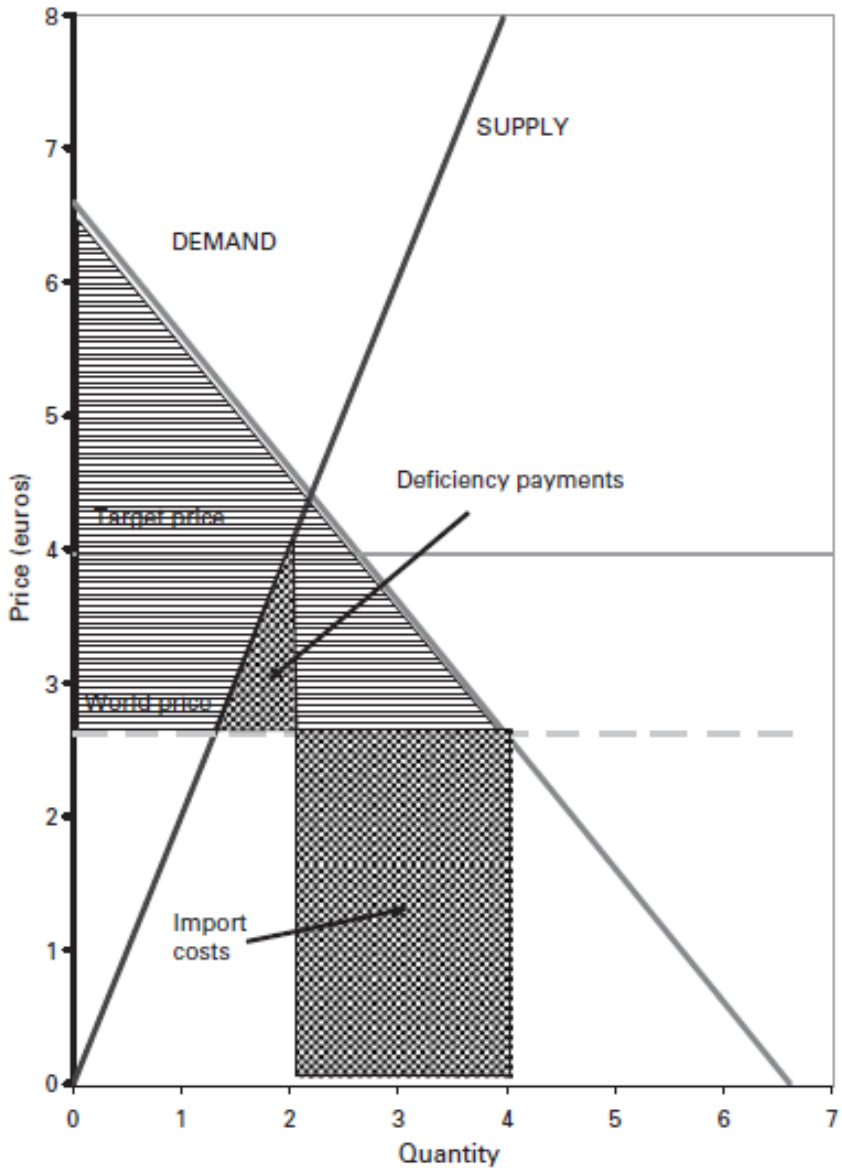
Market Interventions



- Figure 4.4 denotes the employment of deficiency payments as a mechanism to bridge the gap between the target price and the world price.
- The striped area between the world price and the target price represents the amount paid by the government to farmers for each unit of production sold.

Figure: Figure 4.3 Deficiency Payment

Market Interventions



- The shaded rectangle at the bottom reflects the cost of imports. If domestic production (supply) cannot meet demand at the target price, imports are required to fill the gap.
- Deficiency payments serve as a direct transfer of income to producers from the government, while allowing consumers to pay lower world market prices.

Figure: Figure 4.3 Deficiency Payment

Market Interventions

Deficiency Payment

1. Compared to price supports, where governments must purchase and store surplus production, deficiency payments are more targeted and cost-efficient.

2. Consumers are not forced to pay artificially high prices for agricultural goods, as they would under a price support system. This allows them to benefit from the lower world market prices.

3. This system eliminates inefficiencies by not propping up high-cost, inefficient farmers.

Market Interventions

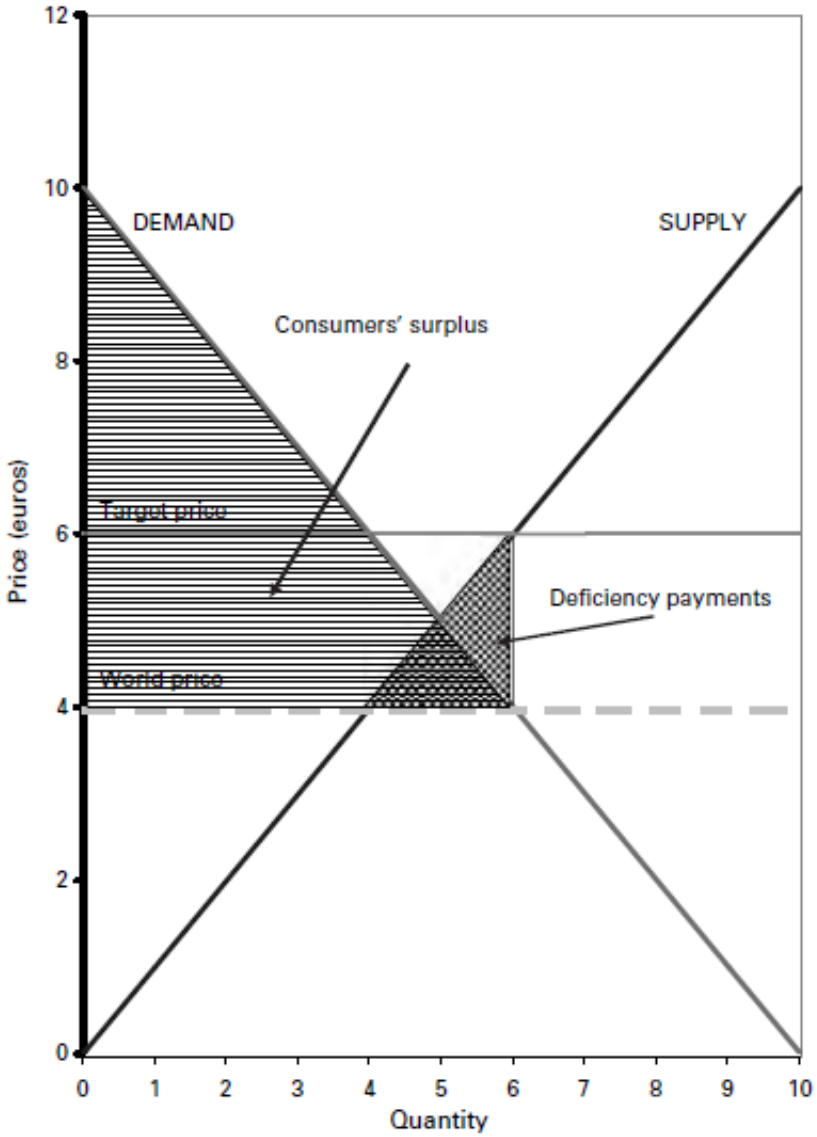


Figure: Figure 4.3 Deficiency Payment

- Figure 4.5 presents the impact of deficiency payments on consumer and producer welfare in a market, highlighting the interaction between government subsidies, market prices, and surpluses.
- The striped triangular area represents the additional welfare or savings for consumers who pay the lower world price rather than the higher target price. This surplus increases consumer welfare compared to a price support system.

Market Interventions

Deficiency Payment

1. In a net exporting country, the system of deficiency payments strikes a better balance than price supports or export subsidies. It reduces government expenditures, minimizes market distortions, and benefits consumers while still supporting producers.

2. Consumers are not forced to pay artificially high prices for agricultural goods, as they would under a price support system. This allows them to benefit from the lower world market prices.

3. The deficiency payments system avoids the distortionary effects of price supports, such as large export surpluses dumped onto international markets, which can create trade tensions.