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BUDGETARY IMPLICATIONS OF ENLARGEMENT: AGRICULTURE

JOHAN F.M. SWINNEN

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Place du Congrès 1 B-1000 Brussels Tel: (32.2) 229.39.11 Fax: (32.2) 219.41.51 http://www.ceps.be

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1. Introduction

The Common Agricultural Policy (CAP) accounts for 45% of the total EU budget. Will its extension to Central and Eastern European countries (CEECs) break the EU budget? The 10 CEECs currently negotiating for membership would increase the number of farmers by 120% and would increase the area under cultivation by 42%. It is thus widely expected that enlargement will dramatically increase the cost of the CAP.

Early studies of the cost of extending the CAP to the CEECs arrived at very large numbers. But most of these studies pre-dated the 1999 Berlin Council and the Agenda 2000 reforms agreed there. These early budgetary impact estimations are now considered inaccurate.

The discussion here is based on a set of more recent studies, which have incorporated the actual Agenda 2000 reforms and adjusted expectations on the number of countries and timing of enlargement, and are considered to be more accurate in their predictions. More specifically, the studies are produced by DIW (Berlin/Göttingen), IBO/LEI (The Hague) and IAMO (Halle).[1]

2. Agricultural expenditures in the EU budget

In 2000, agricultural expenditures accounted for €40.5 billion, which represents 45% of the total EU budget. There are three categories of expenditures on agriculture (see Table 1), as follows.

- Market interventions are expenditures to support EU farm prices through intervention purchases, storage, and export subsidies. In 2000, the EU-15 spent €10.6 billion on agricultural market support, i.e. 12% of the total EU budget.

* Associate Senior Research Fellow, CEPS and Professor of Economics at the University of Leuven.

[1] IBO/LEI study: "The Financing of the Common Agricultural Policy after Enlargement of the European Union" Interdepartmental Policy Study (IBO), unpublished document, The Hague, The Netherlands. Most of the budgetary estimates in the IBO report are based on Silvis, H.J., van Rijswijck, C.W.J., and A.J. de Kleijn, "EU agricultural expenditure for various accession scenarios" Report 6.01.04, Agricultural Economics Research Institute (LEI), The Hague.

IAMO study: Frohberg, K. and G. Weber, "Ein Ausblick in die Zeit nach vollzogener Ost-Erweiterung" Institut für Agrarentwickelung in Mittel- und Osteuropa (IAMO), Halle, Juli 2001

DIW study: Weise, C., Banse, M., Bode, W., Lippert, B., Nölle, F. And S. Tangermann, "Reformbedarf bei den EU-Politiken im Zuge der Osterweiterung der EU", Berlin und Göttingen", 2001.

Estimates in a working document of the European Parliament budget committee (European Parliament, Committee on Budgets, "Working Document on the financial implications of EU enlargement", 11 April 2001) are generally consistent with the estimates presented here, since the estimates in the working documents are also based on the IAMO and Göttingen (DIW) estimates.

- Direct payments are subsidies per hectare or per animal. A large share of these were introduced in the MacSharry reform (1992) and Agenda 2000 reforms to compensate farmers for declining market and price support (see Box 1 for details). In 2000, the EU-15 spent €25.6 billion on direct payments to farmers, i.e. almost 30% of the total EU budget.
- Rural development expenditures (also now referred to as the "second pillar" of the CAP) cover a variety of programs. In 2000, the EU-15 spent €4.2 billion on rural development measures, i.e. 5% of the total EU budget.

Table 1. EU agricultural expenditures in 2000

	Billion €	% of agricultural expenditure	% of EU budget
Market support	10.6	26.2	11.8
Direct payments	25.6	63.4	28.5
Rural development	4.2	10.4	4.7
TOTAL	40.5	100.0	45.0

Box 1. Direct Payments in the CAP

Direct payments include both so-called *area payments* (for crops) and *headage payments* (for livestock).

Area payments have been set by the Council at €63/tonne for cereals, oilseeds, and protein crops (so-called COP commodities), to be applied in relationship to regional variations in yields. For example, if region A has an average yield of 6 tonnes per hectare, then the DP for farmers in that region is €378/ha (= €63/ha x 6).

The reference yields are fixed at sub-country regional levels. For example, the UK has five regions; in Germany the yields are determined at the level of the Länder, and for the largest Länder even on a sub-Länder basis.

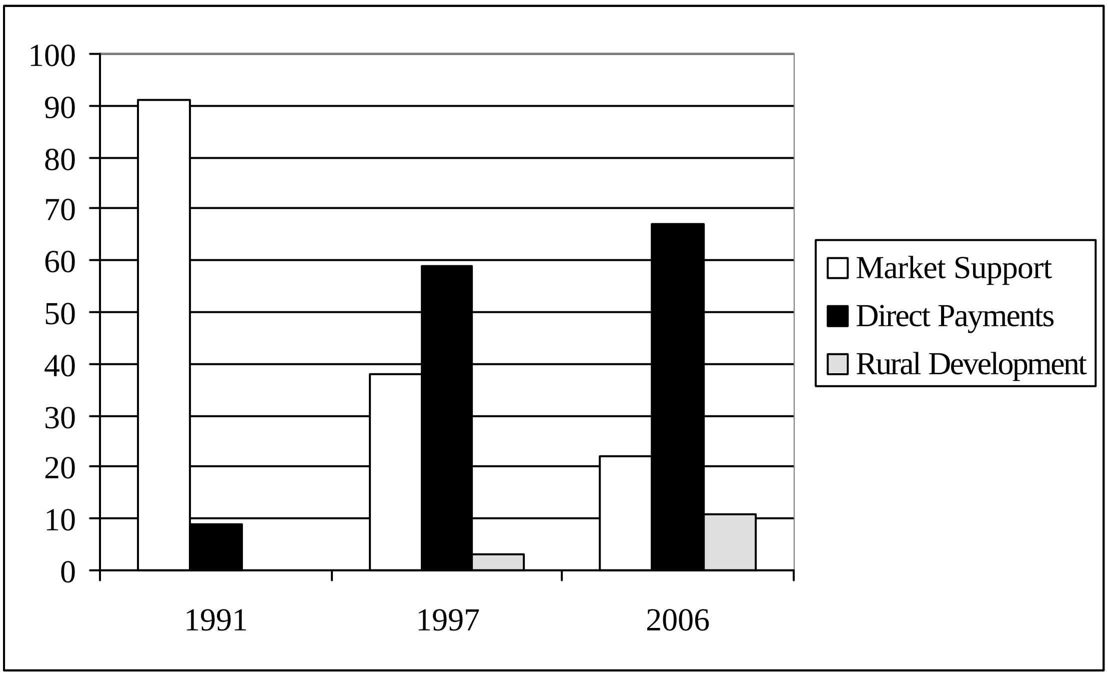
The reference period is 1989-91, as the compensation payments were first introduced with the MacSharry reforms, decided in 1991.

These payments are conditional upon setting aside 10% of the COP land (but which can be planted by other crops). Small producers are exempt from this condition.

In the beef sector, *per headage payments* are used. Three different kinds of "beef animals" are given payments: steers, suckler cows, and bulls; at a rate of €150-200 per animal for 2002. But the premiums are given only once in the life of every bull and twice in the life of every steer. Estimates are that the average payment per head of eligible animal is around €25 in 2002.

The relative shares of the expenditures over the three categories have changed dramatically over the past decade. Figure 1 illustrates how the share of direct payments increased substantially: from less than 10% in 1991 to close to 60% in 1997, and the share is predicted to increase further as Agenda 2000 is fully implemented in the next years. Inversely, the importance of market interventions in budgetary outlays has declined from over 90% in 1991 to less than 40% in 1997 and is predicted to fall to close to 20% by 2006. Rural development expenditures only became significant after Agenda 2000, and will account for slightly more than 10% by 2006.

Figure 1. Distribution of the EU agricultural budget (1991-2006)



It is likely that there will be a further shift in these expenditures with the next CAP reform.[2] Market expenditures are likely to decline further, and rural development expenditures will probably increase. The direct payments category may go either way, since some of the payments currently in that category may be replaced by payments in the rural development category, while new direct payments may be introduced to compensate for reductions in market interventions.

3. The Cost of Enlargement

a) The official framework

The Financial Framework (FF) agreed in Berlin made several assumptions regarding Eastern enlargement. The most important assumptions regarding the agricultural budget were that six new member states would join by 2002 and that agricultural enterprises in the new member countries would not qualify for direct income support.[3] Table 2 presents the agricultural expenditures as they are predicted in the annex to the Conclusions of the European Council of Berlin.

[2] See J. Swinnen, *A Fischler Reform of the Common Agricultural Policy?*, CEPS Working Document No. 173, September 2001.

[3] A variety of arguments have been advanced against extending the direct payments to CEEC farmers. The one most often heard is that, unlike EU farmers, CEEC farmers will not witness a price decline with EU accession, to the contrary even. However, economists have mostly emphasised that extending the payments to CEEC farmers would create major distortions in the CEEC economies (see e.g. *European Economy*, 1996, "The CAP and Enlargement: Economic Effects of the Compensatory Payments", European Commission, Directorate General for Economic and Financial Affairs, Reports and Studies, no. 2, Brussels).

Table 2. Agricultural expenditures in the Financial Framework (million euro)

	2002	2003	2004	2005	2006
Agriculture (cat. 8)	1600	2030	2450	2930	3400
- Market regulation	1034	1107	1091	1153	1223
- Rural development	566	923	1359	1777	2177

Source: European Commission (as summarised in IBO).

Each of these three key assumptions needs to be revised. The first accession is likely to take place in 2004 instead of 2002, and it is probable that more than six countries will join, but only as of 2004. These two changes might offset each other.

Despite much opposition from EU-15 member countries against extending the direct payments to CEEC farmers, all the candidate countries are united in their insistence in an "equal" treatment of their farmers from the moment of accession, i.e. that they should get the same subsidies as the EU-15 farmers, including direct payments. It is now widely accepted that the initial position is no longer tenable, and that CEEC farmers will receive, at least partially, direct payments from the moment of accession.o longer tenable, and that CEEC farmers will receive, at least partially, direct payments from the moment of accession.

b) The most recent independent estimates

A number of independent institutes have recently published estimates of the cost of extending the CAP to the CEECs. Tables 3 and 4 present their estimates for 2007 and 2013-15, respectively, all in 1999 prices. The estimates are given for when all ten CEECs enter before 2007 and when eight (CEEC-8, i.e. without Bulgaria and Romania) join in 2004-05 and Bulgaria and Romania join after 2007.

The estimations are converging on the following numbers:

- With CEEC-8 joining in 2004-05 total agricultural expenditures will be around € 10 million in 2007, while if all ten CEECs join before, total agricultural expenditures will be around €14-16 million by 2007.
- Around 60% of the expenditures go to direct payments,[4] while market expenditures and rural development each account for around 20%.
- According to the DIW and IBO estimates, expenditures will remain constant around €14-15 million after 2007.

[4] Variations in the estimates not only relate to assumptions on (uncertain) market developments but also to assumptions on the outcomes of the accession negotiations. For example, variables such as quota allocations, reference yields and areas for direct payments are part of the negotiation process between the EU-15 (proposing lower levels) and the CEECs (demanding higher levels). See Box 2.

Table 3. Agriculture – Budgetary effects of enlargement in 2007 with 100% direct payments going to CEECs (million euro)

	DIW *market*	**DIW** *DPs*	**DIW** *rural dev*	**DIW** *TOTAL*	**IBO/LEI** *market*	**IBO/LEI** *DPs*	**IBO/LEI** *rural dev*	**IBO/LEI** *TOTAL*	**IAMO** *Exportsupport*	**IAMO** *DPs*	**IAMO** *DP+export*
Czech	-51	809	235	992	423	735	156	1,314			725
Hungary	370	1,063	346	1,780	377	1,030	269	1,676			1,090
Poland	1,739	2,870	994	5,603	878	2,551	1,193	4,622			2,525
Slovakia	-68	377	136	445	117	360	143	620			322
Slovenia	-64	84	38	57	61	101	45	207			111
Estonia	14	93	57	163	41	84	86	211			97
Latvia	21	216	136	373	53	122	206	381			115
Lithuania	91	427	191	718	224	307	288	819			350
Bulgaria	478	583	311	1,372	146	489	363	998			569
Romania	234	3,201	807	4,241	425	1,698	865	2,988			1,898
CEEC-8	**2,052**	**5,939**	**2,133**	**10,131**	**2,174**	**5,290**	**2,386**	**9,850**			**5,335**
CEEC-10	**2,764**	**9,723**	**3,251**	**15,744**	**2,745**	**7,477**	**3,614**	**13,836**	848	6,953	**7,802**
Lux-group	2,008	4,919	1,670	8,595	1,785	4,501	1,777		551	4,037	4,548
Hels-group									337	2,916	3,253
Share in budget exp											
CEEC-8	0.20	0.59	0.21	1.00	0.22	0.54	0.24	1.00			
CEEC-10	0.18	0.62	0.21	1.00	0.20	0.54	0.26	1.00			

Assumptions

IAMO: 10 CEECs have entered in 2007
No CAP reform
1999 prices

DIW: 10 CEECs have entered in 2007
8 CEECs enter beginning 2005
Bulg+Rom join 2007
No CAP Reform
1999 prices

IBO: 10 CEECs join in 2004
No CAP Reform
1999 prices

Table 4. Agriculture – Budgetary effects of enlargement in 2013 with 100% direct payments going to CEECs (million euro)

	DIW *market*	**DIW** *DPs*	**DIW** *rural dev*	**DIW** *TOTAL*	**IBO/LEI** *market*	**IBO/LEI** *DPs*	**IBO/LEI** *rural dev*	**IBO/LEI** *TOTAL*
Czech	-181	696	235	750	489	735	191	1,415
Hungary	362	932	346	1,640	539	1,030	330	1,899
Poland	1,101	2,480	994	4,575	845	2,551	1,461	4,857
Slovakia	-120	326	136	342	131	360	175	666
Slovenia	-73	69	38	34	79	101	55	235
Estonia	-2	79	57	134	38	84	105	227
Latvia	-21	230	136	345	70	122	253	445
Lithuania	5	485	191	681	184	307	353	844
Bulgaria	433	506	311	1,250	172	489	445	1,106
Romania	-104	3,351	807	4,054	498	1,698	1,060	3,256
CEEC-10	**1,400**	**9,154**	**3,251**	**13,805**	**3,045**	**7,477**	**4,428**	**14,950**
Share in budget exp								
CEEC-10	0.10	0.66	0.24	1.00	0.20	0.50	0.30	1.00

If we compare the estimated total agricultural expenditures with enlargement with the Financial Framework, then one can only conclude that total agricultural expenditures will be significantly larger than the numbers in the FF.

Interestingly the sums foreseen in the FF would be approximately enough to cover the cost of rural development and market support. The key issue is thus extending direct payments to CEEC farmers, which would cost an additional €6-7 billion.

Box 2. Direct Payments in the CEECs

The application of the standard formula for calculating direct payments is problematic in CEECs because of the absence of obvious reference periods. In fact, reference yields, and areas for direct payments are part of the negotiation process between the EU-15 (proposing lower levels) and the CEECs (demanding higher levels). For example, CEECs have typically insisted upon using (pre-)1989 indicators as a basis for the determination of the direct payments, while the European Commission has argued that output and yields were biased because of the Communist system and can therefore not be used as reference indicators. Acknowledging that the early transition years are also not good indicators because of transition disruptions, the Commission has proposed using the most recent years as reference periods (an assumption also used in the studies discussed here).

To illustrate the importance, consider the illustration in the table below. Average wheat yields in Poland and Hungary in the period 1988-90 were between 15-26% higher than in 1992-94, and still 8-28% higher than in 1998-2000. The impact on the direct payments per hectare is the same, as these are calculated with a fixed multiplier per tonne (at €63/tonne). This illustration suggests that the impact is very significant.

Table A. Impact of reference years on direct payments

	Poland			Hungary		
	Wheat yield tonne/ha	DP €/ha	Change % 88-90	Wheat yield tonne/ha	DP €/ha	Change % 88-90
1988-90	3.7	237	100	5.2	332	100
1992-94	3.2	201	85	3.9	246	74
1998-2000	3.5	217	92	3.7	238	72

This does not necessarily mean that enlargement will not be possible within the FF. Accession of the CEEC-8 in 2004 instead of 2002 reduces some of the costs and makes it easier to fit enlargement within the Financial Framework. Moreover, the EU is considering phasing in some of the expenditures, in particular the DPs. A proposal to do just that is contained in the recent "Draft Common Position" published by the European Commission in February 2002. According to this proposal, the CEECs would receive the equivalent of 25% of EU-15 direct payments in 2004, 30% in 2005, 35% in 2006, and rising to 100% in 2013. Additional funding for Rural Development is also included.

The budgetary implications are summarised in Table 5. The data in Table 5 show that under this proposal, the total expenditures would fit within the FF. The total additional expenditures for agriculture expected in 2006 would be around €3.9 billion, precisely the amount foreseen in the FF for expenditures on agriculture.

Table 5. Budgetary implications of the February 2002 Draft Common Position of the European Commission (million euro, 1999 prices)

	2004	**2005**	**2006**
Direct payments	25%	30%	35%
Commitments	-	1173	1418
Payments	-	1173	1418
Market expenditures			
Commitments	516	749	734
Payments	516	749	734
Rural Development			
Commitments	1532	1674	1781
Payments	748	1187	1730
TOTAL			
Commitments	2048	3596	3933
Payments	1264	3109	3882
Berlin amounts foreseen for agriculture (incl. SAPARD)			
Commitments	2970	3450	3920

4. Time for reform?

Yet even if the EU manages to "fit" the enlargement process in the Financial Framework 2000-06, we should not be distracted from the fact that in the absence of reform the expenditures will in the years after 2006 run-up to numbers much beyond those used in the 1999 decision-making, and that the budgetary effects for 2013 as presented in Table 4 remain valid.

Part of the budgetary costs can be attributed to the failure of EU decision-makers, both during the MacSharry reforms in 1992 and at the 1999 Berlin Council meeting, to agree on restrictions in size and in time on the direct "compensation" payments. The implications for the budgetary effects of enlargement are obviously significant. Yet, even if those who oppose extending direct payments to CEECs have their way, there will be significant budgetary effects. Those who oppose the direct payments for CEECs (because they distort local economies and slow restructuring) favour structural aid programmes for the CEECs to foster sustainable development.

To get a feeling of the relative size of the subsidies, note that agricultural value-added (i.e. GDP) in the CEEC-10 was less than €18 billion in 1999. Hence €15 billion of support from the EU budget would amount to more than 70% of the 1999 agricultural GDP in CEEC-10.

Moreover, total support to agriculture is even higher because one has to add non-budgetary transfers from consumers through price and trade interventions. The OECD PSE calculations indicate that, on average for 1998-99, for the EU-15, € 67 billion were transferred to farmers agriculture through market support (including non-budgetary transfers). A rough estimate of the non-budgetary transfers to CEEC-10 farmers with accession would add another € 5-10 billion in addition (all in 1999 prices). In total this means that the expected transfers to CEEC farmers in 2007 under the CAP may be larger than value added created in agricultural in those countries.

All this suggests that a reform of the direct payments is needed.[5] Reducing the budget costs of the compensation payments can be done in three ways: first by limiting them over time ("degressivity"); second, by limiting the amount per farm or linking them to the size of the farm ("modulation"); or third, by having them co-financed by the member states ("co-financing").

The simulation results in Table 6 indicate that the introduction of degressivity (a gradual reduction of the DPs over time) has a major impact on expenditures. In fact, even if this degressivity is implemented only after 2007 and over a 10-year period – to allow farmers a long transition period – the budgetary savings achieved by introducing a degressivity system of 10% per year after 2007 could more than offset the agricultural costs of enlargement. Hence, degressivity even of less than 10% would cause substantial savings.

The need to reform the direct payments is even more important in the light of discussions on the reform of the dairy and sugar sector. Dairy and sugar policy reforms may not be politically feasible unless farmers receive some form of compensation through payments per head or per hectare, as was done in other sectors. Agenda 2000 already includes compensation payments for dairy farmers to compensate for price reductions between 2005 and 2007 (5% annually). More direct payments to compensate for further dairy or sugar reforms would require even larger budgetary outlays, and would be easier with a reform of the direct payment system.

The simulation results in Table 6 indicate that compensation for further dairy and sugar reforms could increase the budget by around €2 billion in the short run, and by around €4.5 billion in the longer run. However, as the last scenario in Table 5 illustrates, the savings from a degressive implementation of the direct payments would fully finance not only enlargement, but also the compensation costs of dairy and sugar reforms.

[5] For a more elaborate argument on this issue, see A. Buckwell and S. Tangermann (1999), "The Future of Direct Payments in the Context of Eastern Enlargement", *MOCT/MOST Economic Policy in Transition Economies* 9: 229-252.

Table 6. Agriculture – Budgetary effects of enlargement under various scenarios

		2007				2015			
		Market	*DPs*	*Rural dev*	*TOTAL*	*Market*	*DPs*	*Rural dev*	*TOTAL*
Basis scenario (see Tables 3 and 4)									
	CEEC-8	2,174	5,290	2,386	9,850				
	CEEC-10	2,745	7,477	3,614	13,836	3,045	7,477	4,428	14,950
Phasing in DPs [a)]									
	CEEC-8	2,174	4,139	2,386	8,699				
	CEEC-10	2,745	5,859	3,614	12,218	3,045	7,477	4,428	14,950
Reduction of DPs (Degressivity)[b)]									
	CEEC-10	2,745	7,477	3,614	13,836	3,045	3,229	4,428	10,702
	EU-15				0				-16,056
	EU-25				13,836				-5,354
Dairy + sugar reforms [c)]									
-- Additional effects	CEEC-10	-144	1,134	0	990	-254	1,701	0	1,447
	EU-15	-539	1,490	0	951	-897	3763	0	2,866
	EU-25				1,941				4,313
Dairy + sugar reforms [c)]									
-- Aggregate additional expenditures	CEEC-10	2,601	8,611	3,614	14,826	2,791	9,178	4,428	16,397
of enlargement and reforms	EU-15	-539	1,490	0	951	-897	3763	0	2,866
	EU-25				15,777				19,263
Combined Degressivity									
+ Sugar and Dairy Reforms	CEEC-10	2,601	8,611	3,614	14,826	2,791	4,930	4,428	12,149
-- Aggregate additional effects[d)]	EU-15	-539	1,490	0	951	-897	3763	0	-13,190
	EU-25				15,777				-1,041

Source: IBO/LEI.

[a)] DPs are phased in over the five years: by an increase of 20% annually.
[b)] DPs are annually reduced with 10% as of 2007.
[c)] Dairy reforms of 15% price reduction with 50% compensation implemented under Agenda 2000 is repeated from 2007-2009. Sugar reforms of twice 15% price reduction with 50% compensation (as in dairy, one in 2003, one in 2007).
[d)] The 2015 expenditure is overestimated as degressivity of extra compensation payments for sugar and dairy is not included.