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The Economic and Historical Foundation of the Common Agricultural Policy in Europe.

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By

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Summary

The Common Agricultural Policy (CAP) was founded in the 1950s with price support as the main policy instrument. Despite massive criticism from both within and outside the EU, price support remains the backbone of the CAP. This paper argues that the choice of price support was logical viewed in both historical and economical perspectives, and gives three reasons for this. First, even though talks on agricultural integration began immediately after the war, the CAP was a result of general economic integration in Europe rather than the reason for it. Second, the structure of the CAP was determined by the agricultural policies of the six founding countries. The third and last reason is related to the economic characteristics of running a price support system. The six countries together were net importers of agricultural products and could thereby benefit from import levies. Price support is paid for by the consumers, and European consumers had been paying high prices for food for a long time. This, together with a high level of economic growth in Europe in the 1960s, made it easier for the governments to choose this policy rather than a policy based on direct payments financed by taxpayers that would have put pressure on the national fiscal budgets of the six countries.

Key Words: Agricultural Policy, European Economic History, Agricultural History.

JEL. Classification: Q18, N44, N34

1. Introduction

From its inception, the Common Agricultural Policy (CAP) has been under pressure from many sides (Fennell, 1973). The main argument against the CAP has been the choice of price support

as the main policy instrument. Various groups within the European Community have often argued that only slowly if ever will price support result in a situation where all the objectives of the CAP stated in article 39 in the Treaty of Rome were achieved. The objectives can be divided into two groups, the first relating to farmers' income problems and the second relating to food supply and food prices. The income problem, or the farm problem as it is often called, is well described in the economic literature which is based on the diagnosis by Theodore W. Schultz in his well-known book *Agriculture in an Unstable Economy* (Schultz, 1945). According to the literature, the best way to solve the farm problem is not by price support but through structural policy measures that on one hand allow farmers to adjust and on the other hand raise the alternative salvage value of their factors of production so that adjustment is possible[1] (Cochrane, 1958; Johnson, 1958; Tweeten, 1989). The main concern in Europe in the 1950s was to increase the food supply (Fennell, 1997). The problem with choosing price support to achieve such a goal is that the objective of ensuring reasonable food prices is threatened, because the price support is paid by the consumers. This dilemma could have been solved if deficiency payments[2] had been the main policy instrument of the CAP. In addition to price support being a bad choice of instrument for achieving the objectives, the CAP creates transaction costs, distortionary costs and negative spill-over effects for the rest of the Community. Various groups outside the European Community have argued that price support not only creates problems within the Community but also creates distortionary costs and negative spill-over effects for countries outside the Community and the world economy as a whole. Despite reforms of the CAP over the years and trade agreements between The European Union (EU) and the rest of the world where the overall trend has been a move from price support to direct payments (from coupled to decoupled support), price support is still one of the backbones of agricultural policy in Europe to day (OECD, 2000a pp.70-82).

This paper aims to establish a framework within which the CAP can be understood and thereby shed light on why the CAP was founded with price support as the main policy instrument and why price policy remains a leading instrument of the CAP. The basic idea is that this framework should help us understand why long term changes in both the European economy and the place of agriculture in relation to the economy as a whole have not resulted in a more radical change in the CAP in the same way that other European institutions have evolved over the years.

After a short overview of the agricultural situation in some key European countries,

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1) For a complete overview of the economic literature concerning the farm problem see Zobbe (2001), Brandow (1977) and Gardner (1992). The two first deal with literature in the early period that could have influenced the founding fathers of the CAP, and the latter reviews the whole approach and gives a critique of it.

2) The British operated this taxpayer-financed support system from 1952 to 1970. Deficiency payments have the same influence on farm output as price support. The main difference is the source of the payments. With price support, the consumer pays the difference between the world market price and the institutional price, while in the case of deficiency payments it is the taxpayer who pays the difference.

section 2 discusses the connection between general economic integration and the integration of agricultural policy in Europe. Section 3 deals with the early development of the CAP. Section 4 presents an overview of agricultural policy in Europe before the CAP. Section 5 gives an analysis of the economic theory foundation of the CAP with respect to the income problem in agriculture and the need to ensure secure supplies of food, and presents the economic characteristics of a price support system. The conclusion is in section 6.

2. European Economic Integration and Agriculture

Before we turn to European integration, some agricultural indicators for key European countries are presented in table 1. The message is clear. Agriculture played a major role in the economy of the six founding countries of the EEC in relation to overall production, employment, and trade. The last column of table 1 illustrates the fact that Holland was the only member of the EEC (6) with a positive net foreign trade balance in agricultural products in the period 1955-59. The indicators for the UK, another key player in the discussion of integration in the late 1940s and 1950s, show the minor role of agriculture in the overall economy and demonstrate that the UK was truly a net importer of agricultural products.

Table 1. Main agricultural indicators in some key European countries, 1955-1960.

	Agriculture s share of GDP, percent		Agriculture s share of total employment, percent		Agriculture s share of total trade, percent (average 1955-59)		Net foreign trade in agricultural products. in 1960 US$ (average 1955-59)
	1955	1960	1955	1960	Export	Import	
Belgium[a)]	7.9	7.3	9.3	7.6	5.4	17.2	-386.4
Lux.	9.3	7.6	19.4	16.4			
Holland	11.4	10.5	13.2	11.5	33.6	19.6	+310.0
Germany	8.0	6.0	18.5	14.0	2.8	32.9	-2,124.6
France	11.4	9.7	26.9	22.4	14.9	29.2	-836.0
Italy	20.7	15.1	40.0	32.8	22.6	20.6	-114.2
EEC (6)	11.5	9.0	21.2	17.5	15.9	23.9	
UK	4.8	4.0	4.6	4.3	6.5	41.8	-4,013.6
Denmark	18.4	14.4	24.9	21.2	65.7	20.3	+502.2

a) In the last three columns, the trade data for Luxembourg are included in the data for Belgium.
Source: OECD (1969)

Discussions on the integration of agricultural policy in Europe began immediately after the Second World War had ended. Talks took place in The Council of Europe and the OEEC (Organization for European Economic Co-operation) between seventeen nations, based on proposals from France, Britain and The Netherlands. In broad terms one can say that there were two important

issues in agricultural policy. The first was to ensure the security of food supplies, and the second was the question of security of income for farmers. The former had many aspects. Production was low because of the war, and it was essential to raise productivity and production for three reasons. People were suffering as result of a decline in food consumption (Foreman-Peck, 1983 p. 270), a high level of dependency on food imports was seen as political weakness, and finally foreign currency and especially dollars were a scarce resource (Hoffmeyer, 1958). The second issue of farmer s incomes was also of great importance, because empirical studies showed that farm incomes were lagging behind incomes in other sectors (OECD, 1961). The negotiations failed to reach any agreement. The differences between France and the Dutch on one side, arguing for a supranational policy and strong community preferences, and the British on the other side, opposing any form of supranationalism and with a strong will to maintain relations with the Commonwealth, doomed the talks from the beginning (Tracy, 1982). These negotiations on creating a common policy for agriculture took place between 1952 and 1954 without any agreement being reached. According to Fearne (1997), the discussions and the final breakdown of the talks served to identify the differences between the European countries, at least in relation to agriculture (Fearne, 1997 p. 12). In 1955 the Ministerial Committee for Agriculture and Food was founded under the OEEC with the purpose of using the differences that had been identified in further talks that could lead to reforms and harmonizations of agricultural policy in OEEC member countries (Ingersent & Rayner, 1999 p.149).

After the breakdown of negotiations in 1954 it was evident that some countries shared the same visions of a single market in Europe, a market that also included agriculture. Talks began between the six countries France, Germany, Italy, Netherlands, Belgium and Luxembourg on further economic integration. These six countries had participated in the European Coal and Steel Community (ECSC) since 1951, and this experience, together with the experiences from the Benelux Union, served as the foundation of the discussions at a conference in Mesina, Italy in June 1955. The concluding report from Mesina laid the ground for the European Economic Community (EEC). Agriculture was only one issue out of many, but in the chapter concerning agriculture in the Spark Report it was stated that the establishment of a common market without agriculture was unthinkable (Fearne,1997 p. 14). According to Mansholt (1963), there were at least four good reasons for including agriculture in the economic integration process in Western Europe. First, there was a practical difficulty in excluding agriculture from being a part of an integrated market because in practice it was not possible to draw a clear line between agricultural and industrial products. Second, agriculture played a major role in the economies of the six countries, and in particular the shares of total exports and imports represented by agriculture were of great importance (see table 1). Third, the level and the fluctuations of food prices in a national economy are significantly influenced by agricultural markets and agricultural policy, and are therefore an essential cost factor in the non-agricultural sector. The fourth and last reason for including agriculture in the integration process was that changes and adjustments in the agricultural

sector are essential in connection with general economic growth (Mansholt, 1963 pp. 83-89).

The agenda for the six countries was clear: agriculture should be part of European integration. But it was also clear after almost 10 years of negotiations in the Council of Europe and the OEEC and after Mesina that the actual design of a common policy would be very difficult to agree upon. On January 1st, 1958 the Treaty of Rome between the six countries came into force and the EEC became reality. Agriculture was included in the Treaty in very broad terms. The main reason for this solution was the eagerness of the six countries to ensure peace and stability in Europe by signing the treaty. They were not interested in being held up by discussions of complicated agricultural policy issues, or indeed other specific policy issues for that matter. The basic consequence of this was that the common agricultural policy had to be designed in such a way that it could be implemented through already existing European economic institutions. In other words, the Treaty of Rome not only pressured the decision makers to agree on a common policy, but also put on constraints in relation to time limits and design.

3. The birth and development of the CAP[3]

With the signing of the Treaty of Rome in 1957 and the establishment of the EEC on January 1st, 1958, the common agricultural policy came into being. Agriculture was covered in articles 38 to 47 of the treaty, but there were no specific guidelines for an operational policy. Article 39 of the Treaty specifies a set of objectives for the Common Agricultural Policy. The policy seeks:

a. to increase agricultural productivity by promoting technical progress and by ensuring the rational development of agricultural production and the optimum utilization of the factors of production, in particular labor;
b. thus to ensure a fair standard of living for the agricultural community in particular by increasing the individual earnings of persons engaged in agriculture;
c. to stabilize markets;
d. to ensure the availability of supplies;
e. to ensure that supplies reach consumers at reasonable prices.

Other important points are stated in articles 40 and 43. Article 40 says that the common agricultural policy should be implemented in stages during a five-year transition period starting in 1962. Article 43 places the responsibility for designing the actual policy with the Commission, and the explicit deadline set is two years.

As mentioned earlier, the real discussion of the design of the CAP began after the EEC

3) This paper can only give a short overview of the Common Agricultural Policy. For a more detailed description of this complex policy see Ritson & Harvey (1997) or Tracy (1996). For the complete story of the historical events see Fearne (1997) or Fennel (1997).

was established. In the summer of 1958, delegations including politicians, civil servants and representatives of farm and food industry organizations from the six member countries met with the new Commission in Stresa, Italy to outline the problems that were facing agriculture in Europe and the means by which they could be resolved (Tracy, 1994). The conclusions drawn at Stresa can be summarized as follows. First, agriculture should continue to be a part of the overall general economic strategy of the Community. Second, intra-Community trade in agricultural products should be protected against distortions from the world market. Third, a system of market organization based on price support should be designed which, working in close relation to structural policy measures, could ensure the optimal use of production factors. Fourth, the family farm should be the cornerstone of European agriculture; and finally and fifth, it was believed that price support in connection with structural policy would maintain farmers' income relative to other groups in the economy (Fearne, 1997 p. 16). According to Tracy (1994) and Fearne (1997), the crucial issue at Stresa was structural policy. The Commission pointed out again and again that price support without any form of structural policy would never result in the achievement of the most important objective concerning farmers' income[4]. It was also argued that the policy would create a wide range of problems for the Community in the long run. The delegations from the various countries had differing views about this, because of the different structures and organizations of farms (Tracy, 1994; Fearne 1997 p 16-17). In 1960 the Commission presented the proposal for the CAP (European Commission, 1960). The proposal included the following three principles for the common policy:

a. free intra-community trade: no barriers to trade in agricultural products between the member states;
b. Community preference: suppliers from within the Community were to be given preference in the market over those from outside the Community;
c. common financing: funding for the CAP would be through a European budget for all revenues and expenditures generated by the policy.

The proposal was implemented, more or less, in the course of the 1960s. A tariff union was created to ensure a common market based on free trade for agricultural products between the six countries. All agricultural products were given their own market organizations with institutional prices. The market price on the internal market was to be stabilized through a system of intervention. In order to maintain the (high) prices at all times, the market organizations were combined with a system of variable import levies and export restitutions. In connection with this

4) Even though it is not very clear for the period around the creation of the CAP, it becomes obvious in 1968, when the Commission presented a proposal for the missing structural policy (European Commission, 1968), that the Commission were very much under influence of the early economic literature dealing with the farm problem approach mentioned in section 1. For an analysis see Zobbe (2001).

system, a Community preference was introduced to further protect the farmers in the six countries. The principle of common financing meant that all costs and benefits of the CAP were a matter of common interest and were to be handled through the Community budget. After a period of transition, the CAP was fully implemented in the late 1960s. The institutional prices for some of the major products can be seen in table 2. The high price levels were a result of a long and hard negotiation process between the six countries, and represented an asymmetric compromise in that primarily Germany and Luxembourg had argued strongly for converting their price levels into Community price levels, since these countries saw high prices as a necessity in order to secure the future of small and inefficient farms. Viewed in the light of today one can see that in this case history matters, because products with the highest protection levels, such as sugar and butter, are still among the most sensitive issues in international agricultural policy.

Table 2. Prices for certain agricultural products in the EEC compared with world price levels, 1967/68[a]

Product	EEC common price UC/100 kg. (1)	World market price UC/100 kg. (2)	(1) as a %age of (2)
Soft wheat	10.7	5.8	185
Hard wheat[b]	16.1	8.1	200
Husked rice	18.0	15.3	117
Barley	9.1	5.7	160
Maize	9.0	5.6	160
White sugar	22.3	5.1	438
Beef	68.0	38.8	175
Pig meat	56.7	38.6	147
Poultry meat	72.3	55.0	131
Eggs	51.1	38.7	132
Butter	187.4	47.2	397
Olive oil[b]	115.6	69.8	166
Oil seeds[c]	20.2	10.1	200

a) reference period differs for various products
b)including direct production aids
c) wholesale entry price
Source: Fennel (1997)

Another CAP issue, structural policy, became the responsibility of the national governments after similarly difficult negotiations. In this area, the political will to reach a compromise was hard to find. The only constraint that was put on structural policy committed the member countries to co-ordinate national structural policy on a Community level. The Commission would not accept this. They persisted in the idea that a common structural policy working together with price support was the ideal solution. In 1968 they presented a proposal for a structural policy reform of the CAP in COM (68) 1000 (European Commission, 1968).The aims of the policy were to implement measures that could ease structural adjustment in European agriculture, firstly by helping farmers to withdraw from agriculture through finding alternative occupations or taking

early retirement, and secondly by reducing the quantities of farms, land and dairy cows in the agricultural sector in an effort to decrease overall production. However, European farmers and key politicians in the majority of EEC member countries were not ready for structural policy reforms in the 1960s. According to Tracy (1976), the proposal provoked violent opposition in farming circles throughout the Community. The opposition was concentrated around the proposals for reducing amounts of agricultural labor and agricultural land, and the overall suggestion that the creation of large farm units should be the solution to Europe's agricultural problems (Tracy, 1976 p. 14). A watered-down version of the plan came into force in 1972, but because of the economic recession in Europe it made only a small impact (Tracy, 1984 p. 310-311).

4. Agricultural Policy in Europe before the CAP

Agricultural policies in the 1950s in the founding nations of the CAP naturally played a major role in the process of designing a common policy (Munk, 1994 pp. 112-113; Fearne, 1997 pp. 21-33; Ingersent & Rayner, 1999 p. 152). Policy objectives and instruments in the six countries are summarized in table 3. The objectives of the agricultural policies in the six countries were very similar, since they all covered production and income. The term *structural policy* covers various types of measures. According to OEEC (1956), the main type of farm in Europe at that time was a fairly small-scale family-owned farm which had structural problems to a greater or lesser extent. In Italy and Germany the rural infrastructure had been damaged by the war, and in the other countries there were also indications of a long period of neglect of the infrastructure. Another reason for different structural policy approaches was the different patterns of economic development among the six countries (Tracy, 1982 pp. 5-17). Increased production through increased productivity was seen as the solution to the farmers' income problem, and in all six countries a price policy combined with different structural policy measures was chosen as the way to obtain this goal. In Belgium, France, Germany and Luxembourg the policy was implemented through market organizations for the main products, with governments intervening in the market to obtain a higher price than the world market price. In the Netherlands the government only intervened in the market to maintain stable prices. In Italy there was no explicit price policy, though there was an implicit one, in that the state controlled all the trade in agricultural products. When one reads in the literature (OEEC,1956, 1957 and 1958) about the policies of the time in the six countries, it is easy to see how a CAP based on price support as the main instrument must have looked extremely simple to the decision-makers in the early 1960s.

The historical foundation of agricultural policies in the six countries went back to the arrival of cheap overseas grain that flooded Western Europe in the 1880s. The various European countries responded differently to this supply shock; this was for two reasons, according to O'Rourke (1997). First, the cheap grain generated different price shocks in grain-exporting and grain-importing countries; and second, even identical price shocks would have had different

effects on income distribution in different countries, due to the different roles played by grain production and agriculture in the general economies of these countries (O'Rourke, 1997 pp.798-799). The theoretical rationale for this is a simple textbook sector-specific factor model that assumes two sectors, Agriculture and Industry. Agriculture produces food using land and labor. Industry produces manufactured goods using capital and labor. Food is an import good, and manufactured items are an export good. Labor is mobile between sectors, and land and capital is immobile between sectors. The impact of cheap overseas grain in this model causes a drop in the grain price, which leads to a reduction of the labor force in agriculture. The workers migrate to the towns, nominal wages fall and Industry expands. The income distribution consequences of this are clear: owners of capital gain and owners of land lose. The obvious policy implication, according to O'Rourke (1997), was that landowners in the 1880s should favor agricultural tariffs and capital owners should favor free trade (O Rourke, 1997).

Table 3. The situation of agricultural policy in member countries before membership of the CAP

Country	Policy objectives	Policy regime
Belgium	Make farm incomes secure primarily through migration of farm labor.	(High)price policy and import controls.
France	Increase farm production to maintain farm incomes and balance of payments equilibrium.	(High)price policy through market organization with import controls and export subsidies.
Germany	Increase farm production through higher efficiency to maintain farm incomes and ensure fair food prices for consumers. Improve rural infrastructure.	(High)price policy combined with structural policy.
Italy	Increase farm production, raise productivity and promote land reforms to maintain farm income.	State engaged in both domestic and international trade. Structural policy in a broad sense including credit facilities for all farmers but specially those in the south.
Luxembourg	Increase productivity and production to maintain farm income.	(High) price policy (certain price levels could not be exceeded) through market organization with import controls. Structural policy.
Netherlands	Creation of such conditions as would enable agriculture to contribute in the largest possible way to the national wealth. Price stability.	Price policy and import controls and export support. Structural policy in the broad sense.

Note: From 1955 the three Benelux countries (Belgium, Netherlands and Luxembourg) took a joint decision to harmonize their agricultural policies over a seven year period.
Source: OEEC (1956, 1957 and 1958).

Other major influences over the years have been the great depression of the 1930s, when the

agricultural sector in Europe really was down on its knees, and then of course the two world wars, with war economies and serious structural damage to the heartlands of Europe. For an overview of the impact of these events on agricultural policy in Europe, see Tracy (1976). The result was that the road chosen was paved with protection and price support, and subsequent events tells us that this path was hard to leave.

Even though it is not possible in this paper to give a full description of the foundation of the policy in all six countries, it is necessary to devote some space to a discussion of France. In the economic literature dealing with the creation of the CAP there is a strong consensus that France was the leading agricultural economic power in Europe at that time, and that France was the main driving force in the process of designing a common policy for agriculture[5]. The latter has something to do with the power struggle between France and Germany. According to Grant (1997), it was in the interests of France to ensure that the German market was open to their agricultural products; only if this was possible would France open up its markets for industrial products from Germany (Grant, 1997 p, 63). In the 1880s France decided to take the road of protection in order to defend its farmers from the influx of cheap overseas grain. According to Tracy (1982), agriculture in large parts of the French countryside in the latter part of nineteenth century was at the level of subsistence farming using traditional methods; there was low productivity and little contact with the market outside France. The rural population had a generally low level of education; there was widespread illiteracy, and standards of living were low (Tracy, 1982 p. 66). In 1871 around 50 percent of the French labor force was employed in agriculture (O'Rourke, 1997 p. 792), and the industrial revolution in France, the start of which is generally dated to 1861, played no particular role for the agricultural sector at this time in history. There was only limited opportunity for the peasants to better their situation by migrating to the cities (Tracy, 1982 p. 67). The industrial sector had little use for cheap unskilled labor and had little to offer the farm sector in relation to technology. The case of France fits perfectly into the policy conclusions of O'Rourke mentioned above. The First World War had left France with major problems for the agricultural sector, due to damage to the land and the infrastructure. During the 1920s there was great discussion about the tariff policy established in the 1880s and the relationship of this to the needed kick start to the industrialization process, which was slow in France. The main farm organizations claimed that industrialization would mean low levels of protection for agriculture, and its consequent decline; and since agriculture was essential to France, its decline would mean the decline of the nation (Tracy, 1976 p. 3).The French policy of protecting agriculture survived throughout the period until the creation of the CAP because of the great depression, World War Two and strong French farm fundamentalism in many circles.

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5) Even though the Netherlands had a more market-oriented approach than the other five countries, they could not shift the official French viewpoint about the design of the CAP. If the UK had continued to play a role in the debate the Netherlands might have been able to play a different role in the process.

5. The economics of agricultural policy and the choice of policy regime

As mentioned in the introduction, the five objectives of the Common Agricultural Policy (outlined in section 3) can be divided into two broad groups, concerned with production and income respectively. The first group includes productivity, market stabilization and the availability of supplies. The second group concerns ensuring a reasonable income for farmers on the one hand and a supply of food products for consumers at reasonable prices on the other. According to basic economic policy theory, two objectives demand two or more policy instruments. The Commission presented their ideal proposals for the CAP in 1960 in COM (60) 105 and in 1968 in COM (68) 1000, and the two plans introduced price support and structural policy as the two major instruments of the CAP. The former was seen as the best solution to deal with the desire to increase agricultural production and stabilize markets, while the latter was seen as the best solution for increasing productivity and ensuring a reasonable level of income for farmers. In the following, the alternative to price support, deficiency payments, will be compared with price support. The characteristics of both instruments are shown in figure 1. Both diagrams in figure 1 shows supply and demand curves for agricultural products in a net-importing country in a simple price/quantity framework. The initial point of departure is the price, p, which gives the supply qs and the demand qd. The distance between the two is the level of imports needed. Let us first consider the price support solution.

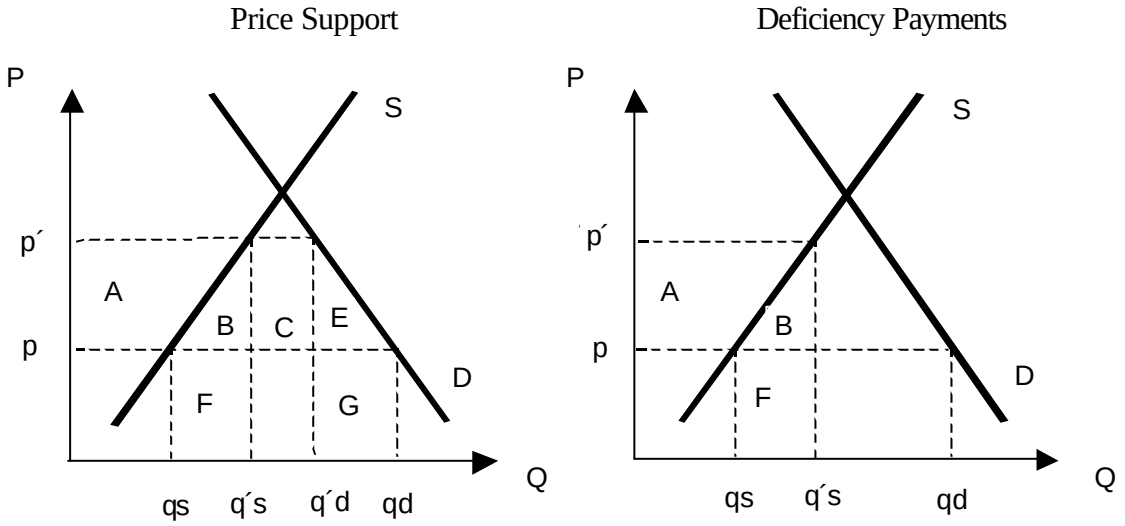

Figure 1: The effects of the implementation of price support and deficiency payments on the market for agricultural products in a large net-importing country.

The government sets the institutional price p and that increases production to q s and decreases demand to q d. Another effect is a decrease in imports to the amount q sq d. In order to control this internal price independently of influence from the equilibrium price (world price), a system of trade barriers must also be implemented. In the case of deficiency payments, on the

other hand, the government sets a target price p at the level they want the farmer to receive for his products. This target price increases production to q s. The equilibrium price, p, is still the market price, and consumers still buy qd. In this case there is a decrease in imports to the amount q sqd.

Table 4 summarizes the welfare economic effects of the two instruments. In both cases the producers gain the same amount, the area A. In the situation with price support this gain is financed by the consumers, since they pay a higher price than the equilibrium price for their food products. The consumer loss is the area A+B+C+E. Because of the import levy the government gains C, and in a sense also the areas F and G, because the amount of (scarce) foreign currency needed for imports decreases. The net loss, or the welfare economic loss, of implementing a price support policy is B+E. In the deficiency payments case the producers' gain is paid by the taxpayers, because the difference between the target price and the equilibrium price is transferred directly to the farmers from the fiscal budget. The taxpayers' loss is A+B. Again, the increase in production produces a decrease in the use of foreign currency due to a reduction in imports, in this case the area F. The welfare economic effect of implementing deficiency payments is B. Figure 1 does not show the effects of the internal policy on the world market, but because of the size of our country, the increase in production pushes the world market price down. In the first case this means that consumers have to pay a larger amount in price support; in the case of deficiency payments it actually means that consumers benefit from lower prices, but it also means that the amount directly transferred from the state to the farmer increases. Both instruments transfer money to agriculture and increase production. The main differences are the control of the market price in the price support regime and the type of financing. The choice of price support thus allows the CAP to help with respect to both the production objective and the income objective (at least in the short run). The financial aspect will be dealt with later, but it is clear that price support has the beneficial effect of creating revenue for the fiscal budget, while the effect of raising consumer prices causes a decline in demand for imports and thus brings about a greater increase in foreign currency reserves (F + G) than is the case with deficiency payments (F).

Table 4. Welfare economic effects of the implementation of price support and deficiency payments on the market for agricultural products in a large net-importing country

	Price Support	Deficiency Payments
Producer Gain	A	A
Consumer Loss	A + B + C + E	
Taxpayer Gain	C	
Taxpayer Loss		A + B
Net Loss	B + E	B

The second instrument of the Commission's ideal CAP was structural policy aimed at reducing the quantity of farmers, land and cows. To understand the logic of the Commission's proposals

and the ability of this instrument to provide good income for farmers and increase productivity, it is necessary to study the economic background of the so-called income problem in agriculture, which was briefly touched upon in section 1. In the economic literature this is known as the farm problem approach, and a simple model of the farm problem (Gardner, 1993 pp. 63-67) is illustrated in figure 2 below. The symptoms of the farm problem are, according to Schultz (1945), the low earnings of farm people relative to others in the economy, and the great instability of income from farming from year to year (Schultz, 1945).The farm problem is a very complex one. For economists, the problem concerns the misallocation of resources, or in other words the use of too many resources producing farm products relative to other goods and services. To the farmer, the problem is a paradox because, despite hard work and large capital investment, the result is a low and unstable income (Hathaway, 1963 p. 81). The agricultural market is characterized by inelastic supply and demand curves, shown in figure 2 by S and D respectively. The characteristics of the nature of the agricultural supply curve can be summerized in three points: first, the high degree of dependence of agricultural production on biological and climate-related factors (Johnson, 1950 and 1958); second, the organization and structure of farms that make agricultural supply fairly independent of variation in prices (Schultz, 1945 and 1953) — the most important argument in this case being that the alternative use of the factors of production in agriculture is of little use elsewhere and therefore they have a high degree of fixity (Johnson, 1958)); and third, the influence of general developments in the overall economy and technology (Schultz, 1945; Cochrane, 1958), which leads to an increase in productivity and a worsening of the terms of trade for agriculture in response to economic growth. The inelastic nature of the demand curve is due to Engel's law and the fact that food is a necessity good.

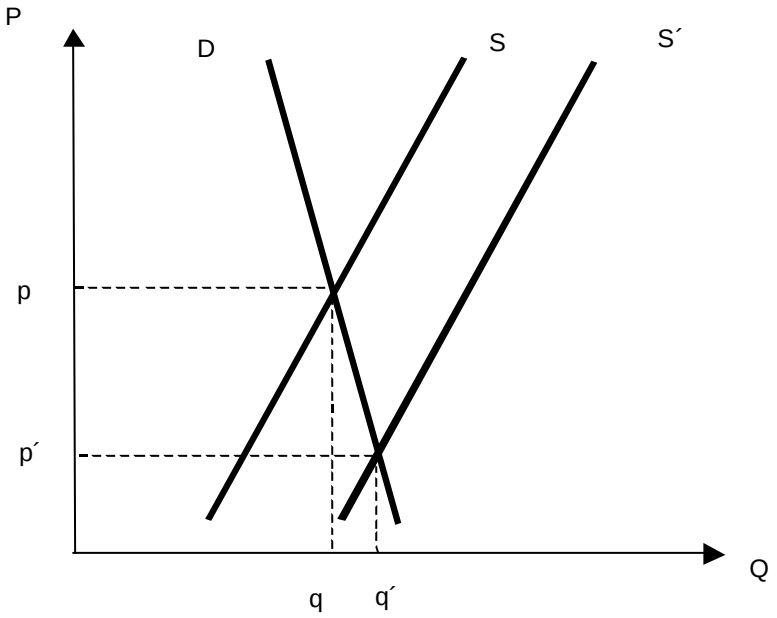

Figure 2. The Farm Problem model showing the market for agricultural products, with the characteristic inelastic supply and demand curves. Over time the demand curve will not move much, because of low population growth and Engel's law. The supply curve moves over time due to technological developments,

and this will put pressure on overall farm income.

According to Cochrane (1958), the root of the problem is the long-run race between aggregated demand, driven by slow growth in population, and aggregated supply, driven by the implementation of new technology by farmers to lower total costs of production. To illustrate this in figure 2, demand D is fixed . Technology developments move S to S and therefore increase production from q to q , which makes the price p fall to p . Farmers implement new technology to reduce costs because the price is given, and therefore every time the price drops they implement new technology. The farmer is thus trapped on a treadmill. Cochrane (1958) sees the implementation of technology as a dynamic process and therefore not all farmers benefit to the same degree from it. Those who hesitate are not able to maintain their income. In a world like this some farmers will always gain more money, the majority will maintain their status quo, and the laggard will lose money. On average, the overall income from agriculture will always be under pressure (Cochrane, 1958 pp. 85-107).

According to the old approaches to the farm problem, the solution to the income problem is structural policy measures that help the laggards to leave agriculture, combined with a market-oriented price support policy (Johnson, 1947; Cochrane, 1958). This can be achieved by means of early retirement schemes or by raising the farmers' alternative value outside agriculture through education, and by providing job opportunities in the urban sector through macroeconomic policy in general. The proposals from the Commission in COM (68) 1000 fitted in perfectly with this idea. This view was also shared by the OECD (Organization for Economic Co-operation and Development) in two reports from 1961 and 1964, where structural policy measures to increase the mobility of factors of production in agriculture were recommended to solve the income problem (OECD, 1961 and 1964). As mentioned earlier, the political will among the ministers of agriculture in the six member countries to implement a common structural policy was lacking, due to the different approaches to structural policy (Fennell, 1997 pp. 38-39) mentioned in section 4. Another major factor in the rejection of a common structural policy was the financial aspect, because calculations showed that such a policy would have to be very costly if it were to succeed. The choice of price support without any kind of structural policy to ease adjustment is not a sound policy in the long run. Such a policy creates overproduction and brings no solution to the farm problem and hence none to the income problem. In more modern economic literature addressing the income problem, structural adjustment policy is seen as the only solution[6] (Tweeten,1979 and1989; Gardner, 1987).

Finally, let us consider discuss the choice of price support as the main instrument of the CAP from the perceptive of the decision-makers in the EEC around 1960. In the light of the Commission's proposals and the strong foundation of those proposals in agricultural economic literature, the question of why a price support mechanism was chosen is of considerable

6) For an analysis of why key agricultural economists changed their policy recommendations for solving the farm problem see Gardner (1996).

importance in the understanding of the Common Agricultural Policy. To answer this question we must consider the financing of the CAP, which operates through higher prices for agricultural products in the European market relative to the world market and a common EEC budget based on the principle of financial solidarity. The European economies had just recovered from a long and turbulent period of depression and entered a period with prospects of high economic growth which were unique in history. Agriculture in the 1950s and in the beginning of the 1960s was still a major part of the general economy in Europe with respect to its share of GNP and employment (see table 1). The ideal working of the price and market policy and of the common budget was seen as being that in the beginning, when the EEC was a net importer of most agricultural products, the CAP would generate revenue for the budget and therefore be able to pay for export restitutions for products where the EEC was a net exporter. Empirical studies summarized in Neville-Rolfe (1973) indicate that by switching transfers to farmers from the national budget to the EEC budget, countries such as Germany and France saved money that could then be used in other sectors of the economy (Neville-Rolfe, 1973 pp. 21-22).

Table 5. Implications of fiscal transfer to farmers in the EEC in 1967 if the EEC level of support was renationalized and changed from a price support regime to a direct support regime

	GDP in billion US $	Agriculture s share of GDP in billion US $		Total tax revenue in billion US $	Tax revenue needed to finance fiscal transfers to farmers	
		Total	whereof support[a)]		Billion US $	Increase needed in percent
France	99.4	8.1	4.1	34.5	38.6	11.9
Holland	20.5	1.5	0.8	7.2	8.0	11.1
Belgium	17.1	0.9	0.5	5.8	6.3	8.6
Luxembourg	0.6	0.0	0.0	0.2	0.2	-
Germany	107.6	5.1	2.6	30.3	32.9	8.6
Italy	62.0	7.9	4.0	20.0	24.0	20.0

a) According to two studies, the amount of support in 1966/67 in the EEC was around 50 percent of the total value of agricultural production.

Sources: Statistical Office of the European Communities (1970), OECD (2000b), Gulbrandsen & Lindbeck (1969) and Vandevalle & Meeusen (1971).

Another explanation of the choice of price support, based on the same line of argument, is a counterfactual one. If deficiency payments had been chosen as the main instrument of the CAP, the fiscal transfers to farmers would have been large; this might have resulted in higher taxes that could have created distortions in the economies of the EEC countries and perhaps dampened the growth process. Both Gulbrandsen & Lindbeck (1969) and Vandevalle & Meeusen (1971) estimate the total transfers to EEC farmers in 1966/67 to be around 50 percent of the total value

of production. In France the total value of agricultural production in 1967 was around US $ 8 billion. This means that the French government would have had to transfer US $ 4.1 billion from the fiscal budget to the farmers. This amount equals 4 percent of GNP in France in 1967, or in other words would have required an increase in the total French tax revenue of 11.9 percent (Statistical Office of the European Communities, 1970 p.17; OECD, 2000b). Table 5 summarizes these counterfactual statistics for all EEC countries. During the 1960s, with high economic growth rates in Europe, the growth of wages in real terms more than offset the rising food prices due to the implementation of the CAP in the same period (Fennell, 1973 p. 6), and this helped to avoid the policy attracting public criticism. The characteristics of the financial aspects of the CAP, together with the simplicity of the policy in regard to the low level of transaction costs needed to operate such a regime, must have made it easy for the decision-makers to reach an agreement.

6. Conclusion

The Common Agricultural Policy officially came into force on January, 1st 1958 as a part of the Treaty of Rome. The policy was actually implemented throughout the 1960s. Since then the CAP has been under pressure, for many reasons. The core of the criticism has often been centered around the choice of a price and market policy as the main instrument of the common policy. The conclusion of this paper is that viewed in both economic and historical perspectives, the choice of price support as the main policy instrument was a logical one.

The first argument for this is that the CAP was a result of the general economic integration in Europe rather than the reason for it. Even though talks on an integrated agricultural policy began in Europe just after the end of the Second World War and continued for years, it was clear to decision-makers that it was going to be very difficult to reach any consensus about the design of a common policy. The Treaty of Rome was signed in late 1957 to ensure that the integration process would take place and also to ensure general political stability in the region. Article 39 stated the objectives of the CAP and article 43 placed responsibility for designing the actual policy with the Commission. The deadline was two years. This must have created some pressure on the Commission, and they therefore delivered their proposal in two stages. The first of these, put forward in 1960, presented a policy based on a price and market policy. This must have seemed fairly simple and straight-forward to the agricultural decision-makers of the day, and it was easy to find a consensus in favor.

The second argument is part of the former argument. The CAP was determined by the agricultural policies of the six founding countries. The historical foundation of these policies goes back to the influx of cheap overseas grain that flooded Western Europe in the 1880s. Other major influences over the years have been the great depression in the 1930s and the two world wars. The objectives of the agricultural policy in the six countries were very similar to those which later became the objectives of the CAP, in that they all considered production and income. The main type of farm in Europe after the Second World War was a fairly small-scale family-owned farm

which had structural problems to a greater or lesser extent. Increased production through increased productivity was seen as a solution to the farmers' income problem. In all the six countries, a price policy combined with various structural policy measures had been chosen as the means to achieve this goal. The reasons for the differences in structural policy approaches were the different patterns of economic development among the six countries.

The third argument has to do with the financial aspects of a price and market policy in connection with a common budget. In the proposals for the CAP made around 1960, it was easy for the politicians to see that the CAP would create revenue for the common budget through import levies as long as the EEC was a net importer of most agricultural products. It was also easy to see that the consumers would not create problems even though they were paying for it all, because it was believed that the economic growth would generate growth in income in real terms in the implementation period of the CAP that would offset the food price increases. The alternative to price support would have been deficiency payments, and had that instrument been chosen it would have dampened economic growth because of the distortions created by taxes raised to create revenue to transfer to the farmers.

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