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Economics Revision Focus: 2004

AS Economics

Costs and Benefits of Farm Support

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Revision Focus on Costs and Benefits of Farm Support (AS)

AS Syllabus Requirements

Government Intervention and Government Failure
Candidates should be able to apply economic models to assess the role of markets and the government in areas such as **agriculture and the CAP**. Candidates should appreciate that government intervention does not necessarily result in an improvement in economic welfare. Governments may create rather than remove market distortions.

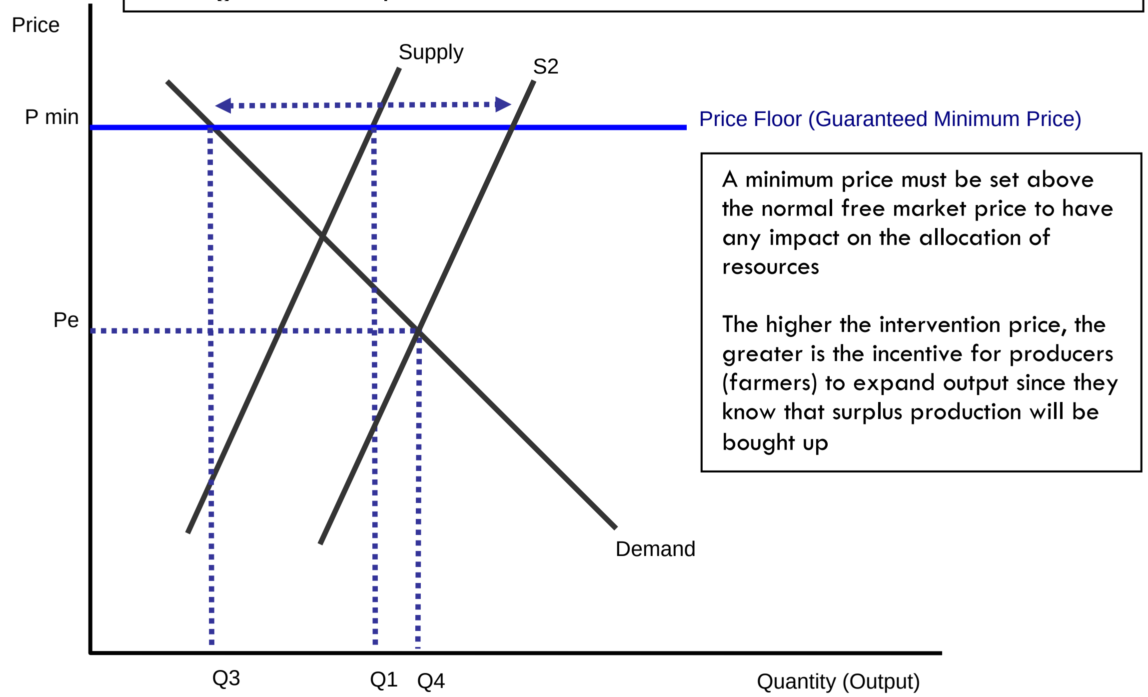
All governments intervene in their farming markets to one degree or another. But farm subsidies are controversial – indeed many economists regard them as a prime source of **government failure,** acting to **deepen existing market failures** and cause a further loss of economic and social welfare.

In this revision focus we consider the theory of farm support and the costs and benefits of the CAP system of agricultural support. We also consider the recent reforms of the CAP and what they are intended to achieve.

The economics of farm support – volatile prices and incomes

The prices of agricultural products such as wheat, tea and coffee tend to **fluctuate** more than the prices of manufactured products and services. This is largely due to the **volatility in market supply** of agricultural products coupled with the fact that demand and supply are both price inelastic. One way to smooth out the fluctuations in prices is for the government to operate **price support schemes** through the use of **buffer stocks**. Buffer stock schemes seek to **stabilize the market price** by buying up supplies of the product when harvests are plentiful and selling stocks onto the market when supplies are low.

Setting a minimum price for wheat – and the effects of an increase in market



The previous diagram illustrates the operation of a buffer stock scheme. The government offers a **guaranteed minimum price** (P min) to farmers of wheat. The price floor is **set above the normal free market equilibrium price**. Notice that the price elasticity of supply for wheat in the short term is low because of the length of time it takes for producers to supply wheat to the market.

If the government is to maintain the guaranteed price at P min, then it must buy up the excess supply (Q3-Q1) and put these purchases into **intervention storage**.

Often the high guaranteed minimum price is a signal to producers to increase **capital investment** spending and devote more resources to stepping up production. After all, they know that whatever they produce, the purchasing agency stands ready to buy-up surpluses at the intervention price. The effect might be a **large rise in market supply** which under normal circumstances would cause the free-market price to fall in order to balance supply and demand.

In this situation, the government will have to intervene once more in the market and buy up the surplus stock of wheat to prevent the price from falling. It is easy to see how if the market supply rises faster than demand then the amount of wheat bought into storage will grow – hence the emergence of **large stockpiles of farm output** – butter mountains, wine lakes, olive oil surpluses etc that were characteristic of the Common Agricultural Policy until a few years ago (it has since been reformed).

Costs and benefits of guaranteed minimum prices

In theory buffer stock schemes should be profit making, since they buy up stocks of the product when the price is low and sell them onto the market when the price is high. However, they do not often work well in practice. Clearly, **perishable items** cannot be stored for long periods of time and can therefore be immediately ruled out of buffer stock schemes. There are also **high administrative and storage costs** to be considered.

The Common Agricultural Policy has come under sustained criticism from many quarters including the British Government which has been a supporter of the reform process.

UK Government Policy on the CAP

The current CAP is not delivering what farmers, the rural economy or the environment need. It is an expensive policy and is insufficient to meet the challenges posed by the enlargement of the EU. Reform is also vital to improve the position of developing countries, who find it harder to access our markets when the EU subsidises its own production. The UK Government's goal is to reduce the overall burden of the CAP, delivering better value for money to taxpayers and consumers; encouraging animal welfare; reducing damage to the environment; giving a better deal for farmers and making world trade fairer.

Source: Adapted from the DEFRA web site www.defra.gov.uk

The main criticisms of the CAP are as follows

1. **Productive inefficiency:** Generous CAP intervention prices have encouraged excess production of many farm products and permitted production inefficiencies and **dependency on farm subsidies** - all of which leads to a **mis-allocation of scarce resources**. Much of the price support goes to farmers who need it least. Because most support is production-based, the bulk of it goes to the larger, often richer, farms able to exploit **economies of scale**
2. **Loss of allocative efficiency and consumer welfare:** The CAP is seen by much of the public as failing to deliver what society wants and needs from agriculture in terms of food safety, animal health and rural environment. It is neither consistent with policies on **sustainable development**, nor

with consumer demands for high quality, local and regional foods. And consumers have ended up **paying twice for their food** – once in higher taxes to fund farm support and secondly in **higher prices of imported foods** because of the **tariff** levied by the EU on many foodstuffs entering the European Union

3. **Fiscal Costs**: The financial cost of EU farm support policies has been huge (well over £40 billion for the EU as a whole in 2002) and involves a **large opportunity cost** – that money might well have been spent on more socially useful programmes over the years
4. **CAP Fraud**: The cost of maintaining the CAP is magnified by what some regard as endemic fraud within the system and rising **costs of administration and compliance**
5. **Loss of equity**: Farm support imposes higher food prices for EU consumers and the cost hits low income families most because they spend a higher proportion of their income on food implying a **regressive effect** on the distribution of income
6. **Environmental Concerns**: The CAP has encouraged **intensive farming** which is prompting concern about the environmental impact of CAP. One recent study of olive growers showed they used more than 400 times the recommended level of **pesticides** – and more generally the trend towards intensive farming is seen as imposing significant **external costs** on the European economy – externalities are a root cause of market failure. Intensive farming has destroyed much of the countryside, turning once traditional landscapes into stretches of tightly packed rows. The disincentive to follow normal crop rotation strategies ruins the soil and in markets where price supports still exist, there remains a direct link between production and profit. Naturally, they then make maximizing production their first priority. We must remember though that putting a value on the environmental damage caused by intensification of farming and use of pesticides is extremely difficult
7. **Global Market Distortions – a barrier to international trade:** The CAP is seen by many critics as **anti-competitive** and distorts domestic, European and international markets threatening the development potential of many lower-income countries. The EU spent £2.14 billion on export subsidies in 2001. The CAP is a cause of tension between the EU and the rest of the world in global trade negotiations

According to a recent speech by Gordon Brown:

"The CAP is expensive, inefficient and ineffective. Because three quarters of the world's poor live in rural areas, because 96 per cent of the world's farmers live in developing countries, our agricultural protectionism costs developing countries 20 billion dollars a year directly, up to 100 billion dollars indirectly -- twice the amount of development aid they receive."

Reforming the Common Agricultural Policy

For several years now farm ministers have been negotiating widespread reforms of the Common Agricultural Policy. There is recognition that CAP reforms are important in the context of the economic welfare of consumers in Europe – but also trade and development issues throughout the global economy.

The main elements of the reforms are as follows:

1. **Replacing price support with a single annual income payment for farmers**: farm payments will no longer be linked to the amount produced (this is known as **"de-coupling"**). Initially the new system will apply mainly to arable farm production and will be extended to beef and sheep

sectors from 2008. If the reforms are implemented in full – 90% of CAP payments will no longer be linked to production

2. **Linking farm incomes to protection and improvement of the environment:** Farmers must meet clear rules on the environmental impact of their farming, food safety and animal welfare and plant health to qualify for the annual income payments. In this sense the CAP will reward farmers who treat their environment as a public good with positive externalities for those people who enjoy our rural heritage
3. **Cutting payments to the largest farms**: CAP aid payments to larger farms of more than euro 5,000 per year will be cut and the proceeds used to encourage **rural development**
4. **Reductions in guaranteed minimum prices:** The intervention price for butter is being cut by 25% over 4 years. There is a 15% cut in intervention prices for skimmed milk powder and a freeze on prices for cereals. You can easily show the effects of a reduction in guaranteed prices using supply and demand diagrams
5. **Extra funds for rural development to promote new employment in farming areas**: The EU rural development fund currently worth around euros 5 billion per year will be given an extra euro 1.2 billion a year – partly this is to improve employment opportunities for young people living in farming areas and to reduce the risk of increased structural unemployment

Will these reforms work?

Some of the main issues to consider are as follows:

1. **The future of smaller-scale farming**: Will reductions in direct payments for production stimulate increases in farm productivity due to a switch to larger-scale production? Trends in the Danish pig industry which is now a sector free of all farm support are illustrative of what is likely to happen. In 1991 only 9.5% of pigs were reared from suppliers with pig herds of 5,000 or more. By 2001 that percentage had grown to 34.1%
2. **Dynamic efficiency gains?** Will reforms to the CAP stimulate improvements in the dynamic efficiency of the UK and European farming industry? Supporters of reform believe that cutting dependency on financial support will encourage farmers to diversify the use of their land including breaking into rural tourism and focusing resources on supplying niche products to local markets / farmers' markets
3. **Risks of unemployment:** Will there be sufficient geographical and occupational mobility in the farming industry to cope with falling price support? The main risk is a sharp rise in structural unemployment and associated problems of rural poverty arising from occupational immobility of labour. That said, the British farming industry has suffered greatly in recent years even without fundamental reforms to the CAP
4. **Will food prices fall?** Textbook analysis would suggest that reducing import tariffs for food coming into the UK and reducing farm support prices should lead to an increase in non-EU food supplies into the EU and lower food prices in real terms. However the extent to which lower costs passes through the supply chain to lower prices for consumers at retail level is dependent on several factors. Will food manufacturers (who should benefit from lower input costs) pass these savings onto retailers who then pass them on to consumers?

5.

Main Winners from CAP Reforms	Main Losers from CAP reforms
Consumers – lower food prices and **improved food safety** in the long run	**Uncompetitive farmers** kept viable by farm subsidies – the future of small farms is a major issue in France, southern Europe and many of the accession countries
Taxpayers – from the reduced fiscal burden of farm support – important to countries such as Germany and the UK (both of whom are net contributors to the CAP)	**Farmers least able to diversify** – this may lead to a rise in unemployment and rural poverty in some regions and countries
Food manufacturers and retailers – higher profit margins	**Landowners** – farm reforms may lead to a fall in value of their assets
Developing countries – freer access to EU markets. The World Bank has estimated that a 50% cut in the subsidies and tariffs protecting developed countries' farmers would boost developing countries' economies by £90 billion	
Larger-scale commercial farmers with modern capital inputs, able to exploit economies of scale and already competitive in international food markets	