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## Common agricultural policy in disarray: How to get out of the deadlock?

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COMMON AGRICULTURAL POLICY IN DISSARRAY  
HOW TO GET OUT OF THE DEADLOCK?

by

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## CAP in Disarray: How to Get Out of the Deadlock?

### 1. The State of the Common Agricultural Policy (CAP)

When the CAP was established back in 1958, it was a powerful means for the economic or - even more ambitious - for the political integration of the European Community. In more recent years, however, it has been identified by a growing number of people as both the origin of mismanaged agricultural markets and of political quarrels, both within the Community and with non-member countries. Some of the well-known results of the CAP are the wine lakes and butter mountains, resulting from high guaranteed producer prices. In the summer of 1987, they surpassed quotations on world markets by the factor of two or three in order of magnitude. Disposing surpluses on either international or national markets through export restitutions or subsidies for an inferior usage (e.g. butter as feed for calves, distillation of wine for fuel-alcohol) has proved to be very costly. The main consequences of this policy which are seriously aggravated by additional subsidies on the national or even regional level could be summarized as follows:

- a high and permanently increasing financial burden for consumers, caused by high food prices;
- the abuse of subsidies and fraud on the level of production, manufacturing and foreign trade due to a permanently growing number of regulations, initiated on the political level to overrule market incentives and difficult to control;
- dramatically expanding budget expenditures increasing at average rate of 20 p.c. between 1975 and 1985. In 1987, outlays for market regulation only (Guarantee Fund) will amount to 25 billion ECU. As the overwhelming share is spent on income transfers to foreigners, inferior internal usage or even on the destruction of food commodities rather than on investments supporting economic development, current plans to expand the EC's own financial resources cannot be justified on economic grounds;
- trade conflicts with non-member countries increasing in number and severity, which are spread increasingly by these countries

to non-agricultural markets where EC-producers have comparative advantages;

- and, last but not least, high economic costs to the EC economy (social costs) in the range of 10 to 20 billion ECU per year (EC 10), depending on the year of estimate, different assumptions and estimation procedures<sup>1)</sup>. These estimates seem to be on the lower end as, among others, administrative costs or costs of democratic machinery and of lobbying are not included. Another important macro-economic aspect of the CAP is an estimated loss of jobs of up to 1 million (Stoeckel et al., 1987, p.9).

With respect to the unification of markets as envisaged for 1992, the achievements of the CAP are equally disappointing. In 1987, price differentials among member countries were as high as 40 p.c. for major commodities. They do not result from transport costs but from Monetary Compensatory Amounts (MCA's) which maintain separate exchange rates, sometimes for single agricultural commodities. This seems to be a typical example of distorting competition.

In addition to the grave disadvantages mentioned above, the CAP has, not surprisingly, missed its main objective, namely the sustained increase of farm income per employee, because income support via higher prices tends to diminish the outflow of labor from the agricultural sector. Ultimately, price support has led to higher returns on land, the only immobile production factor. This has increased land prices which, in turn, has reduced structural change to larger unities. A comparison with several industrial markets lacking such a Common Policy indicates that an unification of markets can be achieved by securing a free flow of commodities on the basis of undistorted competition rather than via intricate common or national policies.

1) Some recent estimates can be found in BAE, 1987, p. 107, (e.g., for 1978: 11.2 billion ECU; 1983: 8 billion ECU) and in Winters (1987), which is actually an overview from a number of recent estimates, a.o. from Anderson/Tyers with 24 billion US-Dollars (1980 prices) for 1985.

## 2. Reform Proposals - Pretension and Reality

Changes in the CAP that have already been implemented or new proposals could be classified in two broad categories:

- reducing supplies by either production quotas (milk and sugar) or paid land diversion, where the final objective is to maintain high producer prices or even to widen the scope for further price increases;
- shifting production incentives to crops with a low degree of self-sufficiency and to renewable raw materials for industrial use.

Production quotas already in use or their implementation in additional markets raise unearned income (economic rents) for producers already in business. Highly-qualified farm managers who would like to expand production because of low production costs are prevented from doing so. Quotas delay structural change<sup>2)</sup>; the risk of quotas being extended to other commodities, or the possibility of quotas cut, hamper investment decisions in the agricultural sector as well as in food-processing firms. As regards quotas, bureaucracy expands at the cost of entrepreneurial freedom. The frequently observed preference of politicians for quotas compared to price cuts can be explained easily: support for a producing sector in the political arena is much easier to accomplish through higher prices than, for example, through direct payments to farmers for which parliamentary consent would be necessary and which would show up in the budget.

Paid land diversion along with persistently high agricultural commodity prices aggravate distortions of factor use in agriculture. *Ceteris paribus*, intensity of land use will be further increased, labor productivity and labor income will decline as economic rents to landowners rise. Land prices will stay at a high level or will even increase, preventing an accelerated structural change to larger units. Apart from considerations on

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2) For a theoretical and empirical analysis see M. Hartmann and P. M. Schmitz (1987).

allocational inefficiency, structural change may be inevitable in certain regions<sup>3)</sup> on distributional grounds, namely to increase the income capacity of farms. The distributional effects mentioned above, are not quite in accordance with the pretension to increase income per capita in agriculture, because people employed in agriculture and land owners are far from being identical. Up to now, only minor programs on national or regional levels have been implemented. But as larger or financially more attractive programs are to be implemented, already now mobility of both land and labor are likely to be affected negatively.

Forcing the cultivation of commodities of - up to now - a low degree of self-sufficiency, e.g. rapeseed, sunflowers, soybeans or peas by even higher incentives for producers than they get for traditional crops, gives an additional push to economic costs for the community. Not the degree of self-sufficiency but the relative competitiveness in comparison to non-member countries should determine the production structure within the EC. This could be accomplished by approximating price relations on the international markets and within the EC. Market chances cannot be derived from low internal production, otherwise one might as well support the cultivation of bananas or of pineapples. The support of cultivation and usage of renewable resources for industrial use has the same objective: the substitution of imported raw materials. That would make sense only if the commodities in question, e.g., flax could be produced at lower costs within the Community. However, this expectation is in contradiction with all results of specific economic expertise. One exception could be wood, but only if the high opportunity costs of land, as a consequence of agricultural protection, could be reduced.

The production of ethanol from renewable resources such as wheat or sugar beets is another topic which is discussed controversially, especially since the number of so-called pilot plants in-

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3) The average farm size in 1985 was e.g., in the UK 65 hectares, Germany 16 hectares. Source: EC-census on structure in agriculture 1985.

creases and the French government has decided to support their production and usage. Again, the literature on the subject, including the latest expertise on behalf of the EC, is unanimous in pointing to a lack in competitiveness of bioethanol production<sup>4)</sup>. The most convincing proof for this fact seems to be the call for subsidies by interest groups outbidding one another with respect to the amount that is allegedly necessary. The widespread view of politicians that cultivation of renewable resources could decrease income deficits in agriculture cannot be justified. Technical progress in plant breeding and processing expected for the future would not change the competitive position of the EC, as this knowledge is available all around the world and will improve the cost position of land-rich countries, e.g., in North or South America.

Summarizing reform proposals, priority is obviously given to the limitation of, or - more ambitiously - the reduction of surpluses. As this would be curing symptoms rather than causes, not even here is visible relief in sight. On the other hand, one could safely assume that because of more regulation, total income losses of the EC-society will increase further. This is the consequence of high protection which keeps too much capital and labor within the agricultural sector. Transfers to agriculture, which amounted to an estimated 56 billion ECU in 1983 (BAE, 1985, p. 104), are nothing but taxes on the non-agricultural sectors. As a result, competitiveness deteriorates and growth and expansion of employment opportunities are endangered.

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4) This statement has to be qualified with respect to economic-side conditions relevant for ethanol production. Pursuing a second-best policy, the EC could compensate alcohol producers for high agricultural prices (input costs) by making inputs available at world market prices. No other support, such as investment subsidies, lower fuel taxes or risk back-up by the EC or national governments, could be economically justified. Under these qualifications, on a strictly private basis, with the risk on investment being left to entrepreneurs, the rise of an ethanol industry is very unlikely. This assessment is confirmed by a decline in bioethanol production in the US and Brazil, countries with very low input costs and even additional government support.



### 3. Coordination by Markets

A policy in accordance with the principles of a market economy is characterized in the first place by governments which - on all administrative levels - limit themselves to institutional policy, i.e., they keep out of fields where markets will coordinate consumer wishes and producer plans more efficiently. To avoid inefficiencies due to competing competences in the decision structure of a federal community such as the EC, some additional principles such as subsidiarity, fiscal equivalence and local accountability have to be observed. This might be wishful thinking, given the realities in existing federally-organized states, e.g., Germany. However, trying to avoid a renationalization of markets, the recognition of the above-mentioned principles would seem to be of utmost relevance for the further development of the EC. As the establishment and maintenance of unified markets is an important field for activities of the Community, e.g., the details of direct income payments to the agricultural sector repeatedly suggested by different institutions, should be closely supervised by the EC to avoid competitive distortions between member countries. But transfers should be financed on the national or regional level. Efforts to redistribute income between member countries could be realized more efficiently by direct budgetary assistance than by more or less unplanned effects of the centralized agricultural price and income-policy presently observed. Following the principle of subsidiarity, plans for environmental protection could basically be established, implemented and financed on the national or local level, strengthening local accountability.

Market forces should not be restricted to the internal market. Dramatic differences in production costs and consumer preferences around the world ask for open borders. This remains valid even if the economy of non-member countries is not ruled by pure market forces.

Producers should earn their income on markets, i.e., they should be paid in accordance with their own performance and not arbit-

rarily as today, by politicians in the way that the council of ministers decides on prices and production quotas.

For farmers to be paid according to their performance includes both the necessity and the freedom to produce the goods and services for which consumers are determined to pay. Then commodities would no longer be stored in warehouses as is now the case, but food specialities, golfcourses or holiday farms would appear on the market. In contrast to politicians, bureaucrats and scientists, the creative ideas of entrepreneurial farmers seem to be unlimited, while the allocation of income by political decision implies the risk for politicians to be blackmailed and by that, the democratic system itself to be endangered.

The quantity of agricultural commodities produced, whatever the quality, place of origin and in whatever organizational type of farm, results from regionally-diverging producer prices, claims on income, and chances to earn money outside the agricultural sector. Payments to farms in so-called disadvantaged areas discriminate against highly productive farms and support high cost producers. The same is true for tax and subsidy regulations, e.g., in Germany, discriminating against so-called commercial farms.

Markets do not regulate everything automatically. Government intervention is justified, if:

- the functioning of markets can be improved; or
- the failure of markets can be identified.

Governments can improve the functioning of markets by implementing and controlling quality standards or veterinary laws, thus preventing the spread of animal epidemics. Market failure means that externalities can be observed, i.e., if the side-effects of production processes are not taken into account by market prices. These could either be costs, i.e., damage to people, or environment or benefits, for which producers are not paid. Both could be relevant with respect to agricultural production and will be discussed later.

The transition from a highly dirigistic to a primarily market oriented agricultural policy has to be carried out smoothly. Not drastic price cuts at the beginning of the transition but the correction of too optimistic price expectations of producers have to be attained in the first place. The prime objective of a switch in policy is the fast reduction of economic costs. A qualified farm manager will base his decisions on medium and long-term economic expectations and not on actual prices. That is why, for example, the latest decreases in producer prices are not in contradiction with persistent increases in production as is frequently argued by politicians and farmers' unions.

EC internal prices should be reduced to world market levels within 5 to 10 years. Prices should be reduced progressively and should be based on the difference between EC prices and a 5-year moving average of international quotations. To make the policy shift credible, a binding, long-term commitment by the EC should be delivered at the new GATT-Round. The proposal includes that - at the beginning - price reductions would be greater for commodities such as milk and sugar with above average protection. Because the share of the EC in these markets is very large, price increases for these commodities on the international markets could also be expected to be above average, as lower price expectations for EC producers will lead to rapidly shrinking surpluses. Parallel to this process, policy-induced trade flows such as high imports of grain substitutes to the EC will be greatly diminished.

Monetary Compensatory Amounts leading to severe allocational distortions between member countries should be reduced rapidly and automatically. The jumble of administrative regulations will simply no longer apply and become unnecessary. This would be valid for quotas on production, preferential import regulations for beef or the "voluntary" export self-restrained agreement with Thailand on tapioca. Similarly, import levies and export restitutions would become ineffective or unnecessary. Consequently, administrative activities and the administration itself could be reduced substantially on both the EC and national level. Remai-

ning issues are a stock policy which could contribute to securing supplies in the event of a food crisis and the permanent improvement of market-efficiency as mentioned above. By opening the borders of the EC, price instability on international agricultural markets would be substantially reduced.

As they undermine the price policy suggested above, subsidies on investment should be abolished instantly. Insofar as the same is true for the majority of structural policy measures on the national level, they should be suspended successively. Regional subsidies are paid to reduce present or future income differences. A growing number of analysts on theoretical as well as on empirical reasons doubt their effectiveness<sup>5)</sup> in improving the interregional allocation of resources. As practical experience, e.g., in Italy, points in the same direction, those programs should be discontinued or, at least, basically reconsidered. In the light of the proposed price policy, this seems to be especially necessary for programs which primarily benefit the agricultural sector such as the EC-program for mediterranean countries. Otherwise the aim of reducing intersectoral distortions by a revised agricultural price policy would remain impossible to reach.

The implementation of a fundamentally revised common and national agricultural policy as outlined above might come unexpected for economic agents. Investments in machines and buildings might prove suboptimal at a later date. Because of that, producers could get direct income payments in relation to lost profits<sup>6)</sup>. Payments have to be tied to present farm managers; they should not be paid for more than 15 years and only up to an age of 65. For farmers discontinuing their farm business before retirement age, the income payments could be capitalized for the respective number of years. Following these principles, allocational distortions between member countries could be avoided even if pay-

5) Rüter (1987); Soltwedel, Bothe, Krieger-Boden (all 1987), Hallett et al. (1973).

6) For a detailed discussion of this kind of program, see Koester/Tangemann (1976).

ments were to differ between countries. Intersectoral allocation would improve rapidly as land prices and rents decrease and structural change accelerates. Proposals for direct income payments by the EC-Commission<sup>7)</sup> do not meet these requirements. The first of the two alternatives suggested (EC-payments) would be payments to badly-managed farms or those with natural disadvantages, i.e., high cost producers. This would only hinder structural change and increase economic costs.

The second proposal is about direct payments to farmers on the national level without a time limit. Again, these payments would give incentives to farmers to remain on their farms, keeping land prices high. Classifying the latter kind of payments as measures on purely social reasons cannot be accepted because of strong negative effects on international as well as on intersectoral allocation. No rationale seems conceivable for the allocation of special transfers to farmers on social grounds. In the case of social distress, the same rules as for other members of the society should apply. The only relevant condition for payments would be personal necessity.

#### 4. Consequences

A reform of the CAP as discussed above would rapidly reduce budgetary outlays and lower consumer prices. Because of presently observable price differences, the severity of consequences for producers would differ between member countries. Producers' incomes would decrease only slightly in the short run as parallel cost reductions are likely to be achievable. On the other hand, medium-term income expectations would immediately be revised downwards. Prices for land and land rental would decline, but a slump to extremely low levels seems unlikely as elasticity of demand will probably be relatively high. It could even be increased, if restrictions on transfers of land, which are quite severe in several member countries, were eliminated. Neverthe-

<sup>7)</sup> See Agra-Europe No. 18/87 (4.5.87).

less, one cannot exclude the insolvency of quite a number of farms because of their heavy indebtedness. This has to be accepted as something normal in market economies. Farmers remaining in business have to decide on their long-term chances. Highly-qualified farm managers without debt problems will take the chance of lower land prices and expand by buying or renting additional land. So, in general, structural change in the direction of larger farms either full time or, part-time farming, will gain pace.

As a further consequence of lower agricultural prices, intensity of land use is likely to decline. This could halt the process of intensification in new member countries adapting right now to higher EC-prices, and reverse the long-term trend in the other countries. Marginal land would be idled. If its economic use for forestry is not profitable, a truly natural landscape would evolve to the benefit of ecologists and environmentalists.

##### 5. Externalities of Farming

Smelling the odour of freshly-applied liquid manure or watching friendly cows on a green meadow, one sensually realizes that relations between farmers and consumers are not limited to market events. Farming has side effects not included in the market process. With respect to the suggested change in price policy, some possible externalities of present and suggested policies will be identified, and government intervention conceivable to enhance market solutions will be discussed.

Coming to negative effects first, of which nitrification of ground water seems to be the most urgent problem, one could safely assume that lower agricultural prices will reduce the amount of nitrate applied and thus reach the ground water. To the extent that flows of ground water cross regional or national borders only to a limited amount, following the principle of subsidiarity, government action to solve the remaining externality should be taken on the national or even regional level. This ar-

gument is in accordance with the fact that scarcity of ground water as well as standards on health and environmental protection differ between regions or states and, therefore, should have consequences on resource allocation between member countries. Governments trying to reduce spoilage of groundwater have to decide first who the owner of groundwater is to be, i.e., how to allocate property rights. Because of economic reasons and giving preference to environmental protection, one should follow the principal of (physical) causality. Because they cause the externality, farmers should bear the costs at least in the first round. As increased costs on the producer level are partly passed on to the consumer, the ultimate shares of consumers and producers in costs of scarcity of groundwater would be determined by markets. What then remains is the all but trivial technical problem relating groundwater spoilage to individual producers. As long as a consistent establishment of field data is not feasible, a tax on nitrogen could be a temporary solution. As the aim of the tax is not an increase in government income, it should be repaid as a lump sum related to area.

Another field of conflicting interests could be allocated between farming and conservation or renaturalization of certain biotopes for ecological reasons. Again, with lower agricultural prices marginal land will be idled, reducing negative external effects on the ecological sphere. But, in such a densely populated area as the EC, conflicts will remain or even be aggravated. Parallel to arguments outlined above, the question arises as to who is going to pay for the scarcity of land. Farmers, because they are not compensated for restrictions on land use, or environmentalists? Because of well-established property rights on behalf of farmers, one tends to keep the rights with farmers. This view is supported by the fact that land is immobile and, therefore, farmers - other than industrial producers - cannot avoid costs of environmental protection, e.g., local claims on restricted land use. With respect to the appropriate level of action, one has to ask whether environmentalists, the group who benefits primarily should negotiate and pay for contracts with farmers on the local

level, or should governments pay? A clear-cut answer is difficult. Solving the conflict on a strictly private basis such that users of a rare environment pay for their benefits proves to be unjust, because certain side effects of environmentalists' action, e.g., the protection of endangered species, is to the benefit of all members of society. Therefore, the protection of certain biotopes could have the character of a public good. The decision will depend on the rareness of the environmental object to be protected, and this, on the other hand, should determine the level of government which has to pay for the public good.

An increasing number of people, politicians and interest groups claim that farming - the way it is done today - has positive side effects. The message is that farming produces the main ingredients to civilized regions, i.e., the landscape with a certain farming structure and small villages characterized by farmsteads. It is demanded that farmers should be paid for preserving this cultural value, giving the present countryside itself the quality of a public good. If this could be ascertained, the new agricultural policy with structural change and the likelihood of land being idled would have negative effects on visitors to rural areas.

To prove these propositions seems hardly possible but, rather than asserting that consumers prefer the landscape as it is, they should be given the choice. It seems quite likely that, in densely populated Western Europe, quite a large number of people would prefer a landscape with more forests or just more area left to itself rather than the intensively used agricultural area. Therefore, general payments to farmers to preserve the landscape cannot be justified. On the other hand, one should not exclude the possibility that people would like to preserve certain unique landscapes such as valleys or mountain areas which could be endangered by a new agricultural policy. Therefore recurring on the principles of subsidiarity and fiscal equivalence, local authorities should be enabled by the EC or national governments to share with visitors their costs of preserving the landscape. Only as an exception, given a consent on the national or EC level to pre-



serve an unique landscape, financial support should be given by the EC or national governments. In any case, preserving a landscape does not necessarily mean preserving the farm structure or the combination of crops cultivated today.

But this is exactly what some governments, especially that in Germany, demand and what seems to be increasingly accepted on the EC level: the preservation of the farm structure by supporting the small family farm ("peasant" family farm). Besides the immense economic costs resulting from such a policy, the demand cannot be justified and would not meet the interests of the peasants themselves. To classify every farmstead as being of cultural value seems to be arbitrary. If one looks at the development of small villages during the recent decades, the number of farms has decreased rapidly. Many farmhouses have been bought and restored by people with other occupations, preserving or even improving the image of many small villages. Conflicts should be settled at the local level and are not a case for subsidies on the national or supranational level. With respect to environmental or social aims, the superiority of small family farms cannot be proved either.

## 6. Objections to a Fundamental Reform

Not only do farmers personally concerned object to the reform proposals as outlined above. Politicians claim the disregard of important social aims and consider such a reform not feasible. That might be true as long as:

- farmers who are severely hindered by bureaucratic regulations do not protest and bring about a shift in the publicly recognized position of farmers' unions;
- consumers and taxpayers do not realize that butter mountains or wine lakes are not the necessary supplements of a CAP, but the result of a political mismanagement; and
- other industries, or respectively their advocates, do not realize that the high protection of the farm sector is an attack on their own competitiveness due to higher taxes, distorted

exchange rates and impaired trade relations to non-member countries.

If these conditions change, politicians supporting the ideas outlined above, will appear on the political market quite rapidly. Another objection frequently brought up in the public debate relates to social aims. It states that a reform of the CAP increasing the outflow of people from the agricultural sector would merely increase the army of unemployed. This argument postulates that market forces which could reduce the income of entrepreneurs and ultimately drive entrepreneurs and employees out of business should not apply to farmers. This argument seems not to be well founded, particularly on social grounds, as presently a major share of transfers to agriculture by high prices is paid by low income groups, while not all farmers are poor.

Without doubt, the implementation of a new agricultural policy would have been easier 15 years ago, when rates of unemployment were low. However, preserving jobs which are not competitive through subsidies and a high protection on borders to non-member countries, taxing consumers directly is a backward-looking strategy. Taxing the non-agricultural sectors leads to a loss of jobs - which would otherwise have been competitive - by a number which by far surpasses the number of jobs preserved in agriculture. A CAP in accordance with the principles of a market economy would halt the waste of human resources, taxpayers' money and scarce capital. Trade relations to competing countries could be greatly improved, which would in the first place benefit the EC itself.

Financial resources saved by a reform of the CAP on the one hand should alleviate burdens on taxpayers and consumers and should be used on the other hand for investment in infrastructure and education. This applies in particular to the new member countries. Here, increasing agricultural prices give the wrong signals for economic development. Apart from government policy, collective bargaining partners on the labor market could improve conditions for growth in regions with structural deficits. Keeping wages on

a lower level where labor capacity is in excess would attract more private capital and by that reduce outmigration.

### Conclusion

In spite of the foreseeable personal hardship for people directly concerned, an alternative to a reform of the CAP along the lines outlined above cannot be seen. To reduce income losses to the EC society and to improve the conditions for growth and for more employment opportunities, the number of farmers, particularly fulltime farmers, will have to decline further. The structural change in agriculture has to gain pace, at least temporarily, to achieve farm sizes which are competitive on international markets. Negative effects of farming on the environment will be greatly reduced; for remaining conflicts solutions on the local level should have precedence.

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