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Critical approach of EU’s Common Agricultural Policy:
based on liberal views of Murray N. Rothbard

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Due to the nature of this paper, some polysemy might appear in the text. “A country” is sometimes used as a replacement for “the whole EU”, especially when discussing overall impact of state intervention to the market (either common market of the EU, or smaller market of one country – the conclusions to be drawn are the same)). Also, if the reader gets confused whether our final remarks apply to Lithuania, the EU or the whole wide world – please note that these are all general remarks, applicable to one country as well as to integrated economic area of many states.

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A remarkable American economist Murray N. Rothbard once wrote that people tend to fall into habits and into unquestioned ruts, especially in the field of government. He also pointed out vividly that in spite of our eagerness to try new products, new life styles, new ideas and other improvements of civilization, when it comes to the area of government people “follow blindly in the path of centuries, content to believe that whatever has been must be right”¹. The idea applies to quite a few aspects of Europe’s economy, including, among others, agriculture: our vital source of living.

A faulty attitude towards agriculture’s role in a country’s economy was developed in Western Europe soon after the Second World War. Agriculture was considered to be a strong priority, therefore European farms were granted more financial and fiscal benefits than any other sector of economy. As a result, Common Agricultural Policy (CAP) was born in the late 1950s and early 1960s when the founding members of the European Commission (EC) had just emerged from over a decade of painful food shortages during and after the war. Although the aim of such policy was to provide farmers with a reasonable standard of living, consumers with quality food at fair prices and to preserve rural heritage – which were, all in all, positive improvements – as occurred so often in the past century, full of best intentions economic policy led to unforeseen and undesired outcomes. That is exactly what happened with the CAP soon after its implementation.

Short history of CAP: “good” intentions – “even better” means

The Common Agricultural Policy is basically a system of the European Union (EU) agricultural subsidies and programs, which represents, based on different estimations, about 44% of the EU’s budget. The CAP combines a direct subsidy payment for crops and cultivated land with price support mechanisms, including guaranteed minimum prices for various forms of production, import tariffs and quotas on certain goods from outside the EU – which are basically means of protectionism. Hence, instead of desired results it led to the following saying about the EU bureaucracy: “Let us say you have two cows. The EU makes you to butcher the first one, milk another, gives you compensation for the milk and splits it to the Baltic Sea.”² Funny as it sounds, the saying applies to not only the CAP, but to most national strategies in terms of agriculture as well.

Already at the time the EC proposed the creation of a common agricultural policy in 1960, some member states, which individually intervened in their agricultural sectors, and farming professional organizations wanted to maintain strong state intervention in agriculture. Hence, it suggests that such protective attitude

¹ Rothbard, M., N. (2002). *For a New Liberty. The Libertarian Manifesto*. Ludwig von Mises Institute, Auburn, Alabama.

² Translated from an Internet joke

existed in an early development stage of the CAP. In other words, the new policy was *not* designed in order to cope with challenges in the sector of agriculture, nor was it genuinely intended to increase competitive ability of the common market. The creation of CAP was essentially nothing else but a political compromise³ and a firm legal fixing of already existing agricultural policies, by harmonizing and transferring them to the EC level.

Why agriculture, or where did we come from?

Why namely agriculture should be seen as sacred cow in economy – that is a question which may and *does* arise today, especially among young generation. Why agriculture is given such a strong priority to within the EU? Why is it monumentalized in the EU's foundation documents? Why is the CAP a central element in the European institutional system?

There are three basic reasons for such exception. Firstly, interventional buying stabilizes prices of agricultural products, which would, otherwise, according to advocates of protectionism, fluctuate dangerously due to weather conditions. Moreover, if food prices were allowed to act freely in the market, it would be much more difficult to control inflationary processes, as food expenditure usually forms about 20% of a household's budget. Secondly, so called alimentary-independence is desired in terms of political, economic and psychological approach. Such independence is also designed to protect the EU from not always predictable conditions of international trade. Thirdly and finally, farmers are then encouraged to stay and take care of their land, as well as to maintain rural development and landscape.

CAP uses a number of well integrated measures of protectionisms – including import levies and quotas⁴, internal intervention prices⁵, production quotas and “set-aside” payments⁶, as well as direct subsidies – that are all generally intended to control what is produced, to maintain certain price level of goods, and to interfere with how farming is organized. With France, Ireland, Belgium and Spain being the most active supporters of the CAP, there is, naturally, other side of the story as well.

Should we – with regard to current economic situation worldwide, as well as to simple logic – continue considering agriculture as an exclusive field? More importantly, will such exemption ever achieve results

³ The CAP is often explained as the result of a political compromise between France and Germany: German industry would have access to the French market; in exchange, Germany, as the largest net contributor into the EU budget, would help pay for France's farmers.

⁴ Import levies and quotas are applied to specific goods imported into the EU, in order to restrict the amount of food being imported, as well as to raise the world market price up to the EU target price.

⁵ Internal intervention price model basically means that the EU – should the internal market price fell below the interventional level – would buy up the production to raise the price to the intervention level.

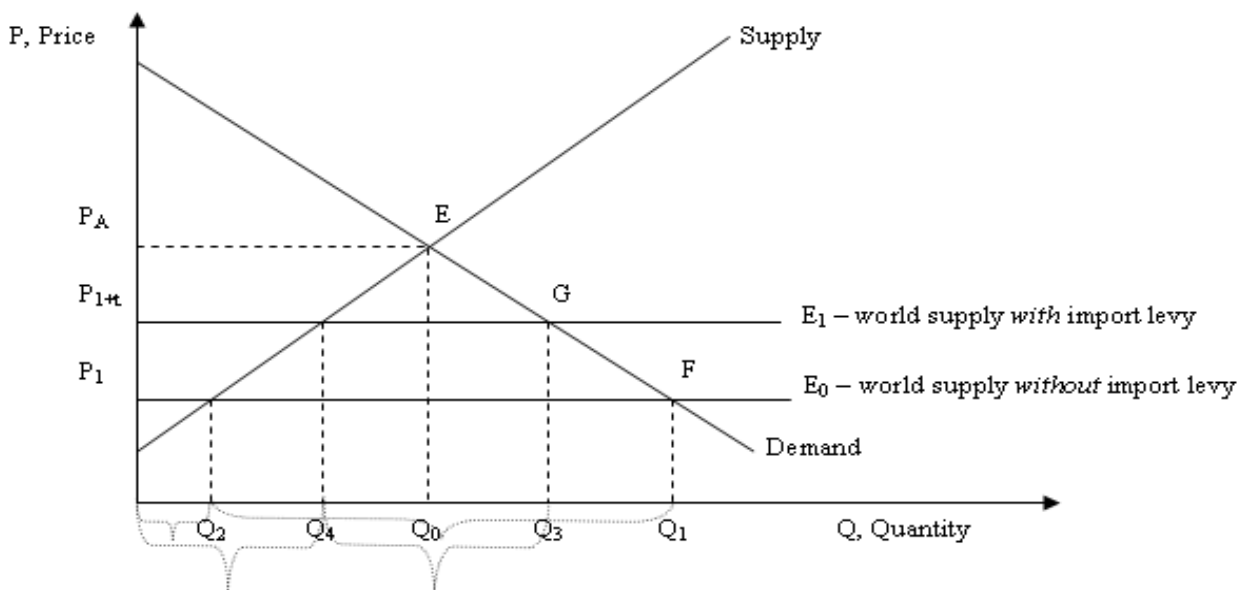
⁶ Set-aside as a political measure was introduced by the EU in 1988 to help reduce the large and costly surpluses produced in Europe under the guaranteed price system of the CAP. It has since become used as a generic term for the practice of leaving a proportion of farm land uncultivated or put to non-agricultural use for a period of time.

– to have a competitive sector of agriculture within global market – that have been long approved as underlying purpose in the EU? Although the answer already lies in the first few paragraphs of the paper (as well as in basic economic logic, as a matter of fact), it is, for some reason, obscure not only to agrarians, but also to many of our leading politicians and economists. Thus, a thorough analysis regarding efficiency, prospects and fairness of current agriculture policy is provided as follows.

Criticism of the CAP

Point No. 1 – Artificially high food prices

In 50 years since the CAP was designed and adopted, its price intervention has already been most criticized for creating artificially high food prices throughout the EU. For one thing, many farmers have found that with food prices dropping over the past thirty years in real terms, their businesses would not be able to survive, if not payments from the EU. On the other hand, high import tariffs (estimated at 18-28%) have the effect of keeping prices high by restricting foreign competition. We shall prove and supplement the latter statement graphically.



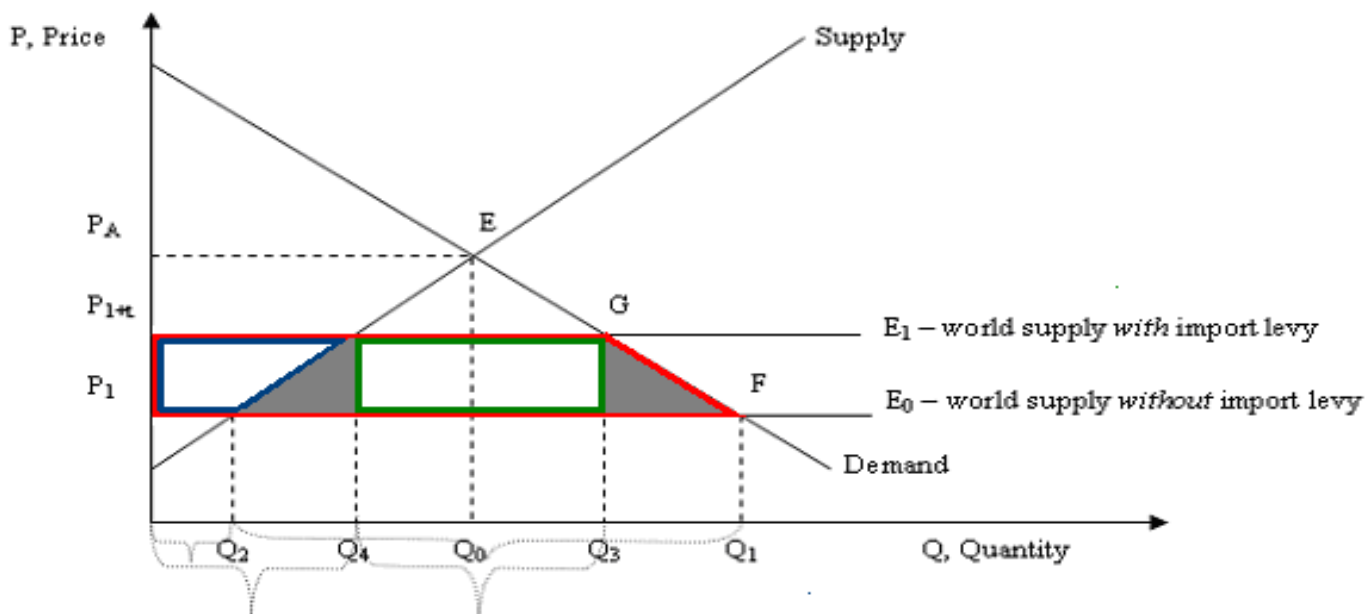
Graph 1: self-made, based on common economic theory

Above is a simplified graph which shows what is the import levy's impact on production, consumption and prices of a relatively small country X⁷. Let us say we have this country's supply and demand curves

⁷ Assuming that a "small country" like Lithuania introduces import levy for some specific product. We say "a country" to make our explanation more apparent, but we could also take the EU or any market with common trade policy here.

of some product Y, which can be either imported or produced locally. In case of an autarky⁸, the product's price P_A is determined by a balance between local production at each price (supply) and the desires of those with purchasing power at each price (demand). Therefore, point E is an economic equilibrium point of price P_A and quantity Q_0 . In case of unlimited international trade without import levy, country X can import product Y for price P_1 ⁹. Consequently, market equilibrium is reached at point F, where Q_1 amount of product Y is consumed (out of which Q_2 is produced locally, and the amount $(Q_1 - Q_2)$ is imported for price P_1). Shortly, unfettered trade allows consumers to buy more of a product Y (Q_1 instead of Q_2) for lower price (P_1 instead of P_A). Due to increased competition, however, local producers sell less (Q_2 instead of Q_0).

Now let us see what happens than a state decides to introduce import levy t on a product Y¹⁰. New market equilibrium occurs at point G, where consumers purchase Q_3 amount of product Y for the higher price P_{1+t} . In this case, local producers are able to sell Q_4 items of product Y, and $(Q_3 - Q_4)$ more is imported. Needless to say, import levy, by reducing import volume and, therefore, competition, had a *positive* impact on local producers (enabling them to sell more and for higher prices than in case of unfettered trade), and a *negative* effect on local consumers (they buy less and pay more than in case of unfettered trade).



Graph 2: self-made, based on common economic theory

⁸ An autarky, or simply “a closed economy” refers to an ecosystem not affected by influences from the outside world, relying entirely on its own resources by severely limiting international trade.

⁹ We assume that world price P_1 is lower than that of autarky. Moreover, country X has no relative advantage producing product Y, which is, therefore, mostly imported from the outside. We also assume that a country is able to purchase “unlimited” amounts of product Y in the world market. Moreover, we assume perfectly elastic world supply.

¹⁰ Horizontal line E_1 then reflects a new world supply curve.

However, if we looked at the *colored* image above, we would see exactly what usually remains hidden when the state introduces import levy. Based on explanations above, we can see that the red trapezium $P_1P_{1+t}GF$ shows the *overall* negative impact on local consumption, procured by the import tariff t .¹¹ In order to discuss its impact on welfare, gainers and losers need to be identified.

A tariff requires importer to pay a given fraction of the world's price to the government, protecting, at the same time, domestic producers by *raising* the price in a certain country. From a consumer's perspective a tariff works like a tax: there are transfers from consumers to both the government (in form of budget revenue) and producers (in form of higher profits). In our graph, import duties as a mean to boost the national budget are marked in form of a green rectangular, and it shows how the **consumers' surplus is taken by the state in form of an import tariff**. Such transfer is thus not yet necessary a net welfare loss. A blue trapezium on the left side of the graph illustrates likewise the effect of income re-distribution, meaning that **consumers' surplus is transferred to local producers**.

In the meantime, two grey triangles within the red line represent the **net welfare loss**, which occurs as a result of an import levy. According to the Glossary of Statistical Terms, net (or deadweight) welfare loss is „a measure of the dollar value of consumers' surplus lost (but not transferred to producers) as a consequence of a price increase.“¹² That is exactly what the triangles stand for, with the left one representing net welfare loss for a country due to *ineffective production*¹³, and the right one showing *net loss of consumption*, as consumers are no longer able to buy (Q_1-Q_3) amount of products, when the price goes up to P_{1+t} . To sum things up, in case of an import tariff consumers not only pay higher prices in order to save local producers, but also a deadweight welfare loss occurs in the country. The statement is proved and supplemented.

Point No. 2 – Unfair competition

Every year, the West spends huge amounts of agricultural subsidies to its farmers, which basically means unfair competition. There are many vivid estimations about the *scope* of such payments, one of which points out that the OECD countries' total agricultural subsidies exceed in amount the GDP of the whole Africa. This policy is not only unfair as such, but it also increases poverty in the Third World by putting its farmers out of business, as the usual overproduction of agricultural products are often realized on the Third World market,

¹¹ In case of international trade without import levy, triangle PP_1F represented the volume of consumption. The plot $P_1P_{1+t}GF$ was lost due to an import levy t .

¹² Glossary of Statistical Terms, Financial statistics, 2002. Web: <http://stats.oecd.org/glossary/detail.asp?ID=3187>

¹³ Although the volume of local production goes up from Q_2 to Q_4 when import levy is introduced, all these additional goods are produced at higher costs than those of imported goods.

simultaneously preventing its farmers from exporting their agrarian goods to the West. Needless to say, the CAP does not help to reach economic sustainability worldwide, nor does it promote fair trade and competition.

Point no. 3 – Economic inefficiency of state intervention

USA president Ronald Reagan once said, that the government's view of the economy could be summed up in a few short phrases: "If it moves, tax it. If it keeps moving, regulate it. And if it stops moving, subsidize it." Laugh all you want, but that is exactly what the EU has been doing with agriculture for the past 60 years. In fact, any type of government intervention (which usually results in protectionism) is incompetent, as free market without interference always allocates resources more efficiently¹⁴. In agriculture, the setting of guaranteed minimum prices, for example, inevitably leads to distortions in production, with overproduction being the usual result¹⁵. Subsidies, on the other hand, allow continued operations of many small, outdated or inefficient farms, which would otherwise be financially impossible¹⁶. Hence we have a situation where farmers are, on the one part, paid to produce (subsidies), and at the same time are being discouraged from producing too much (quotas).

It is not understandable why the EU chooses to stick to its quota-system in, for example, milk sector, even though there are no more logical or, as a matter of fact, illogical reasons to¹⁷. Quotas cannot even be traded between different regions in most countries, let alone between *countries*, so farmers in places ideally suited to dairy farming cannot produce as much as they want, while quotas languish unused in other regions¹⁸. Even if there *was* a risk of potential oversupply, maybe, instead of "dosing" production, cutting subsidies would be an idea?¹⁹ Agriculture is by its nature not so very different from any other field of economics, and therefore should not be treated any special way. Surely, there are certain aspects of such activity, like risk, seasonality and its general importance to physical existence of human kind, but these are not the reasons to provide it with specific state support. Many economists already consider risk in agriculture not so much higher than in any other sector. They also point out that higher risk basically

¹⁴ We suggest a straightforward economic model here, which says that it would be better to let the market find its own price levels, even if it means that uneconomic farming shall cease to exist.

¹⁵ The EU quotas are then being applied to specific goods, in order to restrict the amount of food being produced

¹⁶ *The Economist* vividly marked that "The EU lavishes around euro 40 billion a year on direct subsidies to European farmers. It is an expensive way to create surpluses, high food prices, environmental damage and harm to poor third-world farmers" (*Europe's farm reforms postponed*, *The Economist*, Oct 3rd, 2002. Web: http://www.economist.com/world/europe/displaystory.cfm?story_id=1367934)

¹⁷ Milk quotas were designed in 1984, as a lame reaction to low market prices and high subsidies, which had been killing the EU's budget and producing "butter mountains" at the same time. Today, such surpluses are long gone, with the EU undershooting its milk quotas by altogether about 2mn tonnes last year. Nevertheless, the quota system is still on.

¹⁸ France, for example, proudly prevent milk industry concentration in most profitable areas, like Normandy, and welcome the EU quotas, as they are reason why "milk is still produced in every corner of France" (*The Economist*, Feb 14th 2008)

¹⁹ We wonder naively...

means greater earning potential. Also, risk can nowadays be efficiently reduced by using financial market instruments like insurance or futures contracts. Seasonality, on the other hand, affects not only agriculture, so requirement to give it exceptional support has nothing to do with *fairness*.²⁰

Moreover, only 5% of the EU's population actually work on farms, and the farming sector is responsible for less than 3% of the EU's GDP. Consequently, Europe currently spends nearly one-half of its budget on 5% of inhabitants, in the meantime making the rest pay higher prices for food products. It hardly seems fair to make 95% of the population pay for extravagant life choices²¹ of the 5% minority.

Individual preferences, stiff promises and unpopular decisions

Like everywhere in economics, human factor often plays a major role in a decision making process. If we looked at Lithuania and current state of its agrarian sector, we would have a nice example of a twisted socio-economic situation to analyze. The bottom line is that farmers would like to produce what they are used to, paying no regard to market demand and tax-payers' possibilities. What is more, they also expect to receive government grants for either producing not enough, or producing too much. One should understand, however, that Lithuanian farmers are not entirely guilty for their "selfish" role in the society. Nobody else but the government has created expectations, which we now call "unreasonable". Since independence, the country's farmers have been put under the illusion of great state support and dreamlike grants from the EU²². No wonder why we have a bunch of miserable free-riders in the field of agriculture today.

Rothbard noticed that private companies are so efficient mostly because of the free market, established prices of which permit private firms "to *calculate*, to figure out what their costs are and therefore what they must do to make profits and avoid losses"²³. He also marked that central planning, such as is attempted under socialism, is, in contrast, „deprived of accurate pricing, and therefore cannot calculate costs and prices"²⁴ – which is the major reason why central socialist planning in former communist countries proved to be an economic failure. Although Lithuania is today one of these Eastern European

²⁰ In this work the concept of fairness is interpreted as *equal rules and opportunities* to everyone (M. N. Rothbard would probably back us up on this), rather than equalized income, state support or uniform state regulations (as promoted by most trade-unions today). However, knowing that people are by nature *not* homogenous, it becomes a challenging task to understand *why* equal rules and rights – that are, without doubt, the most simple and the least contradictory way of ensuring equality in a society – are not accepted by most active promoters of "fairness", especially when it gets to social welfare.

²¹ We consider sticking to no longer profitable activity just because one *feels* like it to be an extravagance.

²² The expansion of the EU in 2004 increased the number of farmers from 7 to 11 million, while agricultural land area went up by 30% and crop production by 10-20%. The inclusion of ten additional countries meant a significant increase in recipients under the CAP and naturally has obliged the EU to limit its expenditure. Great expectations of newcomers' farmers remained, therefore, unfulfilled.

²³ Rothbard, M., N. (2002). *For a New Liberty. The Libertarian Manifesto*. Ludwig von Mises Institute, Auburn, Alabama.

²⁴ Rothbard, M., N. (2002). *For a New Liberty. The Libertarian Manifesto*. Ludwig von Mises Institute, Auburn, Alabama.

countries, that, according to Rothbard, “have been moving rapidly away from socialist planning and toward a free-market economy”²⁵, we must remember that these farmers are, to some large extent, hostages of an old system. In Soviet times, people in the sector of agriculture used to work whatever they were assigned to by the government and received standard official salaries. They did not *need* to care about market demand, prices, risks or profits. Indeed it seems that such order was quite acceptable to most of the farmers, as they continue to demand for the same government guarantees as 20 years ago. While being busy going on strike on routine basis, they fail to understand, however, that as central planning is not capable of determining prices and costs with any accuracy, their work can only be adequately rewarded in the free market. Moreover, people, always wanting to get greater disposable income, tend to inaccurately apply the idea of “buying cheaply and selling more expensively” to their daily business. Consequently, they start aiming for higher prices of products they sell²⁶ and lower prices for products they need to buy. They fail to understand, however, that *free market* is an indispensable condition for accurate pricing to develop, which is, by its economic nature, a way to receive maximal income or profit. It can only be regretted that Lithuanian farmers generally prefer state support and market regulations in order to reduce any risks they might face in the free market, instead of freedom and, for that matter, greater profits.

Unfortunately, these are all subjective issues, and it obviously takes more time and efforts to change the way people actually *think*, than to release another ordinary decree and hope for the best. In his *Libertarian Manifesto* Rothbard gave a vivid example of how the state tend to choose the easiest, rather than the most appropriate way to solve problems that society faces. New York City’s reaction to the ever-accelerating crime problem in town (imposing a curfew, banning the use of crime-prone areas, like Central Part in Manhattan, instead of providing more efficient police protection) is very close to the means used by the Lithuanian government, as well as by the EU, in order to “solve” some particular problems in economics. In terms of agriculture, it is, of course, easier to provide farmers with financial support, guarantee them minimum prices for specific corps or protect them from foreign competition by introducing high import tariffs than to really solve issues of inefficiency and low competitive ability. In other words, the state too often chooses to mask the negative consequences of incompetent work organization (i.e. granting social support instead of encouraging people to work) than to risk its reputation by making necessary, but unpopular decisions.

After many years of such policy, it is not surprising that people in Lithuania now tend to *wait* for getting a better job, rather than take a risk and start their own business. They are also not willing to travel within their country with aim of finding a job. Finally, most people better take care of their small farms and

²⁵ Rothbard, M., N. (2002). *For a New Liberty. The Libertarian Manifesto*. Ludwig von Mises Institute, Auburn, Alabama.

²⁶ In agriculture the trend is currently reflected by farmers constantly demanding higher guaranteed minimum prices for various forms of production

receive random income than act actively in the labor market and change their specialization according to market demand. Although economists encourage farmers to think more as businessmen, observe the market and react to its changes, workers in the sector of agriculture keep complaining about low guaranteed minimum prices of crops and high seasonal risks they must take. Very few stop blaming everyone but themselves and actually try to adopt.²⁷ Also, one of most popular arguments against any change in field of agriculture goes quite in line with one of Rothbard's thoughts: attack on state financing appears to many people as an attack on the service itself²⁸. Rothbard's example about the US court system can be well applied to the EU's agriculture system too: the idea that free market principles should also apply to sector of agriculture is often misinterpreted as an encouragement to give up on agriculture as such.

Concluding remarks

It is now evident that a problem exists in many levels, and a need for reforms is obvious as well. The question remains, what could (and should!) the EU, including Lithuania, do to achieve noticeable results in one of the most rigid and difficult to reform fields in economics – agriculture? To keep things simple²⁹, the main conclusion to be drawn is quite straightforward: **agriculture can only be saved by reorienting it towards the free market model**. If you got to this line, you may as well stop reading now, as the main point of the paper has just been presented. Reading forward? Let us then elaborate the latter statement with some final details.

First of all, we need to remember that any state regulation and support to one or another sector is always a temporary gain, which, later on, has more and more negative outcomes, as such support basically perverts market competition and leads to invalid evaluations of risks and all the following. Therefore, the first step is to define boundaries of state regulations clearly and decidedly. This should lead to gradual elimination of guaranteed minimum prices mechanism, as well as production quotas, reduction of subsidies for agrarian production and exports, refusal of exceptional protection from foreign competition and any kind of special support mechanisms³⁰.

The obvious advantage of developing a business based on free trade could hardly be denied. For one thing, market itself (state priorities excluded) would best identify perspective fields of agriculture. It is natural

²⁷ The statement applies to most farmers in the whole EU as well.

²⁸ Rothbard, M., N. (2002). *For a New Liberty. The Libertarian Manifesto*. Ludwig von Mises Institute, Auburn, Alabama.

²⁹ We shall follow the good old KISS (Keep It Simple, Stupid!) rule here

³⁰ Let us not misinterpret that the suggestion to eliminate support to agriculture means the rejection of the social assistance's idea. The proposal is to re-design the support mechanism so that it would least interfere with the free market principles. It means, basically, that social support is to be designated to those in need, but support for the countryside should not be exceptional from any other social support.

that businesses of any sort tend to and *should* move to the most promising economy sectors, rather than pressing on in a stagnant, no longer profitable area. Moreover, such flexibility is nowadays vital in order to succeed in any activity. There is no solid reason³¹ why agriculture should be seen differently.

Finally, we must remember that political climate, as well as the level of state intervention allowed are among the key factors defining if foreign direct investments flow into a country or not. In other words, capital tend to be easily raised in those sectors where state intervention is minimal, as few investors accept the government's ability to decide what is best, while almost all believe in free market mechanism. Moreover, preference loans to farms and processing companies not only capacitate unfair competition, but also, by leaving them no real reason to aim for efficiency, discourage private investments. Needless to say, the only proper way to promote trade and investments into agriculture is to eliminate state regulations³². Instead of continuing with subsidies and preferential financing for farmers, the Lithuanian government (as well as all other governments) should concentrate on improving general business and investment conditions, in terms of both macro economical and legal means. "If you want to feed a man, don't give him a fish: provide him with a rod", says folk wisdom. Hopefully, these sound words will one day not only get to our leaders, but will reach the whole society as well.



³¹ We do not consider state priorities a solid reason. We also refuse to see the state as a know-all agency. On the contrary, we say that the state is *not* itself capable of correctly identifying market demand and the „right“ prices, which are only possible to define in free market conditions.

³² A good example of how state regulations impede business in the countryside is the burden imposed on the proper functioning of the land market by dividing the land into „agricultural purpose“ land and other sorts of land in Lithuania, which discourage capital flows into rural areas, as well as inconvenience the real estate trade.