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# 1 Introduction

The Common Agricultural Policy (CAP) is multi-faceted and in constant evolution. Successive reforms have changed the market incentives faced by producers, consumers and industrial users of agricultural commodities. Since its inception, the CAP has evolved from a set of commodity-specific programs designed to improve food security and support farm incomes in Europe, to a system of industry assistance with multiple objectives.

Relatively recent developments of the CAP have included:

- the partial decoupling of direct income payments to farmers from production
- an increased focus on using assistance to achieve rural development and environmental objectives.

In addition to changes in policy, the membership of the European Union itself has changed dramatically with successive enlargements. For example, enlargement of the European Union from 15 to 25 member states added 4 million farmers to the existing 7 million, and increased the cultivated farming area by around 30 per cent to 130 million hectares (European Commission 2009a).

Changes in policies and membership have influenced how the CAP affects EU economies and, through global markets, economies around the world. The purpose of this paper is to estimate the likely benefits and costs of the CAP to the European Union and to the global economy.

## **Approach**

The economic impacts of the CAP are evaluated using a computable general equilibrium (CGE) modelling framework. The Global Trade Analysis Project (GTAP) comparative static CGE model is used, together with the latest version of the GTAP database (version 7), which has a base year of 2004.

To evaluate the impact of the current regime on economic outcomes, a counterfactual scenario is modelled, where elements of the CAP are removed. Although the components of the CAP are interdependent, the main components

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have been modelled separately in order to interpret better their roles and contributions to the overall effects of the CAP.

The modelling results provide an indication of the aggregate allocative efficiency and welfare effects, along with sectoral effects — both within, and outside of, agriculture — on the European Union and on other parts of the world.

Economic modelling is limited in its ability to replicate the detail and complexity of the CAP, as well as the complex interactions of the global economy. Although CGE modelling is the most useful tool available for assessing the global and allocative economic effects of the CAP, it can only do so in a stylised way. It requires many simplifying assumptions, and cannot directly estimate many potentially important effects of the policy, such as positive or negative externalities and adjustment costs. This means that although the modelling can be used to provide insights for policy analysis, for a complete analysis, it should be complemented by consideration of additional factors that are not accounted for in the modelling.

## Scope

In this paper, the CAP is analysed in terms of a 2007 reference year. The effects of three major components of the CAP — direct income payments, export subsidies, and border protection — are analysed. Rural development spending is not modelled because the effects of this class of spending are too complex and uncertain, and difficult to value (for example, the value of animal welfare or some environmental values). For these reasons, it is difficult to represent this class of expenditure and its effects within the existing GTAP database structure and model.

All 27 members of the European Union are covered in this study. This includes the EU15 member states<sup>1</sup> and the 12 new member states (NMS).<sup>2</sup> In the case of direct payments, however, the focus is only on the EU15 as, for now, the NMS account for only a small share of direct payments. The main focus of CAP expenditure in the NMS is on rural development.

The impacts of assistance to agriculture on both the European Union and other parts of the world are evaluated. Assistance to agriculture covers the crop, meat, dairy and wool sectors. Recognising, however, that protection for agriculture is also

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<sup>1</sup> Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden, and the United Kingdom.

<sup>2</sup> Ten of the NMS joined in 2004: Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, and Slovenia. Two more states joined in 2007: Romania and Bulgaria. These are collectively referred to as the NMS.

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implemented at the stage of processing agricultural products, the relevant food processing sectors are also covered in the case of export subsidies and border protection.<sup>3</sup>

The remainder of this paper is set out as follows. Chapter 2 contains an overview of the current CAP and a discussion of the likely effects of elements of the CAP. In chapter 3, the GTAP model and database are outlined, and the methodology for implementing the policy scenarios is discussed. Chapter 4 is dedicated to the presentation and interpretation of results, and chapter 5 concludes.

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<sup>3</sup> Fishing has its own assistance program called the Common Fisheries Policy, and forestry is affected indirectly by some CAP policies (such as land set-aside and rural development; see chapter 2).