Enlargement of the European Union to Central and Eastern Europe:
Obstacles and Possible Consequences of Policy Harmonization

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Abstract

Ten Central and Eastern European countries (CEEC) have applied for membership in the European Union (EU). This chapter analyzes three factors that are expected to influence how EU farm programs will evolve as the EU expands. First, the wide disparities between EU and CEEC agriculture, in terms of institutions, policies, and productivity mean that considerable restructuring will have to occur if integration is to be successful. Second, farm subsidies under the current CAP are likely to be unsustainable as membership expands, creating budget pressures for CAP reform. And, the direction set by the Uruguay Round of the WTO, committing members to more transparent and less trade-distorting farm supports, is also likely to influence the evolution of farm programs in an extended EU. Analysis of the effects of EU expansion under the current program show a likely reduction of the agricultural trade of third countries, including the United States, with the CEE countries. CAP reforms will reduce that trade-diverting impact.

Introduction

Ten Central and Eastern European (CEE) countries[1] have applied for membership in the European Union (EU), which is one of the largest regional trade agreements (RTA). The EU has a single market with no internal agricultural trade barriers and a Common Agricultural Policy (CAP). This prospective enlargement of the European Union to Central and Eastern Europe could add as many as 100 million new consumers to the EU market and double the number of farmers under the EU subsidy scheme. Since the fall of central planning, most of the CEE's have not had the means to support or insulate their markets to the extent that the EU does. Maintaining current EU agricultural support levels in an enlarged EU could have profound effects on both EU/CEE trade and global (and consequently U.S.) trade.

Here, we discuss three facets of the EU's enlargement. First, we discuss the preparations that the EU and CEE countries have been making toward the anticipated enlargement, and some of the difficulties that they may

[1]Poland, Hungary, Czech Republic, Slovakia, Estonia, Latvia, Lithuania, Slovenia, Romania, and Bulgaria.

face in harmonizing their policies. Second, we describe internal pressures to reform the CAP as the EU expands. Third, we focus on how the World Trade Organization (WTO) monitors the expansion of RTA's and how WTO regulations could limit the increase in trade barriers in the minimally protectionist CEE countries. Last, we provide some quantitative analysis of various EU policy options for enlargement.

Preparations for Enlargement

Since 1993, the EU has been functioning as a single market, with no impediments to the internal movement of goods, services, capital, and people. Regional integration of the CEE countries into the EU is expected to include a harmonization of their domestic farm policies. When the EU admitted the members of the European Free Trade Area (EFTA—Austria, Finland, and Sweden) in 1995, they adopted EU agricultural policies immediately. This differs greatly from the 10-year transition period granted to Spain and Portugal in their 1986 accession to the EU. The EU has yet to decide whether there will be a transition period for the CEE enlargement, though Franz Fischler, European Agricultural Commissioner, recently expressed the possibility of a 3-year phase-in period for compensatory payments, a component of support to EU farmers. Whether the CEE's meet the European Monetary Union's convergence criteria and when to adopt the the Euro currency has also yet to be determined.

By adopting the EU's Common Agricultural Policy (CAP), the CEE countries—which have not had the financial means to provide much financial support to farmers—will become part of a highly protectionist customs union that generously supports its farmers. The CEE countries will benefit from unrestricted access to EU markets, higher prices, and financial support for farmers.

Since implementing the CAP in 1962, the EU has provided a high level of support to farmers. The EU implemented highly protectionist policies to ensure high internal prices. For example, before implementation of the CAP, the EU was a net importer of wheat. Now it is of the world's larger exporters. Because of high price supports and import protection, internal EU markets have maintained prices above world levels. This has encouraged input-intensive farming that has resulted in high yields. Presently, the EU has some of the highest wheat yields in the world.

However, the CAP has been costly to maintain. Government spending to support agriculture is high. EU consumers support farmers through their taxes, as well as through food prices that are higher than in more market-oriented economies, like the United States.

The situation in the CEE's (post-central planning) is far different. Incomes are far lower than in the EU. Except for Slovenia, the governments cannot afford to support agriculture as the EU has in the past. Many of the CEE countries have huge agricultural sectors that despite the advances of recent years, are generally less developed than those of the EU.

With completely open borders between EU and CEE countries, the CEE agro-food sector may find it difficult to compete with Western European firms, particularly the food processing industry. Some CEE food processors have modernized sufficiently to meet EU product standards, but for most of the CEE food industry, considerable investment is still needed. Among raw agricultural products, many meat and dairy products will have difficulty competing in the EU market as they do not yet meet EU quality standards.

CEE agricultural sectors will need considerable restructuring for successful integration into the EU. The CEE's need to improve farm productivity, complete the privatization of state farms and agro-industry, simplify their government purchasing and market management practices, increase training in agribusiness and quality control, and implement programs that encourage rural development and structural adjustment.

Agencies created in the Visegrad countries[2] (Poland's Agency for Agricultural Markets, for example), Romania, and Bulgaria to administer minimum prices, export subsidies, or other measures often operate in a nontransparent way, leading to questions concerning these countries' compliance with World Trade Organization (WTO) regulations on state trading. State policies in Bulgaria and Romania cause significant distortions in their domestic markets. Procurement of bulk commodities is still mainly in the hands of state-owned companies that use their market power to hold down prices. In addition, these governments continue to exert some control over retail prices through limits on processing margins.

The CEE countries will likely be required to adopt all EU legislation immediately upon becoming EU members. This involves setting up structures necessary to make the legislation effective. This alignment of policies requires the CEE's to make adjustments beyond those required by their transition to market economies. In the agricultural sector, these measures will affect the movement of live animals, meat and meat products, fruits, vegetables, and plants, and a wide range of activities in the farming, production, and processing industries. The CEE countries will have to meet EU labeling requirements and quality standards, including veterinary, sanitary, and phytosanitary standards. Restrictions on trade between the current EU-15 and its trading partners will then also apply to imports into the new member countries. This could present problems for U.S. access to CEE-10 countries, particularly for livestock products. Currently, the EU bans the importation of U.S. poultry meat and beef treated with growth hormones. Until these bans are revoked, they will also apply to imports into any CEE country once they join the EU.

The EU has taken a multipronged approach in its preparations for enlargement. It has funded an extensive program of technical assistance for the CEE region, designing projects to improve agricultural structures and market mechanisms, food production, processing and distribution, and infrastructure. The EU has proposed funds to provide cheap loans, secure loan guarantees, and develop equity participation programs in the CEE countries. The 10 prospective member countries have also signed Association Agreements (Europe Agreements) with the EU. The Europe Agreements provide a framework for preparing the CEE countries for eventual membership, allowing them time to continue their economic and political reforms (see box).

Internal Pressures for Reform

Applying the CAP mechanisms to CEE countries would be very costly to the EU. Extending the generous benefits currently provided to EU producers would significantly increase EU agricultural spending. It would also stimulate CEE agricultural production and raise prices in the CEE countries, increasing their reliance on export subsidies. The EU is already close to meeting its WTO commitments on the permitted volume and value of export subsidies. If the CEE's need to subsidize the exports of many of their commodities, they would certainly exceed their export subsidy constraints. For both of these reasons, the EU has proposed the Agenda 2000 reforms, further reducing price support to farmers (reducing the need for export subsidies) and expanding upon the EU agricultural reforms undertaken in 1992. The United States views the impending reforms as an opportunity for the EU to further liberalize its agricultural policies, building on the accomplishments of the Uruguay Round agreements.

Of the 10 prospective members, 5 have been selected to begin negotiating their accession to the EU—Poland, Hungary, Czech Republic, Estonia, and Slovenia. If the EU were to admit these first-tier countries under the current CAP, agricultural production in those countries could increase dramatically. Currently, due to government policies and poor quality of

[2]Poland, Hungary, the Czech Republic, and Slovakia.

Europe Agreements

Ten CEE countries—Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia—have signed Association Agreements (Europe Agreements) with the EU and have applied for membership in the EU. EU enlargement is likely to occur in a number of stages, with the Czech Republic, Estonia, Hungary, Poland, and Slovenia invited to join first. The Europe Agreements form the basis for gradual integration of CEE countries with the EU. The agreements cover five main areas: political dialogue, economic cooperation, financial assistance, adoption of EU legislation, and trade liberalization. The first agreements were signed with Poland, Hungary, and Czechoslovakia in 1991, with mutual trade provisions taking effect the following year and the entire agreements taking effect in 1994.

The bilateral trade and cooperation provisions of the Europe Agreements call for most-favored nation (MFN) treatment and gradual elimination of selective quantitative restrictions over a 10-year period, beginning when the agreements go into effect. Separate protocols cover "sensitive sectors," including agricultural products, clothing, textiles, coal, and steel. For agricultural products, most concessions are phased in within 5 years and involve tariff reductions and quota increases. For example, beef, pork, mutton, poultry, and dairy products are subject to a 20-percent tariff reduction over 3 years, while import quotas will increase 10 percent per year for 5 years. However, trade in some commodity groups, such as grains, has not been liberalized.

The two-way preferences were structured to accelerate liberalization for CEE exports to the EU. Despite this, EU exports to the CEE have far outstripped trade in the opposite direction. In the first years of the agreements, lack of information and lack of familiarity with EU procedures prevented the CEE countries from fully utilizing their allotted quotas. The EU's quarterly administration of preferential quotas, which hinders full utilization of annual quotas where seasonal commodities are concerned, also limited CEE exports. Finally, the method of administering tariff-rate quotas places CEE countries at a disadvantage—the quotas were allocated to EU importers rather than CEE exporters.

production, prices of agricultural commodities in the Central and Eastern European countries are at, or in many cases, below world prices. At the same time, the CAP supports producer prices for most commodities well above world prices. By adopting the CAP, CEE farmers would experience large price increases for most commodities, making them more profitable. Price differences are the greatest in the livestock sector due to high EU support and poor quality in the CEE's. Additionally, CEE yields lag far behind EU yields because farmers cannot afford to purchase hybrid seed or apply much fertilizer. As prices rise, farmers will have the incentive to increase production and will have the means to purchase higher quality inputs to ensure higher quality crops. CEE crop quality will need to increase to meet the CAP's minimum quality requirements for government intervention purchases.

WTO Reduces EU's Ability To Protect Agriculture

Though the enlargement of the EU is being negotiated between the current EU-15 members and the 10 potential CEE members, the rules of the World Trade Organization will influence the negotiations. The WTO provides a framework for the long-term reform of agricultural trade and domestic policies. The expansion of an RTA is governed by Article XXIV of the GATT. Since the EU is a member of the WTO, it must comply with WTO rules. According to Article XXIV of the GATT, (1) members' external trade barriers must not increase from levels prior to the formation of the RTA; (2) substantially all internal trade must be covered; (3) the RTA must be implemented in a reasonable amount of time, normally 10 years; and (4) all RTA's must be reported to the WTO to determine whether these conditions are met (for more on Article XXIV, see the article by Sheffield). The WTO member countries and the Committee on Regional Trade Agreements will closely monitor EU expansion.

The WTO's Uruguay Round Agreement on Agriculture (URAA) also constrains EU expansion. The URAA, which took effect in 1995, established limits on export subsidies and domestic support, and set requirements for market access for all members of the WTO. Of the 10 countries that have applied to become EU members, only the 3 Baltic countries (Estonia, Latvia, and Lithuania) are not yet members of the WTO, though they have observer status and seek to become members soon. By the time enlargement occurs, all 10 countries should be members of the WTO. Therefore, they will all have established WTO limits on their use of export subsidies, domestic support, and market access, which should help the WTO and other interested parties make sure that trade barriers to the region are not increased upon EU membership.

Agricultural policy reform is inevitable for the EU, regardless of whether it expands or not. The EU is already close to, at, or over some of its WTO limits for subsidized exports (which will continue to decrease until they reach their final levels in 2000). With enlargement, the WTO limits will play an even larger role. When the EFTA countries joined the EU in 1995, the EU and EFTA countries' WTO commitments were aggregated, netting out all intra-trade between the acceding countries and the EU. It is likely that the United States, and some of the other WTO member countries, will not settle for anything less than that in the upcoming round(s) of EU enlargement. If so, an enlarged EU's WTO export subsidy commitments could be lower than they currently are in the individual countries, benefiting the United States and other agricultural exporters. However, as in the EFTA enlargement, the adoption of EU border measures will likely result in some tariff increases for the CEE's, resulting in some compensation negotiations (under Article XXIV).

How the enlarged EU will meet its WTO subsidized export and minimum import commitments has become clearer since the EU released its revised Agenda 2000 policy proposal package in March 1998. The EU is proposing a cut in support prices for beef (30 percent), dairy products (15 percent), and grains (20 percent). Oilseeds, which receive no support price, will receive the same compensatory payments as grains (which are lower than those currently in place for oilseeds), resulting in a decline in support to oilseed producers. The EU Commission believes that these price cuts will keep the EU within the bounds of their WTO subsidized-export limits. However, the Agenda 2000 proposals have not been widely embraced by the EU member countries, who ultimately will have to vote whether to adopt the reforms or not. Thus, it is likely that the agricultural policies adopted in the year 2000 could be quite different from the March 1998 Agenda 2000 proposals.

Analysis of Enlargement

Despite much uncertainty as to how the CEE and EU economies may change in the coming decade, some insights into the likely impacts of enlargement can be gained by analyzing some possible outcomes. Our analysis complements the analysis of Liapis and Tsigas (in this report), in that our model has greater agricultural policy detail, provides more detailed results for the agricultural sector, and can analyze differences among the CEE countries, while the Liapis and Tsigas model includes all sectors of the economy, maintains budget constraints, and can measure welfare impacts.

Two different scenarios were analyzed for this study: one where EU policies remain as they are today, and one in which the CAP is fully liberalized. It is likely that actual EU reforms will fall somewhere between these two scenarios. This can be seen in the Agenda 2000 proposals, though it is possible that the EU will need to undertake further agricultural reform prior to enlargement. In both scenarios, we analyze the impact of Poland, Hungary, and the Czech Republic—the three first-tier countries with the largest agricultural sectors—joining the EU. The two other first-tier countries—Slovenia and Estonia—combined produce less than 5 percent of agricultural production in the large first-tier countries.

Current CAP Would Create CEE Livestock Surplus

We assume that the three CEE countries join the EU in 2002 under the current CAP. As in the official USDA baseline projections[3] for the EU, the set-aside rate for the CEE's is fixed at 10 percent of arable land. We assumed that the CEE countries would be subject to the EU dairy quota. We fixed the quota at USDA's projected milk production for each of the CEE countries in 2001. The dairy quota also constrains CEE beef production as more than half of the beef produced is a product of the dairy herd. We assume that the EU would not increase intervention purchases and accumulate stocks beyond the historical average—accumulation of intervention stocks is viewed as a short-term strategy for dealing with excess supplies.

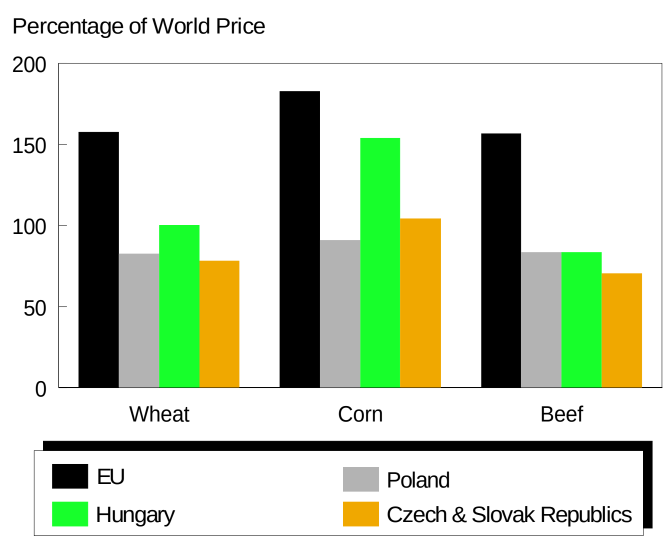
We also assumed that the CEE's will receive compensatory payments, set at their current levels and adjusted for inflation. This assumption is subject to some debate. It is possible that upon joining the EU, the CEE producers will be eligible for intervention and export subsidies, but will not receive compensatory payments. These payments were designed to compensate producers for price declines, such as those experienced by EU producers during the 1993-95 support price declines under the 1992 CAP reform and by producers in Austria, Finland, and Sweden upon joining the EU in 1995. However, CEE producers are unlikely to experience price declines upon application of CAP provisions. Yet, some in the EU argue that providing direct aid to farmers in only some member states would violate the EU principle of "cohesion" and exclude CEE's from one of the main income support instruments of the CAP.

According to our results, under the current CAP, the largest increases in CEE production would take place in the livestock sector, where pre-accession price differences are the greatest (figs. 1 and 2). Consequently, demand for feed grains would increase in the CEE's as well, particularly for wheat. Grain production in an EU-18 (the current EU-15 plus the Czech Republic, Hungary, and Poland) is expected to decline slightly (less than 1 percent) due to the adoption of the land set-aside by the CEE countries (fig. 3). At the same time, grain consumption (for feed use) is expected to increase by about 2 percent. The EU-18 would continue to be a major wheat exporter since we assume that the EU will be able to export wheat without subsidy by the time the CEE's join. However, due to the expansion of the livestock sector, the enlarged EU would need to increase its imports of other feedgrains such as corn.

We estimate that U.S. wheat exports would decline by about 1 million tons as increased EU-18 production would depress world prices, dampening U.S. production while stimulating consumption. However, we estimate that U.S. corn exports would increase by about 1.5 million tons due to the increase in EU demand.

If the CEE's adopt EU prices, CEE meat consumption would decrease by about 13 percent. Due to the large

Figure 1
Price comparisons for major commodities



[3]The official USDA projections for EU agricultural production, consumption, and trade for the period 1998-2007. See USDA, "USDA Agricultural Baseline Projections to 2007." Staff Report WAOB-1.

Figure 2
Potential changes in meat production, consumption, and net surplus

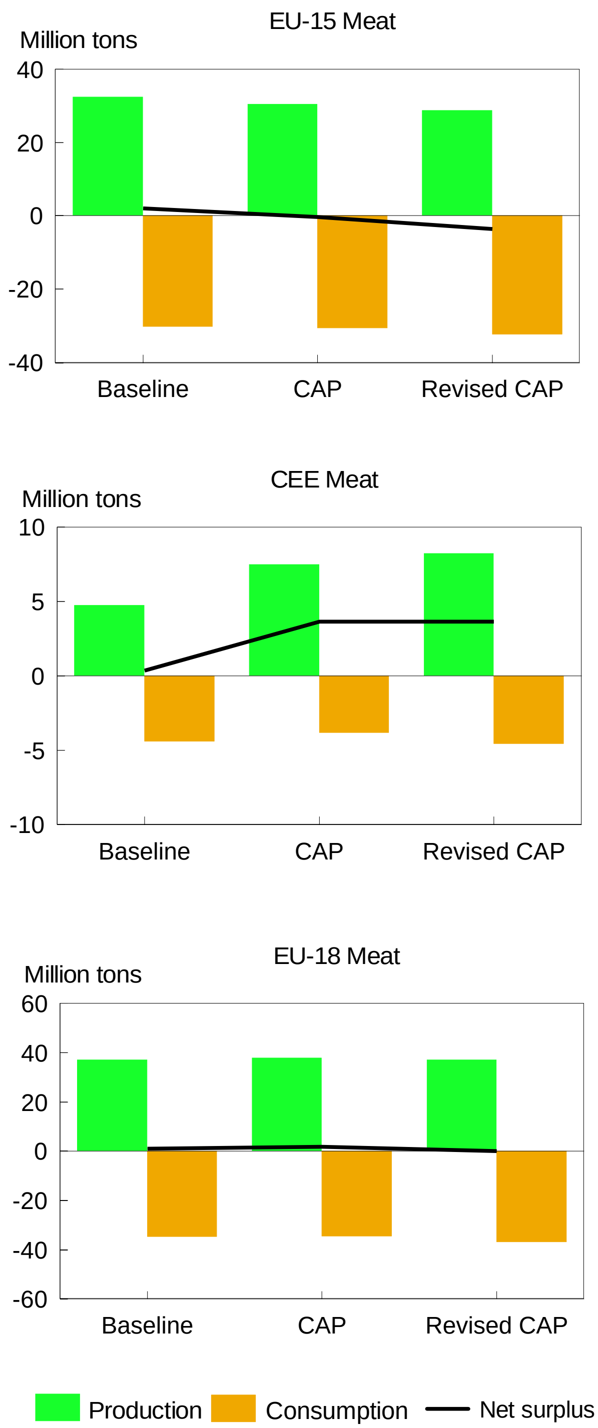
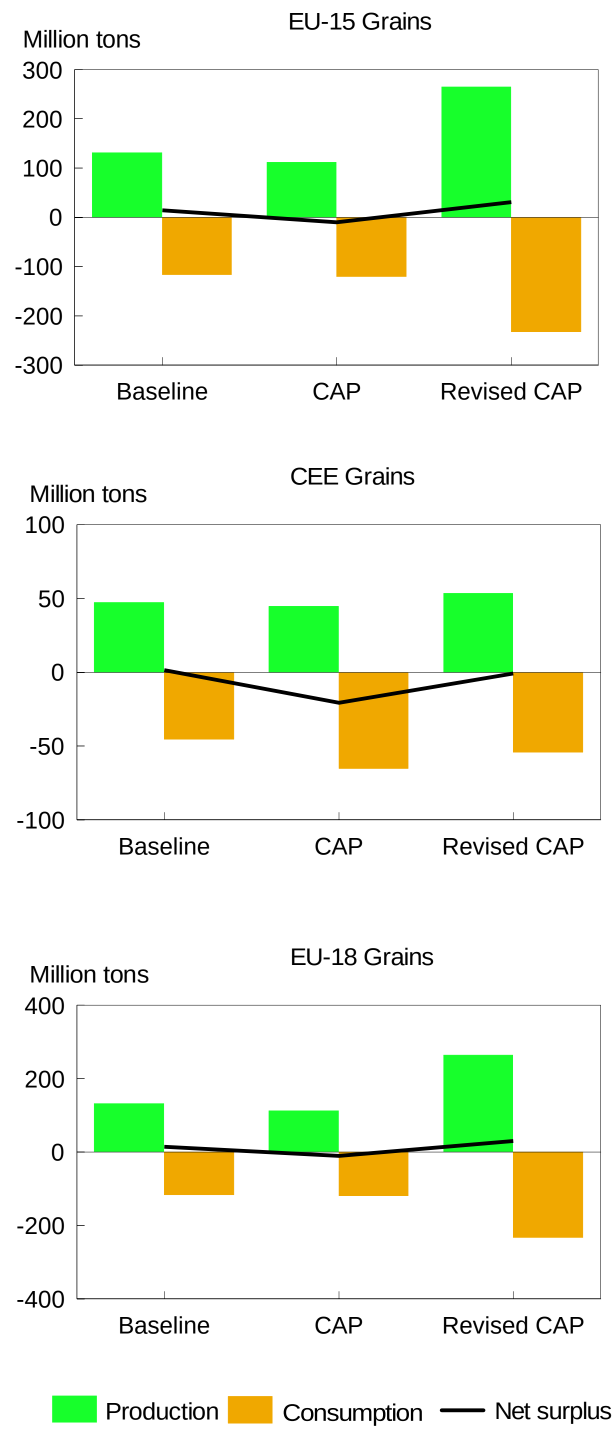


Figure 3
Potential changes in grain production, consumption, and net surplus



surplus in CEE livestock production and the current EU-15 meat surpluses, internal EU livestock prices will fall. Thus, we find that while production increases in the new CEE member states, EU-15 livestock production declines by 6 percent annually. At the same time, the decline in EU livestock prices will increase EU-15 meat consumption slightly (1 percent annually). The net impact for the EU-18 would be an increase in livestock production of 2 percent and a decline in consumption of about 1 percent. This would result in surplus meat production of about 4 million tons (compared with a deficit of about 2 million tons presently). The bulk of the surplus would consist of poultry, followed by pork. Because of WTO constraints on subsidized exports, it is likely that the enlarged EU will be unable to export all of the excess meat onto the world market, with little impact on third-country livestock markets (including the United States).

World Price Scenario: CEE Livestock Growth Dampened, Grains Increase

In our second scenario, we estimated the impact of first-tier enlargement in the absence of the CAP. We assume that the EU will abolish the set-aside requirements (as proposed under Agenda 2000), that there will be no internal EU price supports, and that the EU will move to world prices for all commodities. We also assume that EU farmers will not receive compensatory payments, including producer payments for oilseeds. The EU may continue to support farmers, but we assume that the support will be completely decoupled from production, that is, support payments will not affect farmers' planting decisions.

By adopting world market prices, prices for EU farmers fall to world levels and CEE prices increase in most sectors, but not to the same extent as they do under the current CAP scenario. Consequently, production gains should be smaller than in the current CAP scenario except in the arable crops sector, where elimination of the set-aside requirement will increase planted area. Additionally, the EU would no longer be constrained by WTO limits on subsidized exports because they would be producing at world prices.

With the elimination of the CAP, CEE livestock production gains would be less than under the CAP scenario, as CEE price increases would not be as large as when adopting EU prices. Consequently, feed demand would increase less dramatically than under the CAP scenario. At the same time, EU-15 livestock production would decline (and consumption would increase) as EU-15 farmers face lower prices. Overall, our results suggest that as EU-15 and CEE prices converge, livestock production will shift from the former to the latter. The EU-18 would become a net importer of beef, but would have slightly larger exportable surpluses of pork and poultry than ERS projections under current policies suggest. There would be very little impact on U.S. livestock exports because EU-18 trade would change only minimally.

Elimination of the set-aside would raise arable crop production in both the CEE countries and the EU. If the CAP reforms according to this scenario, the enlarged EU could increase wheat exports by nearly 15 million tons. Coarse grain production in the CEE countries is not expected to change, while EU-15 coarse grain production is expected to increase by about 5 million tons, or just more than 5 percent. As the price of grain falls in the EU-18, consumption is expected to increase, particularly in the CEE region due to an increase in grain feeding at the expense of meals. Thus, we do not anticipate any increase in coarse grain exports from the EU-18. In fact, the EU-18 will still need to rely on corn imports.

World wheat prices are projected to decline due to the large expansion of EU-18 wheat exports. Consequently, U.S. wheat exports are projected to decline about 3.5 million tons per year. At the same time, we estimate that the U.S. corn sector could increase its corn exports by about 1.4 million tons per year, though our model is not capable of specifying whether the exports would go to the EU-18. In 1997,

Table 1--Agriculture's contribution to CEE's and EU-15

	Population	% pop. in ag.	Ag. exports	Ag. imports
EU-15	372,810,000	47.1	$199,301,500,000	$201,893,500,000
Czech Republic	10,250,000	10.7	$1,223,057,000	$2,184,816,000
Slovakia	5,400,000	11.5	$417,387,000	$844,261,000
Hungary	10,200,000	13.5	$2,679,324,000	$964,974,000
Poland	38,500,000	22.7	$2,555,773,000	$4,013,152,000
Estonia	1,500,000	13.1	$334,866,000	$736,177,000
Latvia	2,600,000	13.2	$115,929,000	$299,716,000
Lithuania	3,800,000	17.4	$489,650,000	$323,299,000
Bulgaria	8,468,000	10.2	$892,666,000	$438,342,000
Romania	23,000,000	15.9	$711,457,000	$940,346,000
Slovenia	2,000,000	3.8	$365,281,000	$831,594,000

the United States exported nearly 1.5 million tons of corn to the EU-18 countries.

Our analysis focused on bulk commodities. However, prospects for U.S. agricultural exports to CEE countries as they integrate with the EU are favorable in the near term, particularly for high-value products. Rising income growth resulting from EU membership should increase overall demand for agricultural products, and U.S. exports could rise as total exports to the CEE region expand. U.S. exports of oilseeds, oilseed products, and some feeds may benefit as the CEE livestock sector expands. An expanding and modernizing farm sector may also raise demand for U.S. agricultural inputs.

Conclusions

As a customs union, the EU favors the importation of products from member countries over those from third countries. However, EU expansion will be closely watched by members of the WTO to make sure that it complies with WTO rules.

Much work remains before EU expansion can take place. CEE agricultural sectors will need to restructure for successful integration into the EU. Quality discrepancies between EU and CEE agricultural products could be problematic for the CEE's. Significant investment is still needed to improve farm productivity, complete the privatization of state farms and agro-industry, simplify government purchasing and market management practices, increase training in agribusiness and quality control, and implement programs that encourage rural development and structural adjustment. Further institutional reform will also be needed before EU integration is feasible. Because the EU has been functioning as a single market since 1992, the CEE countries will have to harmonize all of their legislation with that of the EU.

Within an enlarged EU, the absence of trade barriers between existing and new members will likely lead to trade creation among members. For countries outside the EU, including the United States, trade with the CEE countries will likely diminish after accession as new members adopt the CAP, including veterinary, sanitary, and phytosanitary standards, and the EU's border protection, that is, tariff rates. Bans on meat will now apply to new members, effectively blocking nonmember access to the EU market. However, all news may not be bad. EU integration will likely improve the economic situation of the CEE's and increase overall purchasing power to a level where the CEE's may import more than they would otherwise.

External and internal changes are pressuring the EU to modify the protectionist policies of the CAP. Unlike Austria, Finland, and Sweden, which entered the EU as net contributors, the CEE countries will most likely be net recipients, at least initially. The EU must modify the CAP to accommodate the budgetary impact of bringing in several large agriculture-producing countries and to meet its Uruguay Round/WTO commitments. The most recent EU reform proposal, Agenda 2000, reduces price support and increases direct payments to producers. Externally, the URAA requires all WTO members to reduce export subsidies and domestic support and to increase import access over a 5-year period (1995-2000). This multilateral agreement effectively constrains the EU's ability to lend limitless support to its agricultural sector, despite a potential increase in the size of the EU.