Special Article

EU Enlargement: Negotiations Give Rise to New Issues

The European Union (EU) continues active negotiations with 10 countries of Central and Eastern Europe (CEE) for membership in the EU. Negotiations began in March 1998 with five CEE's (Poland, Hungary, Czech Republic, Slovenia, and Estonia). In October 1999, the EU agreed to open negotiation with five others—Latvia, Lithuania, Slovakia, Bulgaria, and Romania. Cyprus and Malta—two non-CEE states—are also candidates for membership.

In 1999, USDA's Economic Research Service (ERS) analyzed implications of the enlargement of the EU by inclusion of the first five CEE candidates (*AO* December 1999). Economic model results suggested that EU enlargement could bring increased regional surpluses of beef, pork, and rye, but could also reduce surpluses of wheat. Recent developments differ from some of the assumptions underlying that analysis and thus some of its predictions.

Accession will most likely be delayed from earlier expectations and will probably include a transition period. EU negotiators have also expressed reluctance to grant CEE producers (farmers) the full range of Common Agricultural Policy (CAP) support immediately on accession. In addition, depreciation of the euro (the EU's new unitary currency) since 1999 means that the gap between CEE and the generally higher EU prices has narrowed considerably, and that higher prices anticipated by CEE producers upon accession may not materialize. Another important issue is the eventual levels at which CEE supply controls are fixed. All these factors could dramatically alter the impacts of accession on agriculture in Europe.

Accession Not Likely Until At Least 2005 . . .

On November 8, 2000, the EU Commission issued its annual set of reports on the readiness of each candidate-country for membership. A major disappointment for all the CEE's was the refusal of the EU to name a definite date for accession. EU officials state that they are hopeful that negotiations with the first group will be completed by the end of 2002. But all the EU member countries must then ratify the agreement, and this process could take up to 18 months. Thus, 2004 seems to be the earliest realistic date for enlargement of the EU with at least some of the 10 CEE candidate countries. Other EU officials say that 2005 is the first feasible date for accepting new members.

The reports praised most of the candidate countries for substantial progress toward harmonizing their legislation with that of the EU, but pointed out that all have more work to do in setting up structures needed to implement EU programs. The EU criticized nearly all the candidate countries for failure to guarantee the rights of minorities (principally the Roma), implement EU environmental standards, and battle corruption. In general, the EU

Nancy J. Cochrane

Commission considered Hungary and Estonia to be the most ready for accession. Poland, Slovenia, and the Czech Republic also have a realistic chance for early accession, and Slovakia and Latvia are not far behind.

Although the report on Poland still included that country in the list of countries almost ready for accession, the EU remains deeply concerned about lagging productivity in Poland's agricultural sector. The EU Commission insists on faster progress toward farm consolidation and a reduction in the labor force employed in agriculture.

A delay in accession will give the CEE's more time to undertake institutional reforms needed to enable their farmers to compete in a single market. EU officials have also hinted that a delay in the accession timetable could make it more likely that CEE producers could receive compensation payments upon accession. The budget in Agenda 2000 (agricultural and financial policy reforms to the EU's CAP) included substantial outlays to aid infrastructure development in the initial years of accession; it was envisioned that these outlays would begin in 2002 or 2003. Delays in accession beyond the year 2002 means that funds budgeted for 2002-04 would not be used. EU Agricultural Commissioner Franz Fischler has suggested that these savings could be redirected to provide higher direct payments for CEE producers. However, such a redirection of funds would have to be approved by the EU member states.

. . . But Price Gaps Are Narrowing

As accession is delayed, the gap between CEE and EU producer prices continues to narrow to the point where it is entirely possible that in 2005 or 2006 any price gaps will be negligible, prima-

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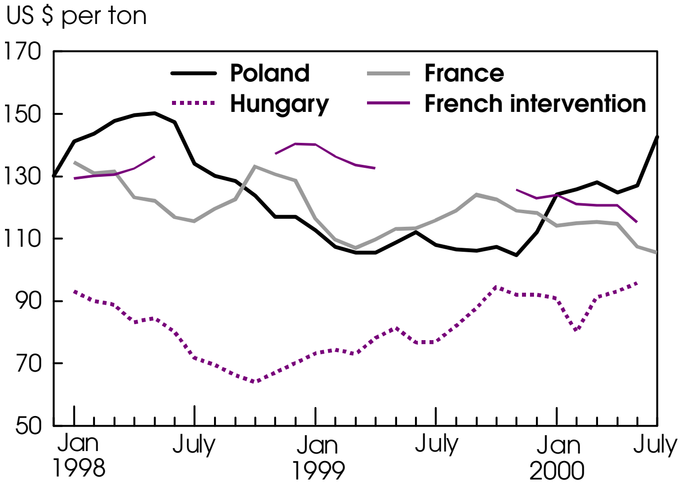
Gap Has Narrowed Between Wheat Prices in Eastern Europe and France



Producer prices in Poland, Hungary, and France. French intervention price supports market prices.
Sources: Agra Europe and Polish and Hungarian Statistical Bulletins.
Economic Research Service, USDA

rily because of continued depreciation of the euro. (Since launching of the euro in January 1999, its value had fallen from $1.16 to $0.85 by November 2000.) For example, in April 1999, the EU intervention wheat price was 70 percent above the Hungarian producer price. (The intervention price is the market floor price, less quality discounts, that triggers intervention mechanisms to support market prices.) In April 2000, the difference was just 29 percent, and the Polish wheat price was well above the EU intervention price. Patterns are similar with the prices of beef, pork, and feed grains.

The principle impact of a narrowing price gap will be to reduce potential pork and beef surpluses. Production will rise less than projected in 1999, and domestic consumption will not decline as much as projected earlier. Likewise, grain surpluses will be lower than earlier projected, although there could still be a shift from wheat to feed grains. Agenda 2000 establishes the same intervention price for wheat, barley, and corn. CEE feed grain prices are currently well below CEE wheat prices. As a result, the ratio of feed grain prices to wheat prices will shift in favor of feed grains.

Transition Periods Now Likely

In initial discussions about enlargement, both CEE and EU officials insisted that there be no transition period. CEE producers would immediately be eligible for all CAP support. But they would have to implement all EU legislation and regulations upon accession.

Both sides are now talking openly about the possibility of a transition period. For political and strategic reasons, the EU wants to move as quickly as possible to admit new members. At the same time, the November 8 reports point to a number of areas where candidate countries still need to improve. In tacit recognition of the immense challenge of implementing the full range of EU regulations, EU officials are now saying that a transition period may be necessary.

A transition period, however, means different things to the EU and the candidate countries. The EU has implied its willingness to allow a transition period for CEE candidates to implement environmental regulations that will require very large investments. But the EU also seeks a transition period before the CEE's are eligible for the full range of CAP benefits, including a 10-year period before CEE producers are eligible for compensation. In fact, one Polish analyst insists that the EU budget in Agenda 2000 does not even contain funds needed to provide any compensation payments to Polish farmers until at least 2010.

The CEE's all insist that they receive the full range of benefits immediately upon accession, but have requested transition periods for meeting some of the requirements for accession. Poland and Hungary have both requested the following:

- a transition period (18 years for Poland, 10 years for Hungary) before foreigners be allowed to purchase land;
- a 3- to 5-year period in which to meet the full range of quality standards for meat and milk, during which time those products not meeting EU standards would be sold only on the domestic market; and
- permission to sell meat not meeting EU standards to third countries during the transition period.

In addition, Hungary has requested exemption of existing wine stocks from EU standards until stocks are depleted.

Extra time to comply with EU sanitary regulations would ease the burden on smaller livestock producers and processors of the CEE's. Roughly half of Poland's meat output and 40 percent of Hungary's comes from processing plants that do not meet EU standards. Owners believe the investment needed to bring their plants into compliance is so prohibitive that they would have no alternative but to close down.

The EU has not given an explicit response to these requests. The EU has expressed willingness to grant transition periods in areas that will require large investments, but only if these exceptions do not interfere with the functioning of a single market. It is unlikely that EU officials will agree to the full range of exceptions requested by the CEE's.

In addition, if the EU were to agree to the CEE proposals to allow lower quality products to be sold on domestic markets, some sort of border controls between the CEE's and the current EU member countries would have to continue. Such controls would be contrary to the idea of a single market.

CEE producers could find themselves considerably worse off if the EU position on the shape of a transition period prevails. The two principal benefits anticipated by CEE producers are higher

The Double-Zero Agreements

A key initiative undertaken by the EU to prepare candidate countries for accession has been negotiation of a so-called double-zero agreement with each of the 10 candidate CEE's. The core of each agreement is elimination of tariffs and exports subsidies for a wide range of raw agricultural products. By July 2000, the EU had signed agreements with all candidate CEE's except Poland, which signed in September 2000.

The agreements are asymmetric in favor of the CEE's, in that they grant concessions for a higher share of CEE exports to the EU than for EU exports to the CEE's. The EU regards these agreements as an important step towards the ultimate goal of a single market.

The double-zero agreement with Hungary took effect July 1, 2000. It calls for reduced tariffs and an end to export subsidies for 72 percent of Hungary's unprocessed agricultural products and 54 percent of the EU's. The agreement establishes three lists of goods. All tariffs will be abolished for goods on the *first list*—a third of Hungary's agricultural exports to the EU. The *second list* includes pork, poultry, cheese, and wheat. For these goods, tariffs will be abolished for exports up to a given quota, provided exports above the quota are not subsidized. The duty-free quotas are to increase by 10 percent per year. The *third list* of goods will be subject to preferential tariff rates and includes exports of honey, mushrooms, and apple juice from Hungary and exports of cut flowers, tomatoes, apples, and rice from the EU. The elimination of export subsidies could make the export of some products to the EU more difficult. Even so, some Hungarian officials expect this agreement to generate an additional $1 billion of sales to the EU per year. The agreement does not cover live cattle, beef, dairy products, or wine. For beef and dairy product exports, Hungary will receive a share of a CEE-wide quota. Wine is covered under a separate agreement.

Negotiations with Poland were dealt a setback by Poland's decision in late 1999 to raise tariffs substantially for wheat, flour, beef, dairy products, and hops imported from the EU. The EU maintained this was a violation of the 1992 Europe Agreement, and the two sides temporarily suspended negotiations. Ultimately, Poland agreed to withdraw these tariff increases but only in exchange for a more favorable double-zero agreement.

According to the new agreement between the EU and Poland, tariffs will be completely removed on 75 percent of food products traded between Poland and the EU, including fruit, vegetables, horse meat, live animals, and mushrooms (the first list.) Pork, beef, poultry, milk, dairy products, and wheat are on the second list, for which the agreement establishes duty-free import quotas, which are to be increased by 10 percent per year. This third list of goods for Poland includes rapeseed and sugar. The EU also agreed to stop all subsidized exports to Poland.

The long-term impact of these agreements is negligible, since they will become void once the CEE's accede to the EU. But in the short term they will bring losses in tariff revenues that could be offset by increased exports of fruit, vegetables, meat, and other products. Both Polish and Hungarian poultry producers expect to benefit during the preaccession period. But in the case of Poland, for the time being, the duty-free pork quota is only theoretical because the EU maintains a ban on imports of Polish pork due to disease problems. And all the CEE's fruit and vegetable exports will continue to be subject to minimum import price requirements, which will continue to exclude all but the very top quality CEE products.

farm prices and access to direct payments currently enjoyed by EU member producers. Direct payments constitute a significant share of farm income in the EU. The 2000/01 payment for grains, for example, was 58.5 euros per ton, equivalent to nearly half the intervention price. It is quite possible that CEE producers would see no rise in revenues while incurring higher costs as they strive to comply with EU regulations. Without direct payments, they would find it very difficult to compete with EU producers whose substantial direct payments offset high production costs. In recognition of this vulnerability, CEE negotiators have refused to consider any sort of delay in eligibility for direct payments.

Supply Controls—Another Bone of Contention

The EU CAP provides for production quotas for milk, sugar, starch, and dried fodder. Agenda 2000 calls for continuation of these quotas (although the quotas will rise). In addition, direct payments provided to grain and oilseed producers are tied to a so-called base area and reference yield, set at a recent historical average for each region or country. Direct payments for male bovines, suckler cattle, and ewes are subject to national limits on herd sizes and limits on stocking density (livestock units per hectare.) These supply controls are the subject of intense negotiation between the EU and the CEE's, and the outcome could have important impacts on both post-accession production in the CEE's and their competitive position in an enlarged EU.

The EU is proposing to base all these quotas on 1995-99 average output and yields. Candidate CEE's have requested higher quotas, citing the now familiar argument that output in that period was still well below its potential because of the shocks brought about by the transition from centrally planned economies. For example:

Milk. Average 1995-99 output of milk was 11 million tons in Poland and 1.9 in Hungary. Poland is requesting a milk quota of 11.2 million tons in 2003 rising to 13.7 million tons in 2008. Hungary requested a quota of 2.8 million tons.

Grain. Hungary requested that 3.6 million hectares of grain be eligible for payments and wants those payments to be made on a yield of 5.2 tons per hectare. In fact, Hungary's grain area during the 1990's ranged from 2.3 to 2.5 million hectares, and average yield was 4 tons per hectare. Poland likewise requested a reference yield 15 percent higher than the 1986-90 average and a base area equivalent to the 1989-91 average, arguing that this would allow Polish grain output to expand to 30.8 million tons from the current level of 24-26 million tons.

Beef. None of the CEE's has a well-developed beef cattle sector. CEE cattle have traditionally been dual-purpose dairy-beef animals. They were raised primarily for dairy products, and beef was considered a byproduct. In addition, cattle numbers throughout Eastern Europe fell by a third to a half during the early years of the post-1989 transition due to a drop in consumer demand for milk. Both Poland and Hungary, eyeing the high beef prices that would come with accession, would like to develop a specialized beef cattle industry. However, EU proposals to use current herd levels as upper limits for beef cattle payments could reduce incentives to expand the beef sector.

A New Look at Land, Labor, and Capital

Production practices in Eastern Europe reflect relative costs of the primary factors of production—land, labor, and capital. Currently, land and labor are relatively cheap, while material inputs (feed, fertilizer, etc.) are very expensive, and capital is both expensive and difficult to obtain. The result is labor-intensive production and yields substantially below those of the EU.

Accession will likely bring substantial capital inflows. A key source of new capital is pre-accession funds pledged by the EU in two programs to aid the CEE's in preparations for accession.

- *Instrument for Structural Policies for Pre-Accession* (ISPA) to support infrastructure projects in transportation and the environment with a budget of 1,040 million euro per year; and
- *Special Accession Program for Agriculture and Rural Development* (SAPARD), targeted specifically to efforts to support sustainable agricultural and rural development during the pre-accession period. The EU has budgeted 520 million euros annually for the 10 CEE countries.

Both funds carry a 50-percent cofinancing requirement, and CEE governments must demonstrate they have established government structures capable of administering the funds. These requirements have slowed the actual disbursal of funds, but this year funds have begun to flow to the CEE's. Poland, for example is due to receive the first tranche of a 168-million-euro SAPARD package. Of this, 15 percent will be spent on farming projects, 35 percent on food processing, 10 percent on rural projects, and 40 percent on infrastructure. One project to be funded will provide grants of 25,000 euros to hog breeders and dairy farmers to bring their operations into compliance with EU standards.

The other source of new capital is accelerating foreign investment in the region, particularly in CEE food-processing sectors. Food processing is becoming more concentrated as a result, and more plants are being modernized to meet EU standards. These plants are already beginning to invest in primary production, to ensure a reliable supply of high quality raw product. Potential impacts on land and labor markets are complex.

Land. If foreigners are allowed to buy CEE land, then one can expect CEE land prices to rise. Even if foreign land ownership is restricted during a transition period, any rise in producer prices could put upward pressure on land prices. But two factors could limit that upward pressure. First, as pointed out above, prices for field crops may not rise as much as previously assumed. Second, a base yield set at the relatively low level of 1995-99 would limit the income potential of the land.

Labor. If labor is fully mobile throughout the enlarged EU, one would expect some convergence of CEE and EU wages. Higher wages could also result in the CEE's if the expected inflows of investment generate an increase in the demand for labor. However, labor mobility is a hotly contested issue in the negotiations. Several of the less wealthy EU members, fearing an outmigration of CEE workers, are insisting on a transition period before allowing full movement of CEE workers.

Another issue affecting wage developments is the relative skill levels of EU and CEE workers. A number of recent studies have pointed to a widening skills gap between CEE and EU workers and criticized the CEE's for insufficient investment in human resources. Poland is considered to be more of a problem in this regard than Hungary or the Czech Republic. One study estimates that Polish labor productivity is five times under the EU average and warns that unemployment could rise significantly after accession. Any rise in investment will lead to greater demand for skilled labor and a decline in demand for less skilled workers.

Is There a Silver Lining?

The outcome of discussions of direct payments and supply controls could have a profound impact on the size and structure of CEE agriculture after accession. Without further restructuring, the agricultural sectors in the CEE's, particularly Poland, could shrink after accession.

On the other hand, the probable delays in accession will give more time to CEE producers and processors to carry out needed restructuring and prepare to compete in a single market. This process will be aided by expected capital inflows from foreign investors and EU pre-accession funds.

The result could be that despite the costs associated with accession, CEE agricultural output will remain stable or even rise. However, the structure of the sector could change profoundly. Structural changes could be most dramatic in Poland. The Communists failed in repeated attempts to collectivize Polish agriculture, with the result that Poland is the only CEE beginning its transition with an agricultural sector dominated by small private farms. Ironically, preparations for EU accession could do more to force changes in Polish agriculture than the Communists were able to do in 40 years. AO

Nancy J. Cochrane (202) 694-5143
cochrane@ers.usda.gov

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