

CHAPTER 5

THE DIRECT COSTS TO BRITAIN OF BELONGING TO THE EEC

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Introduction

The main prospectus which formed the basis of the public discussion about whether or not to join the EEC - the White Paper *The United Kingdom and the European Communities* (Cmnd.4715) published in July 1971 - made no bones about the fact that joining the Community would involve the UK in substantial direct costs to the balance of payments. These were the so called 'static' costs of entry into the club, which were to be paid for through the 'dynamic' benefits conferred by having a 'home market' of 250 million consumers, as well as through advantages of a non-economic kind.

As set out in Cmnd. 4715, the direct costs to the UK balance of payments would fall into two categories. First there would be an annual net cash contribution to the Community budget, most (though not all) of which would support the agriculture of our fellow members in one way or another. Second, the UK would pay the EEC higher prices than we would have to for food imported from traditional suppliers. There would be a rise in food prices to the consumer, but this, though important in itself, would not constitute an additional cost to the UK as a whole. Cmnd.4715 clearly implies that in part the higher retail prices would be paying for the imports already taken account of in the second category of direct cost listed above, and that in part they would represent an internal redistribution of income away from consumers of food in favour of the general taxpayer and the farmer.

In the first part of this paper we compare, so far as possible, what has happened with what was in the prospectus. It seems important to do this not only because it is of interest in itself, but because the nuance at least of some recent comments is that there is a nil or negligible cost, notwithstanding that one was always foreseen. But our results here cannot represent a true test of the accuracy of the original forecast because there have since been too many changes - in particular to exchange rates and concomitant arrangements to deal with these - which were not and could not have been taken into account.

This chapter provides rough estimates of present and future direct costs to the UK on various assumptions about relative currency movements. It also presents estimates of the addition to the retail price of food as a result of membership.

Summary

If approximate allowance for inflation is made, the Cmnd.4715 estimates implied that, in 1978, the total direct balance-of-payments cost would be £800-900 million; the White Paper also suggested that the retail price of food in 1978 would be about 16% higher than would otherwise be the case.

Our estimate of the direct cost to the balance of payments comes to about £1,000 million in 1978, or rather above what was in the prospectus, while our estimate of the addition to the retail price of food - about 12% - is slightly lower. In 1980, at the end of the transitional period, however, the direct cost to the balance of payments (for which the White Paper did not give an estimate) will increase significantly to about £1200 million at 1978 prices, assuming the green pound is not devalued any further.

Moreover since the British economy is constrained by the balance of payments in the extent to which it can expand demand, the true cost of membership, in terms of the sacrifice of real national income, is perhaps 3 times larger than the direct cost to the balance of payments, i.e. if the latter cost is £1 billion per annum, this means that real national income and expenditure could be around £3 billion higher.

Some first principles

Before coming to the quantitative estimates it may be useful to recall some elementary general principles concerning trade in, and support for, agricultural products. The first point to get clear is that there are two fundamentally different ways in which countries have protected their agricultural production in recent years, when prices in world markets have not been high enough to generate adequate income for farmers. Under one method consumers pay for food at world market prices with the government making up domestic farm incomes by deficiency payments. Under the other method consumers maintain farm incomes directly by themselves paying the higher prices; in this case lower priced imported food has to bear a levy.

Given that agriculture is to be protected, the choice between the two methods is predominantly a matter of the internal distribution of income. The real national income is about the same in each case; in the high price case consumers of food are worse off and the general taxpayer better off to a roughly equal extent.

Where the agricultural sector comprises a large percentage of the population, then ease of administration favours the 'high price' method. However, as the agricultural population declines, it becomes easier to adopt a deficiency payments system.

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In any case the problems of the smaller marginal farmer can be tackled more effectively under the deficiency method because (given the total cost of support) this allows greater flexibility in the way support is distributed.

A further important point is that with a deficiency payment system it is generally pretty clear how much domestic farmers are being subsidised in total and which commodities are the main beneficiaries. With consumers paying artificially determined prices which are higher than the world price, the whole thing is much harder to pin down, particularly since it is always possible to argue that the alternative world price is hypothetical and incalculable.

Before our accession to the EEC the British government mainly used the first of the two mechanisms; consumer prices for food were in a number of important cases near to 'low' world market prices but in several instances, e.g. bacon and butter, market sharing agreements were in force which stabilised our import prices at levels higher than normal world prices and in the case of sugar were subject to a long-term agreement partly designed to take account of the welfare of developing Commonwealth countries. Farmers' incomes were made up by deficiency payments.

The CAP method in principle

One of the main changes between the old British system and the CAP system is that the latter relies very much more on the second of the two mechanisms, transferring the main burden of farm support from the general taxpayer to the consumer of food who has to pay such prices - fixed by Community negotiation - as will go most of the way towards keeping the European farmer in business. Note that the total support required by Community farmers in practice exceeds what they receive from consumers by cash sums which are spent on agriculture out of the Community budget; these sums will either be paid direct to farmers in the form of grants or export subsidies, or used to buy in excess supplies which are carried as 'mountains' or 'lakes'. In other words the high consumer prices simultaneously discourage consumption and encourage production; as supply then exceeds demand the taxpayer must finance removal from the market of such excess supplies by intervention, storage, destruction or subsidised sales abroad. Thus the fact that there are net payments out of the farm budget means that, taking the Community as a whole, farmers gain at the expense *both* of the consumer *and* (though to a less extent) of the general taxpayer.

This is looking at the Community as a whole. The change for Britain was more fundamental than this, because we were now to buy our imports not in world markets at world market prices but from the EEC at (higher) EEC prices, with levies imposed on imports from outside the EEC to bring them up to EEC price levels. Thus it was envisaged that the direct costs to our balance of payments of joining the EEC would take two forms: we would both pay higher food prices to foreigners than otherwise and make a cash contribution to the Community budget.

Estimates of all these direct costs were given in the 1971 White Paper. It was there foreseen that our net contribution to the Community budget in 1977 might

be around £200 million, at 1971 prices, with a moderate further increase in 1978 (paragraph 93); the balance-of-payments cost from higher food import prices was put at £50 million per annum at the end of the transitional period (i.e. in 1978), and the cumulative addition to the retail price of food (compared with what otherwise would have happened) would then be about 16% (paragraph 43, which presents this in the form of $2\frac{1}{2}\%$ per annum over six years). To make a fair comparison with the present time, the money figures in these projections should be multiplied by around $3\frac{1}{2}$ to allow for the rise in the price of our imports since 1971, i.e. the budgetary contribution should be about £700 million in 1978 at current prices and the balance-of-payments cost of higher food prices around £150 million. The estimate of the balance-of-payments cost from higher food import prices was struck after allowing for some reduction in consumption of food and a substantial increase in the proportion of food produced at home. By implication, therefore, the CAP prices were expected to be not only above UK consumer prices but also above prices previously guaranteed to UK farmers.

The next section considers how well these forecasts have turned out.

Estimates of the net contribution to the Community budget can be obtained from the recent White Paper on Public Expenditure (Cmnd.7049). The net contribution for 1978 is put at £660 million. Note that this figure does not change significantly (in sterling) if either spot or 'green' currency rates change. This is because up to 1980 the budgetary contribution is fixed in special units of account, which are different in kind from those used for agricultural prices and are translated into spot sterling at a fixed rate of exchange even if depreciation of a normal kind occurs.

Analysis of the balance-of-payments cost of higher import prices falls into two parts. The first, relatively easy, part is the calculation of the level of food prices we shall be paying after the next price review in April; this may be obtained by translating Community prices from agricultural units of account - assumed 1-2% higher than at present February 1978 - into sterling at the proposed green or 'representative' rate. The relevant figures are shown in columns 1 and 2 of Table 5.1.

The second, more difficult, part is the estimation of world prices in the final column. The price shown for grains is indeed the price at which these commodities are being traded in world markets. This seems fair on the grounds that a large international trade is taking place.

The price shown for sugar is far in excess of the current 'world market price' for job lots - at present not much over £100 per tonne. We have entered instead a price which, although it is less than that which the ACP countries are now receiving, is what we believe to be a reasonable estimate of a long-term price for sugar such as might have been negotiated under the old Commonwealth Sugar Agreement. In any case, taking a higher price for sugar will have only a marginal effect on our final results.

A similar assumption has been made for butter. The £900 shown as the world price is that at present guaranteed to New Zealand, which is far higher than that obtaining in the 'job lot' market and about double

Table 5.1. Community* and 'world' prices

	Community prices (per tonne)		'World' prices (per tonne)
	Units of account ^(a)	1978 prices £	spot sterling £
Wheat	164	105	85 ^(b)
Barley	151	99	75 ^(b)
Maize	151	99	70 ^(b)
Raw sugar	340	219	160 ^(c)
Refined sugar	397	256	200 ^(c)
Butter	2520	1630	900 ^(c)

Sources: (a) EEC and UK Prices 1977/78 Agricultural Commodities, Ministry of Agriculture, July 1977.

(b) Financial Times Commodity Market Report, 8.2.78.

(c) See text.

* In converting to 1978 prices it has been assumed that the prices shown in units of account (which are those set for 1977) will be increased as follows in 1978: grains by 1.3%, sugar by 2%, butter by 2%. The conversion rate is 1.58u.a./£1.

the price which the Community has recently obtained on a few occasions.

There are some important commodities, in particular cheese, beef and pigmeat, which are not shown above because with so many small components within the broad categories we have not been able to put together useful figures. There is no doubt, however, that average CAP prices for these commodities in sterling at par would substantially exceed 'world' prices, as levies are payable on imports from non-EEC countries.

These figures enable us to put together Table 5.2 which shows, in column 3, a rough estimate of the balance-of-payments cost of higher food prices on the assumptions that the green pound is devalued by 7½% as now agreed and that imports under the CAP are the same as those actually recorded in 1977. In practice, with higher prices, imports will probably be lower in future and we shall make allowance for this.

The rough estimate of the addition of the cost of imports (i.e. £400 million) may be used in conjunction with information in Table 5.3 to make estimates of the difference which has been made to consumer prices.

Column 1 gives rough estimates of food sales and their components. Column 2 adjusts the cost of all the levy products (lines 1, 2 and 4) to correspond roughly with world prices excluding levies. Other costs are entered at the same values as in column 1, apart from the mark-up of manufacturers and distributors, which is assumed constant at 30% of total input costs. This figuring implies that the addition to the retail price of food as a result of membership is about 12% (i.e. 1 - 21.0/18.7).

We can now compare the 1978 position with that in the 'prospectus'. In presenting these it cannot be too strongly emphasised how rough and ready they are. We have perforce ignored what could conceivably be significant problems to do with aggregation and differing cost structures for different industries.

Table 5.2. The balance-of-payments cost of higher food prices

	1 Community less world prices: (£ per tonne)	2 Volume of imports from EEC ^(a) in 1977 (million tonnes)	3 Additional cost of food imports ((1) x (2)) £ million
Wheat	20	2.43	49
Barley	24	0.62	15
Maize	29	0.87	25
Raw sugar	59	0.11	6
Refined sugar	56	0.22	12
Butter	730	0.19	139
Cheese, beef ^(b) , pigmeat, etc.			150
Total imports			400
Less Exports of levy products to EEC			70
Less Allowance for lower imports			30
Total net balance-of- payments cost of higher food prices			300

Sources: (a) HMSO, Overseas Trade Statistics of the United Kingdom, December 1977.

(b) An estimate based mainly on the size of levies on imports from non-EEC countries.

Column (1) in this table is obtained by subtracting column (3) from Column (2) in Table 5.1.

On item 1 the prospectus appears to have been in the right target area. There is some difference between the estimates of the balance-of-payments cost through higher food prices and this appears to be because Cmnd.4715 assumed a greater addition to consumer prices - item 4 - and farm incomes than has actually occurred; consequently it was inferred that imports would be lower because domestic consumption would be lower and production higher (see Table 5.4).

Notes on the green currency system

Changes in real exchange rates between EEC countries are mainly governed not by trade in food but by divergent trends in the balance of trade in manufactures and oil, by divergent fiscal and monetary policies and by speculative and other international capital movements.

Were agricultural units of account to remain convertible into domestic currencies at spot rates, the prices to both consumers and producers would of course move by the full amount of any appreciation or depreciation. The potential effect, particularly on producers and the pattern of production, makes this situation unsatisfactory; the success of German manufactures in world markets would cause a drastic

Table 5.3. Food sales and their components in 1978 on alternative assumptions about the price of levy products

<i>£ billion</i>	1 Estimated actual ^(a) including levies	2 Col. 1 at world prices excluding levies
Imports of levy products from EEC	1.6	1.2
Imports of levy products from elsewhere	1.3	1.1
Imports of other food	2.7	2.7
Domestic farm production of levy products	4.6	3.5
Other domestic farm production	1.4	1.4
Other inputs to food production (i.e. mainly costs to manufacturers)	4.5	4.5
Total input costs	16.1	14.4
Mark-up of manufacturers and distributors (0.3 of input costs)	4.9	4.3
Total final sales of food (including catering, exports, etc.)	21.0	18.7

(a) Authors' estimates based on the following official publications: Overseas Trade Statistics of the United Kingdom, December 1977; Annual Review of Agriculture, Cmnd.7058; National Income and Expenditure 1966-1976, August 1977.

fall in German farm income and production; the failure of British industry would bring about a big bonanza for British agriculture.

Accordingly the green currency system was invented; this allowed countries, when their currencies depreciated or appreciated, to continue to translate agricultural units of account into spot currency at whatever was the rate before the exchange rate adjustment. It was also open to countries, subject to negotiation, to change the 'green' rate (i.e. the rate between agricultural units of account and spot currencies) by some part, or the whole, of the distance to the new par. Note that under present arrangements the green pound can only move towards par, never away from it. Thus a country whose exchange rate is above its green rate cannot devalue its green rate; a country whose exchange rate is equal to its representative rate can neither devalue nor revalue its green rate; and so on.

After the proposed 7½% devaluation takes effect, the combination of spot and green rate adjustments means that the present sterling exchange rate will still be 20% lower than its par value for the purpose of Community agricultural price fixing, while the German mark will have appreciated by 7½%.

The whole thing is much easier to understand in terms of the prices which are implied by alternative

Table 5.4 The cost of membership in 1978 as foreseen in 1971

	Cmnd. 4715	Current estimate
1. Contribution to budget (£ million at current prices)	700	660
2. Balance-of-payments cost of higher food prices (£ million at current prices)	150	300
3. Total balance-of-payments cost ((1) + (2))	850	960
4. Effect on consumer price of food	16%	12%

assumptions about the green pound rate. Table 5.5 below adapts the format of Table 5.1 to display these.

Are we being 'subsidised' by the Community?

The view is often expressed that with a green pound which has not been fully devalued, the Community is 'subsidising' us to the extent of 'about £1 million a day'. The question who is subsidising whom falls into the familiar two parts, the cost of food and the contribution to the budget.

The cost of food is derived from the prices in Table 5.5 in conjunction with the volumes in Table 5.2.

The 'subsidy' we are sometimes said to be receiving is shown in column 3 - this is the difference between what we are paying and what we would be paying with a fully devalued green pound, assuming unchanged volumes. Our total is £375 million, which is close to £1 million a day even if some downward adjustment were made to volumes.

This is a way of considering the matter which is simpler than, but logically equivalent to, that expressed in terms of the infernally complex

Table 5.5. Community and world prices in 1978 on alternative assumptions about the green pound^(a)

<i>£ per tonne</i>	(1) With proposed 7½% devaluation*	(2) With full devaluation	'World' price
Wheat	105	130	85
Barley	99	120	75
Maize	99	120	70
Raw sugar	219	267	160
Refined sugar	256	311	200
Butter	1630	1980	900

(a) Column (1), EEC prices translated at 1.58 u.a./£1.

Column (2), EEC prices translated at 1.3 u.a./£1

* But here and in column 2 the same assumptions are made about higher Community prices as in Table 5.1.

machinery for making monetary compensation amounts (MCAs) - the cash payments which have to be made if trade occurs between countries when the price received by producers differs from that paid by consumers (each denominated in its own currency). thus MCAs paid for the benefit of the UK in 1977 should equal the approximately £375 million shown in Table 5.6.

We have two major comments on the proposition that the £325 million in Table 5.6 represents a 'subsidy'. First, if the green pound were fully devalued this would add about 20% to the price received by British farmers for levy products and generate a large increase in production; it would also add about 6% directly to the retail price of food - 8% if a reasonable allowance for 'mark-ups' is made as in Table 5.3 - and cause some reduction in consumption. Imports of food from the EEC would therefore be much lower - probably *at least* £330 million lower- and one major market for those products which are currently in surplus would be significantly reduced.

But second, the situation is in our view much better indicated by the final column of Table 5.4, which suggests that the balance-of-payments cost of food imports would be £330 million *less* than at present if we were not members at all. It should be added, moreover, that the gain to the rest of the Community's balance of payments through our paying them the prices we do exceeds the direct cost to us of belonging. This is because, whereas we probably could not satisfy our needs for, say, butter and sugar at low 'job lot' prices (and in our calculation it has been assumed that we do not), the Community is unable to sell its surpluses on world markets at prices better than these 'disposal' prices, if at all. If the Community were otherwise selling at disposal prices (say £100 and £450 per tonne) the sugar and butter it now sells to the UK the gain to the rest of the Community as a result of our membership would be increased by £100 million or so (making say £450 million in all), while if, as now seems rather likely, they were not sold at all the gain is raised to about £200 million (making a total of £550 million).

So far as our contribution to the Community budget is concerned, it is sometimes suggested that there would be something equitable or natural about our gross contribution to the Community corresponding to our proportion of its gross national product. This is certainly the implication of Cmnd.4715, paragraph 93. But there is in our view no justification whatever for this view.¹ The Community budget as a whole is kept in approximate balance, so the relevant questions are: *who are the net contributors and who are the recipients?* What is the size of the net contributions or receipts? What possible justification is there for the pattern that is in prospect? So far as we know no table has ever been published which provides this elementary information. What seems clear is that, since we are net contributors, to the tune of £660 million in 1978 rising to at least £830 million in 1980, our fellow members taken together are net recipients to the same extent. The cause of this situation would appear to be simply that we import a relatively high proportion of our food; it has in our view no justification whatever in economics or equity.

¹In any case our gross contribution in 1980 looks like being about 21%, compared with a GNP share of about 15%.

In sum, so far from the Community subsidising us, clearly it is we who are subsidising the Community, to the extent of around £1000 million taking everything into account (including the recent 7½% devaluation).

Looking further ahead to 1980 our net contribution to the budget is expected to rise by another £200 million or so to £830 million at 1978 prices; so on the assumption that food prices rise in future at the same rate as other prices, both in the EEC and in the rest of the world, the net direct cost to our balance of payments will rise to about £1200 million.

Should the green pound be fully devalued - and our understanding is that common prices remain, at least formally, a long-run objective of the Community - this would raise our net contribution to the budget, because levies on non-EEC imports would go up and from 1980 (but not before) these will be payable to the Community budget.

A digression on macroeconomics

It is argued in the main article in this *Review* that the rate at which the British economy can expand is likely to be severely constrained in the medium term by the balance of payments. If this is correct, the loss of real national income and output which is indirectly caused

Table 5.6. The additional balance-of-payments cost of full devaluation of the green pound

	1 Volume of imports (in tonnes)	2 Community price with green pound fully devalued less community price with green pound as at present proposed (£ per tonne)	3 Cost of full devaluation 1 x 2
Wheat	2.43	25	61
Barley	0.62	21	13
Maize	0.87	21	18
Raw sugar	0.11	48	5
Refined sugar	0.22	55	12
Butter	0.19	350	66
Other levy ^(a) products			100
Total			375
Less benefit from export earnings			50
Total			325

(a) An estimate based on the size of current MCAs paid on imports from the EEC.

²We do not take account here of the putative 'dynamic' advantages which are supposed to come from having a 'home market' of 250 million people. Any dynamic advantages are, in our view much more likely to arise from the additional growth in demand which the raising of the balance-of-payments constraint would make possible than from a measure of free trade within the Community.

by the direct cost of membership to the balance of payments is far greater than that cost itself. Thus if we take the balance-of-payments target as given, and therefore assume that without having to pay direct costs we could import an equal amount more in the form of goods or services, there could be an addition to the real national output, according to the relationships set out in the CEPG model, about twice the size of the direct costs; i.e. with direct balance-of-payments costs of £1 billion the addition to the GDP would be about £2 billion, or nearly 2%. But the addition to the national income (i.e. what could be added to what we can actually spend) would be about £1 billion more than this, making £3 billion in all, because of the improvement in the terms of trade and in the flow of net income from abroad. In 1980 with an estimated direct cost of £1.2 billion (at 1978 prices) the addition to the real national income would be £3.6 billion.

Postscript on the current negotiations

We first point out the pretty obvious fact that the difference made to our position through belonging to the Community is far more fundamental than moving over to a system where consumers themselves carry the main burden of farm support. The Community prices which we as heavy importers have to pay are determined as a result of political pressures in which farming interests have a great deal of leverage, and the fact that imports from outside the Community are largely excluded by protective devices removes a considerable part of the constraints which economic forces would otherwise be exerting. Because these political pressures have been so strong, notwithstanding the protection afforded, prices have been set so high that huge surpluses have been accumulated and continue to grow within the Community.

The extent to which the UK can insulate itself by not devaluing the green pound is limited by the fact that British farm incomes get progressively squeezed; their prices are fixed in money terms while their money costs rise. Moreover anomalies arise because *relative* prices of individual commodities remain fixed in agricultural units of account; the overall squeeze will fall on different categories of produce with different and, on the whole, arbitrary severity.³

Somewhat surprisingly, in view of the argument presented here, the Council of Ministers initially threatened to reject the recent proposal by the British government to devalue the green pound by 7½%. This seems at first sight surprising simply because, taken by itself, this change would increase our payments to the Community.

The strong presumption must be that the Commission's reluctance to allow the green pound's unconditional devaluation is related to the fact that Britain and the Commission itself will wish, with considerable justification in view of the growing surpluses, to limit the forthcoming rise in farm prices to an absolute minimum at a time when there is heavy pressure from the European farming lobby to make sizeable increases. Britain is in a potentially favourable position at the moment because of the possibility of having it both ways; it can argue that Community prices should not be raised to Community farmers because of the surpluses, but at the same time obtain a sizeable benefit to British farmers (with not too large an increase in consumer food prices) by devaluing the green pound - although this will have the effect of raising production. It thus seems rather likely that the Commission wishes to relate the green pound arrangements to the price fixing arrangements, so as to ensure that if British farmers benefit farmers in other countries will do so as well.

³ This is because (for instance) that part of the import content which has to be paid for in (ordinary) foreign exchange will form varying proportions of different commodities.