

Reform of the EU's Agricultural Policy

by Chris Milner¹

1. CONTEXT

European farm ministers announced on June 26th what they claim represents a fundamental reform of the EU's Common Agricultural Policy (CAP). Certainly the principles underpinning the reforms are a radical change with the past. Franz Fischler, the EU's agricultural commissioner described the reforms as the 'beginning of a new era', and the EU press release starts with the sentence 'EU fundamentally reforms its farm policy to accomplish sustainable farming in Europe'. In headline terms – the breaking of the link between farm subsidies and production levels and the lowering of support prices for some major products – the reforms appear to confront the major internal and external challenges to the existing CAP arrangements.

The CAP currently costs around •43 billion a year (about 40% of the total EU budget). Some member states have long objected to the cost of the arrangements, and to the inefficiencies associated with paying farmers to produce unwanted food. The prospect of a major enlargement of the EU, including of entrants with major agricultural sectors, has intensified budgetary concerns. Although the CAP benefits are not currently on offer to the new entrants, pressures for uniformity of treatment within a common policy will no doubt persist post-accession. With the current CAP arrangements, extension to the new members would definitely be unsustainable in budgetary terms. The current reforms seek to introduce new financial disciplines, but the budgetary time bomb of enlargement has not necessarily been diffused.

The external criticisms of the CAP come from other industrial countries and from the developing countries, who are excluded from the large EU market by trade barriers or hurt by world prices depressed by subsidised EU exports or undercut in their own or others' markets by subsidised EU farmers. Agricultural trade liberalisation was in fact on the agenda for the first time during the last multilateral trade negotiations (the Uruguay Round). Many of the developing countries have been dissatisfied both with the limited reforms agreed to and with the amount of reform actually implemented following that round of negotiations. They have been even more determined as a result to use the current Doha Round of trade negotiations to bring about fundamental reform and improved market access. The negotiations have, however, already been delayed by EU resistance, and it is suggested that the survival of the Round is at risk if no progress is made this autumn at the Cancun meeting of trade

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ministers. The current reforms are presented by the EU as strengthening the EU's negotiating hand in these World Trade Organisation (WTO) trade talks. Again the headline reforms – 'de-coupling' and reduced price supports – appear to make the prospect of concessions by the developing countries and other industrial countries (especially the USA) more likely. It will be the detailed, actual implications of the reforms for world prices and EU market access, however, that fashion the attitudes and positions of the other 'actors' and the progress of the trade talks.

2. THE ANNOUNCED REFORMS IN SUMMARY

- *De-coupling from production*

Farmers will receive a single farm payment from 2005, based on the average level of subsidies in the last 3 years (2000-2). This payment will in general no longer be linked to the amount of production or be related to individual product premiums.

The new system will apply principally to arable production, but will also cover the beef and sheep sectors and be extended later (from 2008) to dairy production.

Note two important deviations from the above reforms. First, member states may delay the move to single farm payments until 2007. Second, member states may maintain some production-based subsidies if they deem it necessary to reduce the risk of land abandonment. For arable crops per hectare payments of up to 25% of the existing levels can be made. Similarly production-related payments (of varying percentages of current levels and including upto 100%) can be used by member states in the livestock sector.

- *New coupling to the environment and standards*

Full granting of the single farm payments and other direct payments will now be linked to satisfying of a number of environmental, food safety, animal and plant health, and animal welfare standards.

- *New incentives for rural development*

Incentive payments will be available to farmers who participate in schemes to improve environmental and product quality and to meet new production standards. Support will also be available to producer groups for product quality enhancement schemes.

- *Reduction in direct payments for larger farmers*

In order to fund the above rural development measures, direct payments to larger farmers (with direct payments over •5000 per year) will reduce (with the exception of the outermost regions). These reductions or 'modulations' of direct payments will rise from 3% in 2005 to 5% from 2007.

- *Strengthening overall financial discipline*

The fixing of a ceiling for CAP expenditure (at approximately current levels) means that a financial discipline mechanism will have to be introduced from 2007.

- *Revisions to specific price and market policies*

The reforms maintain some and amend some specific price support measures in the arable and dairy sectors; the details are set out in table 1 below. There is also a commitment to future reforms of the olive oil, tobacco and cotton sectors.

Table 1: Summary of Specific Pricing and Marketing Reforms in the Arable and Dairy Sectors

<i>Sector</i>	<i>Revisions</i>
ARABLE	
- Cereals	<ul style="list-style-type: none"> • Current intervention price maintained • Seasonal correction to interventions price reduced by 50% • Rye to be excluded from intervention system, but with transitional support given
- Protein crops	<ul style="list-style-type: none"> • Current supplement maintained and converted into crop specific area payment (subject to an overall limit)
- Energy crops	<ul style="list-style-type: none"> • Aid proposed, subject to an area maximum
- Durum wheat	<ul style="list-style-type: none"> • Supplement in traditional production zones de-linked from production, except member state may keep 40% of supplement tied to production • Specific aid for other regions will be phased out • New premium introduced in traditional zones to improve quality used for semolina and pasta production
- Starch potatoes	<ul style="list-style-type: none"> • 40% current payment to producers will be included in single farm payment, remainder continued as a crop specific payment
- Dried fodder	<ul style="list-style-type: none"> • Direct support to growers will be integrated into single farm payments; national quantity ceiling will apply • Processing aid fixed from 2004/5
- Rice	<ul style="list-style-type: none"> • One step reduction in intervention price by 50% • Intervention limits set • Direct aid will be increased; partly through single farm payment and partly through crop-specific aid
- Nuts	<ul style="list-style-type: none"> • Introduction of annual flat rate payment, for fixed national areas • Aid can be supplemented by member states up to a maximum amount per hectare
DAIRY (Quota system prolonged until 2014/15, with following revisions:)	
- Milk sector	<ul style="list-style-type: none"> • Intervention price for butter will be reduced by 25% (progressively from 2004 to 2007) • Intervention purchases for butter will be suspended above falling limits. • Intervention price for skimmed milk powder cut by 15% (progressively from 2004 to 2006)

3. ASSESSMENT OF THE REFORMS

The CAP was the product of a deal between France and Germany in 1962, which gave generous EU support for in particular French agriculture and access to the large German market in return for Germany's access to the French market for its manufactured goods. With the objective of stimulating production and eliminating food shortages (and providing stable market conditions and higher incomes for an important domestic constituency), the CAP used a mixture of guaranteed prices through intervention buying and customs duties to restrict imports from outside the EU to achieve this. This indirect method of income support for farmers imposed costs on both consumers in the form of higher food prices and on tax payers in terms of national contributions to the EU budget (to fund the implicit subsidies on products purchased at EU intervention prices and sold at the lower world price). This market organisation, combined with generous grants to farmers and technological progress, soon encouraged excess production in Europe and resulting in downward distortions to world prices. Attempts have been made from the late 1970s to reform the CAP, by using quantity limits on guaranteed prices to limit overproduction, CAP spending increases and co-incidentally the distortions to world prices. These attempts were increasingly recognised to be insufficient to control CAP spending and limit the market distortions, and external pressures for eliminating explicitly or implicitly subsidised EU exports and improving access for imports to the EU have intensified. Further changes during the 1990's cut guaranteed prices, restricted production through the setting aside of land and began to shift support towards farmers rather than farm products. The current reforms, the tone and direction of which had been signalled in the mid term review of the CAP published in 2002, continue this shift toward direct income support for farmers and seek to reduce the costs of the CAP bureaucracy and the administrative complexities faced by farmers.

Assessment in principle

De-coupling of farm income support from production and the greater freedom for farmers to choose the product mix in the light of less regulated market conditions is clearly a fundamental change in the principles underpinning the EU's agricultural policy. A policy of de-coupling is desirable on both efficiency and equity grounds. With the breaking of the link between the subsidy and the amount produced of a particular commodity, the farmer's decision about what and how much to produce is, as it should be, based on the costs of production and market price of the output. The change should improve allocative efficiency in EU farming (improving the amount and distribution of land allocated to alternative commodities or activities) and the productive efficiency of EU farmers (improving the usage of land, capital and labour and product quality), with farmers responding to market pressures and incentives rather than seeking to maximise subsidy receipts determined by administrative rules. Of course the size and composition of the EU farm sector should change. This is partly because the market signals about product mix and production levels will be different to administratively-set incentives, and partly because there will be greater uncertainty about market conditions than was the case under the current administrative rules. This will impose adjustment costs on the sector, towards which tax payers can be expected to have to make compensation contributions. The speed and extent of the adjustment will depend on how, for instance, planning restrictions affect land-use changes and on how well the new single farm payments system provides incentives to maintain environmental quality and the visual amenity of the rural landscape. Clearly reduced production of specific crops and the 'de-commissioning' of land could encourage farmers to allow some environmental degradation. The current reform proposals do require, however, that the single farm payments will be conditional upon compliance with statutory environmental and other standards.

De-coupling, in isolation from any other changes in the CAP, can be expected to lower EU production and exporting (especially of cereals) and to stimulate EU and world prices. DEFRA's estimates of the impact of de-coupling proposals included in the 2002 mid-term review of the CAP indicate 5-10% falls in cereal, beef and sheep production, and rises in world prices of cereals of up to 5%. In the case of cereals, in particular, reduced EU exports and higher world prices would provide definite benefits for non-EU, including developing country, exporters. Given that EU import duties on cereals are generally

viewed to be a binding constraint on imports, de-coupling will do nothing to improve access to the EU market for non-EU cereal exporters. (Note that the current CAP reforms leave all the EU's tariff and other import barriers wholly unaltered.)

Assessment in practice

Whether the potential benefits of de-coupling identified above will actually be delivered depends critically upon:

- i) how much de-coupling is actually achieved
- ii) how much reduction in EU market price support is actually introduced by the changes to the commodity regimes.

Both of these issues need to be critically considered.

De-coupling is required to start in 2005 (or by 2007 at the latest), but only initially for arable production. The beef and sheep sectors will be later, the arrangements for dairy, olive oil, tobacco and cotton are still to be set, and the special sugar regime does not appear to be covered by the reform proposals. More critical, however, ultimately than as yet incomplete sector coverage is the fact the reforms do not require full de-coupling. As reported earlier, the reforms allow member states to retain some production-based subsidies to avoid land abandonment. Given the reluctance of some member states (eg France and Ireland) to agree to the reforms, there is a high probability that these coupled subsidies will be retained by these countries to placate their large farming lobbies, and by other member states who would not wish to be less supportive to their farmers than other members. Even with lower per unit subsidies than previously, an incentive to produce up to similar quantity limits (for intervention support) as currently apply may exist. In which case the reduction of EU export and world price distortions may be substantially more muted than the 'in principle' assessment above suggests. A similar scenario is possible even if member states do not take up the option of partial de-coupling. The proposals for the single farm payments require that the payments are conditional on compliance with various environmental, food safety, animal health and welfare standards. If the conditions are specified in terms, for example, of the maintenance of land use and specified land areas for specific purposes, then there is a risk that the payment is effectively re-linked to production.

A more optimistic scenario emerges if the take-up of partial coupling to production by member states were to be limited and if the conditionality for the single farm payments does avoid re-linking to the production. But even in this setting the distortions to EU production, exports and world prices would be sensitive to the detail of the changes in the EU marketing and price regimes for specific commodities, and to how much reduction in market price support emerges. For a range of products the reforms are yet to be set, and the outcome must remain uncertain. Even for those products for which the market organisation reforms have been announced, the picture is mixed and the net effects unclear. The devil is in the detail! For rice a substantial reduction in the intervention price is planned, and this may well bring the EU intervention price down to at least world prices. By contrast the proposals leave the intervention price for cereals unaltered. At the current exchange rate for the euro, this intervention price is above current world prices and has resulted in the reintroduction of export refunds since December 2002.

There are overall budgetary constraints on the ability of the EU to maintain both direct payments to farmers and (at least for long periods of time and across a large product range) large market price supports which diverge markedly from export (world) prices. Although the reforms are intended to bring EU intervention prices down over time, the outcome will be fashioned by how the member states (especially the reluctant reformers such as France) react to the new environment. This uncertainty is compounded by the uncertainty surrounding how the new member states will be treated by CAP post-enlargement and how their entry will affect EU market conditions. Note, further, that the EU farm budget has not been cut (only capped in principle), and that national policy makers faced with lobbying and electoral pressures may be less financially disciplined than is planned or look for new instruments of agricultural protection (eg the further extension and importance of sanitary and Phyto-sanitary (SPS)

measures in regulating imports). Further it is widely argued that the ‘dirty tariffication’ of non-tariff measures (eg variable import levies, minimum import prices etc) as part of the Uruguay Round agriculture agreement meant that the EU’s bound tariffs were set higher than the tariff-equivalents of the non-tariff measures and higher than the applied tariffs. This gives the EU the opportunity to vary applied tariffs within these high bound ceilings.

4. IMPLICATIONS FOR THE DEVELOPING COUNTRIES

The CAP reforms only have direct implications for the developing countries to the extent that changes in EU agricultural production and exporting bring about changes in the world prices of the agricultural and food exports of the developing countries. In themselves the reforms do nothing to alter the terms of access to the EU market; tariffs and other non-tariff barriers (NTBs) on agricultural imports are unaltered. The reform may of course have indirect effects. Efficiency and other dynamic benefits of reform might increase incomes and growth in the EU and elsewhere, and have positive affects on the EU’s demand for developing country exports (agricultural and non-agricultural). Similarly the reforms might have implications for the longterm prospects for agricultural market access in both the EU and other industrial country markets by influencing the outcome of the Doha Round trade negotiations. We consider this last issue in the section below, and focus here on the static and dynamic implications of CAP reform for the developing countries.

EU reform-induced rises in world prices of agricultural and food products would help some developing countries and groups in developing countries and harm other developing countries and groups in developing countries. Consider the simple analytical framework below:

Effect of Rise in World Agricultural Prices:

	<i>Net food-importing developing country</i>	<i>Net food-exporting developing country</i>
Food producers	+	+
Consumers	-	(-) *
Net effect	-	+

(* foreign as well as home consumers)

General rises in world agricultural prices would benefit food-exporting developing countries and food producers in all developing countries, but harm food-importing developing countries and food consumers in developing countries. If there were across-the-board rises in world prices resulting from CAP reform, it would be relatively easy to list the gaining and losing developing countries on the basis of whether they were net food-exporters or -importers. In practice, of course, it is rather more difficult to predict who will gain and lose, and over what time scale. The reforms to beef, sheep and dairy products will come later than those in the arable sector. Even if we concentrate on arable products, which developing countries are net gainers and which net losers will depend on the weights of specific crops in each countries’ imports and exports and on the world price effects in those specific crops. Given that many developing countries (especially in the Commonwealth) are often fairly specialised in their export production (and certainly more specialised therefore in food exports than food imports), it is possible to be a net food exporter and still lose in net terms from the reforms if the price increase effects to imports dominate those to exports.

Some of these harmful effects may be offset in the longer term by positive income effects in the EU and other countries. This could increase the demand for the exports of developing countries in general. But this is a less certain effect, and would require the reforms to have substantial effects on EU production and incomes and on world prices.

5. IMPLICATIONS FOR THE DOHA ROUND

Without prejudging the outcome, WTO members committed themselves in the Doha Declaration to comprehensive negotiations aimed at fundamental reforms which:

- improve market access through substantial reduction in tariffs
- substantially reduce domestic supports that support trade
- reduce, with a view to phasing out, all forms of export subsidies.

At the start of the negotiations the EU would have been viewed as a major target of the developing country proponents of agricultural liberalisation; the EU accounting for 80% of export subsidies by value, having bound tariffs of 178% for dairy products, 76% for meat products and 82% for wheat, and having large production-related domestic support expenditures. After the announcement of these reforms the EU is likely to be much less defensive in the forthcoming WTO trade negotiations in Cancun (later this year). Given an apparently more protected US agriculture sector post- the US Farm Bill, the EU will no doubt want to seek to put the spot light on the US and other OECD countries, and will seek offers on agriculture from these countries and the large developing country importers. In headlines terms definitely, and probably with some substance, the EU can assert that the CAP reforms will give substantial unilateral reduction of domestic supports that distort trade and will result in a corresponding substantial reduction in subsidised exports. As argued earlier in this article, this interpretation may be challenged by other countries. They may feel (or adopt a negotiating position) that the de-coupling of farm payments will be less in practice than is claimed by the EU. They may in turn be reluctant to accept that the new farm payments should be placed in the 'green box' (ie where they would be deemed non-, or minimally, trade-distorting) or in the 'blue box' (production-limiting programmes) and resistant to the idea therefore that they should be excluded from the Aggregate Measure of Support calculations for the EU. Of course concentration on such contentious issues, rather than market access issues, may well be in the negotiating interest of the EU. The reluctant farm reformers in Europe in particular (eg France and Ireland) may well be anxious to avoid substantial improved market access on top of the announced CAP reforms. Resistance to further liberalisation may be stiffened by the fact that there is the prospect of other adjustment pressures in the European agricultural sector resulting from EU enlargement.

It is not clear therefore whether the announcement of the EU's farm reforms gives an impetus to the WTO negotiations, on agriculture in particular or to the talks in general given the single undertaking approach adopted, or whether it will make it more difficult to negotiate reciprocated concessions. The empirical evidence suggests that the greatest welfare gains to the developing countries would come from liberalisation of the agriculture and food sectors, both in developed and their own markets. But there is not necessarily commonality of interest in the negotiations. Developing country agricultural exporters are keen to gain improved market access and have world prices stimulated by reduced domestic supports and exports subsidisation by the OECD countries. By contrast, the developing country importers are likely to be less enthusiastic about world price rises and about reducing their own bound agricultural tariffs (even if this would be a source of significant own welfare gain). Similarly some developing countries would see their preferences eroded in specific markets if there were multilateral tariff reductions in the agriculture sector. If the above argument that the EU may be reluctant to make concessions on market access applies, then it will be particularly important that there are significant offers from developing countries on their own liberalisation. The support of the developing country importers for such a common negotiating strategy is likely however to be dependent on appropriate safeguards being part also of the negotiating position. The continuation of special and differential treatment (allowing smaller and slower tariff reductions) and improvement relative to the Uruguay Round agreement on practical measures to compensate negative effects of reform on least developed and net food importing countries may well be required to maintain the cohesion of the developing countries as the Doha Round negotiations progress.

SUMMARY CONCLUSIONS

- Reforms, represented by the EU as ‘fundamental’, have been announced by the EU. By ‘de-coupling’ farm subsidies from production levels and by lowering support prices, the reforms in principle at least go a considerable way to responding to the internal and external pressures for liberalising the farming sector and reducing the costs on consumers and tax payers. The reforms might be viewed therefore as providing a significant boost to the prospects for successful negotiation of multilateral liberalisation of agriculture as part of the ongoing Doha Round.
- This article warns against premature adoption of this optimistic interpretation of the nature and implications of the CAP reforms. The CAP budget has not been reduced and there may in practice be less ‘de-coupling’ of domestic supports from production than is apparently the case. EU member states will be allowed to continue to use some production-related support, while the single farm payments which will be linked to environmental and other standards requirements may re-introduce implicit links to production depending on how the requirements are set. Further it should be recognised that the existing administrative marketing arrangements for agricultural products will remain. The detail in practice of how intervention prices are set relative to world prices will continue to determine EU production and export volumes.
- Given continuing budgetary pressures to limit over-production in Europe, it is likely that the reforms will bring about some improvements in the matching of production levels to consumer needs, and some reduction in the depressing effect of EU over-production on world prices. The net-food exporting developing countries may well benefit from this, but the actual gainers and gains can not be identified until the detail of the new regime is actually implemented. But there may also be net-food importing developing countries that will lose out as a result of rises in world prices.
- Differing interests across developing countries on agriculture trade reform, combined with the disagreement that can be expected between the EU and USA about the extent of domestic support each will have post their latest reforms, does mean that the upcoming WTO trade negotiations at Cancun may not be smooth despite the announced CAP reforms. It must be emphasised that the CAP reforms themselves do nothing directly to affect market access to the EU. EU trade barriers to imports from outside the EU remain unaffected. Developing country exporters will need to work hard to keep the developing countries united around the position of tariff liberalisation in agriculture and to persuade the EU (and other OECD countries) that they can cope with further liberalisation of their farming sectors.

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