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**Book Part**

## Expectations and challenges: Reasons for re-initiating the discussion on a CAP reform

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# **Expectations and Challenges - Reasons for Re-initiating the Discussion on a CAP Reform<sup>3</sup>**

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## **1 Introduction**

It is obvious that there is continuing and perhaps even growing domestic dissatisfaction with the CAP.<sup>4</sup> This dissatisfaction leads to demands for change and to expectations concerning the improvements to be brought by reforms. Many of these expectations are diverse and sometimes are in conflict with each other.

The occurrence of BSE has made consumers sensitive for food safety. All consumers want safe food and expect from agricultural and food policies institutional regulations that make sure that all food offered to consumers is safe. Food quality is another issue of increasing interest to consumers. Many citizens are concerned about environmental and animal-welfare aspects linked to agricultural production and expect from agricultural policy a regulatory framework that makes sure that agricultural production is friendly to the environment and to animals. Farmers expect from agricultural policy that farm incomes achieve levels commensurate with other incomes. Taxpayers are concerned about the high expenditures for the CAP and want to see these expenditures

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<sup>2</sup> These papers reflect the opinion of the authors alone and should not to be interpreted as the position of their organisations.

<sup>3</sup> Paper prepared as a contribution to the Working Group on “*The future role of agriculture in Europe*” of the Akademie für Raumforschung und Landesplanung (ARL), Hanover, 2000-2003.

<sup>4</sup> European Commission, Directorate-General for Economic and Social Affairs: *Towards a Common Agricultural and Rural Policy for Europe*, p. 8.

reduced. Economists regret the distorting effect the present CAP has on the allocation of the factors of production and want to see a CAP which leads to efficient factor use in the interest of general economic welfare. Politicians want a CAP which best serves the interest of their countries, as they see it.

The existence of dissatisfaction indicates that many people believe that the present CAP falls well short of meeting their expectations and that a different CAP would be more appropriate in this regard. Given the inherent conflict between many of the expectations, the question arises whether this would be possible at all. It will certainly not be possible to fulfil all expectations, but a better compromise between conflicting expectations may be possible.

In addition to internal dissatisfaction, challenges resulting from multilateral agreements in which the EU has a major interest have to be taken into account. As a member of WTO, the EU has committed itself to certain rules, which the CAP has to respect. This holds also for ongoing negotiations into which the CAP has to be integrated in a way that does not put at risk the ultimate objective of rule-bound, undistorted trade in agricultural and in non-agricultural commodities as well as in services for the benefit of all countries. Moreover, the EU has a strong interest in political stability in the Central and Eastern European Countries (CEECs) based on sound economic and social development. It has therefore offered the CEECs the prospect of becoming members of the EU, from which specific requirements result which a reform of the CAP will have to take into account.

This paper tries to highlight the most important issues of domestic dissatisfaction with the present CAP and the expectations deriving therefrom for a reform. It also deals with the challenges resulting from existing WTO commitments and ongoing negotiations as well as with those resulting from the eastward enlargement of the EU. This is done in the sense that these challenges set some limits to the room for manoeuvre of the CAP or make some options more appropriate than others. It is not the purpose of this paper to offer solutions. What can be done to make the CAP more responsive to expectations and challenges is dealt with in other papers prepared by the working group, in which the authors present their opinions and the results of the discussions within the group on some of the main issues.

## 2 Domestic dissatisfaction with the CAP

### 2.1 New needs for change

The incidence of BSE (Bovine Spongiform Encephalitis) has made consumers concerned about **food safety**.<sup>5</sup> There is a general suspicion that intensive production is itself a threat to food integrity and food safety. One may argue that, from a scientific point of view, never in history has food been safer than at present, but the perception of the public at large is completely the other way round. It cannot be denied that the BSE crisis revealed weaknesses in the control system of food safety. Responsibilities, including that of controlling the controllers, are not assigned in a clear and coherent system that guarantees effective checks.

**Food quality** also ranks high among consumers' expectations. Their perception of quality may include quality of the product as well as quality of the production process. Some consumers may be prepared to pay higher prices for food which meets their

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<sup>5</sup> For more details as regard food safety and food quality see the contribution of A. BUCKWELL in this volume.

perception of quality, whereas others may be more interested in cheap food. All consumers expect from agricultural and food policies that they will be able to find on the market what they wish to purchase.

That there are **environmental problems** caused by agriculture is beyond dispute. There is a fundamental conflict between many systems of intensive crop and animal production and many aspects of the environment. In the past, EU agro-environmental measures (under Regulation 2078/92) have been used by Member States in different ways. The programmes were largely accepted by farmers, but their environmental impact from a scientific point of view was limited. Problems that generally result from highly intensive agriculture were not solved by these programmes. Standards that specify good farming practices to be respected by all farmers have partially been defined by Member States but not at the Community level. The Nitrate Directive of 1991, which can be seen as an attempt in that direction, met with tremendous difficulties when it came to implementation. The Rural Development Regulation (Reg.1257/99), as part of the Agenda 2000, offers the possibility to continue agro-environmental schemes along the lines of Regulation 2078/92 within a different institutional arrangement but does not tackle the general problems of highly intensive agriculture.

**Animal welfare** is a growing concern for many people. It is mostly seen in connection with the number of animals kept on a farm and the intensity of production. This connection may be questioned. Small herds do not necessarily mean that the way animals are kept respects the conditions of their wellbeing, as many examples from the past may illustrate. Better respect for animal welfare can only be brought about by standards. There is an inherent conflict here because such standards must take into account the competitiveness of European farmers vis-à-vis imports. If standards lead to a shift of production into countries outside the EU, the purpose will not be fulfilled. The EU is working on such standards (batteries for layers, rearing of calves, etc.), but given the complexity of the issue one cannot expect fast progress.

During the last few years a new discussion on the need to change the CAP has started. This is particularly the case in Germany, where a new word “Agrarwende” was even created. At the core of this development was the question as to whether the problems of BSE and FMD should be used as a stimulus for a fundamental reform. The call for a fundamental overhaul of the CAP was not limited to Germany. In other EU countries as well one can find consumer groups, environmental organisations and officials expressing the view that massive public support for farming practices which do not adhere to appropriate food-safety, environmental and animal-welfare standards should be unacceptable.<sup>6</sup>

The concerns mentioned above are concerns about modern types of farming. They are linked to the CAP by the argument that the CAP, by setting incentives (wrong incentives in the eyes of the critics), has encouraged these types of farming and has failed in bringing about necessary control mechanisms. Comparing the EU with other developed countries that have different agricultural policies but are facing similar problems leads to the conclusion that linking the unwarranted effect of modern farming directly to the CAP is at least an oversimplification.

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<sup>6</sup> SWINNEN, J.F.M.: A. FISCHLER Reform of the Common Agricultural Policy, Special Report, Centre for European Policy Studies (CEPS), Version: 27 June 2001, p. 18.

## 2.2 Traditional criticism of the CAP

Besides the increasing dissatisfaction with the CAP mentioned in the previous section, longer established criticism and the expectations deriving therefrom should not be forgotten. **Farmers are frustrated** because the CAP has failed in achieving its aim of enabling farmers to earn an income that by large reflects general income development and allows them a standard of living comparable to other groups in society. Moreover, they feel unfairly exposed by the visibility of the compensation payments and discouraged by increasing environmentally motivated restrictions on farming practices, which they do not consider necessary.

In some Member States, citizens, primarily politicians, are concerned about the **high expenditures of the CAP**, which – despite the upper limit of 40.5 billion Euro per annum (at 1998 prices) imposed by the Berlin Summit – still absorb about 50% of the EU budget. Economists in general regret the low efficiency of the expenditures.<sup>7</sup> Public expenditures and transfers from consumers resulting from price support exceed the income effect of policy measures for European farmers, primarily because of the low efficiency of export subsidies, through which consumers in the countries that import EU surpluses are subsidised.

Economists also tend to blame the CAP for leading to a **misallocation of resources**. At the level of the national economy, price support or income support for farmers linked to factors of production such as land has the effect that more factors of production will stay in agriculture than otherwise would have been the case. According to economic theory, these factors of production would have made a greater contribution to welfare if allocated to other activities. The same holds true at the international level. The argument mainly used to justify the deviation from an allocation by markets and prices is the existence of external effects (external benefits originating from agricultural production). Critics doubt its validity. One question raised is whether these external benefits are really as important as argued and whether they are really wanted by society at current levels. Another question to which no answer can be given refers to the causal connection between the CAP and the actual amount of external benefits of agriculture.

Besides external benefits, market failures are an argument to justify market interventions. In an imperfect world in which world market prices are distorted by all sorts of interventions, it would be unwise to rely completely on a free-market philosophy. A certain degree of protection may be a second-best solution, if the first-best solution, world-wide liberalisation, cannot be brought about (see section 6 and the contribution of EWA RABINOWICZ in this Volume).

Some of the interventions lead to misallocations within the agricultural sector. This is particularly the case for production quotas. Before milk quotas became tradable they led to a freezing of the historical distribution of milk production irrespective of efficiency. In maintaining milk production in less favoured areas they have been successful. Tradable quotas allow milk production to become concentrated in the hands of the more efficient producers, but in many countries these have to share the rent originating from the quota system with those who discontinued production and sold their quotas.

Among the general criticisms of economists is the **distribution effect between factors of production within agriculture**. Price support and income support, if not completely decoupled from production, automatically lead to higher prices for land.

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<sup>7</sup> Wissenschaftlicher Beirat beim Bundesministerium für Ernährung, Landwirtschaft und Forsten: Zur Weiterentwicklung der EU-Agrarreform, Schriftenreihe des Bundesministeriums für Ernährung, Landwirtschaft und Forsten, Reihe A: Angewandte Wissenschaft, Heft 459, Bonn 1997.

Insofar as farmers own the land they operate, they are the beneficiaries. If more and more land is taken on a rental basis, which is the natural result of structural change, an increasing part of the land rent does not go to the farmer but to the landowner. Thus, money collected from the taxpayer or the consumer and spent in order to increase farmers' incomes, or to bring about desired effects originating from farming, becomes a rental income of landowners often not belonging to the farming community.

From a social point of view, the **distribution effect between large and small farms** is criticised by old and new critics as well. It is evident that the major part of price support and direct payments per hectare or per livestock unit goes to farmers who operate big units and apparently do not belong to the lower income groups.

Efficiency of the CAP with regard to the **development of rural areas**<sup>8</sup> is also less than satisfactory. Many rural areas are still lagging behind in economic development, despite high CAP expenditures, due to the fact that these expenditures are not adequately geared to development purposes but mainly distributed depending on the volume of production.

**Lack of coherence between the CAP and other policies** – development policy in particular – has long been a matter of concern. With globalisation this issue becomes more and more important. In its bilateral and multilateral agreements, the EU has to take into account legitimate export interests of its partners. It has done so in its “everything-but-arms initiative” and – to a varying degree – in the Cotonou Convention and in its agreements with the Mediterranean Countries and with South Africa. An agreement with MERCOSUR has not yet materialised among other reasons because of the difficulties related to agricultural trade.

A **need for simplification** of the CAP is widely felt. There are many complaints – most of them justified – that the CAP rules and regulations have become excessively comprehensive and complicated.

### 2.3 Where to go?

Some of the reform ideas coming out of the new wave of dissatisfaction with the present CAP tend to go in the direction of more regulation rather than less, and more protection and/or public payments, albeit redirected, rather than less. This contrasts with the “more traditional” pressure for CAP reform pushing towards less regulation, subsidisation, and intervention and favouring more liberalised trade and markets. Whereas “old reformers” tend to look sceptically upon the concept of “multifunctionality”, which the EU is pushing in the WTO negotiations as an argument to maintain a large part of its support system, “new reformers” tend to appreciate this concept as it is consistent with their desire to protect a certain farming system. There is a large consensus that something needs to be done, but it is less clear in which direction a reform should go.<sup>9</sup>

Part of the confusion is due to the fact that the terminology is not as clear as it should be. In addition to “old reformers” and “new reformers”, a third group can be identified, i.e. those who are convinced that the provision of public goods related to land management is an important dimension which will not automatically be brought about as an external effect of farming and therefore has to be paid for. Instead of supporting a certain type of farming, assuming that it will bring about the desired public goods, they

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<sup>8</sup> See the contribution of ELENA SARACENO in this volume.

<sup>9</sup> SWINNEN, J.F.M.: A. FISCHLER, Reform of the Common Agricultural Policy, Special Report, Centre for European Policy Studies (CEPS), Version: 27 June 2001, p. 19.

advocate specifying the goods and services the society wants and paying land managers for providing them, something that is completely different from subsidising farming.

Positions of Member States seem to cover a wide range. The direction in which Germany, represented by Green minister RENATE KÜNAST, wants to see a fundamental change in the agricultural policy can be summarised as “greening” in combination with more emphasis on consumer protection and on social aspects (more support for organic farming, no large-scale production, more employment in agriculture, more emphasis on animal welfare, high food-safety standards) under the implicit assumption that there is a strong positive correlation between the underlying objectives.<sup>10</sup> France is apparently committed to a “re-orientation” rather than wholesale reform of the CAP. In its agro-environmental policy, France, before the new government came into power, built a contractual relationship between farmers and society represented by public authorities on a regional basis. Spain is primarily concerned with the future of the structural policy. The UK government has always been one of the more liberal Member States and emphasises that the CAP has to encourage market-oriented and consumer-focused farming taking into account environmental issues.<sup>11</sup> The Swedish government stresses that agricultural reform should be linked to a clear environmental strategy. Other priorities for a CAP reform include improving animal welfare, and food quality and safety.<sup>12</sup>

Following the submission of the Mid-Term Review by the Commission on 10 July 2002 (see section 4) one may identify two camps within the EU Member States. Germany, the UK, the Netherlands and Sweden support in principle the substantial changes to the CAP proposed by the Commission, whereas the rest of the Member States, particularly France and Ireland, but also (for somewhat different reasons) the Mediterranean countries, strictly oppose them.

### **3 The issue of re-nationalisation of agricultural policy**

The increasing importance of direct payments in comparison to the costs of market interventions has initiated a debate as to whether these payments could and should be co-financed by the Member States. The discussion is intimately linked with the never-ending issue of net payers and net beneficiaries of the CAP. The distributional effect of the market and price policy has been an object of criticism since the time when common financial responsibility came into being. In 2001 an amount of 10.3 billion Euro of the Guarantee Section originated in Germany, whereas expenditures in Germany were only 5.9 billion Euro, thus resulting in a German net contribution of 4.4 billion Euro. Other net payers were the Netherlands, Austria, Sweden, Belgium and Italy. Net beneficiaries were Denmark, Greece, Spain, Ireland, Portugal, Finland, France, and – surprisingly – the United Kingdom.<sup>13</sup> The main criticism is that the distribution effects do not follow the principle that comparatively rich countries support poor countries, but are accidental, sometimes benefiting rich countries with a strong agricultural sector.

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<sup>10</sup> Bundesministerium für Verbraucherschutz, Ernährung und Landwirtschaft: Agrarbericht der Bundesregierung 2001, p. 9/10.

<sup>11</sup> European Parliament: Assessment of Agenda 2000 in the agricultural sector, Working Paper, October 2001, p. 47.

<sup>12</sup> European Parliament: Assessment of Agenda 2000 in the agricultural sector, Working Paper, October 2001, p. 49.

<sup>13</sup> Bundesministerium für Verbraucherschutz, Ernährung und Landwirtschaft: Agrarbericht der Bundesregierung 2003, Annex, p. 151.

German requests in the past to introduce co-financing for market expenditures did not meet with success. The counterargument was that the financial burden resulting from jointly decided policies has to be borne jointly. Moreover, one has to take into account that the incidence of expenditures of the market and price policy is not as straightforward as they seem to be. If surpluses are withheld from the market by interventions, and thus prices stabilised, the beneficiaries are all farmers who produce the respective commodity within the single market, and not only those of the country in which the intervention actually takes place. If surpluses are reduced by exports with the help of export restitutions, the beneficiaries are European farmers and not the country in which the exporter resides.

The shift from price support to direct payments fuelled the debate on co-financing. A favourite argument is that, in contrast to market interventions, these payments directly benefit farmers within the respective Member States. It would therefore be fair – so the argument – to put part of the burden on the national budgets. Among the German *Länder* (states), Bavaria goes further by arguing that even the amount of the direct payments (in their present form) should be left to the decision of national or regional authorities, thus allowing them to maintain small farms under unfavourable conditions if they give high priority to traditional farm structure and are prepared to pay for it in addition to EU payments.

One may, however, have serious doubts as to whether nationally co-financed or national payments are feasible from both a legal and a political point of view. Would it really be possible for the Council of Ministers to decide on the level of payments which have partly to be paid by the Member States? Most probably the answer is no.<sup>14</sup> Would it be possible for EU compensation payments to be topped up by national payments? Does this not imply a violation of the principle forbidding national subsidies, which may distort competition? In order to allow national direct payments, their character must be different from the compensation payments introduced by the CAP reform of 1992 and increased by the Agenda 2000.

## **4 The framework set by the Agenda 2000**

### **4.1 Market and price policy**

The shift from market interventions to direct payments, brought about by the reform of 1992, was continued by following the decisions of the Agenda 2000. A new element is Council Regulation No.1259/99 setting out common rules for direct support schemes under the CAP that offer Member States the options of cross-compliance and modulation.

The principle of **cross-compliance** establishes a link between the receipt of direct payments and respect for particular environmental considerations (see the contribution of JOSÉ M. SUMPSI VIÑAS; ALLAN BUCKWELL in this volume). In order to ensure the integration of the environment into the various commodity regimes, Member States have to define appropriate environmental measures to be applied by farmers. These may include support in return for agro-environmental commitments; general mandatory environmental requirements; or specific environmental requirements constituting a

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<sup>14</sup> SEIDEL, M.: Rückführung der Landwirtschaftspolitik in die Verantwortung der Mitgliedstaaten? Recht- und Verfassungsfragen des Gemeinschaftsrechts, Zentrum für Europäische Integrationsforschung, Policy Paper B00-17, Bonn 2000.



condition for direct payments. In the event of a farmer not complying with these commitments, Member States can withhold, reduce or withdraw direct payments.

**Modulation** allows Member States to reduce payments to farmers (for example as flat-rate reductions) according to three criteria:

- the labour force on their holding falls short of limits set by Member States;
- the overall prosperity of their holdings exceeds limits set by Member States;
- the total amount of payments granted under support schemes exceeds limits set by Member States.

However, any reduction in support given to a farmer through modulation cannot exceed 20% of the total amount of payments granted to the farmer. Any money saved by a Member State through applying the principle of modulation can be used for agro-environmental measures, early retirement schemes, less favoured areas and areas with environmental restrictions and forestry.

Only six Member States, France, Denmark, Finland, Austria, the Netherlands and Greece, have applied new environmental constraints to direct payments. For the first three, application of cross-compliance is seen as an extension of current government policy regarding agro-environmental schemes since similar schemes were in operation prior to Agenda 2000. In the Netherlands, the introduction of cross-compliance in two sectors only (starch potatoes and maize) suggests the caution of the Dutch government, and in Greece the introduction is designed to improve practices where no such measures had previously existed.<sup>15</sup>

France and the UK introduced modulation, but France discontinued when the new government came into power. Germany started implementing modulation in 2003.

There is a strong tendency among “new reformers” to make cross-compliance and modulation compulsory. The question as to why it should be made compulsory, given the flexibility the present regulation allows, is normally answered by the argument that the present regulation may lead to a distortion of competition to the disadvantage of farmers in countries where cross-compliance and modulation are applied.

## **4.2 Structural policy**

The Berlin Summit decided an allocation to the structural funds of 258 billion Euro for the period 2000-2006, of which 45 billion Euro should go to the Central and Eastern Europe Countries. Of the 213 billion Euro planned for the EU-15, 18 billion Euro were earmarked for the Cohesion Fund. The number of objectives was reduced from 7 to 3. Objective 1 was practically maintained. About two-thirds of the total amount was allocated to this objective. The newly-defined objective 2 (“Economic and social restructuring”) brought together measures for other regions suffering from structural problems. These are areas undergoing economic decline, including declining rural areas, crisis-hit areas dependent on the fishing industry and urban areas in difficulty. The new programmes to support the objective 2 areas, to which 11% of the total financial means were allocated, will favour economic diversification. As compared with the previous objective 5b regions, covering an area in which 9% of Europe’s population were living, rural areas within the new objective 2 regions will only comprise 5% of the population. A new objective 3 will be introduced for regions not covered by objectives 1 and 2 to develop human resources.

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<sup>15</sup> European Parliament: Assessment of Agenda 2000 in the agricultural sector, Working Paper, October 2001.

Following the Commission's proposal, the Berlin Summit decided on – and the Council of Ministers adopted – Regulation No 1257/99 on Promoting Rural Development, which is considered as the “**second pillar**” of the CAP and to which 30 billion Euro were allocated for the period 2000-2006 within the Guarantee Section of the EAGGF. Regulation 1257/99 established a new framework embracing:

- the accompanying measures of the 1992 reform (agro-environment scheme, afforestation, early retirement) plus the Less Favoured Areas scheme;
- all types of measures supporting structural adjustment (former objective 5a measures) and rural development (former objective 5b measures), plus measures to diversify agriculture and to support income-earning activities going beyond agricultural production.

For areas located in objective 1 regions, the approach of integrated development programmes was maintained. In all areas outside objective 1 regions, the measures mentioned under the second indent are financed by the EAGGF Guarantee Section. They are applied horizontally and implemented in a decentralised way at the appropriate level, at the initiative of Member States.

Taking into account that most of the measures mentioned under the second indent were formerly financed by the Guidance Section of the EAGGF, the annual amount available of 4.3 billion Euro is practically the same as it was in the period 1994-1999 for the measures that are now integrated into the Regulation on Rural Development (see the contribution of ELENA SARACENO in this volume). The concept of the new approach consists in offering a broad spectrum of potential measures and leaving it to national or regional authorities to choose among these measures and to design programmes according to their development priorities.

### **4.3 Shortcomings of the Agenda 2000**

The decisions of the Agenda 2000 regarding market and price policy were a major step in the shift from price support to direct payments. It is vital, however, not to forget that this was limited to major arable crops and to the beef sector. A reform of the milk sector was postponed and other sectors, sugar in particular, were not even touched. From a logical point of view, it is difficult to find a justification for the coexistence of two completely different types of farm-income support within the CAP.

Neither the MACSHARRY Reform nor the Agenda 2000 reduced budget expenditures for the CAP. They were not meant to. They made the real costs of the CAP more transparent, shifted part of the burden from the consumer to the taxpayer, and increased cost effectiveness with regard to farm income. At present 60% of the costs of the Common Market Organisations are absorbed by direct payments. With the increasing importance of direct payments, the total amount redistributed among Member States via the CAP has increased and the direction has changed in favour of countries in which reform products play a major role – and to the disadvantage of countries whose agriculture is dominated by non-reform products. This has increased old problems and created new ones.

An evaluation of the implementation of the Rural Development Regulation reveals a mixed picture.<sup>16</sup> First, one has to note that practically all measures already existed

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<sup>16</sup> NEI Regional and Urban Development: Rural Development in the Context of the Agenda 2000. Mid –Term Review in the European Union and in Applicant Countries, Rotterdam, November 2001.

previously, albeit in different administrative settings, and that the total amount for these measures did not increase.

The most innovative approach in implementing the new regulation was that developed by France. The “contrats territoriaux d’exploitation” were innovative in the sense that they created a new contractual relationship between the state and the farmer, encouraging the latter to integrate his holding, for a 5-year period, into a coherent and comprehensive programme incorporating a socio-economic dimension as well as an environmental and regional-development aspect. In its turn, the government provides financial support for this approach for the same period of time. The new instrument was designed to assist farmers who agree to implement systems of production providing services to the community but which can not be completely remunerated by the market and thus require a financial contribution from society.<sup>17</sup> The administrative burden of this detailed approach was quite heavy.

In all Member States the programmes have a strong sectoral focus on agriculture (see the contribution of ELENA SARACENO in this volume). A new element can be seen in their regional orientation. With the exception of France, almost all measures existed previously. Some of them have been slightly adapted by strengthening and/or adding conditions. What is new is the form and the format of the rural development policy based on the experience and prime example of the structural fund approach. In particular:

- all existing measures have been put together in one single reference framework
- each Member State had to produce regionalised Rural Development Programmes which formed the basis for further programming
- a programming period of 7 years was enforced.

## **5 Mid-Term Review and Reform Proposals of 2003**

The Commission reacted to some of the expectations and challenges mentioned in the previous sections in its Mid-Term Review of the Agenda 2000, submitted on 10 July 2002 as a Communication to the Council and the European Parliament followed by detailed proposals for Regulations by the Council on 27 January 2003.

With regard to the common market organisations, the Commission sees a need for adjustment in order to reinforce the role of intervention as a safety net without compromising the potential for European farmers to benefit from trends on world markets. Agricultural production should be more orientated to the products and services that the public wants and not to artificially created price incentives or product-specific aids. Direct-income payments should not steer the production decisions of farmers.

In the cereal sector, the Commission proposes completing the Agenda 2000 by reducing the intervention by an additional 5%, thus bringing the total reduction to 20% (as originally proposed), abolishing the monthly increments, abolishing the intervention for rye (because three-quarters of the production goes into intervention), reducing the supplement for durum wheat in traditional areas and abolishing the special aid in established areas, while introducing a quality premium for durum wheat sold to the processing industry under contracts specifying quality criteria (in order to combat the

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<sup>17</sup> NEI Regional and Urban Development: Rural Development in the Context of the Agenda 2000. Mid –Term Review in the European Union and in Applicant Countries, Rotterdam, November 2001, p. 11.

trend that durum wheat is increasingly used as animal feed). For rice the Commission proposes a reduction of the intervention price by 50% and a reduction of the maximum guaranteed areas in order to be coherent with the expected increase in imports as a consequence of the “everything-but-arms initiative”.

For beef the Commission proposes a decoupling of headage payments and their replacement with a single income payment per farm based on historical entitlements (see below). Together with reinforced cross-compliance conditions, including land-management obligations, this should reduce pressures towards intensive production and help achieve a more balanced market situation.

With regard to the dairy sector, the Commission in its original Communication referred to a technical study dealing with the advantages and disadvantages of several options without making proposals. In its January 2003 proposals, the Commission advocated: (1) an annual reduction of the intervention price for butter of 7% and for skimmed milk powder of 3.5% over five years, leading to a total reduction in the milk price of 28%; (2) beginning the implementation period in 2004/05; (3) an extension of the quota system until 2013; (4) an additional increase of the quotas by 2%.

Crucial in the Commission’s proposals is the introduction of a single, decoupled payment per farm, based on historical payments, adjusted to take into account the full implementation of Agenda 2000. Only specific payments related to quality or limited to traditional production areas should be exempt from decoupling. Farmers under the decoupled payments scheme will have complete flexibility for increasing market orientation, but payments will be conditional on compliance with statutory environmental, food-safety, and animal-health and welfare standards. Cross-compliance will be applied as a whole-farm approach with conditions attached to both used and unused agricultural land. In the case of non-respect, direct payments should be reduced while maintaining proportionality with respect to risk or damage concerned. The Commission proposed that a system of farm auditing will be mandatory as a part of cross-compliance requirements for producers receiving more than EUR 5,000 per year in direct payments.

In order to maintain the supply-control benefits of set-aside, while reinforcing its environmental benefits under the decoupled system of support, the Commission proposed introducing compulsory long-term set-aside (10 years) on arable land instead of the present rotational set-aside. The existing arrangement for non-food crops that can be grown on set-aside land should be replaced with a non-specific aid for energy crops.

The Commission emphasised that a better balance of support between market policy and rural development would increase both the social acceptability of the CAP and the possibility of addressing consumer, environmental and animal-welfare concerns within the second pillar. In order to achieve such better balance and to release funds required for introducing a premia system in Common Market Organisations which have not yet undergone a reform, the Commission proposed introducing a system that combines compulsory modulation with degressivity. Under this system, direct payments above a franchise of 5000 Euro should be reduced annually to reach 12.5% (19% above 50,000 Euro) within seven years. About half of the cuts will be regarded as modulation, which means that the amounts saved will be distributed to Member States for rural development on the basis of agricultural area, agricultural employment and per capita GDP. The remaining savings, regarded as savings from degressivity, will be available for funding payments in Common Market Organisations that are still to be reformed.

The Commission proposed consolidating and strengthening the second pillar by increasing the scope of the accompanying measures and widening and clarifying the

scope and level of certain measures. Among these are measures aiming at encouraging farmers to participate in quality-assurance and certification schemes and measures to help farmers to adapt to demanding standards on Community legislation in the field of the environment, food safety and animal welfare, as well as implementing farm audits by direct payments that should cover part of the additional costs. The agro-environment chapter should be widened by introducing the possibility to offer animal welfare payments for efforts that go beyond a mandatory reference level. Article 33 of the Rural Development Regulation should be clarified to include the eligibility of the costs of setting up quality-assurance and certification schemes as well as of farm-auditing systems.

At the time when the last update of this paper took place, a fierce and controversial debate was going on in the Council of Ministers. There seemed to be little prospect of full acceptance of the Commission's proposals. A majority of countries was against decoupling of the major parts of direct payments – particularly direct payments in the livestock sector – and also against the proposed reductions in the milk price. Without bold decisions on decoupling, the reform will be a further step along the lines of the MACSHARRY reform and the Agenda 2000, and will certainly help to ease the WTO negotiations, but will fail to bring about the fundamental changes required to meet future expectations and challenges.

## **6 Implementing the decisions of the Agreement on Agriculture and WTO negotiations**

Among the reasons for a revision of the CAP, the WTO negotiations play an important role. They are briefly summarised here. A comprehensive analysis is given by ANANIA (see his contribution in this volume).

In the Agreement on Agriculture (AoA) of the Uruguay Round, the EU – like all developed countries – agreed (1) to reduce its internal level of support by 20% as compared to 1986-88 over a period of six years, (2) to replace variable import levies by tariffs and to reduce the level of protection by 36% within the same period, (3) to reduce the amount of export subsidies by 36% and the quantities exported with the help of export restitutions by 21%, (4) to open up a minimum access to the internal market of 3% of domestic demand at the beginning, increasing to 5% at the end of the transition period. Members agreed on a peace clause, which remains in force until December, 31, 2003, under which export subsidies that comply with AoA commitments cannot be challenged under WTO rules.

There is a broad consensus that the Uruguay Round was successful in bringing agriculture back on to the GATT/WTO agenda as a step in an ongoing process aimed at rule-bound and less distorted trade. A new element was seen in establishing a link between domestic policy aspects and international trade implications. The factual impacts of the commitments have, however, been limited.

The commitment on domestic support has not become binding, neither for the EU nor for any other country, primarily because of the exemptions specified in Annex 2 of the AoA, such as direct payments per hectare or per livestock unit linked to set-aside regulations or to production levels in a defined and fixed base period (blue box) or measures that are regarded as non-trade-distorting (green box). Developing countries complain that the internal support agreed upon in the AoA distorts competition to their disadvantage.

Tariff-reduction commitments had also little impact on trade flows because nearly all countries were successful in using tariffication to bind their tariffs at levels much above the actually applied levels (“dirty tariffication”) with the result that the reduction commitments based on the bound tariffs left them with sufficient scope for effective protection. Also market-access commitments were of little practical importance. Since existing concessions were considered as part of the access commitments, this is not surprising.

From the EU’s point of view, the commitment on export subsidies (reduction of quantities to be exported with the help of export restitutions) was practically the only one that became binding during the implementation period. This was particularly the case for rice, cheese, other milk products, poultry, beef, wine, and fresh fruit and vegetables. From the point of view of exporting countries, the existence of export subsidies is heavily criticised because they are seen as the measure that most distorts international trade. For the EU it will be essential that the CAP, after accession of the countries of Central and Eastern Europe, prevents the creation of surpluses that exceed the limits set for export subsidies by the AoA, or perhaps more constraining limits resulting from future negotiations.

Part of the AoA was the decision to start new negotiations one year before the end of the implementation period, recognising that the long-term objective of substantial progressive reduction in support and protection resulting in fundamental reform is an ongoing process. In the negotiations, which started on the basis of Art. 20 of the AoA, some of the major players strongly advocated substantial changes required to achieve the stipulated objectives.

The USA started with attacks on the “blue box” and on the philosophy that differentiation should only be made between two kinds of measures: those which are subject to reduction commitments and those which are not. This was when the Federal Agricultural Improvement Act (FAIR Act) of 1996 had practically decoupled most support to US farmers from production. The US Government considered all remaining measures as eligible for the “green box”. However, during the last years the US has to a large extent re-introduced payments linked to production, which other WTO members will find difficult to accept as being eligible for the “green box”. They will also have difficulties accepting the argument that State Trading Enterprises (STEs) and export enhancement should be treated as purely domestic measures.

The Cairns Group was most outspoken in demanding abolition of the “blue box” and restrictive criteria for the “green box”. They also criticised the consolidation of tariffs at high levels (dirty tariffication) and advocated a reduction formula aimed particularly at reducing tariff peaks. According to the Cairns Group, export subsidies should be abolished and STEs should pursue transparent and market-oriented policies. Developing countries condemned the protectionism of developed countries, particularly the EU, and demanded tariff reductions or improved market access for their products and, at the same time, generous exemptions from reduction commitments for themselves. A further extension of “special and differential treatment” was high on their agenda as well as the establishment of a “development and food-security box”.

The EU took the position that there was no need for a fundamental change, i.e. that the instruments of agricultural policy and their categorisation into the “green”, “blue” and “amber” boxes should be maintained. The EU argued that further reductions in tariffs and export subsidies, as well as in improving market access, should be seen as part of a long-term process, as stipulated by Art. 20 of the AoA. It requested more transparency in the management of tariff quotas and of the role of STE in importing and

exporting agricultural commodities. With regard to the United States, the EU emphasised that, on the export side, not only export restitutions should be taken into account, but also export credits and other means of export enhancement. The EU was interested in getting non-trade concerns acknowledged as subjects of the negotiations.

With the Ministerial Conference of Doha of November, 9-13, 2001, a new full round of trade negotiations was initiated. With regard to agriculture, Art. 13 of the Ministerial Declaration states: “..... We recall the long-term objective referred to in the Agreement (i.e. the AoA,) to establish a fair and market-oriented trading system through a programme of fundamental reform encompassing strengthened rules and specific commitments on support and protection in order to correct and prevent restrictions and distortions in world agricultural markets. We reconfirm our commitment to this programme. Building on the work carried out to date and without prejudging the outcome of the negotiations, we commit ourselves to comprehensive negotiations aimed at: substantial improvements in market access; reduction of, with a view to phasing out, all forms of export subsidies; and substantial reductions in trade-distorting domestic support ..... We take note of the non-trade concerns reflected in the negotiating proposals submitted by Members and confirm that non-trade concerns will be taken into account in the negotiations as provided for in the Agreement on Agriculture”.

The wording of Art. 13 reflects a compromise. The EU finally accepted the formula “reduction of, with a view of phasing out, all forms of export subsidies” because it includes all forms of export subsidies and it is subject to the condition “without prejudging the outcome of the negotiations”, on which France insisted until the very last moment. Reference to non-trade concerns includes the notion of the European model of multifunctional agriculture, which may be used to defend exemptions from reduction commitments.

To what extent new commitments will be more constraining than those of the Uruguay Round (UR) is difficult to predict. From the negotiations preceding the Ministerial Conference of Doha and of the Ministerial Declaration, one may, however conclude that the results of the new round will be less severe for the EU than it was felt in the beginning. Among the reasons for this estimation, the position of the USA has to be mentioned, which has lost much of its credibility as an advocate for reducing protection for agriculture. The new US Farm Bill, recently passed, not only allocates \$ 73.5 billion of extra spending to agriculture over a ten-year period (additional to so-called baseline spending, representing the projected cost of extending the 1996 FAIR Act for a further ten years), but also re-introduces – in addition to the existing decoupled payments – as a means of counter-cyclical support modified deficiency payments, which do not fulfil the green-box requirements.

In contrast to what happened in the UR, the EU took the initiative and presented its own proposal along the lines outlined above in December 2002. This was followed by proposals of the chairman of the Committee on Agriculture, STUART HARBINSON, in February 2003 which went much further concerning reduction commitments for internal support, import tariffs and export subsidies. A revised version presented one month later was not very different. It was rejected by the EU. Non-agreement before the end of March 2003 implied that it was not possible to agree on the modalities of countries’ commitments as planned in Doha. No prediction can be made for the Ministerial Meeting in Cancun in September 2003, but, whatever the result may be, it is clear a CAP reform will have to take into account any commitments to which the EU agrees in the WTO negotiations.

## 7 The eastward enlargement of the EU

In the eastward enlargement of the EU, agriculture and agricultural policy were among the most critical issues. Again, in this introductory paper the issues can only be highlighted. For a comprehensive analysis, see the paper by WILKIN (see contribution of JERZY WILKIN in this volume).

From the point of view of the CEEC the importance placed on agricultural policy is comprehensible because the role of agriculture in their national economies is much more important than in the EU-15.<sup>18</sup> Taking the 10 CEECs together, about 23% of the economically active population works in the agricultural sector, in the EU-15 the corresponding figure is only 5%. In the mid-1990s, 10.3 million persons were employed in agriculture in the CEEC-10 compared to 7.6 million in the EU-15, which roughly corresponds to the combined agricultural workforce of Poland and Romania. There is still a high degree of disguised unemployment in the agricultural sector of the CEECs. They expected large financial transfers via the CAP and hoped that acute economic and political problems would be eased.

European farmers feared increased competition from the large production potential of the CEECs bringing about 45% additional agricultural land to the EU, while increasing its population only by 28%. At present the production potential of the CEECs is not fully used. Yields have recovered from the low level to which they had fallen after the collapse of the old system, but are still below the EU level. Animal production is still 30-50% below the level of 1989. Feed consumption per unit of production is extremely high. Input use is below the EU level and the quality of inputs is not always comparable. Farm equipment is largely worn out but could not be replaced because of lack of capital. Most of the farms have no access to the capital market.<sup>19</sup> Markets do not function properly. The processing sector is largely inefficient and quality standards are low. Contrary to initial fears, a positive trade flow in agricultural commodities from the EU towards the CEECs has occurred and increased over time.

Many of the CEECs are characterised by the dual structure of their agricultural sector. A major part of the land is operated by large-scale farms either as co-operatives or commercial enterprises. At the other end of the spectrum there is a large number of small farms, many of them part-time or subsistence farms. Large-scale farms find it difficult to generate the salaries of their employees, although the salary level is still low. Small farms survive because the opportunity cost of labour is zero or they are primarily used to produce food for home consumption. In general the agri-food sector of the CEECs is far from being competitive in the Single Market.<sup>20</sup>

The question as to whether eastward enlargement can take place without changing the CAP has several aspects:

- What will happen to agricultural production in an enlarged EU without changing the CAP?
- Would the result be feasible from a financial point of view ?
- Would the result be feasible under WTO commitments?

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<sup>18</sup> EUROPEAN UNION: Agricultural Situation and Prospects in the Central and Eastern European Countries, Summary Report, Brussels, June 1998.

<sup>19</sup> POULIQUEN, A.: Competitiveness and Farm Income in the CEEC Agri-food Sectors – Implications before and after Accession for EU Markets and Policies.  
[www.europa.eu.int/comm/agriculture/publi/reports/ceeccomp/index\\_en.htm](http://www.europa.eu.int/comm/agriculture/publi/reports/ceeccomp/index_en.htm)

<sup>20</sup> POULIQUEN, A.: Competitiveness and Farm Income in the CEEC Agri-food Sectors.



- Would the result be desirable from the point of view of the accession countries?

Several model calculations have been used to find an answer to the first question. A recent one, done by the IAMO in Halle/Germany,<sup>21</sup> in which the situation in the CEEC-10 in 2007 with and without accession was calculated, came to the conclusion that the implementation of the Common Market Organisations in their present form in the CEECs would lead to considerable additional export surpluses in the case of milk<sup>22</sup> and beef and to a smaller extent in the case of sugar. Export surpluses in wheat, coarse grains and pork would be reduced. With regard to eggs and poultry, additional import demand would absorb part of the surpluses of the present EU-15. To some extent the results reflect the inefficiency in the conversion of feed grain into pork, poultry and eggs. Vegetables would lose part of their competitiveness and be replaced by imports.

According to the simulation model, additional expenditures from the EU budget for export restitutions in 2007 would be 848 million Euro at 1999 prices. Expenditures originating from the Communal Market Organisations (CMOs) for fruits, vegetables, wine, olive oil, tobacco and sheep, as well as direct payments and expenditures for rural development, are not included in this figure. In spite of these omissions, the conclusion may be allowed that additional costs for handling market surpluses should not be a major problem. The question of direct payments will be dealt with in one of the subsequent paragraphs.

Regarding potential conflicts with WTO commitments, one has to take into account that, in GATT/WTO terms, accession of the CEECs to the EU is the enlargement of a customs union. The EU and the CEECs will have to satisfy the other members of the WTO that enlargement does not result in a rise in the overall level of agricultural protection. Since tariffs in the CEECs are in many cases significantly below those found in the EU, negotiations will have to be held in the WTO on how to compensate other countries for the increase in tariffs on their agricultural and food exports to the CEECs.<sup>23</sup> A similar problem applies in respect of export-subsidy commitments. The amounts and quantities notified by many of the CEECs are small, which means that the permitted subsidised exports they contribute to an enlarged EU are small in comparison to their potential export production. The problem is exacerbated by the fact that the permitted subsidised exports of the enlarged EU will probably be less than the sum of the permitted exports of the EU-15 and of the CEEC-10; this is because EU-CEEC and CEEC-EU exports, which become internal trade as a result of accession, will be deducted (netting-out). It can therefore not be taken for granted that the effects of extending the present CAP to the CEECs will be compatible with WTO commitments.

Seen from the accession countries' point of view, accession with an unchanged CAP would have advantages and disadvantages. It would certainly satisfy farmers' expectations and induce financial transfers to the agricultural sector of the new members. It would not help to solve the problems of the processing sector. On the contrary, it may even worsen the situation of this sector because high prices for raw

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<sup>21</sup> FROHBERG, K.; WEBER, G.: Ein Ausblick in die Zeit nach vollzogener Ost-Erweiterung. Schriftliche Fassung eines Vortrags, gehalten auf der wissenschaftlichen Akademietagung „EU-Osterweiterung: Was erwartet die deutsche Landwirtschaft?“ des Deutschen Bauernverbandes und der Deutschen Landjugendakademie in Bonn-Röttgen, 12./13.10.2000, Halle, Juli 2001.

<sup>22</sup> The result is based on the assumption that the CEECs receive milk quotas corresponding to their production in 2000-2001, projected on the basis of the actual production in 1997 and the growth between 1992 and 1997.

<sup>23</sup> SWINNEN, J.F.M.: A. FISCHLER Reform of the Common Agricultural Policy, Special Report, Center for European Policy Studies (CEPS), Version: 27 June 2001, p. 15.

materials may further reduce competitiveness. In countries where 30% to 60% of consumer incomes are spent for food, one also has to take into account the effect of high prices for agricultural commodities on low-income consumers.

In the case of sugar and milk, the debate on the quotas was one of the difficult issues in the accession negotiations. The CEECs demanded quotas that take into account their production potential on the basis of historical levels of production before the collapse of the socialist system, whereas the EU offered quotas at the much lower level of present production, which the Accession Countries finally had to accept.

Most controversial was the issue of *direct payments*. The decisions of the Berlin Summit were based on the hypothesis that direct payments were not to be granted to farmers in the CEECs, based on the argument that direct payments were compensations for price cuts and that for most of the CEECs accession to the EU would lead to a price increase. A convergence of agricultural prices in the CEECs and the EU has taken place over the last few years narrowing the price gap, so that finally the original argument was no longer valid. Direct payments have become a regular component of the CAP, the change in terminology from “compensatory payments” to “direct payments“ being indicative of this. In the eyes of the CEECs, direct payments were an essential element of the CAP. They vehemently rejected what they called “second-class citizenship”.

The legitimacy of financial arguments for excluding the CEECs from direct payments can be questioned. According to the simulation model of IAMO mentioned above,<sup>24</sup> direct payments to CEECs in 2007 would amount to 7.8 billion Euro (at 1999 prices). This amount is not included in the financial framework decided at the Berlin Summit and would exceed the Agricultural Guideline, but, in the context of the total costs of eastward enlargement, the amount – below previous estimates – does not seem to be really threatening.

The question may be raised to what extent direct payments can really contribute to solving the problems of the CEECs. It has been argued that it would be unwise to grant direct payments to the accession countries in the same way as they are granted to EU farmers because this would contribute to a cementation of the present dualistic agrarian structure. It would help large-scale farms to finance investments, and thus to some extent be a substitute for access to a capital market, but for the majority of small farms direct payments would mean an encouragement to continue farming in a manner which is uneconomical and can only be justified by social reasons. In both cases, the effect of direct payments could be achieved by better targeted measures. Moreover, direct payments would lead to an increase in land rents and thus benefit landowners, who in the majority of cases are not farmers.<sup>25</sup>

The validity of these arguments cannot be denied, but they also hold for the EU-15. The proposal not to deprive the CEECs of the financial transfers which would otherwise have originated from direct payments, but to use the corresponding amounts for different purposes – such as rural infrastructure, investment aids for “sustainable” farms, investment aids for processing industries, etc. – had some appeal to economists, but one had to question its feasibility. The critical aspect of the absorptive capacity in

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<sup>24</sup> FROHYBERG, K.; WEBER, G.: Ein Ausblick in die Zeit nach vollzogener Ost-Erweiterung. Schriftliche Fassung eines Vortrags, gehalten auf der wissenschaftlichen Akademietagung „EU-Osterweiterung: Was erwartet die deutsche Landwirtschaft?“ des Deutschen Bauernverbandes und der Deutschen Landjugendakademie in Bonn-Röttgen, 12./13.10.2000, Halle, Juli 2001.

<sup>25</sup> POULIQUEN, A.: Competitiveness and Farm Income in the CEEC Agri-food Sectors – Implications before and after Accession for EU Markets and Policies.  
[www.europa.eu.int/comm/agriculture/publi/reports/ceeccomp/index\\_en.htm](http://www.europa.eu.int/comm/agriculture/publi/reports/ceeccomp/index_en.htm)

the CEECs for investments in rural areas in addition to the interventions of the structural funds, for which financial allocations had been made, was omitted.

At the Copenhagen Summit of 15-16 December 2002, the Accession Countries finally accepted the EU proposal of phasing in direct payments by EU funds over a period of ten years, starting with a level of 25% of what EU farmers receive. However, this compromise was only achieved after the EU had accepted the possibility of topping up of these direct payments by 30 percentage points, financed by national funds of the Accession Countries, including a transfer of funds allocated for rural development up to a limit of 20%. This result demonstrates the high interest of the new Member States in immediately channelling financial means into the agricultural sector of their economies. After the outcome of the Copenhagen Summit, it seems more likely that the new Member States will become supporters of the present or a slightly modified CAP than promoters of a fundamental change.

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