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European Union Adopts Significant Farm Reform

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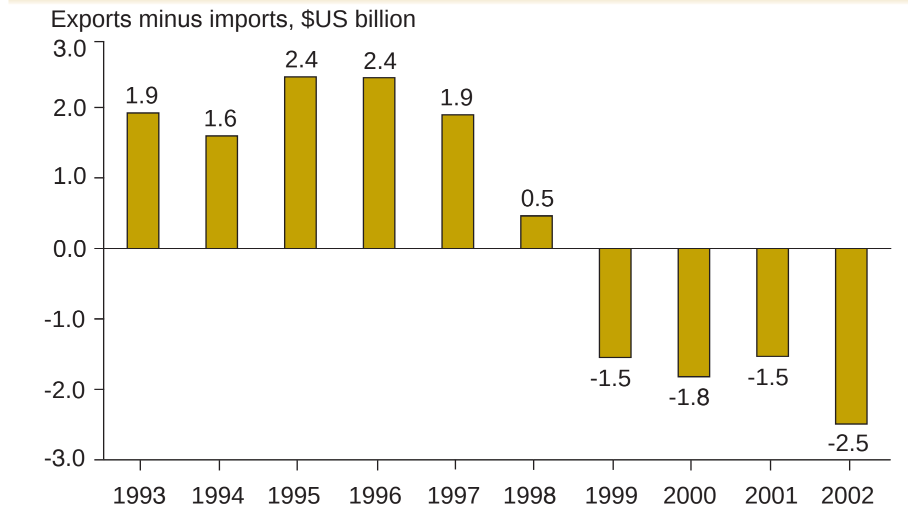
In June 2003, the European Union (EU) adopted a program of agricultural policy reform, building on earlier agricultural policy reforms enacted since 1992. This program was expanded to include additional commodities in 2004. The policy changes under these recent reforms will dramatically alter the way that producers are supported and alter the incentive structure for EU farmers, but are likely to have modest impacts on EU production and consumption. The policy reforms will have implications for competition in global food and agricultural markets as well as for the EU's position in World Trade Organization (WTO) agricultural trade talks.

For decades, the United States and the European Union have dominated world agricultural markets. The U.S. has long been a leading producer and exporter of agricultural products, but in more recent years, the EU has also become an agricultural trade powerhouse. As recently as the 1970s, the EU was a large net importer of nearly all major agricultural products, but by the 1980s, it had become a major exporter of wheat, sugar, meat, and dairy products. The EU now competes with the U.S. as one of the world's two top agricultural exporters. In the 2000-02 period, the U.S. and the EU together accounted for over a third of the world's agricultural exports, with the U.S. accounting for nearly 19 percent and the EU nearly 17 percent. The growing competitiveness of the EU is also reflected in the change in the balance in agricultural trade between the EU and the U.S., with the U.S. moving from an agricultural trade surplus to a substantial deficit. The EU however is still the world's largest agricultural importer and remains a net food importer, owing to its large and affluent population and small land base.

U.S. balance of agricultural trade with EU erodes



The EU's success in expanding agricultural production and exports is due in part to support provided to member states' producers under the Common Agricultural Policy (CAP). High and stable support prices guaranteed by the CAP, in combination with restrictive import policies for agricultural commodities, were a hallmark of the program since its inception in the 1960s. Thus, the CAP stimulated production and slowed consumption growth, leading to chronic surpluses that were exported with the aid of subsidies. The escalating costs of surplus disposal, however, led to a series of EU budget crises. In 1992, domestic budget constraints and external demands of multilateral agricultural trade negotiations pressured the EU to make substantial reforms to the CAP. The policy changes reduced support prices for selected commodities—primarily grains, oilseeds, protein crops, and beef—and introduced direct payments to producers based on crop area or cattle numbers to compensate for lower prices. Additional agricultural policy reforms were enacted under the EU's Agenda 2000 program, which helped prepare for EU enlargement by further reducing selected support prices and compensating producers through direct payments.

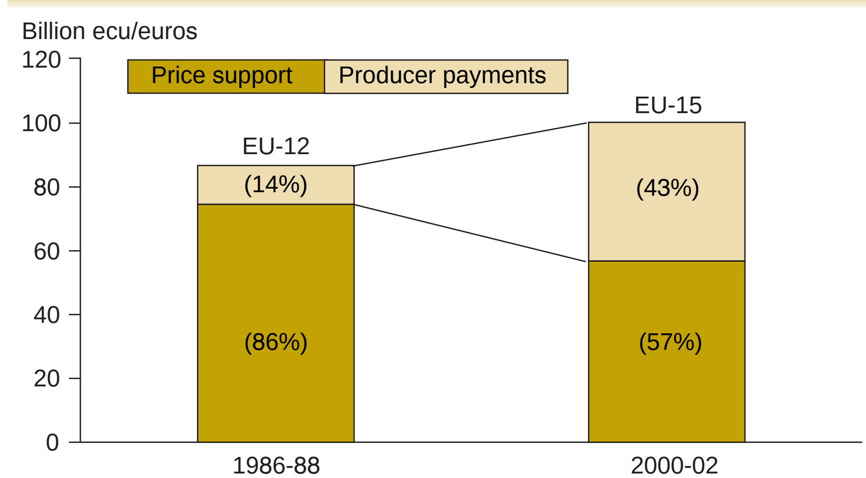
2003-04 CAP Reform Shaped by Environmental and Consumer Concerns

Like the earlier reforms, the June 2003 CAP reform was motivated by the agricultural negotiations in the WTO and the need to prepare for EU enlargement.

Like the previous reforms, the latest CAP reform is aimed at reducing current and potential commodity surpluses, assuring the EU's ability to stay within agricultural budget limits, and increasing the market orientation of EU agriculture by replacing some support prices with producer payments as the primary instrument of domestic support. However, the latest reform program was also motivated by new issues raised by consumers and environmentalists and recognized by policymakers (and farmers) as important to the long-term well-being of EU agriculture--food safety and quality, animal welfare, and environmental concerns. The main features of the 2003 reforms and the April 2004 reforms include the following (for more details, see table):

- *Commodity support price reductions.* The new CAP reform continues the process of reducing support prices for selected commodities, eliminating price support for rye, and substantially cutting back support for rice, butter, and skim milk powder. The EU continues to support prices of major grains,

Producer payments grow as a share of total EU support to producers



Note: In 1986-88 the exchange rate was $1.11 per ecu; in 2000-02 (after the ecu was replaced by the euro), it was $0.92 per euro.

Source: Organization for Economic Cooperation and Development, Paris.

Policy changes under 2003 and 2004 CAP reforms

Program/commodity	Policy change
	Crops
Rye	Rye intervention price support eliminated. Rye-producing areas receive temporary transitional aid.
Grains	Minimum of 75 percent decoupled aid. Monthly storage increments to support price reduced 50 percent.
Durum wheat	Supplemental durum payment reduced in traditional producing areas, phased out for other areas. Payment included in single farm payment (SFP), but countries may opt to retain up to 40 percent linked to production. Durum quality premium paid on per hectare basis on limited area.
Rice	Intervention support price reduced by 50 percent, intervention purchasing limited. Direct income payment; part included in SFP, part converted to crop-specific aid.
Starch potatoes	Part of direct payment included in SFP, remainder is crop-specific payment.
Nuts income payment	Fixed flat-rate payment based on fixed acreage.
Protein crops	Protein crop supplement (increase in payment to encourage protein crop production) preserved.
Set-aside payment	Included in SFP.
Carbon credit for energy crops	Aid of 45 euro/hectare for energy crops, up to maximum of 1.5 million hectares.
Dried fodder income payment	Single farm payment paid to growers plus support to industry through direct payment.
Cotton	Minimum of 65 percent decoupled payment with 22 million euros provided for transition to other uses. Begins in 2006.
Olive oil and olives	Minimum of 60 percent decoupled payment and 4-year reference period (2000-03) of which 3 are chosen for payment reference period. No trees count if planted after May 1, 1998. Begins in 2006.
Tobacco	Minimum of 40 percent decoupled to be phased in from 2006-09. In 2010, 50 percent of aid in SFP with remainder in restructuring fund. Begins in 2006.
Hops	Minimum of 75 percent of aid decoupled. Begins in 2005.
	Livestock
Beef	Beef payments converted to SFP. Member states may opt to retain some payments, in full or in part, as coupled to beef production.
Ewe/goat premium	Included in SFP; member states may opt to retain up to 50 percent coupled to production.
Dairy	Reduced intervention prices for butter (-25 percent), skim milk powder (-15 percent). Intervention purchases of butter limited. Dairy income payments plus member state additional payments, 2004-08. Dairy income payments included in SFP after 2008.
	General
Single farm payment	Direct income payment based on historical entitlement replaces payments from arable crops, beef, ewe/goat, and dairy (after 2008) sectors.
Member state payments	Member states may make additional payments to encourage production (quality, environmental) up to 10 percent of national SFP ceilings; amount reduced by amount of retained coupled payments.
Quality incentives	Support for promotion (quality assurance, geographical indication, organic farming).
Support to help farmers meet standards	Support for farm audits, aid to farmers to help implement standards in areas of environment, food safety, animal welfare, and occupational safety.
Support to farmers for improving animal welfare	Support to extent of additional costs involved in improving welfare of farm animals.
Investment support for young farmers	Increased investment aid for young farmers.
Rural development measures	Funds from taxation of large farms ("modulation") to be used to increase spending on rural development measures.

dairy products, sugar, and, at reduced levels, beef and rice. Prices for EU sugar, dairy products, and beef remain well above world levels.

- *Single farm payment.* The EU's current system of direct payments is tied to production of specific products—arable crops (grains and oilseeds) and set-aside payments on an area and yield basis and livestock payments on a per head basis. Single farm payments (SFP) will replace the current direct payments beginning in 2005-07 at the discretion of the member states. As "decoupled payments," SFPs are not tied to current production because they will be based on producers' 2000-02 historical payments and will not require production (see box, "Why Switch to Decoupled Payments?"). Member states will have significant discretion in implementing the SFP. They may choose to retain a portion of current payments as production-linked, within limits set by the EU. They may also choose when to adopt the SFP (2005, 2006, or 2007), whether to vary the degree of decoupling in different regions, and how to allocate the payments among farms. For example, member states may choose to make the single farm payment a flat per hectare payment to all farms in a region or vary the payment by farm based on its historical payments. Member states may "top up" payments by up to 10 percent of the SFP, but for each member state, total payments must not exceed limits established for that country by the European Commission. The net effect may be that the "Common" Agricultural Policy may not be as common among member states as it has been in the past three decades.

- *Cross-compliance and environmental programs.* Though farmers receiving SFPs are not bound by production requirements, they must adhere to environmental standards and keep the land in "good agricultural condition." SFPs are also contingent on compliance with food safety and animal health and welfare standards. Support will be available to help farmers adapt to these standards.

- *Funding for rural development programs.* Under Agenda 2000, EU member states were allowed to reduce payments for larger farms and redirect the savings to rural development programs. The 2003 CAP reform expands this program, and member states will be required to reduce SFPs for large farms, with most of the savings going toward a rural development fund.

- *Budget measures.* Reforms were motivated in part by concerns about the impact on the EU's agricultural budget of the 10 new members that joined in May 2004, including a few large agricultural producers, such as Poland and Hungary. CAP reform, by fixing payment rates and establishing a financial discipline measure to stay within the CAP budget, alleviates some of these concerns. The CAP budget allows for 1-percent annual increases from 2007 to 2013, and the financial mechanism will reduce the SFP if support outlays threaten to breach this ceiling.

- *Enlargement.* Ten additional countries joined the EU on May 1, 2004: Czech Republic, Poland, Hungary, Slovakia, Slovenia, Estonia, Latvia,

Why Switch to Decoupled Payments?

Decoupled payments are fixed payments that are not tied to current production activities, inputs, or practices. No production decision or change in market price can alter the size of the payment owed to eligible producers. In contrast, "coupled" subsidies directly affect production decisions by changing the producer's net returns for specific commodities.

Decoupled payments are increasingly being used as a policy tool to support farm income, especially in the United States and the European Union. Use of decoupled payments enables policymakers to address both domestic and international policy goals.

Domestically, decoupled payments reduce variability in budgetary outlays, since the payments are based on fixed factors (like historical production) and the payment rates are generally known in advance. In addition, use of decoupled payments greatly reduces market distortions associated with agricultural support programs. Since decoupled payments are not tied to current production or price, producers are free to base production decisions on market incentives rather than on expectations of government payments.

International commitments to the World Trade Organization (WTO) also create a strong incentive to use decoupled payments. WTO rules limit the use of domestic support ("amber box") programs that encourage farmers to increase production. Currently, WTO rules allow countries to provide unlimited support for so called "green box" policies, such as decoupled payments, that do not encourage farmers to expand production. A special class of payments that limit production and meet specified criteria is also exempted because such payments are considered partially decoupled ("blue box"). Presumably, the current WTO agreement reflects the negotiating countries' assumption that decoupled payments do not distort production decisions and create only minimal incentives to expand production, thus encouraging countries to switch to this type of support because it would reduce trade distortions.

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Lithuania, Malta, and Cyprus. For the purposes of the SFP, the treatment of the 10 new member countries will differ from that of the current EU members. Producer payments will be phased in over a 10-year period beginning in 2004, but converted to SFPs in 2005 at 30 percent of the EU-15 level, (although the new members are allowed to top up their SFPs with their own funds by an additional 30 percent of the full payment). Because the new entrants have no history of payments, their SFPs will be based on their average area and yield between 1995 and 1999. During this period, yields in the 10 new member countries were only about half the level for the EU-15; as a result, SFPs for the incoming members will be lower than for EU-15 members. New members will not be subject to payment reductions under the budget discipline mechanism until their payments are fully phased in by 2013.

The policy changes will move the EU further from supporting the market through commodity price support to supporting producers directly. Decoupled payments will be established as the main policy instrument for supporting EU producers of most commodities, while some coupled support may be retained to prevent land abandonment in marginally productive areas. With support no longer tied to production of these commodities, farmers will have more flexibility as to what they can produce, with the exception of explicitly excluded commodities—mainly fruits and vegetables. Also, the new policy will provide EU members with greater discretion over the timing and method of policy implementation, thus returning a certain degree of national control of agricultural policy to the members.

Production and Trade Impacts Likely To Be Small

The effects of CAP reform on global markets will depend on the impacts on domestic production and consumption. Overall effects on EU production and consumption from CAP reform are likely to be small because support price cuts are limited to a handful of commodities. Rye, rice, butter, and skim milk powder are likely to be affected the most because the reform cuts support prices for these products, but other crops will be affected indirectly because of a reallocation of resources. For example, barley production is expected to increase as rye production becomes less profitable following the elimination of price support. Beef production is likely to decline by more than arable crop production because the SFP replaces beef payments that were tied to herd numbers. Arable crop producers already had considerable flexibility under the old system—they were able to switch among certain crops or leave the land idle. EU milk production is likely to remain constrained by production quotas, but lower support prices should increase consumption of dairy products, reduce production and exports of butter and skim milk powder, and increase cheese production.

The effects of reforms on production will also depend on the degree of decoupling of support payments chosen by member states. Arable crop payments will

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be decoupled by a minimum of 75 percent, but the percentage of decoupling for livestock payments will be smaller. If members opt to retain production-linked support to the maximum extent allowed, production changes will be smaller. Marginal land operations, which are most likely to be affected by the reforms, are the least productive, and their retirement will thus have minor effects on total production. However, the land must be kept in good agricultural condition and may not be sold for development purposes. This requirement strongly suggests that the land will not exit agriculture, thus creating a minor incentive for production despite the decoupled nature of the SFPs. Decoupling may lead to efficiency gains as subsidy reductions spur resource allocation that could contribute, in the longer term, to structural change.

Any decline in EU production in response to the decoupling of payments would reduce exports and increase imports. While the direct and indirect effects of CAP reform on EU production will likely be small relative to the EU market, the effects on world prices could be larger because EU exports of some commodities account for a significant share of the world market.

Because intervention price support continues, the EU is likely to continue to require subsidies to export beef and dairy products, and depending on exchange rates and world prices, possibly grains as well. Export subsidies will also be required for high-support products not affected by the policy changes. The recent appreciation of the euro relative to the U.S. dollar has increased the likelihood that export subsidies will be needed to export many EU food and agricultural products. However, lower support prices will facilitate reductions in (per unit) export subsidies for selected commodities.

Production effects will differ in the 10 entrant countries because they are not currently receiving support prices or payments. For some products, like beef, the production effects of higher support prices are likely to outweigh any impact from decoupling of payments. Without reform of rye support, accession to the EU would have brought large increases in rye output, particularly in Poland, where rye is an important crop. With the elimination of support for rye, the Eastern European countries will likely increase barley production to replace rye.

WTO Impacts More Dramatic

The policy reforms are likely to have a greater impact on world trade (and the EU's position in WTO negotiations on agriculture) than on EU production or consumption. The CAP policy changes will affect the treatment of EU support programs under the WTO's current rules on agricultural domestic support. The WTO Agreement on Agriculture accords domestic support programs different treatment depending on the extent to which they are coupled or decoupled from production decisions. Under the current CAP, many EU payments to farmers meet WTO blue box criteria and are exempt from reductions (see box, "Why Switch to Decoupled Payments?"). Most of these payments will be converted to the single farm payment, which will be based on a producer's historical payments, rather than tied to production of a specific product. The EU is expected to report these payments to the WTO as green box payments.

This payment conversion in the latest CAP reform is very timely for the EU. In the agricultural negotiations in the current Doha Round, changes in domestic support policies have been proposed, including limits or reductions to blue box support. By moving a considerable portion of EU producer support from blue box to green box, the EU may exempt this support from possible WTO disciplines.

CAP reform would allow the EU to accept further disciplines on domestic support, but does not address market access at all, and will have only marginal effects on export subsidies. Reducing support prices for rye, rice, and milk would result in some further reductions in coupled ("amber box") support. However, import barriers remain unchanged under the new CAP provisions, and export subsidies would be reduced only in response to limited support price reductions and lower export levels.


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Additional Policy Reforms Agreed on Mediterranean Crops

In April 2004, the European Commission adopted reforms of the support regimes for tobacco, olive oil and olives, cotton, and hops. The reforms follow the principles established in the June 2003 CAP reform but differ in the details: a significant part of current production-linked support will be converted to the decoupled SFP, although a portion of support can be retained as production-linked aid for producers with small holdings or in marginal areas. These new reforms will begin in 2006 for all but hops, which begins in 2005. On July 14, 2004, the EU Commission proposed a reform of the sugar sector, calling for lower support prices, decoupled payments, and a reduction of the production quota. Final agreement is not expected until 2005. Reforms in these sectors, if implemented as envisioned, would shift EU domestic support from the amber box to the green box, rather than the blue box, and help the EU to meet additional commitments to reduce domestic support that might result from the ongoing WTO negotiations on agriculture.

Conclusions

Will the latest CAP reform further enhance the EU's competitiveness in agricultural trade? Severing the link between producer payments and production of specific products will give EU producers greater flexibility, within limits, to produce those goods best suited for production and market conditions. Further cuts in support prices, along with the delinking of payments from production, represent a move toward greater market orientation that could improve competitiveness. Some marginal land is likely to go out of production, leading to some decrease in production and exports, and thus increase world prices. However, prices of most EU agricultural products are still supported above world prices through government purchases, storage aid, or import barriers, and continue to interfere with market signals. The increases in EU exports and share of world exports, to the extent that they have been aided by high support prices, export subsidies, and production of surpluses, could be reversed by the move toward increased market orientation.

The member states themselves may be the wild card in this latest CAP reform. The path of reform selected by each member state could have consequences for production, efficiency, land prices, and other factors with the potential to affect trade. Member states may even decide that the costs of administering national programs are prohibitive and revert to the default EU policy, which would essentially decouple all payments. Much remains to be decided in the EU over the next 3 years before the full impact of this potentially very complex reform of EU farm policy can be fully evaluated. W

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This article is drawn from . . .

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