CENTRE FOR EUROPEAN REFORM

THE FUTURE OF EUROPEAN AGRICULTURE

Julie Wolf

about the CER

CENTRE FOR EUROPEAN REFORM

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The future of European agriculture

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1 Introduction

European farming is at a crossroads. A series of crises – from mad cow disease to foot and mouth – has heightened public unease about food quality and reduced farmers' incomes. Despite massive changes in farming methods and consumer demand over the last 30 years, agriculture labours under outdated policies designed for a hungry post-war Europe. The European Union (EU) began reform of its Common Agricultural Policy (CAP) during the 1990s. Nonetheless substantial subsidies remain in place. These encourage farmers to increase their output and partially insulate them from the market-place. This support system is expensive, but it fails to provide sufficient income for all, especially small-scale farmers. Moreover, the average age of farm-workers is rising, as agriculture becomes less and less attractive to the young. As a result, much of Europe can expect a continued exodus from the countryside to urban areas in the coming years.

At the same time, the EU is seeking a more prominent role on the international stage. But the EU's aspirations for economic and political leadership are undermined by its tendency to place the interests of a small number of European farmers ahead of the needs of the rest of the world. A dispute over agricultural subsidies could once again pose a major obstacle to the EU's global trade liberalisation agenda, and undermine its attempts to help developing countries.

The US farm bill, adopted in May 2002 by the Bush administration, will make it even more difficult to reach a global trade agreement. The US is planning a major increase in agricultural subsidies, including measures that distort trade. In the short term, US plans may deflect international criticism of EU farm policies. But the EU and the US must both think about the long term. They will have to make concessions to developing countries on agriculture, to ensure the success of the Doha round of trade talks. Poorer countries will be especially hostile to negotiations if they see the world's two richest trading powers stitching up an accord that protects their own farmers and neglects others. And European criticism of the US farm policies will ring hollow if the EU is unwilling to shake up its own subsidy programme.

Understandably, consumers, farmers and governments are increasingly questioning existing farming methods and policies. But the debate is confused. Some blame farm subsidies for enabling small but economically inefficient producers to remain in business. Meanwhile, environmentalists and many consumers complain that existing policies lead to over-intensive production, poor quality food and the destruction of the environment.

Many environmentalists argue that European agriculture should be founded on organic production techniques and small-scale farms that are closer, geographically and emotionally, to their customers. However, those who seek liberalisation of the EU's farming sector contend that these policies would lead to reduced production and more costly food – as well as a continued reliance on protectionism.

The EU is conducting its current debate on the future of the CAP against this domestic and international backdrop. Franz Fischler, the agriculture commissioner, published a 'mid-term review' of the CAP in July 2002, which outlined a surprisingly radical set of reform ideas. But the Commission's proposal still leaves room for improvement. Most notably, the reforms do not reduce the high levels of agricultural subsidies, and they only partially address the special needs of small and medium-sized farmers.

The Commission's reform plans face strong opposition. The French government has made clear that it does not want substantive

changes to the CAP until after 2006, when the EU's current budgetary cycle comes to an end. Ireland and most Mediterranean countries are also unhappy with the proposed reforms. Following a summit of EU leaders in Brussels in late October 2002, there are strong indications that France will ultimately succeed in delaying the implementation of these reforms. However, the negotiations on the mid-term review proposals are set to continue, with the Commission and its allies making the case for change. As this pamphlet will show, there is nothing to be gained from maintaining the status quo or adopting quick-fix solutions. The EU must agree to a far-reaching reform plan, even if it has to be phased in.

The CAP review should not be reduced to a battle over the spoils of the EU budget, even if the desire to clamp down on farm spending is a useful spur for encouraging reform. Back-room budgetary deals are not a good way to make farm policy. This was highlighted by the October Brussels summit, which endorsed a Franco-German agreement to set a ceiling on the major portion of CAP spending after 2006. The accord looked more like a last-minute compromise, aimed at allowing enlargement to go ahead, than a long-term strategic decision on funding a reformed CAP.

Europe must therefore begin a broad public debate on the future of its agriculture. Many issues need to be addressed, including what role governments should play in farming, the type of countryside that Europeans want, and the role of agriculture in the European and international economy. Europeans need to think about these broader issues, to help destroy damaging myths and allow agriculture to be viewed in relation to other policies, instead of in isolation.

This pamphlet contributes to the coming debate by exploring the political and economic implications of farm policies. It suggests ways of creating an agricultural regime that is more open to trade, friendly to the environment and responsive to the needs of consumers and the market. Complex farm subsidies and rules make it difficult for non-experts to influence outcomes. But the stakes are too high for agricultural reform to be left to experts and the lobby groups. The choices made in the next few years will affect not just the economic health of rural communities but also the EU's relations with the rest of the world, the success of enlargement, and the credibility of European and national institutions.

By looking at the broader picture, this pamphlet hopes to draw non-experts into the debate. The ideas outlined here are based on the view that there is a continued role for government in shaping Europe's agricultural practices and supporting rural communities. But this role needs to better targeted. European governments need to encourage their farmers to be more responsive to consumer demands, and to restore consumer confidence through effective and open regulation of food safety.

There is little benefit in extending the current CAP to the new member-states due to join the Union in 2004. At the same time, CAP reform should not become an excuse for a lengthy delay in enlargement. It is possible for both to happen in parallel, as this pamphlet will explain. Meanwhile, the EU needs to promote measures that will help the world's poorest farmers in developing countries to compete, while encouraging the spread of sustainable agriculture. This pamphlet does not offer a take-it-or-leave-it prescription for reform. Instead, it sets out a series of ways in which the EU can create a strategic framework for European agriculture in the 21st century.

KEY DATES AND DEADLINES

End of 2002	Target for the EU to wrap up accession negotiations with 10 applicant countries – Czech Republic, Cyprus, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia.
March 31st 2003	Deadline for WTO countries to agree on 'modalities' – key principles for achieving agricultural trade liberalisation, including numerical targets.
Spring 2003	Commission's target for agreeing on implementation of the 'mid-term review' for reforming CAP, based on its July 2002 proposals.
September 2003	WTO's Fifth Ministerial Meeting in Cancun, Mexico. This is the deadline for WTO members to produce their first offers, or 'comprehensive draft commitments', on how to carry out farm trade liberalisation.
2004	Target date for accession of 10 new EU member-states.
January 1st 2005	Deadline for conclusion of WTO's Doha Round of trade negotiations in most areas, including agriculture.
End of 2006	The EU's current budgetary framework ends.

2 The changing landscape

During the 1960s and 1970s, most Europeans gave little thought to the system of agricultural subsidies and protection that had been created after the Second World War to ensure an adequate supply of food and a decent income for farmers. People only began to realise that the CAP had gone awry when mountains of unwanted food began to pile up in the 1980s. The high domestic prices guaranteed by the CAP, together with improved agricultural techniques, stimulated over-production in the main commodities such as dairy and cereals. The EU was forced either to store excess food or dump it on world markets, while compensating farmers for the difference between higher European and lower global prices. As EU stocks grew, world market prices fell further, pushing up the costs of dealing with the overproduction.

The risk of an ever-spiralling farm budget, combined with intense pressure from trading partners, led European politicians to conclude that the EU's agriculture policies were unsustainable. This decision resulted in the first radical shake-up of the CAP in 1992, known as the 'MacSharry reforms' after the then commissioner for agriculture, Ray MacSharry. Shortly afterwards, the EU was able to conclude the Uruguay Round of world trade negotiations – subjecting agriculture to international trade rules for the first time.

Dissatisfied public

The wider European public was little involved in the debate over the MacSharry reforms, except when farmers took to the streets to defend their subsidies. Alot of Europeans remained broadly content with the CAP, assuming that it defended the kind of family farm that produced tastier food than that from American mass production. The crisis over mad cow disease shattered this illusion. The British government admitted in 1996 that bovine spongiform encephalopathy (BSE), known as mad cow disease, was linked to a similar and deadly human disease.

Many consumers were repulsed by the facts emerging from the BSE investigations, in particular the widespread use of ground-up meat and bone in animal feed – which turned cows into carnivores. And while BSE was the most alarming of the 1990s food safety crises, it was not the only one. The discovery of salmonella in eggs and dioxin in chickens highlighted unsavoury and sometimes illegal practices in the production of food. There was also bad publicity about the husbandry of veal calves in crates. And then in 2001 foot and mouth disease emerged in the UK and – like BSE before it – spread to other European countries. Although not dangerous to humans, foot and mouth disease led to the mass slaughter of animals as well as widespread disruption of rural life. As consumers began to view farming as an industry, they asked why farmers earned subsidies to produce food that people did not want to eat.

The level of public concern about food safety, and uncertainty about old-style farm policies, is evident in public opinion surveys carried out for the Commission. For example, a Eurobarometer opinion poll carried out from February to April 2002[1] showed that only 40 per cent of the European public felt that EU agriculture guaranteed the safety of their food, although 90 per cent said this should be the key aim of the CAP. Over 80 per cent of respondents said the CAP should protect small and medium-sized farms, but only a quarter believed the EU's agricultural policies achieved this aim.

[1] Eurobarometer 57, 'Europeans and the Common Agricultural Policy 2001-2002', European Research Group for the Agriculture Directorate-General, June 2002.

Some member-states have begun to respond to this shift in public attitudes by changing their regulation of farming, for example by restructuring agriculture ministries which are viewed as too close to the farming community. They have created new ministries

covering issues as diverse as environmental protection and consumer interests, food safety and rural development. In addition, new food safety bodies have been set up at national and EU level. It is too early to tell whether these organisational changes will deliver better food policies, but it is clear that agriculture will in future be subject to a much wider debate.

In Britain, for example, Margaret Beckett – the minister in charge of the recently created Department for Environment, Food and Rural Affairs – is pushing for reforms to make farming more market-oriented and responsive to consumers' needs. Meanwhile, Germany is placing greater emphasis on encouraging environmentally friendly farming methods, such as organic farming. "We cannot expect that ever more sections of society will always be prepared to put money into agriculture without any clear returns," says the German government.[2] Britain and Germany – along with the Netherlands and the Scandinavian countries – also want to restrict the growth of the EU budget, and have therefore formed an alliance in favour of CAP reform.

[2] German position on the mid-term review of Agenda 2000, February 2002.

In contrast, France's recently elected centre-right government, led by President Jacques Chirac, sees no need for a radical shake-up. It has adopted a more reactionary stance than the previous Socialist administration, which had sought to shift subsidies away from the biggest farms toward rural development programmes. This shift is known in EU jargon as 'modulation'. It is favoured by some CAP reformers as a way of redistributing subsidies among farmers and promoting environmental protection. One of the first actions of the new centre-right administration was to suspend modulation in France.

Chirac's support for the current design of the CAP is no surprise, given his long-standing links to the main French farm lobby. However, the Eurobarometer survey cited above suggests that the French are just as concerned about food safety and the protection of the environment as their EU counterparts. Indeed, the French were among the most critical of the CAP's performance in improving life in the countryside, and in protecting medium-sized and small farms. Public attitudes are changing. Most people care much more about food safety, environmental issues and often animal welfare too. Europe's system for managing agriculture will not be able to address those concerns unless there is a closer relationship between farmers and consumers than the CAP permits.

Costly CAP

The CAP no longer produces big food mountains, but agriculture is still largely a protected market. The CAP began its life in 1962 as a combination of high guaranteed prices, import levies and export subsidies. This European system replaced national farm subsidy programmes and created a single agricultural market, with the purpose of guaranteeing adequate food production and farming incomes.

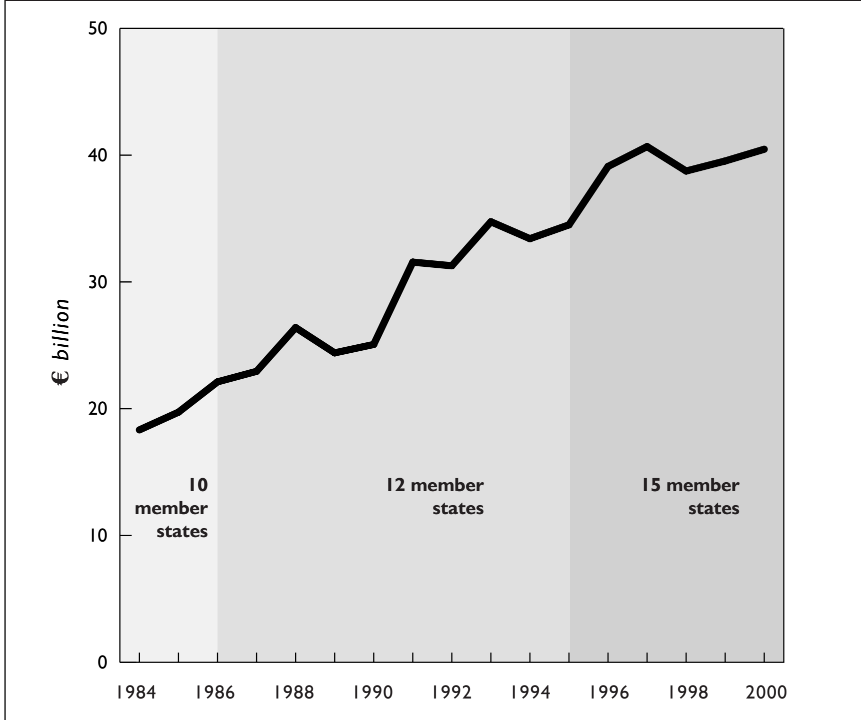
Unfortunately, the CAP worked only too well in encouraging production. The 1992 MacSharry reforms attempted to resolve the problem of overproduction by reducing the guaranteed prices paid to farmers, who instead received compensation in the form of new subsidies. These 'direct payments' encompass a number of different types of aid, and are paid directly to farmers. The MacSharry reforms introduced measures to encourage the setting aside of farmland. And they permitted member-states to make some of the direct payments contingent on farmers meeting certain environmental standards.

While the changes marked an important shift in the philosophy behind the CAP, the price cuts affected only a limited number of crops, most notably cereals. In addition, many of the direct payments introduced under MacSharry were based on farm yields, the numbers of animals or quota rights, and thus to some extent still encouraged more production. In practice, the biggest producers

have continued to receive hefty sums from the CAP, helping to swell the size of the EU's farm budget to €44.5 billion in 2002 from €34 billion in 1993. As shown in Figure 1, farm spending has continued to increase after each reform of the CAP.

The European Commission claims publicly that most of these direct payments are no longer directly linked to production. However, many agricultural economists and the EU's trading partners disagree, arguing that there is still too much of a connection.

FIGURE 1: EU CAP SPENDING



SOURCE: EUROPEAN COMMISSION

Moreover, the indefinite continuation of direct payments – which were originally intended as temporary compensation for price cuts – keeps Europe addicted to farm subsidies. The future of direct payments is therefore a core issue in reforming European farm policies.

At the Berlin European Council in March 1999, the EU's heads of government agreed on a wide-ranging package of Commission proposals to prepare for the Union's enlargement. This accord, known as Agenda 2000, set the parameters for the EU's financial arrangements until 2006. Agenda 2000 extended the price cuts introduced by the MacSharry reforms, but this second CAP reform failed to go as far as the Commission had proposed. Under strong pressure from President Chirac, EU leaders watered down the price cuts and delayed other reforms. Furthermore, the Berlin summit rejected proposals to scale back direct payments (called 'degressivity') or to oblige member-states to co-finance them. Instead, the final compromise in Berlin meant that the EU might not meet its Uruguay Round commitment to cut export subsidies. Moreover, the Union would risk breaching its overall spending limits if the CAP were extended to the new members without further reforms after enlargement.

In the event, the EU's reliance on export subsidies has diminished since 1999. An increase in world cereal prices and the euro's decline against the dollar have narrowed the difference between EU and world prices. The Commission predicts that the EU's cereal exports will be largely without subsidy in coming years.[3] The curbing of export subsides is the main achievement of the MacSharry reforms, with EU spending on the supports falling to 10 per cent of the agricultural budget in 2001 from 25 per cent in 1992. But the EU continues to need export subsidies for other commodities, especially dairy, beef and sugar, as well as processed foods made with milk and sugar. Moreover, export subsidies could return to being a problem, if the recent

[3] *European Commission Directorate-General for Agriculture, 'Prospects for agricultural markets 2001-2008' July 2001.*

strengthening of the euro continues or if new US legislation leads to a drop in world prices for agricultural commodities.

The impact of Doha

The new round of international trade talks, launched in Doha in November 2001, will entail more changes in EU farm policies. Under the Doha agreement, WTO members reaffirmed their commitment to reform:

> 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 to world agricultural markets .... Building on the work carried out to date and without prejudging the outcome of negotiations, we commit ourselves to comprehensive negotiations aimed at: substantial improvements in market access; reductions of, with a view toward phasing out, all forms of export subsidies; and substantial reductions in trade-distorting domestic support.[4]

The wording reflects the EU's refusal to bow to pressure to eliminate export subsidies. But any WTO accord is likely to restrict the EU's ability to subsidise its farm exports. The EU will therefore need to ensure that its domestic prices are more in line with world prices, or impose limits on production, or both.

[4] *Ministerial Declaration at the WTO conference in Doha, November 14th 2001.*

The implications of Doha are less clear-cut when it comes to the EU's domestic subsidies, especially direct payments. Much rests on which types of subsidies are defined as distorting trade, a point on which there is considerable scope for disagreement.

The Uruguay Round agreement on agriculture established three categories for assessing subsidies: the green, amber and blue boxes.

In the green box are subsidies that do not distort trade and can be maintained. The amber box covers subsidies that are subject to overall limits and must be reduced because of their impact on trade. The creation of a blue box, exempted from reduction, reflected a compromise over how to deal with subsidies that were not as directly linked to production as price supports. Into this blue box went subsidies such as the direct payments created under the MacSharry reforms, which were viewed as less trade distorting or temporary. To qualify for the blue box, subsidies must be part of a wider scheme aimed at limiting production.

The EU is determined to defend the blue box in the current WTO round, in the face of strong opposition. The Cairns Group, along with many agricultural trade experts, believes that the Uruguay Round agreements failed to reign in domestic farm subsidies.[5] They want to introduce more rigorous controls, including a reduction in overall expenditure. The fact that direct payments now account for about two-thirds of the EU's farm budget and have replaced some price supports means the EU will find it difficult to argue that they do not directly encourage production. On the other hand, the Commission believes that the decoupled payments it is proposing in the mid-term review would be eligible for the green box, on the grounds that they do not distort trade because they are not directly connected to production.

[5] The Cairns Group consists of Argentina, Australia, Bolivia, Brazil, Canada, Chile, Columbia, Costa Rica, Guatemala, Indonesia, Malaysia, New Zealand, Paraguay, Philippines, South Africa, Thailand and Uruguay.

Meanwhile, the US is raising subsidy levels for its farmers, which will only add to the uncertainty surrounding the WTO talks. The latest US farm bill introduces new farm payments that will help to swell agricultural spending by an estimated 80 per cent to about $180 billion over the next decade. The main beneficiaries are expected to be the country's biggest grain and cotton farmers. The bill includes subsidies that offset drops in market prices for some products. These 'counter-cyclical measures' are a form of price support that encourage production, even when market prices have dropped owing to oversupply.

The US farm bill has soured relations between the US and other WTO countries (especially coming on top of US tariffs on steel imports), raising questions about Washington's commitment to freeing up trade in agriculture. However, soon after President George W. Bush signed the bill into law, the US moved to reassert its credentials as an advocate of farm trade liberalisation. In proposals submitted in Geneva at the end of July 2002, Washington called for the Doha round to reach a far-reaching accord on agriculture. The US proposed eliminating all export subsidies, reducing and simplifying domestic supports, scaling back trade tariffs and increasing import quotas. Trade-distorting domestic subsidies should be reduced to no more than 5 per cent of the value of a country's agricultural production within five years. The blue box would be eliminated, leaving subsidies to be classified either as trade-distorting (amber box) or acceptable (green box). On market access, the US proposed that all tariffs be reduced to less than 25 per cent, using a formula that would have the greatest impact on the highest tariffs.

The US position has drawn praise from traditional proponents of agricultural trade liberalisation, such as Australia and other members of the Cairns Group. But the EU is unenthusiastic: Commissioner Fischler contended that the US proposals were "unbalanced" because they would oblige the EU and other countries to make more changes than the US. For example, the US did not propose specific cuts in export credits, which the EU regards as an export subsidy. Instead, the US called for the WTO to develop rules to govern export promotion schemes. In addition, the abolition of the blue box, combined with a tight limit on trade-distorting domestic subsidies, would require big cuts and reforms of EU agriculture policies. While the EU has said it is prepared to scale back domestic and export subsidies, it has yet to put forward any specific numbers.

Fischler also argued that Washington's stance lacks coherence, given the big increases in spending called for under the US farm bill. The US government rejected this criticism, contending that the farm bill would be running out by the time any Doha accord took effect. US officials insisted that their offer shows that Washington is willing to reduce its own subsidies. "We're ready to cut if others step up to the plate too," US Trade Representative Robert Zoellick said in presenting the proposal.

While the US offer for Doha is welcome, Fischler has a point in questioning Washington's consistency. The funding in the farm bill covers the period up to 2012, even though its specific measures run out in 2007. Moreover, other WTO members are entitled to wonder how serious the US is about achieving a far-reaching farm trade agreement, given the domestic pressures that led Congress to pass the farm bill. The suspicion, especially among developing countries, is that the US and EU will ultimately make a deal on agriculture that leaves hefty domestic subsidies in place. Other countries, many of which were unenthusiastic about the Doha round in the first place, are likely to walk away if they see the two big economic powers crafting an accord to protect their domestic agriculture sectors.

Despite such uncertainties, the WTO negotiations provide ammunition for Fischler and others in the EU who want to revamp direct payments and promote rural development. Agenda 2000 introduced a category of spending for rural development, known as the CAP's 'second pillar', but it only accounts for about 10 per cent of the agriculture budget. Subsidies for rural development, which include environmental protection and the promotion of tourism, tend to be put in the green box. Indeed if the EU can reach agreement on reform of the CAP – and if the US shows some flexibility – it should be possible to reach a WTO deal on agriculture. However, the talks are unlikely to meet the 2005 deadline set in Doha, which was highly ambitious by the standards of international trade negotiations.

A number of WTO countries are concerned not only about tariffs and quotas, but also legal measures and practices that hinder trade, which are known as non-tariff barriers. In particular, they accuse the EU of using food safety concerns to keep out products. For example, there is considerable suspicion about the 'precautionary principle' that is being incorporated into EU legislation. This principle gives the EU considerable latitude to ban – or hold off approving – products if there are concerns about their safety.

Another potential force for change in EU farm policies comes from the expiration at the end of 2003 of the 'peace clause' from the Uruguay Round agreement on agriculture. Although interpretations of its legal power vary, the clause represents a tacit agreement among WTO members not to challenge one another's agricultural subsidies. Once the clause runs out, the CAP could well face legal challenges at the WTO. Whether this happens hinges in part on the state of the WTO farm talks. It also depends on developments in the simmering EU-US row over the reluctance of EU countries to grow and import crops containing genetically modified organisms.

Pressure from enlargement

The long-term impact of enlargement on EU farm spending hinges on two key factors: the terms of accession and the development of agricultural production in the applicant countries. The EU initially argued that direct payments should not be extended to the new members, as their farmers did not need compensation for price cuts. However, under pressure from the applicant countries for immediate access to direct payments, the Commission relented and proposed phasing in these subsidies over a ten-year transitional period. New member-states would receive 25 per cent of the level of direct payments paid to farmers in existing EU members at the time of accession, set for 2004. This sum would then steadily increase until it reached 100 per cent in 2013. EU leaders backed this timetable at their summit in Brussels at the end of October 2002.

These proposals would ensure that EU spending until 2006 remained within the budgetary limits (known as the 'financial perspective') set by EU leaders in Berlin. However, the applicant countries have condemned the plan as a recipe for a two-tier Europe. There is very little room for manoeuvre if the EU is to respect the 2004-06 spending limits and meet its end-2002 deadline for concluding accession negotiations. If applicant countries succeed in winning higher farm payments, the EU will have to cut spending elsewhere or agree unanimously to increase the budgetary ceiling set in Berlin. Equally, it is difficult for the EU to maintain a take-it-or-leave-it attitude in the accession negotiations, given the dangers of an anti-EU backlash over unfair treatment in countries such as Poland, as all the candidates are due to hold referenda on accession in 2003. The most likely compromise is a reduction in the transitional period for direct payments to farmers in the applicant countries.

The Commission has not published calculations on the cost of direct payments for the applicants after 2006, because the EU has yet to tackle the heated issue of spending for the next budgetary period. Nonetheless, the Commission's current proposals and the possibility of compromises more favourable to the applicants have increased the pressure for limits on overall CAP spending after 2006. This was reflected in the deal struck by EU leaders at their summit in late October 2002, which called for the main portion of the CAP budget to grow by no more than 1 per cent a year after 2006.

The summit accord was a disappointment for those seeking an overall reduction in the size of the CAP, not the least because the ceiling would cover direct payments and market supports, but not rural development programmes. However, the limit keeps up the pressure for reforms to the direct payment system and means

that direct payments to the farmers of existing member-states must decline after enlargement.

A Dutch government report estimates that, as of 2007-2008, it would cost €7.5 billion a year to extend direct payments to the 12 applicants expected to join the EU in coming years.[6] The rest of the Common Agricultural Policy subsidies (for market support and rural development) would cost another €7.5 billion. This would increase CAP spending – currently €44.5 billion – by about a third. These types of estimates are highly contentious, however. The overall total can change significantly, depending on the base years used for calculations and the eventual entry dates for the new members. Moreover, EU governments and institutions have tended to over-estimate the speed with which post-communist agriculture increases production in Central and Eastern Europe. Still, even if the €15 billion figure is exaggerated, it is hard to imagine the current member-states agreeing to foot a bill of anything like that magnitude.

[6] *Estimates from Dutch Agricultural Economic Institute, 'The financing of the Common Agricultural Policy after enlargement of the European Union', June 2001.*

The direct payments will not only impact the EU budget, but also increase the productive capacity of farmers in the applicant countries, notably by funding investment in technology and chemicals. While modernisation of agriculture is to be encouraged, there is a danger that a jump in production post-enlargement could lead to the return of mountains of surplus food. Under the Commission's proposals, direct payments would be linked to farm acreage, not numbers of animals or the level of output. The result should be less of a bias toward large producers than at present. But such payments would do little to alleviate poverty in the smallest farm units in the applicant countries. Revisions to the CAP need to take these problems into account, by expanding the funds available for rural development.

Bringing the strands together

Under the terms of Agenda 2000, the EU is obliged to conduct a mid-term review of the CAP and assess whether the budgetary plans are adequate for enlargement. There is a strong case for using this review as an opportunity to reform the CAP, given the range of problems discussed above.

But there are many potential obstacles to a full-scale overhaul of the CAP. Timing is a particular problem because the mid-term review takes place at the same time as enlargement and some key deadlines in the Doha trade talks. The CAP review could hold up either enlargement or the trade talks, particularly since the Commission delayed its proposals until after the French elections in June 2002. EU governments may be tempted to head off immediate financial problems by agreeing on temporary measures and transition periods for the applicants, instead of adopting more sweeping changes that prepare European agriculture for the future. Moreover, it essential that member-states consider CAP reform in the context of other EU policies – ranging from the environment to foreign policy. The next chapters look at why and how the EU should avoid the errors of the past.

3 The economics of agriculture

Agriculture in much of the developed world is heavily subsidised. The Organisation for Economic Cooperation and Development (OECD) estimates that its members spent $311 billion supporting agriculture through protection and subsidies in 2001 – equal to 1.3 per cent of gross domestic product (GDP).

Overall support to farmers accounted for 31 per cent of gross farm receipts in 2001.[7] Figure 2 shows just how reliant the agriculture sector is on state aid and transfers from consumers. Although farm supports have declined since 1986-88, the figures mask big variations among OECD members. In 2001, New Zealand support amounted to just 1 per cent of gross farm receipts, compared with between 59 per cent and 69 per cent in Japan, Korea, Norway, Switzerland and Iceland. The EU figure for 2001 was 35 per cent, compared with 21 per cent in the US.

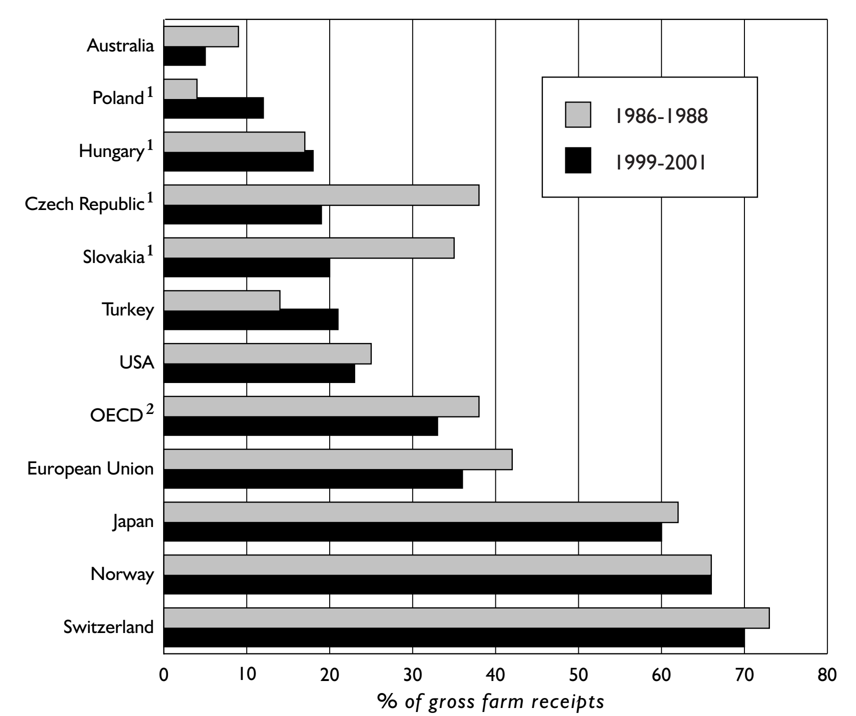
[7] *The measure used here is the OECD's 'producer support estimate', which calculates the value of all transfers from consumers and taxpayers to farmers.*

Europe's citizens pay for agriculture subsidies at the cash register as well as through taxation. European consumer groups estimate that EU agriculture policies cost a family of four about €26 each week, through both higher food bills and taxes.

Uneven benefits

The CAP subsidy regime long ago ended food shortages in Europe. However, its other economic benefits are much less clear. While extensive subsidies have helped to keep some farming communities alive, overall they have failed to stem the decline in the EU's farming population. The number of farms has dropped by about 40 per cent

FIGURE 2: SUPPORT TO FARMERS



SOURCE: OECD PRODUCER SUPPORT ESTIMATES

1 Figure is for 1991-93 because data for 1986-88 are not available

2 Not including Czech Republic, Hungary, Poland and Slovakia for 1986-88

over the past 30 years. Regardless of future policies, this trend is likely to continue, given that about 55 per cent of the seven million farmers in the EU are over 55, with many farmers past the normal age of retirement.

The subsidy system has also failed to stop farm incomes from declining relative to the rest of the population. This is partly due to

uneven distribution of support among farmers and regions, but it is also because price supports are a relatively inefficient way of bolstering farm incomes. The OECD estimates that for every $4 spent on such subsidies, farm incomes go up by only $1. Previous CAP reforms have reduced price supports in the EU, but the direct payments provided to farmers as compensation remain partially linked to past production. This means that most CAP funds continue to go to producers of a narrow range of commodities, especially cereal farmers. As a result, about one third of EU farmers derive part of their income from sources other than producing food. There is also hidden unemployment in the farm sector, especially in Southern European countries, with farmers often relying on income from other family members.

Meanwhile, 15 per cent of farms produce over 70 per cent of the EU's agricultural output. This concentration of production, along with the uneven spread of subsidies across crops, explains why about 80 per cent of CAP money goes to just 20 per cent of Europe's farmers. The EU has increased support for products such as olive oil, wine and tobacco following the accession of Spain, Portugal and Greece. However, nearly two-thirds of CAP expenditure is on arable crops, beef, sheep-meat and dairy. These are the core products in most of the EU's founding member-states. Arable crops alone account for about 40 per cent of the overall agriculture budget and about 65 per cent of direct payments. Future changes to EU farm policy, which might base subsidies on other factors such as the environment, would be sure to alter the balance of benefits between farmers and regions. But it will not be easy to overcome the resistance of the vested interests, which have successfully defended spending on certain commodities throughout the various CAP reforms.

Managed market

Farm subsidies and external protection can also be viewed as a way to promote a stable market, avoiding the big swings in food production that could be provoked by climatic factors or an overreaction to market signals. This helps explain why the EU, along with most developed countries and some developing ones, treats the agriculture sector very differently from manufacturing industry.

If the EU left agriculture entirely to market forces, it would risk frequent farm bankruptcies, rural depopulation, big price swings and disruptions in the supply of foodstuffs. The developed countries with the lowest levels of public intervention in agriculture – most notably Australia and New Zealand – have particularly favourable conditions for farming, abundant land and low population density. By exporting products in which they have a natural advantage, these countries can maintain a successful farming sector with little or no subsidy, although their move to low-subsidy agriculture was not without pain.

The EU would find it difficult to follow the example of Australia and New Zealand and remove all subsidies. European cities are in close proximity to the countryside, farms tend to be smaller and weather conditions are generally less favourable. Moreover, there is no political consensus to end subsidies. On the contrary, there appears to be widespread agreement that government has a role in helping rural communities and keeping farmers on the land. However, the level of EU intervention in agriculture is anachronistic. Self-sufficiency in food production in Europe is no longer the imperative that it was after the Second World War. In fact, it is in the developed world's long-term economic interests to provide outlets for food produced in the developing world (see Chapter 4).

Moreover, it is difficult to use subsidies to balance supply and demand, especially when the system is the result of negotiations between 15 countries with a variety of interests. Subsidies often have unintended effects – the most obvious example in the EU's case was excess production. Even now, the need to keep a lid on production is a constant issue, prompting complex set-aside rules and milk quotas.

When the EU introduces subsidies to discourage production it is in effect paying to cancel out the effect of previous subsidies.

That said, the CAP reforms of the past decade have brought the EU market close to a match between supply and demand in most commodities. Opinions vary about how long the EU can maintain this balance without a further overhaul of the CAP. Among the developments that could throw the EU market out of kilter are changes in the euro-dollar exchange rate; international talks on cutting export subsidies and external protection; the planned reduction of import duties on sugar from the least developed countries; and EU enlargement. And the effectiveness of subsidies in influencing market balance depends very much on external protection, because tariffs and quotas control the supply of imports. The EU is unlikely to retain its high level of protection, given that any agriculture agreement in the new round of trade talks will require further opening of the EU agriculture market.

In addition, the CAP divorced many farmers from their markets. New eating habits can take years to be reflected in the level of production, with subsidies sometimes actively discouraging farmers from producing the food that people want. Organic farming is a case in point. Because farmers were rewarded for producing more, a shift to organic agriculture with lower yields often meant a drop in income. The EU now allows for subsidies to help farmers make the change, but this does not always cover the loss of income from growing the most subsidised commodities. Meanwhile, consumer demand for organic food is soaring and in countries such as the UK outstripping local production. Although it has expanded rapidly in recent years, organic farming still only accounts for about 3 per cent of total land in agricultural use in the EU.

Public perceptions

The growing gulf between farmers and consumers has other socio-economic repercussions. An absence of trust between the farming community and the wider population helped to aggravate the recent food safety crises. The lack of contact also discourages entrepreneurship among farmers, who usually do not need to go out and seek clients. Nina Planck, director of London Farmers' Markets, sees widespread benefits in the contact between producer and consumer that takes place at such markets. "Farmers have to grow something that people want to buy at a price they want to pay," she says. This is easier when farmers meet their customers on a regular basis. In Britain, the gap between rural and urban communities is more pronounced than in some continental countries. In France and its southern European neighbours street markets never went out of fashion and family ties to the countryside remain strong. Even so, increased public distrust of food quality is just as strong, if not stronger, on the continent than in Britain.

The CAP is often viewed as the main culprit for problems such as environmental damage and over-intensive production in farming. But the truth is far more complex. Some of the most intensive – and polluting – farming practices in Europe are found in the pig and poultry sectors. But these are the least subsidised and protected parts of the EU farming world. In 2001, for example, EU budgetary spending on pig meat, eggs and poultry was €170 million – a fraction of the €17.8 billion spent on arable crops or the €11 billion on dairy, beef, veal and sheep. The drive to reduce the cost of food production is just as important as the CAP in the intensification of farming and the growth of pollution.

Large farms are also blamed for the excessive use of fertilisers and pesticides, as well as practices that led to the spread of mad cow disease. But while big farms may have more to spend on chemicals, they also more often have trained staff who know how to use them properly. According to Dr Hiltrud Nieberg, of the Institute of Farm Economics and Rural Studies at Germany's Federal Agricultural Research Centre, a recent study in western Germany showed that farm size was not the most important factor in the environmental impact of agriculture. The region in which farms were located

played a much bigger role in their use of chemicals. BSE cases were as common in small farms as large, while organic farms are bigger in size than the EU average.

There is a need to look beyond the 'big is bad, small is good' view when devising policies. What can be said is that larger farms tend to be more able to compete, because of economies of scale, and therefore should be less dependent on subsidies. In addition, the desire to keep rural areas populated may necessitate specific measures to preserve small farms.

Agriculture and the wider economy

The current subsidy system also raises a series of questions about the role of agriculture in the economy. Price supports, and to a lesser extent direct payments, mostly focus on one aspect of farming – the production of abundant food. For many years the CAP provided no mechanisms to tackle other issues such as pollution, biodiversity and food quality. The Agenda 2000 agreement changed this by making rural development an integral and important part of farm policy – but it still only accounted for 10 per cent of CAP expenditure in 2001.

Public opinion provides conflicting signals: people put food quality high on their list of demands and yet keep up the pressure for lower prices. Recently, though, food safety crises and foot and mouth disease have prompted policy-makers and the public to reconsider what they want from the farming community. In particular, they recognise the need to improve environmental practices and the quality of food, while preserving an attractive rural landscape. In some countries there is also pressure for improved animal welfare, lower government spending, or both. In so far as subsidies continue, they offer an economic lever to move agriculture in these directions.

Policy-makers have coined the term 'multifunctionality' to describe the view that agriculture is about more than just food production.

However, many of the EU's trading partners remain sceptical about this concept, suspecting it is merely a new disguise for old-fashioned protectionist policies. There is no doubt that some EU and national officials do wish to maintain a protectionist approach. But many Europeans who want to reform the CAP do see the benefits of approaching agriculture in a multifunctional way.

As such, multifunctionality can be a useful way of looking at the economics of agriculture. "Farming is multifunctional. It shapes our rural landscape, provides storm protection and can help against climate change by absorbing carbon in trees and soils," says Jules Pretty, who is professor of environment and society at the University of Essex and a harsh critic of the CAP. Conversely, agriculture can have costs, such as environmental pollution, which are usually not reflected in food prices. If subsidies are to be maintained at all, he argues, the aim should be to devise a system which stimulates the positive aspects of agriculture while cutting down on negative features such as pollution.

Some economists reject such ideas as too interventionist and argue for an unfettered market, perhaps combined with the principle of 'polluter pays'. While there is some merit to this argument – and it certainly would reduce the scope for fiddling subsidies – it is far from certain that the market alone would produce the type of agriculture and countryside that Europeans want.

Moreover, market failures are common in agriculture, and the state usually has to pick up the bill. For example, the short-term savings that resulted from recycling animals into feed were vastly outweighed by the costs of Mad Cow disease and salmonella in eggs. Antibiotics given to animals have created antibiotic resistance in humans, leading to higher healthcare costs. And water authorities have to spend millions of euro in removing nitrates and other chemicals that run off farmland. In all these cases, it is not the individual farmers that bear the bulk of the costs, but the taxpayer.

The principle underlying multifunctionality should be the recognition that agriculture provides public goods, which can be encouraged or compensated through public policies. The challenge is to develop policies that do not provoke new economic problems, such as trade distortion or unfair competition. To help governments weigh the potential costs and benefits of 'multifunctional' policy options, the OECD has developed a framework and terminology.[8] It defines agricultural commodities and other outputs (related to the environment, culture, rural development, food security or other social goals) as joint products. The OECD recommends that governments should justify their agricultural policies in terms of the wider impact of farming, including whether there are market failures and whether the agriculture sector produces positive or negative outcomes.

[8] *'Multifuntionality: towards an analytical framework', OECD 2001.*

The OECD's framework could provide a useful tool for assessing whether proposed changes in EU farm subsidies are really helpful – or merely the same system with a new name. Multifunctionality need not become a blank cheque for new and more generous subsidies, as many liberalisers fear. Instead, it can, and should, help to provide the criteria for developing more ambitious agriculture policies that include scaled-back and better-targeted subsidies.

The task of government

At the national and EU level, government's main role has been to administer an expensive agriculture policy with uneven benefits for farmers and society. Strategic thinking has been notably absent: the main motivation behind previous CAP reforms has been the desire to cap spending and output, rather than engineer long-term reforms of farming.

However, there are some encouraging signs of change, such as the creation of new ministries responsible for consumer and rural affairs. For its part, the European Commission is committed to improving co-operation between the directorates-general responsible for agriculture, consumers and the environment. And the Commission's emphasis – in its mid-term review proposals – on rural development and raising environmental standards shows that it is trying to link up different policy goals. A number of recent studies, ranging from Britain's Policy Commission on the Future of Farming[9] to a pamphlet by senior French Socialists,[10] question the status quo and call for agriculture to be better connected to other social and economic policies.

[9] *Report of the 'Policy Commission on the Future of Farming and Food', chaired by Sir Donald Curry, January 2002. See www.cabinet-office.gov.uk/farming.*

[10] *Pascal Lamy and Jean-Pisani Ferry, 'L'Europe de nos volontés', Fondation Jean-Jaurès, Paris, 2001.*

The multifunctional view of agriculture suggests that governments should play a clear economic management role and promote public goods – such as a pleasing landscape – that are related to farming. But in our wealthy European economic setting, a stable supply of food is a public good that the market can provide. Even if the government needs to help rural communities, that does not mean farmers must receive production support – they could receive an income safety net instead.

However, governments must consider more than just domestic issues. Europe has wider responsibilities and aspirations on the world stage. The next chapter looks at how freeing up trade fits into the equation.

4 The case for reducing trade barriers

Ever since the Seattle WTO meeting collapsed amid demonstrations and acrimony three years ago, free trade has become like religion – either you have it or you don't. Simplistic views reign: free traders are portrayed as champions of a capitalist free-for-all and their adversaries as backward-looking protectionists.

Reality, of course, is more complicated. A desire to reduce trade barriers can coexist with a perception that today's globalised economy – and the institutions that govern it – is weighted in favour of developed countries and their powerful interests, ranging from banks and drug companies to farmers. And for politicians to give free trade priority over all other aspects of economic and social activity is not necessarily the best way to build an efficient, equitable and inclusive international economic system. Many countries, such as Korea, Malaysia and Germany, have successfully opened up their markets after periods during which tariffs protected their industries.

The plight of farmers

In Europe and the US, critics of globalisation like to blame the problems of farmers in the developed and developing world on the Uruguay Round. In agriculture, however, this charge is undermined by the dearth of free trade. Tariffs and quotas shelter Europe's market so that prices received by EU farmers are on average 33 per cent higher than world market prices.[11] The level of protection varies widely across sectors, with EU sugar prices up to three times the world price, for example. Protection is even more pronounced in Japan, Korea and several other European countries.

[11] *'Agricultural Policies in OECD Countries, Monitoring and Evaluation 2002', OECD, Paris.*

While the US relies less on trade barriers than the EU, the generous subsidies showered on American farmers are in stark contrast to the treatment of other industries. In both the EU and US, direct budgetary spending on farm subsidies has risen in recent years.

It is true that the CAP, through its protective barriers, has kept some small farmers in Europe afloat. But the biggest beneficiaries of farm subsidies on both sides of the Atlantic are a relatively small number of large producers. The Environmental Working Group – an environmental research charity based in the US – prompted controversy by publishing a database that details how much individual American farmers received from state hand-outs in 2001.[12] In Britain, meanwhile, Brian Gardner, editor of Food Policy International and a long-time analyst of EU agricultural policies, reckons there are some individual farmers who receive €1.5 million a year in subsidies. Evidence that the developed world's farmers are losing out due to the trade agreements is very thin on the ground. And if further liberalisation is phased in, as seems likely, there will be time for an adjustment process.

12 See Environmental Working Group: www.ewg.org/farm.

A recent joint study by the Adelaide Centre for International Economics and the Tinbergen Institute in the Netherlands estimates that a 50 per cent reduction in agricultural trade protection would provide a $27 billion boost to the world economy.[13] The developed world, and especially the European Union, would enjoy around two-thirds of this gain. On the other hand, Africa would fair badly owing to the overall weakness of its agricultural sector and the loss of preferential treatment in certain export markets. Interestingly, the study finds that such losses would be more than offset by gains for African countries from a cut of 50 per cent in all tariffs, not just those for agriculture. Since the liberalisation of agricultural trade would almost certainly only happen as part of a wider trade round, the balance of benefits remains positive. However, the North should help to devise other

13 Joseph Francois, 'The next WTO round: North-South stakes in new market access negotiations', Adelaide University, 2001.

policies, including development funding, to enable the world's poorest farmers to compete internationally. National governments, the WTO and other international institutions like the World Bank need to co-ordinate their policies better to start such measures before world trade liberalisation occurs.

Moreover, liberalisation need not result in lower prices for agricultural commodities, which could damage farmers in developing countries. Many economists expect the next round of farm trade liberalisation to lead to higher commodity prices, because there is likely to be a move away from subsidies that encourage production and underwrite exports. The developed world's surplus production, which is exported with subsidies, stockpiled or used as food aid, tends to weigh on the market and push down prices. After the Uruguay Round, world prices for grains, oilseed and some dairy and meat products initially rose sharply (although they have since fallen back). What can be said with certainty is that the current system, which provides EU farmers with high guaranteed prices, regardless of world trends, is especially unfavourable – and unfair – to farmers in developing countries.

Arguably even more damaging to developing economies are the existing tariff structures. Developed countries maintain higher barriers on manufactured food products than on raw agricultural commodities. Such 'tariff escalation' makes it much harder for developing countries to move up into more lucrative 'added-value' products. They remain reliant on commodity exports, which are subject to much greater price volatility.

Environmental costs

Many environmental organisations are among those arguing against further liberalisation of world trade, including agriculture. Yet these groups generally support a substantial reform of the CAP, to ensure it promotes 'greener' agriculture. This can produce an unfortunate situation in which, for world trade negotiations on agriculture, environmental opponents of globalisation and those seeking to maintain the current CAP form an unholy alliance.

In the UK, one detractor of the world trading system is Professor Tim Lang of Thames Valley University, co-author of a book on the 'new protectionism'. He is highly critical of the CAP's subsidies, since they have helped to fund intensive farming and the use of pesticides and herbicides. However, unlike some CAP critics, he does not advocate the removal of trade barriers. Instead he argues that liberalisation and free-market capitalism damage the environment and increase economic inequalities between the developed and developing world. "Our vision is for less trade and, where it happens, for trade to be more local, more equitable and to meet higher standards. More long-distance trade will only intensify the damaging trends which are already bringing the world to its current sorry state."[14]

[14] *Tim Lang and Colin Hines, 'The new protectionism: protecting the future against free trade', Earthscan Publications, 1993.*

Professor Lang and like-minded critics of trade liberalisation argue that prices do not reflect the true environmental costs of transporting products. Thus it makes economic sense for producers and distributors to send goods halfway around the world, or up and down national motorways, given that the local and global cleaning-up process is subsidised by the taxpayer. Professor Lang points to a German study of strawberry yoghurt, which found that the ingredients in a 150-gram yoghurt had travelled a total of 1,005 kilometres.[15] On the other hand, Food Policy International's Brian Gardner estimates that it is less polluting per packet to ship butter from New Zealand to Europe in big container vessels than to move it up the motorway in a lorry. The economics of food prices are not always easy to decipher.

[15] *Financial Times, February 23-24th 2002.*

There are a number of ways of making prices better reflect the true costs of economic activity to society. These include taxation of petrol, airplane fuel and chemicals, as well as linking subsidies to higher environmental standards. If the aim is to encourage the

consumption of food as close to the source as possible, agricultural policy-makers should opt for positive measures rather than blaming or blocking trade. In the developed world, strategies include promoting farmers' markets and helping local producers work together to meet the quantity and quality demands of supermarkets.

In developing countries, the main impediment to local consumption of food is low incomes, not international trade. Debt relief, poverty reduction strategies, land reform, education and training are all ways to help raise living standards and create local markets. Improved human and trade union rights for agricultural workers and farmers also can help on this score. Furthermore, such policies are not inconsistent with the lowering of trade barriers in the developed world.

A global view

This argument in favour of trade liberalisation is not to dismiss the concerns of environmentalists, who fear that freer trade will spread polluting and intensive agricultural practices from the developed to the developing world, or of those who see the poorest losing out if big business moves into agriculture in developing countries. However, it is better to address these problems by developing policies that promote equitable and environmentally sustainable development, rather than preventing the developing world from exporting food. The EU should lead efforts to ensure that the issues of environment and food safety are part of the global trade agenda. But unless Europe opens up its own market further, it will have a hard time defending any continuation of farm subsidies, even if these are aimed at improving the environment and are 'decoupled' from production.

The EU waged a long campaign for the kind of wide-ranging trade round that was agreed in Doha. But if it is to draw the economic and political gains promised by such a round, the EU will have to make concessions on agriculture. The EU and its trade commissioner, Pascal Lamy, have advocated a pro-development agenda that included granting duty-free access to exports of 'everything-but-arms' from the least-developed countries (LDCs). Although most LDC farm exports go to the EU, the amounts involved are not very significant. As a result, the initiative is more symbolic than practical. For many developing countries, the EU's approach to agriculture remains the key issue for the trade talks. In Doha, other countries were not impressed by the EU's insistence on avoiding a commitment to eliminate export subsidies. If the mid-term review produces a substantial CAP reform, the EU's negotiating hand will be much stronger.

The impact on developing countries

For their part, developing nations do not share the view that they have anything to gain from continued farm trade restrictions in the developed world. On the contrary, trade officials in developing countries, along with a number of independent analysts, are disappointed with the modest impact of the Uruguay Round agreement on agriculture. But the next round of trade liberalisation could pose some problems for certain developing countries. For example, an opening of the EU market to all agricultural products would end the preferential treatment given to products from African, Caribbean and Pacific (ACP) countries. Some of these losses could be offset by any price increases that stemmed from the liberalisation of trade in sugar – an important ACP export but one that is highly subsidised and protected in the developed world.[16]

[16] *See Panos Konandreas, 'WTO negotiations on agriculture: possible implications for sugar-exporting ACP countries', Food and Agriculture Organisation, 2000.*

There is also an issue over how quickly developing countries should open up their own markets. Doha is billed as a 'development round', which makes it more likely that liberalisation of developing country markets will be phased in at a slower pace than in the Uruguay Round. There is nothing wrong with transition periods to give developing countries time to adjust. But these should not become an

excuse for foot-dragging by the EU, other western European countries and Japan. Moreover, protection is not the most effective way of bolstering agriculture in developing countries. Instead, policy-makers in the developed world should concentrate aid on rural road-building, training, improved farming techniques and better use of water.

5 The CAP and the applicant countries

The CAP's mid-term review began in the second half of 2002, at the same time as accession negotiations with ten applicant countries entered their final stages. The juxtaposition of the two political debates has increased the pressure for an early decision on revamping the CAP, before the new member-states start voting in the council of farm ministers.

The most immediate political issue is the cost of extending the CAP to ten new members. With the exception of tiny Malta, agriculture accounts for a higher proportion of employment in all accession countries than the EU average of 4 per cent. The biggest budgetary implications involve Poland, where nearly 20 per cent of the population lives on the land. The EU also needs to ensure that CAP reform makes the policy suitable for Central and East European farmers. If the EU governments are able to put aside their narrow national interests, they have a real chance of reforming the CAP in a manner that meets the long-term needs of agriculture across the EU-25.

Two-tier agriculture

One of the biggest problems posed by enlargement is the many small and semi-subsistence farms that are not involved in commercial production. These are found in poor rural areas that have not kept up with the rapid economic development of cities. Poland, notably, "is about 30 years behind the most highly developed European countries" in terms of the level of development of its agriculture sector, according to one recent report.[17] A paper

[17] *Lena Kolarska-Bobinska, Andrzej Rosner and Jerzy Wilkin, 'The future of rural areas in Poland', Institute of Public Affairs, Warsaw, 2001.*

from the Commission puts it more diplomatically, but the gist is the same:

"Despite efforts – and in most countries successful developments – restructuring of agriculture and food industries is still far from being complete, particularly in the livestock sector. The competitiveness of agriculture and the agro-food chain in the candidate countries is generally much lower than the EU average."[18]

[18] *Enlargement and agriculture: Succcessfully integrating the new member-states into the CAP', European Commission issues paper, January 30th 2002.*

In effect, there is a two-tier agriculture sector with a growing but small number of competitive farms, and a much larger number of small, essentially non-commercial ones. The Commission is worried about the political and social repercussions of farm restructuring. The risk is that consolidation of farming in the first few years of EU membership could aggravate already serious rural poverty and the EU would be likely to take the blame.

So, in addition to resolving the technical difficulties of merging agriculture in the applicant countries into the EU's system of subsidies and market regimes, there needs to be a concerted effort to combat rural poverty. This means extensive investment in education, roads and other infrastructure, as well as the development of non-agricultural economic activities in the countryside. Agricultural subsidies must be channelled in this direction and supplemented by other funding.

The Commission's strategy

The Commission's emphasis on rural development is the strongest point in its strategy for bringing the new member-states into the CAP. Under the Commission plan, half of the proposed €10 billion in agriculture spending allotted to the 10 candidate countries in 2004-2006 would be devoted to rural development. Moreover, the EU would fund up to 80 per cent of some rural

development programmes, compared with the 50-50 split that applies to the 15 current member-states. The Commission also aims to widen the eligibility criteria for rural development funds, to allow specific help for semi-subsistence farms.

In addition, applicant countries would receive over €25 billion in structural funds during the three-year period. EU leaders reduced this offer to €23 billion at their summit in Brussels on October 24-25th, 2002. This means that nearly three-quarters of the €40 billion budgeted for the early years of enlargement would go to funding social and economic development in the new member-states.

Another positive aspect of the Commission plan gives the new member-states the option, at least initially, to make direct payments in a way that is not tied to production. This 'decoupled area payment' would be on a per hectare basis. It would cover all types of agricultural land and involve no obligation to produce. In contrast, in the existing member-states there are now nearly 30 types of direct payments, going mainly to arable and cattle farmers. These direct payments were introduced to compensate for price cuts in the MacSharry reforms, and were calculated on the basis of cereal yields or numbers of animals. They were extended to rice in 1995 and are due to cover milk producers as of 2005. A number of other schemes aimed at supporting farmers' incomes are also classified as direct payments.

Not only would the optional system proposed for the new member-states be easier to administer, it would also limit the scope for errors and cheating, as well as reducing the incentive for farmers to switch crops merely to gain greater subsidies. This in turn would reduce the danger of surpluses in certain crops and promote demand-led production. The Commission sees this simpler system lasting for a maximum of three years, with new member-states then switching to the system for direct payments which applies in the existing member-states.

The Commission's mid-term review, which came out six months after its proposals on enlargement, also has implications for integrating applicant countries into the CAP. For example, the new member-states would move directly to a new system of direct payments that the Commission has proposed for the whole of the EU. The Commission is calling for these payments to be distributed per farm and based on historical entitlements. In the case of the new member-states, this would be a theoretical calculation, given that their farmers would not have received payments under the current CAP.

Implementation of the mid-term review proposals in the EU would not change the amount of aid already proposed for the applicants. However, because such payments would not be tied to production of a particular crop – but based on acreage instead – farmers in applicant countries would join their EU counterparts in having more freedom to produce for the market. In addition, the simplified administrative system for direct payments outlined in the Commission's mid-term review would make integration into the CAP easier for farmers in new member-states. The Commission's proposals also mean that farmers in the applicant countries would have to meet higher environmental, food safety and animal welfare standards than otherwise would have been the case.

The Commission also called in its mid-term review for 20 per cent of direct payments to be shifted gradually into rural development. This would lead to a tapering-off of overall direct payments to EU-15 farmers during the period that the new members' payments were being phased in. The new members would thus gain full access to the agriculture funds on the same basis as the EU-15 countries before the 2013 date, but the EU's overall level of direct payments would already have declined. Meanwhile, there would be more money available for rural development programmes in the new member-states.

The Commission's mid-term review proposals should help to keep a lid on the budgetary cost of enlargement. Farmers in the applicant

countries would no longer be encouraged to produce simply to attain subsidies. However, if East European farmers believe they have been treated unfairly, they will resent the EU.

Political and economic drawbacks

The main problem with the Commission's overall strategy, however, remains the wide disparity between the treatment of farmers in applicant countries and their counterparts in the current EU, when it comes to direct payments. When the proposals were announced in January 2002, the then Hungarian prime minister, Victor Orban, spoke for many other candidate country politicians in warning of the creation of two classes of EU member-state.[19] He pointed out that the internal market for agriculture would be distorted, with farmers in the new member-states at a competitive disadvantage compared with more heavily subsidised farmers in the existing EU 15. Dissatisfaction in the applicant countries runs very deep. The Polish government for example, has threatened to impose import duties on EU agricultural imports if accession terms are not improved.

[19] *Financial Times, January 31st 2002.*

Under the Commission's plan, farmers in the ten new member-states would receive under €10 billion in farm subsidies over three years, compared with the approximately €45 billion the EU spends annually on agriculture in 15 countries. In addition, the reference periods proposed by the Commission for setting production quotas were times when the applicant countries' agricultural sectors were producing at low levels. As result, they will get lower quotas than they otherwise might have had. And the new members are likely to have to cut sugar production to prevent cost overruns in the EU's highly protectionist and generous sugar regime. This measure will keep agricultural spending down, but it will mean a considerable difference in treatment of farmers in the new and old members.

Apart from the distortion to the internal market, there are obvious political problems from the Commission's approach. The

Commission argues that too high a level of direct payments could discourage much-needed restructuring in the applicant countries' farm sectors. While this may be true, the candidate countries are justified in wondering why direct payments are good for EU farmers but bad for those in Central and Eastern Europe. The perception among the candidate countries is that the proposals are aimed at meeting EU budgetary needs, rather than those of their own farmers. There is a real potential for resentment among the new members' populations and a souring of relations after enlargement.

Squaring the circle

Aside from the desire to limit spending, there are longer-term strategic reasons for phasing in direct payments gradually. One, already mentioned, is to avoid a situation where the new members would block CAP reform in order to protect the already generous direct payments they were receiving. Another is to prevent a surge in production of certain crops, such as cereals. Most important of all, Eastern Europe should not repeat the mistakes of Western Europe. The EU should target its money at reducing poverty and modernising farming, rather than encouraging production in the new member-states. It is neither in the interests of the applicants nor of the EU if farm subsidies and market support lead to the production of goods for which the state is the only real customer. It is also important that increased subsidies do not lead to destruction of the environment.

For this reason, the EU should seek an early political agreement among the existing 15 member-states on some basic principles regarding their future farm policies. These principles should include the reduction of direct payments, which should be less linked to production than is currently the case; an increase in rural development funding; and an overall reduction in CAP spending across the 15 member-states. Even if the calendar for the enlargement talks proves too tight for such a political accord to contain definitive figures, setting out such a policy direction would

make it clear to the applicants that the phasing in of direct payments was a temporary transition within a wider strategy. For EU enlargement to take place close on schedule in 2004, such a political agreement would have to be reached by early 2003. While this is a tall order, it is not impossible.

At the same time, more funding should be provided to the applicants, both in terms of rural development and direct payments. However, in the absence of a reform of the EU's direct payments, this increased package should be conditional on the new member-states adopting the simplified decoupled area payment system, which could run for longer than the proposed three years. The CAP should also emphasise high levels of environmental protection in the applicant countries, through rural development programmes and also the environmental conditions attached to direct payments.

Such a strategy would allow money to be spread throughout the farming sector in the new member-states, rather than concentrated in certain commodities. Although it could distort trade in certain sectors where only farmers in the new members would be receiving direct payments, the amounts involved should be low enough not to cause major disruptions. Moreover, the EU would be presenting a more coherent picture for the future of farming in both new and existing member-states.

6 What kind of European agriculture?

The EU needs a wide variety of policies that take into consideration issues not traditionally dealt with by agriculture ministers alone. Politicians with courage and foresight are sorely needed. This chapter suggests a framework for change in light of current policies and farm structures, while the next chapter weighs up the Commission's mid-term review proposals.

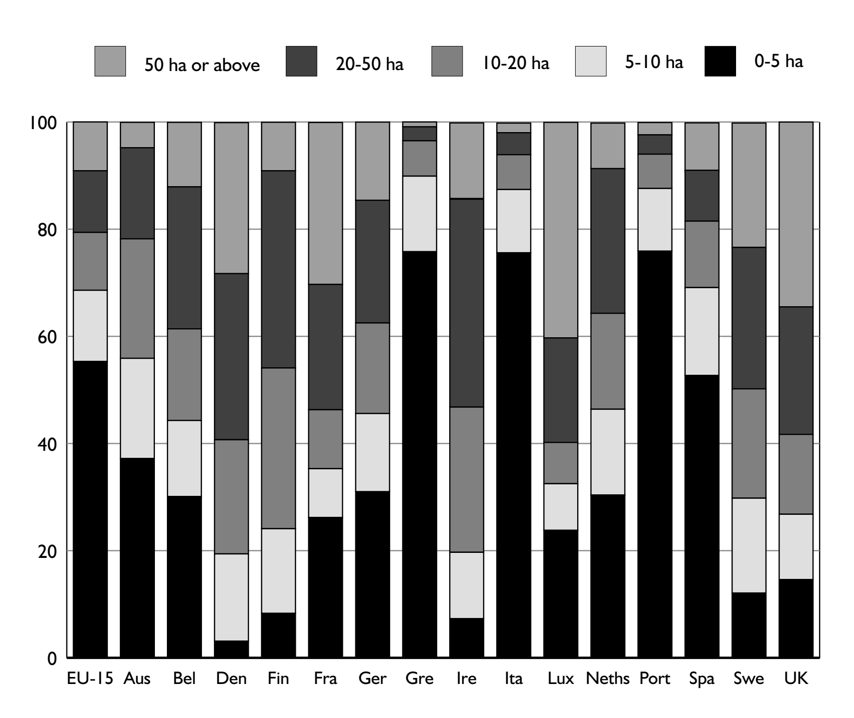
Agricultural diversity

The structure of the EU's agricultural policies has not kept pace with the increasing diversity of the Union itself. The CAP remains too much of a 'one-size-fits-all' approach to farm policy, with price supports used to help small hill farmers as well as big intensive producers. Subsidies are concentrated on commodities found in the original member-states, mainly arable and dairy products. This approach is already out of date, and the accession of ten new member-states will make it untenable.

Farming structures vary considerably among the 15 member-states. The number of agricultural holdings has fallen by 40 per cent, while agricultural employment has halved over the past 30 years. However, the area under cultivation in the EU has remained stable. Thus the average size of holdings has grown from 15 hectares in 1975 to 29 hectares in 1997. But this masks big differences, with about 55 per cent of agricultural holdings at five or less hectares. At the other end of the spectrum, nearly 9 per cent of farms consist of 50 hectares or more.

Britain, Denmark, France, Luxembourg and Sweden are the countries with the highest percentage of large farms, as shown in Figure 3. Although the number of large holdings rose sharply in Germany with unification, only about 14 per cent of German farms are bigger than 50 hectares, compared with nearly 34 per cent in Britain. As might be expected, the highest proportion of small farms is found in Portugal, Italy and Greece, where about three-quarters of holding are five hectares or less. In Spain the figure is just over 50 per cent.

FIGURE 3: FARM SIZES IN THE EU:
BREAKDOWN BY UTILISED LAND PER FARM (1997)



SOURCE: EUROSTAT

Enlargement will increase the number of small farms in the EU, given that about 55 per cent of agricultural holdings in the applicant countries are smaller than 5 hectares. It will also push up the proportion of the population employed in agriculture.

In recent years, the EU has begun to adapt its policies to the diversity of European agriculture. In addition to the rural development funding introduced under Agenda 2000, in 2001 the EU launched a pilot programme for small farmers. Under this programme, farmers qualifying for less than €1,250 in subsidies each year can apply for a single payment, based on the average amount received over the previous three years. This cuts red tape, as farmers no longer have to fill out forms for various support programmes. Moreover, it is a step towards breaking the link between subsidies and production and is therefore less trade distorting. A similar approach is evident in the Commission's proposal to allow applicant countries to opt for a simplified direct-payments scheme based on a decoupled area payment.

While such efforts are welcome, they are only a small part of what is needed if European agriculture and rural communities are to meet the challenges of the next few years. The EU needs to develop a new framework which seeks to:

★ Bring agriculture closer to the market;

★ enhance food quality and safety;

★ safeguard and improve the environment;

★ bolster rural communities;

★ and promote agricultural trade for developing countries as well as environmentally sustainable practices.

Food that people want to buy

If farmers tailor production to the market rather than subsidies, they become much more attuned to what consumers want. Safer and better-tasting food is high on the list of consumer demands. Consumers are also concerned about the environmental impact of agricultural production methods. The success of organic foods is an example of farmers responding to market signals – even though public policy, in the form of subsidies, has sometimes provided a disincentive to switch production methods. Both organic foods and the growth of labels guaranteeing certain production methods, such as France's 'Label Rouge' scheme, suggest that consumers are willing to "dig deeper into their pockets" where food is concerned, as German agriculture minister Renate Künast puts it. "Quality, not quantity" is now the motto in Germany, according to Künast. And certainly, consumers resent paying billions in subsidies when farmers produce food they do not want. That said, there is also pressure from many consumers, as well as from retailers, for lower food prices. This has led farmers' organisations to argue that their members are receiving mixed signals.

However, market pressure for cheaper food should not be allowed to lead to unsafe practices in food production – which will require clearer and better regulation throughout the food chain. For too long, those making policy at the EU and national level have turned a blind eye to unsavoury and unsafe production methods. As one EU agriculture official said at the height of the crisis over dioxin in Belgian chickens: "When a kilo of chicken costs the same as a kilo of bread, you know something is wrong." The high levels of dioxin in chicken and pork most likely resulted from the use of contaminated fats in animal feed.

Better standards may lead to an increase in food prices, although other factors such as the level of competition in the retail sector probably have an equal, if not greater, impact on prices paid at the till. If price rises impact on less well-off households, the answer is to develop public policies that are aimed at improving the incomes of

society's poorest. Savings on agricultural subsidies could be channelled into higher child benefit, for example.

Some farmers' groups also argue that they bear too much of the pressure for lower prices, because other sections of the industry, such as processors, distributors and retailers, seek ever greater profits. But if there is free competition, pressure for lower prices should fall on these other players as well. It is up to governments to ensure that such competition exists through rigorous enforcement of anti-trust policies. Public policy can also encourage competition by supporting other channels for selling food, such as farmers' markets and producer co-operatives. Local authorities can encourage farmers' markets, which cut out the middlemen, and governments can offer tax breaks to producer co-operatives, as is the case in France.

In terms of improving food safety, the EU must focus on ensuring the success of its new European Food Safety Authority. National and European authorities need to work together both to prevent future crises and improve current quality. The Commission recently gained greater powers to take emergency action during crises. The EU's rapid alert system, which spreads information about food problems, has been extended to include animal feed, which was at the centre of the BSE epidemic.

The EU faces greater difficulty in handling the issue of biotechnology and other new production techniques. European consumers are often hostile to scientific advances in food production, while many of the new methods are the subject of disagreement among scientists. As a result, confusion and delays have beset EU attempts to establish a coherent regulatory framework for genetically modified organisms. After years of discussion, the EU now has new tough rules on growing and importing genetically modified (GMO) crops. But many member-states are expected to continue their moratorium on approving such crops until a separate food-labelling law can be agreed. At the time of writing, the EU was struggling to agree on the threshold level of GMOs that should be allowed in products labelled as GMO-free, with the European Parliament seeking stricter limits than some member-states. An earlier attempt to legislate on labelling was complicated by the failure of the US and Canada to require that GMOs be segregated from conventional crops.

The EU needs to adopt a more transparent system for food regulation. Consumer groups should be more closely involved in regulatory procedures, so that they understand the motives for decisions. Environment agencies need to be included because objections to biotech products are as often based on environmental as food safety concerns. And farmers' organisations should put food safety high on their agenda, rather that focusing on protecting subsidies. Farming groups could even improve their image by publicising efforts to make food safer, for example by reducing the use of antibiotics in feed.

The EU and US also need to work more closely to try to resolve differences in the way they handle food safety and environmental regulation. Improved transatlantic co-operation is preferable to relying on the WTO's disputes settlement process to resolve such sensitive matters. However, it will take time to restore public confidence in European food regulation. In the meantime, farmers are likely to suffer from continued uncertainty.

A different kind of support

There are a number of different ways to shift subsidies away from merely encouraging production. For example, there is growing enthusiasm for the idea of paying farmers to provide society with certain services. This is reflected in the calls for an expansion of rural development subsidies. The 10 per cent of EU farm spending that goes toward rural development includes payments to encourage environmentally friendly production methods, the forestation of agricultural land, early retirement and help in developing tourism in rural areas.

Rural development spending has other benefits compared with the traditional elements of the CAP. It is much less centralised than the rest of the CAP, with member-states given considerable leeway in setting their own programmes. This allows funding to be tailored to the specific needs and problems of different communities. It also allows money to be channelled to farmers who have not benefited much from traditional CAP subsidies. In some countries, rural development is run at a more local level; in Germany, the *Länder* distribute the funds. The downside of decentralisation is that the quality of programmes can vary widely across the EU and individual member-states. The Commission will need to keep a sharp eye on how the money is used, to ensure the scheme does not become plagued by inefficiencies and even fraud.

The other problem with rural development involves the current funding arrangements. In addition to devoting a small proportion of CAP funds to rural development, Agenda 2000 allowed member-states to shift up to 20 per cent of direct aid payments per farm into rural development schemes (modulation in EU jargon). But member-states are required to co-finance the ensuing rural development programmes.

As a result, there has been a very low take-up of this Agenda 2000 provision, with only Britain, France and Portugal introducing modulation. And while France's previous Socialist government was enthusiastic about modulation, using it as a means to channel funds away from big producers to smaller ones, the Chirac government is not. French agriculture minister Hervé Gaymard has questioned the benefits of rural development programmes at French and EU level. While there is no doubt scope to improve rural development programmes, it is difficult not to view the French government stance as a reflection of the political strength of farmers who had suffered a decline in direct payments under the previous government's policies. Rural development is likely to prove a controversial issue in the forthcoming CAP negotiations.

If the EU is to expand its rural development programme without increasing the overall agriculture budget, the method of financing will have to change. There are a number of ways to achieve this aim. The system of modulation could be made compulsory. However, if the requirement for member-states to co-finance rural development programmes was maintained, the result would be an increase in national farm subsidies. The Commission and most member-states have doubts about this scenario, seeing it as 'renationalisation' of farm aid. Moreover, this option is made more difficult by the national budgetary constraints imposed by the EU's Stability and Growth Pact.

An alternative would be to make across-the-board cuts in other sorts of CAP spending, to finance more rural development programmes. This would mean scaling back direct payments as well as the market regimes of price supports and intervention buying. If deep enough cuts were made, overall farm spending could be reduced and the CAP reoriented towards rural development. However, the EU would need to make sure the heaviest burden did not fall on the farmers who are least able to afford subsidy cuts.

The EU also needs to reform the system of direct payments so that they are no longer based on past guaranteed prices. When farmers get payments that are equivalent to the price supports they used to receive, the system continues to encourage production, regardless of market realities. Breaking the link with production means transforming direct payments into a clearer form of income support. In essence, farmers should no longer have to produce in order to receive a payment. Such a move would encourage farmers to grow what consumers want to buy. There would be enormous political symbolism in the EU making clear that its subsidies were to keep rural areas going, rather than to produce food. But the long-term effectiveness and fairness of a reform that pays farmers regardless of whether they produce depends on a number of elements: these include whether price supports and other market management mechanisms are diminished, the terms for calculating and granting

direct payments, and whether such payments are also reduced over time. After all, if a new scheme resulted in the same farmers getting the same amounts for an indefinite period, the impact of the change would be limited.

One possible solution would be to transform direct payments into a bond scheme. Professors Stefan Tangermann of Göttingen University (who has since become the OECD's director for food, agriculture and fisheries) and Alan Swinbank of the University of Reading have outlined this concept.[20] Direct payments could be gradually converted into bonds that would guarantee farmers a stream of income that was no longer related to production. The so-called Tangermann bonds would have a limited duration of between ten and twenty years. This would not only decouple subsidies from production but also lead to a clear deadline for ending direct payments. But the latter causes political problems. "It would be heroic of agriculture ministers to say that direct payments are going to be phased out," says one EU diplomat. The complexity of the scheme could also lead to administrative problems, and its impact on bond markets is unclear.

[20] *Alan Swinbank and Stefan Tangermann, 'A proposal for the future of direct payments under the CAP', University of Reading, October 2000.*

If a reformed CAP is to include decoupled direct payments, they should be as divorced as possible from previous price supports and should take into account the wide range of farm size and income found in the EU. While there is no magic formula for doing this, some of the ingredients are clear: the income of less well-off farmers should be supported and funding must be more equitably distributed. The EU should also consider the economic differences between regions and types of agriculture, as well as the relationship between farm incomes and those of the rest of society. These factors make it difficult, if not impossible, to establish a single flat-rate figure for all farmers throughout the EU. But it would be feasible to start with an amount based on farm size or farm income and then adjust it (in both directions) to take into account other issues. There could be minimum and maximum levels established for any individual farm. If farmers are to be encouraged to produce for the market, rather than for subsidies, the overall funding that is devoted to such a decoupled payment system should be very much lower than at present. Of course, there would have to be a transition period to reduce the economic and social disruptions involved.

The EU also needs to explore the possibility of using non-CAP measures, including tax incentives, or disincentives, to help reform agricultural policy. For example, Professor Jules Pretty of the University of Essex argues for a policy package that includes 'green' taxes to discourage excessive use of chemicals and to ensure that prices for inputs and products reflect the environmental costs of farming.[21] These taxes would be combined with subsidies that encouraged farmers to adopt non-polluting practices. Pretty suggests rebates on tax, national insurance and business rates for organic farms, which he views as small businesses that can drive economic growth in rural areas. He also calls for public policies to encourage rural regeneration, through co-operatives, farmers' groups and community councils. Along similar lines, others suggest improving infrastructure in the countryside, especially education, healthcare, public transport, roads, internet connections and mobile phone coverage. Not only are these important for farming families, they also encourage other people to remain in or move to rural areas.

[21] Jules Pretty, 'Diversity is the sweetest cash crop', New Statesman, September 24th 2001.

These reforms would allow the EU and its member-states to pursue a wider range of objectives in supporting rural communities, without contributing directly to increasing production. But the new programmes would need careful monitoring to ensure that the money was not wasted and that the result was not disguised production subsidies. Because rural development programmes are partially financed by member-states, there is a greater incentive for national governments to fight fraud and ensure they are getting value for money. In contrast, member-states are forced to reimburse

the EU budget when they uncover malpractices in normal CAP payments. Still, the Commission has an important role to play here. The OECD guidelines on multifunctionality should help policy-makers in assessing the impact of new payments both on public goods and on production.

The international picture

Europe has to open up its agriculture sector more to the rest of the world. This point is doubly important as improved food standards in the EU risk creating new non-tariff trade barriers. Moreover, those who favour environmental subsidies, for example to promote organic agriculture, may argue for continued protection to prevent imports from undercutting higher EU prices.

If Europe is to play a positive role on the international stage, it will have to resist such pressures. That is not to ignore the real problems that can come from imports of unsafe food, and countries have the right to prevent dangerous products from entering their market. It is also possible for food standards to affect trade inadvertently, as was the case with the EU's ban on hormones in meat, which led it to reject imports of US beef. However, the only long-term solution is to establish internationally-agreed standards on food safety and related issues, such as organic agricultural production methods, rather than curb imports. Such an approach could help to raise environmental practices elsewhere in the world. For example, non-EU countries should have the opportunity to help meet the rapidly growing demand for organic food in Europe. The EU, as well as international development agencies, can work with such countries to ensure that organic practices are being followed.

Of course, there will be tricky issues related to both standards and subsidies that are likely to come up in the next round of WTO negotiations. One of these is the labelling of food products. Some trading partners may view special 'green' or quality labels as a form of protectionism. And there are certain to be arguments over whether any new subsidies that replace direct payments are really trade neutral – and qualify for the green box. But when the crunch comes, the EU's ability to defend itself will be enhanced if policies are devised with the aim of opening up the market rather than closing it down.

7 The mid-term review

The European Commission has made a bold attempt to begin CAP reform in its mid-term review, published in July 2002. The proposals, if adopted, would mark the biggest change in direction in European agriculture policy since the MacSharry revamp of the early 1990s. Those reforms were mainly about ending overproduction and reducing the EU's reliance on export subsidies, hence allowing Europe to conclude international trade negotiations. Commissioner Fischler is aiming not only to continue that process but also to turn the CAP into a different kind of agricultural policy. His proposals would begin this transformation by no longer making subsidies contingent on production. Higher environmental, food and animal welfare standards would become key goals of the CAP, and there would be a greater focus on rural development.

However, the plans would not make any sizable reductions in overall farm spending and would only gradually move money from direct payments into rural development. They also do little to address directly the concerns of less well-off farmers and southern European countries. On the international front, the plans fail to provide trading partners with greater access to the EU market.

Loosening the link

The most radical part of the Commission mid-term review concerns direct payments, with a call for the introduction of a single payment per farm that would no longer be tied to production. The amount granted to each farm would be based on historical entitlements during an as-yet-unspecified reference period. This single income payment would go a long way toward simplifying existing arrangements, under which a single farmer can be eligible for several dozen or more subsidies. However, some separate payments would continue for an indefinite period to excluded sectors, such as fruit and vegetables.

The new payment would be dependent on farmers meeting standards regarding food safety, animal health and welfare, protection of the environment and occupational health and safety. This 'cross compliance' would be based on standards defined and enforced by national governments under a European-level framework. Farmers would also be required to keep out of production, or set aside, a certain amount of arable land for a long period of time – and not 'rotate' it back into production. This reflects the view that past set aside schemes have done little to protect the environment.

To improve standards and consumer confidence, the Commission proposes establishing a system of audits for farms deemed to be commercial, defined as those receiving more than €5,000 in direct payments annually. Other farmers could join the system voluntarily. These audits will "help farmers become aware of material flows and on-farm processes relating to environment, food safety, animal health and welfare and occupational safety standards."[22] Rural development funds would be made available to help set up the audit system.

[22] *'Mid-Term Review of the Common Agricultural Policy', Communication from the Commission, July 10th 2002.*

The proposed decoupled payment system would reduce the link between subsidy and production and encourage farmers to grow for the market, rather than to justify a specific subsidy. However, because the payment would be based on historical entitlements, it would result in the bulk of CAP subsidies continuing to go to the same farmers. As such, the new payments are not designed to redistribute income among farmers, a point acknowledged by the Commission, which argues that this objective should be achieved through other means.

Nonetheless, the Commission has proposed measures that would begin moving money away from the biggest recipients of CAP funds toward rural development programmes. First, modulation – the transfer of funds from direct payments to rural development – would no longer be voluntary. Second, no farm would be allowed to receive more than €300,000 in direct payments per year, after the application of the threshold and modulation.

The transfer of direct payments to rural development would be done through the EU budget, in contrast to the current situation whereby the money is returned to member-states. The funds saved through the €300,000-per-farm ceiling would be passed on to national governments to be used for rural development programmes. If the Commission's calculations are correct – and farm lobbies will no doubt come up with different sums – modulation and capping would begin to redress the imbalance in the CAP.

As well as boosting funding for rural development programmes, the Commission's mid-term review plans would extend their scope. The so-called accompanying measures that are part of rural development would expand to cover food safety, food quality and animal welfare. Farmers would be able to receive aid to take part in schemes that promote food quality, organic farming or geographical specialities. These subsidies would be time-limited and some would decline over the given period. As mentioned earlier, there would be funding to help cover the costs of farm audits. In a further incentive for rural development programmes, the Commission proposes that the EU cover more than half the cost of some schemes. The ceiling would be 60 per cent in most of the EU, rising to 85 per cent in the poorest regions.

Products and markets

In addition to the more general measures outlined above, the Commission looked at the specific sectors targeted for review under the Agenda 2000 accord – cereals, oilseeds, dairy and beef. It concluded that some measures were needed to keep markets in balance and improve the functioning of the CAP. The most notable among these would be a 5 per cent reduction in the intervention price for cereals. While the Commission forecast that the EU was not in danger of overproducing most cereals, it justified the price cut on the grounds of uncertainty over the evolution of world prices and the dollar/euro exchange rate. The US farm bill could lead to higher US exports, which would push down world prices. And a further strengthening of the euro would increase the gap between European and world prices, which are quoted in dollars. Without the 5 per cent cut, such developments could force the EU to subsidise its cereal exports at a time when Europe needs to keep export subsidies in check, as required by the Uruguay Round trade accords.

The Commission also stressed that intervention buying of cereals should become "a real safety net, to be rarely triggered." Moreover, the Commission called for an end to all intervention purchases of rye, the only cereal product in which the EU has a real problem of overproduction. And it proposed changes in subsidies for durum wheat, given that the European Court of Auditors has criticised the current system for "overcompensating" farmers. The mid-term review also proposed measures to balance markets and improve the functioning of subsidies for rice and beef.

The mid-term review proposals published in July 2002 are not the Commission's final say on agricultural reform. Agenda 2000 calls for the Commission to review the wine sector in 2003. If other subjects, such as olive oil and sugar, are also looked at in 2003, the mid-term review will continue over a two-year period. In spring 2003, the Commission is due to receive the results of an external study it has contracted on options for the highly protectionist sugar regime. The 'everything-but-arms' package provides least-developed countries with duty-free access to the EU sugar market by 2009, thereby increasing the pressure for change.

Implications of reform

The Commission's mid-term review proposals would not completely end the CAP's role in managing markets through intervention prices and purchasing. They would also leave in place external protection and guaranteed prices that are higher than world market levels for many products, although not for the significant cereal sector. And farmers would receive some compensation for cuts in guaranteed prices.

In addition, the budgetary impact of the entire package of mid-term review proposals would be small, with savings of about €200 million a year compared with unchanged policies, according to the Commission. It forecasts that farm spending will remain below the maximum allowed during the current 2000-2006 budgetary period, but will still grow slightly from the €44.5 billion expected in 2002. This is still nearly half the EU's annual budget.

The Commission's proposals should help to reduce the trade-distorting element in EU subsidies. The measures should diminish the need for intervention buying and export subsidies, by reducing both production incentives and some guaranteed prices. This would be good for food exporting countries, including developing nations, because EU overproduction depresses world commodity prices, and export subsidies allow Europe to capture more markets. If other WTO countries accept the Commission's contention that the decoupled income payments are production-neutral and qualify for the green box, the mid-term review proposals will aid the conclusion of international trade talks. However, the major exporters may well remain unconvinced by the Commission's argument because these payments would be based on previous entitlements.

In terms of enlargement, the Commission plans should reduce the cost of expanding the CAP to cover more countries. In the longer term, farmers in the new member-states would be discouraged from overproducing. In addition, by lowering direct payments in the EU 15, modulation would allow new member-states to attain the same level of this form of subsidy as existing members in a shorter period of time. However, applicant countries are likely to remain hostile to the Commission's call for their direct payments to be phased in slowly.

The Commission has certainly demonstrated political bravery by coming up with radical proposals on direct payments. The Commission's emphasis on environmental, food safety and animal welfare standards, as well as rural development, is also to be welcomed. The proposal to exclude many smaller farms from modulation – the transfer of funding from direct payments to rural development – should lessen the disruptive effect for the more vulnerable.

But there are drawbacks. CAP spending would remain high, and the market protected. Because guaranteed prices, quotas and various other payments would remain in some sectors, the market would continue to be managed, albeit less than before. A 20 per cent ceiling on the amount to be moved out of direct payments would restrict spending on new areas and less well-off farmers. This problem is compounded by the lack of a clear mechanism for redistributing funds within the farming community, and among member-states. In addition, the Commission's wish to base direct payments on past entitlements reduces the scope for change and prevents it from setting out a long-term strategic view about the future shape of the direct payments system.

Moreover, the Commission continues to be timid about urging agricultural reform in the context of international trade or enlargement. Instead, the Commission argues for change in order to meet the EU's own domestic needs. This reflects concern about alienating lobbies and some governments by implying that the EU should make sacrifices to appease non-European interests. Unfortunately, ducking the issue does not make it go away. Agricultural organisations already are accusing the Commission of wanting to make farmers pay for enlargement. And the hostility of farmers to international trade negotiations is legendary.

Instead, the Commission and others who advocate reform should face these issues head on. There is a compelling case for developed countries to make the kinds of changes to agricultural policies that would benefit the developing world. Moreover, as the Adelaide/Tinbergen study mentioned in Chapter 4 indicates, the EU itself stands to gain from the liberalisation of agricultural trade.

The battle lines

The Commission looks likely to issue its July 2002 proposals in the form of legislative texts at the end of 2002. The aim is that member-states should reach agreement in the first half of 2003, so that changes can take effect as of 2004-2005, in parallel with enlargement. This deadline will be tough to meet.

Commissioner Fischler used stark language about the choices ahead when he unveiled the package to the European Parliament. The CAP must be brought closer to farmers, consumers and taxpayers, the commissioner said. "This cannot be achieved by dint of a few minor cosmetic changes, however. Restoring the credibility of the Common Agricultural Policy will require a wholesale makeover," he warned. Otherwise farmers would suffer as European taxpayers increasingly shunned "a support regime characterised by production-distorting incentives that encourage farmers to use the most intensive methods possible and smothered in red tape, with production directed by the straitjacket of subsidies rather than market demand."

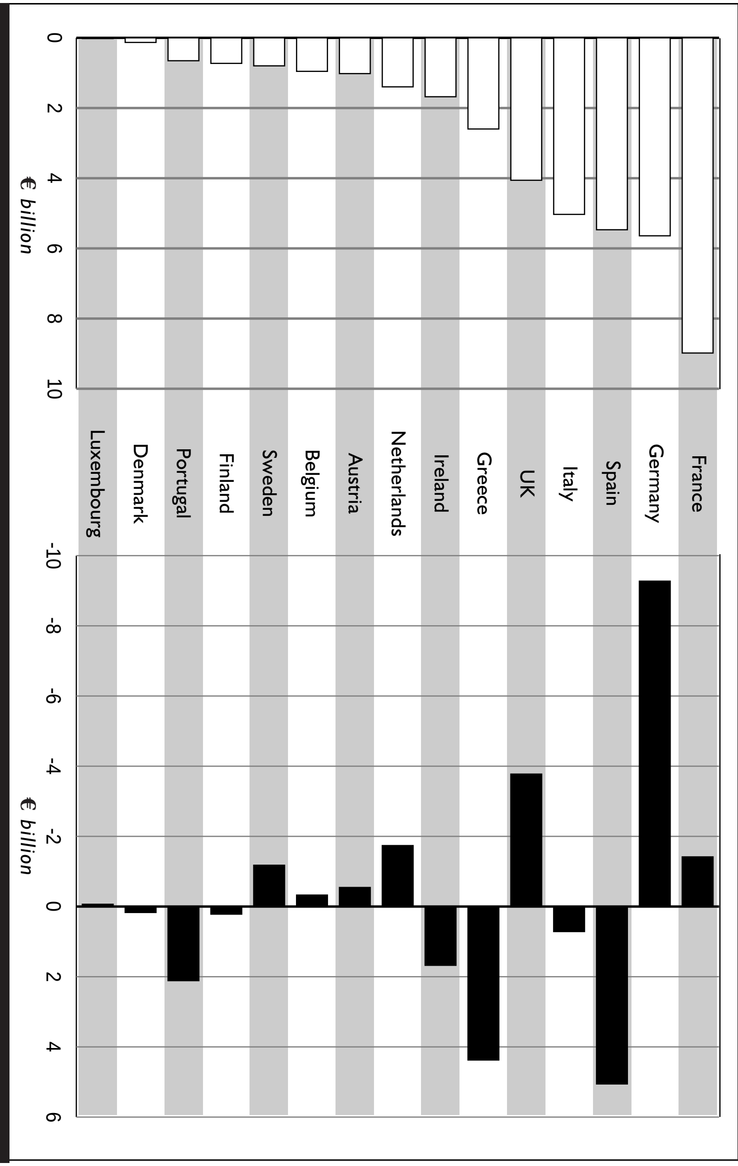
A pro-reform CAP coalition made up of Germany, Britain, the Netherlands, Denmark and Sweden has offered broad support to the Commission's proposals. In fact, some of these countries want more far-reaching measures that would reduce overall agricultural spending. Most of these budgetary hawks pay more into the EU budget than they get back and do not do as well out of the CAP as the others. They would also like to see a more market-oriented CAP that does not hinder the successful conclusion of a new international trade round. Figure 4 shows each country's net contributions to, or net receipts from the budget – including CAP funds – and also a comparison of the amount of money that each country receives from the CAP. Even though France is a net contributor to the EU's budget, its contribution is much smaller than those of Germany and Britain, and France receives the lion's share of CAP funds.

Unsuprisingly, the most vociferous opponent of Fischler's plans is the French government, following President Chirac's re-election in 2002. But Spain, Ireland, Austria and Belgium share France's view that the Commission has gone beyond the Agenda 2000 mandate for change. Greece, Portugal, Italy, Luxembourg and Finland are against various parts of the plans. At first glance, southern European countries should favour changes that shift money from direct payments, which benefit arable farmers in northern Europe more than producers of Mediterranean products. However, the southern Europeans worry that any eventual compromise will be aimed at trimming budget payments from the EU's main contributors, such as Germany, rather than redirecting funds toward farmers in the poorer regions. In other words, their opposition to CAP change presages a struggle between the net contributors to the EU budget and those who receive more than they pay in.

The Commission contends that its proposals would allow "some redistribution from intensive cereal and livestock producing countries to poorer and more extensive/mountainous countries." This is because the funding gained by reducing direct payments (estimated at about €500 to €600 million a year, beginning in 2005, and eventually growing to €3 billion to €4 billion) would go into the rural development portion of the CAP. This money would be distributed to member-states "on the basis of agricultural area, agricultural employment and a prosperity criterion," according to

FIGURE 4A: CAP FUNDS RECEIVED 2000

FIGURE 4B: NET POSITION IN COMMUNITY BUDGET 2000[1]



SOURCE: EUROPEAN COMMISSION

1 Operational budgetary balance after UK rebate

the Commission. To win over countries such as Spain, Greece, Portugal and Italy, the Commission will have to come up with the figures that prove such redistribution.

The northern European countries seeking reform also have a role to play in allaying the concerns of the southern Europeans. They will need to make clear that they are not pushing for change that is mainly at the expense of less well-off farmers in the EU. For example, the British government's negative reaction to the idea of capping payments to an individual farm at €300,000 is unlikely to go down well with countries where few, if any, farmers see those kinds of subsidies. During the negotiations on the MacSharry reforms, Britain was instrumental in defending the interests of big producers, who ended up receiving the bulk of the direct payments introduced to compensate for price cuts. The UK should not repeat this stance, if it wants its ideas on the CAP to be taken seriously. It also would help if countries such as the Netherlands put all forms of aid – including cheap natural gas for heating greenhouses – on the table for discussion. And when arguing in favour of curbing farm spending, these countries should avoid shadow-boxing over the size of their contributions into the EU budget.

Another subtler fault line is likely to emerge in the mid-term review discussions, over whether reform is consistent with further opening of the EU market. Some farmers and governments will argue that the new, higher standards for food safety and animal welfare should also apply immediately to imports and food produced in the new member-states in Central and Eastern Europe. Otherwise, farmers in the EU 15 would risk being priced out of their own market. The German government looks likely to be among those most receptive to such arguments. However, a move in this direction risks undermining the EU's position in the WTO talks, as well as relations with the applicant countries. As a result, it is important for the EU to be wary of erecting new trade barriers. It is also important to remember that most of the EU's recent food safety crises were homemade, not imported.

Given the degree of disharmony on agriculture at the time of writing, there is much work to be done if a compromise is to emerge. Greece, which holds the EU presidency in the first half of 2003, will have to pull out all the stops – and put aside its own hostility to the Commission plans – to ensure a resolution sooner rather than later. There is a serious risk that the debate will get bogged down in technicalities or result in a partial deal that brings little change, as happened in Berlin in 1999. The date at which reforms take effect also could be pushed back from the Commission's target of 2004, especially if France succeeds in its campaign to get Germany to agree to put off radical reforms until 2007.

It is worth noting that agriculture is subject to qualified majority voting (QMV), unlike the Agenda 2000 package, which needed unanimity as it involved financing arrangements. While there is little likelihood that a major country, such as France, would be outvoted, the threat of QMV does sometimes force member-states to seek a compromise.

Moreover, there is scope for advocates of reform to take the arguments to the European public. Rural development programmes and subsidies that are less linked to production will benefit many farming communities throughout the EU. The cries of alarm from the farm lobbies often reflect the excessive influence of the biggest producers. Higher environmental, or food quality, standards will be good for farmers, other country dwellers and consumers. To quote the French daily *Le Monde,* which has not always been a champion of CAP reform:

"France has much to gain from the modulation proposed by Brussels, which would gradually decouple subsidies from production and link them to rural development. Subsidies should go to the countryside and all those who live there, not only to those who work on the land. They should also help to reduce inequalities, not aggravate them."[23]

[23] *Le Monde, July 19th 2002.*

The accord on funding the CAP struck at the Brussels summit in October 2002 looks likely to slow the momentum for reform, at least in the short-run. But the longer-term problems of the current CAP will not go away. As a result, negotiations over the Commission's mid-term review proposals are set to continue. Proponents of change will have to work harder to focus the debate on the types of farming policies needed for the future.

8 Conclusions

EU agriculture policies are ripe for change. The CAP's traditional approach, of giving farmers incentives to increase production through subsidies, and protecting them from external competition, is anachronistic. Consumers want safer food and less polluting farming methods, while developing countries need markets for their exports. The system also fails rural communities because it lacks flexibility in responding to the market, and excessively concentrates subsidies on a relatively small group of farmers. Finally – and probably decisively as far as finance ministries in EU countries are concerned – the cost of extending such policies to new member-states could prove prohibitively expensive.

The EU should capitalise on this opportunity and prepare its agricultural sector and rural communities for the future. The focus of reform will be mainly the CAP, because this is where most legislative change has to happen, but the bigger picture is also important. This means defining the role of government in agriculture and the environment, tackling the difficult issue of how European policies affect the rest of the world, and improving food safety regulation.

Government policy at the national and EU level should focus on promoting public goods, such as the environment and food safety, rather than managing markets. And since the CAP is not the only context for policies affecting rural communities and agriculture, better co-ordination is needed between the different parts of government. For example, governments can seek to raise environmental standards through a combination of taxes and fiscal incentives. Rural areas should receive help through investment in education, transport and telecommunications, not just farm subsidies.

In terms of the CAP, such a framework translates into moving away from – and eventually ending – market support, such as intervention, high guaranteed prices and export subsidies. The current form of direct payments, which still encourages production because of its link to past price supports, needs to be rethought. It would be preferable for the existing system to be phased out over an agreed – and not too lengthy – timetable, and replaced with lower, but better targeted farm spending that is as production-neutral as possible. This goal could be achieved through a combination of rural development programmes and income payments for less well-off farmers, as well as the use of incentives, investment and rules to improve the environment and food safety.

If the political obstacles to root and branch reform are too great, the next best option would be to begin by reducing direct payments in favour of other programmes, such as rural development. This is what the Commission has proposed in its mid-term review. However, for the CAP to be truly transformed, the shift needs to be greater and speedier than the Commission is suggesting. Moreover, 'decoupled' direct payments based on historical entitlements do not address the problems of less well-off farmers and the inequitable distribution of EU funds. Other elements, such as income level or farm size, should be taken into account. Otherwise, there is the risk that much of the money will continue to encourage production.

Whatever the route, it is preferable for the change to begin soon. Enlargement increases the desirability of an early agreement on CAP reform, even if this comes in the form of a political accord, with some of the details left for later. Otherwise, an expanded EU faces the unenviable task of having to forge an accord on agriculture with 25 member-states instead of 15. Moreover, accession countries will be more willing to accept a phasing in of direct payments if they know that these are being reduced in the current member-states. That said, the EU will need to improve its offer to the applicants regarding access to CAP funding.

Any new system of subsidies should be designed with a view to avoiding fraud and excess bureaucracy. It should not be difficult to enlist present and former agriculture officials, in Brussels and national capitals, in the drive to outsmart fraudsters.

EU and national politicians, meanwhile, need to make the case for reform as well as for a more open trading system. They need to focus the debate on the fact that the current system neither protects the environment nor delivers enough benefit to farmers in the EU, and that it also harms people in some developing countries. Additional policies are needed to counter any adverse effects from liberalisation both at home and abroad. For example, international agencies should work to ensure that farmers in Africa do not lose out. Such a debate and accompanying policies could help avoid alliances between protectionists and those concerned about a fairer and less-polluted world.

It would be a major success for the EU to adopt agricultural policies that are fair, comprehensive in scope, less expensive and better for the rest of the world. And if consumers become less distrustful of the food they buy, that can only be good news for Europe's rural communities.

Summary of recommendations

★ Reform of the CAP should be bold, and driven by a comprehensive debate on the future of European farming. This means avoiding half-baked budgetary deals that often raise more questions than they answer.

★ Joined-up policy is vital. The future of agriculture in the EU is about more than just farming interests. It involves a range of public goods, such as food-safety and environmental stewardship. The regulations, taxes and incentives that can achieve these aims require the involvement not just of the agriculture ministries but also of other parts of governments.

★ Agriculture must move closer to its market. There should be a shift away from subsidies that encourage production, once and for all.

★ Direct payments must be revamped and reduced. This should happen on the shortest possible timetable. The link with past price supports must be broken. Payments also must meet the needs of less well-off farmers.

★ New supports can replace some of the old subsidies. But these should be less costly and better targeted.

★ Timing is essential – change must begin soon. The issues that need to be resolved are complex and politically charged. Enlargement will make things even more difficult if discussions are not completed early.

★ A reformed CAP must help to integrate the applicant countries into the EU, without leading to spiralling agriculture subsidies. CAP and regional funding should be used to promote rural development in Central and Eastern Europe.

★ Developing countries must be given new trading opportunities and they should be encouraged to move towards environmentally sustainable farming practices.

★ The EU must avoid the label ‘protectionist’ by constructively engaging in international negotiations on such issues as standards, and labelling for food and genetically modified organisms.

★ The EU must avoid fraud and excessive bureaucracy by designing systems that tackle these problems from the outset.

★

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CENTRE FOR EUROPEAN REFORM
NEW IDEAS FOR A NEW EUROPE

THE FUTURE OF EUROPEAN AGRICULTURE

Julie Wolf

Europe's Common Agricultural Policy no longer suits consumers or small farmers, it damages the environment and it hurts the world's poorer economies. Julie Wolf argues that the EU will not be able to meet the challenges of enlargement and world trade liberalisation unless it reforms its farm policy drastically, notably by breaking the link between subsidies and production. Moreover, there should be more emphasis on improving food safety and the quality of the environment, and less on managed markets. Rural areas need investment in telecoms, education and transport as much as farm subsidies.

Julie Wolf is a writer on international trade and economics. She was formerly a journalist with the Wall Street Journal Europe and the Guardian.

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