

Enlargement and reform of the EU Common agricultural policy : impacts on the western hemisphere countries

Interim report

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Contents

1.	Introduction	3
2.	The political context and the main mechanisms of the CAP	5
2.1	Institutions and policy instruments	5
2.1.1	Insitutional arrangements.....	5
2.1.2	The basic CAP principles... and the reality	6
2.1.3	The historical roots of the CAP reform puzzle	11
2.2	Success and failure of the CAP	13
2.3	A succession of limited reforms	14
2.4	The 1992 inflexion	15
2.5	The Agenda 2000	16
2.6	Ten years of significant CAP reform	18
3.	The present CAP	20
3.1	The budget	20
3.1.1	The FEOGA	20
3.1.2	The nature of expenses	22
3.1.3	Budget expenditures per commodity.....	22
3.1.4	National sharing of the budget	23
3.2	The main Common market organizations	24

3.3	Farm support under the CAP	24
3.4	An assessment of the main CAP instruments.....	26
3.5	The CAP and the environment	29
3.5.1	The main instruments	29
3.5.2	The effect of the CAP on the environment	31
3.5.3	The effect of agri-environmental measures.....	33
3.6	The CAP and rural development	35
3.7	The CAP and the consumers	38
4.	The EU enlargement and the CAP	43
4.1	The agenda of EU enlargement	43
4.2	Agriculture in accessing member countries	44
4.3	The EU policy towards accessing members.....	45
4.4	The CAP in the PECO's	46
5.	The CAP and third countries	49
5.1	The EU and the WTO discipline	49
5.2	The EU tariff structure.....	52
5.3	Non-tariff barriers	54
5.4	Tariff rate quotas.....	55
5.5	Preferential agreements	56
5.6	The CAP and developing countries	60
5.7	Enlargement and WTO commitments	63
5.8	The EU position in WTO negotiations	63
6.	Political economy aspects and prospects for reform	66
6.1	Recent changes favorable to a CAP reform	66
6.2	The debate on multifunctionality	68
6.3	The Commission's proposals	70
6.4	Strengths and weaknesses of the Commission's proposal	72
7.	Conclusion	75

1. Introduction

Most economists have long acknowledged that the Common Agriculture Policy (CAP), still mostly directed to support production, no longer fulfills the needs of a society that has changed more rapidly than the agricultural policy instruments. For years, critiques have focused on the costs that the CAP imposes on consumers through extra food prices. They have underlined that spending half of the European Union (EU) budget on the agricultural sector prevented funding other European policies such as research and defense, ridiculing the role of Western Europe both as a scientific and a political power, and that the CAP, originally the cement of the European community, now acted against European integration. Even those who agree that farmers must be supported acknowledge that the CAP policy instruments are inappropriate and, in spite of recent reforms, still lead to the production of large quantities of low quality products that are disposed with high costs on the world market. This creates many conflicts with other exporting countries, and these subsidized exports oppose the growth of the developing world by competing unfairly with local producers. In addition, the CAP arrangements benefit disproportionally to a small number of producers. That is, the CAP has questionable distributional impacts in addition to a poor record in terms of economic efficiency. Finally, critiques point out the negative environmental record of a policy that encourages the use of pesticides and fertilizers, and the substitution of grassland for environmentally damaging productions.

This diagnostic, that was recently re-stated in reports by the European court of auditors as well as by the Commission is not new. It has been made repeatedly over the last decades.¹ In spite of considerable resistance to changes, a significant reform took place in 1992. In 1999, this reform was deepened and new objectives were assigned to the CAP. However, the main instruments of the CAP still follow the same general pattern designed 40 years ago, to support production rather than fulfil the new demands of the society.

There are several reasons why a policy so widely criticized from an economic standpoint can survive intact for decades. A major obstacle to reform is the large rents that have capitalized in asset prices (land, production rights, implicit premium rights) and have drawn into the sector large amounts of resources that are difficult to value outside the sector (machinery, human capital). A significant reform therefore involves large losses in patrimony for a group of agents, raising social acceptance issues. Another reason is the particular decision structure and financing of the CAP that leads to what game theoreticians would qualify as a collectively suboptimal equilibrium between national governments : an individual country supports collectively costly and inefficient instruments because the cost is shared by all. The over-representation of farmers compared to their actual weight in the population, and the efficiency of farm lobbies in a few influent countries is another reason.

However, among the traditional explanations, it is often underestimated that in many EU countries there is a strong willingness to support the farm sector in the public opinion. The CAP would not have persisted so long if politicians had followed the vested interests of farmers only. Many EU citizens have seen the CAP as a success story that made it possible to maintain small farms, avoid congestion in cities, while eradicating the ghost of food scarcity. This idyllic vision is certainly flawed by a lack of information and the propaganda of producer organizations, but there has been a genuine social preference for supporting farmers. For example, the price intervention mechanisms designed in the 1960s that still imposes significant food costs for consumers, would have long been abolished if consumers had shown serious objection to paying a premium on world prices for a guaranteed supply of high quality food.

¹ Many analysts have raised the inadaptation of the CAP instruments to the modern society, from Vedel (1967) to Mahé and Ortalo-Magné (2001).

Times are nevertheless changing. There are reasons to believe that, in spite of the resistance of particular countries and interest groups, there is an historical opportunity for change in the coming years. Several incentives for a significant reform are now converging :

- The costs for the taxpayers, which have been reasonably well accepted in the past, now seem out of proportion with the benefits of the CAP to several key contributors to the EU budget, including Germany. The enlargement of the EU is likely to increase the bill beyond acceptability if no major reform of the CAP takes place before full accession of the new members.
- The international framework imposes new constraints on the definition of the policy instruments. There are powerful economic interests in the industrial and service sectors that need international agreements, either in the multilateral (WTO) or the regional framework (e.g. negotiations with Mercosur countries). In the ongoing negotiations, it looks certain that significant changes in some key agricultural sector in the EU (beef, sugar) are necessary before a deal can be reached with third countries.
- The poor record of the CAP on the environment is becoming more visible. There are now direct costs for some other industries (nitrates have made tap water unfit to drink in many areas, and have led to the closure of some tourist resorts in Brittany, France, for example). The importance of the farm sector in the rural area has declined so that the positive externalities of agriculture are now second to those of other industries that participate to the rural development.
- Finally, and perhaps more important, recent food scandals have shed a new light on the actual nature of agricultural production for urban citizens. The ability of farmers' organization to market the CAP as a way to protect small farms, landscape, and the environment, while indeed these instruments pursue very different objectives, is being challenged. Because of the Bovine Spongiform Encephalopathy (BSE) and Foot and Mouth Disease (FMD) crises that have been widely exposed in the medias since 1996, consumers are now aware that farm production can be very capital intensive, that cows can be fed with meat meal. The resulting change in the perception of the CAP, and on the implicit support of the population to the cause of the farm lobby is changing dramatically. This aspect should not be underestimated. It might be the driving force of a deep reform of the CAP in a near future.

The paper focuses on the evolution and the future of the CAP as well as its effects on international trade. The first section of this paper reviews the main motivations and mechanisms of the CAP from its creation. The second section focuses on the present CAP mechanisms, following the changes brought by Agenda 2000 and the links with the World trade organization discipline. Section three focuses on the assessment of the effects of the enlargement to the Central and Eastern European countries and its impact on production, financing and trade in the agro-food sector. Section four deals with the effects of the EU tariff structure and the numerous preferential agreements that characterize the EU trading system in the agricultural sector. Section five surveys the main political economy aspects that have made a significant reform of the CAP so difficult in the last decades and the changes in the institutional context brought by the enlargement as well as by the recent food scares. This helps assessing the possibility of a reform as suggested by recent proposal from the Commission in the framework of the Agenda 2000 mid term review.

2. The political context and the main mechanisms of the CAP

2.1 Institutions and policy instruments

2.1.1 Institutional arrangements

Many books have been published on the institutions of the CAP, and we will focus on the historical aspects that still play a major role in the present process of reforming the CAP in the early 2000s.

The European Communities resulted from five legislative treaties. These are the 1951 treaty of Paris establishing the Coal and Steel Community, the 1957 Treaty of Rome establishing the Economic Community, the 1958 Treaty establishing the European atomic energy community, the 1987 Single European Act and the 1993 Treaty of Maastricht. The 1997 Treaty of Amsterdam and the 2000 Treaty of Nice amended the Treaty of Rome. (Here, we use the term "European Union" for the period following ratification of the Maastricht Treaty).

Box 1. Landmarks in the history of the European Union

After world war II, western European countries embarked in talks for an economic union with 15 members. However, several countries were afraid of abandoning sovereignty and to damage the interest of their former colonies by entering a regional custom union. In the 1950s, a group of six countries (Belgium, France, Germany, Italy, Luxembourg, The Netherlands) created three distinct communities, on coal and steel, on civilian nuclear energy and the European Economic Community (EEC). The administrative arm, the Commission of the European Communities was created in 1965. Denmark, Ireland and the United Kingdom joined in 1973, Greece in 1981, Spain and Portugal in 1986, Austria, Finland and Sweden in 1995.

The Single European Act in 1987 turned the custom union in a free trade area, which was achieved by the single market 1993. All goods, services, people and capital could subsequently move freely within member countries. Since the Maastricht Treaty in 1993, the EEC is no longer only an economic union, but a European Union with a single currency since 1999, a common monetary policy, and coordinated macroeconomic policies. The prospects of enlargement to new members led to an intergovernmental conference that was designed to revise the institutions of the EU, and led to the 2000 Nice Treaty.

As far as agricultural issues are concerned, the Rome Treaty still provides the guideline for CAP decisions. The 1997 Amsterdam Treaty had little impact on the CAP, except that it made more precise the principles of subsidiarity, that is widely used in agri-environmental and rural development policies. The 2000 Nice Treaty modified the weights of vote in the Council and extended qualified majority voting that applies to CAP related decisions (see Box 3.). It also included measures relating to the environment. The Treaty must still be ratified by member countries, and rejection of the Nice treaty by voters in a referendum in Ireland causes major institutional problems.

While the 1957 Rome Treaty set the basis of the CAP, it did so in terms that were vague and not totally consistent. Indeed, the goals of common agricultural policy mention the increase in the productivity of the sector, the increase in the level of income in the sector, and the supply of food to consumers at reasonable prices, without evoking the possible conflict arising between the various policy instruments used for achieving these objectives. The main policy content of the CAP was defined in the early 1960s when countries had to put together the economic instruments of market management and structural aid to farmers (Fennell, 1979). The creation of the European Agricultural Guidance and Guarantee Fund (EAGGF, more often quoted by the French acronym FEOGA that we will use hereafter) in 1962 provided the financial instrument for the management of the CAP. The creation of the Common Market Organizations (hereafter CMOs) aimed at supporting and managing markets. The CMOs gather the main arrangements in order to orientate production, stabilize price and to ensure a stable product supply. The

CMOs were progressively extended to all sectors with the exception of potatoes and spirits. While some CMOs have involved very large market intervention and budget costs (grains, beef, dairy, and oilseeds in the 1980s) and have largely substituted public intervention for market mechanisms, some others like horticulture or pigmeat have had a limited impact on markets, and have used parcimoniously public instruments, only designed to smooth the functioning of markets.

From the beginning, the CAP was designed to be a centralized policy, restricting the possibility of national governments to define their own policy instruments. Because one of the objectives was to ensure a safe supply of food to Europeans consumers, the policy aimed at boosting production in a Community which, in 1962 only produced 80% of its food consumption and where memories of food shortage were still recent. The institutions and policies that were put in place were clearly oriented towards an interventionist policy, where market orientation was second to administrative prices and management (Bergmann, 1979). A system of guaranteed prices was implemented for staple food. An administrative price was set, at a level in general higher than the world price, and an intervention mechanism ensured a guaranteed outlet for all quantities produced.

There was a clear distinction between market management and the structural policy. The "Guarantee" section of the FEOGA was designed to fund the expenses relative to common market organizations, i.e. the funding of intervention stocks, of the subsidies that facilitate the disposal of surplus production, and some direct payments to farmer. The "Orientation" section of the FEOGA was devoted to the improvement of production structures, of the transformation and marketing of agricultural products and the funding of rural development. It soon became clear that market intervention would be far more central to the CAP than the structural aspect, as shown in the relative budget devoted to the guarantee section of the EAGGF and the orientation section (Table 1.).

[Insert Table 1.]

2.1.2 The basic CAP principles... and the reality

Three fundamental principles have provided grounds for the CAP : free circulation of goods and its consequence, the unicity of prices and payments ; community preference ; financial solidarity. These principles have however suffered from many exemptions.

Free circulation of goods without restriction between member countries includes the absence of tariffs and quantitative barriers to trade within the union and the harmonization of regulations that might act as trade barriers. While this is no longer an exception since the single market of 1993, agricultural goods have freely circulated for 40 years between members of the EU. The automatic effect of this principle was normally unicity of prices within the community. Progressive harmonization of Value Added Taxes (VAT) rates have also led to a convergence in food prices.

European jurisprudence, and in particular the "Cassis de Dijon" ruling (case 120/78, Court of Justice of the European communities, February 1979), ensures that while standards might differ across countries, mutual recognition prevails. That is, a country cannot oppose importation from another EU country for technical reasons, except in cases involving sanitary issues (Article 36 of the Rome Treaty) or toxic waste issues.

Free circulation required the removal of national subsidies in order to avoid distortions of competition (Article 92, Rome Treaty). This explains while the CAP has always been a very centralized policy, leaving little room for national policies, while, for example, environmental policies (including agri-environmental measures, that are not supposed to affect competition) have been more largely decentralized at the national level. Most national subsidies were therefore abolished (e.g. subsidies to fertilizers), as well as the measures that were output enhancing.

For years, however, the fluctuations in exchange rates between EU currencies have long been at odds with a common policy. This resulted in significant breaches in the principle of free circulation, as well as the principle of unicity of prices and direct payments. While most of this system is now history, the consequences are still visible. The fact that direct payments, import duties and institutional prices that were set in a common currency (Ecus and then Euros) had to be converted into national currencies with varying exchange rates has raised problems. Normally, payments in national currency would have decreased in a country whose currency appreciated. However, they were converted with a special conversion rate for agriculture, which showed less and less connection with the regular exchange rate, until a major reform in 1995. Overall, the agri-monetary system has resulted in major distortions, involving complex mechanisms described in Bureau and Le Roux (2000). Monetary compensatory amounts, a system of export tax (for countries whose currency had experienced devaluation) and export subsidies (for countries that experience appreciation of the currency) specific to the agricultural sector, aimed at compensating the effect of monetary adjustments on relative competitiveness of agricultural goods. In practice, this opposed the principle of free circulation. In the area of direct payments as well as institutional prices, the consequence of the special conversion rate (the "green rates") was that adjustment was such that no country would experience significant price decreases, resulting in a continuous inflation of administered prices. This created artificial advantages in competition for countries with a strong currency which benefited from cheap imported inputs while seeing their output subsidized as a way to compensate for the appreciation of the currency. For years, opportunist trade took place, so that exports could get a higher refund when passing through Dutch territorial waters, for example, or where imported soybean was cheaper in strong currency countries, while green rates and monetary compensatory amount offset the effect of a strong Guilder or Mark on the final output. This contributed to shape the location of pork production in the EU, and to strengthen the role of ports of the North Sea for agricultural products.

The introduction of the Euro has ended most of the discrepancies in direct payments, import duties and institutional prices that were previously caused by the agri-monetary system. The UK, Denmark and Sweden have kept their national currency. Now, a mechanism allows direct payments to be provided in Euros even in non Euro-countries, and compensations to farmers can be provided in a way that is not supposed to create distortions of competition.² For import duties, the rates for converting common tariffs into national currency is set every month by the Commission, which limits opportunistic trade.

A single set of prices and payments. In spite of the single market, the CAP does not provide a uniform rate of support within the EU. The CAP has unequal effects across regions and commodities (see Bureau and Butault 1992). One reason is that the support provided by the CMOs differs largely. Under the CAP, producers of cereals, milk and sugar have always enjoyed large support, far more than producers of typical southern commodities (horticulture, fruits and vegetables). Clearly, the geographical repartition of production results in very different rate of support. This is often seen as an unfair north-south disequilibrium (see for example a recent report by the European Parliament that emphasizes this aspect), even though the effect is partially offset by higher agricultural prices in Greece and Italy at the producer level.³

² Member States may grant compensatory aid to farmers in cases of appreciable (exceeding 2.6%) revaluation, i.e. "a situation where the annual average exchange rate is below a threshold defined as the lowest average annual conversion rate applied during the preceding three years and the exchange rate of 1 January 1999". The EU finances 50% of the compensation actually paid. Arrangements ensure that fluctuations between the Swedish, Danish currency and the Euro are limited. In the case of the UK, the appreciation of the sterling in 2000s compared to the Euro resulted in payments that were, in national currency, much lower than those received in 1998, since the UK does not participate to the EU arrangements that ensure a lower margin of fluctuation to the currency compared to the Euro. In 2002, a special scheme (213 million euros, mainly financed by the EU budget) was adopted in order to compensate UK livestock farmers for the adverse effect of the exchange rate on direct payments set in Euros.

³ Ball et al (2001), for example, find that over 20 years, Italian aggregate output price is 12% higher than the EU average, while aggregate Dutch output price is 15% lower (this can be explained by the horticultural sector).

When constructing spatial price indexes of agricultural output and input across countries, Ball et al found (2001) out that the significant differences existing within the EU corresponded to the net trade situation of each country in a given product, and to the efficiency of the downstream sector (For example, taxes are paid by producers in order to finance storage and extension in countries such as France). The CAP has magnified some of the normal price effect between deficit regions and excess regions in a particular commodity. For example, the fact that national milk quotas were attributed on the basis of past production, has resulted in "freezing" the allocation of production, with countries that will necessarily remain net importers (e.g. Italy), regardless of the efficiency in production. The structural deficit of a particular area seems to be maintained forever with the system of quotas. The same holds with the sugar quota. Because of the a two tier regime and the possibility of producing for the world market at a lower price than the in-quota sugar, the farmers who do so in some particular regions, receive a much lower average price than in the regions where inefficient production is maintained by high in-quota price.

In spite of economic integration, discrepancies in food prices are also very large. There are many "natural" transaction costs between countries (including those linked to the language) that create a home market effect. Local oligopolies in the marketing and retailing sector result in significant regional differences in food prices across the EU. Overall, few markets are fully integrated (the flower market is an example), and food markets are still compartmented at the national level. A recent study on the sugar sector shows for example, that there are considerable differences in the price paid by consumers across the EU (NEI, 2000). Excise duties for alcoholic beverages vary a lot across countries, resulting in large differences in the price of wine. Recently, some consumers have protested against the high price of food in Sweden compared to what is observed in other member states. The structure of competition in the distribution sector seems to be responsible of higher food prices some countries, more than the present CAP.

Input prices also vary a lot. Differences in the cost of labor for example, under an more integrated market, contribute to a shift of labor intensive fruit production in countries such as Spain, an issue ill-accepted by French farmers. If cost of labor reflects more fundamental market conditions, it also reflects differences in the tax and social security system. Large differences also exist for intermediate inputs. Some of them are caused by natural advantages (imported feedstuffs and fertilizers are much cheaper close to large importing harbors of the North Sea, resulting in prices in the Netherlands for intermediate inputs 15% below EU average once corrected for exchange rates effects), but some other are caused by national legislations and tax breaks. Even though some input subsidies must normally be approved by the Commission, such policies reduce the cost of inputs (tax deductions on fuel, for example). Such tax breaks can hardly be seen as remains of old tax systems since new arrangements were introduced in Germany, Spain and France in 2000. Subsidized interest rate for loans to farmers represent large amounts in Germany and France, for example. While in the past interest rates used to differ a lot between countries, they have converged as a result of the European monetary union and the integration of financial markets. Now, compensation of national farmers for a handicap in interest rates relative to other farmers can no longer be a motive for keeping interest subsidies.

National support are limited by the large degree of centralization of the CAP to measures that have a small impact on production such as "rural development" or "environmental payments". The issue of an implicit "re-nationalization" of the CAP, and of distortions of competition is often raised, now that national countries have a large degree of freedom in allocating payments for environmental and rural development purposes. There is no clearcut distinction between subsidies that directly affect production, which are scrutinized by the Commission and these structural or compensating policies for which member states are allowed to provide support to the farm sector. While these payments must be approved by the Commission, and some of them face ceilings on a per hectare basis, some countries might use them in an extent such that it creates distortions. So far the budget devoted to this payment has been limited. Large scale programs whose consistency with the common policy principles have never been questioned since they are supposed to have minimal impact on production. They include national subsidies for infrastructures, for research and development, for social security. For example, French and German

farmers pay only 20% of their retirement pensions, which are subsidised by the national budget and other budgets funded by non farmers. The contribution of the national budget to the farmers' retirement scheme is understandable given that there is one active worker for 2.5 retirees in agriculture in France, while there is one active worker for 0.5 retirees in other sectors. However, national programs to support investment, infrastructure, education, extension and social security may still introduce variations in the cost incurred by farmers across countries.

Another issue that limits the unicity of the CAP across the EU is the intervention of sub-national institutions, which sometimes provide payments to farmers. Normally, these payments must be non distortive and agreed with the EU, but their level and their allocation is not always fully transparent to the EU authorities and observers. In Italy, a large share of the agricultural policy is now managed at the regional level. In Germany, the Länder fund many structural operations, and manage a preferential VAT system for farmers whose compatibility with EU treaties was questioned in 1996 by the German Court of auditors. Table 12. includes the national expenses in the framework of the CAP as communicated by member states to the Organisation for economic co-operation and development (OECD) for the annual monitoring and evaluation of agricultural policies. These budgets are normally devoted to structural adjustment, rural development, marketing, extension, agri-environmental programmes, and input subsidies. It is noteworthy that, at least in the case of Italy, Spain and Germany, the figures do not include many expenses at the regional level. Public support to retirement schemes and social security for farmers, particularly large in France and Germany, do not appear either.

Community preference. As in any custom union, EU countries have delegated the trade policy to a supra-national entity. Exporters of agricultural products to any EU member country face a common set of tariffs. However, the community preference, as mentioned in the 1958 Stresa conference, that defined the basic principles of the CAP encourages consumption of Community's production. Because prices were set at a level superior to the world price for main commodities, the preference involved that products imported from outside the Community would face levies or tariffs so that consumers would prefer local production. This was achieved by a system of import levies and export refunds. In 1995, variables levies were replaced by bound (fixed) tariffs. In spite of a decrease in tariff since 1995, tariff protection is still high for some commodities, and export refunds are still largely used (see Table 1.).

The principle of community preference was nevertheless limited by the need to maintain historical import flows from some traditional trade partners (e.g. former colonies), and by the need to compensate some policy measures affecting other countries (e.g. compensation for the loss of traditional market to commonwealth countries when the UK joined the EU, compensation to traditional corn exporters when Spain and Portugal joined the EU). Most of the time, this was achieved by opening import quotas with preferential or zero tariff. In addition, the EU provided free access to its market as part of a development aid strategy, again with limitations on quantities. This was the case for African Caribbean and Pacific (ACP) countries, under a special agreement, and to a larger set of developing countries under the Generalized System of Preferences (GSP). Over the last 10 years, the principle of community preference has been losing effectiveness as the EU market gradually opened to the outside world as a result of multilateral and bilateral agreements.

Financial solidarity means that receipts (e.g. from the common tariff structure) are affected to the a common budget regardless of the importing countries, and that expenses (e.g. export refunds) are funded by this budget, regardless of the countries that "creates" the expense by, say, excess supply of a particular product. Therefore resources are affected to common expenses, independently of the contribution of member states to the budget. This principle paved the way for some strategic behaviors from particular countries, pushing for the adoption of policies that benefits them while they are paid by the whole community. This problem was made more damaging for the EU budget by the particular decision making structure within the EU (see Box 2 and Box 3).

Therefore, several limitations to this principle have been progressively introduced. First, the contribution to the EU budget of some member countries was capped because of their reluctance to pay for costly

community policies. The 1984 Fontainebleau agreement limits the UK contribution to the EU budget, for example. Second, there has been persistent threats of "renationalizing" the CAP, as a way to reach consensus between those countries that push for costly agricultural policies benefiting to their producers, and those unwilling to pay for them. Several authors have proposed either to make countries participate financially to the measures they support in Brussels, in order to reduce their incentive to press for collectively costly policies. Others proposed to make members budgetary contribution based on their share of total Community agricultural production rather than on value added tax and GNP (Buckwell et al 1981). Because of the severe constraints introduced by the Article 40 of the Rome Treaty, which limits national subsidies, this "renationalization" has not really taken place, but the funding (partial or total) of some policies that would have minimum effect on production conditions has increased.

Box 2. The EU's institutions

In the present European Union, the Council of Ministers has the main responsibility for CAP related decisions, but the Commission plays an important role by preparing proposals and ensuring application of the Council's decisions.

The European Council is the meeting of the 15 heads of government, that sets the main orientations of the EU. The presidency rotates every six months. Because decisions are often sectoral by nature, government heads are replaced by a particular minister, e.g. the ministers of agriculture for CAP related aspects. The Council of Ministers is the real executive power, and is the ultimate decision-making institution, especially in agriculture where the role of the Parliament is limited. The Council is a committee of ministerial representatives of the member states.. The presidency of the Council rotates on a six-month basis, but since 1998 there is a relative sharing of responsibility within a "troika" (the President, the immediate predecessor and designated successor). In foreign matters, the country holding the presidency speaks on behalf of the EU. In addition, the role of the President is particularly important because the minister of the country in charge draws up the agenda of the council meetings. This makes it possible to impulse or delay reforms depending on the interest of the member state on a particular topic.

The Commission constitutes the EU's executive arm. It is responsible for management of policies including the CAP. It represents the EU in negotiations with third countries. The Commission acts as a guardian of treaties, and is the initiator of policies. The Commission includes 20 commissioners, appointed by member states. The president of the Commission allocates a particular area of responsibility to each commissioner, but all proposals and measures must be adopted by the Commission as a body. The Commissioner of particular works with a Directorate general (e.g. Commissioner Fischler with the Directorate General for Agriculture), headed by a General Director. In CAP matters (as well as in competition policy) the Commission has special powers.

The European Parliament has an increasing role in policy making since the Maastricht and Nice treaties. It nominates the Commission, contributes to the making of EU regulations and directives (with the Council), votes the budget, and investigates petitions from EU citizens. It can therefore amend legislative proposals from the Commission, including the budget. However, in the area of the CAP, the power of the parliament is particularly limited. The Council of minister needs to consult the Parliament but can proceed without approval of its decisions by the Parliament. The only agricultural area where the Parliament has important power is the one related to the impact on human health, where the Treaty of Amsterdam gives the Parliament the power of co-decision on matters related to public health. The Parliament can force the whole Commission to resign, but has limited pressure on a particular Commissioner.

The Court of Justice regulates conflicts between EU institutions, between EU institutions and a member country. It can be seized by individuals and firms about the application of a EU text by a member states, and by national court for interpretation of European texts. The European Court of Auditors reviews accounts and reports to the Council and the Parliament. It has reviewed several CAP arrangements, and has often been very critical (review of the sugar policy in 1991, review of the environmental aspects of the CAP in 2000 for example).

2.1.3 The historical roots of the CAP reform puzzle

The CAP: a permanent horse trading story. Several of the "original sins" of the CAP still affect the present debate on CAP reform. The first one is perhaps that the common policy regarding agriculture was from the beginning a matter of accommodating national interests (Fearne, 1997). The main motivations for an economic union in the agricultural sector were largely political. The common market for steel and coal was seen by France as benefiting to the powerful German industry. A Common agricultural policy, with a large single market and some production subsidies that would benefit mostly to the large French sector, was seen as a compensation. This suggests that the CAP was implemented in order to make cooperation possible.⁴ This might explain why it has been so difficult to implement significant reforms because of the vested interests in this particular sector, unless remaining in the (limited) scope of Pareto-improving reforms. The fact is that, 40 years later, France is still the main opponent to significant reforms of a policy that was implemented in 1960, and seeks in any reform some financial "compensations" perhaps results from the original sin of using a sectoral policy as a way to solve a political game.

The importance of the agricultural sector differed a lot in 1957. It represented 6% of the GDP in Germany, but 15% in Italy, where agriculture accounted for 28% of total employment. A common agricultural policy could only result in uneven benefits between countries. The policy instruments, in particular market price support, did not allow for precise targeting. In addition, from the beginning, the CAP has tried to achieve various objectives, such as self-sufficiency and farm income level with one single instrument in a Community where members show large differences in their farm population as well as in their net trade position. Subsequently, the distribution of costs and benefits of the CAP has largely determined the attitude of EU members in the policy negotiations. During the last 40 years, most decisions taken in the agricultural sectors have resulted from painful compromises. Today, net food importing countries experience the largest welfare losses caused by the CAP and its high support prices and push for reforms. Countries that are net beneficiaries from the CAP such as France tend to push for policies that bring back some, or more, of their contribution to the common budget. Other countries that contribute more to the funding of the CAP such as Germany or the UK are keen on limiting the CAP related expenses. The relative specialization of each country complicates the game. For example, Italy has long supported interventionist policies in those sectors (olive oil, tomatoes) where it could draw the most subsidies, while supporting the idea of low intervention prices in other sectors. The Netherlands has also favored interventionist policies in the animal sector, while favoring freer trade with third countries in the grain and oilseed sector, an input for their animal products.

In addition, the political weight of the countries in the decision making process affects the common outcome. In 1966, France imposed the right to veto decisions regarding national interests. For years this led to search for unanimity in CAP related issues. Decisions reflected a compromise rather than common interests. Game theory suggests that this may have highly damageable results for the common interest, when each country pursues national interest objectives and considers that the cost will be shared. CAP related decisions are now adopted under a qualified majority procedure. However, horse trading is still very active. In order to avoid being outvoted, a large country sometimes buys out a small country by supporting a proposal in its national interest on another issue. The new voting procedure will change the possibilities for a blocking minority in qualified votes, without guarantees that a selfish country will be easier to outvote (see Box 3). This is of particular importance since, unlike the US farm bills, which are limited in time, CAP measures are more or less permanent, and are in practice usually very difficult to amend : many basic texts regulating the CAP are still the ones decided in the late 1950s.

⁴ This version of history is shared by many observers (Bergmann, 1979; Fearne, 1997). However, the version that the CAP was a German concession to please the French ignores that Germany obtained many advantages, in particular higher cereal prices than wished France, and overall, German agriculture also benefited from the CAP.

Box 3. Decision making in the EU

EU legislation takes either the form of "Regulations", which override national law and are legally binding on every citizen of the Union after the Parliament has given its view, or the form of "Directive", which is a framework within which each member state is required to adapt its legislation to conform to a common objective. Both are adopted by the Council of Ministers. A third category of texts, the "Decisions" can be taken by the Commission without prior recourse to the Council, for cases that do not raise significant political problems. They are in general of technical nature.

Voting procedures. Some Regulations and Directives require unanimity, some others only required qualified majority. On aspects related to the CAP, the Council acts on the basis of a vote with qualified majority, on the proposal by the Commission. In 1966, France refused to give up some of its prerogative in decision making, and blocked the functioning of institutions. This attitude led to the so-called compromise of Luxembourg that effectively led to a power of veto over national decisions and to the traditions of searching a consensus. For years, CAP was considered as a matter where unanimity was required. The search for compromises, in particular on annual negotiations on the setting of administrative prices is said to have caused inflation in CAP expenditures. After 1982, the Luxembourg compromise was very seldom invoked, but the practice of a consensus remains on sensitive issues (see Swinbank, 1997).

Qualified majority rules. The Nice Treaty (still to be ratified) has reformed the weights of each member in the voting procedure, as well as defining weights for successive future member countries. Presently, when the council is required to act by a qualified majority voting, 62 votes in favor are necessary to adopt a proposal of the Commission (62 votes in favor, cast by at least 10 members in other cases). Since the total number of votes available is 87, a minority of 26 votes can block a proposal. Under the so-called Ionnina agreement, if members of the Council representing a total of 23 to 25 votes indicate their intention to oppose the adoption, the Council is legally obliged to do all it can do to reach an agreement that can be adopted by at least 65 votes. After ratification of the 2000 Nice Treaty, adoption of a proposal by qualified majority will require 169 votes out of a possible 237, and the vote must represent at least 62% of the total population of the EU.

Procedure of adoption of a change in the CAP. A proposal for change may originate from a Committee, from the Parliament, or from Member states organization, but the Commission is the only body that formally submits the proposal. In areas relating to the CAP, the Directorate general for agriculture drafts a proposal. Member states experts are consulted during the initial stages. The Commission discusses successive drafts with interested parties (such as the farmers organization, processors, distributors and consumers). Because the Council has the final decision, the Commission must in practice have close contacts and make compromises with ministries in charge in member states before submitting a proposal to the Council. After consultations and re-drafting, the text is put into legal form, the Director of agriculture has the proposal approved by the Commissioner for agriculture. At some point the whole Commission as a body must adopt the proposal, and submit it to the Council and to the Parliament. With agreement of the (rotating) President, the proposal is put on the agenda of the Council. In the case of proposals related to agriculture, the Council normally instructs its Special committee on agriculture to make a technical review. Council decisions are taken only in plenary sessions. The Council debates the proposal until an agreement is found.

The measure is then forwarded to the Parliament, which must give an opinion and make amendments. In CAP related decisions, the Council can reject amendments from the Parliament. However, by failing to give an opinion, the Parliament can delay the implementation of a proposal. In addition, the Parliament can raise public interest in an issue and put indirect pressure on the Council, for example through increased media exposure. In areas such as public health and regional policy, co-decision between the Parliament and the Council is necessary.

"Normal" prices mean high prices, lower prices require compensation. In addition to the political motivations, i.e. favoring economic integration in order to promote growth and ease tensions that had led to armed conflicts, the creation of the CAP also aimed to ensure an independent and reliable supply of food. The public opinion was still traumatized by food shortage during and after World War II. Several European countries had incurred large debts during World War I in order to import food mainly from the United States, and the payment of the war debts had fueled economic difficulties as well as political

tensions between the two wars. The choice was therefore made of setting producer prices administratively, at a level that would ensure farmers some incentive to increase production. This original decision can still be felt 40 years later, even though European agriculture faces excess supply. Farmers have taken high stable prices for granted for 40 years, and any attempt to reduce the gap between world prices and domestic prices is still felt as unfair and requiring compensations.

During the years following the 1958 Stresa conference that laid out the policy framework, many concessions from member countries proved necessary. France and Italy favored and obtained a high degree of market organization. This led to the establishment of a set of common market organizations, and to a levy system that ensured guaranteed prices for producers (Fearne 1997). In order to obtain Germany's agreement for the alignment of national support prices on a single Community price for wheat, administrative prices were set close to the (high) level of German prices, i.e. roughly 50 percent higher than the average world price, at the time relatively stable. In order to avoid a shift of resources to this sector, other support prices were also set to a high level. The gap between the Community's internal price and the world market price for grains increased dramatically during the next three decades. The idea that high prices are "normal prices" and that world prices have no meaning has however persisted as part of the motto of the farm lobby in the EU. Proposals to pay farmers for their contribution to positive externalities through production decoupled direct payments are still opposed by producers, who claim that they need a "fair price that covers production costs" and not direct payments, regarded as close to charity. That production costs can be considered as exogenous from output price, and that subsidies through market price support could be more virtuous than (more visible) direct subsidies are puzzling for an economist. However, the psychological opposition of EU farmers to be paid as "landscape gardeners" should not be underestimated. The attachment to the "a fair price, not subsidies", is still a major obstacle to the acceptability of CAP reforms.

[Insert Table 5.]

2.2 Success and failure of the CAP

The CAP was the first and remains the major common policy. It has helped EU integration and has served as a experimental field for the functioning of a economic as well as political union. From 1962 to 1992, the CAP relied on a managed market system that relied on import restrictions so as to maintain internal market prices above a pre-determined administrative price; intervention buying to guarantee that every quantity produced would be sold at least at a pre-determined price; subsidies to export or to destroy excess supply that would have caused the internal price to fall below this administrative price. These mechanisms have succeeded to make the EU less dependant on foreign supply and to stabilize prices, avoiding a risk premium that would have eventually been paid by consumers. The market management system prevented major market crises, thanks to the open ended intervention buying.

It is not certain that the expansion of the agricultural sector in the EU was caused primarily by CAP arrangements. Mahé et Ortalo-Magné (2002) point out that general macroeconomic conditions might have been more important for the expansion of the sector than the actual agricultural policy. In countries such as France, the contribution of agriculture to macroeconomic equilibria is mainly caused by goods that were largely outside CMOs (exports of wine, spirits). This applied to horticulture in the Netherlands, or to wine and fruits in Spain. However, the CAP arrangements clearly help western Europe to become a major producer in countries such as France, that imported half of its consumption of wheat right after World War II.

The most impressive accomplishment of the CAP has perhaps been the successful accompanying of one of the most dramatic economic transition in western Europe, i.e. the rapid shift from an agrarian society to an

economy of industries and services. In a country such as France, the farm population amounted to 5.5 million workers in 1950, and one out of three worker was employed in agriculture. 50 years later, the farm population is roughly 900 000, and only one in 24 worker is employed in the sector. With the exception of the UK and the Netherlands, a similar evolution can be observed in every EU country, with sometimes a different timing. Most of this transition was achieved rather smoothly, even though there has been some limited periods in time and space where some farmers were brutally driven out of business (in Denmark in the mid seventies, for example). In most cases, the transition was achieved simply by a non continuation of farming by the children of small farmers, rather than bankruptcies. The CAP therefore played its role of social cohesion in front of rapid changes. In sectors that had to adjust as rapidly (the coal sector in the 1970s and 1980s, the steel sector in the 1980s), public money was also poured in order to facilitate transition. None of these sectors were as large as the farm sector in the early days of the CAP.

The negative effects of the CAP have also been largely discussed. The setting of institutional prices at a high level, because of the need for a consensus as much as for a deliberate objective of increasing domestic production, led to the production of surplus. High prices drove resources to the production of the most supported commodities, and lowered demand. The decision making process, in particular the permanent need for compromises in the so called "marathon" negotiations on the annual setting of institutional prices, had an inflationist effect on agricultural prices. The agri-monetary mechanisms made it possible to avoid any price decrease because of the increasing gap between the "green rates" and the market exchange rates. Technical change played a major role by lowering unit production costs, while output prices were maintained at the same level.

Open ended intervention led to considerable quantities stored in public stocks. The basic mechanism of financing the CAP was not appropriate for a net exporting community : import levies were not sufficient for covering public storage and export subsidies. The disposal of surplus involved large budget costs, which were inflated by the negative effect of export subsidies on world prices. Unit export subsidies reached ridiculous levels in the early 1980s in commodities such as milkpowder.⁵

Intervention provided incentives for producing large amounts of low cost products, regardless of the quality. In the 1970s, some countries developed a production for intervention purposes, rather than trying to add value to the raw commodity and find a suitable market (Ireland in the case of milk, France in the case of wheat). This resulted in poor quality products. The CAP has also contributed to an increased used of chemical inputs, to the intensification of agriculture, and to regional specialization. This proved particularly damaging to the environment, in particular to the quality of groundwater and rivers.

Finally, policy instruments of the CAP failed at providing decent income to a large share of farmers. Price support benefits mainly to larger producers. Price support lead to larger consumption of intermediate inputs and creates a rent that capitalizes in the price of land. When farmers rent their land, most of the rent is passed to absentee landowners, hardly a population that was primarily targeted by the CAP. When farmers are also landowners, price support increases their asset rather than their income. Inflated land prices act as a barrier to entry and this is particularly detrimental to young farmers. In addition, most of the capitalized support is passed to non farmers when there is intergenerational transfers, since farmers must compensate other family members who inherit a share of the land.

2.3 A succession of limited reforms

For almost three decades, the CAP experienced little change. Many proposals were put together, from the 1968 Mansholt "Plan", which recommended substantial price cuts, to the 1973 Wageningen memorandum. Several policies attempted to increase consumption of EU agricultural products in the 1970s and 1980s : school milk, special operations for subsidizing consumption of butter, free distribution of products for

⁵ Tyers and Anderson (1988) estimated that the EU export subsidies in the dairy sector, whose world market was dominated by EU exports, led to a 33% fall in world prices.

charity. However, it is well known that such operations cannot be very ambitious, since the possibility of reaching new consumers without shifting demand from regular markets to subsidized consumptions is limited. Most of the significant actions on demand included costly subsidization of surplus disposal, such as export subsidies, food aid to third countries, and subsidies for the incorporation of milk powder into feedstuffs for animals.

Programs to ease pre-retirement of farmers started to be implemented in 1972. This made it possible to increase the average size of farms, but did little to limit surplus production. Payments for activities that were not directly related to production were introduced in 1985, with the concept of "Environmentally sensitive areas". They were the first step of the "greening of the CAP", but budget outlays were extremely small compared to the amounts spent on storage and export subsidies.

The need for changes in the CAP became more binding in the 1980s, as a result of the high budgetary cost and the imbalance between supply and demand. While it proved impossible to reach a political consensus for reform, the costs of the CAP became unbearable. The sharp progression in budgetary outlays put some pressures on the financing. Under the pressure of the net contributing countries, the principle was adopted in 1984 of capping CAP outlays.

The same year, the first significant reform of the CAP was introduced in the dairy sector, with a supply control on production and the implementation of individual milk quotas. They followed the introduction of sugar quotas in the late 1960s, but producers were not allowed to produce beyond the quota for the world market, as it is the case in the sugar sector. In addition, provisions were introduced to manage the cereals and wine markets.

In 1988, the budget could not be balanced. Emergency measures (monthly limitation of expenses) did not make it possible to manage markets under the current price and intervention system. The Council voted additional resources of 6 billion Ecu (the ancestor of the Euro), but introduced a new ceiling on the progression of the CAP expenditure : outlays under the guarantee section of the FEOGA could not increase more than 74% of the growth rate of Community Gross National Product (GNP).

During the 1980s, many measures were introduced to limit CAP expenditures. "Co-responsibility levies" were introduced for milk in 1977 and for cereals in 1986. The system worked so that, in case of production exceeding a certain threshold, producer prices decrease so that part of the support paid by consumers fueled the EU budget. The purpose was both the increase funding and to limit price incentives to produce surplus. The 1988 "stabilizers" were based on maximum guaranteed quantities, with automatic price cuts when production exceeded the quantities at the EU level. Socio-structural measures were also introduced to adjust supply and demand by reducing area under cultivation (voluntary land set aside, encouragement for cessation of farming or early retirement, direct income support and a scheme for extensification of production, premia for producers agreeing to reduce their production).

However, the Council did not implement the price cuts that would have led to a significant decrease in production. In practice, the succession of instruments (co-responsibility levies, stabilizers, set aside) had a limited effect on the growth of surplus, since technical change kept lowering production costs. These instruments were based on aggregate maximum quantities, but the individual producer saw little incentive for limiting his own production. Voluntary set-aside proved costly for the budget, and had a limited role in controlling supply.

2.4 The 1992 inflexion

By 1992, a more fundamental reform could no longer be delayed. The main pressure came from budgetary expenses, which were seen as growing permanently because of the increasing unbalance between supply and demand. The cereal sector raised particular problems, since high prices of EU wheat and corn had led the feedstuff industry to look for cheaper substitutes. Pig and poultry producers, especially those in Northern Europe located close to main ports who had access to cheap imports, were using marginal

quantities of EU grains, but increasing quantities of cereal substitutes such as cassava or corn gluten feed, a byproduct of the US isoglucose and ethanol industry. The situation was such that taxpayers had to subsidized exports of products that were so expensive that they could not find an outlet in the EU market, where consumers imported substitutes.

In spite of the measures taken in the 1980s, surpluses were rapidly piling up in "mountains" of beef and grains and of "lakes" of milk purchased by the intervention system. Public stocks amounted to 25 million tonnes of grains in 1991, against 10 millions in 1988, and to 900 000 tonnes of beef in 1991 against 380 000 in 1988. The cost of storage and disposal of surplus had let the FEOGA expenses to reach 30 billions of ECUs in 1992, from 11 billions in 1981. At the same time, the EC came under growing pressure to reduce the effect of its subsidized export and its production subsidies on world markets. This led the Commission to propose the first deep reform of the CAP in 1992.

The 1992 reform of the CAP, often called the McSharry reform, from the name of the Commissioner who managed to have it passed in spite of many political obstacles, took place during the Uruguay Round of multilateral trade negotiations. Although the Commission denied any formal link with the GATT negotiation, the reform clearly helped the negotiations by meeting some of the fiercest criticism to the CAP.

The Commission's proposal set new objectives for the CAP : adapt quantities supplied to demand ; restore competitiveness of EU products, by bringing producer prices closes to worlds prices ; increase the sales of domestic products in the EU (grains) ; limit the increase of budgetary expenses and use them in a more efficient way ; contribute to a better geographic repartition and production and to the preservation of environment. Although the proposal met strong criticisms from some member states, an amended text was ratified by the Council in May 1992. It brought radical changes in the farm support system. It partially replaced the market price support as the main CAP instrument with a direct income support scheme. It began to take effect in 1993 with arable crops, beef, sheep and goat meat. dairy products and tobacco sectors. Shortly afterwards, it was applied to the dried fodder, cotton and in 1996 to the fruit and vegetable sector. The wine and olive oil sectors experienced some reform in 1995.

The central aspect of the reform was a cut in support price for grains by 35% over three years. The purpose was to make EU cereals more attractive to the animal feed industry. Area based payments on acreage devoted to cereals, oilseeds and protein crops were designed to compensate for the price decrease. Beyond a certain farm size, these payments were conditional to setting aside a portion of their arable land, in a proportion that, in practice, turned out to be set annually, between 5% and 15% depending on the world market. Farmers received payments on the set aside land. On the land set aside, farmers were allowed to grow non-food (i.e. mainly energy) crops. In the beef sector, existing premiums per head of cattle were increased as a compensation of a progressive 15% reduction in support prices. The reform also included agri-environmental measures to encourage less intensive farming and environment protection, afforestation of agricultural land and to provide an attractive early retirement scheme for farmers over 55 years old.

The reform turned out to be more limited than the Commission's initial ambitions. The sugar, wine and fruit and vegetable sectors were not reformed, for example. In addition, direct payments kept providing significant incentive to extra production. Each member state specified a number of grain growing regions and determined an average annual yield for a period prior to 1990. Direct payments were attributed on a per ton basis, the reference production level being determined on the basis of the acreage devoted to arable crops and this reference (regional) yield, but remained coupled to the acreage in production. However, the McSharry proposal was a breakthrough in the history of the CAP.

2.5 The Agenda 2000

The McSharry reform was fully implemented in 1996, the last year of the progressive decrease in intervention prices and increase in direct payements. At the end the the 1990s, talks with the Central and

eastern european countries (PECOs) reached the point where the CAP needed to account for future enlargement. In addition, the Uruguay round agreement had set a limit on export subsidies. That proved to be a major constraint on the CAP since public intervention would now acquire stocks that would become impossible to sell on the world market. The Commission forecasted the return of increasing stocks, up to 50 million tonnes of cereals in the next few years if intervention prices were not brought down closer to the level of world prices. The Commission therefore proposed to deepen the McSharry reform, and to curb the evolution of the CAP towards less incentive to production, but more incentive to the provision of positive externalities.

The Agenda 2000 agreement reached at the Berlin European Council in 1999 shapes the CAP until 2006, even though the mid term review of the reform has led the Commission to put forward a new proposal in July 2002. The reform sets a ceiling for the CAP expenditures over the 2000-2006 period, with an average level of 40.5 billions euros a year plus 14 billion for rural development as well as veterinary and plant health measures. Intervention prices for cereals and beefs experienced an additional decrease, and were again compensated by direct payments. It is noteworthy that the intervention price for beef was set at a very low level, so that the whole system will only act as a safety net when the Agenda 2000 is fully implemented (see Table 25. for details of the measures in 2006).

Although direct payments remains the dominant instrument, it is clearly stated that rural development is the "second pillar" of the CAP. The reform aims to re-orientate the CAP towards measures in favor of a multifunctional, sustainable agriculture, including in regions facing particular difficulties. The emphasis is also put on the maintenance of landscape and countryside and to respond to consumer concerns and demands regarding food quality and safety, environmental protection and maintaining animal welfare standards. Agricultural expenditure is also devoted more than in the past to spatial development and nature conservancy and the establishment of young farmers. Member States were allowed to limit the direct aids awarded to holdings in line with criteria to be defined by each Member State relating to the amount of labour employed on a farm. Money released in this way is to be allocated by the Member State to agri-environmental schemes. Because rural development and agri-environmental payments raised criticisms from farmers who found the procedures too bureaucratic, rules were simplified. There is also a new division of functions between the Commission and the Member States, whether concerning compensation in the form of direct payments or rural development measures incorporated into an overall programming framework.

A striking feature of the new policy is the degree of decentralization of programming and implementation as far as the "second pillar" is concerned. Member states draw up their own rural development plans, and submit them to the Commission for approval. By doing so, they have a large degree of freedom for picking measures from a large menu. Most schemes involve a element of national co-financing.

More precisely, decisions taken in 1999 include the following measures.

- CMOs were simplified in the sector of beef, dairy, wine and arable crops. Some of the direct payments were distributed to member states in the beef and dairy sector, which will allocate them in function of their own priorities provided that there is no distortion of competition between EU countries.
- The intervention price was progressively reduced by 20% for beef. Compensation for the loss in income took the form of increased headage payments. A safety net, which took effect in July 2002, officially replaced the public intervention scheme. A special premium for slaughtering was introduced; regional ceilings for the special premium were introduced. Headage payments can be conditional to environmental criteria.
- A 15% reduction in intervention price for cereals took place in two steps, partially offset by a 17% increase in direct aid. Oilseeds arrangements were aligned in three steps with the existing

arrangements for cereals. Mandatory set aside was maintained with a rate set to 10% for arable crops. Extra premium of 9.5 euros/tonne of a reference yield were provided for protein crops.

- Milk quotas were maintained until 2005/2006, with an increase in quota for some countries. It was decided that the intervention price for butter and milkpowder would be reduced by 15% in exchange for the allocation of a dairy cow head (17.24 euros/head). Perplexingly, an increase in the quotas for all member states, in spite of quotas rights that already exceed domestic consumption.
- Rural development was encouraged, with some emphasis on the links between agriculture and the environment.
- Member states have to possibility to "modulate" (i.e. adjust) direct payments, i.e. to limit the payments on the basis of wealth criteria, and to impose environmental conditions to these payments. The savings on payments to wealthier farmers can be used to fund environmental and rural development measures, and to support to non-food crops.⁶

The various measures for rural development and research-development were consolidated. They now distinguish the former 1992 CAP reform accompanying measures (pre-retirement scheme, agri-environmental measures, forestry) and measures for less favored area on one side, and structural funds on the other side. The latter include modernization and diversification (investment aids, education, marketing and promotion of farm products, and reconversion of agriculture). Environmental objectives must be taken into account in the attribution of support to less-favored areas.

The reform adopted in March 1999 falls short of the ambitions of the initial proposal of the Commission. The premium for silage corn, scrapped in the early proposal, was reintroduced, in spite of the poor environmental record of this crop. Such a premium contradicts other effort for encouraging extensive livestock production. The redistribution of payments in favor of rewards for environmental services and rural development is not compulsory. The shift to direct payments is significant, but OECD figures show that, even after the Agenda 2000, market price support still provides the bulk of EU support. In addition, the direct payments remain coupled and not subject to severe cross-compliance rules.

Nevertheless, the inflexion of the CAP is considerable. In addition to the recognition of the "traditional" roles of agriculture, such as producing food and raw material, contributing to economic growth, employment and trade balance, the reform emphasizes new functions. It is clearly stated that agriculture must contribute to regional planning, with the complementation of activity by other industries and tourism and complete an environmental function of land conservation, maintaining biodiversity and protecting the countryside, through encouraging farming methods which respect the environment. Clearly, the Agenda 2000 has been a major reorientation of the CAP.

2.6 Ten years of significant CAP reform

In spite of the moderate decoupling of the payments and the limited impact on yields and output, the 1992 reform was successful in many aspects. In the grain sector, consumption boosted and public stocks substantially reduced from 32 million tonnes in 1992 to 13 million tonnes in 1998, after the end of the implementation period. A consequence was the come back in animal feed of local grain production (barley, wheat and maize). The volume of grains used as compound feedstuff rose from 82 million tonnes in 1992 to 107 million tonnes in 1998, an increase of 30%. Guaranteed prices were brought close to world prices, especially in the wheat sector, making it possible to limit export subsidies (a temporary rise in the mid 1990s even shifted world prices above the intervention price).

⁶ France used this provision and withheld money from larger farmers in order to fund environmentally friendly and quality improvement measures, while the UK withholds a flat rate basis on all farms receiving CAP payments. In 2002, large farmers obtained the suspension of the modulation arrangements in France. Portugal is so far the only other country to apply modulation.

In the beef sector, intervention stocks exceeding 1 million tonnes before the reform fell to 20000 tonnes in 1995, even though, the BSE crisis subsequently resulted in a fall in demand. This made stocks surge again and the effect of the 1992 reform less apparent.

During the implementation period, agricultural income has increased by 4.5% between 1992 and 1996 in the EU. World prices were high during that period. Because direct payments were not conditional to market situation, in the cereal sector, producers experienced particularly high incomes. Indeed, the direct payments, which originally aimed to compensate for a fall in producer prices that did not take place, provided extra resources to producers.

The 1999 reform deepened some of the McSharry reform, especially through the extra decrease in grains and beef prices, and the shift towards direct payments. Both reforms brought the the CAP closer to market mechanisms. The 1999 reform stressed the role of agriculture as a provider of positive externalities. The "second pillar" of the CAP remained limited in practice under Agenda 2000, but this nevertheless shows a major inflexion in the way the role of the CAP is considered, and set the guidelines for future reforms.

There are however several aspects where the reforms have had questionable effects.

- First, the effect of the reform on intensive practices has not been clearly visible. The partial decoupling of direct payments may have limited the historical trend for using more capital and intermediate inputs, but yields have kept increasing in most cereals (a slight decrease in yields for oilseeds was observed in some regions). Overall, the decoupling of arable payments is likely to have been too limited for significant environmental impacts.

[Insert Figure 1 : evolution of yields in the EU, selected commodities]

- Second, the effect of the reforms on beef surplus are less visible than the ones for cereals, because the effect of the decrease in institutional prices on quantities demanded were more limited. The disequilibrium between supply and demand has decreased during the last 10 years, but the diminution of stocks is likely to result more from various measures encouraging slaughtering in the wake of the BSE crisis. The decrease in intervention price has not resulted in a significant dent to the long term trend of a decrease in beef consumption. Explanations might lie in the poor transmission of prices decreases in the marketing and retailing sector. The decrease in the price of cereals also led to more competition from pigmeat and poultry. In addition, the ceiling on the headage payments for suckler cows has not resulted in a decrease in the number of animals, which has kept increasing. More generally, the system of payments has not provided the incentives required for significant increase in extensification (the fact that silage corn was eligible to arable payments might have offset some of these incentives). The 1999 reform provides more incentives for reduction of stocking density, but it is too early to make an assessment of the consequences of the new measures.
- Third, the 1992 and 1999 reforms resulted in increased budgetary outlays (see Table 1.). The decrease in storage expenditures was more than offset by the increase in direct payments. This reflects the fact that the burden of farm support has shifted from consumers to taxpayers. The reform has also significantly modified the way member countries benefited from the CAP. Previously, some of these costs were paid by consumers of net importing countries, which resulted in slightly different transfers from member states. France appears to have gained particularly because of the generous direct payments to the arable crop sector, while Italy and the Netherlands' net contribution to the budget has increased.
- Fourth, the CAP has not succeeded in fulfilling the (posted) objective of maintaining a large farm population. The dramatic fall in the number of farmers results from low incomes for inefficient

farm under a sustainable size and is a condition for the rationalization of the production system. The decline in the farm population is likely to continue in the next decades. This is not as catastrophic as many farm organizations claim it : most of the decline in the number of farmers is caused by the fact that the children of small farmers find more lucrative jobs in other sectors, and sudden bankruptcies are limited. In addition, if the decline in agricultural population contributes negatively to economic activity in rural areas, it has long become clear that rural development could not be based on farming alone. Other rural industries are likely to play a more active role in rural development than agriculture.⁷

- Fifth, while the shift from market price support to direct payments is likely to have increased the efficiency of transfers as well as transparency, the amount of payments is such that they now exceed the agricultural income in a large number of farms. This has raised problems for the acceptability of reforms since farmers feel that their work is not remunerated and that they receive assistance. Because they replaced price instruments, direct payments have not contributed to the resorption of inequalities in farm support. Large farms simply keep receive larger payments. The large support on Northern arable crops has become more visible, but the unbalance in support between sectors and countries has remained intact.
- Finally, even though the Agenda 2000 sets new objectives to the CAP, so far, the 1992 and 1999 reforms have mainly replaced market price support by direct payments, without a considerable shift of policy instruments towards new measures. Structural measures, and the so-called "accompanying measures" of the 1992 reform (i.e. agri-environmental and afforestation payments, early retirement schemes) remain limited only represent a small share of the CAP budget. Overall, only 16 % of total FEOGA (guarantee and guidance) expenditure on agricultural policy and only 10 % of FEOGA-Guarantee expenditure are currently used for structural and rural development. After ten years of reform, the "second pillar" of the CAP, that is, the measures aimed at improving agri-environmental performance, promoting rural development and structural adjustment still represent a small share of the EU budget in spite of the willingness of the EU to make such policies more central instruments of the CAP, as shown by the July 2002 proposals from the Commission.

3. The present CAP

3.1 The budget

3.1.1 The FEOGA

The general budget of the EU is currently Euro 89 billions per year, i.e. slightly over 1% of the EU GNP. Agriculture accounts for almost half of the expenses of the EU budget (see Table 8.).

⁷ Estimates of costs of the recent FMD outbreak in the UK shows that, already, the value added generated by non agricultural rural activities far exceeds the value added generated by agriculture. The cost of foot and mouth disease over the 2001-05 period are estimated to 5.4 billion pounds for farmers, and to 5.2 billion pounds for tourism and other related business (source : The Economist, July 27 2002, using DEFRA, Department of culture, media and sports figures.). Even though the case of the UK is a bit extreme in the EU, this illustrates the declining importance of agricultural production in the whole rural economy.

The EU budget is established annually and made up of four types of revenues : VAT based contributions (37% of the resources), GNP based contribution (48% of the resources), custom duties (12.5% of the resources, member states deducting 10% to cover collection costs) and a small amount coming from agricultural/sugar levies, bank interests and other minor receipts. The Agenda 2000 package of set a 7-year financial framework taking account of changes such as further enlargement of the European Union and reforms to spending policies such as agriculture and structural funds. Spending throughout the period 2000-2006 will remain within the ceiling agreed for 1999, i.e. 1.27% of EU GNP.

CAP expenditures used to represent 80% of the EU budget in the 1980s, when agriculture was the only significant common policy. The share of the FEOGA Guarantee section in the total budget of the EU fell from 67% in 1988 to a forecasted 44% in 2002. The emergence of a common policy in the area of research, and of the various structural funds, explain the decrease in the relative share of the CAP in the budget. Another explanation is the ceiling put in 1988 on agricultural expenses and the constraint that the annual growth of the FEOGA expenditure section remained under 74% of the GNP growth rate (from the 1988 reference of 27.5 billion euros). This annual reduction in relative terms made it possible to double the sum allocated to the structural funds over the period 1988 to 1993. This decision was extended until 1999, and Agenda 2000 has confirmed the budgetary discipline policy and the agricultural guideline for the period 2000-2006 by setting ceilings for the CAP expenditures : 43.9 billion euros for 2002 (in constant 1999 prices) and 41.7 billions in 2006, with annual subceilings of 39.6 for the guarantee expenditures in 2002 and 4.3 billions for rural development expenditures. It is noteworthy, though that the ceilings were never a binding constraints. They act more as a potential security against a possible uncontrolled increase of budgetary outlays.

The distinction between the Guarantee and the Guidance sections of the FEOGA has persisted. The FEOGA Guarantee Section finances expenditure on the agricultural market organisations. Since 1993, the Guarantee section of financed measures which are not strictly speaking market management, including set-aside of land, income support, environmental protection, certain veterinary expenditure and information measures relating to the CAP and action to combat fraud. The Guarantee section now finances all the rural development measures that accompany market support, rural and structural measures outside of so-called "Objective 1" regions,⁸. The Guidance Section finances other rural development expenditure (not financed by the FEOGA Guarantee Section).

[Insert Table 8.]

[Insert Table 9.]

During the fiscal year 2000, expenses related to the "first pillar" (i.e. market intervention and direct payments) amounted to 36 billion euros, against 4.4 billions for measures relative to the "second pillar". Because the latter are co-funded by member states and actual expenses are larger. However, there is therefore a discrepancy between the importance given to the "second" pillar in official speeches and its importance in the budget.

According to the 2000-2006 budgetary framework, "second pillar measures" amount respectively to 47% of the budget for agri-environment, 20% for less favored areas, 10% for forestry, 5% for early retirement, and the rest devoted to investment and settlement aids and training. Rural development expenditures remain limited, but their share in the budget is growing (9.5% of the expenses in 1995, 14.9% in 2000).

⁸ In the EU vocabulary, "objective 1" regions are those lagging behind the average of the EU in terms of GDP per capita. See the section on rural development for details.

The relative importance of the two pillars in total expenses varies, however between countries. This results both from the priority given by member states for stressing agri-environmental and rural development measures. For example, the second pillar represents less than 10% of the CAP expenses in France, while it represents 18% in the UK, and more than 40% in Austria and Finland.

3.1.2 The nature of expenses

A brief examination of the CAP budget sheds a light on the relative importance of the various policy instruments. In the Guarantee Section, expenditure on refunds (i.e. export subsidies) total 5.6 billion euros. Intervention expenditure, consisting mainly of direct aid, storage, withdrawals and similar operations total 30.5 billions euros. Expenditure on veterinary and plant health measures, information measures and rural development total 4.3 billions euros (figures for the consolidated 2000 budget).

[Insert Table 10.]

Changes in the Guarantee section of the FEOGA over the years reflect the 1992 and 1999 CAP reforms. Direct payments were minimal in 1992, and now amount to the largest share of the outlays (23 billion euros out of 39 billions in 2000). Export refunds have dropped considerably since 1995. This is partly due to the limitation on export subsidies agreed upon during the Uruguay Round of multilateral trade negotiations, and to the relatively high world prices and the appreciation of the US dollar in the late 1990s. Export subsidies now represent 14% of total Guarantee Section expenditure, remaining at the same level as in the previous year.

Intervention payments through prices now come second to the direct payments to producers. Direct payments amount to 63% of total Guarantee Section expenditure. They include area payments and set-aside of arable land, production aid for olive oil, area payments for flax, hemp, dried vegetables, rice, dried grapes, premiums for tobacco, suckler cows, male cattle, ewes and she-goats, and agrimonetary aid.

Expenditure on storage totalled 951 million euros, i.e. 2% of total Guarantee Section expenditure. The book value of intervention stocks at the end of the 2000 financial year was down to 885 millions euros, compared with 1.6 billion euros at the end of 1999. Cereal and rice alone account for 85% of the total value of products in storage. The remaining 15% consisted of olive oil (4%), milk products (10%) and beef and alcohol (1%). Expenditure on withdrawals and related operations totalled 517 million euros, i.e. 1.3% of total Guarantee Section. Other intervention expenditure amounted to 9% of total Guarantee Section expenditure. This category of expenditure covers intervention other than storage costs for sugar, aid for the production of dried fodder, aid for cotton, operating funds of producer organisations, aid for the production of citrus fruit and financial compensation to encourage citrus processing, aid for the use of grape must, aid for the use of skim milk powder and measures relating to butterfat, special support measures for beef, expenditure under food aid programmes, clearance of accounts corrections, etc.

3.1.3 Budget expenditures per commodity

The examination of the budget devoted to each CMO shows that arable crops now captures the largest share of the FEOGA Guarantee section expenditures (45%), followed by beef (12%) and milk (6%). However, one must keep in mind that budgetary outlays only provide a partial vision of the importance of public support in such or such sector (see section 2.3. for a more complete evaluation of the support). Market price support, for example, is still very high in the sugar, dairy and milk sector, and the related transfers from consumers to producers do not appear in budget data. That is, over time, changes in budget expenditures reflect a shift from a support funded by consumers to a support funded by taxpayers.

[Insert Table 11.]

For the fiscal year 2000, expenditure on crop products totalled 25.8 billion euros. Arable crops represented a total of 16.7 billion euros in budget. Cereals account for 73% of the expenses, while oilseeds and set-aside land account for roughly 10%. Direct area payments account for nearly 90% of expenditure in arable crops, export refunds for 5%, in sharp decrease for the last 10 years because of both the progressive alignment of EU cereal prices on world prices and the decrease in total exports.

Expenditure on sugar totalled 1.9 billion euros. Export subsidies represent the main part of the expenses, but they are funded by producers, who pay a levy that enters as a receipt in the FEOGA budget. Olive oil expenses amounted to 2.2 billion euros. Most of it is the production aid to farmers, and export subsidies are now close to zero in this sector. Expenditure on dried fodder and grain legumes came to 381 million, fibre plants and silkworms to 991 million, fruit and vegetables to 1.6 billion (expenses devoted to intervention in both fresh and processed fruits), and the wine sector 765 million euros. Although production is limited to a few countries, tobacco accounts for 980 million euros.

Expenditure on livestock products totalled 9.3 billion. For milk products, expenditure totalled 2.5 billion euros. Export refunds account for 65%, but other forms of disposing excess production, e.g. aid for the use of milkpowder in feedstuffs and in the production of casein, represent 700 million euros. Expenditure on beef and veal totalled 4.5 billion euros. Direct payments represent two thirds of the expenses, and export subsidies 15%. Sheepmeat and goatmeat cost 1.7 billion euros to the taxpayer, pigmeat 435 million.

3.1.4 National sharing of the budget

Not all countries benefit the same way from the CAP, depending on their share in the EU production of the most supported commodities. The repartition of the FEOGA budget between member states provides only a partial vision, since some countries that are large producers of sugar, beef, milk also benefits from transfers from consumers from all over the EU. In addition, countries also contribute in an uneven way to the funding of the CAP.

Germany is the largest contributor to the EU budget. The rate of return of the money devoted to the CAP by German taxpayers is only 47%. France is the second largest contributor, with a rate of return of 84%, then the United Kingdom with a rate of return of 56%. Among those who benefit most from the EU budget are the countries that receive large amounts of structural funds. This includes Greece (rate of return of 418%), Ireland (242%), Portugal (259%) and Spain (169%).

Calculating a net contribution to the CAP budget is not supposed to make sense : indeed, the principle of financial solidarity assumes that a country is not liable for such or such expense. However, it is current practice for member states to calculate their net contribution to the agricultural budget. In the political game between member states that drives the decision making procedures in the Council of ministers, EU countries often focus on the effect of such or such proposal on their net contribution, or to the "rate of return" of their contribution to the CAP budget. In some cases, such as France, a high rate of return on CAP expenditure is seen as a way to balance its net contribution to other EU policies, such as the structural funds.

In spite of the questionable methodology (the contribution of a given country is not allocated to a particular EU policy) calculation of net contribution to the CAP shows that Germany is the largest net contributor to the agricultural budget (rate of return in agricultural policies of 54%). The large transfers to French arable crop producers compensate the contribution of France to non farm policies. That is, if we focus on the CAP, France is a net beneficiary of the agricultural budget, with a rate of return of 129%. Ireland (372%) and Southern countries (Greece, Spain, Portugal) remain net beneficiaries of the CAP, or at least of the farm support paid by EU taxpayers.

[Insert Table 12.]

3.2 The main Common market organizations

Historically, the CAP has relied mainly on common prices and common market organizations (CMOs), which differ according to the commodities. Most CMOs have combined market management and protection from exports of third countries. For many products including grains, butter, milkpowder, sugar, beef, special intervention bodies have purchased excess production in order to guarantee a stable market price to producers. For some other products, this goal was achieved by financial incentives to private storage in periods of excess production (wine, pork, some fruits and vegetable). In all these cases, trade protection was required to be able to guarantee a market price. In the case of other CMOs (eggs, poultry), public intervention was limited to import measures and export subsidies, but public intervention buying was not seen as necessary to regulate markets. In other cases, the CMO has focused on flat payments for some specific productions such as silkworms, seeds, or durum.

The 1992 and 1999 reforms, as well as the result of the Uruguay Round of multilateral trade negotiations, have led to amend significantly the way most CMOs operate. Under the new framework set by the Agenda 2000, price support is still an important instrument. A system of guaranteed prices, export subsidies and tariffs and tariff quotas is still active, even though the system of variable import levies was abolished in 1995. Table 6. provides a selection of institutional prices.

[Insert Table 6.]

In the arable crop sector area payments are based on historic, regional yields. Table 7. provides the main unit payments, which must be multiplied by the regional reference yield.

[Insert Table 7.]

Several CMOs condition support to limitations of supply. In the case of arable crops (grains, oilseeds and protein crops), per hectare payment are conditional to setting aside a certain percentage of their surface in arable crops (there is no administered prices for oilseeds and protein crops). In the case of milk and sugar administrative prices are guaranteed under the constraint of respecting a production quota. In the case of sugar, tariff rate quotas and tariff rate quotas are combined ensure a high EU internal price, while producers pay the cost of disposing of production in excess of the quota through producer levies. Support in the beef sector takes several forms : a guaranteed price, aid to private storage, aid per head of cattle, on the basis of a fixed reference and subject to stocking density limitations (see Table 7.). The CMO in the pork sector includes administrative prices, public intervention purchases, export subsidies and tariffs. Sheepmeat relies on tariffs and direct payment per ewe. The CMO for eggs and poultry rely on tariff quotas and export subsidies. The Appendix details the way the main CMOs operate as well as the main issues related to the particular sector.

3.3 Farm support under the CAP

Budgetary outlays do not provide a complete picture of transfers to farmers, which themselves differ from production support. If we focus on production support, it is necessary to take into account transfers from consumers. If we focus on the overall transfers, it is necessary to include payments (including domestic

payments) to the agricultural sector, even though they are not directly tied to production. The OECD has attempted to provide a more complete picture of the several concepts of farm support.

The PSEs and other indicators. The OECD measures support to producers. The relevant indicator is the Producer Support Estimate (PSE). It is an indicator of the annual monetary value of gross transfers to agricultural producers, measured at the farm-gate level, arising from policy measures that support agriculture. However, it is not in itself an estimate of the impact on farm production or income. The PSE includes several components:

- Market price support (MPS), which accounts for transfers relying on a producer price higher than the world price;⁹
- Production payments, which include direct payments that are conditional to the production of a particular product;

These two types of support are recognized as being particularly distortive in the sense that they provide direct incentives to extra production, and drive resources to a particular sector.

- Payments based on acreage or number of animals;
- Payments based on historical entitlements;

These payments introduce some partial decoupling since, for example, a producer receiving payments for an hectare of arable crop, can adjust yields so that this payment has a more limited impact on quantities produced than a payment per tonne. However, these are still considered as distortive payments.

- Payments based on input use;
- Payments based on input constraints;
- Payment based on overall farming income.

The last three types of payments are normally less distortive even though they are still tied to production activities, or have an indirect impact on production, for example by increasing financial capacities for investment.

The PSE in percentage makes it possible to express support to producers relative to the value of gross total farm receipts, measured by the value of total production (at farm-gate prices), plus budgetary support. This makes it possible to compare support to producers across commodities, and also to make meaningful comparisons over time, by minimizing the effect of inflation.

The OECD compiles other indicators that are not directed to producers, and sometimes have little impact on production, but which include expenses either from the consumers or taxpayers, benefiting the agricultural sector. The indicator "General Services Support Estimate" (GSSE) includes transfers to general services provided to the agricultural sector generally and not individually to farmers. This includes funding of research, training, marketing, inspection services. Such transfers do not affect farm receipts (revenue) or consumption expenditure, although they have affect the production and consumption of agricultural commodities.

The "Total Support Estimate" (TSE) are an indicator of the annual monetary value of all gross transfers from taxpayers and consumers arising from policy measures that support agriculture, net of the associated budgetary receipts, regardless of their objectives and impacts on farm production and income, or consumption of farm products. This includes transfers from taxpayers to consumers.

[Insert Table 14.]

⁹ This indicator is constructed on the basis of policies that only apply to a subset of commodities produced. In the EU, this indicator covers 72% of the value of agricultural production.

Farm support in the EU. Table 14. shows the value of the PSE, the GSSE and the TSE in the European Union. Producer support amounts to roughly 103.9 billion euros, far more than transfers to producers that were identified in the FEOGA budget. In spite of a significant reduction since the 1980s, market price support is still the dominant way to subsidize producers in the EU, and MPS transfers amount to 60.6 billion euros. Support to producers represents 35% of the gross receipts of the sector, compared to an OECD average of 31%. Among OECD members, Japan, Iceland, Korea, Norway and Switzerland are the only countries that display a higher percentage PSE.

The budget devoted to general policies (research and development, training, inspection services, infrastructures, marketing and promotion, stockholding) as measured by the GSSE amounts to 10 billion euros. It is noteworthy that expenses for stockholding have decreased from an annual average of 4.6 billion euros over the period 1986-88 to an average of 1.4 billions over the 1998-2001 period.

The data on TSE compiled by the OECD shows that under the current CAP, transfers from taxpayers (i.e. mainly budget expenses such as direct payments and general services) are roughly equivalent to transfers from consumers (i.e. mainly transfers induced by market prices). Indeed, for the first time in 2001, transfers from taxpayers have actually slightly exceeded those from consumers. This results from the successive policy reforms that have made support more transparent through a decrease in intervention price and the larger use of direct payments.

[Insert Table 15.]

Table 15. provides a comparison of the percentage PSE by commodity. The percentage PSE for arable crops lies between 40 and 50 percent. The PSE for milk is 40%, for poultry 46%, and for pigmeat 20%. The PSE for beef amounts to 91% and the one for sheepmeat to 72%. Clearly, this type of calculation is more questionable for those commodities that rely most on support from consumers than from taxpayers, because of the arbitrariness when picking a reference price. The reference price used in the case of milk is particularly questionable, because of the absence of trade in fluid milk. However, such calculations give a very different picture than the one given by budget expenditures, which suggested a disequilibrium in assistance, and that arable crops were receiving more support.

3.4 An assessment of the main CAP instruments

Guaranteed prices, requiring public intervention buying, export subsidies, border protection are used to ensure market price support. Direct payments, production quotas, set aside are the other main instruments used in the CAP.

Public intervention buying has declined over time, as the CAP became more market oriented. Recent reforms made this system less central in the fruits and vegetable and wine sector. Although the practical effects (and the sustainability of the CMO) remains to be tested, it will also be far less central in the beef sector in the future, when the Agenda 2000 reform will have been fully implemented. In the cereal sector, progressive alignment of the intervention price with the world market price have also limited public intervention. However, a number of CMOs still rely on guaranteed prices.

One can distinguish the case where the guaranteed price only acts as a floor price (as in the present CMO for cereals or in the future CMO for beef), and where it is used to keep producer prices permanently much higher than world market prices, as it was the case in many sectors until recently.

The use of a floor price as a safety net presents a number of advantages. It makes provides guidelines for producers to make decisions, and therefore contributes to stabilize markets. By limiting price fluctuations,

it reduces the risk premium demanded by producers and may have overall a positive impact on consumers surplus, by reducing the average price closer to the certain equivalent. Overall, it is possible that the cost of stabilizing markets with an intervention price be lower than the costs of alternative safety nets such as insurance systems. In that sense, the system adopted for cereals and beef under the Agenda 2000 presents some form of optimality, since intervention prices are set at levels that are close to an average world price. If such prices are lowered in order to compensate for the effect of technical change in the future (a source of major problems in the CAP of the 1980s), there are serious arguments for defending this form of public intervention.

If institutional prices are set at levels structurally higher than world price, market price support is highly distortive and there is a broad agreement among economists that it is a suboptimal policy instrument, compared to other forms of support. Indeed, supporting prices in a particular sector draws resources into this sector, that could often have been used more productively in other sectors. Most of the time, higher producer prices also translate into higher consumer prices under EU policies, and result in a lower demand. Combining increased production and a lower demand often results in surplus. Not only are they costly to dispose, but they are damaging to other countries by driving down world prices. Finally, the form of support is particularly inefficient if the goal is to support farm incomes, since most of the support results in higher production costs, deadweight losses, and capitalization in fixed inputs or transfers to the upstream sector. In that aspect, the CAP arrangements for sugar, milk, beef, sheepmeat, whose producer and consumer prices are much higher than average world prices, are hardly satisfactory from an economic point of view.

Export subsidies are used in the EU either as a way to dispose of surplus created by high administrative prices (case of beef or dairy products), or as a way to maintain market prices at a higher level (case of poultry, fruits and vegetable, pigmeat).¹⁰ The EU represents more than 80% of export subsidies from WTO members, even though the EU Commission points out that other countries, such as the US, use other forms of less transparent subsidies such as export credits.

Economists often consider export subsidies as one of the vilest form of public intervention. Such subsidies result in lower world prices and are damaging to foreign producers. When used as an instrument to stabilize domestic market prices, they increase price instability on the world market. Most economists also point out that an export subsidy is a relatively inefficient way to support farm income, since a large share of the money spent by consumers disappears in deadweight losses and in subsidies to foreign consumers. More generally, it makes little sense to deteriorate your own terms of trade by subsidizing exports. In 2001, preliminary figures suggest that export subsidies have declined to 3.4 billion euros (from 5.6 billions in 2000). This is still a considerable amount of money, and the decrease in budget expenditures is mainly explained by the exchange rate between the euro and the dollar during the last few years. Clearly, international pressures for ending export subsidies should be welcome by EU taxpayers, since there is no real apparent willingness of the Council to reform this aspect of the CAP.

However, simulations show that the ending of export subsidies in a short run, without any other measure would have large consequences on domestic prices in sectors such as dairy, where demand is inelastic. If the quantities presently exported were not taken out of the domestic market, producer prices would fall dramatically. That is, ending export subsidies would only be possible with a decrease in the milk and sugar quotas, and with incentives (lower prices or more decoupled payments) to lower production in the beef sector. This can be only part of a larger reform package.

¹⁰ In addition, a special procedure makes it possible to fund exports of processed products that include raw material benefiting from high internal prices. This fund (called budget outside Annex 1 of the FEOGA) makes it possible to subsidize exports of processed products including grains, rice, sugar, dairy products and eggs. The amount of refund depends on the share of the supported raw material, but also of the final use of the product.

Tariffs. Large amounts of agricultural goods enter the EU with limited or zero duties (coffee, oilseeds, feedstuffs under the general regime of most favored nation tariffs; sugar, beef, pigmeat under preferential agreements; dairy products under tariff rate quotas). However, several important commodities face high tariffs, at least outside preferential agreements and quotas (see the section on trade issues). Although they contribute to the creation of deadweight losses by pulling resources towards processing sectors, tariffs are transparent instruments for trade partners, and have the advantage of providing resources to the EU budget. The main problem with this instrument in the EU is the cost for the consumer. If demand is relatively inelastic, deadweight loss are limited and tariffs can be a decent second best instrument for transferring income to producers. However, in the EU, the overall tax on consumers is considerable. The OECD has calculated the monetary value of the transfers paid by consumers of agricultural products. These transfers, which can roughly be considered as extra costs caused by the CAP to consumers (even though the assumption that consumers could access products at the reference price without the CAP is an heroic assumption) amount to 52.8 billion euros in 2001. The implicit consumption tax is therefore significant.

Direct payments. Direct payments are now a major CAP instrument in both the arable crops and the beef sector. Most economists believe that this is a more efficient way to transfer income to farmers than measures that affect prices. However, in the case of the arable crops, payments are still conditional to production. They are provided on a per hectare basis, and the degree of decoupling between the actual output and the payment introduced by using reference yields rather than observed yields is limited. There has been no decline in yields observed since the 1992 reform in the cereal sector. Because the guarantee of a payment for arable crops limits uncertainty in income, they still contribute to draw resources in this sector, compared to more risky productions. In a region where the total area of crops and set-aside land on which area payments are claimed exceeds the base period area, then all payments claimed are scaled back by a corresponding percentage and an additional area of uncompensated set-aside is imposed in that region in the following year. While this introduces an effective limitation at the regional level, at the microeconomic level, producers have little incentive to reduce their acreage devoted to arable crops. Direct payments in the beef sector are paid per head of animal and still set incentives to produce up to the payment ceiling.

That is, the present scheme of direct payments still encourages the production of surplus. It also encourages intensive practices that are damageable to the environment (even though it is less the case than the previous system). Direct payments also capitalize into asset prices such as land. This contributes to erecting barriers to entry for new farmers, and to the dilution of farm support into transfers to non-farmers.

If compensatory payments are an effective way to smooth reforms in sectors where sunk costs are high, human capital is specialized, there is no particular reason for permanent compensation in a sector that should adjust like every other economic sector. The fact that the CAP "compensatory" direct payments are provided to newcomers is questionable. Direct payments are often criticized because they benefit disproportionally to larger farms. Even though they are now more transparent, they only replace a system that also had unequal effects in terms of the distribution of support. Another problem with the present system of direct payment is their complexity. They are seen by farmers as very time consuming, and generate large administrative costs. The scheme for beef, for example, is particularly complicated (to say nothing about agri-environmental and rural development payments). This makes fraud a major risk, and control costs could become large if more support is provided through direct payments in the future.

Production quotas. Quotas have solved the problem of milk surplus, and have made it possible to manage the sugar market in a smooth and relatively non controversial way, with little cost for the EU budget. Quotas do not involve large distortions on the producer side, by capping the resources drawn "artificially" in the protected sector, and the deadweight loss on the consumer side is limited in the case of products such as milk and sugar, whose demand is inelastic. Quotas with guaranteed prices provide a predictable environment for producers. They are therefore attractive instruments for policy makers.

However, in the case of the EU production quotas, the system suffers from major drawback. First, transfers of quotas are limited, which prevents a reallocation to least cost producers. In the case of milk, the positive side is that this makes it possible to maintain production in mountain areas, arguably a policy that provides some positive externalities. In the case of sugar, the argument is not valid, and economic efficiency could be improved by allowing more transferability of production rights. Second, because of the relatively high in-quota prices, a rent is associated to production rights, which capitalizes into land (when quotas are not transferable, such as sugar) or into the price of quota rights (when quotas are transferable such as milk quotas in some EU countries). In both cases, income support become support to an asset, and a share of it leaves the farm sector (high rents to owners of land with quotas; compensation to other family members in the case of inheritance). Therefore, the system of quotas could be more defensible if the rents were lower. This would require a decrease in production prices for quantities under quota. Third, and perhaps more important, the political decision making in the EU is such that when a quota is introduced, quantities are set most of the time on the basis of past production. Not only this is questionable from the point of view of economic efficiency (supporting inefficient production of sugar in Portugal while preventing French and German producers for expanding their quota increases the overall production costs of EU sugar). It also locks the EU into a regime of quotas whose suppression would have large asset price effects, and require compensations.

[Insert Figure X: land prices inflated by sugar quota rights in France]

Set-aside. The set-aside scheme was introduced to limit production whose disposal required large export subsidies. However, this is hardly a satisfactory solution from an economic point of view. There are environmental benefits for the flora and fauna, but they are more significant with permanent set-aside than with rotational set aside. More generally, taking a plot out of production while other plots are stuffed with fertilizers and other chemical inputs to boost yields is close to economic nonsense. A mandatory set asides moves supply curves upwards, and this creates deadweight losses. In the case of an exportable good, removing quotas and lowering guaranteed prices lead to two types of collective gains : a surplus component caused by a more efficient supply curve, and surplus for producers caused by export opportunities (see Bureau and Bureau, 1999).

However, the set-aside could not be abolished without a significant reform of the arable crop CMO. The set aside acts as a measure that limits the production incentive effects of direct payments that are so far tied to output. Again, abolition of set-aside can only be part of a larger reform package.

3.5 The CAP and the environment

3.5.1 The main instruments

Environment has only recently become a major concern for policy makers. In some member states, such as France or Spain, the government is still very latitudinal with farmers. Regulations on groundwater pollutions by nitrates and pesticides are still very lax, an issue raised on a regular basis by the various national and European courts of auditors. While in Northern Europe, citizens have long put political pressures on government for a larger application of the polluter-pays principle to farmers, the waking up of public opinion is recent in highly polluted regions such as French Brittany (pig manure), or wine growing regions in Spain and Italy (pesticides).

In the 1960s and 1970s, the CAP was mainly designed to increase production or farmer's income. The structural policy of both the EU and member states encouraged measures which had a questionable impact on the flora and fauna. It is only in 1985 that a regulation authorised member states to introduce national subsidies to environmentally friendly practices in sensitive areas (Council regulation 797/85). Such

measures became eligible for partial funding from the FEOGA. However, in 1990, the funds for agri-environmental measures from the EU budget were limited to 10 million Ecus, showing how minor this policy was compared to market support measures (see Table 9.).

The 1992 agri-environmental policies. The 1992 reform introduced some "accompanying measures", including a scheme for pre-retirement of farmers, and two agri-environmental measures. Regulation 2078/92 (CEE) introduced some aid to production methods compatible with the protection of the environment. Regulation 2080/92 (CEE) introduced some payments for agro-forestry, in order to encourage plantation of trees on farms, including for the storing of carbon dioxide.

The scheme of agri-environmental measures states that aid can be provided to farmers who undertake :

- to reduce substantially their use of fertilisers and/or plant protection products or to keep the reductions already made, or to introduce or continue with organic farming methods;
- to adopt a more extensive forms of crop, including forage, production or to maintain extensive production methods introduced in the past, or to convert arable land into extensive grassland;
- to reduce the proportion of sheep and cattle per forage area;
- to use other farming practices compatible with the requirements of protection of the environment and natural resources, as well as maintenance of the countryside and landscape, or to rear animals of local breeds in danger of extinction;
- to ensure the upkeep of abandoned farmland and woodlands;
- to set aside farmland for at least 20 years with a view to its use for purpose connected to the environment, in particular for the establishment of biotope reserves or natural parks or for the protection of hydrological systems;
- to manage land for public access and leisure activities.

Because the EU environmental policy is much more decentralized than the agricultural policy, subsidiarity was largely used in the definition of these programs. Member states elaborate projects, often at the local level, with a control from the national ministry of agriculture, and submit them for approval to the Commission on the advice of a special committee (the Agricultural and rural development structures, or "STAR" Committee) composed of member states representatives. Payments are provided on a per hectare or per animal basis, and are normally supposed to compensate for the extra costs caused by the protection of the environment, or for the decrease in yields. These payments are jointly funded by the national government and by the EU, in a proportion of respectively 25% (national) and 75% (EU) in less favored areas (the so-called "Objective 1" regions) and in a proportion of 50% in more prosperous regions. A ceiling payment at the EU level is set for several types of measures, depending on the crop which they apply.

The 1992 agri-environmental measures have been a significant inflexion of the CAP, even though the budgetary outlays are small, compared to the classical CAP instruments. It is the first significant effort for subsidizing not only agriculture as a source of production, but also as a source of amenities. The subsequent Agenda 2000, and the concept of "second pillar" have extended this idea.

The Agenda 2000 and the environment. The Agenda 2000 reform package introduces a rural development pillar to the CAP with more emphasis on environmental respect. It establishes a link between basic environmental protection requirements and direct support payments to producers with eco-conditionality as a principle. Member States are required to take appropriate environmental measures in view of the agricultural land used or the production concerned.¹¹ Again, large latitude is left to member

¹¹ More specifically, the measures aim to : strengthen the agricultural and forestry sectors by trying to promote quality agricultural products; help installation of young farmers; improve the competitiveness of rural areas with the aim above all of improving the quality of life of rural communities and creating new sources of income for farmers

states in conditioning support to the respect of environment and in deciding appropriate sanctions. Sanctions to producers for non-respect of environmental requirements include reduction or cancellation of support payments. Support not paid to producers in this way shall be channelled into the member State's rural development programme.

In addition, member States will have to draw up comprehensive national or regional programmes from a menu of possible measures, of which agri-environment is a compulsory element. Among these measures are enhanced environmental possibilities for the training of farmers, for support in less favoured areas and notably for forests of high ecological value. Within the market regimes, more support for extensive beef production is envisaged and there are opportunities for Member States to use some funding to favour more environmentally beneficial production methods in the beef and milk sectors. Farmers expected to observe basic environmental standards without compensation.

Additional environmental services can be remunerated through reinforced agri-environmental measures. Member states can provide extra payments on a per hectare basis, to farmers who subscribed agri-environmental contracts under the 2078/92 regulation, provided that the scheme is renewed for at least 5 years and environmental benefits are increased. To improve integration of environmental objectives in the common market organisations, the new reform enables Member States to make direct aid payments conditional on compliance with environmental provisions.

In addition to curbing CAP arrangements towards more environmentally friendly practices, the new Structural Funds regulation also reflect more emphasis on environment protection and improvement. (the environment is now included among the objectives of the structural funds). Environmental assessment, the principle of conformity to community law and policies, the polluter-pays principle are now procedures and principles that must be applied to large projects financed by structural funds. New instruments to ensure the effective integration of the environment in the programmes were created, like the adjustment of participation percentages according to the environmental interest of the actions to be funded.

Overall, under the Agenda 2000, the average annual expenditure on agri-environmental programmes is scheduled to increase by 68% from 2.2 billion euros per annum in the late 1990s, to 3.7 billions per annum over the 2000-2006 period.

3.5.2 The effect of the CAP on the environment

Some of the most damaging agricultural pollutions occur in the less protected sectors, such as pigmeat (manure and nitrate pollution) or fruits (contamination of rivers by pesticides). However, CAP instruments have also contributed to the negative effect of agriculture on the environment. The main economic mechanism at stake is simple : a rational producer uses intermediate inputs up to the level where the marginal costs equals the marginal revenue, i.e. the unit price. By supporting prices, the CAP has long induced a quest for high yields per hectare, which were obtained by extra use of fertilizer and pesticide. This has resulted in water and soil pollution which has destroyed important ecosystems. Over use of aquifers for irrigation purposes in Europe is responsible both for the depletion of some traditional sources of water for human consumption, erosion, and for salinization, a problem particularly important in southern Europe. Among the other environmental developments accelerated by the CAP price policy are the effects of the changes to the countryside brought about by the intensification of agriculture. The

and their families; preserve the environment and European rural heritage via agri-environmental measures such as organic farming. To help the further 'greening' of the CAP, the traditional compensatory allowances in support of farming in less-favoured areas will be extended to areas where farming is restricted by the existence of specific environmental constraints. Member States must, however, ensure that farmers are able to demonstrate that they do not exercise activities solely for the purpose of obtaining the benefit of support payments.

destruction of hedgerows, stone walls and ditches and the draining of wetlands have contributed to the loss of natural habitats for many birds, plants and other species.

In some cases, there is a direct link in the arrangements of a particular CMO and environmental degradation. For example, the regulation on wine, with premiums for the uprooting of vineyards, often results in erosion by leaving the soil uncovered (see the report by the Court of auditors, ECA, 2000). The limitation of the acreage devoted to grains and oilseeds without imposing any constraints on other arable crops benefiting from direct payments (e.g. linen) act as an incentive to grow arable crops on areas formerly devoted to permanent grassland. Export subsidies in the pork and poultry sector, because they increases prices, are a major incentive to the development of an intensive and polluting industry. The program for dried fodder includes specifically a subsidy for using fossil fuel : in a country like Spain, where most of the fodder was dried naturally, this program has led to replace the sun by petrol and gas. According to the Court of auditors, this has led production of foddered dried with fossil fuel to increase from 61 000 tonnes to 1 440 000 tonnes over 10 years, requiring fuel that corresponds to the consumption of a city of 285000 inhabitants.

There are also less direct effects. For example, capitalization of rents in land prices has modified the relative price between land and intermediate inputs and has encouraged intensification. By stabilizing prices, the CAP has favored specialization in a particular enterprise, which proves more damaging, locally, than a system of polyculture and livestock. Regions where productions has been concentrated have lost habitats for wildlife, biodiversity, and landscape was deteriorated. The support to arable crops, together with unfortunate structural policies, have led to the replacement of permanent pasture and the disparition of hedgerows and marshes (see Mahé and Ortalo-Magné, 2001 for a deeper analysis).

The European court of auditors has recently provided a comprehensive assessment of the environmental effect of the CAP (ECA 2000). The Court points out the negative effects of the common market organizations on the environment, stressing the water pollution due to nitrates ("an alarming problem"), and the irreversible depletion of soils du to the impoverishment in organic content. Other issues involve the contamination of groundwater by pesticides, especially in the fruit, vegetable and wine areas, but also in areas where corn is grown intensively. The Court also stressed that the CAP itself has done little to mitigate the negative environmental impacts : most of the measures that were taken in order to reduce the use of fertilizers were taken by a few national government rather than at the EU level.

In an assessment of the effects of the CAP, the European agency for environment concludes that, while it was supposed to go in the right direction for reducing pollution, by reducing output prices, the 1992 reform has not had a visible incidence on the use of fertilizers and pesticides. The reason is the subsistence of incentives for intermediate input intensive production, and the fact that direct payments were still linked, at the microeconomic level to output: the use of fertilizers per hectare in the grain sector has actually increased after the 1992 reform (EAE, 1999 p 57). Regionalization of the reference yields for direct payment, and specific yields for irrigated areas have maintain a link between input intensive production and higher payments. The mandatory set aside, implemented in 1992, has not been accompanied by measures that would make sure that the soil would be protected (some countries including France and Germany have not enforced dispositions on the environmental aspect of set-aside). While permanent set-aside has a positive impact on flora and fauna, rotational set-aside was often encouraged by higher premia. In the beef sector, the limitation of the premia to a certain number of animals per hectare has not resulted in incitations for a more land intensive production, since this premium could still be obtained even if the density is much larger and includes (non eligible) animals¹². The fact

¹² A direct payment is given per head of cattle, up to a limit of 2 bovine unit equivalents (UGB) per hectare. In addition, a premium for extensive production is given if the stocking density is less than 1.4 UGB/ha. Until Agenda 2000, farmers often declared only a small number of animals when it was profitable to obtain both payments. Since Agenda 2000, the payment of the extensification premium is conditional to a density based on the total number of

that silage corn, a production that is particularly damaging to soils (erosion) as well as groundwater (pesticides) has been eligible to arable crop payments is clearly a subsidy to pollution.

As underlined by the OECD (2002), while agri-environmental measures, and rural development in general, are the "second pillar" of the CAP, these measures are implemented in conjunction with policies that are damaging to the environment, such as market price support. These policies increase the costs of improving environmental quality. The failure of some EU member states to implement the "nitrates directive" raises concerns as to compatibility of agri-environmental measures with the polluter pays principle to which the EU has committed to some 25 years ago.

3.5.3 The effect of agri-environmental measures

The adoption of the Regulation 2078/92 started a significant change in the orientation of the CAP, even though the EU budget devoted to agri-environmental payments has remained small. By 2000, 17% of the agricultural surface of the EU was involved in agri-environmental measures. The evaluation of several regional programmes have shown that well designed and well managed schemes could have a positive impact on the environment. The well-known MEKA program in Baden-Wurtemberg (Germany) or the OPÜL program in Austria have significantly modified production methods in a sense that benefits to the environment. The latter program, for example, offers a menu of 25 measures that aim to encourage extensification of animal production, support sustainable farming in less favored areas, diversify the rotation system and support organic farming, on a voluntary basis. Participating farmers receive a payment per hectare. In 2000, 20% of the farms targeted participated to at least one of the measure offered under the program, and the OPÜL was the largest public program directed to farmers in Austria (amounting to 36% of direct payments provided in Austria). Even though the size of the program raises suspicion as to the motivations of the Austrian government (Austria multiplied environmental programs after accession to the EU, which resulted in a fall in producer prices and many observers thought that the measures were used as a way to compensate farmers from loss in income), the effect on environment is considered as positive. Austria is, for example, the EU country with the largest share of farmers (7.5%) involved in organic farming.

However, other assessments of the agri-environmental programs have shown the limitations of the scheme.

First, the 2078/92 regulation appears too limited to curb the negative effect of the CAP on the environment. The measures implemented under this regulation are not constraining, let alone consistent with the polluter-pays principle : polluting farmers are subsidized to pollute less. In many cases, the scheme works so that they are provided money for keeping existing techniques, e.g. for not polluting more.

Measures must be approved by the Commission, but are defined at the local level and implemented at the member state level. The European court of auditors has stressed the poor control of the Commission on the effectiveness of the measures co-funded. In several cases, the Commission has approved measures that have not a clear environmental objective. For example, the French program of subsidizing all cattle farms that have a low stocking density has primarily an income support objective. The Finnish program of subsidizing forestry is also suspected to be more production oriented than environment oriented. Criteria for attribution are sometimes lenient. This makes it possible for regions and member states to obtain some funding from the EU for measures whose environmental interest is questionable. Finally, the Court has found many cases where there is little evidence that the objectives for which agri-environmental payments were provided have been fulfilled and many cases where a thorough audit showed that the payments far exceeded the costs incurred by the constraints.

animals presents on the farm. Nevertheless, the standard direct payment can still be perceived even if the total density exceeds 2 UGB/ha, even though it is only given up to this ceiling.

Box 5. The French extensive grazing scheme

France has used the arrangements of the 2078/92 regulation in order to implement a premium system aiming at maintaining extensive systems. The premium of FF300 (Euros 46) per hectare is provided to producers whose livestock density is lower than 1 Livestock Unit (LU) per hectare, or 1.4 LU if grassland represents more than 75% of the total farm acreage. This measure has made it possible to limit the decrease in extensive grazing production techniques. However, farmers were not subject to new constraints, except that of not shifting to more intensive production techniques, and the measure can be seen as assistance to farm income rather than a true environmental measure. This measure accounts for 75% of the total agri-environmental budget in France, and one may consider that it uses resources not available for more local operations on more ecologically sensitive areas.

However, the main limitation is perhaps that the effect of this agri-environmental scheme is offset by other policies that the French ministry of agriculture has pursued in a very active way. Indeed, France was one of the main country to push for the eligibility of silage corn to the arable crops payments, and to the renewal of this measure in the Agenda 2000. The result is that extensive producers face a very simple choice : opt for an extensive grazing system with a 46 euros per hectare, or opt for an extensive system, with a premium for silage corn six times higher.

Similar contradictions can be raised with the male bovine premium that encourages intensive livestock production, or the specific reference yield for irrigated corn, which encourages irrigated corn. All these policies make environmental measures useless and costly. The French court of auditors has raised the issue of the 1.2 billion euros spent to help farmers to limit pollution. Not only such aids are in complete contradiction with the incentive role of the Polluter pays principle (to which France subscribed as other OECD members some 25 years ago). But the effect of such payments are annihilated by measures that encourage concentration of pig production in some areas. Indeed, France, as other EU member states the EC for failing to prevent water pollution by nitrates, and to comply to a EU directive, proving that the farm lobby keeps to have a strong influence at the national level and manages to delay the implementation of EU legislation.

The European court of auditors has underlies the uneven allocation of the EU budget. For example, while Greece and Austria have a similar surface but Austrian farmers have received 80 times the agri-environmental budget. While Greece and Spain have dramatic problems of water pollution, overgrazing and erosion, more money is allocated to these questions in Germany and Austria. Austria, with a tradition of protecting the environment, has absorbed 21% of the EU expenditures on agri-environmental measures on only 3% of the total EU agricultural surface over the 1993-1998 period.

[Insert Table 16.]

Differences in the degree of concern across countries are not the only explanation these discrepancies. Bontems and Bureau (1996) have stressed the large differences in terms of payment per hectare that exist between countries : for a set of measures that seem relatively similar, a producer in Luxembourg can receive more than 8 times the level of support than a producer in Spain. They have also pointed out that constraints vary a lot across countries, and have raised the suspicion that a national government could impose lax technical constraints, given the fact that a large share of the budget comes from the EU, at least in Objective 1 regions. In such a situation of "collusion" between producers and national authorities, the environmental impact of a given budget is clearly not maximized.

The agri-environmental scheme is certainly not the aspect of the CAP that deserves more critiques. Even if, in practice, it is often a way to provide money to farmers, at least it does so without encouraging more pollution and excess supply, as do other CAP instruments. However, the decentralisation of the

policy at the local level might lead governments to use agri-environmental schemes mainly to subsidize their farmers, and to capture a share of the EU budget. The difficulty of monitoring and control in this area are tremendous : without a thorough (and costly) audit, it is difficult for a central agency like the Commission to make sure that payments correspond to extra costs incurred and that environmental objectives are fulfilled. The modest impact of the agri-environmental scheme point out the difficulties to reform the CAP in a way that would focus more on environment and amenities.

3.6 The CAP and rural development

A growing attention paid to structural policy. Rural development has often been a vague but convenient term that has been used to include a variety of policy measures. As no clear definition seems to exist, we will consider that the term includes structural policies as well as policies that focus on economic development in rural areas, not necessarily tied to agricultural production.

While little attention was paid to these aspects in the first period of the CAP, it has become clear that a modernized agriculture, with farms large enough to provide sufficient returns to family labor for a farmer to live, would not be compatible with the objective of maintaining a large rural population. The decline in the farm population had cumulative effects in some areas, leading to closing schools, public services, which themselves made these regions less attractive. Supporting infrastructures and activities that are not directly linked to production is seen as a way to revitalize the countryside and generate public goods.

In the early stage of the CAP, structural policy budgets (the "Guidance" section of the FEOGA) and budgets devoted to environment or non agricultural activities for farmers were minimal. In 1972, three socio-structural directives were mainly targeted to improve the productivity of the agricultural sector (development plans, early retirement scheme, education and training of farmers). A 1975 directive on mountain and less favored areas made it possible to provide payments for maintaining farmers in areas where they were considered as providing positive externalities. In 1985, a regulation on the improvement of structures shed a light on new concerns such as forestry or agri-environmental payments. In 1986, the single European act introduced an "Economic and social cohesion" title into the Treaty of Rome, involving in particular that attention should be paid to remote rural areas. In 1988, the reform of the structural funds, and the publication by the Commission of a document on the "Future of rural society" initiated a change in the vision of agriculture as a sole provider of commodities. This corresponded to a growing awareness in the public opinion of the negative effects of the intensive agricultural production on the environment and on the fact that market price instruments that concentrated support on a small share of producers did little to maintain a large rural population. The 1992 MacSharry reform of the CMOs was accompanied by measures targeted to environment and early retirement program. But these actions remained limited until the 1996 Cork conference on rural development, that triggered a significant inflexion in the role devoted to the CAP.

The Cork declaration lists ten points that should structure rural policies, including integrated approaches, sustainability, subsidiarity and adaptation to local situations, etc. In 1997, the Luxembourg European Council stated that EU agriculture should be "multifunctional", sustainable, and scattered on the whole territory in an harmonious way. The Commission made a number of proposals in order to shift some of the CAP resources towards new objectives, such as ensuring the safety and quality of foodstuffs, guaranteeing fair and stable incomes for farmers, and assessing a variety of functions to agriculture. Encouragement for complementary or alternative activities productive of new jobs in the fields of rural tourism and sporting or cultural leisure, services for SMEs, services linked to new technology, environment-related trades were emphasized as means of strengthening the economic and social fabric of rural areas and slowing migration to towns and cities.

Rural development, the "second pillar" of the CAP. The Agenda 2000 laid the foundations for a rural development policy which supplements market-focused policy, became known as "the second pillar" of

the CAP. In spite of its limited budget share, the expression intends to show that rural development is now considered to be of equal importance to market support in the CAP.

The "rural development" regulation, which came into force in 2000 places emphasis on the multifunctional role of agriculture and forestry, on the environmental aspects and on an integrated approach to the rural economy through multisectoral development. All rural development policy was put into a single regulatory framework (Regulation 1257/99). The regulation includes the simplification of regulatory controls and modified the relative attributions of the "Guarantee" and "Guidance" sections of the FEOGA. The reform moved towards decentralisation of aid management and stricter application of the principle of subsidiarity. The executive responsibility over programming and implementation is devolved to member states.

Because they put together a large set of existing measures, the actions covered by the "second pillar" of the Agenda 2000 are indeed multiple. Rural development measures include: aids to investment and settlement of young farmers; training ; early retirement; support to less favored areas and areas subject to environmental constraints; agri-environmental measures; forestry; improvement of processing and marketing of agricultural products in rural areas; aids to the adaptation, development and diversification of rural areas (Article 33 measures).

To a large extent, national authorities can choose options in a menu of policies proposed by the Commission. Only agri-environmental payments are a compulsory part of rural development measures. That is, national governments may apply those more appropriate to local conditions, including aid to less favored areas, afforestation of agricultural land, aid to young farmers, early retirement programs, training, aids to marketing and processing, aids for forestry. In addition to agri-environmental measures, a menu of policies specifically provides aids for :

- land improvement
- reparation
- setting up farm relief and farm management services
- basic services for the local economy and rural population
- renovation, development and protection of the rural heritage
- diversification of activities to provide alternative incomes to agriculture
- agricultural water resources management

In 2000, agri-environmental measures accounted for 50% of the expenses under the 22 rural development measures for which EU support is offered. Measures under objective 1 (see Box 6) are 75% co-funded by the EU, while other measures the rate is 50%.

Structural funds. The Agenda 2000 has also rationalised the way EU structural funds operate, and have limited to 3 objectives the list of priorities (see Box 6). The population that is covered by structural funds now covers 40% of the EU (instead of 51% previously). Most measures related to rural development are funded from the FEOGA guarantee section in regions other than Objective 1. In regions designated as Objective 1 regions (the least developed areas of the EU) budgets come from the guidance section of the FEOGA as well as other structural funds.

As part of the action financed by structural funds, the EU has implemented "initiatives". Two of them, the LEADER initiative, which aims at supporting coordinated actions for the development of regions, and the INTERREG initiative, focusing more on cooperation between regions, have a rural development content. Under Agenda 2000, the new initiative LEADER + aims to encourage and support a series of small scale pilot approaches to integrated rural development at local level in selected rural areas throughout the European Union.

Box 6 : Structural funds and rural development policy

Structural funds account for 35% of the EU budget. Total expenditures on the structural funds are scheduled to amount to 213 billion euros for the six years period 2000-2006, an amount that could be revised with the accession of new member states. These funds involve considerable transfers between member countries. They proved particularly important elements for the cohesion of the Union, for easing reconversion of some particular regions, and for helping economic development of some regions lagging behind. It is admitted that transfers from the EU through structural funds have played a major role in the development of countries that have caught up with the rest of the EU such as Ireland and Spain, during the last 20 years.

The 2000 reform of the structural funds set three priority objectives (rather than six in the past)¹³. Objective 1 is to promote the development and structural adjustment of regions lagging behind as well as that of most remote regions; Objective 2 contributes to social conversion of regions having structural difficulties other than those eligible for assistance under the new Objective 1; Objective 3 covers all the measures for education and training outside the regions eligible for Objective 1. There are also four "initiatives" for the period 2000-2006 (INTERREG, URBAN, EQUAL and LEADER) which are funded by structural funds.

Since the 2000 reform, rural development measures are mainly funded by the FEOGA Orientation section (which is one of the structural funds) and by the FEOGA Guarantee section. Previously, the Guarantee section only funded the CAP accompanying measures (agri-environmental and forestry payments) and market intervention. Now the Guarantee section funds all rural development measures in regions that are not under objective 1, as well as the measures relative to agri-environment and forestry, early retirement, aid to less favored regions and those subject to environmental constraints (even in Objective 1 regions). The Guidance section funds all other rural development measures in Objective 1 regions. The reform therefore results in a shift of the support to less favored areas and most structural policy measures to the Guarantee section.

The LEADER initiative is designed as a model programme for the support and development of local rural development initiatives, with the aim of setting up a Community network of local action groups to further transfer of skills and exchange of experience. Under the first two LEADER initiatives (1990-99) rural communities have benefited from funding of initiatives to stimulate the development of local economy. The new initiative, LEADER+ is funded by the FEOGA Guidance section.

Other structural funds than the Guidance section of the FEOGA also contribute to rural development but in a more indirect way, through larger social and structural policies. The European Regional Development Fund finances objectives 1 and 2 and initiatives INTERREG and URBAN. The European Social Funds finances objectives 3, as well as some of the policies under objectives 1 and 2, and the initiative EQUAL. The Financial Instrument for Fisheries Guidance finances the common fisheries policy.

How serious is the reorientation of the CAP towards the "second pillar" ? The use and abuse of the word "multifunctionality", and the thousand of less-than-compelling pages written on "rural development" could raise legitimate questions on the relevance of the concepts. Speeches from EU members delegations in international fora have sometimes given the impression that so-called "non trade concerns", the protection of the environment or the amenities associated with agriculture are used as a reason or an excuse for government intervention.

As far as budget expenditure is concerned, the sum of rural development measures funded by the Guarantee section of the FEOGA amount to an annual average of 4.3 billions euros (at constant 1999 prices) over the

¹³ Because former programmes applied to 7 objectives, it might be useful to explain changes in the denomination of structural policy. The Agenda 2000 consolidation of objectives implies that the new objective 1 includes former objective 6 measures, while objective 2 includes the former objectives 2 (reconversion of areas affected by industrial decline) and 5b (promotion of the development of rural areas); the new objective 3 includes former objectives 3 (fight long term unemployment) and 4 (ease insertion of youngsters on the job market).

2000-2006 period. This includes the agri-environmental, forestry and early retirement measures, as well as the support to less favored areas, training, marketing, infrastructure, etc. This figure does not include funding by member states. Rural development measures under Objective 1 (funded by the guidance section of the FEOGA) must also be taken into account. Altogether, the OECD estimates that the budget devoted to rural development (in a broad sense) amounts to 15 billion euros a year, excluding the LEADER+ initiative financed by Member states and the Guidance section (the EU contribution is scheduled to be 2 billion euros for the 2000-2006 period). Altogether, if one considers as "rural development" a variety of heterogeneous measures that range from structural policies that aim to increase farm productivity to agri-environmental measures and aid to small processing industry, the "second pillar" of the CAP now represents a share of the CAP budget that is no longer laughable.

However, if there is now a strong impetus from the Commission as well as from some member states to curb the CAP towards rural development and the protection of the environment, the most influential farmer's organizations largely oppose significant shifts of the budget from the first to the second pillar. Because a significant shift in policy might involve a significant redistribution of the CAP budget between member states, to the expenses of those countries such as France, that benefit most from the large transfers to arable crop producers for example, there is still opposition in the Council. The accession of new members is likely to redistribute the budget between member states and erode some of the transfers to countries benefiting from the first pillar. This is perhaps the opportunity for a deeper orientation of the CAP towards the second pillar.

3.7 The CAP and the consumers

The costs of the CAP for consumers. When facing criticisms about the high price of agricultural products, the poor record of the CAP on the environment, defenders of the CAP point out that this policy has provided food security, ensured to consumers the availability of a wide range of foodstuffs throughout the year. They also point out that most of the food items whose consumption has grown over the recent years are gourmet food, organic food, or processed products such as sophisticated dairy products and fruit juice, which are actually the more expensive goods, suggesting that food prices are not the issue in the EU. Finally, they provide evidence (although mostly anecdotal) that the decrease in production prices for commodities such as beef has had no noticeable impact on the final price paid by consumers, because of the share of the processing and marketing margins in the final product, and the lack of competition in the retailing sector that has managed to keep most of the rents.

As a free-trade area, the CAP has benefited the consumer by increasing the number of product varieties that could circulate within the EU without custom duties. It is noteworthy that a Danish consumer has been able to enjoy free access to Italian specialty products for 40 years, while, in 2002, there are still obstacles for importing a car from another EU country. This brought impressive changes in consumption patterns. Olive oil, which was consumed only in the Mediterranean fringe of the EU, is now widespread. The impact of a larger variety of products on consumers' welfare is difficult to measure, but is not questionable.

There is little doubt that supported prices and external tariffs have contributed to higher prices of food for consumers. This is particularly obvious in countries that applied lower tariffs before joining the EU, like the UK and Sweden, and where consumers suffered from the adoption of the community preference. The OECD figure of 56 billions euros transferred from consumers to producers due to supported agricultural prices in 2001, shows a decrease from the 73.5 billion euros in the mid 1980s, in current prices. This reflects the fall in intervention prices of arable crops and beef decided under the 1992 and 1999 reforms. The overall cost for consumers is still high, amounting to some 600 euros per household in the EU. These results must be taken with caution, though. The OECD results, derived from a crude approximation of transfers in a partial equilibrium context, cannot seriously be taken as an estimate of the gains that consumers would make if there was no agricultural policy. Ritson (1997) clearly explains why such an approach exaggerates the costs, even though he concludes that the burden for consumers is significant.

The price stabilization argument. Arguably, consumers benefit from more stable prices under the CAP than what they would experience without it. Indeed, world prices of most commodities show large fluctuations. With the progressive trade liberalization, which is likely to lead to a concentration of production in least costs regions, it is possible that this variability increases in the future. Because producers face less administrative prices, their price expectations could also be more unpredictable and amplify short term variations. It is well known that price instability can be damageable to consumers since producers ask for a risk premium that increases the average price paid by their customers, compared to the certain equivalent. From that point of view, the stabilization effect of the CMOs benefits to consumers. In some areas such as fruit and vegetables, many economic textbooks describe the positive contribution of price stabilization policies on consumers' surplus as a justification for the withdrawal and destruction of surplus production in certain periods.

However, price stabilization only benefits consumers if the guaranteed price lies within the range of (unregulated) market prices. If they always pay a higher price, the stabilization only "protects" them from possible welfare gains. From that point of view, the guaranteed producer price of wheat, sugar in the EU has seldom be lower than the world price. Over the last 20 years this occurred only 3 times for sugar, and once for wheat. It has never occurred for beef or butter, for example.

[Insert Figure 2 : fluctuations of the world price of sugar, wheat, beef, and EU producer price]

Productivity gains have been particularly large in the agricultural sector (OECD 1995). The CAP has not prevented these gains to be passed to consumers. The examination of the formation and repartition of productivity gains in agriculture shows the contribution of the sector to the decrease in real prices. Bureau et al (1991) have used surplus accounting methods to see how much of the value generated by technical change was transferred to consumers and to the upstream sector, and how much were kept by farmers as returns to self-employed labor and to their own primary factors. They show that, while during some short periods some of the benefits of productivity gains in agriculture were passed to input suppliers (through higher prices of fertilizers or machinery), some to landowners (through higher rents), most of the gains were passed to the downstream sector, through lower output prices. This occurred even under the guaranteed prices that limited the fall of farm gate level prices in real terms. Recent updates confirm that the agricultural sector has contributed in a positive way to limit consumer's expenditures by passing most of its productivity gains to the downstream sector through lower output prices in the 1990s (see Box 7). Part of these transfers can be directly imputable to the CAP: by liberalizing trade within the EU, it has encouraged the reallocation of some products (at least those that are not subject to national quotas) towards least cost production areas. France now imports strawberries and peaches from Spain, and export potatoes. This has contributed to the fall in consumer prices.

Box 7 : Pass-through of agricultural productivity gains to consumers

The agricultural sector experienced a larger increase than most sectors in total factor productivity. In the 1970s, the productivity gains took the form of large production increases, while in the 1980s, a significant share of the gains was caused by a decrease in input use, in particular in a decrease in labor. In both cases, this generated a "productivity surplus". Bureau et al (1991) attributed a monetary value, in purchasing power standards, to productivity gains which generate either increased output or lower input use. Then they used relatively sophisticated index number techniques to study the repartition of these gains through changes in input prices, output prices and returns to fixed factors.

They showed that, for first EU members, all the monetary value of productivity gains in the farm sector between 1967 and 1990 were passed to other sectors, and were not kept as extra returns to fixed factors such as self-employed labor, i.e. as extra agricultural income. In the 1970s, some of the gains were passed to the upstream sector, in

particular through the increased prices of fuels and fertilizers. However, after 1977, most of the gains are passed to consumers through lower real output prices.

This study has not been updated for the whole EU, but figures for France show that, in the 1990s, the productivity gains in the farm sector, together with a decrease in price of some inputs such as fertilizers, have benefited even more than in the past to consumers. Indeed, the successive CAP reforms have led to larger decrease in output prices. For example, the price of beef experience an average 2.7% decrease per annum in the 1980s, but by a 4.7% in the 1990s, the price of milk respectively 0.8% and 1.5%, the price of pigmeat respectively 3.2% and 4.5%. However, unlike the 1970s and 1980s, transfers from taxpayers compensated integrally the value of productivity surplus passed to consumers. That is, the 1992 CAP reform direct payments resulted in an increase in agricultural income. One can consider that over this period, farmers "kept" their productivity gains as extra income, or more exactly, that these productivity gains were passed to consumers, but given back to farmers by taxpayers (see Butault, 2000).

The CAP and product quality. The CAP has had ambiguous effect on the quality of products. Indeed, by encouraging bulk production, the intervention system has sometimes led to massive quantities of products of low quality. The intervention system still contributes to the production of surplus of low quality wine that find no buyer and low quality wheat that sells poorly on the world market.

The EU legislation contains many texts designed to ensure the safety of food products, and to promote food quality. Over two decades, most legislations regarding food safety have been harmonized in the Community. Because of the high administrative costs of harmonization, the principle of mutual recognition was used for those issues that did not directly endangered consumers' health. The EU legislation on food labelling prevents presentation and advertising to mislead the consumer as to the foodstuff's characteristics or effects. It also prevents attribution of properties for the prevention, treatment or cure of a human illness to a foodstuff. Compulsory labelling includes the list of ingredients, net quantity, date of minimum durability, special conditions for keeping or use. The name or business name and address of the manufacturer or packager or of a vendor established in the Community must be indicated. Place of origin or provenance, must only be indicated when the omission of such information might mislead the consumer.

In 1991 and 1999, regulations defined organic foods and the conditions for using the corresponding denomination. Conditions are particularly stringent, especially compared to non EU countries. Animals must be fed only with feedstuffs that are themselves organic, and conditions of production include some rules that go beyond the ban on chemicals, such as a minimal slaughtering age, or free-range requirements.

In 1992, the EU adopted a scheme for protecting and promoting quality products that focused on traditional products and products from a designated origin. These regulations were largely based on the French and Italian systems. Three systems of identification and protection of food products were implemented : the Protected Designations of Origin (PDO) and Protected Geographical Indication (PGI) and the Traditional Speciality Guaranteed (TSG). PDO covers the term used to describe foodstuffs which are produced, processed and prepared in a given geographical area using recognised know-how. In the case of the PGI (Protected Geographical Indication) the geographical link must occur in at least one of the stages of production, processing or preparation. Furthermore, the product can benefit from a good reputation. A TSG does not refer to the origin but highlights traditional character, either in the composition or means of production. The basic idea behind these appellations is that ham sold as Parma, for example, or cheese sold under one protected French names, should come only from that product's traditional region of origin and be made according to traditional methods. Products from other areas or made by other methods would have to be sold under variant names. This means that Danablu, for example, may no longer be produced in any country other than Denmark. At the same time, other product names were designated as generic (including some cheese such as emmenthal), and can be used for goods made essentially anywhere and by any methods.

The link between origin and the actual quality of product is not always obvious, and these regulations have been criticized as barriers to entry, some of them even faced challenges from national anti-trust commissions. However, this policy has far reaching implications not only for consumers, but also for rural development. By making it possible to differentiate products that result from particular production methods and alleviating the "Greisham law", the policy has, in some cases, made it possible for rural areas to value their productions in a way that benefits consumers as well as producers, with minimal costs for taxpayers. Mahé and Ortalo-Magné (2001) quote several examples of the success of such a policy both for farm incomes and rural development and provide evidence of the positive impact of the policy. Sceptics point out that, in most cases, commercial brand names for these productions would have been more visible, and would have benefited from a better legal protection, making them perhaps a more efficient instrument than the present EU labels and appellations.

The CAP and product safety. Over the last few years, the CAP has been accused of generating unsafe products. Most of these criticisms came from the BSE crisis, which was sometimes seen as a direct result of the "productivist" orientation of the CAP, which pushed farmers to more intensive and low costs techniques. Feeding cows with meatmeal, or, as the medias put it, turning cows into "cannibals" was seen as the ultimate foolishness of a twisted policy.

In 1996, the official recognition of the possible link between the bovine spongiform encephalopathy (BSE) and a variant of a deadly neuro-degenerative disease that affects humans, triggered a major confidence crisis that affected dramatically the consumption of beef. Measures were soon taken to limit the fall in beef prices. All animals more than 30 months old were culled in the United Kingdom, which was by far the most affected country, and many other member states implemented selective culling. From 1996 to 2001, 8.6 millions of animals were slaughtered and destroyed, representing 2.3 million tonnes of beef. Animal meat meal, the most suspected source of contamination, was subsequently banned in the EU. The budgetary costs were enormous, amounting to 6 billions euros in 2001, i.e. 0.1 % of the EU GNP according to some estimates. A number of emergency measures were taken with regard to traceability and withdrawal of specified risk material at both the EU and national level. For the single 2001 year, the costs of the measures taken is estimated to amount to 1.3 billion euros.

After the finding of a possible link between BSE and a new strain of human disease, demand for beef fell, export bans hurt the entire sector throughout the European Union, costing billions of euros. The poor management of this crisis by British, then by other national and European authorities has also led to less visible, but very large impacts in terms of citizens' emotion. In 1999, when it became public that some fat used in animal feed was inadvertently contaminated with cancer inducing dioxin in Belgium, some animal exports of several European countries were banned in a number of regions, including the United States. This resulted in a decline in meat production in Belgium, hitting particularly the swine and poultry sectors. Again, a major effect was the loss of consumer confidence, which at some point led to imaginary risks. The withdrawal of Belgian soda (Coca Cola) from the market in 1999, in spite of any scientific evidence, can be seen as an indirect consequence of the dioxin crisis. The frequent food scares that have followed the release of information about pathogens such as *Listeria* found in some prepared meat and some soft cheese during the years 2000 in France, can also be attributed to a general mistrust of consumers (statistics show that the number of foodborne disease due to *Listeria* has actually been falling and that fatal casualties are very exceptional). Such food scares seem to be mainly due to the release of information that did not occur in the past.

New production methods driven by technology have added to consumer unease. Indeed, European consumers have a peculiar position regarding biotech food. While GMOs seem to have been tacitly accepted in the US, they have caused large protests in Europe. In some EU countries such as France and the UK, GMO experiments have led to numerous acts of destruction, up to a point where experimental research is practically impossible on the territory. While the reluctance of consumers to purchase processed food containing GM ingredients is perhaps overestimated, the obligation of labeling has led processors to avoid using GM material when they could. Under the public opinion's pressure, EU

regulations have limited the approbation of GMOs, and have made it mandatory to label food containing GMOs (see Box 8).

Box 8: Regulation of GMOs in Europe

The body of regulation relative to GMOs relies on EU directives that have been adopted over the last ten years.

The EU directive 90/220/CEE relative to the dissemination of GMOs is oriented towards the regulation of the protection of environment. The main purpose of this directive is to regulate and harmonize the administrative procedures and the evaluations of GMOs for dissemination. This regulation has recently been amended by Directive 2001/18/CE in the spirit of the precautionary principle. The revised directive specifies the conditions that have to be fulfilled – assessment of the risks to the environment, a plan for monitoring in order to identify effects of GMOs on human health or the environment, among others – for the release of GMOs to proceed. The same conditions apply for GMOs or products containing GMOs that are placed on the market with additional proposals for labeling and packaging.

With respect to the issue of liability, the revised directive does not include any liability regime that would make marketers of GM food compensate financially for sanitary or environmental damage. However, article 32 states that the Commission should make a legislative proposal for implementing the Cartagena Protocol on biosafety. And article 27 of the Protocol states that the parties must adopt rules and procedures appropriate to responsibility and compensation for possible damage resulting from cross-border transport of live modified organisms.

The food safety aspects of GMOs are regulated by the Novel Foods regulation CE 258/97. This regulation states that the safety of the products must be assessed when the new product contains a GMO or, resulting from genetic engineering, is substantially different from a traditional ingredient. In such cases, labeling is required. The procedures to evaluate innocuousness of novel foods are described. Notice that the most worldwide used GMOs, Monsanto Roundup Ready soybean and Novartis Bt corn, were marketed before the regulation. A regulation that states that food containing these ingredients must be labeled was adopted in 1998 (1139/98). The regulation 49/2000 sets the threshold for mandatory labeling at 1% GMO, in order to account for accidental contamination. And the regulation 50/2000 provides for specific additional labeling requirements for food and food ingredients containing additives and/or flavourings that have been genetically modified or have been produced from genetically modified organism.

The EU regulation raises concerns regarding compatibility with international rules. The US-Canadian approach for evaluating GMOs (based on risk assessment) differs from the EU conception, which is more based on a precautionary approach to risk assessment and management. Up to now, the diverging conceptions have not led to an official dispute brought to the WTO.¹⁴ The odds that such a dispute occur in the future are high.¹⁵ The IATRC has examined the issue, whose outcome is uncertain. Given the various GATT agreements, the EU mandatory labeling could be challenged under either the SPS or the TBT agreement. The Article III of the GATT states that countries cannot discriminate between like goods on the basis of origin, raising the issue of the equivalence of GM and non GM goods. The SPS agreement approach of precaution (Article 5.7), is more restricted than the one underlying the EU regulation. The GATT provisions for ethical concerns (article XX) are unlikely to legitimate a ban. The EU could argue that there is a difference between the concept of equivalence and the concept of substantial equivalence mentioned in the agreements, and that GM crops are not equivalent to their GM counterparts and should therefore be labeled.

The BSE crisis and the subsequent food and mouth crisis in 2001, with images of thousands of animals culled and burnt in open fields for weeks, resulted in questioning the rationale of the CAP by the average

¹⁴ Note that there has been a formal WTO notification of a dispute of Egypt challenging imports of tuna in GM soybean oil from Thailand (WT/DS205/1, WTO)

¹⁵ Sheldon (2002) provides an analysis of the reasons for such a dispute along with a discussion of whether such a dispute can be resolved through existing WTO procedures.

European citizen. It is a paradox that the most influential criticisms of the CAP have come from accusations that the policy generates unsafe food, and not that it generates budget costs or environmental degradation. Indeed, these criticisms have little scientific foundations. There is no evidence that products of intensive agriculture are more tainted than those from extensive agriculture. True, pesticide residues are obviously higher than in, say, organic farming ; industrial chicken are subject to salmonella, and industrial salmon production with potentially hazardous parasites and diseases; nitrates in vegetable can be hazardous for babies. However, toxins have killed many more people in times where agriculture was extensive (ergot, and other aflatoxins have killed millions in the past). Microbiological contamination of the products of extensive farming is also a problem, and the products of organic farming also contain ochratoxins and other toxins (dried fruits, cereals). Food and mouth disease existed before intensive agriculture. The BSE has been a terrible problem, but it has been used in a somewhat dishonest way to challenge modern agriculture.¹⁶ Even though there is not necessarily a causal relationship, intensification of agriculture has corresponded to a period where, at least statistically, the safety of food products has dramatically increased. It is unfortunate that the questioning of modern production methods for food safety reasons hides some more accurate reasons for questioning the CAP, such as its costs and its environmental effects. By encouraging pollution of groundwater by pesticides (whose responsibility in the fall in male fertility as well as in cancer inducement raises questions), the CAP might have indirect negative effects on consumer's safety than exceed the direct effects.

4. The EU enlargement and the CAP

4.1 The agenda of EU enlargement

Talks had been going on for accession of Malta, Cyprus, Turkey and the Mediterranean basin about future enlargement of the EU, but the end of communist regimes sped up the negotiations with Central and Eastern European Countries (PECOs). In 1990, the EU started a program of technical and economic assistance with central European countries. The European Bank for Reconstruction and Development was created, and the PHARE program was launched in 1990 (the acronym stands for Poland, Hungary, Assistance for Reconstruction of the Economy, but the program soon included all ten countries in central and eastern europe as well as Albania). The TACIS program was launched with the Commonwealth of Independent States. These were followed by formal negotiations for association agreements with the 10 PECO's officially candidate to membership.

The principle of enlargement of the EU to new members was decided in the 1993 Copenhagen Council. Thirteen countries, including 10 PECO's, Cyprus, Malta and Turkey are now formally candidates to accession. Three criteria have been defined for candidate countries to meet: to have stable democratic institutions, a market economy, and to be able to adopt all the "acquis communautaire", i.e. the set of EU texts, and translate them into their national regulation. The 1997 Luxembourg Council started negotiations with 6 countries (Poland, Hungary, Czech Republic, Estonia, Slovenia, Cyprus). The 1999 Berlin Council defined the financial guidelines within the Agenda 2000. The 1999 Helsinki council started negotiations with 6 other countries (Latvia, Lithuania, Slovakia, Romania, Bulgaria, Malta, i.e. the Helsinki group). In December 2000, the Nice council stated that a first wave of candidate countries that fill the criteria should become member in the beginning of 2004, which implies that negotiations be completed by the end of 2002.

¹⁶ Even extensive livestock producers use concentrate proteins in the feeding of animals. The fact that these proteins came from meatmeal was perhaps a change in traditional production techniques, but it was quite logical given the availability of an abundant source of proteins, and – according to all scientists- of high quality.

Officially, the June 2002 European Council in Seville states that the negotiations with Cyprus, Malta, Hungary, Poland, the Slovak Republic, Lithuania, Latvia, Estonia, the Czech Republic and Slovenia should be concluded by the end of 2002, and these countries should become members before the EU elections of 2004, if they are ready. Romania, Bulgaria do not aim to become members in the first wave of countries. However, candidate countries are required to implement the "acquis communautaire" as soon as they become members. This requires considerable reforms in regulations and administration in the pre-adhesion period. The European Parliament raised concerns about the implementation of the acquis by countries such as Malta, and about the territorial division of Cyprus, that could prevent these countries to become members in the first wave. The actual date of accession will depend on the adoption of the "acquis", but might also depend on the result of referenda in future member countries. In some countries, some political problems seem to be still pending, such as the status of the Benes decrees with the Czech republic¹⁷, or the incompatibility of some of candidates' policy regarding minority groups (Estonia, Latvia, etc.). While the process is not yet finalized, unofficially Poland, Hungary, the Czech republic, Slovenia are thought to become members in the first wave. The October 2002 council is supposed to provide more insight on the actual schedule.

Negotiations with candidate countries include 31 chapters. The state of the negotiation depends on each country, but for the countries most advanced in implementing the acquis, more than 24 chapters have been closed. Agriculture is one of the chapter that is still not closed by negotiators.

4.2 Agriculture in accessing member countries

Accession of Turkey seems remote, given the conditions imposed in terms of human rights, of independence from a military power. Cyprus and Malta are very small countries. The main issues of the EU enlargement is therefore the accession of the 10 PECO's. The 10 countries would add 105 millions citizens to the 375 present ones. Some of them lag considerably behind the rest of the EU in economic terms, with an average GDP per capita roughly one third of the average one in the EU-15.

Agriculture is a major issue in the negotiations, and enlargement is a formidable challenge for the CAP. Indeed, 22% of the workforce in the PECO's is still employed in farming, compared to 5% in the EU. By adding 60 millions d'hectares of arable land to the 135 millions in the EU-15, adhesion of the PECO's to the EU would increase the agricultural area by 45%. The 10 PECO's would increase the overall population by 30%, but add 9.5 millions of farm workers to the 7.1. millions in the EU-15. The ability of these countries to fund themselves levels of farm support comparable to the EU-15 ones is limited, raising questions on the sustainability of the present CAP.

There are however large differences among the candidate countries. The contribution of agriculture to GDP varies between 15.8% in Bulgaria and 2.9% in Slovenia (The equivalent range for the Member States is between 6.6% in Greece and 0.6% in Luxembourg). The high average employment in agriculture in the PECO's is mainly explained by Romania, Poland, and Lithuania, where 42%, 18.8% and 19.6%, respectively, of the active work force is in the agricultural sector. In the other PECO's the share of employment in agriculture is comparable to the figures in the Member States.

If the 10 PECO's became members, their present production (based on 2001 figures) would amount to 27% of the EU-25 cereal production, 26% of its oilseeds production, 19% of the milk and pigmeat production, 11% of the beef production. The 10 PECO's show potential comparative advantages for agriculture, with 0.57 ha of arable land per capita, vs 0.36 ha in the EU-15. Poland is the most significant agricultural country amongst the applicant countries, accounting for about a third of the CEECs' total area under cultivation, whereas, compared with current EU Member States, Poland, Romania and Hungary are

¹⁷ After world war II, the Czech expelled the German minority that had supported the Nazi invasion of the Sudetes, and the Czech legislation still contains provisions against the settlement of other citizens which are not conform to the acquis.

also a large producer of foodstuffs. Historically, they made an important contribution to Europe's food supply, especially before the Second World War, testifying of their production potential.

[Insert Table 17.]

However, prospects as to the agricultural production potential in the PECO countries are controversial. Some authors believe that the PECO countries can rapidly become large suppliers of agricultural commodities, while some others point out the decline in their production potential, and the shape of their system, arguing that they would be customers rather than competitors of EU farmers in the medium run (Pouliquen, 2000). Indeed, the PECO countries experienced an average 25% decrease in agricultural production between 1989 and 1994, and the fall was larger in some countries such as the Baltic states, Czech Republic and Bulgaria. Explanations are both the fall in market demand, and the negative effect of the transition on production systems. During the recent years, the growth in agricultural production was limited, and the countries most likely to access the EU in the first wave have only managed to stabilize production, in spite of more public intervention. Because of the growth in demand, this has translated in increased imports.

The net trade position in agricultural and food products of the PECO countries shows large deficit, except for Bulgaria and Hungary. The net balance in these products with the EU is negative for all the PECO countries except Hungary (over the 1994-1998 period, the agricultural trade deficit of the 10 PECO countries with the EU averages 1.4 billion euros a year).

EU producer prices are significantly higher than those in Poland (milk, beef, pigmeat), Hungary (beef, pigmeat), the Czech Republic (sugar, milk, beef) and Slovakia (sugar, beef), even though the gaps are limited in some cases because of the significant market price support provided in some PECO countries (milk in Hungary, wheat and sugar in Poland, for example). However, the comparison of prices and costs of production between the EU-15 and the PECO countries is also subject to controversies. While the Commission estimates that the gaps amount to 40 to 50% for sugar and between 30 and 40% for sugar and milk, other observers point out the need to correct for product quality. Because of the need to adopt the *acquis* will imply substantial efforts to overcome existing veterinary, phytosanitary and quality problems, the gap could actually be much lower by the time of accession.

[Insert Table 18.]

In brief, there is still a lot of doubt about the future production of the PECO countries after they joined the EU, even though it is well admitted that, in the longer run, the potential for production is very large. This issue is particularly controversial since the Commission, as well as many observers, point out that the EU enlargement requires a rapid and significant reform of the CAP, while others (such as the French Parliament) accuse the Commission to overstate the PECO countries' production potential in order to justify a reform motivated by other reasons (Marre, 2001). A less controversial issue is that, in the short run, modernisation of the PECO countries' agricultural sectors and their integration into the CAP is going to pose a big challenge and require large budgets for structural policy.

4.3 The EU policy towards accessing members

The Europe Agreements include the establishment of an industrial free trade area, progresses towards a free trade for agricultural products, economic cooperation, including in the environmental area. A preferential trade regime was implemented between 1991 and 1995, which has provided significant tariff reductions on PECO countries' exports. These reductions were granted quantities that were most of the time

established on the basis of historical import flows, which have been subsequently increased (see Bureau and Tangermann, 2000 for details). The agreement therefore benefited most to Hungary, Czechoslovakia and Poland, to which the EU was a large outlet for agricultural exports. Some authors have pointed out that the economic rents generated by these preferential import regimes did not benefit much to the PECO exporters, because of the procedure used to allocate quotas, which in practice led the EU importers to capture a large share of the rent (Buckwell and Tangermann, 1999). However, these quotas under preferential access provide a significant opportunity for imports and an impressive set of preferences, compared to what other countries benefit.

In 2000, agreements on agricultural trade liberalization with the PECO came into effect. This involved full liberalization of trade for more than 400 agricultural products, which entered in force immediately (2001 for Poland and Lithuania). Under these so-called "Europe agreements", trade in agricultural goods is to be gradually liberalised, based on mutual tariff concessions. However, the tariffs that persisted for agricultural commodities involved the most politically sensitive products.

Technical assistance to the accessing countries relies on three special programs, and on the cooperation of EU-15 members administrations on some topics (including technical cooperation for implementing the *acquis communautaire* in the sanitary and phytosanitary area, for example).

The 1989 PHARE program aims at preparing administrations of candidate countries to accession, by strengthening their technical capacity and adapting to the EU regulatory framework. This includes investments in areas such as transportation, product quality, working conditions and environmental improvement. The annual budget is 1.6 billion euros during the 2000-2006 period. It was reoriented in 1999 towards two priority objectives, strengthening administrative and judicial capacity and investments connected with the adoption and implementation of the *acquis communautaire*. Agriculture is among the priority sectors. Funding takes the form of non reimbursable grants to beneficiary governments. The Instrument for structural policies for pre-accession (ISPA, which does not apply to Cyprus and Malta) provides aid for infrastructure, transport and the environment (the annual budget is 1 billion euros).

The Special action for pre-accession measures for agricultural and rural development (SAPARD) is more specific to the agricultural and rural sector. It is designed to prepare enlargement and solve priority problems in agriculture and rural development in the PECO. The annual budget (520 millions) come from the guarantee section of the FEOGA. Because Poland and Romania have the largest farm population and agricultural area, they benefit from most (169 and 151 billion euros). The program covers actions that are roughly similar to those covered by the EU-15 rural development policy (i.e. investment, infrastructure, training, environmental measures, diversification, afforestation), with perhaps more emphasis on improving the processing and quality control of food products. Agencies that are established to operate SAPARD are supposed to be able to operate the structural funds after accession.

In addition to these programs the 1999 Berlin council has allocated extra resources for the first wave of enlargement. These expenses are capped by the UE resources (1.27% of the EU GNP), and amount to 45.4 billion euros for the 2002-2006 period (in constant 1999 prices), including the 12.4 billions for the agricultural sector.

4.4 The CAP in the PECO

A sector raising particular difficulties. Among the 29 chapters involved in the pre-adhesion negotiations on technical aspects, agriculture is among the most difficult. Discussions include the sanitary and phytosanitary issues; the CMOs and other technical issues; the financial issue.

Sanitary and phytosanitary issues raise delicate questions, such as the control capacities, border inspections, standards and control in slaughterhouses, testing of animals for BSE, evaluation of pesticides and the control of pesticide residues. The EU Parliament has recently stressed that it was crucial for accession that applicant countries bring their agriculture and foodstuffs industries into line with the

European Union's high hygiene, veterinary and phytosanitary standards. Right now, many of the foodstuffs produced in the PECO fall short of the quality standards required on EU markets.

The technical chapters, and the preparation of the PECO to adopt the EU CMOs arrangements are also difficult. They include talks on the level of dairy and sugar quotas, on the thresholds for livestock density, the rate of set-aside land. A significant problem is that because of the lower prices for most commodities in the PECO and the large share of food in consumers' budget, adopting the present CMOs would have inflationary issues and would add to consumers' economic difficulties. However, this issue could perhaps be solved by a progressive adaptation over a long transition period. Among the EU negotiators, it seems that in spite of the limited administrative capacity of the PECO, the widespread corruption and the complexity of the CAP, the main arrangements could be adopted by new members. Recently, the Czech republic, for example, has introduced a system of direct payments on a per hectare basis and land set aside, dairy quotas, and a minimum price for sugar.

One of the largest controversial topics is perhaps the direct payment issues. Producers of most of the PECO likely to be part of the first wave of accession benefit from a national scheme of direct payments, but which fall short of the CAP arable crops and beef payments.¹⁸ Accessing to the high direct payments provided for beef and arable crops in the EU-15 is likely to boost production in a considerable way, as long as they are not decoupled from output and are still provided on a per hectare or per animal basis. In addition, the legitimacy of these payments is questionable, since they are officially "compensatory payments" for a fall in intervention prices, that candidate countries never experienced. While in the EU, direct payments substituted for a market price support policy, the introduction of full direct payments in the PECO would create an increase profitability of cereals and oilseeds and disequilibrium in the output mix with, perhaps, unwanted environmental consequences. Finally, one may argue that, because of the particular land tenure structure in the PECO, these payments would benefit most to absentee landowners (in some countries, large share of agricultural land was re-distributed to the -mostly urban- heirs of the original owners, before the socialist collectivization). The EU parliament, in particular states that an "excessive influx of cash as a result of direct payments could result in low productivity with existing structures being maintained, discourage investment in production or alternative activities and lead to capital formation in the value of property, which in turn results in higher costs and so does not benefit agriculture".

However, if direct payments were not provided to new members, this would be inconsistent with the Treaty of Rome provisions, that states the unicity of prices and subsidies. In the 1999 Berlin summit, some Member States refused the inclusion of direct aid in the negotiation package with the candidate countries, but the Parliament stressed that direct aid is part of the current *acquis communautaire*, and that this makes it inevitable to include this part of the EU agricultural policy in the negotiations with the candidate countries.

Box 8. The impact of EU enlargement on markets

In a March 2002 document, the Commission has analyzed the impact of EU enlargement on agricultural markets. The assumption is that the 10 PECO candidate will have become members in 2007. Four scenarios are investigated, adhesion without direct payments, adhesion with the direct payments based on historical references, and adhesion with the references proposed by the PECO.

With the integration of the PECO, cereal production in 2007 would reach 315 million tonnes, compared to 221 million tons in the EU-15. Cereal uses would modestly expand, and the surplus would increase to levels close to 40 million tons (mainly wheat, but also barley and rye, the EU-25 would remain a net importer of maize) compared to 24 million tons without accession. In 2007 the granting of full direct payments would increase production of cereals

¹⁸ These payments amount to 17 €/ha in Hungary, 26 €/ha in Estonia, 37 €/ha in the Czech republic, with higher transfers for community farms. Source A. Blogowski, personal communication.

in the PECO to approximately 5 million tonnes more than the implementation of CAP without direct payments. In all scenarios, the EU-25 would keep importing some 20 million tons of oilseeds.

Pork production would increase in the EU-15, which would compete successfully with new members, at least until 2007, the PECO production is likely to increase afterwards. Overall, the surplus of EU-25 is likely to increase between 1 and 2.5 million tonnes depending on the scenarios, while surplus in poultry would increase by 0.7 million tonnes.

The beef market in a EU-25 would depend a lot on the level of milk quotas. Enlargement with the CAP direct payments would lead to surplus of lower quality beef produced in the PECO.

Despite a forecasted increase in the consumption of fresh dairy products and cheese, surpluses of butter would continue to increase in the EU-15. The new members might bring in some additional market surpluses in particular for butter, despite having a similar trend in restructuring of the dairy sector than in the EU-15.

The Commission's proposals. On January 2002, the Commission set out its proposal about enlargement negotiations on agriculture, including the controversial issue of direct payments and level of production quotas for the new members, assuming that they join the EU in 2004. To ease the problems of transition in rural areas and to encourage the necessary restructuring of the agricultural sector in new members, the Commission proposes to increase the existing financial support provided under the SAPARD, through an enhanced rural development policy. Rural development measures would be cofinanced up to 80% by the EU budget. They include early retirement, support for less favored areas, afforestation, technical assistance, but also specific measures for semi-subsistence farms, that would take the form of a flat rate aid in order to alleviate cash flow constraints, conditional on submitting a business plan demonstrating the future economic viability of the enterprise.

The Commission favors a gradual introduction of direct payments over a transition period of ten years. For 2004, 2005, 2006, direct payments would amount to 25, 30 and 35% of the payment per hectare or per head in the EU-15. They would reach 100% in 2013. This aid could also be topped up with national funds. The new member states would however have full and immediate access to the CAP market measures such as public intervention. New members would have the option to grant direct payments through a simplified scheme, available for three years, with the option of prolongation for two more years. The simplified scheme would make it possible to provide a decoupled area payment applied to the whole agricultural area, until management and control structures function properly so that member states would enter the regular system of direct income support.

The Commission also proposed to determine production quotas for sugar and milk essentially on the basis of average production over the years 1995 and 1999 (1997-99 for milk quotas), a period reflecting better statistics and the adaptation of production structures. Where appropriate exceptional conditions such as natural disasters or significant market disturbances could be taken into account.

The Commission argues that the proposal would significantly improve the prospects for farmers in the PECO, emphasize support for the restructuring process. The progressive adjustment of the level of direct payments would prevent major brutal destructure and limit distortions on the land market and sudden increase in inequalities. Because of the great diversity of situations in candidate countries, the large latitude given to adopt the general scheme at local conditions provides a necessary flexibility. The simplified scheme would be easy to implement and verify and reduce the possibilities of irregularities in countries that need time to consolidate the administration and control system.

The EU Parliament has approved the Commission's proposals. There has been positive reactions from most EU member countries (with the usual exception of France). Candidate countries have reacted with limited enthusiasm to these proposals. Simulations show that the single premium proposed by the commission would severely limit the benefits that arable crops producers would reap from the CAP.

The impact on the EU budget. The impact of adhesion of the 10 PECO is difficult to estimate, without an agreement on the conditions provided to newcomers, especially on the issue of direct payments. It seems obvious that, with their large farm population and their limited GDP, all PECO will be net beneficiaries of the CAP, not to mention the rest of the EU budget, and in particular the structural funds.

Several studies had been released on the effect of enlargement on the CAP, which showed troubling discrepancies in the estimates. Upper estimates of the effect of enlargement on the EU budget, exceeding 40 billion euros a year, would be such that it would make a radical CAP reform necessary. Estimates by the Commission itself suggested that the extension of the present CAP to the 10 PECO would involve increase in expenditure of around 11 billion euros a year, mainly because of direct payments (7 billions).

Estimates of the costs of the January 2002 Commissions' proposals until 2006 range between 6.5 billion euros in 2002 and 16.8 billion euros in 2006. This includes expenses for agriculture amounting to 3.9 billion euros in 2006, including 734 million euros for market management, 1.4 billion euros for direct payments and 1.78 billion euros for rural development (figures in 2006 at 1999 prices). In addition to the 3.9 billion euros specific to agriculture and rural development measures, the rural sector would also benefit from the structural funds, allowing an average aid of €137 per capita to be reached in the new Member States in 2006 (this can be compared to €231 per capita that the "cohesion Member States" will continue to receive by the same year). On average, the new Member States should thus receive amounts that represent 2.5% of their GDPs.

These figures are the own Commission's estimates under the assumption that the EU would accept 6 new members by 2004. The European Parliament pointed out that these estimates only provided a short term vision, two years after the actual enlargement. The parliament estimated that the Commission's proposals, if extended beyond 2006 could lead to an annual budget cost for enlargement of 39 billion euros in 2013 if the CAP was not reformed and if the structural fund policy was put in line with the one for other member states.¹⁹

5. The CAP and third countries

5.1 The EU and the WTO discipline

The General Agreement on Tariffs and Trade (GATT) imposed relatively few constraints on the CAP before the Uruguay Round. In particular, agriculture was exempted from some GATT discipline such as anti-dumping rules, which made it possible for the system of export subsidies to be used to manage domestic prices. The Dillon Round (1960-61) had however a major indirect effect on the CAP. Very low or zero tariffs were bound on imports of oilseeds, oilcakes and other raw materials that could be used in feedstuffs. These bound tariffs could never be modified in future negotiations. As a result, feed manufacturers replaced EU cereals and protein crops by large imports of oilcakes and cereal substitutes. The disequilibrium between the supply and demand of EU grain became subsequently one of the major reasons for the 1992 CAP reform.

The Uruguay Round. The 1993 Uruguay Round discipline has only had a modest direct impact on EU agriculture. It had, however, a considerable indirect impact by putting some pressure on EU decision

¹⁹ Estimate under the following assumptions: no reform of the CAP, constant costs of market organisations, increase in rural development policy, participation of the new Member States in direct aid to 100% of the level of the current Member States in 2013, accession of Bulgaria and Romania in 2008, structural operations reach 4% of the new Member States GDP in 2007, constant costs for internal policy and administration, discontinuation of budget compensation in 2007.

makers for long delayed, but necessary reforms. The Uruguay Round Agreement on Agriculture focused on three key aspects, domestic support, market access, and export subsidisation. In each of these areas, WTO-members entered into specific commitments. Internal support was reduced by 20%, where it is regarded as trade distortive. According to its effect on trade, internal support was divided into three categories which are commonly referred to as the "amber box", the "blue box" and the "green box". Only support measures in the amber box had to be reduced. This mainly concerns, in the case of the EU, price support measures. Measures which fall in the green box or the blue box are at present exempt from reduction. On market access, the Uruguay round resulted in the conversion and consolidation of the EU's variable import levies into tariffs (custom duties) with an obligation to reduce them by 36% on average over a 6 year period. In addition, WTO members agreed to import a minimum percentage of 5% of their domestic consumption of different agricultural products at the end of the implementation period. Quotas with reduced tariffs had to be opened where the general tariff was too high. On export refunds it was agreed to put a ceiling on both the money that can be spent on export subsidies and on the quantities that can be exported with the benefit of a subsidy. The money spent on export refunds for each individual product or product group was reduced by 36% and the subsidised quantities by 21% over a transition period ending in 2001. Beside the agreement on agriculture, the Technical Barriers to Trade (TBT) and the Sanitary and Phytosanitary (SPS) agreements constrained the way EU regulations could be defined, in particular by imposing that domestic regulations that affect trade be based on scientific evidence.

Consequences for the CAP. Regarding market access, a consequence of the Agreement was the conversion of the CAP variable import levies into bound tariffs. That is, internal EU prices are no longer isolated from the fluctuations of world market prices. In the first years of the agreement the consequences have been limited for EU farmers, because of the high tariffs that have persisted on most sensitive commodities. Some particular commodities, such as the fruit and vegetables, are still partially isolated from world market prices. In other cases, the Special safeguard clause can be invoked and result in extra duties if imports surge or if the import prices fall under a certain threshold (sugar, butter). However, for low levels of the world price, imports are nevertheless able to compete with domestic products in the case of wheat, and for high quality beef, in spite of large tariffs.

The 36% decrease in tariffs that followed the Uruguay Round agreement, has not fundamentally changed the level of protection in the EU. The references that were used for the calculation of tariff equivalents gave a large degree of freedom. In addition, for some sensitive commodities, tariffs were reduced by 20% only, 36% being an average reduction.²⁰ However, the market access provisions have had a significant impact on the CAP in the longer run. First, for some commodities, such as cheese, the consequence was a significant import flow. Second, the minimum access provisions led to the opening of tariff rate quotas. Third, it is largely because of the market access arrangements that the EU became in 2001 the world largest importer of wheat (see below).

The internal support measures of the URAA have not imposed major constraints on the CAP. The exemption of most direct payments for beef and arable crops from the calculation of the Aggregate measures of support (AMS), which measures the (amber box) support that had to be reduced, has exempted a large share of the CAP from the discipline. Table 19. shows the AMS measures that were notified by the EU to the WTO, and the ceiling under the URAA.

[Insert Table 19.]

²⁰ It is noteworthy that the EU did not use the possibilities of the Agreement to "dilute" tariff reductions by imposing large reductions on very low tariffs or marginal commodities and imposing the minimum 15% reduction on commodities of considerable importance, as most other countries did. See Bureau, Fulponi and Salvatici, 2001 for details.

The Uruguay Round discipline on domestic support has nevertheless had an indirect effect, by constraining the domain of possible reforms of the CAP. Trade distorting instruments could not be expanded, and all the CAP reforms and reform proposals after the Uruguay Round have stayed out of the traditional solutions of increased reference prices and coupled payments. It is anticipated that the future of the "blue box" in the ongoing negotiations is, at best, uncertain. This category, which included payments tied to production, but subject to measures that limited supply (such as set-aside or production quotas) was mainly exempted from mandatory reductions because of the combined pressure of the EU and US. Subsequent US farm bills did not rely on such measures, and in spite of the willingness of EU negotiators to maintain such an arrangement in the new round of trade negotiations, it is unlikely that the blue box will remain untouched. This now provides an impetus for defining future forms of farm support that are less coupled to production, and could be eligible to a reformed "green box". From this point of view, the URAA has had a considerable indirect effect, which can be seen in the July 2002 proposals from the Commission for a reformed CAP.

Only a very small number of Members (25 of the WTO's 140 Members) use export subsidies. The EU export refunds amount to more than 80% of the subsidies, even though other countries use indirect subsidies (such as export credits, export credit guarantees or insurance programmes). Many observers agree that this form of intervention is likely to be banned completely in future multilateral trade agreement, and that the CAP should learn how to live without them.

Export subsidies, have so far been the main constraint on the CAP imposed by the Uruguay Round. Basically, beyond a certain quantity, the commodities purchased by public intervention can no longer be sold on the world market. The world price being lower than the intervention price, this would require export subsidies, which were capped under the URAA. The EU has benefited from high world prices in the late 1990s, then from the depreciation of the Euro. This has limited the effect of the constraints on export subsidies, at least in value. Table 20. shows the export subsidies notified to the WTO, which hit the binding ceilings in some cases. The EU has also used some of the provisions of the URAA, that made it possible to "roll over" export subsidies possibilities from one year to another. However, the prospect of piling up stocks that could not be disposed on the world market has been a major motivation for the Agenda 2000 reform, in particular for the decrease in intervention prices. This also played a significant indirect role in the reform of the beef and wine CMOs, which rely less than in the past on public intervention and storage. From this point of view, the external constraint of the WTO proved politically useful for imposing to some Member states a reform that was useful for domestic reasons.

[Insert Table 20.]

On the sanitary/phytosanitary area, the new framework designed by the SPS and TBT agreement have changed dramatically the way the EU regulates food safety. Since 1995 all WTO members have had to comply with the TBT Agreement, and a country may not reject panel conclusions simply because they are unfavorable. A 1997 WTO panel concluded to the non conformity of the EU ban on hormone treated beef, because most of the hormones incriminated had been tested within the *Codex*, which had set maximum residues limits or declared these substances innocuous, in normal conditions of use. The outcome of the panel has changed the status of the international standards in the EU regulatory process. The EU was not used to justify such or such standards by a risk analysis approach as defined in the *Codex Alimentarius*. Because these standards are now at the core of economic disputes, "scientific" discussions have been difficult within the *Codex*.

Up to now, the adoption of controversial standards with large economic consequences for the EU has been delayed in the *Codex* (case of maximum limits on residues of rBGH or somatotropin, case of GMOs), or have been adopted with an ambiguous wording (standards on pasteurization of dairy products). However, the Uruguay Round has had large indirect effects in this area too. Already, the EU, as many other

countries, has amended restrictive practices, and the very large number of notifications and discussions on potential flashpoints have made it possible to solve problems without embarking on the dispute settlement procedure under the WTO. In the future, controversial issues are likely to be raised. In a case such as GMOs, for example, either the adoption of precise standards or the clarification of the status of GMOs by a WTO panel or appellate body in the international framework might prove necessary. The outcome is likely to be of major importance for the EU domestic regulation. This puts some pressure on EU regulators to adopt legislations that are less likely to be challenged in the WTO.

5.2 The EU tariff structure

The not-so fortress Europe. From July 1 1995, the agricultural sector has been subject to bound tariffs. Tariff equivalents were defined so as to correspond to the level of protection provided by previous measures. Then, a tariff was set at this level. Tariffs were subsequently decreased by an arithmetic (non-weighted) average of 36% over 5 years. After this procedure, all EU agricultural tariffs were bound, and the list was submitted to the WTO, which became the official EU tariff commitments.

Since 1988, tariffs and trade statistics rely on the Combined Nomenclature (NC) which is consistent to the United Nations's harmonized system up to the 6 digit level. The list of bound tariffs at the 8-digit level, that was submitted to the WTO, is based on the NC at the 8-digit level. This is also the classification used for the EU trade statistics (available at the 8-digit level). In practice, however, custom officers use a classification up to 14 digit numbers, the TARIC (Integrated tariffs of the European communities), which is much more detailed than the NC in order to include all possible preferential agreements and import regimes.

There is a lot of controversy on the actual level of tariffs in the EU. Estimates of the EU average agricultural tariff for agriculture range between 10% and 40%. There are three main reasons for this broad range of estimate. First, most studies rely on the bound tariffs, i.e. the tariffs the EU applies under the most favored nation clause. The data are readily available, since this is the official list of tariffs submitted to the WTO. However, half of the value of agricultural imports in the EU enter under preferential agreements or tariff rate quotas, at a much lower tariff than the bound tariff (agreement with the PECO, Lomé/Cotonou, System of generalized preference, etc.). The use of the TARIC dataset, which is particularly user-unfriendly, is necessary to obtain the relevant information. Second, the EU tariff structure is very complex, with a large number of specific tariffs (i.e. in Euros per tonne, liter, head, etc.). In order to construct useful indicators, one needs to convert them into ad valorem (i.e. percentage tariffs). Not only this introduces a bias in the appreciation of the overall effect of the tariff (a specific tariff affects low unit value commodities more than high quality products), but the price used for the conversion has, in practice, a considerable impact on the value of the ad valorem equivalent.²¹ Third, there are several ways to construct an average tariffs. Using a simple arithmetic mean, or using a trade weighted average lead to different results, because of the large quantities of commodities such as coffee or soybeans, that are imported with very low tariffs. Bureau et al (2000) show that in spite of imperfections, the trade weighted average provides a better indication than a simple non-weighted average.²²

²¹ For example, Gibson et al (2000) and Bureau et al (2000) find an average bound tariff of respectively 30% and 18% for the EU bound tariff, using the same data on tariffs, but different reference prices (Gibson et al use an average unit value of worldwide transactions at the 6 digit level in the first case, Bureau et al use a 4-year average unit value of EU imports at the 8 digit level, both averages are non-weighted).

²² The trade weighted average is biased because it gives little weight to high tariffs, because of the inverse correlation between the level of tariff and the volume of import. A prohibitive tariff, for example, has a zero weight. However, a non-weighted average is meaningless, because it aggregates the same way very minor commodities (say, a specific type of nutmeg) with much more important commodities (say, wheat). Altogether, Bach and Martin (2002) show that the trade weighted average is a first order approximation of the true tariff. Bureau and Salvatici (2002) conclude that the non weighted index shows no relation whatsoever with the true theoretical tariff.

When accounting for import under preferential agreements, and using a trade weighted mean, the average EU applied tariff in agriculture is lower than 10%²³ The overall bound tariff that WTO members face under the Most favored nation (MFN) clause is 17%. There relatively few very high tariffs (only 8% of bound tariffs lines are above 50% in *ad valorem* equivalent, according to our computations, see Table 21. and 22.). That suggests that the protection of what is called the "fortress Europe" is often overestimated. The EU is indeed the largest importer of agricultural and food products in the world. Imports of coffee, cocoa, soybean, cassava, palm oil , for example, which account for considerable quantities face zero tariff (although a 7.5% tariff is applied on roasted and processed coffee on imports on the Most favored nation basis, suggesting tariff escalation).

[Insert Table 21.]

However, these relatively low figures result from the many tariff concessions made to a group of countries. Countries that are excluded face the (high) bound tariffs. In addition, tariff peaks are concentrated in specific sectors that are seen as crucial by other countries, because they could represent large market opportunities. Would-be exporters from the Cairns group in multilateral negotiations, or Mercosur countries in bilateral negotiations point out the very large tariffs in the beef sector (EU tariffs exceed 80%), sugar (they exceed 65%), dairy, grains and fruit sectors. Table 22. shows that the sectors that raise more domestic policy problems are more protected. In addition, within each of the chapters mentioned in this table, there is a large variability in the level of tariffs across tariff lines. Table 23. provides a liste of some selected peak tariffs in the EU (conversions of specific tariff into *ad valorem* tariffs made by the author).

[Insert Table 22.]

[Insert Table 23.]

The special safeguard clause. The Special safeguard provisions allow an additional duty to be charged on a consignment basis if the cif value of the shiplment falls below a "trigger" price equal to the average import price of the base period. It can also be activated under a volume-based trigger. Special safeguards are much easier to invoke than the normal safeguard mechanisms provided through Article XIX of GATT 1994 in that the SSG does not require an 'injury test'.

The Special safeguard clause creates as significant protection in addition to tariffs in the EU. For example, the special safeguard for butter and sugar, for example, could be invoked almost everytime the EU wanted it during the 6 years following the Uruguay Round. The trigger price for butter was set at 2483 Euros per ton, while the EU itself had estimated (in the tariffication process) that the relevant world market price for tariff calculations was 943 Euros per ton. For white sugar, the threshold price was set at 531 Euros per ton, compared to the 193 Euros per ton used for tariffication.

The EU invoked the special safeguard on the basis of prices for chicken carcasses, for processed preparations, and for sugar and molasses in 2000. The clause was invoked on the basis of volumes for 15 types of fruits, on a temporary basis.

Some particularities of the tariff structure. Tariffs on cereals are subject to a special arrangement. Because the tariffication process, based on previous levels of protection and on the large price gaps previous to the McSharry reform, would lead to a large tariff, the U.S. insisted that the EU limit to applying an import duty so that the import price of cereals does not exceed 155% of the intervention price.

²³ This figure is a trade weighted average of applied rates, source TARIC. See for example Gallezot, 2002.

This applies to common wheat, durum, maize and barley (which also determines the import charge for rye and barley). This set an upper limit to the tariff, regardless of the world price. The way the tariff is calculated (based on the price of US exports as a reference price) made it possible for Russian and Ukrainian wheat producers to export large quantities to the EU in 2001 and 2002.²⁴ The unit price of the "Black sea" exports was considerably lower than the reference price for imports, making the tariff ineffective. In addition, the tariff (95 Euros per tonne for common wheat) is specific, protecting less high quality cereals than an ad valorem tariff.

The import regime for fruits and vegetables acts as much as the previous system of reference prices, even though the flexibility introduced by the shipment-by-shipment basis lowers the protective effect. The regime applies to a subset of fruit and vegetables considered particularly "sensitive" in the EU. It establishes a minimum import price. A price gap between the highest reference price among the seasonally variable reference prices and an EU internal price was bound as a "maximum tariff equivalent". Two tariff lines were set, one on imports at or above entry price level and a second one to imports below entry price level. Only the "normal" ad valorem tariff is charged on imports at or above entry price level. If the import comes in at a lower import price, but not more than 8 per cent below the entry price, an additional duty is charged which equals the difference between the entry price and the import price. If, however, the import price is more than 8 per cent below the entry price, the full maximum tariff equivalent plus the ad valorem tariff will be charged. This results in a prohibitive import barrier for most imports below 92 per cent of the entry price (see Grethe and Tangermann, 1999).

5.3 Non-tariff barriers

Standards and technical regulations appear increasingly as major barrier to exports in agriculture. Sanitary, phytosanitary and technical regulations are particularly harmful to developing countries exports. However, the issue is particularly complex, because of the genuine demand of consumers in developed countries for stricter regulations (OECD, 1999). The EU system of regulations and standards creates obstacles to would-be exporters of agriculture and food, but this is not always the primary objective.

There are not many estimates of the impact of non-tariff barriers. A 1997 study by the US department of agriculture suggest that EU regulations imposed 0.7 billion loss of US exports in the food sector. The study was however based on a surveys of the industry and the measures in accusation are not always clearcut trade barriers, since they also apply to domestic goods. Fontagné and Mimouni (2001) survey regulations on some 4917 products, and identify as technical barriers those measures that affect trade of particular products only in a small percentage of countries. They show that sanitary, phytosanitary, and environmental barriers are much less a trade obstacle in the EU than in Cairns group countries. Overall, these measures affect three times less products in the EU than in the US or Canada. The lack of measures to restrain invasion of pests and unwanted species in the EU, as well as the poor capacity of EU countries to perform border inspections, compared to countries such as Australia, Japan or the US has often been noticed by observers (Mumford, 2002).

²⁴ The tariff, set every two weeks for three qualities of soft wheat, corresponds to the difference between 155% of the intervention price in the EC (101,31€/tonne in 2002) and Chicago commodities exchange quotations including transport costs to Rotterdam. These quotations are considered as representative for world market prices although they are much higher than the quotations applied in the Black Sea area, known as "Odessa quotations". The Chicago exchange quotations do not properly reflect the market prices of an important share of the wheat flows, in particular between Ukraine and Russia on the one hand and the European Community on the other hand. This contributed to large imports from Ukraine and Russia, especially when the Commission decided to remove a special import tax for these countries, that supplemented the MFN tariffs applied to WTO members. The Commission refused to change the mode of calculation and to consider a special reference price for Black sea cereals, as it was asked by some member states. Presently, the Commission suggests replacing the current custom duties system with a Tariff Rate Quotas and fixed duties in the framework of negotiations to be held in the WTO under Article XXVIII of the GATT.

Developing countries and the PECO are perhaps hurt by EU sanitary and technical standards more deeply than other countries. For example, meat exports from the PECO under the preferential Europe agreements run into a problem of standards. Since the BSE crisis, the EU has limited imports of live animals because of the fear that detection and control be insufficient. More generally, EU standards on hygiene and control capacity make it difficult for small businesses to comply. The issue is particularly difficult for African countries. The recent (temporary) import ban on some fish products from Eastern Africa, for example, had large consequences on the local producers. The low standards for aflatoxins that the EU plans to implement might constitute a considerable obstacles to exports of grains and dried fruits from developing countries.

Administrative barriers can also impede trade. The EU has a reasonable record in terms of import licences administrations, compared to other OECD countries (Bureau and Tangermann 2000). However, in some preferential agreements, in particular with Mediterranean countries, a complex system of tariff rate quotas administration has an impact on trade, and may shift the rent to importers (Alvarez-Coque, 2002). The rules of origin regulations are also applied in a strict way, and the definition of "sufficient transformation" for a product to be declared as "originated in country X" creates difficulties to would be exporters under preferential agreements.

Domestic and import regulations that do not primarily have protectionist purposes may have significant effects for would-be exporters to the EU. In the EU, some consumer organizations are particularly voiciferous and impose regulations that are stricter than in other countries. For example, the ban on imports of hormone-treated beef, to conform with the ban applied within the EU is seen as a illegitimate non-tariff barrier by the US. The US has imposed 114 million dollars of retaliatory tariffs after a WTO panel and the Appellate body concluded that the EU had not provided enough scientific evidence to justify its ban. However, most of the EU population oppose the use of such hormones, and the ban was endorsed by a democratically elected parliament (the ban also applies to domestic production). Although this has not led to a WTO challenge, the mandatory labelling of Genetically modified food (GM) in the EU is also seen as a trade barrier by the US. However, the assumption that this measure has not been taken for protectionist purposes is not defensible. It has clearly been imposed by the pressure of scared consumers.

The situation where a public opinion imposes stricter rules, sometimes regardless of scientific evidence, and where the trade policy is constrained by the international agreements such as the SPS agreement sometimes put the EU in a difficult position. For example, the use and marketing of bovine somatotropin (BST or rBGH) is banned in the EU. The official reason is the effect on animal welfare and the fact that it favors mastitis and therefore creates hygiene problems for milk, but the real motive is that consumers refuse the use of such hormones. Because of international agreements, the ban is not applied to imports from the 25 countries or so where BST is permitted. This creates significant distortions of competition, since BST is said to increase yields by some 8 to 10%. The issue of competitiveness of EU products is likely to become a problem in the future, given that consumers impose stricter standards than the international standards on animal welfare, environment, social issues, while trade is liberalized.

5.4 Tariff rate quotas

The Uruguay Round agreement stated that, starting in 2000, markets should be able to imports to amounts that represent 5% of domestic consumption. This does not mean that the corresponding quantities have to be imported if domestic production is competitive, but this intended to open up markets even if the tariffication process had resulted in bound tariffs that were still prohibitive. These provisions are referred to as "minimum access". In addition, it was agreed in the Uruguay Round agreement on agriculture that pre-existing access had to be preserved. That is, access conditions for historical import quantities had to be maintained (provisions referred to as "current access"). For a number of products the EU opened up Tariff Rate Quotas (TRQs) in order to meet the obligations of current access. When traditional imports did not represent a sufficient percentage of domestic consumption, TRQs were also opened so as to meet

minimum access commitments. Altogether, the EU established 87 tariff rate quotas, out of the 1370 TRQs established by 34 countries.²⁵

Under current access, within-quota tariffs as percentages of above-quota tariffs vary widely across products, because the individual TRQs very much reflect their historical origin, and hence the (usually) low levels of protection that the EU had historically agreed with the exporting countries concerned. For most minimum access TRQs, on the other hand, the EU has set within-quota tariffs at a universal percentage (32%) of over-quota tariffs and has not distinguished between less and more sensitive products. For both current and minimum access quotas, within-quota tariffs remained constant during the Uruguay Round agreement implementation period, so that over time they have risen relative to the declining over-quota tariffs.

Bureau and Tangermann (2000) show that, fill rates of TRQs in the EU have been reasonably high and have increased over time. Some of the larger current access quotas have exhibited relatively low fill rates, more so than minimum access quotas. This was particularly the case with current access quotas for feedstuffs that in the past were used as cereal substitutes in the EU. With the significant cut in EU cereal support prices, it cannot come as a surprise that import demand for these feedstuffs has declined noticeably. Bureau and Tangermann conclude that, overall, the EU has "played a reasonable fair game" as far as TRQs are concerned, and that the separate notification of minimum access and current access quotas makes the system more transparent than for most WTO members using TRQs. Concerns remain, though as to the exact articulation of the Europe agreement and the quotas under minimum access. The EU has indicated in its schedule that imports under the (preferential) Europe Agreement could be counted against certain quotas. Even though this provision is used when preferential tariffs under the Europe agreement and in-quota (MFN) tariffs are similar, third countries fear that this could result in the PECO's to take greatest advantage of the EU increase in market access under the minimum access provisions.

[Insert Table 24.]

5.5 Preferential agreements

In 2002, only nine WTO Members are subject to exclusively MFN treatment in all product categories: Australia, Canada, Chinese Taipei, Hong Kong, China, Japan, Republic of Korea, New Zealand; Singapore, and the United States. These countries accounted for 45.2% of EU's total merchandise imports in 2001. All other countries benefit from preferential access for some of all imports.

One of the oldest regional agreement is the European Free Trade Area (EFTA). Over time, many members have joined the EU. However, the agreement still involves Iceland, Norway, Lichtenstein, and, for some aspects, Switzerland. It involves preferential tariffs for some particular goods such as cheese, processed foodstuffs, wine and fish, and harmonization of standards, sanitary and phytosanitary policies.

The EU has a free trade agreement with Israel, which, for agricultural products, mainly involves fruits and vegetables, processed or not. It covers 85% of Israeli agricultural exports to the EU. The EU also admits a quota of citrus from the occupied Palestinian territories.

The 1999 agreement with South Africa raised controversial issues on appellations of origin, fisheries, wine and spirits, which were finally solved in 2002. The agreement involves almost total liberalization of trade

²⁵ It is important to stress that the economic importance of the imports covered is varies widely. For example, in the EU TRQ volumes are as little as 300 tons of meat, or 129 tons of poultry, while some other TRQs deal with 2 million tons of maize, 34 000 tons of tenderloins or 2.2 million tons of bananas. The number of TRQs has therefore little meaning.

by 2012, including 60% of agricultural trade and partial liberalization of 13% of other agricultural goods (exceptions include beef and sugar, fruits and vegetables). South Africa is now excluded from the trade regime of the Lomé/Cotonou protocol.

The 2000 free trade agreement with Mexico focuses mainly on industrial products. It covers 62% of bilateral agricultural trade but excludes meat, dairy and cereals until 2003. The agreement provides access for Mexican fruit and orchard products including avocado, tomato, limes, grapefruit, coffee, garbanzos, mango, guayaba, cerveza and tequila. Some concessions, including cut flowers and fruit juices, are provided within quotas.

Free-trade agreements are also being used as an instrument to integrate the Western Balkans. Stabilisation and Association agreements were concluded with the Former Yugoslav Republic of Macedonia and Croatia. Albania and certain countries and territories of the former Yugoslavia — Bosnia-Herzegovina, the Federal Republic of Yugoslavia, including Kosovo — remain under the regime of Autonomous trade measures, which runs until the end of 2005. These agreements seem to create some problems of re-exportation from the Balkans of imported products, raising the issue of the rules of origin (see a recent problem with sugar imports from Croatia, which turned out being cane sugar).

However, the agreements that have the largest impact on the EU agricultural sector are the Generalized system of preferences, the Lomé/Cotonou agreement and the association agreements with the PECO countries. Two negotiations with potential major implications for EU agriculture are also under way, one with Mediterranean countries, and the other with the Mercosur. The Everything But Arms agreement could also have significant impact on agriculture in the longer run.

The **Central Europe association agreements** have been signed from 1991. Protocols on reciprocal tariff concessions on agricultural products raised the share of the ten PECO countries' duty-free agricultural exports to the EU to 75% and the share of EU duty-free exports of agricultural products to the PECO countries to 61%. Because of preferences accorded, the US administration believes that the PECO countries actually capture the largest share of the EU's minimum access TRQs for pork and butter and a substantial share of the minimum access TRQs for skimmed milk powder and fresh/chilled poultry meats (minimum access quotas are normally not allocated to particular countries). The 10 PECO countries may also gain EU import share for skimmed milk powder outside the framework of the association agreements.

The Generalized System of Preferences (GSP) scheme was initiated by the EU in 1971, and then adopted by other countries. It gives preferential EU market access to products originating from developing countries. In the case of the EU, only certain products are covered, and tariff exemption is not always complete. Since 1996, new rules account for the level of development of the beneficiary countries in order to calculate preferential margins. Access is limited for a country that would account for a large share of the EU imports under this arrangement, in order to spread the benefits between a large number of the countries.

The present scheme went into effect on January 1 2002 and will expire on December 31 2004. It covers approximately 180 countries and the degree of access varies with the level of product sensitivities. With the exception of the 48 poorest countries (see the Everything but arms agreement), agricultural products are only partly covered. The new GSP provides an additional 5% tariff reduction for countries who meet additional environmental and labor conditions. It also has built in an expulsion provision for those countries which seriously and systematically violate minimum labor standards. Duty free access is granted to countries effectively fighting drug production and trafficking and those encouraging human rights and protection of the environment. Use of forced labor and money laundering can result in temporary withdrawal of preferences.

The Lomé-Cotonou agreement. The 1957 Treaty of Rome included projects for a convention between EC members and overseas territories. From 1957 to 1975, this involved transfers under the European development fund. The 1963 Yaoundé convention resulted in preferential trade agreements and in financial and technical assistance. Between 1975 and 2000, four successive Lomé conventions enlarged

the list of beneficiaries. The successive Lomé agreements provided unilateral preferential access to the EU market to exports from African-Caribbean-Pacific (ACP) countries. Most of the products under a CMO were excluded (with the exemptions of fruits and vegetables, that could enter the EU with low tariffs, but at periods different from the European production period). However, three protocols provided significant access to the EU market for ACP countries, the sugar, bananas and beef protocols. Special arrangements, within quantitative limits also included horticultural products, tobacco and rice.

The Lomé sugar protocol was a major concession to the developing countries since imports of ACP sugar entering the EU market requires exporting large amount of local production. Under the agreement, ACP countries have access to the Community market for 1.3 million tonnes, and in addition receive the high EU internal price. That is, the EU imports raw sugar at the EU guaranteed price (for example, the import price was recently around 520 euros/tonne while the world price was around 240 dollars/tonne). The initial quota (1.4 million tonnes) was supplemented by a new quota in 1995 (326000 tonnes, paid at 85% of the EU price). Mauritius benefits from 38% of the quota, and together 81% of the quota is shared by only 5 countries.

ACP countries benefited to preferential access for bananas (857 000 tonnes) under a complex scheme (importers of bananas from outside ACP countries were provided import licences if they also imported ACP bananas). The US succeeded in defence of US operators, and officially on behalf of the producers of central America, in obtaining a ruling of a WTO dispute panel against this import regime. Because the EU refused to comply, the US imposed 100% tariffs on selected exports of the EU. The dispute was subsequently solved, but involved a revision of the Lomé protocol. After a period of expanding tariff quotas, a new regime relying only on tariffs will enter in force in 2006.²⁶ It will result in the ending of large preferences for ACP countries, affecting particularly Caribbean countries.

The beef protocol exempted almost totally (92%) from tariffs imports from ACP countries, up to a limited quantity. However, the total amount of quotas is very limited.²⁷

The unilateral trade preferences for ACP countries under the Lomé convention were not consistent with WTO rules because they were limited to a subset of developing countries and were unilateral preferences (and therefore not a free trade area). In addition, the EU wanted to apply greater aid selectivity and differentiation in the treatment of ACP countries, to link aid and performance and to ensure a closer involvement of civil society, the private sector and the economic and social actors.

In 2000, a major reform of the relations between the EU and ACP took place with the Cotonou agreement, to which 77 ACP countries took part. The new agreement is designed to run for 20 years, and includes an 13.5 billion euros budget for the first five years. It recapitulates some of the arrangements included in the Lomé IV convention. It also relies on trade preference and on technical and financial assistance, but is likely to make the status of ACP countries less specific than it was, compared to other developing countries. Under the Cotonou Agreement, the current all-ACP non reciprocal tariff preferences will be maintained until the end of 2007. Then, a set of reciprocal Economic partnership agreements (EPAs) will normally replace them, following negotiations that began in September 2002. These free trade agreements will be WTO-compatible, would cover "essentially all trade" and will include provisions for cooperation and support in areas other than trade (structural adjustment, etc.). ACP countries are invited to sign as groups or individually, building on their own regional integration schemes. Not all ACP countries will have to open their markets to EU products after 2008. The least developed countries (LDCs) are entitled

²⁶ There will be a temporarily system of tariff quotas maintaining the present quota of 2.2 and the supplementary quotas of 353000 tonnes with a duty of 75 euros/tonnes, open to all suppliers. Another 850 000 tonnes quota will be open at a maximum rate of 3000 euros per tonne. Imports from ACP country will enter with a zero tariff. This regime will be revised in 2006 and lead to a system relying only on tariffs. The detailed arrangements will depend on the WTO negotiations.

²⁷ 1900 tonnes for Botswana, 13000 tons for Namibia, 9000 for Zimbabwe, 7500 tonnes for Madagascar.

not to reciprocate, under the everything but arms agreement. By contrast, non-LDCs who would decide they are not in a position to enter into EPAs could be transferred into the EU's Generalised system of preferences (GSP) which remains non-reciprocal and less generous than Lomé, or they could benefit from alternative WTO-compatible arrangements.

Provisions continue to be made for loss of export earnings (ending the existing arrangements under the stabilisation scheme STABEX) but in a revised version : compensations will be provided where a 10% loss of earnings has occurred that represent more than 40% of export revenues. It is designed to address more exceptional circumstances than the previous version of the STABEX.

Until the new regimes are established, the Cotonou Agreement extends the Lomé non-reciprocal preferences. In agriculture, in particular, all preferences that existed under Lomé IV continue to be granted in exactly the same manner. New tariff lines were added to the list of products benefiting from EU preferences. The number of tariff lines benefiting from preferences increased by 32%. Almost two thirds of the preferential tariff lines are actually subject to a zero tariff (see Tangermann, 2000 for details). However, while this temporary regime shows some improvement in the market access, the consequences of the future agreements are unclear. Overall, it is likely that the effect of the Lomé protocols will be weakened substantially under the Cotonou framework, and that different ACP countries and regions will receive different treatment from the EU.

The Everything but arms agreement. In 2001, the EU amended its GSP to grant duty-free access for all goods except for arms to 48 least-developed-countries (LDC). Three of the most sensitive products (bananas, rice and sugar) will be liberalized gradually. Import duties on bananas will be suspended as of 2006. EU imports of sugar and rice from the LDCs are subject to transition arrangements until 2009. After 2009, the option of a safeguard will exist if imports become a significant threat.

This EBA agreement has been presented by the Commission as a major instrument to support development of poorest countries, under the principle that trade is better than aid. The shift from aid to market opportunities resulted from a genuine concern about the impact of past EU policies on these countries. It was also part of a strategy to gain support from developing countries in international fora such as the WTO. This agreement was signed in spite of the opposition of EU farmers. The French ministry of agriculture, echoing French sugar producers in particular, managed to delay signature for months, but also to delay implementation of the agreement for that commodity for 8 years. Major competition from LDCs is foreseen in the sugar and rice sector in the longer run.

Mediterranean countries. Turkey, Morocco and Israël are significant exporters of agricultural products to the EU (flowers, citrus, tomatoes, grapes, melon, dried fruits, strawberries, wine). Cyprus exports significant quantities of potatoes, citrus and grapes. Tunisia exports mainly olive oil and oranges.

Cyprus and Malta applied for membership respectively in 1990 and 1989. The agreement with Malta grants tariff reductions for products such as fruit and vegetables, cut flowers, potatoes, onions, cucumbers and asparagus. In the case of Cyprus, a custom union is progressively leading to the phasing out of all tariffs for products such as wine, fruit juice, citrus, grapes, potatoes and carrots. Turkey has also applied for EU membership in 1987. Farm products are excluded from the 1996 free trade agreement, but they benefit from tariff concessions under the previous preferential regime which provides special access (68% duty-free and 35% subject to reduced duties) for Turkey's agricultural exports. It covers products such as wine, citrus, olive oil, dried fruit and nuts, tobacco and cereals.

Preferential agreements with the Maghreb and Mashreq have existed since the 1970s, on the basis of unilateral tariff concessions. Since 1976, the EU has had agreements with Morocco, Algeria and Tunisia which provide free access for non-agricultural goods and substantial concessions in the form of tariff reductions of 20-80% for agricultural products. The agreement covers products such as wine, citrus, olive oil and fruit and vegetables. In 1977, the EU entered the Mashraq agreement with Egypt, Jordan, Syria, Lebanon and Palestine. This agreement covers tariff concessions for onions, potatoes, beans, tomatoes, citrus, olive oil and tomato paste. Palestine and Jordan also enjoy a 3 000 ton quota for tomato paste.

The so-called Barcelona process, launched in 1995, has provided a framework for agreements between the EU and 12 Mediterranean countries. Successive agreements with Cyprus, Malta, Israël, as well as the enlargement of the EU to Spain and Portugal and the decrease in MFN tariffs after the Uruguay Round have eroded most of the preferential margins to these countries. One of the aims of the Barcelona process is a free trade agreement by 2010. However, agricultural products are largely excluded. Under these agreements, agricultural goods benefit mainly from tariff rate quotas and lower preferential tariffs.

A trade agreement with South Mediterranean countries could have a considerable impact on some of the CMOs, including for politically sensitive products such as tomatoes, citrus, grapes, melon, strawberries, wine and flowers. This has given rise to serious disputes during the negotiations between EU members. Several agreements within the Euro-mediterranean partnership have been delayed by the refusal of formal ratification by certain EU member states that object to some agricultural provisions. The reluctance of the EU to liberalize trade in the agricultural sector is partly caused by the low cost of labor and the comparative climatic advantages in fruits, vegetables and agriculture.

Negotiations with the Mercosur. A cooperative agreement was signed in 1995 between the EU and the four South American states of the Mercosur. While trade is roughly balanced between the two entities, imports of the UE from Mercosur includes mainly agricultural commodities, while exports include mainly industrial goods. Proposals for liberalizing agricultural trade, a condition for Mercosur to sign an agreement, has so far met strong oppositions from some members. As part as a regional negotiation, the EU has offered to dismantle tariffs over 10 years on around 2.2 billion euros of agricultural exports from Mercosur countries. However, for sensitive products, the EU offers to adopt TRQs (beef, sugar, dairy and cereals), a proposal which has so far met little enthusiasm from Mercosur countries. Mercosur countries have proposed a progressive elimination of tariffs on a significant share of imports. However, Mercosur countries insist that a larger access to EU markets on commodities such as beef and sugar is crucial for an agreement.

Negotiations with Mercosur are of particular importance for the CAP. Clearly, Mercosur countries will never accept an agreement that would leave agriculture out. Because of the large potential for exporting sugar (Brazil) and beef (Argentina), a free trade area with Mercosur would require major changes in these CMOs.

5.6 The CAP and developing countries

The overall effect of the CAP on developing countries is ambiguous. The tariff structure provides numerous tariff exemptions, and ACP protocols clearly intend to support the development of these countries. However, for most products that could compete with EU production, high tariffs restrict exports of developing countries in what may be one of their few comparative advantages (agriculture). Enormous subsidies to production, leading to the dumping of surplus production on world markets results in a drop in world prices whose effect on developing countries farmers is particularly devastating.

Market access as a development tool. The Everything but arms agreement is widely recognized as a major instrument of development. The fact that it will include all agricultural products starting in 2009 is clearly an opportunity for these countries, which will benefit from the high EU domestic prices. The major expected effects are in the sugar, beef, rice and banana sectors. Right now, all LDCs but two are net importers of sugar, and they are not likely to become serious threat for EU beet producers in the short run, even though the export potential of Soudan and Zambia is said to be of 200 000 tonnes of sugar. However, in the longer run, the rent provided by the high EU domestic prices, may attract significant investments in the sugar sector in the LDCs (remember that Saint Domingue, now Hai ti, accounted for 70% of world trade in sugar, two hundrer years ago). The attractive EU prices is also likely to lead to a reduction of exports to other developing countries. Another concern is that, like with the Balkans agreement, these countries could re-export foreign sugar.

In addition to sugar, the LDCs could become rapidly major exporters of rice to the EU, especially because of the provisions that re-exports of Asian products are eligible under the agreement if they have been processed in LDCs so that the value added has reached 100%. Imports of bananas with a zero tariff could become rapidly very large, given the very high domestic price in the EU and the tariff that normally applies to bananas. EU internal prices for bananas are likely to fall. LDCs bananas could replace a large share of imports from other countries. Because of the arrangements with domestic (i.e. Spain and French overseas departments) production, the EU estimates that this could create some significant budget expenditures).

However, the way the agreement will be applied is a key component of success. If the less developed countries do not limit the re-export of imported goods to the EU, the EU will apply strict rules of origin conditions. Special safeguard clause could also be in a relatively extensive way by the EU. And imports can be limited by sanitary and phytosanitary regulations. Overall, the success of the Everything but arms agreement as a development tool will depend on the way it is managed. It can have a significant impact on the LDCs, but divert imports from other developing countries.

The Lomé Convention was the most complete framework for North-South cooperation, and opened the EU market to some 8.3 billions euros of food exports from ACP countries (exports from the EU to ACP amounted to 3.4 billion euros). The sugar protocol has been a considerable dent to the EU policy of protecting agriculture. It is estimated that the transfer to ACP countries resulting from the sales of sugar at high guaranteed prices amounts to roughly 500 millions euros on average, and up to 1 billion euros in years with a particularly low world price. The banana protocol also provided considerable advantages to ACP countries. So did the import regime of fruits and vegetables, since the entry price system acted in a way that was relatively similar to a voluntary export restraint, enabling the exporting country to capture a significant share of the rent (Grethe and Tangermann, 1998). For a few countries that have been able to take advantages (Mauritius, Senegal, Côte d'Ivoire), Lomé agreements have been helpful.

However, the ACP exports are concentrated on a few commodities : coffee and cocoa amount to 33%, fish products to 17%; sugar to 10 % and fruits and vegetables to 11%, cotton, tobacco, oils and rum amounting to close to 5% each, even though horticulture products have increased recently and now represent 3% of total agricultural exports to the EU. A protocol such as the Lomé beef arrangements only provides access to the EU market to 6 countries. Under the sugar protocol, only 5 countries benefit from more than 100000 tonnes of exports possibility. With the exception of sugar, the goods that could compete with EU domestic production still face large trade barriers. The benefits of the Lomé convention for developing countries must also be balanced. In practice the agreement evolved into a very complex tool, with too many objectives, instruments and procedures. The result was often reflected in long delays, bureaucratisation, reduced efficiency that have limited the development impact of the agreement. In spite of 25 years of Lomé agreements, the share of ACP countries in world trade has decreased from 3% to 1.5% since 1975. Lomé has not generated a diversification of ACP countries: their exports are still concentrated on a small number of agricultural commodities.

The Cotonou agreement will lead to replace the Lomé (by 2008) by new trade agreements that will vary depending on the situation of each country. Although the final economic impact is uncertain, the new arrangements are likely to be less favorable to ACP countries than the Lomé conventions, as far as trade preferences are concerned. Because future arrangements will be based on free trade (i.e. reciprocity), the benefit for ACP producers are likely to be more ambiguous, since ACP countries will have to lower tariffs. This will have budget consequences, since import taxes account for 20% of the the budget. Because the LDCs will have access to the EU market under the Everything but arms agreement, they will have no incentive to engage in the partnership (i.e. reciprocal concessions) proposed under the Cotonou agreement, at least with the EU. The differential in treatment is between LDCs and other ACP countries is likely to hamper regional ACP agreements, that Cotonou is supposed to encourage. The articulation of a future agreement between the EU and Côte d'Ivoire, while other members of the West African economic

union (Mali, Burkina, benefiting from the Everything but arms agreement) remain outside such an agreement, could endanger the economic integration of the west African region.

Still some unfair competition for developing countries. Forty years of community preference have hit traditional exporters to Europe (Caribbean and South American countries for sugar; Southern African countries for beef). For most developing countries, preferential tariffs for limited quantities do not offset the loss of market opportunities lost because of the high EU tariffs. This is particularly true for Latin America, which has not benefited from the Lomé agreement, and which gains little from the Generalized system of preference. Domestic subsidies also hit developing countries in the beef, sugar, tobacco sectors. In the case of cotton, Burkina Faso has complained that the EU producer received 1.06 Euros per kilo of cotton, once subsidies are included, while Burkinabe producers receive less than a third of this price. The fact that Burkina has access to the EU market under the Everything but arms agreement does not prevent unfair competition.

In addition to tariff barriers, developing countries face considerable obstacles to export to the EU. A major problem for them is to conform to the high EU sanitary standards. Measures against pest dissemination are major import barriers for these countries (fruits and vegetables). So are the sanitary standards (fishery products, dried fruits). The growing requirement of certifications is becoming an obstacle for countries lacking administrative infrastructures (Congo in the wood sector).

Some net importing countries have benefited from EU export refunds and from a generous use of food aid as a way to gain market shares, a practice in which the EU competed with the United States in the 1980s. However, in general, export subsidies have hit third world farmers. For example, Oxfam (2002), a British non governmental agency, shows that the dynamic Jamaican dairy was suddenly swamped by powdered milk imported from the EU, which spent some 4 million Euros annually on subsidising exports to this country, after an structural adjustment plan that liberalized trade. The dumping of EU surplus beef on West African markets has deterred domestic production in these countries for decades. Since 1980, many African countries and non governmental organizations have complained about EU beef subsidies, which have exacerbated the unfair competition with local producers, have resulted in a large drop in local market prices in countries such as Senegal, Mali, Burkina Faso and has also affected other African countries that used to export beef such as Namibia. After a brief recovery, caused mainly by the devaluation of the CFA Franc (which resulted in significant increase in production in Burkina Faso, Mali and Côte d'Ivoire), the BSE crisis has led the EU to resume large subsidized exports. This issue shows no sign of improvement, in spite of the Uruguay Round limitations of export subsidies : in order to get rid of surplus beef the EU has exported German and British beef at a highly subsidized price in 2001 (the price of some exports to Nigeria were as low as 350 euros a ton, for example).

It is often said that the previous CAP system of import levies and export subsidies increased market fluctuations, that are particularly damaging for developing countries producers, and that the 1995 tariffication process has limited this effect. Indeed, internal stabilization was achieved at the expense of increased foreign volatility. This is more likely to be true for beef production than for wheat and barley production. The fact that administered prices play a major role in the planting decision of cereal growers may actually lead to more complex expectations that might result in increased variability of production, and the global effect on price fluctuation is not straightforward (Boussard, 1997).

The use of food aid as an outlet for disposing excess production by the EU also has been questioned by non governmental organizations. If using food aid in emergency situation cannot be questioned, some aid is more structural. When coupled to regular exports, aid can sometimes be seen as a simple way to reduce the unit price of shipments. Following sharp criticisms from non governmental organizations, the EU has reformed the food aid policy. The EU has adopted a Code of conduct on Food aid, and has reoriented its policy toward replacing aid-in-kind with financial assistance in 1996. The official policy of the EU is now to provide food aid in specific situations where it is the most appropriate instrument to tackle nutritional problems and food shortages. Before 1996 the main instrument was food aid-in-kind, which accounted for almost 90% of the budget, but this percentage has fallen to 40% in 1999. The annual volume of aid given

to developing countries is 1 650 000 tonnes of grains (annually), part of it being supplied by member states and the other by the EU, in addition to skimmed milk powder and butteroil. Food aid is used for relief, for humanitarian assistance, and for "food for work" projects.

5.7 Enlargement and WTO commitments

As the "pre-ins" members will join the EU, they will aggregate their WTO commitments to the EU ones. The WTO commitments of the PECOs vary considerably between countries. For example, Polish tariffs are close to the EU bound tariffs, but this is not the case for other PECOs. Poland has set domestic support and export subsidies in dollars, which is not the case of other countries, which turned out to have low levels of commitment after years of depreciation of their currency.

Several studies have pointed out that, at the time of accession, adhesion of the PECOs would cause difficulties for the EU to respect WTO commitments. However, the issue seems to be a problem mainly in the area of export subsidies. Indeed, the WTO commitments of the PECOS in terms of quantities that can be exported with subsidies are limited (1.7 million tonnes of cereals, 0.3 million tonnes of beef, 0.65 million tons of milk, 0.3 million tonnes of sugar for the 10 PECOs). When facing EU-15 prices and payments, their contribution to EU-25 production will be significantly larger than their "credit" in export subsidies allowances. Simulations show that the main problems raised by export subsidies commitments for the EU-25 would result from the pigmeat sector, followed by the grain and the beef sector (Le Mouel 1999). However, these results are conditional to crude estimates of the ability of the PECOs to increase production rapidly, and on this point, there is a complete lack of consensus. The evolution of domestic demand in the PECOs, as well as the trends in world market prices are also a major factor of uncertainty. Overall, given the large probability that export subsidies be simply no longer allowed in the on-going round of negotiations, the problems of the PECOs commitments seems minor compared to the problem of adapting the common market organizations.

There could also be problem in merging the domestic support limits (AMS) with the EU-15. However, here too, the possible violation of the WTO obligations by the United States under the new farm bill (the Agricultural Risk Protection Act) creates a situation where many things seem renegotiable. In addition, the Commission's proposals after the mid-term review of the CAP in July 2002 suggest that there might be policy changes that could result in a drastic modification of the EU AMS before 2006.

There could be objections raised by other WTO members if PECOS raise tariffs to the EU level. However, this issue was already raised in the case of the adhesion of Sweden and Finland. Negotiations of compensations, for example under the form of tariff rate quotas in the EU, with countries which suffered from trade diversion of imports from the PECOS are always a possibility. In other cases, tariff levels are always negotiable and the EU could adapt its tariff structure so as to find an agreement.

5.8 The EU position in WTO negotiations

Multilateral trade negotiations limited to agriculture started again in March 2000. Set out in Article 20 of the Agreement on Agriculture, they are among the WTO's built-in agenda commitments which Member countries entered into when signing the Final Act embodying the results of the Uruguay Round of multilateral trade negotiations in Marrakech on 15 April 1994. The Doha meeting at the end of 2001 resulted in the effective start of the negotiations.

The combination of the CAP and the special role devoted to the EU Commission, Council and Parliament as far as external relations are concerned, result in a situation where EU agricultural trade is under EU decision making and EU management, rather under than member states'. The EU negotiates trade arrangements as a single entity, including in the WTO to where each member state is a formal participant. Any negotiations with third parties must be conducted by the Commission on behalf of the EU and adopted by the Council and Parliament. Member states may not modify tariffs or trade instruments

unilaterally, and any amendment to the trade policy must be agreed by the Council of ministers. Member states can only influence decisions through their participation to the Council.

So far (September 2002) the EU has not tabled any formal proposals on the agriculture negotiations that covers export subsidies, domestic support and market access. However, the EU position in WTO negotiations has been stated in several documents submitted to the WTO before the 2001 Doha meeting, and in various speeches by Commissioner Fischler. It can also be inferred from the mandate given to the Commission by the Council. In September 2002, the EU has also laid out demands in the WTO negotiations, which it said must be met before it can make any concessions in agricultural subsidies and market access barriers : The EU said that trading partners must agree to a list of products named after geographical locations that would be protected for exclusive use, food safety rules that would allow precautionary measures and guidelines on food labeling before it could make any concessions on other agricultural areas.

In some cases, it is difficult to unravel the true objectives of the Commission, and strategic positions in order to prepare future compromises. There are however several aspects that make the EU position quite peculiar.

Export subsidies. The EU opposed the preliminary wording of the final Doha declaration stating that the objective was the phasing out of export subsidies. That is, the EU sticks to this policy instrument, whose suppression would require large changes in some market organizations. The EU position can perhaps be seen as strategic. The EU insists on introducing a strict discipline on the utilization of export credits and credit guarantees and to include other less transparent forms of export supports. A rigid attitude on export subsidies can be understood as a way to put pressure on the US scheme of export credits, that is seen by the EU as being as much distorting as export subsidies. When facing the accusation that most export subsidies to agricultural products are provided by the EU, the Commission argues that 84% of export credits are provided by three countries the US, Australia, and Canada, in a much less transparent way. The EU pleads for export credits to be limited and conditional to the lifespan of the product.

The EU also questions the indirect export subsidies that might be provided by public monopolies acting on the world market and submitted recommendations on state-trading enterprises to ensure that the operation of these organisations is more transparent. The EU proposes the adoption of clearer and stronger disciplines including the prohibition of unfair trading practices (cross-subsidisation, price pooling, etc.).

Finally, the EU argues that its export subsidies are more transparent than the use and abuse of food aid by the US (which accounts for half of world wide distribution of food aid). The negotiation position is that this form of export subsidies should be subject to a stricter discipline, that a distinction be established between emergency aid and other forms of aid, and that the use of food aid by the US be capped on a pluri-annual basis in order to avoid its use as an export enhancement system. The EU stresses in particular that food aid should be given fully in grant form and in a way that does not damage local production. Their recommendations in this field include devising a code of good conduct and drawing up concrete provisions (including, among other things, the definition of the types of operation covered, a list of recipients and a mandatory notification mechanism).

On market access, the EU fears the impact of large tariff cuts on some sensible products that would require a large reform of the CMOs, politically difficult in the short run. While many members of the WTO propose substantial reductions of each tariff line in order to tackle disparities in tariff levels and tariff peaks, the EU defended an overall average reduction of bound tariffs together with a minimum reduction per tariff line using the same methods as in the Uruguay Round in various statements. The EU also insists that unilateral tariff concessions (non reciprocal tariff regimes, EU-ACP partnership) be taken into account in market access arrangements. The EU wishes to keep the special safeguard clause. However, the EU did not offer specifics as to how it wanted to negotiate tariff reductions, which provoked criticisms from the US and Cairns members, who insist that timeframes for reductions and exceptions demanded be discussed rapidly.

Domestic support. The EU stresses that future agreements must ensure the survival of the "European model of agriculture", the multifunctional role of this sector and argues that the social, environmental and food safety dimensions of agriculture call for the presence of farmers in the countryside and for the continuation of agriculture's productive function throughout EU territory. The EU supports a further reduction in the Total AMS starting from the final bound commitment level, by a further strengthening of the rules concerning non-product-specific domestic support and by a reduction of the 'de minimis' clause for developed countries; a specific discipline to be applied to the various 'amber' box subsidies which boost export performance by providing compensation for variations in market prices; a review of the criteria to be met by 'green box' measures to ensure minimal trade distortion while ensuring that the measures meet important societal goals.

The EU considers the continuation of the exemption of reduction of blue box support as necessary. The EU would like the future agreement to account for the possibility of targeted measures to protect the environment and promote the sustainable vitality of rural areas and poverty alleviation. The EU (together with Japan and the Republic of Korea) would like to extend the green box scheme to other measures so that better account can be taken of non-trade concerns.

Other issues. The EU wishes to enlarge the field of the negotiations on agricultural trade, arguing that key problems for the sector depend on negotiations which go beyond the framework of the agreement on agriculture. The EU considers that the precautionary principle set out in the SPS Agreement needs to be examined in order to find an appropriate solution to the hormone problem, that the TBT Agreement needs to be overhauled so that adequate regulation of the use of transgenics, biological products and animal welfare can be included. In September 2002, the EU said more precisely that it wants to interpret the agriculture agreement to allow use of precautionary measures instead of seeking to amend the SPS measures. These measures should be proportionate to the risk, implemented in a non-discriminatory way, consistently applied, and include a cost benefit analysis.

The EU argues for an appropriate regulation by the WTO of labelling schemes in order to satisfy consumers' concerns about food safety and their demand for better information on production and processing. Emphasis is also set on taking into account efforts to improve animal welfare (through multilateral agreements, appropriate labelling rules or reduction exemptions, provided that certain conditions are met) and the recognition of compensation to cover the additional costs required to address this concern.

The EU finds that certain provisions of the TRIPS Agreement should be amended. This is the case of geographical indications for wines and spirits (Articles 23 and 24), products linked to the territory and rights in respect of biodiversity (Article 27.3.b) which need to be improved. It stresses the need to establish fair competition as regards food quality in order to open up the markets by eliminating distortions of competition and encouraging the preservation of traditional expertise.

How isolated is the EU ? The EU's demand that the focus should not just be on export subsidies but also on the reduction or even abolition of other types of measures that have distorting effects has been echoed by other WTO members (Mercosur and associated countries, Japan, Norway, India, in particular). On food aid, several countries including Switzerland, Mercosur and India support the EU. The US seems to disagree with a reform in this area, and has reiterated that the system and that the disciplines set out in Article 10.4 of the Agreement on Agriculture should be maintained.

Like the EU, Korea, Japan, Switzerland, Norway, Taiwan and India oppose the US proposal of using a "Swiss formula" that cut higher tariffs disproportionately. The EU's proposal to keep the special safeguard clause, supported by Japan, Norway and Switzerland, the ASEAN countries and the Republic of Korea, has faced criticisms, especially by the United States, the Cairns group, as well as some developing countries which call for the prohibition of this mechanism by the developed countries.

The position that the EU of maintaining the current framework of rules and disciplines on domestic support is supported by Japan, the Republic of Korea, Poland, Norway and Switzerland, but other

countries strongly disagree. The USA, Canada and some developing countries consider that the non-exempt support of each Member must be more severely limited than with the actual blue box. The Cairns Group would like to eradicate all support that distorts trade and production. Members such as India call for a limiting reduction exemptions on domestic support to developing countries. Most WTO members are critical of the lack of arguments put forward by the EU to justify keeping the blue box and point to the need for clarification of the relevant concepts.

All members agree that green box criteria need to be reviewed, but most are sceptical about the idea that the green box should include more criteria in order to take care of non-trade concerns. Sceptical countries want to make sure that the measures exempted do not have trade-distorting effects (USA, Cairns Group, India) or want special criteria geared towards developing countries (ASEAN, India). Many developed countries support the proposals of the Cairns group.

The EU leads a group of "the Friends of Multifunctionality" that opposes the "anti-subsidy" front led by the Cairns Group and the United States, and a share of the developing world. The convergence of the EU concerns and of the concerns of countries such as India, which insists on a "development box", and of countries such as Korea, that insist on the need to ensure food security, are unclear. While the EU thinks that it has many common negotiation positions in common with developing countries, a detailed examination of their negotiation position shows that interests diverge significantly (Lind 2002). India has in particular cautioned the EU about any improper attempts to erase the basic differences that exist between the non-trade concerns of the developing countries (food and subsistence security and the development of genuine food autonomy) and those put forward by other developed countries under the pretext of the multifunctional role of agriculture. The few developing countries that do not support the Cairns group position have reservations about the EU's position. Their position is shaped by their desire better to justify the special and differential treatment in order to meet their needs in the areas of food security, poverty alleviation and rural development.

Developing countries disagree with the EU proposals on the quality of food products and animal welfare. A number of countries, including Argentina, Malaysia and Thailand in the Cairns Group, also consider that issues connected with geographical designations or labelling should not be among the issues to be included in these negotiations. On the issue of geographical indications, the demand laid out by the EU in September 2002 has not echoed support from the EU's main supporters, Japan, Norway and Korea. On the issue of precaution, the EU demand was rejected by the US, China and the Cairns group.

Overall, on many issues, the EU appears quite isolated and target of criticism. The approach on export subsidies is seen as excessively defensive, and the attitude of the EU in blocking the final declaration has irritated many members, including many EU countries (France seems to have been a major opponent to the initial version whose wording was finally modified). As in the Uruguay Round, the attitude of the EU is largely defensive, in an attempt to protect and preserve the aid system (blue-box measures) and the Community preference (maintaining the special safeguard clause). The EU arguments on non trade concerns and multifunctionality could face favourable echoes in other countries, including the US and India. However, these arguments are not convincing enough on their own, especially for those developing countries that are agricultural product exporters. Even sympathetic countries often pick up on the inconsistencies between Community discourse and policy on export subsidies which place their products at an unfair disadvantage.

6. Political economy aspects and prospects for reform

6.1 Recent changes favorable to a CAP reform

Over the last 5 years, the growing dissatisfaction of consumers and taxpayers has resulted in changes in the perception of agricultural policy. The CAP has evolved towards the "second pillar" and now aims at

promoting the positive externalities of agriculture. In the EU several ministries of agriculture have been renamed, emphasising the concerns on food safety, consumer protection, and environmental policy, echoing deeper concerns of the society.

One might argue that these changes are cosmetic. Fundamentally, the CAP remains a policy that is mainly targeted to supporting producer's income and which does so with instruments that provide large incentives to production and encourage the adoption of intensive production techniques. Indeed, for a taxpayer who expects its subsidies to encourage the provision of public goods, environmental and social amenities as well as food quality, there are still major reasons for dissatisfaction. Production of bulk commodities is less encouraged than in the past, but quality still comes second to quantity under some common market organizations such as beef and wine. The present CAP does not match social objectives, with most of the support for a relatively small numbers of producers. There are many examples of inconsistencies of the environmental objective of the CAP and the actual incentive given to farmers by administrative prices and coupled direct payments. Agricultural support is distributed unequally between regions, resulting in poor countryside management : a decline in agriculture in some regions and overly intensive farming practices in others, generating pollution or erosion. Finally, the budget costs are likely to appear non sustainable to a growing number of member states. Presently, agriculture still accounts for half of the EU budget, making it difficult to fund new challenges in the area of European research policy and defense.

However, the Agenda 2000 reform is more than a simple set of good intentions. If the posted shift from the first to the second pillar has not yet resulted in significant shifts in the budget allocation, the different parts for a gradual but major evolution of the CAP are in place. The July 2002 proposals of the Commission are a clear signal of the willingness to translate the policy shift of the Agenda 2000 into real policy instruments.

There are several reasons for being optimistic about a major reform of the CAP. First, the political support to the farm lobby is being eroded. The farm population has decreased a lot since the Uruguay Round, and so has the political influence of farmers. Resistance to abandon traditional policy instruments such as price support and public intervention comes mainly from a powerful but small sector, which would have a lot to lose if support was directed towards the supply of amenities rather than production. Developing countries and the Cairns group will demand stricter rules for supporting agriculture, which will put pressure for shifting support away from production incentives. A large share of the industry (services, utilities companies) has conflicting interests with agricultural producers. Within a broad trade negotiations agenda, this would offset the influence of some farm lobbies. In the food sector itself, the production of agricultural commodities is now second to the processing sector in terms of value added. Agribusiness interests could offset those of the relatively small number of sugar beet producers, for example, which have so far been an obstacle to regional agreements such as the one with Mercosur.

Perhaps more important, support from the public opinion is also changing, and the need to protect farmers is no longer universally shared in Europe. Individual annual payments of 100 000 Euros are frequent in the EU arable crop sector, and this form of support is more visible than market price support. Such payments will not be tolerated in the long run without real services to the society (environment, landscape, etc.). The CAP is bound to evolve toward payments for amenities, cross compliance and eco-conditionality and move away from protection and market support. More generally, the citizens' attitude towards the farm sector has changed dramatically over the last year or so. Bovine Spongiform Encephalopathy, Food and Mouth Disease have made the public opinion aware of the reality of the agricultural production process. Because they are more and more seen as polluting rivers and groundwater, farmers are no longer perceived as friends of nature. The future policy impact of these changes in public opinion has been underestimated, but it is an engine for political change.

One major obstacle to a significant reform of the CAP has so far been the policy decision making within the EU. Countries that benefit most of the CAP support policies that have a high rate of return to the domestic economy, regardless of their cost for the EU as a whole. A few countries like France, that draws individual benefits from a collectively unsound policy, play a crucial role in maintaining large payments

to the arable crop sector in spite of the limited positive externalities. Enlargement will break the existing coalitions within member states, by diverting the EU money to other beneficiaries (Poland, Romania). It is also foreseeable that German taxpayers will eventually refuse to pour money on the French arable crop sector. Altogether, this could lift one of the major institutional obstacle to a significant reform of the CAP.

6.2 The debate on multifunctionality

Between EU members, there is much debate on the orientations of the future CAP. So far, some vague but convenient terms such as "multifunctionality" and "rural development" have been used to describe the orientations that the CAP should take. While this might have proved useful to avoid sterile conflictual debates, the actual definition of technical aspects of a future CAP is a more difficult step.

As it now stands, the concept of multifunctionality is sufficiently vague as to potentially be open for by politicians aiming at justifying a wide range of policies. Pascal Lamy, European Commissioner for Trade, defines the concept in a speech in September 2000 that "For us, the concept of multifunctionality denotes the importance of agriculture for food security, product quality, the countryside and the rural way of life, the protection of the environment, and jobs". It is difficult not to adhere to proposed reforms that would follow such objectives. However, within the EU, not all members have the same vision of how to achieve them. Some member states countries have an even larger use (and abuse) of the term : For example, some national officials consider that export subsidies are part of a multifunctional agriculture, since they help maintaining farm incomes, and therefore a large farm population.

While the Commission was trying to define lines for a broad agreement on the future evolution of the CAP, it also used the concept of multifunctionality as a way to defend the CAP in international fora. It insists that non-trade concerns that should be taken into account in a future trade agreement, and on the necessity of finding a balance between the control of agricultural policies and the appropriate inclusion of issues that are not strictly trade-related.

The October 1999 Council stated that WTO negotiations must promote the multifunctional role of agriculture. The EU considers that trade rules separate from those for the industrial sector need to be maintained because of the particular place that agriculture occupies in the identity of every nation and the notion of goods of public interest (better environment, biological diversity, living rural economy) that underpins it. That is, the EU would like to tackle the question of multilateral trade in agricultural products from angles that are not strictly trade-related in order to respond to the demand of civil society.

Support for the multifunctional nature of agriculture has two objectives. First, to maintain special treatment for this sector in the WTO. Second, to provide reasonable flexible multilateral trade rules allowing the various countries, on the basis of their respective situations, to implement policies and measures that satisfactorily address non-trade concerns (in the areas of rural development and food security in particular, and from the environmental and cultural point of view). Because these demands require the production of public goods that cannot be completely dissociated from agricultural production, some farm support such as the instruments that are now within the "blue box" are legitimate.

However, other countries have so far remained sceptical. Some countries, including the US and India, are sympathetic with the idea that legitimate multifunctions do exist, and that the whole issue merits attention, but do not intend to provide the EU with an excuse for maintaining trade distortive instruments. They argue that multifunctionality can be achieved by green box instruments and see the EU's version of multifunctionality as a veiled attempt at protectionism. Some developing countries include food security as a major objective but are less keen at recognizing the legitimacy of non trade concerns for developed countries.

Some other countries, such as the Cairns group and developing countries have been even more critical. They claim that providing agricultural support is a very indirect, high cost and often ineffective way to achieve enhanced spillover benefits from agriculture, and that many of the benefits put forward by

supporters of multifunctionality as a basis for agricultural protection are related to agricultural production only indirectly. Australia, for example, has stated repeatedly that the spillovers are not related to agriculture but happen to be located in rural areas. In most other cases, beneficial spillovers could be enhanced without using agricultural protection to maintain or increase agricultural production. European farm households earn a larger part of their income from nonfarm activities, and a more efficient and lower cost option would be to redirect agricultural support payments specifically to rural or regional employment programs.

Box 9. Economic rationale of multifunctionality

"Agriculture provides services apart from agricultural commodity production. These services are linked to the land and are mainly of a public good character (...). Apart from its production function, agriculture encompasses other functions such as the preservation, the management and enhancement of the rural landscape, the protection of the environment, including against natural hazards, and a contribution to the viability of rural areas" (F. Fischler, 1999). In position papers, the EU has also mentioned food safety, poverty alleviation, and other consumers concerns including animal welfare as part of the outputs of a multifunctional agriculture.

The legitimacy of the non trade concerns that the EU wishes to address through a new agricultural agreement at the WTO is not challenged. However, the question is whether the list of multifunctional outputs mentioned by the EU as "linked to land and of public good character" are joint outputs, or they can be provided independently of agriculture production. As pointed out by Burrell (2002), are they consequences or attributes of production ? Can multifunctional outputs be provided without government programmes that support agriculture ? This raises the question of *i/* technical interdependence between commodities and non commodities output (jointness in supply); *ii/* the absence of market for a positive externality.

Studies by the OECD, by Burrell (2001) find little evidence of technical interdependence with the list of non-commodity outputs mentioned by the EU. Nonetheless, there is evidence of impacts resulting from jointness involving the use of non-allocatable factors, and from the reallocation of land to alternative uses. In addition, downward pressure on incomes could well trigger the adoption of technologies and techniques that will reduce the provision of non commodity outputs. Vatn (2002) argues that the transaction costs of policy measures that would permit non-commodity outputs to be targeted separately by direct payments are very high. While this solution is feasible, it is not efficient, and could lead to greater total expenditure per unit of non-commodity output than current agricultural support arrangements. Finally, there are aspects such as food security and rural vitality that, if considered as vital national interests, are bound to the level of domestic food production.

Regarding market failures, it is conceivable that public goods such as biodiversity (e.g. endangered breeds of domestic animals, birds and game that relies on farm activity), water accumulation, nutrient fixation, carbon sequestration or even non-use value of landscape could have both the characteristics of technical interdependence with agricultural production, and find no market expression of collective willingness to pay.

Opponents point out that countries such as the EU (and Norway, Korea, Switzerland) that defend multifunctionality have the highest levels of agricultural protection, and a large share of it in the "amber box". They draw attention on the negative externalities of agriculture, and claim that most of the multifunctional outputs can be induced by targeted green box programmes. They also argue that food security does not mean self-sufficiency and can be achieved by green box instruments such as trade and public storage, and that animal welfare is not an issue that should be taken into account, and that production techniques are part of the concept of comparative advantages.

There is little doubt that many of the posted objectives of the EU regarding multifunctionality can be achieved through green box instruments. The July 2002 proposals of the Commission for the midterm review of the CAP show that the EU agricultural policy could shift towards rural development and environmental protection within the present multilateral framework. There is more uncertainty, though, on issues such as the vitality of the rural population with lower prices and fully decoupled subsidies. Few studies that provides compelling evidence that farmers could find market based activities that would allow

dynamic rural economy. The question of jointness between commodity and non-commodity outputs remains open. If, in some cases, non-commodity output can find a market on its own that may draw agricultural production (e.g. some agricultural areas that became hunting areas, and where the maintaining of grouse and deer populations require farming), it is not always the case.

6.3 The Commission's proposals

The European Council of Berlin mandated the Commission to submit a midterm review of the Agenda 2000, putting it into the wider context of the recent public debate about the CAP and its future. On July 10 2002, the European Commission has tabled a mid-term review of the CAP. The proposal has appeared to many observers as surprisingly ambitious, closer to a radical reform than a simple review.

The Commission's paper started with a very accurate review of the problems raised by the Common agricultural policy, which were not solved by the Agenda 2000 reform. The Commission rightly argues that public expenditure for the farm sector must be better justified. Consumers and taxpayers expect that, besides supporting farming incomes, CAP expenditures must yield more in return regarding food quality, the preservation of the environment and animal welfare, landscapes, cultural heritage, or enhancing social balance and equity. Farmers must be encouraged to at high standards for the highest market return, rather than for the sake of the maximum possible subsidy. To achieve those goals, the Commission proposes :

- to cut the link between production and direct payments, and to cap those payments per farm ;
- to make those payments conditional to environmental, food safety, animal welfare and occupational safety standards ;
- to substantially increase EU support for rural development via a modulation of direct payments with the exemption of small farmers ;
- to make a 10% set-aside for arable crops a condition for direct payments ;
- to introduce a new farm audit system ;
- new rural development measures to boost quality production, food safety, animal welfare and to cover the costs of the farm audit.

As to the market policy, which remains an essential pillar of the CAP, the Commission proposes :

- to bring to a close the process of cereal reforms, notably with a final 5% cut in the intervention price and a new border protection system ;
- a decrease in the additional durum payment accompanied by a new quality premium ;
- a compensated decrease in the rice intervention price;
- adjustments in the dried fodder, protein crop and nuts sectors.

Subsidies would be limited to 300 000 euros per farm. Some market arrangements include a fall in the intervention price of rice, wheat, the ending of intervention for rye, as well as the choice between four policy options for a major reform of the dairy CMO. Overall, the proposal aims at the simplification of the support to EU producers. Table 25. details the proposals, compared to the situation that would prevail if the Agenda 2000 remained unchanged.

The main innovations of the proposal are the radical degree of decoupling of direct payments (see Box 10). Not only would these payments grouped into a single premium, based on historical references and independent from both production and input used, but this payments would be conditional upon cross-compliance to environmental, animal welfare and food quality criteria. In order to ensure eco-conditionality, an audit would be mandatory for farms of a significant size. The compulsory system of "dynamic" modulation would help strengthening rural development by transferring funds from the first to the second pillar of the CAP and expanding the scope of currently available instruments for rural

development to promote food quality, meet higher standards and foster animal welfare. The set-aside obligation would be long term oriented on a non-rotational basis, with necessary land management requirement as part of cross compliance for direct payments. This strengthens the environmental orientation of land retirement programmes. All these proposals are quite radical, and depart significantly from the present situation, where the "second pillar" is largely on paper only, and where its funding (modulation) is only an option for national governments.

Box 10. The main innovations of the Commission's proposals of July 10 2002.

The Commission proposes to introduce a single decoupled income payment per farm. In a first stage, this payment, based on historical payments adjusted to take into account the full implementation of Agenda 2000, would cover the arable crop, beef and sheep sector, as well as grain legumes and starch potatoes. The revised payments for rice, durum wheat and dried fodder would be also integrated into the scheme. Other sectors could follow later. The farm income payment would be conditional on compliance with statutory environmental, animal welfare and food safety standards ("cross compliance"). The decoupled farm income payment would be established at the farm level. The overall amount to which a farm is entitled would be split into parts (payment entitlements) in order to facilitate a partial transfer of the payment when only a part of a farm is sold or leased.

The full granting of the decoupled farm income payment and other direct payments would be conditional on the respect of certain number of statutory environmental, animal welfare and food safety standards, as well as occupational safety requirements for farmers. Cross-compliance would be applied as a whole-farm approach attached to both used and unused agricultural land.

The Commission proposes to establish and support a EU wide system of farm auditing for professional farms, to be defined by member states on the basis of economic size. The focus of such farm audits would be material flows, on-farm processes and equipment relating to environment, food safety, animal welfare and occupational safety standards. The introduction of farm audits for all professional farms is a general objective to be pursued, but as a first step, the Commission proposes that a system of farm auditing will be mandatory as a part of cross-compliance requirements for producers receiving more than 5000 Euros a year in direct payments.

The Commission proposes introducing compulsory long-term set-aside (10 years) on arable land. Farmers would be obliged to put an amount of arable land equivalent to current compulsory set-aside on their holding they have to meet in order to receive direct payments. The current set-aside arrangements would therefore be replaced by long-term environmental set-aside. The new set-aside arrangements would no longer lend themselves to the production of energy crops. The Commission therefore proposes replacing the existing arrangements for non-food crops with carbon credit, a non-crop specific aid for energy crops with the objective of achieving carbon dioxide substitution.

The Commission proposes introducing a system of dynamic modulation on a compulsory basis for all member states. Under dynamic modulation all direct payments would be reduced progressively in arithmetic steps of 3% per year to reach 20%, the maximum agreed in Agenda 2000. This covers both coupled and decoupled payments. It is proposed to introduce a franchise dependent on the employment situation on each farm. After the application of the franchise and modulation the maximum sum paid to a farm would be 300 000 Euros. Direct aids beyond this amount (and the franchise) would be capped and made available for transfer to the second pillar in the member state concerned. The amounts saved by modulation each year will be distributed to member states to target specific rural needs. This would allow some redistribution from intensive cereal and livestock producing countries to poorer and more extensive/mountainous countries.

The Commission proposes to extend the scope of the accompanying measures (agri-environment, less favored areas, afforestation of agricultural land and early retirement) to better address concerns about food safety and quality, to help farmers to adapt to the introduction of demanding standards, and to promote animal welfare. A new food quality chapter will be added into the rural development regulation to encourage farmers to participate in quality assurance and certification schemes, including geographical indications and designation of origin and organic farming. There will be support for producer groups to promote these agricultural products. The Commission proposes to introduce into the agri-environment chapter the possibility to offer animal welfare payments for efforts that go beyond a mandatory reference level in line with agri-environment schemes. In addition, it is proposed to increase the fixed co-financing rate for these measures by a further 10 points, to 85% in areas covered by Objective 1 and 60% in other areas.

The proposals intend to respect the objectives policy direction and financial framework for the CAP set in Agenda 2000.

6.4 Strengths and weaknesses of the Commission's proposal

The Commission's proposal has been received with violent opposition from French, German and Belgian farmers organisations. The governments of France, Spain and Portugal have officially opposed it. Italy is also against most of the proposal but supports a reform that would re-balance support across agricultural sectors. Other countries including, Austria, Ireland, Luxembourg, have major criticisms to the proposals. Germany and the UK have criticized the fact that budget expenses will not be reduced, and that their large farms (East Germany) would be hit most by the "modulation", but seem to be sympathetic with the main orientations. Sweden, Denmark, The Netherlands have welcome the proposal, Sweden pleading for an even deeper liberalization, and the Netherlands for further cuts in direct payments. Many organization of consumers and environmentalists have supported the proposal, including Friends of the Earth and the World Wildlife Foundation.

Although this is unlikely to have a significant impact on EU policymakers, most economists have so far endorsed the Commission's proposal. The proposal would dramatically increase the market orientation of the CAP and remove any incentive for producing for subsidies or for intervention. It would maintain safety nets, through the low intervention prices decided upon during the Agenda 2000 for beef, and those that would take place for rice and wheat, that would limit downwards the price variations and reduce the risk premium eventually paid by consumers. The decoupling would contribute to environmental integration by removing production specific incentives, which damage the environment. The reorientation of the support to reward farmers for their environmental, food safety and quality or animal welfare services, matches a long term trend in the aspirations of EU taxpayers, who want to see some positive externalities for their money. Finally, the proposal, if adopted, would ease the EU position in international trade talks, the EU being presently quite isolated and help the CAP to adjust to future trade agreements.

The future of the Commission's proposal is uncertain. Opposition from some member states and farmers' unions suggests that, the proposal will face a hard time in the Council of ministers. The changes proposed by the Commission exceed most expectations by CAP observers. It is possible that the Commission's strategy was to table a radical reform scenario, expecting some opposition from member states on issues such as complete decoupling, ceiling on payments per farm, and perhaps the decrease in wheat intervention price, in order to save the essence of the reform, i.e. the reorientation of 20% of the budget for direct payments from the first to the second pillar, the eco-conditionality, and the mandatory audit. In such a case, it is difficult to anticipate the effects of a reform that might (or might not) be more limited than the Commission's proposal.

However, overall, the reform would be a significant move of the CAP towards a more efficient policy, more in line with consumers and citizen's expectations.

Some interrogations. Some aspects of the proposal raise questions. The proposal remains relatively obscure as far as the obligation of production is concerned. Even though it is said that the decoupling will "remove production specific incentives", the wording suggests there would still be the need to produce to get the "single decoupled income payment per farm". However, the exact impact of a payment that would be based on historical payments is difficult to assess. Would producers be tempted to cash the payments and quit production ? How would producers react to fully decoupled direct payments, given the low prices under the Agenda 2000 safety nets, that would be complemented by even lower prices for cereals under the proposal ? Preliminary studies at the microeconomic level suggest that, while in the most productive areas, the decoupling would have little impact on output, some intermediate regions could stop producing cereals, for example.

In addition, a considerable uncertainty surrounds the effect of the payments for energy crops. Under Agenda 2000, these crops can be grown on set-aside land. This would no longer be the case, and if payments for carbon sequestration are found attractive by producers, the development of these productions would be at the expense of food production. The impact could be considerable. So far there is no assessment of the overall effect of this program.

The transfer of payment entitlement, and the degree of linkage to land are unclear. The wording of the proposal suggests that the decoupling of the direct payments does not reach the point where a farmer could sell the right to payments to other individuals (the ultimate step of decoupling, where farmers could cash, or sell as a bond, the right for payments for the next 10 or 15 years is known as the "bond scheme", and is advocated for by some economists. See Swinbank and Tangermann, 2001). The proposal includes a section on transfer entitlements that suggest (in spite of an ambiguous wording, and doors left open for some national adjustments) that the payments rights could only be transferred with the transfer of land. If it is the case, there will be no significant effect on the price of land in the short run.

Another question mark is the compatibility of the proposal with the EU enlargement. In the present proposal, nothing is said about the reference (i.e. historical) payments on which the "decoupled farm income payment" would be based, for the future members of the EU. The articulation of the July 2002 proposal on the midterm review of the CAP and the January 2002 proposals on the extension of the direct payments to new members is unclear. This is likely to have considerable budget impact.

Finally, what would be the impact of the ceiling on direct payments ? It is likely that many producers will find a way to escape the discipline by dividing larger farm entities into smaller ones. However, this strategy might be limited by the size of large domains in Eastern Germany or the UK. Again, an assessment of the impact of this measure is needed.

Possible caveats of the Commission's proposal. The next months will provide the opportunity for debates, and for a deeper assessment of the Commission's proposals. The following issues need to be investigated.

- A frequent criticism of the Commission's proposal is that it is based on ideas that were the backbone of the 1997 US FAIR Act, which also introduced a decoupling of the direct payments. However, during a period of low world market prices, the US government supplemented dramatically the FAIR Act payments by several assistance schemes, largely coupled to production, and introduced in 2002 a new farm bill that departs from the orientation of the FAIR Act, and introduces "counter cyclical" payments that depend on the level of prices. In the Commission's proposals, the payments are not countercyclical, and this might raise the question of political acceptance, should world prices remain at a low level.
- If world prices remained low for several years, the proposed reform could drive large areas in the EU out of production. Because of the sector specific inputs, this might have some irreversible effects. While this issue refers to the debate on jointness of between commodity and non-commodity outputs of agriculture, it is uncertain that the vitality of rural areas can be ensured by policies that would completely substitute non farm activities for agricultural production.
- The Commission's proposal can be seen as "freezing" a present situation. Indeed, farms that presently benefit most of the CAP are the relatively large intensive farms, i.e. exactly those that should not be favored by the "second pillar" of the CAP, because they contribute very little to rural employment, landscape and the protection of environment. The farmers that capture most of the subsidies are located in best arable farms with the highest yields and are exactly those who need not to be subsidised more heavily by the EU budget. However, by perpetuating the present level of support, the CAP will keep supporting most (perhaps perpetually, since the proposal does not set any time limit for the direct payments) the farms that it intends to target less. Alternative proposals such as a single payment per hectare, regardless of the production, was dismissed by

the Commission. Even though this would result in large in the sharing of the CAP budget, this alternative should be discussed.

- No direct payment is fully decoupled, including those that would result from the radical decoupling proposed by the Commission.²⁸ By providing permanent payments to established producers and no payment to newcomers, the Commission's proposal would introduce considerable distortions in the capacity to invest, to face poor harvests, and to cope with risk in general among farmers, even within the same area. This could result not only in extra barriers to entry for young farmers, but also in a competitive advantage for established farmer, who might eventually expand their farms. Favouring the concentration of agriculture to the profit of such or such individual is not in the primary objectives of the CAP.
- A major interrogation lies in the ability to substitute second pillar payments for first pillar payments to a large extent. In the Commission's proposal, 20% of the direct payments will shift from the first to the second pillar. That is, the budget devoted to second pillar direct payments will soon be considerable. However, it is dubious that one can distribute huge amounts of money (roughly one third of the present CAP budget) for issues such as environmental payments or rural development, without major unwanted effects. Already, the budget for rural development is under-utilized, because of the lack of eligible projects. Large transfers can only be distributed if the criteria for attributing payments are lenient. We saw earlier that, already, some of the conditions for eligibility to some agri-environmental payments were questionable, even though the amounts of money at stake are very limited. Environmental and rural development programmes can only be managed in a very decentralized way, since they only have sense if they are adapted to local conditions. The combination of huge budgets, decentralized management, and technical criteria that lack precision opens the door for classical problems of collusion between supervisees (i.e. farmers) and supervisors (i.e. local authorities) at the expense of the agency's (i.e. the Commission) budget. In addition, this is a clear incentive for bringing more corruption into programmes that are already affected by a significant problem of fraud. Clearly, the management of the second pillar is a problem so difficult that it could limit the ambitions of the Commission for a major reorientation of the CAP.
- Finally, under the Commission's proposals, one cannot be sure that the objectives of a more extensive and environmentally friendly agriculture will be achieved. A defensible point of view is that, because payments will be decoupled and producers will mainly based their production decisions on world market prices, the proposals might lead to a concentration of production in very intensive areas, in particular in the beef sector. For example, one can imagine beef production that would move to feedlot production in areas such as French Brittany or the Netherlands, a phenomenon observed for pork production during the last 20 years. The present proposal includes some ecoconditionality. However, it is possible that very intensive production feedlots match the criteria, if they have the appropriate techniques to dispose manure, and implement perfect traceability. The evolution of the CAP, towards a more "Californian" type of agriculture would not be the one that the proposal is supposed to encourage. Again, there might be clauses and conditions given to direct payments for channelling the evolution of the CAP towards the rural development that the Commission has in mind, but the market will find ways around and it is unlikely that this new CAP can be managed so that all possible loopholes are avoided.

²⁸ There is an admitted rule of thumb among applied modellers that, in the US, the effect of the FAIR Act "flexibility" payments were such that 1 dollar of payment has a similar impact on production as a 30 cents increase in output price.

7. Conclusion

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Table 1. Budget of the EAAGF (current Ecus and Euros).

	1967	1980	1993	1997	2000	2001
Total EAAGF						
Orientation section						
Guarantee section			34 747	40 675	40 434	
including export subsidies				5 884	5 646	
including direct payments						

Table 2. Basic figures on agriculture

	Agricultural area (1000ha)	Average farm size (1997)	Output Mio Euros	Intermediate inputs	Value added	Share agriculture in GDP	Share of food, drinks, tobacco in households expenditure
Austria	3399	16.3	5246	2942	2304	1.2 %	15.3
Belgium	1396	20.6	6921	4224	2967	1.8 %	17.8
Denmark	2666	42.6	7722	4579	3143	2.0 %	18.1
Finland	2211	23.7	3533	2429	1103	0.9 %	18.9
France	29865	41.7	62929	31159	31338	2.4 %	
Germany	17067	32.1	41612	24549	17062	0.9 %	16.0
Greece	3901	4.3	11285	2880	8405	7.1 %	
Ireland	4418	29.4	5469	2973	2496	2.9 %	19.1
Italy	15401	6.4	42049	13168	28881	2.6 %	18.0
Luxembourg	135	42.5	251	129	122	0.7 %	15.3
Netherlands	1976	18.6	18457	9997	8459	2.4 %	-
Portugal	3881	9.2	6309	2913	3396	3.3 %	-
Spain	25425	21.2	33344	11398	21947	4.1 %	-
Sweden	2980	34.7	4385	2941	1443	0.7 %	-
United Kingdom	15772	69.3	24147	13249	10898	0.9 %	-
EU-15	130443	18.4	273658	129963	143695	1.8 %	-
Japan	4731						
United States	381605						

Source : EU Commission, FAO

Table 3. : Main productions in EU agriculture (% of total EU production)

	Wheat	barley	Maize	Sugar	Milk	Beef	Pigmeat
Austria	1.3	2.3	4.0	2.7	2.2	1.9	3.2
Belgium	1.4	0.7	0.1	5.1	2.6	4.1	6.0
Denmark	4.1	8.2	0	2.9	3.9	1.5	9.1
Finland	0.3	0.4	0	1.2	2.7	1.0	1.2
France	34.2	19.6	36.9	22.1	20.2	27.8	12.4
Germany	19.4	26.6	9.0	23.5	21.7	14.8	21.0
Greece	4.0	1.0	7.9	2.1	2.2	0.9	1.2
Ireland	0.4	2.3	0	1.5	3.7	6.5	1.1
Italy	10.9	3.9	28.4	12.1	11.0	12.7	9.3
Luxembourg	0	0.1	0	0	0.2	0.2	0.1
Netherlands	0.7	0.5	0.2	6.5	8.5	10.0	3.2
Portugal	0.7	0.1	3.4	0.5	2.2	1.5	2.3
Spain	2.0	13.2	9.9	8.3	1.6	8.8	15.4
Sweden	1.5	3.6	0	2.6	3.0	1.3	1.9
United Kingdom	14.1	14.1	0	9.0	10.6	12.1	6.0
EU-15	Tonnes						
Australia							
Japan							
United States							

Source : EU Commission

Table 4. : Share and evolution of agricultural employment in the EU

	Number (in 1000 annual worker units, 1999)	Employment in agriculture, forest, fishing and hunting as a % of total employment (2000)	Change 1986 to 1998, in full time farm equivalent	Share of farmers above 50 years old
Austria	128.5	6.1%	-26%	
Belgium	74.8	1.9%	-21%	
Denmark	77.9	3.7%	-19%	
Finland	127.1	6.2%	-22%	
France	1033.3	4.2%	-28%	
Germany	641.0	2.6%	-19%	
Greece	578.2	17.0%	-29%	
Ireland	183.6	7.9%	-15%	
Italy	1639.2	5.2%	-28%	
Luxembourg	4.4	2.4	-30%	
Netherlands	212.5	3.3%	-7%	
Portugal	494.3	12.5%	-39%	
Spain	1055.0	6.9%	-12%	
Sweden	78.6	2.9%	-11%	
United Kingdom	357.0	1.5%	-14%	
EU-15		4.3%	-24%	
Australia		5.1%	+0%	

Japan		4.4%	-32%	
United States		2.7%	+3%	

Source : OCDE, EU Commission

Table 5. Weights in the voting system for decisions adopted at qualify majority.

	Weights (total 87)	Weights after ratification of the Nice Treaty (total 237)
Austria	4	10
Belgium	5	12
Denmark	3	7
Finland	3	7
France	10	29
Germany	10	29
Greece	5	12
Ireland	3	7
Italy	10	29
Luxembourg	2	4
Netherlands	5	13
Portugal	5	12
Spain	8	27
Sweden	4	10
United Kigdom	10	29

Table 6. Selected institutional prices

	2001/2002	2006 (under unreformed Agenda 2000)
Cereals (intervention price)	101 €/tonne	
Rice	298€/tonne	
Sugarbeet (basic price)	48 €/tonne	
Olive oil target price	3838 €/tonne	
skim milk powder (intervention price)	2055 €/tonne	
butter (intervention price)	3282 €/tonne	
beef (intervention price for R3 beef carcass)	3013 €/tonne	
pigmeat (basic price)	1509 €/tonne	
sheepmeat (basic price)	5401 €/tonne	

source : European commission, compiled by OECD

Table 7. : Area and headage payment rates

(Exemple of reference regional yield in France : 5.9 tonne/ha)

	2002	2006 (scheduled under Agenda 2000)
Cereals (including corn silage)	63.0 €/t (times the regional reference yield)	
Oilseeds	72.4 €/t (times the regional reference yield)	
Protein crops	72.5 €/t (times the regional reference yield)	
Set-aside payment	63.0 €/t (times the regional reference yield)	
Beef: suckler cow premium special beef premium bull steer extensification premium stocking density < 2 UGB/ha <1.6 UGB/ha Slaughter premium adult bovines calves	182 €/head 185 €/head 136 €/head 33 €/head 66 €/head 53 €/head 33 €/head	
Sheepmeat		
Ewe premium addition ewe premium in less favored areas	based on basic price 5.9 to 6.6 €/head	

Source : Commission, OECD.

Table 8. Budget of the European Union.**Table 9. Importance of the two "pillars" in the EU budget.****Table 10. Budget expenditures, per type of measure, Million Euros or Ecus.**

Table 11. Budget expenditures, per sector, Million Euros or Ecus.

	1993	2000	2001	
				% direct payment s
Arable crops	10611			
Sugar	2189			
Olive oil	2468			
Fodder	532			
Fiber	861			
Fruits and vegetables	1664			
Wine	1509			
Tobacco	1165			
Other crops	259			
Dairy	5211			
Beef	3986			
Sheep and goats	1800			
Pigs	200			
Poultry and eggs	291			
Other animals	135			
Fisheries	32			
Other measures (1)	1838			
agrienvironmental and forestry measures	222			
Total agricultral expenses, Guarantee section of EAGGF (2)	34590.5			
Share of expenses :				
Storage costs				
Direct payments				
Export subsidies				
Agri- environmental and agro-forestry	0.6%			

(1) including pre-retirement schemes

(2) does not add up because of reports of previous years balance

Table 12. EU agricultural budget per member state, and national expenditures Million Euros or Ecus.

	FEOGA Guarantee	FEOGA orientation	National expenses in addition to those covered by the EU budget. Millions euros (average 1999-2001)
Austria			896
Belgium			341
Denmark			247
Finland			1385
France			3242
Germany			1740
Greece			223
Ireland			240
Italy			1165
Luxembourg			35
Netherlands			1056
Portugal			308
Spain			686
Sweden			381
United Kingdom			1113

Source : FEOGA, OCDE estimate for national expenditures

Table 13. Milk quotas and national consumption

	Quota	Self sufficiency ratio
Austria	2749	
Belgium	3310	
Denmark	4455	
Finland	2406	
France	24236	
Germany	27865	
Greece	701	
Ireland	5396	
Italy	10530	
Luxembourg	269	
Netherlands	11075	
Portugal	1872	
Spain	6117	
Sweden	3303	
United Kigdom	14610	

Table 14. Producer Support Estimate, General Service Support Estimate and Total Support Estimate

	UE : 1986-88	UE : 2001	OECD : 2001
Total value of production			
PSE			
including MPS			
including payment based on output			
including payments based on area planted/animal numbers			
Percentage PSE			
GSSE			
TSE			
including transfers from consumers			
including transfers from taxpayers			

Table 15. Percentage Producer Support Estimate per commodity

Table 16. Expenses relative to agri-environmental measures per member state

Table 17. The agriculture in accessing countries

	Agricultural land		Agricultural production		Agricultural employment		Trade in agricultural and food products	
	millions ha	% total surface	millions euros	% GDP	millions	% total employment	% total exports	% total imports
Poland	18.4	59%	4.4	3%	4.0	25%	11%	11%
Hungary	6.2	66%	2.7	6%	0.3	7%	18%	5%
Czech Republic	4.3	54%	2.0	4%	0.2	5%	6%	8%
Slovenia	0.5	24%	0.7	4%	0.1	7%	4%	8%
Estonia	1.5	32%	0.3	6%	0.1	9%	16%	16%
PECO-1	31.0	56%	10.1	4%	4.6	18%		
in % EU-15	21%	-	8%	-	56%			
Romania	14.8	62%	5.1	16%	3.4	38%	9%	8%
Bulgaria	6.2	56%	1.7	15%	0.8	23%	19%	8%
Slovakia	2.4	50%	0.7	4%	0.2	8%	5%	9%
Lituania	3.2	49%	0.9	9%	0.4	24%	13% %	17%
Lettonia	2.5	39%	0.2	4%	0.2	15%	17%	13%
PECO-2	29.1	55%	8.7	11%	5.6	28%		
in % EU-15	20%	-	7%	-	68%			
PECO-10	60.1	56%	19	6%	10.2	22%		
in % EU-15	41.5%		15%		125%			
UE-15	144.9	45%	122.6	2%	8.2	6%	7%	10%

source : national, world bank, compiled by M.Girard-Vasseur and E.Vergniaud. Based on 1999 Figures.

Table 18. Price differences and nominal assistance coefficient in selected in accessing countries and the EU

		Czech Republic	Hungary	Poland	Slovakia	EU-15
Ratio of producer price to the EU-15 producer price						
	Wheat					
	Sugar					
	Milk					
	Pigmeat					
	Beef					
Nominal Protection coefficient (Producer)						
	Wheat					
	Sugar					
	Milk					
	Pigmeat					
	Beef					
Percentage PSE						
	Wheat					
	Sugar					
	Milk					
	Pigmeat					
	Beef					

Table 19. EU Aggregate Measures of Support, notifications to the WTO and ceilings (million euros), marketing year 1999/2000 (june 2002 notifications)

Category		EU notification	Ceiling
Green box measures		19930.5	none
Blue box measures			
including	Arable crops	15128	none
including	Beef	2930	none
including	Sheep, goats	1734	
Amber box		47886	69463
including	AMS arable crops	7205	
including	AMS sugar	5758	
including	AMS olive oil	2070	
including	AMS dairy	5814	
including	AMS beef	13089	

Table 20. EU export subsidies, notifications to the WTO and ceilings, 2000

	Outlay (million Euros)	Ceiling for year	Fullfilm ent	Quantity (1000 tonnes)	Ceiling for year (1000 tonnes)	Fulfillem ent
Wheat and flour	509.3	1493.2	34%	15606	15630	100%
Coarse grains	7030.2	1158.6	63%	18379	11412	161%
Rice	26.4	40.4	65%	140	139	101%
Rapeseed	0	30.3	0%	0	108	0%
Olive oil	0	59.4	0%	0	120	0%
Sugar (after deduction of ACP imports)	470.1	545.9	86%	971	1330	73%
Butter	333.4	1036.7	32%	194	417	46%
Skim milkpowder	337.8	301.9	112%	417	285	146%
Cheese	253.8	392.1	60%	305	342	89%
Other milk products	905.4	763.1	119%	1104	1004	110%
Beef	726.1	1387.4	52%	766	885	87%
Pigmeat	243.0	210.8	115%	694	463	150%
Poultrymeat	75.1	99.8	75%	318	316	101%
Eggs	14.1	47.1	30%	101	104	96%
Wine	26.2	42.8	61%	2387	2414	99%
Fruit and veg (fresh)	37.2	57.8	64%	873	787	111%
Fruit and veg (proc)	5.5	9.1	60%	108	150	72%
Tobacco	0	51.4	0	0	127	0%
Alcohol	218.6	105.1	208%	1998	1198	167%
Incorporated product	719.5	475.4	151%			

Table 21. Average EU tariffs for agricultural and food products**Table 22. Average EU tariffs by sectors****Table 23. Selected peak tariffs in the EU**

Table 24. Tariff rate quotas in the EU (an item may include several official TRQs).

Products	Current access (tonnes)	Minimum access (tonnes)
Live bovines	194.000 (heads)	
Beef	151.050	20.000
Pork		75.600
Sheep and goats	319.875	
Poultry		29.000
Eggs		208.000
Butter	76.667	90.000
Skim milk powder		69.000
Cheese	15.250	104.000
Cassava, sweet potatoes	6.857.390	
Bananas	2.000.000	
Citrus	45.000	
Maize-sorghum	2.300.000	500.000
Wheat		300.000
Sugar	1.565.000	
Bran	475.000	
Mushrooms	62.660	

Table 25. Changes under the July 2002's Commission proposals

	Agenda 2000, no reform	Commission's proposals
Cereals	Intervention price at 101,31 €/t; Direct payments of 63 €/t multiplied with the reference yield Monthly increments applied in seven steps each adding 0,93 €/t to the intervention price	Final intervention price cut of 5% (from the 20 % proposed in Agenda 2000), down to 95.35 €/t. Compensation following the Agenda 2000 approach, i.e. at a rate of 50 %. Abolition of monthly increments. Revision of border protection. Abolition of rye intervention.
Durum Wheat	Specific supplementary payment:- 344.50 €/ha in "traditional" areas- 138.90 €/ha in "established" areas.	Reduction of the supplementary payment to 250 €/ha in "traditional areas", phased in over three years. No supplement in "established areas". Introduction of a quality top-up of 15 €/t applicable everywhere.
Oilseeds	Alignment of the area payment for oilseeds and cereals	No specific measures foreseen. Increase in payment the same as for cereal payments
Protein	Specific supplementary payment of 9.5 €/t times the reference yield	Under the decoupling scheme, a new stand-alone protein supplement of 55,57 €/ha (9,5 €/t times the average reference yields of regions where protein crops are grown).
Rice	Intervention price at 298.35 €/t (paddy rice). Direct payment of 52.65 €/t, paid per hectare, within Maximum Guaranteed Areas	50 % reduction of intervention price to a basic price of 150 €/t, triggering private storage. Safety net intervention at 120 €/t. Compensation payments of 177 €/t of which a smaller part (75 €/t) will be granted as a crop-specific payment. Reduction of the maximum guaranteed area to the 1999-2001 average or the current maximum area, whichever is the lower.
CO ₂ Credits	Non-food regime on set-aside land (contract with processor required)	45 €/ha for energy crops (contract with processor required). Maximum guaranteed area of 1.5 Mio ha
Dried Fodder	Direct payments: - 68.83 €/t for dehydrated fodder - 38,64 €/t for sun dried fodder	Income payment for farmers as a part of the single farm income payment (envelope of 160 Mio €). Simplified single support to industry for dehydrated and sun-dried fodder with a reduced payment of 33 €/t
Nuts	Multi-annual quality and marketing improvement plans, run by producers organisations.	Flat-rate payment of 100 €/ha with top-up option from member states up to 109 €/ha. Maximum guaranteed area 800 000 ha.
Beef	Basic price at 2224 €/t with private storage possible at 103 % of this price. Buying-in tenders at safety net intervention level of 1560 €/t; Headage payment within limits with 150 € for steers (two payments per life), 210 € for bulls and 200 € for suckler cows (annual). The latter requires 15 % heifers. Additional slaughter premium of 80 € (bulls, steers, cows) and 50 € (calves) Eligibility criteria: up to 1.8 LU/ha (from 01.01.03, currently 1.9 LU), head limit of 90 (with derogation) Extensification premium: 100 € per premium for a stocking density of 1.4 LU/ha. Another option : 80 € per premium for a stocking density below 1.4 LU/ha and 40 € for 1.4 to 1.8 LU/ha (limits valid as from 2002). National envelope	No specific measure foreseen, however major implications of decoupling (single premium per farm based on historical rights); Reduction of incentives towards intensive beef production (decoupling); Reinforced cross-compliance conditions including land management conditions; Strengthening of quality and support for environmentally friendly beef production through the 2nd pillar;
Dairy	Quota-regime valid until 2008. Stepwise reduction of intervention price by 15% from 2005/6 onwards. Cow premium rising from 5.75 €/t to 17,24 €/t of quota from 2005/6 onwards plus additional payment ("top-up premium and/or area payment). Global increase of quota by 2.39 %	Options encompassing: (a) the continuation of the Agenda 2000 measures until 2015. (b) Agenda 2000 approach with a further price cut (-15% for butter and -5% for SMP) and increase of quota (+3%); (c) introduction of a two-tier quota regime; (d) removal of quota with a cut of intervention by 25 %.
Decoupling	Various arable premia linked to the	Single decoupled farm income payment . Can be split into

	production of specific crops. Partial decoupling only due to the alignment of the cereals and oilseeds payments Animal premia linked to the requirement of producing beef or dairy	payment rights attached to eligible hectares. The single farm income payments includes the payments for cereals, oilseeds, protein crops ; grain legumes ; rice ; flax, hemp linseed ; starch potatoes; durum wheat supplement; dried fodder (after reform); beef; sheep ; milk from 2005/06. Further crops can follow. The following payments are not included: durum wheat quality premium, protein crop supplement, specific payments for rice. Member states may opt for balancing payment levels within certain limits.
Cross-Compliance	Optional use of reductions of direct payments for enforcing statutory environmental legislation and so-called specific environmental requirements	Compulsory cross-compliance as a whole farm approach: direct payments conditional on the respect of statutory legal standards (environment, food safety, and animal welfare) and keeping land in good agricultural conditions in line with environmental requirements.
Set-aside	10 % set aside, exempting farmers producing less than annually 92 t of cereals (calculated with the reference yields)	Continuation of the individual historical set-aside obligation (based on the 10 % set-aside requirement) on long-term-oriented (10 years), non-rotational basis; Compliance with necessary land management requirements (part of cross-compliance) Abolition of the non-food regime on set-aside land (replaced by the Carbon credit, see above).
Farm Audits	The establishment (not the operation) of certification systems is an option under the Rural Development package	Farm audits compulsory for all farms receiving more than 5000 € Audits will account for all relevant material flows and on-farm processes. Financial support covering operation costs for farmers is eligible under Rural Development
Dynamic Modulation	Optional reduction of direct payments up to 20 % Unspent money remains in Member State to be spend on "accompanying measures	Dynamic modulation of 3 % per year up to a total reduction of 20%; Savings shifted to Rural Development (any measure) through the EU budget (adding 500-600 mio € per year). Distribution key based on agricultural area, farm employment and prosperity. 5000 €for each farm exempted from the cut. Member States may further exempt 3000 €for each labour unit above two. Capping at 300 000 €per farm, with savings kept in the member state concerned.
Food Quality	Investment aid in favour of food quality including the establishment of certification systems eligible under rural development plans Promotion of certain commodities subject to two horizontal regimes: one for internal promotion, one for external promotion.	Establishment of a food quality chapter as a new "accompanying measure" including : encouragement to farmers to participate in quality assurance and certification schemes ; support for producer groups for promotion in the context of quality assurance, geographical indication and organic farming . Targeting first pillar measures only to external promotion
Animal Welfare	Only regulatory measures (DG SANCO)	New animal welfare measure alongside and in the same logic as agri-environment measures (covering cost incurred and income forgone do to commitments beyond legal standards) Granting export subsidies for live animal only on the basis of justified requests and in line with animal welfare requirements.
Agri-Environment	Current aid intensity - 75 % in Objective 1 areas - 50 % in others;	Raising of the aid-intensity for agri-environmental measures: - 85 % in Objective 1 areas - 60 % in others;
Meeting Standards	no incentive measure in place	Support for farm audits - flat-rate payments to farmers to cover operation costs of audits. Temporary and degressive aid (max 200 €/ha) to farmers to help them implementing statutory standards". Not applicable to the non-application of standards already established by national legislation
State aid	Ex-ante notification and authorisation	Consideration of block exemptions with a view to speed up implementation. Ex-post reporting and monitoring