Reform and adjustment in the European Union: the 2003 reform of the Common Agricultural Policy and enlargement

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Abstract: This paper aims at presenting the main findings of an impact analysis of the reform of the Common Agricultural Policy on the agricultural markets and income of the current and the enlarged European Union over the 2004-2010 period, with specific investigation of the impact of the single farm payment. This policy changes towards significantly less-trade distorting instruments should reduce the risk of structural surpluses. The market projections indicate that adjustment of production would take part in key areas of agricultural production in Europe (cereal, beef and dairy production) while keeping agricultural income little affected.

Key words: Common Agricultural Policy, enlargement, decoupled payments, reform

Introduction and main hypotheses

Over the medium term agriculture in the EU will be exposed to significant adjustments and changes. The reform of the Common Agricultural Policy (CAP) in June 2003 brought about a major change in the agricultural policy by largely decoupling agricultural support from production. Moreover, the historical enlargement of the European Union (EU) will integrate the agricultural sectors of 10 new countries into a single market which will expand from 378 to 453 mio inhabitants.

This paper aims at presenting the main findings of an impact analysis of the reform of the CAP on the agricultural markets and income of the current and the enlarged European Union over the 2004-2010 period (European Commission 2003a). The paper also gives a view of the developments of agricultural markets in the EU-25 by taking into account the CAP reform as well as the specific conditions of entry for the new Member States.

The paper summarises the different scenarios for the EU-15 and the EU-25. This analysis has been undertaken on the basis of the statistical information available at the end of 2003 using the modelling tools[ii] currently available at the Directorate-General for Agriculture of the EU Commission. They have also been established under a specific set of assumptions, the most important of which concerns the Common Agricultural Policy where the projections based on the implementation of the latest decisions for CAP reform[iii] (i.e. the baseline) are compared with a *counterfactual* scenario, which corresponds to the continuation of the Agenda 2000 policy measures. The other important assumptions regard mainly the agricultural policy in the new Member States, other domestic policy measures, the trade policy framework, the macro-economic environment and the medium-term developments on world agricultural markets[iv]:

Main characteristics of the CAP reform

The key elements of the reformed CAP can be summarised as follows (European Commission 2003b):

- The introduction of a single farm payment (SFP) for EU farmers, replacing most of the premia currently offered, independent from production with limited coupled elements maintained where Member States consider this necessary to avoid abandonment of production. The granting of the SFP is conditional to the respect of environmental, food safety, animal and plant health, and animal welfare standards, as well as to the requirements to keep farmland in good agricultural and environmental conditions;
- Strengthening of rural development with a significant extension of the scope of measures and funds through the implementation of modulation (reduction of the SFP for larger farms);
- Revisions to some common market organisations (cereals, dairy, rice, nuts etc.) with a significant reduction in price support;
- Financial discipline: introduction of strict budgetary ceilings for farm support (decreasing in real terms).

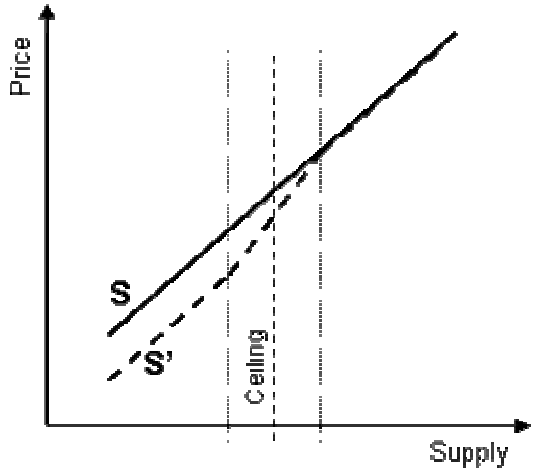
Introduction of decoupled payments

One of the key features of the latest CAP reform is the introduction of the single farm payment decoupled from production. From a theoretical point of view, decoupling refers to the idealized situation where policy measures do not affect production (and trade) as they do not distort decision making by producers

(or consumers) and markets adjusts as if there were no policy in place. Different concepts of decoupling have been put forward with varying degree of restrictions regarding the impact on production and trade (OECD 2001). Several studies have shown that decoupled payments without condition can still create distortions associated with risk and dynamics effects. This may occur by influencing the individual decision to stay in agriculture and to continue producing (Rude 2000, Benjamin 1992). There may also be an announcement effect whereby farmers anticipate on the information about future transfers being contingent on actual cultivation (Young and Westcott 2000). Finally, the impact on the collateral value of land (Phimister 1995), and the income and insurance effects (Hennessy 1998) may be significant. Nonetheless, such effects are seldom recognized as creating important distortions on international trade.

The transition from a situation with direct payments limited to a certain area/number of animals towards a situation with support totally decoupled from production level can be synthesised in the following graph. Supply S' is influenced by direct payments until ceilings are reached. Then aggregated supply S' gradually moves to the left, to reflect the fact that, even when the overall average ceiling is reached, there are some individual farmers who have not yet reached their limit and continue to be influenced in their production decisions. After a certain quantity, any additional quantity produced depends entirely on price. Under total decoupling of direct payments the supply curve moves back to S.

Graph 1



The quantitative assessment of the impact of the decoupled payments is a difficult analytical task, in particular with the modelling tools currently available. The way in which the single farm payment is implemented and modelled may notably influence producer decisions and the projected production patterns. The single farm payments have been considered in our analysis to operate as lump sum transfers with no impact on production decisions of farmers. However, the cross-compliance requirements, the respect of good agricultural practices, the eligibility conditions attached to the decoupling scheme as well as agricultural legislation in Member States have been assumed to constrain the shift between activities, notably between grassland and arable land production and between agricultural activities and abandonment of production. Other studies (such as FAPRI, 2003, University of Bonn, 2003, and OECD, 2004) have all used different assumptions: whereas the single farm payments are considered as lump sum transfers retaining some production-inducing effects, assumed at some 30 % of the supply-inducing effect of the more coupled payments they replace in the FAPRI analysis and at 0.06 in the OECD analysis, the

University of Bonn treated the single farm payment as a uniform payment at national or regional level, i.e. a uniform non-crop-specific payment (entailing a redistribution of support between crops and farms, which would tend to overestimate the impact of the single farm payment based on historical references on land allocation – reflecting the implementing situation in some Member States). The analyses of the different ways of implementing the SFP confirm limited differences in terms of production impact. By contrast, the income impact would be more pronounced between farming groups (cereals, livestock and dairy) and regions.

The implementation of the single farm payment scheme as part of the CAP reform decisions[v] allows Member States to choose among different options, which should influence the degree of decoupling of the payments. For the purpose of this impact analysis exercise, a series of assumptions has been made regarding the implementation option which could be adopted by each Member States for the sectors concerned. These working hypotheses have been defined on the basis of the information available, which at the time of the analysis were judged the most plausible. However, in order to limit the uncertainty attached to these assumptions, the main findings of alternative scenarios based on a "maximum" and "minimum" decoupling assumption are summarized in a box at the end of the paper.

Under decoupled support mechanisms, producers may be expected to increasingly base their production decisions on market signals (profitability expectations), thus potentially leading to significant changes in the allocation of production. However producers' behaviour could also be influenced by other considerations, such as social inertia (arguably a short-term issue), the maintenance of some crops for agronomic purposes, the participation in agri-environmental programmes, the need to depreciate long-term investment, the eligibility to specific well-targeted support programmes addressed to less favoured area payments, etc., which could all be expected to mitigate the overall impact of decoupling on the farm sector.

Production may also be expected to adjust when market revenues do not cover variable cost on a structural basis (such as some crop production in marginal areas, in the beef and sheep sectors where the support system may create incentives to base production decisions on the maximisation of subsidy revenues rather than on the basis of what market prices would normally imply).

This adjustment could take several forms including:

- An adjustment in the production mix (including non-eligible production alternatives): this adjustment may be expected to be constrained between major production sectors -such as animal and arable crop sectors- as the conversion of pasture land to arable land is limited on a statutory basis. Any significant shift between arable crops and fresh fruit and vegetables production may also be reasonably assumed to be limited as a major increase in land allocation towards fruit and vegetables could create major economic disturbances in these sectors;
- An adjustment in the production intensity, notably in the beef and sheep sectors;
- Abandonment of production: this alternative may be expected to be constrained by cross-compliance conditions for the receipt of the single payment (it may, in some cases, be more profitable for some producers to simply reduce their production intensity than to stop producing);
- Adjustment in the farm structure with sale or lease of all or part of the land: this last alternative does not necessarily entail a reduction in the production potential.

The pressure for (structural) adjustment in the farm sector consecutive to the introduction of the SFP is expected to be particularly important in the beef and sheep sectors, notably in countries of Northern Europe. For example, more than a third of farms specialised in suckler cow activity in the EU had negative gross margins (without direct payments), with figures even significantly higher in some European regions. A similar picture can be found in the sheep meat sector. The lack of competitiveness of specific sectors is particularly acute in regions subject to environmental constraints and/or classified as less favoured as more than three quarters of the farms not covering variable costs in the animal sector come from these regions.

Enlargement of the European Union

The implementation of the CAP would generally improve the situation of agriculture in the new Member States compared to the situation without membership and under domestic policies. The CAP in combination with the size of the Single Market provides more stable and on average slightly higher prices than domestic policies of the individual Accession Countries could secure for the years to come.

The new Member States will add about 38 mio ha of utilised agricultural area to the 130 mio ha of the current Member States representing an increase of 30 %, whereas production in the EU will increase by about 10 % to 20 % for most products. Gross value added of agriculture in the EU-25 will be 6 % higher than that of the EU-15 and employment in agriculture will increase by 60 %. These differences illustrate an important lower intensity of production in the new Member States and a significantly lower labour productivity than in the EU-15.

Despite all the positive achievements in the preparation for EU membership a considerable task of restructuring agriculture and food industries, most notably in animal production, remains in the new Member States in order to increase competitiveness on the Single Market. Subsistence farming is an important new farm type in the EU-25. The emphasis on rural development measures until 2013 will put the new Member States into a position to ease and support the necessary structural change. However, the structural change in the agriculture sectors of the new Member States certainly will be more dependent on economic and social developments than on agricultural policies.

The increase in total agricultural area in the EU-25 shows the significant production potential in the new Member States. The ongoing restructuring process suggests however that it will be gradually exploited and fully used only in the longer term. Agricultural production in the ten new Member States would expand slightly over the medium term thanks to slightly higher and significantly more stable producer prices, increasingly favourable perspectives on the Single Market, and rural development measures. Accession should also result in some trade creation and diversion effects between regions of the enlarged EU. However, these effects would be comparably small as most of the bilateral trade in agri-food products has already been liberalised under the Europe Agreements (including the double-zero and double-profit agreements). Nevertheless, accession would significantly change some of the dynamics of agricultural markets in the EU-25 as compared to the current situation in the EU-15 (without enlargement).

The main trade creation effects would result from growing demand for agri-food products in the new Member States. Amongst the products covered by the this analysis, fresh dairy products, cheese, poultry and pork would benefit most. These developments would be supported by the high level of income growth -which stood on average at approximately double the rate recorded in the current Member States over the last ten years. This trend is projected to be strengthened by the accession process[vi].

The CAP reform would have diverging impacts across regions and commodity sectors. By 2010 and compared to the projected Agenda 2000 levels, total receipts (i.e. market revenues and single farm payment) in the milk sector are foreseen to decline by slightly less than 5 %. In contrast, total receipts in the cereal sector would broadly stagnate, while the meat sector –beef, pork and poultry- would display significant gains (estimated at between 1 % and 3 %) as meat price increases would more than compensate the combined impact of the fall in production and modulation. These trends however remain conditional on the option adopted for the implementation of the single farm payment. The full decoupling option would for example generate a very slight increase in sector income against Agenda 2000 thanks to more sustained price developments.

The prospects for agriculture in the new Member States would develop very positively over the medium term as the real gross value added including the direct payments and the effects of rural development would increase sector income by 35 % as compared to 2002. This strong development in farm income in the new Member States is largely related to the phasing-in of direct payments, the effect of rural development measures (about 80% of these measures are directed towards farms and should materialise into farm income) as well as improved efficiency of production. The decoupled nature of direct payments reduces the incentives to invest in those production areas characterised by weaker markets and high direct payments (which would have been the case under Agenda 2000).

For the current Member States sector income including direct payments would be little affected by the CAP reform. From 2010 onwards, income levels would be slightly superior to those under Agenda 2000. This outlook is slightly more positive for the current Member States than in the EU-15 analysis without enlargement. The main difference lays in the more positive market dynamics of the EU-25, which would be more pronounced under the CAP reform.

Conclusions

The agricultural sector in the EU would have to adjust significantly over the medium term. Enlargement of the EU is certainly one of the factors which would create significant adjustments within EU agriculture and food industries, largely independent of agricultural policies. New market opportunities would arise for agriculture throughout the EU, but the relative competitiveness of production will decide in which region the additional supply would actually be realised. The integration into the single market as well as the rural development funds made available to the new Member States would speed the structural adjustment process in the market-oriented part of agriculture. The important part of subsistence agriculture, which is in some countries a significant provider of livelihood in rural areas, would on the other hand be more dependent on the economic and social development than on agricultural policies. The analyses however show that the CAP reform would positively contribute to the development of agriculture in the new Member States.

The CAP reform is another important contributor to adjustment in agriculture and food industries in the EU. The CAP reform decouples a large part of the agricultural support, thus enhancing income transfer efficiency. This policy move towards significantly less-trade distorting instruments provides stable policy conditions until 2013, reduces the risk of structural surpluses and encourages farmers to base their production and investment decisions on markets developments rather than on product specific support. The market projections indicate that adjustment of production would take part in key areas of agricultural production in Europe: cereal, beef and dairy production. Farmers would have to gain efficiency of production which would affect farm structures as well. In order to support and accompany these structural changes, rural development policies provide for targeted instruments to help farmers to retire, young

farmers to enter the sector, to adapt and meet higher cross-compliance standards, to diversify income sources and to support investments.

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NOTES

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[ii] These projections have been undertaken on the basis of two modelling tools. The EU-15 projections have been conducted with a set of partial equilibrium, dynamic models covering the most important arable crops, animal and dairy products. The ESIM model, which is a price driven, world, multi-country non-linear, agricultural sector model has been used to develop the EU-25 projections. For more information on the modelling and methodological framework, cf. "*Prospects for agricultural markets 2002-2009*", published in June 2002, EC Commission.

[iii] A summary of the main decisions is given in European Commission (2003a), in comparison with the continuation of the Agenda 2000 policy, the initial proposals from the Mid-Term Review Communication (July 2002) and the draft legislative proposals presented in January 2003.

[iv] These other assumptions are kept identical in the impact analysis for both the baseline and *counterfactual* scenarios. All the specific conditions of accession of the ten new Member States are expected to operate under the rules decided by the end of 2003 for the 2003-2010 period (in particular the phasing-in of direct payments, the top-up possibility and the production quotas). It is also assumed that the URAA commitments remain unchanged over the 2003-2010 period. The macro-economic environment in the EU is expected to remain sluggish in the short-term and stabilise around 2.5% from 2005 onwards. By contrast, economic growth in the new Member States should remain solid reaching more than 4 % over the medium-term. After a recent strengthening, the $/€ exchange rate is expected to gradually stabilise around 1.1 as the impact of the short-term factors contributing to the recent weakness of the US dollar may be expected to weaken over the medium-term. Finally, the medium-term outlook for world agricultural markets is projected to remain essentially supported by rising food demand driven by a recovery in the global macro-economic environment, higher population, urbanisation and changes in dietary patterns, particularly in many emerging economies.

[v] It should be mentioned that the proposals to extend the scope of currently available instruments for rural development to promote food quality, meet higher standards and foster animal welfare and those relative to some specific sectors such as the nuts, dried fodder and starch potato sectors have not been incorporated in these analyses.

[vi] For more details see Network of Independent Experts of the Accession and Candidate Countries (2004), "Consumption trends for dairy and livestock products and the use of feeds in production in the CEE Accession and Candidate Countries".
http://europa.eu.int/comm/agriculture/publi/reports/ccconsumption/index_en.htm

[vii] These projections for energy crops have been established on the assumption that the tax incentives currently existing in EU Member States would prevail over the simulation period.

[viii] Under Agenda 2000 policy, milk prices were projected to stand well above support price towards the end of the decade.

[ix] The savings generated each year by the modulation scheme destined for the rural development measures have been taken into account in the income calculation for approximately 80 % (estimated to amount to 930 mio EUR in 2010).