

## **AGENDA 2000 MID-TERM REVIEW DECOUPLING OF SUBSIDIES**

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Some argue that CAP has been more of a curse than a blessing for the EU economy, and the need for reform is evident. Ciara Comerford examines the changes to CAP proposed under Agenda 2000, focusing specifically on the decoupling of farm subsidies. After investigating in detail what decoupling entails for farmers' incomes, environment and world trade, she concludes that although it will involve adjustment costs for farmers, decoupling is a way forward for European agriculture.

### **Introduction**

I propose commencing this discussion by explaining the reasons for reform, specifically why the Common Agricultural Policy (CAP) was not meeting the needs of farmers and consumers, how it was damaging the environment and distorting world trade. The Luxembourg Agreement outlined key horizontal measures to counteract the disrupting effects of the Current Agricultural Policy. To cut the link between production and direct payments was perhaps the most radical proposal, "the core element of the reforms is decoupling" (Fischler, 2003b). At this juncture, I concede that the confines of this essay would not allow me to explore decoupling and its impact on Europe and the world to the extent that it has consequences. Therefore, I can only hope to elucidate this concept to some extent, to illustrate what it will achieve in relation to farm incomes, in WTO terms, for the environment and in relation to bureaucracy. It is my contention that the proposed measures will have a definite positive impact on what farmers produce, the corresponding impact on our rural environment and will aid in the WTO negotiations.

### **Background**

The Agenda 2000 Berlin Agreement of March 1999, set out EU agriculture policy to 2006 subject to a review operation in 2003. This Mid-Term Review was subsequently brought forward to 2002. As part of the Mid Term-Review, an initial communication from the Commission to the EU Council of Ministers was published

in July 2002. This was followed by detailed legislative proposals for agriculture policy reform in January 2003. Finally on the 26<sup>th</sup> of June 2003 an agreement was reached by the Council of Ministers in Luxembourg, which outlined a framework for a fully decoupled or partially decoupled single premium area based payment system.<sup>1</sup> Ireland has opted for a fully decoupled system, which hopefully heralds an era of profound and exciting change for farmers, with a move away from subsidy-based production to market driven production. What brought about this reform?

Soon after the advent of the CAP, budgetary issues coupled with the problem of growing surpluses made evident the need for reform. In previous years reform has come in the form of ‘milk quotas’, ‘stabilisers’ and ‘set-aside’. Market imbalances and the fear that ‘80% of support was going to 20% of the farmers’ led to the MacSharry Plan (agreed in June 1992). Shortly afterwards, the EU was able to conclude the Uruguay Round of world trade negotiations – subjecting agriculture to international trade rules for the first time (Wolfe, 2002). A series of factors including BSE, the discovery of salmonella in eggs, dioxin in chickens and foot and mouth disease increased public unease about food quality and reduced farmers’ incomes. Policy makers soon recognised the need to improve environmental practices and the quality of food, while preserving the rural environment<sup>2</sup> (Tracy, 1997).

### **The Call For Reform ...**

CAP, viewed by some as a “crazy and distorted waste of resources” (Cadogan, 2003), was no longer suited to consumers or small farmers, it damaged the environment and it hurt the world’s poorer economies. The EU would not be able to meet the challenges of enlargement and world trade liberalisation unless it reformed the CAP. It was of paramount importance to show that our policy could provide real value for money and real services to citizens throughout an enlarged EU (The European Commission in Ireland, 2003). The notion that reformation would promote a substantial simplification in the CAP, facilitated the enlargement process and helped to better defend the CAP in the WTO, coupled with the guarantee of income stability for farmers and the removal of the environmentally negative incentives of the current policy that illustrated a dire need for reformation. The Commission decided to move agricultural policy forwards; “indeed to break a series

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<sup>1</sup> Due to the confines of this essay, it would be impossible to assess the impact of decoupling on all Member States. Ireland is the only country that has chosen to fully decouple livestock premia. The discussion is in reference to full decoupling and the economic analysis refers specifically to Ireland.

<sup>2</sup> Multifunctionality – a term coined to describe the view that agriculture is about more than just food production.

of anodyne measures that in the end turn out to be a poisoned chalice” (Fischler, 2002).

### **Achievements under the Mid-Term Review**

The Commission outlined a set of proposals to ensure that these goals and objectives were achieved. To cut the link between production and direct payments, linking decoupled payments to environmental, food-safety, animal welfare, health and occupational safety standards (cross-compliance); to increase EU support for rural development by a modulation<sup>3</sup> of direct payments; to introduce a new farm advisory system; new rural development measures to boost quality production, food safety, animal welfare and to cover the costs of the farm advisory system; revisions to the market policy of the CAP, including arable crops, milk and rice (Fischler, 2003b).

“Decoupling implies that payments will not be linked to production, farmers will receive direct support without having to produce, in return however, they are expected to provide, to satisfactory standards, the public goods demanded by society – the services the market has no way of rewarding” (Fischler, 2002).

“They are also expected to comply with specific requests on environment, food safety and animal welfare, the Commission proposes to employ a farm audit to verify compliance and cut direct income payments to farmers if they fail to fulfil these requirements” (Fischler, 2003c).

Modulation serves the purpose of compensating farmers for the additional services they perform. The goal is to withhold an extra 3% of direct payments every year. An exemption will be granted for the first €5,000 of each direct payment, plus an additional €3,000 for every worker above two on the farm, ultimately, the expectation is that the expansion of the second pillar will result in the transfer of 20% of the funding from direct payments into rural development over seven years (Fischler, 2002). This implies a huge increase in EU funding for rural development. The Commission is adamant that financial support for rural development is not the sole purpose and new proposals have been put in place to improve product quality. These will include certification schemes for products and measures to promote quality products, products with geographical designations of origin and organic products.

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<sup>3</sup> Modulation – the Commission’s proposal to reduce farmers’ direct payments and use these funds for rural development measures, such as environmental programmes, organic farming, promotion of quality or animal welfare (Fischler, 2003c).

**Decoupling ...**

Decoupling means providing support payments to farmers in a way that is not linked to what they produce. The Commission proposes to introduce a single decoupled income payment per farm, that is, from 1<sup>st</sup> of January 2005, the link between EU subsidy payments and production will be broken. Farmers will receive an annual payment based on the amount of subsidies claimed in the 2000 to 2002 reference period. “To qualify for his/her full level of payments... the farmer must manage the same area as that farmed during the reference years” (Mooney, 2003).

The European Commission predicts that decoupling will help to achieve certain objectives that our previous policy was unable to do; decoupling will stabilise incomes of farmers; give farmers back their entrepreneurial freedom; improve market orientation of agriculture; enable farmers to supply products that consumers want; allow EU support to focus on quality as opposed to quantity; a single payment means that the value of support is constant therefore the farmer is encouraged to farm for the market, not for the subsidy, it also implies a system that is easier to manage, one that is simpler and more transparent; it will allow more money to end up in farmers’ pockets than other forms of support that we have (OECD, 2003); it will strengthen the EU’s hand in the WTO negotiations, cutting the link between production and subsidy makes direct payments non-trade distorting (The European Commission in Ireland, 2003).

**... And farm incomes**

Six impact studies (two internal<sup>4</sup> and four external<sup>5</sup>) published by the European Commission concluded that “the reforms envisaged would significantly improve market balances”. It is reported that on aggregate farm incomes will improve “by 11% by 2010” (Binfield et al, 2003), however, this statement must be explored to a greater extent. It is predicted that the revenue of beef producers would increase by 4% but “dairy farmers and calf and weanling producers ... stand to lose out severely” (O’Rourke, 2003). There is a predicted 30% fall in dairy farming incomes following decoupling and an annual €100 million loss in incomes due to lower calf and weanling prices (O’Rourke, 2003). Dairy, calf and weanling farmers are not the only ones set to loss out when full decoupling is imposed. Joe Walsh insisted that “the reduction in the Irish suckler herd and sheep flock as a result of decoupling would have a devastating effect on the processing industry” (Mooney, 2003). The meat industry warned that the CAP reform proposals would put hundreds

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<sup>4</sup> The internal studies have been realised by DG Agriculture.

<sup>5</sup> The external studies have been realised by Food and Agricultural Policy Research Institute (FAPRI), University of Missouri-EuroCARE, University of Bonn Centre for World Food Studies, Amsterdam and the Netherlands Bureau for Economic Policy Analysis, The Hague.

of jobs at risk and result in export losses to the economy of €500 million per annum. Matthews, however, denounces these ideas suggesting that live trade is the major factor affecting the buoyancy of calf and weanling prices, ‘in all probability there would be an increase in jobs’ in the processing industry. He cites two mitigating factors that contribute to this contention, one, scarcity in mainland Europe will give us a greater opportunity to supply real market needs and two, improved quality will increase value added and a greater journey along the value chain, this implies more consumer cuts and more jobs (Matthews, 2002).

### ... And the environment

“Full decoupling will have the greatest positive impact on the environment by the reduction in the contribution by agriculture to green house gas emissions”, coupled with the notion that the vast majority of farmers (are critical of the level of bureaucracy) they like to roll up their sleeves and go out on the farm” (Ryan, 2003).

This implies that decoupling has environmental and bureaucratic implications. The environmental benefit arises because decoupling should lead farmers to more extensive production<sup>6</sup> as they will now use inputs only up to the point where their use is justified by the market price return, and not by the combined market price and direct payment, thus reducing pressures on rural resources (Matthews, 2002). Reduced production however, could have a knock-on effect on the processing sector and it could lead to the abandonment of land in some marginal farming areas. The Commission posits that reduced production is a desirable outcome; they believe that more targeted policy instruments, such as less favoured area or agri-environment payments, could meet the threat of land abandonment (Matthews, 2002). Another positive outcome is the prospect of greater funding for REPS on the one hand and a reduction in the opportunity cost of complying with REPS conditions on the other. This will be evidenced by a greater influx of farmers into REPS, if decoupling has the effect of reducing the intensity of agricultural production. Overall, the Commission’s emphasis on environmental, food safety and animal welfare standards, as well as rural development, is to be welcomed. If the Commission implements the audit and penalty system that it purposes, the expected results of a cleaner environment and higher quality food are more likely.

The system of decoupling will integrate most existing direct payments a producer receives from various schemes into one single payment, this implies less paper work and red-tape for farmers, whose priority is to work the farm. ICSA have

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<sup>6</sup> A recent review of the impact of the MacSharry and Agenda 2000 reforms on extensification commissioned by the UK Ministry for the Environment, Food and Rural Affairs came to a somewhat ambiguous conclusion (Matthews, 2002)

reported that the cost of administration of the various EU schemes to farmers will reduce by 50% (OECD, 2003). It must also be noted however, that since a large proportion of land in Ireland is in conacre (seasonally rented land), there will be a significant administrative burden when the first transfers take place.

### ... And World Trade

Talks at the 5<sup>th</sup> WTO Ministerial Conference in Cancun included negotiations regarding investment, competition, trade facilitation, transparency in government procurement and how to free up trade in agriculture (The Economist, 2003). There is a desperate desire for movement toward free trade in agricultural products because markets are currently distorted by more than \$200 billion in annual subsidies, a 50% reduction in agricultural trade protection would provide a \$27 billion boost to the world economy (Francois, 2001), developing countries could achieve annual welfare gains in excess of \$100 billion and trade facilitation could also yield some developing countries gains of up to 5% of their GDP (OECD, 2003). The two key players in the trade negotiations are the US and the EU. In 2001, the Bush administration adopted a farm bill that includes measures that distort trade. The EU, on the other hand, has adopted a policy of trade liberalisation, “precisely in the area of domestic subsidies, decoupling, together with our proposal to scrap the *de minimis*<sup>7</sup> rule for developed countries, would put us ahead of our great partner and competitor” (Fischler, 2003a). Decoupling should help to reduce the trade-distorting element in EU subsidies, this is because decoupled payments would be eligible for the green box,<sup>8</sup> on the grounds that they do not distort trade because they are not directly connected to production (Wolfe, 2002). These trade-distorting measures should diminish the need for intervention buying and export subsidies, by reducing both production incentives and some guaranteed prices. This would be good for food exporting countries, including developing nations, and export subsidies would allow Europe to capture more markets. Overall, it would aid the conclusion of international trade talks. However, despite initial optimism that a deal could be brokered at the WTO meeting in Cancun, the WTO talks process broke

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<sup>7</sup> *De minimis*: Developed countries: provision allows exclusion of product-specific support less than 5% of output value of Aggregate Measures of Support (AMS). Developing countries: provision allows exclusion of product-specific support less than 10% of output value from AMS.

<sup>8</sup> ‘Green box’ are subsidies that do not distort trade and can be maintained. The amber box covers subsidies that are subject to overall limits and must be reduced because of their impact on trade. The blue box reflects a compromise over how to deal with subsidies that are not as directly linked to production as price support s e.g. subsidies such as the direct payments created under the MacSharry reforms, which were viewed as less trade distorting or temporary.

down on 14<sup>th</sup> of September 2003, when developing countries refused to accept a WTO proposal that would have allowed for cuts in agriculture subsidies in developed countries only if developing nations agreed to launch new talks on liberalising competition and investment policies. In the end, the developing world is the biggest loser because it had the most to gain. It now appears as though it will take extensive political effort to put the talks back on the rails. If trade talks are not resumed by spring 2004, “they are likely to drift rudderless until well after the new American administration and the EU Commission take office in 2005” (The Economist, 2003). The expansion of the EU will further complicate the decision-making process. The Commission’s proposals should reduce the cost of expanding the CAP to cover more countries. In the longer term, farmers in the new member-states would be discouraged from overproducing, in addition, by lowering direct payments in the EU-15, modulation would allow new member states to attain the same level of this form of subsidy as existing members in a shorter period of time. The EU initially argued that direct payments should not be extended to new members, as their farmers did not need compensation for price cuts. However, under pressure from the applicant countries for immediate access to direct payments, the Commission relented and proposed phasing in these subsidies over a ten-year transitional period. However, applicant countries are likely to be hostile to the Commission’s call for the direct payments to be phased in slowly.

## **Conclusion**

Should Irish farmers, consumers, taxpayers, environmentalists and free trade advocates applaud the Commission’s move towards the decoupled single farm payment? It is my contention that we should embrace this change, however, I do concede to being sceptical at the outset. There are particular issues, which I am concerned about, if decoupling has the desired effect of reducing output there could be a major contraction in agricultural activity leading to a decline in rural economic activity; could the countryside ideal, where man toils the land leading to a thriving rural economy and community disappear forever. It is also reported that there could be a significant reduction in suckler cows across the EU “with the largest proportionate decline expected to occur in Ireland”, thus having adverse effects on meat plants, service industries and livestock marts (Binefield et al, 2003). Basing direct payments on past entitlements is not cutting the cord from subsidies in the way that we should, “it reduces the scope for change and prevents it from setting a long-term strategic view about the future shape of the direct payments system” (Ibid). I come from a dairy farm background thus certain issues are extremely prevalent, I am concerned about the threat of a 30% reduction in incomes and the

abolishment of milk quotas come 2014. Payments were proposed to offset the extent of the decline in milk prices, but these payments are smaller than suggested in the January 2003 legislative proposals. The incentive for marginal producers to exit the sector are reduced, thus making it difficult for competent producers to expand, be competitive and produce what the market wants using economies of scale.

However, this issue cannot be viewed with bias towards a particular sector, there is too much at stake and in review, I can see that the benefits far outweigh the cons. Farmers now have the ability to produce what the market wants, to act as entrepreneurs and to engage in competition. Consumers and taxpayers will not be contributing towards food mountains and milk lakes and they will have a greater guarantee of purchasing quality produce. Due to the horizontal measures proposed, including modulation and cross-compliance, farmers will be encouraged to develop, attain and sustain a healthy rural environment. Unfortunately, the world trade talks collapsed in September, but I feel that Europe made a concerted effort to reach a compromise that will promote trade with the developing world.

Decoupling heralds an era of profound and exciting change for farmers with a move away from subsidy-based production to market driven production. This proposal should be embraced as we are moving out of an era of trade distorting policies, over productive techniques and poor quality produce.

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