TABLE 3.7

**Cumulative estimated expenditures under ACRE for two periods using percentage deviations in prices, yields and acreage observed during 1996-2006**

| Period | Corn | Soybeans | Wheat | Total |
|---|---|---|---|---|
| | | *(US$ billion)* | | |
| 1996-2006 Prices, Yields and Acreage | 20.1 | 2.4 | 11.5 | 34.0 |
| Direct payments | 0.0 | 0.0 | 0.0 | 0.0 |
| Loan-rate related | 5.9 | 6.2 | 3.5 | 15.6 |
| Countercyclical | 26.0 | 8.6 | 15.0 | 49.6 |
| Total | | | | |
| 2009-2012 Forecast Average Prices, Yields and Acreage | | | | |
| Direct payments | 20.1 | 2.4 | 11.5 | 34.0 |
| Loan-rate related | 0.0 | 0.0 | 0.0 | 0.0 |
| State Revenue Payments | 12.9 | 10.2 | 4.7 | 27.8 |
| Total | 33.0 | 12.6 | 16.2 | 61.8 |

Source: Zulauf and Orden (2009).

revenues fall from these higher levels. State revenue payments increase to $27.8 billion and total payments to $61.8 billion. In contrast, with these same variations in prices, yields and acreage, countercyclical and loan-rate-related payments under the traditional programs would remain below $1 billion with the 2009-2012 forecasts and the target prices and loan rates in the 2008 FCE Act.

The relatively low ACRE payments illustrated by Zulauf and Orden for 1996-2006 would not have caused the U.S. Total AMS to exceed its Uruguay Round commitment in any year had this program existed rather than traditional programs. The ACRE program would have faced some constraints, and the traditional programs even more so during 1996-2006, if the Doha Round draft modality final commitments had applied during this period. Moreover, while the traditional programs with the support parameters of the FCE Act do not appear constrained by the Doha draft final commitments, ACRE payments exceed the final product-specific AMS caps (for corn and soybeans in three years and wheat in five years) and the Total AMS commitment is exceeded in two years when the percentage deviations from 1996-2006 are applied to the forecast average 2009-2012 prices, yields and acreage. While the ACRE program is legislated to come into effect in 2009, the level of sign up by farmers remained low through July 2009. Even with full sign-up assumed, concern that ACRE payments could cause U.S. support to exceed limits other than the Uruguay Round Total AMS commitment remains hypothetical unless a new WTO agreement on agriculture is concluded and new commitments take effect.

Beyond this, generally, the optimistic price environment foreseen in early 2009 and incorporated into our projections may not materialize in terms of average levels of prices, as well as in terms of a sharp price decline that would trigger ACRE revenue guarantee payments at market prices above the target prices and loan rates of the FCE Act. In the case of lower prices, even without ACRE payments, the Total AMS constraint and some product-specific limits could well be exceeded under the Doha draft modalities, unless some other alternatives to current support policies were found. That is, if prices were to fall substantially, so that major countercyclical, price-support, or state revenue-guarantee payments under the ACRE program were triggered, it would become difficult for the U.S. to meet the proposed Doha Round WTO commitments on domestic support under a continuation of its existing programs.

### 3.4.3 Political economy of future policies

Our analysis of post-Uruguay Round U.S. farm policy suggests the continued ability of the farm sector to extract support in the political arena through a number of programs. Yet there have been some substantial changes in policy in each of the key areas: commodity support, agri-environmental programs, and crop and revenue insurance and disaster relief.

The absence of significant reform to existing commodity programs in 2008 was due in part to political differences reflected in the election-year platforms of Democrats and Republicans. In contrast to the overarching call for deregulation and scaling back of social welfare programs by the 1996 congressional Republican majority, the Democratic majority in 2008 championed new government help for constituents in financial trouble and the inclusion of additional funds for food stamps and other nutrition programs as the economy slowed. In this political environment, certainly among Democrats and even among many Republicans in Congress, there were few calls for eliminating the farm safety net that both parties have long endorsed.

There was also less need for changes in farm policy in 2008 than in 1996 because the increased flexibility achieved through the earlier reforms had been retained for large segments of agriculture. Radical buyouts such as those for peanuts and tobacco were hardly representative of broader reform options. Declining quota rents for peanuts and tobacco had been conducive to buyouts, but this had little relevance for other commodities.

Differences in macroeconomic circumstances between 2008 and 1996 also dampened interest in reform. The short-lived farm commodity boom in 1995-1996 occurred when the U.S. dollar and world oil prices had been stable in preceding years. There was little concern at the time about either excessive inflation or an economic downturn and recession. In contrast, macroeconomic stress in 2008 had its origins in low interest rates, the substantial depreciation of the dollar that ensued

after 2001, and rising oil prices after 2003. This gave the farm commodity price boom in 2008 a precarious dimension. The farm sector knew from past experience that retaining price-linked support programs, even with few anticipated payouts, provided a structure of support whose nominal parameters could be ratcheted up if the sector were to fall on hard times through rising costs or declining revenues. This sentiment was reinforced (and dairy price support increased) once commodity prices that peaked in mid 2008 fell sharply as the full dimensions of the global financial crisis and recession became evident later in the year.

Despite the continuation of farm support programs through 2012, there are several uncertainties about the political alignments that have allowed U.S. farm subsidies to endure. The nutrition title has come to dominate total expenditures in farm bills and is projected to increase its share further. Likewise, when prices are relatively high conservation and environmental spending is a substantial part of total expenditures on agriculture. Nutrition and environmental interests might at some stage decide that their objectives could be better served outside the context of the farm bill, or by imposing more regulation or costs on agriculture. That fixed direct payments were a focus of domestic controversy in a high price environment is also indicative of limits to the political power of the farm sector. International rules provide room for this domestic debate but acrimony over the direct payments in the U.S. reduced their attractiveness to farm groups seeking minimum controversy over the support they receive.

The deepening entrenchment of the domestic ethanol sector during the oil-price boom of the mid 2000s both constitutes a substantial intervention coupled to production and, in contrast to the points above, demonstrates the continued political strength of production agricultural. In addition, restrictive land-use policy was never completely abandoned—the CRP has always been a supply-reducing policy. If biofuel demand persists under ethanol mandates and tax credits, conservation spending may decline as farmers voluntarily abandon the CRP. This would shift the political balance within farm bill deliberations back towards the commodity interests, but it could also provoke a break in the political alliance that forged the 2008 FCE Act.

A Doha Round agreement that reduced the Total AMS commitment and *de minimis* thresholds and for the first time set limits on OTDS, product-specific AMS and total and product-specific blue-box expenditures would be a valuable check in the event that traditional U.S. programs are ratcheted up or agricultural prices return to the downward trend that has characterized most of the past half century. In such circumstances, an option for U.S. policymakers would be to expand green-box support for farmers under the environmental category or fixed direct payments that

[20] Arguments can also be made that the WTO green box rules may need some modification to allow countries to pursue environmental objectives—see Cox (2007) and Blandford, Josling and Arha (2007).

are modified as necessary to meet any WTO challenges. If U.S. policy moves further toward recoupled instruments with greater emphasis on energy crops, disaster assistance or environmental programs for working land and livestock operations, scrutiny for consistency with the green box will provide a bulwark against new forms of production- and trade-distorting programs[20]. But as policy stood in 2009, it is unlikely that the WTO will affect ethanol tax credits and mandates or long-term land idling under the CRP. These instruments, largely outside WTO expenditure disciplines, work to drive agricultural prices up and arguably have become, along with other environmental payments and crop and revenue insurance subsidies, the most important elements of U.S. farm policy. The boom-related optimism in the agricultural sector in the late 2000s arose in part because demand augmentation through "food, fiber and fuel" reinforced environmentally-rationalized supply control as a mechanism for keeping farm commodity prices higher than otherwise. The WTO has little ability to limit these latter distortions.

All of these considerations are relevant in a world economy that has been shaken recently by both a sharp commodity price boom, which has caused anxiety about global food supplies and affordability, and a larger financial crisis and recession, that as one consequence dampened the commodity price boom and as another raised fears of a long slowdown in economic growth. Some U.S. support policies tend to drive down world market prices for agricultural commodities—such as its domestic price support payments, countercyclical payments and insurance subsidies, and to a lesser-extent even fixed direct payments. These effects have been the concern of developing countries that are either competing exporters or fault low world prices for undermining long-term investments in their own agricultural sectors. But other U.S. policies, such as conservation land idling and biofuels mandates, have the offsetting effect of reducing U.S. production or raising demand for basic crops such as corn. These policies come under sharper scrutiny when world food prices increase and low-income food importing countries face difficulties. The 2008 FCE Act did little to lessen these conflicting policy impacts.

We introduced the U.S. farm policy issues with Gardner's assessment of the long-term developments of the 20th century. We conclude by referring to his views (Gardner 2009) on the prospects for future reforms that would lessen market distortions. Gardner concluded that the best prospects for reform pressure arise from the WTO Doha Round negotiations, from a combination of environmental/taxpayer interests that would shift agricultural support spending toward public good provision, or from the resurrection of a general predisposition to economic liberalism. Our assessment of the three post-Uruguay Round farm bills implies each of these pressures is a weak reed upon which to rest prospects for reform.

Were the reform pressures nonetheless to progress in a substantial way, Gardner argued that there could be a politically salient case for one-time buyout payments. He noted that the direct payments in the 1996 farm bill were a step in that direction,

but the buyout did not subsequently materialize, as we have described. Any such proposals were summarily rejected in Congress and the buyout idea remained far from the center of the farm bill debate in 2008. Nor do we anticipate a large-scale buyout happening in the foreseeable future.

So what can be done to improve U.S. farm policy and make it less production- or trade-distorting in a political environment where both major political parties endorse government involvement in providing an extensive safety net for farmers and public investments in agricultural productivity, while far-ranging critics question whether the modern form of agriculture has been a desirable development or can be sustained? Our analysis shows that securing a Doha Round agreement on domestic support rules along lines of the December 2008 draft modalities is an essential step. Both developed- and developing-countries policy makers need to seek to lock in such domestic policy restraint commitments.

We conclude further that a good argument can be made that there is a continuum of policies in terms of their production- or trade-distorting effects. It is clear that decoupled income support as defined in the green box is less distorting as a policy instrument than the price-linked measures included in the Total AMS. We concur that commodity support and insurance policies that the U.S. has notified as non-product-specific fall between these other two categories in their distortionary effect. Thus the architecture of the WTO domestic support rules is broadly sound. A caveat arises from the latitude that countries have to redefine market price support in ways that leave more room for other subsidies in the Total AMS. And of course there is nothing in international agreements to prompt countries to spend less than their commitments allow.

Nor are the green box rules a full guide to optimal policies. As we have emphasized about the CRP, the rules do not preclude an environmental or resource retirement program that has significant effects on production. Our brief review of conservation and environmental programs suggests more can be done to achieve a mix of domestic policies that achieves environmental gains at a lower cost.

The green box also allows latitude for policies that may not distort trade but certainly shift countries competitiveness over time and enhance agricultural production. Among these, we would argue—for the United States and elsewhere—in favor of research investments that raise agricultural productivity and infrastructure investments that lower transaction costs. In the broad scope of history, we believe these investments hold the key to addressing the challenges that face agriculture in the 21st century. In short, we complement Gardner's assessment for the past century in seeing a success in the development of American agriculture that can be extended with thoughtful policy design.

## 3.5 Conclusions

This chapter examines continuity and change in the farm support policies of the United States from 1995 to the most recent legislation for 2008 that defines domestic support programs through 2012. We highlight three interacting components of recent policies: commodity price and income support; long-term land idling and other agri-environmental programs; and crop and revenue insurance and disaster relief. We also assess the implications for support of an optional new state revenue guarantee program (ACRE) and recent biofuel mandates whose effects interface with the more traditional programs.

U.S. farm policies continue to provide substantial economic support to producers but there have been significant reforms that improve their efficiency and reduce market-distorting effects. Commodity price and income support programs now comprise fixed direct, market loss and countercyclical payments that are more decoupled from current production decisions and prices than in the past. Long-term land idling has become more targeted toward providing identifiable environmental benefits and there has been a shift in the focus of other agri-environmental programs toward managing environmental damage from agricultural production. Diversity has emerged in crop and revenue insurance contracts and experience and accumulation of data has improved their actuarial basis.

The relative importance of various policy instruments has also changed. Biofuel mandates and tax credits that augment demand play a role in this regard, resulting in higher crop prices and, consequently, lower commodity support payments, a relative shift in transfers toward fixed direct income support and agri-environmental payments, and increased subsidies for crop and revenue insurance. During 1999-2001 product-specific support under the most distortionary U.S. policies came close to the Uruguay Round commitment under the WTO Agreement on Agriculture and additional non-product-specific support used up most of the available *de minimis* allowance. In contrast, with relatively high prices anticipated through 2016, the existing commitment and *de minimis* rules leave considerable latitude for increasing subsidies above levels we project under an extension of the current legislation.

It seems inevitable that the United States will continue to devote public resources to support agriculture. There is a bipartisan political consensus for an economic safety net for farmers and investments in agricultural research that can be traced to the successful modernization of agriculture since the 1930s. The improved efficiency of various policy instruments and their changing weight in the policy mix matter in this context. We concur with recent assessments that there is a continuum of policies in terms of distorting effects on production and trade. Drawing on recent work by the OECD, we construct a weighted index of distorting support provided by U.S. policies that are likely to depress market prices. The index follows a similar pattern during 1995-2007 to other measures of support but with a dampened

level and variability compared to their unweighted values. This provides a useful indication of the potential net distorting effect of various forms of support, using market price support as a base of comparison. However, it does not provide a measure of the absolute effects of U.S. policies on production or prices.

Strengthened disciplines in the 2008 draft agricultural modalities under the Doha Round WTO negotiations would reduce the U.S. leeway for providing trade-distorting support. Proposed product-specific caps on the Aggregate Measurement of Support (AMS) when fully implemented might prove limiting for some politically sensitive commodities such as cotton and sugar. The U.S. has increased its support latitude under the WTO rules by redefining its dairy support program in 2008, which could reduce the dairy AMS by over $3 billion. Without that change, projected U.S. dairy and sugar market price support would both exceed the Doha product-specific caps and absorb the entire Total AMS commitment by 2016. The redefinition of the dairy program means that the United States would be able to increase support prices for dairy products (as it did in 2009) under the Doha rules without violating its commitments, assuming prices for other commodities remain relatively high.

The continuation of current legislation leaves room with relatively high prices for additional total expenditures above projected levels of roughly $5.7 billion under the proposed commitment on Overall Trade-Distorting Support (OTDS). The U.S. would retain the option to raise target prices or loan rates, increasing blue-box or product-specific AMS expenditures from projected levels of less than $0.1 billion and $3.4 billion, respectively, to their proposed limits of $4.8 billion and $7.6 billion, as long as support remained under product-specific caps for each commodity. Pushing both of these categories of support to their limits simultaneously would reduce allowed *de minimis* non-product-specific support to only about $2 billion given the OTDS commitment, which is less than the projected level. An alternative would be to expand the use of non-product-specific support up to the limit imposed by the *de minimis* threshold. We estimate that in 2016 this would leave room for blue-box and product-specific AMS support of roughly $8 billion. More constructive than increasing any of these subsidies, we argue, would be to expand green-box programs that raise productivity, improve the environment, or enhance rural infrastructure.

The new ACRE program could make it more difficult for the United States to meet the proposed Doha commitments on support since payments can be triggered even when prices are high. The program makes payments when crop revenue in a state falls below a moving average of past levels. Projections of prices and yields lack the variability to trigger significant ACRE payments. However, if the relative variability in prices, yields and acreage that occurred during 1996-2006 were to be repeated using average forecast levels of revenue in 2009-2012 as a base, ACRE payments for corn, soybeans and wheat could exceed the Doha Round draft modality final commitments in future years, if a large number of farmers sign up for the program.

All of these considerations are relevant in a world agricultural economy that has been shaken recently by both a sharp commodity price boom and by financial crisis and recession. Some U.S. farm support policies tend to increase production and drive world market commodity prices down—such as the domestic price support payments, countercyclical payments and insurance subsidies, and to a lesser extent, fixed direct payments. This has been a concern to developing countries that are either competing exporters or fault low world prices for undermining long-term investments in their agricultural sectors. But other U.S. policies, such as conservation land idling and biofuels mandates, have the opposite effect by reducing U.S. production or raising demand for basic crops such as corn. These policies come under sharper scrutiny when world food prices increase and low-income food importing countries face difficulties.

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4

# Farm support policies in the European Union: an appraisal of their non-distortionary effects

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## Introduction

The purpose of this chapter is to review the empirical evidence of production and trade distortion impacts of the European Common Agricultural Policy (CAP). This policy is complex, targeting many objectives and involving interrelated instruments. Moreover, the policy has dramatically changed since its conception in the 1960s. In order to understand these changes, we briefly review the objectives and historical developments of the policy in section A of this chapter. We then provide an overall assessment of the efficiency of the CAP in meeting the stated objectives in section B. Section C is devoted to the production and trade-distorting impacts of the CAP. Methodological challenges are discussed before turning to empirical studies. A distinction is made between *ex post* studies and prospective ones. Finally the last section looks at the possible evolution of the CAP.

## 4.1 The EU farm policy

### Objectives

In the European Union (EU), the goals that can be considered as the official objectives of the CAP are still those stated in the 1957 Rome Treaty, i.e. to increase agricultural productivity, to increase the individual earnings of persons engaged in agriculture, and to ensure stable markets as well as regular supplies at reasonable prices (Article 39). In practice, the emphasis on increasing both production and farm incomes combined with the decision-making procedure within the Council during

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the 1970s and 1980s resulted in a high level of support to farmers. This support combined public intervention, border protection and export subsidies that ensured high guaranteed prices for major agricultural products. Because of the success of the early CAP in boosting production, the depressive effects of high prices on demand, and the accumulation of surplus and the budgetary cost of the intervention system, the initial objectives of the CAP needed to be amended in the 1980s. Meanwhile, socio-economic changes in the population as well as the negative externalities of modern agriculture led to a questioning of the "productivist" form of agriculture. Successive reforms in 1992, 1999 and 2003 curbed the original orientation of the EU farm policy. A major inflexion of the CAP came from the recognition of the "multifunctional" role of agriculture, i.e. the fact that it provides not only foodstuffs but also a range of amenities and public goods (OECD 2008a). This recognition meant that some of the CAP budget was channelled towards the "second pillar", i.e. a set of measures designed to encourage the preservation of environment, the development of quality food and more generally anything included under the broad term of "rural development". These reforms were also motivated by the World Trade Organization (WTO) negotiations and by internal pressures, namely the enlargement of the EU and the resulting budgetary consequences. Without having ever been drawn up as formal objectives, the new orientations changed the CAP.

Despite various reforms, the original objectives of the CAP have never been formally redefined. Both the Commission and the European Council have produced statements that we can understand as some kind of official, if not formal, reconsideration of these objectives. They emphasise in particular that strong economic performance must go hand in hand with managing natural resources and levels of waste sustainably, maintaining biodiversity, preserving ecosystems and avoiding desertification. In addition, the CAP should contribute to encouraging healthy, high-quality products and environmentally sustainable production methods, including organic production, renewable raw materials and the protection of biodiversity[2]. If we refer to the Commission's Communications preparing the 2003 reform and the 2008 Health Check, the CAP is supposed to achieve:

- a competitive agricultural sector;
- production methods that support environmentally friendly, quality products that the public wants;
- a fair standard of living and income stability for the agricultural community;
- diversity in the forms of agriculture that maintain visual amenities and support rural communities;

[2] Here we refer particularly to the decisions of the European Summits of Berlin (1999) and Göteborg (2001), as well as different regulations, directives and Commission documents, namely EEC (1985), EEC (1992), EC (1999), EC (2006a) EC (2006b).

- simplicity in agricultural policy and shared responsibilities among Commission and member states;
- justification of support through the provision of services that the public expects farmers to provide.

To sum up, the objectives of the CAP are still the ones that were formulated at the outset. In practice, the increasing concerns of EU citizens regarding "multifunctionality", the challenges of enlargement, trade negotiations and budget issues gain importance in the definition of policy instruments.

**Original instruments**

The initial CAP objectives led the first six members of the European Community to create one single budget for the CAP and Common Market Organisations (CMOs) in order to manage markets, stabilise prices and ensure a stable product supply. From the beginning, the CAP was designed to be a centralised policy, restricting the possibility of national governments to define their own policy instruments so as to avoid distortions of competition. The CMOs were progressively extended to basically all sectors. By setting administrative prices, and sometimes quantities, some CMOs largely substituted public intervention for market mechanisms. Others, like horticulture or pork, rather parsimoniously used public instruments designed to smooth the functioning of markets. For the major staple crops, beef and dairy, the administrative price was set at a level in general higher than the world price, and public purchases (intervention) ensured a guaranteed outlet for all quantities produced at this pre-determined price. Subsidies were used to export or to destroy excess supply that would have caused the internal price to fall below this administrative price.

Aside from the "Guarantee" section of the CAP budget that funded the expenditures relative to CMOs, the "Orientation" section of the fund was devoted to the improvement of production structures, the transformation and marketing of agricultural products and the funding of rural development. However, only a small share of the budget, which rapidly became absorbed in market management costs and then in direct payments to farmers, was eventually devoted to "orientation".

The CAP provisions succeeded in increasing the Community's self-sufficiency in food and in stabilising prices for consumers, albeit at a high level in some sectors that enjoyed high border protection (beef, sugar, sheep meat). Overall, the CAP has contributed to making Western Europe less depending on foreign food imports. It also provided the conditions for modernisation of the sector. Income support and predictable prices made it possible to invest in equipment. A major accomplishment of the CAP was also to have successfully accompanied of one of the most dramatic economic transitions in Western Europe, i.e. the rapid shift from an agrarian society to an economy of industries and services, without social trauma.

However, because of the incentives provided to producers and the high prices that deterred demand, in particular for cereals, market imbalances appeared as early as the late 1970s. Storage and export refunds costs increased dramatically, and budgetary problems led to considerable tensions within the EU. It proved impossible to reach a political consensus for reform, and meanwhile the costs of the CAP became unbearable. Under the pressure of the net contributing countries, the principle of capping CAP outlays was adopted in 1984. That same year, production quotas were implemented to control the supply of milk. However, the Council did not implement the price cuts that would have led to a significant decrease in production in spite of the persisting market imbalances throughout the 1970s and 1980s. In spite of the (limited) measures taken in the 1980s, surpluses were piling up in "mountains" of beef and grains and "lakes" of milk purchased by the intervention system.

By 1992, a more fundamental reform could no longer be delayed. The main pressure came from budgetary expenses stemming from the growing imbalance 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 who had access to cheap imports, especially those in Northern Europe located close to main ports, were using only marginal quantities of EU grains but increasing quantities of cereal substitutes such as cassava or corn gluten feed, a by-product of the US isoglucose and ethanol industry. The situation was such that taxpayers had to subsidised exports of products that were so expensive they could not find an outlet in the EU market, while consumers imported substitutes. The international trade negotiations were also instrumental in the radical shift brought about since the 1990s.

**The path towards market orientation**

Since 1992, successive reforms have dramatically modified the CAP towards a greater market orientation of the farm sector and direct income compensation for farmers. The new objectives set by the Commission were to:

- adapt quantities being supplied to demand;
- restore the competitiveness of EU products by bringing producer prices closes to world 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; and
- contribute to a better geographic repartition of the production and to the preservation of the environment (EC 1999).

Radical changes began with the 1992 reform which led to a cut in support prices for grains by 35% over three years. Area-based payments on acreage devoted to cereals, oilseeds and protein crops were designed to compensate for the price decrease. 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 the reference (regional) yield, but it remained coupled to the acreage in production. Beyond a certain farm size, these payments were conditional to farmers 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. In the beef sector, existing premiums per head of cattle were increased as a compensation for a progressive reduction in support prices. Eligibility conditions to these beef premiums were strengthened without completely removing production incentives. The reform was fully implemented in 1996, the last year of the progressive decrease in intervention prices and increase in direct payments.

At the end the 1990s, talks with the Central and Eastern European countries reached the point where the CAP needed to account for future enlargement. The Agenda 2000 agreement reached in 1999 led to another fundamental adjustment of the CAP. On the market side, it included further cuts in intervention prices for cereals and beef, again (this time partially) compensated by direct payments. CMOs were simplified in the sector of beef, dairy, wine and arable crops.

Over 10 years, the guaranteed prices for cereals were cut by half and the price support for beef was virtually eliminated, keeping only a safety net at a very low level (it is noteworthy, however that the sector is still highly protected by tariffs). Direct payments to farmers as "compensatory payments" became the largest of the CAP outlays. The Agenda 2000 also set the principles for the application of the CAP in future/new member states. The exact modalities of support (i.e. progressive convergence in direct payments with other member states until 2013, simplified schemes for direct payments, as well as the possibility for some "top up" payments funded by national budgets) were defined before the accession of new EU member countries in 2004 (2007 for Bulgaria and Romania).

The 2003 reform pursued the 1992 and 1999 reforms towards greater market orientation. The Council rejected further cuts in intervention prices proposed by the Commission for cereals. However, guaranteed prices for milk powder, butter and rice went down, and intervention for rye and maize was subsequently abolished. In addition, a central proposal of the Commission, i.e. the decoupling of direct payments from production and inputs, was implemented starting in 2006. Since that date, farmers no longer need to produce to receive the direct payments, which have been consolidated into a "single farm payment" (SFP) with no link to a particular crop or type of livestock produced. In practice, the SFP is an entitlement to receive payments. In some countries it has been calculated for each individual farmer on a historical basis. That is, a farmer benefits from a particular level of entitlement

if he/she has produced particular crops eligible to payments in the past (grains, oilseeds, beef and fallow land – corresponding to land set-aside; the list was then expanded to fodder and to products whose CMOs were subsequently reformed, such as potatoes for starch, durum, dried fruits, rice, dairy products, sugar, etc.). In other countries, this entitlement is a flat amount per hectare, identical between all farmers in a given region or in the whole country. There is no need to produce in order to receive this payment, but the entitlement must be "activated" by certain conditions to receive the actual payment (see Box 4.1 for details). This payment is also conditional to a set of good agricultural and environmental practices.

A revision of the reformed CAP took place in 2008, known as the "Health Check". It led to a series of adjustments in November 2008, mostly on six issues:

- Continuation of the move toward market orientation, with barley, sorghum and rice no longer eligible to public purchases to support price (in addition to pork, rye and maize decided earlier). Quality wheat is now de facto the only cereal that is still supported by intervention, and automatic purchase is limited to 3 million tons every year.

- End of compulsory land set aside.

- End of the system of dairy quotas in 2015, with a progressive increase of quota limits.

- Increase in the rate of compulsory modulation to 10 percent, all farmers receiving less than €5,000 in direct aid will continue to be exempted, as are all producers in the twelve new member states. Progressive modulation, i.e. farms receiving more than €300,000 in direct support every year, face an additional 4 percent shift in funds.

- Further decoupling of the direct payments that remained tied to production, in particular full decoupling of direct payments in the arable crop sectors (some member states had used the flexibility to maintain some payments coupled after the 2003 reform).

- Member States are encouraged to move their SFP model towards a flat-rate per hectare payment (per region) and away from a historically based model.

**A gradual shift towards the second pillar**

While the EU agricultural policy moved progressively towards a combination of more market orientation and a large amount of direct payments to producers, it also moved progressively towards the remuneration of amenities and public goods.

BOX 4.1

Main provisions of the 2003 and Heath Check reforms

*Single payment.* On the basis of the direct payments provided in the past, a ceiling for direct payments to farmers was defined for each member state. This ceiling has been used to calculate a unit value for the single farm payment (SFP) and the number of hectares eligible to this payment. In countries that have adopted a regional basis, e.g. Denmark, the unit value is similar for all hectares eligible. In other countries that have used an individual basis, e.g. France, the unit value may vary significantly between two farmers and between two regions. Farmers can request the payment up to the number of rights they are entitled to. This number of entitlement is equal to the number of hectares of the surface of reference. The payment is therefore the product of the number of entitlements and the unit value of the payment right. However, for each entitlement, the farmer must show an eligible hectare in order to "activate" the entitlement. The eligible hectares include all arable crops and pasture. That is, farmers do not have to produce in order to benefit from the payment. They also have the freedom to produce (almost) whatever they wish without the decision affecting the payment.

*Flexibility.* After the Health Check, each member state can maintain a link with production only for suckling cows, sheep and goats up to a certain ceiling. Each member state has the freedom to define the single payment on a per hectare basis or on another basis, either national, regional or individual. A member state can keep up to 10% of the national ceilings of direct payments and allocate the corresponding amount to other farmers for environmental or quality improving objectives and, since the Health Check, support fragile production, less-favoured areas or risk management as well as pest control programmes (Article 68). New resources coming from the decoupling of arable crops payments in 2008 can also be used with some domestic latitude (Article 63).

As a result, the different modalities for the implementation of the CAP reform have led to a great complexity in the national situations, and a CAP that appears less and less "common".

*Conditionality.* The SFP is conditioned to the respect of EU Directives on environment (conservation of wild birds; protection of groundwater from chemical substances; use of urban sewage; protection of water against nitrates; conservation of natural habitats; etc.); traceability of animals and meat; and health issues and animal welfare. The payments are also conditional to the respect of a set of good practices, such as protection against erosion, soil protection and so on defined at the local level. In addition, there is an obligation not to reduce the surface in permanent pasture, relative to a 2003 benchmark (a provision that does not seem well-enforced in practice). In case of infringement of these directives or good practices, payments can be cut.

In the mid-1970s the idea that farmers in less-favoured areas deserved to be supported by public policy led to a series of payments to livestock producers in mountainous as well as other less-favoured areas. The motivation was twofold. The idea of "compensation for natural handicap" was one of them. The idea that extensive livestock production participates in rural development and avoids desertification and destruction of rural communities in these areas was another one. Further reforms in 1985 and 1992 targeted the environment and afforestation on farmland. The 1996 Cork conference on rural development triggered a significant inflexion in the role devoted to the CAP. The Cork declaration listed 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 spread over the entire territory in a harmonious way.

The Agenda 2000 laid the foundations for a rural development policy that supplements market-focused policy. It has become 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, emphasises the multifunctional role of agriculture and forestry, environmental aspects, and an integrated approach to the rural economy through multisectoral development (see Box 4.2). While the concept of second pillar has become a tangible reality, the set of measures covered still looks quite heterogeneous. In the "rural development" measures, support to less-favoured areas and areas subject to environmental constraints as well as agri-environmental measures and forestry account for the largest part of the budget. But the term "rural development" seems to have been left rather vague on purpose, so as to include a cornucopia of measures, including aids to investment and settlement of young farmers; training; early retirement; improvement of processing and marketing of agricultural products in rural areas; aids to the adaptation, development and diversification of rural areas; land improvement; reparceling; 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; etc.

Both the Agenda 2000 (i.e. 1999 reform) and the 2003 reform rationalised the various measures encompassed under the term "rural development". All of them are now subject to one regulation, the Rural Development Regulation, and funded by a single budget, the European Agricultural Fund for Rural Development (EAFRD), which includes the former "orientation" section of the CAP budget (the "guarantee" section has led to the creation of a specific budget, the European Agricultural Guarantee Fund (EAGF) dealing with markets and direct payments, i.e. what is still included in the term "first pillar"). The new Rural Development Regulation for 2007-2013 aims to reinforce rural development policy and simplify