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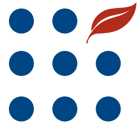

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CAP Reform of 2003-04

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Abstract

In 2003-04, the European Union (EU) introduced direct payments to EU farmers based solely on historical payments. The direct payments, to be implemented in 2005-07 at the discretion of its member states, greatly enhance ongoing reforms of the EU's Common Agricultural Policy (CAP). Such payments, by being up to 100 percent decoupled from current production, allow farmers to make production decisions based more on market signals than on policy interventions. More important, EU policymakers have a policy tool that allows them more flexibility in both domestic policy and multilateral agricultural negotiations during a time when the EU is absorbing 10 new member states, which depend more on agriculture economically than the EU-15. While significant production and consumption effects are unlikely for most commodities, trade could be affected because even small changes in EU production and consumption can lead to relatively large effects on world markets for commodities such as wheat, barley, rice, beef, butter, and sugar. Implementation of the reforms depends to a great degree on the member states' timing and methods, and could have unforeseen effects on world and U.S. trade over the next few years.

Keywords
European Union, agriculture reform, common agricultural policy, CAP, decoupled payments, farm payments, multilateral negotiations, World Trade Organization, WTO, trade, farm income, ERS, USDA.

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Introduction

The European Union (EU) passed the third major reform of its Common Agricultural Policy (CAP) in June 2003,[1] followed by a reform of Mediterranean commodities in April 2004. In July 2004, EU Farm Commissioner Franz Fischler proposed a reform of the organization's sugar regime. The sugar reform is expected to be accepted in some form in early 2005. The latest reforms are part of an evolutionary process that began with two previous reforms in 1992 (MacSharry reforms) and 1999 (Agenda 2000).

[1] The 15 member states of the European Union in 2003 were: Germany, France, Italy, the United Kingdom, Belgium, Denmark, Luxembourg, Iceland, Greece, Spain, Portugal, Austria, Finland, Sweden, and the Netherlands.

The 1992 reforms helped set the stage for the Uruguay Round Agreement on Agriculture (URAA). Those reforms focused on major crops (cereals, oilseeds, and protein crops) and beef, by lowering guaranteed (intervention) prices substantially and compensating farmers for lower prices with direct payments. These direct payments were linked to a mandatory 10-percent land "set aside" for farmers. The payments were coupled to production through a requirement to plant on land not set aside. Crop farmers producing less than 92 metric tons were not required to set aside land. Premiums were also established for low stocking rates in cattle farming. Before the 1992 reforms, high guaranteed prices (intervention prices), often set far above world prices, were paid to EU farmers for any amount of product not sold on the market. As a result, the EU became a large stockholder of wheat, barley, beef, butter, dry milk powder, and wine. The 1992 reform reduced beef intervention prices by 15 percent and cereal intervention prices by 30 percent. EU farmers were compensated for the price cuts, as long as farmers continued to produce, with direct payments based on historical yields and animal numbers.

Agenda 2000 was principally designed to prepare the EU for enlargement to include 10 countries to the East.[2] The guaranteed beef price was reduced by another 20 percent and guaranteed cereal prices were reduced by another 15 percent. Direct payments to compensate farmers for lower prices made up for only half of the lower prices, however. Farmers receiving direct payments had to use environmental practices that limited ground and water pollution as a prerequisite for the payment. In addition, to receive direct payments, farmers producing more than 92 metric tons of grains or oilseeds were required to plant grains or oilseeds on land not designated as set aside. Agenda 2000 laid the groundwork for future dairy reform by mandating phased-in price reductions for butter and dry milk powder beginning in 2005.

[2] Poland, Hungary, the Czech Republic, Slovakia, Slovenia, Estonia, Latvia, Lithuania, Cyprus, and Malta joined the EU on May 1, 2004.

While many other details accompanied these reforms, the principles of lower prices and direct payments with accompanying requirements to set aside land and use environmentally sound farming practices set the stage for the reforms of 2003-04. EU farmers became accustomed to receiving direct payments in exchange for lower prices, while complying with set-aside and environmental practices. EU taxpayers became more keenly aware of the CAP's costs because direct payments were funded by their taxes. The timing happened to roughly coincide with public awareness of numerous animal-health issues, such as "mad cow" disease, as they related to human health, and environmental problems (nitrate pollution) in agriculture production. A public social debate ensued that centered on the functions of agriculture and the role of agricultural policy in the European Union.

With previous CAP reforms firmly established and the member states fully accepting the reform principles, the EU Commission proposed reforms in 2002 after a mandated review of the efficacy of Agenda 2000. Not coincidentally, multilateral negotiations on agriculture under the auspices of the World Trade Organization (WTO) were fast approaching and the proposed reforms, if approved, might provide the EU with more bargaining power at the negotiating table (see box on domestic support). The proposal was based on what had already been accepted in previous reforms but included more commodity sectors and payments not tied to the production of specific crops ("decoupled payments"). The reforms were passed in June 2003, followed by further commodity coverage in April 2004 and a sugar reform proposal in July 2004. The reforms of 2003-04 principally address four issues:

1) Control of market-support budget expenditures through financial discipline;

2) Preparation for multilateral agricultural negotiations;

3) Budget and support problems resulting from enlargement to the East; and

4) Consumer and environmental issues in agricultural policy.

The principal means to accomplish the multiple goals of the 2003-04 CAP reforms were to move from commodity support to support of farmers through direct payments based on average historical commodity-based payments from 2000-02. Decoupled payments will allow EU farmers to be more responsive to domestic market signals than to policy interventions. Member states, however, can opt to retain coupled payments equal to 25 percent of the area for arable crops, 50 percent of the sheep and goat premiums, 40 percent of supplemental durum wheat aid, and from 40 percent to 100 percent of various beef premiums.

Farmers must comply with food safety, animal welfare, and environmental standards to receive the single farm payment (SFP). They are not required to produce any crop, unlike previous reforms, unless member states opt for partially decoupled payments. Most EU member states are planning to take advantage of the latitude allowed them regarding the timing of implementation (2005, 2006, or 2007) and the degree of coupling of payments to production. To qualify for the SFP, farmers also must maintain the land in good agricultural condition if it is not planted. In addition, pasture land may not be planted to arable crops, and land may not be diverted to nonagricultural uses.

While the new reforms have introduced new policy tools and reduced some prices, intervention at guaranteed prices for major commodities, generally above world prices, still remains an important component of the CAP. The reforms do not address market access issues as the EU is still encumbered by high tariff walls. Export subsidies are still available for surplus commodities (within WTO limits), although some reduction in intervention prices should result in lower per-unit subsidies for those commodities in the future, depending on the strength of the euro. A strong euro has recently made EU exports more expensive, which has pushed some subsidized exports close to WTO quantity ceilings.

EU Domestic Support Policies

Under the Uruguay Round Agreement on Agriculture (URAA), domestic support policies were categorized into three "boxes" (amber, blue, and green). The boxes are ranked by their presumed trade- and production-distorting effects, as follows:

- **Amber box policies** directly influence production decisions. An indicator called the Aggregate Measure of Support (AMS) measures the most trade-distorting domestic support. The AMS combines direct payments, input subsidies, and price support; the AMS is scheduled for reduction.

- **Blue box policies** represent a special exemption from the reductions required of amber box policies. This exemption was allowed for payments tied to limits on production such as the EU's compensatory payments that were paid on a fixed area and were based on historical area and yield. Many countries considered the blue box exemption to be a transitional measure, permitted until payments are restructured to qualify as green box policies.

- **Green box policies** were those policies considered to have minimal or no effect on production or trade, including such activities as research, domestic food aid, environmental programs, certain crop insurance and income safety net programs, and payments not linked to production ("decoupled" payments). Green box policies were exempted from reduction commitments and were not subject to expenditure limits.

Under the 2003-04 CAP reform, direct payments meeting green box criteria are expected to be classified as green box outlays. Many EU direct payments are blue box payments; shifting them to the green box will shrink the EU's blue box significantly. Amber box policies affected by the reform include support price reductions that will reduce the EU's AMS.

Commodity-Specific Programs

Intervention prices were only reduced for rice (50 percent), dry milk powder (15 percent), and butter (25 percent). Agenda 2000 had already provided for a 15-percent price reduction for butter beginning in 2005. The 2003 reform begins with 5-percent price cuts for milk powder in 2004 through 2006 and 7-percent price cuts for butter from 2005-07, with a 4-percent cut in 2008. Public butter storage will be limited to 30,000 metric tons annually by 2008, beginning with a limit of 70,000 metric tons in 2004 and reduced by 10,000 metric tons annually. Direct payments will be paid by the EU, in combination with additional payments by member states from a national ceiling budget provided by the EU, from 2004-08 at the member states' discretion. These payments may by coupled to production or not and that decision is left to the discretion of member states until 2008 when they must be incorporated into the SFP. The payments are expected to cover 60 percent of the revenue lost through price reductions.

The guaranteed price for rye was eliminated in the 2003 reform beginning in 2004, thus eliminating storage of surplus rye. Also, monthly storage payments to grain farmers were cut by 50 percent from 1.00 euro ($1.20) per metric ton to 0.5 euro ($.70) per metric ton.[3] Annual buying-in intervention limits by the EU for public storage were imposed on rice (75,000 metric tons). The 50-percent price cut for rice intervention will be offset by direct payments phased into the SFP. The policy changes for rye and rice are

[3] In July 2004, 1 euro = US$1.20.

particularly significant, as EU surpluses of these commodities had been building. Abandonment of rye intervention was necessary before Poland's accession into the EU in May 2004, as Poland is a large rye producer; a high intervention price for Polish rye production would have added to already high EU stocks. EU rice intervention also had led to high stock levels, and the EU was ready to rationalize the market and allow more imports of rice, in part through the Everything But Arms (EBA) agreement with 49 of the least developed countries. The EBA agreement will phase in imports of unlimited amounts of unmilled rice into the EU at zero duty by September 2009. The rice intervention price drops to 150 euros ($180) per metric ton from 298 euros ($358) and farmers will receive the equivalent of 88 percent of that lost revenue in direct decoupled payments. In addition, the tariff on brown rice will be reduced from 460 euros ($552) per metric ton to 175 euros ($210) and the tariff on milled rice will drop to 65 euros ($78) per metric ton from 264 euros ($317).

Other major components of the reform will affect prices more indirectly, particularly for beef. Various options exist for beef payments and their implementation will affect production and income. Beef producers could receive a completely decoupled historical payment, or a 100-percent coupled payment of the historical beef cattle premium[4] and up to 40 percent of the historical slaughter premium, or 100 percent of the slaughter premium, or 75 percent of the historical special male bovine premium.[5] The EU Commission’s analysis indicated that beef production would likely decline by around 3 percent as a result of decoupling payments even though most member states will retain some form of coupled payment. Beef prices are expected to rise as a consequence, leading to an increase in poultry and pork consumption, which will be met by an increase in EU production.

[4] A premium provided to specialist beef producers to promote production of better quality beef than that produced from the dairy herd.

[5] Three payments made over time to farmers raising male cattle, to prevent the cattle from being sold for meat and adding to the beef surplus.

The member state can also “top up” payments to a given commodity by 10 percent of its national historical ceiling in order to keep farmers on the land in marginally productive areas. However, the SFP to other farmers must be reduced by an equal amount to stay within the national ceiling, determined by historical payments in the 2000-02 period.

The Single Farm Payment (SFP)

The move from payments linked entirely to production to direct payments that are at least partially decoupled from a farmer’s decision to produce is the most important component of the recent reforms. Member states have discretion to maintain coupled payments to a limited degree in marginal regions to meet environmental and economic development goals. When member states implement the reform in 2005, 2006, or 2007, farmers will receive an SFP based on the average historical payments received in 2000-02 regardless of their current level of production. Unlike previous reforms, member states have some discretion regarding the timing and implementation of the reform. Member states can begin the SFP in any year from 2005-07, and it can be applied in various ways in different regions of the member states. Member states have the option of retaining up to 25 percent of the direct payment for arable crops—grains, pulses, and oilseeds—and up to 40 percent in traditional durum wheat areas to remain coupled to production in order to maintain production in marginal areas. They also may have coupled

payments from 40 percent to 100 percent for the various historical premiums in the beef sector. Farmers producing other commodities such as rice, nuts, potatoes for starch, dried fodder, sheep, and milk, will also receive direct payments under various decoupling schemes.

A key question will be how the member states will implement the SFP. Member states can divide their country into regions and apply different methods of calculating the SFP. These divisions across regions could have significant redistributive effects and affect land prices, income, and production (because of the different degrees of coupling allowed). A country faces the following basic choices:

- Divide the average historical payment by the number of hectares per farm including forage area;
- Divide total average payments in a region by total farm hectares to provide a uniform flat payment per hectare across the region;
- Vary payment levels between arable land and grassland;
- Combine a regional uniform payment with a per-farm payment depending on the commodity.

For example, a country can delineate regions where farmers receive an average regional payment based on the region's average historical payments in 2000-02, or it could opt for a region's farmers to receive what the individual farmers received historically. Also, regions could be designated where decoupling is less than 100 percent while others are set at 100 percent decoupled, and for different commodities. Or an entire country could be treated as a region and differ from other member states in the timing and implementation of the SFP. The extensive state discretion allowed under the SFP could lead to difficult administrative problems and unpredictable outcomes across the 25 member states.

Commission letter. The European Commission addressed this problem by sending a letter in the spring of 2004 to each member state's farm minister urging them to follow the spirit of the reform and refrain from regional hybridization of CAP reform citing the potential for differential effects on land prices, farm incomes, and production throughout the EU. The Commission intends farmers to be guided more by market prices than government intervention and warns that hybrid applications of the SFP would differentiate production response to markets by region. The Commission expects that member states will, in the end, adopt an EU-wide approach based on historical payments to farmers with a near maximum degree of decoupling. The Commission believes that the administrative costs to the member states would be too great and the bureaucratic process too onerous to impose a state-administered program that is regionally differentiated on top of the EU's requirements. Some member states have notified the Commission of their intentions and have indicated their desire to exercise their discretion and implement methods suited to their local circumstances.

Compliance. An important element of the reform is to make producers more responsive to consumer and environmental concerns. In order to receive the SFP, farmers must comply with food safety and food quality assurances,

animal health and welfare standards, and environmental standards, and they must maintain their land in good agricultural condition. "Good agricultural condition" is generally interpreted to mean that the land will not be abandoned and environmental problems such as erosion will be avoided. Additional funds will be made available to farmers to enable them to comply with certain regulations, particularly animal welfare regulations. Most of the regulations were already in place but have been simplified to 18 and are now compulsory, compared with the original 77 which were voluntary. The 18 regulations are largely environmental in nature, including preservation of wildlife habitat, but also strictly regulate the treatment of animals, and provide food safety and quality assurances through such procedures as traceability of seeds to the farm level.

The mandatory land set-aside must also be adhered to by farmers producing over 92 metric tons of grain, as in the previous program. The current set-aside rate for the 2003-04 marketing year was reduced to 5 percent from the previous rate of 10 percent because of the poor harvest in the 2002-03 marketing year. While set-aside land may be used for a limited amount of industrial oilseeds under the old and current reforms, land previously cropped cannot be turned over to the production of fruits and vegetables under the 2003-04 CAP reform implementation because oversupply of these products have been burdensome to the CAP budget.

EU Enlargement to 25 Members and CAP Reform

The reforms will apply to the 10 new member states, but because of negotiated agreements before accession on May 1, 2004, differential treatment will apply. The SFP will be phased in beginning at 25 percent of the EU-15 level in 2004 and will increase by 5 percent or more each year until the new members receive 100 percent of EU payments in 2013. Governments of the new entrants will be allowed to "top up" these payments by a maximum of 30 percent each year from national funds, meaning that the SFP could reach 55 percent of their historical payments compared to EU-15 farmers in the first year of implementation.

In the end, however, the SFP will be significantly lower for the new member states because their SFP is based on the yields associated with a reference period—1995-99—and to the area cropped during this period. The market disruptions during the transition from central planning to a market-based economy in the 1990s resulted in substantially lower yields compared with the EU-15 countries during this period, which means that farmers in the entrant countries will receive a lower per hectare payment than EU-15 farmers. SFP payments will vary considerably by farm size in the entrant countries, varying from 300 euros for small farms in Poland to 40,000 euros for the large farms in Hungary and the Czech Republic. The reforms are in force as of May 2004 for the new member states rather than having the option of choosing between 2005-07 granted to the EU-15 members. New prices and intervention rules apply to the new entrants since they are full members in 2004. Decoupling will be adopted at 100 percent for all but

Slovenia and Hungary, which will apply different decoupling rates within the limits set by the CAP reforms.

Budgetary Discipline

A critical component of the CAP reform that will have long-term repercussions for agricultural policy in the EU is the financial discipline imposed on market support and direct payments in the "guarantee" section of the CAP budget. The component of the CAP budget comprising price support and direct payments (the guarantee section) is referred to as "Pillar 1" of the CAP budget and is subject to budget limits. The rural development component (the guidance section) of the budget that is now designated as "Pillar 2" is not subject to budget limits. The CAP budget for Pillar 1 is fixed from 2004-06, and then will be limited to a 1-percent increase from 2007-13.

The CAP budget for Pillar 1 under this scheme begins at 42.8 billion euros ($51.4 billion) in 2004 and reaches 48.6 billion euros ($58.3 billion) in 2013. If spending comes within 300 million euros ($360 million) of the Pillar 1 ceiling beginning in 2007, then the SFP will be reduced to respect the budget ceiling. It is unknown at this time whether the budget ceiling will be reached, but reforms of sugar, tobacco, cotton, and olive oil, in combination with enlargement to an EU-25 (and an EU-27 with the possible additions of Bulgaria and Romania in 2007), could result in bumping up against the budget ceiling. Reductions would only apply to the EU-15 member states; any reductions in the SFP to farmers in the acceding 10 countries as a result of budget limits being reached could not occur until the SFP is fully phased in.

Rural Development

Maintaining economic activity in rural areas was a priority in the Agenda 2000 reform, principally because of enlargement to include the 10 countries that are more dependent on agriculture for employment and economic activity than the EU-15. The EU has always provided funds for rural development, but the 2003 reform emphasized the EU's renewed commitment to rural development, as introduced in Agenda 2000 as Pillar 2, by increasing the rural development budget substantially. For the EU, rural development will be the key to assuring that food quality, animal welfare, and environmental standards will be attained through funds generated by Pillar 2. A Farm Advisory System will be funded that will assist farmers in complying with the procedures and regulations required to comply with the environment, food safety and quality, and animal welfare standards desired by EU consumers and environmentalists.

Part of the increase in funds to rural development will derive from "modulation" of the SFP by farm size, which essentially works like a tax on the SFP above a certain amount. Farmers receiving an SFP of 5,000 euros ($6,000) or more will have their SFP reduced by 3 percent in 2005 with a maximum reduction of 5 percent by 2007. The funds from modulation would be largely retained (80 percent for all countries but Germany, which is allowed 90 percent for accepting abolition of rye intervention) by the member state in which the penalty occurred. Member states also have the discretion of

increasing the SFP tax for those receiving over 5,000 euros, and Wales and England have indicated they will increase the penalty to 10 percent. These additional modulation funds collected are to be used by the member state for rural development purposes.

The rural development fund is expected to rise by 1.2 billion euros ($1.4 billion) per year to reach 13.2 billion euros ($15.8 billion) by 2013 compared with a CAP budget for Pillar 1 (direct payments and market support) of 48.6 billion euros ($58.3 billion). The increased importance of rural development in the reform is underlined by the open-ended budget for the Pillar 2 program (rural development) in contrast to the strict budgetary limits placed on market support and SFP payments. Rural development funds have traditionally accounted for only 10-11 percent of the CAP budget but will be allowed to double through modulation of SFP payments and specific rural development funds granted by the EU or member states.

Further Reform in Mediterranean Products and Sugar

In April 2004, the cotton, olive oil, tobacco, and hops sectors were reformed along the lines of the reforms of 2003. All crop reforms are to begin in 2006 with the exception of hops, which begins in 2005. Decoupled payments of varying amounts are allowed with historical payments to be incorporated into the SFP. The degree of coupling is at the discretion of member states. A brief summary follows:

Cotton. A decoupling payment of at least 65 percent of the 2000-02 historical payments is to be paid. Coupled aid up to 35 percent will be allowed as an area-based subsidy with a maximum base of 455,360 hectares split among Greece, Portugal, and Spain. Funds amounting to 22 million euros ($26.4 million) will be shifted from market support to a transitional restructuring fund that will assist farmers to produce alternative crops.

Tobacco. Decoupling of a minimum of 40 percent of area from 2006-09 will be increased to 50 percent from 2010 onward. The initial period will allow a 60 percent coupling of payments with the remaining aid used to improve quality. From 2010 forward, 50 percent of decoupled payments will go into the SFP with the other half moving into a restructuring fund to finance more efficient uses of tobacco land.

Olive oil. A minimum of 60 percent of payments will be decoupled with a base of 2002-03 to determine the aggregate amount of aid. The reference area will apply only to areas planted before May 1, 1998, and member states may use up to 10 percent of their national olive oil payments to improve the quality of oils.

Hops. This reform begins in 2005 with a minimum 75-percent decoupled payment incorporated into the SFP and up to 25 percent may be coupled and paid directly to farmers or through producer groups.

The olive oil reform will primarily affect Spain, which voted against the reform, but also Greece and Italy. The tobacco reforms will be felt most

keenly by Greece, with Italy and Spain affected to a lesser degree. The cotton reform will affect Greece principally but also Spain. Hops are produced chiefly in Germany. The degree of decoupling varies by commodity but will likely exceed the minimum amount specified. All reforms are expected to improve the quality of the products and to influence farmers to be guided more by market signals than by EU policy.

A Proposal for Sugar Reform

The promised reform of the sugar regime was proposed in July 2004 and followed the basic principles of the 2003 reforms. In sugar's case, the EU has a rather complicated production quota system that motivates sugarbeet farmers to produce beyond the quota to ensure they earn full quota rents. This overproduction spills out into the world market, depressing world prices because of costly EU export subsidies. The subsidies are normally between 1.5 billion to 2 billion euros ($1.8 billion to $2.4 billion) annually. To complicate the reform, the EU has preferential trading arrangements with many former colonies (African, Caribbean, and Pacific countries or ACP) and imports over 1 million tons from them annually. Consequently, the EU will have to consider the impacts on the ACP countries as well.

The proposal again follows the basic principles of the 2003 reforms. The proposal represents a significant price cut with decoupled direct payments incorporated into the SFP to partially compensate for the price reduction, a significant reduction in the production quota, and funds available to assist domestic and ACP farmers in the transition to production of other crops. Details are as follows:

- Refined sugar price cut from 632 euros ($758) to 421 euros ($505) per metric ton;
- Sugarbeet price reduced from 32.8 to 27.4 euros ($39.4 to $32.9) per metric ton;
- Direct payments equivalent to 60 percent of lost revenue incorporated into SFP based on 2000-02 period;
- New member states paid at 100 percent;
- Quota reduced from 17.4 million metric tons to 14.6 million;
- ACP and India imports remain at 1.3 million metric tons, but price reduced from 421 euros ($505) per metric ton to 329 euros ($395). Further negotiations are required between the EU and ACP countries.

If the EU is able to pass a sugar reform of this nature, EU production and exports would be reduced significantly, which may increase world prices. The EU would also gain additional leverage in the Doha Round of multilateral negotiations dealing with the domestic support and export subsidy components of the URAA. More EU support to producers would move from policies considered trade distorting to policies more acceptable to its WTO trading partners and EU export subsidies would be reduced.

Economic Impacts of the 2003-04 Reforms

According to the European Commission's analysis of the reforms, the economic impacts are most likely to be felt in the beef, grain, rice, and dairy sectors in the next 5 to 10 years. A significant reform of the sugar regime, as currently proposed, would also lead to substantial effects on production and exports. Both would be reduced significantly with the world price possibly rising as less EU-subsidized sugar would be exported.

Beef, dairy, and rice markets in the EU would likely experience declining production and rising domestic prices. EU exports of these products would be lower, likely raising world market prices. The United States would likely benefit from such a result, but much would depend on exchange rates and the response of EU farmers to a more market-oriented agricultural economy.

An analysis from the Organization for Economic Cooperation and Development (OECD) concludes that the results for grain production and consumption are not very significant despite the obvious loss of support for rye production. While some crop area goes out of production as a result of decoupling, yields increase somewhat because the area going out of production is marginal land. The highest quality land is still in production. Consequently, production of all grains declines only marginally. The OECD results show a significant decline in rice production as a result of the 50-percent decline in the intervention price and large decoupled payments. The overall decline in EU crop area results in increased use of pasture and more extensification (fewer animals per acre) of animal production, particularly beef and dairy animals.

While the OECD study does not fully estimate an impact on beef production, it does show an extensification of beef production. This would not be inconsistent with the EU Commission's estimate of a 3-percent decline in beef production over the next 10 years, resulting in fewer EU beef exports and higher world prices. The decline in production of butter and dry milk powder as a result of the reduction in intervention prices results in higher world prices, as the EU exports significantly less of these products.

Implications for the WTO Negotiations

The 2003 reform, complemented by the Mediterranean reforms in 2004, has allowed the EU to take the initiative in the multilateral talks on agriculture in the Doha Round of WTO negotiations. If the EU reforms its sugar program as proposed, following the same philosophy pursued in the 2003 reforms, then the EU can be even more flexible in multilateral negotiations. The major impacts of the recent reforms for the purpose of multilateral negotiations do not result from lower price support or increasing market access, but from shifting some commodities' support to policies that are not considered trade distorting under the URAA.

International commitments to the WTO after the URAA provided a strong motivation for EU policymakers to employ decoupled payments as a means of providing domestic support. Domestic policies considered trade distorting are limited by a country's "amber box" commitments, but countries are free to provide unlimited support for "green box" policies that are considered minimally trade distorting, including decoupled payments. There are also "blue box" policies which are payments based on fixed area and yields, fixed livestock numbers, or on a maximum of 85 percent of a base level of production. Such payments are partially decoupled, and therefore not subject to the restrictions on amber box policies. However, many WTO members consider the blue box a temporary arrangement and want these payments to be disciplined in the current Doha Round of WTO negotiations. The EU has asserted that decoupled payments under CAP reform would transfer most of the EU's blue box support to the green box. Nevertheless, many developing countries would like to see the green box disciplined, thus potentially devaluing the importance of the EU's movement of support from the blue box to the green box.

There are two other pillars upon which the URAA rests—export subsidies and market access. Export subsidies are likely to be reduced by the recent CAP reforms through the price reductions on dairy products and rice. The export subsidies also are likely to be reduced through the small effect of decoupled payments on production and trade of beef and cereals, among other commodities. The price reductions for butter and skim milk powder, however, while not sufficient to reach world price levels, would reduce EU export subsidies. The substantial reduction in the rice price, by contrast, will not lead to much lower export subsidies because rice is not exported in any significant amount by the EU. Market access will not be directly affected by the reforms, although the EU should be more efficient in resource allocation, and, with the price reductions, will be in a better position to compete in world markets.

Conclusions

The EU began to comprehensively reform the CAP in 1992 and has made significant reforms through Agenda 2000 in 1998, further reforms in 2003 and 2004, and a sugar reform likely in 2005. With the exception of rice, butter, dry milk powder, and sugar (if a sugar reform is successful), and possibly beef, the reforms likely will not affect world commodity markets significantly, but could have a significant effect on multilateral agricultural negotiations in the WTO. The creation of additional policy tools, such as decoupled payments and compliance rules that reinforce regulations and policies, are significant additions to the EU's flexibility in meeting domestic and international challenges. The recent reforms combine with the ability to set aside land, reduce prices and quotas, and provide funds for a variety of rural development activities, provide EU policymakers with more latitude in international negotiations; such latitude was lacking before the 1992 reforms.

The final outcome of the 2003-04 reforms for production and consumption in the EU is uncertain because the reforms will not be implemented until 2005-07. The discretion granted EU member states in implementing the reforms makes for more uncertainty. Enlargement is another issue that complicates any

conclusions as 10 new member states adjust to new prices, standards, rules and regulations included in the 80,000 pages of membership requirements. The EU's record in the past would indicate that EU farm income will not be greatly affected nor will EU consumption. While it is not clear that the ultimate production and trade effects will be significantly positive for world markets, the direction of the potential effects is less trade distorting.

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