

EU Direct Support Distorts International Trade

Recent enlargement proposal does meet the challenges

The European Commission has proposed that the direct support measures of the Common Agricultural Policy (CAP) to farmers in the ten candidate Central and Eastern European countries should be phased in over a 10-year transition period, with full integration into the EU's subsidy system in 2013. Not only does this strategy lack ambition and vision, this is also an unwise path to follow because the CAP direct support measures are not as innocent as their name suggests.

The so-called direct support measures include area and animal premiums that were once introduced as compensation for lower intervention prices. Yet these payments are indeed coupled to production and hence they affect production decisions and distort international trade with adverse effects on the export potential of e.g. developing countries as a consequence. Furthermore, the value of this support is capitalised in significantly higher land prices than would otherwise prevail, thereby making it difficult for young farmers to enter the business.

The direct income support measures as they are currently defined in the CAP must be eliminated. This recommendation is to be seen in light of the general need to reform the CAP as well as the interaction of the direct payments with other elements of the agricultural policy, e.g. the quantitative restrictions, and their impacts on farmers in the EU. A feasible strategy will balance the need for accommodating pressures from the international trade negotiations, the future enlargement of the EU and the position of the developing countries on the one hand against the need for a gradual and co-ordinated elimination of the direct income support on the other. A study published by the Danish Research Institute of Food Economics (Melgaard, 2001) describes and analyses the future opportunities and constraints for eliminating CAP direct support payments. More specifically, a gradual phasing-out of the direct

income support is suggested ensuring a balanced removal across the different agricultural sectors.

WHY DIRECT SUPPORT

The direct support measures were introduced in connection with the reforms of the CAP that the EU initiated in response to the liberalisation commitments it agreed to as part of the GATT Uruguay Round Agreement on Agriculture (URAA). The commitment to increase market access and to limit the use of export subsidies has forced the EU to reduce its internal (intervention) prices for products that have not been controlled by production quotas and where the internal prices have been significantly higher than world market prices. But the gap between EU and world market prices had been wide for many years before the URAA and so the supply situation had of course adjusted to the high prices leaving the EU in a severe surplus production situation. Moreover, the support has become capitalised in terms of higher land prices.

Because of the political sensitivity surrounding the development of this situation, the EU has avoided any rapid liberalisation of the CAP and has felt it impossible to reduce prices without compensating farmers who would of course suffer significant losses. A rapid liberalisation would initiate a dramatic adjustment of the current production structure, affecting not only the primary agricultural sectors, but also suppliers and the entire food processing industry. Moreover, the resulting capital losses would hurt creditors with a major stake in the agricultural sector.

The direct support scheme is expensive. In 1998 total outlays from the EAGGF Guarantee Fund amounted to € 39 billion. Direct payments made up € 28.2 billion, of which area payments (to reform crops and including set-aside payments)

TABLE 1. AREA AND ANIMAL PREMIUMS IN THE EUROPEAN UNION AT MEMBER STATE LEVEL, 1998.

	Area premiums				Animal premiums			Area and animal Total
	Cereals	Oil seeds	Set-aside	Total	Cattle	Sheep, goats	Total	
EU15, mill. €	11,784	3,115	1,263	16,162	4,253	1,535	5,788	21,950
	----- Per cent of EU15 -----							
Belgium	1.1	0.1	0.4	0.9	2.6	0.1	2.0	1.2
Denmark	4.1	2.7	4.6	3.9	1.1	0.1	0.8	3.1
Germany	20.4	18.1	24.4	20.3	8.2	2.3	6.7	16.7
Greece	3.8	0.3	0.2	2.8	1.2	10.3	3.6	3.0
Spain	9.7	9.7	13.9	10.0	9.3	27.3	14.1	11.1
France	28.2	38.3	29.5	30.2	25.1	10.2	21.1	27.9
Ireland	0.9	0.2	1.3	0.8	12.8	7.1	11.3	3.5
Italy	12.3	13.0	5.1	11.8	4.5	8.3	5.5	10.2
Luxembourg	0.1	0.0	0.0	0.1	0.1	0.0	0.1	0.1
Holland	1.1	0.0	0.3	0.8	1.3	0.7	1.1	0.9
Austria	2.2	2.0	2.0	2.2	2.3	0.1	1.7	2.0
Portugal	1.1	0.6	0.4	1.0	2.0	3.4	2.4	1.3
Finland	1.5	0.6	2.3	1.4	0.9	0.1	0.7	1.2
Sweden	2.7	1.3	4.9	2.6	1.8	0.2	1.3	2.3
UK	10.8	13.1	10.7	11.2	26.8	29.8	27.6	15.5

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RESEARCH PROJECT MISSION

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accounted for € 16 billion and animal premiums accounted for € 5.8 billion. In other words, the area and animal premiums that were introduced with the McSharry reforms of 1992, account for 57% of the total outlays from the EAGGF Guarantee Fund. Moreover, this share will increase as the Agenda 2000 reforms are implemented. In terms of the distribution of the area payments across member states, it may be mentioned that France and Germany alone receive half of the total payments and they also receive a significant share of the animal premiums, cf. table 1.

CONSEQUENCES OF THE DIRECT SUPPORT

Just like market price support the direct income payments distort the market mechanism. The switch to direct support rather than market price support has simply moved the burden from EU consumers to the EU budget, which to a large extent is financed by EU taxpayers. The administrative burden of the support scheme should not be ignored either. This burden has been increasing in part because the direct support measures must be backed by substantial control functions to ensure that the quantitative limitations embedded in the system are upheld.

Even if the EU's direct payments are seen as less distortionary than market price support in terms of their effects on production and trade, the support scheme is under pressure for reform vis à vis the EU's international trade commitments. The current area and animal premiums are classified as Blue Box payments in the WTO. As part of the URAA measures included in this Box are exempt from the ordinary reduction requirements until 2003. The problem with the Blue Box measures is that they are not decoupled from production and hence they also distort international trade.

ELIMINATING THE DIRECT PAYMENTS

There are many reasons why the direct payments should be eliminated. First of all, the reason why these measures were introduced in the first place will gradually be diluted. To the extent that the original intention was to stop the hastily increasing supply response as a consequence of the EU's policy of high intervention prices and to avoid a dramatic change in the production structure in connection with market liberalisation, this goal is achieved through quantitative restrictions such as set aside requirements, base area restrictions and limits on the number of animals eligible for premiums. Secondly, the EU will face pressure after 2003 to remove or restructure the payments that are currently classified as Blue Box.

Another reason for reform is that the EU enlargement eastward will entail a significant expansion of the agricultural sector, not least because agriculture in these countries account for a significantly larger share of the economy than in the current EU. The agricultural sectors of these countries are far less protected and less supported than those of the EU. If the direct payments are extended to the ten candidate countries the effects will be dramatic. Both production and land prices in the new member states would increase significantly, cf. Frandsen and Jensen (2000). They find that the production of wheat and other grains will be 20 and 25 per cent higher, respectively, if the direct payments are extended fully to the new member countries compared to a situation where new members do not receive any direct support. Furthermore, land prices will more than double in the new member countries. Finally the budgetary impact of extending the direct support to the Central and Eastern European countries is an increase of more than 20 per cent.

The direct payment scheme should be eliminated too in order to remove the unfair competitive advantage they provide EU farmers relative to farmers in the developing countries. So although efforts are being made to assist developing countries in engaging in international trade, the playing field will not be level as long as the developed countries continue to provide their farmers with direct support. The developing countries do not have the financial means to support their agricultural sectors.

To continue liberalisation efforts that also ensure that the

agricultural sector can adapt to the new and lower levels of earnings through productivity increases and structural adjustment, a strategy for eliminating the support measures must take account of the embedded quantitative limitations. Moreover, the elimination of the support measures must be coordinated across sectors so as to avoid undesirable costs in relation to the longer-term development of the sector as a whole. There will be substantial capital losses for the individual landowners - losses that can only be absorbed over a longer transition period. Future landowners, on the other hand, being informed about the elimination of the support, will not suffer any losses, and they will also avoid the administrative burden of these systems.

Finally, a more domestic focused argument in favour of reforming the system of direct payments is that the current system is very inflexible and does not enable adjustments in relation to the continued technological development. In an economy-wide perspective, the measures constitute a welfare loss because the use of resources is distorted.

CONCLUSION

The direct support measures as they are currently defined in the CAP are not independent of production decisions. Hence they affect production and international trade with adverse effects on the export potential of e.g. developing countries as a consequence. Within the EU the direct support scheme retains more resources in agriculture than is rational from an economy-wide perspective. Another important implication is the significant degree of capitalisation of the support that takes the form of higher land prices.

There are several reasons why the direct support measures should be eliminated or at least be fully decoupled from the farmers' decisions to produce. The eastward enlargement of the Union, the EU's commitment to liberalise trade, and the economy-wide welfare losses are the most important. A reduction of the support measures would affect the relative competitiveness of the different products and it is therefore necessary that an elimination strategy is co-ordinated so that undesired structural changes are avoided.

One of the most difficult aspects of an elimination of the direct support scheme would be the economic consequence for independent farmers. An important factor to be determined is therefore the speed with which the elimination should take place since restructuring and adjustment takes time. The recommendation is threefold: (1) conduct a relatively quick harmonisation of the direct support measures across the various agricultural products, (2) gradually phase-out the direct support measures, and (3) remove the quantitative restrictions as they become redundant. The elimination of the direct support scheme will reduce the EU's budgetary outlays relating to the CAP and thereby enable the tackling of other important tasks - not least in relation to the eastward enlargement.

REFERENCES

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