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Stiftung
Wissenschaft und
Politik

German Institute
for International and
Security Affairs

European Agricultural Reform and WTO Negotiations in Parallel

Mutually Impeding or Reinforcing Processes?

Bettina Rudloff

The Common Agricultural Policy (CAP) of the European Union (EU) is today subject to a double pressure: an internal one, arising from the reform debate caused by the CAP's "Health Check", and an external one, spurred by the ongoing WTO Round. In the past, EU agricultural reforms and WTO negotiations have mutually influenced one another. The present situation is no exception. The question again arises whether and how this influence will come together, and what path the EU will choose in its internal reform and the WTO negotiations.

Since the last Round of WTO negotiations, the Uruguay Round, national agricultural reforms and multilateral negotiations have run in parallel. The European agricultural reform that was carried out during the 1992 WTO Round marked a system change for the EU's agricultural policy—above all in the CAP's "first pillar", which is dedicated to income support: the reform consisted of the dismantling of the guaranteed minimum price. Resulting income losses were compensated for by new forms of aid calculated with reference to animal stocks and acreage. In order to hem in the production surpluses, which in those days were sizeable, this aid was tied to supply control in the form of quotas. The "second pillar" of the CAP, which was created at this time, offered support to rural areas. It brought together a range of existing programmes on structural development aid.

With this reform, the EU was reacting to virulent conflicts between the WTO parties. The Union thus paved the way decisively for the resumption of WTO negotiations which had long been blocked. Thanks to these changes, the CAP was brought into line with the WTO Agreement forged in 1994. Under the terms of the Agreement, national subsidies were to be classified in terms of their trade-distorting effect, and had to be reduced:

- the *Amber Box* contains those subsidies tied directly to production, and thus those with the greatest market-distorting effects. These are to be reduced by a set degree. The EU's minimum price system fell into this category.

Dr. Bettina Rudloff is a researcher at the EU External Relations Division

- the *Blue Box* contains measures deemed to have less of a distorting effect. These must be accompanied by instruments aimed at supply control. These measures do not have to be reduced. The forms of aid newly introduced by the EU in 1992 were categorised as such.
- in the *Green Box* are to be found subsidies that are clearly permitted. These do not have to be reduced. Income-support measures decoupled from current production fall into this category, as do a defined catalogue of structural development aid. The second pillar of the CAP was classified as such.
- one category of subsidies that can be ignored in reduction commitments is *de minimis* payments. Depending upon the production-volume of a particular commodity, a ceiling for these payments is defined. Up to this point, payments may not be reduced. The EU has not yet reached this ceiling.

The WTO decisions concerning external trade have affected the question of market access and thus the import side: all existing forms of border measure have to be transformed into tariffs, which must in turn be reduced. Developing countries, though, do not have to reduce these tariffs to the same degree. Within the framework of the Special Safeguard Clause, additional tariffs can be imposed automatically on selected products in situations in which the amount of imports is particularly high.

On the export side, reductions in export refunds were required. These export-refunds offset the difference between high domestic prices and low prices on the global market, and thus create artificial incentives for export. The EU has used this instrument frequently in order to dump surpluses on the global market through subsidies. The price on the global market has subsequently fallen, leading to significant losses for competing countries. Since food aids in the form of the donation of comestibles can destroy markets in receiving countries as well as placing pressure on competing producers, the WTO has formulated general rules for this area too.

The last comprehensive CAP reform ("the Mid-Term Review-Reform" from 2003) anticipated a new WTO-agreement on agriculture, which was expected to be agreed upon in 2005. A precedent in the CAP's history was thus set when the way to the most efficient form of income transfer was opened—the decoupled single-farm payment made to individual farms: the previous direct payments for producers had been tied to the actual production of a particular commodity. The production focus was thus fixed on highly subsidised products (oilseed; milk; beef). Thanks to this reform, these payments were transformed into a single-farm payment. The farmer's decision on production can now be made independent of any specific product. Hereby European payments were thus brought into line with the Green Box.

The calculation of this single-farm payment can currently be decided upon at the level of the farm or at a regional level: in the case of the former, claims for payments result from the allocations that an individual farm received in the past. In the regionalised historical model, meanwhile, the calculation is based upon the past allocations of an entire region to be defined by the member states. The connection to the past decisions of individual farms thus falls away; the farms' level of payment within the region is uniform; and in that way the decoupling effect is strengthened.

Alongside this reform of the support's design, in 2003 it was decided to continuously reduce income support: all payments are to be reduced annually by a certain rate ("modulation"). Additionally, payments are now bound to the farmer's compliance with regulations on environmental protection, animal welfare and food quality ("cross-compliance"). Breaking these regulations will result in a reduction of payments.

Both means lead to savings, which the member state in question can then use for rural development, i.e. the second pillar.

Unlike under the first pillar, these programmes are subject to requirements as regards co-financing. They are thus only applicable if they can be complemented by funding from the national budget.

Health-check proposals: starting signal for a better future?

The Commission's Communication *Preparing for the "Health Check" of the CAP Reform* of November 2007 heralded the mid-term stocktaking of the current CAP—a process which was to act as a basis for reform. On 20th May 2008, at the end of the consultation phase the Communication initiated, the Commission's legislative proposals have been published. In the best case-scenario, a legally-binding reform could be adopted under the French Presidency by the end of this year. The co-decision procedure will, however, have to be applied to CAP next year. This infers greater powers for the European Parliament should the adoption of the proposals be postponed until 2009.

The Heath Check completes previous reforms rather than laying the foundations for a further system change. All its elements are aimed at reinforcing the process of decoupling as well as increasing the means available under the second pillar.

1. The **reinforcement of decoupling** aims at the following goals:

- the total transfer of all forms of aid into the decoupled single farm payment. This is still subject to exceptions. Some of the EU-27, in particular the southern member states like Spain (tobacco, olive oil and bananas), Italy (tobacco and rice) and Slovenia (in mountainous regions), but also Austria and Finland (rearing of suckler cows) still resort to the option of tying aid to production. This allows them to prevent production and land from being abandoned in marginal regions. At the same time, this process is complementary to the goals of environmental protection and nature conservation, which are directly linked to the use of acreage for agricultural purposes.
- the more expeditious implementation of the historical model harmonising levels of payment between farms.
- the greater use of specific support payments in certain regions. For environmental reasons and to support marketing, this kind of payment is already allowed as an "Article-69 measure" (after the eponymous article in Regulation 1782/03 on direct-support schemes). The relevant proposals in the Health Check is supposed to offset the implications of enforced decoupling for the most affected regions. They should in particular compensate the income losses that are expected due to the dismantling of milk quotas. This support is special as it does not require co-financing, unlike all the other forms of regional support.

In sum, the completion of the decoupling process will lead above all to a further regrouping between sectors: products that were strongly supported in the past (milk, cereal, beef) lose ground in comparison to other products which were scarcely supported (potatoes). In this way, those farms, which have placed particular focus on such products, will lose out — like France and Germany.

2. The Health Check's proposals suggested the following measures to **expand the second pillar**, the policy for rural development:

- the automatic annual reduction of single farm payments will be accelerated. In this way, an extra sum of approximately 3bn. Euro *per annum* could be channelled into the second pillar.
- a progressive reduction undertaken in such a way that farms receiving more payments in total will undergo a greater reduction. Of all the Health Check's suggestions, this proposal has garnered the most criticism , with Germany, the Netherlands, Britain and the Czech Republic the most affected. The reduction now finally envisaged under the Commission's May-20th proposals has

thus turned out to be smaller than originally proposed. Up to c.500mn. Euro could be saved, leading to a considerable redistribution of finances from high-income to low-income farms. Nearly half of the total sum will be redistributed within Germany alone.
The funds thus freed up will remain in the member state affected and are to be used for second-pillar purposes only. However, the farms that may benefit from these changes are not necessarily identical to those farms that will be affected by reductions. Besides, these additional means are subject to co-financing requirements. For this reason, member states will encounter different levels of strain on their budgets: those states most affected must find the most additional national resources.

- the efficiency of cross-compliance rules is to be put to the test. In particular, complying with and supervising food-safety regulations are a cause of high costs. Yet, these regulations are of relatively little benefit, since farmers can only influence these factors to a limited degree themselves.

3. As before, instruments for **risk management** to cushion income risks are to be given a thorough once-over:

- states' continued practice of buying up produce (feedgrain) is to be completely stopped.
- insurance against price risks is put forward as a completely new strategy. It remains unclear how this support from public means should be put together. Should these crisis instruments be financed under the first or second pillars? Will national co-financing be necessary?

4. In the light of **upcoming challenges** like climate change, water shortages and a loss of bio-diversity, the Communication proposes the extension of related programmes under the second pillar. All additional money won from the new degree of modulation should accordingly be dedicated to those existing programmes which have been selected as most appropriate by the Commission.

WTO proposals: consolidated consensus

The WTO's last great compromise paper was adopted under the name "July Package" shortly before the collapse of the Doha Round The Round ought to have come to a conclusion in 2005 had all gone to plan. The Package contains proposals of a rather general nature, and without any fixed instructions—for example on means to reduce tariffs. The declaration released by the last Conference of Ministers in Hong Kong in 2005 reiterated these general proposals.

Only in August 2007 were negotiators able to agree on specific and numerical proposals. The negotiations, thus intensified, ended on 19^{th} May 2008 with the latest revised proposal. The decision about whether and how to continue negotiations is expected in June.

Looking beyond the different phases, one can identify a growing common consensus as regards the following issues: (1) the progressive approach behind not only the reduction of tariffs but also of domestic subsidies; the progressive approach foresees that higher levels of tariff should be subject to greater reductions than lower ones. (2) the increase in exceptions affecting specific products or groups of countries. In particular, the number of country groups qualifying for exceptions grew: a group including the newest WTO members, as well as those with small and vulnerable economies, join the developing and least-developed countries (LDC).

The inter-linkage of WTO-negotiations and the CAP reform

Does the Health Check offer the EU new leverage in the negotiations on the current WTO Round? Alternatively, do the possible results of the WTO's Agricultural Agreement influence the details of the future CAP-reform? These questions can only be properly addressed by differentiating between different areas—market access, export competition and domestic subsidies.

Market access: reduced elbowroom thanks to greater interest in protectionism

The question of market access, and thus the commitments regarding tariff cuts, were of the most critical importance in all past WTO rounds and for all parties—making it the most conflict-laden area of negotiations. Consensus was achieved on two points:

- a progressive formula which lays down that the highest tariffs should be subject to the greatest reductions. For the EU, with its high tariffs this would entail a particularly broad dismantling effort.
- a percentual tariff which is dependent upon the world-market price could be proposed for the very first time for agricultural tariffs. It is deemed the most efficient kind of tariff, being in effect less partitioning than a constant specific tariff. The EU would have to adapt its arrangements for many products with specific or mixed tariffs. The precise formula for converting these tariffs has proved to be one of the most difficult technical questions in negotiations thus far.

Such a resolute tariff-cut would lead to a rise in imports and a reduction of domestic prices. In the EU, feedgrain, proteins and oilseeds but also fruit would be most affected. This implies losses for producers and gains for consumers. Since world-market prices would rise, producers of export products will gain and consumers will lose (grain, milk products, processed fruit and vegetables). The dismantling of tariffs provides for countervailing income effects, depending on individual products. For this reason, the member states will also be affected in different ways, according to the domestic significance of the relevant product.

The EU is interested in protecting domestic producers. The question of market access is therefore the most problematic of the negotiation points, precisely because of the Health Check: as the Health Check aims for a further dismantling of income support, the EU cannot see any room for further tariff reductions. Seen from another angle, the WTO's proposed tariff cuts provide an internal reason—and pretext—to desist from more drastic reductions in income support in the near future of the CAP. At the same time, it lends weight to all options for additional payments like the ones allowed under Article 69

Given the narrow scope for manoeuvre with further concessions, the EU will increasingly concentrate on the negotiation of *exceptions* from the reduction of tariffs: for sensitive products, a cut in tariffs smaller than that applying to all other products has been put forward. Yet, the suggestion that only a handful of products should count as "sensitive" was criticised by the EU. In those products relevant for income—grain, milk and beef for example—the EU will seek to maintain its scope for protectionism and even expand it.

Previously the members enjoyed recourse to a particular safeguard clause, allowing for automatic additional tariffs as soon as import levels rose. It has been a point of consensus for some time that this mechanism not be used, at least not by developed countries. There is scope for manoeuvre, though, in the concrete steps to be taken in the run-up to its expiry. Here, the Health Check supports to demand longer transitional regimes and thus to profit from this form of protection for as long as possible.

As for the special rules for developing countries, the EU is unlikely to offer expanded market access, at least when dealing with products that it wishes to protect to a greater degree. The picture is rather different with the proposal, made for the first time in this Doha Round, of cushioning preference erosion: thanks to the trend towards a general reduction of tariffs, the advantages previously enjoyed by trading partners that profited from low (preferential) tariffs are dwindling. These partners are mainly developing countries. In the proposal, the tariffs cut should be implemented within longer transitional periods for products that play a large role in preferential agreements with developing countries. This appeals to the EU's protectionist interests, and the EU can thus support the interests of developing countries in this point.

Export subsidies: no additional scope beyond the maximum offer of abolishment

The EU's desire to completely dismantle export refunds, apparent in the July Package, is currently supported by market conditions: price rises on the world markets are given extra puff by the proposed dismantling of tariffs. In this way, the difference between domestic and world-market prices shrinks, automatically reducing export refunds. Since the complete abolition of export refunds already constitutes the EU's maximum offer in negotiations any further proposal can only be linked to the implementation side, e.g., reduction steps and transitional periods.

Domestic subsidies: generosity within bounds

With its idea of decoupling, the CAP-reform of 2003 sent a powerful signal in this area and strengthened the EU's bargaining hand considerably. The system change thus initiated a regrouping of subsidies, from those with few distorting effects to those with no distorting effect on trade. According to the WTO's proposed reductions, individual categories as well as total volumes of subsidies should both be reduced for the first time.

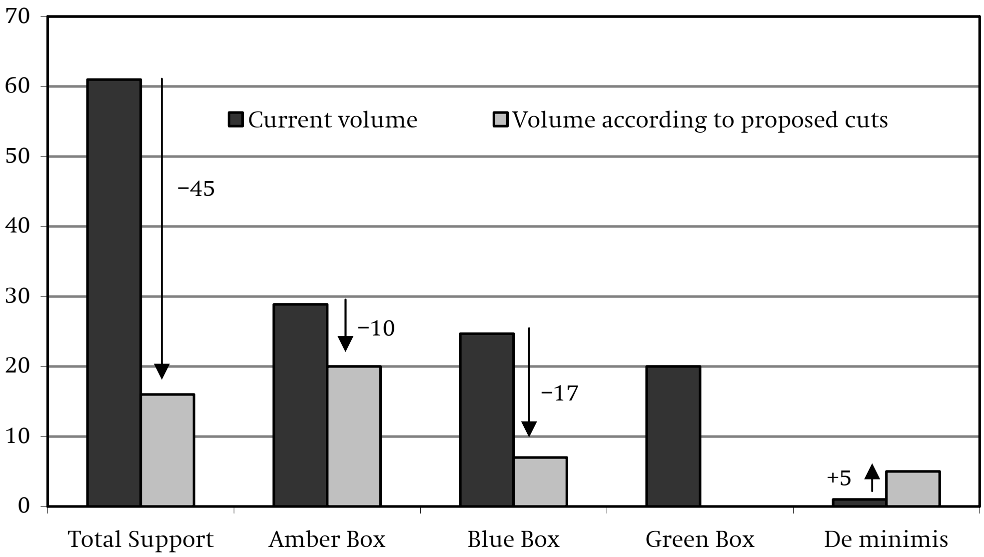
- For *overall support* (the total from the Amber Box, Blue Box and *de-minimis* support), a progressive reduction has been proposed. For the EU, this would entail a reduction to 16bn. Euros; at present, the EU is overstepping this level by 45bn. Euros. This prescription is the most decisive obligation facing the EU.
- The progressive reduction of the *Amber Box* would require the EU to cut levels to 20bn. Euros. The necessary reduction by (currently) 10bn. Euros could be achieved without further reform, relying simply upon the complete implementation of 2003's CAP reform. For the EU, this area is thus unproblematic.
- As for the *Blue Box*, the proposal would entail the EU halving the initial value to 7bn. Euros. According to the notification most recently given to the WTO, these payments were as high as 24bn. Euros, meaning that 17bn. Euros would need to be saved. At the same time, the complete implementation of the last reform would promise large-scale savings: the introduction of decoupled payments has already led to a shift of 13bn. Euros from the Blue to the Green Box. The proposal contained in the Health Check for the inclusion of the remaining coupled payments would further reduce the overhang.

The EU sees only limited scope for manoeuvre as regards further reductions in this Box, since it needs to retain a certain flexibility internally if the scale of decoupling and the rate of modulation might again be changed during the decision-making process.

- In the case of the *Green Box*, no reductions would be necessary, if the criteria, thus tightened, applied from now on. With the help of this tightening, farmers should be prevented from strategically ceasing production in expectation of future changes in the level of payments. The clear signal sent out by the Health Check—to implement the historical model expeditiously—is conducive to such tightening: decisions tailored to individual farms will no longer play a role.

In the case of the proposed new measures for cushioning income risks, everything depends upon their concrete form. Those measures that are neutral as regards

Figure 1
Effects of the WTO proposal on the EU's subsidy-payments (in billions of Euros)



production belong in the Green Box; (hidden) production subsidies would be sorted into the Amber or Blue Boxes.

- Even for the category of negligible supports (*de minimis*), which were spared reduction under the Uruguay Agreement, a reduction has now been proposed. In fact, the EU would be allowed to raise its current levels by 5bn. Euros, since the Union currently falls short of the newly-defined ceiling by 4bn. Euros. The Article-69 payments in the milk-sector must be categorised as *de minimis* because of their relationship to production. Should all EU members exhaust this option, this could equate to a sum of 4bn. Euros per year. The scope for manoeuvre would thus be exploited almost to the full.

What way to go for the EU in the negotiations?

Unlike the CAP reform during the Uruguay Round, the Health Check does not strengthen the EU's hand at the negotiating table. The reasons for this lie above all in the delay of the latest WTO Round: in the area of *domestic subsidies*, the 2003 CAP reform supported the European position thanks to the most powerful liberalising signal it sent out. The effect of this signal burnt brightly precisely because no WTO agreement was concluded at the time. The proposed reductions in the Health Check are rather modest in terms of their volume. In fact they reduce the scope for offering further reductions because they leave little margin for the implementation of existing WTO-proposals. In the question of *market access* too, the Health Check, with its further dismantling of income support, favours a somewhat conservative approach, since it retains the protection elements as well as granting exceptions from the process of tariff reduction. The same is true of the EU's maximum offer in negotiations of completely removing *export refunds*, which has lost its initial impact because of the delays to the WTO-negotiations. The only new negotiating offer open to the EU remains the possibility of accelerating the dismantling process.

If the EU wishes to breathe life into the stuttering WTO negotiations, its internal resolutions for reform need to orient themselves around the maximum options set out in the Health Check.

- In order to gain a margin for manoeuvre in the reduction of subventions, the current proposed modulation rate should not be diluted again.
- The progressive reduction of the single-farm payments has already been alleviated compared to the Health Check's proposal which will not hinder the WTO negotiations: the small savings that this reduction would bring are not viewed by the WTO as a means of overcoming the impasse in negotiations; nor would they decisively contribute to the relief of the EU budget. The implementation of this reduction even in diluted form would, however, accommodate the current debate on the social iniquity of payments. This perception of iniquity was recently fuelled by the "Transparency Initiative", which outed large farms, and those with high incomes, as the main beneficiaries of agricultural subsidies.
- The complementary payments of Article 69 could be limited in the ongoing decision-making procedure. Their possible link to products smothers the signal effect of decoupling. This undermines the credibility of the EU's commitment to a competitive future CAP. For this regional support, the EU should identify better-suited means from the second pillar.

Should, once again, no consensus be achieved at the WTO-level, these steps will exude a conspicuous willingness for liberalisation, generally strengthening the EU's hand in all future international negotiations.

Rural area: the undiscovered ace up the EU's sleeve

One area, neglected to this day by the WTO, could play an even more decisive role for the future of the CAP than all the previous proposals. Further, it is not tied to any WTO-agreement—just the opposite in fact:

Under the "Peace Clause" of the current Uruguay Agreement on Agriculture, agricultural subsidies are shielded from the stricter rules of the agreement on Subsidies and Countervailing Measures. According to this Agreement, all subsidies specific to single firms and sectors are actionable and can justify the introduction of protective tariffs by affected trading partners. The exception made for agricultural subsidies was to run out in 2003. The judgment on the Cotton Dispute between the USA and Brazil in 2005 underlined the relevance of this situation: it condemned the USA's subsidies based on the stricter rules of the general Subsidy's Agreement.

Seen in this light even the EU's self-declared dray horse, the second pillar, will be vulnerable since it compromises sector-specific subsidies. Opening up the scope to promote payments in rural areas to non-agricultural actors, and thus integrating the second pillar into the general EU's regional policy, could overcome this kind of problematic differentiation by sector.

This type of comprehensive, strategic approach is missing from the debate on the reform of the CAP. Neither the Health Check nor the positions of the individual member states boast such thinking. Yet, opening up the area of eligibility would secure its long-term compatibility with the WTO, even—indeed especially—when no new Agreement is concluded. Then in any case the Peace Clause cannot be applied anymore to protect sector-specific agricultural subsidies.

SWP
Stiftung Wissenschaft und Politik
German Institute for International and Security Affairs

Ludwigkirchplatz 3−4
10719 Berlin
Telephone +49 30 880 07-0
Fax +49 30 880 07-100
www.swp-berlin.org
swp@swp-berlin.org

ISSN 1861-1761