AGRICULTURE AND EU ENLARGEMENT

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Abstract. *Agriculture poses considerable tensions for enlargement of the European Union, because of its continuing importance both in the economies of the applicant countries of Central and Eastern Europe, and in the EU budget and acquis communautaire. The preparation of agriculture in the candidate countries to join the EU is rendered more complex by the fact that the Community's Common Agricultural Policy is a moving target. The aim of this paper is to provide a survey of recent developments relating to food and agriculture in the EU and Central and East European candidate countries in order to indicate the main challenges and difficulties posed by enlargement. It seems likely that agricultural policy in an enlarged EU will attach increased priority to objectives such as food safety, rural development and the environment. However, these new priorities may be expensive to realise, and may impose a growing burden on the national budgets of EU member states.*

1. INTRODUCTION

Many of the toughest questions posed by enlargement relate to agriculture.[1] This is due to the continuing importance of agriculture both in the economies of the applicant countries and in the EU budget. At the same time food and agricultural measures account for roughly half the *acquis communautaire*,[2] so the applicant countries have the daunting task of adapting to EU policies and standards. Land and labour costs tend to be lower in the CEECs (Central and East European countries), so farmers in the EU(15) have expressed concern about the increased competitive pressures in an enlarged EU, though the impact seems likely to be less than initially feared.

The preparation of their agriculture to join the EU is rendered more complex for the candidate countries by the fact that the CAP is a moving target. Substantial changes in the CAP were introduced by the MacSharry Reform of 1992 and the 1999 Berlin Agreement. The CAP is subject to a mid-term review in 2002, and the issue of reform will be back on the table when the financial perspective for the years after 2006

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[1] The discussion here is limited to the ten applicant countries of Central and Eastern Europe (see Table 1 for a list of these countries), and excludes Cyprus, Malta and Turkey. For an account of Cypriot agriculture and enlargement see Senior Nello (2000).

[2] The *acquis communautaire* is the body of EU legislation, practices, principles, and objectives which has to be accepted by the member states. It has been accumulating over the years and now amounts to some 12,000 legislative acts.

comes up for discussion. The question is further complicated because the issues of CAP reform, enlargement and GATT/WTO obligations are all interlinked.

Given the importance of agriculture for enlargement, the aim here is to provide a brief survey of the issues. Section 2 provides data illustrating the weight of agriculture in the CEEC economies, the CAP budget and the *acquis*. Section 3 deals with agricultural transition in the CEECs, before discussing the prospects for agricultural production and consumption in an enlarged EU in Section 4. Section 5 illustrates how the CAP is a moving target, while the problem of extending direct payments to the CEECs is discussed in Section 6. Section 7 deals with the application of quotas, set-aside and rural development policies in the CEECs. Section 8 indicates the budgetary implications of enlargement. Section 9 illustrates how the issues of CAP reform, enlargement and WTO negotiations are interconnected, before drawing conclusions about the outlook for the CAP in an enlarged EU in the final Section.

2. THE IMPORTANCE OF AGRICULTURE IN THE CEEC ECONOMIES, THE COMMUNITY BUDGET AND THE ACQUIS COMMUNAUTAIRE.

As shown in Table 1, in 1999 the share of agriculture in GDP was 5.1% for the CEEC(10) compared with 2% for the EU.[3] The average share of agriculture in employment was 26.1% for the CEEC(10) and as high as 35.2% in Romania and 25.6% in Poland, but only 5.7% in the EU(15) in 1999. In Lithuania and Romania the share of the work force in agriculture has increased since 1989, as farming may act as a buffer providing an element of food security and additional income during the transition process.[4]

Though over the years the share of agriculture in EU spending has been reduced, the CAP continues to absorb just under half of the Community budget. In 2002 46% of the budget was earmarked for agriculture with a further 36% for the Structural Funds).

With accession the applicant countries will be obliged to take on the *acquis communautaire* relating to food and agriculture, including veterinary and phytosanitary rules. By 2000 the candidate countries had requested 170 derogations and temporary exceptions from the *acquis* on non-agricultural questions, but 340 relating to agriculture.[5] Particular difficulties arose

[3] Unless otherwise stated, the statistics in this paper are taken from Eurostat. The national statistical offices of the applicant countries are generally bringing their statistics in line with Eurostat practices, but the process is not always complete.
[4] The share of the work force in agriculture in 1989 was only 27.5% in Romania, and 17.6% in Lithuania. In the early years of transition the share of agriculture in employment also rose in Poland and Bulgaria, but it has subsequently fallen.
[5] The statistics in this paragraph are taken from *Agra Europe*, March 2001.

relating to meat and milk production, and it was estimated that roughly 50% meat production in Poland, and 40% in Hungary failed to meet EU standards. The two countries have asked for derogations of three to five years before the *acquis* is fully adopted in these areas. In some cases the cost of the investments required to bring the processing industry in line with the *acquis* is prohibitive, so it seems likely that many firms in the CEECs will close. As transport costs for agricultural products tend to be relatively high, this is likely to have implications for farmers upstream. FDI (Foreign Direct Investment) can play a crucial role in assisting adjustment to EU standards.[6]

Table 1: Basic data on agriculture in the Applicant Countries

	Land area (mio ha) 2001	**Gross value added in ag. euro billion 2000**	**Agriculture as % GDP 2000**	**Ag. employment (1000)2000**	**Ag. % total employment 2000**	**Food expenditures % income 1999**
Bulgaria	5.5	1.6	14.5	342b	11.3b	54a
Czech Rep.	4.3	1.9	3.9	193	7.4	32
Slovakia	2.4	0.8	4.5	119	6.7	32
Hungary	5.9	1.8	4.1	227	4.8	42a
Poland	18.4	5.0	3.3	2698	18.8	30
Romania	14.8	4.6	12.6	4861b	42.8b	58
Slovenia	0.5	0.6	3.2	81	9.9	24
Estonia	1.0	0.3	6.3	32	7.4	36
Latvia	2.5	0.3	4.5	118	13.5	39
Lithuania	3.5	0.8	7.5	262	19.6	40
CEEC(10)	58.8	17.8	5.1	8933	21.4	37
Cyprus	0.1c	0.3b	4.2b	14b	9.2b	19
Malta	0.01	0.08	2.3	3	1.9b	
EU	130.0	167.5	2.0	7129	4.3	17

a= 1998, b=1999, c= 2000

Source: European Commission (2002b)

[6] See Senior Nello (forthcoming) for a discussion of FDI in the CEEC food industry.

3. TRANSITION IN AGRICULTURE

As shown in Table 2, production collapsed in the CEEC(10) at the beginning of transition, followed by a stabilisation of the level of production in most CEECs. Recovery was generally faster for grains, while milk and beef production has been declining in most CEECs. Various reasons can be given for the fall in output:

- The reduction in subsidies at the beginning of transition;
- The disruption or "creative destruction"[7] associated with the transition process;
- Macroeconomic uncertainty;
- The Russian crisis;
- Adverse weather conditions such as drought in many of the CEECs in 1992 and also in 1993 in some countries, and flooding in the late 1990s;
- The worsening terms of trade for farmers with prices for inputs and other non-agricultural products rising faster than those for outputs in the early years of transition. Subsequently in most CEECs the terms of trade tended to level out. [8]

Agricultural productivity in the CEECs is lower than in the EU, but has been increasing since the mid-1990s (Swinnen, 2001).[9] Productivity tends to be higher in countries such as Hungary which have been able to attract high levels of FDI in food processing, but lower in countries like Romania, Bulgaria and Poland, where small-scale farmers seem less able or willing to undertake restructuring

Table 2: Agricultural Output (US$ million, base year 1990) 1990-1999

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Bulgaria	8,960	6,979	4,777	4,001	4,753	5,456	4,352	6,857	5,635	4,736
Czech Rep.	5,777	4,053	2,822	2,905	2,557	2,709	2,722	2,730	2,610	2,095
Estonia	2,360	2,292	1,561	1,117	1,000	675	663	620	589	n/a
Hungary	9,740	5,259	4,302	3,885	4,129	4,196	4,150	3,804	3,721	3,889
Latvia	5,573	5,185	2,653	1,351	1,102	1,165	1,028	1,015	779	n/a
Lithuania	8,835	5,796	2,733	2,092	1,348	1,594	2,293	2,503	2,315	n/a
Poland	16,100	12,053	12,273	12,737	12,399	13,241	13,811	14,750	13,521	10,718
Romania	17,019	12,792	11,863	12,999	13,990	13,990	14,026	12,916	9,886	9,145
Slovakia	3,023	1,990	1,730	1,857	2,190	1,799	1,767	1,763	1,693	1,698
Slovenia	908	884	823	789	823	834	852	841	853	n/a

Source: Cioni (forthcoming) who bases her estimates on Maddison (2000) and European Commission.
n/a: not available

[7] This term was coined by Kornai (2000).
[8] Davidova and Buckwell (2000).
[9] Productivity as measured by yields per hectare. As Davidova and Buckwell (2000) point out, though there are wide variations in the estimates for labour productivity published by different sources, it appears to be particularly low on semi-subsistence farms which are often characterised by hidden unemployment.

and improvements in farming methods.[10] Productivity is expected to rise when these countries join the EU, due to improved access to capital, technology and know-how (Swinnen, 2002).

After 1989 agricultural policies in the CEECs were characterised by an initial phase of liberalisation of prices and trade, and the elimination of subsidies. Consumer prices for food products rose rapidly, while real farm incomes fell, leading to a second phase of *ad hoc* price and trade intervention during the early 1990s to protect producers and consumers from the adverse effects of early reforms (Hartell and Swinnen, 2000). In a third phase from about 1995 as governments gained experience in intervention in agriculture longer term measures were introduced, and there was a more systematic tendency to adopt CAP-like measures.[11] Subsequently adjustments to policies were introduced, partly in response to domestic pressures and to meet international obligations, but also to mirror the changes in the CAP, though at times with a certain delay.[12] After 1994 there was a tendency to rely less on price support, and more on direct payments (producer subsidies) to farmers. A difference with EU policies has been in the CEEC use of a wider range of measures, including input subsidies and subsidised credit, but these will have to be brought in line with EU regulations with enlargement (Davidova and Buckwell, 2000).

One of the difficulties in comparing the level of agricultural support of different countries is that a wide range of policies are available (direct subsidies, price support, subsidised credit, tax breaks and so on) and the combination of measures adopted varies between countries. The PSE (producer subsidy equivalent, whose name was changed to producer support estimate from 1999)[13] provides a means of collapsing all these different policies into a single measure of support. The PSE can be defined as the subsidy necessary to leave the revenue of farmers unchanged if all policies with an impact on the agricultural sector were abolished. Each year the OECD publishes PSE estimates for various countries. These are expressed either in money value (generally in dollars) or as a percentage of the value of agricultural production at the farm gate.

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[10] Swinnen (2001).

[11] The CAP-like measures introduced in the applicant CEECs include: price support (the Visegrad 4, Lithuania, Bulgaria (until 1997), Romania (until 1998) and Slovenia), export subsidies (the Visegrad 4, Lithuania and Romania (from 1998)), direct payments (Bulgaria, Estonia, the Czech Republic, Hungary, Slovakia and Slovenia) production quotas (Poland, Slovakia, Hungary and the Czech Republic from 2001). For more detailed descriptions see Hartell and Swinnen (2000), Rabinowicz (2000), and OECD (1999).

[12] Hartell and Swinnen, 2000.

[13] Since 1999 with the change in name the OECD classification of certain policies has also altered slightly, but not sufficiently to cause a break in time series.

Table 3: Percentage PSEs in the EU and CEEC(10)

	1986-1990	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001*
Bulgaria	n/a	n/a	-39	-45	-4	-27	-25	-54	-10	2	6	2*	
Czech Rep.	57	54	52	31	28	20	12	13	9	21	25	16	17
Estonia	75	71	59	-97	-32	-10	0	7	5	19	15	10*	
Hungary	34	-18	11	16	20	24	14	9	7	13	23	20	12
Latvia	80	76	83	-101	-40	6	5	3	4	17	18	18*	
Lithuania	77	72	-262	-124	-37	-15	1	5	7	20	21	18*	
Poland	17	-18	1	18	15	18	18	23	22	23	19	7	
Romania	45	45	15	8	16	19	10	12	3	25	20	11*	
Slovakia	51	51	35	28	26	23	18	11	13	26	25	23	11
Slovenia	n/a	n/a	n/a	35	28	32	37	29	37	44	48	43*	
EU(15)	48#	47#	48#	47#	49#	49#	49	43	38	38	36	33	35

*Estimate, # EU(12), n/a: not available
Source: EC Commission and OECD

Table 4: Agricultural Trade between the EU and CEEC(10) (million ECU)

	EU imports from CEECs	EU Exports to CEECs	EU trade balance
Average 1988-90	2119	1143	-976
1991	2515	1734	-781
1992	2406	2164	-242
1993	2184	2913	729
1994	2404	3172	768
1995*	2779	4301	1522
1996	2897	4663	1766
1997	3106	5043	1937
1998	3142	5389	2247
1999	3486	4549	1064
2000	3802	5307	1506

*EU(15) from 1995
Source: Eurostat

Table 5: The main partners in CEEC agricultural trade (1998)

	exports					imports				
	EU	**Other OECD***	**CEEC**	**NIS**	**other**	**EU**	**Other OECD**	**CEEC**	**NIS**	**other**
Bulgaria	27	12	10	34	17	37	14	10	2	37
Czech Rep.	31	4	38	17	10	50	8	20	0	22
Estonia	16	4	19	60	1	49	23	10	5	13
Hungary	44	N/a	13	18	N/a	42	N/a	8	1	N/a
Latvia	20	1	22	47	2	51	8	29	4	8
Lithuania	23	11	17	47	2	53	12	25	8	2
Poland	43	6	14	32	5	48	11	9	3	29
Romania	61	14	7	5	13	41	16	23	4	16
Slovakia	20	0	61	11	8	39	3	43	0	15
Slovenia	40	6	3	3	48	50	7	13	2	28

*excluding the Czech Republic, Hungary and Poland
n/a: not available
Source: OECD

Table 3 provides PSE estimates for the CEEC(10) and EU. As can be seen from the Table, with the exception of Slovenia, the level of support to agriculture in the CEECs tends to be lower than in the EU, but has generally been increasing in recent years.[14]

Table 4 illustrates how, with the exception of Bulgaria in some years and Hungary the EU agricultural trade deficit was transformed into a surplus from 1993. Difficulty in meeting EU standards, poor quality and less experience in marketing help to explain the problems experienced by the CEECs in exporting food and agricultural products to the EU, but these countries also accuse the EU of agricultural protectionism.[15] Table 5 indicates the main partners in CEEC agricultural trade.

[14] A negative PSE value implies that the farm sector was taxed in that year.

[15] See Senior Nello (forthcoming) for a discussion of this issue.

4. AGRICULTURAL PRODUCTION AND CONSUMPTION IN AN ENLARGED EU

One of the early fears was that when the CEECs joined the EU the application of the CAP would lead to substantial price increases in the new member states, thereby stimulating agricultural production and adding to the problem of EU surpluses.[16] However, more recent studies generally suggest that with enlargement agricultural production will not expand significantly for various reasons:

- The narrowing of the price gap between the EU and CEECs, with prices for some agricultural products and in certain CEECs exceeding those of the EU.[17] This is due to reductions in EU prices following the 1992 and 1999 reforms (see Section 5 below), increases in CEEC prices, and the real appreciation of exchange rates in the CEECs.
- The slow pace of restructuring may limit the production capacity of the CEECs (Pouliquen, 2001).
- Difficulties in meeting the *acquis* may cause many CEEC processing firms to close, and this is likely to have implications upstream for agricultural output.

The simulations of the Commission Report of March 2002 also suggest that accession will bring about significant price and production increases only for a few products.[18] Though production of wheat is likely to rise, wheat prices are expected to remain competitive on world markets so eventual surpluses could be exported without export subsidies. According to the Commission study, surpluses are likely result for rye. Increased feed requirements are predicted to absorb higher maize production, while developments on the barley market are likely to depend on exchange rate movements. The production of beef is expected to increase, but on a manageable scale if no major change in consumer preferences occurs. Higher consumption of fresh milk and cheese are predicted, but the impact of accession on dairy production will depend on the allocation of production quotas, and developments in the structure of production in the CEECs. With accession CEEC consumption of pork is expected to rise, while a fall in production is predicted because of increased competitive pressures. In the CEECS feed use tends to be inefficient, and prices are generally higher, in particular for high quality pork, than in the EU(15). In contrast, poultry production is competitive in the CEECs and is expected to increase slightly to meet expanding demand.

[16] See, for instance, Anderson and Tyres (1993).

[17] According to *Euro-East* no. 90 of July 2000, p.6, grain prices in Slovenia were 70-80% higher than in the EU, and Polish beef prices were well above EU averages. In 1997 wheat prices in Romania, Lithuania, Poland and Slovenia were higher than in the EU (*Agra Europe* 1/8/99).

[18] Depending on the reference areas and yields used, the introduction of direct payments in these countries is also likely to contribute to increased cereal production as more land would be devoted to crop production.

5. THE CAP AS A MOVING TARGET

One of the difficulties encountered by the candidate countries in preparing for EU membership is that in recent years the CAP has been changing. Major reforms were introduced in 1992 and 1999, the Commission presented proposals for a mid-term review in 2002, and further reform is likely to be necessary for the financial perspective after 2006.

Central to the MacSharry Reform of 1992 was a 29% cut in the intervention price for cereals. Farmers were to be compensated for the price cut by direct payments on a per hectare basis. The calculation of the level of compensation was based on average yields in the past in each region. For farmers claiming compensation for an area producing less than 92 tonnes of cereals, compensation was available unconditionally in what was called the "simplified scheme". Farmers claiming a higher level of compensation through the "general scheme" were required to set-aside or leave idle a certain percentage of their land. The percentage of land which had to be set-aside varied with market conditions, and, for example, was 15% in 1993/4.[19] The intervention price for beef was also cut by 15%, and premia per head of cattle were introduced to compensate farmers. The MacSharry reform also included "accompanying measures" with a series of financial incentives for early retirement, reforestation and protection of the environment.

According to Buckwell et al (1997), the direct payments overcompensated cereal farmers for the price cuts by 16% between 1992 and 1996. This entailed excess payments of 2 billion ECU in 1993/4, 4.2 billion in 1994/5 and 5 billion in 1995/6.

The initial aim of basing direct payments on historical yields of cereal production was to "decouple" support to farmers from the quantity produced. As will be explained below, the concept of "decoupling" has important implications in the GATT/WTO context. A policy which is not decoupled, such as price support (where the transfer to the farmer depends directly on the quantity produced) is generally considered to cause more distortions in international trade. For instance, the EC's reliance on price support for so many years encouraged farmers to produce more, leading to surpluses. These surpluses could either be held in public storage (the famous grain mountains, wine lakes and so on) or sold on world markets with the help of export subsidies. However, as numerous empirical studies have illustrated, the increase in EC net exports of many agricultural products had the effect of lowering prices on world markets and increasing their instability.[20]

In the context of the MacSharry reform an example of totally decoupled support is a lump-sum payment to farmers (or a bond) which farmers would receive as compensation for the price cut regardless of whether they continued to produce or not. In contrast, the direct payments introduced by the reform were considered

[19] The percentages of compulsory set-aside were 12% for 1994, 10% for 1995, 17.5% for 1996 and 5% for 1997.

[20] See Tarditi, Marsh and Senior Nello (1995) for a review of some of these empirical studies.

only "partially decoupled" as to receive full compensation farmers had to continue producing.

With regard to agriculture, the March 1999 Berlin Agreement of the European Council entailed cuts in support prices of 15% for cereals and dairy products, with partial compensation for farmers of 50% and 65% respectively through direct aids. Prices for beef were to be cut by 20% with 85% compensation for through direct payments. The direct aids continued to be calculated on an acreage or headage basis, and in the case of cereals were still based on historical yields. Quotas (or physical limits) on the production of milk were to continue until at least 2006, and sugar quotas were also left in place.

By 2002 direct aids accounted for roughly 62% of the CAP budget, and were expected to rise to 68% in 2006. This amounts to transfers of 30 billion euro to farmers in the EU(15) each year, or 4000 euro per farm.

Rural Development Policy became the second pillar of the CAP (but still only accounted for 10% of CAP spending in 2002). New legislation was introduced in order to promote environmentally-friendly measures through the use of "good farming practices" and to encourage products for which there is a market, while discouraging production of those in surplus.

The reform also introduced the concept of cross compliance whereby countries have to indicate appropriate environmental measures which farmers have to take in order to receive their headage and acreage payments in full. A further innovation was modulation which entails that member States can, if they wish, introduce measures to "modulate" i.e. reduce the acreage and headage payments a farm can receive on the basis of overall employment on the farm, overall prosperity of the holding, or total amount of aid paid to the holding. The funds saved in this way may be used to further rural development (including environmental) objectives.

The Berlin Agreement reflects the increasing emphasis placed on the "multifunctionality" of agriculture. Rather than being considered mere producers, there is growing recognition of the role of farmers in protecting the environment, animal welfare, promoting rural development and meeting the new insistence of consumers on adequate guarantees concerning the health implications, safety, quality and variety of food. Stress is also being placed on the "European model" of agriculture which also takes into account the historical, social and environmental role of agriculture.

Price support had always favoured the largest farmers, and between 1973 and 1990 80% of support went to the 20% richest farmers.[21] One of the stated objectives of the 1992 and 1999 reforms was to correct the inequity in the distribution of CAP transfers. However, "compensation" is highest for those who produced most and who were expected to lose most from the price reductions. The system of direct payments therefore protracts the iniquity of the system.

[21] This frequently quoted statistic was first published in Commission Document COM(91)100 of 1991.

A proposal to introduce degressivity i.e. the phasing out of direct payments was rejected at the time of the Berlin agreement, but was revived as part of the Commission proposal for the 2002 mid-term review. According to the Commission proposal, direct payments should gradually be reduced by 20% over six or seven years,using the funds so released for additional spending on rural development objectives. This proposal was supported by the Netherlands, Sweden and Denmark, but was opposed by France and Italy.[22]

The July 2002 Commission proposals for the mid-term review also entailed decoupling direct payments from production, and increasing the use of cross compliance and modulation. It was proposed to cap subsidies to individual farms at 300,000 euro, though this measure could be eased for farms such as those in East Germany employing a large number of workers. Both the UK and Germany feared that this ceiling could penalise their larger farmers.

More generally, countries such as France, Ireland and Spain criticised the Commission proposals as being less a "review" and more a revolution, arguing that the 1999 Berlin Agreement was supposed to have fixed the main features of the CAP until 2006. France argued that guidelines for reform should be drawn up in 2004, so that reforms could take place in 2006. In September 2002 farm ministers from seven EU countries wrote a letter to the Financial Times defending the CAP against various "false accusations" about its negative effects.[23] Against such a background, the Commission proposals seem likely to have a rough ride.

6. APPLYING DIRECT PAYMENTS IN THE APPLICANT COUNTRIES

There has been considerable debate about how far (or whether) direct income payments should be extended to farmers in countries joining the EU. These payments were considered part of the *acquis*, and were extended to the three EFTA countries, Austria, Finland and Sweden, when they joined the EU in 1995.

At least initially such payments were introduced as compensation for the reductions in price support introduced by the 1992 MacSharry reform and the Berlin Agreement. At first the EC Commission maintained that as prices for most CEEC agricultural products were below EU levels, farmers in the new member states would benefit from higher prices when they joined the EU, so compensation in the form of direct payments was superfluous.[24] This view was reflected in the Berlin Agreement which made no financial provision for extending direct payments to the new member states even though the Commission argued subsequently that this did not necessarily

[22] As reported on the Commission website, http://europa.eu.int/comm.

[23] *Financial Times* of 23/9/2002. The farm ministers were from Luxembourg, Spain, Portugal, France, Wallonia (Belgium), Austria and Ireland.

[24] See, for example, the 1995 **Agricultural Strategy Paper** (EC Commission, 1995), and **Agenda 2000** (EC Commission, 1997). According to the EC Commission (1995), depending on the product CEEC prices were between 40-80% of EU levels.

exclude the CEECs from receiving such payments.[25]

However, the initial stance of the Commission was somewhat undermined by rapid narrowing of the gap between prices for agricultural products in the EU and CEECs, and by the fact that it was questionable how far direct aids in effect represent compensatory payments. For this reason the term "compensatory payment" was replaced with "direct aid" in the Berlin Agreement. If the direct aids are compensation for a once-and-for-all price cut, presumably they should be temporary and eventually eliminated. The compensation argument was also weakened by the lack of correspondance between injury and compensation: the MacSharry reform overcompensated, and the Berlin Agreement undercompensated the price cuts.

The concept of cross compliance introduced with the Berlin Agreement is linked to the more general debate about whether direct payments should be rendered conditional on realising environmental and other rural development objectives. However, if this occurs the case for not extending direct payments to the applicant countries is further weakened.

In the January 2000 Issues Paper the Commission proposed a gradual phasing in of direct payments to farmers in the new member states.[26] These countries would receive direct payments equivalent to 25% of the present system in 2004, 30% in 2005 and 35% in 2006, and would only receive full direct payments in 2013. The Commission also suggested allowing additional national aids in the new member states up to the total level of support applied before accession.

In order to meet problems of administrative costs and fraud, the new member states could opt for simplified system of direct payments for 3 years, renewable for up to two more years.[27] This would entail area payments per hectare on the whole of the agricultural area of the applicant countries. There would be no obligation for farmers to produce in order to receive these payments, and so the direct aids would be "decoupled" from the level of production.[28]

In March 2002 the Commission published an extensive study of the impact of enlargement on agricultural markets and incomes,[29] confirming the view that immediate payment of 100% direct payments on accession of the CEECs would lead to social distortions and inequalities. According to the Commission, tensions between the farm and non-farm sectors would result. The direct payments would also benefit non-rural landowners created by the privatisation process which included restitution in most CEECs. The Commission argued that full application of direct payments would slow or stop the restructuring

[25] EC Commission (2002a).
[26] EC Commission (2002a)
[27] The need for a simplified system arose because the EU applies 30 types of direct payment, and 6 for beef alone. The various types of direct payments are listed in an Annex to Council Regulation No.1259/1999.
[28] As explained below, this has important implications for GATT/WTO commitments.
[29] EC Commission (2002b)

process by discouraging farmers from leaving the sector, and permitting semi-subsistence agriculture to continue.The EU experience has shown that direct payments are usually reflected in higher land prices, and these would also hinder restructuring of farms in the applicant countries.

However, the non-application of direct payments would also lead to distortions and income disparities in an enlarged EU. Moreover, insofar as the direct payments in the EU(15) increased land prices, the value gap between East and West would widen, giving a cost advantage to CEEC farmers, and encouraging speculation when the land market was liberalised.

The proposed difference in treatment between "rich" Western farmers, and their poorer counterparts in the CEECs has been fiercely criticised in the applicant countries. Polish farm associations have been urging their members to vote "no" in the referendum on EU accession unless comparable treatment with farmers in the EU(15) was guaranteed. In contrast, the present net contributors to the EU budget (Germany, Britain, Sweden, the Netherlands and Austria) oppose the extension of direct payments to the new member states for 2004-2006 because it was not foreseen in the Agenda 2000 financial framework.

7. APPLYING OTHER CAP MEASURES IN THE NEW MEMBER STATES

Difficulties are also likely to arise in applying supply-control measures such as quotas and set-aside to the new member states. The administrative costs of such measures are high and there are considerable opportunities for fraud in the absence of effective controls.

In the case of production quotas, it is necessary to ensure that the base quantities are appropriate. The EC Commission has proposed taking 1995-1999 as the reference period, as adjustment was underway, and statistics tended to be more reliable. However, this has been contested by some of the CEECs as not being representative. For instance, milk production fell during these years due to the process of restructuring, so various CEECs have argued in favour of a quota based on production in the 1980s, or some estimate of "productive potential". This has so far been rejected by the Commission as not being consistent with the objective of limiting excess supply.[30]

Doubts have also been expressed about the effectiveness of compulsory set-aside as a supply-control measure in the CEECs.[31] Following privatization many CEEC holdings are small and fragmented, and are often owned by non-farming landowners. If the EU system were applied in the applicant countries, small farmers could avoid the obligation to take land out of production (by

[30] See the speech by the Commissioner for Agriculture, Franz Fischler at the PHARE COPA/COGECA/CEJA project of July 2000, http://europa.eu.int/rapid/start/c.
[31] Buckwell et al. (1997)

requesting compensation for land producing less than 92 tonnes of cereals). The Commission proposal that the applicant countries could opt for a simplified system of direct payments was an attempt to resolve such difficulties.[32]

A further sensitive issue is whether the CEECs will be allowed a derogation on land ownership. Land prices are much lower in the CEECs, and though the Commission suggested a general derogation of 7 years (12 years for Poland), the initial delay requested by some of the countries (18 years in the case of Poland) was much longer.

It is frequently argued that the use of structural actions in the CEECs would be more appropriate than the extension of direct payments. As part of the pre-accession strategy to prepare for EU membership the CEEC applicant countries are already participating in ISPA (the Pre-Accession Structural Instrument) and SAPARD (Special Accession Programme for Agriculture and Rural Development).

The SAPARD measures applied by the candidate countries include investments in agricultural holdings, processing and marketing, rural infrastructure and diversification, though the picture varies according to candidate country (EC Commission 2002a).

When the CEECs join the EU three types of programme are envisaged to assist rural development: [33]

- Measures under Objective 1 of the Structural Funds,[34]
- The four accompanying measures (early retirement, Less Favoured Areas/Areas with Environmental Restrictions, agri-environment measures and afforestation)
- Certain special additional measures to assist rural transition. These measures include: assisting semi-subsistence farms, improving quality and standards, setting up producer groups, establishing land registrars, and encouraging good farming practices.

All these measures would be partially financed by the FEOGA (European Fund for Agricultural Guarantee and Guidance), and the Commission has proposed that the Community co-financing rate should be up to 80%.

[32] EC Commission (2002a).
[33] EC Commission (2002a).
[34] The criteria for a region to be eligible under Objective 1 is that its GDP per capita is less than 75% of the EU average.

8. BUDGETARY IMPLICATIONS

In the January 2002 Issues Paper[35] the Commission set out its proposals for the budgetary allocation for EU enlargement over the 2004-2006 period (see Table 6). These were based on the assumption that 10 countries would join in 2004 (Bulgaria and Romania were expected to join later) and that direct payments would be phased in gradually, in line with the Commission's proposals.

What emerges from Table 6 is that the annual budgetary allocation for enlarging to the CEEC(8) proposed by the Commission in 2002 is below the Berlin allocation for the CEEC (5). Under the 2002 proposal the total appropriations for payments (all in 1999 prices) for agriculture amounted to 8255 million euro for 2004-2006, while those of the Berlin Agreement were 12410 for 2002-2006. The total allocation for accession was 45400 million in the 1999 financial perpective, and 28019 million in the 2002 proposal.[36]

Table 6: Financial framework for EU enlargement
(million euro, 1999 prices)

	2004	2005	2006
Commitment appropriations			
Agriculture	2048	3596	3933
Of which: *total direct payments*	-	1173	1418
Market expenditure	516	749	734
Rural development	1532	1674	1781
Structural actions	7067	8150	10350
Internal policies	1176	1096	1071
Administration	503	558	612
Total commitment appropriations	10794	13400	15966
Berlin 1999 scenario: total commitment appropriations	11610	14200	16780
Total payment appropriations	5686	10493	11840
Berlin 1999 scenario: total payment appropriations	8890	11440	14220

Source: EC Commission

[35] EC Commission (2002a).
[36] Appropriations for payments.

9. THE LINKS BETWEEN ENLARGEMENT, CAP REFORM AND GATT/WTO OBLIGATIONS

Before the 1986-94 Uruguay Round agriculture had never been included in GATT/WTO negotiations in more than a marginal way.[37] The main aspects of the Uruguay Round Agreement on Agriculture, signed at Marrakesh in 1994 are set out in Box 1.

After the initial fiasco at Seattle, a new WTO round was effectively launched at Doha in November 2001. A major concern is whether an enlarged EU will be able to meet its Uruguay Round commitments, and possible additional obligations emerging from the Doha Round.

The Doha mandate of November 2001 called for:

"comprehensive negotiations aimed at substantial improvements in market access; reductions, with a view to phasing out, all forms of export subsidies; and substantial reductions in trade-distorting domestic support."[38]

Though it still has to be decided how EU and CEEC commitments will be merged after accession,[39] with regard to tariffs, the EU and

Box 1: The Uruguay Round Agricultural Agreement (URAA)

The Uruguay Round Agricultural Agreement (URAA) introduced a series of commitments with regard to agricultural policies (with slower liberalisation envisaged for developing countries) to be implemented over a six-year period (1995-2000):

- **The domestic support provisions**

Domestic agricultural support was to be reduced by 20% from a base period of 1986-1988 in terms of an Aggregate Measure of Support (AMS).

- **The export competition provisions**

Export subsidies were to be reduced by 21% in terms of volume, and 36% in terms of expenditure from a base period of 1986-1990.

No new export subsidies were to be introduced.

- **The market access commitments**

Non-tariff barriers were to be converted into tariffs (tariffication) from July 1995 and the resulting tariffs were to be reduced by 36% compared to a base period of 1986-1988. All the resulting tariffs were to be cut by a minimum of 15%.

Minimum market access was to rise from 3% of domestic consumption to 5% in 1999.

- The **peace clause** protects policies (such as decoupled domestic subsidies or export subsidies) conforming with the URAA from certain kinds of challenge under the WTO until 2003.

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[37] The US was largely responsible for the exclusion of agriculture for the most part from earlier GATT Rounds, and for insisting on its inclusion in the Uruguay Round.

[38] WTO(2002).

[39] See Buckwell and Tangermann (2000), Burrell (2000) or Swinnen (2002) for a discussion of this issue.

CEECs will have to convince other WTO members that enlargement does not lead to an increase in the overall level of agricultural protection. Poland has a relatively high level of protection, while some of the other CEEC applicant countries (and notably Estonia) have lower levels than the EU (OECD, 2000). With enlargement it will probably be necessary to obtain WTO permission for some kind of compensation for third countries (such as Russia) facing higher agricultural trade barriers as a result of application of the CAP in the new EU member states.

The EU and some CEECs have already encountered difficulties in meeting their GATT commitments on export subsidies for certain products.[40] This is the case for dairy products for the EU, Slovakia and the Czech Republic, for sugar for Slovakia and Poland, and for a number of products for Hungary (Tangermann (2000), Buckwell and Tangermann, 2000). An earlier fear was that enlargement would lead to increased production for a number of goods, requiring additional export subsidies for the disposal of surpluses, but as explained above in Section 4, the impact of enlargement on the level of EU production is expected to be less than initially predicted.

The future development of the CAP is likely to hang on its commitment to reducing domestic support. The obligation to reduce the aggregate level of domestic support excludes certain categories of policy and, in particular, those falling into the green and blue boxes.

Green box measures can be freely adopted and are not negotiated at the international level. They are said to be "decoupled" from production, as they have a minimal effect on production and trade, and include training, research, environmental measures, payments for natural calamities and so on. The Community initially hoped that the 1992 MacSharry direct payments would fall into this category, but this was not accepted by the US. Instead the EC and US agreed on the blue box, which was specifically designed to cover the US deficiency payments and MacSharry compensatory payments. Blue box measures include support under "production-limiting schemes" on the basis of acreage or animal numbers. These are excluded from the obligation to reduce domestic support, but after 2003 when the peace clause no longer applies, their exemption could be subject to challenge.

At Seattle the Clinton administration called for the abolition of the blue box. It was argued that with the 1996 US FAIR Farm Act (which averaged agricultural assistance over a seven-year period), the US no longer required the blue box. However, this position was somewhat undermined by the additional emergency aid to US farmers in most of the following years and the 2002 Farm Bill which increased support to US farmers by an estimated 70% over 10 years.[41]

[40] According to the WTO Secretariat the EU exceeded its basic export subsidy commitment for nine out of twenty product groups in 1999/2000 (Swinnen, 2002).

[41] www.europa.eu.int:comm/agriculture/external/wto/usfarm bill. **The US Farm Bill – Questions and Answers.**

In June 2000 the US proposed a simplification in the way all forms of domestic support are disciplined through the WTO framework.[42] This would entail a distinction between "exempt" and "non-exempt" forms of support. Exempt programmes would be those aimed at promoting sustainable agriculture and rural communities in a way which minimizes distortions. All non-exempt support would have to be reduced in annual installments.

The EU was only able to meet its Uruguay Round commitment to reduce domestic support because its direct payments were classified in the blue box.[43] If the blue box were abolished, an enlarged EU could run into difficulty in meeting this commitment. As Buckwell and Tangermann (2000) argue, the CEECs have some slack in their domestic support commitments, but probably not enough for full application of EU direct payments in their present form in the absence of the blue-box exemption.

The Commission proposal to introduce direct payments gradually and in a simplified form in the new member state can be interpreted as an attempt to find a way round this dilemma. Under the simplified system the direct payments would be "de-coupled" from production and would be received even by farmers in the new member states who stopped production. The aim is clearly to exclude such payments from the commitment to reduce aggregate domestic support.

10. THE OUTLOOK FOR FOOD AND AGRICULTURE IN AN ENLARGED EU

Since the mid-1980s the CAP has changed fundamentally. One of the first indications of this change was the 1985 Green Paper published by the EC Commission.[44] This document called for an end to the almost exclusive reliance on price support, and listed among the priorities of the CAP: the reduction of surpluses, the promotion of the quality and variety of agricultural production, rural development, and environmental objectives.

After a rather limited attempt to move the CAP in this direction with a package of reforms in 1988, radical changes followed with the 1992 MacSharry Reform, and the 1999 Berlin Agreement. As a result of these measures, by 2002 market support had shrunk to only 28% of CAP spending, rural development had become the second pillar of the CAP, and the "multifunctionality" of farmers was recognised as a central tenet of EU policy.

Four developments influenced (and continue to influence) the pace and shape of CAP reform: the weight of agricultural spending in the Community budget, enlargement, GATT/WTO commitments, and the concern of the public for safer food and more environmentally favourable agriculture.

In order to finance emerging EU policy areas (and notably the Internal Market and Single Currency Projects, which were accompanied by

[42] **Note on domestic support reform negotiation on agriculture**. Submission from the US of 23 June 2000. www.wto.org.
[43] See Buckwell and Tangermann (2000) for a more complete discussion of this issue.
[44] (COM(85)333) of December 1985.

increased spending on structural actions), the CAP share of the EC budget had to be re-dimensioned, at least in relative terms. A new financial framework will have to be decided for the years after 2006, and this seems likely to provide a catalyst for further CAP reform. The net contributors to the Community budget (and Germany in particular) are reluctant to increase the budget ceiling, and if direct payments continue, they will eventually have to be extended in full to the new member states.

A solution to this dilemma would be to move further in the direction of co-financing of agricultural policy by the Member States, as the largest net contributor the EU budget (Germany) proposes. In 2002 the Commission also proposed degressivity (i.e. partial phasing out of direct payments, and use of the funds released for rural development), but this is likely to be opposed by member states such as France and Italy.

A second factor influencing CAP reform was enlargement. Though the results of empirical studies vary considerably, all the early estimates of how much it would cost to extend the unreformed system of CAP price support to the new member states were substantial.[45] The solution proposed by Nallet and Von Stolk (1994) was to have different levels of administrative prices in East and West Europe. Aside from the dubious political feasibility of such a proposal, it clearly contravened the principles of the Single Market. The switch to direct payments (and the belief that their full application in the new member states could be delayed) was clearly influenced by enlargement.

The third factor influencing reform is the GATT/WTO framework. The 1992 MacSharry Reform has to be read against the background of fear of collapse of the Uruguay Round because of disputes on agriculture. The US was pushing for larger cuts in domestic support and export subsidies, and easier market access than the EU was prepared to grant. When a compromise had to be reached, the EU solution was to transform price support into direct payments, thereby reducing the need for export subsidies. The initial EU aim was also to include direct payments in the green box, thereby exonerating them from the commitment to reduce domestic support, but ultimately the EU had to accept inclusion of the direct aids in the blue box.

If the blue box were to disappear, the EU would have difficulties in meeting its commitment to reduce domestic support, and this would be even more the case if the present system of direct payments were extended to the new member states. The solution of the EC Commission is to offer the applicant countries the option of a simplified version of direct payments, which are clearly aimed at exclusion from the commitment to cut domestic support.

The fourth factor behind reform is the growing public insistence on increased priority for rural development, environmental objectives and guaranteeing the safety and quality of food. The Commission's proposals for the 2002

[45] See Tarditi, Marsh and Senior Nello (1995) for a review of some of these studies.

midterm review to some extent meets these requests by suggesting that the direct payments be rendered more conditional on furthering these objectives. This "greening" of the direct payments is likely to increase the chances of their inclusion in the green box, rendering it easier for an enlarged EU to meet its GATT commitments.

In a Eurobarometer survey carried out in May-June 2002 on opinions towards the CAP, 90% were in favour of healthier and safer food products, 89% were in favour of environmental measures, and 77% in favour of adequate incomes for farmers. However, when asked if they thought the CAP performed those tasks well the satisfaction levels were 37%, 41% and 29% respectively.[46]

It is unrealistic to expect that a CAP based more on these new priorities will cost less. Health and quality controls involve high administrative costs, in particular, when associated with measures such as effective labelling, animal passports and the traceability of all stages of the production and distribution processes. Budgetary constraints are likely to become even tighter in an enlarged EU. The increased emphasis on rural development and environmental measures implies a shift towards measures which already tend to be partially co-financed by national governments. It certainly was not what CEEC governments initially expected from participation in the CAP, but a partial re-nationalisation of the CAP seems difficult to avoid.

[46] For the results of the survey see www.europa.eu.int/comm/agriculture.

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