Executive Summary

The Common Agricultural Policy (CAP) is the first common policy adopted by the European Community under the Treaty of Rome. It was originally put in place to regulate agricultural markets and to support domestic commodity prices, while structural and environmental measures were gradually developed afterwards. The 1992 MacSharry reform marked the beginning of a series of reforms by which expected income losses due to reductions in price support and protection were partly compensated by direct payments, originally based on current area and animal numbers. The 2003 reform introduced fixed payment entitlements based on historical, regional or hybrid references, which do not require production of any commodity, to replace part or all of MacSharry payments. Subsequent reforms of commodity sectors and the Health Check of the CAP in 2009 have consolidated the movement towards de-linking payments from current production parameters initiated by the 2003 reform and strengthening measures, whose declared objectives are to contribute to improving the competitiveness of the agricultural and forestry sectors, the environment and the countryside, as well as the quality of life in rural areas.

This study covers the CAP changes that have taken place over the last 25 years. It first highlights main developments in the agricultural sector of the European Union (EU) and its physical environment. Among agricultural policy objectives, resource sustainability has become more prominent, while traditional concerns regarding farm income and competitiveness remain. The EU farm sector has faced variable market conditions, but border protection, domestic market measures and fixed payments have to some extent attenuated farm income variability or the consequences of price variability on income. With successive enlargements, the European Union has grown and become more diverse. The 12 member states that have joined the European Union since 2004 have multiplied the number of farms in the European Union by almost three, but raised the total value of agricultural production by less than 20%. Farms in new member states are characterised by a pronounced dual structure with few, very large farms and many, very small ones. At the same time structural adjustment has occurred in all member states: farm consolidation has occurred while small, subsistence or hobby farms remain; the farm population has declined sharply and has aged; farm productivity has increased; and the share of agriculture in the economy has continued to decrease.

Before analysing agricultural policy developments, the report describes the main characteristics and structure of the current CAP, including border and domestic measures, their implementation and funding arrangements. In 2010, CAP expenditures reached close to EUR 53 billion. Pillar 1 direct payments accounted for three quarters, while market price support measures, which are also funded under Pillar 1, accounted for another 8%. The remaining 16% of CAP expenditures funded Pillar 2 measures, which include a variety of

payments and investment aids to improve the competitiveness of the agricultural and forestry sectors, the environment and the countryside and the quality of life in rural areas. Information is provided on implementation of Pillar 1 payments and national priorities under Pillar 2, by member states. An annex provides an overview of the integration of environmental concerns into EU agricultural policy.

The description of CAP measures is illustrated by the level and type of support they provided to EU producers, using the OECD Producer Support Estimate (PSE) and related indicators. OECD indicators are then used to track developments in the level and composition of support due to CAP reforms over the period 1986-2009. The share of gross farm receipts derived from support to producers decreased from 39% to 22% between 1986-88 and 2008-10. This share is close to the OECD average of 20% in 2008-10. CAP reforms led to successive re-instrumentations, which are well tracked by developments in the composition of the PSE. Following the MacSharry reform, market price support decreased and direct payments based on current production factors increased. This movement was reinforced with the Agenda 2000 reform. With the implementation of the 2003 reform and successive reforms, there was an increase in the share of payments for which production is not required. They are gradually replacing most payments based on current area and animal numbers. As a result, the share of potentially most distorting support — market price support and payments based on output or variable input use without input constraints — in the PSE decreases from 92% to 29% between 1986-88 and 2008-10 (it is projected to decrease to 27% in 2012), while the share of least distorting payments, which place no requirement to produce, increased from zero to 44% over the same periods (and it is projected to reach 46% in 2012). At the same time, constraints on input use and production practices are now attached to most payments. This reflects the generalization of cross-compliance conditions attached to the receipt of most payments, and the development of payments to manage land and improve the environment under Pillar 2.

The impact analyses, which use different modelling frameworks, confirm the gradual reduction of distortions to production and trade in the agricultural sector. Policy Evaluation Model (PEM) analysis estimates that the impact of agricultural support on production is divided by three over the period 1986-2008, with the 1992 MacSharry and the 2003 reforms as the main milestones. In consequence, negative trade effects of the CAP decreased significantly as commodity regimes were gradually reformed. While the policy mix favoured arable crops over livestock at the beginning of the period, successive reforms have increased support to pastures to the extent that more land is used in pasture with the current CAP than would otherwise be the case. According to simulations carried out with the CAPRI model, the 2003 reform resulted in a significant expansion of fodder area and a reduction in land used for arable crops. Combined with lower herd size and fodder yields, this led to an extensification of livestock production (lower livestock density). As production on marginal land is abandoned, cereal yields increased, but production decreased and this lead to higher domestic prices for cereals. The same impacts are found for the oilseed sector. The implementation of the Health Check is found to reinforce these effects, in particular in France and Spain, which kept some crop specific payments under the 2003 reform. The Health Check also leads to a sharp decrease in durum wheat, protein crops and tobacco areas, as those crops no longer receive specific premia. The removal of dairy quotas under the Health Check is simulated to result in larger herds and higher milk yields. As a result, milk production increases and milk prices decrease. Overall, beef production continues to decrease and beef prices increase, but there are very differentiated

impacts on beef output per hectare depending on regions and between the 2003 and Health Check reforms. Compared to a continuation of Agenda 2000, recent reforms result in increases in imports and reductions in exports for all products. Both reforms lead to increased farm specialisation. Compared to a continuation of Agenda 2000 and the 2003 reform, highest land rents are found with the Health Check, under the assumption that support from single payments is nearly fully capitalised into land value. However, recent studies suggest that capitalisation into land values is partial. Quota rents disappear with the removal of dairy quotas.

A specific dairy model, EDIM, is used to shed light on the impacts of recent reforms in the dairy sector. A dairy reform scenario results in an initial decrease in milk prices when intervention prices for butter and skimmed milk powder are lowered in 2004. Milk prices start increasing again in 2007/08 as the quota is estimated to be binding. As with CAPRI scenarios, the phasing out of the dairy quota is estimated to lead to an overall increase in milk production (by 3.6% compared to the 2003 reform scenario), with contrasted developments across member states and to a decrease in the milk price both within and outside the European Union. In the scenario analysis, the price of butter in the European Union decreases more than the price of Skimmed Milk Powder (SMP). These scenario results do not take account of other developments that could affect dairy prices. According to OECD and FAO *Outlook* (2010e), projections, domestic and border milk prices are expected to converge. The 2006 sugar reform has reduced protection and improved the competitiveness and the market orientation of the sector, but the domestic market is still sheltered by market access regulations.

CAP reforms also had an impact on land markets, which varies by country depending on farm structure and regulations governing transfers of land and payment entitlements. Impacts on structural change and farm competitiveness of recent reforms also depend on countries and regions: impacts of reforms on structural change are generally small, mainly because payment entitlements remain linked to land and structural factors such as farmers' age are the main determinants. However the impacts of recent reforms are estimated to be greater in regions with natural handicaps, where they slow adjustment as less profitable farmers may choose to remain in business, reduce production activities and still receive the single payment; or in new member states, not so much because of reform but because support increases with accession and during the transition period. De-linking payments from production factors affects farm dynamics in different and opposite ways. On the one hand, it is expected to have a positive impact, as farmers can better respond to market signals and thus, derive higher average profits per hectare. On the other hand, it may slow structural change and raise land prices, and thus contribute to reducing farm competitiveness. More evidence is thus needed on the impact of policy reforms, in particular to distinguish it from other factors that affect structural change.

In CAPRI simulations, the impact of recent reforms on farm income is moderate except in new member states because payments are increasing during the ten-year transition period following accession. The 2003 reform results in higher income from higher prices, while incomes decrease slightly with the Health Check, mainly due to the phasing out of quota rents. PEM analysis also highlights the increase in the efficiency with which CAP measures deliver additional income to farmers and landowners over the period 1986-2008, as the share of support with lower or no link to commodity production increases and leakages to input suppliers and deadweight losses diminish. As a result, while the level of support decreases, the income transferred to farmers is relatively stable until it increases

from 2005 with the implementation of single payments. However, the growing importance of rented land over the period increases significantly benefits captured by landowners other than farm operators.

Distributional aspects of CAP reform between economic agents and within the farm sector are also considered. The move away from price support towards direct payments has led to transfers to producers from consumers being gradually replaced by transfers from taxpayers. Welfare has increased as deadweight losses were reduced. Support by farm size is unequally distributed in the EU27 as the 25% of largest farms receive 74% of all support (71% of all payments and) 73% of Pillar 1 payments) in 2007. In particular, income support benefits mainly larger farms with higher than average levels of income per farm. The reforms are changing the distribution of support marginally, mainly because direct payments are a little less unequally distributed than market price support. In addition, member states have some flexibility to change the distribution of support since 2003, through regional implementation, Article 68 of Health Check regulation or reinforcement of Pillar 2 funds and some used it. On average in the EU15, the distribution of support by farm size has become less unequal between 2004 and 2007. This is mainly due to the reduction of market price support, but also to a slightly more equal distribution of Pillar 1 payments after the reform. It should however be noted that equal distribution of support is not an objective and that developments in the distribution of support have to be considered in relation to policy objectives. Reforms have affected commodity sectors at a different pace. As a result, the composition and level of support by farm type has changed over the period. Implementing single payments as a per hectare flat rate payment at national level would change significantly the distribution of support and income between farms within countries.

A summary of most recent findings on the impact of reform on the environment is also included. All policies have an impact on the environment to the extent they influence management practices. In addition, impacts are likely to vary within and between regions. Among market measures, the introduction of set-aside, first voluntary in 1988 and compulsory in 1992 has had significant environmental impacts, estimated to be positive overall. De-linking support from current production is expected to be beneficial for the environment as all other things equal, it leads to some extensification of production practices. Cross compliance conditions introduced in 2004 apply to all land and are expected to deliver a minimum level of environmental management across the farmed countryside, but they do not target specific problems. Agri-environmental measures provide incentives to low input, extensive farming systems, particularly grassland systems, or target more complex management requirements needed for the maintenance or restoration of particular habitats, species or geographical areas. The extent of environmental benefits delivered is subject to much debate, as they are difficult to measure. Evaluations of the agri-environment measure under Pillar 2 have shown that its implementation has achieved benefits for biodiversity, or at least reduced the rate of biodiversity loss. Recent evaluations have also showed that the measure has had a generally beneficial impact upon maintaining landscape patterns. In contrast there is less information on the impact of agri-environment schemes on soil and water quality within the evaluation literature, with insufficient data being the main limiting factor. Where benefits have been identified, these are largely delivered through actions requiring reductions in inputs, the use of cover crops on arable land, appropriate arable rotations,

arable reversion to grassland, organic agriculture and the introduction of buffer strips of varying widths alongside water courses.

Finally, some considerations are given on the impact of reforms for some aspects of rural development. As illustrated with CAPRI simulations, reforms are expected to have some impact on the location of production. While direct payments, in particular those which place no requirement to produce, decrease spatial agglomeration of farms, the reduction of commodity-related support is expected to result in a concentration of production in most competitive regions as commodity farming in less competitive rural areas may decrease. This movement should increase with the phasing out of dairy quotas, leading to potential difficulties in regions with natural handicaps where alternative agricultural activities are limited. However, the increase in Pillar 2 funds linked to modulation and the 10% flexibility given to member states within Pillar 1 would allow them to increase support for less competitive regions or production if they wish to do so.

Overall, CAP reforms over the 25 years have substantially and continuously increased the market orientation of the sector, reduced distortions and improved the capacity of the CAP to transfer income to farmers. While deadweight losses have become smaller, an increasing proportion of support is captured by non farming landowners. The level of support received by farmers has decreased, but remains concentrated on larger farms. Large reductions in overall protection have been gradually achieved, with a variable and unequal pace across commodity sectors. Some of them remain sheltered by market access restrictions and provisions for using export subsidies are maintained although they have not been used to a great extent in recent years and expenditures on export subsidies have decreased to 1% of Pillar 1 funds in 2010. Moving funds from Pillar 1 to Pillar 2 has facilitated the move towards policy measures that are better targeted to specific objectives, but they still account for a limited share of support.

Evolving in a gradual and steady way, successive reforms have achieved significant improvement in the performance of European Union's agricultural policies. The reduction in distortions to European Union and world markets has allowed EU farmers to take advantage of market opportunities from stronger and diversified demand for food and non-food use, as well as from higher real prices for a number of major commodities that are expected over the next decade. At the same time, the EU agricultural sector will have to respond to major challenges, including global food security, mitigation and adaptation to climate change, and market volatility. With the reduction of market management, farmers are becoming more exposed to price volatility in agricultural commodity markets.

Future reform should build on past success and continue to increase the market orientation of the sector and reduce distortions, mainly from remaining market price support. Future efforts should focus on improving market access more widely as part of on-going international trade negotiations and bilateral agreements. Some steps have already been taken with respect to improved market access for least developed countries. Reform should address the remaining market deficiencies that constrain the competitiveness of the EU food and agricultural sector. An effective policy framework should be developed to provide a wide variety of risk management tools for farmers to manage their risk. The scope of agri-environmental measures is expected to increase to better take into account challenges related to climate change. At the same time, improving the environmental performance of agriculture would require better information on problems, demand for public goods and practices and institutional arrangements best able to achieve

requirements. Strengthening the contribution of agriculture to rural economies would require co-ordinated approaches that recognise the diversity of rural areas and draw on local assets. In order to improve the efficiency and equity of agricultural policy, efforts should be made to better target support to specific objectives. A pre-requisite would be to clarify the definition of policy objectives, in particular with regard to income objectives and define measurable targets corresponding to each objective. Improving targeting would require defining the type and level of income to be targeted, as well as using information on the income and wealth situation of the farming community. The optimal precision of targeting would depend, among other things, of the size of transaction costs, which varies with farm structure, relative to other costs and benefits. Clarifying the link between instruments and objectives of agricultural policies is essential to further improve the performance of the CAP and its ability to respond to emerging challenges. It would allow for a comparison of policy options potentially able to meet objectives, taking into account all costs and benefits, including transaction costs and side-effects. The current debate on the CAP post-2013 represents a unique opportunity for the European Union to align future policy instruments with its future objectives.