



## New budget priorities for the Common Agricultural Policy

November 30, 2006



**Common Agricultural Policy spending still accounts for the lion's share of the EU budget**, even though this has been brought down over the past 25 years from more than 75% to 40%-plus.

**The Common Agricultural policy consists of two pillars.** The first comprises all types of market intervention, such as agricultural income support; the second consists of a large number of structural measures, e.g. environmental and regional development instruments. However, 90% of EU farm spending still goes on market intervention.

**Agricultural policy reform in 2003 triggered a paradigm shift towards more market focus and efficiency.** Under the new "decoupling" model, income support is provided in the form of an annual payment to individual farms. Its use is not tied to the production of certain commodities – in contrast to the old subsidies, which were paid product-specifically per unit of output.

**The EU agricultural budget in the framework of the Financial Perspective 2007-2013 will exert further pressure for reform of the Common Agricultural Policy.** The political decision has already been taken on a thorough review of budget priorities in 2008 and 2009 and a mechanism firmly agreed for further cuts in direct payments. There are inherent risks to the agricultural budget from a higher exchange rate for the euro and the possible resumption of WTO negotiations.

**Simulation results on sustainability of the EU agricultural budget reveal the necessity for future agricultural reform.** If future WTO negotiations lead to only small cuts in export subsidies, in 2012 actual CAP expenditure in the region of EUR 46 bn will be slightly higher than the medium-term budget appropriation.

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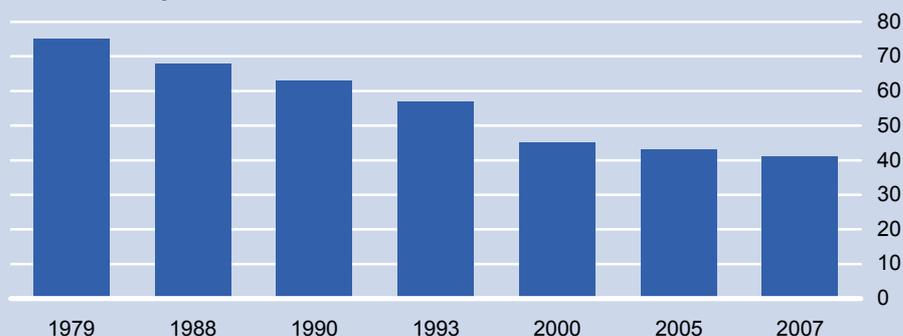
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### Agricultural budget becomes less important

as % of EU budget



Source: European Commission, various years

\* Guest authors express their own opinions which may not necessarily be those of Deutsche Bank Research.





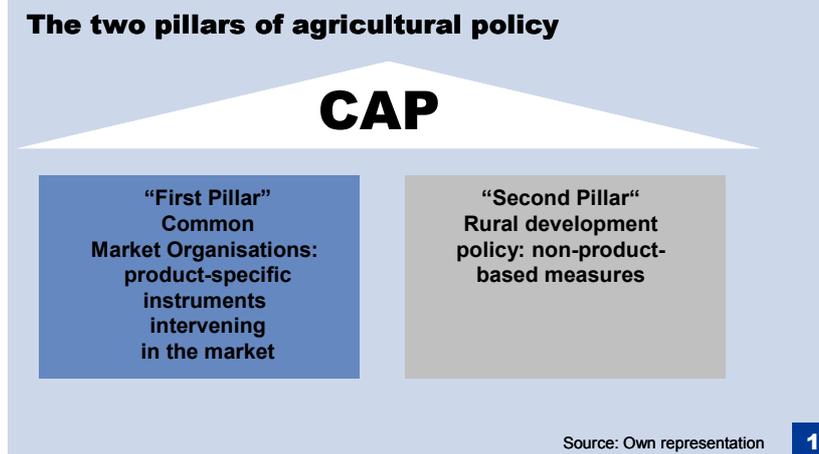
## 1. The Common Agricultural Policy

### Agricultural policy as part of policy establishing the EU

The European Union's Common Agricultural Policy (CAP) was defined as part of the Common Market back in 1957 in the Treaty of Rome establishing the European Economic Community (EEC). This policy area was thus one of the first for which harmonisation was envisaged in the hour of the EU's birth.

The CAP rests on two pillars:

### Income support as traditional objective



— The first pillar describes the traditional CAP objectives – the harmonisation of market and price policies to achieve equality in the development of agricultural incomes. The objectives of the CAP have remained unchanged since the founding treaty and are set out in Article 33 of the Treaty of Nice as (1) to increase agricultural productivity, (2) to ensure a fair standard of living for farmers, (3) to stabilise markets, (4) to assure the availability of supplies and (5) to ensure reasonable prices for consumers. These objectives are realised with the aid of the Common Market Organisations (CMO) defined in 1962 for individual categories of produce and containing a catalogue of individual mechanisms (differing for each separate product) such as guaranteed product prices (intervention prices) or intermediate input subsidies and tariffs.<sup>1</sup>

### Increasing focus on regional policy objectives

— The second pillar, as a political rural development mechanism, comprises a large number of heterogeneous measures, some of which go back to old CAP structural policies envisaged in the Mansholt Plan as early as 1968.<sup>2</sup> Foremost among these traditional measures are productivity-based instruments such as investment aid for individual farms, which in turn focus on income support. Other measures were developed in the EU enlargement rounds to meet new members' special requirements, for example irrigation support for Mediterranean countries. Not until 1988 were targeted and systematic structural programmes developed, designed along sectoral regional promotion lines. Of late this second pillar has gained in political importance in the context of the WTO negotiations on agriculture. For the first time in the history of the GATT an Agreement on Agriculture was signed in 1994 classifying subsidies according to their potential trade distortion. Under this arrangement, regional and environmental

<sup>1</sup> See Schmitt (1998) on the history of the Common Agricultural Policy.

<sup>2</sup> Sicco Mansholt was the first Commissioner for Agriculture 1958-1972.

### The EU's own resources system

The EU's own resources, which as from 1970 replaced funding by national contributions in line with the practice at international organisations, include (1) customs duties and agricultural levies, (2) agricultural duties on the production of sugar and isoglucose, (3) VAT resources and (4) resources based on gross national income (GNI).\*

Categories 1 and 2 are deemed traditional own resources, the amount of which the EU is effectively at liberty to decide: Agricultural levies represented a special form of customs protection for EU agricultural produce, balancing out the difference, as a flexible levy, between world market prices and the politically supported higher EU price. This flexibility made EU revenue budgeting unstable, and in compliance with WTO requirements such particularly trade-distorting external protection measures had to be transformed into customs duties, which thus remained as the only source of revenue from imports. The duties on sugar and isoglucose are production levies; in the case of sugar an additional storage levy is charged to cover storage expenses, payable by the producers.\*\* The VAT own resources result from regularly determined maximum call-in rates, which are applied to defined VAT bases to limit this category. Finally, the GNI own resources serve to cover the rest of the budget and have gained in importance over time. Overall, a ceiling is imposed on all own resources; at present this equals 1.24% of the GNI of the EU.

\* The term "gross national income" replaces the earlier concept of gross national product. It was introduced in connection with application of the European System of Accounts (ESA) by analogy with international terminology for official statistical purposes.

\*\* 75% of the revenues from these traditional own resources customs duties and agricultural duties flow into the EU budget, 25% are retained by the levying member state to cover administrative costs.

Source: See website EU Directorate-General Budget.

measures are permitted as possible subsidies, unlike many traditional EU measures in the first pillar.<sup>3</sup>

## 2. European agricultural policy – it's a money thing

Since its inception, the CAP has had a crucial impact on the EU budget, in terms of both revenues and expenditures.

### 2.1 Relevance of CAP to EU revenues

Particularly as regards the development in the EU's major source of agricultural revenues – customs duties – various special features apply. Receipts from these trade policy measures depend on the relationship between EU and world market prices, which determines import flows to the EU and the attendant revenues. For a long time in the agricultural sector, these price relationships rode on political decisions in the EU with respect to the first pillar of the CAP: Income-supporting price instruments led to comparatively high EU prices relative to the world market, which in turn tended to generate high imports and customs revenues. But over time a reduction in this income component is discernible (Table 2), explained largely by progressive general cuts in customs duties within the framework of the WTO. Another explanatory factor is the increase in internal supply – triggered precisely by internal price support and high rates of technological progress. The CAP thus unleashed a trend moving the EU away from being an importing, deficit-making country towards becoming an exporting, surplus-producing country. The result is a drop in farm imports and the revenues related to them.

#### Development in EU revenues over time

Percentage of total revenues

	1984	1988	1995	2000	2003
1. Customs duties	31	22	17	15	13
					- no longer shown separately -
2. Agricultural duties	9	6	3	2	
2. VAT own resources	56	58	53	38	15
4. GNP/GNI own resources					

Figures are rounded: residual amounts are explained by other receipts, e.g. contributions by non-EU countries under research programmes

Source: European Commission

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On balance, therefore, for a long time steadily falling revenues from agriculture contrasted with constantly rising expenditures.

<sup>3</sup> The GATT (General Agreement on Tariffs and Trade) can be seen as a precursor of the World Trade Organisation (WTO) established in 1994. It was signed in 1947 as a multilateral agreement, and until the WTO was set up the system consisted of a large number of agreements existing side by side without an umbrella organisation. The WTO "traffic light system" in the Agriculture Agreement grades agricultural subsidies by "boxes" into measures that are permitted or to be reduced. "Red box" measures are prohibited, "amber box" measures must be reduced, "blue box" measures are permitted on condition that they are accompanied by measures to limit output, and "green box" measures are permitted. As far as the EU is concerned, intervention prices come under the "amber box" category and are subject to reduction requirements. Direct payments belong in the "blue box" and are therefore conditionally exempt from reductions, and second-pillar measures belong in the non-critical "green box" category.



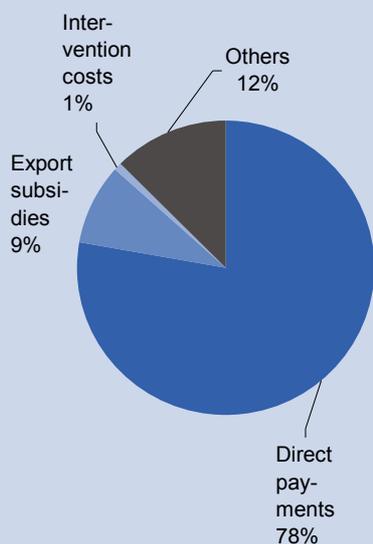
### Agricultural guideline caps agricultural expenditure for the first time

### Financing from European Agricultural Guidance and Guarantee Fund

### Agricultural expenditure under budget heading 2

#### Categories of expenditure in EAGGF Guarantee

2004, EU-25



Source: European Commission, 2005

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## 2.2 Relevance of CAP to EU expenditures

The share of agricultural spending in the total budget has always been high, although meanwhile it is decreasing. The key drivers of this reduction in the proportion of total expenditure are the agricultural guideline and ever more substantial CAP reform:

- In 1988 the agricultural guideline capped the annual increase in agricultural expenditure at 74% of the annual growth in EU GNI. For the new budget 2007-13 this agricultural guideline was replaced by a new ceiling on farm spending (see Section 3.2).
- The 1994 WTO agreements triggered the first-ever systematic reform of the CAP, the 1992 McSharry-Reform<sup>4</sup>, heralding an increasing departure from traditional, cost-intensive political instruments.

Agricultural expenditures are paid for from the European Agricultural Guidance and Guarantee Fund (EAGGF) set up in 1962 and consisting of two sections.<sup>5</sup> The Guarantee Section is responsible primarily for the first pillar, but also for individual measures under the second pillar, whereas the Guidance Section is responsible for the second pillar only.<sup>6</sup> The first pillar dominates the agricultural budget, with 90% spent on market organisation. Only 10% is available for the second pillar.<sup>7</sup>

The general EU budget was previously based on seven defined expenditure headings, reduced to six for the new budget as from 2007. Agricultural expenditure makes up one component of heading 2 – “Sustainable management and protection of natural resources” – alongside spending on fisheries and the environment.

### 2.2.1 Expenditure for the first pillar

The lion’s share of the agricultural budget goes to the first pillar and is divided among the various instruments of relevance to expenditure. Direct payments consume the largest part, followed by export subsidies and intervention costs.

The three components of expenditure – direct payments, intervention costs and export subsidies – depend to varying extents on different exogenous drivers, which can influence the amount of expenditure irrespective of any political reforms.<sup>8</sup> Relevant exogenous factors are developments on world markets and the related price effects, the exchange rate of the euro and the results of ongoing WTO negotiations.

#### 2.2.1.1 Intervention costs

Intervention costs had fallen by 2004 to a mere 1% of all spending in the first pillar.<sup>9</sup> They are linked to the traditional agricultural-policy income support tool, intervention prices. These can be interpreted as guaranteed minimum prices: If the market situation leads to a

<sup>4</sup> Named for the Irish agricultural commissioner during that period.

<sup>5</sup> The use of one of these sections to finance measures impacts on the accounting for the payments, which is subject to different methods for the two sections.

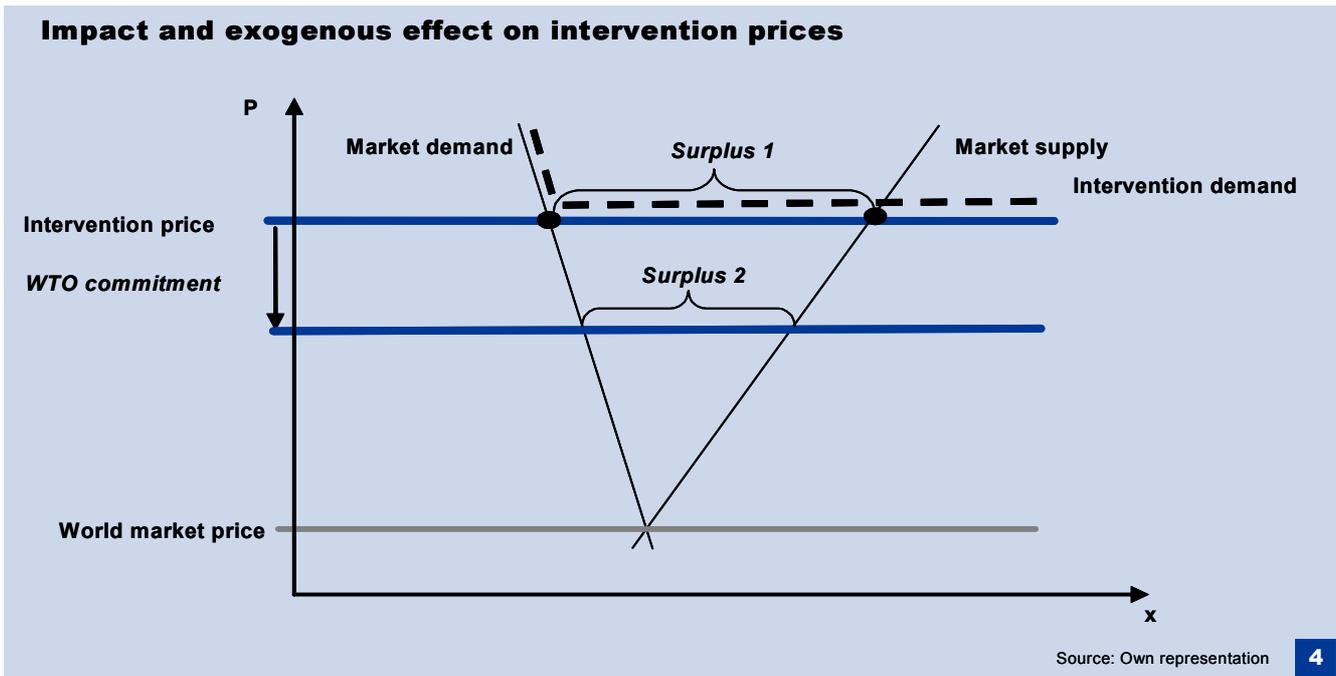
<sup>6</sup> Reform of the second pillar in 2005 led to the EAFRD Regulation and refers, besides amendments to the measures eligible for support, most particularly to uniform funding. According to this the first and second pillar are now funded entirely separately from one another and the relevant administrative systems, e.g. for accounting, are standardised (Commission 2005a).

<sup>7</sup> Commission (2005b).

<sup>8</sup> For an overview of agricultural policy see Schmitt (1998); BMELV (2006).

<sup>9</sup> By way of comparison, in 2000 this expenditure still consumed 2.3% of all expenditures for the first pillar.

market price below a politically established intervention price (world market price < intervention price in the following overview), this results in a production surplus that can only be taken off the market at the higher intervention price through public intervention demand (surplus 1). Public intervention agencies store these surpluses, which are then sold cheaply on the internal market at a later date<sup>10</sup> or offered on the world market via export subsidies. The resultant intervention costs are incurred through expenditure on the physical storage infrastructure (refrigeration plant) and the loss in value from cut-price sale.



**Intervention costs falling as a result of WTO commitments**

Various factors affect the scale of public intervention and the costs involved, with the following tendencies.

- Rising domestic demand lowers surpluses and the attendant intervention costs, whereas rising supply pushes up costs.<sup>11</sup>
- Falling world market prices due to increased supply from other countries push up imports, lowering opportunities to sell surpluses on the EU internal market, exacerbating the loss in value and fuelling intervention costs. A rising exchange rate for the euro has a similar effect, leading to relative declines in world market prices.
- The 1994 WTO Agreement on Agriculture committed all WTO members to a 20% cutback in all price-related measures such as intervention prices by 1999. In the EU this reduction was anticipated by the McSharry reform. Discounting any other factors, this is leading to a decline in intervention costs. In contrast, the other WTO commitment to lower tariffs<sup>12</sup> may lead to more imports, making it more difficult to sell off intervention stocks.

<sup>10</sup> A typical measure for a long time was cheap “Christmas butter”.  
<sup>11</sup> The influence of domestic demand was clearly evident in the case of beef in 1996, when it slumped as a result of the BSE crisis and caused a temporary increase in surpluses.  
<sup>12</sup> An average reduction of 36% was agreed for tariffs on agricultural products, with a simultaneous minimum reduction of 15%.



### Development in intervention costs over time

EUR m

	1985	1990	2003
Cereal	1,291	1,544	124
Butter	1,360	286	3
Beef	814	472	522

Source: European Commission, various years

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### Market orientation and efficiency from decoupling

#### Trend towards direct payment cuts

On the whole, however, we see these cost components decreasing with the passage of time, driven mainly by the WTO commitment on the reduction of intervention prices.

#### 2.2.1.2 Direct payments

Direct payments accounted for the largest share, 78%, of agricultural expenditures in 2004<sup>13</sup>. These are subsidies introduced under the McSharry reform. They served to compensate farmers for income losses as a result of the cuts in intervention prices and were defined product-specifically per tonne of produce, with the amount of the subsidy varying from product to product. However, based on historical reference yields per hectare in a defined producing region, direct payments are transformed into a uniform amount per hectare in that producing region. The direct payments are paid only for part of the land farmed, because a compulsory set-aside requirement calls for the withdrawal of areas from production.<sup>14</sup> Since this combination with land set-aside programmes can reduce the risks of surpluses, direct payments – unlike intervention prices – are not subject to any reduction obligations in the WTO agreement.<sup>15</sup> Running counter to the cuts in intervention prices, these direct payments initially escalated, driving up agricultural expenditures.

As part of the latest 2003 farm reform (Mid-Term Review) setting out agricultural policy through 2013, these payments were altered to make them more efficient and generate less expenditure.

- “Decoupling” removed the link between direct payments and actual production, resulting in production-neutral payment of a fixed amount (“single farm payment”)<sup>16</sup> geared to past support received. This switchover to lump sum payments can be interpreted as a trend reversal towards greater efficiency, with farm owners at liberty to decide on uses for the payment depending on their market expectations, now that the focus is no longer on individual production lines.
- Furthermore, an automatic annual reduction of the single farm premium or direct payments still in operation was resolved with “modulation”. Cross-compliance established a link between payment of the premium and the observation of certain standards, inasmuch as non-compliance leads to cuts in payments (see Chapter 3.2).

The development in these components of expenditure is not determined by exogenous factors such as parity changes or price trends on the world market. Rather, spending levels depend on politically fixed direct payments, which in the early years led to an increase in these components, as the direct aid was intended to compensate for the growing cutback in intervention prices. Other new political developments such as automatic modulation or cross-compliance will lower expenditure going forward through premium reductions.

<sup>13</sup> In 2000 they represented just 63%.

<sup>14</sup> Direct payments are also made for set-aside land.

<sup>15</sup> The direct payments come under the category of blue box measures.

<sup>16</sup> Not all existing direct payments for all products have already been transformed into single farm premiums, and there is an option only partially to decouple and to pay a part-amount in the form of the old direct payments. For details see BMELV (2006); Commission (2006b and c).

**Development in expenditure on direct payments**

EUR bn

	1995	2000	2004	2006
Arable crops	15.92	14.76	16.97	7.93
Beef	2.0	1.63	7.52	3.48

Source: Own representation

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**2.2.1.3 Export refunds**

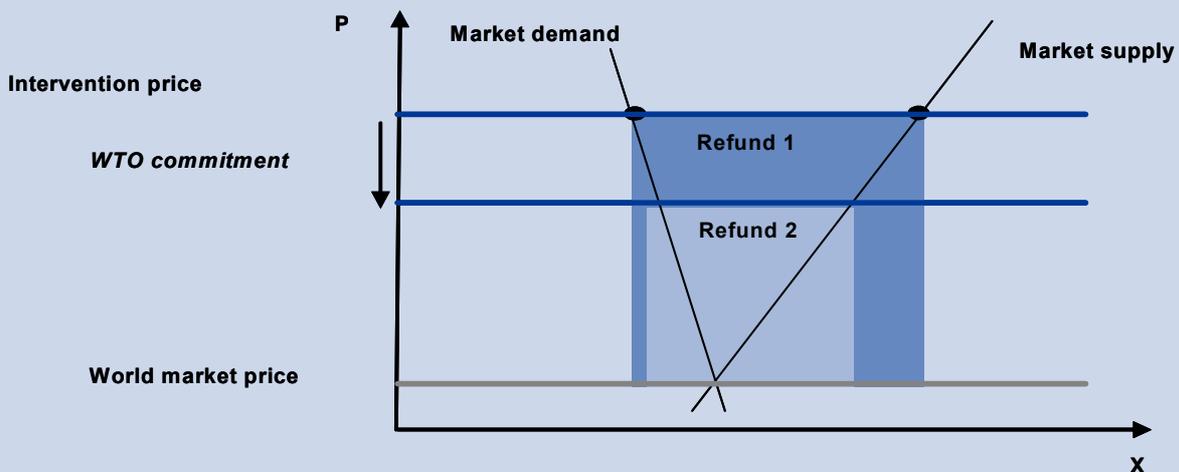
**Export refund costs depend on price developments**

The export subsidies<sup>17</sup> paid are equivalent to the difference between EU domestic and world market prices, meaning that they depend directly on price developments. In 2004 they consumed 9% of all first-pillar expenditures<sup>18</sup>:

**WTO requirements lower export refund bill**

- As world market prices drop, so expenditure on export refunds rises; the same is true of an increase in the USD/EUR parity strengthening the euro. Falling world market prices can be induced as an endogenous factor by export refunds themselves, as subsidised exports push up supplies on the world market. But factors such as technological progress and positive climatic conditions also lower world market prices by boosting world market supply.
- The higher the intervention prices, and hence internal market prices, are set, the greater export refunds will tend to be.
- The WTO agreements on intervention price cuts reduce the risk of surpluses and hence of subsidised exports (this is illustrated in the chart by the transition from refund 1 to refund 2). Other commitments from the Uruguay round refer explicitly to export refunds, which were to be reduced by 36% in outlay or 21% in quantity by 1999. The agreements on lowering customs duties with retention of the intervention price have the opposite effect, as expanding imports curtail the possibilities for selling off existing surpluses on the internal market.

**Impact of export refunds**



Source: Own representation

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<sup>17</sup> The term export refund is also used synonymously.

<sup>18</sup> In 2000 they still accounted for 13.9% of expenditure on the first pillar.



### Development in export subsidies over time

EUR m

	1985	1990	2003
Cereal	1,034	2,961	72
Dairy products	2,375	2,401	1,495
Beef	1,148	977	251

Source: European Commission, various years

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### National co-financing for second pillar

#### Regional income grouping

Objective 1 regions are those with poor economic performance and GNI below 75% of the EU average. For measures under the second pillar in these regions the EU contributes 75% of the funding, leaving 25% to be co-financed by the member state.

In regions other than those with objective 1 priority, the EU finances only 50% of measures, leaving 50% to be co-financed from national budgets.\*

\* In Germany part of the rural development measures are dealt with by the Joint Task for the Improvement of Agricultural Structures and Coastal Protection, for which in turn a further co-financing concept operates, with the national co-financing share (25 or 50%) divided between the Federal Government and the German states.

The development in expenditure shows different reductions in export refunds for different products: dairy products continue to attract relatively high export refunds owing to still-strong price support in comparison to other sectors. Consequently, surpluses and export subsidies remain at a traditionally high level despite the WTO reduction commitments.

#### 2.2.1.4 Other expenditure

The heading other expenditure comprises a raft of very different measures that vary from product to product, e.g. spending on veterinary strategies to combat diseases or for marketing support programmes.

#### 2.2.2 Expenditure for the second pillar

A mixed financing concept is applied to the second pillar. EU expenditure for the second pillar agreed in the Financial Programming has to be co-financed from national funds. Actual use of the funds shown thus depends on the possibility of national co-financing.

This principle of co-financing for rural development measures conforms to the EU's general, non-agriculture-specific regional development policy. It also applies to the amount of national co-financing, based on regions defined with reference to their income in which the development measures are implemented.

### 2.3 Budgetary losers and winners of the CAP

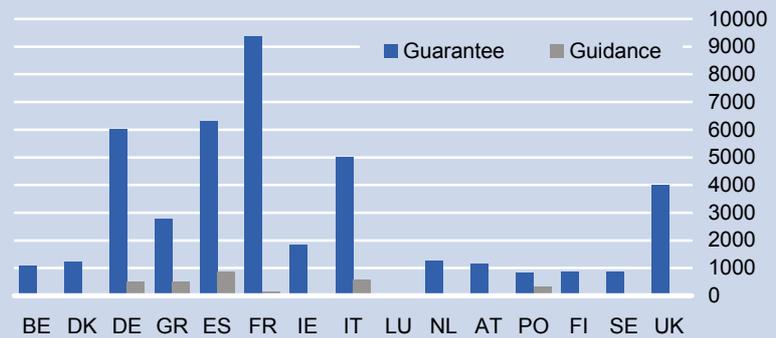
The funds that flow back to each individual member state from the agricultural budget are determined by the production-related character of the expenditures. Since the amount of key agricultural expenditures was defined product-specifically (e.g. intervention prices and direct payments), the flowback from the agricultural budget under the first pillar to a member state depends on that country's internal production structure. The funds for the second pillar are distributed according to set criteria characterising the importance of the rural area (proportion of agricultural land, relevance of the farm sector for employment etc.).<sup>19</sup>

Owing to the overall high share of farm subsidies in total expenditure, the return flow of funds from the agricultural budget is also significant in terms of the budgetary (or net) balance, because low receipts from the farm budget in conjunction with a high contribution towards revenues tends to produce a negative net balance.

<sup>19</sup> Under new budget decisions these funds are generally geared to historically chosen allocations in the past, keeping the relative allocation of funds constant among the member states.

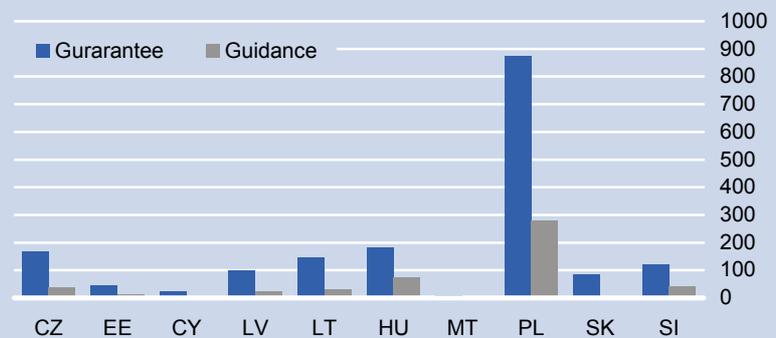
### Winners of the agricultural budget EU-15

2004, EUR m



### Winners of the agricultural budget EU-10

2004, EUR m



Source: European Commission, 2004, Agriculture and Rural Development DG, Financial Report 2004

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#### Lion's share of first-pillar funds for France and Germany

France and Germany attract the most expenditure from the first pillar, at roughly EUR 9 bn and 6 bn respectively, due chiefly to the high support level for cereal, beef and dairy products, of which they are the main producers. Spain benefits from spending on typical Mediterranean products such as olive oil and some fruit and vegetables, for which high support levels were negotiated during the southern enlargement of the EU. In the group of new member states Poland receives the highest return flows, which is explained by its strong agricultural sector relative to other new members. However, at roughly EUR 850 m this amount is many times lower than that received by the old members.<sup>20</sup>

#### Spain the biggest recipient of second-pillar budget

Funds from the second pillar benefit Spain in particular from among the old member states and, once again, Poland among the newcomers, because rural development there enjoys relatively high relevance for the economy as a whole according to the regionally-based criteria. These funds merely express the EU share of financing; their actual use depends on national co-financing.

All in all, the budgetary benefit from the CAP influences countries' fundamental attitude to agricultural policy reform, as illustrated, for instance, by France's predominantly conservative stance.

<sup>20</sup> The low level of agricultural expenditure for new member states is due to the "phasing-in" arrangement according to which direct payments start out from a lower level than in old member states, progressively reaching in 2013 the level then generally applicable.

**Product-based expenditure structure places UK in a special position****“British rebate” and agriculture**

The Fontainebleau agreement of 1984 provides for the general possibility of corrections to individual member states' payment commitments towards financing the EU budget when they are in a particularly weak economic situation.<sup>21</sup> The upshot was preferential treatment for the UK with the “British rebate”, which it has defended down to the present day. In addition to Britain's ailing economic position, the heavy weighting of farm spending in total EU expenditure in 1984 meant that the UK was a net contributor. The small British agricultural sector had a detrimental budgetary effect for the UK inasmuch as the country received little in the way of payments from the agricultural budget while its high import ratio resulted in heavy contributions to the traditional own resources customs duties and agricultural levies. A compensation mechanism was agreed according to which the UK was reimbursed with two-thirds of the negative net difference between its expenditures and revenues. In the financial framework 2000-2006 this led to an average rebate for the UK of EUR 3.8 bn a year. The member states pay different shares towards funding of the rebate, with France having to shoulder the largest part.<sup>22</sup>

To the present day, the relatively minor budgetary importance of agriculture in the UK continues to impact both budget negotiations and CAP reforms. In the negotiations on the new financial perspective 2007-13 the UK called for a complete overhaul of the CAP, without which it threatened to delay the negotiations.

**EU budget programming**

To improve planning reliability and tighten up budgetary discipline, in 1988 the original annual budget procedure was replaced by multiyear financial programming, the Financial Perspectives, which are adopted as inter-institutional agreements between the three institutions European Council, Commission and European Parliament. Expenditures are stated for the individual headings in the form of maximum amounts at constant prices for a period of at present seven years. Within these ceilings, each year a detailed review of the spending plan for the next year is conducted in what is known as a discharge procedure under which the Commission is accountable to the European Council and Parliament. The Council has the final say on agricultural spending, as obligatory expenditure.

To take alterations in economic developments within the multi-year period into account, each year a technical adjustment is made, consisting of indexing to allow for inflation and a review of the compatibility of expenditure with the total own resources ceiling of 1.24% of GNI.

**3. The future of the agricultural budget: decisions and ongoing reform****3.1 The Agenda 2007 and the new financial perspective**

Negotiations on the new financial perspective were not brought to a close until May 2006, when they were finally adopted by the European Parliament. In the course of negotiations various amendments were also made to the agricultural budget between the Commission's original proposal in 2004 and the final version.

Based on the Commission's original proposal, a reduction of the first-pillar agricultural budget by EUR 8 bn is apparent in the Interinstitutional Agreement. No defined amounts were shown for the second pillar, because it was not possible to calculate the redistributions resulting from voluntary modulation and cross-compliance (see page 12). However, there was no further change vis-à-vis the December 2005 Council decision; all that happened was a EUR 4 bn increase in total spending under the EU budget.

<sup>21</sup> See Directorate-General Budget.

<sup>22</sup> The share is calculated according to the national share of gross domestic product. Germany, the Netherlands, Austria and Sweden negotiated in 1999 a “rebate on the rebate”, placing a ceiling on their shares.

### Negotiation process for the budget 2007-13 and amendments

EUR bn, 2004 prices

Institution	Stage	Content	Total expenditure*	1 <sup>st</sup> pillar agricultural budget
Commission proposal	July 04		992.7	301
Luxembourg Council	June 05	No agreement		
European Parliament	June 05	Resolution	973.3	396.2
Council	Dec 05		860.3	293
European Parliament	18 Jan 06	Dismissal		
Interinstitutional Agreement	17 May 06		864.3	293
Change on Council 05			+ 4	+ 0

\* expressed as commitment. Source: Author's compilation

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All told, the agricultural budget in the new preview is thus 16% higher than in the previous financial perspective. However, owing to modulation the budget for the first pillar is 3% lower.

### Agricultural budget 2007-2013

EUR bn, 2004 prices

	2007	2008	2009	2010	2011	2012	2013	Total
	54.98	54.33	53.67	53.03	52.40	51.77	51.16	371.34
of which:								
1 <sup>st</sup> pillar	43.12	42.70	42.28	41.86	41.45	41.05	40.64	293.10
less compulsory modulation 5%	40.96	40.56	40.16	39.38	39.38	38.99	38.61	278.45

Sources: European Commission, 2006. European Council, Presidency Conclusions, 2005

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#### 2003 reform reduces direct payments as largest budget component

#### Automatic annual cuts through modulation

#### Disbursement of direct payments bound by conditions

### 3.2 Other agricultural regulations affecting future spending

Aside from the financial perspective, other decisions on CAP also have an influence on the future agricultural budget:

(1) A mid-term assessment of the agricultural budget and its underlying policies had already been agreed in the negotiations on the financial perspective 2000-06. The Commission subsequently published a review containing comprehensive reform proposals, which were finally adopted in 2003.

Key elements of this **Mid-Term Review reform** impacting the budget are as follows:

- Obligatory “**modulation**” means an automatic annual reduction in direct payments, rising from 3% in 2005 to 5% as from 2007. The funds freed up are available for spending under the second pillar of the EU budget and must therefore be co-financed from national funds. The funds are distributed among the EU member states in such a way that each retains at least 80% of its own funds.
- **Cross-compliance** denotes the conditionality of direct payments on the observation of statutory regulations governing environ-

mental protection, product quality and animal health and welfare. Non-compliance can lead to the reduction or complete suspension of direct payments. The funds freed up are for use under the second pillar, also with the appropriate co-financing. Unlike modulation, only 25% can be retained directly in the source country, the rest is redistributed according to regional development criteria.<sup>23</sup>

Obligatory modulation in particular explains the strong reduction in funds for the first pillar vis-à-vis the previous arrangement and the increase in the second pillar. For the first time in the history of the CAP this marks the adoption of a mechanism for the automatic scaling down of the strongest component of expenditure in the agricultural budget.

#### Automatic mechanism for further cuts

**(2) Financial discipline:** With a view to ensuring budgetary discipline, a reduction in direct payments was decided according to Regulation 1782/2003, triggered by the threshold “annual ceiling less EUR 300 million”.<sup>24</sup>

#### New agricultural guideline adopted

**(3) New agricultural guideline:** Ahead of enlargement in 2004 the shape of agricultural policy for the ten new members was agreed in October 2002 in the Council Decision of Copenhagen, leading to two different systems for old and new EU member states. According to this, uniform intervention prices are defined in the enlarged Union, while a phasing-in period for direct payments was adopted for the ten new members, with direct aid starting at a lower level and rising progressively.<sup>25</sup> This phase-in period means that the second pillar is proportionately higher than the first in the new member states. Additionally, the annual nominal increase in the budget for the first pillar was capped at 1% as from 2007, with the consequence that any higher rate of inflation will result in real-term decreases. This ceiling on agricultural expenditure for the first pillar replaces the old agricultural guideline.

#### Optional further modulation negotiated

**(4) Voluntary modulation:** In addition to compulsory modulation in the form of automatic annual cuts in direct payments the possibility of an optional 20% cut was agreed, for which final decisions on technical implementation have yet to be made.

#### Resumption of WTO negotiations uncertain

**(5) Present status on WTO talks and likely WTO regulations:** Following the Uruguay Round, negotiations resumed 2001 in Doha aimed at signing a new Agreement on Agriculture in 2005. Owing to the considerable differences between the parties to the negotiations, however, this objective was not achieved; it is not certain at present when talks will continue.<sup>26</sup>

The latest position on the negotiations can be summarised as follows:

- Customs tariffs: Thus far consensus has been reached on a tiered formula, to be achieved through deeper cuts in higher tariffs than low tariffs. For this, existing tariffs are to be divided into tariff bands, subject to different degrees of reduction. So far consensus could not be reached on definition of the ‘sensitive products’ for which exemptions from the tariff cuts exist. Talks were also held on continuation of the Special Safeguards clause

<sup>23</sup> For details see BMELV (2006).

<sup>24</sup> EU Regulation 1782/2003.

<sup>25</sup> The new members have the possibility to increase these lower direct payments, but the funds for this will only be paid from the EU budget for new members until 2006. As from 2007 they must come from the national purse.

<sup>26</sup> The terminology officially used to describe the present negotiation situation speaks not of a “failure of the negotiations”, but of their “suspension for the time being”.

permitting protective tariffs to be levied in critical domestic market situations.

- Export subsidies: Before the suspension of negotiations the complete elimination of export refunds was agreed, but without a specific time frame.
- Direct payments: To the last, different negotiation proposals on domestic subsidies were on the table, ranging from progressive reduction across all types of subsidies to continuation of the present system of separate commitments for different subsidies.
- Developing countries: Overall, a deepening of existing special arrangements for the developing countries, such as exceptions from tariff cuts, was negotiated.<sup>27</sup>

### 3.3 Assessment of budgetary stability for 2007-13

Assessment of the agricultural budget serves to examine how far the agricultural budget adopted in the Interinstitutional Agreement accommodates actual spending in the future, or whether there is an identifiable need for reform under budgetary pressure.

#### Economic model used for analysis

The analysis is based on simulation calculations from a partial equilibrium model by the Institute for Food and Resource Economics, University of Bonn<sup>28</sup>. The CAPRI (Common Agricultural Policy Regional Impact Analysis)<sup>29</sup> equilibrium model is applied partially to agriculture only and models 250 European regions (NUTS 2-level)<sup>30</sup> as well as 39 crop activities and 19 animal activities. On the basis of economic simulations, political changes such as agricultural reforms or amendments to WTO commitments can be estimated in terms of their impact on agricultural incomes, production or agricultural expenditures. World market prices are calculated in the model as equilibrium prices of supply and demand in international trade.

For the purposes of the analysis, actual spending in the first pillar for 2012 is estimated on the assumption of different scenarios and compared with the CAP budget ceiling set in the financial perspective for that year.

#### Different future scenarios assumed

The relevant scenarios describe the external drivers discussed for the expenditure components intervention costs and export refunds<sup>31</sup>:

- The currency impact is simulated through the strength of the euro, for which a standard rate of exchange of USD/EUR 1.12 is assumed over the entire model period. The effects of a higher parity – e.g. USD/EUR 1.37 – are computed in scenarios 2b and 3b.
- Possible results of future WTO negotiations cover requirements for bound tariff reductions and export refunds.<sup>32</sup>

<sup>27</sup> These special arrangements are negotiated in the Doha Round as “special and differential treatment” for all existing agreements.

<sup>28</sup> Britz et al. (2005).

<sup>29</sup> Further information at [http://www.agp.uni-bonn.de/agpo/-rsrch/capri/capri\\_e.htm](http://www.agp.uni-bonn.de/agpo/-rsrch/capri/capri_e.htm).

<sup>30</sup> NUTS is the acronym denoting a system of official EU statistics for the classification of comparable territorial units. NUTS stands for “Nomenclature des unités territoriales statistiques”. In Germany NUTS 2 corresponds to administrative district level.

<sup>31</sup> Since direct payments are independent of exogenous factors, they have been kept constant in size.

<sup>32</sup> Scenarios for tariff quotas are also included, but these have been disregarded here for the sake of simplicity. The basis for the selection of possible WTO results is formed by the last available decisions on relevant sectors before the suspension of negotiations. See WTO (2006).

The determinants are additionally combined, producing the following five scenarios in all:

- Scenario 1:** Retention of the status quo, implying that the commitments in the last round of WTO negotiations and the standard rate for the euro of USD/EUR 1.12 are assumed.
- Scenario 2a+b:** Possible weak WTO results in the form of a 60% bound tariff reduction and a slight 50% cut in export refunds are assumed and simulated for the standard parity of USD/EUR 1.12 and an increase in the exchange rate in 2012 to USD/EUR 1.37.
- Scenario 3a+b:** More extensive WTO results are assumed, with simulation of a drastic reduction to 0% in export subsidies, in addition to the 60% cut in bound tariffs, again for the standard rate and the higher parity.

Within the EU the 2003 Mid-Term Review reform<sup>33</sup> and the related EU prices apply.

#### Budget in 2012 at EUR 46 bn

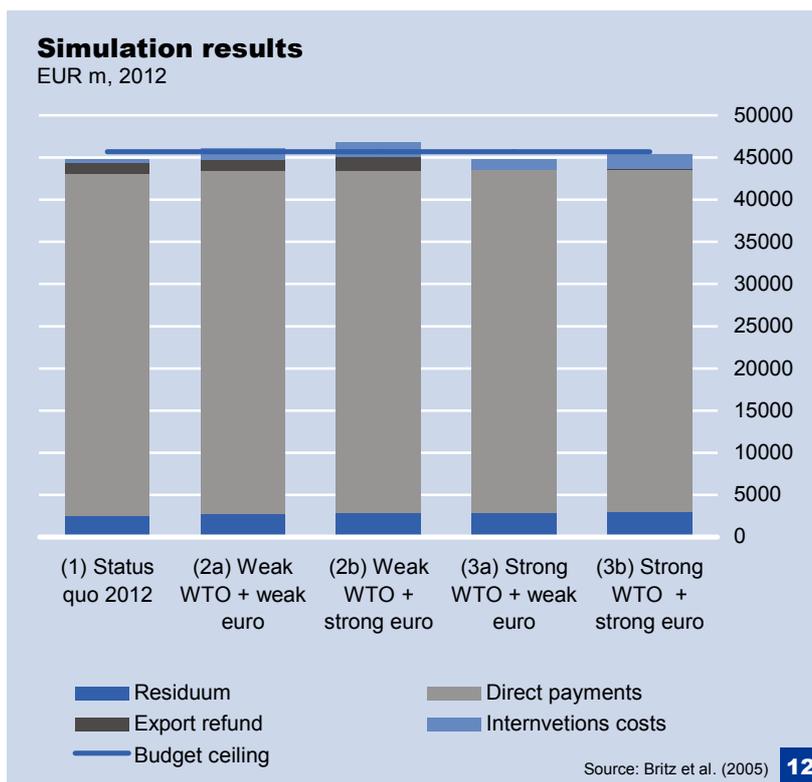
For the ceiling on the first pillar in the financial perspective for 2012, with indexing and deduction of the compulsory 5% modulation, we arrive at a figure of EUR 45.688 bn, which is compared with the simulated actual expenditures in that year.

The model restrictions, determined for example by the datasets available, are crucial to interpretation of the results. Further constraints lie in insufficient allowance for all the agricultural reforms implemented for individual products and in differences in the definition of expenditure headings between the model and the formal agricultural budget.<sup>34</sup>

On the whole, the model results show only very slight differences for the estimated expenditures in different scenarios. A slight overrun of the budget ceiling is evident only for the scenarios of a weak WTO with marginal reductions in export refunds.

<sup>33</sup> For details on the scenarios see Britz et al. (2005).

<sup>34</sup> The expenditure taken into account in the model, for instance, contains only spending of immediate market relevance, whereas first-pillar measures relating to animal and plant diseases, for example, are not included. For details of the model assumptions see Britz et al. (2005).



**Actual expenditure in 2012 estimated at EUR 46.1 to 46.7 bn**

**Tight budget calls for reform**

- In **scenario 2a** actual expenditure is estimated at EUR 46.097 bn, just above the ceiling of approx. EUR 45 bn for 2012.
- In **scenario 2b** the actual expenditure, at EUR 46.735 bn. is even a little higher owing to the relative appreciation of the euro, because the strength of the euro leads to rising spending on export subsidies and poorer sales of intervention stocks.

These scenarios flag a need for reform of the CAP arising from the budgetary constraints. This may be put into more specific terms in the context of the 2008 Mid-Term Review and is already on the agenda with budgetary discipline to reduce direct payments. If, on the other hand, no new results emerge from WTO negotiations and the status quo is unchanged, the budget appropriated will be adequate.

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EU – Directorate-General for Agriculture and Rural Development:  
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