Box 5

THE EUROPEAN UNION'S COMMON AGRICULTURAL POLICY AGAINST THE BACKGROUND OF GLOBALLY RISING FOOD PRICES

Global food prices have risen significantly in 2007. This is the result of a number of factors, such as increases in energy and fertiliser prices, adverse weather conditions in some regions, greater demand for biofuel production and a generally strong demand for crops in emerging economies (see Box 4 in this issue of the Monthly Bulletin). The increase in food prices has also raised questions regarding the effects of the EU's common agricultural policy (CAP) on food prices. This box provides some background to these questions.

The CAP of the European Union is anchored in Article 33 of the Treaty establishing the European Community. Its objectives are (i) to increase agricultural productivity, (ii) to ensure a fair standard of living for the agricultural community, (iii) to stabilise markets, (iv) to assure the availability of supplies and (v) to ensure that supplies reach consumers at "reasonable prices". The CAP also contains policies and measures to improve rural development and the environment. In 1980 the CAP accounted for 69% of the total EU budget, with the share declining to 50% in 2003 and 43% today. It is expected to account for 36% of the budget by 2013.

Originally, the CAP supported EU farmers' incomes through import levies, export subsidies and guaranteed prices for products that would otherwise have remained at the much lower world market price level. By the 1980s, these measures had led to high budgetary costs and an oversupply of agricultural products. Against this background, the EU introduced various measures to limit expenditure and production, such as introducing milk quotas in 1984, imposing planting restrictions on vineyards, establishing ceilings on national aid for various products and introducing a programme for setting aside agricultural land (see below).

In 2003 the CAP was reformed extensively in order to meet the requirements of international trade liberalisation agreements (such as the Doha trade round), to alleviate EU budgetary pressures and to make EU farming both more environmentally friendly and more competitive. The reform lowered guaranteed prices substantially and introduced a "single farm payment" to replace many of the previous payments that were tied to production and direct payments to farmers. Most CAP expenditure is now accounted for by aid to farmers that is not coupled to production.

As well as setting import taxes and import quotas, the CAP imposes two important types of direct supply constraint: production quota regimes and "set-aside" obligations. Production quotas are imposed on certain products (in particular, milk and sugar) and result in penalties such as milk super-levies in cases of overshooting. Farmers are also obliged to "set aside" (i.e. leave uncultivated) a specific proportion of agricultural land. The rate of obligatory setting-aside can vary between harvest years.[1] The obligation to set land aside is expected to be abolished in the near future, and the European Commission is also in favour of gradually phasing out milk quotas so as to reduce market distortions on the supply side of the CAP[2].

1 In July 2007 the European Commission decided to set the obligatory set-aside rate for sowings in autumn 2007 and spring 2008 at 0%, in response to the increasingly tight situation in the cereals market.
2 For more details, see "Preparing for the 'Health Check' of the CAP reform", Communication from the Commission to the Council and the European Parliament, Brussels, November 2007.

Given the substantial reduction of guaranteed prices as a result of the 2003 reform[3] and the increase in prices on world markets[4], the instrument of export subsidies has hardly been used.

The 2003 reform succeeded in diminishing distortionary effects on the agricultural markets by, for example, reducing the market intervention price for a number of agricultural products (such as butter, skimmed milk powder and rice). The decoupling[5] of farm payments under the reformed CAP has reduced the instruments that affect supply. However, despite the 2003 reform, CAP policies still entail distortionary effects and divergence between the EU prices and the international prices of a number of agricultural products (such as milk, beef and sugar). The impact of higher food prices is regressive, given that poorer households spend a higher fraction of their income on food. Certain subsidies are still linked to production or land area, and thus often benefit larger farms.[6] The Commission has acknowledged this distortion and recently proposed an increase in the decoupling rate, as well as payment cuts for larger farms. In general, an excessive use of the CAP may trap resources in a low-productivity sector, thereby hampering the EU economy's capacity to adjust. A more market-led allocation of resources in the agricultural markets should, in principle, be beneficial for the most efficient, innovative and productive farmers, thus guaranteeing an efficient allocation of resources.

Against the background of a marked increase in international food prices, further liberalisation and reforms in the EU agricultural markets are particularly important. Reforms would help to enhance market efficiency and benefit European consumers in the form of lower prices. In order to allow consumers to profit from lower farm-gate prices, adequate competition in the downstream sectors (food processing, retail trade and catering) and compliance with Single Market provisions are necessary. The successful conclusion of the Doha round of world trade negotiations should also help to improve the functioning of global trade in general, and of agricultural markets in Europe and worldwide in particular.

3 Before the 2003 reform, guaranteed prices were intervention prices that guided the market prices. After the reform, the guaranteed prices became "safety-net" prices like those in the US Farm Bill.
4 See the box entitled "Recent food price developments in world markets and the euro area" in the September 2007 issue of the Monthly Bulletin.
5 The rate of decoupling is the percentage of EU agricultural aid that is given to farmers without any link to actual agricultural production or land use.
6 OECD, "Economic Survey of the European Union", Paris, 2007.