

Franz Sinabell, Erwin Schmid

# The Reform of the Common Agricultural Policy

## Consequences for the Austrian Agricultural Sector

**In the summer of 2002, the European Commission published a mid-term review of the Agenda 2000 Reform of the Common Agricultural Policy (CAP). Based on this document, a detailed proposal for a Council Regulation was submitted in January 2003 in which elements for a follow-up reform were defined in detail. After a thorough discussion of reform issues between the European Commission and farm ministers of the EU member states, the Greek presidency achieved a compromise on 26 June 2003.**

Franz Sinabell is an economist at WIFO, Erwin Schmid is Assistant Professor at the Department of Economics, Politics, and Law at the University of Natural Resources and Applied Life Sciences Vienna. The authors are grateful to Wilfried Puwein for useful and constructive comments. The data were processed and analysed with the assistance of Dietmar Weinberger • E-mail address: [Franz.Sinabell@wifo.ac.at](mailto:Franz.Sinabell@wifo.ac.at)

The decoupling of direct payments from farm output and a reduction of intervention prices have been core elements of the reform proposal submitted by the European Commission. This reform is expected to produce a lower output of cereals and beef, enhance competitiveness of the EU farm sector, and stabilise farm incomes. Model simulations show that these objectives are likely to be achieved in Austria. One result of such changes will be a slight acceleration in the rate of structural change (owing to the fact that the demand for farm labour will further decline). In order to facilitate the gradual structural adjustment, the presidency's compromise offers a wide scope for national modifications. Model simulations were carried out to analyse some of the options available to national discretion. Simulation results reveal that output-coupling of 25 percent of the crop premiums will have only minor effects, but those on beef output are significant if 75 percent of premiums for bulls and steers remain coupled.

In its annual monitoring report, the OECD publishes an international comparison of indicators of support for the agricultural sector (Figure 2). The key indicators of this survey are the Producer Support Estimate (PSE) and the estimate of the Market Price Support (MPS) element within the range of support measures (OECD, 2003):

- PSE is an indicator of the annual monetary value of gross transfers from consumers and taxpayers to support agricultural producers, measured at farm gate level. The PSE measures support arising from policies targeted at agriculture relative to a situation without such policies, i.e., when producers are subject only to general policies (including economic, social, environmental and tax policies) of the country. The PSE is a gross value, implying that the costs associated with such policies and incurred by individual producers are not deducted. It is also a nominal assistance value, i.e., increased costs associated with import duties on inputs are not deducted. But it is a value net of producer contributions to help finance the policy measure (e.g., producer levies), and it provides a given transfer to producers.
- MPS is an element of the PSE, indicating the annual monetary value of gross transfers from consumers and taxpayers to agricultural producers arising from policy measures that create a gap between domestic producer prices and reference prices. Conditional on the production of a specific commodity, MPS includes the transfer to producers for total production (for domestic use and ex-

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### The agricultural policy framework

ports), and is measured by the price gap applied to current production. In the case of livestock production, it is net of the market price support for domestically produced coarse grains and oilseeds used as animal feed.

The comparison of the levels of PSE and MPS over the last years shows the effects of the CAP reform in 1992 (frequently called McSharry reform): an ever decreasing part of farm support (measured as PSE) is due to (direct and indirect) measures to lift domestic market prices above world market prices (see MPS versus PSE in Figure 3). This process has continued in the period since the Agenda 2000 Reform.

The shift among support measures has several implications: the weight of direct support measures will increase, and the weight of export subsidies will decline (Figure 1). When intervention prices are reduced, consumer prices are likely to decline as well, so that the market price support will be similarly reduced.

### *The Two Pillars of the Common Agricultural Policy*

The 1992 CAP reform introduced accompanying measures (CR 2078-1992) which were directed towards limiting the adverse effects of the reform of market regimes (price drops and introduction of crops and livestock premiums). Since then, funds allocated for such measures have taken up an ever increasing part of farm payments (Figure 1). After the Agenda 2000 Reform this set of measures became part of the rural development programme (CR 1257-1999) which is developing the tools for a "European model of agriculture". This vaguely defined long-term strategy aims at strengthening rural development, improving the well-being of the farming community, and tries to achieve efficient and environmentally friendly farming. Elements of this programme are agri-environmental schemes, payments for farms in less favoured areas, support for young farmers, investment aids and programmes for diversification.

The programme is a synonym for the "second pillar of the CAP", the rhetoric alternative to the "first pillar of the CAP" (market regimes for specific farm commodities, e.g., intervention, export refunds, production quota). Measures of the "first pillar" are financed solely by the Guarantee section of the European Agricultural Guidance and Guarantee Fund (EAGGF).

Financing of "second pillar" measures is shared between member states and the EAGGF. The Guarantee Section contributes to financing four accompanying measures under the CAP (agri-environmental schemes, re-forestation, early retirement and compensatory allowances for less favoured areas) and it co-finances structural and rural development measures across the whole Community except in the less developed regions (these are funded under the EAGGF Guidance Section).

Decoupling direct payments from farm production is a prerequisite for further negotiations within the WTO (in the Doha round) to liberalise international agricultural trade. In mid-December of 2002, the European Commission submitted a position paper for the trade talks (Fischler, 2002) in which it made, i.a., the following proposals:

- a reduction of the average tariff by 36 percent and a minimum of 15 percent per tariff line;
- an average substantial cut in the volume of export subsidies and an average 45 percent cut in the level of budgetary outlays;
- total elimination of export refunds for certain key products (such as wheat, oilseeds, olive oil and tobacco) provided that no other form of export subsidisation is given for the products in question by other WTO Members;
- a 55 percent reduction in "amber box" support (i.e., the most trade-distorting agricultural supports), starting from the level of commitments made in the last round of negotiations.

These concessions are only possible if intervention prices of several commodities are lowered and support measures are de-coupled from farm output. The European Commission obviously is advancing the view that support from a decoupled single

farm payment is "minimally trade distorting" and therefore part of the so-called "green box" of support measures which are exempt from further reductions. Abolition of export subsidies may lead to less volatility on world markets for the farm commodities in question and to higher world market prices. The European Commission argues that low intervention prices which act only as a safety net will eventually lead to higher market prices in the EU because market distortions can be avoided.

In 1999, the Berlin Council agreed on a reform of the CAP (Agenda 2000 Reform). The European Commission was instructed to conduct a mid-term review in order to analyse the reform process and to submit proposals in the event that further adjustments were seen to be necessary. In mid 2002, the European Commission published its report on the review, and six months later submitted a proposal for a Council Regulation which showed that – according to the European Commission – mere adjustments would not be sufficient to cope with the challenges of the future. Therefore a further substantial reform was proposed that offered "a long-term perspective for a sustainable agriculture" (Fischler, 2003A).

The reform is to achieve the following objectives (European Commission, 2003A):

- stimulate competitiveness of the EU's agricultural sector: production decisions to be made according to market signals and not in response to government intervention;
- reduce export subsidies and enhance transfer efficiency by utilising a new way of support;
- stabilise agricultural incomes;
- allocate more funds for the rural development programme;
- finance further reforms within existing budget limits;
- get agricultural production to give more thought to consumer interests, improve the quality of farm products, make production processes more environmentally friendly and give more weight to animal welfare concerns.

In order to achieve these goals, the following measures were proposed:

- modify market regimes – reduction of intervention prices (which translates into fewer production incentives), special regulations for protein crops and durum wheat, prolongation of the milk quota system;
- decouple direct payments linked to the production of farm commodities;
- degression – cuts of support for bigger farms;
- modulation – allocation of more funds for the rural development programme (which translates into a shift of transfers among and within EU member states);
- introduce instruments to enhance consumer trust in food produced within the EU (training for farmers, introduction of certification schemes, farm auditing programmes, animal welfare-related measures);
- cross-compliance: support to be granted only if farmers abide by a set of (mostly environmental) standards.

Several reform proposals from this list have already been introduced in the Agenda 2000 Reform of the CAP as part of the rural development programme. However, member states have not been obliged to actually institute these proposals.

In 1992, farm commodity prices that had been kept at high levels via government intervention were reduced significantly with a view to controlling excess production. In order to restrict to a minimum the resultant effects on farm incomes, premiums were introduced which were linked to the amount of land used for production and the number of livestock raised. Direct production incentives of higher prices were reduced, but it is still necessary to produce some crop such as wheat in order to get a crop premium. Additional premiums are granted when specified animals are slaughtered (bulls, oxen, calves, cows, heifers) or reared on the farm (suckler cows

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## The reform proposal of the EU Commission

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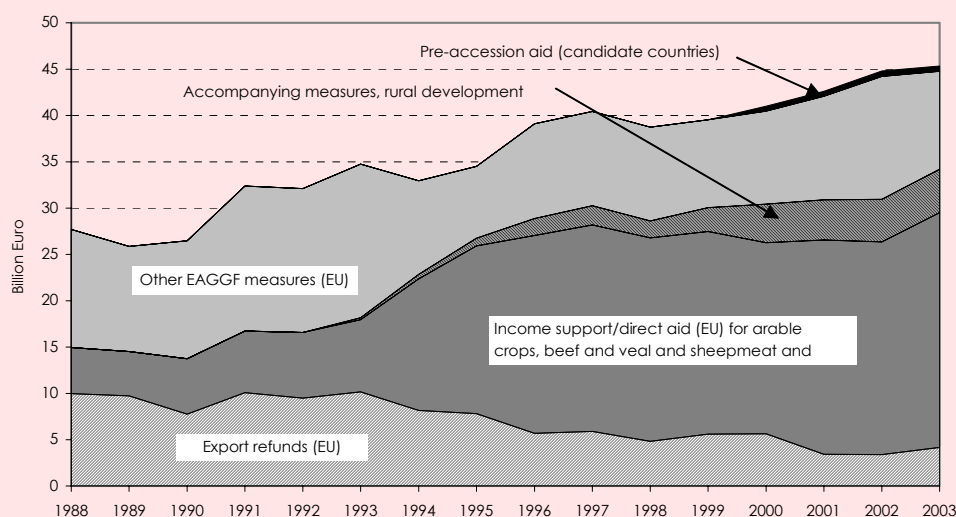
### Objectives and scope of the proposal

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### Decoupling, degression and modulation

and heifers) and an extensification premium is granted when the number of livestock per hectare of land is below a specified limit. The European Commission planned to decouple these premiums from production and to grant a transfer for the farm instead (dubbed "single farm payment"). This subsidy would be paid even if a farmer chose to produce nothing, as long as "land is maintained in good agronomic condition". The transfers which would be subject to decoupling (dubbed "crop premiums" or "livestock premiums" or "CAP premiums") are equivalent to more than half of the EU funds spent on agriculture (Figure 1).

Figure 1: EAGGF Guarantee section expenditure for the European Union and pre-accession aid – agriculture for the candidate countries



Source: European Commission, Directorate General for Agriculture, Agriculture in the European Union, Statistical and Economic Information.

Many support schemes are not part of the decoupling process (e.g., subsidies for agro-environmental programmes and payments for farms in less favoured areas). member states co-finance farm subsidies in addition to EU funds. These payments need to be accounted for even when the effect of decoupling is analysed (Figure 2).

The Agenda 2000 Reform introduced several modifications of the milk market regime. As of 2005, milk prices are to be lowered and the introduction of a premium per tonne of milk was planned to compensate revenue losses. Under the European Commission's proposals, this premium is to become part of the single farm premium.

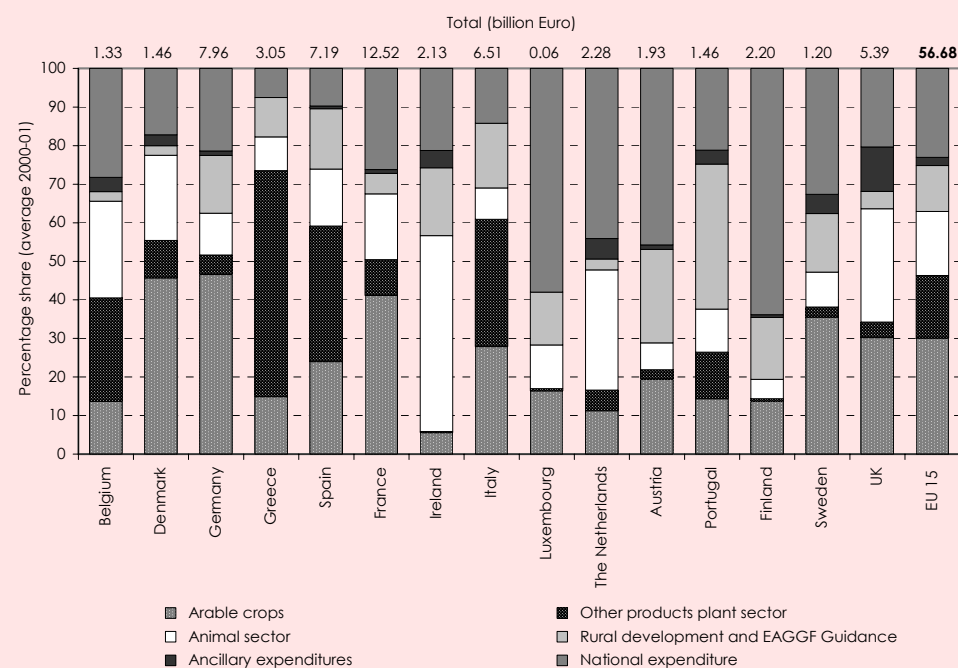
Farm operators (but not the owners of land) are entitled to premiums based on historic payment entitlements (average of 2000 to 2002). These entitlements are weighted by premiums and will be adjusted during the reform period. The total of premiums per farm is divided by the sum of the relevant crop and forage area, thus obtaining the average farm premium per hectare. Premiums per hectare will therefore vary among farms.

It is expected that decoupled premiums have considerable impact on production incentives. Farmers do not need to plant certain crops or breed bulls in order to obtain subsidies. Certain production decisions are expected to be based on market signals (prices) and consequently resource allocations should improve. Premium entitlements can be transferred to other farms as long as the buyer has enough land (entitlements are linked to a reference land base).

The European Commission proposed to introduce an instrument known as "degression" which means that part of the farm subsidy will be cut at an increasing rate from 2006 on. By 2012, 12 percent of this subsidy will be retained by the European Commission for further reforms (e.g., sugar beets and olives). Farm subsidies between

€ 5,000 and € 50,000 are to be reduced at a lower rate, whereas farm subsidies lower than € 5,000 will not be reduced at all.

Figure 2: CAP expenditures (EAGGF, national expenditure) for the EU countries



Source: European Commission, Directorate-General for Agriculture, Agriculture in the European Union, Statistical and Economic Information.

Part of the funds saved by degression is transferred to strengthen the "second pillar of the CAP" in the form of "modulation". Modulation of funds would allow a re-allocation of farm subsidies within and among member states.

Under the proposal, the intervention price (a minimum price) for cereals (except rye) is to be reduced to € 101.3 to € 95.35 per tonne, whereas the premium for crops will be increased from € 63 to € 66 per tonne to compensate income losses. Monthly increments of the intervention price in periods after harvest time will be cancelled. Intervention for rye will be abolished as well, so that the price of rye will be primarily determined by world market conditions.

Special regulations are planned for durum wheat, protein crops and energy crops. In order to boost production of these crops, non-decoupled premiums will be granted. Another exception is made for starch potatoes: only 50 percent of the premium is to be decoupled from production.

Milk producers in the EU need to have a production quota in order to be allowed to market milk. Minimum intervention prices for butter and milk powder are supplementary instruments used to achieve a discretionary (farm level) target price for milk in the common market. This regulation will remain in place until 2014-15. However, starting in 2004, the intervention prices for butter and milk powder are to be reduced by 35 percent and 17.5 percent, respectively. To compensate revenue losses from this reduction, a quota premium will be granted which will become part of the decoupled farm premium. When the reform is fully implemented (2008-09), this premium will be € 28.74 per tonne (to which a national supplement will be added). In addition to these modifications, an extension of the milk quota of 2 percent is planned.

The Agenda 2000 Reform provided a substantial modification of the market regime for beef. Intervention prices were cancelled. The current "basic price" (a minimum price) is a mere safety net for low prices. Reform steps already undertaken were assumed to be sufficient and consequently no further modifications were planned dur-

### Proposal for a reform of market regimes for crops, milk and beef

ing the mid-term review. In the beef sector many premiums are still linked to production: special premiums for bulls and steers, suckler cow premiums, slaughter premiums, and extensification premiums. These premiums will become elements of the decoupled farm payment.

According to the European Commission's proposal, recipients of decoupled farm premiums (with the exception of small producers) have to set aside 10 percent of their land (rotational set aside is an exception, not the rule). Such land must not be used to produce non-food commodities but needs to be dedicated to ecological purposes (e.g., to increase biodiversity).

In order to benefit from farm payments, farmers need to comply with a number of very detailed regulations ("cross-compliance"), which guarantee that farm land will be maintained in "good agronomic condition". Farms with substantial amounts of premiums (above € 150,000 per year) will be required to train their workers in special courses and to participate in a farm auditing scheme.

The public discussion of the European Commission's reform proposals made clear that also implicit goals were pursued to:

- maintain agricultural land in productive condition (farmers who receive decoupled premiums are not allowed to re-forest their land or use it for other permanent crops);
- freeze the distribution of transfers under farm commodity policies at the level of the reference period 2000-2002 (with the exception of large farms which are facing cuts from depression);
- minimise the economic losses of those operators that retire from the farm sector;
- strengthen the position of the operator of land versus the owner of land (where owner and operator are identical, this feature is of no relevance);
- set the amount of decoupled transfers at a nominal level, so that the real value of farm premiums will decline if inflation is above zero.

Many agricultural economists share the European Commission's view that this reform package will contribute to enhance the efficiency and competitiveness of the EU's agricultural sector. Narrowing the gap between world market prices and domestic market prices is seen to have positive effects on farm commodity markets. Reviewers of the reform point out that distortions in some markets (cereals) will be eliminated while in others (e.g., olives, sugar) they will not. This might in fact aggravate distortions in some domestic markets. Apart from such inconsistencies, some authors showed that the criteria of depression and modulation are arbitrary and that the reform might contradict with goals of the European model of agricultural policy (Schneider, 2002, Alvensleben, 2003).

The effects of changes in the market regimes and of modulation and depression can be estimated with relative precision, whereas the consequences of the proposed decoupling and transfer of farm premiums are very difficult to forecast. Depending on the detail and subtlety of the regulation, the rents of agricultural policy differ considerably in their distribution. According to Isermeyer (2003), the general uncertainty is further enhanced by a lack of understanding about the consequences that a transfer of farm premiums might have. Thus, farmers who finance their retirement income from land tenancy might face serious losses and mortgages on farm land might become devalued.

In the public debate, the European Commission's reform proposal was approved by representatives of some countries (the Netherlands, UK, Denmark) but rejected by farm ministers from countries with a relatively large share of less favoured areas (e.g., France and Portugal).

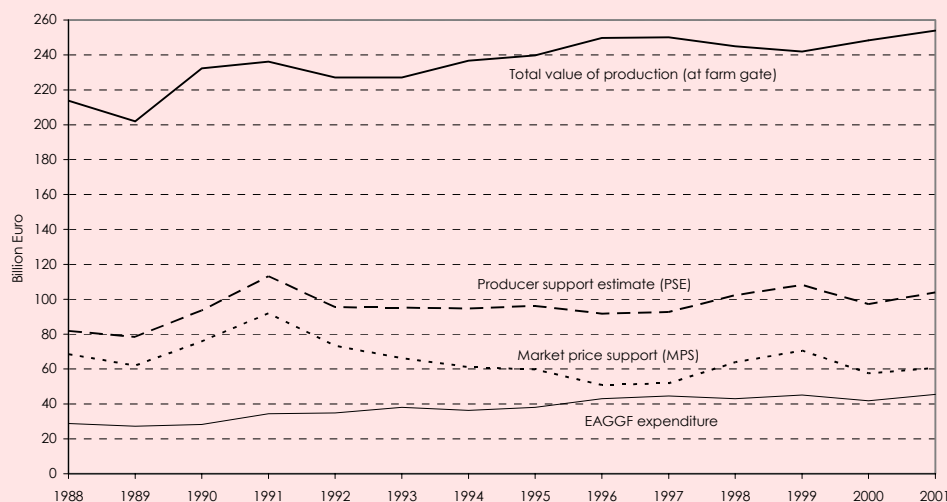
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### Conditions for premiums and cross-compliance

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### Public appraisal of the reform proposals

Figure 3: Production, PSE, MPS, and the EAGGF expenditure



Source: OECD, PSE Database; European Commission, Directorate-General for Agriculture, Agriculture in the European Union, Statistical and Economic Information.

Austrian agricultural policy makers (the Federal Minister of Agriculture, the Head of the Agricultural Chambers, the Head of the Farmers Union) took a subtly differentiated position. A joint statement on the reform proposal (*Molterer – Grillitsch – Schwarzböck, 2003*) opposed the degeneration and dynamic modulation of premiums, decoupling without specific conditions, the lowering of intervention prices, and the farm audit. However, they did not reject the reform proposals entirely. By the end of May 2003, the negotiation position had been formulated in more detail and a compromise proposal for the partial rather than full decoupling, as proposed by the European Commission, was furnished.

Representatives of farmers unions and agricultural co-operatives at EU level criticised the European Commission for exceeding its mandate granted in the Council Decision of the 1999 Berlin summit (*Agra-Europe, 2003*). They proposed to delay reform steps of such vast implications until the post-Doha round negotiations. In addition, they criticised that new member states were given no opportunity to contribute to the reform.

Several meetings of EU farm ministers were necessary to arrive at a final compromise on the reform of the Common Agricultural Policy on 26 June 2003. The key elements of the reform are (*Greek Presidency, 2003, Fischler, 2003B*):

A single farm payment will replace premiums formerly linked to output or land. The change will become effective as of 1 January 2005 (although in some well-reasoned cases its introduction may be postponed until 1 January 2007). The decoupled single farm payments are calculated on the basis of payment entitlements in 2000-2002, which are transferable with or without land between farmers within the same Member State. Payment entitlements will trigger direct payments only if accompanied by eligible hectares.

Member states may choose to introduce the single farm payment in full or they may opt to:

- retain up to 25 percent of the payments for arable crops or up to 40 percent of the special assistance for durum wheat,
- continue to couple up to 50 percent of the premiums for sheep and goats,
- keep the slaughter premium, or 75 percent of the special bull and steer premium, or the suckler cow premium and up to 40 percent of the slaughter premium,

## The Compromise of the Greek Presidency

### Decoupling and conditions for single farm payments

- retain up to 10 percent of direct payments for measures that have a positive environmental effect or improve the quality and marketing of agricultural products.

In addition, member states may implement the single farm payment at regional level, for which they have a broad range of options at their disposal, including redistribution of money between holdings, between regions, and within regions.

Farmers receiving direct payments must set aside part of their land (organic farms are exempt) and will be subject to compulsory cross-compliance. Recipients of farm payments must abide by a list of 18 statutory European standards in the field of environment, food safety, and animal health and welfare.

For cereals (apart from rye), the intervention price remains the same, but the monthly increments will be cut by half. For rye, the intervention price mechanism will be abolished.

For protein crops, the current tonnage supplement of € 9.50 per tonne will be maintained for overall production and converted into a crop-specific area payment for up to a maximum of 1.4 million hectares. The production refunds for starch will remain in place, the minimum price for starch potatoes will be maintained and 40 percent of the direct payment to the producers of starch will be integrated in the decoupled single farm payment. A new subsidy (€ 45 per hectare) will be introduced for renewable raw materials and energy crops.

A reformed milk quota system will be maintained until the 2014-15 marketing year. The 5 percent reduction of the intervention price in three steps agreed at the Berlin European Council will be replaced. Prices of butter and skimmed milk powder will be cut asymmetrically in four stages. The quota expansion decided under Agenda 2000 will be postponed until 2006. The suckler cow premium for Austria is increased by 50,000 entitlements. These animals are deducted from the Austrian regional ceiling of special bull and steer premium (the regional ceiling of special premiums will be reduced accordingly). The premiums will probably be allocated among farmers who have bred heifers during the reference period.

Direct payments to larger farms (above a threshold of € 5,000) will be reduced by 3 percent in 2005, 4 percent in 2006 and 5 percent from 2007 to 2013. Despite this gradual phasing-in, channelling expenditure away from market policies will make available € 1.2 billion for rural development. Member states may keep part of the savings the rest will be retained by the European Commission for a re-distribution. According to *Pröll* (2003), the Austrian agricultural sector will be a beneficiary of modulation (the net benefit until 2012-13 is estimated to be € 144 million).

The European Commission estimates that up to 2006, CAP expenditure will remain within the planned financial framework agreed upon at the Brussels Summit from 2002. Starting from 2007, a new mechanism for maintaining budgetary discipline will be introduced which is essentially the same as the degression mechanism proposed by the European Commission in January 2003. The difference is that in the original proposal degression was mandatory, and that after the compromise it will be triggered only in case of budgetary excess.

In 2002, subsidies on agricultural products totalled € 535 million in Austria (*Sinabell*, 2003) – an amount that is almost identical to the sum of direct decoupled payments (or partly decoupled payments if Austria opts for retaining part of the subsidies). It represents approximately 10 percent of the total value of output of the agricultural sector at producer prices. Decoupling these subsidies will have an effect on production decisions. The reforms of the common market organisation are likely to have significant effects on selected markets (cereals, milk, beef).

The impact of the reform is difficult to evaluate because crop and livestock production are interlinked by feed and manure transfers. Other support measures will remain in place more or less unchanged. Due to their magnitude (€ 1.2 billion, equivalent to 23 percent of the total value of output), reciprocal effects can be expected.

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## Common market organisations

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## Modulation and financial discipline

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## Decoupling and the reform of common market organisations: consequences for the Austrian agricultural sector

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## Model, assumptions and scenarios



A simulation model is utilized to evaluate the effects of the CAP reform, and scenario analyses were made to assess the sensitivity of the results. The model applied to the analysis depicts the Austrian agricultural sector in detail (see box "PASMA – Positive Agricultural Sector Model of Austria"). The CAP instruments are modelled in detail and the measures of the rural development programme are explicitly accounted for. The Austrian agri-environmental programme ÖPUL and compensatory allowances for farms in less favoured areas (€ 900 million in 2002) are also modelled.

#### *PASMA – Positive Agricultural Sector Model of Austria*

PASMA is a regional partial equilibrium model of the Austrian agricultural sector. Depicting the agricultural structure and production in great detail, the model is used to analyse the production and income effects of agricultural policy measures at various levels.

The method used in this model is positive mathematical programming (PMP). It was introduced by *Howitt* (1995) and is frequently used in applied policy analysis (e.g., *Lee – Howitt, 1996, Paris – Arfini, 1995, Heckeley – Britz, 1999, Cypris, 2000, Röhm, 2001, Röhm – Dabbert, 2003*). The PMP method allows calibrating models to observed data. The method is based on the duality principles of linear programming

The objective function in PASMA is maximising producer surplus (sector gross margin) from up to 40 production regions. For this analysis, results are obtained at a sub regional level according to the nine Austrian federal states.

All relevant CAP instruments are modelled explicitly (direct payments for crops and livestock, the milk quota system, the starch potato regime, etc.). In addition to these instruments, the measures of the second pillar of the CAP (the rural development programme, the agri-environmental programme and compensatory allowances for farmers in less favoured regions) that are of major importance in Austria, are modelled in a similarly detailed manner.

Due to the type of model, interrelations with the rest of the Austrian economy are modelled at a rudimentary level only. All prices of inputs and outputs are given exogenously. This limitation is justified by a very small share of agricultural production in the common market.

The relevant elements of the reform of the common market organisation and the alternative options of decoupling direct payments are modelled in PASMA. Several scenarios were simulated to account for different assumptions on farm output price expectations.

Thus, in order to get the single farm payment, farmers will be required to maintain farm land in good agronomic condition. This requirement was interpreted as an obligation to prevent re-forestation of agricultural land. If no other agricultural use is found for such land, costs will accrue to the farmer in order to carry out some minimum cultivation operations.

As reference period, the model uses price expectations of 2008-09 when the reform of the milk market regime is scheduled to be completed. By that time, payments may well be reduced due to the "financial discipline" provision in the Council compromise. Yet, since this is only a conditional measure, it may not be put into force, so that it was not accounted for in the analyses. Neither were the costs and benefits of "modulation", because of the wide scope of options to use the expected net transfer for measures of the rural development programme. But, as the use of this budget item has not yet been decided upon, the effect of modulation has not been analysed in quantitative terms.

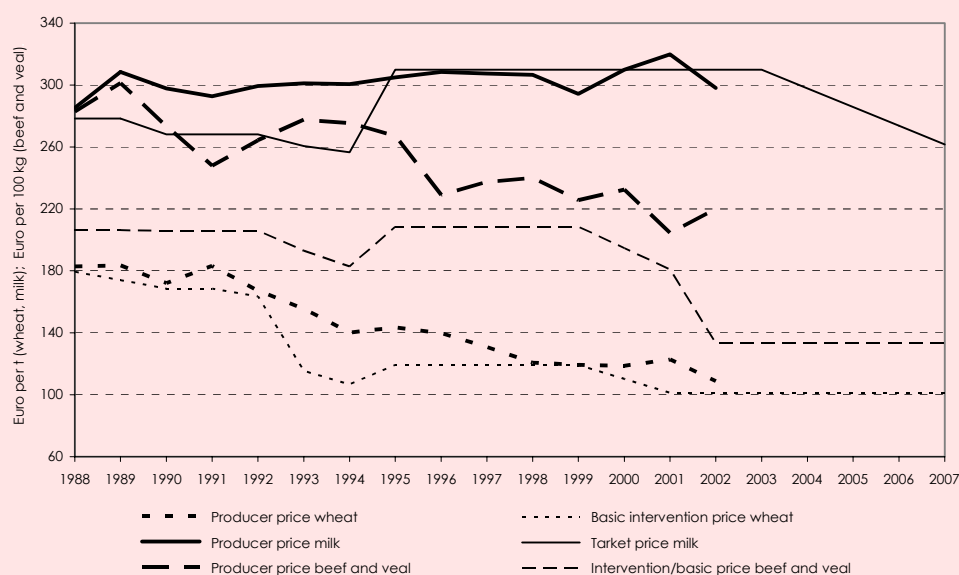
Table 1: Price assumptions in scenarios

	Expected prices in 2008-09 in scenarios			
	High	Medium	Low	Reference
	Percentage change of producer price versus 2000-01			
Quality wheat	- 8	- 10	- 14	- 9
Other soft wheat	- 8	- 10	- 14	- 8
Durum wheat	- 1	- 3	- 5	+ 1
Quality rye	- 8	- 12	- 22	- 11
Other rye	- 7	- 11	- 11	- 3
Winter barley	- 6	- 7	- 7	- 7
Summer barley	- 8	- 10	- 12	- 6
Oats	- 7	- 10	- 12	- 5
Triticale	- 9	- 17	- 17	- 10
Field beans	- 6	- 6	- 6	- 6
Starch potatoes	+ 2	- 3	- 3	- 3
Milk A quota	- 12	- 12	- 19	- 12
Veal	- 16	- 20	- 24	- 10
Heifer (milk cow)	- 11	- 15	- 19	- 19
Heifer (suckler cow)	- 16	- 20	- 24	- 20
Meat of heifers	- 16	- 19	- 24	- 19
Beef of oxen	- 16	- 20	- 24	- 20
Other beef	- 16	- 20	- 24	- 20
Calves male	- 16	- 20	- 24	- 20
Beef young cattle	- 11	- 15	- 19	- 15
Beef old cows	- 20	- 24	- 28	- 24

Source: WIFO calculations.

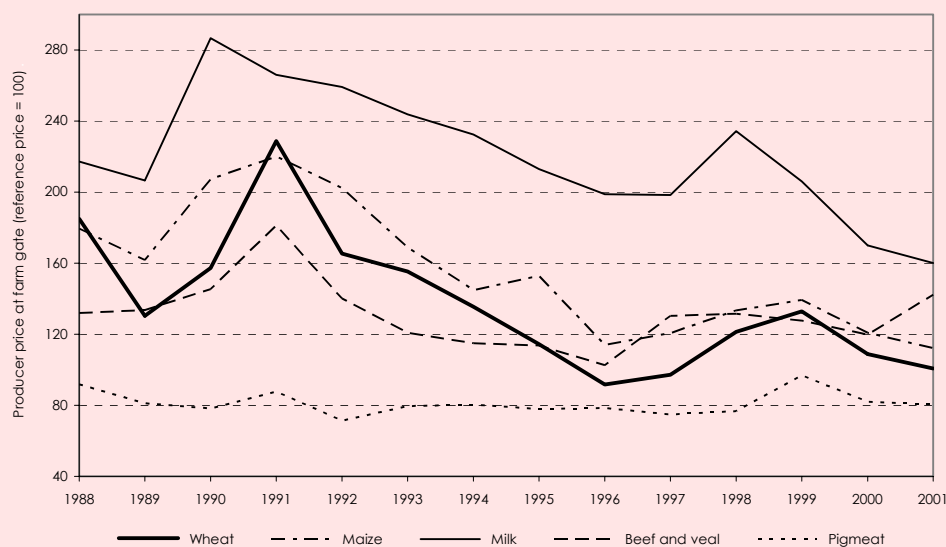
Table 1 lists the administrative prices which deviate from those observed in the reference period (2000-2002). In order to account for uncertainties about future price developments, three different scenarios are estimated. The levels are based on comparisons of internal market prices to administrative prices (Figure 4), the gap between EU prices and world market reference prices (Figure 5) and forecasts of prices obtained from the literature.

Figure 4: Producer prices (at farm gate) for wheat, milk, beef and veal in comparison with the respective intervention price (wheat), target price (milk) and intervention/basic price (beef and veal) in the European Union



Source: OECD, PSE Database; European Commission, Directorate General for Agriculture, Agriculture in the European Union, Statistical and Economic Information.

Figure 5: Important agricultural producer prices (at farm gate) in comparison with the respective reference price in the European Union



Source: OECD, PSE Database.

Compared to other studies (*Consortium INRA – Wageningen, 2002, EC – DG Agri, 2002, 2003, Kleinhanß et al., 2003*), the assumptions about prices in 2007-08 are cautious but within the range of the figures given in the literature. The scenarios using "low" prices are not very likely to be implemented because safety net measures of the CAP might prevent prices to fall below such levels.

The following scenarios for the newly reformed CAP are analysed:

1. introduction of a single farm premium not linked to production (full decoupling), at three price expectation scenarios (high, medium and low prices);
2. same as 1. but retaining 25 percent of the current per-hectare premiums in the arable sector linked to production and assuming a medium price level;
3. same as 1. but retaining 100 percent of the premiums for suckler cows and 40 percent of the slaughter premium (and the supplementary refund) coupled to production and assuming a medium price level;
4. same as 1. but retaining 100 percent of the slaughter premium (and the supplementary refund) coupled to the output and assuming a medium price level;
5. same as 1. but retaining 75 percent of the special premium for bulls and steers linked to production and assuming a medium price level.

According to the Council compromise, member states have a large range of options to fine-tune their measures: part of the premiums for goats and sheep may be retained as well, and member states can differentiate between regions or introduce flat payments per hectare for arable and grass lands. These options were not investigated in this first assessment, as they were not favoured in the Austrian policy debate on the CAP reform.

It is likely that productivity will grow during the next years and equally likely that structural adjustment will take place as well. However, in order to isolate the effects of the CAP reform from other developments, these effects were not accounted for.

To evaluate the income effects of decoupling direct payments from production (the corner stone of the CAP reform), model simulations are used to estimate the producer surplus. This indicator measures revenues minus variable cost (equivalent to the gross margin at sector level). The underlying results were obtained at the level of nine federal states and aggregated at the national level.

**Full decoupling of direct payments and its effects on income, inputs, and output**

The producer surplus of three different price scenarios was compared to a reference situation, followed by computing percentage deviations (Table 2). The reference situation is defined as the continuation of the Agenda 2000 Reform (agreed upon at the 1999 Berlin Council). This reform is not yet fully implemented because several modifications of the milk market regime are planned to be applied only in 2005. The reference scenario also needed to be simulated, with the consequence that the findings are comparisons of simulations.

*Table 2: Effects of the reform of the Common Agricultural Policy – complete implementation of decoupled single farm payment*

*Time horizon 2008-09, without additional funds from modulation*

	Expected prices		
	High	Medium	Low
	Percentage change versus continuation of Agenda 2000 Reform		
<i>Producer surplus</i>			
Agricultural sector	+ 1	± 0	- 2
Per hectare	+ 1	± 0	- 2
Per labour unit	+ 3	+ 2	+ 1
<i>Inputs</i>			
Variable cost of livestock production	- 6	- 8	≤ - 10
Variable cost of crop production	- 3	- 3	- 4
Farm labour	- 1	- 2	- 2
Arable land	- 4	- 4	- 4
<i>Output (volume)</i>			
Beef	≤ - 10	≤ - 10	≤ - 10
Other meat <sup>1</sup>	± 0	± 0	± 0
Eggs	± 0	± 0	± 0
Milk (within quota)	± 0	± 0	± 0

Source: WIFO calculations. Assumptions: 50,000 additional suckling cow premium entitlements are shared among owners of heifers. Additional funds for the program of rural development (€ 17 million annually) are not accounted for in the total of transfers. – <sup>1</sup> In the low-price scenario mutton production increases slightly.

The effects of the Fischler reform of 2003 on the income of the Austrian agricultural sector are within a range of +1 percent to -2 percent. The differences are due to different assumptions about farm commodity prices in 2008-09. More optimistic prices from a farmer's perspective (if output is reduced and demand behaviour remains unchanged) are likely to lead to more positive income effects. When the income change is related to hectares of agricultural land, the result is identical (because of the cross-compliance obligation to maintain land in good agronomic condition).

Comparing the incomes from livestock production before and after the reform best highlights the effect of the new CAP policy. Premiums which were previously linked to breeding of ruminants will be now linked to farm land. As a result, the incentive to produce cattle, sheep and goats diminishes substantially. Premiums formerly considered as an income component from livestock production are now income from "land management". This concept does not necessarily mean "crop production" since a minimum in land management operations is sufficient to comply with the most basic requirement. In the short run, this may not make much difference for farmers and many probably will not adjust their production because their income is held at a relatively constant level. In the long run, farmers may adjust to the new situation, in particular if they have to make decisions on investment, or retirement or how to use their labour most productively.

In the model, the producer surplus of a region – and therefore for the whole country – is maximised. By relating this income indicator to the number of hours spent for production, it is possible to estimate an average income per labour unit. The reform will reduce the demand for farm labour (by 2 percent), which means that structural adjustment will be slightly accelerated. Since the sector income from agricultural production falls less, income per labour unit increases even under low price expectations. In addition, modulation will make additional extra funds available to Austrian agriculture (Pröll, 2003). If structural adjustments are not accelerated, income might

still increase due to such additional support, although the extent depends on the choice of actual measures.

In each of the price scenarios, farm output declines due to decoupling. The output of beef is likely to be reduced by over 10 percent, although part of the reduction is due to lower prices. The reduction of output is complemented by lower costs of some inputs. The output of other livestock products will not change significantly (at a regional scale some specialisation can be observed). Crop output will decrease similar to the 4-percent reduction in agricultural land used.

The production of organic food will be affected to a much lesser extent. One important assumption of the simulations is that the agri-environmental programme will be continued unchanged during the simulation period. Decoupling will make farm production more extensive, and as a result, organic farming will become relatively more competitive. If the Austrian agri-environmental programme were not in place, crop output would decline even more.

Land use will change considerably once the reform is fully implemented. The share of arable land will decline and the share of extensively used grassland will increase. Because re-forestation of agricultural land is ruled out due to cross-compliance, the total acreage of agricultural land is kept constant. Without the obligation to keep land in production we would expect to see a considerable share of agricultural land gradually turn into forest land.

Due to the compromise of the Greek Presidency, member states have considerable room for modification within certain limits. These limits are defined by the fact that only small deviations from fully decoupling direct payments will be possible. Four of these options were investigated in the model analysis. According to the agreement of farm ministers, several of these options can be combined or implemented only at a regional scale. They were, however, analysed separately in order to show the isolated impact of each of these options. Future analysis work could include a regional differentiation.

### Partial decoupling of direct payments and its effects on income, inputs and output

*Table 3: Effects of the reform of the Common Agricultural Policy – partial implementation of decoupled single farm payment*

*Time horizon 2008-09, without additional funds from modulation*

	Option of partial implementation			
	25 percent of crop premiums	100 percent of suckler cow premium + 40 percent of slaughter premium	100 percent of slaughter premium	75 percent of special premium for bulls
Percentage change versus continuation of Agenda 2000 Reform (medium price expectation)				
<i>Producer surplus</i>				
Agricultural sector	± 0	+ 1	+ 1	± 0
Per hectare	± 0	+ 1	+ 1	± 0
Per labour unit	+ 2	+ 2	+ 2	+ 2
<i>Inputs</i>				
Variable cost of livestock production	- 8	- 5	- 6	- 6
Variable cost of crop production	- 3	- 3	- 3	- 3
Farm labour	- 1	- 1	- 1	- 1
Arable land	- 3	- 4	- 4	- 4
<i>Output (volume)</i>				
Beef	≤ - 10	- 8	- 10	- 7
Other meat <sup>1</sup>	± 0	± 0	± 0	± 0
Eggs	± 0	± 0	± 0	± 0
Milk (within quota)	± 0	± 0	± 0	± 0

Source: WIFO calculations. Assumptions: 50,000 additional suckler cow premium entitlements are shared among owners of heifers. Options are analysed separately. The supplementary refund is accounted for as the slaughter premium. Additional funds for the program of rural development (€ 17 million annually) are not accounted for in the total of transfers. – <sup>1</sup> In the low-price scenario mutton production is increasing slightly.

At sector level, partially decoupling direct payments has only a marginal effect on the farm income (Table 3). There are only two cases where a slight increase of ag-

gregate income can be identified. No difference can be found between incomes per farm labour unit among the four scenarios. The reason is that slightly more labour is needed in the two scenarios with income increases at sector level. Retaining 25 percent of the premiums linked to the production of arable crops leads to an increase of approximately 1 percentage point of arable crop output compared to the fully decoupled case. The effects on the output of beef differ between the scenarios in the livestock sector. The decline of beef production is minimised if the special premium on bulls and steers is not decoupled. In addition, the more premiums are decoupled, the less inputs will be purchased.

Farm commodity prices are not estimated by the model but given exogenously. The sensitivity results of Figure 2 show that the sign of the most important indicator (aggregate income) changes subject to price assumptions. Therefore conclusions about the effects of the CAP reform are fraught with uncertainties. If prices are more favourable from a farmer's perspective (as in *EC – DG Agri, 2003*), unambiguously positive effects on the incomes of Austrian farmers are possible.

With the exception of the farm income indicators, most other indicators are not very sensitive to price changes. In each of the analysed scenarios production will become more extensive, fewer inputs will be used, the share of arable land will decline, crop output and beef production will be reduced significantly, and structural adjustment will be (slightly) accelerated.

On 26 June 2003, the Greek Presidency achieved a compromise on the reform of the Common Agricultural Policy (CAP). Many details of the accompanying legislative texts have yet to be published. However, available documents (*Greek Presidency, 2003, Fischler, 2003B*) are detailed enough to allow for an estimate of the likely effects of the reform. Model simulations show that compared to a business-as-usual scenario (continuation of the Agenda 2000 Reform of 1999) the CAP reform

- will have only minor effects on the expected aggregate farm income;
- can be made to balance negative income effects from very low farm commodity prices by specifically tailored measures to be financed by additional funds (from modulation);
- will slightly accelerate structural adjustment (which means fewer people employed in agricultural production);
- will change the framework of production decisions significantly because farm incomes will become less dependent on premiums coupled to production;
- will lead to less intensive farming practices and reduce the output of arable crops and beef.

The results show that many of the concerns voiced by Austrian agricultural policy makers have been accounted for by the compromise. Compared to the European Commission's original proposal of January 2003, many effects are likely to better conform with the Austrian model of agriculture. This achievement is due to the following outcomes:

- Austria will get 50,000 premium entitlements for suckler cows (equivalent to an additional € 10 million annually),
- administrative prices will either not be cut at all (cereals with the exception of rye) or lowered to a lesser extent (milk), and
- Austria will get more CAP funds from modulation, the effort to strengthen the second pillar of the CAP (rural development) at the cost of the first pillar (market intervention).

The reform grants member states considerably leeway to design their own CAP version that will better meet their own vision of agricultural policy. The options available can be used to soften the decline of crop output (by retaining 25 percent of crop premiums linked to production). A likely effect of the reform will be a decline in the output of beef. By partly coupling some of the premiums (most effectively, the spe-

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## Discussion of the model's findings

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## Summary and conclusions

cial premium for bulls and steers is retained) some of the decline could be prevented.

The results presented in this paper focus only on a few elements of the CAP reform, in particular on decoupling and the modifications of the common market regulations. Several very important aspects (e.g., transfer of single farm premiums, the option to make additional payments for measures to protect and enhance the environment and to improve the quality and marketing of agricultural products) were not analysed, nor were options which are left to the discretion of member states (such as regional differentiation and/or introduction of uniform grassland premiums). The first results presented in this study suggest that effects are likely to vary between regional levels. In order to analyse such effects, the model used here needs to be adjusted. The impact of the reform is also contingent upon the new rural development programme (likely to be introduced in 2005) and other specific measures to be financed by the funds obtained from modulation.

If *full decoupling* were to be implemented, the CAP reform would have the following effects compared to continuing the Agenda 2000 Reform:

- *On aggregate farm income:* The outcomes are dominated by price effects which are difficult to estimate. In the event of relatively lower prices, farm incomes may decline by 2 percent. Such a decline can be compensated by funds from modulation. In the event of relatively higher prices, the aggregate income is likely to increase.
- *On income per farm labour unit:* Each of the scenarios shows that structural adjustment may be accelerated (less farm labour will be required for agricultural production). In terms of farm labour units, incomes should improve (slightly in the event of low prices). Consequently, alternative income sources (agro-tourism, self marketing, machinery coops, etc.) or employment possibilities in other sectors should be available.
- *On inputs:* Due to decoupling, less farm output is produced in a more extensive way. Consequently, fewer inputs are required. Production costs should decline, less farm labour may be employed and less arable land will likely be used for crop production.
- *On output:* If direct payments are fully decoupled, significantly less beef should be produced. Other livestock products are not much affected by the reform. The output of crop may decline in line with the reduction of arable land (organic products are affected to a lesser extent).

If *partial decoupling* of direct payments were to be implemented, the effects compared to continuing the Agenda 2000 Reform would be:

- *On aggregate farm income:* Two options of partially decoupling direct payments show positive income effects ("medium" price scenario), although these are very small. On sub-regional level, the effects could be more significant, but a further analysis is necessary to verify this assumption.
- *On income per farm labour unit:* Partially decoupling direct payments shows no effect on incomes per farm labour unit. Income increases at sector level are offset by more labour hours used for production due to less extensification.
- *On inputs:* Partially decoupling direct payments may decelerate extensification processes. Therefore more inputs are likely to be used (including farm labour).
- *On output:* Partial decoupling may lead to a relatively greater output of the product linked to the subsidy. This effect is greatest for bull and steer premiums.

Provided that the Austrian agri-environmental programme ÖPUL is continued, it may prevent organic production from declining at the same rate as conventional crop production. In general, ÖPUL has a stabilising effect on crop output: without this programme, crop output would decline even more.

Decoupling may have a major impact on land use. The share of arable land should decline while that of extensive grassland may increase. Due to cross-compliance

requirements, farm land might not be re-afforested. It is a condition to receive single farm payments and it might prevent any substantial change in the character of agricultural landscapes.

The findings corroborate the European Commission's expectations that this reform should enhance the competitiveness of the EU farm sector. Farm output is expected to decline, but average production cost may be reduced even more. Narrowing the gap between domestic prices and world market prices might improve the welfare position of consumers.

The European Commission aims to cut export subsidies in order to facilitate an agreement at the WTO negotiations of the Doha round. According to the model results of this study, the output of beef and cereals will be declining. Therefore, the incidence of export subsidies is reduced. Consequently, price signals from markets should improve allocative efficiency in the farm sector. However, since several farm commodities (olives, sugar) were exempted from the reform, distortions may even be aggravated in the short run.

The expected reduction of farm outputs (in particular beef and rye) will make adjustments necessary for many farmers. Those farmers that had invested in the production of these goods are facing considerable challenges. The single farm premium should guarantee a relatively stable cash-flow and therefore make adjustment better feasible without jeopardising farmers' livelihood. All scenarios show that structural adjustment will be slightly accelerated (labour is likely to decline by 2 percent until 2008-09). Given that, on average, farm labour declined at a rate of 2.7 percent (measured at annual working units) during the last decades this acceleration is comparably low.

According to the EU Treaty, the Common Agricultural Policy has the following objectives:

- increase agricultural productivity by promoting technical progress and by ensuring the rational development of agricultural production and the optimum utilisation of the factors of production, in particular labour;
- ensure a fair standard of living for the agricultural community, in particular by increasing the individual earnings of persons engaged in agriculture;
- ensure that agricultural commodities reach consumers at reasonable prices;
- stabilise markets;
- assure the availability of agricultural commodities.

According to the results obtained in this study the reform is consistent with the first and third objectives. Whether the second objective can be achieved by the reform is not yet clear. By linking the single farm premium to operators in the reference period of 2000-2002, individual earnings of "persons engaged in agriculture" are given a greater weight than the owners of land. However, in the long run, a second feature of the reform may be more important: the single farm premium subsidises "land in good agronomic condition" rather than "farm labour engaged in agriculture".

This subtle difference may have implications in the long run which cannot be analysed with the instruments used in this study. Along with this question, further efforts should be made to analyse the impact of the reform at regional level and, particularly, the consequences of a regime proposing to transfer single farm premiums between regions.

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## *The Reform of the Common Agricultural Policy*

### *Consequences for the Austrian Agricultural Sector – Summary*

On the 26<sup>th</sup> of June 2003 a compromise on the reform of the Common Agricultural Policy (CAP) was reached under the Greek Presidency. Model simulations for the Austrian agricultural sector show that compared to a business-as-usual scenario (continuation of the Agenda 2000 Reform from 1999) the CAP reform:

- will have only minor effects on the expected aggregate farm income,
- even in the case of very low farm commodity prices negative income effects can be balanced by specifically tailored measures which are financed by additional funds (from modulation),
- will slightly accelerate structural adjustment (which means less people employed in agriculture),
- will change the framework of production decisions significantly because farm incomes will become less dependent on premiums which are coupled with production,
- will lead to less extensive farming practices and reduce the output of arable crops and beef.

The results show that many of the concerns of Austrian agricultural policy makers have been accounted for by the compromise. Compared to the original proposal of the European Commission from January 2003 many effects are likely to be conforming better with the Austrian model of agriculture. This achievement is due to the following outcomes:

- Austria will get 50,000 premium rights for mother cows (equivalent to additional 10 million € annually);
- administrative prices will either not be lowered at all (cereals with the exception of rye) or lower to a lesser extent (milk) and
- Austria will get more CAP funds due to modulation, the effort to strengthening the Second Pillar of the CAP (rural development) at the cost of the first pillar (market intervention).

The longer-term consequences of the reform will be a more competitive farm structure, less people employed in agriculture and a pressure for further reforms (e.g., in the sugar policy). Price signals from world markets will become more important for the production decisions of European farmers. However, even after the reform the total expenditures for agricultural policy will not change, only its composition.