Acta Agraria Kaposváriensis (2005) Vol 9 No 2, 73-80
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Issues why the European agricultural subsidies were voidable in terms of decouplement

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ABSTRACT

The finance of the Agribusiness Industry is a highly criticised issue both on national and on international levels. Moreover, this will be one of the most questioned and negotiated key issues of the forthcoming WTO negotiations in Hong Kong. The developing countries continue to argue that the EU's agriculture subsidy system is not decoupled enough. This paper discusses the major origins of these arguments and seeks an answer to whether these arguments are correct. Also, it discusses the box system of the EU agricultural subsidies. Moreover, it tries to exceed the decouplement issue to the new agricultural point of view of the EU, namely the multifunctionality, and to show why this question can raise more arguments from the developing world against the Common Agricultural Policy (CAP).
(Key words: agriculture, subsidy, decoupled, green box)

ÖSSZEFOGLALÁS

Az európai agrártámogatások problémái a termelésfüggetlenséggel kapcsolatban
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Az agrár szektor finanszírozása erősen vitatott kérdés, mind hazai mind nemzetközi szinten. A WTO is különös figyelmet fordít rá, a soron következő honkongi csúcsnak ez a szakterület lesz az egyik központi témája. A fejlődő országok folyamatosan támadják az Európai Unió finanszírozási és támogatási rendszerét, amelynek legfőbb oka az, hogy nem piacfüggetlen és a piaci-mechanizmusokat erősen befolyásoló elemeket tartalmaz. A tanulmány legfőbb célja a rendszer előnyeinek, hátrányainak részletes bemutatása. Vizsgálja az Uniós agrár támogatások és a WTO „doboz rendszerének" (piros, zöld, sárga) kapcsolatát, röviden áttekintve az egyes dobozok paramétereit. Végül azt a kérdéskört is érinti, hogy vajon a mezőgazdaság multifunkciós felfogása és értelmezése miért adhat okot a fejlődő országok újabb támadásaira.
(Kulcsszavak: agárgazdaság, támogatás, termelés-független, zöld-doboz, KAP)

INTRODUCTION

The financial condition of the agricultural sector is a broadly discussed and highly debated issue; indeed, it is one of the most important items on the agenda of the current WTO negotiations.

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The focus of this paper is on the "greenness" of the EU's Agricultural subsidy system before the newly implemented SFP (single farm payment) system[1]. (The paper will not discuss the SFP system.) The study particularly will discuss the issues of the so-called "decoupled" payment and agro-insurance (farmer income, etc.) systems and it will debate the question: whether these support/ policy instruments were appropriate to the Green box's flag or whether the lack of neutral marketing resulted in the EU having to reallocated them under the SPF. Moreover, the paper will briefly discuss the issue and the awarding of the so-called Agri-Environmental Programs in the EU according to the "multifunctional agriculture" theory.

The paper proceeds as follows. First, it briefly examines the "box system" of agricultural finance, according to the Uruguay Round Agreement on Agriculture (referred to as the URAA in this paper), by highlighting the *Green box*. Second, it gives a short summary of the former EU agricultural support system under the previously introduced boxes with the limitation on the land and COP (cereals, oilseed and protein crops) payments. Third, it focuses on the issues of the decoupled payments and will discuss some of the theoretical problems from recent studies as to whether it was "*green enough*". Fourth, it will consider the insurance issues as well, and find the cardinal criticism against their "greenness". Fifth, it notes some controversial issues of the Agri-Environmental Programs.

DISCUSSION

The agricultural box system focused on the green box

To understand the question under discuss we recall briefly the box system of the *URAA* (1994). According to this agreement, agriculture finance in all WTO members, thus in the EU also, should follow the 3-box system: the Amber, the Blue and the Green box.
The *Amber box* encompasses those agricultural subsidies, which were considered to distort trade and to be an obstacle to the fair trade situations; however, these should have been reduced by 20% by 2000 ([2]*Walter and Trine,* 2001). These are, for instance, the product specific supports (based on administrative prices etc.).

The second category is the *Blue box* supports, which are implemented under certain production-limiting projects and programs, and which are exempt from reduction requirements (*Frandsen* et al., 2002). There are subsidies such as the headage or area payments, which have become less coupled during the CAP reforms, thus the EU wanted to qualify them as *Green box* subsidies, but they were still declared in the *Blue box* (*Beard & Swinbank*, 2001) by 2004, since the SFP reformed them.

Perhaps the most crucial question of the forthcoming WTO agricultural negotiations will be the issue of the rearrangement of these two boxes. Some agro-political groups would like to tighten the *Amber box;* however, there are members who would like to move the entire *Blue box* into the *Amber* box ([3]*Frandsen et al.*, 2002).

The third box is the *Green box*, which encompasses all those policy instruments which have *"no or at most minimal trade-distorting effects or effects on production"*

[1]The EU launched the SFP in 2004, which changed and reformed the concept of the CAP; information available: www.europa.eu.int/scadplus/leg/en/lvb/l11089.htm

[2]The time period encompassed originally the years between 1995- 2000 (*Walter and Trine* 2001**)**

[3]The Blue box policies were protected until 2003 according to the "Peace Clause", which expired at the end of 2003 (13. article of URAA, cit *Frandsen et al.,* 2002)

(*URAA*, 1994). Here are found policy instruments such as domestic food aid, direct payments, income insurance and income safety-net programmes, producer retirement programmes, agri-environmental programmes and decoupled payments etc. (*URAA*, 1994). According to the *URAA* (1994), all the conditions and specifications, which enable a policy to be declared as qualifying as a *Green* box category, are in the Annex 2. As for decoupled payments, there are five main definitions in the 6th paragraph, which declare the main features of a decoupled payment and define which subsidies are endorsed here.

The EU support system according to the *Box structure* before the SFP

Before the Uruguay Round the preferred policy instrument of the EU agricultural policy was the market price policy, which had to be changed after the Round in response to the *McSharry* reform in 1993. According to this reform, two types of direct payments have compensated farmers: area and headage payments (*Walter and Trine*, 2001). However, the Agenda 2000[4] modified the payment system, both the amount and the proportion. According to that structure, COP producer farmers had to decide between two different types of finance system: the so-called general scheme and the simplified scheme (*Frandsen et al.*, 2002). The basic differences between these are in the set-aside program[5] and in the connected support payments. In the simplified scheme, farmers were not requested to participate in the set-aside program, but received a "*non crop-specific payment".* However, those producers who preferred the general scheme had to set aside a certain percentage of the farmed area, but were able to receive a "*compensatory payment*" based on the amount of the land which was being set-aside, and also were eligible to receive the so-called "*crop-specific payment*" for the land which was being farmed (*Walter and Trine* 2001; *Frandsen et al.,* 2002). All EU member countries have their own fixed *"Member State basis"* which declares clearly the country's quota for payments under COP reasons. Naturally, if the county exceeded its own payments limit, the payments per hectare decreased proportionately. For example, in Hungary the Member State basis was 3.48 million hectare and the basis output is 4.73 t/hectare and the payment is 298 Euro/hectare for the year 2004 (*Szendrő, MARD*, 2004).

Although the structure, introduced above, was planned to be market neutral, and tended not to affect or just minimally affect the equilibrium, it was strongly criticized. Therefore the EU changed it and launched the SFP system in 2004. According to this regulation, the system may be more appropriate to the "Green box" declarations (*Europa*, 2004).

But why was the former system not appropriate on international level? Why was it so strongly criticised? In the following the paper will discuss these issues.

Problematic questions of the decoupled payments:

The first problem of the decoupled payments implementation may arise from the theoretical point of view. There is a significant difference between the two leading concepts. Namely, according to an *OECD* paper (2001), OECD has two possible readings of these definitions. It is possible to define an "*effective full decoupling*" and a "*full decoupling (in the restrictive sense)*" category. The basic difference between the two concepts is in their objectives. While the former highlights the equilibrium

[4]More inform about the Agenda 2000 available at The European Commission's homepage: http://europa.eu.int/comm/agenda2000

[5]More information about the set-aside program is available by the *OECD* 2001 reference

quantities, the latter is more focused on the adjustment processes. Consequently, in the first case the emphasis on a decoupled payment is that the equilibrium level of production and market should not change after applying the policy, if it is to be declared a decoupled payment. However, in the second case, the stress is more on the reaction to the policy, namely, not just that the market equilibrium should not change, but no outside shock should be caused by the system (*OECD*, 2001). Therefore, there must be a distinction between policy as influence and as design. Consequently, before judging a whether a policy meets the declarations of the decoupled payments, policy makers also should recognise the outside effects of the policy. It can easily happen, that although the policy has been designed to be production and market equilibrium neutral, it has an impact on another, unmeasured, factor in the market, which could lead to an increase in the production or an outside shock. Thus, decoupled policies should give more attention to their "market-environment" as well. This could be one of the reasons why some decoupled subsidies, which are launched, according to the URAA definitions in the EU, have received such a strong criticism among developing countries.

Connected to this theoretical issue, *Frandsen et al.* argues (2002), that decoupling policies should be evaluated on a broader level rather than just as single instruments, since they can have an impact on "*non-targeted*" commodities through cross-commodity effects. Therefore the second basic problem of the decoupled payment system's five declarations, given by the URAA, could be that they allow policy instruments to be treated as policy packages. However, as some experts suggest, these should be handled as single instruments instead of packages, because of fair trade reasons (*Gohin et al.*, 1999).

As this section has showed the first and basic problem of the decoupled issue is that there are differences in the theoretical concepts of understanding and interpretation, which are quite opposite to each other. Thus, obviously there are arguments in its implementation.

Does the "expectation mechanism" cause payments not to be decoupled?

Farmers' investment decisions and production depend on three main issues, which are interconnected: 1, recent policies; 2, expectations about the future policies; 3, risk aversion. Theoretically in a given perfect market, where the policy instruments are explicitly decoupled, farmers will have a quite steady investment and production level and strategy, so the market equilibrium presumably will not change. However, markets tend to be imperfect. Therefore, despite the strictly decoupled payments, farmers will not be able to make clear decisions between investment and production or consumption, and the policy will affect the level of the production. Thus, it will become coupled instead of decoupled. Consequently, because of current policies, the farmer's expectation will change also, as the risk effect increases. It is like a "domino effect".

The expectation factor has also another issue, which is interconnected with decoupled payments. If farmers think future payments and supports – like the income support under the URAA *Green box* – depend on former production levels, they will still increase production because of the "*expectation mechanism*" (*Frandsen et al.*, 2002). In other words, farmers will expect the government to update the basic production level of the payments; consequently, the current production will determine the future subsidies. Thus, the current production should increase to guarantee a higher future payment (*OECD*, 2001). Moreover, the briefly explained COP payment system was definitely not separate from the current production but directly linked to it because of the farmers expectation, since it stimulated farmers to farm on larger areas than they normally would. It is important to highlight that those rules did not require farmers to harvest the reported field, just to sow it. Consequently, the final decision of the production depended just on the cost of the harvest (*Frandsen et al.*, 2002).

In other words, although the EU decoupled payments met the *Green box* declarations, they could have been criticised as not “green enough” due to the expectation mechanism of farmers. Since farmers will increase their production level with the hope that the payments will also rise, these seems to be interrelated. Therefore, the decoupled subsidy structure might become coupled instead of adhering to the initial design.

The income and crop insurance systems and their criteria

As was mentioned above, the risk-aversion of the farmers also is a highly problematic issue. Agricultural production contains a wide range of risk factors anyway, such as weather and water or technological problems etc.; therefore, policies should aim to minimising the risk of production. If policy failures increase the income risk-aversion of farmers, they will try to change the production level as an automatic survival mechanism. Thus, policies must try to launch instruments that are able to secure farmers’ income level. However, these instruments must also meet the URAA declarations. Moreover, this issue is very sensitive, as the position of farmers is highly related to their production.

In the Annex 2, there are two paragraphs that deal with the “insurance” concept: the 7th which is focused on “income insurance and income safety-net programmes”; and the 8th which deals with the “crop insurance schemes” (*URAA*, 1994). According to *Rude* (2001), there are two main justifications of these programmes. The first is a simple economic theoretical issue, explained by the market failures, saying that the contingency markets[6] force farmers to deal with production and price risk. The second point of view is a resource reallocation, so these kinds of programmes are originated and based on income reallocation to the farmers from the industrial sector. *Rude* also argues (2001) the redistribution is not the same across time and across individuals, which is an interesting concept. He also claims that as the objectives of the two points of views are so different, it is difficult to develop standard criteria for these programmes.

To insure farmers’ income, either the policy creates a “*missing market*” or tries to raise a bridge system between good and bad income periods. Consequently, these policy instruments are not neutral for the market, and can have a strong influence on the equilibrium; however, they should be decoupled under the URRA. The income insurance policies are extremely strong instruments, and to decouple them from production decisions is not so straightforward, since they are designed to affect producers’ behaviour according to market failures. Moreover – as *Rude* claims (2001) – if an insurance policy compensates for bad periods but does not tax in good times, it will automatically raise the income level and stimulate a gradual rise in the production. Therefore, the criteria contained in paragraph 7 are very important. These exclude the possibility of distortion and place strict limits on the amount that can be used for these programs. Also, a criteria which, for instance, declares that income safety payments must be related to income and not to price or level of production, limits the possibility of a market distortion effect and makes the policy more neutral (*Rude*, 2001).

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[6]More information about contingency market issues available at Contingency Analysis http://www.contingencyanalysis.com

Then, again, policies can achieve risk reduction by forcing and improving diversification in the production and by adopting new technology. In this case, to reach the aim it could be helpful to connect the policy with a credit policy, as has been done in Hungary, for instance (*MARD*, 2005). However, the information channels must be clear between the policy makers and the farmers, because if the flow of the information is not secure and appropriate, although the aims are right and decoupled, the outcome may be different than intended.

Crop insurance programs are also criticised as not being decoupled enough. This criticism originates from theory that these programs may encourage farmers to farm on fields where the production risk is higher (*Rude*, 2001). Consequently, although the production at that field will be naturally poorer than in the areas that are more appropriate for crop production, the aggregate level of production can increase. Moreover, there is an argument whether these programmes encourage the aims of the agri-environmental feature of the EU agriculture. According to *Rude* (2001), there are two researcher groups who are arguing directly the opposite of each other. Whereas, cited by to *Rude* (2001), *Horowitz & Lichtenberg* stated that crop insurance programs lead to an increase in the use of pesticides and fertilisers, *Smith & Goodwin* concluded exactly the opposite of this theory (*Rude*, 2001). Thus, in the former theory, the policy will result in an increase in the production level, the latter will decrease the current production, so from this point of view the system seems to be more neutral and acceptable.

As can be seen, the issue of the insurance policies, which play a significant role in the CAP, has not settled down yet, and has been widely criticised. The policies are strongly objected to in both theoretical and implementation concepts. However, this kind of support for farmers is vital to enable them to participate in the market system and to produce on a steady level[7].

The issue of the agri-environmental programmes

As was mentioned above, improved diversification is also a good method to increase the safety of the farmers, and it is decoupled and based on the URAA Annex 2, also. This idea, additionally, fits well into the "multifunctional" theory of European agriculture. Environmentally friendly agriculture, which puts less pressure on nature, is also a highly debated issue. Although environmentally friendly production is widely accepted, there is strong criticism against the EU's "multifunctional" idea, which contains those elements.
In the URAA Annex 2, the 12th paragraph particularly deals with environmental programmes. Albeit EU launched its agri-environmental policy according to those determinations, this policy is strongly criticised by the developing countries as being just an "umbrella" and "excuse" for a hidden and not decoupled subsidy system (*Glebe*, 2003). There are even voices which, although agreeing with the aims of the EU's agri-environmental policy, call it just a "*new label and trick*" of the European agro lobby "*to do business as usual and to hide protectionist policies behind*" this title (*Mahe*, 2001). Moreover, according to *Glebe* (2003), the payment scheme before the SFP did not lead to an improvement in the landscape and biodiversity, although one of the main aims of the environmentally friendly and multifunctional system is to improve these and analogues factors. In addition, there was another reason why these programmes were widely discussed, namely in the EU countries farmers were given a premium for using

[7]During my research I could not find any new declaration about income insurance projects in the SFP scheme.

fewer chemicals, rather than tax incentives, which makes it a somewhat controversial paradox (*Glebe*, 2003). However, *Latacz-Lohmann and Hodge* argues (2001) that although the agri-environmental policies may have more than minimal effect on the production and trade, they do not contradict the fair trade requirement agreements even though they are not 100% decoupled.

As this section showed, the idea of “multifunctionality ” is strongly objected to, also, and criticised as being just an extra “excuse” for the coupled and non-market neutral support system of the EU. However, this issue will play a major role in the CAP system in the future as environmental and conservation issues are getting to be more and more important within the EU.

CONCLUSIONS

We have seen that the EU’s subsidy policy before the SFP was highly debated among the professionals as to whether it was appropriate to the context of the URAA and its box system. Moreover, it was directly questioned whether the policy could have been defended and justified in the long term.

The system before the SFP was widely criticised. Firstly, there was a basic theoretical argument among professionals since the idea of decoupling can be reflected from two different points of view, according to the URAA declarations. Secondly, according to the quoted professionals in the paper, the policy may did not pay enough attention to the farmers’ “expectation mechanism", and, therefore, it became coupled and led to market distortions. Thirdly, there were papers, which recommended the restructuring of the whole Green box system and argued that it just operates as income insurance for the farmers in the industrialised countries, and pushes the developing countries into an even worse and more unfair market position. Finally, the EU’s Agri-Environmental concept also is strongly criticised as being just an extra “excuse” for not decoupling payments. In addition, there is no consensus among European professionals about the agricultural finance, but it is agreed that the CAP is vital for European Agriculture.

In the view of all these criticism and issues, it is not surprising that the EU changed its CAP and launched the SFP. However, whether the SFP will be more accepted among countries at the international level is still an issue.

ACKNOWLEDGEMENTS

I would like to thank Professor Alan Swinbank from the University of Reading for his professional support, and, also, the Chevening Scholarship for its financial support which furthered my work at the University of Reading.

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