The Common Agricultural Policy

Options for reform and their potential impact

UK FOOD GROUP

sustain
the alliance for better food and farming

Background Briefing 2

Introduction
The UK Food Group and Sustain are calling for a more sustainable and equitable agricultural policy for the European Union. In support of this work, the UK Food Group and Sustain commissioned the Institute for European Environmental Policy (IEEP) to produce a briefing paper outlining the main reform scenarios for the Common Agricultural Policy (CAP) and their impacts on key stakeholders: consumers, small farmers, developing countries and the environment.

Other briefings in the CAP series include, *Background Briefing 1: The Common Agricultural Policy: How the CAP operates, the key commodities, competitors and markets for the European Union.* (UK Food Group/Sustain 2002)

UK Food Group
The UK Food Group is a network of non-governmental organisations from a broad range of development, farming, consumer and environment organisations, who share a common concern for global food security. Through raising awareness of the impact of globalisation in food and agriculture the UK Food Group seeks to promote sustainable and equitable food security policies. The priority areas of action are trade policies, sustainable agriculture and the regulation of food and agriculture transnational corporations.

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Sustain: The alliance for better food and farming
Sustain represents over 100 national public interest organisations working at international, national, regional and local level. Sustain's aim is to advocate food and agriculture policies and practices that enhance the health and welfare of people and animals, improve the working and living environment, promote equity and enrich society and culture.

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This background briefing has been funded by ActionAid, Christian Aid, CAFOD, Methodist Relief and Development Fund, Oxfam (GB), the Rowan Trust, RSPB, Save the Children Fund (UK), RSPCA and the European Commission under its programme to raise public awareness of development issues.

July 2002

Contents

Introduction

An important feature of the variety of reform proposals that has been made, is in the level of detail that they include. In general, those organisations and interests that have traditionally taken less of an active role in campaigning for CAP reform tend to call for a fairly crude set of changes – eg reduced prices to consumers, less protection for producers – without specifying how these changes should be achieved through the modification of policy instruments. By contrast, those who have become more embroiled in the policy development process may make highly detailed sets of recommendations for future policy (eg demands for 25% of the future budget to be spent on agri-environment measures, calls for suckler cow premia to be increased, proposals to switch livestock headage payments to area payments). Overall, most groups have not articulated a fully developed 'alternative policy package', although some NGOs such as Birdlife and the European Environmental Bureau (EEB) are attempting to do so.

For these reasons, this paper does not include an exhaustive documentation or analysis of all proposals for CAP reform and their likely impacts on small farmers, developing countries, consumers or the environment. To do so would require us to make many assumptions about the desired details of the various reform proposals, in order to discuss their impacts in each case.

Instead, we have opted to group the main types of reform proposal into broad 'archetypes' or models that represent the most clearly-defined short or longer term options for the future, and to undertake our impact analysis in relation to these. In so doing, we will lose some of the interesting potential effects of certain more detailed proposals (eg in relation to specific individual policy instruments within the broad CAP package), but we will be able to undertake the impact analyses with a much greater degree of clarity.

The background to CAP reform

In recent years, the volume and variety of proposals for further reform of the CAP have increased. They have come from Member State governments, from the European Commission (EC), from farmers' organisations and from an increasing number of NGOs, particularly those working on environmental and consumer issues.

In the main, recent proposals for further CAP reform arise from concerns about the following issues and developments.

- The budgetary and market impacts of the planned enlargement of the EU to embrace central and eastern European countries (CECs), as these countries have potentially highly productive agricultural sectors which have a far lower level of support than that in the existing EU. Put simply, some existing Member States (eg Germany, the UK) are not prepared to consider supporting the agriculture of countries such as Poland to the same extent that their own domestic agriculture is supported, as this would entail greatly increased EU spending on agriculture and much larger Member State contributions to the EU budget. However, the principle of the single European market means that it would be difficult to sustain unequal treatment for farmers in CECs compared to those in the existing Member States, for any significant length of time following accession, so it is argued that the CAP itself will have to change, to enable accession.

- The environmental impacts of the current policy, which is widely seen as a hindrance to the promotion and expansion of less intensive and more sustainable farming systems across the EU and which has undoubtedly had a role in encouraging unsustainable resource use in agriculture, in recent decades (UKFG/Sustain, 2002).

- The forthcoming round of World Trade Organisation (WTO) negotiations and the intention to negotiate a new agreement on agriculture which should take further steps towards liberalisation in agricultural trade. Although the EU's starting point for these discussions is that it has already made significant moves to liberalise its markets through the Agenda 2000 reforms, many commentators predict a need for European policy to accept further reforms as part of the negotiation of a new settlement. This pressure is intensifying with the expiry of the 'peace clause' on the substantial blue box element of the CAP at the end of 2002, and the aggressive stance being taken by the Cairns group and other exporters, in the run-up to the new round.

- The failure of the CAP to protect 'small family farms' from continuing economic pressures to enlarge, specialise and industrialise, with consequent rapid decline in the farm population in both productive and marginal areas.

- Food scares and reduced consumer confidence in agricultural products and production methods, especially in north west Europe.

In addition, some groups and sectors have long called for more radical and fundamental reform of the CAP on more basic grounds related to liberal economic theory and the alleged costs of 'protection' as opposed to free markets, including the supposed costs of the policy to consumers. These groups include some consumer organisations, many agricultural economists worldwide, and key international organisations such as the Organisation for Economic Cooperation and Development (OECD), as well as the Cairns group of agricultural exporting nations which are active within the WTO.

So, the underlying impetus for reform comes from several quite different critiques of the CAP, whose motives do not necessarily dovetail in any particularly clear way. For some, the key consideration is to ensure that the policy does not cost domestic taxpayers too much money while still providing support to the farming sector. For others, it is to remove any incentives to farm in ways which damage the environment and to provide more incentives to produce or maintain environmental goods and services. For a third group, it is to encourage a more explicitly 'small is beautiful' sustainable agriculture sector, with smaller family farms producing high quality goods for mainly local markets and continuing to employ a significant number of people and make a significant contribution to rural communities. One strand in the environmental and sustainability camp explicitly supports organic farming as a central feature in achieving these aims. For a fourth group of reformists, the goal is to demonstrate further moves towards the removal of the most 'trade distorting' elements of the policy – notably, export subsidies and import taxes. Finally, for those who oppose the CAP on free market grounds, the key aim is to reduce protection overall – that is, including any domestic support which effectively subsidises producers' costs, as well as import tariffs and export subsidies.

Proposals for reform

Three models of reform

1: 'the modified status quo'
= A further decoupling of first pillar aids and market support regimes and significant reduction of export subsidies and import tariffs, but no significant shift of resources out of first pillar measures.

2: 'The Cork model'
= A significant shift of existing CAP resources from first to second pillar through modulation, degressivity or more ambitious systems such as 'bonds' applied to first pillar aids and market support regimes, and significant enlargement of spending on rural development and environment.

3: 'radical liberalisation'
= A significant net reduction in support to the agricultural sector involving a major reduction in direct aids and in market support but without an explicit, corresponding increase in aid for other purposes (eg environment and rural development) and the use of much less interventionist policy mechanisms for the sector as a whole.

Model 1: 'the modified status quo'
This model concentrates the process of reform on meeting WTO goals to reduce 'amber box' forms of protectionist policy which still apply to many CAP sectors, thereby enabling the EU to respond to pressures to cut export subsidies and import tariffs.

It would involve reform of the dairy, sugar and olive oil regimes to cut guaranteed prices to these producers and would enable the removal of production quotas in dairy and sugar as a consequence. In those regimes which have already become 'partially decoupled' – ie arable crops and beef and veal – it would continue this process by reducing guaranteed prices to world market levels. However, these reforms would not require the removal of direct payments to producers, and it is likely that in those regimes where direct payments do not already exist (eg dairy and sugar), they would need to be introduced as 'compensation' in return for cuts in guaranteed prices. In the longer term, in view of enlargement, it is unclear what would happen to direct payments but it is theoretically possible that the enlargement countries could successfully demand such payments for their own producers.

As the Agenda 2000 reforms introduced a new ability for the application of environmental cross-compliance to all direct payments under the CAP, this model would provide scope for a form of 'greening' of the policy in that environmental conditions could be applied to an increasing array of the direct payments on offer to different producers. In view of wider developments in EU policy it seems likely that cross-compliance would be more widely used than it has been to date, under this scenario.

Key outcomes
- The EU could greatly reduce its use of export subsidies and import tariffs for the major sectors;
- EU producers would still receive support for producing food but the level of that support would be less directly dependent on current output. However, it would probably be based largely on the area of land farmed, potentially with some 'ceilings' on support for the largest producers. (This is more likely to happen in some Member States than others, eg by using modulation of direct aids, as allowed for in the Agenda 2000 reforms – see UKFG/Sustain 2002.)
- The cost of the CAP to taxpayers would increase significantly, while, in principle, the cost to consumers (processors and retailers) would fall;
- The main mechanism for pursuing environmental goals via the CAP would be through cross-compliance conditions attached to direct payments and through the existing requirement that these payments should not undermine or contradict 'environmental protection requirements' (eg the requirements of EU environmental legislation);
- There is unlikely to be a significant increase in resources devoted to second pillar measures (targeted funds for rural development, farming in marginal areas, agri-environment) since the first pillar would remain so costly;
- There would probably be a continued decline in small farms through competitive pressure within the single European market and increasingly with world market competitors, as tariffs reduce;

- 'Export dumping' using export subsidies would cease, but since EU producers would still be supported by direct aids, they would continue to have a competitive advantage on world markets.

Proponents of this model

- Member States who are basically supportive of the CAP and anxious to protect their own farm sectors in a relatively established way (potentially France, Benelux, Spain) have some sympathy with this approach although it would nevertheless represent a much more radical change than some would prefer (see Conclusion).
- Some major farmers' organisations (eg COPA), although they remain unhappy about the use of cross-compliance on direct payments;
- Some interests within the European Commission for whom it offers a potentially simple response to WTO issues and a potential simplification of CAP policy instruments, as direct payments are gradually harmonised between regimes (eg adopting a standard direct payment for all arable crops, over time, and then transforming livestock headage payments into area payments, to increase decoupling and simplify administration, leading to a unified area payment on all land);
- Some consumer interests, since it would meet their immediate concerns about removing price supports and quotas and food prices should fall, in general;
- A minority of environmental interests who are unconvinced as to the value of second pillar aids and whose primary concern is to increase the use of environmental cross-compliance to constrain negative CAP impacts upon the environment.

Model 2: 'The Cork model'

This is the model essentially underlying the vision expressed in the 1997 'Cork Declaration' on future rural policy in Europe. It involves the gradual transformation of the CAP from a policy focused upon support to the agriculture sector for production and market reasons, to a policy focused upon support to rural areas (predominantly to farm businesses, emphasising farming's role in this), and given for explicit social, rural development and environmental goals. This would entail the reduction of all support given to farmers under the existing production 'regimes' (full decoupling) and its replacement by a raft of policies for environmental management, marginal producers, and the stimulation of rural economies through training, investment and diversification aids. However, a variety of mechanisms has been proposed for achieving this shift in resources from first to second pillars.

Under compulsory modulation, which would be a development of the current voluntary provisions, Member States would be required to make cuts in direct aids to producers and to use the savings generated in their rural development programmes under the second pillar. Under Agenda 2000, modulation was introduced as an option for Member States to use if they so desired, and the UK, France, Portugal, Germany and the Netherlands have all taken up this option or are proposing to do so by 2003. Currently, modulation money can only be used for agri-environment, marginal farming, farmland afforestation and early retirement aids under the second pillar, but this restriction could be lifted.

Importantly, modulation can be applied in a progressive or a neutral way. Member States can use it selectively to cut aids to the wealthiest or largest producers and exempt smaller producers from the cuts, or they can choose to apply it equally to all farms as a standard proportion of the aids they receive. Different interest groups place very different emphasis upon their preferences for using modulation in one or other of these ways. With progressive modulation, it would in theory be possible to attempt to redress some of the current distributive effects of CAP payments which favour larger producers, by cutting their aids much more significantly and protecting aid to smaller farms. However, some critics of this tactic argue that if applied to any significant degree it would simply encourage 'paper splitting' of farm businesses rather than applying a brake on pressures to enlarge and shed labour. As the UK has implemented modulation in a 'standard' way while France is applying it 'progressively', lessons from these early implementers are likely to be valuable for the longer term.

Under degressivity, progressive cuts in direct aid to producers would be made centrally by the EU, in stages over time, and funds reallocated centrally to the second pillar budget. It is potentially possible for these cuts to be made in a progressive or a neutral way – as with modulation – but it seems administratively unlikely that a progressive method would be adopted and simple, across-the-board percentage cuts in direct payments applying to each regime are more likely.

Under bonds, the basic method for removing first pillar aid would be to offer farmers a one-off compensation payment rather than direct aids over a continuing period, in return for cuts in guaranteed prices for different commodities. Certain influential agricultural economists (eg Tangermann (D), Harvey (UK)) favour this option over direct payments because it gives a 'once for all' measure and thus avoids governments getting locked in to continuing compensation which itself becomes a form of producer subsidy.

Of these mechanisms, modulation or degressivity are already potentially applicable to those regimes which already offer direct payments to producers (eg arable, beef, sheep) but in order to apply them to market-supported regimes (eg dairy, sugar) you would first need to undertake further decoupling, as described under Model 1. Bonds offer the advantage to these regimes that they could be introduced as an alternative to direct payments, but in respect of the arable, beef and sheep sectors the direct payments would have to be ended, if bonds were introduced.

(nb as adjustment mechanisms, both degressivity and bonds provide means to cut the size of the first pillar of the CAP, but do not necessarily require the savings to be used to fund the second pillar. In the case of the 'Cork model' of reform, it is assumed that they would be applied with an explicit commitment to increase resources simultaneously for the second pillar, on a similar scale to current first pillar spending).

Key outcomes

- The existing CAP budget would be largely sustained;
- Very little of this would be spent on classic forms of market support and there would be a reduced internal market need for export subsidies or import tariffs, assuming that EU prices fell to nearer world market prices (as has been seen with wheat);
- Rural businesses (mainly farms) would receive relatively significant sums of money to manage the environment, to keep farming in marginal areas, and to develop and diversify their enterprise mix and sector coverage, as well as assistance with skills development, provision of infrastructure and marketing and processing investment;
- This could effectively give a sufficient level of income support to allow agricultural production to be higher volume or lower cost than without the policy, but the effects are likely to be weak, non-uniform and much less trade distorting than the support regimes that they replace;
- Second pillar aids will target farm businesses in quite a different way to first pillar aids, so there are likely to be large 'gainers' and 'losers' from the policy shift, by comparison with the current pattern of support;
- There would probably be a reduced level of EU production of many significant commodities, particularly those which are currently most heavily supported (eg dairy, oilseeds, wheat, beef, sugar and wine, as well as minor crops like cotton and rice unless these became explicit targets for agri-environment schemes). This would lead to reduced up- and downstream employment in the sectors closest to production. However, agri-environment and rural development schemes may generate new alternative rural employment and in the food processing sector, there could be increased employment opportunities particularly in large agro-industries who may be able to source their raw materials more cheaply.

Proponents of this model

- Most of the environmental NGOs active in the debate in Europe (eg Birdlife, EEB), among whom there is a general view that rural areas need more resources available for environmental management and the protection of marginal areas while at the same time removing incentives to intensify agricultural production. It is argued that by decoupling funds from production and 'recoupling' them to the explicit provision of environmental and social goods and services, public money would be more effectively used to produce 'public goods' and the market could be otherwise left to determine patterns and intensities of production, subject to environmental and other regulation;
- Some farming and landowning interests, for whom this scenario represents the most durable long-term way of ensuring that rural areas remain a significant target for future EU funding and support, on the basis of a new 'contract with society' in which they generate the goods and services that the public requires but which are not reflected in conventional markets for food and other products. The European Landowners Organisation and certain smaller farmers' organisations have tended to take this position. (ELO, 2001);
- Several of the 'reformist' Member States' governments broadly subscribe to this view of the desirable future direction of EU policy – notably the UK, Sweden, Denmark and Italy. The former French socialist government and the German social democrats have also expressed some support for this view, but there remain

strong opponents of their positions within their own countries who may be more or less influential in the longer term. However, with all governments in this group, there is a variety of assumptions implied about the scale of the shift of resources needed from first to second pillar. Among some governments (most notably the UK) there is a clear assumption that more money would be cut from the first pillar than would be diverted into the second pillar – producing a significant net saving on CAP spend overall.

In contrast, for other governments (notably France) the implicit assumption is that second pillar spend would fully replace first pillar spend, retaining a substantial CAP budget devoted to rural areas. The German government is particularly schizophrenic on this point – its treasury wishes to reduce CAP spend, but its strong farming lobbies and rural ministers tend to imply that support for rural areas in Germany must be maintained.

Model 3: 'radical liberalisation'
This archetype is the classic preserve of the mainstream market liberalisers, both in academia and among the export-oriented governments of the Cairns group. It sees the reduction of production support as the primary goal of CAP reform, in order to allow markets to determine a 'more efficient allocation' of resources and to set prices for agricultural goods and services. As such, the proposals involve cutting all guaranteed prices to world market levels and removing export subsidies, import tariffs and quotas on production, as well as removing all direct aid to producers that is even partially linked to production and can thus be said to be 'trade distorting' (full decoupling).

In relation to the WTO categories of aid, it would entail removal of all amber box support, removal of all blue box support and potentially, curtailment of some kinds of green box support if these involved substantial and clear effects upon producer costs. As with the 'Cork model' , this model would have to be applied using one or more of a variety of mechanisms to decouple or remove first pillar supports, which could include degressivity and/or bonds. However, under this option, there would be no related, explicit commitment to 'grow' the second pillar, and indeed any aids under the second pillar would have to be justified and funded independently and in ways which could be demonstrated to cause minimal 'trade distortion'. Proponents of this model would be likely to seek to avoid the kinds of agri-environment payment that, for example, supported extensive pasture management by grazing with livestock across large areas of the EU, on the grounds that this effectively subsidises livestock producers in Europe who are then able to sell at reduced prices by comparison with their international competitors. However, they would be less likely to criticise environmental policies which involved paying targeted groups of producers for specific benefits such as managing wetland areas for particular, threatened species of bird or plant.

Key outcomes
- Export subsidies and import tariffs would cease, and EU prices would settle at or near world market prices. This implies some greater price instability in the EU than at present, although world prices might become more stable due to the greater scale of EU influence upon them;
- In marginal areas of Europe, land prices would fall and depopulation might accelerate;
- Cost-cutting would be an imperative for survival, particularly in export-oriented sectors (eg dairy);
- As production support is dismantled, there is likely to be a major phase of structural adjustment on EU farms including enlargement and the shedding of labour particularly in those regions where current farm sizes are small and relatively 'inefficient' in classic economic terms.

Proponents of this model
- The majority of UK agricultural economists and some of their colleagues in other EU Member States;
- The governments of the Cairns group of exporting nations (Australia, New Zealand, Canada, Brazil). While in the run-up to the next WTO round most of these parties are focusing their attention on eliminating amber and blue box supports, it is generally accepted that if the EU were to shift very large sums of money into green box second pillar aids, these would also be a target for continuing criticism as 'disguised production support' (as is the case for the USA, currently);
- Some leading figures in the UK food industry (eg Lord Haskins) believe that agriculture should no longer be supported to a far greater extent than other industries, and this generally translates into a call to dismantle the CAP. However, in general, the interests of the food industry are in the removal of price supports, tariffs and production quotas, and they tend to be relatively silent or broadly supportive in relation to the 'second pillar'. Hence it may be unfair to assume that they would generally favour this model over the alternatives presented above;
- Some consumer organisations and some organisations who seek to represent developing countries, although many are unclear about how the CAP should be reformed in order to promote development considerations and thus the above comments in relation to the food sector may also be relevant here;
- A minority of environmental NGOs remain unconvinced as to the merits of the second pillar measures of the CAP and thus would subscribe to the tactic of calling for the removal of the CAP as the first priority, on the basis that this would do more environmental good than harm. Beyond this they would probably recognise the need for management resources for environmental purposes but may feel that this could more effectively be done without the mechanisms and politics of the CAP.

Potential impacts of reform

The three main reform models all involve reforming the current mix of policies so that the EU can largely phase out the use of export subsidies and import tariffs – the most visible 'trade distorting' elements. This reflects the fact that the EU is already committed to reducing these kinds of support and the Commission's trade negotiators are talking about further reductions as part of the next agriculture round in WTO.

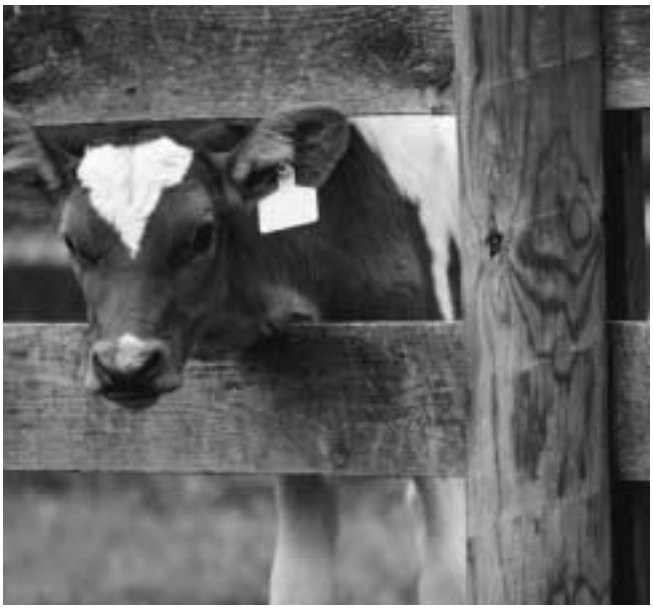
Where they vary, is in how they choose to support agriculture in the EU. In Model 1, the 'modified status quo', the majority of support remains tied to production sectors and thus linked to production patterns, implying a still evident trade distorting impact. In Model 2, support is given to environmental managers and marginal farmers, as well as those who develop their businesses and benefit the wider rural economy. It will affect production choices and relative costs but in a much less uniformly trade-distorting way – some aids could even be seen as a brake on production. In Model 3, the overall level of producer support is envisaged to be significantly lower, so trade distorting effects should be minimal but structural effects on the agriculture sector in the EU would be considerable.

The likely impacts of these three models on consumers, small farms, developing countries, and the environment are discussed below.

Impacts on consumers

Under all three models, reforms would include the reduction of EU guaranteed prices to world levels, across most of the EU regimes where these currently apply. Thus market prices within the EU for key commodities/raw materials would fall, particularly for milk and milk products, sugar, cereals and oilseeds, beef and veal, olives and wine. World market prices might rise slightly because of the elimination of export subsidies on these products. However it is important to remember the following factors:

- A variety of economic estimates suggest that food prices could fall by a significant amount if EU prices were no longer artificially supported by the CAP. However most of these studies assume that the full extent of any price cuts would be directly reflected in food prices in the shops.



- Most ‘consumers’ of the raw materials produced by farming in Europe are not individual families and households, but food distribution, processing and manufacturing companies. Thus while these organisations would benefit immediately from lower prices for their raw materials, there is no automatic guarantee that the price cuts would be passed through to consumers, particularly in those commodities subject to the longest processing and manufacturing chains. These would include dairy products and sugar, of which a significant proportion undergoes secondary or tertiary processing (eg milk – butter – ingredient in confectionery, biscuits, ready meals, etc).

- In relative terms, household expenditure on food as a proportion of total spending has decreased significantly over recent decades, and food today takes less than 20% of average household incomes. In addition, a growing proportion of food is now eaten out, rather than prepared at home, and consumers eat a much higher proportion of processed and manufactured foods than they used to. Thus a higher proportion of their spending on food goes on the costs of processing and retailing (including restaurant service, etc) than used to be the case, reducing the scope for agricultural price cuts to affect consumers’ everyday budgets.

Farmers' organisations claim there would be a fall in the quality of food available to consumers without EU barriers, since production standards outside the EU are alleged to be lower than those within it. This is a contentious point requiring judgement about production conditions, the use of inputs, health and environmental legislation, enforcement of standards and other factors in a range of countries.

There is some evidence of lower standards, including higher levels of pesticide residues in certain imported fruit and vegetables. However, in a recent study for DG Agriculture covering the US, Canada, Australia and New Zealand, it was found that the evidence for many such claims is relatively thin. One exception was farm animal welfare where it appears that the EU’s production standards are generally higher than these exporting nations. There are other cases where EU standards are higher than in the US, particularly in the livestock sector. Examples include the regulation of GMOs, the use of antibiotics and hormone treated meat. In principle EU standards might still be maintained through Community legislation, in such a way as to prevent market access to these products inside the EU on human health grounds.

Under Model 1, EU production would remain high because support would still be related to the area of land or number of livestock used in farming. Thus distribution, processing and manufacturing patterns are likely to remain similar to the present, and consumption patterns may not alter greatly. At the same time, EU consumers would be paying through their taxes to support the costs of the policy. If compensation payments had been introduced in all the main sectors where minimum guaranteed prices formerly applied, the total costs of the policy could be significantly greater than at present, particularly if enlargement led to the eventual extension of these payments to producers in the applicant countries.
Under Model 2, EU production might fall in some areas (especially in oilseeds, cereals, beef, sugar) and imports would make up a larger share of domestic processors' supplies. Funding should enable the environmental and social services provided by rural areas to be maintained and the policies might provide additional support for regional products, organic food, branding and quality, thus potentially increasing some areas of EU consumer choice.
Under Model 3, the significant decline in funding for rural areas could lead to changes in the types and levels of services that they provide to consumers as well as to significant declines in EU production of various commodities. This implies a greater proportion of EU consumption being sourced from other countries; but for the main commodities affected it is quite likely that the major beneficiaries of these new market opportunities would be the USA and Cairns group of exporters.

Impacts on small farms

Throughout Europe there is a trend towards a lower farm population and increasing average farm size, accompanied by a sizeable part time farming sector in many countries. Similar trends are evident elsewhere, particularly in the more liberalised economies such as the USA. This trend will be difficult to reverse, despite mixed evidence about the economic efficiency of very large farms (see RICS 1998).

In the EU, farm size is usually measured either in relation to labour input or turnover or land area. In practice, farms with a relatively large area of land at their disposal may be in a small category under the other two measurements. The bias within the CAP up to now has been towards those with the greatest level of production rather than those with the greatest land area. This could change if area payments become a more widespread tool, particularly in the livestock sector.

Under Model 1, because blue box payments would still be linked to production patterns, larger farms would still tend to receive larger subsidies than smaller ones. However the support system would be familiar to small farmers, relatively easy-access and non-competitive, so it could offer some attractions by comparison with Model 2. Increased use of cross-compliance could offer some relative benefit to extensive producers compared to intensive ones.
Under Model 2, in theory, these payments should benefit small farms who manage more extensive or environmentally sensitive holdings, as well as those in marginal areas. However, environmental payments tend to be area based so pay more to larger farms, and where they involve a competitive application process or detailed monitoring and record-keeping, they may fail to attract small farms for whom management time is often more stretched than on larger farms. If progressive forms of modulation are adopted it is possible to discriminate in favour of smaller farms, for example by exempting the smaller holdings from cuts in support payments. Finally, because second pillar aids are delivered through nationally or regionally determined programmes, there is much scope to tailor aids to suit local needs. Thus the extent to which the policy then favours small farms becomes a decision for national or regional administrations.
Under Model 3, it seems likely that a significant number of small farms in the EU would go out of business as those that survive have to pursue an even stronger drive for low cost production, looking for economies of scale and system. However, evidence from previous economic down-turns is that there can be cost-cutting/value adding strategies that involve staying small and diverse to survive as well as those which involve enlargement and specialisation. A lot depends upon local market opportunities and support to develop new ideas and enterprises, as well as changes in the farm population and the availability of complementary off-farm income. In particular, it seems likely that the trend towards an increasing number of part-time or 'hobby' farms in many regions of the EU could accelerate.

Considering effects upon small farmers outside the EU, it seems likely that Model 1 would produce little change in the existing picture, while Models 2 and 3 might increase exporters' incentives to produce for the EU market, which can give an incentive to restructure and favour larger producers (RSPB, 2001).

Impacts on Developing Countries

In all models, the ending of export subsidies and import tariffs should increase opportunities for exporting countries who produce temperate agricultural products to access EU and other markets. Importing countries will be able to maintain their own domestic production of certain products because they will no longer be undercut by similar EU products being sold with export subsidies; and exporting countries will be able to compete favourably with EU exports in other markets by reducing EU competition.

However, some DCs have special arrangements with the EU which allow them preferential market access (particularly former colonies) and this special access could be lost under all these models. Some also benefit from the current high EU internal prices (eg sugar), which would be lost to some extent under all three models. The most notable recent agreement on 'everything but arms' for the LDCs is a case in point, but bananas and sugar provide other examples where certain DCs currently get preferential access to, or treatment within, EU markets.

What is less clear is whether these impacts would be beneficial for the DCs themselves, in economic, social and environmental terms. Increased incentives and opportunities to produce temperate products for EU markets may give rise to both costs and benefits, the balance of which will vary between these countries and also between different stakeholder groups within each country.

In **Model 1** the continuing production linked effect of CAP direct payments would mean that LDC market access to the EU could still be somewhat restricted, since domestic producers could in theory undercut the costs of LDC producers because of the extent of their subsidies. Against this would need to be set other major cost differences which will tend to work the other way (eg for labour).

In relation to non-EU market opportunities, Model 1 would see a transferral of support from export subsidies to direct payments. Direct payments are included in the blue box group of measures and so are considered less trade distorting by some, especially the EU. However while not directly trade distorting they still allow EU producers to maintain their price competitiveness. The fact that direct payments are considered less trade-distorting at a macro-economic level will prove little consolation if they allow EU producers to take contracts and supply markets otherwise served by developing countries. Paul Goodison of the European Research Office likens the use of direct payments as opposed to export subsidies to being 'pick-pocketed instead of being mugged'. The move towards direct aid would also allow the removal of quantitative ceilings on exports, thus presenting the EU with a potentially greater competitive advantage than under current WTO constraints.

The potential impact of direct payments can be illustrated by research into local purchasing of food aid in Africa. (DanChurch Aid 2000). The research found that local suppliers of pulses commonly bought for food aid were unable to compete with the low prices of Danish suppliers of pre-cooked split peas. The Danish suppliers were benefiting from no other type of support than direct payments, which provided 46% of their income. Such trade effects serve to undermine the EU's international development commitment to sourcing food supplies locally, to stimulate local food production and industry.

The effects from **Model 2** are much less easy to predict because this model involves a much greater redistribution of support among different EU producers according to their role and potential contribution to rural development and social and environmental goals. In general terms the competitive effect vis a vis DCs is likely to be less because more aid is likely to target less productive and less export-oriented farm sectors and regions. However, the second pillar could also give a boost to certain high quality niche market development, including for export, and to a move away from commodity production and marketing towards exporting more high value, processed and branded products, particularly in certain more marginal EU regions and sectors.

In attempting to predict the impacts of **Model 3** it is useful to look at the effects of the global liberalisation measures for agricultural trade implemented under the Uruguay Round Agreement on Agriculture (AoA). So far liberalisation has benefited developed countries more than developing and it follows that liberalisation of the EU market with CAP reform would bring greater benefits to the EU than to developing countries.

The Food and Agriculture Organisation (FAO) has conducted a study of the experiences of 16 developing countries since implementation of the AoA (FAO 1999). The study showed that the increase in trade liberalisation had led to an imbalance between changes in levels of food imports and agricultural exports. There

had been an almost instantaneous surge in food imports but many countries had been unable to raise their exports to take advantage of increased global access. Domestic sectors could not compete with surge of cheap imports and so small producers were marginalised, causing increased unemployment and poverty. Increased competition for world market access benefited large efficient producers and led to greater productivity and competitiveness but again served to marginalise small producers. These two factors were damaging to domestic agriculture and food production and thus also to food security in these countries.

As liberalisation is a key goal for the WTO there has been extensive discussion of, and research into, the effects of increased liberalisation, particularly with regard to developing countries. The WTO maintain that low income countries (especially LDCs) stand to gain more than middle-income countries from liberalisation, due to the greater relative importance of agriculture to their economies. Analysis from other sources is more pessimistic. While trade liberalisation could improve efficiency and competitiveness in the agricultural sector, it could have wide ranging negative effects in other sectors and throughout society as a whole, partly due to increased marginalisation of small producers and rural areas generally. Liberalisation of agricultural trade would increase world food prices, hurting the poorest consumers in low-income food-importing countries.

An economic model developed by Borrel and Hubbard (2000) to analyse the current effects of the CAP showed that liberalisation was unlikely to have a positive effect on markets in developing countries and that the ‘biggest gains from liberalisation accrue to the country doing the liberalising.’ Their model looks in detail at the possible implications of liberalising the sugar trade. Europe is one of the greatest sources of distortion of the sugar market. Accordingly liberalisation of the market would afford the EU the most profits – as much as $2.5 billion.

An important obstacle to the exploitation of increased market access under trade liberalisation is the Agreement on Sanitary and Phytosanitary (SPS) Technical Barriers to Trade. This agreement has a negative effect for the following reasons: a wide gap in the ability to meet standards between developing and developed countries; lack of mutual recognition or inspection and standards; and failure to provide promised financial and technical assistance in meeting criteria. The wide gap in standards between developing and developed countries could lead to an instantaneous surge in agricultural imports to low-income countries.

Trade liberalisation in developing countries could lead to an instantaneous surge in food imports, as they would not be likely to refuse products from developed countries on grounds of technical standards. Trade liberalisation in developed countries, however, would not necessarily lead to increased market access for developing countries as they would be more likely to refuse products on technical grounds. Finally, the cost of meeting legitimate SPS standards is large: it is estimated that meeting SPS requirements, plus custom and intellectual property reform, would cost a country some US$150 million. (Finger and Schuler, 1999; cited in Binswanger and Lutz, 2000). This is more than the development budget of many of the LDCs.

There are many non-transparent mechanisms that present barriers to the improvement of export opportunities for developing countries. The general picture from these studies is that trade liberalisation is likely to be harmful for developing countries. This is in stark contrast to the prevailing view of many supporters of Model 3, who tend to assume that market liberalisation benefits all parties, largely based upon the predictions of liberal economic theory.

The following table provides a useful summary of the effects of the three reform models on developing countries.

Types of CAP effect on developing countries

Source: The Catholic Institute for International Relations (1998)

Type of effect	Positive features	Negative features	Implications for development policy
Increased world supply – reduced under models 2 and 3, little change under model 1	Lowers import costs for importers (and may increase supply of food aid)	Lowers export prices for exporters. Disincentive to agricultural development of importers and exporters	May undermine agricultural development policies, but also reduces food costs
Artificially high EU prices – removed under all 3 models	Artificially high prices for developing countries able to export (eg because of Lomé Protocols)	Exports may be viable only if high prices continue	May support export diversification, but new exports may be unsustainable
Over-subsidised prices of exports – removed under all 3 models	Lowers import costs for importers	May undermine domestic agriculture and disrupt legitimate trade	May undermine agricultural development policies
Increased world price instability – possibly reduced under all 3 models		Increases food insecurity and complicates agricultural development planning	Disrupts long-term agricultural development

Impacts on the environment

Model 1 would involve unchanged spending on paying farmers directly to deliver environmental benefits, but it could involve increased effectiveness in the enforcement of environmental legislation through more widespread application of cross-compliance to the receipt of future direct payments in most of the principal regimes. However, increased effectiveness will rely upon adequate promotion, monitoring and enforcement of any such conditions, which could be particularly costly to Member States governments and may therefore not be guaranteed. There remain many uncertainties about the potential effectiveness of cross-compliance as a policy tool for the environment, and most environmental NGOs view it as a relatively limited measure by comparison with the options of direct environmental legislation and environmental payments under agri-environment schemes.

Model 2 would provide sufficient resource for a significant expansion of LFA (Least Favoured Areas) supports and agri-environment supports, assuming that the shift in funds also involved some increase in the proportion of these aids that were EC funded rather than funded by Member States' budgets and would thus promote an increased willingness and ability to use these measures, on the part of the poorer countries. The model should therefore enable enhanced environmental benefits from the CAP. The schemes could involve both compensation to cover farmers' costs in complying with management restrictions due to environmental legislation as well as voluntary aids to fund positive environmental management going beyond the regulatory baseline. However there remain questions about take up levels, the accessibility of aids to small farms (because of high transaction costs to join some schemes) and their ability to tackle key issues of sustainable management where there are very strong market incentives not to do so (eg water use, input use on certain crop types, restructuring of fields and removal of field boundaries, etc). Often, these issues depend upon measures to strengthen environmental legislation (most notably, water policies), acting alongside enhanced agri-environment scheme provision.

Under **Model 3**, non-EU economists frequently argue that liberalisation would bring an 'environmental dividend' in the form of reduced use of artificial inputs and extensification of land management (OECD, 2001). Both environmental and animal welfare NGOs argue that any reduction in EU output arising from the withdrawal of export subsidies would be potentially beneficial. The underlying assumption is that the reductions would be concentrated in the more intensive sector and that this could be scaled back, reducing environmental and animal welfare pressures while leaving the more extensive producers to continue as at present. Indeed, it can be argued that lower livestock production could be accompanied by a cutback in the feeding of concentrates and a corresponding reduction in imports of concentrated feed from the US, Brazil, Thailand and elsewhere. In principle this could indeed occur and would represent a preferable scenario from both an environmental and animal welfare standpoint. In some parts of the EU, such as the Netherlands, the current stocking rate is a source of major pollution problems and appears incompatible with compliance with the nitrates Directive. Some de-stocking could make a positive contribution to meeting the EU's own environmental policy.

In relation to our three models, this effect would be more likely under models 2 and 3 than under model 1. However, even if there is an overall reduction in livestock numbers or crop production as a result of the withdrawal of export subsidies, there is no guarantee that this will occur in the intensive sectors. Indeed, there are strong trends in both beef and dairy production towards the abandonment of smaller scale, more extensive systems, even at current levels of support, and there is evidence of strong non-CAP effects driving continuing intensification in the wine, olive, fruit and vegetable sectors (Dwyer, Baldock and Sumpsi, IEEP, forthcoming).

Recent research within the EU has also cast some doubt on the relative significance of these alleged beneficial effects of liberalisation by comparison with potentially detrimental effects such as further loss of farm labour and reduced resources devoted to countryside management.

A study has been carried out into what would happen to the European countryside without the CAP (Potter et al., 1999). The survey covers five countries where farmers have been interviewed. Regarding full liberalisation the survey showed the following types of farmer responses: cost cutting and enterprise restructuring; reductions in farm household consumption; diversification and a move towards becoming more pluriactive; sale of land and other farm assets; early retirement, with or without succession; and exit from farming.

It was concluded that the agricultural adjustment could be very difficult to manage in environmental terms. Withdrawal of agricultural support would create a countryside with fewer and larger farms and many traditional systems of farming and land management would disappear. In some regions the protection of biodiversity requires a continuation of current farming methods and an alteration of the existing CAP could therefore lead to undesirable environmental effects. However, some regions could benefit from a liberalisation of the CAP in environmental terms, creating new habitats and new landscape features. With regard to main types of environmental effects the following was concluded:

- Short term, direct effects: would cause some in-field extensification of production but there would also be a cut-back in conservation investment and management of the conservation resource.
- Medium term, indirect effects: there would be an indirect environmental consequence resulting from the adjustments farmers would make in order to maintain their farm household income.
- Long term, delayed effects: there will be changes in land use management over a longer period of time but this will vary from region to region. In the survey carried out it is predicted that it is likely that in East Anglia 80% of any land given up is to remain in farming, whereas in Ceredigion 48% is thought likely to move into a non-agricultural use such as forestry or leisure development.

Conclusions

The next proposals for reform are likely to come alongside the EU's 'mid-term review' of the Agenda 2000 proposals, which will begin in 2002. However, opinion is divided as to the extent and scope of these expected proposals. Some believe they could amount to a significant revision of the main regimes dealt with under the Agenda 2000 reforms, while others see them as a much more restricted affair, dealing principally with beef, rye and durum wheat, where EU markets face oversupply and EU budget overspending issues. In any case, some regimes are unlikely to be dealt with at this time, and these include sugar and wine, among the key import/export commodities.

The EC's official position is that there will be no major reforms until 2006, when the CAP is next due for strategic review and amendment. However, it is possible that enlargement, the ending of the WTO 'peace clause' protecting blue box supports from challenge, in 2002, and the continuing calls from the Cairns group for further reductions in domestic support to agriculture, will increase the pace of proposals for reform.

As regards the 3 archetype models of reform presented in this briefing paper, opinion is divided as to whether the Commission and Member States are likely, once discussion begins in earnest, to favour either Model 1 or Model 2. It is generally held that Model 3 is unlikely to find favour within EU decision-making fora, even though it may be strongly supported outside the EU. The only factors that might change this view are likely to be budgetary considerations, since both Models 1 and 2 involve the implicit maintenance of a substantial budget for the farm sector and/or rural environmental land management. As regards the favoured mechanisms for achieving a shift in resources from pillar one to pillar two, the most commonly mentioned at present is compulsory modulation, while degressivity has some proponents too (notably the UK government, for whom modulation is simply an exercise in pre-emptive degressivity). Bonds have been favoured by academics, including some in fairly influential positions, but so far they have failed to attract the politicians.

All three archetype models assume ending minimum guaranteed prices (MGPs) and export subsidies. This cannot be taken as read, particularly for dairy and sugars as due to the existence of supply controls, current spending is contained and surpluses minimised. Thus the EU's domestic market management goals are achieved. For that reason, some relatively influential stakeholder groups believe no radical reform of either of these regimes is needed (eg the French Government and major farming unions in France). Evidence of the strength of these views was shown in the Agenda 2000 negotiations when, despite Commission proposals to cut MGPs and introduce direct payments in 2003 to the dairy regime, with a view to phasing out milk quotas by 2006, the Agricultural Council deferred the proposal to 2005 and agreed that the regime would simply be reviewed in 2003, giving the possibility that it could be continued beyond 2006.

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This background briefing outlines the main reform scenarios for Europe's Common Agricultural Policy, and their impacts on key stakeholders: consumers, small farmers, developing countries and the environment.

Background Briefing 2 **July 2002**