

# The Domestic Policy Environment for Farm-Firms in the European Union

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**Paper prepared for presentation at the 94<sup>th</sup> EAAE Seminar  
'From households to firms with independent legal status: the spectrum of  
institutional units in the development of European agriculture',  
Ashford (UK), 9-10 April 2005**

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# The Domestic Policy Environment for Farm-Firms in the European Union

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The future profitability and growth of farm-firms in the European Union will be affected by a range of policies implemented at national and EU levels. This paper provides a brief review of the types of policies concerned and their potential implications for the future evolution of the economic environment for farm-firms in the Union.

The operations of EU farm-firms can be influenced by policies that are directly oriented towards agricultural production or the operation of the food and agricultural system (agribusiness), or by more general economic and social policies. In assessing the potential impact of such policies, it is important to take into account the fact that many farm-firms in Europe are diversified businesses in which non-agricultural or off-farm activities make an important contribution to income and returns to factors of production. Business decisions are taken by the household unit or related households, rather than by a single manager. The policy environment must be viewed in terms of the effects that it has on the household-farm-firm allocation of productive resources (land, labor and capital).

## ***Forces driving structural change in EU agriculture***

Slowly increasing consumption, associated with modest population growth and low income elasticity of demand, combined with rapid technological change, has generated sustained downward pressure on the real (inflation-adjusted) prices of agricultural products in the European Union. Historical analysis by the OECD has confirmed the rapid technical change in agriculture in many European countries, with rates of productivity growth exceeding those in the economy as a whole (OECD, 1993). The slow growth in demand for food and agricultural products has been reflected by a continuous decline in the proportion of consumers' disposable income spent on these products.<sup>2</sup> At the same time, changes in food consumption preferences, in particular a growing demand for convenience, have resulted in farmers obtaining a progressively smaller share of the final sales price of most food products. The changing nature of the food and agricultural system, with increased use of purchased inputs in farming and increased value-added beyond the farm gate, have resulted in a declining share of the total value added in the food and agricultural sector being retained by farmers.

Other things being equal, sustained downward pressure on net income at the farm level should promote structural change at the sectoral level. Change may be reflected in a reduction in the number of farms, an increase in the area farmed by individual units, an increase in the

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<sup>2</sup> See Blandford (2000) for a more extensive review of these developments and their implications for the agricultural sectors of developed countries.

intensity of production for the individual unit or some combination of these. The principal agricultural option for the farm-firm faced with cost-price pressure is to increase the scale of its operations in order to survive on lower margins. Greater specialization and the intensification of production can allow the firm to exploit economies of scale. However, at some point (and this is particularly true for crop production or for integrated crop-livestock operations) the exploitation of scale economies becomes constrained by size, i.e. farms must become larger in order to exploit further scale economies. If an increase in size and scale is not possible, farmers will experience a decline in income over time and may have to exit the industry (either through retirement or by shifting to non-agricultural employment). Where it is possible to combine agricultural and other activities, continued involvement in the farming operation is likely to become increasingly dependent on non-agricultural earnings (from farm activities that do not relate directly to commodity production, such as agri-tourism, or off-farm earnings).

### ***The commercial environment in the food system***

The EU's food and agricultural system is subject to the same forces that are driving global systemic structural change. As indicated above, the trend has been towards a smaller proportion of total value-added being captured by farm-firms. This has been due to the increased use of purchased inputs, rather than those supplied by the farm, increased processing, the provision of additional services in food distribution (in retailing and the provision of food away from home). Many of the changes are being driven by consumer/retailer needs. Paralleling these developments has been a decline in the use of auction markets for food and agricultural products and the spread of contracting.

A number of factors are driving the closer integration of production, processing and distribution in agriculture. These include the desire for product standardization and responses to health and safety concerns, as well as the realization of efficiency gains through the development and application of standard production processes and the transfer of technology. For the individual firm, contracting can have several benefits such as a reduction in price risk through access to a guaranteed market, greater access to capital, new technology and to technical support etc., but it can also lock farm-firms into a limited and declining share of the value-added in the food chain. For many bulk commodities, it seems likely that the closer integration of farm-firms in the production-marketing system is likely to continue. It will become increasingly difficult for independent farm-firms to find a market for their output. In Europe, as elsewhere, it is food retailers and distributors who are driving developments in the food and agricultural system, since they are closest to the consumer. Wealthy European consumers who spend a relatively small proportion of their disposable income on food are increasingly demanding about the food they eat, and those closest to the consumer are in the strongest position to respond to consumer trends and to profit from them.

Also contributing to integration in the food system is increasing concentration in food processing and retailing. At the retail level, for example, the five-firm concentration ratio in the EU15 increased from a weighted average of roughly 41 percent in 1993 to 49 percent in 1999 (Dobson et al, 2003). While there are still examples of countries with a relatively diversified

retailing structure, for example, Greece, Italy, and Spain, concentration is rapidly increasing in such countries. Mass merchandisers of food that provide a one-stop shopping model for food, non-food goods and services (e.g., Tesco, Asda, Auchan, Carrefour) are expanding at the expense of more traditional food retailers. The mass merchandisers are able to take advantage of their buying power, the use of technology for just-in-time inventory management, and their ability to provide competitive private label products in order to maximize their share of value added in the food chain. In general, such retailers impose higher product requirements on suppliers, exert downward pressure on supplier prices and margins, and generate larger volume requirements (contributing to the need for increased scale in production). Even in areas where there has been some product differentiation at the farm level (e.g., organic foods) the same tendencies are apparent.

Within this general context, we can explore the potential implications of various types of policy for the future economic environment facing farm-firms in the European Union. The focus will be on the following areas:

1. EU agricultural and related policies
2. National policies directly affecting farming
3. Policies affecting the commercial environment in Europe.

### ***EU agricultural policies***

Beginning with the MacSharry reforms to the Common Agricultural Policy (CAP) in 1992, the European Union has gradually been shifting from supporting market prices as a means of assisting farmers towards the use of direct payments that supplement earnings from the market. This has resulted in a more market-oriented environment in the production of many crops, although there are still some notable exceptions (for example, sugar whose production is regulated through quotas). Elements of the EU's livestock production, such as pork and poultry, have traditionally been subject to less public intervention. Other elements, such as beef, have gradually moved to a more market-oriented environment. Dairy production, however, is still subject to quotas.

Overall, successive reforms in the CAP have reflected a trend towards a more competitive (less-regulated) market environment, with less government intervention. This trend has been driven by the need to control the costs of the policies and, to a lesser extent, to adapt to a more open environment for international trade. A basic question is whether the way that the CAP is evolving will change further the economic environment facing EU farm-firms and how it will affect their ability to adapt to that environment.

Quotas have been used by the Union to limit the costs of price supports for commodities such as milk and sugar. Such schemes limit the ability of individual producers to adapt to changing economic circumstances and to take advantage of economies of scale. However, they do not prevent the adoption of cost-reducing technologies and may actually intensify pressures to adopt these, since such technologies affect the size of the quota rent generated for an individual farm. Tradeable quotas allow lower cost producers to expand and to exploit economies of scale, but impose additional production costs through the need to pay for an

additional productive asset (the quota). The rental (purchase) of quota redistributes income (wealth) from current producers to former producers. The use of national quotas, rather than a global EU quota with full tradeability, limits the ability of EU dairy producers as a whole to become more competitive in the face of increased international competition (in particular, tendencies for production to move to lower cost production areas) and limits the ability of individual dairy farm-firms to grow. The strong national preferences implicit in the quota scheme (and in other elements of policies in the EU) limit the growth potential of individual farm-firms in more competitive regions.

Despite proposed changes in the sugar regime, designed primarily to eliminate exports of subsidized sugar by the EU and some adjustments in milk quotas under the Agenda 2000 reforms, it seems likely that quotas will continue to affect the ability of individual farm-firms to adapt to a changing economic environment in the Union, and the international competitiveness of the sectors involved.

Under the MacSharry reforms, direct payments were linked to the area in production or the number of livestock. Recent reforms under the Mid-term Review (2003) provide for a single farm payment (SFP) that can be completely decoupled from current crop area or livestock numbers. Payments that are coupled to current production introduce greater rigidity into the reallocation of factors in agriculture in the EU than payments which are unrelated to current production.

The new system will not entirely eliminate such rigidity. It is being implemented on a national basis and countries differ in terms of the proportion of the payment that is linked directly to production and other production requirements.<sup>3</sup> Differences in the design and implementation of the payments, in particular the degree of coupling adopted, will affect the economic environment for agriculture within and between member countries. Furthermore the entitlement to payments is not tradeable since it is attached to particular holdings. This may encourage producers who are entitled to payments to stay on the land, and thus inhibit the growth of more competitive farm-firms through land rental or sales, or the transfer of land among generations. The enduring nature of payments (that they are not time-limited, at least not for the foreseeable future, although budgetary constraints may ultimately make this necessary) means that they (like dairy quotas) affect the cost structure of farming. Ultimately, the payments are reflected in the cost of land (as reflected explicitly in the market or in the terms of succession) and in higher overall costs of production for individual firms. Even where markets for the rental or sale of land function relatively efficiently, the increased costs created by the payments may discourage the expansion of farm size.

### ***Environmental and animal welfare policies***

Increasing attention has been devoted to the relationship between agriculture and the environment in Europe. It is argued that agriculture is multifunctional, i.e., provides a range of non-commodity outputs that are of value to society but are not traded in organized markets, in

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<sup>3</sup> The complexity of the choices open to individual countries is described by Kelch and Normile (2004).

addition to the production of agricultural commodities. The precise nature of the non-commodity outputs and the way that they are related to agricultural production is often unclear, which complicates the formation and implementation of appropriate policies to ensure their supply.<sup>4</sup> In Europe much of the focus has been on promoting the positive environmental contributions of agriculture (as opposed to addressing negative contributions, such as pollution). This has been reflected in the incorporation of environmental (particularly land-use) conditions for the receipt of income support payments, or the provision of inducements that are specifically targeted to achieving environmental aims. The impact of both of these approaches on the farm-firm depends on the costs of achieving the environmental outcome, and the extent to which the conditions attached to the payment limits production choices. Payments that are linked to the preservation of existing farming systems (e.g., use of techniques, capital intensity, preservation of existing farm structure) may limit the ability of farmers to take advantage of economies of scale. From the perspective of the individual farmer this may not be a problem, providing that the payment received is sufficient to cover the costs of providing the environmental service, including any income lost from foregone efficiency gains. However, if the conditions attached to the payment affect the competitiveness of the firm over the longer term this may intensify downward pressure on the total net income derived from farming. The long-term sustainability of such policies in the absence of structural change, either in farming itself or in the sources of income of farmers, is perhaps open to question.

Higher animal welfare standards are being driven by EU and national policies, as well as through the proliferation of private standards (Blandford et al. 2002). Higher animal welfare standards are likely to result in higher costs of production which may not be able to be recouped by individual producers. Unless consumers perceive a difference from welfare-friendly products that they are willing to pay for, lower-cost non-conforming products may displace conforming products. Labeling may be used to address this and the EU is also proposing that offsetting subsidies should be allowed, i.e., that there would be welfare-enhancing payments that parallel environmentally-enhancing payments. The use of payments to promote production practices that satisfy higher animal welfare standards is not currently permitted under international law (the green box provisions of the Uruguay Round Agreement of the General Agreement on Tariffs and Trade). Private standards might be viewed to be less problematic for a firm, in that production to specific purchaser requirements may be viewed to convey a commercial advantage (this is one of the benefits of the supply of products under contract). To the extent that product standards help processors or retailers capture market share and sell their products at a premium, they may be willing to cover some of the additional costs of meeting the standards at the farm level by paying higher product prices. However, in a competitive commercial environment, processors and retailers will be concerned about controlling their costs and this will affect what they are prepared (or able) to pay their suppliers over the longer term.

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<sup>4</sup> See Blandford and Boisvert (2005) for a discussion of the non-commodity attributes associated with agriculture under the heading of multifunctionality and the broader grouping of non-trade concerns in the debate on trade liberalization. We argue that optimal policy choice is crucially dependent on whether the attributes in question are pure public goods, technical externalities or pecuniary externalities.

### ***Rural development policies***

At the same time as EU policy for agriculture has tended to focus on environmental and other issues, there has been a gradual increase in emphasis on rural development as an aim, as distinct from the provision of support to farmers. Under the Agenda 2000 reforms of the CAP, rural development became the “second pillar” of the CAP. As indicated elsewhere, many of the initiatives undertaken under the heading of rural development are only loosely related to broader economic development in rural areas (Blandford and Hill, 2004). Spending has been dominated by agri-environmental schemes and support for farming in mountainous and less-favored areas. As such, much of what has been labeled as rural development in the Union to this point has been income support for agriculture in another guise. Nevertheless, there have been some elements oriented towards improving efficiency at the farm-firm level, such as investment grants and support for vocational training, as well as grants to improve the processing and marketing of agricultural products. It remains to be seen whether a broader rural development focus will tend to develop in the Union. To the extent that this is successful in generating alternative income-earning opportunities for farm-firm-households, it could affect the future viability of farming in rural areas.

### ***National policies directly affecting agriculture***

A range of national policies, in addition to those already discussed, can influence the economic environment for farm-firms. Probably those with the greatest direct effect are those that govern the sale, rental or use of farmland. Policies in this area can be implemented with the intent of protecting small farms, to provide a mechanism for the allocation of land to new entrants, for equity reasons (in particular the balance of advantage between landlord and tenant when land is rented), and to prevent the reallocation of land to non-agricultural uses (through specific agricultural land policies or through more general land-use and zoning policies). A key issue is the extent to which such policies limit the ability of farms to increase the scale of their operations, constrain the ability of land to be allocated to its most profitable use or limit the injection of new and superior human capital into farming.

### ***Competition policy***

As noted earlier, growing concentration is taking place in the food system in Europe. This has been reflected by a parallel growth in activity at EU and national levels in the application of competition policies in agriculture and the food system. EU competition rules relate to three areas: 1. prohibition of restrictive agreements among firms; 2. prevention of the abuse of a dominant market position; and 3. regulation of mergers. In the last few years there have been cases relating to the first and last of these areas in agriculture.

Under restrictive agreements, a celebrated case was the imposition of €16.7 million in fines in 2003 on six French farmer federations for setting minimum prices for beef and suspending or limiting imports of beef into France. This was the first time that the Commission had imposed fines on farmers' unions.<sup>5</sup> In the press release on its judgment the Commission states “The

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<sup>5</sup> Farmers and farmers' associations received a limited exemption from the competition rules in the Treaty of Rome, particularly Article 85(1), through Regulation No. 26 of 1962.

finances imposed by the Commission on the trade bodies concerned demonstrate clearly that agriculture is bound by the competition rules." (CEC, 2003).

Under mergers, a notable case was that in 2002 in which the Commission granted approval for the merger of the two largest slaughterhouses in Denmark (Danish Crown and Steff-Houlberg) on the basis that this did not affect markets outside of Denmark, but referred the consideration of its effects on the Danish market to that country's competition authority. The Danish Competition Authority approved the merger subject to the adoption by Danish Crown of a series of undertakings to reduce the anti-competitive effects of the merger within Denmark (Danish Competition Authority, 2002).

Other national competition authorities have begun to take a more active role, particularly with respect to mergers in the food industry. In 2000, for example, the UK's competition commission produced an extensive report on the operations of supermarkets in the United Kingdom (UK Competition Commission, 2000). The investigation was prompted by the public perception of high prices for groceries in the UK in comparison to the rest of Europe and the United States; an apparent disparity between farm-gate and retail prices; and by concerns that the growth of large out-of-town supermarkets were contributing to the decay of inner-city shopping areas. The investigation concluded that the market was broadly competitive, and that prices and profits were not excessive. The report noted that for the most part, cost reductions at the farm gate had been passed through to consumer prices, but that "the existence of buyer power among some of the main parties has meant that the burden of cost increases in the supply chain has fallen disproportionately heavily on small suppliers such as farmers." (p.4). In a subsequent inquiry, the Commission ruled that the two leading food retailers (Tesco and Asda) could not absorb the Safeway chain of supermarkets; that chain was subsequently acquired by a smaller competitor (Morrison's).

Greater concentration in processing and retailing may induce farmers to attempt to exert countervailing power through the formation of producer associations or cooperatives. The former EU competition commissioner, Mario Monti, raised questions as to whether farmer cooperatives with dominant market shares, such as those in many northern European countries, could expect to remain exempt from European competition law – in particular, that governing the abuse of dominant market position (Monti, 2003). It seems likely that growing concentration of economic power in Europe's food and agricultural system and its impact on the economic environment may be subject to greater scrutiny by national and EU competition authorities in the future.

### ***Other policies***

Despite the sustained and extensive development of EU institutions, and the adoption of a common currency by eleven members of the EU15, there remains a lack of harmonization in many aspects of economic policy across the members of the European Union. There are substantial differences in taxation and social policies among the member states. There is



evidence of the costs and consequences when national policies diverge significantly, for example, the high unemployment rates and slower growth in countries such as France and Germany, compared to the Netherlands and the United Kingdom. Divergent policies affect the competitive position of farm-firms in the member states of the EU, as well as the off-farm earnings opportunities of farm households. In some cases there seems to be a tendency for such divergence to increase (e.g., the renationalization of agricultural policies reflected in the spread of environmental programs and the introduction of the single farm payment system) but in other areas there is tendency for differences to decrease (labor market reforms).<sup>6</sup> It is an open question as to whether the pressures of globalization (freer trade, movement of global capital, increasing competition with developing countries) will lead to greater national policy convergence. Such policy convergence is likely to be of greater importance for EU economic integration than other forms of convergence, e.g., extension of the common currency area, and may even be a necessary condition for long-term stability in that area. It is clear that continued national policy differences will continue to affect the relative competitiveness of national agricultural subsectors and the business environment of farm-firms in the European Union for many years to come.

### ***Conclusions***

The economic environment facing farm firms in the European Union is changing rapidly. Much of this is being driven by structural change in the food and agricultural system. Policies at the EU and national levels will influence the process of adjustment at the sectoral and firm levels. The recent expansion of the membership of the Union, and potential further expansion, seem likely to generate additional economic pressures. The tendency for greater devolution of policy to the national level and slow progress towards policy harmonization may hinder the process of economic integration. At the very least, they will impose further stresses and strains on the economic system. Farm-firms in the Union will not be exempt from the resulting effects.

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<sup>6</sup> The recent position of France in resisting the liberalization of services employment shows that convergence is not a smooth process.

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