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accompanying document to the

**Proposal for a
COUNCIL REGULATION
amending Regulation (EC) No 1782/2003 establishing common rules for direct support
schemes under the common agricultural policy and establishing certain support schemes
for farmers, as regards the support scheme for cotton**

Impact Assessment summary

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1. PROBLEM DEFINITION

The Impact Assessment addresses the need to find an appropriate balance between respecting the Protocols agreed when the cotton-producing Member States acceded to the EC and the move to decoupled support initiated by the 2003 reform of the common agricultural policy (CAP).

The Protocols state that the Community shall support cotton production in the regions where it is important for the agricultural economy. The support system should permit the producers concerned to earn a fair income and include an aid to production.

The first cotton regime was set up with the accession of Greece to the EC in 1980, then extended to Spain and Portugal in 1986. The regime was based on a "deficiency payment" to processors, who paid a minimum price to farmers supplying them with unginned cotton. The aid and minimum price were based on the difference between an internal target price and the world market price.

The regime prompted a big expansion of the EU cotton sector.

The guiding principle behind the ongoing reform process of the CAP is to move away from price and production support towards decoupled income support.

To bring cotton more in line with the reformed CAP, the Council in April 2004 adopted a new regime for cotton, based on a decoupled income aid and a crop specific (area) payment, both paid directly to cotton farmers. It came into force in January 2006.

On 7 September 2006, following a legal challenge by Spain, the European Court of Justice annulled the reform.

The Court's ruling was based on infringement of the proportionality principle, in that:

- the EC failed to carry out an impact study;
- the EC failed to consider family labour costs in the evaluation and decision process;
- the EC failed to take into consideration the impact of the new regime on the ginning industry which, although not included in the Protocol, is directly linked to cotton production.

Particular attention is paid to the latter two points in the Impact Assessment.

2. OBJECTIVES

Taking these different elements into account, the new cotton regime should encourage a competitive, sustainable and market-driven cotton sector, while safeguarding the Protocol commitments. In particular, it should aim to ensure:

- the continuation of agricultural activity as a component of the sustainable development of the cotton-producing regions,
- compatibility of support for cotton producers with the principles of the reformed CAP,

- compatibility of support for cotton producers with the EU's WTO commitments and the limitation of any negative impact on developing countries,
- stability and control of the EU budget,
- the competitiveness and market orientation of the cotton sector,
- reduction of the impact of cotton production on the environment,
- simplification of the support regime for cotton producers.

3. POLICY OPTIONS

Three options were assessed, representing three distinct policy choices. Any alternatives or variations fall into one of these "families" of option.

The **Production Aid Option** (Pre-Reform scenario) returns to the regime in place before the 2004 reform. It provides for a "deficiency" payment to the processor (ginner) on condition that a minimum price is paid to cotton growers for the unginned cotton.

The **Mainly Decoupled Option** (2004 Reform scenario) is similar to the regime in place since 1 January 2006.

The previous deficiency payment is split 65%–35% into a decoupled payment and a crop-specific area payment, both aid directly to the cotton farmer. The remaining budget is allocated to rural development measures such as restructuring of the industry and marketing, in the regions affected by the reform.

The impact of different levels of coupled payment is considered.

This option also includes the possibility of an obligation to harvest, together with a minimum quality standard.

The **Full Decoupling Option** contemplates the complete removal of all coupled payments for cotton, including the current crop-specific area payment.

Under this option part of the previously coupled aid is earmarked for rural development measures in the regions affected by the reform, including restructuring of the industry, diversification and innovation measures.

4. ANALYSIS OF IMPACTS

4.1. Economic Impact

The farmer's decision whether to continue growing cotton will be based mainly on the profitability of cotton compared with that of the alternative crops. The main indicator of profitability, which is used for this analysis, is the gross margin.

An analysis was made of the gross margins for different cotton production methods and support regimes (i.e. the 3 options) and for the alternative crops that could be grown in the regions concerned.

As the gross margin does not take into account the cost of unpaid family labour, this first step was complemented by a further analysis of the impact of the three options on Family Farm Income. This represents the remuneration of family labour.

The availability of agri-environmental payments can strongly influence the farmer's planting decisions. Although not part of the cotton regime, the farmer's participation, or not, in agri-environmental schemes was therefore taken into account.

For Option 2, a sensitivity analysis was made of the impact on cotton production of different levels of coupling, compared with the 35% decided by the Council in April 2004.

Production Aid Option (Option 1)

- As support is coupled to production, cotton is far more profitable than growing any alternative crop.
- Any switch from cotton to grain results in an income loss of over €1 500 per ha in Spain and €700–1 000 per ha in Greece.
- National Guaranteed Quantities are likely to overshoot and the aid per tonne be reduced, harming the most vulnerable farmers and speeding up concentration among the most competitive.
- The high incentive for growing cotton ensures that it continues in the regions concerned.
- A coupled payment regime for cotton is an anomaly, as aid for the competing crops is now largely decoupled.
- This option does nothing to address over-capacity in the ginning industry and delays restructuring. In 2003–2005, under the former similar regime, Spain's capacity utilisation rate was 41%, while in Greece it was 70%.

Mainly Decoupled Option (Option 2)

- In 2006, Spain's cotton area fell to pre-accession levels, while yields dropped by about a third. In Greece the cotton area remained stable and yields fell by only one fifth.
- Where agri-environmental programmes are available, cotton remains the most profitable crop.
- In Spain, even when no agri-environmental payments are made, cotton is more profitable than the alternatives. This would be reinforced by the removal of residual coupled payments to the alternative crops.
- In Greece, there is more potential for cotton areas to fall and be replaced by maize and, to some extent, wheat.
- In both countries cotton areas are unlikely to fall much below accession levels.
- Cotton farmers can choose alternatives, without losing their decoupled payment entitlements.
- The sensitivity analysis suggests it is unnecessary to increase the coupled payment to 40% in order to maintain cotton production at a reasonable level. A sharp decline could result if it were cut to 30% or 25%.
- Higher quality might be achieved by combining an obligation to harvest – in place of the current boll-opening condition – with a minimum quality standard.

- The impact on the ginning industry in both countries will necessitate major restructuring and consolidation. In 2006 in Spain, use of ginning capacity fell to 17%, while in Greece it fell to 56%. Part of the ginning industry will cease activity, while the remainder will have to increase its capacity utilisation rate, in order to improve profitability.
- Additional rural development funds could support the adaptation and diversification of the cotton-growing regions.

Full Decoupling Option (Option 3)

- In Greece, cotton production would probably be limited to extensive production under agri-environmental programmes, so environmentally positive.
- In Spain, as cotton production would no longer be economically viable, it would probably cease completely.
- Replacement by wheat would have environmental benefits, compared with cotton; a switch to maize would see no major environmental gains and water needs would be higher.
- Most ginning plants would be forced to close.
- While in line with the CAP reform process, full decoupling of cotton support does not ensure the continuation of cotton production in the regions concerned. With no specific aid for cotton, this option fails to comply with the Protocols.

4.2. Environmental Impact

Cotton production is associated with a number of negative environmental impacts.

Water quantity: almost all the EU's cotton area is irrigated. Cotton is grown in areas where water is a limited resource.

Water quality: high input of pesticides, herbicides, plant growth inhibitors and defoliants, made worse when associated with monoculture.

Soil: high input use, irrigation and monoculture cause deterioration.

Biodiversity and habitats: high input use and monoculture have a negative impact on biodiversity, availability of habitats and biological stability.

The importance of these risks varies according to farming practice, how intensively the cotton is grown and site-specific vulnerability.

A comparison with alternative crops shows that, while a switch to winter cereals, sunflowers or irrigated fodder crops could offer environmental benefits, maize and vegetables would represent no improvement.

Production Aid Option (Option 1)

- As price support encourages intensification, the environmental impact of this option is particularly marked.
- Water pollution is identified as the biggest problem, as cotton is mainly grown in zones classified as vulnerable by the Nitrate Directive.

- Cross-compliance is not enforceable on holdings growing only cotton.
- Agri-environmental programmes may now prove more attractive to cotton farmers in some regions.

Mainly Decoupled Option (Option 2)

- In Greece slow reaction to the regime change resulted in a small expansion of cotton area.
- In Spain cotton area and yields fell, with lower input use. Greater participation in agri-environmental schemes.
- Coupled and decoupled payments are subject to cross-compliance.

Full Decoupling Option (Option 3)

- In Greece, cotton would probably be limited to extensive production under agri-environmental programmes.
- In Spain, cotton production would probably cease completely.
- Substitution by wheat would have environmental benefits; a switch to maize would not.

The ginning industry

The ginning industry is not associated specifically with environmental problems.

4.3. Social Impact

Greece has 79 700 cotton farmers, Spain around 9 500.

As cotton growing is relatively labour intensive, a switch to other crops would mean that fewer hours are needed per hectare. In this respect, Option 3 would have the greatest impact.

In 2005/06 the cotton ginning industry employed about 3 200 people in Greece and 1 350 in Spain; one-third to a quarter of the employment is seasonal.

Due to over-capacity, some job losses are inevitable under all options. While these are moderate under Option 2, under Option 3 Spain's losses are total, while in Greece 2 600 work units are lost.

4.4. Impact on International Relations

EU production represents only 2% of global output world consumption. EU trade in cotton is completely free: no import duties or quantitative restrictions apply and no refunds are paid on exports. The EU is a net importer of cotton.

Production Aid Option (Option 1): a return to deficiency payments would contradict the EU's negotiating position in the "Doha Round" and would be viewed as negative.

Mainly Decoupled Option (Option 2): the 2004 reform reduced the trade-distorting effect of EU subsidies granted to cotton and is viewed as fairly positive.

Full Decoupling Option (Option 3): a fully decoupled support regime would be consistent with the EU's negotiating position in the "Doha Round" and would be viewed as very positive.

4.5. Impact on the EU Budget

The three options are all budget neutral compared with current expenditure, about €800 million.

Production Aid Option (Option 1)

As this option is based on a deficiency payment, dependent on variations in world prices, high variability in Community spending is to be expected, as well as additional control costs.

Mainly Decoupled Option (Option 2)

Spending is far more stable, as the decoupled part of the aid is fixed. The coupled area payment is limited to a maximum guaranteed area and so subject only to downward variation.

Full Decoupling Option (Option 3)

As the decoupled aid is fixed, this option is the most stable and predictable from the point of view of EU expenditure.

4.6. Impact on Administrative Costs and Simplification

Production Aid Option (Option 1)

As it would have to co-exist with the reformed CAP regime (largely decoupled payments), this option would be complex and burdensome for beneficiaries and public administrations. It requires separate information, control and monitoring systems. Adjustment costs would be high for the Commission administration, national and regional authorities and for businesses that have made adaptations to the new system.

Mainly Decoupled Option (Option 2)

This option is administratively simpler. As it is similar to the post-reform regime, adjustment costs would be minor. All direct payments would be subject to common rules for direct support, in particular the Single Farm Payment.

Full Decoupling Option (Option 3)

The management of this option is lighter. The absence of any crop-specific payment reduces both the costs and risks related to controls. Cotton production would be subject to the common rules for the Single Farm Payment.

4.7. Governance and Participation

The three options have no significantly different implications for governance and participation, although Options 2 and 3 both allow the agricultural entrepreneur more autonomy.

5. CONCLUSION

When the various impacts of the three options are compared, Option 2 (Mainly Decoupled Option) is seen best to respond to the different objectives of the reform. It both meets the requirements of the Protocols and is consistent with the thrust of the CAP reform process. While it would be feasible to increase the level of coupled payment, the administrative burden outweighs the small possible advantages. Some modifications to the current regime are seen as desirable, in particular to ensure quality.