

Prospects for a Reformed Agricultural Policy

Introduction

The Common Agricultural Policy (CAP) is not only the EU's* most expensive policy –it costs some €58 billion per year and accounts for some 40 per cent of the EU budget – but also it is its most complex and interventionist programme. Yet, despite its many faults and failures outside academic circles it attracts relatively little attention and criticism. This may reflect its presentation as delivering the benefits of a pleasant countryside and supporting a traditional rural way of life. The CAP has enjoyed an exceptional and prominent position since the founding of the EU; indeed, the promise of a common agricultural policy helped secure ratification of the Treaty of Rome (Parsons, 2003). French determination to secure a profitable arrangement for their farmers reinforced a Commission keen to press ahead with at least one ambitious common policy and none seemed more promising than agriculture (Ludlow, 2005). Paradoxically, it was a sector with strong farmers' unions upon which the Commission hoped to build the type of relationship capable of breaking the national mould of European politics (White, 2003).

Compared to its current manifestation the CAP started out with the straightforward intention of holding the domestic prices of key agricultural commodities at sufficiently high and stable levels to encourage production and provide a reasonable standard of living for farmers. Since its inception in the 1960s the CAP has undergone several reforms. Each reform has been driven by political disquiet regarding the CAP's cost and effectiveness. Agricultural exceptionalism continues but the method of support has changed and the policy's complexity and scope has increased with the addition of new and diverse objectives. Despite the reforms amongst academics there is widespread doubt regarding its ability to achieve its diverse objectives (Jambor and Harvey, 2010).

The purpose of this chapter is twofold: firstly, to consider the prospects for fundamental reform of the CAP; and secondly, in the event of a Brexit, to examine the nature and pace of agricultural policy reform in the UK. Fundamental reform is defined here as ending agricultural exceptionalism and allowing the industry's structure and performance to be determined by unfettered market forces. In order to understand something of the complexity of the CAP and why it has proved so difficult to reduce the level of farm subsidies I will first briefly outline how the policy has developed. I will also explain the political and industry forces that have successfully protected its exceptional position. Finally, I will consider to what extent the influence of these forces might wane following a Brexit thereby allowing a fundamental reform of UK agricultural policy.

A Politically Driven Policy

Perhaps inevitably in reaching agreement between divergent interests, the objectives set for the CAP at its founding were vague. In summary its five objectives were to: i) increase productivity; ii) ensure a fair standard of living; iii) stabilise markets; iv) assure supplies; and v) deliver 'reasonable' prices for consumers (European Union, 2006). The objectives were

*The term EU will be used throughout, even where it would be more historically correct to speak of the EU's predecessors ie, the European Economic Community (EEC) or the European Communities (EC).

crafted with the depressed state of agriculture in the 1930s and the food deprivations of World War II in mind. Consequently, of the five objectives, ensuring a fair standard of living for farmers – by implication protecting farm incomes and farm numbers – was *primus inter pares*. Based largely on ‘price support’ involving variable levies i.e. tariffs to raise import prices to domestic levels, and official intervention buying at pre-determined prices, the CAP was spread from grains to other major products during the 1960s. Intervention prices for the coming year were set by the Agricultural Council which operated *de facto* under an implicit rule of consensus (Hayes-Renshaw, *et al.*, 2006). This *modus operandi* ensured that as production responded to higher prices eventually creating structural surpluses i.e. a permanent state of excess supply, the Agricultural Council’s reaction was to increase budgetary expenditure to cover the cost.

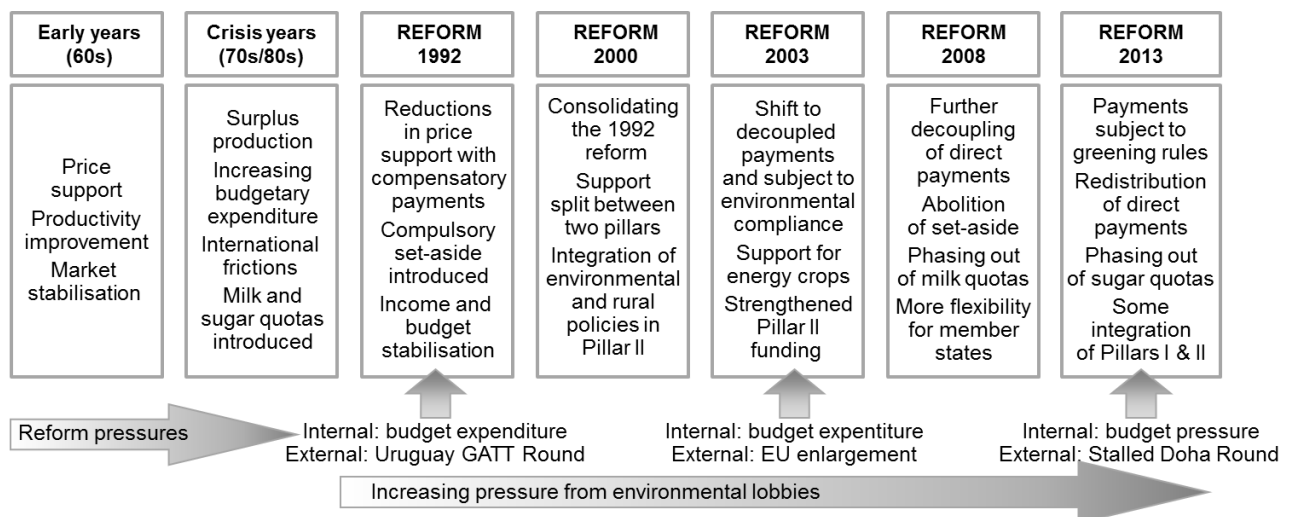
Under pressure from national governments and farmers’ unions the Agricultural Council refused to countenance a reduction in support price levels. Instead, as budgetary expenditure rose, it chose the less divisive policies of supply management and export subsidies. Production controls were first introduced for sugar in 1968 and for milk in 1983 to be followed by the voluntary ‘set-aside’ of productive land for cereals in 1988. But surpluses continued to mount and the cost of export subsidies rose as the EU increasingly resorted to dumping its surplus agricultural commodities on world markets. Not only were these interventionist policies failing to stem rising budgetary costs but also the use of export subsidies were a source of tension with trading partners.

Within the European Council, as CAP expenditure rose to account for around 70 per cent of the EU budget, there was growing recognition that reform was inevitable. This view was reinforced by the launch of the Uruguay GATT Round and mounting anger by the US and Cairns Group at the CAP’s trade distorting policies. Eventually these pressures resulted in the 1992 ‘MacSharry’ reform. The reform transferred the basis of support from farm prices to annual direct payments. In the process it shifted the burden of support from consumers to taxpayers. By 1992 agricultural production in the EU was in chronic over supply so the authorities could not credibly claim that continued support was necessary to protect production. Thus, the payments were defended as ‘temporary compensation’ for lower market prices while protection of the environment and rural development were introduced as justifying continued support.

The piece-meal approach to the environment embodied in the 1992 reform reinforced the belief that the objective was primarily to continue to support farm incomes without encouraging production growth. The reform had, however, opened the door to the environmental lobby who seized the opportunity. The result was the consolidation of environmental objectives in the 2000 reform which separated CAP expenditure into two tranches: Pillar I and Pillar II. Pillar I accounts for more than 70 per cent of CAP expenditure and is largely used to fund direct farm payments. Pillar II, which is co-financed from national funds, is aimed at improving agricultural competitiveness, the environment and the rural economy i.e. largely channelled to farm businesses. The introduction of co-financing was implicit recognition that budgetary restraints would constrain future CAP expenditure but it also marked, albeit on a small scale, the introduction of renationalisation. In other words, under Pillar II national and/or regional authorities can decide, within limits, the objectives and content of rural policies for their regions.

In preparation for the impending eastward enlargement of the EU the CAP was further reformed in 2003. This reform fully decoupled direct payments from production i.e. they were to be set on an area basis regardless of historical production. The new decoupled payments added a further dimension to renationalisation by allowing Members States to adjust modestly the conditions attached to their receipt and the scope to modulate i.e. reduce, the payments for larger scale farms. A bizarre side effect was that it was no longer necessary to grow anything in order to receive payments. In principle decoupling increased the influence of markets in farmers' decisions and the 2008 reform continued this trend, most notably by abolishing set-aside and setting 2015 for the phasing out of milk quotas. In 2013 the CAP underwent further reform to make it 'more equitable and greener' and to phase out sugar quotas by 2017. The history of the CAP, the key pressures for reform and its growing complexity are summarised in Figure 1. In contrast to the US where agricultural reform during the 1990s represented a decisive move towards market liberalism, in the EU the underlying protectionist goals remain intact (Skogstad, 1998).

Figure 1: History and Reforms of the CAP



Based on European Commission data

An Inefficient and Ineffective Policy

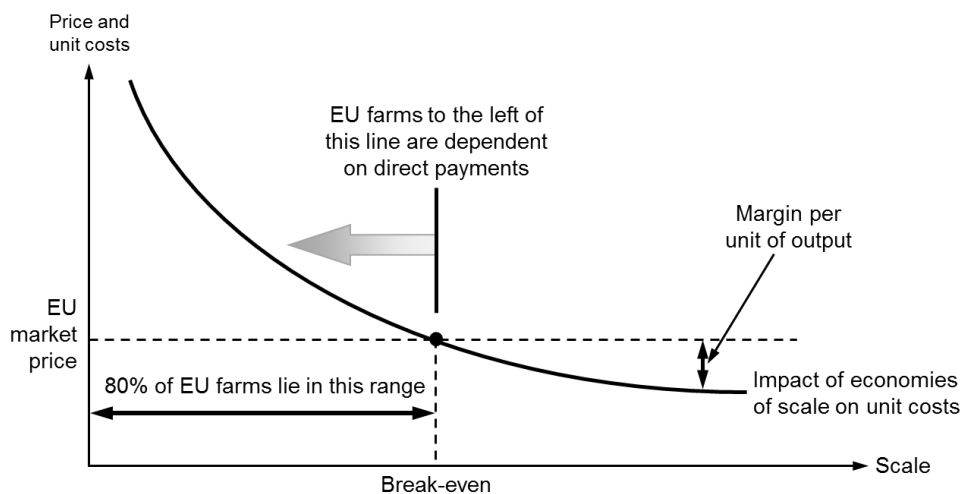
According to the European Commission, financial support for farming is necessary to deliver 'viable' food production, the sustainable management of natural resources and balanced development across the EU (Commission, 2014). But the ability of the CAP to protect farm incomes and numbers is weak. At best, direct payments have slowed the long-term decline in the numbers engaged in farming. In practice 'sustainable management' consists largely of attempts to constrain highly productive, intensive systems. As regards balanced development, direct payments are inequitably distributed; the product of their historical role as compensation for reductions in support prices. Direct payments, per hectare, are smallest in the countries with the lowest per capita incomes and greatest dependence on agriculture as measured by share of GDP.

Since the 1960s both the number of EU farms and the numbers engaged in farming have declined at an annual rate of 2 per cent. Over the same period the annual reduction in the utilised agricultural area has been less than one per cent. Consequently, there has been a

slow but steady concentration of production on larger-scale, more specialised farms (Brouwer, 2006). In the absence of decoupled payments some 80 per cent of EU farms would not break-even. If the payments are included in the farms' revenue then this proportion only falls to 65 per cent (Commission, 2010). The growing average size of farm in the EU is evidence of the existence of economies of scale. Larger farms deliver a superior performance in terms of productivity, unit costs and incomes. The average value added per labour unit for the EU's largest farm size group is more than ten times that for the smallest farms' group (*op cit.*).

Figure 2 is a schematic illustration of the relationship between scale and dependency. The diagram shows how economies of scale cause unit costs to decline as farm size increases. In practice some of the smallest farms are profitable but most should be described as hobby or lifestyle farms operated on a non-commercial basis. More than one third are involved in off-farm gainful activity e.g., are part-time or have other sources of unearned income (*op cit.*). Most EU farms are constrained by their small scale; about 70 per cent have an area of less than five hectares (Commission, 2013). Few of these farms are likely to ever be in a position to earn a reasonable living from their land. The logic of Figure 2 is that structural change towards an industry composed of fewer, larger scale farms would reduce the need for public subsidy. As decoupled payments prolong the life of unprofitable farms they frustrate evolution to a more efficient industry structure. The Commission argue that decoupled payments improve competitiveness by encouraging farmers to tailor production decisions to market requirements but the evidence for this is lacking (Rickard and Roberts, 2008). Rather they impact negatively on efficiency (Rizov, *et al.*, 2013) by enabling farms to avoid productivity enhancing change at a time when productivity growth and most notably, crop yields across the EU display a slowing rate of increase (Lobell, *et al.*, 2009).

Figure 2: Scale and Dependency



Besides public expenditure savings other advantages would follow the removal of decoupled payments. Agricultural support was largely phased out in New Zealand during the 1980s. An OECD study concluded that this had *enhanced the flexibility of a sector that had been renowned for its inability to respond to change* (Vitalis, 2006). What is beyond dispute is the need for EU agriculture to greatly increase current levels of productivity, particularly with

respect to natural resources e.g., land, freshwater, minerals and fossil fuels. The Royal Society (2009), argues that more productive and sustainable agricultural systems – inevitably dubbed ‘sustainable intensification’ – could be delivered by technological advances. While much scientific research is now focused on scale-neutral biotechnology, engineering advances are now heavily concentrated on scale-biased, precision technologies. Defined as the fusing of agricultural engineering and information technology, precision technologies achieve much greater efficiency in the use of scarce resources, but these benefits can only be realised when adopted at the farm level and this involves expensive investment.

Decoupled payments may prolong the life of many smaller farms but the extent to which they augment incomes is not sufficient to generate a surplus to fund performance improving investment (Viaggi, 2011). An OECD review of the evidence concluded that ... *larger farms are better performers as they can achieve economies of scale* (OECD, 2011). As implied in Figure 2, economies of scale not only increase the likelihood than a farm is generating profits but also it means a greater volume of output over which to spread investment costs. Hence, larger scale farms are better able than their smaller counterparts to invest in productivity and sustainability enhancing, technological advances. Moreover there is some evidence that when a scale-invariant advance e.g. GM crops, is combined with scale-enhanced advance e.g. precision technology, farms gain an additional economy of scope (Fernandez-Cornejo, *et al.* 2001).

Prospects for Radical Reform of the CAP

The foregoing indicates that if the objective is economic efficiency the priority for future CAP reform should be the phasing out of direct payments. Indeed, the European Commission has acknowledged that such action would not only lead to:

... a more competitive and less diverse sector ... [but also] farms which will continue to be economically viable in the new environment will be larger, more open to innovation leading to cost optimisation, productivity growth and less labour-intensive (Commission, 2011).

But the European Commission and the farmers’ unions argue that the objectives of the CAP now embrace more than efficiency and competitiveness. The Commission rejected the phasing out of decoupled payments because it would ... *lead to failure of many agricultural holdings and would put additional pressure on the viability of rural areas with higher unemployment and migration ...* and the concentration of production on larger scale farms would cause the ... *likely intensification of production in fertile areas and the abandonment of production and land in more marginal regions (op cit.)*. Significantly, the Commission did not claim that the removal of decoupled payments would be followed by a fall in total EU agricultural output. This reflects the fact that the contribution of smaller-scale farms – those deemed most vulnerable to the removal of support – is proportionally less than their numbers (Martins and Tosstorff, 2011).

A modelling exercise by a group of European academics (Renwick, 2011) concluded that the overall reduction in EU production following the removal of decoupled payments was likely to be small – around one per cent – though the impact for regions and farm types would vary more significantly. The study also identified environmental benefits such as lower overall

greenhouse gas emissions and reduced soil erosion. Indeed, the budgetary savings arising from the removal of all payments to farmers under the CAP would create scope for better targeted and more efficiently funded environmental and rural policies. In the absence of the CAP national governments would be free to implement environmental and rural policies based on regional rather than agricultural priorities. Moreover, the release of land as less efficient farms exited the industry would provide space to deliver ecosystem services such as woodlands and habitat conservation, recreation as well as carbon sequestration (Burgess and Morris, 2009).

The CAP's multifunctionalism is an inefficient way to deliver environmental and rural policies but it serves to deflect attention and criticism from income support. That it remains, despite multiple objectives, primarily a social policy was confirmed by an expert report (Sapir, *et al.* 2003), commissioned by the President of the European Commission. The report concluded that the CAP had become a redistributive policy spreading wealth to farmers instead of an instrument to promote efficiency. Despite its authority the report was ignored. Born in the era of the post war welfare state, the CAP's objective of protecting farm incomes has endured. A situation viewed by both the political and wider populations of Europe as legitimate, if no-longer open-ended. The fact that in each member state average agricultural earnings are lower than the national average and around a half of the EU's farms are defined as semi-subsistent (Davidova, *et al.*, 2013) is stressed by the farming lobby as the justification for continued income support. And now that the Lisbon Treaty has given the European Parliament greater oversight of the CAP, there is little prospect of a significant reduction in funding for farm payments in the foreseeable future.

Strong political support for 'family farms' and very powerful farmers' lobbies explain why it has proved impossible to undertake any reform of the CAP without the assurance that funding would continue at prevailing nominal levels. The evidence points to another twenty years or more in which there will be periodic reforms of the CAP but in the absence of some unforeseen external pressure they will not seriously disturb the course set: the real value of decoupled payments will decline alongside a steady reduction in farm numbers. Future reforms will continue to the drift towards a greater influence for market forces, the encouragement of sustainable farming practices and partial renationalisation. The farmers' lobbies are bitterly opposed to renationalisation (NFU, 2013) and for this reason renationalisation will remain a minor adjunct to the CAP.

Visualising a Reformed UK Agricultural Policy outside the EU

The relative efficiency of UK agriculture within the EU has featured heavily in the literature (see, for example Lund and Hill, 1979). Compared to other EU farm industries only the Czech Republic has an average farm size greater than the UK and as indicated above larger scale farms tend to be more productively efficient. Productivity growth is a good indicator of longer term survivability but comparative studies show that since 1960 UK agriculture's total factor productivity (TFP) has grown at a slower rate than comparable countries e.g. Germany and Denmark. This may indicate that other EU agricultural industries are now far ahead of the UK or simply that they have been playing catch-up. What is beyond dispute is that all EU farming industries are being hampered by CAP Directives restricting or withdrawing some advanced technologies. Genetically modified (GM) plant seeds and the

recent banning of certain plant protection products are examples. These restrictions are the product of the growing influence of non-farm pressure groups, specifically environmentalists. Whatever the merits of their campaigns the result is that within the EU farmers are being required to operate below the technological frontier while increasingly facing international competition from farming industries that are not so constrained.

David Cameron has not revealed the areas in which he hopes to negotiate a new relationship with the EU but the foregoing suggests it would be futile to attempt fundamental reform of the CAP. At best, if he is so minded, he might be able to extend renationalisation to allow national governments to determine what practices and technologies farmers adopt. For example, the EU has recently given governments the power to decide – within limits – whether to plant GM crops. In principle, if the UK voted to leave the EU fundamental reform would be possible. This however raises two questions: firstly, would the actual pace of reform in the UK be faster; and secondly, what form might it take? In 2005 the Labour government published its ‘vision for the CAP’ (Treasury, 2005) where it argued that the CAP not only imposed substantial costs on consumers and taxpayers but also it was out of step with the challenges of globalisation and a source of international criticism. According to the ‘vision document’ the solution was the elimination of all market support including decoupled payments while retaining ‘targeted’ payments to maintain the environment and promote sustainable rural development.

Further guidance as to UK agricultural policy in the event of Brexit is provided by the Coalition’s submission to the European Commission in advance of the 2013 reform (Defra, 2011). On this basis the UK would reduce public expenditure on farming ‘without interfering with the EU level playing field,’ but funding would continue for environmental and rural payments to farmers. The concern to preserve a level playing field is worrying. This is a key argument used by the National Farmers’ Union (NFU) and its fellow lobbies to justify the continued receipt of direct payments. And the devolved administrations in Scotland, Wales and Northern Ireland are supportive of decoupled payments as a larger proportion of their farmers would be vulnerable by virtue of their smaller scale and more difficult geography. The erroneous argument that the loss of direct payments for UK farmers would make them less competitive within the EU holds sway with many who perhaps should know better (House of Commons (a), 2013). Also the rapid removal of decoupled payments might be thwarted if the government feared claims for compensation on the basis that investment decisions had been made on the expectation that the payments would continue for many years. That said, it seems likely that whatever government is in power decoupled payments would be reduced at a faster pace if the UK was freed of the need to comply with the CAP.

The speed and nature of agricultural policy reform in the UK would be subject to negotiation not only with the devolved administrations but also with the NFU, as *primus inter pares* amongst farmers’ lobbies and non-farm pressure groups. The reaction of the environmental lobby to the ‘vision document’ was more positive than that of the farmers because of the expectation that expenditure on Pillar II type environmental and rural payments would be increased. The existence of devolved administrations and powerful pressure groups suggests that there would be transitional arrangements spreading a substantial reduction, if not the

complete removal, of decoupled payments over a period of years. Furthermore, the overall fall in public spending would be moderated by a significant switch to Pillar II type measures. These are often criticised as indirect farm income support but the government might view such expenditure – in principle aimed at improving farm efficiency and productivity – as serving to temper the farming and developed administrations’ opposition to cuts in decoupled payments.

In addition to reduced public funding UK agricultural policy outside the EU would almost certainly involve a greater focus on competitiveness. Successive UK governments have argued for the removal of remaining trade barriers and the liberation of farmers in making decisions regarding their businesses. However, it is far from clear to what extent the government would remove the regulations currently imposed on farm businesses. It is difficult to conceive – particularly given the strength of the UK environmental lobbies – a significant moderation of existing EU Directives regarding pollution eg, nitrate and pesticide leaching, water quality, birds, habitats and animal welfare.

A more subtle but potentially significant change would be a more embracing attitude towards the frontiers of science and technology. Freed from the constraints of the CAP’s voting rules, a British government is likely to be more accepting of biotechnological advances. These would include GM technology and both farmers and manufactures would benefit from the UK’s exit from the EU’s long drawn out, opaque system for approving new pesticide products. There is however, a question as to how quickly British farmers would take-up the more controversial technologies. Consumer attitudes would be a major influence: a recent survey showed that only 14 per cent of UK consumers are strongly opposed to GM foods but 82 per cent were either undecided or held only a mildly positive or negative opinions (IGD, 2014). Experience suggests environmental lobbies would continue to oppose the adoption of GM technologies and more generally, larger scale, intensive farms.

Of key importance would be the trade arrangements between the UK and the EU in the event of Brexit. There are essential five trade relationships that the UK could try to negotiate with the EU as part of its withdrawal, depending on the level of integration it wanted with the EU Single Market (House of Commons (a), 2013). These range from the highly integrated options of European Economic Area (EEA) and European Free Trade Area (EFTA) agreements to existing WTO most-favoured-nation (MFN) agreements. The House of Commons Foreign Affairs Committee inquiry into the UK’s future relationship with the EU concluded... *we agree with the Government that the current arrangements for relations with the EU which are maintained by Norway, as a member of the European Economic Area, or Switzerland, would not be appropriate for the UK if it were to leave the EU.* (House of Commons (b), 2013, pp9).

Agricultural trade is, in principle, excluded from EEA and EFTA agreements and covered by separate bilateral agreements which grant limited preferential access to both sides. However, it is doubtful whether the EU would be willing to enter into such an agreement if it did not include the four ‘freedoms’ involving the movement of goods, capital, services and people. These four freedoms are incorporate in the EU’s treaties with the EEA and Switzerland as a member of EFTA (House of Commons (a), 2013). If Plan A is to negotiate an agricultural

free trade agreement, given the uncertainty voters should be clear as to Plan B before an in-out referendum. This presumably would be the adoption of WTO MFN tariffs. To take but one of many examples: UK exports to the EU of cheddar cheese with a minimum fat content of 50 per cent would face a tariff of €167.1 per 100kg. As the UK has a persistent trade deficit with the EU in food and agricultural products – £16.4bn in 2014 (Defra 2014) – this suggests that it would be in the EU's interest to reach a negotiated bilateral agreement.

The resort to WTO MFN agreements would leave UK exporters of agricultural products in the position of, say, US exporters today in facing non-tariff barriers of various kinds involving compliance with prevailing CAP regulations. For example, the UK exports would continue to be subject to the CAP's regulations concerning maximum pesticide residues. However, in the event of the UK rapidly adopting GM crops this is unlikely to pose a problem; the CAP's paradoxical approach is an almost complete de facto moratorium on growing genetically altered crops but the same products can be imported from non-EU countries. The removal or reduction in trade barriers arising from regulations and standards lie at the heart of the Transatlantic Trade and Investment Partnership (TTIP) currently being negotiated with the US. Membership of a TTIP agreement should be a priority for an independent UK, otherwise regulations, particularly those addressing new products and technologies are likely to increasingly diverge, creating additional challenges for food producers seeking to be certified as permitted to sell in both the EU and US. Finally, further uncertainty surrounds the web of RTAs that the EU has with many countries. Presumably, the UK would seek to negotiate new RTAs with these countries in order to continue with the EU's tariff preferences. But there might be opposition; for example, Brazil would surely protest if the UK offered tariff concessions on raw sugar to Least Developed Countries (LDCs) as if it were still applying the EU's Economic Partnership Agreements.

End Piece

Following the 2013 reform, the CAP's current multifunctional structure will not change before 2020 and following the adoption by the EU of a seven year multiannual financial framework there is little prospect, in the absence of a serious funding crisis, of an overall reduction in the funds devoted to the CAP and specifically a lessening in the share going to decoupled payments in the following seven years. This implies that the pace of structural change will continue at its lacklustre, historic rate. Renationalisation will continue within strict limits though it is highly probable that the EU's reticence towards biotechnological advances will wane. In the event of Brexit, UK agricultural policy reform is likely to move at a faster pace and also in a direction that gives primacy to productivity and competitiveness. Unfettered access to the single market would be a priority for the food industry in any exit negotiation but it is impossible at this time to anticipate how successful the UK might be in this endeavour. Finally, those hoping for a rapid reduction in wasteful public expenditure on agriculture are likely to be disappointed as powerful lobbies will bring their influence to bear to minimise cuts in payments and to extend the transitional period.

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