

Evaluation of the relevance of border protection for agriculture in Switzerland**Assessment and recommendations****Report to the Swiss Federal Office for Agriculture (FOAG)**

Final report.

Assessment and recommendations

1. Switzerland's overarching agricultural policy objectives reflect societal concerns about various production aspects of agriculture, such as environmental sustainability and animal welfare, and the expectation that agriculture will provide public goods demanded by society. The sector is tasked with making a significant contribution towards: ensuring food supplies for the population; preserving natural resources; maintaining agricultural land in a cultivated state; encouraging decentralised settlement; and guaranteeing animal welfare.

2. Among the various policy instruments used by Switzerland to achieve these objectives, border protection – reflecting either single tariffs or a system of tariff rate quotas (TRQs) on agriculture and food imports – represents a significant component of support, in addition to direct payments to producers. Tariff protection for agricultural products averages 30.8%, but is significantly higher for some products (WTO, 2017).

3. On balance, border protection is not relevant for achieving the overarching objectives of Swiss agriculture. As an instrument of agricultural policy, border protection targets farm incomes by maintaining a price differential between domestic and international prices. This stimulates domestic production so that Switzerland meets its target rate of gross food production. But it does not address the range of market failures that affect the externalities and the provision of public goods generated through agricultural activities of concern to Swiss society. In addition, by stimulating domestic production and raising domestic prices to high levels, border protection may lead to conflicting outcomes across the overarching objectives.

4. In summary, border protection is unlikely to deliver the outcomes and public goods desired by Swiss society. This is because support provided through border protection is:

- *Not conditional on delivery* of the outcomes and public goods demanded by society, such as improved environmental outcomes and animal welfare.
- *Untargeted towards the activity or factor of production* most strongly related to those outcomes and public goods, for example, farming systems and practices that preserve natural resources or deliver a higher level of animal welfare.
- *Untargeted to regions* that are valued by society for services beyond agricultural production, for example, land at risk of abandonment or in areas favoured for recreation and by tourists.

5. Further, while higher incomes may compensate producers for the costs associated with supplying non-commodity outputs, such as a higher level of animal welfare, border protection is an inefficient instrument for raising farm incomes.

6. Moreover, border protection imposes significant costs on the Swiss economy by increasing costs for domestic consumers and intermediaries, reducing consumer choice and economic welfare, and constraining growth in less protected and more efficient sectors, including in agriculture. While the TRQ system generates rents, since domestic prices are higher than international ones, they are largely captured by the downstream sectors – and retailers in particular – for most products, as a result of an uncompetitive structure in downstream markets.

7. In place of border protection, a more effective and efficient set of policies is needed to achieve the overarching objectives of Swiss agricultural policy. The OECD has shown that specific and tailored instruments are necessary to address the social, environmental *and commercial* objectives of Swiss agriculture (OECD, 2015, 2008, 2003a). Reflecting this, the alternative policies proposed below target the outcomes and public goods demanded by Swiss society, with a view to also improving the productivity and competitiveness of the sector and meeting the objectives at a lower cost to consumers and taxpayers.

8. Six alternative policy instruments are proposed. To a great extent, Switzerland already has the instruments in place, both to achieve the overarching objectives and to manage the transition to a more open market. For this reason, the proposed policies are classified into two groups. The first includes instruments that are already in place, but could be better structured according to the target of the policy. The second group consists of new instruments. Collectively, these policy instruments target the outcomes and public goods where there is a role for agricultural policy – ensuring food supplies for the population; preserving natural resources; maintaining agricultural land in a cultivated state; and guaranteeing animal welfare. It does not consider the broader, non-agricultural policies that are required to address some overarching objectives, including ‘decentralised settlement to help maintain rural areas’ and ‘preservation of natural resources’. For these objectives, other policy areas will have to be considered, including rural development policy and environmental policy.

1.1. Group 1 – Existing instruments newly structured

9. The first group of policy instruments are defined according to the recommendations in OECD (2015). Taking those recommendations as a starting point, the following sections propose a restructuring of existing instruments so that they are more in line with the overarching policy objectives and, as a consequence, help the agriculture sector adjust to a more open market. Specifically, existing policies would be restructured to become more targeted and tailored to policy objectives, potentially leading to lower costs, including direct payments, administrative costs and transaction costs. The first group has the following policy instruments:

- Regional differentiation of direct payments.
- Stronger environmental standards.
- Consumer information system.
- Sustainable productivity matrix.

1.1.1. Regional differentiation of direct payments

10. Government support will be necessary to ensure the provision of some non-commodity outputs if border protection is abolished. In particular, there will continue to be a role for agricultural policy in ensuring the *maintenance of cultivated landscapes*, and agriculture will continue to place pressure on agriculture’s *natural resources* even if border protection was abolished. However, these issues are specific to certain areas. To maintain agricultural landscapes in a cultivated state, government support should be targeted to low productivity areas with the potential for abandonment, and agricultural areas in regions that also have leisure value and attract tourists. Similarly, environmental challenges, and the payoffs to environmental measures –for example, setting aside land as

ecological compensation areas to enhance biodiversity – are likely to differ between regions.

11. In its 2015 review, the OECD recommended a differentiated direct payment system to secure the provision of non-commodity outputs demanded by society, such as cultural landscape and biodiversity. Specifically, the system of direct payments could be restructured to link even more explicitly with the overarching policy objectives. Currently, only 34% of direct payments are regionalised to reflect conditions and objectives in different areas (OFAG, 2016). This means that 66% of payments are untargeted to production situations and geographical conditions, leading to inconsistencies between implemented policies and the various outcomes targeted by those policies (in terms of the overarching objectives). This suggests that there is considerable scope to improve the targeting of support to site-specific non-commodity outputs.

12. The existing system of direct payments, and the non-regionalised share in particular, could be restructured to differentiate between the geographic locations of producers, in order to better reflect differences in production situations, the potential to supply non-commodity outputs, and environmental challenges (Figure 1). For example, funding could be reallocated among existing payment categories, and some payments restricted to certain regions. This would ensure the provision of non-commodity outputs for which demand and supply differ by area, such as ‘maintenance of cultivated landscapes’.

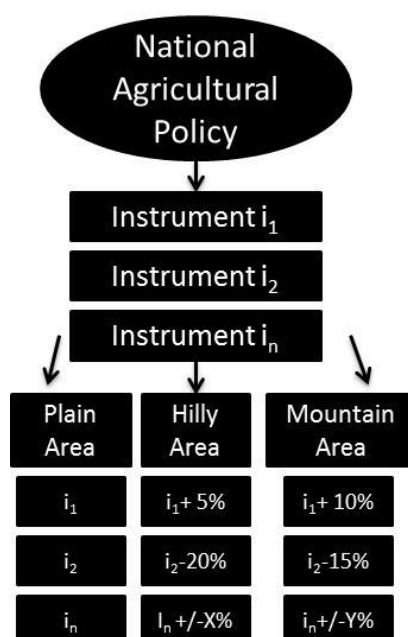
13. The main advantages of restructuring direct payments to differentiate between areas are:

- They are more target-oriented.
- They better match to relevant production conditions.
- Better targeting of direct payments will lead to efficiency gains. As a result, the total sum of direct payments can be reduced in the long term, reducing the burden on the budget.

14. The main disadvantages of restructuring direct payments to differentiate between areas are:

- From an administrative perspective, the design of the system of direct payments becomes more complex, which could increase administrative costs.
- Identifying which direct payments can be regionalised will generate additional administration costs in the short term.

Figure 1. Regional differentiation of national direct payments



Source: Derived from OFAG (2016) on regional differentiation of direct payments.

1.1.2. Strengthen environmental standards

15. Agriculture plays a key role in the national sustainable development strategy. Yet, even though 98% of producers comply with environmental regulations, most of the agri-environmental targets for the sector have not been met and remaining challenges highlight the need to improve the sector's environmental performance.

16. The border protection is not relevant for achieving the objective of *preserving natural resources*, because it encourages more intensive production. This is associated with negative environmental outcomes in Swiss agriculture (OECD, 2015). Abolishing border protection is expected to reduce the negative environmental externalities of agricultural production. However, persistent gaps in the environmental performance of the agricultural sector mean that further adjustments to policy are needed to achieve the objective of preserving natural resources. This is despite current high levels of direct payments – 33% of gross farm receipts on average in 2013-15 – that provide direct incentives targeted to environmental outcomes and specific farming systems and practices.

17. In its 2015 review, the OECD recommended that agri-environmental policies be strengthened by incorporating current cross-compliance requirements into mandatory regulations, to provide a baseline for new and more stringent cross-compliance requirements linked to support payments (OECD, 2015). Moreover, through targeting cross-compliance conditions geographically – for example, by varying the stringency of conditions according to the nature of environmental challenges in a region – the environmental performance of agriculture would be improved more effectively and at a lower cost.

18. The advantages of strengthening environmental regulations and implementing more stringent and targeted cross-compliance requirements are as follows:

- The effectiveness and efficiency of environmental regulations would be increased. Agri-environmental targets could be met at no additional budgetary costs.
- More stringent and targeted cross-compliance requirements are relatively easy to establish from an administrative point of view, as the system is already in place.
- The increase in the administrative burden would be limited as the current system of direct payments already targets certain farming systems and practices, and uses some geographical differentiation.

19. The main disadvantage is that farmers may incur higher costs to comply with strengthened environmental regulations, as some environmental and sustainability criteria would no longer be voluntary or linked to direct payments.

1.1.3. Consumer information system – influencing consumer preferences

20. Abolishing border protection will expose Swiss producers to world prices and increased competition from imports in the domestic market. However, lower overall food prices may create an opportunity for Swiss producers to differentiate their production and capture a market premium based on a range of attributes, including: higher food standards, more sustainable and animal-friendly production systems, and better taste. In particular, this may help producers offset the additional costs of *guaranteeing animal welfare* through implementing more stringent voluntary programmes.

21. Switzerland's consumers are willing to pay a premium for Swiss agro-food products. A recent study found that Swiss consumers were willing to pay more for Swiss products, on the grounds that they meet higher standards and taste better, and that it is a way to support domestic producers (Bolliger, 2012). This suggests that the Swiss agro-food sector can adjust to a more open domestic market and increased competition from imports by positioning itself as a competitive supplier of high quality products.

22. In its 2015 review, the OECD argued that the 'Swiss brand' image should be maintained and enhanced for domestic and foreign customers, to increase the competitiveness of Swiss food industries. Likewise, a 'Swiss brand' would allow the agriculture sector to differentiate itself from imported products and benefit from Swiss consumers' preferences for domestically produced products – in economic parlance, lower the substitutability of imports and Swiss products.

23. Switzerland has already developed legislation to strengthen and preserve the competitive advantage represented by the "Switzerland" brand. In January 2017, the Ordinance on 'Swissness' (HasLV) came into force, which defines the criteria that have to be fulfilled in order to use the Label "Swiss", and the use of the label of the Swiss cross. For food and beverages two requirements have to be met: (i) 80% of the raw material or ingredients have to originate from Switzerland (100% for milk and milk products); and (ii) the processing of the products has to take place in Switzerland (for example, milk processing into cheese) (OECD, 2017).

24. Given that the Swiss brand sends a clear quality signal for consumers, there could be a high payoff to investments in generic (that is, agro-food sector wide) promotion of the "Switzerland" brand. Key steps would include developing promotions and marketing to inform consumers about the attributes of Swiss products, to help consumers make informed choices between Swiss and imported products. Key attributes would include aspects of animal welfare, as well as environmental sustainability and products with low carbon footprint. Central to this, the signal sent by this label to consumers must be *credible*. The 'Switzerland' label will need to be supported by efforts to further enhance

the transparency of food value chains through fully developed traceability and systems audits.

25. The advantages of further developing Switzerland's consumer information system are:

- It enhances trust in the food system and educates consumers in domestic and export markets about the quality attributes of Swiss agro-food products.
- Customers are included in the information process.
- It enables a better match of supply of local products to demand.
- The government acts as an enabler of market solutions, not a regulator of markets.

26. Disadvantages:

- Additional administrative and transaction costs occur, including monitoring of compliance.
- In the event that the "Switzerland" brand is misused or misrepresentation by some producers, the Swiss agro-food sector as a whole may be harmed by association.

1.1.4. Sustainable Productivity Matrix

27. The performance of Swiss agricultural policy could be improved by more closely aligning policy instruments with objectives, including as they differ between regions. As discussed in the previous sections, government support will be necessary to ensure the provision of some non-commodity outputs if border protection is abolished – specifically, to ensure the *maintenance of cultivated landscapes* and to *preserve natural resources*. However, support should be targeted to areas with the greatest value for non-commodity output provision and to the environmental challenges of specific regions. Equally, the objective of *ensuring food supplies for the population* may be best achieved through targeting investments to improve the productivity of Swiss agriculture to potentially competitive producers (mainly in the plain region).

28. A *sustainable productivity matrix*, such as the representative matrix presented in Table 1, could be used to better organise existing policy instruments, by structuring and targeting them according to the overarching objectives and their relevance to Swiss agricultural regions.

29. In practice, the matrix would distinguish between regions to reflect differences in the productive value of areas for commodity and/or non-commodity production. For each region, policy aims would be defined that align with the overarching policy objectives (to the extent that they are relevant). The matrix also includes a menu of policy programmes, where each programme would incorporate a number of instruments, including – but not limited to – existing instruments such as direct payments.

30. The *sustainable productivity matrix* also represents a practical way of implementing the recommendation from the OECD's 2015 review. Specifically, the OECD recommended a regionally differentiated, two-track system of policies:

- Under the first track, a differentiated system of direct payments to secure the provision of non-commodity outputs demanded by society.
- Under the second track, potentially competitive producers (mainly in the plain region) would be allowed more freedom to optimise their production and respond to market signals (OECD, 2015).

31. Some possible policy programmes that could be included in the matrix are:

- Innovation programme.
- Rural development programme.
- Special services programme.

32. An *innovation programme* would aim to increase the productivity and sustainability of Swiss farms and the agricultural sector more broadly. It would include measures that foster knowledge generation and transfer, and support on-farm investments in innovation, including new technologies and sustainable management practices, as well as marketing and organisational innovations. Specific measures might include investments in agricultural research and extension, innovation allowances and credits, support to potentially competitive farmers to modernise their businesses.

33. A *rural development programme* would address those aspects of rural development for which agricultural policy is relevant, and impediments that restrict the ability of farm households to take advantage of new economic opportunities. It might include measures to support the economic diversification of agricultural households (for example, into farm tourism and ecosystem services), and the development of niche markets and on-farm value adding (OECD, 2003b). It would be important to coordinate any new measures with existing rural development frameworks, such as Switzerland's New Rural Policy (NRP, since 2008), which aims to foster investments in non-agricultural areas such as tourism (RegioSuisse, 2016).

34. A *special services programme* would target the non-commodity outputs of Swiss agriculture that are amenable to agricultural policy. It would include measures to maintain agricultural land in a cultivated state, and ensure the provision of other agricultural ecosystem services, such as biodiversity. Specific measures might include the current system of direct payments, including: farmland payments to maintain open landscape; biodiversity payments; payments for landscape quality; payments for production systems and resource-efficiency payments.

35. Other considerations would also inform the development of the *sustainable productivity matrix*, beyond what is shown in the representative matrix in Table 1. Access to some measures would be determined by the geographic location of producers. For example, payments to maintain a cultivated landscape (special services programme) would only be available to producers in the mountain area, whereas payments conditional on meeting certain ecological requirements would be available to producers in all areas. Similarly, some measures to support farm business modernisation and facilitate structural change (for example, investment support and exit strategies) may only be available to producers in the plain area. Moreover, access to some measures should be open to non-agricultural providers, for example, measures under the special services programme.

Table 1. Sustainable productivity matrix

Policy programme		Innovation programme	Rural Development programme	Special Services programme	Policy programme <i>m</i>
Region and policy aim					
Region 1	Aim 1	✓	✓	■	?
	Aim 2	✓	■	✓	?
	Aim <i>i</i>	■	■	✓	?
Region 2	Aim 1	■	✓	■	?
	Aim 2	■	✓	■	?
	Aim <i>i</i>	✓	■	✓	?
Region <i>n</i>	Aim 1	■	✓	■	?
	Aim 2	■	■	✓	?
	Aim <i>i</i>	✓	■	✓	?

Note: A check (✓) mark indicates a suitable programme for achieving identified future aim, a square (■) means less suitable.

36. The advantages of developing and implementing the sustainable productivity matrix are as follows:

- The policy design becomes more efficient as it would be more target-oriented.
- It can lead to cost reduction in the long term.
- Less efficient programmes may be more easily identified, revised or abolished.
- More competitive producers achieve more freedom to optimise their production.

37. The main disadvantages are:

- In the introduction phase the matrix will appear more complex.
- Limited new implementation costs.

1.2. Group 2 - New instruments

38. In the absence of border protection, Swiss producers may experience greater price volatility as a result of exposure to international prices. This is already evident in the Swiss milk sector, where the volatility of Swiss domestic prices for raw milk has increased (Conseil fédéral, 2017). This may reduce producers' incentives to invest in productivity-enhancing innovations or to expand the scale of their operations. Going forward, this might affect the capacity of the Swiss agro-food sector to make an essential contribution towards *ensuring food supplies for the population*. It may also reduce producers' incentives to invest in sustainability-enhancing innovations to help *preserve natural resources*. New risk management tools will be important for helping improve producers' resilience to risks emanating from both domestic and international sources (Brooks and Matthews, 2015) and to provide a more stable operating environment for investment. This section proposes a set of instruments to help farmers cope with new market conditions.

1.2.1. Risk management

39. Risk management tools are essential to enable farmers to anticipate, avoid and react to shocks. Currently the Swiss agricultural sector has limited access to risk management instruments. Private insurance companies offer contracts to cover production risks (yield losses), but not income losses. There are intervention measures for providing *ad hoc* counter-cyclical payments to the meat and eggs sectors. The government also guarantees payments for a share of losses due to livestock disease outbreaks. Additional risk management tools have not been considered necessary, because border protection, in combination with high levels of direct payments, stabilises farm incomes and shields producers from market risks (Conseil fédéral, 2016).

40. Two instruments are proposed to help farmers manage risk due to market volatility and disaster situations – a *Farm Risk Account* and *disaster payments*. These would be a first step in developing a systematic, comprehensive approach for handling risks to minimise potential damages and losses, as is the aim of the Federal Council (Conseil fédéral, 2016b). Going forward, the government could also consider opportunities to facilitate the development of market-based risk management tools, such as by providing information, regulation and training for the development of futures, insurance and marketing contracts (see Box 1 and OECD, 2011).

Box 1. Agricultural risk management

OECD analysis of risk management in agriculture has identified three layers of risks which require different responses from government:

Normal risks are those that arise from variations in production, prices and weather. These do not require any specific policy response, but can be directly managed by farmers as part of normal business strategy, including through the diversification of production or the use of production technologies which make yields less variable. Income-smoothing through tax instruments for businesses is also part of normal risk management.

Marketable risks are those that can be handled through market tools, such as insurance and futures markets, or through co-operative arrangements between farmers. Examples of marketable risks include hail damage and some variations in market prices. There may be a role for government in providing information on climate and market risks to farmers and the private sector, to facilitate the development of risk management strategies and tools.

Catastrophic risks are infrequent but catastrophic events that are rare but cause significant damage to many farmers at the same time or over a wide area. Catastrophic risks will usually be beyond farmers' or markets' capacity to cope. Examples include severe and widespread drought or the outbreak and spread of a highly contagious and damaging disease. Governments may need to intervene in such cases.

Source: OECD (2011), <http://dx.doi.org/10.1787/9789264116146-en>.

1.2.2. Farm Risk Account

41. The *Farm Risk Account* is a voluntary savings account. The objective is to encourage farmers to take on more responsibility for managing risks arising from normal variations in production, prices and weather, while providing protection from more extreme market-related shocks. It draws on the experience of other OECD countries in managing risk, such as Canada's *AgriInvest programme*, a government-matched producer savings account for moderate income declines or for making investments in farming operations to mitigate risk (OECD, 2016). By building producers' resilience to normal risks, the *Farm Risk Account* enhances the viability of Swiss farms and helps ensure the production of non-commodity outputs in the long-term.

42. The *Farm Risk Account* could operate as follows. A part of farmers' direct payments would be deposited in the account, to be drawn on in the case of income losses from operational risks (such as market volatility or unexpected weather conditions). To provide an incentive for farmers to save, deposits of direct payments could be deducted from farmers' taxable income and would not have to be taxed when disbursed (in the case of losses) or at the closure of the account when used to supplement pension payments. Use of the *Farm Risk Account* would be mandatory in the event of a temporary shortfall in income from operational risks. Pay-out rules could limit access to the account to losses that lead to an income level below a certain percentage, for example 80%, of the reference income, with losses up to that level to be treated as a normal individual business risk.

43. In order for the *Farm Risk Account* to be effective, it must balance two incentives: the incentive to save; and the incentive to use the savings in case of a temporary income shortfall. Experience in other OECD countries, such as Canada, has shown that if the risk management instrument in place covers risks too comprehensively it increases 1) the incentive of farmers to specialise in riskier products; and 2) the crowding-out of other risk management programmes for handling marketable risks (for example, crop insurance), which can increase the cost for government (OECD, 2011). For this reason, the reference income level will need to be chosen carefully.

44. The *Farm Risk Account* could be introduced in Switzerland as a Private-Public-Partnership (PPP) between private banks, which would administer the accounts, and the Swiss government, which defines the conditions and may consider paying part of the administration costs. Agricultural producers would pay 100% of the premium through the direct payments.

45. The main advantages of the *Farm Risk Account* are:

- By implementing the instrument as a PPP the government can determine the conditions under which this instrument is implemented in the market, without crowding-out the private sector.
- The instrument could be used as a vehicle to reduce the direct payments over time, as farmers can use the *Farm Risk Account* to smooth their income from year to year through savings.
- No new payments are required as deposits will be taken from the direct payments.
- It encourages individual agricultural producers to take on more responsibility for managing risk.

46. The main disadvantage relates to the choice of a reference income level, as border protection has resulted in very stable incomes.

1.2.3. Disaster payments

47. Another instrument that is already in place but could be refined further is disaster payments. In contrast to the Farm Risk Account, these payments address catastrophic risks that are beyond farmers' or markets' capacity to cope, such as natural disasters, the outbreak and spread of a highly contagious and damaging disease, or a threat to food security. Effective policy responses to catastrophic events can help minimise the disruption to agricultural production, ensuring that sector is able to make an essential contribution towards ***ensuring food supplies for the population***. The procedures, responsibilities and limits of the policy response – including explicit triggering criteria and types and levels of assistance – would need to be defined as precisely as possible. Similar systems already exist and function well in several OECD countries (Conseil fédéral, 2016b; OECD, 2011).

1.2.4. Transition period - phasing out of border protection system

48. A transition period will be necessary to manage phasing out high border protection and the move towards a more open market. A first step would be to lower the existing out-of-quota tariffs, and to expand quota levels. Tariff reductions and quota expansion could be introduced according to a schedule, which would increase access to the Swiss market, while allowing domestic producers to adapt to a more open domestic market – reducing the severity of the shock to the domestic market. This would be decided on a case-by-case basis and estimated at the farm level and with clear sunset clauses.

49. The advantages of such a transition instrument would be:

- No additional administrative costs, as the administration system for TRQs is already in place.
- System would become more transparent.
- Quota-rents would disappear gradually, leading to potential benefits for consumers.
- Producers have time to adapt to the new market situation.

50. Disadvantages could be:

- Transition payments would establish new direct payments to producers.
- Low incentive to abolish tariffs completely.

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