

A NEW PAYMENT SCHEME FOR THE CAP BEYOND 2013¹

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Introduction

The successive waves of CAP reforms since 1993 have been both drastic and minor. By this paradox I mean that changes in policy instruments were deep, but changes in the magnitude and the distribution of support were limited. The switch from price support to direct payments has corrected major internal market imbalances, reduced surpluses and soothed external trade conflicts. But the distribution of support across farms and productions is still very much influenced by the past and highly skewed because of heterogeneous farm structures. It has been adjusted through modulation, “regionalization” and other flexibilities, but marginally.

The main instruments of the CAP are now the direct payments of Pillar I and Pillar II, the single Farm Payment (SFP) being the essential part. The key issue for the future is whether legitimate objectives of the CAP, inasmuch as they reflect society’s expectations, are well served by the latter instrument. In particular, are income support and food security goals convincing arguments to justify the current SFP? And are essential public stakes, such as environmental quality in rural areas, being effectively addressed? To sum up, do the current payments give farmers the proper incentives to deliver the various services that society wants, and rural public goods in particular?

This presentation is focused on designing future payments, but two other concerns for agricultural policy, namely price instability and balanced competition in the food chain, deserve a brief mention since they are central worries in the farm community and they interact with the reform process. Expectedly, recent price developments have shown that price instability has become a more familiar feature of European agriculture than in the past. The swing of prices has harshly depressed farm incomes, the more so as overly optimistic expectations in 2007 triggered excessive investments in farming. A reconsideration of direct

¹ This presentation is based on three published sources: 1) Notre Europe’s report *CAP reform beyond 2013: An idea for a longer view*, by Jean-Christophe Bureau and Louis-Pascal Mahé (available at <http://www.notre-europe.eu>), (2) the book *Politique Agricole: Un Modèle Européen* (2001) Presses de SciencesPo Paris (Agricultural Policy: A European Model) by Louis-Pascal Mahé and François Ortalo-Magné (the book is available in French but has not yet been translated into English) and (3) chapter 7 (The UK Rebate, the budget and the post-2013 CAP Faced with Fiscal Federalism) by L.P. Mahé, H. Naudet and M.A. Roussillon-Montfort) of a book to be published in June by Routledge (<http://www.routledge.com/books/International-Trade-Consumer-Interests-and-Reform-of-the-Common-Agricultural-Policy-isbn9780415570190>) .

payments will be easier if proper devices to shelter farm incomes from extreme shocks are implemented. On this regard my own view is that price safety nets should not be discarded as a complementary tool to other instruments such as insurance or futures markets. Free financial markets have shown that they may fail, and agricultural markets as well. But on the other hand, price safety nets should be designed to avoid the vagaries of the old CAP, be sheltered from short run political pressure and not be diverted into schemes generating surpluses or inducing risk exposure due to excessive specialisation of farms.

Regarding competition along the food chain, it is evident that both farmers and consumers are the weakest players just by the sheer ratio of numbers involved in transactions. My view is that competition policy implementation is more lenient towards firms in a dominant position than towards farmers who organize to increase their market power. I do not believe that formal contracts will be a sufficient solution to restore the market balance in favour of farmers. Monitoring the fairness of price negotiations requires more than formal contracts. It is apparently easier to prove collusion in cartels than excessive use of market power by oligopolies, hence the exceptional possibility granted to farmers to organize as producer groups should be protected.

This note has three sections: (i) reasons to reform the Single Payment Scheme, (ii) a new concept for agriculture policy in Europe, (iii) reasons for maintaining a supranational CAP but with “financial responsibility”.

One basic message of the note is that the most solid argument for granting direct payments to farmers today is their contribution to the provision of rural public goods. Hence the payments have to be adequate incentives to ensure this provision. A second message is that European competence and more financial responsibility of MS are necessary to avoid opportunism in the European Governance decision making. But, contrary to some positions in favour of full renationalization, my reading of the literature and experience on fiscal federalism is that it does confirm the merits of some competence at the central (European) governance for agricultural and rural policies.

1. Reasons to reform the Single Farm Payments

Three goals are usually mentioned to justify the current direct payments to farmers in Europe: to support farm incomes, to ensure « food security », and to reward the provision of rural public goods. Some goals can be fulfilled in parallel such as farm income and food production (a component of global food security), for example by payments to farmers. But other goals may be conflicting such as more production for food security and environmental protection. Some goals have lost legitimacy and others have gained weight such as the provision of rural public goods.

Justifying current payments by income support arguments is much less relevant today. It is true that in some parts of Europe farmers incomes are lower than average, but in other areas it is the converse. In several regions or countries farm incomes are even higher than incomes of other rural dwellers and there is ample evidence that payments per farms are larger in the relatively rich regions. More basically, a genuine income support policy should pursue distribution equity over the whole economy and sector policies such as the CAP are not an adequate tool for this purpose. Hence this argument is at best ambiguous. Of course, the current farm incomes are now in such a dire situation that the general picture may appear

optimistic. But the pessimism of today is as excessive as was the optimism of 2007. The long run outlook for prices and demand is however not gloomy and stands between the boom of 2007 and the depression of 2008-9. Adverse market conditions should not blur the distinction between risk management and long run income policies. A main problem is the heterogeneity of incomes levels in agriculture, and the distribution of payments is a factor of aggravation rather than mitigation. Moreover the benefits to farm labour are limited due to several mechanisms of dissipation upstream or down stream. Hence the record of the Single Farm Payment does not pass the test of legitimacy regarding a genuine goal of income policy.

Food security is a perfectly justifiable goal from a political and statehood view point. This argument has even gained support in countries which are traditionally free trade minded. One difficulty is that its promoters often confuse food security with more agricultural production only, and nearly of every commodity. But Europe is more than self sufficient in most temperate zone food products. Moreover, if this argument is genuine, then countries who claim its validity should have sizeable food programmes targeted at the most deprived and malnourished part of their population. This does not seem to be the case. Moreover, for the pursuit of this objective to be authentic, a panoply of other instruments should be used as well and be focused on the management of food shortage crises. Consequently the direct payment scheme is a very peripheral way to attain food security.

One related problem is however probably more serious and appears to be a matter of concern for all the top policy makers in charge of agriculture in Europe. What proportion of European farms can survive an eventual complete phasing out of the Single Farm Payment? First, I believe that static simulations of a brutal cut of payments on accounting farm data has to produce a pessimistic picture. Thanks to a sufficiently long transition period, adjustments possibilities would be exploited. Second, this is not the envisaged alternative scenario since a reshuffle rather than an elimination of payments is at stake.

The preservation and enhancement of rural public goods (biodiversity, landscapes, open rural space, water quality etc.) is now a widely accepted function of agriculture beside food production. It has been recognized by European Councils. European citizens value the farm landscapes and rural environment inherited from the past. But the “jointness” (combination) of agriculture with environment is positive in cases and negative in others. A lot depends on farm practices, on intensity of techniques and on curbing pollution devices. Farm practices and techniques have long been influenced by coupled payments and are still impacted by the present payments, particularly when the historical reference is still applied. Simple examples are the “compensatory” payment to silage maize and the premium to irrigated maize which had implications on the decline of meadows and on water tables etc. The credit for payment rights inherited from past intensification strategies of farmers are still rewarding practices and techniques which are at odds with public good provision.

Decoupling was a progress but it has only curtailed the wrong incentives long given by the first pillar of the CAP regarding rural public goods. The magnitude of current payments is in no way related to the provision of environmental services since it is largely influenced by past price support references. Now time has come to switch from wrong or neutral to positive incentives and to reward good rather than bad farm practices.

The environmental benefits of the reforms carried out thus far are mixed. There is only scant evidence of a positive effect from National Rural Development Plans assessments and other analyses. The record of positive impacts of Rural Development Plans on rural employment and development is patchy and uncertain. We have little evidence that cross-compliance is really effective, it works to some extent on buffer strips but pollution abatement apparently does not work at all and biodiversity losses persist. The history of support has created across Europe a culture of “right to receive support” in the farm community. Hence the implementation of cross-compliance (which included too many items of existing regulations) was perceived as a further bureaucratic burden and not as a legitimate counterpart. “Negotiation” of actual conditions and sanctions lead in some instances to seriously weaken the incentive to conform.

The way the budget is financed and the payments are distributed makes the CAP prone to inefficient governance. Net financial balances have long been a bone of contention, which has culminated in the rebate granted to the UK and a few other Member States. The “financial solidarity principle” creates a situation akin to the Tragedy of the Commons or the “restaurant table” effect. In most Council decisions Member States are concerned by the “*retour budgétaire*”. Decisions are exposed to national biases and may act against the welfare of the Union as a whole. The current process of revision of the CAP may be polluted by this problem. Pillar I is financed by the EU budget and only Pillar II is co-financed by Member States. There are good reasons it should be the other way around from a perspective of fiscal federalism. The problem makes the Member States less responsible for their respective negotiating position and in particular with respect to EU spending.

2. A new concept for the CAP – a Contractual Payment Scheme

The design of the CAP payments for the future faces many challenges. Three are repeated here:

- Find a workable differentiation of rewards across regions, farm types and production techniques in accordance with the diverse impacts of agriculture on rural resources
- Tailor payments to incentives to husband rural public goods better than with the present SFP system
- Discipline national interests and second thoughts in the decision process regarding national financial balances

A new concept is needed for designing a new generation of payments. To ensure effective delivery of rural public goods, the new policy should be inspired by basic principles:

- *differentiation* and *targeting* – according to space and practices;
- *proportionality-efficiency* – there should be a closer link between the value of services and subsidies and, if possible, between the value of those services and the incurred costs;
- *consistency* – for example, the aids to organic farming – which combine farm products and services for the environment – should be more attractive than those for conventional farming. Today the reverse is true due to the historical weight on the system;
- *simplicity* and *stability* of policy instruments – this is very difficult to achieve, particularly for politicians, as they want to be seen doing new things. Often changing schemes increases administrative costs since sunk costs at launching stage are

dominant; stable schemes benefit from learning processes and returns to scale due to spreading of sunk costs over years.

- *contracts* –the open-counter payments that we have now in place should be substituted for a contract system (described below);
- *financial responsibility* of the Member States – rather than so-called “financial solidarity” – to discipline national interests and to free the decision-making process at the EU level from national hidden motives.

The proposal is essentially to introduce a three-stage *Contractual Payment Scheme* that covers the current Pillars I and II.

1. The Single Farm Payment is replaced by a contract which offers *Basic Husbandry Payments (BHP)*. These payments are the counterparts of few but easily observable commitments regarding rural farming landscapes, biodiversity and natural resources conservation. The BHP target commercial farms in areas of rural territory considered to be “ordinary” – *i.e.*, farms in the main part of the rural territory with fairly good agricultural land – and they are tied to commitments made by the operators. This reverses the current logic of cross-compliance, which amounted to grant entitlements and after to ask for additional commitments. Moreover, payments are substantially scaled down compared with the current Single Farm Payments. They are neither tradable nor transmissible to heirs, and their duration is significant but not unlimited (to avoid capitalization into entitlements or land and to curtail leakages up and downstream).

The BHP is supposed to reflect the opportunity cost of using farm practices that are more demanding than the strict accordance with existing regulations. It is expected to be scaled down from the average European SFP. Inasmuch as it reflects opportunity cost of commitments, the BHP should also differ across space or even across countries since the opportunity costs of labour and primary factors also are different.

2. The second stage is *Natural Handicap Payments (NHP)*. These are contractual payments targeting farms in rural zones with natural handicaps that hamper their competitiveness but at the same time are essential to the rural fabric (sparsely populated, mountain, remote, northern, dry..). The NHP are akin to the existing LFA payments of Pillar II, but the handicapped zones would be defined more strictly and more finely. For a rural zone to be eligible for NHP, agriculture has to be the essential base of economic development. These payments may be coupled with production or with numbers of animals under conditions of low input or low stocking rates. There is evidence (Scottish study) that strict decoupling may lead to abandonment and loss of jobs otherwise induced by agriculture. The reason to associate BHP with less intensive techniques is that in less favoured areas environmentally is often both sensitive and endowed with a potential to generate recreation activities.
3. The third stage is *Green Points Payments* (or green stars as I used to call them before). These payments would target the farms that use organic production techniques or commit to a higher level of environmental services than stipulated in the basic regulations. There is a schedule of credit points associated with a menu of commitments regarding rural landscapes and environmental resources in rural areas. The Green Points Payments should be prescribed for portions of the rural territory that are environmentally sensitive or endowed with high nature value assets. They could also contribute to alleviating the footprint of agriculture in other areas, such as the ordinary areas, by supporting farms that

engage in organic and certified extensive methods. But the bulk should be for the zones that have a high nature potential.

The horizontal principles of the system are the following:

- payments for services to rural public goods instead of the right to income support;
- no more open-counter aids, but contracts that are of limited duration and *intuitu personae*, i.e. not transmissible;
- financial responsibility instead of so-called financial solidarity: all the contractual payments, including the Basic Husbandry Payments, are co-financed by the national budgets (the percentage can be discussed). This would greatly reduce existing disparities in financial balances across Member States.

3. Reasons for maintaining a supranational CAP but with “financial responsibility”.

Following lessons from fiscal federalism, the EU would be expected

- to limit its domain of competence to European public goods and to leave it to national or local governments to rule local public issues,
- unless an inefficient outcome for local communities is viewed as resulting from political failure (inadequate decision making at the local level)
- and when redistribution objectives (in favor of the less well off citizens, countries and regions) are at stake.

The proposals maintain a degree of supranational CAP. The assumption is that rural public goods can be provided by agriculture under certain conditions and that some public goods are global enough to justify EU competence and spending from European funds. The challenge is to avoid free-riding by Member States.

Global public goods clearly include climate change control, general biodiversity and endangered species and existence value of rural landscapes. Other amenities in the rural areas such as user value of landscapes and water resources for irrigation are mainly of local nature. Water quality of water tables and rivers is to a large extent local, unless they cross borders.

Green points payments can clearly be eligible for EU financial support as they enhance environmental quality in general and biodiversity in particular which have a clear public good nature with a European component. Other targets such as extensive meadows, river banks protection and limits of nitrates spreading which aim at water quality protection have a predominant local public good nature. Hence there are some arguments for a degree of subsidiarity in both decision and financing. Co-financing of these payments by EU, National and local funds reflects the mixed nature of the corresponding public goods regarding the eventual beneficiaries.

The *Natural Handicap Payments* find a clear legitimacy in the principle of cohesion; hence the co-financing is a logical implication. The difficulty is the definition of the relevant zoning and eligibility conditions of recipients. Local or national governments will have an inclination to overestimate the size of the eligible population even if the national budget is participating. The criteria for the zoning should be strict enough to avoid such deviation.

Contrary to the current SFP which have a doubtful contribution to rural public goods, the *Basic Husbandry Payments*, are more legitimate candidate for EU funds as long as they are associated with commitments to environmental friendly practices. But since these commitments would be tied to public goods which are partly global (biodiversity) and partly local, there is no reason why they should be totally financed out of the EU budget. Hence joint financing by Members States and the EU budget appears to be an adequate solution.

Those who argue for renationalization tend to underestimate that Europe has captured competence over a number of public goods that, in principle and on theoretical grounds, could instead be the prerogative of local competence because of their predominantly local nature. Water quality is an example and European citizens are grateful to benefit from the water directives. This reflects a concern that some local public goods would not be taken care of adequately because of political failures at local or national levels. EU competence is also accepted on matters for which political preferences are quite different across Member States such as animal welfare. Another reason for maintaining EU competence on agricultural policy is to maintain a discipline on national aids and preserve the single market. Generalised co-financing would greatly reduce the magnitude of national net balances and therefore improve the decision making for the welfare gain of Europe as a whole.

Conclusion

The suggestions are partly radical – with respect to personal contracts, land sliding redistribution of the payments and joint co-financing of Pillar I – and they are partly *ad hoc*. They will not substitute for other policies, such as environmental or regional policies. They recognise empirical constraints; in particular the fact that there are limits to fine-tuning and that there are administrative costs. The administrative costs may burden the schemes if they are too detailed and complicated, or if targeting is too narrowly defined. Hence they are not entirely consistent with the principle of proportionality-efficiency. The Basic husbandry payment granted per hectare of land managed in a given manner is a second best for a precise targeting of environmental services.

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