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A CAP fit for the 21st Century

1 - DRIVING FORCES FOR CAP REFORM

These are summarised under four headings: international pressure; budgetary pressure, societal concerns, and the needs of the farming sector itself.

1.1 - *International pressures: trade liberalisation*

There is no doubt that in the 1990s the need to bring agricultural policy within the disciplines of the world trading system under first GATT and then the WTO was a very important driver of policy change in the EU. As one of the world's largest trading blocs, the EU saw the continued process of trade liberalisation, particularly to bring service trade and intellectual property into the system of disciplines, was in its self interest. The price was that agricultural trade had to be subject to rules on domestic supports, export subsidies and import access.

The Doha Development Agenda continues this process and once again agriculture has been a critical element of this round. At the outset of this round in 2001, the product-linked domestic supports of the CAP, the continued use of export subsidies and the generally high tariff protection of EU agriculture were all seen as disadvantageous to the development of poorer countries, and therefore areas where the EU should offer change. From an EU perspective again the trade-off were in the service sector which economically is much larger for the EU.

Because the EU is a supra-national organisation it has to agree amongst the Member States (MS) some core elements of it's negoti-

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ation position before it can enter into the multilateral negotiations. The most important of these was the need to decouple domestic farm supports from agricultural production. This was largely accomplished by the Fischler reform of 2003/04 whose central element was the decoupling of the Direct Payments to a range of core products and the bringing together of these payments into the Single Payment System. As the Doha Round continued, the EU also indicated, in 2006, willingness to eliminate the use of export subsidies provided there was full reciprocation from countries using export credits, state trading and food aid as their instruments of choice in assisting their farm exports.

Despite these very significant EU concessions, and a willingness to cut bound tariffs subject to special treatment of sensitive products, the Doha Round reached no conclusion before the expiry of the mandate of the Bush-led US Republican administration. The failure was not because of the EU but disagreements between the USA and India.

In short, the immediate pressure for CAP reform arising from trade liberalisation has diminished, but, there is no going back on the Doha price the EU has already paid. However, assuming the global economy has emerged from recession by 2011/12 when the real CAP reform debate is next in full swing, it seems reasonable to expect that the conventional argument that developed country agricultural protection hurts developing countries will be back on the agenda.

1.2 - *International pressures: structural change in agricultural commodity markets*

The period 2007/08 will surely be recorded in economic history as truly extraordinary. Not only did it witness the worst global financial crisis, perhaps ever, as the over-stretched banking system imploded, but it also saw energy, hard and soft commodity prices rise spectacularly only to collapse even faster. The food price spike was long enough and severe enough to cause significant market disruption, hardship in many food-importing developing countries and a noticeable rise in numbers of malnourished people. It also introduced an understandable but dangerous tendency for export restrictions to be used in many countries which added to the world price rise.

Many commentators rushed to the judgement that the world, and agricultural markets really had structurally changed. They argued that

pressure of global demand from population and economic growth, together with approaching environmental capacity limits for water, pollution absorption – especially green house gases – and the requirement to produce energy from land, place us in a new era. They claim this era will be characterised by food insecurity and therefore higher, and perhaps more volatile, agricultural prices.

However by the autumn of 2008 the collapse of energy and agricultural prices, the observed supply response in the 2008 harvests, the impending recession, and more thorough analyses of the markets, led to less dramatic conclusions. The consensus of EU, OECD and FAO analysts is that for the medium term, and certainly the period during which the next CAP reform will be debated, prices may be significantly above the low levels of 2000-2008, but that volatility may continue¹. In short, it is too soon to say if the 20th Century long-run downward real agricultural price trend has reversed.

The conclusion from these events for the CAP is not so clear. An era of higher international prices for farm products might imply less justification for publicly financed farmer supports and payments. Alternatively, reawakened concern for food security might imply continued, or even higher, farmer protection in Europe. Predictably, there are voices arguing for each of these positions.

1.3 - BUDGETARY PRESSURES

In the last two decades the principal effective force for CAP reform have been the international pressures and the pressure from the EU budget. In December 2005 European Council, the UK Presidency was determined that there must be a full review of all EU policies and their expenditures as well as the own-resources of the EU before the finances beyond 2013 were agreed². This budget and policy review was launched in late 2008. However it is not expected that the review of the EU budget will really gather momentum until after the new European Parliament and Commission are settled in place in late 2009.

¹ See MAP (2009) and OECD/FAO (2009) for assessments of world food markets and trade.

² European Council (2005) paragraph 80: «The European Council therefore invites the Commission to undertake a wide ranging review covering all aspects of EU spending including the CAP, and of resources, including the UK rebate, to report in 2008/09. On the basis of such a review the European Council can take decisions on all the subjects covered by the review. The review will also be taken into account in the preparatory work on the following Financial Perspectives».

In the meantime DG Agri took the view that it would be better for the CAP if it was reviewed before the general budget review had gathered pace. In 2007, Agriculture and Rural Development Commissioner Fischer Boel therefore launched what she called her CAP Health Check. It did not constitute a thorough-going review of why Europe needs a policy at all, what it should do, and why it should be a common policy financed from an EU budget, it was more an exercise in streamlining and simplification.

By mid-2009 the real budget debate had scarcely started. However it can safely be asserted that. First, there is no significant group calling for “more Europe” and a bigger budget to support it. The overwhelming tone of the last five years under fairly weak EU and national leadership has been a growing Euro-scepticism. This is illustrated most starkly by the French and Dutch rejections of the proposed European Constitution in May and June 2005 followed by the July 2008 Irish rejection of the watered-down version of the Constitution in the Lisbon Treaty. At the same time the 2004 and 2007 enlargements have brought into membership countries with quite different economic and political profile to most of the EU15.

It therefore seems generally to be expected that there is no question of increasing the EU budget beyond the current 1% of GDP level let alone raising the Treaty defined limit of 1.26%. The debate about the principles of the EU budget centre on what really can only be achieved at EU level with the presumption that all else must be left to the Member States. Several Member States have made it clear that they expect a significant cut in expenditure on the CAP, particularly Pillar 1. The UK Government has expressed this most boldly, their vision is for an elimination of Pillar 1 expenditure by 2020³.

The net contributors to the budget are also expecting a review of the own resources and the current system of refunds.

These were some of the principal elements of the EU budget debate before the financial crisis and recession hit. How these economic shocks affect the EU budget debate remains to be seen. There have been big increases in annual fiscal deficits, and the total public debt, in most EU countries during the recession as tax receipts fell, social payments rose and fiscal stimuli were applied. These have caused strains in the Eurozone, and seeking to enter it, particular some new Member

³ See H.M. Treasury and DEFRA (2005) *A Vision for the CAP*, and UK Chancellor to the Exchequer Alistair Darling's (2008) letter to the Ecofin Council.

States. It was always clear that the creation of a monetary union amongst countries with rather different economic performance and no willingness to pool significant fiscal policy power would provide a real test if subject to shocks. There certainly have been shocks! However it seems extremely unlikely that even the Eurozone countries will decide that these shocks necessitate a massive extension in EU fiscal coordination via an enlarged EU budget.

The point of mentioning these macro-economic issues is that they are now so large and important, they will dominate EU political affairs for many years. The implications for agriculture, agricultural policy and the EU agricultural budget, seem fairly clear. These matters will not rise in the political agenda, they will fall in EU priorities. Therefore there will be no let up in the pressure for CAP reform arising from the EU budget.

1.4 - SOCIETAL CONCERNS FOR FOOD, FARMING AND THE RURAL ENVIRONMENT

1.4.1 - *Food quality and safety*

What European society wants from its farmers and other land managers does seem to be increasing, both in quantity and complexity. Of course the first fruit of the land must be to satisfy the food needs of the population. Europe's population is growing, from immigration as much, if not more, than natural increase. It is, or was until the recession, enjoying increasing incomes. The consequential growth in food demand is a demand for much more than sheer quantity. It is a demand for higher and consistent quality, more variety, more value-added in service and convenience, and constant availability. Consumers are gradually becoming more conscious of health aspects of their food consumption. They demand higher welfare standards for farmed animals. Of course they demand the highest standards of food safety. These complex matters are regulated under many aspects of EU legislation including some measures under both pillars of the CAP. These matters are of enduring concern and, of course, they will evolve over time but they will not be major forces reshaping the post-2013 CAP.

Candidates for changing European societal attitudes towards the CAP are: food security, international development issues, renewable energy and the relationship between farming and the environment.

1.4.2 - *Food security*

It is not clear yet how the food security argument will play out in coming years. Much depends on the evolution of international markets as discussed above. It is clear that the EU is currently food secure. There were no EU food scarcity dramas during the 2007/08 crisis, although food price inflation increased causing some worries for some people in some member states. Indeed the EU remains one of the world's largest grain exporters (as well as being a big importer). Even with expected negative impacts from climate change, e.g. increased drought and heat stress in S Europe, there are analyses showing that the EU is relatively less badly affected by climate change than the tropics or high latitudes. Given that EU agriculture is already protected by the Single Payment System (SPS) and external tariff, concerns about EU food security from the non-farming community do not seem likely to be a big force in CAP reform. Farming organisations have been swift to use global food security concerns to try and justify agricultural support, however beyond calls for more research and development these organisations have not proposed specific policy measures.

Concerns about food security for the poor parts of the world have been a significant element in the CAP debate and are likely to remain so. This takes us back to the WTO and EU budget pressures for reform.

1.4.3 - *Renewable energy*

The appropriate contribution of land-based renewable energy has become a major matter for debate in the EU. The prime motive is to replace Greenhouse Gas (GHG) emitting fossil fuels by renewable energy whose production and use offers far lower emissions. There is also some element of energy security in the use of domestically produced renewable energy rather than imported oil or gas, especially if these fuels come from politically unstable or unreliable areas. Whilst EU targets have been agreed – to reduce GHG emissions by 20%, produce 20% of energy from renewable sources and increase energy efficiency, all by 2020, considerable controversy has arisen especially over the appropriate renewable energy target.

This is mostly because it is argued that in many parts of the world growing more crops for energy will bring about indirect land use change – especially deforestation – which means that these fuels increase rather

than diminish GHG emissions. However biofuels in Europe will be produced from normal arable rotations involving no land use change. In addition it may well be that a greater energy substitution in Europe comes from woody biomass, miscanthus and short rotation coppice, and from anaerobic digestion of animal and food waste. Of course to the extent that land is used for energy rather than food production there is inevitably some impact on food prices. The magnitude of this effect has become a matter of great dispute – although it is capable of being settled by fairly simple analysis.

Renewable energy therefore poses important land use questions. Also the way it is addressed, and by what policy instruments, will also be very important for farmers' revenues. However, in the world of decoupled CAP payments and the withdrawal in the Health Check of the energy crop payments, these matters have moved outside the scope of the CAP.

1.4.4 - Environmental stewardship

Until the 2008 food and financial crises, it could reasonably be asserted that environmental pressures were amongst the most important factors arguing for further CAP reform. There has been a steady growth in the perception that agriculture impacts on the environment. It does this beneficially, stewarding certain ecosystems and habitat, and maintaining important parts of the cultural landscape and rural heritage. It also impacts negatively diminishing biodiversity, and polluting water, soil and atmosphere. As these perceptions have grown and as the evidence of the scale of both the positive and negative environmental effects has accumulated, dealing with these environmental externalities have increasingly been seen as important reasons for policy interventions⁴. Indeed these have become core aspects of the second, Rural Development pillar of the CAP. Since the second Pillar was established in the Agenda 2000 reform there has been a general presumption that resources would gradually move from Pillar 1 direct payments to this second pillar to deal with such market failures.

⁴ Research commissioned in the UK by the Department of Environment Food and Rural Affairs estimated that the positive externalities of UK agriculture were £1100m in 2006, the negative externalities (apart from green house gas emissions) were £324m and the GHG emissions were valued at £942m (Jacobs, 2008).

This is another matter which could well be influenced by the general economic developments in the next few years. If the recession is prolonged and deep and it bites into consumer spending power, and if agricultural price inflation takes off again, then the public generally may become less motivated by environmental matters, even climate change, and more by the price and availability of food.

But equally, if we have moved into a new era of food insecurity implying higher food prices, this will incentivise more intensive farming, potentially creating more negative pressure on the environment, and increasing the opportunity cost of farmers delivering environmental services. The conclusion is that we should expect a rise in pressure to switch the emphasis of the CAP towards managing environmental market failures because environmental scarcity and its value is likely to rise in the future.

1.4.5 - Rural Economic Development and Rural Society

At early stages of economic development, when agriculture is the dominant employer in rural areas, agricultural development and rural development are practically synonymous. However as the share of activity and employment in agriculture falls, rural development become essentially a requirement for rural economic diversification. This in turn means dealing with the defining features of rurality namely low population density and often remoteness from other centres of population. Classic problems are declining and aging population, poorer services and infrastructure especially transport and communications. The rural economic and social challenges are different between rural areas. Some which are not so far from centres of population can experience counter-urbanisation, where the wealthy move to the countryside displacing the rural poor who can no longer afford to live there. Remoter areas suffer from outflow of young and employed people and an influx of second home owners and tourists.

The big question is then what is the role and the power of the CAP to deal with these issues? There is a very wide variation amongst the Member States in the use of the Pillar 2 measures for Rural Development. This reflects the very wide variation in the economic and political importance of rural areas around the EU. But the real determinants of the success of rural economic development will be the rate of general economic development and not decisions about the CAP. It is also questioned whether there are European market failures in rural devel-

opment which justify the use of European funds. That said, the rural development measures are one part of the CAP which have real potential to deliver cohesion objectives for the EU budget. These arguments are not clear cut. Also, the fact that there is not a strong political lobby for rural development comparable to that for the environment, suggests that rural development needs will be an element, but not decisive, in the next stage of CAP reform.

1.5 - The needs of the farming sector

It is an unfortunate truth that despite decades of assistance from what is seen internationally as lavish taxpayer support, European farming is still highly dependent on public support. When asked how they can justify public supports, farmers' organisations generally point to their low incomes; the volatility they face, the burden of regulation; their stewardship of the countryside and the needs for investment and innovation. Unfortunately, whilst there is some truth in all these matters, it is very difficult to explain how the particular pattern of support under the CAP systematically addresses any of these issues, or even how a decoupled payment could address these issues.

Figures 1 and 2 show the distribution of direct payments under the CAP as between the 27 Member States for 2007 expressed in € per hectare and € per beneficiary respectively. A close analysis of the complex series of the history of Council decisions since 1968 can explain how this distribution of farming support came about. However it would be extremely difficult to show that the distribution makes sense, or has been calibrated as a response to farmers' income, the volatility they face, the extent and cost of meeting regulatory standards, the environmental services they deliver or in relation to R&D or infrastructure needs.

A case can of course be made that many European farmers are living in poverty; that farmers face increased volatility and uncertainty in weather conditions, plant and animal disease, commodity markets and exchange rates; that European citizens are demanding tougher and costlier standards for food and operator safety, animal welfare and the environment; and that agriculture requires constant investment in new technology both to maintain productivity growth and better environmental care. However, it is extremely hard to make a reasoned case that decoupled direct payments are the optimal policy response to any of these challenges.

FIG. 1 - Average direct payment per Ms (in Uper hectare)

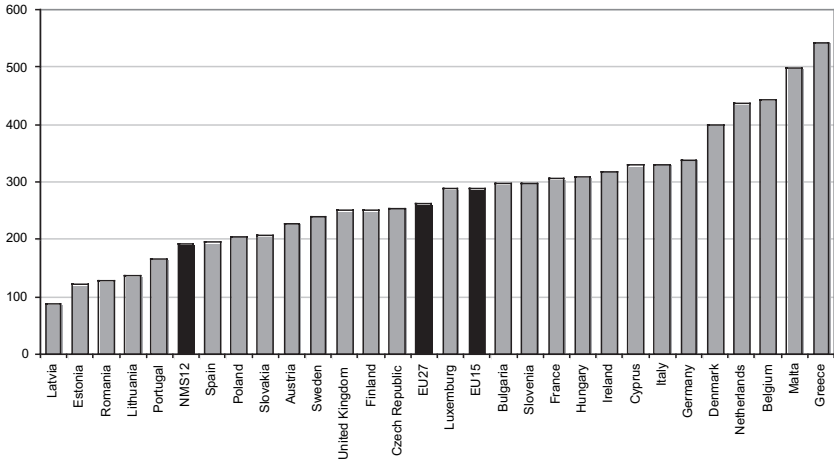
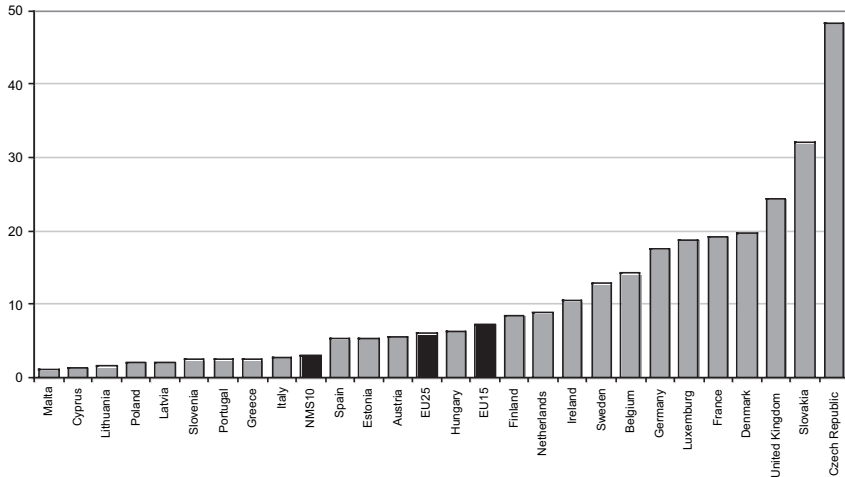


FIG. 2 - Average direct payment per Ms (in 000 Uper beneficiary)



In short, the principal effective pressure for the next CAP reform is the determination of some Member States to reduce the CAP budget. Meanwhile farmers find themselves in the difficult situation that: farming is deeply dependent on public support and yet it is unable to refute the penetrating criticisms of the type and levels of support it receives. The budget pressure and this dilemma constitute the biggest challenges for the next reform of the CAP.

2 - IDEAS FOR REFORM

The CAP has been with us for so long now, and has been the subject of such continuous debate and reform that there is an industry of CAP commentators who are constantly pushing out ideas for the next stage in this process. With some element of caricature, three broad visions for the future of CAP can be defined. These will be called the Anglo-Saxon, the Romance and the Green models.

2.1 - *The Anglo-Saxon model*

This approach claims a strong intellectual, and ideological base, namely that where markets exist they can, and should, be left to perform their function of determining prices and allocating resources. It is recognised that for markets to function well this requires a legal framework of property rights and contract law, and a regulatory framework for food safety, social and employment conditions, food labelling, competition, animal welfare and the environment.

This approach does acknowledge market failures, the fact that there are externalities and public services and disservices which are provided, or could be provided, by farmers and other land managers. There is an over-production of environmental “bads”, like pollution of atmosphere (by ammonia and Greenhouse Gases) and water (mostly by nitrates, phosphates and sediments), and an under-provision of environmental “goods” like biodiversity, landscape and cultural heritage.

It is therefore recognised that some collective action is needed to address these failures. It is generally held that the most important examples of these market failures are concerned with the environment. There is also some acceptance that common provision, transboundary effects and cohesion justify that these environmental market failures can correctly be matters for European policy action. Whilst many in this tradition are prepared to argue and justify the case for collective action for environmental measures there seems to be some reluctance and inability to spell out so clearly social failures and thus a role for policy here. Even when social issues are identified, such as human capital and community development, farm restructuring or village renewal, there is a tendency to argue that these are regional and national rather than EU concerns.

The adherents of this model will also acknowledge the need for some publicly funded research and development and that there are sound reasons for some of this to be pooled at EU level.

The stance on the CAP and its post 2013 future which emerges from this camp is clear. It is exemplified by the UK Treasury and DEFRA 2005 Vision for the CAP, and the report of the Dutch Social and Economic Council (2008). The essence is to phase out Pillar 1 direct payments and to conclude international trade liberalisation talks which embrace agricultural trade. This approach recognises that resource devoted to Pillar 2 may have to be enhanced, especially for the delivery of environmental public goods, and it also emphasises the need to harmonise the regulatory frameworks within the single market.

2.2 - *The Romance Model*

This harder to articulate, indeed no specific reference is cited. Adherents of this approach generally have been the strongest defenders of the CAP who have sought to prevent or slow down the reforms since the early 1990s. These arguments generally emanate from the main EU and national farmers' organisations. It is an approach which seeks to justify farmer protection *per se* and is inclined to come from a social (as opposed to economic or environmental) perspective, and is sometimes tinged with leftist, anti-capitalism.

The arguments advanced are nearly always qualitative, and often appeal to emotions. They stress the honest, hard work of farming, and that this is the base of the food chain which sustains us all. The approach stresses the low incomes in agriculture and thus the need for income supports. It claims that farming is at the core of rural communities, and also that farming has created and maintains the beauty of the countryside.

The approach is deeply distrustful of market forces, and thus trade liberalisation and gains from specialisation and trade. Some proponents argue that EU agricultural produce can never be internationally competitive. It must therefore depend on producing higher quality produce – which it is assumed European consumers will prefer and be willing to pay for.

There is a strong tendency amongst proponents of this school to reach for arguments that the social and environmental regulatory burden on EU farming is significantly higher than in other parts of the world and this justifies the border protection and domestic supports.

There are two other important dimensions of the arguments raised by this group. The first are structural issues. Proponents always speak of family farms, they refer to the high proportion of aged farmers, the difficulties of attracting young blood into the industry, and the general need of restructuring. The second is that all land currently farmed must

remain farmed, land abandonment is strongly to be avoided for social reasons, and perhaps environmental reasons too.

The prescriptions for the CAP from this school are therefore strongly defensive of the status quo at each stage of CAP reform. Its proponents do not feel the need to provide a vision for the CAP. They do not see any inherent difficulty in farming being dependent on taxpayer support. Their task is to minimise, slow and delay reforms.

2.3 - The Green Model

Environmental organisations, both Governmental and Non-Governmental have long understood that private land management by farmers (and foresters) has a massive impact on the natural environment and therefore that they must be active in the debates on the main policy drivers for farmers.

These organisations blame the CAP for encouraging farming practices which are damaging to the environment. The pre-1993 commodity-based CAP is seen to have driven the intensification and industrialisation of farming through the use of mechanisation, inorganic fertilisers, pesticides and farm and field enlargement⁵. The main concerns of those promoting the green model are first to reduce environmental damage caused by intensive agriculture, and second to promote incentives for the delivery of public environmental services by farmers. They are now very happy to use the economic terminology of market failure, externalities and public goods to justify these interventions.

A third concern in the Green view of farming policy is the future of the marginal areas, and in particular with what these groups refer to as High Nature-Value Farming systems. These are established, traditional farming systems, usually based on extensive livestock grazing. They have generally been in existence for many generations and are associated with landscapes and habitats that are man-made but the flora and fauna have adapted to the relatively low intensity management and have become treasured in their own right. The high degree of dependence on public support of farmers in these areas is all too obvious and the fear is that without such support these areas will be aban-

⁵ They seem to persist in this analysis despite the evidence that the intensification and industrialisation has occurred everywhere in the world whether farming was protected or not, and that the relatively unprotected white meat and horticultural sectors in Europe intensified every bit as much as the highly protected cereals, beef and milk sectors.

done, or management intensity drops to the extent that much of their value will be lost. The other main concern of this school is for the management of protected species and areas, that is the Natura 2000 areas.

Perhaps not unnaturally, the Green view of agricultural policy sees practically no role for the CAP in regard to farming. Although most green groups appear to sign up to the concept of sustainability, and most recognise that this concept has an economic as well as social and environmental dimension, their view is an orthodox economic one that there are no market failures, or market imperfections which justify collective actions on income support, risk management, structural change, or marketing. This is somewhat curious because Green groups tend not to be in favour of markets and trade liberalisation. Internationally they emphasise unfair market power on behalf of developing country producers (but rarely domestic producers), and they are concerned that the framework for international trade is not able or willing to cope with externalities.

On the CAP the green prescriptions are not unlike those of the Anglo-Saxon model: all the emphasis is on Pillar 2 and specifically environmental measures. The difference lies in the scale of resources required and the Greens' concerns for the marginal areas. Two examples of the visions for the CAP from the green perspective are the Bird Life International paper (2008) and the UK Land Use Policy Group's (2009) Vision for the Future of the CAP post 2013.

3 - CRITICAL ISSUES FOR THE POST 2013 REFORM

There is nothing new in suggesting that market fundamentalists, protectionists and greens have quite different ideas about how agricultural policy should be conducted. What seems to be different now compared to the decade of CAP reforms from MacSharry in 1993 to Fischler 2 in 2004, is that there is no emerging consensus on the structure of the CAP which should follow. The sequence of the MacSharry reform in 1993 and the two Fischler reforms of 1999 and 2004 recognised that the original commodity support based CAP had run its course. In particular the budget pressure of dealing with the results of open-ended commodity supports, and the international pressure against the market distortions became irresistible.

Under MacSharry, price support was supplanted by direct payments, initially these were coupled directly to continued production of arable crops and to the numbers of beef animals and sheep. Fischler's Agenda 2000 extended this approach, and in his second reform the direct pay-

ments were consolidated into a Single Payment which was to be decoupled from production. This approach was applied to the main “northern” products and was later extended to cover milk, sugar, olive oil, cotton, fruit and vegetables and wine. In parallel with this sequence of reforms to the agricultural market supports which constituted the first Pillar, Agenda 2000 added a new strategic approach to rural development and agri-environment in what we now call Pillar 2.

A critical problem in this reform sequence was that a vital dynamic element which was suggested by some of the early thinking on this model⁶ was omitted. This was the suggestion that the direct payments should be called, and made into, Transitional Adjustment Assistance. This was proposed deliberately to signal that the direct payments were not permanent, they were compensation for policy change which was supposed to help the industry adjust to life without, or with much lower, agricultural subsidies. If this could have been agreed, then what ever trajectory and speed of transition came out of the negotiation would have been built-in and this could have ensured a continued evolution of the policy.

Patently there was insufficient political support to integrate this dynamic explicitly into the reform. Instead we have discovered that almost as soon as each of these reforms is agreed, and before implementation gets very far, the debate commences on the next reform. It is suggested that three structural features have blocked the continued evolution of the CAP along these lines, namely modulation, cofinancing and enlargement.

3.1 - *Modulation*⁷

This the mechanism for adjusting the balance between the two Pillars of the CAP. It was an intrinsic part of the Agenda 2000 framework.

⁶ See European Commission (1997).

⁷ The name modulation for this process of transfer of funds from one part of the CAP to another arose because in each proposal to make such transfers an extra twist is added that the payment cuts should be differentiated, i.e. modulated, by size of payments. Thus the larger payments should be cut and transferred to the member State's Pillar 2 funds at a higher rate than smaller payments. In the most recent Health Check debate the initial proposal was for a payment ceiling. The motives for modulation are based on a concept of social fairness. This in turn illustrates the confusion over the purpose of the payments. If they were enduring social income support payments then there might indeed be a reason to differentiate them – although in this case it might be expected that the differentiation would be based on some objectively measured income criterion. However the direct payments were patently scaled as compensation for revenue loss. Therefore it is not surprising that all attempts at meaningful modulated payment cuts have been strongly resisted on each occasion by the Member States most affected, the UK, Germany and (latterly) the Czech Republic.

It is the name given to the process of cutting the direct payments and transferring funds to Pillar 2. In agenda 2000 modulation was voluntary and in the event whilst several Member States toyed with it, only the UK persisted⁸. The problem is that compulsory modulation rates have been modest. It rose to 5% by 2006 under Agenda 2000, and after further protracted negotiation is to rise only by another 8% to 13% by 2012 as agreed in the Health Check of 2007. The option to use national voluntary modulation on top of this has only been taken up by two Member States, the UK and Portugal. This reluctance to switch funds is partly because of reluctance mostly by farmers to accept it is a desirable policy to follow. This not surprising. If any economic agents are offered more or less guaranteed payments for respecting not-too-demanding conditions or less certain payments for delivering environmental services, it is not difficult to anticipate their preference. Importantly however, many Member State Governments are not enthusiastic to switch appreciable funds between the Pillars because of the financing difficulties this creates.

3.2 - Different financing of the two Pillars of the CAP

For historic reasons Pillar 1 is 100% EU financed, on the other hand, it was decided in principle that Pillar 2 measures should be co-financed. This creates difficulties when funds are switched between the Pillars.

The historic reason for wholly EU funding the Pillar 1 market support expenditures (intervention and subsidised exports) is that these confer the same benefit for producers of supported commodities across the entire single EU market, whereas a high proportion of the expenditures to provide this support falls in the net exporting countries. Therefore financial solidarity was a core principle of the classic CAP. This logic of this argument largely evaporates once commodity supports are turned into decoupled direct payments. Yet the 100% financing of Pillar 1 persists⁹.

⁸ This was for historic reasons because of the UK's low share of core Pillar 2 funds. This came about because the allocation for Pillar 2 in Agenda 2000 was made on the basis of use made of the predecessor accompanying and other rural development measures which had been shunned by the UK. By 2009 modulation in England reached 19% (5% compulsory and 14% national voluntary modulation).

⁹ Suggestions that Single Payments should be cofinanced run into several objections. First that this would be an undesirable "renationalisation" of the CAP. Evidently renationalisation is bad, although subsidiarity is generally thought to be a good thing! Second, it is suggested that it would distort intra-EU trade. Although it should be noted that the EU explains to non-EU trading partners that our payments do not distort extra-EU trade. Third, it is suggested that it would not be legally possible to oblige Member States to co-finance the Single Payment. The validity of this statement is debated.

The main reason for co-financing of Pillar 2 measures is to encourage sound public policy. The idea is that if national or regional funds are required then greater effort will be made to ensure that the measures meet national and regional objectives. That is, money from Brussels will be less well spent than money raised more locally. The Member State contributions for Pillar 2 actions are also justified on the basis that if the mix of benefits, and the measures chosen provide mostly regional or local benefits then they should be funded locally too.

Whatever is thought about these arguments, the facts on the ground are that most of the CAP support is currently channelled through the EU funded Pillar 1 and so for every € 100m of funds in any Member State which is switched to finance measures in Pillar 2, it demands an additional € 100m of national match funding¹⁰. Many if not most Member States are unwilling or unable to find this match funding, hence the strong reluctance to take switch funds between the Pillars much further or faster. Given the tight state of public finances in all Member States following the 2007/08 financial crisis this constraint on the development of the CAP can be expected to be even more important for the next reform.

However the modulation and cofinancing rules are man-made and can be changed. It is not so difficult to see ways out of the impasse. If a critical obstacle to desired policy progress is the different rates of MS co-financing in the two pillars, political choices can be made to narrow the gap. In principle this could be done from either side: reducing the Member State contributions (from 50%) for Pillar 2 measures, or increasing them, from zero, for Pillar 1. It is a matter of judgement which is more important: keeping 50:50 funding as the norm for Pillar 2 or accepting a lower Member State contribution; keeping sacrosanct the 0% direct Member State funding of Pillar 1, or trying to restrain any increased public expenditure cost of the CAP. These financing arrangements for the CAP will be a critical part of the next reform.

If the policy goal is to increase the resources devoted to Pillar 2, in absolute terms in € m or as a share of the budget, then it can be done through a judicious combination of modulation rate, Pillar 2 cofinancing rate, and Pillar 1 cofinancing rate. It can be achieved keeping the current total CAP budget constant, but with no additional Member State financing (by reducing the MS cofinancing rates), or if there was a willingness to introduce Pillar 1 cofinancing, then it can be done

¹⁰ This presumes the Member State co-financing rate is 50%. There are lower MS co-financing rates for regions with lower income levels and for certain types of measures.

whilst reducing the total CAP budget, and still not increasing Member State public expenditure cost of the CAP. The real point to be understood is that the most important thing is to decide what we want the policy to do and the best way to finance it should be a secondary, not a primary consideration.

3.3 - The different perspective of the new Member States

A third consideration which has significantly complicated the debate about the direction for the CAP – post 2013 is the 2004 and 2007 enlargements taking the EU from 15 to 27 Member States. The number, scale and, in particular, the different development level of the new Member States (nMS) has widened the range of views of the CAP and its future development. At risk of oversimplification, the prime concern of the nMS or the next reform is to receive what they perceive as a fairer share of the Single Payment funds. This was explicitly indicated in the political Agreement on the Health Check in November 2008¹¹. With respect to Pillar 2, the nMS have a large requirement for assistance with both agricultural and rural development, and they are least interested in the environmental dimension.

The debates over the appropriate application of the Single Payment System (SPS) to the new Member States perfectly illustrate again the difficulty with the SPS, namely the lack of agreement on what the payments are for. If it was crystal clear that they were compensation for the removal of the predecessor price support system then this would leave no doubt that the SPS was a purely transitional system – and it would also make it very hard to explain why farmers in the new Member States were being compensated for the removal of a system they had never enjoyed! If on the other hand the payments are farmer income supports, this would certainly explain why the new Member States were included, although the distribution of the payments patently has nothing to do with income levels of recipients. There is nothing in the current system of support, nor in its predecessor that measured income and scaled the support accordingly. In any case social support systems

¹¹ Political Agreement on the Health Check, 30 November 2008: «In the framework of the discussions that started in Annecy on the 23/9/08 on the future of the Common Agricultural Policy after 2013 and without prejudice to the new financial perspective for that period the Council and the Commission are committed to thoroughly examine the possibilities for development of the direct payment system in the Community and addressing the differing level of the direct payments between Member States».

exist in all Member States and are not differentiated according to occupation. Swinnen (2009) explores the extent to which the Single Payment system can reasonably be described as an income support system, he concludes it cannot.

However the stark truth of these arguments is trumped by an even clearer reality that it is impossible to defend the present distribution of the direct payments under the CAP. The fact that as shown in Figures 1 and 2, most of the nMS are at the lower end of these distributions is a political embarrassment – this explains the determination as expressed at the conclusion of the Health Check negotiation to review the distribution.

3.4 - Redistribution of the SPS

Unfortunately if there is no agreement on what the SPS is for, then it is very hard to agree how it should be redistributed. There are three broad remedies to deal with this lack of legitimacy of the SPS: to cut the payments over time; to redistribute them, or to link them more explicitly to defined objectives. The first approach is that suggested by the Anglo Saxon school, indeed a mechanism for doing it is already contained in Article 11 of the 2003 regulation which brought the Single Payment System into being (1782/03). The mechanism is called Financial Discipline.

The redistribution option is now clearly on the table. A favourite, and simple suggestion is that the national ceilings for the SPS system should be redistributed to bring about greater, if not full, convergence of payment rates per hectare across the EU¹². This would certainly be seen as a simpler system, and in a certain restricted sense fairer. Some will argue that if the cross compliance conditions for receiving the payments are roughly the same over the EU, then the payment rates per hectare should be also. However, (more) uniform payments per hectare would still not address the question what are the payments for? It would still be the case that there is an enormous disparity in the payments per beneficiary because land holdings vary so widely between and within Member States. Likewise this redistribution would not change the lack

¹² The redistribution would presumably take place over a period of years. Because the rates are so different some Member States would be large losers whilst others gained. This would have large impacts on farmers' incomes and also asset, particularly land, values for both losers and gainers. For these reasons it might be decided to close a fraction of the gap between the payment per hectare and the EU27 average, i.e. not to seek full convergence.

of relation between the payments and the income level of beneficiaries. Some small beneficiaries may have high alternative non-farming incomes, some larger beneficiaries might be completely dependent on their farming incomes.

3.5 - Specific purposes for the Single Payment, Article 68

The third option is to assign a clearer purpose to part of the funds in the SPS. This is precisely the idea behind Article 68 of the Health Check. This can either be viewed as an intelligent, pragmatic way of targeting the SPS to address market failures, or an unprincipled manoeuvre to try and dress up part of the SPS system to delay and frustrate its removal.

The article allows Member States to deploy up to 10% of their SPS funds to provide environmental benefits, improve marketing and to assist risk management in the crop and livestock sectors by contributing to crop animal health insurance. It is not yet clear to what extent the Member States will take up these options. Nor is it clear whether payments under Article 68 are subject to modulation or digressivity. Neither is it clear why the established principles of Pillar 2 should be waived. The strength of Pillar 2 is supposed to be that these sorts of measures are justified by Member States as part of regionally-defined, rural development programmes extending over a seven year period, and all within the EU's strategic objectives. Also it certainly does not seem to be a simplification that, for example, dairy farms in mountain areas could now not only receive Single Payments, Less Favoured Area payments and agri-environment payments, but also payments under Article 68. This seems, and is unnecessarily complex.

3.6 - Dependence on supports

Maybe a simpler explanation is the uncomfortable truth that farming, and in this case particularly dairy farming, is so highly dependent on protection and support that removing the market support measures (milk quotas) has to be compensated by some other assistance. This points to the scale of the difficulty of the challenge facing the next reform.

The SPS may be very difficult to justify, but the degree of dependence on the payments is shockingly high. This is illustrated for the UK in Table 1 below.

TAB. 1 - England Farm Business Survey Farm Accounts 2007/08

Type	Number in sample	Average total area	Farm Business Income		Single Payment	Environment Payments		Total Public Payments	
			Ha	£/farm		£/farm	%	£/farm	%
Dairy	296	117	55,100	22,075	40	3,569	6	25,644	47
Grazing Livestock LFA	248	129	10,400	16,164	155	9,213	89	25,377	244
Grazing Livestock Lowland	241	94	12,400	16,053	129	4,239	34	20,292	164
Cereals	356	205	73,400	37,104	51	8,260	11	45,344	51
General cropping	195	220	81,000	37,588	46	8,243	10	45,831	57
Specialist pigs	59	39	6,300	4,942	78	937	15	5,879	93
Specialist poultry	69	25	139,200	3,875	3	934	1	4,809	3
Mixed	169	151	37,300	27,666	74	6,058	16	33,724	90
Horticulture	213	30	51,800	2,043	4	1,261	2	3,304	6
All Types	1826	140	48,100	23,916	50	5,859	12	29,775	62

This shows the results of the Farm Business Survey of 1,826 farms¹³. The share of Farm Business Income represented by the Single Payment in this sample averages 50%, and excluding specialist poultry and horticulture farms, it ranges from 40% for dairy farms to 155% for Less Favoured Area grazing livestock farms. When Environmental payments are added the dependency rises to 62% over all types and 244% for the LFA grazing livestock farms.

Clearly, reducing the Single Payments will reduce farming income. This will induce accelerated structural change and undoubtedly asset values will adjust too. Surviving farms will almost certainly enlarge and or diversify. The policy decision process is hampered by the fact that these impacts are rarely discussed openly. This is partly because it is very difficult to model farm structural change because we do not have good models of the processes involved nor do we have good data on the operational structure of farming and how it changes.

In the absence of more comprehensive study of how farming structures change in response to new technology, economic signals, and changing policy, two related structural aspects of farming are of enduring concern, these are the avoidance of land abandonment, and the fate of farming in the marginal areas.

3.7 - Land abandonment and farming in marginal areas.

These will certainly be important ingredients in the debates on the next reform. Many Member States insist that all the areas currently in agriculture must remain so. Avoidance of land abandonment is evidently a high-level policy objective. It is hard to determine the precise grounds for this policy position, sometimes the social dimension is paramount, to maintain populations in areas which would otherwise become depopulated. In some situations the motive is more clearly concerned with maintaining open farmed landscape with the biodiversity and other services that the farmed landscape provides. Areas at risk of abandonment are clearly those where the farming systems are most marginal.

Whether and how to support such areas is a continuing challenge. The UK data exposed above showed that farming in these areas is totally dependent on public supports from both Pillars of the CAP. No doubt more could be done to extend the range and improve the mar-

¹³ See Farm Business Income in England, DEFRA (2008). These survey results provide the data for the UK input to the EU Farm Accountancy data Network.

keting of regionally distinctive food from these areas to maximise the return from consumers for high quality produce. These areas are not capable of competing on price with the areas more favoured for farming. However this approach alone cannot provide the answer. The future of the Single Payments is clearly under threat. In the current discussion of the basis of Less favoured Areas the view is to define these more objectively on criteria reflecting their unsuitability for agricultural production, e.g. using criteria such as soils, topography, and climate. It is not obvious how this is going to address ways of supporting these regions to produce that they are treasured for. The language of “permanent natural handicap” and “less favoured area” is a negative way of approaching areas which are valued most for their contribution to cultural landscape. If they were not valued in this way, why would society care if they become depopulated?

It might therefore be argued that it would make more sense to define them by criteria of what they are good for, namely cultural landscape, rather than what they are not suitable for. This reasoning also should lead to a reappraisal of the way we assess the appropriate payment rates for agri-environment schemes in such areas. At present we are locked into the logic of income forgone from farming as a key determinant of the appropriate payment rate. Unfortunately, by definition in these not very productive areas, there is not much income forgone by farming them slightly less intensively. Indeed there is not much income forgone if they are not farmed at all! What is lost is the open, managed landscape, and the habitat and biodiversity which have adapted, often over centuries, to these extensively grazed systems. Therefore payment rates to maintain people managing these areas would more intelligently relate to the opportunity cost in its strict economic definition – the income forgone from the *best* alternative (rather than what may often be the worst alternative occupation, farming). This would be comparable incomes in nearby towns.

Another approach to try and secure the future of the marginal areas is to try and exploit the growing possibilities for supplying new environmental services through business to business payments, as opposed to contracts between land managers and the State. Two areas where this might be developed are for carbon sequestration and for water and flood risk management. There may well be significant potential for some large tracts of marginal land to be managed in a way which sequesters carbon. This might be in peaty soils or in woody vegetation. There are undoubtedly technical questions to be resolved to find the management systems which can satisfy the strict conditions for such carbon storage to

be eligible to be part of official carbon trading schemes, namely verification, additionality and permanence. If these can be resolved the purchasers of the carbon credits are the businesses or sectors which find it difficult to reduce their Greenhouse Gas emissions. In the case of water catchment management to reduce water discoloration or nitrates, or to take flood waters to reduce urban flooding downstream, the purchasers are water utilities or local authorities for whom paying for avoidance of the problem is cheaper and surer than cleanup after the event. These sorts of solution will generally be outside the CAP, the point is that to the extent that there is significant scope to develop these approaches it may reduce the need for a public payments approach within the CAP.

4 - SUMMARY: SPS-CUT; REDISTRIBUTE OR TRANSFORM?

The two strongest forces pushing for further and potentially quite radical reforms of the CAP for the next financial perspective 2014-20 are the budget and the lack of legitimacy of the SPS. Another force for change comes from environmental NGOs who complain that aspects of the CAP still encourage farming practices detrimental to the environment and that the system is insufficiently tuned to ensure the provision of environmental public goods and particularly to ensure the what they term High Nature Value farming. The pressure for a less protected and distorted international trading system for agricultural products has not disappeared but given actions already taken (decoupling of the SPS) and promises made (to eliminate export subsidies) this pressure is lower now than in the last decade.

Unsurprisingly there are strong defensive forces acting in the opposite direction to maintain current supports even if they are to be re-deployed or redistributed. The strongest is the sheer degree of dependence of EU farming on the support system. Also enlargement has created a new constituency who benefit from the SPS, their prime motive is to get what they feel is a fairer share of this cake.

The reform proposals which emerge from the interplay of these forces have been caricatured here as the Anglo Saxon, Romance and Green Models. None can claim to have overwhelmed the others, this is the problem, there is no consensus on the way forward. The key ingredients of the debate are clear:

- The balance between the two CAP pillars: more modulation to Pillar 2?
- The degree of Member State cofinancing of the two pillars.

- Whether and how the Single Payment funds will be redistributed to be more uniform per hectare or per recipient.
- Whether Article 68's greening of Pillar 1 is the way forward or a dead end.
- The basis of support for the environment, especially for the marginal areas.

Of course these are not the only elements of the CAP but it is suggested they are the candidates for the most important changes. There are a number of other matters which are discussed in every debate on CAP reform: the remaining market supports; safety nets and risk management; skills and training; early retirement and new entrants; rural development actions on food marketing, producer groups and encouraging quality; and the community action approach of LEADER. However it is suggested that these will not be the subject of radical changes. There will also be a continued effort to find ways to incorporate what were termed the 'new' environmental challenges into the CAP; climate change, renewable energy, water management and biodiversity. However again there are few signs that there are radical ideas for how this is to be done.

Reducing the argument to its core it is suggested that the key debate in the period 2009-13 will revolve around three actions on the Pillar 1 Single Payment System – cuts, redistribution, and transformation. The most critical decision will be in which order are these three actions to be executed?

It is suggested that the groundwork for the EU Budget and Policy review laid by the UK in its presidency in the second half of 2005 has borne fruit. The UK opening negotiation position for the post 2013 reform is to eliminate the SPS system by the end of the next period and thereby to reduce the share of the CAP in the EU budget. Whilst of course this is by no means a done deal, officials in Ministries of Agriculture in many Member States and in some parts of the Commission including DG Agri, have been heard voicing the opinion that "the budget will be cut for the next perspective". Not only does this seem to be widely accepted, but it has not been uncommon also to hear suggestions of how much it will be cut, with phrases like "by a third" or "to a third of the EU budget". The UK Government strategy seems to be working. If Ministries who tend to defend the CAP are already mentally prepared to accept a lower budget then the deed is well on the way to being delivered. This suggests that the first action post 2013 is to cut the funds available for the SPS.

From the fact that the November 2008 Agriculture Council mandated a review of the distribution of the Direct Payments it seems rea-

sonable that the next action is to redistribute the funds in the Single Payment national ceilings. How this will be done will be the subject of intense debate. Each Member state will of course seek to gain as much as possible, or lose as little as possible. This will influence the system they will favour for any redistribution. From Figures 1 and 2 it is not hard to see some Member States who are most likely to lose from the SPS cuts and redistribution, and some who may emerge with least loss or even some gain. For many the outcome is indeterminate until the details of the negotiations are underway.

If this analysis is correct and priority in the next reform is given to cuts and redistribution of the Single Payments, then it seems a safe prediction that the scope for transformation or switching of payments from Pillar 1 to Pillar 2 to realign the CAP towards payments for public goods will be rather small. There will simply be little or no further appetite to further reduce the Single Payment in order to make space for resources to buy environmental services or stimulate more rural development. Those who argue that there must be much greater emphasis in the CAP on dealing with the market failures surrounding land management should therefore be alert to these arguments and perhaps campaign to change the order of priority; perhaps to reverse it.

It was precisely this line of thought which has led some groups, for example the European Landowners Organisation, to propose a vision for the CAP for the coming decades based on the twin objectives of Food and Environmental Security. Their argument is summarised in the pamphlet "Land Management in the 21st Century" and the essence is that dealing with the land-based market failures not only demands more resources than currently devoted to Pillar 2 of the CAP but that these resources are likely to increase in the future. As food insecurity rises, food prices will rise encouraging more resources to be devoted to, and greater intensity of, food production. This will increase environmental scarcity and value and therefore increase the cost of delivering the environment.

To the extent that there is validity in such arguments a wise approach in considering the next CAP reform is first to assess the nature and scale of public environmental services European society may wish to have delivered by their farmers via publicly paid schemes of one sort or another. Then and only then can we judge what resources are needed in the EU budget for the next financial perspective. Rational policy making generally decides objectives and resources needed to reach them before bidding for a budget. On our present course the next CAP reform debate is moving in exactly the reverse direction.

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Riassunto
Una politica agricola comunitaria adatta al 21° secolo

Partendo da un esame delle forze che spingono verso ulteriori riforme della PAC, si descrivono tre linee di approccio formulate da alcuni gruppi d'interesse. Nella terza sezione si analizzano in maggiore dettaglio gli elementi critici della riforma che, con molta probabilità costituiranno il punto focale del dibattito nei prossimi anni.

Queste considerazioni ci fanno concludere che, in contrasto con il periodo della riforma 1992-2004, in cui è emerso un ampio consenso su come la PAC avrebbe dovuto evolvere, fin'ora non vi è alcuna visione condivisa per il prossimo periodo. È verosimile, perciò, che in questo vuoto il dibattito sulle riforme sia dominato da tre azioni: tagliare, redistribuire e trasformare il pagamento unico. I gruppi d'interesse che ritengono sia essenziale prima di tutto trasformare i pagamenti destinati a contrastare i fallimenti di mercato dovrebbero ricoprire un ruolo più attivo nel dibattito.