NEW DIRECT PAYMENTS SCHEME: TARGETING AND REDISTRIBUTION IN THE FUTURE CAP
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Abstract
The Commission has proposed that a revised version of the present regime of direct payments should be rolled forward into the post-2013 CAP. There would be a limited redistribution of funds between Member States. Thirty per cent of the budget would be allocated to a new greening component, which would be problematic in the WTO. Non-active farmers would not qualify for aid; and payments would be capped. Special schemes would be introduced for small farmers, for young new entrants, and for disadvantaged regions.
CONTENTS

LIST OF ABBREVIATIONS 5
LIST OF TABLES 7
LIST OF FIGURES 7
LIST OF BOXES 7
EXECUTIVE SUMMARY 9

1. INTRODUCTION 13

2. FROM COMPENSATION TO INCOME SUPPORT 15
   2.1. Compensation Payments 15
   2.2. And then Income Support 17
   2.3. The Single Payment Scheme 18

3. THE IMPACT OF DIRECT PAYMENTS? A THOUGHT EXPERIMENT 21

4. WHAT ARE DIRECT PAYMENTS FOR? 25
   4.1. The Commission’s Perspective 25
   4.2. Farm Incomes? 26
   4.3. Public Goods? 27
   4.4. Some Other Possible Justifications 29

5. THE COMMISSION’S PROPOSAL: A CRITIQUE 31
   5.1. The Budget Allocation for Direct Payments 33
   5.2. Redistribution between Member States 34
   5.3. Redistribution within Member States 35
   5.4. The Greening Element 36
   5.5. Active Farmers 37
   5.6. Progressive Reduction and Capping of Direct Payments 38
   5.7. Additional Payments for Young Farmers 39
   5.8. Small Famers 40
   5.9. Additional Payments for Areas with Natural Constraints 40
   5.10. Coupled Payments 41

6. WTO CONSTRAINTS 43
   6.1. Coloured Boxes 45
   6.2. The Green Box 47
   6.3. Developments in the Doha Round 49
   6.4. The Green Box, and Direct Payments in the Post-2013 CAP 51
   6.5. Does the Green Box Status of Direct Payments Matter? 53
7. CONCLUSIONS AND RECOMMENDATIONS 55
   7.1. A Missed Opportunity 56
   7.2. Room for Improvement 56
   7.3. Preparing for the Next ‘Reform’ 58

REFERENCES 59

ANNEX: ANNEX 2 OF THE AOA (THE GREEN BOX) 63
**LIST OF ABBREVIATIONS**

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>AMS</td>
<td>Aggregate Measurement of Support</td>
</tr>
<tr>
<td>AoA</td>
<td>Agreement on Agriculture, negotiated in the Uruguay Round</td>
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<tr>
<td>CAP</td>
<td>Common Agricultural Policy</td>
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<tr>
<td>COMAGRI</td>
<td>Committee on Agriculture and Rural Development</td>
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<tr>
<td>Defra</td>
<td>The UK’s Department for Environment, Food and Rural Affairs</td>
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<tr>
<td>EU15</td>
<td>The 15 member states prior to EU enlargement in 2004 and 2007</td>
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<tr>
<td>GAEC</td>
<td>Good Agricultural and Environmental Condition</td>
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<tr>
<td>GATT</td>
<td>General Agreement on Tariffs and Trade</td>
</tr>
<tr>
<td>MFF</td>
<td>Multiannual Financial Framework</td>
</tr>
<tr>
<td>OECD</td>
<td>Organisation for Economic Co-operation and Development</td>
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<td>OTDS</td>
<td>Overall Trade-Distorting Support</td>
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<td>SAPS</td>
<td>Single Area Payment Scheme</td>
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<td>SMRs</td>
<td>Statutory Management Requirements</td>
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<td>SPS</td>
<td>Single Payment Scheme</td>
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<tr>
<td>US/A</td>
<td>United States/of America</td>
</tr>
<tr>
<td>WTO</td>
<td>World Trade Organization</td>
</tr>
</tbody>
</table>
LIST OF TABLES

TABLE 1
Budget Expenditure on the CAP 20

TABLE 2
Proposed Allocation of Funds in the New Direct Payments Scheme 33

TABLE 3
Summary of the EU’s Green Box Submission for 2007/08 48

LIST OF FIGURES

FIGURE 1
Distribution of Direct Payments in the UK in 2010, by Size of Payment 28

FIGURE 2
The EU’s Declarations of Domestic Support to the WTO 46

LIST OF BOXES

BOX 1
Decoupling 18

BOX 2
Proposed Redraft of Paragraph 6(a) of the Green Box 50
EXECUTIVE SUMMARY

Background

The current system of direct payments has emerged in an ad hoc fashion over two decades. This began with the 1992 reforms that introduced area and headage payments into the CAP to compensate farmers for the implied revenue loss associated with reductions in the intervention prices for cereals and beef. These area and headage payments qualified for inclusion in the blue box in the WTO Agreement on Agriculture, which was key to the EU’s readiness to conclude the Uruguay Round of GATT negotiations. In Agenda 2000 the terminology switched from compensation to direct payment. In 2002 it was decided to extend direct payments to the new Member States (joining the EU in 2004 and 2007), albeit over a transitional period and with levels of entitlement that many of the new entrants considered too low. Most applied the simplified Single Area Payment Scheme (SAPS). The 2003 reforms bundled most of the direct payments (in EU15) into the Single Payment Scheme (SPS), which was decoupled from production, but still linked to land. The SPS was declared as green box support to the WTO, and was described as ‘an income support for farmers’. In part, its purpose was to support multifunctional agriculture. The Commission’s intent, in proposing the SPS, was to minimise the redistribution of support, both between and within Member States. The 2008 Health Check did away with set-aside, and some of the partial decoupling options from the 2003 package were removed. As a consequence the only partial coupling options left after 2012 relate to sheep and goats, and suckler cows. Expenditure on direct payments now accounts for the bulk of the CAP budget. In October 2011, as part of its package of proposals for the post-2013 CAP, the European Commission suggested that a revised version of the existing regime be rolled forward. Those proposals are the subject of this report.

Key findings

Despite a large number of excellent empirical studies, it is still extremely difficult to know how farmers, landowners, and other economic agents would have responded to a different set of policy decisions. A thought experiment suggests, however, that the long-term impact of a system of income support on farm incomes might be limited, with farmers ‘shockingly’ dependent on direct payments for their survival, whereas land and other asset values are likely to remain high. This will particularly disadvantage new entrants, who will be expected to pay rents (or buy land) at prices that partially reflect the income supports that land can attract.

Various arguments have been put forward to justify decoupled direct payments including: compensation, income support, income stabilisation, support for farmers, territorial cohesion, food security, or as an offset for the higher production costs involved in the supply of public goods. All are problematic.

The European Commission’s view is that ‘Decoupled direct payments provide ... basic income support and support for basic public goods desired by European society.’ The European Commission and the European Parliament have claimed that agricultural incomes are notably lower than those in the rest of the economy. If so, this could be seen as a shocking indictment of the failure of EU farm policy over the last 50 years. Other studies suggest that farm household incomes (for those engaged in
commercial agriculture) are not lower than those in the rest of society. Unfortunately, the European Commission has ‘little available data on incomes at the farm household level that could be used for analysis.’

All industries have rules and regulations they must obey. This is simply the cost of doing business in Europe. **Under firm contractual arrangements farmers should be paid for providing the public goods that society is willing to fund.** There is no hint that the proposed greening component is to be targeted in any way, or related to the cost of provision, both key requirements in the WTO. It is a one-size-fits-all policy, rather than a targeted approach.

**World food security is an important concern,** but it is the diets of the world’s marginalised and dispossessed, rather than those of most EU citizens, that are at stake. **The EU’s system of direct payments does little to enhance world food security.**

The Commission has gone to extraordinary lengths to ensure overall budget neutrality, but it is to be hoped there is a Plan B. A 20% cut would take €80 billion out the CAP budget over the next Multiannual Financial Framework (MFF). This is equal to 80% of the budget for Pillar 2, and four-times the budget for market-related expenditure.

The notion that the average direct payment per hectare is an objective measure of fairness is contestable. **The proposed allocation of direct payments to Member States is a political exercise, strongly influenced by past budget allocations.** None of the possible justifications for maintaining a system of direct payments are invoked in the proposed redistribution.

The debate about **active farmers** has dogged the CAP for some time, and the European Commission is clearly responding to criticisms from the Court of Auditors and the European Parliament. Under the proposal, so-called ‘non-active’ farmers would no longer receive direct payments. **Why the ownership or management structure should be of importance in the effective management of agricultural land is unclear.**

It is difficult to see any economic logic arguing in favour of capping. Rather the reverse, because it will discourage farm amalgamations and other structural changes (such as contracting-in services) which would push the business above the limit.

A succession of policy reforms has significantly changed the way EU farmers are supported, **enabling the EU to switch the bulk of its declarations of domestic farm support in the WTO away from the amber and blue boxes to the green box.** This should allow the EU to comply with any further reduction commitments that might result from a conclusion of the ongoing, but stalled, Doha Round, provided its declaration of direct payments in the green box is legitimate.

**The SPS is claimed and paid annually when entitlements are activated by matching them with eligible land at the farmer’s disposal, and cross compliance and the need to keep land in Good Agricultural and Environmental Condition (GAEC) apply.** This might be seen as an infringement of the green box requirement (for decoupled income support) that the payments in any year should not be based on, or related to, the factors of production employed in any year after the base period. **Suggestions that direct payments are necessary to maintain agricultural production are also problematic,** as this might be construed to mean that they infringe
the fundamental requirement that green box payments have no, or at most minimal, effects on production.

**New legislation on greening, and on active farmers, will have to be carefully crafted.** As presented by the European Commission, both are in danger of infringing the green box requirement that no production is required to qualify for payment. Nor would the greening component appear to fit within the green box exemption for payments under environmental programmes.

A challenge to the EU’s classification of domestic support, and its use of the green box, would take some time to be resolved in the WTO’s Dispute Settlement procedures; and the outcome is uncertain. However, there is little that other WTO Members would gain by challenging the EU’s current, or post-2013, policy under the present WTO arrangements. If not green, there is ample scope to declare direct payments in either the amber or the blue box.

**Should there be a Doha Agreement,** restrictions on amber and blue box payments would be considerably tightened, and then the green box status of the post-2013 system of direct payments would become critical. **The EU would be in danger of flouting its WTO commitments.** The EU has not negotiated a watertight agreement guaranteeing that its use of the green box to shelter its direct payments would go unchallenged following a Doha agreement.

Unfortunately the European Commission’s plans for the post-2013 CAP are unlikely to improve the competitiveness of European agriculture; help it adapt to the challenges of climate change; prove cost-effective in sustaining a multifunctional agriculture; or contribute much to world food security. As a consequence, this will not be the last CAP reform. Policy makers will continue to worry about the farm income problem. Overseas governments, and farmers, will still suspect that the direct payments regime continues to distort trade. Taxpayers will continue to question whether their money is well spent.

**Key recommendations**

Rather than allocating 30% of the direct payments budget to a notional greening component, these funds should be transferred to the Pillar 2 budget where Member States can better ensure a targeted, and contractual, approach to delivering the environmental goods that European taxpayers want, and help the farm sector adapt to, and adopt mitigation strategies to offset, climate change. **This would also help ensure the international acceptability of CAP expenditure in the WTO.** The transfer could be phased: say, 10% per year. If a transfer of these funds to Pillar 2 is not possible, then the basic payment and the greening component should be kept as two separate payments, with Member States allowed greater discretion, on a regional basis, to determine the greening criteria.

**The proposal on active farmers should be abandoned.** There is no economic justification for it. There is no reason to believe that ownership or management structures are relevant in delivering environmental services. Furthermore, it will seriously prejudice the EU’s attempts to declare all its direct payments in the green box.

There is merit in the scheme to make additional payments for areas with natural constraints, in conjunction with a reduction (or even elimination) of payments in areas that
do not suffer from these constraints. Policies need to be carefully crafted to ensure that they comply with the WTO requirements for payments under regional assistance programmes.

**It is important that policy makers have a Plan B.** If CAP payments are reduced in the next MFF, **the Pillar 2 budget should be protected, and the Pillar 1 budget cut.** Within Pillar 1 the heaviest cuts should apply in those Member States with a payment per hectare above the EU average.

**There needs to be a fundamental rethink about the purpose of the CAP,** its policy objectives, and its policy mechanisms; and a clearer explanation of how expenditure on the CAP contributes to smart, sustainable and inclusive growth. For example, one of the CAP’s objectives, according to the Treaty, is ‘to ensure a fair standard of living for the agricultural community, in particular by increasing the individual earnings of persons engaged in agriculture.’ Questions that should be addressed include: Who are these members of the agricultural community, what is a fair standard of living, and how do we measure and monitor the individual earnings of persons engaged in agriculture?
1. INTRODUCTION

This Briefing Note has been commissioned for the Committee on Agriculture and Rural Development (COMAGRI) of the European Parliament. Its objective is to “provide an analysis of critical issues and possible options for revising the Commission’s proposals establishing rules for direct payments” in the post-2013 CAP. These formal proposals were tabled in October 2011 (European Commission, 2011d, and associated texts), and form part of a package of measures for the post-2013 CAP. They are embedded within the European Commission’s proposals for a Multiannual Financial Framework (MFF) for the period 2014-2020 (European Commission, 2011c). The proposals follow-on from a wide-ranging review of the existing CAP by the European Commission, the European Parliament, the Member States, and interest groups; and the European Parliament’s resolutions of 8 July 2010 and 23 June 2011 (European Parliament, 2010 and 2011). In parallel to this Briefing Note, another has been commissioned on the Impact of greening proposals and possible alternatives, and consequently—to avoid excessive overlap—discussion of greening is minimised in this text, although some consideration of the WTO compatibility of the greening issues is important.

The intention is to ‘focus on the current stage of the reform process and ways that the legislative texts put forward by the Commission could potentially be improved.’ Accordingly this Briefing Note does not advocate sweeping reform, despite the predilections of the author. It is set out as outlined below.

The current system of direct payments is not the result of a carefully thought out master plan, reflecting the consensus view of all interested parties. Instead it has evolved over a number of years, as policy-makers strove to accommodate a variety of conflicting interests, and budget and international constraints. Section 2 of this Briefing Note sets out a short history of direct payments in the CAP, seeking to give context to the current debate.

Section 3 sets out, as a though experiment, some of the likely consequences of making direct payments to producers. Section 4 considers the European Commission’s justifications for a system of direct payments, and asks the question: What are direct payments for?

Section 5 outlines the main elements of the Commission’s proposals and assesses them against its own impact assessment. This short Briefing Note, however, cannot deal with all the detail of the European Commission’s complex proposal, or acknowledge all the contributions to the post-2013 CAP reform debate since its launch at the European Council meeting in London in December 2005.

Section 6 considers how direct payments are treated in the WTO, and challenges the claim that the EU’s direct payments can unequivocally be placed in the green box.

Some recommendations are outlined in Section 7.
2. FROM COMPENSATION TO INCOME SUPPORT

**KEY FINDINGS**

- The 1992 reforms introduced *area* and *headage payments* into the CAP to *compensate* farmers for the implied revenue loss associated with reductions in the intervention prices for cereals and beef.

- These area and headage payments qualified for inclusion in the *blue box* in the WTO Agreement on Agriculture, which was key to the EU’s readiness to conclude the Uruguay Round.

- In Agenda 2000 the terminology switched from compensation to *direct payment*.

- In 2002 it was decided to extend direct payments to the new Member States (joining the EU in 2004 and 2007), albeit over a transitional period and with levels of entitlement that many of the new entrants considered too low.

- The 2003 reforms bundled most of the direct payments (in EU15) into the *Single Payment Scheme* (SPS), which was *decoupled* from production, but still linked to land.

- The SPS was declared as *green box* support to the WTO, and was described as ‘*an income support for farmers*’. In part, its purpose was to support *multifunctional* agriculture.

- The Commission’s intent, in proposing the SPS, was to minimise the redistribution of support, both between and within Member States.

- Expenditure on direct payments accounts for the bulk of the CAP budget.

2.1. Compensation Payments

Although farmers were able to benefit from some direct payments under the CAP in the 1970s and 1980s, it was not until the policy reforms of 1991 and 1992 that direct payments became a mainstay of farm income support. Until then, the CAP’s main policy instruments involved market price support: high import taxes (often in the form of variable import levies), intervention buying (and other mechanisms to expand EU demand), and export refunds (subsidies). The 1992 (MacSharry) *reform* resulted in a substantial cut in the support (intervention) prices for cereals and beef. In compensation for the implied revenue loss, farmers became eligible for *area payments* on the area of land sown to cereals and for enhanced *headage payments* on the number of beef animals kept. A similar area payments scheme for oilseeds had been agreed in December 1991, in an attempt to resolve a long-standing GATT dispute with the US over support for the oilseeds sector, and the existing headage payment scheme for sheep and goats was remodelled. Both headage payments and area payments were subject to limits (for example area and set-aside payments could only be claimed on land that was in an arable rotation in December 1991, and the suckler cow premium was restricted to the numbers the producer had claimed in a reference period). Larger farmers had to *set aside* some of their arable land (initially 15%) before they could claim arable area payments. Area payments were fixed on a regional basis, reflecting past yields. Consequently *farmers in the more productive regions (with higher yields and livestock stocking densities) qualified for higher payments per hectare*; and despite the Commission’s early attempts to limit
the size of payments to larger farmers there were no effective limits on the level of payments any farm business could receive.

Scholars still debate the forces that drove and shaped the 1992 reforms (for a discussion see Cunha and Swinbank, 2011, Chapter 5). Three key factors have been identified: concerns about the growth in surplus production, and hence budget costs, in the 1980s; pressure from the EU’s trade partners in the Uruguay Round of GATT negotiations that had begun in 1986; and a change in society’s expectations, with a greater emphasis on farming’s positive, and negative, impacts on the environment, in a world that was apparently characterised by abundant food supplies. These three themes still have resonance in the policy debates of today.

Although the budget cost was initially increased, as a result of the switch from market price support (for which consumers paid, in higher prices) to direct payments (funded by taxpayers), the growth in budget expenditure on disposing of surplus production was curbed, and expenditure stabilised (as payments were in effect fixed for the foreseeable future).

Whether or not the 1992 reforms were driven by the deadlocked Uruguay Round of GATT negotiations, particularly following the failure of the GATT Ministerial Meeting in Brussels in December 1990, they did have the fortunate effect of unlocking the deadlock, allowing the EU to accept the package of Uruguay Round Agreements. But this was only after further prolonged discussions between the US and the EU. One consequence of the rapprochement between the US and the EU was the introduction of the so-called blue box of domestic farm support into the new Uruguay Round Agreement on Agriculture (AoA) which was to be administered by the new World Trade Organization (WTO). The domestic support provisions of the AoA will be outlined in Section 6. The important point to note is that the EU’s area and headage payments stemming from the 1992 reform were classified (by the EU) as blue box payments. As blue box payments they were exempt from the reductions that the AoA imposed on trade-distorting support.

From an environmental perspective the new policy, compared to its predecessor, had much to commend it. Whilst it kept land in production (a key characteristic of what was later to be called multifunctional agriculture) because crops had to be sown and livestock kept, it reduced farmers’ incentives to intensify production, as the marginal revenue from the sale of crops and livestock diminished. Moreover, set-aside came to be valued by many environmentalists.

The Council Regulation introducing area payments was quite clear that these were designed to compensate farmers for the expected fall in revenue. In particular it referred to the need to ‘compensate the loss of income caused by the reduction of the institutional prices by a compensatory payment for producers who sow such products’. According to the Commission (1993, p. 11) it was ‘a system of permanent compensatory aid to neutralize the negative effect on incomes caused by the decisions to lower prices in the cereals, oilseeds and beef and veal sectors.’ Some analysts, and members of the farming community, found the concept of a permanent system of compensatory payments rather hard to grasp, and doubted they would last.

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2.2. And then Income Support

By the time of the Agenda 2000 reforms, agreed in Berlin in March 1999, the language was beginning to change. In initiating the CAP reform debate, for example, the Commission (1997, p. 29) said that it proposed ‘deepening and extending the 1992 reform through further shifts from price support to direct payments, and developing a coherent rural policy to accompany this process. Direct payments will be set at an appropriate level while avoiding any overcompensation.’ Over a decade later Franz Fischler (2011, p. vi) was to comment: ‘the compensation approach was changed from compensating price losses to compensating income losses.’ Serger’s (2001, p. 149) interpretation was that:

Important officials within the Directorate General for Agriculture were highly critical of compensation payments. They argued that it was a serious strategic error to coin the term ‘compensation payments’, as had been done in the MacSharry reform negotiations, since it created an expectation, among farmers, that every price cut had to be compensated. This also explains why, in the Agenda 2000 proposals, the European Commission referred to ‘direct’ rather than ‘compensation’ payments.

In Agenda 2000 the support prices for beef and cereals were reduced, and area and headage payments increased, but not by enough to fully compensate for the implied revenue loss. The Commission’s original proposal to impose a ceiling on the amount of direct payments an individual farm business could claim was rejected, although Member States were authorised to introduce their own systems of modulation, shifting budget funds away from that Member State’s budget for direct payments into its funding for Pillar 2 activities (as defined by the new Rural Development Regulation). Direct payments and market price support now comprised Pillar 1 of the CAP. In addition, Member States were authorised to introduce a system of cross compliance which meant that a farmer’s receipt of direct payments could be curtailed if specified environmental conditions were not met (Cunha and Swinbank, 2011, pps. 110-1; Serger, 2001, p. 125).

In January 2002, discussing the issues that were raised for the CAP by the prospect of enlargement to embrace states from central and eastern Europe, the Commission (2002, p. 4) conceded: ‘Although direct payments were introduced initially to compensate for support price cuts, they have lost part of their compensatory character after 10 years of implementation and have instead become simple direct income payments. Therefore, the term “direct aid” has replaced “compensation payment”. As direct income payments, and a permanent part of the CAP, they would logically apply ipso facto in the new member states too. However, for the 10 states acceding to the EU in 2004, there was to be a phased introduction with the funding level only reaching ‘100% of the then applicable EU level in 2013’ (European Commission, 2002, p. 21). They were entitled to apply a simplified scheme, which most did, which came to be called the Single Area Payment Scheme (SAPS). This simplified scheme involved a flat-rate payment per hectare (but specific to each of the new entrants), unlike the farm-based entitlements that still prevailed in the existing EU15. The new member states were unhappy about these transitional arrangements, and also with the level of funding entitlements negotiated, and they still are (see for example the comments of the three Baltic States in January 2012 (Government of Latvia, 2012)).

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2 Documents from the time are cited as authored either by the Commission of the European Communities or by the European Commission, following the Commission’s own practice.
2.3. The Single Payment Scheme

The 2003 (Fischler) Reforms resulted in a further decoupling of support (see Box 1 on decoupling). It bundled the area and headage payments from the MacSharry and Agenda 2000 Reforms, and some other direct payments, into the Single Payment Scheme (SPS). Although there were significant differences between (and even within) Member States, the Commission's basic idea had been that a farmer's entitlement to direct payments under the pre-reform regime would be carried forward unchanged to the SPS, but that the old requirement to sow crops or keep animals would be dropped. Accordingly the EU notified the WTO that it considered the SPS to be a green box payment, and has declared them as such in its subsequent notifications to the WTO.

Box 1: Decoupling

Decoupling is a key concept in the WTO’s AoA. The basic aim of decoupling is to separate (decouple) support for farmers from their production decisions. Thus, support should not be linked to production, nor should subsidies be tied to the volume of inputs used.

With an open-ended system of market price support, producers are incentivised to increase output and produce up to the point where the revenue obtained from the sale of the last unit (the producer’s marginal revenue) equals the extra costs incurred in producing that last unit (marginal cost). Producing beyond that point involves a loss on the extra units produced (because marginal cost is greater than marginal revenue). Producing less than this ‘optimal’ amount involves profits foregone, as marginal revenue on these last units is greater than marginal cost.

Within the GATT/WTO system, countries have expressed an interest in curbing farm policies that increase production, because such policies are likely to result in a reduction in world market prices, and reduced export opportunities for efficient exporters. Consequently, in the Uruguay Round, negotiators tried to differentiate between coupled support, which did impact on production and hence trade, and would thus be subject to WTO disciplines; and decoupled support, that had no impact, or only a minimal impact, on production and trade, and hence was of no concern to other nations.

The MacSharry Reform involved a partial decoupling of support. Although crops still had to be sown, and animals kept, the incentive to increase yields (or even harvest the crop) was reduced.

SAPS and the SPS involved a further decoupling, in that the requirement to grow particular crops or keep animals was removed; but payments were still tied to agricultural land, and under the SPS member states were allowed to retain some coupled payments.

A further step in the decoupling process would be the Bond Scheme, as outlined by Tangermann (1991) for the Land Use and Food Policy Inter-Group (LUFPiG) of the European Parliament. The basic idea here is for a compensation scheme in which payments would be irrecoverably fixed for the duration of the payment period. Recipients would be free to continue farming as before, adopt new enterprises, or sell-up to retire or invest elsewhere. However, even this level of decoupling may impact on levels of production. For example, risk-averse recipients might be expected to take riskier production decisions, secure in the knowledge that part of their revenue stream (the Bond payments) is guaranteed. Their cost of capital will be reduced, as the need to borrow from the bank will diminish. And, reluctant to change, they may choose to subsidise their unprofitable farming activities by their Bond Scheme payments.

Consequently there is a sizeable economics literature discussing the extent to which decoupled policies really are decoupled. Policy analysts, trying to model the effect of policy change, often have to make ad hoc adjustments to differentiate between alternative stages in the decoupling process: To what extent would a shift from the SPS to the Bond Scheme impact upon production, for example? These queries feed into our understanding of how policy change might impact upon farm incomes, land rents and prices, land use, and production volumes. They are also relevant in determining the appropriate WTO classification of these payments (amber or green box, for example), as discussed in Section 6.
Article 1 of the Regulation\(^3\) introducing the new regime for direct payments said of the SPS that it was ‘an income support for farmers.’ In its introduction to the Regulation, the Council did not really explain why an income support scheme was required, but the 21\(^{st}\) ‘Whereas’ did say: ‘The support schemes under the common agricultural policy provide for direct income support in particular with a view to ensuring a fair standard of living for the agricultural community. This objective is closely related to the maintenance of rural areas.’ Although the Commission was by now eschewing use of the word ‘multifunctionality’, the implication is that as well as providing for ‘a fair standard of living for the agricultural community’ (rather than for each individual member of the agricultural community), these payments were expected to support multifunctional agriculture. As Haniotis (2011: 26) was later to remark: ‘These payments do not only provide a necessary income safety net to farming activity, but contribute in parallel, and jointly, to the provision of public goods from farming, such as scenic cultivated landscapes, grassland habitats, or carbon sequestration in soils.’ Thus **cross compliance** now became an integral, and mandatory, part of the system of direct payments for EU15.

There was very little redistribution of support in EU15, as in essence the original intent was that a farm’s past entitlements for area and headage payments, and new awards from the milk reforms, would be rolled forward into the new regime. Haniotis (2007, p. 58, his italics) emphasises that ‘the Commission proposal opted explicitly not to use decoupling as an instrument of redistribution of support.’ During the negotiations the proposed cap (of €300 thousand per annum per farm) was dropped; but a 5% rate of **modulation** was imposed on payments in excess of €5 thousand, thus excluding thousands of smaller farms. However, Member States retained at least 80% of the modulated funds for transfer to their Rural Development Programmes, and so this resulted in very little redistribution of funding between the EU15 Member States (Swinbank and Daugbjerg, 2006, pps. 56-8). Those Member States that had been applying voluntary modulation from the Agenda 2000 Reforms were allowed to continue to do so. Despite the Commission’s earlier concerns, there was however some redistribution of payments within some Member States. The default scheme based a farm’s receipt of direct payments to its own **historic** pattern of payments; but Member States were entitled to pool the payment entitlements of all the farms in a region and make payments on a regionalised flat-rate basis. In practice most of the old Member States used the historic mode (European Commission, 2011a), and continued to do so even after the Heath Check of 2008 gave them the opportunity to switch to a regionalised model.

In 2004 the approach was extended to the so-called Mediterranean products (hops, olive oil, tobacco and cotton, although the provisions for cotton were challenged in the European Court), and then to sugar, bananas, processed fruits and vegetables, and wine. The 2008 **Health Check** did away with set-aside and direct aid payments for energy crops, some of the partial decoupling options from the 2003 package were removed (for the main arable crops in 2010, and for some specialised crops and most livestock payments in 2012), and modulation was increased, with even higher rates above €300 thousand a year (Daugbjerg and Swinbank, 2011).\(^4\) As a consequence the only partial coupling options left after 2012

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relate to sheep and goats (50% of the payment) and beef (100% of the sucker premium), and only for those Member States that had applied this provision from 2003. In addition, full coupling can be retained in the outermost regions of the Union: the French Overseas Departments, the Azores and Madeira, and the Canary Islands. Furthermore, a crop specific payment for cotton has been retained. Thus by 2012 the bulk of CAP support took the form of decoupled payments: the SPS in EU15, and SAPS in most of the new Member States, as illustrated by the 2012 budget data in Table 1.

**Table 1: Budget Expenditure on the CAP**

Appropriations for Payments, €1,000. Chapters 05.03 (Direct aids), 05.02 (Interventions in Agricultural Markets) and 05.04 (Rural Development) respectively

<table>
<thead>
<tr>
<th></th>
<th>2012 Budget</th>
<th>2011 Appropriations</th>
<th>2010 Outturn</th>
</tr>
</thead>
<tbody>
<tr>
<td>Decoupled direct aids</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Of which:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>SPS</strong></td>
<td>30,472.0</td>
<td>30,389.0</td>
<td>29,070.9</td>
</tr>
<tr>
<td><strong>SAPS</strong></td>
<td>5,963.0</td>
<td>5,136.0</td>
<td>4,460.9</td>
</tr>
<tr>
<td><strong>Article 68</strong></td>
<td>458.0</td>
<td>513.0</td>
<td>–</td>
</tr>
<tr>
<td>Other direct aids</td>
<td>3,321.7</td>
<td>3,447.1</td>
<td>5,850.7</td>
</tr>
<tr>
<td><strong>Of which:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Crop area payments</strong></td>
<td>4.0</td>
<td>10.0</td>
<td>1,434.9</td>
</tr>
<tr>
<td><strong>Livestock payments</strong></td>
<td>1,151.0</td>
<td>1,164.0</td>
<td>1,937.2</td>
</tr>
<tr>
<td><strong>Article 68</strong></td>
<td>866.0</td>
<td>805.0</td>
<td>–</td>
</tr>
<tr>
<td><strong>Total Direct Aids</strong></td>
<td><strong>40,510.7</strong></td>
<td><strong>39,771.1</strong></td>
<td><strong>39,675.7</strong></td>
</tr>
<tr>
<td>Interventions in Agricultural Markets</td>
<td>3,233.0</td>
<td>2,966.2</td>
<td>4,313.8</td>
</tr>
<tr>
<td>Rural Development</td>
<td>12,088.9</td>
<td>12,125.2</td>
<td>11,483.4</td>
</tr>
</tbody>
</table>

3. THE IMPACT OF DIRECT PAYMENTS? A THOUGHT EXPERIMENT

**KEY FINDINGS**

- Despite a large number of excellent empirical studies, it is still extremely difficult to know how farmers, landowners, and other economic agents would have responded to a different set of policy decisions. Consequently this thought experiment tries to tease out the likely longer-term consequences of a system of income supports.

- It suggests that the long-term impact on income from farming might be limited, with farmers ‘shockingly’ dependent on income supports for their survival, whereas land and other asset values are likely to remain high. This will particularly disadvantage new entrants, who will be expected to pay rents (or buy land) at prices that partially reflect the income supports that land can attract.

Farmers, taxpayers, policy makers and analysts, both in the EU and in the EU’s trading partners, would like to know what impact the direct payments scheme has had on a variety of variables, including farm incomes; land prices and rents; the use (and abandonment) of land and its implications for the environment; and the volume of EU production, and thus its implications for trade. Answering this fundamental set of questions, however, is rather difficult.

First, there is the unmistakeable fact that EU agriculture is enormously varied. There are differences in: farm sizes and structures; employment of hired labour and contracting services; tenure and ownership arrangements; crops grown and livestock kept; climate, soil and typography; and the land’s inherent environmental attributes.

Second, the world has not stood still since the 1992 reforms, which followed on from what Garzon (2006, p. 21) characterised as thirty years of immobility in the CAP. This itself was preceded by decades of state intervention in the agricultural sector. The political, technical, and economic changes that have occurred over that period have been profound. Many of those who were farming in 1992 have either retired or died, and a new generation of farmers has taken their place.

Consequently it is extraordinarily difficult to determine what the outcome might have been (the counterfactual) had other decisions been made: had a Bond Scheme been adopted in 1992, as proposed by Tangermann (1991) for example in his LUFPIG report, with a predetermined and finite payment period, rather than the area and headage payments of the MacSharry reforms, the legacy of which can still be identified in the SPS scheme of today.

To some extent the way farmers (and other economic operators) would have responded can be determined by observing how they have responded to price or policy changes in the past, using sophisticated econometric techniques to estimate their response elasticities. These can then be built into models that attempt predict how they might react to changes proposed for the future. However, despite the large numbers of studies undertaken, past experience of thirty-plus-twenty years of policy immobility is of limited value; and offers little guide on how economic actors might respond to radical policy change.
To advance the debate, readers are invited to participate in a thought experiment. Its purpose is not to diminish or disparage the many important empirical studies, but rather to clarify some of the concerns and issues that are associated with direct payments.

Suppose the government of a particular country decided, quite unexpectedly and with no prior consultation, to award its farmers a one-off income support paid on the area of land at a farmer’s disposal. No one would have the opportunity to change their behaviour. Farm revenues, and farm incomes, would rise, matching the receipt of the taxpayer funded income support.

Now suppose that rather than a one-off payment, these income supports (or direct payments) become a permanent, annual payment to farmers, based on the land at their disposal, and that the policy runs for a number of years. How will farmers, and the economic actors with whom they interact, react; and what will be the long-term effect on the sector? Expectations will be important in this; but the more firm the belief that the policy will continue into the indefinite future, the more profound the changes are likely to be.

What will farmers do with that initial boost to farm revenues? Some of the benefit might leak away into the supply chain, with input suppliers, for example, more able to extract higher prices from the farm sector. As economic, personal, and technical circumstances change, some farmers might not feel the need to adapt: they might continue farming as they have in the past, with the direct payment cushioning them from commercial realities. Some may explicitly choose to subsidise the farming activities they want to undertake, to farm in an environmentally friendly way. Some may want to expand, and in particular gain access to more land. But in order to do so they must negotiate a price (or rent) for that land, and the seller or lessor will be well aware that control of land attracts a direct payment on every hectare farmed. Consequently land prices and rents will tend to reflect these payments; and those farmers who expand their businesses will be saddled with high mortgage payments or rents. The European Commission (2011f, Annex 3, p. 19), in its Impact Assessment of the proposed changes, does acknowledge the likely impact on land prices. In discussing a potential redistribution of payments among beneficiaries it remarks: ‘the sometimes important gains on direct payments per hectare ... could not only drive up land prices but also prove to be an impediment to structural changes as they could prevent farmers from restructuring, growing and improving the profitability of their farms.’

The problem of inflated land prices will be particularly profound for new entrants, even those who inherit their farms with death duties to pay and co-inheritors to buy out. The longer the policy remains in place, the more profound these changes are likely to be. The longer-term effect—compared to what might have been had this policy not be pursued—is likely to be a larger number of farmers, farming smaller farms, who are more indebted, and probably making an income from farming no bigger (in comparative terms with the rest of society) than it had been at the outset. Landowners, however, including those farmers who owned their land when the policy began, will be richer. As measured in the accounts for the ‘national farm’, it may well be that ‘farm’ income’ and ‘direct payments’ are of a similar magnitude. The overall impact on production, and the environment, is less easy to predict. Nor is it easy to see a painless way out of the dilemma into which policy-makers have condemned the farm sector: the dependence of farming on these payments’ may be, as Buckwell (2009, p. 14) observes of the present policy, ‘shockingly high.’
It will be the new entrants, and those who have expanded, that will be particularly dependent on the payments. One of the alleged benefits of direct payments is that they tend to stabilise farm revenues (and, by implication, incomes). Paradoxically, in the scenario outlined in these paragraphs, whilst direct payments stabilise the receipts of the farm sector, it cannot be said that they stabilise the incomes of this growing group of individuals who were not the original recipients of the scheme. Their fixed rents and mortgage payments will be largely premised on the continuing receipt of direct payments, leaving their incomes solely dependent upon their variable farming profits.

A couple of caveats must now be added. The first is to note that the EU's system of direct payments was not introduced as a one-off, unexpected, event as in the foregoing thought experiment. Instead the system has grown in a rather ad hoc fashion over two decades, and at each stage great care has been taken to replace existing systems of support with the least disruption (although the original concept of full compensation in 1992 was not followed in 1999 and the 2000s). **Farm costs in 1992, including land prices, would have already reflected the effects of the previous 30 years of farm income support.**

Second, most Member States have continued to operate the SPS on the basis of a farm’s historical entitlement. Consequently the number of entitlement hectares has been smaller than the potential eligible area, leaving a sizeable area of *naked* land on which entitlements have not been activated (unlike England, for example, where there is a much smaller percentage of naked land). This inevitably affects the dynamics of the land market for, if naked land can easily be accessed, landowners can less readily gain a large share of the benefits of the direct payment. In a crowded continent, with many competing uses for agricultural land, and differing tenure and legal systems, it is not just the profits from farming, but many other factors too that impact on farmland prices and rents.
4. WHAT ARE DIRECT PAYMENTS FOR?

KEY FINDINGS

- Various arguments have been put forward to justify decoupled direct payments including: compensation, income support, income stabilisation, support for farmers, territorial cohesion, food security, or as an offset for the higher production costs involved in the supply of public goods. All are problematic.

- The European Commission’s view is that ‘Decoupled direct payments provide … basic income support and support for basic public goods desired by European society.’

- The European Commission and the European Parliament have claimed that agricultural incomes are notably lower than those in the rest of the economy. If so, this could be seen as a shocking indictment of the failure of EU farm policy. The Commission has failed to explain why there is still a farm income problem for the generality of the EU’s commercial farmers despite 50 years of the CAP.

- Other studies suggest that farm household incomes (for those engaged in commercial agriculture) are not lower than those in the rest of society.

- The European Commission has ‘little available data on incomes at the farm household level that could be used for analysis.’

- All industries have rules and regulations they must obey. This is simply the cost of doing business in Europe.

- Under firm contractual arrangement farmers should be paid for providing the public goods that society is willing to fund.

- World food security is an important concern, but it is the diets of the world’s marginalised and dispossessed, rather than those of most EU citizens, that are at stake.

It would greatly help the policy debate over the shape, and funding, of the post-2013 CAP if a consensus view could emerge on the role of direct payments. Do they have a legitimate role (or roles) to play, and if so what? In an earlier report for COMAGRI, Buckwell (2009, p. 13) suggested that the ‘main candidates as justifications for the direct payments are: income support, income stabilisation, compensation for the costs of higher EU standards, environmental payments and food security.’ He added: ‘There is some truth in all of these justifications … . But … it is difficult to find evidence to support using these arguments to justify the whole payments, and it is especially hard to relate these justifications to the observed distribution of the Single Payment amongst regions and farmers.’

4.1. The Commission’s Perspective

Despite the mass of documentation, it is not easy to discern what exactly the European Commission’s view is. It has said that ‘Decoupled direct payments provide today basic income support and support for basic public goods desired by European society’ (European Commission, 2010b, p. 4), but this still does not get to the heart of the matter. A further indication of its thinking is its statement that:
The necessary adaptations of the direct payment system relate to the redistribution, redesign and better targeting of support, to add value and quality in spending. There is widespread agreement that the distribution of direct payments should be reviewed and made more understandable to the taxpayer. The criteria should be both economic, in order to fulfil the basic income function of direct payments, and environmental, so as to support for the provision of public goods. (European Commission, 2010b, p. 8).

4.2. Farm Incomes?

The European Commission has stressed the continuing need for income support. Its Impact Analysis for example, states that: ‘The income support function of direct payments has contributed to ensure the longer term economic viability, and a smooth structural adjustment of the farming sector. This is particularly important given the relatively low level of income in the agricultural sector, which on average remains below 50% of the average salary in the total economy in the EU-27’ (European Commission, 2011f, Annex 3, p. 8). No indication is given that European farmers will ever be able to earn a satisfactory income from the market, with the implication that income support will always be required. Similarly the European Parliament (2011, paragraph Q) has claimed that ‘agricultural incomes are notably lower (by an estimated 40% per working unit) than in the rest of the economy.’ But this conclusion, that agricultural incomes are lower, generates a number of thoughts.

The first is the polar opposite to the European Commission’s position. Rather, critics might conclude that this evidence is a shocking indictment of the failure of EU farm policy over the last 50 years, suggesting that fundamental policy change is long overdue.

A second reaction, which is compatible with both positions outlined above, is to question whether we have the right information to answer the question, despite the apparent wealth of farm income data at our disposal, or whether we are even asking the right question. There is a problem with aggregate accounts, in that these include hobby, part-time, and retired farmers, who remain on the books for a variety of reasons. Farms that are sufficiently large and well capitalised to be run on a commercial basis can often form part of a more complex business structure, and trying to measure the returns to farming can be difficult. Hill’s work over the years (e.g. Hill, 2000) suggests that we tend to underestimate the income (and wealth) of households running commercial farms in EU15, and Tangermann (2011, p. 14) cites an OECD (2003) study that reaches a similar conclusion. Bureau (2010) asked pointedly: ‘Why are we so lousy at measuring farmers’ incomes?’

In its Impact Analysis, however, the European Commission (2011f, Annex 3, p.8) rejects this approach: ‘The analysis in this Impact Assessment focuses on farms and the agricultural sector as unit of analysis, not on agricultural households. The reason for this is that the objectives of the CAP ... are linked to the operation, competitiveness and performance of the sector/farm as an economic unit and not the economic survival of a household. Analysis in other sectors of the economy would also not consider the incomes of spouse or children gained in other sectors in order to measure the economic viability of a certain activity. Furthermore, there is little available data on incomes at the farm household level that could be used for analysis.’
One of the Treaty objectives for the CAP, dating back to 1957, is ‘to ensure a fair standard of living for the agricultural community, in particular by increasing the individual earnings of persons engaged in agriculture’ (Article 39(1)(b) of the Treaty on the Functioning of the European Union). The European Commission’s claim that the objectives of the CAP are linked to the ‘sector/farm as an economic unit and not to the economic survival of the household’ seems somewhat disingenuous given the Treaty’s reference to the ‘individual earnings of persons engaged in agriculture.’

The focus on average earnings fails to recognize the significant variations between farm households, and is incapable of differentiating between those in need, and those who are not. Furthermore, it is difficult to see how the EU has managed to pursue objectively this Treaty provision over the last 50 years if there is ‘little available evidence on incomes at the farm household level.’

Farmers might willingly accept a lower return from farming, because they value the lifestyle (Bellerby, 1956). If true, this suggests that government attempts to increase unfairly-low ‘farm incomes’ will in the longer run be frustrated as more farmers manage to maintain a meagre living in the sector.

But even if farm incomes are depressed, it is not clear why one sector of the economy should benefit from an EU-funded social policy, rather than this being a national responsibility. Nor is there any hint in the design of the policy that the benefits are targeted on those in need. Payments are not means tested; they are directly linked to the size of business (i.e. the bigger the farm, the bigger the payment); and even if they were to be capped at €300 thousand per annum this would still be extremely generous compared to the income of other EU citizens dependent upon social security payments. Payments are highly skewed, and it is not easy to see on what basis they are paid, apart from a direct link with the size of the farming business. In the United Kingdom in 2010 for example, 44% of all beneficiaries claimed €5,000 or less, and collected 4.2% of the funds dispersed. At the other extreme, just over 1% of all beneficiaries claimed €150,000 or more, and scooped 9% of the funds, as illustrated in Figure 1.

There is, admittedly, a vast number of extremely small subsistence farms in a number of EU countries, not least in the new Member States; but the policy is not targeted on them. A policy of income support for small subsistence farms could perhaps be justified; but it would be difficult to devise criteria that excluded hobby farms, and did not give a financial incentive to perpetuate the small farm problem.

**4.3. Public Goods?**

The basic concern is that EU farmers face higher costs than their competitors elsewhere, because of the EU requirement that farmers provide public goods. At least three themes can be detected in the discussion: i) that direct payments reimburse farmers for the higher costs they face as a result of cross compliance and the requirements for maintaining their land in Good Agricultural and Environmental Condition (GAEC); ii) that they reimburse farmers for multifunctionality; and iii) that they reimburse farmers for the higher food safety standards imposed in the EU. This is dangerous territory in the international arena, because it is tantamount to admitting that direct payments are not decoupled.

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5 Quite who ‘the persons engaged in agriculture’ are, is also unclear. Does it include employees and landowners for example?

6 Animal welfare and other ethical concerns, however, raise some complex issues.
In its Impact Assessment the European Commission (2011f, Annex 3, p. 9) focuses largely on cross compliance:

In addition to its role as income support for farmers, direct payments play a crucial role in the delivery of basic public goods through sustainable land management, due to the link between direct payments and the fulfilment of cross compliance requirements. This link is crucial, as there is evidence of undersupply of most important public goods, for which certain forms of land management are particularly beneficial (such as extensive livestock and mixed systems). The public goods concerned are mostly environmental and relate for example to maintaining agricultural landscapes, farm-land biodiversity, water availability, soil functionality, climate stability and air quality. Direct payments also contribute to public goods which are not related to the environment, such as rural vitality.

The statement as it stands, however, is rather confused. If there is a ‘crucial’ link ‘between direct payments and the fulfilment of cross compliance’ it is not evident why there is ‘undersupply of most important public goods’ unless either: i) the cross compliance provisions are widely disregarded, or ii) the Commission has in mind the supply of ‘important public goods’ over and above those built into cross compliance.

The suggestion that direct payments might be justified to offset the extra costs farmers might incur in observing a set of statutory management requirements (SMRs) and maintaining their land in GAEC is curious on two counts. First, cross compliance should surely be seen as a mechanism deployed to ensure that farmers cannot claim CAP support if they fail to obey the law, but it is not normal practice to reward law-abiding citizens. Defra’s Agricultural Change and Environment Observatory (2010, p. 2) even makes the
curious suggestion that the scheme is advantageous in that ‘infringements [of SRMs] can be penalised by means of SPS deductions, rather than by more lengthy and expensive legal proceedings.’ Second, all industries have rules and regulations they must obey. Although it might be true that those imposed on agriculture are relatively more onerous than those imposed on other industries, this is simply the cost of doing business in Europe.

The concept of multifunctionality implies the supply of positive attributes valued by society (landscape, ecosystem services, etc.), over and above those covered by cross compliance and GAEC. These services are not conventionally sold and bought in a market, and consequently they are in danger of being undersupplied. Many of these services will be location specific; and yet there is no attempt to differentiate payments according to services supplied. Furthermore, there is no contractual obligation placed on farmers to supply, although many farmers take pride in farming in environmentally friendly ways.7 It would be far more efficient if, under firm contractual arrangements, farmers were paid for providing the public goods that society is willing to fund.

Food safety is a crucially important attribute of food. Most consumers would not willingly buy food they felt was unsafe, provided they can afford to do so (although they might smoke, drink excessive alcohol, and drive fast cars!). Sometimes they cannot tell when food is unsafe, and they rely on state regulation instead. Lapses can occur, with both imported and EU-sourced supplies. If there is felt to be a problem with imported foods, this should be dealt with at source. Giving direct payments to EU producers in the belief this will induce them to produce ‘safe’ food could be thought to be rather naïve and simplistic.

4.4. Some Other Possible Justifications

Other justifications for decoupled direct payments could include one, or more, of the following:

Compensation. Although compensation was the original justification for direct payments, and possibly still has some validity with respect to commodity regimes that have only recently been reformed (e.g. sugar, processed fruit and vegetables) most policy-makers and analysts now accept that the compensation phase is past. Moreover, the facility in the 2003 reform to make payments on a regional basis, to all farmers regardless of whether they had produced the products that prompted the compensation payment in the first place, fundamentally undermined the compensation principle, as did the decision to make payments in the new Member States. The Commission’s proposal for the post-2013 CAP, that all Member States should move to a regional system of payments, makes the compensation principle even less tenable, unless the case is made for compensating the agricultural sector in aggregate for past policy change.

Income Stabilisation: Whilst direct payments help stabilise farm revenues it is misleading to conclude that they necessarily stabilise farm incomes. Direct payments do not vary when prices or output fluctuates (if they did, they would certainly not qualify for inclusion in the WTO’s green box), and so they do not stabilise the revenues from the sale of farm output. Moreover they are likely to be reflected to a greater or lesser extent in the rents farmers pay, or the price at which they buy land. So costs will be higher. High rents and high land prices are a major barrier for new entrants into

7 Unfortunately, critics in the Ministry of Finance might conclude that this implies that farmers are being overpaid for doing something they would have done anyway
farming, who become dependent upon a continuation of the payment regime to cover their costs.

Support for Farmers: It might be argued that the purpose of the scheme is simply to support farmers, as otherwise there would be fewer ‘farmers’ in the European Union. No doubt other groups—pianists for example—would welcome similar support. Member States do support other groups in society: child benefit, for example, could involve a weekly flat-rate payment for every child in the household, regardless of household income.\textsuperscript{8} It could be differentiated by Member State, according to the cost of living. But it is much easier to agree objective criteria to define a ‘child’ than it is to define a ‘farmer’; and there is no hint in the present scheme, or that proposed for the post-2013 CAP, that generic support for farmers is the objective.

Territorial Cohesion: As farming is often a significant activity in poor rural regions, it might be argued that direct income support is a proxy for providing financial support to those regions. The problem is that support has not been focussed on those regions; indeed in many instances it has given higher levels of support to more productive regions. The WTO’s green box gives directions on how WTO-compatible ‘payments under regional assistance programmes’ could be designed, but payments must be limited to ‘the extra costs or loss of income involved in undertaking agricultural production in the prescribed area.’

Food Security: It is often suggested that direct payments are in some way linked with food security, for example the European Parliament (2010, paragraph 69) declared ‘there should be a basic EU-funded direct area payment to all EU farmers in order to ensure the social and economic sustainability of the European agricultural production model, which should provide basic food security for European consumers.’ The world’s ability to produce enough food for a potential 9 billion consumers is an issue; but it is the food security of the world’s marginalised and disposed, rather than that of most relatively-wealthy European consumers, that is at risk. If world market prices soar, most European consumers will still be able to afford an adequate diet, whilst millions of others in low-income economies will go short of food. Consequently the link between EU farm policy and ‘basic food security for European consumers’ is not entirely clear. But presumably the implication is that direct payments impact either on current, or on potential, production. If they impact upon current production, they are not decoupled policies, and it is difficult to see how they enhance the food security of the world’s poorest citizens (although there will be a slight depressing affect on world market prices). A more sophisticated argument, but one rather difficult to defend in front of the CAP’s international critics, is that direct payments are decoupled from current production, but that they help ensure that European land remains available for agricultural production at some time in the future when higher world market prices justify an unsubsidised increase in EU food production.

\textsuperscript{8} See for example the UK scheme at http://www.hmrc.gov.uk/childbenefit/start/who-qualifies/what-is-childbenefit.htm
5. THE COMMISSION’S PROPOSAL: A CRITIQUE

KEY FINDINGS

- The Commission has gone to extraordinary lengths to ensure overall budget neutrality.
- It is to be hoped there is a Plan B. A 20% cut would take €80 billion out the CAP budget over the next MFF. This is equal to 80% of the budget for Pillar 2, and four-times the budget for market-related expenditure.
- The notion that the average direct payment per hectare is an objective measure of fairness is contestable.
- There is no hint that the greening payments are to be targeted in any way, or related to the cost of provision, both key requirements in the WTO. It is a one-size-fits-all policy, rather than a targeted approach.
- It would appear that there would be a legal requirement on farmers entitled to the basic payment to follow the greening provisions. If so, there is only one payment (nominally made up of two parts), and greening simply amounts to additional cross compliance.
- The debate about active farmers has dogged the CAP for some time, and the European Commission is clearly responding to criticisms from the Court of Auditors and the European Parliament. Why the ownership or management structure should be of importance in the effective management of agricultural land is unclear.
- It is difficult to see any economic logic arguing in favour of capping. Rather the reverse, because it will discourage farm amalgamations and other structural changes (such as contracting-in services) which would push the business above the limit.
- If farm income in the EU is significantly lower than incomes in the rest of the economy, young people are perhaps making a rational choice when they decide not to become farmers. Additional payments for young farmers fail to address the root cause of the problem new entrants face, which is the high entry cost resulting from support.
- One concern about any small farmer scheme is that the financial inducement locks small farmers in to an otherwise ‘unprofitable and uncompetitive’ business structure, deterring their growth and farm amalgamations.
- Coupling of support will reduce the farmer’s freedom to pursue the most commercially viable opportunities available, thus potentially reducing the farming profits to be earned. Nonetheless there is a long-standing concern about land abandonment when decoupling occurs. However, other elements of the direct payments package (and the Rural Development Regulation) should help ensure that land is not abandoned.

In its 2010 communication on The EU Budget Review, which spoke of the need for smart, sustainable and inclusive growth, the European Commission (2010a, p. 12) concluded its review of the CAP by saying:

Reform of the CAP could … be pursued with different degrees of intensity. It could restrict itself to ironing out some current discrepancies, such as more equity in the
distribution of direct payments between Member States and farmers. It could make major overhauls of the policy in order to ensure that it becomes more sustainable, and reshapes the balance between different policy objectives, farmers and Member States, in particular by introducing a more targeted approach to priorities. A more radical reform would go further, moving away from income support and most market measures, and giving priority to environmental and climate change objectives rather than the economic and social dimensions of the CAP.

The proposal actually tabled for the post-2013 CAP (European Commission, 2011d) is closer to the first of these three options, although it does make some effort to reshape the direct payments regime, to become more sustainable (the greening component) and more targeted (for example, the proposal on active farmers). However, it could not readily be characterised as a proposal for radical reform. In particular it continues to emphasise income support.

Budget expenditure on the CAP, and its allocation to direct payments, market price support, and rural development, is set to remain more-or-less unchanged through to 2020 in current (money) terms, although this implies a reduction in real terms and as a percentage of the EU budget spend. However there will be new environmental constraints put upon 30% of expenditure under the new direct payments scheme.

In particular it is proposed that the existing system of direct payments (covering SPS, SAPS, and some coupled support) should be extended for a further year, into 2013, and then cease. From 2014 it will be replaced by a new, legally distinct, regime that will include:

(i) a basic payment for farmers (... referred to as the ‘basic payment scheme’);
(ii) a payment for farmers observing agricultural practises beneficial for the climate and the environment;
(iii) a voluntary payment for farmers in areas under natural constraints;
(iv) a payment for young farmers who commence their agricultural activity;
(v) a voluntary coupled support scheme;
(vi) a crop specific payment for cotton;
(vii) a simplified scheme for small farmers;
(viii) a framework to enable Bulgaria and Romania to complement direct payments (European Commission, 2011d, Article 1).

The proposed breakdown of a Member State’s National Ceiling can be found in Table 2, which also indicates whether Member States are obliged to implement the component, or not. In addition Article 14 would allow Member States to make transfers between Pillar 1 and Pillar 2. In particular, all Member States can opt to transfer up to 10% of their national ceilings to their Rural Development budgets. Alternatively, those Member States whose direct payment levels per hectare fall below 90% of the EU average (Bulgaria, Estonia, Finland, Latvia, Lithuania, Poland, Portugal, Romania, Slovakia, Spain, Sweden and the United-Kingdom) can transfer up to 5% of their Pillar 2 budget allocation for spending on direct payments.

This Briefing Note cannot consider in detail all the elements of a long and complex document. Instead it will focus on some of the key elements of the proposal.
Table 2: Proposed Allocation of Funds in the New Direct Payments Scheme

<table>
<thead>
<tr>
<th>Component</th>
<th>% of National Ceiling</th>
<th>Optional or Compulsory for the Member State?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Greening</td>
<td>30%</td>
<td>Compulsory</td>
</tr>
<tr>
<td>Areas under natural constraints</td>
<td>5% maximum</td>
<td>Optional</td>
</tr>
<tr>
<td>Young farmers</td>
<td>2% maximum</td>
<td>Compulsory</td>
</tr>
<tr>
<td>Small farmers</td>
<td>10% maximum</td>
<td>Compulsory</td>
</tr>
<tr>
<td>Coupled support</td>
<td>Up to 10%</td>
<td>Optional</td>
</tr>
<tr>
<td>Basic payment</td>
<td>Remainder</td>
<td>Compulsory</td>
</tr>
</tbody>
</table>

5.1. The Budget Allocation for Direct Payments

The Commission has gone to extraordinary lengths to ensure overall budget neutrality between the existing scheme for direct payments (extended into 2013), and that for the post-2013 CAP (see for example the detail in European Commission, 2011g). The basic aim has been to maintain the existing level of expenditure (in money terms) on direct payments, net of compulsory modulation, into the new MFF. The European Commission (2011g, p. 1) refers to this as a ‘minimal freeze’ of funding for both Pillar 1 and Pillar 2 of the CAP at the 2013 level. Thus Annex II of the proposed regulation on the post-2013 regime for direct payments (European Commission, 2011d) fixes an annual amount of €42.78 billion from 2017, when all of the phased adjustments (including those for Bulgaria and Romania) would be completed. Although this budget allocation will be eroded by inflation (the payments are to be fixed in money terms, with no adjustment for inflation), meaning that the percentage share that direct payments occupy in the EU budget will have declined by 2020, it will still represent a large call on the EU budget, and will continue to dwarf budget expenditure on Pillar 2.

Over the 7 years of the 2014-20 MFF the overall funding for the three core aspects of the CAP is expected to be:

- Market-related expenditure: €18,764 m
- Direct aids (after capping): €302,027 m
- Pillar 2 (after capping): €102,263 m (European Commission, 2011g, p. 15)

These expenditure ceilings for direct payments could also be eroded if expenditure on other Pillar 1 activities were to increase, as the Financial Discipline will continue to apply, although the main provisions will switch from the regulation fixing direct payments (Article 11 of Regulation 73/2009) to the proposed financing regulation (European Commission, 2011e, Article 25). Thus if expenditure on Pillar 1 (market-related expenditure and direct payments) threatens to exceed the MFF annual ceiling, reductions in direct payments of over €5,000 per year will be triggered.

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9 For the United Kingdom, where voluntary modulation has been applied in addition to compulsory modulation, the €313.9 million from voluntary modulation is added back into the budget for direct payments.

It may be that as a consequence of a series of well-considered policy changes over the last two decades the EU has determined exactly the appropriate level of funding for direct payments, which should be carried forward into the next MFF, albeit declining in real terms. If so, that would be quite extraordinary. But there is little, or no, objective evidence accompanying the proposals to suggest that this is so, or to justify this continuing level of support. Rather, the impression given is that of political expediency, either to appease the lobby that has championed for an ambitious budget for the CAP, or as an opening bid against finance ministers who might be expected to seek budget cuts.

It is to be hoped there is a Plan B; should finance ministers decide, for example, to impose a 20% cut on the CAP budget for the next MFF (a percentage reduction not totally out of line with that faced in other spheres of public finance in these straightened times). Neither the European Commission nor COMAGRI could be expected to reveal their Plan B before the real negotiations begin; but it is to be hoped that the European Commission, and individual members of the European Parliament, do have a clear set of priorities. A 20% cut would take €80 billion out the CAP budget over the next MFF. This is equal to 80% of the budget for Pillar 2, and four-times the budget for market-related expenditure. Would direct payments be protected (reducing Pillar 2 to a residual of its former self, for example), and if not, how would the cuts to direct payments be applied?

5.2. Redistribution between Member States

Within the unchanged budget allocation for direct payments, there is however to be some redistribution, a process referred to as convergence. The first relates to a redistribution between Member States. The policy objective that the European Commission appears to have in mind is that of fairness. There has been a lot of comment about the ‘unfair’ allocations in the current regime, and the European Commission has tried to judge what degree of redistribution might be politically acceptable to both those countries that see their direct payments budget reduced, and those that see theirs increased.

The criterion cited is that of the Member States’ average payments per hectare. Specifically the European Commission has taken (after some adjustments) the current National Ceilings for 2016 (after the full phasing in of payments in Bulgaria and Romania) and divided this by the potentially eligible area (PEA) declared by the Member States for 2009. This gives an average level of direct payments per hectare. For all those Member States where this average level of payments is below 90% of the EU average (€267 per ha of PEA), one-third of the difference will be made up. This will involve a transfer of about €748 million a year. To keep the overall budget neutral, this will be clawed-back from those Member States whose payment levels are above the EU average ‘proportionally to their distance from the EU average,’ although the maths underpinning this latter calculation is not spelt-out (European Commission, 2011g, pp. 7-8).

Despite the mathematical precision of the proposal, it is quite arbitrary. The notion that the average direct payment per PEA is an objective measure of fairness is contestable; although it must be conceded that objections could be raised about other ratios too (for example the direct payment per farm, or per labour unit employed in the farm sector).

The European Commission (2011f, Annex 3, p. 19) did debate the possibility of adjusting a EU flat rate ‘by objective criteria based on economic, physical and/or or environmental
indicators,’ but conceded that it would be difficult to achieve political agreement on what these criteria might be. In the end it opted for the ‘pragmatic’ approach outlined above. Consequently, **none of the possible justifications for maintaining a system of direct payments are invoked in the proposed redistribution.** One might imagine a redistribution of funds between Member States being driven by environmental or income concerns, or as simply a proxy for budget transfers on cohesion grounds, but none of these are used. **If these considerations are irrelevant in determining the allocation of funds between Member States, this surely weakens the case for a European system of direct payments:** what added value does the EU dimension bring?

### 5.3. Redistribution within Member States

There is also to be convergence within Member States, either on a national or regional basis, and this has two dimensions. It affects countries or regions in which the historic mode of the SPS has been in force. Under the revised scheme, payment **entitlements** will be issued in 2014 on the basis of the area of **eligible agricultural land** at a farm’s disposal. This means that the number of entitlement hectares under the new scheme will be greater than under the SPS, as so called **naked land** (land which was not used to activate entitlements under the old SPS scheme) will be brought into the equation. Thus, depending upon their past use of land, the first consequence is that some farmers will be able to increase the number of their entitlement hectares, and others, who did not qualify for the SPS, will now be able to join the new scheme.

Second, as of claim year 2019, **payments under the basic payment scheme will have a ‘uniform unit value’ on either a regional or national basis.** There will be a transition from the current historic system of payments; but the net result will be that those farms with high-value entitlements will see then diminish in value, and vice versa.

The motivation for this change would again appear to be that of ‘fairness,’ and the criterion used is that of equality of payments per hectare in a particular region. It is difficult to discern an economic rational motivating the proposed change, but the financial circumstances of individual farmers would clearly be affected. The European Commission’s (2011f, Annex 3, pp. 29-30) assessment, which is undoubtedly correct, is that ‘field crop, mixed and milk farms would lose payments compared to the status quo while payments would increase in grazing livestock, wine and horticulture farms. As a general matter, a uniform flat rate would reduce support in more productive regions and sectors in favour of more marginal regions. In addition, the move to a regional model ... is likely to increase the rate of capitalisation of support in land prices.’ The last comment rests upon the consideration that with less naked land available, under the regionalised scheme, there is increased demand for naked land from farmers who want to establish entitlements (in 2014) and subsequently, from those who own entitlements, but who no longer have access to eligible land.11

Moving to a regionalised scheme will expand the number of farms and the hence area of agricultural land subject to cross compliance. For Defra’s Agricultural Change and Environment Observatory (Defra, 2010) this was one of the advantages of the regional scheme adopted in England after 2003; but curiously the European Commission does not

11 For an insight of this market at work see Madeleys Chartered Surveyors’ website where they point out: ‘We have a number of clients looking for “naked acres” on which to claim their Single Payment Scheme entitlements on. If you have land which is not being claimed on, or have entitlements without land to claim them on, you could benefit from speaking to us about Naked Land Transfers ...’ [http://www.madeleys.co.uk/single-payment-scheme-entitlement-trading/](http://www.madeleys.co.uk/single-payment-scheme-entitlement-trading/), last accessed 9 February 2012.
seem to recognise this in its Impact Assessment. Nor is it clear how many additional hectares will be brought into cross compliance.

When Member States opt to use more than one region (rather than the country as a whole), then the region has to be defined ‘in accordance with objective and non-discriminatory criteria such as their agronomic and economic characteristics and their regional agricultural potential, or their institutional or administrative structure.’ Furthermore, the national ceilings have to be divided between the regions ‘in accordance with objective and non-discriminatory criteria’ (Article 20). Even when operating ‘in accordance with objective and non-discriminatory criteria’ Member States will still have scope to vary the re-distributional effect, and may well be mindful of the experience in England after the 2003 reform. As Buckwell (2009, p. 19) reminds us: ‘Initially it was decided to define two regions essentially lowland and upland England. However it was soon observed that this would massively increase payments for moorland farms which tend to have very large area but with low stocking density sheep, at the expense of upland beef and dairy farmers whose stock are mostly on the lower slopes of the hills (the so-called in-bye land). The result was a hasty redefinition of the area payments to a three region model, essentially lowland, upland and moorland.’

5.4. The Greening Element

Although the overall budget, in nominal terms, is to remain unchanged, with some limited redistribution between and within Member States, 30% of a Member State’s National Envelope is to be reserved for the greening component (Article 33). This is a sizeable sum: about €90 billion over the 2014-20 MFF. This compares to €102 billion for Pillar 2, and a question that inevitably arises is whether these two numbers (90 and 102) are proportionate. The other Briefing Note, on the Impact of greening proposals and possible alternatives, is the more appropriate place to discuss: the advantages and disadvantages of using Pillar 1 or Pillar 2 (or Pillars 1 and 2) to deliver environmental benefits; whether the proposed measures under Pillar 1 will deliver the claimed benefits; whether €90 billion does reflect the EU citizens’ likely evaluation of the benefits to them; and whether the €90 billion could be better spent on other greening measures. Some comments of a more general nature are, however, warranted in this Briefing Note, not least because of the WTO implications that will be explored in more detail in Section 6.

The payment is to be a flat rate payment per hectare in any given region, obtained by dividing the total amount available (i.e. 30% of the region’s share of the National Envelope) by the number of eligible hectares in the region. Thus, within the region, there will be no attempt to target the payment to objective criteria. Across the EU the average payment will be €80.1 per PEA (30% x €267), but clearly there will be significant differences between Member States, even after the envisaged, but limited, redistribution of funds between Member States; and there could be significant differences within Member States, depending on how their regions are defined. Thus there is no hint that the payments are to be targeted in any way, or related to the cost of provision (both key requirements in the WTO), and—without wishing to prejudge the conclusions of the companion Briefing Note on the Impact of greening proposals and possible alternatives—they are unlikely to deliver benefits in a cost effective way. It is a one-size-fits-all policy, rather than a targeted approach.

It is unclear from the English text of the proposal whether the basic payment can be claimed separately from the greening payment, or whether the two are inextricably linked; but it does appear to be the European Commission’s intention that there should be one
combined payment rather than two separate payments. This is an important issue for farmers (might they have to forego their basic payment if they are unable, or unwilling, to meet the greening requirements?); the treatment of the payments in the WTO; and the coverage of the scheme (will it apply to all eligible hectares, or will significant areas opt out?).

The English text of Article 29 reads: 'Farmers entitled to a payment under the basic payment scheme referred to in Chapter 1 shall observe on their eligible hectares as defined in Article 25(2) the following agricultural practices beneficial for the climate and the environment ...' This implies that there is a legal requirement on farmers entitled to the basic payment to follow the greening provisions and thereby become eligible for the greening payment. If so, then there is only one payment (nominally made up of two parts), and greening simply amounts to additional cross compliance. This has important implications in the WTO.

If farmers were able to claim the basic payment without undertaking greening, thereby foregoing the greening payment, the strong financial incentive might still induce them to do so. Thus, although *de jure* voluntary, it would still be *de facto* mandatory. This too could potentially be problematic in the WTO.

There is moreover a cost imposed on farm businesses that should be considered. Again this is an issue more properly addressed in the companion Briefing Note, but the Impact Assessment does read in part: 'The resulting average costs per ha of all the greening measures together across the EU27 range from €33 to €41/ha, depending on the implementation option of greening, with up to half coming from the cost of maintaining permanent grassland (average € 17/ha). Per farm, average costs range from €1041 to €1280. These figures represent average costs spread out over all agricultural area, including area not affected by greening. The relevant costs for the land affected are considerably higher (it is estimated that 25-30% of the agricultural area would see its land use and production methods modified or would face an opportunity cost)’ (European Commission, 2011f, p. 56).

Thus the European Commission does concede that costs are farmer or location specific, whereas the flat-rate payments are determined regionally (and there is no guarantee that higher-cost regions have higher payments). It should also be noted that, in the WTO, payments for environmental programmes in the Green Box have to be limited ‘to the extra cost or loss of income’ involved. Contrast an average greening payment across EU27 of €80.1 per ha of PEA, and an average cost ranging from €33 to €41 per ha.

### 5.5. Active Farmers

The debate about *active farmers* has dogged the CAP for some time, and the European Commission is clearly responding to criticisms from the Court of Auditors and the European Parliament. It says of its proposal that it will help legitimize the CAP to the public.

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12 *Declaration of interest:* The author’s former employer runs a large commercial farm, and the author at one time served on the Farms Board. It is doubtful that the University farm’s receipts of direct payments amounts to more than 5% of the University’s total receipts for all non-agricultural activities.
The proposal (Article 9) as it stands is that:

No direct payments shall be granted to natural or legal persons, or to groups of natural or legal persons, where one of the following applies:

(a) the annual amount of direct payments is less than 5% of the total receipts they obtained from non-agricultural activities in the most recent fiscal year; or

(b) their agricultural areas are mainly areas naturally kept in a state suitable for grazing or cultivation and they do not carry out on those areas the minimum activity established by Member States in accordance with Article 4(1)(c).

However, it does not apply to farmers who received less than €5,000 in direct payments the previous year. Whilst the latter is clearly designed to exclude from the provisions small farm businesses who are seen to be genuine recipients, paradoxically it will also exclude a number of golf courses, aerodromes, and other businesses that engage in farming on a small scale.

Whilst one can understand the political concern, it is difficult to deduce any rationale from economic theory. Why the ownership or management structure should be of importance in the effective management of agricultural land is unclear. Indeed, there is an inconsistency in the European Commission’s position. When arguing that agricultural incomes are depressed it claimed that the appropriate focus was ‘on farms and the agricultural sector as unit of analysis, not on agricultural households’ (European Commission, 2011f, Annex 3, p.8). So in one context it rejected a contextual approach; in another it argues for a contextual approach.

If, as claimed, cross compliance and greening are important mechanisms for delivering environmental benefits, it seems rather illogical to exclude land from these controls purely on the basis of management structure.

The author’s expectation is that many ‘natural or legal persons’ that run farms but are potentially excluded from the receipt of direct payments because of the proposed 5% rule will attempt to hive off their farms into legally distinct personalities. This will do little to foster simplification, or transparency. The significant WTO implications are examined in Section 6.

### 5.6. Progressive Reduction and Capping of Direct Payments

Above €150,000 per annum, a farm’s direct payments, but excluding the greening component, are to be subject to a progressively increasing tax, rising to 100% above €300,000 (Article 11). Thus the effective cap on payments to an individual farm business, before adding in the greening component, is €235,000 per year. Member States are to take measures to ensure that no payments are made when, as from the date of publication of the proposal (October 2011), farm businesses ‘artificially created the conditions to avoid the effects of this Article.’ Whether this latter provision can be effectively enforced is an open question. Presumably, for example, it would still be possible to sell surplus entitlements, with or without land, in an arms-length transaction, that could then be activated by another farm business?

Some offsets will be allowed: ‘the salaries effectively paid and declared by the farmer in the previous year, including taxes and social contributions related to employment.’ This
potentially leads to unequal treatment of otherwise identical farms: one that employs labour and maintains its own equipment for example, compared to one that contracts-in many farming services (such as ploughing, hedge trimming, combining). At the margin this could act as an impediment to structural change and efficient operations.

**It is difficult to see any economic logic arguing in favour of capping. Rather the reverse, because it will discourage farm amalgamations and other structural changes (such as contracting-in services) which would push the business above the limit.**

The arguments in favour of the proposal are essentially political: that it would be seen to be a fairer distribution of support amongst farmers, and that it would enhance the legitimacy of the CAP among the wider public (who probably think a cap of €300,000 is still rather high). In addition, the European Commission (2011f, Annex 3, p. 15) has argued that there is likely to be a reduced need for income support in this class of claimants, declaring (probably quite rightly) that ‘it can be reasonably assumed that large farms benefit from economies of scale and therefore their income support needs may not be proportional to the farm size.’ Despite this supposition, the €300,000 remains an arbitrary ceiling, unsupported by objective evidence.

The European Commission (2011f, Annex 3, pp. 50) has worked hard to produce estimates of the impact of capping on average income per work unit, and it has come to the conclusion that across the EU average income would be little affected (between -0.5 and -0.0%). Whether this result will be of any comfort to those businesses that will be affected (i.e. potential claimants above €300,000) is doubtful.

If farms are to be limited to a direct payments claim of €300,000, before adding in the greening component, but have more eligible land at their disposal, they will presumably only claim on enough land to trigger a notional payment of €300,000, selling off any additional entitlements that they were able to acquire. (But can they claim the greening component on additional land on which the basic payment cannot be claimed?) However, cross compliance will continue to apply to ‘all the production units and areas managed by the beneficiary … situated within the territory of the same Member State’ (Article 91 of the draft financing regulation, European Commission 2011e).

**5.7. Additional Payments for Young Farmers**

Member States would be obliged to apply this scheme, but would have some discretion over the funding. They could devote up to 2% of their National Envelope to the scheme. It would take the form of a 25% supplement to the farmer’s basic payment, for up to 5 years; but subject to a size restriction. This would be 25 hectares in Member States where the average size of holding is 25 hectares or less; and no more than the average size of holding elsewhere. Recipients would have to be less than 40 years of age at the time of application, and setting-up as a farmer for the first time (Article 36).

The concern focuses on the age structure of EU farmers, and a fear that too few new entrants are entering the industry. *If, as the European Commission has claimed, farm income in the EU is significantly lower than incomes in the rest of the economy, perhaps young people are making a rational choice when they decide not to become farmers.* One of the problems (young and old) new entrants to the industry face is the high rents and land prices they must pay, reflecting the inflated returns the current
owners of land can expect because of the coupling of direct payments to land. Instead of tackling the root cause of the problem (direct payments giving rise to high land prices) the EU is, rather perversely, attempting to address the symptom. In adding to the demand for land, the likely impact is further upward pressure on land prices.

5.8. Small Famers

The European Commission (2011f, Annex 3, p. 52) has said ‘Many small farms may be unprofitable and uncompetitive from an economic perspective. Yet, they are of crucial social importance in certain Member States and rural regions where they make a significant contribution to employment, to the maintenance of viable areas and to cultural heritage.’ It (op. cit.) also claims that ‘small farms are important for the provision of public goods.’

Consequently, a simplified scheme for small farmers has been proposed, but restricted to existing holdings. Under the simplified scheme small farms could choose to receive a lump sum payment rather than the direct payments for which they would otherwise qualify, and they would not be subject to cross compliance or greening. They would, however, have to keep enough hectares of agricultural land to match their entitlements (Articles 47-51). The idea is that small farmers should receive enhanced levels of support, paid in a less administratively complex way.

Whilst a reduction in administrative costs (for both the recipient and the payer) is to be welcomed, it is rather curious to learn that ‘small’ farms can be trusted to provide public goods, without the need for cross compliance, whereas larger farms need to be subject to cross compliance to ensure that they do. It would be helpful to have some empirical evidence to support this assertion.

One concern about any small farmer scheme is that the financial inducement locks small farmers in to an otherwise ‘unprofitable and uncompetitive’ business structure, deterring their growth and farm amalgamations. Indeed, the proposed Article 50(3) as drafted would seem to hinder farm amalgamation. It currently reads: ‘payment entitlements held by farmers participating in the small farmers scheme shall not be transferable, except in case of inheritance or anticipated inheritance.’

5.9. Additional Payments for Areas with Natural Constraints

Member States may if they choose implement this provision, and allocate up to 5% of their National Envelope to the scheme to make additional area payments to farmers in designated regions facing natural constraints. Areas facing natural and other restrictive constraints are determined according to criteria set out in the Rural Development Regulation. The payment would be additional to any support offered under the Rural Development Regulation.

Whilst the draft is clear that all farmers in a region would be eligible for payment, and that ‘objective and non-discriminatory criteria’ have to be used in determining regions, and the allocation of funds between regions (Article 34), there is little, or no, guidance on how the overall level of funding is to be determined. This is rather important with regard to the WTO classification of the scheme.
5.10. **Coupled Payments**

Coupled payments would be retained for cotton, but the residual partial coupling options left over from the Health Check (suckler cows, and sheep and goats) would disappear. In a complex set of provisions, Articles 68 and 69 of the current regulation (73/2009) allow Member States to allocate up to 10% of their National Envelopes for ‘specific support’, including some elements of coupled support.

Under the new regime it is proposed that Member States be allowed to allocate up to 5% of their National Ceilings (or up to 10% in certain circumstances) to offer coupled support to 'sectors or to regions of a Member State where specific types of farming or specific agricultural sectors undergo certain difficulties and are particularly important for economic and/or social and/or environmental reasons.' Support could ‘only be granted to the extent necessary to create an incentive to maintain current levels of production in the regions concerned.’ It would ‘take the form of an annual payment … granted within defined quantitative limits and based on fixed areas and yields or on a fixed number of animals’ (Article 38). These would be either amber or blue box payments in the WTO’s classification scheme.

**Coupling of support, where applied, will reduce the farmer’s freedom to pursue the most commercially viable opportunities available, thus potentially reducing the farming profits to be earned.** The policy motivation is the fear that ‘specific types of farming’, ‘particularly important for economic and/or social and/or environmental reasons,’ might otherwise disappear. It is not easy to see what these ‘economic’ reasons might be, unless it refers to the availability of raw material supplies to locally based food-processing facilities (abattoirs for example, although livestock often travel hundreds of kilometres before slaughter). Nonetheless, **there is a long-standing concern about land abandonment when decoupling occurs.** However, **other elements of the direct payments package (and the Rural Development Regulation) should help ensure that land is not abandoned,** particularly where there is little naked land under the regional payment model advocated by the European Commission. Defra’s Agricultural Change and Environment Observatory (2010, p. 6) for example found little evidence of land abandonment in the moorland regions of England following the full decoupling of payments after the 2003 reform.
6. WTO CONSTRAINTS

KEY FINDINGS

- The EU is a founder member, and co-architect of the WTO’s rules-based system of international trade, and strives to obey its rules.

- A succession of policy reforms have significantly changed the way EU farmers are supported, and this has enabled the EU to switch the bulk of its declarations of domestic farm support away from the amber and blue boxes to the green box.

- This should allow the EU to comply with any further reduction commitments that might result from a conclusion of the ongoing, but stalled, Doha Round.

- However, the SPS is claimed and paid annually when entitlements are activated by matching them with eligible land at the farmer’s disposal, and cross compliance and GAEC apply. This might be seen as an infringement of the green box requirement (for decoupled income support) that the payments in any year should not be based on, or related to, the factors of production employed in any year after the base period.

- Suggestions that direct payments are necessary to maintain agricultural production are also problematic, as this might be construed to mean that they infringe the fundamental requirement that green box payments have no, or at most minimal, effects on production.

- New legislation on greening, and on active farmers, will have to be carefully crafted. As presented by the European Commission, both are in danger of infringing the green box requirement that no production is required to qualify for payment. Nor would the greening component appear to fit within the green box exemption for payments under environmental programmes.

- A challenge to the EU’s classification of domestic support, and its use of the green box, would take some time to be resolved in the WTO’s Dispute Settlement procedures; and the outcome is uncertain.

- However, there is little that other WTO Members would gain by challenging the EU’s current, or post-2013, policy under the present WTO arrangements. If not green, there is ample scope to declare direct payments in either the amber or the blue box.

- But, should there be a Doha Agreement, restrictions on amber and blue box payments would be considerably tightened, and the green box status of the post-2013 system of direct payments would become critical. The EU would then be in danger of flouting its WTO commitments.

- The EU has not negotiated a watertight agreement guaranteeing that its use of the green box to shelter its direct payments would go unchallenged following a Doha agreement.

The basic premise underpinning this section of the Briefing Note is that, as a founder member of the WTO and a co-architect (with the US) of many of its key agreements, the EU is committed to a rules-based system of international trade, and will strive, when possible, to comply with the WTO Agreements. It is the view of this author that throughout the period of policy change documented in Section 2, from the MacSharry Reform though to
the Health Check and the sugar reforms, GATT/WTO constraints have had an important formative influence on policy. Others take a more jaundiced view, with Bureau and Mahé (2008, p. 31) commenting, for instance, that: ‘The EU experience with phasing out export refunds and decoupling direct payments is a reminder that an alleged «WTO constraint» has on many occasions been an opportunity to spur reforms which clearly serve the EU’s self-interest but which prove difficult to agree on in the Council for political reasons.’

This Briefing Note is exclusively concerned with direct payments. Thus this Section examines how direct payments are dealt with in the WTO agreements, particularly the Agreement on Agriculture (AoA).13 The EU has declared the bulk of its direct payments as so-called green box payments, and all the indications are that it would wish to continue doing so for the post-2013 CAP. The first question to be addressed is whether current practice is legitimate, and whether the Commission’s proposals for the post-2013 CAP would undermine this position. It should be stressed that this is a hypothetical question. It is up to individual WTO members to decide how their agricultural support is to be declared in the AoA. The WTO, as an institution, does not verify or police these claims; but other members can challenge measures that they think infringe WTO provisions and undermine their legitimate expectations under the WTO agreements. If disagreements cannot be resolved by bilateral discussion, the Dispute Settlement Process will be invoked, resulting in a binding ruling that WTO members are expected to respect. But this is a lengthy process.

The Uruguay Round negotiation that led to the current suite of WTO agreements was a political process, and the agreements reflect this. However disputes are settled by a judicial process that can involve highly complex legal issues. The author of this Briefing Note is not trained in international law; and even experienced practitioners can have difficulty predicting the outcome of the Dispute Settlement Process. Thus the conclusions drawn in this Section must be treated with caution.

The second question to address is whether it matters that direct payments (either current or planned) might be problematic occupants of the green box. As will be explained below, any potential problem arises not with the provisions of the current AoA, but with a Doha settlement. The Doha Round of WTO negotiations is stalled, and there seems little prospect of a revival in the near future. Readers who take the view that the Doha Round is dead will undoubtedly conclude that a potential WTO challenge to the EU’s post-2013 system of direct payments can be entirely discounted for the next decade or so (although challenges to other aspects of the CAP, and the EU’s biofuel policies, might become more likely). Those who are more optimistic about a Doha revival should be more concerned about WTO constraints.

This Section proceeds as follows. There is first a brief introduction to green, blue and amber boxes, and the EU’s declarations to the WTO of its domestic farm support. Second the current provisions of the green box are examined in a little more detail, and then the text considers how this might change if there is a Doha agreement. Next, the EU’s present system of direct payments, and the Commission’s proposals for the post-2013 regime, are examined from the perspective of a hostile trading partner. Finally the text asks whether this matters.

13 The text does not attempt to explore the relationship between the AoA and the Agreement on Subsidies and Countervailing Measures.
6.1. Coloured Boxes

Part IV of the AoA, dealing with domestic support commitments, covers all ‘domestic support measures in favour of agricultural producers’. Although the agreement itself does not use the terminology of amber, blue and green boxes, these are widely used and understood terms. One aim of the Uruguay Round negotiations was to bring some discipline to farm support programmes that distorted trade, and were thus seen as a legitimate concern for other WTO members. Programmes that were decoupled, with little or no impact on production and trade, were of no concern to the wider WTO membership. Thus the AoA attempts to identify a group of policies that ‘have no, or at most minimal, trade-distorting effects or effects on production.’ These are listed in Annex 2 to the AoA, together with some over-arching conditions that must be met; and this is what is commonly referred to as the green box. The green box will be examined in greater detail below. Under the current AoA, there are no limits on the amount of expenditure WTO members can incur on green box measures; and nor would there be if the December 2008 version of the draft modalities for a Doha Agreement on Agriculture (WTO, 2008) were adopted. Some WTO members, though, do want to see some changes to the green box; and a number remain highly critical of the provisions that allow the EU to use the green box to shelter the bulk of its expenditure on direct payments.

The blue box refers to the provisions of Article 6(5) of the AoA, which owes its origins to a bilateral agreement between the EU and the US confirmed in the Blair House Accord of November 1992 (Cunha and Swinbank, 2011, pp. 91-2), but rather disliked by Australia and other members of the Cairns Group. Specifically it sought to exclude the area and headage payments introduced by the MacSharry Reform (and the then deficiency payments paid in the US) from the disciplines of the amber box. Objectively it could be claimed that these were partially decoupled policies, with potentially less trade-distorting effects than many amber box policies, and so arguably they were entitled to different treatment. Politically the decision to create a blue box was important in that it allowed the EU to undertake a significant reform of the CAP (the MacSharry Reform) and accept the AoA.

The relevant provisions of Article 6(5) read:

Direct payments under production-limiting programmes shall not be subject to the commitment to reduce domestic support if:

(i) such payments are based on fixed area and yields; or ...

(iii) livestock payments are made on a fixed number of head.

Accordingly the EU declared its area and headage payments in the blue box; and as far as the author is aware this was never challenged.

The amber box is the residual of all ‘domestic support measures in favour of agricultural producers’ that do not qualify for inclusion in either the green or the blue box (with slightly different provisions applying to developing countries). The disciplines of the amber box are applied through a complicated calculation known as the Aggregate Measurement of Support, or AMS. This is calculated on an annual basis (the Current Total AMS) and...
the WTO member is obliged to ensure that this is no greater than the **AMS Binding** that the WTO member agreed when the Uruguay Round Agreements were signed.

Many WTO members have an AMS Binding of zero, reflecting the fact that they notified no AMS for the base period of 1986-88 (although the *de minimis* rules, explained in Brink (2011), do allow for some support). The **AMS Binding for EU27**, with which the EU works, is **€72.2 billion**. The **Current Total AMS it declared for the marketing year 2007/08 was €12.4 billion**, well within its limits (WTO, 2011). Figure 2 shows how the EU’s green, blue and amber box declarations have evolved over the years. In particular the 2003 and subsequent reforms have shifted support from amber and blue to the green box.

**Figure 2: The EU’s Declarations of Domestic Support to the WTO**

The December 2008 draft modalities (WTO, 2008) envisaged a **70% reduction** in the EU’s AMS binding, which would bring it down over a transitional period to €21.7 billion. The 2007/08 declaration, at €12.4 billion, is comfortably below this.

There would be other constraints: possibly product-specific AMS bindings, blue box payments limited to 2.5% by value of 1995-2000 agricultural production, a reduction in the *de minimis* allowance, and a new overarching constraint on Overall Trade-Distorting Support (OTDS) (for a summary see Brink, 2011, pps. 43-4). But, providing the EU’s recent declarations (summarised in Figure 2) can be defended, the EU has already largely met the reduction commitments for domestic support envisaged for the Doha Round (Josling and Swinbank, 2011). **Critical to this is the €31.3 billion of ‘decoupled income support’**

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16 The EU managed to halve its Current Total AMS between the 2006/07 and 2007/08 marketing years. An explanation of how this was done lies beyond the scope of the present Briefing Note, but for further explanation see Swinbank (2011).
that the EU declared in the green box in its 2007/08 submission. Had this been declared in either the amber or the blue box, Figure 2 would have looked rather different, and the EU’s ability to comply with a Doha Agreement would be jeopardised.

6.2. The Green Box

Annex 2 of the AoA—the green box—is reproduced in the Annex to this Briefing Paper for ease of reference. Paragraph 1 sets out the over-arching criteria that must be met if a measure is to qualify as a legitimate green box provision. Paragraphs 2 to 13 lay down policy-specific criteria that are also mandatory.

The EU’s green box submission for 2007/08 is summarised in Table 3. General Services is clearly a big category. It includes expenditure on research, on extension services, and a range of other expenditure categories that ‘provide services or benefits to agriculture or the rural community. But it specifically excludes ‘direct payments to producers or processors.’ The biggest item is Decoupled income support (paragraph 6 of Annex 2), which includes SPS payments. Interestingly the EU has declared SAPS as Other, presumably in accordance with paragraph 5 of Annex 2 (which is very similar to paragraph 6). The other potential ‘homes’ for the post-2013 direct payments regime would appear to be Environmental Programmes, particularly given the Commission’s wish to see a greening of payments, and Regional Assistance Programmes, both of which will be considered further below.

Paragraph 1 sets out a fundamental requirement that domestic support measures for which the green box exemption is made should have ‘no, or at most minimal, trade-distorting effects or effects on production.’ Accordingly two ‘basic criteria’ apply: first, the support should be ‘provided through a publicly-funded government programme,’ and not through ‘transfers from consumers.’ Second, that the support should ‘not have the effect of providing price support to producers’. Finally Paragraph 1 also makes clear that the ‘policy-specific criteria and conditions’ set out in the following paragraphs of Annex 2 have to be met.

Paragraph 6, dealing with ‘Decoupled income support’ is fairly typical, and highly relevant to the present discussion. It specifies that:

(a) Eligibility for such payments shall be determined by clearly-defined criteria such as income, status as a producer or landowner, factor use or production level in a defined and fixed base period.

(b) The amount of such payments in any given year shall not be related to, or based on, the type or volume of production (including livestock units) undertaken by the producer in any year after the base period.

(c) The amount of such payments in any given year shall not be related to, or based on, the prices, domestic or international, applying to any production undertaken in any year after the base period.

(d) The amount of such payments in any given year shall not be related to, or based on, the factors of production employed in any year after the base period.

(e) No production shall be required in order to receive such payments.
### Table 3: Summary of the EU’s Green Box Submission for 2007/08

<table>
<thead>
<tr>
<th>Category</th>
<th>€ million</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) General Services</td>
<td>6,780.9</td>
</tr>
<tr>
<td>(b) Public Stockholding for Food Security Purposes</td>
<td>49.9</td>
</tr>
<tr>
<td>(c) Domestic Food Aid</td>
<td>428.7</td>
</tr>
<tr>
<td>(d) Decoupled Income Support ([Single Payment Scheme, Separate Sugar Payment, decoupled Complementary National Direct Payments])</td>
<td>31,346.0</td>
</tr>
<tr>
<td>(e) Income Insurance and Income Safety-net Programmes</td>
<td>13.6</td>
</tr>
<tr>
<td>(f) Payments for Relief from Natural Disasters</td>
<td>968.1</td>
</tr>
<tr>
<td>(g) Structural Adjustment Assistance provided through Producer Retirement Programmes</td>
<td>944.0</td>
</tr>
<tr>
<td>(h) Structural Adjustment Assistance provided through Resource Retirement Programmes</td>
<td>451.6</td>
</tr>
<tr>
<td>(i) Structural Adjustment Assistance provided through Investment Aids</td>
<td>7,593.7</td>
</tr>
<tr>
<td>(j) Environmental Programmes</td>
<td>6,344.5</td>
</tr>
<tr>
<td>(k) Regional Assistance Programmes</td>
<td>4,507.5</td>
</tr>
<tr>
<td>(l) Other ([Single Area Payment])</td>
<td>3,181.7</td>
</tr>
<tr>
<td><strong>TOTAL GREEN</strong></td>
<td><strong>62,610.2</strong></td>
</tr>
</tbody>
</table>

Adapted from WTO (2011: Supporting Table DS:1)

These provisions were examined in detail by the WTO panel and the Appellate Body in the US-Upland Cotton case brought by Brazil (DS267). In particular the Appellate Body (WTO, 1995, paragraphs 341-2) upheld the panel’s view that various aspects of US farm policy—its allegedly decoupled direct payments—were not green box payments, as the US had declared, because they did not meet the requirements of paragraph 6(b). Farmers were entitled to payments because of their past production of crops (in particular, upland cotton), but were free to produce (or not produce) what they chose, except for permanent crops and fruits and vegetables. Because of this restriction on permanent crops and on fruits and vegetables, the conclusion was that payments were ‘related to the type of production undertaken by a producer after the base period, within the meaning of paragraph 6(b).’

By implication, if not green, these payments were either blue or amber box payments, but as Brazil had not alleged an infringement of the USA’s AMS Binding the matter was not pursued. In a very similar challenge based on paragraph 6(b) and US support for corn (maize), Canada (WTO, 2007) did allege that the USA’s AMS Binding had been breached, but the dispute has not been pursued.

In its original (2003) formulation, the EU’s SPS also debarred producers from claiming on land on which fruit and vegetables were grown, but this restriction was removed in the reform of the fruit and vegetables regime. But if Paragraph 6(b) could be so easily infringed, what about the other provisions of Paragraph 6? As the Appellate Body (WTO, 1995, paragraph 325) in US-Upland Cotton had noted, Paragraph 6 has a number of parts:

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17 [http://www.wto.org/english/tratop_e/dispu_e/cases_e/ds267_e.htm](http://www.wto.org/english/tratop_e/dispu_e/cases_e/ds267_e.htm), last accessed 4 February 2012.
18 DS357. [http://www.wto.org/english/tratop_e/dispu_e/cases_e/ds357_e.htm](http://www.wto.org/english/tratop_e/dispu_e/cases_e/ds357_e.htm), last accessed 4 February 2012. See also DS365, a very similar case raised by Brazil, which is also on hold.
Paragraph 6 of Annex 2 ... seeks to decouple or de-link direct payments to producers from various aspects of their production decisions and thus aims at neutrality in this regard. Subparagraph (b) decouples the payments from production; subparagraph (c) decouples payments from prices; and subparagraph (d) decouples payments from factors of production. Subparagraph (e) completes the process by making it clear that no production shall be required in order to receive such payments.

Several authors (e.g. Swinbank and Tranter, 2005; McMahon, 2007) have suggested that the SPS might still be vulnerable. In particular, an entitlement to receive payments under the SPS does not guarantee payment. The entitlement has to be activated. The SPS is claimed annually on the agricultural land at the claimant’s disposal (for the new regime this is specified in Article 73 of the financing regulation, European Commission, 2011e). If an entitlement is not activated over a two-year period it is lost (it reverts to the National Reserve). It might be found that this infringes the provisions of Subparagraph (d) that specifies: ‘The amount of such payments in any given year shall not be related to, or based on, the factors of production employed in any year after the base period.’ The requirement that land be kept in Good Agricultural and Environmental Condition (GAEC) is also problematic if it could be inferred from this that some agricultural production is required.

The provisions of Paragraphs 2 to 13 of the green box relate to programme design, whereas the fundamental requirement of Paragraph 1, that programmes should have ‘no, or at most minimal, trade-distorting effects or effects on production’ is an ex post provision relating to programme effect. How the word minimal would be interpreted if it had to be arbitrated in a dispute is difficult to say. This would probably involve what Daugbjerg and Swinbank (2009, p. 104) refer to as an ‘economic test’, with both parties to the dispute marshalling evidence for their stance, and against their opponent’s position. As well as economic models, other evidence might be drawn upon. Suggestions that the EU’s SPS was important in maintaining agricultural production could undermine its position that the SPS is a decoupled payment in full compliance with the requirements of the green box. The European Parliament’s resolution of July 2010 could be problematic for example. In paragraph 69 it maintains that ‘farm viability and quality of life for farmers are a sine qua non if farming activity is to continue.’ It then continues: it ‘believes therefore that there should be a basic EU-funded direct area payment to all EU farmers in order to ensure the social and economic sustainability of the European agricultural production model, ...’ If this means that European agriculture would produce less were it not for a ‘direct area payment,’ then the payments are patently not decoupled according to the WTO definition.

In US–Upland Cotton, Brazil had claimed that US payments had infringed this fundamental requirement (WTO, 2004b, paragraph 7.355). However, the panel concluded that, as it had already decided that paragraph 6 had not been satisfied, it was unnecessary to determine whether or not this fundamental requirement was met (paragraph 7.412). As this was not appealed, the Appellate Body (WTO, 2005, footnote 331 to paragraph 334) gave no further indication of how such a claim would be resolved.

6.3. Developments in the Doha Round

In the early years of the Doha Round a number of WTO members strove for tighter disciplines on green box measures, particular those allowed under Paragraphs 5 and 6. In preparation for the 5th Ministerial Meeting in Cancún for example, the newly-formed G20 group of developing nations, not only argued that the blue box should be eliminated from the AoA but also that ‘Green box direct payments (paragraphs 5 to 13 of Annex 2 of
the AoA) shall be, as appropriate, capped and/or reduced for developed countries. Additional disciplines shall be elaborated and agreed upon’ (WTO, 2003).

Although the proposal to cap or reduce green box direct payments for developed countries never really gained traction in the negotiations, the **Framework Agreement of August 2004** did say that: ‘Green Box criteria will be reviewed and clarified with a view to ensuring that Green Box measures have no, or at most minimal, trade-distorting effects or effects on production. Such a review and clarification will need to ensure that the basic concepts, principles and effectiveness of the Green Box remain and take due account of non-trade concerns. The improved obligations for monitoring and surveillance of all new disciplines foreshadowed in paragraph 48 below will be particularly important with respect to the Green Box’ (WTO, 2004a, paragraph 16). Accordingly, the latest (December 2008) version of the Revised Draft Modalities for Agriculture has a detailed 6-page annex outlining drafting amendments to the green box.

Paragraph 1, with its over-arching requirements, attracts no comment. Paragraph 6, on Decoupled Income Payments, has a redrafted Subparagraph (a), as reproduced in Box 2. No other drafting changes to Paragraph 6 are on the table. Furthermore it should be re-emphasised that this is not an agreed text, and even were a Doha Agreement to be agreed, which included these provisions, this is unlikely to be before Parliament and Council agree on the provisions of the post-2013 CAP.

The text would allow for the transfer of entitlements, which is not mentioned in the present provisions, and tries to tighten-up on the updating of entitlements. The latter could be problematic if a Doha Agreement along these lines precedes the EU Institutions’ agreement on the post-2013 CAP. Tangermann (2011, p. 19), however, was of the view that the ‘new provisions envisaged in the draft modalities would not get in the way of making the changes to direct payments’ then envisaged by the Commission.

**Box 2: Proposed Redraft of Paragraph 6(a) of the Green Box**

Eligibility for such payments shall be determined by clearly-defined criteria such as income, status as a producer or landowner, factor use or production level in a defined, fixed and unchanging historical base period which shall be notified to the Committee on Agriculture. Transfer of entitlements to existing decoupled income support between producers or landowners shall not be precluded. An exceptional update is not precluded, provided that producer expectations and production decisions are unaffected, in particular due to (a) ensuring that any updated base period is not only a significant number of years in the past but is also determined and promulgated by the administering authority in such a way that the updated base concerned could not have been reasonably anticipated by producers such that their production decisions could be materially altered, (b) that such updating is not made in conjunction with, or otherwise amounts de facto to, a decision to increase the uniform unitary rate per crop and (c) that this updating shall not, in itself or otherwise by reason of its introduction, have the effect, directly or indirectly, of circumventing the obligations regarding domestic support measures and price support to producers pursuant to paragraph 1. Members which have not previously made use of this type of payment and thus have not notified and which cannot establish a historical base period because of a lack of data shall not be precluded from establishing an appropriate base period which, provided that it is not based on any future factor use or production, need not be based on a pre-existing determinate historical record, but which shall be fixed and unchanging and shall be notified. This is without prejudice to the possibility for Members to establish appropriate base periods for substantially different decoupled income support in accordance with the conditions laid down in this paragraph.
Footnotes: (1) Where a Member has, at the time of entry into force of this Agreement, more than one type of direct payments within the same system of decoupled income support, it shall be possible to decide, within a period of no more than five years from the date of entry into force of this Agreement, to move from one to another type of direct payments for all or part of the territory of that Member, including the use of a changed base period. This decision shall be taken once and for all for each part of the territory of the Member concerned. Where a Member intends to exercise this possibility, it shall notify its decision to the Committee on Agriculture within 180 days of the entry into force of this Agreement.

(2) This shall mean the rate used to calculate the support per recipient on the basis of criteria such as area or yields.

(3) Developing country Members may not have the capacity to fully assess the impact of innovation in their agricultural policies. Accordingly, the base period of a time-limited experimental or pilot programme may not be taken as the fixed and unchanging base period for the purposes of this paragraph.

6.4. The Green Box, and Direct Payments in the Post-2013 CAP

Direct payments in the post-2013 CAP would still be paid annually and linked to the area of land at the applicant’s disposal, as with the existing SPS, and so the question would still arise: Is this compatible with the requirements of Subparagraph 6(d) that: ‘The amount of such payments in any given year shall not be related to, or based on, the factors of production employed in any year after the base period’? But, as pointed out by Horseman (2011), Swinbank (2012) and Tangermann (2011) two of the new provisions in the Commission’s text could be challenged as well.

On active farmers, the Commission has worked hard to come up with a formulation that does not imply that an agricultural product has to be produced, as this would appear to be quite clearly forbidden by Subparagraph 6(e), which reads: ‘No production shall be required in order to receive such payments.’ Indeed, it is inactive farmers that would best fit the strictures of the green box. As the European Commission (2011f, p. 72) itself recognises, the provisions ‘cannot imply an obligation to produce.’ Article 9 of the draft Regulation (European Commission, 2011d) is quite carefully crafted so that it excludes certain groups, rather than specifying what businesses have to do to be considered active farmers. Two criteria would be set in determining which farmers are non-active: a) either ‘the annual amount of direct payments is less than 5% of the total receipts they obtained from non-agricultural activities in the most recent fiscal year’, or ‘their agricultural areas are mainly areas naturally kept in a state suitable for grazing or cultivation and they do not carry out on those areas the minimum activity established by Member States in accordance with Article 4(1)(c)’ (emphasis added). According to Article 4(1)(c), ‘agricultural activity’ means, inter alia, ‘rearing or growing of agricultural products including harvesting, milking, breeding animals and keeping animals for farming purposes.’ Moreover, in explaining its proposals, the European Commission (2011d, p. 8) says: ‘The definition of active farmer further enhances targeting on farmers genuinely engaged in agricultural activities, and thus legitimizes support.’ It is difficult to avoid the conclusion that farmers would have to produce to be considered active, thereby infringing the green box criteria. This impression has permeated the debate about ‘active’ farmers. For example, in its resolution of July 2010, the European Parliament (2010, p. 70) called for ‘an absolute requirement that only active agricultural production be rewarded, whereby minimum activity requirements would be included in the cross-compliance rules as a precondition for payments.’
The **greening** proposals are problematic too. To qualify for the greening element (and the basic payment too, if greening is mandatory), non-organic arable farmers have to grow 3 crops, none of which can occupy more than 70% of their arable area, or less than 5%, and maintain the existing permanent grassland on their holdings (European Commission, 2011d, Article 29). Again, this seems to fly in the face of the provisions of Paragraph 6; and it is difficult to see how expenditure on the greening component could be declared under Paragraph 6 (or under ‘other’ direct payments to producers under Paragraph 5).

If the greening component can be separated from the basic payment, then the EU might declare the latter under Paragraph 6; but if the two are inextricably linked—if the basic payment can only be claimed if the greening requirements can be met—then the whole of the expenditure would appear to be precluded from Paragraph 6.

If the greening component cannot be considered a legitimate green box measure on the basis of Paragraph 6, would it fit elsewhere? Paragraph 12, ‘Payments under environmental programmes,’ might seem an obvious home, but it too is subject to exacting conditions:

1. *Eligibility for such payments shall be determined as part of a clearly-defined government environmental or conservation programme and be dependent on the fulfilment of specific conditions under the government programme, including conditions related to production methods or inputs.*

2. *The amount of payment shall be limited to the extra costs or loss of income involved in complying with the government programme.*

Whilst one can see that targeted environmental programmes under CAP’s Pillar 2 could be tailored to fit within Paragraph 12, it is much more difficult to see how flat-rate payments under Pillar 1 could. There is no evidence to suggest that the greening payment (at 30% of national envelope) is related in any way to ‘the extra costs or loss of income involved in complying with the government programme,’ or that it is related in any way to ‘a clearly-defined government environmental or conservation programme.’ The payments are annual payments, and there are no contractual obligations on the recipient from one year to the next.

The proposal to make additional payments to farmers in areas facing natural constraints could be made to fit paragraph 13 which permits ‘payments under regional assistance programmes’, in regions with ‘clearly designated contiguous geographical area with a definable economic and administrative identity, considered as disadvantaged on the basis of neutral and objective criteria clearly spelt out in law or regulation and indicating that the region’s difficulties arise out of more than temporary circumstances’. But again a series of strict criteria would apply, including the requirement that payments ‘be limited to the extra costs or loss of income involved in undertaking agricultural production in the prescribed area,’ and there seems to be no such provision in the draft regulation. The European Commission’s (2011f, Annex 3, p. 44) claim that ‘As a decoupled lump sum per hectare payment, support to areas with specific natural constraints in Pillar I would be WTO Green Box compatible’ is contestable.
6.5. Does the Green Box Status of Direct Payments Matter?

The European Commission’s (2011f, p. 32) claim that ‘Today more than 90% of direct payments are decoupled and qualify for WTO green box (with no or limited trade distorting effects)’ has some substance. The EU has made a major effort over the last decade to decouple support, as recognised by the OECD (2011), and as reflected the declarations reported in Figure 2. However, the EU’s use of the green box could be challenged. In particular it might be argued that the SPS is linked to the use of land in a period after the base period, or that it had more than a minimal impact on production. The post-2013 system of direct payments, with restrictions on payments to non-active farmers, and its greening provisions, could be even more problematic, as it might be inferred that this infringed the paragraph 6(e) requirement that no production should be required to qualify for payment.

With the current AoA this hardly matters, because the EU has plenty of scope to declare its direct payments in either the amber or blue boxes. No WTO Member is likely to incur the expense, and political opprobrium, associated with a long and uncertain challenge in the Dispute Settlement Body, just to prove a point. Thus, the absence of a challenge to-date does not imply that there will not be one in the future.

The situation could change dramatically if there was to be a Doha agreement along the lines outlined in the December 2008 Draft Modalities document (WTO, 2008). This envisages a 70% reduction on the EU’s AMS binding, tight constraints on blue box expenditure, and a new over-arching constraint on Overall Trade-Distorting Support. Some changes to the green box criteria are also contained in the Draft Modalities. These do not envisage tighter constraints on decoupled income support, as was at one time demanded by some WTO Members; but nor do the envisaged changes defuse the concerns outlined above. The EU has not negotiated a watertight agreement guaranteeing that its use of the green box to shelter its direct payments would go unchallenged. Whether it would be challenged, and whether such a challenge would succeed, are open questions.
7. CONCLUSIONS AND RECOMMENDATIONS

Key Findings

- Unfortunately, the European Commission’s plans for the post-2013 CAP are unlikely to improve the competitiveness of European agriculture; help it adapt to the challenges of climate change; prove cost-effective in sustaining a multifunctional agriculture; or contribute much to world food security.

- Rather than nominally allocating 30% of the direct payments budget to a nebulous greening component, these funds should be transferred to the Pillar 2 budget. If a transfer to Pillar 2 is not possible, then the basic payment and the greening component should be kept as two separate payments, with Member States allowed greater discretion, on a regional basis, to determine the greening criteria.

- The proposal on active farmers should be abandoned.

- There are no compelling economic reasons for capping, the small farmer scheme, additional payments for young entrants, or for coupled payments.

- There is merit in the scheme to make additional payments for areas with natural constraints, in conjunction with a reduction (or even elimination) of payments in areas that do not suffer from these constraints.

- The proposed allocation of direct payments to Member States is a political exercise, strongly influenced by past budget allocations. None of the possible justifications for maintaining a system of direct payments are invoked in the proposed redistribution.

- It is important that policy makers have a Plan B. If CAP payments are reduced in the next MFF, the Pillar 2 budget should be protected, and the Pillar 1 budget cut. Within Pillar 1 the heaviest cuts should apply in those Member States with a payment per hectare above the EU average.

- This will not be the last CAP reform. Policy makers will continue to worry about farm incomes. Overseas governments, and farmers, will continue to suspect that the direct payments regime still distorts trade. Taxpayers will continue to question whether their money is well spent.

- There needs to be a fundamental rethink about the purpose of the CAP, its policy objectives, and its policy mechanisms.

Tangermann’s (2011, p. 32) assessment of the European Commission’s 2010 Communication was that it was ‘focused on maintaining direct payments as the backbone of the CAP and fails to make the next step forward in the process of strategic CAP reform.’ He also commented that ‘in preparing the CAP for the future it would be preferable to embark now on a longer-term schedule of gradual decline in direct payments, rather than making attempts at constructing justifications for a policy that is not really consistent with its objectives.’ Little has changed to suggest that Tangermann’s assessment should be revised. However, proposals have been tabled, and it is those proposals that will largely shape the current debate.
7.1. A Missed Opportunity

Unfortunately, the European Commission’s plans for the post-2013 CAP are unlikely to improve the competitiveness of European agriculture, help it adapt to the challenges of climate change, prove cost-effective in sustaining a multifunctional agriculture, or contribute much to world food security. Moreover, in attempting the redistribution, redesign and better targeting of support, the proposals neither simplify the CAP, nor make it demonstrably fairer, and they could render it more susceptible to a WTO challenge.

Direct payments, tied to land, are ultimately a self-defeating policy tool. As farm businesses compete for scarce assets, particularly land, they drive up costs. Extra revenues are likely to be dissipated in higher costs, with the farm sector becoming extremely dependent on continued state support. The problem is particularly severe for new entrants to the industry, or those who want to expand the area of their farms, as they face enhanced entry costs. It is a pity that the European Commission has not proposed a phasing-out of direct payments.

Flat rate area payments, even with cross compliance, GAEC, and the new greening provisions, are unlikely to enhance European agriculture’s ability to adapt to (or mitigate) climate change, or improve its delivery of other multifunctional attributes in a cost effective way. All industries have Statutory Management Requirements (SMRs) with which they must comply, and many are facing new demands to reduce their greenhouse gas emissions. The extra costs incurred are the quid pro quo for doing business in a crowded and relatively prosperous continent. The CAP is quite exceptional in seeking to reimburse farmers for this. Most EU citizens value the multifunctional attributes of European agriculture, although it is less clear how much they are willing to pay. The most effective and cost-effective way of securing these attributes is through targeted, contractual, arrangements, which suggests that Pillar 2 might be a more effective home. It is a pity the European Commission has not proposed a significant shift of funds from Pillar 1 to Pillar 2. There is a trade-off, however, between detailed and highly specific schemes, with high transaction costs, and broader-brush, less-detailed approaches.

World food security is an important concern. The world’s population continues to increase; millions of poor consumers wish to improve (and westernise) their diets; many jurisdictions (including the EU) have ambitious bioenergy programmes; climate change will have an impact on our global capacity to produce; and yet water, land, and other natural resources are finite. There are no easy solutions to this complex array of inter-linked challenges. But key elements are likely to include the continued need to invest in research and development and embrace new technologies, and to help the world’s poor to improve their incomes, and hence their diet. In many developing countries, agriculture could be an engine for growth. It is not European farmers that need support.

7.2. Room for Improvement

There are a number of ways in which the European Commission’s proposal could be improved.

Rather than nominally allocating 30% of the direct payments budget to a nebulous greening component, these funds should be transferred to the Pillar 2 budget where Member States can better ensure a targeted, and contractual, approach to
delivering the environmental goods that European taxpayers want, and help the farm sector adapt to, and adopt mitigation strategies to offset, climate change. This would also help ensure the international acceptability of CAP expenditure in the WTO. The transfer could be phased: say, 10% per year.

If a transfer of these funds to Pillar 2 is not possible, then the basic payment and the greening component should be kept as two separate payments, with Member States allowed greater discretion, on a regional basis, to determine the greening criteria. This would allow more objective criteria on a regional basis to be set, and help ensure the WTO acceptability of the basic payment. It might allow the greening component to be classified as a green box payment under an environmental programme.

The proposal on active farmers should be abandoned. There is no economic justification for this proposal. There is no reason to believe that ownership or management structures are relevant in delivering environmental services. It will seriously prejudice the EU’s attempts to declare all its direct payments in the green box. It simply adds to the complexity of the CAP. Furthermore, the European Commission (2011f, Annex 3, p. 69) has itself pointed out that, in the Health Check, Member States were given the option of setting ‘additional criteria for the exclusion of persons/companies from the aid whose agricultural activity is only an insignificant part of their overall activity and/or whose main business objects do not consist of exercising an agricultural activity.’ The fact that no Member State has done so suggests either that there is no political appetite for it, or that it is simply too difficult to do.

There are no compelling economic reasons for capping, the small farmer scheme, additional payments for young entrants, or for coupled payments. They all add to the bureaucracy of the CAP, and have the potential to hinder the structural changes that the industry needs if it is to become more internationally competitive.

There is merit in the scheme to make additional payments for areas with natural constraints, in conjunction with a reduction (or even elimination) of payments in areas that do not suffer from these constraints. However, policies need to be carefully crafted to ensure that they comply with the WTO requirements for payments under regional assistance programmes.

The proposed allocation of direct payments to Member States (their National Envelopes) is a political exercise, strongly influenced by past budget allocations. The only criterion cited to moderate the change from the present to the post-2013 regime is that of payments per hectare of PEA. None of the possible justifications for maintaining a system of direct payments are invoked in the proposed redistribution.

It is important that policy makers have a Plan B, even if this is not divulged during the negotiations. If the budget allocation for the CAP in the 2014-2020 MFF were to be reduced, what part of the European Commission’s proposal for the post-2013 CAP would be affected? Would there be a proportionate reduction across the board, or would Pillar 1 be protected at the expense of Pillar 2, or vice versa? If Pillar 1 is cut, how would this be distributed between the Member States? If CAP payments are reduced in the next MFF, the Pillar 2 budget should be protected, and the Pillar 1 budget cut. Within Pillar 1 the heaviest cuts should apply in those Member States with a payment per hectare above the EU average.
7.3. Preparing for the Next ‘Reform’

This will not be the last CAP reform. If the European Commission’s proposals are accepted, policy makers will continue to worry about the farm income problem. Overseas governments, and farmers, will still suspect that the direct payments regime continues to distort trade; and a WTO challenge to the EU’s use of the green box might be launched. Taxpayers will continue to question whether their money is well spent, particularly if European economies fail to recover from the current crisis. Very soon there will be a clamour for a new reform.

The European Commission believes that there is a farm income ‘problem’, with farm incomes lagging behind those in the rest of the economy. But it has failed to explain why, after 50 years of the CAP providing farm income support, there is still a farm income problem for the generality of the EU’s commercial farmers.

This suggests that there needs to be a fundamental rethink about the purpose of the CAP, its policy objectives, and its policy mechanisms; and that there needs to be a clearer explanation of how expenditure on the CAP contributes to smart, sustainable and inclusive growth.

For example, one of the CAP’s objectives, according to the Treaty, is ‘to ensure a fair standard of living for the agricultural community, in particular by increasing the individual earnings of persons engaged in agriculture’ (Article 39(1)(b) of the Treaty on the Functioning of the European Union). Who are these members of the agricultural community, what is a fair standard of living, and how do we measure and monitor the individual earnings of persons engaged in agriculture?
REFERENCES


New Direct Payments Scheme: Targeting and Redistribution in the Future CAP

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ANNEX: Annex 2 of the AoA (the green box)

Source: WTO Legal Texts, at http://www.wto.org/english/docs_e/legal_e/legal_e.htm

DOMESTIC SUPPORT: THE BASIS FOR EXEMPTION FROM THE REDUCTION COMMITMENTS

1. Domestic support measures for which exemption from the reduction commitments is claimed shall meet the fundamental requirement that they have no, or at most minimal, trade-distorting effects or effects on production. Accordingly, all measures for which exemption is claimed shall conform to the following basic criteria:

(a) the support in question shall be provided through a publicly-funded government programme (including government revenue foregone) not involving transfers from consumers; and,

(b) the support in question shall not have the effect of providing price support to producers;

plus policy-specific criteria and conditions as set out below.

Government Service Programmes

2. General services

Policies in this category involve expenditures (or revenue foregone) in relation to programmes which provide services or benefits to agriculture or the rural community. They shall not involve direct payments to producers or processors. Such programmes, which include but are not restricted to the following list, shall meet the general criteria in paragraph 1 above and policy-specific conditions where set out below:

(a) research, including general research, research in connection with environmental programmes, and research programmes relating to particular products;

(b) pest and disease control, including general and product-specific pest and disease control measures, such as early-warning systems, quarantine and eradication;

(c) training services, including both general and specialist training facilities;

(d) extension and advisory services, including the provision of means to facilitate the transfer of information and the results of research to producers and consumers;

(e) inspection services, including general inspection services and the inspection of particular products for health, safety, grading or standardization purposes;

(f) marketing and promotion services, including market information, advice and promotion relating to particular products but excluding expenditure for unspecified purposes that could be used by sellers to reduce their selling price or confer a direct economic benefit to purchasers; and

(g) infrastructural services, including: electricity reticulation, roads and other means of transport, market and port facilities, water supply facilities, dams and drainage schemes, and infrastructural works associated with environmental programmes. In all cases the expenditure shall be directed to the provision or construction of capital works only, and shall exclude the subsidized provision of on-farm facilities other than for the reticulation of generally available public utilities. It shall not include subsidies to inputs or operating costs, or preferential user charges.
3. Public stockholding for food security purposes (*Footnote 5*)

Expenditures (or revenue foregone) in relation to the accumulation and holding of stocks of products which form an integral part of a food security programme identified in national legislation. This may include government aid to private storage of products as part of such a programme. The volume and accumulation of such stocks shall correspond to predetermined targets related solely to food security. The process of stock accumulation and disposal shall be financially transparent. Food purchases by the government shall be made at current market prices and sales from food security stocks shall be made at no less than the current domestic market price for the product and quality in question.

4. Domestic food aid (*Footnote 6*)

Expenditures (or revenue foregone) in relation to the provision of domestic food aid to sections of the population in need. Eligibility to receive the food aid shall be subject to clearly-defined criteria related to nutritional objectives. Such aid shall be in the form of direct provision of food to those concerned or the provision of means to allow eligible recipients to buy food either at market or at subsidized prices. Food purchases by the government shall be made at current market prices and the financing and administration of the aid shall be transparent.

5. Direct payments to producers

Support provided through direct payments (or revenue foregone, including payments in kind) to producers for which exemption from reduction commitments is claimed shall meet the basic criteria set out in paragraph 1 above, plus specific criteria applying to individual types of direct payment as set out in paragraphs 6 through 13 below. Where exemption from reduction is claimed for any existing or new type of direct payment other than those specified in paragraphs 6 through 13, it shall conform to criteria (b) through (e) in paragraph 6, in addition to the general criteria set out in paragraph 1.

6. Decoupled income support

(a) Eligibility for such payments shall be determined by clearly-defined criteria such as income, status as a producer or landowner, factor use or production level in a defined and fixed base period.

(b) The amount of such payments in any given year shall not be related to, or based on, the type or volume of production (including livestock units) undertaken by the producer in any year after the base period.

(c) The amount of such payments in any given year shall not be related to, or based on, the prices, domestic or international, applying to any production undertaken in any year after the base period.

(d) The amount of such payments in any given year shall not be related to, or based on, the factors of production employed in any year after the base period.

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*Footnote 5* For the purposes of paragraph 3 of this Annex, governmental stockholding programmes for food security purposes in developing countries whose operation is transparent and conducted in accordance with officially published objective criteria or guidelines shall be considered to be in conformity with the provisions of this paragraph, including programmes under which stocks of foodstuffs for food security purposes are acquired and released at administered prices, provided that the difference between the acquisition price and the external reference price is accounted for in the AMS.

*Footnotes 5&6* For the purposes of paragraphs 3 and 4 of this Annex, the provision of foodstuffs at subsidized prices with the objective of meeting food requirements of urban and rural poor in developing countries on a regular basis at reasonable prices shall be considered to be in conformity with the provisions of this paragraph.
(e) No production shall be required in order to receive such payments.

7. Government financial participation in income insurance and income safety-net programmes
(a) Eligibility for such payments shall be determined by an income loss, taking into account only income derived from agriculture, which exceeds 30 per cent of average gross income or the equivalent in net income terms (excluding any payments from the same or similar schemes) in the preceding three-year period or a three-year average based on the preceding five-year period, excluding the highest and the lowest entry. Any producer meeting this condition shall be eligible to receive the payments.
(b) The amount of such payments shall compensate for less than 70 per cent of the producer's income loss in the year the producer becomes eligible to receive this assistance.
(c) The amount of any such payments shall relate solely to income; it shall not relate to the type or volume of production (including livestock units) undertaken by the producer; or to the prices, domestic or international, applying to such production; or to the factors of production employed.
(d) Where a producer receives in the same year payments under this paragraph and under paragraph 8 (relief from natural disasters), the total of such payments shall be less than 100 per cent of the producer's total loss.

8. Payments (made either directly or by way of government financial participation in crop insurance schemes) for relief from natural disasters
(a) Eligibility for such payments shall arise only following a formal recognition by government authorities that a natural or like disaster (including disease outbreaks, pest infestations, nuclear accidents, and war on the territory of the Member concerned) has occurred or is occurring; and shall be determined by a production loss which exceeds 30 per cent of the average of production in the preceding three-year period or a three-year average based on the preceding five-year period, excluding the highest and the lowest entry.
(b) Payments made following a disaster shall be applied only in respect of losses of income, livestock (including payments in connection with the veterinary treatment of animals), land or other production factors due to the natural disaster in question.
(c) Payments shall compensate for not more than the total cost of replacing such losses and shall not require or specify the type or quantity of future production.
(d) Payments made during a disaster shall not exceed the level required to prevent or alleviate further loss as defined in criterion (b) above.
(e) Where a producer receives in the same year payments under this paragraph and under paragraph 7 (income insurance and income safety-net programmes), the total of such payments shall be less than 100 per cent of the producer's total loss.

9. Structural adjustment assistance provided through producer retirement programmes
(a) Eligibility for such payments shall be determined by reference to clearly defined criteria in programmes designed to facilitate the retirement of persons engaged in marketable agricultural production, or their movement to non-agricultural activities.
(b) Payments shall be conditional upon the total and permanent retirement of the recipients from marketable agricultural production.
10. Structural adjustment assistance provided through resource retirement programmes
(a) Eligibility for such payments shall be determined by reference to clearly defined criteria in programmes designed to remove land or other resources, including livestock, from marketable agricultural production.
(b) Payments shall be conditional upon the retirement of land from marketable agricultural production for a minimum of three years, and in the case of livestock on its slaughter or definitive permanent disposal.
(c) Payments shall not require or specify any alternative use for such land or other resources which involves the production of marketable agricultural products.
(d) Payments shall not be related to either the type or quantity of production or to the prices, domestic or international, applying to production undertaken using the land or other resources remaining in production.

11. Structural adjustment assistance provided through investment aids
(a) Eligibility for such payments shall be determined by reference to clearly-defined criteria in government programmes designed to assist the financial or physical restructuring of a producer’s operations in response to objectively demonstrated structural disadvantages. Eligibility for such programmes may also be based on a clearly-defined government programme for the reprivatization of agricultural land.
(b) The amount of such payments in any given year shall not be related to, or based on, the type or volume of production (including livestock units) undertaken by the producer in any year after the base period other than as provided for under criterion (e) below.
(c) The amount of such payments in any given year shall not be related to, or based on, the prices, domestic or international, applying to any production undertaken in any year after the base period.
(d) The payments shall be given only for the period of time necessary for the realization of the investment in respect of which they are provided.
(e) The payments shall not mandate or in any way designate the agricultural products to be produced by the recipients except to require them not to produce a particular product.
(f) The payments shall be limited to the amount required to compensate for the structural disadvantage.

12. Payments under environmental programmes
(a) Eligibility for such payments shall be determined as part of a clearly-defined government environmental or conservation programme and be dependent on the fulfilment of specific conditions under the government programme, including conditions related to production methods or inputs.
(b) The amount of payment shall be limited to the extra costs or loss of income involved in complying with the government programme.

13. Payments under regional assistance programmes
(a) Eligibility for such payments shall be limited to producers in disadvantaged regions. Each such region must be a clearly designated contiguous geographical area with a definable economic and administrative identity, considered as disadvantaged on the basis of neutral and objective criteria clearly spelt out in law or regulation and indicating that the region’s difficulties arise out of more than temporary circumstances.
(b) The amount of such payments in any given year shall not be related to, or based on, the type or volume of production (including livestock units) undertaken by the producer in any year after the base period other than to reduce that production.
(c) The amount of such payments in any given year shall not be related to, or based on, the prices, domestic or international, applying to any production undertaken in any year after the base period.
(d) Payments shall be available only to producers in eligible regions, but generally available to all producers within such regions.
(e) Where related to production factors, payments shall be made at a degressive rate above a threshold level of the factor concerned.
(f) The payments shall be limited to the extra costs or loss of income involved in undertaking agricultural production in the prescribed area.
Role

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