Briefing Papers

EUROPEAN PARLIAMENT

DIRECTORATE GENERAL INTERNAL POLICIES OF THE UNION

Policy Department on Budgetary Affairs

COMMITTEE ON BUDGETS

COMMITTEE ON AGRICULTURE AND RURAL DEVELOPMENT

JOINT WORKSHOP

"The financing and effectiveness of agricultural expenditure"

Wednesday 2nd April 2008

9.00 a.m. - 11.30 a.m.

ASP IG 3 - Brussels

2 April 2008

EN

INDEX

PARLAMENTO EUROPEO EVROPSKÝ PARLAMENT EUROPA-PARLAMENTET
EUROPÄISCHES PARLAMENT EUROOPA PARLAMENT ΕΥΡΩΠΑΪΚΟ ΚΟΙΝΟΒΟΥΛΙΟ EUROPEAN PARLIAMENT
PARLEMENT EUROPÉEN PARLAMENTO EUROPEO EIROPAS PARLAMENTS
EUROPOS PARLAMENTAS EURÓPAI PARLAMENT IL-PARLAMENT EWROPEW EUROPEES PARLEMENT
PARLAMENT EUROPEJSKI PARLAMENTO EUROPEU EURÓPSKY PARLAMENT
EVROPSKI PARLAMENT EUROOPAN PARLAMENTTI EUROPAPARLAMENTET

COMMITTEE ON BUDGETS

COMMITTEE ON AGRICULTURE AND RURAL DEVELOPMENT

Joint Workshop on

"The financing and effectiveness of agricultural expenditure"

Wednesday 2nd April 2008 - 9.00 a.m. - 11.30 a.m.

Room ASP 1G3

9.00 a.m.	Introduction Mr. R. Böge, Chairman, Committee on Budgets Mr. N. Parish, Chairman (t.b.c.), Committee on Agriculture and Rural Development
9.10 - 9.25	Professor José Ma García Alvarez Coque *(documents to be distributed separately)*
9.25 - 9.40	Mr. Vincent Chatellier *(documents to be distributed separately)*
9.40 - 9.55	Mrs. Margherita Scoppola
9.55 - 10.10	Dr. David Baldock
10.10 - 11.20	Discussion following the presentations
11.20 - 11.30	Final comments

European Parliament - Committee on Budgets and Committee on Agriculture
Joint Workshop on
"**The financing and effectiveness of agricultural expenditure**"
Brussels, 2 April 2008

Briefing paper by

Margherita Scoppola

(University of Macerata, Italy)

The Common Agricultural Policy (CAP) has been substantially reformed in the past two decades; market support measures have been almost eliminated - although for some products old CAP instruments (e.g. production quotas) and a considerable degree of border protection are still in place - and replaced by decoupled payments which are less trade distorting, more transparent and more efficient in transferring resources to farmers. After 2003 and subsequent reforms, most of the EU support to agriculture is ensured by the Single Farm Payment (SFP), although a growing role is given to rural development policies. All farm aids previously granted under the various Common Market Organizations (CMOs) have been included in the SFP and CMOs almost eliminated. The SFP expenditure in 2012 will be 43,309 million Euro, accounting for about the 93.4% of Pillar 1 expenditure and about the 71.4% of total expenditure under the budget heading “Natural resources”; the remaining 28.6% is devoted to rural development, fisheries and environment, and quality of life. Therefore, to date the effectiveness of EU agricultural expenditure largely depends on the effectiveness of the SFP.

Although the dismantling of the old market support and decoupling are not under discussion, nevertheless the new CAP has been facing in recent years a growing criticism. This paper is aimed at addressing what are the basic criticisms to the current CAP, and specifically to the SFP, in terms of its effectiveness and how it is financed, and the possible scenarios for agricultural policies instruments and their financing after 2013.

Main problems with the current CAP

The 2003 Fischler reform has substantially changed the EU agricultural policy with a number of widely recognized positive effects: by decoupling a significant share of farm support from “how much” and “what” farms produce, previous price distortions have been considerably reduced and the role of market price in orienting farmer choices has been restored, with overall gains in economic efficiency. Decoupling also improves international relations and helps the EU to develop a credible negotiating position within the current WTO Doha Development Round; the CAP is now consistent with even significant reductions in the “amber box” and “blue box” support and with the elimination of export subsidies. Finally, by compulsory conditioning the SFP to the compliance to environmental and other social objectives, the new CAP is less conflicting with environmental objectives than the old one, which provided incentives to use intensive production methods, heavy water usage and depletion of permanent pastures.

Despite these unquestionable positive features, the new CAP is currently criticised mainly from two points of view. On one hand, it is argued that the current CAP is lacking in effectiveness in achieving the declared objectives of the EU policy for agriculture and rural areas; on the other hand, it is often argued that the money spent for the CAP could be allocated to other EU policies with greater social benefits.

The effectiveness of the current CAP

The main criticism is that the instruments of the new CAP are not effective in achieving the new objectives of agricultural and rural development policies of the EU stated in *Agenda 2000* and mentioned afterwards in many official documents. Three major objectives are often envisaged as the key justifications for the CAP today. There are several reasons to claim that Pillar 1 expenditure does not effectively contribute to these goals.

Public goods and externalities. It is claimed that the SFP is a payment to farmers justified by the fact that they produce positive externalities and public goods; cross-compliance links the support to the observance of specific conditions regarding environment, animal welfare, animal and plant health and good husbandry. However, there are two ambiguous aspects of this mechanism which undermine its effectiveness. The amount of the payment in not linked to variables related to the production of externalities; this means that farms producing a higher amount of positive externalities or public goods (e.g. extensive farming in areas, like mountains, where this makes a significant contribution to landscape and biodiversity) do not benefit from higher payments. Often the opposite is true; farms benefiting from higher payments are those located in areas where it is more likely that agriculture produces negative externalities (e.g. water pollution in flat areas with very intensive farming). The second point is that conditioning is very weak, as farmers are required to comply only with EU legislation in force (the Statutory Management Requirements, SMR) and to keep land in Good Agricultural Environmental Condition (GAEC). Low standards are in general likely to produce low effects, although it is has been recently argued that cross compliance is in fact having some positive environmental effects (Cooper *et al*, 2007). A basic critic is that with this mechanism farmers are paid, essentially, to avoid the production of negative externalities (i.e. not to pollute the water) instead of being encouraged in producing positive externalities; this is contrary to the polluter pays principle and implicitly supports the unacceptable principle that farmers have the right to pollute and that the society must compensate them if they are not to pollute (Bureau and Witzke, 2007). The November 2007 proposals by the Commission (EC Commission, 2007) include a revision of the list of SMR and the removal of provisions which increase the administrative burden of the implementation of the policy without improving its effectiveness. Thus these proposals seem oriented toward a simplification of the mechanism, as advocated by farmer organizations, rather than toward a reinforcement of the standards to comply with, or an improvement of the controls over compliance.

Income support. It is also claimed that the SFP is aimed at supporting income of EU farmers, even though in several EU-15 areas farmer average income is not lower than that of other rural areas households. Income support to farmers today is justified because agricultural incomes, differently from other sectors, are subject to high production and market risks; the expected reduction in border protection and the dismantling of public intervention and exports refunds will increase the exposure of European farmers to market risks. Further, it is also claimed that, especially after the 2004 and 2007 enlargements, in the less developed areas of the EU, agriculture is still an important source of employment and income; thus, supporting agriculture means supporting low income areas and households and reducing income disparities within the EU. However, there is poor evidence that the current distribution of support among regions is consistent with income needs; often support is concentrated in areas with higher incomes, while it is lower where incomes are lower (Shucksmith *et al.*, 2005). There is also poor evidence that current support reaches farmers with lower incomes; data made available from the European Commission (EC, 2006) suggest that around 15% of the SFP expenditure is captured by 0.44% of the farms, which receive more than 100,000 Euros per year and are located mostly in EU-15; these are likely to be large size farms and it is questionable that they represent the target of an income policy. On the other hand, around 13% of SFP expenditure is captured by 77% of the farms, which receive less than 5,000 euros each; more than 56 % of the beneficiaries of the SFP receive less than 1,250 euros per year. It is questionable whether a payment of this magnitude could have any appreciable effect in supporting income, especially in the EU 15. Finally, the SFP is often capitalised in land price and this means that in areas where more often farmers do not own the land the SFP mainly supports social groups different from the farmers (Matthews, 2007). In the New Member Countries (NMCs) the dissipation of policy rents to landowners is larger due to the farm credit constraints; hence the final benefit from these payments for farmers is often small (Ciaian and Swinnen, 2007). Overall, the current unsound distribution of the SFP among farms and areas severely limits the effectiveness of its contribution to income support objectives. The Commission proposals to extend compulsory regionalisation to all member countries and to introduce capping (through the mechanism of the so called "progressive modulation") certainly affect the current distribution of support and could in some cases contribute to lower the degree of concentration of payments; however, income support, as the payments, remain not targeted and this undermines the effectiveness of the SFP expenditure in achieving income support objectives.

Competitiveness and quality. The SFP does not actively contribute to increase the competitiveness of European farms; it is unquestionable that under the new CAP farmer decisions are driven by the market and not, as was often the case in the past, by the policy. However, there are no reasons to believe that the SFP should or could improve European agriculture competitiveness; on the contrary, in some cases it may produce the opposite result. For example, it has been argued that the payments granted to the large number of semi-subsistence farms still present in NMCs, rather than stimulating competitiveness, are preventing from restructuring (to a less extent this has been true in EU-15 Southern countries as well); EU financial resources, instead of being used for modernization of agriculture, are used to increase consumption in peasant farms (Wilkin, 2003 and 2007). As for quality, there is one provision linking the payment to quality, that is, art 69 of Reg.1782/2003; this article states that member countries can use 10% of the national SFP resources to grant supplementary (coupled) payment to farmers to improve quality. The implementation of this voluntary measure however has been rather unsatisfactory, as member countries have set very low quality standards.

The core problem is that while the EU has redefined the general objectives of its agricultural policy, it is less clear and rather ambiguous what are the key goals pursued with the current instruments of the CAP. The SFP has not been designed with the goal to effectively achieve the declared objectives. Rather, it has been introduced in 2003 with the objective to decouple the EU support and, by doing so, to reduce market distortions and make it compatible with the "green box" definition; the choice to decouple support while maintaining its historical distribution among farms and areas is the cause of its current ineffectiveness in reaching the mentioned goals. Further, it is also questionable whether it is appropriate to use a single instrument to pursue different objectives; the "targeting principle" suggests that this would result in inefficiencies and that the effectiveness of the EU expenditure diminishes.

The financing of the CAP and the budget debate

In 2012, 31.5% of the whole EU budget will be devoted to Pillar 1 of the CAP (29.5% to the SFP); almost 83% of SFP expenditure will be captured by EU 15 countries while 17% will be allocated to NMCs. If one considers also Pillar 2, the share allocated to agriculture is more than the 35% of total EU expenditure. It is often questioned that more than one third of the EU budget is devoted to a sector accounting for less than the 5% of the EU GDP and that this unsound allocation of the EU expenditure undermines the ability of the EU to pursue the key objectives of the Lisbon Agenda (Sapir, 2003). In the face of this criticism, it should be reminded that agricultural policy remains one of the few EU funded policies; differently from other sectors, public intervention in agriculture to date is funded almost entirely by the EU. A further criticism is that as the size of the value added in EU agriculture (the difference between revenue and intermediate inputs) is smaller than total support, the net social benefit of the CAP, i.e. its “added value”, is negative (Sapir, 2003; Wichern, 2004). However, social benefits should take into account also production of public goods (including food security at the aggregate level) and positive externalities (if any) produced by agriculture.

The budget debate is, by and large, influenced by political concerns about the net contributions of member States to the EU budget. Countries with negative net contributions from the CAP ask for maintaining a consistent share of the EU expenditure for agricultural policies, while those with positive net contributions call for a substantial reduction. As for the SFP, major net contributors are Germany, United Kingdom, Italy and the Netherlands, while the main beneficiaries are Poland, France, Greece and Spain. Also Pillar 2 expenditure has a redistributive effect, with Germany, United Kingdom, France and the Netherlands as major net contributors and Poland, Hungary, Portugal and Greece as major beneficiaries. Hence, a reduction in the financial resources absorbed by Pillar 1 to increase those in Pillar 2 affects these net positions. However, the reduction in Pillar 1 expenditure through an increase in the rate of compulsory modulation, as proposed by the Commission, that is by keeping in each member country the financial resources resulting from the modulation, would not produce any redistribution of the EU budget. Such a shift of resources from Pillar 1 to Pillar 2 , in fact, maintains the “historical” allocation (i.e. based on the CAP benefits of the past) of agricultural expenditure in the member countries; the rationale for this “freeze” in the financial expenditure by country is today difficult to justify.

Besides legitimate concerns about net contributions, the issue of the financing of the CAP should be addressed on the basis of a careful consideration of what is an efficient and rational allocation between member States and EU of competences and financing (Grethe, 2006). Financial neutrality at the country level should not be the binding constraint of reforms. Reforms should be driven by the aim of improving the effectiveness and consistency of agricultural policies. As already mentioned, the current allocation of agricultural expenditure between member countries does not have a particular justification; it is the result of the “path-dependency” of the CAP, that is, the distribution of support among countries we have inherited from the old CAP.

Beyond 2013

The current CAP represents a step in the reform process of the CAP which started in the early nineties, and cannot be considered as the arrival point of this process. The European Commission is proposing reasonable adjustments to the current CAP before 2013 which, by removing the link between the payment received by the farmer and its “historical rights”, could pave the way to a more radical change; further, the shift of additional resources from the first to the second Pillar could contribute to a rebalancing in the future of the two principal sets of policies for agriculture. The changes proposed by the Commission in November 2007, however, do not remove the basic problems of the current CAP, in terms of its budgetary sustainability and effectiveness. The two issues are strictly related: different objectives and instruments of the CAP are consistent with different allocation of competences and financing. For example, it is true that if the goal of the CAP is farmer incomes support, then there are good arguments in favour of a re-nationalization of the policy, given that the national level is more suited to deal with social policies (Sapir, 2003). However, there are many reasons to support the view that after 2013 there is the need for an agricultural policy in the EU, whose objectives go well beyond farmer incomes support.

The two major priorities for European agriculture should be competitiveness and preservation of environment and the production of other socially relevant public goods in rural areas, consistently with the overall Lisbon objectives and with the sustainable development strategy of the EU.

Competitiveness should be the main goal of a profoundly reformed Pillar 1 of the CAP. Despite the favourable current conditions and prospects for international markets, European agriculture is pressed from an increased competition: trade liberalization, as a consequence of both multilateral and preferential trade agreements, is putting pressure on many farming system (e.g. the sugar industry in some EU countries; the fruit and vegetables industry in areas where small farms prevail) which need to restructure, to reduce costs, to increase quality (responding to specific consumer demands), and in some cases to shift to other products. New competitive exporters are entering the world market and displacing traditional EU exporters (e.g. in the wine industry the traditional EU exporters are losing market shares, even though world demand is growing significantly). In addition, EU productivity in agriculture is growing at a lower rate than for its main competitors and this result in a loss of relative competitiveness (Bureau and Witzke, 2007). Finally, major challenges for Europe and its agriculture are, on one hand, the implications in the years to come of climate change and, on the other, the opportunities and challenges for EU agriculture as a result of the increased demand for bio-fuels. These are medium term issues which, nevertheless, need policy action today to be dealt with.

As already mentioned, the current SFP does not appear to be an adequate instrument to tackle these issues. A growing share of the financial resources currently allocated to the SFP could be devoted to finance various pro-competitiveness policies such as: innovation oriented policy supporting extension, training ad education, stimulating the adoption of innovation by European farms, with possible positive side-effects in terms of the adoption of environmentally friendly production processes and of the growth of production of renewable energy; policies oriented to improve farm structures and, where needed, increase farm sizes in order to exploit economies of scale, which increasingly affect farms' profitability. In addition, one of the objectives of Pillar 1 should be to mitigate production and market risks, which are expected to increase in the future as a result of CAP reforms; old market management instruments (e.g. the intervention system and export refunds) are to be eliminated, but price volatility will increase and extreme climatic events are expected to occur more often. New instruments for market risk management are often asked for, such as safety nets to be activated under exceptional circumstances.

Most of these pro-competitiveness policies are to be designed at the EU level to avoid distortions of competition.

The second priority, environmental protection and the production of other public goods in rural areas which are particularly valuable for the society at large, should be pursued within the second Pillar of the CAP, which should be more actively promoting than in the past local development in rural areas. Agro-environmental and other targeted payments to farmers producing positive externalities and public goods should be reinforced and their implementation improved; the amount of the payment should be cost-based (i.e. based on the cost of producing the positive externalities) (Nuñez Ferrer, Kaditi, 2007) or based on the amount of benefits produced by the farmer; this will make payments even more efficient from an economic point of view. Energy crop payments could also be taken into consideration in Pillar 2, even though to date their effectiveness is rather controversial (Bureau, Witzke, 2007); concerns about the negative environmental impact of these subsidies (because of the increase in the use of pesticides and fertilisers they will likely induce) and the marginal contribute they give to reduce the degree of dependence of the EU from imported fossil oil, suggests a cautionary approach to this issue. Second generation of bio-fuels based on ethanol is more promising. These payments, as long as there are no transboundary effects, are better implemented at the national or local area, while policies with transboundary effects should be designed and managed at the EU level (Grethe, 2006).

Farmer incomes support objective should be pursued by means of targeted national (social, not agricultural) policies, while issues related to farmers income disparities among EU territories should be tackled within the EU regional policy.

As for financing, various scenarios have been depicted to date.

One is co-financing of Pillar 1 measures; this has one major advantage: it would increase EU financial resources available for other policies without increasing the overall EU budget. However, it is not obvious what the impact on member countries financial positions is. For example, if resources saved from the first Pillar are used to increase the budget of regional policies, then the traditional net contributors to the EU agriculture expenditure would not improve and could even be made worse off. Further, some of the NMCs find difficult making available national resources to co-finance Pillar 1 expenditure, and this may result in an overall decrease in Pillar 1 expenditure in these countries. NMCs could reasonably complain that while the EU 15 Member countries have benefited for decades from high EU financed support to agriculture now this would be eliminated for the NMCs where agriculture has still an important role in the economy. Different rates of co-financing could be introduced to mitigate the extent of the problem.

Another option is to shift most of resources from Pillar 1 to Pillar 2 through modulation, but without constraining these resources to remain in the same member country - a scenario consistent with the gradual dismantling of the SFP and the reinforcement of agro-environmental and rural development policies – while maintaining 100% of EU financing for the downsized Pillar 1; this could also result in an overall reduction of EU agriculture expenditure, even though this would not improve net contributor positions. Among EU-15, France would clearly be worse off, but also Germany, the Netherlands and United Kingdom would lose, as their share of Pillar 1 expenditure is higher than that of Pillar 2. Other EU-15 countries, like Portugal and Austria, would probably gain, as their shares of Pillar 1 expenditure is much lower than that of rural development policies. NMCs as a whole would gain significantly (their share on Pillar 1 is 17 %, while they capture more than 35% of Pillar 2 expenditure), even though to access these additional EU resources they have to make available additional financial resources from national budgets.

These represent some of the challenges and needed changes for the current CAP related with budgetary and effectiveness issues. Several proposals are under discussion throughout Europe. Whatever the result of the on going debate over the future of the CAP will be, the most important thing is that this should lead to a clarification, first, of the aims and instruments of the CAP and, then, of competences and financing. This process could result in significant changes not only in the policy instruments, but also in the financial position of member countries, a side-effect of a necessary reform which could be properly mitigated. In fact, this is a necessary condition to improve the effectiveness of the EU expenditure in agriculture and rural development policies and to make European agriculture capable to face the increasing challenges in the years to come.

References

Bureau, J-C., Witzke, H., (2007) Reflection on the possibilities for the future development of the CAP, Study Draft Report, Directorate General for Internal Policies of the Union, Policy Department B : Structural and Cohesion Policies, European Parliament, December;

Ciaian, P. and Swinnen J.F.M. (2007) "Credit Market Imperfections and the Distribution of Policy Rents: The Common Agricultural Policy in the New EU Member States", Discussion Paper 183/2007, LICOS Centre for Institutions and Economic Performance, Katholieke Universiteit Leuven, http://www.econ.kuleuven.be/licos/DP/DP2007/DP183.pdf;

Cooper, T., Baldock D., and Farmer M., (2007) Towards the Health Check and the European budget Review, the proposals, options for reform and issues arising, IEEP, September, downloadable from http://www.ieep.eu/publications/pdfs/2007/health_check_12_10_07.pdf

EC Commission (2006), Report on the distribution of direct aids to the producers. Financial year 2005, http://ec.europa.eu/agriculture/funding/index_en.htm;

EC Commission (2007), Communication from the Commission to the European Parliament and the Council. Preparing for the "Health Check" of the CAP reform, Brussels, 20 November COM(2007) 722 final;

Grethe, H., (2006) Environmental and Agricultural Policy: What Roles for the EU and the Member States? Conference on "Subsidiarity and Economic Reform in Europe", Brussels, November 9;

Matthews A. (2007), More on who benefits from farm subsidies, downloadable from http://caphealthcheck.eu/2007/10/14/more-on-who-benefits-from-farm-subsidies/.

Nuñez Ferrer, J., Kaditi E. (2007) The EU added value of agricultural expenditure. From market to multifunctionality. Gathering the criticism and the success stories of the CAP, Directorate General for Internal Policies of the Union, Policy Department on Budgetary Affairs, European Parliament, Brussels, December;

Sapir, A. (chair) (2003) An Agenda for Growing Europe, making the EU Economic system Deliver, Report of an independent High level Study group established on the initiative of the President of the European Commission, July.

Shucksmith M., Thomson K., Roberts D. (eds.) (2005), CAP and the Regions: Territorial Impact of Common Agricultural Policy, Wallingford: CAB International;

Wichern (2004) The Economics of the Common Agricultural Policy, *European Economy,* Economic papers;

Wilkin, J., (2003) The future of EU agricultural and rural policy from the perspective of CEE candidate countries, in *Policy Vision for Sustainable Rural Economies in an Enlarged Union,* ARL, Hannover;

Wilkin, J. (2007), Agriculture in new Member States – expectations and lessons learned, paper presented at the joint IAAE - 104th EAAE Seminar "Agricultural Economics and Transition: What was expected, what we observed, the lessons learned", Budapest, Hungary, September 6-8.

The financing and effectiveness of agricultural expenditure

Briefing paper by

Margherita Scoppola

(University of Macerata, Italy)

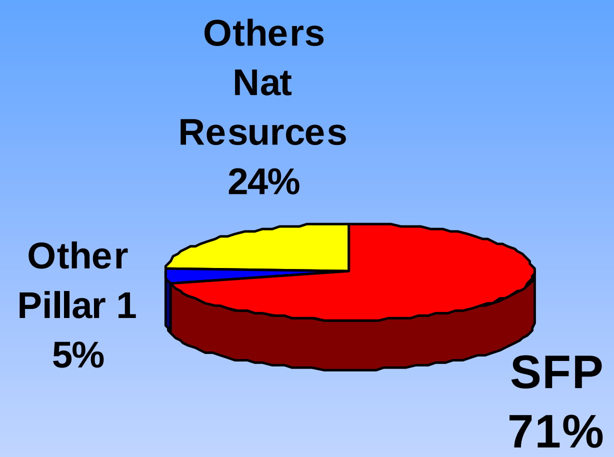
European Parliament - Committee on Budgets and Committee on Agriculture

Joint Workshop

Brussels, 2 April 2008

The Single Farm Payment (SFP) expenditure in 2012 will be 43,309 million Euro, i.e. 93.4% of Pillar 1 expenditure and 71.4% of total expenditure under the budget heading “Natural resources”

Natural resources expenditure



The effectiveness of EU agricultural expenditure largely depends on the effectiveness of the SFP expenditure

- The SFP is the outcome of the 2003 reform which had a number of widely recognized positive effects;
- However, there are two main criticisms:
  - poor effectiveness in achieving the declared objectives of the EU policy for agriculture: farmer income, environment, competitiveness, quality, food safety and food security;
  - budget sustainability: the money spent for the CAP could be allocated to other EU policies with greater social benefits;

Objectives of the CAP and effectiveness

Public goods and positive externalities:

SFP is a payment to farmers because they produce positive externalities and public goods (environment, food security, food safety…). However:

- The payment is not linked to the production of externalities or public goods
- Conditioning is very weak, as farmers are asked to comply with the EU legislation already in force

Income support:

SFP is aimed at supporting income of EU farmers. However:

- The payment is not linked to income needs;
- Support is concentrated in areas with higher incomes (Shucksmith *et al.*, 2005) ...
- … in relatively few farms of the EU 15 which should not be the target of an income policy;
- in some cases beneficiaries are not even farmers (SFP capitalisation in the land price..)

Competitiveness and quality:

- The SFP does not actively contribute to increase the competitiveness of European farms;
- In some cases it contributes to worsen competitiveness (e.g. in semi-subsistence farms in New member countries and/or in small farms in Southern Europe it prevents restructuring);
- Contribution to quality improvement is very weak and limited to the national voluntary implementation of art. 69, Reg.1782/2003;

The key problems are:

- the SFP has not been designed with the goal to effectively achieve these objectives:
  - the aim was to decouple the EU support and make it compatible with the “green box” definition;
  - the choice to decouple support while maintaining its historical distribution (path-dependency) is the cause of its current ineffectiveness in reaching the declared goals

- Too many goals for one instruments: it is questionable whether it is appropriate to use a single instrument to pursue different objectives; this result in inefficiencies

Budget debate and the CAP

1. How many resources should the EU devote to agriculture?

- It is questioned that one third of the EU budget is devoted to a sector accounting for less than 5% of the EU GDP and that this undermines the ability of the EU to pursue the key objectives of the Lisbon Agenda (Sapir, 2003)
- However, agricultural policy is one of the few EU funded policies; public intervention in agriculture is funded almost entirely by the EU.

- A further criticism is that the net social benefit of the CAP, i.e. its “added value”, is negative (the difference between revenue and intermediate inputs is smaller than total support) (Sapir, 2003; Wichern, 2004).
- However, social benefits should take into account also production of public goods (including food security at the aggregate level) and positive externalities produced by agriculture.

2. How agricultural expenditure redistributes resources among member countries?

- Countries with positive net benefits from Pillar 1 ask for maintaining a consistent share of the EU expenditure for agricultural policies; those with negative net benefits call for a substantial reduction;
- Current allocation of SFP expenditure among countries does not have a particular justification; as for the EU 15, is what we have inherited from the old CAP (path-dependency);

- There is no justification for a “freeze” in the agricultural expenditure by country…
- … and anyway, a shift of resources to Pillar 2 or to other EU policies not necessarily improves the financial position of net contributors;
- Besides net contributions, the issue of CAP financing should be addressed by considering what an efficient and rational allocation between member States and EU of competences and financing is

The health check proposals are reasonable adjustments to the current CAP which:

- complete the 2003 reform by eliminating old instruments (e.g. intervention, milk quotas, coupled payments)
- remove the link between the payment received by the farmer and its "historical rights" (e.g. compulsory regionalisation)
- shift additional resources from the first to the second Pillar and improve support distribution (modulation+capping)

However, these adjustments do not remove effectiveness problems

- Preliminary estimations suggest that modulation and capping would shift a max of 7-10% of Pillar 1 expenditure to Pillar 2 (Eu-15); the SFP will continue to capture more than 66% of the natural resources expenditure;
- Regionalisation and capping may improve the distribution of SFP expenditure, but the payment remains not targeted;
- There is no reinforcement of the standards to comply with, or an improvement of the controls over compliance.

Beyond 2013:

scenarios for the EU agricultural policies

- It has been argued that, as the EU has decoupled support, it has become substantially a social policy and thus it should be re-nationalised;
- However, there are important reasons, beyond farmer income, to maintain a EU policy for agriculture, consistently with the Lisbon agenda and the EU sustainable development strategy

- Competitiveness is a serious challenge for EU agriculture: trade liberalization (multilateral and preferential agreements), rapid change in consumers preferences, new competitors, low EU productivity, increasing production and market risks and climate changes
- Environmental protection and the production of other public goods in rural areas which are particularly valuable for the society at large is another relevant objective of the EU

T*wo* priority goals could be pursued by *two* different targeted policies:

- Pro-competitiveness policies such as:
  - **innovation** oriented policy (extension, training ad education, stimulating the adoption of innovation by European farms);
  - policies oriented to improve **farm structures**
  - policies to mitigate production and market **risks;**
  - policies to improve **quality….**

Some of these policies are now included in rural development policy (Axis 1). However:

– relatively few resources;

– co-financing (from 20% to 75%)

– some of these measures are to be designed at the EU level to avoid distortions of competition

Pro-competitiveness policies as the new Pillar 1 of the CAP?

- Environmental protection and public goods (Pillar 2) :

  - Agro-environmental and other targeted payments to farmers producing positive externalities and public goods;
  - Payments for energy crop and other crops for renewable energies (i.e bio-fuels)
  - Payments should be cost-based (as it is the case in the current rural development policies) or based on the amount of benefits produced by the farmer;

Other objectives should be pursued with other more apprpriate instruments:

- Farmer income support should be pursued with national social (and not agricultural) policies;

- Regional disparities between farmers should be tackled within the EU regional policies;

How a new EU agricultural policy should be financed?

- The gradual dismantling of the SFP and its replacement with safety net and pro-competitiveness policies would reduce significantly Pillar 1 expenditure; it would be then sustainable to maintain a 100% EU funded Pillar 1;
- EU resources of Pillar 2 should substantially increase; different rate of co-financing could mitigate possible problems for low income countries to match EU funds and other undesirable redistributive effects

Concluding remark

- There is the need of a EU agricultural policy
- The SFP, even adjusted after the Health check, cannot effectively achieve the EU objectives;
- Targeted instruments to pursue the declared objectives should be clearly defined;
- Path-dependency of the CAP (budget allocation, historical rights and current instruments) should not shape the CAP of the future

POWERPOINT PRESENTATION

THE FINANCING AND EFFECTIVENESS OF AGRICULTURAL EXPENDITURE: REFLECTIONS ON THE CAP

Dr. David Baldock

Institute for European Environmental Policy

The financing & effectiveness of agricultural expenditure: Reflections on the CAP

by David Baldock

www.ieep.eu

25 March 2008

The Starting Point: Financing agriculture

- CAP expenditure is generally transparent;
- But politically less so with multiplicity of variations in Pillar One, e.g. Article 69, National top ups in new Member States;
- State aids are less transparent or monitored;
- Further variations at the local and national level, e.g. taxation have non-uniform impacts on agriculture.

The Starting Point: Judging Effectiveness

- Monitoring and evaluation historically weak within the CAP. Both EU and Member States studies patchy;
- In recent years, greater investment in evaluation (NB my Institute involved);
- Limited results available for period since 2003 and major changes to the CAP;
- Lag in data availability, e.g. FADN data for 2005 only recently in public domain;
- Data on environmental and social change at farm level scarce, not consistent at EU level; insights from some Member States.

Challenges in Judging Effectiveness (1)

- Clarity of policy objectives is essential;
- But these are often couched in very broad terms within the CAP;
- Multifunctional objectives need to be supported by agreed sets of indicators and supporting data sets. Progress in Pillar Two not Pillar One;
- Need for consistent data sets to reflect decoupled approach, e.g. on agricultural land prices, farm nutrient budgets, status of land management.

Challenges in Judging Effectiveness (2)

- Problems of the counterfactual are often significant;
- What is the policy counterfactual for the CAP? Not the absence of intervention;
- What would have occurred under the counterfactual?
- Example of the dairy sector; the combined impact of quota and prices above world level;
- Assumptions unavoidable; but evidence required too;
- Example of deadweight.

Policy Development Within the CAP

- Substantial change in objectives drawn by internal and external factors, e.g. WTO;
- But severe constraints on distributional changes continue to shape the policy;
- Financing decisions arise from political negotiation rather than being embedded in agricultural policy logic;
- Existing policy instruments may be used in rather different ways by Member States; they don't necessarily pursue newer objectives;
- Impact assessments now published but not a strong tradition in the CAP.

Pillar One Objectives

- Direct payments heavily reliant on compensation logic; the foundations of the Single Farm Payment
- This is unrelated to the emerging objectives of providing public goods/public benefit and food security;
- Payments are not targeted at income support in a systematic way; incompatible with compensation logic;
- Flat rate payments are less distorted towards historically high yield or high subsidy farms but still not aligned to emerging objectives.

Meeting EU Standards

- EU Farmers are subject to constraints that may not apply in other major production regions;
- Some will arise from the interwoven land use pattern in Europe and co-existence of urban and rural cultures;
- Some will arise from more demanding standards than apply elsewhere, e.g. for farm animal welfare;
- But it should not be assumed that EU standards are higher than other OECD countries; the evidence from studies is mixed.

Cross Compliance

- Common confusion that farmers should be compensated for having to accept cross compliance discipline per se;
- This is incorrect; cross compliance is predominantly an aid to enforcement of existing standards;
- These standards apply to all farmers, whether they receive the Single Farm Payment or not;
- The only additional obligations arise from Good Agricultural and Environmental Condition, (not substantial in most Member States) and higher transition costs;
- If there is to be compensation for EU farmers it should reflect the extent of obligations in mandatory measures, not the existence of cross compliance.

Farm Incomes and Public Goods

- Direct payments clearly do contribute to the maintenance of farm incomes, including in those areas with relatively high provision of public benefit, e.g. LFA;
- Targeting of payments towards individual farm needs would be a very demanding task, given variations between farms and over time, with changing price levels;
- Also demanding to target payments more towards public goods/public benefit; considerable data requirement;
- But becoming more feasible as we know more about distribution of environmental goods, e.g. High Nature Value farming.

Environmental Public Goods

- Agriculture and forestry have a key role in land management in Europe and related public goods, e.g. cultural landscapes;
- Biodiversity, both habitats and species;
- Flood prevention and water management;
- Carbon sequestration;
- Other ecosystem services, e.g. pollination;
- The market will not in itself create the types of agricultural management needed for supplying these goods.

Climate Change

- Important factor for agriculture (and forestry) in future;
- Agriculture has a role in mitigating emissions, including carbon sequestration and in producing new non-fossil based fuels and raw materials;
- Also has role in adaptation to climate change, e.g. improved water management, soil management;
- Need long term capacity for food and bioenergy production in Europe;
- No immediate food security issue for Europe.

Climate Change and the CAP

- The CAP should provide a holistic framework for appropriate land management and overall supply balance in Europe.
- Some grounds for intervention to pursue investment or land management options, e.g. improved nitrogen management and retirement of certain peaty soil from production;
- Valuable to target measures with non-climate benefits as well; especially via Pillar Two;
- Incentives for bioenergy and industrial crops to come from energy/climate policies, not via the CAP;
- No need for reverting to production aids for bioenergy;
- Bioenergy policy needs to be much more stringently tied to demonstrated benefits.

Future Expenditure Requirements

- There is a continued role for public intervention and expenditure on agriculture/forestry;
- Clearly the case for land management and related investment linked to public goods provision;
- Implies a different pattern of expenditure targeted under new criteria;
- Pillar Two provides many of the Instruments needed to pursue this approach if well funded and targeted;
- Long term considerations need to be built into policy from the Heath Check onwards;
- Modulation as a model should not be rejected because of the co-funding requirements.