

## 6. CONCLUDING COMMENTS ON THE NATURE OF CAP CHANGES

We have provided a quantitative evaluation of the changes brought about by the 1992 reforms; at yet, we have not explained why the new policy measures have produced those results previously assessed. In this closing chapter, we will provide a basic theoretical framework in order to understand the nature of the change and we will evaluate the new measures in terms of cohesion concerns.

Agenda 2000 has to be seen basically as a deepening of the approach introduced in 1992, therefore the link between policy measures, economic theories and academic researches, provided for the 1992 policy measures, still keeps its validity for Agenda 2000.

Cohesion issues connected with the EAGGF Guarantee Section expenditure regard also rural development measures; with Agenda 2000, rural development expenditure has been put under the EAGGF financial guideline and we will briefly have a look at the positive and negative elements for cohesion concerns of this new framework.

In paragraph 6.1 we will examine which are the implications of a shift from price support measures to targeted lump-sum transfers as direct payments. For both sets of measures, our analysis will consider: administrative costs, impact on efficiency and potential redistributive effects.

In paragraph 6.2, we will investigate the characteristics of the specific type of direct payments carried out by the CAP; a succinct review will be done about the impact on economic efficiency of supply management measures like milk quotas or set-aside for cereals.

In paragraph 6.3 we will examine the motivations underlying the introduction of the direct payments within the EU. This will give us the go-ahead to see why CAP direct payments have not been linked to a fairer distribution of the support in agriculture within the EU.

Finally, in paragraph 6.4 we will look at those developments which characterize the EU rural development policy.

### 6.1. From price support to direct payments: what changes?

Transfers are defined as payments from one agent in the economy to another, for which there is no corresponding flow of goods and service. Within CAP, the main transfer instrument has been the *market price support*. This type of transfer is achieved by creating a price wedge between internal producer prices and world market price. Therefore, it causes a change in the production and consumption decisions compared with a situation where producers and consumers face world market prices; in particular, producers receive an incentive to produce more, increase the productivity by using more intensive production processes. Furthermore, price support is mainly concentrated on large farms and, as we have seen in chapter 5, there is evidence that price misses its target of transferring income to producers with low relative incomes. Besides, land rent will increase because of higher agricultural prices and land will be destined not to the most efficient use, but rather it will be used to cultivate highly supported products.

Market Price Support implies a transfer from consumers to producers. In the case of a product which is exported, it also involves a transfer from the government budget. The transfer tied to the MPS produces a kind of regressive taxation, since lower income consumers pay a disproportionate share of transfers relative to their income share.

As for the administrative cost due to the MPS, these are relatively low since only a price wedge at the external border has to be policed.

Turning to the *direct payments* decoupled from the level of output, by definition they do not influence producers decisions as price support measures. In other words, producers decisions on what to produce and how to produce are only determined by the market situation. On the other hand, this type of transfer is associated with high transaction costs. This is occurred since direct payments are targeted, so they need to be based on detailed information about individual households; this increases the informational and administrative costs connected with defining the eligibility of the support and providing it.

Direct payments do not need to be financed by consumers, but only by taxpayers. Therefore, they can increase the social equity of the support depending on how progressive the taxation system is.

Another important aspect tied to redistributive concerns is that direct payments may be targeted to increase revenues of low income farmers or, anyway, of those who deserve compensation (i.e. farmers which use environmental-friendly materials).

Significantly, direct payments are not only beneficial for purposes of social justice, but also for the agricultural sector. The results of a model carried out by a group of experts for the EC (1994)<sup>1</sup>, show that the decline in farm incomes is reduced from 0,9% to 0,5% a year in real terms, by replacing price support with direct payments.

Indeed, also due to the introduction of direct payments and in spite of a decrease in 1997 (-2,8%), average farm income in the EU exceeds by 18% its level before the CAP reform in 1992 and the European agriculture has seen a steady increase of farm income since 1992. This translates into a remarkable average annual growth of more than 3,5% in real terms until 1996.

Direct payments are more efficient in increasing agricultural income than market support because they support people rather than products. In the case of price support, a consistent part of the unit support was captured by higher land and other input prices. As one important parameter affecting transfer efficiency is the elasticity of farm supplied resources used in the production of supported commodities, payments not linked to production may be a considerably more effective means of providing support to farmers.

As it has been shown (OECD, 1995)<sup>2</sup>, 1\$ of direct payments provided by the EU produces 0,75\$ of farm income, while we get only 0,35\$ of income if the initial unit transfer is the price support.

Finally, decoupled direct payments do not stimulate increases in productivity, which may be harmful for the environment, rather they can be tied to environmentally friendly practices, although this operation will not be costless when administrative costs are taken into account.

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<sup>1</sup> EC, 1994, EC Agricultural Policy for the 21<sup>st</sup> Century, No4

<sup>2</sup> OECD, 1995, "Transfers Efficiency of Agricultural Price Support"

## 6.2. CAP measures, allocation of production and producer's decisions

There are major elements of the Mac Sharry and Agenda 2000 which need to be examined. The way in which both reforms influence the allocation of resources in agriculture production is of great concern for structural adjustment and also for cohesion. From a political point of view, a firm move towards major efficiency in the EU agriculture may be the necessary step for recognizing the necessity to redress the support mainly to the benefit of low income farmers and areas. A clearer repartition of responsibility concerning efficiency and income aspects can help to overcome the confusion of the present policy and achieve the main goals in terms of equity and efficiency. We will analyse the effects of two sets of measures: supply quantitative restrictions and direct compensatory payments.

*Quantitative restrictions* in the form of production quotas for milk and sugar, reference levels of regional cattle herds and sheep flocks, and set-aside proportions may have desirable effects in reducing budget expenditure, but also create inefficiencies and administrative costs.

Inefficiencies arise because farmers cannot use the most efficient production techniques and exploit economies of scale.

Milk quotas, combined with high prices, damage above all the production of quality products. Since high milk prices make it impossible to export without subsidies, the principal adverse effect of the WTO export limits could be to reorient the industry away from production of high value products such as cheese, towards low value surplus bulk production. Over time this will progressively erode the competitive position and ability to innovate for both farmers and the dairy processing industry. For instance the EU share of world cheese exports is projected to fall from 40% to 28% by 2005.

Nevertheless, the introduction of fully transferable quotas (like in Italy and France) may improve the situation by creating the conditions through which resources are destined to those farmers who can produce more efficiently.

Set aside, whereby arable land is taken out of production, implies a waste of land resources; it increases the rent for land remaining in production and hence creates a transfer from land users to land owners. At unchanged producer price, the resources remaining in production will be farmed more intensively, which may have adverse consequences for the environment.

Milk quota and set aside "freeze" the market to the benefit of those producers and those areas which occupied the principal position in the past. This explains partly why there have not been great changes in the distribution of milk and cereals production across the EU regions in the 90s and why the most dynamic developments have been observed for mediterranean products like wine, and fruit and vegetables.

Turning to *direct payments*, there is a major factor of the Mac Sharry and Agenda 2000's direct payments which has to be taken into account: these area payments are to be granted to base area, provided the land is allocated to growing one of the program crops, specifically cereals and oilseeds, or placed in set-aside. Under Agenda 2000 payments are equalised across cereals, oilseeds and set aside, whilst under the Mac Sharry payments for oilseeds were higher than those for cereals. This determined a switch of land cultivated from cereals to oilseeds. After the Berlin

Agreement, with equalised payments among crops, a producer considering planting wheat or rapeseed on base area will receive the payment regardless of which activity is chosen, so the economic decision criteria will essentially be expected prices and costs. On the other hand, a producer debating between planting rapeseed or a fruit crop on base area will factor in the loss of area payments if planting fruits. Total land available to cereal and oilseeds planting and set aside will continue to be influenced by the payments, since any decision to put land to another economic use will terminate the payments for that land (OECD, 1999)<sup>3</sup>. For this reason, payments are not entirely decoupled from output decisions.

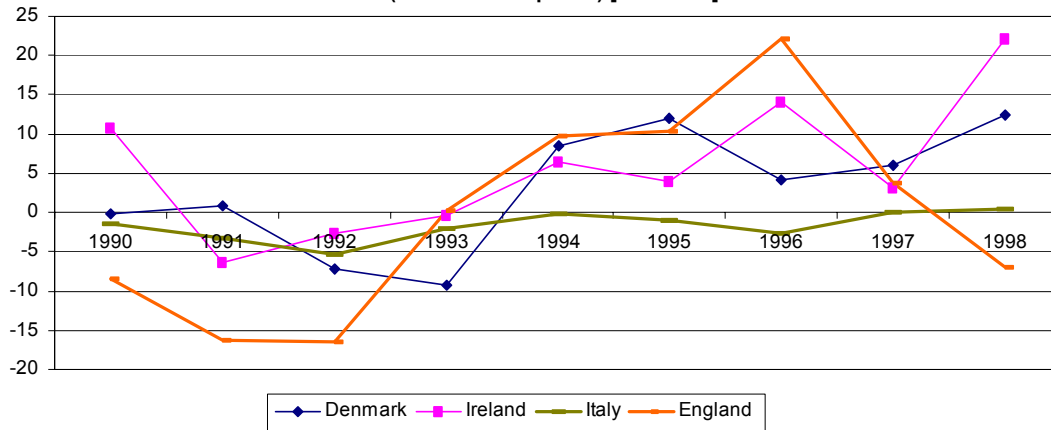
Furthermore, the specific way, under which area payments are provided, contributes to create conditions which make it difficult shifting the distribution of the support to other subjects. Cereals and oilseeds' producers who want to receive area payments have to continue to produce one of the program crop or set the land aside; this creates a vicious circle since these farmers receive an incentive to remain in the sector, but become more dependent on the payments, thereby demanding further support in the future. Whether they did not incorporate area payments in their economic decision, they would harmonize their activities only on the basis of market signals, thereby becoming less dependent from the support.

The definition of the aid on the basis of the cultivated area strengthens the elements characterising land rent, and in this manner, it increases the rigidity of the land market by constituting a major limit to structural adjustment. In fact, after the Mac Sharry, payments per hectare in the cereal sector, combined with a positive evolution of market prices, led to an increase in agricultural land prices (graph 6.1); this is shown even more clearly by the trend in the price of arable land in France, which is the most important producer of cereals in the EU (graph 6.2). In the new Member States, the increase in land price has been occurred after the accession in 1995 (graph 6.3).

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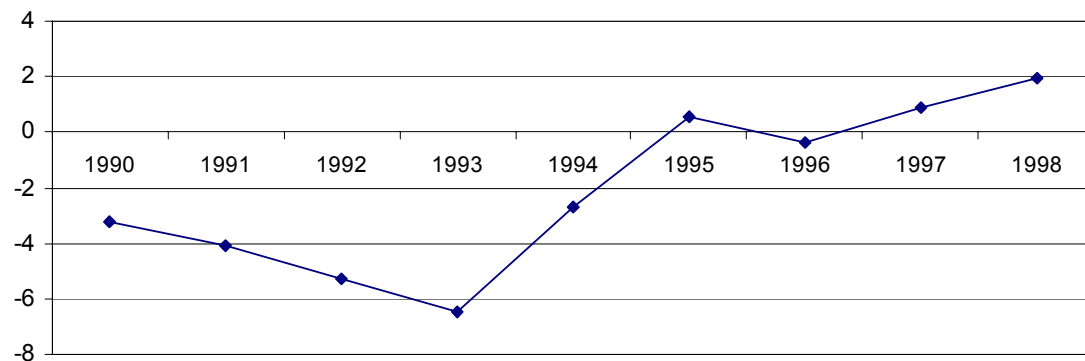
<sup>3</sup> OECD, 1999, Market Impacts of Agenda 2000 – Berlin Agreement

**Graph 6.1 Annual rate of change of agricultural land prices (deflated 1990 prices) [1990-1998]**



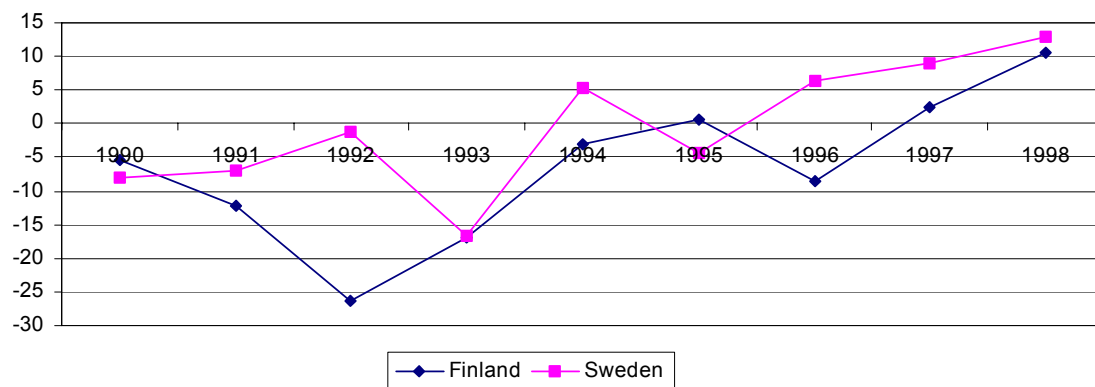
Source: our elaborations - Eurostat data

**Graph 6.2 Annual rate of change of arable land price in France (1990=100) [1990-1998]**



Source: our elaboration - Eurostat data

**Graph 6.3 Annual rate of change in price of agricultural land in Finland and Sweden (deflated 1990 prices) [1990-1998]**



Source: our elaborations - Eurostat data

As for cattle premia, the effect on production will be less marked than for cereals. Though two new premia have been introduced under Agenda 2000 and existing payments have been raised, the suckler cow ceiling has also been lowered and allowed 20 per cent to be shifted to heifers. The reduction in ceiling decreases the likelihood that the premium affects the decision at the margin (OECD, 1999)<sup>4</sup>. In fact, if a producer expects the next cow held to receive a suckler cow premium, then that payment will affect the decision whether to increase his herd. Since the ceilings have been lowered, it is more likely that the producer does not expect to receive any further premia payment for additional cows, and its decision of whether to invest further in additional cows will be based on market returns only.

Therefore, we can say that direct payment for beef are “more decoupled” than for cereals with important consequences in terms of the evolution and distribution of production and support.

### **6.3. The CAP direct payments and redistributive concerns**

In 1991, the EC estimated that 80% of CAP spending went to only about 20% of farmers, overwhelmingly the bigger and richer ones. This was partly the result of both the price support as main transfer instrument, and of biasing it towards “northern products”. In 1992, a declared objective of agricultural policy was the correction of the imbalances of the support among commodities, among big and small farms and between regions.

Anyway, in chapter 5, we have seen that the distribution of the overall support is not significantly changed after the introduction in 1992 of direct payments for oilseeds, cereals, tobacco and in the beef sector. Why has this been occurred?

The key point is that the 1992 reform has been aimed at compensating the negative effects of price reductions on incomes through adequate increases in direct payments. In order to achieve this objective, direct payments have been limited to historical references (areas cultivated, yields, number of animals); this explains why the distribution of the overall support among farmers and regions has remained almost unchanged. The significant shift concerns the form under which the support is provided: from price support to direct payments.

In 1992, it was reasonable to compensate farmers for incomes losses produced by the price reduction; from a political point of view, a radical shift in the distribution of the CAP support was impossible. Nevertheless, the Mac Sharry represented a big step towards a new philosophy in the carrying out of the CAP; above all, the Mac Sharry had laid down the foundation for a new CAP: more market oriented and mainly based on direct payments. Agenda 2000 could have been the right momentum to build on these foundations, but the final Berlin agreement (Council of Berlin, March 1999) on Agenda 2000 is not as far reaching as in the hope expressed by some Member States and as claimed in the original proposal of the Commission.

Intervention prices for cereals and beef meat have not been cut as severely as in the Commission proposal, milk quotas are extended until 2008, the price cut in the dairy sector and the introduction of direct payments for dairy cows are postponed to 2005/2006 (2000/2001 in the original Commission proposal), the allocation of direct

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<sup>4</sup> see note 3

payments for arable crops, oilseeds and beef continues to be tied to historical FADNI references.

Though the 1992 Mac Sharry reform and Agenda 2000 correspond to a fundamental turning point by defining a new set of objectives, and by introducing the principle of separation between price policy and policy of income support, they do not represent a fundamental improvement from a redistributive point of view.

As we have seen, after 1992 the support has remained centred on the traditional “strong” sectors, whilst the others have been considered as residuals. As for cereals and cattle, there has been only a gradual substitution of old instruments with new ones, while the nature of support for dairy products and sugar has remained unchanged. If we take into account both direct payments and price support, it is evident that the distribution of the support has changed not significantly.

#### **6.4. Rural development measures under Agenda 2000**

Agenda 2000 makes rural development the second pillar of the CAP. It identifies rural development as a major challenge for the future and suggests three main objectives for a rural development policy at EU level. It facilitates the structural adjustment of the farm sector, favours the integration of environmental concerns into agricultural activities, and promotes the diversification of on- and off- farm activities. It brings all relevant existing measures into one policy framework and makes them available – at least in principle – in all rural areas of the EU. In particular, simplification is attained by replacing nine previously existing regulations with a single text (Reg. No 1257/1999). Outside the EU’s least developed regions, the so-called Objective 1 regions, rural development measures will be financed from a single source: the EAGGF-Guarantee Section.

The set of rural development measures contains innovative elements such as measures to support the quality of life of the rural communities, maintenance of semi natural habitats, promotion of low-input farming system. In particular, the last measure should be destined to Less Favoured Areas which often overlap with Areas of High Nature Value. Since rural areas are increasingly required to fulfil important environmental and recreational functions, targeted environmental measures will be encouraged to support environment-friendly agricultural methods. They will be the only compulsory element in the new generation of rural development programmes and hence a decisive step towards the recognition of the multifunctional role of agriculture. Rural development policy will be applied horizontally and implemented in a decentralised way, at the initiative of the Member States.

Anyway, even for rural development, the conclusions of the Council of Berlin are not as far reaching as it had originally proposed by the Commission and by many experts. In terms of budget expenditure, the weight of the traditional market and income support remains overwhelming as compared to the budget foreseen for rural development, and the introduction of two distinct sub-headings under the agricultural guidelines does not allow any financial flexibility between the two pillars of the CAP.

Opinion leaders, experts and policy makers agree about the importance of rural development policy; it is generally acknowledged that a strong rural development policy is necessary to accompany and manage the processes of economic adjustment and diversification brought about by the world wide liberalisation of trade created in most rural areas of the EU. In practice, this acknowledgement is still not translated

fully in concrete policy decisions since the traditional agricultural support captures most of the budget.

Final remarks concern the agri-environmental policy: there is now the possibility for Member States to link the allocation of direct income payments to environmental requirements. This may cause differences in the application of the agri-environmental approach across EU areas: the most opulent regions might probably introduce severe environmental constraints whilst less developed regions might not link the payment of direct payments to environmental requirements. In the latter areas, sustaining incomes and employment levels is the main issue and environmental concerns occupy generally a secondary importance in the political agenda. Excessive differences in environmental standards may be an undesirable effect of a decentralised environmental policy. If the quality of the environment is judged to be a major objective by the EU community, then it is necessary a single and firmer inception of the agri-environmental policy.