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**Book Part**

## Greening the CAP: The future of the first pillar

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## GREENING THE CAP: THE FUTURE OF THE FIRST PILLAR

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### **1 Introduction**

This paper has emerged from discussions in an ARL working group<sup>4</sup> which has met on five occasions during 2001/02 pooling ideas for the next phase of CAP reforms. The two authors and three other members<sup>5</sup> of the ARL group were also participants of the Commission's 1995/96 working group which produced the so-called CARPE concept for a more integrated rural policy. Earlier versions of this paper entitled 'Greening Pillar 1' were written before the Commission produced its "Mid Term Review of the Common Agricultural Policy" (henceforth MTR). A condensed version of what we mean by Greening Pillar 1 forms section 2 below, a fuller discussion of the idea is in SUMPSI VIÑAS and BUCKWELL (2002). The argument of the earlier paper was that if moving funds from Pillar 1 to Pillar 2 by voluntary or compulsory modulation, or by degressivity was so difficult politically, then we should consider the option of achieving the objective of greening the CAP by greening the first pillar. In the light of the more radical than expected MTR, the paper has been restructured to aid the discussion of the further evolution of the CAP which will be publicly debated over the coming months.

There is little disagreement that the present CAP does not fulfil what Europeans want from their prime rural policy (see the contribution of VON URFF in this volume). At the same time the agricultural chapter is the most difficult in the enlargement negotiations with the applicant states in Central and Eastern Europe (see the contribution of WILKIN in this volume). Also the CAP is a continuing source of tension in international relations (see the contribution of ANANIA in this volume). We contend that there is, within the EU-15, a broad consensus between many groups representing consumers, the environment, and the rural economy – and even some representing farmers and land managers<sup>6</sup> – about the shape of the Common Rural Policy which would better deliver what European citizens want. This in turn defines the direction in which reforms should take place, namely to move more of the support offered by the CAP from its existing connection to agricultural production towards a system of more effectively dealing with

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<sup>3</sup> This paper is the opinion of the authors alone and is not to be interpreted as the position of their organisations.

<sup>4</sup> This paper was prepared as a contribution to the Working Group on "The Future role of Agriculture in Europe of the AKADEMIE FÜR RAUMFORSCHUNG UND LANDESPLANUNG (ARL) Hanover, 2000-2002.

<sup>5</sup> EWA RABINOWICZ, JAN BLOM and TOMAS GARCIA AZCARATE

<sup>6</sup> For example the ELO, the European Landowners Organisation and Condiretti, the Italian Farmers Union.

the pervasive market failures surrounding rural land management.<sup>7</sup> To bring this about means continuing the MACSHARRY and AGENDA 2000 reform processes, involving the further decoupling and reduction of production related subsidies and switching support to the delivery of public environmental and cultural landscape services and assisting rural development. Moving the policy in this direction is what we mean by ‘Greening the CAP’. We do not go into the details of the environmental issues in this paper. A comprehensive analysis of what greening the CAP means is discussed in BALDOCK and DWYER (2002).

In the present paper we focus attention on what we consider are the most important structural aspects of the next reforms, focussing particularly on Pillar 1. Even within Pillar 1 this paper says nothing about the residual commodity-linked parts of the CAP, which (following CARPE) are, mostly, transformed into the safety net or stabilisation instruments. RABINOWICZ (in this volume) discusses these risk management issues. Neither do we deal with the future of the unreformed sectors such as dairy and sugar, or the detailed adjustments to other commodity regimes (wine, tobacco, olive oil and fruit and vegetables). These are, of course, critical issues, but we argue they are secondary to the structural questions about the future logic and justification of large-scale public support to agriculture and rural areas. As these lagging regimes are reformed they will have to fit in with the new architecture of the Policy. In our view the essence of the debate is how to get more of the CAP support into Pillar 2-type measures. We do not examine the nature and purpose of such measures, this is provided by SARACENO (in this volume), especially with regard to the rural development (as opposed to the agro-environmental) measures.

## **2 Greening the first pillar: why and how.**

The prime aim of future CAP reform is to achieve a better harmony between the conflicting aims of different strands of public policy. The stated aims of the CAP enshrined in Article 39 of the Treaty of Rome made no mention of environment. It was not until the Single European Act (1986) that environmental policy was introduced in the Treaties. In the process the environmental goal became an overarching objective with which, in principle, sectoral policies such as the CAP have to comply. This raises a question of whether it is better to achieve (rural) environmental objectives with suitably modified agricultural policy or to start again with purpose-built environmental policy. Practical politics rules out the second option.

There is a corresponding debate *within* agricultural policy itself. It seems rational to suggest that rural environmental policy aims would be best achieved using explicit agro-environmental instruments whose sole objective is the achievement of the

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<sup>7</sup> Two styles of rhetoric have been used to describe these concerns. Some refer to multi-functional agriculture in which many outputs beyond food and fibre production are deemed important. The list of components of the outputs claimed for multifunctional ‘agriculture’ is very long indeed: landscape, habitat protection, biodiversity, flood protection, water purification, leisure, recreation and sport, heritage features, vernacular architecture, social structures and practices, diet, costume, as well as food safety and security, and animal welfare. However because there is no agreement on which of these non-food goods and services are included in this term and even less agreement about which of them are associated with sufficient market failure and jointness in production to justify public payments, this term will not be used. The rhetorical style currently in vogue in the Commission is to refer to a policy for quality rather than quantity. The more elaborated version of this then refers to many of the same list as above, mentioning specifically, environment, animal welfare, food safety and quality and occasionally the safety of farm workers. BUCKWELL (in this volume) discusses specifically the public roles in food safety and quality, so the rest of this paper focuses on the environmental and rural development market failures justifying public assistance.

environmental goals.<sup>8</sup> This follows the Tinbergen principle of matching policy instruments and targets. It suggests that the first best solution is to expand the agro-environment programmes under Article 24 of the Rural Development Regulation 1257/99. Why then consider the greening of pillar 1 instruments which patently have had the prime purpose of farm income support?<sup>9</sup> Four reasons are offered.

First, there must be coherence between agricultural and environmental policy. European environmental law exists in the form of the nitrate, habitats, birds, waste and water framework directives. In addition, Member States have their own environmental law. Agricultural policy should, at the very least, not induce behaviour which undermines these directives and laws. This is enshrined in the environmental protection requirements in Article 3 of the Horizontal Regulation 1259/99 of Agenda 2000.<sup>10</sup> Second, there should be policy coherence between the 1<sup>st</sup> and 2<sup>nd</sup> pillars of the CAP. Steps should be taken to ensure that environmental services supplied at public expense through pillar 2 are not undermined by the (currently) six-times-greater public expenditures on pillar 1 measures. The third argument concerns hearts and minds. By introducing environmental requirements into Pillar 1 measures, this could raise consciousness of all concerned about the need to switch the purpose of public supports. This alone has the potential to induce more environmentally benign performance. The fourth is a dynamic argument. Suitably redefined commodity payments might be seen as providing financial assistance to farmers to enable them to adapt their farming system and practices to be less environmentally damaging.

Bringing these together, the important point, and main objective of Greening the CAP is to restore its legitimacy. The thrust of the current paper is that whatever the outcome of the debate on the MTR, the likely rates of implementation of change will still leave, at the end of this decade, the majority of public support being provided within the first pillar. Given European society's high level of concern for environmental goals, the legitimacy of the CAP demands a more conscious effort to ensure that its principal instruments are applied in such a way as to better contribute to the environmental objectives of rural policy. Added to this, and given the volume of protection under discussion, a mere decoupling of pillar 1 support from production, with only a limpid re-coupling to environment or other social goals by cross-compliance, may prove insufficient defence in WTO of the Commission's proposed decoupled payments.

There are a number of ways in which environmental greening can be achieved, they are *not* mutually exclusive. It is most likely that progress will be made by utilising several of these approaches, although this risks complication of the policy.

The first and most obvious is to try to ensure there are not CAP market measures which directly undo or diminish the environmental achievements of the agro-

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<sup>8</sup> It might also be helpful if the language were changed to speak of rural environment schemes rather than agro-environment. Although such is the defensiveness of agricultural interests in 'not losing our money' that this might be seen as unhelpfully provocative.

<sup>9</sup> The most usual interpretation of the price support system of the CAP, and the direct payments which were introduced to compensate farmers when support prices were reduced, is that their purpose is to raise farm incomes. In turn, it would seem reasonable if there is such a goal, then the objective would be to raise the incomes of those who were poorest. It is a curious feature of the CAP that of course, price policy and direct payments help most those who produce most. In addition, as a large proportion of European farmers have non-farming sources of income, it might be expected that an income policy would pay some regard to the total income of agricultural households. In fact the payments are made with reference only to eligible crop areas and livestock numbers. Thus the claim that the CAP is an income support policy is, at best, a crude approximation.

<sup>10</sup> This regulation has not, to date, been implemented with much rigour. It is well known that most member states have a long way to go to fully implement all the environmental directives.

environmental programmes and the environmental directives. Thus, as a general principle of policy coherence, it can be argued that environmental conditions should be attached where feasible to all Common Market Organisations (CMO) supports in first pillar.

In fact, this is already the status quo for direct payments. The environmental protection requirements, article 3, of the common rules for direct support schemes (1259/99) requires MS to “take the environmental measures they consider to be appropriate... These measures may include:

- support in return for agro-environment commitments,
- general mandatory environmental requirements,
- specific environmental requirements constituting a condition for direct payments.”

The article then goes on to require that MS decide on the penalties “that are appropriate and proportionate to the seriousness of the ecological consequences of not observing the environmental requirements... They may provide for a reduction or, where appropriate, a cancellation of the benefits accruing from the support schemes...”

Interestingly, almost all discussion of this issue interprets the whole Article 3 as a ‘cross compliance’ measure, yet, strictly, this only refers to the third indent, attaching specific environmental conditions to direct payments. At present, there is a fairly relaxed interpretation of the cross compliance conditions amongst the Member States. In *SUMPSI VIÑAS* and *BUCKWELL* (in this volume), section 3.1, we discuss how more meaningful environmental conditions could be attached to the receipt of direct payments. This is certainly one way of improving the environmental performance of the CAP. Another way of achieving this goal is to attach environmental conditions to investment plans – this is particularly relevant to sectors, e.g. fruit and vegetables, where there are no direct payments. A third method is to achieve some greening by requiring all farmers to conduct an environmental audit. An important principle here is that the first, and vital, step towards changing behaviour is to raise awareness of the environmental effects of the current farming system. It is interesting to note that this latter idea forms part of the Mid Term Review proposals.

The more radical suggestion for genuinely Greening Pillar 1 is to make full use of the first indent - “support in return for agro-environment commitment”. The fundamental principle of this approach – as for all agro-environment schemes – is that society has effectively defined as private the property ownership and use rights for land, above the statutory levels embraced in environmental law. Therefore, if society wishes to induce users of the land to provide certain public environmental and cultural landscape services, then society must pay land managers to do so. The strongest version of our idea for Greening Pillar 1, is to launch a base, tier zero, agro-environment scheme within the first Pillar. Suitably adjusted higher tiers of agro-environment schemes remain in the second pillar.

The core idea is that all member states would agree to a schedule for segregating the direct payments into two parts. The greened part would involve switching, say 20%, of their total current Pillar 1 direct payments into an entry-level agro-environment scheme involving flat-rate area payments. It is for the member states to decide precisely how to operate the scheme within the principles explained in paragraphs 15 to 17 below. The fate of the non-greened remainder of direct payments is then subject to further negotiation – part will be switched to Pillar 2 for rural development schemes, it is likely that the remainder would be subject to a schedule of cuts (i.e. degressivity).

The rationale for a base tier agro-environment scheme follows from the observation from environmental NGOs that applications of the current approach to custom-built agro-environment schemes have been generally conceived to achieve significant environmental improvements on a minority of the agricultural land area.<sup>11</sup> This gives rise to two problems. First, the ecologically rich pockets may be too small and isolated to survive, so the strategy may fail biologically. Second, it encourages the idea that once these pockets of environmental richness are preserved then it does not matter what goes on elsewhere (a segregation approach). An alternative concept is therefore to try and achieve smaller, but still significant, environmental improvements on the majority of the land area (an integration approach), but above the reference level dictated by existing environmental regulation and minimal environmental standards (Codes of Good Farming Practice).

One way to do this is to require recipients of the arable and livestock direct payments to enrol in a base-level, entry tier, land management scheme in return for a suitably scaled part of their direct payments.<sup>12</sup> Such a base-level stewardship scheme would define the parameters of the farming system which have the potential to bring about significant improvements in biodiversity, landscape and heritage conservation, and resource protection. This would include the following sorts of elements:

- specification of management of field margins, and margins along water courses,
- requirements of a proportion of non-cropped habitat on the farm,
- management of certain aspects of water on the farm,
- specific practices to provide food supplies for bird species, and habitat for other fauna and flora, e.g. beetle strips,
- cutting dates for grassland, and (maximum or minimum) stocking densities,
- care for heritage and other valued man-made features.

The details of such schemes would be drawn up within an EU framework, but with flexibility for regional and farming system-specific adaptation. The key principles are that the scheme is kept administratively simple, with non-competitive entry, applicable to all recipients of direct payment and paid regionally-defined, flat-rate, per hectare payments (which would be part of, i.e. not all, existing direct payments).<sup>13</sup> The contracts should be multi-annual, and the scheme would be integrated into the regional programming approach introduced by the Rural Development Regulation.

Greening Pillar 1 through a Base Stewardship Scheme in this way adds a new tier of agro-environmental achievement. Conceptually, it delivers higher environmental standards than achieved by cross compliance (on any remaining payments) and below those of most of the existing higher-level environmental schemes. Figure 1 summarises the interrelation between these schemes in terms of the areas involved (along the horizontal axis) and the scale of environmental performance and thus payment levels

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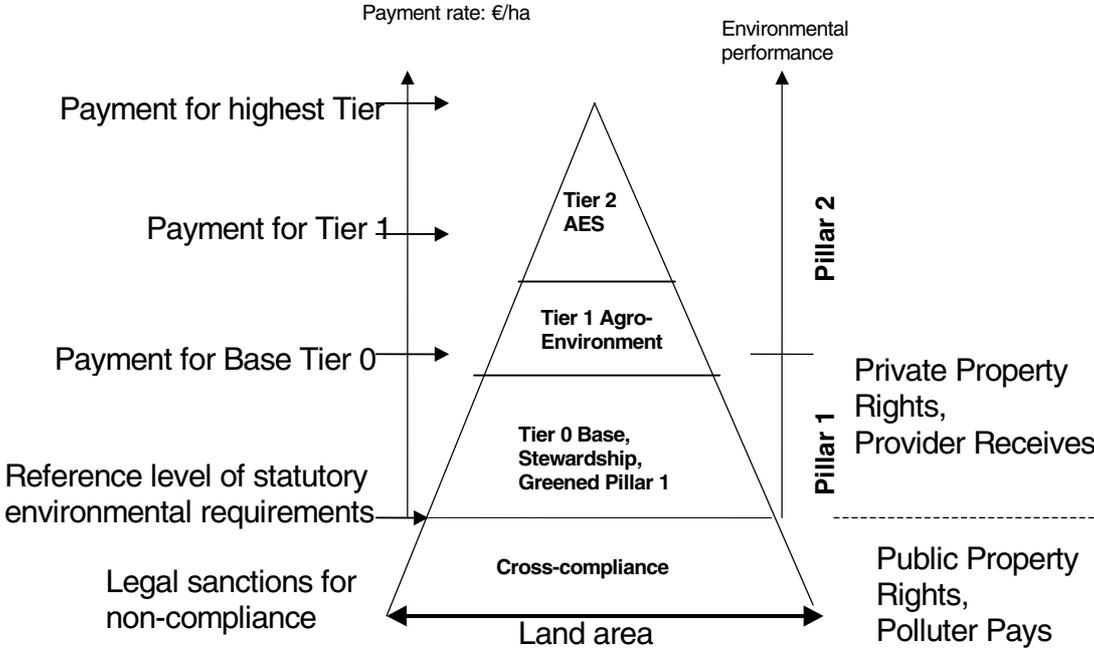
<sup>11</sup> This applies to the Member States where the agro-environment schemes only encompass a small minority of the land area and there are quite demanding environmental conditions and consequently quite large payments. This has been the approach in the UK. At the other extreme is Austria where a majority of agricultural land comes under such schemes, the other member states range in between.

<sup>12</sup> Our proposal here is that the base stewardship scheme should be compulsory. In practice because there is a significant administrative task to get all eligible land enrolled in such a scheme in a single year, it may be necessary to allow it to be optional, but with strong financial incentives for enrolment within a very few years.

<sup>13</sup> Note that this basic land management scheme is identical in concept to the, so-called, entry-level, broad and shallow stewardship scheme proposed by the Independent Policy Commission which recently reported on the Future of Food and Farming in England (the so-called *Curry report*).

(up the vertical axis). It shows the cross compliance conditions applied at the legal reference level, and progressively higher environmental standards, and thus payments, for the new base level or tier zero, stewardship scheme and higher tier schemes.

Figure 1 Interrelationship between Agro-Environment Schemes



The figure is purely illustrative and is not drawn to scale. Some conceptual difficulties of the present and prospective schemes are evident. The first concerns the cross-compliance conditions for remaining direct payments. DPs are sure to continue for many years given politically feasible rates of reform. If the conditions are really no more than the legal reference level, then it is hard to justify any payment at all.<sup>14</sup> Second, in reality, for many years to come, the size of direct payments (whether decoupled or not) will actually greatly exceed the base-tier environment payments which are associated with a higher level of environmental delivery.<sup>15</sup> Third, the intention of a base stewardship scheme is that it should ultimately embrace the whole farmed area. At present the cross compliance conditions can only be enforced on that part of the farmed area subject to existing or future direct payments. A further difficulty with the diagram is that environmental performance is not a simple uni-dimensional scale as depicted here, although for practical administration the payment has to be.

There would be three key decisions required to implement this Greening of Pillar 1:

<sup>14</sup> The logic of paying farmers to respect the law is doubly difficult. From non-farmers point of view it seems to contradict the polluters pays principle. From the farmers' point of view they face a double jeopardy that they get punished once for breaking the law by the normal sanctions, and again by loss of established payments.

<sup>15</sup> Note that a difficult debate is looming on how environmental payments, are related to the (declining) scale of production or decoupled payments. Budget controllers will no doubt argue that smaller decoupled payments means smaller environmental payments (based on the principle of opportunity costs within farming). Farmers will argue that smaller decoupled payments necessitates higher environmental payments (based on their non-farm opportunity costs).

- (i) the amount of current expenditure on direct payments to be devoted to base stewardship within Pillar 1,
- (ii) the amount (of Direct Payments) to be switched to Pillar 2 for other rural development measures – including new measures for improving quality and meeting standards,
- (iii) whether to decouple and reduce the remaining non-greened Pillar 1 Direct payments.<sup>16</sup>

Such a proposal would have six significant benefits:

- (a) The main attraction of implementing base stewardship in Pillar 1 is that the EU's prime instrument of agro-environment policy is then implemented in its 100% EU funded Pillar. This helps to overcome the reluctance of some Member States to switch payments towards the environment as it removes their co-financing obligation. For the core delivery of good basic biodiversity and resource protection, it seems reasonable that this should be taken as a community-wide environmental, and thus financial, responsibility. Higher tiers of environmental delivery are, correctly, a shared responsibility.
- (b) It would reduce the volume of Direct Payments which are only very weakly linked through cross-compliance to the delivery of environmental, or other non-market, services. Thus it would strengthen the claim to have truly 'greened' part of the Pillar 1 Blue Box payments.
- (c) It would enable changes to the current distribution of direct payments which is determined by the historical agricultural production in the EU, as a bigger part of direct payments would be determined by demands for public environmental services in the EU.
- (d) Some of the problems of Eastern enlargement could be eased as during the transition period any reductions of direct payments would only apply to the part which is independent of base-level stewardship scheme.
- (e) A base-level stewardship scheme as proposed would help increase the cost effectiveness of achieving environmental objectives. The agro-environmental schemes of pillar 2 spend a significant part of total budget assigned to RD Regulation and have high transaction costs on a small part of territory. In contrast, the base-level stewardship scheme would spend (initially) a small part of total budget assigned to direct payments and would be designed to have low transaction costs on a major part of the territory.
- (f) This could help achieve a rather quicker switch in the objectives of the CAP payments from income support to supply of environmental services. This would help legitimise the CAP faster than relying on the drip-by-drip approach of fund switching from pillar 1 to pillar 2.

Of course there would be significant costs and an administrative challenge to enrol, monitor and enforce most current recipients of direct aids into such a scheme. The ideal approach would be to switch the purpose and functioning of the IACS data base, from its socially redundant role of monitoring production payments to be an integrated land use and environmental information system - preferably in electronic form. This could

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<sup>16</sup> The remaining Pillar 1 non-greened direct payments – whether decoupled or not-would, of course, be subject to cross compliance conditions – with all the same logical difficulties as discussed above.

enable the information system to become a comprehensive land management tool for the benefit of the land managers as well as the administration<sup>17</sup>. The audits proposed in the MTR would be an important contribution to this, and it is realistic to acknowledge (as the MTR does) that there is an initial investment required setting up the systems.

### 3 An overview of CAP reform mechanisms

The ideas for greening Pillar 1 were developed in the months preceding the publication of the Commission's Mid Term Review. Broadly, we share the Commission's vision for the future shape of the CAP. The task of the next few months is to decide how best to set off towards this vision. The MTR indicates the Commission's suggested route. The purpose of this section is to examine how this fits with Greening Pillar 1 and other suggested routes for the next stage of reform.

The CARPE report summarised the process of changing the balance of objectives and therefore instruments of the CAP in a diagram depicting the shares of the budget devoted to four broad categories of measures. The robustness of this analysis is demonstrated by the fact that the same four categories of support are still relevant although time and fashion results in slightly different labels for them. The four categories identified by CARPE and their current equivalents are:

- |   |   |                           |
|---|---|---------------------------|
| ▪ Market Stabilisation                          | - | Safety Net                |
| ▪ Transitional Adjustment Assistance            | - | Decoupled Direct Payments |
| ▪ Environmental and Cultural Landscape Services | - | Agri Environment Schemes  |
| ▪ Rural Development Incentives                  | - | Rural Development schemes |

The essence of CARPE was that the importance of the Commodity Market Organisations (CMOs) would continue to decline and be transformed into Market Stabilisation measures. Whatever remained of the direct payments would become Transitional Adjustment Assistance, and much of the existing Direct Payments would be switched into Agro-Environment and Rural Development. The principal deficiency of this analysis was the absence of discussion of the mechanisms to bring about these changes. Agenda 2000 provided the policy vehicle of the Rural Development Regulation (1257/99) to receive more of the funds and the Horizontal Regulation (1259/99) was supposed to provide a mechanism to shift the funds between Pillars. However the voluntary Modulation mechanism has proved an insufficient instrument to bring about a real shift in resources.<sup>18</sup>

The thrust of the MTR proposals is to decouple direct payments and move more resources into agro-environment schemes and rural development. The main questions are how to do this, and at what rate. This paper focuses on the mechanisms: The complexities of doing this and the quite different characteristics and impacts of

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<sup>17</sup> It has been observed (MARTIN HAWORTH of the UK National Farmers Union), that the IACS system really is a missed opportunity. It provides no service beyond administrative control. Even for this purpose it was found wanting; for example, it turned out to be of no assistance at all in tracing animals during the UK, Foot and Mouth Disease epidemic in 2001.

<sup>18</sup> The principle reasons for the 'failure' of voluntary modulation have been cited as the problem of finding match funding, and the risk to a Member State of exposing its own farmers to unfair competition from those in other Member States where the direct payments are not cut.

available mechanisms. The rate of change under the chosen mechanism will be decided by political negotiation. The mechanisms have acquired unusual and difficult names with no generally agreed definitions. Tables 1 and 2 represent an attempt to define these mechanisms and their properties. The tables show five adjustment mechanisms.<sup>19</sup> Of these, only the first currently exists.

- **Voluntary Modulation** was proposed as part of the Agenda 2000 package. It is defined in Article 4 of the Horizontal Regulation 1259/99.<sup>20</sup> It allows member states to reduce direct payments by up to 20% and switch the funds into certain Pillar 2 measures. It is in play in the UK, rising to 4.5% by 2004. Until the French Presidential elections in June 2002, it was in play in France at a similarly modest level.
- **Decoupling and Compulsory Modulation.** These are the core elements of the MTR.<sup>21</sup> The essence is that most direct payments are to be converted into historically-based decoupled direct payments (DDP), and these are to be cut by a small amount per year which rises cumulatively to 20%.<sup>22</sup> The smallest farms are to be exempt from the payment cuts, and largest farms are to have a ceiling in their payments.<sup>23</sup>
- **Greening of Pillar 1 (GP1)** is the suggested alternative approach in which part of the production linked direct payments is converted to environmental payments within Pillar 1. This leaves to be decided the fate of remaining Pillar 1 payments.
- **Degressivity** was debated in the final stage of the Agenda 2000 process but not adopted. We are not aware of the existence of a definitive statement on degressivity. The most common interpretation is that involves the progressive reduction of Pillar 1 direct payments. Most proposals suggest differentiating the rate of cuts by farm size, and the presumption is that some, but not all of the funds saved are switched to Pillar 2 schemes. It is not clear if the recycled payments remain with the Member State or are 'returned to Brussels' for redistribution.
- The **Bonds** idea has six components: decouple payments from crop and livestock production, further decouple them from land, fix the duration and extent of the payments and transform them into bonds. These ideas have been promoted for many years by TANGERMANN and his collaborators. The current version is described in SWINBANK and TANGERMANN (2000).<sup>24</sup>

The jargon introduced by this discussion is the invention of Euro-imagination and gives rise to considerable confusion. We therefore summarise our interpretation of what these

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<sup>19</sup> We note in passing that another mechanism for achieving some of the objectives of further CAP reform seems to have gone off the agenda, namely re-nationalisation of the direct payments. We choose not to discuss this as it is a pure financing mechanism rather than concerned with adjusting the purpose of the policy.

<sup>20</sup> Note the voluntary refers to the member state's choice of whether to implement the scheme. Given the decision to implement, it is compulsory on farmers in that MS.

<sup>21</sup> There are of course many other important proposals in the MTR not considered here because we are concerned in this paper in the mechanisms of bringing about reform and not the details of the reform.

<sup>22</sup> Of the total direct payments of € 26.3b (excluding accompanying measures) the COPs, Beef and Sheep payments due to be decoupled account for €22b (83%). The direct aids omitted from the decoupling are for olive oil, dried fodder, textile plants, fruit and vegetables, tobacco and others.

<sup>23</sup> The criteria for defining the size of farm and thus whether they are exempt from payment cuts or have their payments capped, is the size of CAP direct payments and the farm labour force.

<sup>24</sup> In this analysis we do not explore all aspects of the Bonds idea, particularly the debate on whether they are attached to land or seen as entitlements for individuals.

terms mean in Table 1. This shows the presence or absence of six features of the five mechanisms. Further explanation is given in the following paragraphs.

**Decoupling** the pillar 1 direct payments means removing the direct connection between the receipt of a payment and the current (or future) areas, animal numbers, production or prices of agricultural products. It is a defining feature of Bonds Scheme, it is a core part of the MTR. It could be part of the Greening Pillar 1 idea, although the necessity to do this depends on how much of these payments are Greened and how much switched to Pillar 2. It was not part of the Agenda 2000 modulation, but it could be part of degressivity.

A prime reason for decoupling the production-linked, and thus trade distorting, direct payments is to make them more legitimate, and specifically, eligible for the WTO Green Box. It might be thought that part of the purpose of doing this (as seen by EU rural interests) is to render payments exempt from reduction commitments. However, avoiding reduction commitments cannot be the aim of decoupling. Proposals to decouple the payments, such as the MTR and the Bonds Scheme, also propose cutting them!

Table 1: Adjustment mechanisms for the CAP (N = no; Y = yes)

<i>Features</i>	<i>Adjustment mechanisms</i>				
	<b>Modulation Agenda 2000</b>	<b>MTR Dynamic Modulation</b>	<b>Greening Pillar 1</b>	<b>Degressivity</b>	<b>Bonds</b>
<b>Decouple the pillar 1 Direct Payments (DPs)</b>	N	Y	Y in part	?	Y
<b>Decrease the payments annually and cumulatively</b>	Y	Y	Y	Y	Y
<b>Phase-out the payments, Allow capitalisation</b>	N, N	?, N	?, N	?, N	Y, Y
<b>Switching payments into second pillar</b>	All	All	Little	Some	Little
<b>Convert Pillar 1 DPs into AEPs<sup>25</sup> within Pillar 1.</b>	N	?	Y	N	N
<b>Differentiate payment cuts by farm size</b>	Y	Y	?	Y	N

Indeed, once payments are divorced from production (and anything else) it is even more difficult to explain what they are for and to avoid such cuts. The Commission's proposals to impose cross-compliance conditions will not protect these payments for long. First, the notion of cross-compliance has always implied that the payments have some primary purpose, but at the same time it is reasonable to ensure coherence with other objectives of policy such as respect for the environment, food safety and animal welfare.<sup>26</sup> When the payments are divorced from the compensation principle and from

<sup>25</sup> AEP = Agro-Environment Payment

<sup>26</sup> The inclusion of food safety in this list is a particular example of pure political rhetoric – it implies that there is no need, or less need, to worry about the safety of foods not covered by decoupled payments, like pig and poultry products, olive oil or fruit and vegetables! This is, of course, nonsense. *All* food is, and should be, subject to food safety regulation and sanctions for non-compliance.

production, the primary purpose has evaporated.<sup>27</sup> Second, the cross-compliance conditions proposed are existing statutory EU and Member State environmental, food safety and animal welfare regulations. The public are entitled to ask why compliance with these laws is not already expected without the bribes of DPs. Likewise, producers are entitled to ask why they are to be doubly punished, first by the normal legal sanctions resulting from non-compliance with the law, and second, by loss of their long-established payments. Third, a big part of the policy changes (in all options except Bonds) is to put significantly more money into agro-environment schemes. The reference level for environmental performance in all these schemes is certainly well above the statutory legal requirements. If, as many propose, the new agro-environment schemes are rolled out to cover most of the agricultural area, then the Pillar 1 cross-compliance conditions become redundant, covering a smaller part of the total area at lower environmental standards (see Figure 1 above).

**Reducing the direct payments** in Pillar 1, whether decoupled or not, is a core part of *all* five mechanisms. The main distinction between the mechanisms is that in the case of GP1, the main idea is to convert the purpose of part of the direct payments to payment for basic environmental stewardship, the non-greened part is either switched to Pillar 2 or would be subject to gradual reductions. This means that at similar rates of policy change over all options, Pillar 1 expenditure will fall by less under GP1 than the others.

**Phasing out DPs and allowing capitalisation** of payments is the main idea of the ultimate component of the Bonds proposal, though, curiously, its authors suggest that failing to complete this final step does not demolish their idea.<sup>28</sup> Agenda 2000 mentioned neither of these ideas. Whether decoupled payments (which are not tied explicitly to environmental, or other public good, delivery) can persist indefinitely is not addressed by the MTR, GP1 or degressivity. None of these three mechanisms mentions 'phasing out, i.e. ultimately eliminating, direct payments. Neither do these three suggest capitalisation of the payment streams.

**Fund switching** is one of the two defining features of so-called Modulation (see footnote 29). The interpretation in Agenda 2000 is that all funds cut from direct payments are switched, within the same member State, into Pillar 2 agro-environment and rural development schemes. The purposes to which the switched funds can be put in Pillar 2 are also restricted: they can only go to schemes directed at farmers under the so-called accompanying measures. Under degressivity, it is generally assumed that only part of the 'savings' on direct payments is redirected to the Rural Development Regulation. The authors of the Bonds idea are mostly concerned with finding an exit strategy for the mainstream direct payments and have been rather sceptical about the necessity to bolster the second pillar. However, more recent versions of their proposal acknowledge that the Bonds would be part of a more comprehensive reform allowing some fund switching into Pillar 2 as an option. Converting Pillar 1 direct payments into environmental payments is the essence of GP1. The logic of this approach is that if there is political reluctance to switch funds from Pillar 1 to 2, then why not seek to convert some of the Pillar 1 payments to their more justified purpose without shifting them between pillars? It is interesting to note that the Commission's MTR proposals

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<sup>27</sup> The reference in the MTR to direct income payments is not very convincing either. There is no attempt now, and there is no proposal in the future, to discover the income of the recipients of DPs or DDPs. With a very wide range of degree of dependence on farming amongst recipients, and evidence in many MS that rural households are financially better off than urban households, this is at best an extremely blunt instrument of social policy. In any case it has always been difficult to explain why one particular occupational group (*some* farmers) deserves a special and additional category of social payments compared to all others in society.

<sup>28</sup> A Bond Scheme which does not offer a bond seems contradictory!

contain elements which could be interpreted partly as Greening Pillar 1 – specifically, the proposals for cross-compliance and set-aside. The MTR proposals also, understandably, abandon the notion that funds recycled through Modulation necessarily remain in the same Member State. Furthermore, the MTR proposals widen the range of actions for which switched funds may be directed, but not beyond farmers.

The sixth characteristic of the mechanisms is the *differentiation or modulation of the payment cuts by farm size*. This sounds as if it ought to be a defining feature of Modulation schemes. However, linguistic confusion was sown when the UK interpreted the Agenda 2000 Modulation mechanism as not requiring any differentiation amongst farmers in the payment cuts.<sup>29</sup> In the UK a flat percentage rate of cut has been applied to all direct payments irrespective of the size of the recipient. The MTR proposals, and also proposals for degressivity, contain strong elements of modulation. If politically desired, some modulation of any cuts in the non-greened portion of DPs could figure in the GP1 proposal. The Bond scheme, as an exit strategy for direct payments, does not bother with modulation.

The debate on the merits of these schemes, as seen by the Member States and interest groups, has been intensified by the publication of the MTR. It may help this discussion to elaborate further on some of the most important properties and impacts of the five mechanisms. These are summarised in Table 2, and explained in the following paragraphs.

Table 2: Properties and some Impacts of CAP Adjustment Mechanisms

<i>Properties &amp; impacts</i>	<i>Adjustment mechanisms</i>				
	<b>Voluntary Modulation</b>	<b>Decoupling and Compulsory Modulation</b>	<b>Greening Pillar 1</b>	<b>Degressivity</b>	<b>Bonds</b>
<b>EU Budgetary Cost</b>	=	=	= or ↓	↓	↓
<b>Member State Budget Cost</b>	↑	↑, ↓ or =	=	↓ or =	↓
<b>Redistribution between Member States</b>	N	Y	?	Y	N
<b>Redistribution between farms</b>	?	Y	N	Y	N

*The EU budgetary cost* of the proposals is of great interest for all member States.<sup>30</sup> The net contributors to the budget, (especially Germany, UK, Sweden and the Netherlands), are mostly concerned that the mechanism should provide a route for cutting this cost.<sup>31</sup> Other member states are more concerned with preserving the current level of support to farmers. Table 2 shows that fund-switching mechanisms of Modulation are designed to maintain (EU) “budget neutrality”, although in the MTR paper this is only specified for the period of the current financial perspective, until the

<sup>29</sup> It is important to note that this interpretation has been accepted by the Commission, thus Modulation need not imply modulation! To try and rescue the integrity of the English language we denote the mechanism of Modulation as a proper noun, and the act of differentiating payment cuts within this mechanism as a common noun: modulation.

<sup>30</sup> Note that in most of what follows the discussion is confined to the EU-15, and not to the applicant states.

<sup>31</sup> This is based on reported statements of Ministers at the open, televised, Agriculture Council of 15/7/02.

end of 2006. An important purpose of both degressivity and bonds is to reduce FEOGA costs. The GP1 mechanism could do either.

*The Member State budget costs* here refers only to the MS co-financing of CAP expenditures. Since the publication of the MTR this is more difficult to analyse. Until this document appeared, the logic, and indeed appeal to farmers, of Modulation was that not only did it preserve the level of EU expenditure, but it required additional Member State expenditure.<sup>32</sup> This came about because funds switched from (the 100% FEOGA financed) Pillar 1 required on average the same amount of extra Member State match funding from their finance Ministries to implement the co-financed Pillar 2 measures. The proposed Dynamic Modulation in the MTR apparently breaks this link. The Commission asserts that “no additional budgetary effort” will be required from the Member States to implement the proposals.<sup>33</sup> This relaxation of co-financing requirements arises from the proposal that Member States will, apparently, have the option to avoid co-financing new funds switched into Pillar 2, and from the proposed reductions in MS co-financing rates for certain existing, and new, measures. Thus the outcome for MTR Modulation, and one assumes also for degressivity, is that the Member State budgetary impact is indeterminate. It depends on the outcome for co-financing rates in Pillar 2, on the extent of Member State discretion available for this, and on the share-out of the additional Pillar 2 funds. For any MS, under the MTR and degressivity, their co-financing responsibility could rise, fall, or stay the same. The purpose of Bonds is to reduce both the EU and MS financial burden. This is not explicitly a purpose of GP1, though it could be.

*Redistribution of support between the Member States.* This is quite explicitly one of the objectives of the MTR proposals. Again, it must be assumed that it would also apply if degressivity is pursued as an active option. Redistribution is explicitly ruled out by the existing Agenda 2000 Modulation, and it is not part of the Bonds proposals. It could be part of any cuts in remaining DPs in the GP1 proposal. The redistributive effect of the MTR derives from two sources: the way Pillar 1 payments are reduced, and the explicit redistribution of these funds to Pillar 2. If the reduction in DPs was applied as a flat-rate percentage cut, it would contribute funds in proportion to the current distribution of the direct payments (which is uneven). If in addition, the payment cuts are modulated, the redistributive effect will depend on the modulation formula.<sup>34</sup> Countries with more, larger and more capital intensive farms would contribute more. Some countries would hardly contribute at all, as the majority of their farms are below the cut-free franchise.<sup>35</sup> The Commission’s proposed criteria for redistribution of additional Pillar 2 funds will inject a welcome element of objectivity into the allocation of Pillar 2 funds.<sup>36</sup> The criteria proposed are agricultural area, employment and general

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<sup>32</sup> It was also part of the appeal to farmers that Modulated funds remained within the Member State and could only be spent on farmer-oriented measures. The MTR proposes to change both of these features.

<sup>33</sup> It is not completely clear if this refers only to the period until 2006.

<sup>34</sup> The Commission’s formula comprises a no-cut franchise of € 5000, plus € 3000 per additional annual work unit on the farm, and a ceiling of € 300K in DDPs. Numerous other formulae are of course possible. French modulation had a € 30K franchise and progressively larger cuts in successive higher bands of DPs with allowances for labour employed.

<sup>35</sup> The modulation parameters of the MTR proposals are calculated to exempt 75% of farms accounting for 20% of payments. In the scale of fund switching proposed, the ceilings of € 300K are a distraction. They move relatively few funds, and in any case the Commission has proposed that they should remain with the affected MS so do not affect the distribution argument. This proposal also removes the possibility of cutting part of the total payments, which, unfortunately, affects most the two countries keenest to bring about cuts in total expenditure (Germany and the UK).

<sup>36</sup> It prompts the thought whether such redistribution should not also apply to the existing RDR funds.

prosperity levels, ideally the criteria would be the demand for agro-environment services and rural development, these factors are probably the most workable proxies.

**Redistribution between farms** is an essential part of the MTR Modulation proposals. It is escapable under Agenda 2000 Modulation as demonstrated in the UK. It is likely to be part of degressivity, and could be part of GP1. Note that modulation is only partly based on Robin- Hood-principles, it takes from the large, but it gives no more to the small. The other way in which funds can be redistributed between farms is in the way that the additional Pillar 2 funds are deployed. Non-competitive entry schemes such as broad application stewardship (see paragraphs below), or less favoured area payments, are accessible to all farms meeting the eligibility criteria (which could be wide). On the other hand, other schemes for agricultural development (improving marketing, encouraging producer groups, training etc) are generally operated through competitive entry and tend therefore to accrue to the more alert farmers who are engaged with officialdom. Such schemes are often criticised by small farmers as too bureaucratic and thus inaccessible.

**To summarise.** The debate facing the EU over the coming years, concerns the choice of how to bring about a CAP which is less distortive of commodity markets, and more capable of delivering the non-market services by land managers and encouraging wider rural development. This has to be done at a rate acceptable to the recipients of the existing support regimes. The rate at which these mechanisms could be put in place and the timing are political decisions. However it helps consideration of the options and their effects to illustrate the implications of the sort of changes under discussion. This is done in Figure 2.

The figure updates and amends the diagrammatic representation of the broad reform options in the style shown in the CARPE report. The figure shows the budget distribution by function in 2002 and in 2020 for three reform options. The vertical axis is scaled in billions of Euro (i.e. the absolute budget allocations not just the shares as in the original version of this diagram). In 2002 about 86% of EU budgetary resources were allocated to the pillar 1 (light shaded) Commodity Market Organisations (CMOs) and Direct Payments (DPs). The remaining 14% of funds (darker shaded) were devoted to the second Pillar Agro-environment Schemes (AES) and Rural Development (RD) actions.<sup>37</sup>

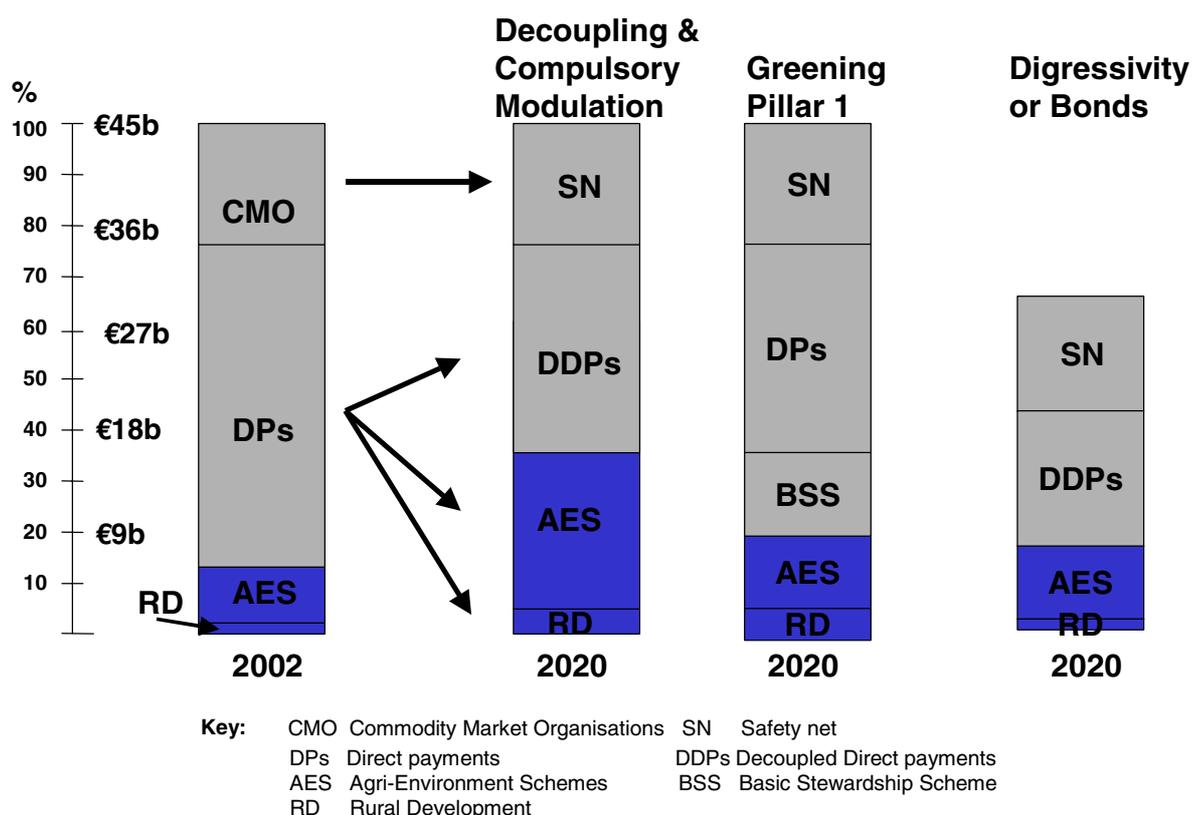
To simplify the presentation, only three of the above five adjustment mechanisms are shown: Decoupling and Compulsory Modulation, Greening Pillar 1 and Degressivity. The intention is to illustrate the broad orders of magnitude, and therefore the schemes are shown way out into the future in 2020. We have not analysed the specific commodity market issues and the conversion of milk, sugar and other unreformed sectors to the new approach. For this reason it is assumed that the non-direct payment part of Pillar 1 (€ 11b) changes only in name to remind us of its main future *raison d'être*.

Under the option of **decoupling and compulsory modulation**, the assumed rate of cut in direct payments is 3% per annum, starting in 2004 and rising to 20% in 2010, this is projected forward rising to 50% in 2020. It is further assumed that 20% of the DDPs are exempt from cuts, and for simplicity the ceilings are ignored. The outcome is that by

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<sup>37</sup> Including the accompanying measures, even though these are financed from FEOGA guarantee.

Figure 2 Reforming the structure of the CAP (EU-15)



2020 Pillar 2 has grown to € 17b (37% of the constant FEOGA total of € 45b.) and DDPs have declined to € 17b. We have shown the shares of Pillar 2 funds between Agri Environment Schemes and Rural Development as remaining in their current proportions.

In the **degressivity option**, the same rates of reduction in Direct Payments, and exemption from cuts are assumed, but in addition it is assumed that only 25% of the funds saved are switched to Pillar 2. The result is a decline in total FEOGA expenditure from € 45b to just under € 30b, of which about € 12b is DDPs, and just under € 7b is Pillar 2 measures.

The illustration of the **Greening Pillar 1** option assumes the same rate of transformation of Pillar 1 payments into environmental payments as the MTR. Thus the Direct Payments decline to the same level. The main difference is that all the growth in Agri Environment Schemes is achieved within Pillar 1 under what we have termed a Base Stewardship Scheme. For simplicity the existing Rural Development and Agri Environment Schemes are shown not to evolve from their 2002 levels. Taking this extreme case is enough to demonstrate that in reality Greening Pillar 1 would have to be accompanied by some fund switching from Pillar 1 to 2 to enable more RD activity.

#### 4 Concluding comments

**Political cost effectiveness.** This is the essential argument to be judged. How can the social performance of EU land management, and thus the internal EU political legitimacy of the CAP, be strengthened most quickly and effectively? The case for Greening Pillar 1 is that it offers the possibility of achieving more gains in this direction

across a larger part of the rural territory, and faster, than the alternatives. The alternatives are strengthening the purpose-built agro-environment schemes under pillar 2 by fund switching using Modulation or degressivity. Part of this judgement must be the real effectiveness of the greening. There is a danger that the most politically acceptable way of greening the CAP is the one which offers the least demanding real change in practices and thus minimal real environmental delivery. Emphatically, this is **not** our purpose. There should be no reason to assume that Greening Pillar 1 offers to farmers' organisations the hope that they will get less demanding schemes than under Pillar 2. Whether a base stewardship scheme is implemented in either pillar it should have the same restrictions and same sanctions for non-compliance. The difference lies in the, far from trivial, financing arrangements and ease of bringing about the policy change.

More analysis is required to make judgements about the relative institutional and administrative ease of engaging a large proportion of farmers into delivering environmental services through schemes delivered under pillar 1 or 2. It is not obvious that there would be any fundamental difference at all. The practical challenges of defining the 'rules' of the entry level, base tier land stewardship scheme, for example, would be no different whether they are implemented under either pillar of the CAP. The argument essentially boils down to the scale of what we have in mind, in particular, whether the objective is to have agro-environment schemes embracing a minor part of the land area or the majority.

There remains a feeling that Greening Pillar 1 is an opportunistic, supply-driven approach to policy change. Production payments exist, how can we legitimate them? There is truth in this, but it is unavoidable. It is in the nature of the provision of public goods that there is no market place to establish the demand, therefore the political market place is used to agree the funds available to fulfil the social needs. Schemes to deliver the service are then devised within this budget. The current debate can therefore be seen as an exercise in establishing the budgetary limits for public environmental and cultural landscape schemes and rural development.

**EU budgetary considerations.** This is an extremely important factor. The fact that Pillar 1 payments are obligatory expenditures from the EAGGF guarantee section and are 100% EU financed, offers, possibly, a more secure way of publicly funding environmental payments. This is how the issue might be seen by environmental NGOs, net FEOGA beneficiaries, poor countries and the applicant countries. The contrast is that Pillar 2 agro-environment schemes rely on non-obligatory, co-financed expenditure.<sup>38</sup> To combat this differential attraction of Pillar 1, perhaps there could be a greater range or flexibility of co-financing arrangements for second pillar measures in relation to environmental demands and ability to pay amongst the regions.

**Wrong starting point?** On the other side of the balance it might be argued that achieving environmental benefits by Greening Pillar 1 is starting in the wrong place. Why should the recipients of direct payments be the most important target group for environmental amelioration? If public money is to be devoted to producing an incremental improvement in resource protection and biodiversity would we choose to start from those areas which are recipients of arable and livestock direct payments? Actually, the rational answer is indeed, yes. These are the farmers who have been led, by the previous support system to focus more on agricultural output rather than on the environmental outputs (quantity rather than quality). If European society really wants

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<sup>38</sup> Although the Commission has proposed raising the EU co-financing from 50% to 60%.

(and is prepared to pay for) better environmental performance over most of its managed territory than what better place to start with the areas engaged in some of its most intensive production? Because recipients of direct payments occupy, it is estimated, in the region of 60% of the agricultural area, then much, perhaps most, if not all, of this territory *would* be the target for environmental improvement in purpose-built agro-environment schemes. The complaint is just as likely to be why *only* the present area subject to direct payments is subject to the proposed reform? Why not the land presently occupied in dairy farming, sugar, wine, olive oil, tobacco and horticultural crops too? To answer this we must answer another question, how much of these landscape and biodiversity goods does the public wish to buy? We don't require the road system or industrial parks to supply biodiversity or landscape, so why the glass house or field-scale vegetables area? Second, we can only work from existing policy thus to achieve the switch in payment justification over the area occupied by COPs, beef and sheep would already be a significant advance.

**Overlap, confusion and duplication with second pillar.** If the first-best solution to deliver environmental and cultural landscape services is from custom-made agro-environment schemes, then trying to achieve the same objectives via Pillar 1 may further confuse and complicate the CAP. Whilst true, it may be unavoidable. However another view is that the bulk of existing support can be justified on environmental grounds therefore sooner or later the whole CAP has to be greened. It does suggest however that policy makers keep a very clear strategic view of the way the CAP is evolving so that there can be a route through which, temporarily distinct programmes in pillar 1 and pillar 2 which produce related outcomes can, ultimately, be re-united. This was illustrated in Figure 2. It should be noted that the Commission's MTR proposals do not avoid muddying the water. The MTR appears to contain four new agro-environment ideas: (i) to continue set-aside as an environmental measure in Pillar 1. (ii) The suggestions for environmental cross-compliance of Pillar 1 decoupled payments. (iii) The proposed new 'Meeting Standards' and 'Quality' chapters of the RDR involving temporary payment for higher environmental standards. (iv) The extra resources for Pillar 2, much of which presumably will be allocated to agro-environment schemes. This does not sound much different, and is certainly no simpler than the ideas presented here.

It will be difficult to avoid **effects on competition** between the EU member states if the determination of the environment conditions is devolved to national or regional level. Whether these will constitute serious market distortions is difficult to judge as a general point. The question is the intra-EU equivalent of the non-trade concerns argument currently being discussed under the WTO. If, in each member state, there were a perfect match between consumers purchasing behaviour and citizens willingness to impose environmental requirements and costs, then there would be no distortions. However this seems an unlikely coincidence. It is more likely that MS whose citizens and NGOs have the taste for the strictest environmental conditions and whose consumers are the least discriminating are likely to see their market shares of affected production fall most. However these considerations will apply whether environmental schemes and their restrictions are implemented in Pillar 1 or Pillar 2. In fact as the latter are co-financed, and consequently less controlled from Brussels, this might be a greater problem for Pillar 2 schemes than those in Pillar 1.

At the very least some greening of Pillar 1 direct payments is essential for reasons of policy coherence. The EU can not justify spending significant public money through agro-environment measures under the RDR and take no action to ensure that this effort is not undone by the much greater sums of public money spent on direct payments. This

and the Treaty requirement that all policies must pay due attention to the respect of EU environmental directives, were the motivating forces for the Article 3 environmental requirements in the Agenda 2000 Horizontal regulation.

In addition to the internal political motive for greening Pillar 1 payments we also consider the international, WTO, motive to green these supports. Under this heading our conclusion is that a *token* environmental greening is not likely to satisfy international pressures to reduce the trade-distorting effect of these domestic supports. To achieve this would require a more fundamental decoupling of the payments, for example by linking payments to past and not current levels of eligible crops and animals, and releasing farmers to determine their crop areas and livestock numbers in accordance with market demands. It is worth noting that fully decoupling Pillar 1 payments, in itself, has the capability of providing environmental benefits as if it were achieved it would open even greater possibilities of environmental linkage. This is because it would be very hard to explain to European taxpayers what the decoupled payments were for, unless they were then tuned to the delivery of environmental services.

This paper has considered taking these ideas much further. We do not support *token* greening. Having explained some possibilities and virtues of Greening Pillar 1, we compared this idea with other ways of achieving a socially more defensible CAP. It has not been our intention or expectation to find a conclusive set of arguments in favour of one of these approaches. Our hope is that setting out the possibilities and some of their advantages and weaknesses is a contribution to the debate.

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