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Direct Payments between Income Support and Public Goods

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Abstract. Direct payments maintain a fundamental role in the future CAP, since they still absorb a high share of the CAP budget. However, despite some confirmations (mainly related to internal convergence, types of interventions and the role of genuine/active farmers), several relevant innovations (e.g., a reinforced cross-compliance, new eco-schemes that replace the greening payments, a new capping model) are expected to affect their implementation and the way they contribute to achieving the CAP goals. The aim of this article is twofold. First, it analyzes the innovations that are going to be applied in relation to direct payments, following the two strategic objectives these public aids have been traditionally called to pursue: enhancing income support and fostering the provision of environmental public goods. Secondly, it focuses on three types of direct payments – basic income support for sustainability, eco-schemes, coupled payment – in order to provide indications on their greater effectiveness, with particular reference to the Italian case.

Keywords: Common Agricultural Policy, direct payments, flate rate, eco-schemes.
JEL codes: Q18.

1. INTRODUCTION

Direct payments will play a key role in the future post-2020 CAP in order to ensure an income support to farmers and the supply of public goods, in line with the aim of promoting a resilient and smart agricultural sector.

The new post-2020 CAP classifies payments into two categories and six types¹:

- decoupled: basic income support for sustainability, redistributive complementary support, complementary support for young farmers, climate and environment schemes (*eco-schemes*);
- coupled: coupled income support (coupled payments include also the specific payment for cotton which does not concern Italy).

In order to ensure a fairer and more efficient distribution of payments, the new CAP provides for:

¹The optional possibility remains for the Member State to provide for a specific flat-rate payment for small farmers, replacing all direct payments, the definition of which must be reported in the national Cap strategic Plans.

- the sub-division of the ceiling into several payments for a more target-oriented support within the CAP;
- historical payments abolition with the aim to come to a uniform payment for all the eligible area or alternatively a solid convergence towards uniform payment;
- a redistributive payment to provide targeted support to small and medium-sized farms;
- abolition of *greening* payment, whose commitments are partly included in the cross-compliance policies;
- introduction of voluntary schemes for the climate and the environment (*eco-schemes*);
- mandatory *capping* of the total amount of direct payments taking into account the amount of work to avoid negative effects on employment;
- support for farmers who carry out an agricultural activity to «earn a living», re-proposing the principle of the «active» farmer.

The importance of direct payments became clear also in the Commission notice published on 29th November 2017² as they are considered to be an instrument to bridge the gap between farmers' income and those engaged in other sectors, to boost agriculture resilience as well as the compensation for the provision of public goods agriculture (Guyomard *et al.*, 2020).

2. BETWEEN INCOME SUPPORT AND PUBLIC GOODS

Recognising the role of direct payments in the new CAP is relevant and not trivial. Two objectives – income support and sustainability – have been constantly pursued in the history of the CAP, since 2003 (Fischler Reform) onwards, notwithstanding the uncoordinated use of a set of instruments, often confused and heavily influenced by path dependency and political mediations at sectoral and territorial level.

Based on these considerations, one may wonder if the direct payments confirmation may be widely shared and if these aids may be considered able to meet the future challenges.

Before trying to answer to these questions, a premise is necessary. The CAP reform is not the main driver of change for farms, and the impact among them is not uniform (Lobley, Butler, 2010). Many simulations and large amount of modelling have been unable to provide confirmation of the final effects of the reforms which – in most cases – were much «lighter» than the initial assumptions (Balkhausen *et al.*, 2008; Gorton *et al.*, 2008). All in all, CAP should not be considered the driving factor of all agricultural transformations.

Change is also driven by other factors, such as market dynamics, tax policies and trends of input prices (land, labor). In this regard, it is quite straight forward that the importance of these factors has steadily grown since the CAP gave farmers more freedom, by decoupling direct payments, dismantling sectoral policies and strengthening the second pillar (Matthews *et al.*, 2006).

Nonetheless, the CAP plays a great role and like all public policies, it must focus its resources and its interventions just in case of «market failures», in particular with regard to those goods and services for which *the market does not exist* (this is the case of public goods: environmental goods, biodiversity, landscape conservation, soil fertility, water quality, water resources-agricultural use, fight to climate change, rural development, etc.).

This solution is particularly beneficial in all those cases where, like in the agricultural practices, public benefits are obtained through multifunctional production processes. In these cases, the expediency consists of the connection between private good, remunerated by the market price, and public good, remunerated by the State.

The alternative would be much more expensive for the society, as to produce the aforementioned public goods (or to avoid public bads) an alternative programme to agriculture should be implemented by employing ecological workers, civil protection, firefighters, park workers, gardeners, etc.

3. THE CAP FOR THE REMUNERATION OF PUBLIC GOODS

The need for a common European agricultural policy aimed at «paying» the production of public goods and services to the primary sector has become increasingly evident in the evolution of the CAP. From MacSharry onwards, all the CAP reforms have always increased financial resources in favour of a more environmentally sustainable agriculture:

- the first agri-environmental measures arising with the *Mac Sharry* reform in 1992 were initially regarded with suspicion by farmers, but within a few years everyone began to know and adopt them;
- *Agenda 2000*, which put in place the second pillar of the CAP;
- the *Fischler reform* through cross-compliance, so that the direct payments also had to comply with environmental standards (SMR) and Good Agricultural and Environmental Conditions (GAEC);
- *Health Check* through the strengthening of the second pillar of the CAP and by allocating more

² European Commission, The Future of Food and Farming, COM(2017) 713, Brussels, 29.11.2017.

resources for specific agri-environmental measures (biodiversity, fight to climate change, water management, bioenergy);

- the CAP 2014-2020 through the *greening* payment on the first pillar and the enhancement of agri-environmental measures in the second pillar.

The post-2020 CAP provides further guidelines with regard to the compensation of public goods, through:

- enhanced compliance encompassing most of the greening commitments;
- the climate and environment scheme or eco-schemes;
- increased environmental measures in rural development policy.

Nonetheless, the environmental associations and many scholars (Matthews, 2020; Navarro, López-Bao, 2019; Pe'er *et al.*, 2019) were deeply disappointed by the choices about the CAP and have openly accused European politicians of betraying the objectives related to the environmental sustainability, especially after the expectations raised by the European Green Deal, by the «A Farm To Fork» strategy³ and the «Biodiversity strategy»⁴.

On the ground of economy and economic policy, and having in mind what would be theoretically desirable in terms of efficiency and equity, the new CAP is disappointing; in that, its earlier promises are still far from being kept in terms of innovation and from providing a real drive towards a policy aimed at remunerating public goods and the positive externalities of agriculture. However, realistically taking into account how the «political compromise» works (Petit, 2020) and the complicated decision-making mechanisms⁵ at stake, the post-2020 CAP can be considered as an acceptable compromise, which – although not fulfilling the initial ambitions – does not stray from the main objective of public goods compensation (Guyomard *et al.*, 2020).

The CAP progress in this field is consistent with the economic policy indications; if anything, the problem is the need to be more effective in terms of tools. To this end, this paper especially focuses on three types of direct payments (basic income support for sustainability, eco-schemes, coupled payment) in order to provide guidance on their greater effectiveness.

³ European Commission, A Farm To Fork strategy for a fair, healthy and environmentally-friendly food system, COM(2020) 381, Brussels, 20.05.2020.

⁴ European Commission, EU Biodiversity Strategy for 2030. Bringing nature back into our lives, COM(2020) 380, Brussels, 20.05.2020.

⁵ The 2014-2020 CAP and the post-2020 CAP are the first reforms after the Lisbon Treaty, according to the legislative procedure of codecision between the European Parliament and the Council.

4. BASIC INCOME SUPPORT FOR SUSTAINABILITY

Member States shall grant a basic income support payment in the form of annual decoupled payment per eligible hectare to *active farmers*.

The first innovation of the post-2020 CAP, to which adequate attention should be paid, is the new name of the basic payment⁶, reported in the proposed regulation as *Basic income support for sustainability*. This name clarifies and justifies the role of direct support to farmers: an income aid to remunerate farmers' contribution to sustainability. In other words, the new payment is an income support to bridge the gap between farmers' income and that of other sectors (Ciliberti, Frascarelli, 2018), increasing their resilience and taking into account that agriculture is a sector producing public environmental goods (Matthews, 2017; Engel, Muller, 2016). The support is therefore a remuneration for sustainability, outlined by the cross-compliance commitments. The new name *Basic income support for sustainability* therefore answers unequivocally to the detractors of direct payments (Sotte, 2017), by clarifying its purpose which is pursued in a uniform manner across the entire agricultural area of the Union.

The second innovation of the basic payment concerns the criteria for setting the amount which can be settled in two ways, at the discretion of the Member States:

1. as a uniform annual payment per eligible hectare, or rather a payment linked to the area, without entitlements;
2. allocating the support on the basis of aid entitlements (i.e., Member states can decide to continue granting basic income support on the basis of aid entitlements).

In other words, Member States can decide to move away from the Single Payment System (SPS) to the Single Area Payment System (SAPS).

The SPS needs to establish and manage individual aid entitlements, with the possibility of selling or renting; it is applied according to two models of entitlements allocation:

1. historical model, in force in 9 EU countries (including Italy)⁷, based on the allocation of the entitlements value considering historical references;
2. regional model, in force in 7 EU countries⁸, based on the allocation of uniform value entitlements at the regional level.

⁶ European Commission, Proposal for a Regulation of the European Parliament of the Council establishing rules on support for strategic plans, COM(2018) 392, Brussels, 01.06.2018.

⁷ The SPS with historical model has been adopted by Austria, Belgium, Greece, France, Ireland, Italy, Holland, Portugal and Spain

⁸ The SPS with regional model has been adopted by Denmark, Finland, Germany, Luxembourg, Sweden, Malta and Slovenia.

The SAPS is a simplified income support scheme, proposed to Member States that joined the European Union in 2004 with the aim to ease the implementation of direct payments⁹ in 2007.

Through the new post-2020 CAP, the EU offers the possibility to move away from the aid entitlements system to the uniform annual payment per eligible hectare (*flat rate*). The level of payment is obtained by dividing the country's annual financial envelope by its eligible agricultural area.

As an alternative to *flat rate* without entitlements, Member States may continue to grant basic income support on the basis of aid entitlements. In this case, the new CAP requires a process of convergence of historical payments.

Aid entitlements arose in 2005 with the decoupling under the Fischler reform, which had fixed the amount of support based on historical references during the period 2000-2002. Allocation of entitlements on historical basis had crystallized strong disparities between farmers and territories; however, at the same time, it was justified by the need to «acquire» the consent of farmers on a very radical reform as that of total decoupling was.

As early as 2005, Member States could choose between a historical model for allocating entitlements and a regional or uniform model (*flat rate*). Italy, along with 9 other Member States, had opted for the historical model, while the majority of Member States had adopted a regional flat-rate model.

With the *Health check* first, and then with the CAP 2014-2020, the EU has re-proposed the transition from payments based on historical data to «flat-rate» or uniform aid. In both reforms, Italy did not take the flat-rate option.

In the new post-2020 CAP reform, Italy has opted for the more conservative model, the so-called «Irish model» enabling a partial convergence in 2019, while maintaining the historical references of direct payments until 2020.

With the new post-2020 CAP, the same option is proposed again; the possibility of abolishing entitlements would be a real innovation for the direct payment scheme in Italy. The transition from historical payments to the flat-rate scheme, accompanied by the abolition of entitlements, offers two important advantages: justification and simplification.

In the long run, the historical model, based on previous rights, may be difficult to justify: it is not clear today, and even less tomorrow, why farmers who can

carry out similar agricultural activities shall receive different amounts of direct payments, creating inequalities in terms of competition. The fact that these payments derive from a different production situation during the period 2000-2002 does not justify the persistence of these differences.

The regional model (*flat rate*) foreseeing the abolition of entitlements offers many advantages: it allows to improve the accountability of the CAP towards European citizens, silence critics about the historical model of decoupling which «crystallizes and makes direct payments fully visible, weakening them from the point of view of their social and economic justification» (Henke, 2004), all the more so as they are linked to the – historical – *status* of farmer rather than to «virtuous» behaviours.

The abolition of entitlements strongly simplifies the management of direct payments, by abolishing the Entitlements Register as well as the transfer of entitlements which resulted in a high degree of complexity. Furthermore, payments without entitlements favour land and rental mobility (Ciaian, Kancs, 2012; Latruffe, Le Mouel, 2009; Ciliberti, Frascarelli, 2018) and stimulate market orientation through the abolition of high-value entitlements that may lead some farmers to «settle for» the support from the CAP (Frascarelli, 2019).

The only (weak) advantages to maintain entitlements are a gradual transition towards uniform support, without significant impact on income, and a higher support for some strategic sectors (milk, beef, durum wheat, olive tree).

In light of the clear predominance of the advantages related to the *flat rate*, a proposal for setting aside the historical references and moving towards a uniform payment was expected by the Commission, instead the choice has once again been left to the Member States (European Commission, 2018).

5. ECO-SCHEMES

The schemes for the climate and the environment (ecological schemes or eco-schemes) are another crucial matter of debate within the new CAP. They are delivered through an annual payment per hectare to farmers who voluntarily observe certain agricultural practices beneficial for the climate and the environment.

The voluntary option of the eco-scheme for farmers, but compulsory for the Member States, differs from the mandatory *greening* payment; however, it does not pay less attention to the environmental issue, but it expresses the desire to ensure Member States greater flexibility so as to align the environmental measures with the

⁹ This scheme, adopted by all EU12 Member States, except Slovenia and Malta, replaces all direct payments with a single area payment (Pupo D'Andrea, 2014).

local needs and the real conditions of farmers. This new vision is also the result of the negative assessment on *greening* by the Court of Auditors that considers *greening*, as applied in the current programming, to be unlikely to significantly improve the performance of the CAP from the climatic and environmental point of view (European Court of Auditors, 2017).

Eco-schemes and the green architecture of the CAP in general have been reason of disagreements among the EU institutions as well as among the Members of the European Parliament and agricultural ministers, when they voted to reform the CAP, in the second-last week of October 2020. The Council of Agricultural Ministers approved to allocate 20% of the direct payment budget to the new eco-schemes, against the 30% requested by the European Parliament, and to allocate 30% of the resources of the second pillar to agri-climate-environmental measures, compared to the 35% requested by the MEPs.

The confrontation continued with stakeholders at European and national level, especially the environmental associations which asked for greater ambition in the environmental matters and strongly accused the choice to finance mostly a model of intensive agriculture and industrial breeding.

On the other hand, farmers' concern, with the new eco-schemes, regards the increase of adaptation costs and the reduction in the income support benefits¹⁰.

The accusations by environmentalists, on the one hand, are justified considering the role that should rightly distinguish the green component of civil society, but on the other hand, they are unjustified because they neglect the strong growth of the environmental orientation of the new CAP, through reinforced cross-compliance, the new eco-schemes as well as the increase in the number of environmental measures in rural development policy (Strambi, 2016).

The reluctance towards the greening of the CAP on the part of farmers is equally unjustified. Citizens-consumers pay increasing attention to environmental sustainability, health, ecosystems. European agriculture has every interest in meeting the expectations of citizens, both for internal and external reasons to enhance the competitiveness of European agri-food products worldwide.

On the domestic front, the most far-sighted position is embracing citizens expectations, building good, simple and effective eco-schemes (Cullen *et al.*, 2018), enhancing the environmental values already existing in

the European agriculture and creating new opportunities for green business¹¹.

In this way, the CAP is defensible and can aspire to increase public resources (Guyomard *et al.*, 2020) and it represents a trade lever for agricultural and food products, not a constraint.

6. COUPLED SUPPORT

A particularly debated issue in the negotiations on the CAP and its application at the national level has always regarded coupled payments, as opposed to or in complementarity with decoupling.

This debate raises questions about the effectiveness of coupled payments.

The new post-2020 CAP endorses the importance of coupled support in favour of sectors that are valuable for economic, social or environmental reasons to face difficulties, improve competitiveness, their sustainability or their quality¹².

It is interesting to note how the guidelines of the academic research, both in scientific works and in reports often debated by the community institutions, are diametrically opposed to those expressed by the political decision makers (Pupo D'Andrea, 2014).

The academic research agrees that coupled payments should be abolished, or at least limited in time, because they are ineffective with respect to the objectives for which they were designed, since they limit the freedom of farmers to produce or not. The academic research also highlights the undesirable effects derived from coupled payments due to the distortive consequences on production and on the market compared to the free market trend. In general, all pricing policies and/or coupled payments have proved to be inefficient with respect to the objectives for which they were conceived, including the prevention of land abandonment (Tangermann, 2011; Swinbank, 2012).

On the other hand, *policy makers* and agricultural and agro-industrial organizations have always looked

¹¹ Some occasions of green businesses are the following: carbon sequestration in agricultural soils (carbon farming) by farmers and foresters, agricultural practices rewarded through the CAP or other public or private initiatives (carbon market), advanced biorefineries that produce biofertilizers, protein feeds, bioenergy and biochemicals, production of renewable energy in anaerobic digesters for the production of biogas from agricultural waste and residues (European Commission, «A Farm To Fork Strategy»).

¹² Coupled support may be granted, at the discretion of the Member States, in the form of annual payment per eligible hectare or per eligible animal, up to a maximum amount of 10% of the ceiling for direct payments (13% for the Council of Agriculture Ministers), with a 2% increase for protein legumes

¹⁰ The same criticisms were expressed in 2014 on *greening*, which later proved to have little impact for Italian farmers, if it were not for an excessive bureaucratic burden.

positively at maintaining coupled payments; in the post-2020 CAP, the more conservative positions, supported by the Council of agricultural ministers and agricultural organizations, have obtained an increase in the ceiling of coupled payments. In Italy, then, the debate shifts to the sectors where coupled payments are to be allocated, turning into a «highway robbery» aimed to attract political consensus in some sectors and territories.

In reality, justifications for coupled payment are limited to a few cases, for various reasons.

Decoupled policies are more effective in remedying «market failures», in particular by encouraging the public good for certain aspects of the agricultural activity and ensuring compensation for the positive externalities of which agriculture and farmers are producers (environment, landscape, hydraulic-agricultural structure), while a free market price system is not able to adequately remunerate (De Filippis, 1988).

The claims in support of the decoupling of agricultural policies are based on the commonly accepted belief that deregulated markets are more efficient than those subject to public intervention (Rizov, Pokrivcak, Caian, 2013)¹³.

In the debate on the CAP, the contributions of scholars and *think tanks* have always placed great emphasis on the abolition or drastic reduction of direct payments (coupled and non-coupled) of the first pillar of the CAP and on the introduction of payments aimed at the remunerating environmental services and supporting rural areas (Bureau, Witzke, 2010; Pe'er, Lakner, 2020; Jansson *et al.*, 2020)¹⁴.

In some studies (Bureau, Witzke, 2010) the possibility of using coupled payments is envisaged only if they are necessary to produce particular public goods and within the limits in which they perform this task.

In summary, the limitations of coupled policies are indisputable; therefore, the only cases in which coupled

payments may be justified are those in which production is associated with public goods. This is the case of support for extensive animal husbandry in the mountains (suckler cow, sheep and goat), where this type of agro-zootechnical production is the only one capable of guaranteeing a certain level of supply of public goods.

7. FINAL CONSIDERATIONS

The role and decisions on post-2020 direct payments confirm some of the past tendencies, but also contain relevant new features.

An important confirmation is the recognition of the role of direct payments amounting to about 40% of EU agricultural income (28% in Italy). Moreover, these aids are aimed at bridging (at least partially) the gap between agricultural income and income generated in other economic sectors; they represent a contribution to agricultural resilience and an important safety net for farmers' incomes and ensure agricultural activity in all regions of the Union, including areas subject to natural constraints.

The new name of the basic support, defined as *Basic income support for sustainability*, clearly and explicitly explains the role of direct support as income aid to remunerate farmers' contribution to sustainability.

The unpacking of payments is confirmed with the aim of granting more targeted, selective and flexible payments.

The abolition of the *greening* payment therefore does not imply that the environmental objectives of the CAP are being downsized; rather, they are strengthened, since the majority of *greening* commitments flow into the cross-compliance rules, and a new green component of the CAP gains momentum with the introduction of theeco-schemes, on the one hand, and the increase in the number of agri-climate-environmental payments of the second pillar, on the other hand.

However, the most important innovation would be represented by the possibility of introducing a uniform annual payment per eligible hectare, without entitlements, based on the model of the current Single Area Payment Scheme: it would allow to leave behind, once for all, the system and the underlying logic of payment entitlements.

In conclusion, the «heart» of the reform of direct payments in Italy, poised between a real change and a «watered down reform», is based on three main decisions to be taken when the CAP strategic plan will be approved: the basic support option «without entitlements», the agricultural practices to be included in the eco-schemes, the percentage and the sectors of coupled payment.

¹³ However, it should be noted that the social consequences of agricultural market liberalization depend on the level and nature of competition and must be carefully evaluated (Russo, 2007). Many analyses on decoupling, in fact, ignore the problem of market power exercised by the intermediaries in the supply chain located downstream of the farms, despite the fact that there is now a substantial literature suggesting that agri-food markets are imperfectly competitive (Russo *et al.*, 2011). It is possible to demonstrate how, in the presence of market power, the decoupling of agricultural policies does not necessarily increase social welfare. However, minimum price system or coupled payments represent a less efficient solution than a policy based on the joint adoption of decoupled policies and interventions in favour of competition (Russo, 2007).

¹⁴ Along the same lines, the European Court of Auditors stated its opinion on the CAP reform proposals (European Court of Auditors, 2012), focusing on the matter related to the effectiveness and efficiency of the instrument, arguing that countries deciding to apply coupled payments are asked to set clear and easily monitored objectives.

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