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The future of CAP direct payments

This *Brief* looks closer into the topic of direct payments. Direct payments currently make up the backbone of the Common Agricultural Policy (CAP), and they take the largest share of the CAP budget. What is their role today, and what should their role be in the future? How should the payments be designed and distributed?

There are two schools of thought debating the role of direct payments in the future. One school argues that they make up a necessary basic income support for farmers. Others consider that the payments should rather provide a compensation for the public goods farmers deliver. Some even doubt the need of the payment altogether, considering that there is no need to distinguish between farming and other economic sectors.

Linked to this is the discussion on distribution of support between farmers and Member States. Today, support levels are based on farms' historical subsidy receipts, which in turn are linked to their production in the past. In the future, there is however a need to make payments better targeted to public goods provided by farmers as well as more equitably distributed. This *Brief* provides facts to frame the discussion around direct payments in the future by identifying potential impacts that changes of the payment scheme could have on farmers' income and on the delivery of public goods.

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1. The role of direct payments

Direct payments have been one of the main support instruments to the agricultural sector in the EU since the early 1990s, but their nature has changed significantly over the years. With the 1992 reform, they were introduced as coupled payments, linked to area or animals and compensating farmers for cuts in price support. In 2003, direct payments were then decoupled from farmers' production decisions. In order to decide the rate of payment each farmer was eligible for, previous support receipts (linked to either the individual farmers' or the regions' production history) were used as reference.[1]

The introduction of direct payments helped to steer the CAP towards consistent market oriented reforms for the past two decades. The design of the payments, de-linked from production, has encouraged farmers to adapt to market conditions, thereby enhancing the competitiveness of the agricultural sector. Together with other instruments of the CAP, direct payments make an important contribution to keeping sustainable farming in place throughout the EU territory.

Today, with all sectors reformed, there is little justification for continuing support based on past production levels

However, direct support is also subject to public criticism. The spotlight is mainly on the issues of 'targeting' and 'distribution':

- Targeting relates to the idea of better linking payments to farmers to the provision of specific objectives, such as the fulfilment of environmental objectives linked to public goods, or better targeting of farming income support.
- Distributional concerns stem from the current disparate distribution of support between individual farms and Member States. The latter issue is especially emphasized by many of the new Member States (EU-12) that feel disadvantaged compared to EU-15 countries, because their average levels of direct payments per hectare are lower.

The current design of decoupled payments was a logical and necessary approach in order to achieve a reform in 2003. Decoupled payments linked to historic support values was considered to be the most neutral design of support in terms of impact on farms' asset values. It was therefore politically realistic at the time to allow for the link between decoupled payment levels and historic support levels, especially since not all sectors were reformed at the same time. Today, as adjustments of all sectors have taken place and as 12 more member states have joined the union with a substantially different production and support history, it is natural that the differences in support levels cannot be justified on a long term.

This is why, in the 2008 'Health Check' of the CAP, the European Council and the Commission declared that they are committed to thoroughly examine the possibilities for development of the direct payment system, and to address the differing levels of direct payments.

The first issue to tackle is the purpose of the payment. Is it foremost an income support to farmers, or is it a compensation payment for the public goods farmers provide but for which they are not rewarded from the market?

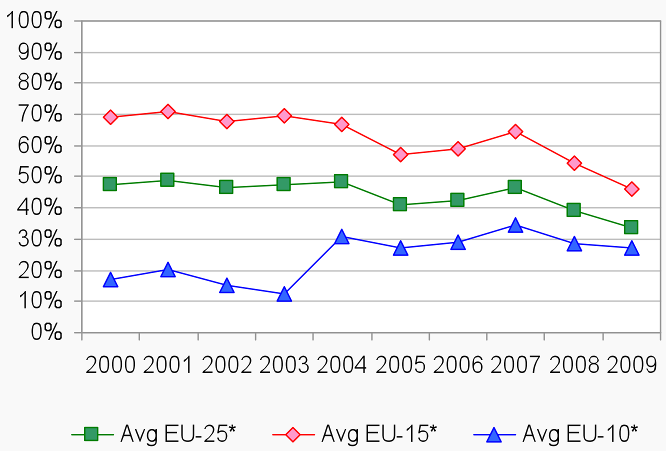
In fact, it is not exclusively one or the other because the two issues are interlinked. Paying farmers income support is important in itself as the agricultural sector is a low income sector in the economy. At the same time, paying income support to farmers enables the provision of basic public goods in a territorially and environmentally balanced way across the EU.

[1] To learn more on the CAP reforms and the history of direct payments, see *Brief* No 1.

The income support function of direct payments contributes to fulfilling this precondition by helping to ensure the longer term economic viability, and a smooth structural adjustment, of the farming sector. This is particularly important given the relatively low level of income in the agricultural sector. Average agricultural income in EU-27 is less than half of the average salary in the total economy (figure 1).

Average agricultural income is less than half of the average salary in EU-27

Figure 1: Evolution of agricultural income as a share of average income in the economy.[2]



Source: DG Agriculture and Rural Development, based on Eurostat data on national and agricultural accounts.

Paying income support to farmers is at the same time a precondition for delivery of basic public goods through responsible land management. With the vast majority of EU territory being used for either agricultural or forestry purposes, it is important that the people managing our natural resources are provided sufficient incomes. (Map 1 on next page).

In parallel, the link between direct payments and the fulfilment of cross compliance requirements contributes to the provision of public goods. This link is key, as there is evidence of undersupply of most important public goods, for which certain forms of land management are particularly beneficial (such as extensive livestock and mixed systems, more traditional permanent crop systems and organic systems).[3] The public goods concerned are mostly environmental and relates for example to maintaining agricultural landscapes, farmland biodiversity, water availability, soil functionality, climate stability and air quality. However, also public goods which are not related to environment are important, where rural vitality is frequently mentioned.

Cross compliance links the payments to the respect of basic rules related to environment, health and animal welfare. For instance, GAEC (Good Agricultural and Environmental Conditions) obligations are related to preserving landscape features, permanent grassland conservation and water courses, and obligations related to soil conservation. Farmers' direct payments are reduced when cross compliance obligations are not fulfilled.

Direct payments support agricultural land management throughout Europe and thus the delivery of public goods

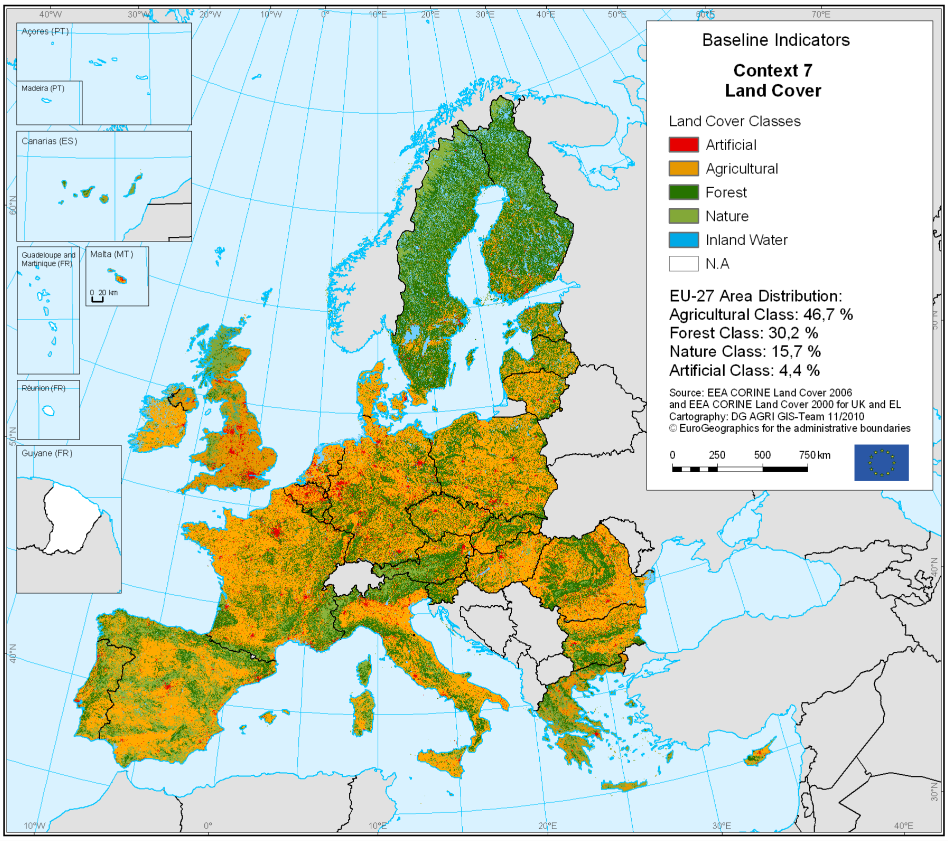
The basic delivery of public goods – agricultural land management throughout Europe – enabled through direct payments, is a precondition for being able to provide more specific public goods, e.g. through rural development measures. This is particularly important in areas facing serious natural constraints that make farming more difficult.

Thus, the income support element of direct payments and the provision of public goods cannot be separated.

[2] The figures in the graph reflect the agricultural entrepreneurial income/AWU as % of wages and salaries/AWU in the total economy. Note that these figures should be interpreted with care owing to conceptual differences between the measurement of farmer's income from agricultural activities and average wages in the economy, and that, due to the lack of reliable data on full-time equivalent labour statistics for the total economy for some Member States, only some of them have been considered to calculate the averages (EU-15*: EL, ES, FR, IT, NL, AT, PT; EU-10*: CZ, EE, HU, PL, SK; EU-25* = EU-15* + EU-10* countries).

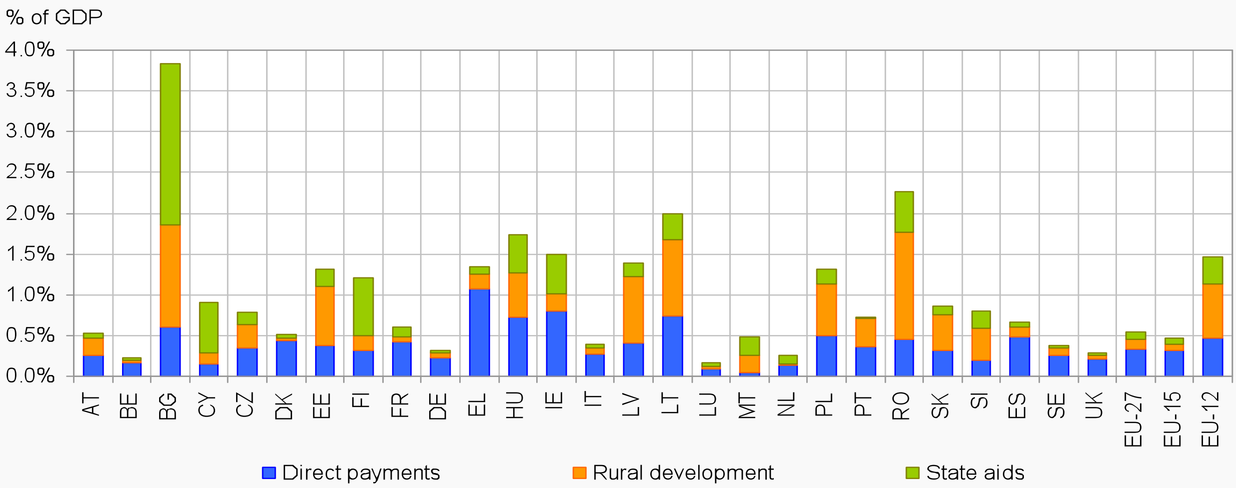
[3] See http://ec.europa.eu/agriculture/analysis/external/public-goods/index_en.htm - Study on the provision of public goods through agriculture in the European Union.

Map 1. Land cover in the EU.



Source: DG Agriculture and Rural Development, 2009 Rural Development Report.

Figure 2: Total payments for agriculture in the Member States as share of their GDP (2009).



Source: DG Agriculture and Rural Development.

2. Current support levels

The debate on direct payments is not only limited to the objectives with the payments, but also extends into the discussion on distribution of the payments. Currently, the global amount of direct payments in Member States mirrors their average production and support during a historic period.

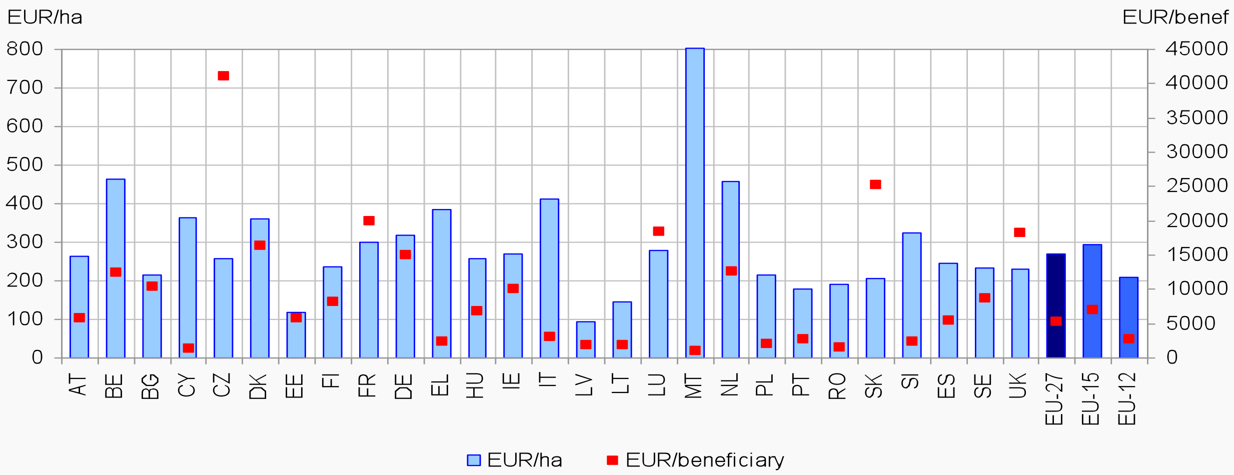
When implementing the decoupled payments, after the 2003 reform, it was up to the EU-15 Member States to decide individually how to divide their 'direct payment envelopes' (i.e. their global amount of previous support). They could either divide it equally between farmers at a regional level, based on the average support and production history of the agricultural area in the region ('regional model'). Or they could give each farmer an individual payment, based on the individual farms' historic receipts ('historic model'). Member States could also implement a mix of the two models ('hybrid model'). In the regional model, all farmers in one region get the same payment per hectare. In the historic model, all farms have different payment levels. In all models the payment is however fixed from year to year, and does not depend on, or vary, with production decisions.

Currently, direct payment levels per hectare differ substantially between Member States

When the new Member States joined in 2004 and 2007, they could choose to implement a simplified area payment model (SAPS) for a transition period, where payment levels were decided with a similar method as for the regional model. The big difference compared to EU-15 was that the payments were not linked to actual historic support levels, as these did not exist, but had to be estimated based on historic production.

Different starting points for agricultural production value lead to significant differences between Member States in payment amounts. Figure 3 presents the current direct payment distribution, showing both the average payment per area (hectare of potentially eligible area) and per farm (beneficiary). Payment levels per hectare differ substantially between Member States. The average value for EU-12 is lower than that for EU-15, but there are exceptions to this rule, both in EU-15 and in EU-12. When looking instead at the payment level per beneficiary, the 'ranking' between Member States is quite different. The reason is that the average farm size, which varies considerably between Member States, comes in as an additional determining factor for the amounts received per hectare. Countries with large average holding sizes have higher payments. The picture is very different, again, when payments are considered as a share of GDP (figure 2).

Figure 3: Average payments per beneficiary and per hectare.



Source: DG Agriculture and Rural Development.

Note that this figure is a simplified calculation of direct payments based on the national envelopes of Member States after full phasing-in of direct payments in the EU-12 and the number of potentially eligible hectares in IACS for 2008.

3. Potential impacts from changing direct payments

Direct payments make up an important part of farmers' income. Figure 4 gives an idea of how important the payments are for the individual MS.

The agricultural factor income represents the income generated by the farming activities which is used to remunerate borrowed/rented production factors (capital investment, wages for salaries and rented land), and its own production factors (work and/or enterprise, own capital and owned land). In 2007-2009, the share of EU direct payments in agricultural factor income was around 29% for the average EU farmer (31% in EU-15 and 19% in the EU-12). The financial crises substantially affected these figures, driving the EU-27 average up to 33% in 2009 compared to 26% in 2007.

This wide variation in the share of public support in agricultural income reflects the current system of distribution of support across countries, and across agricultural sectors, as well as the competitiveness of the agricultural sector in the various EU Member States.

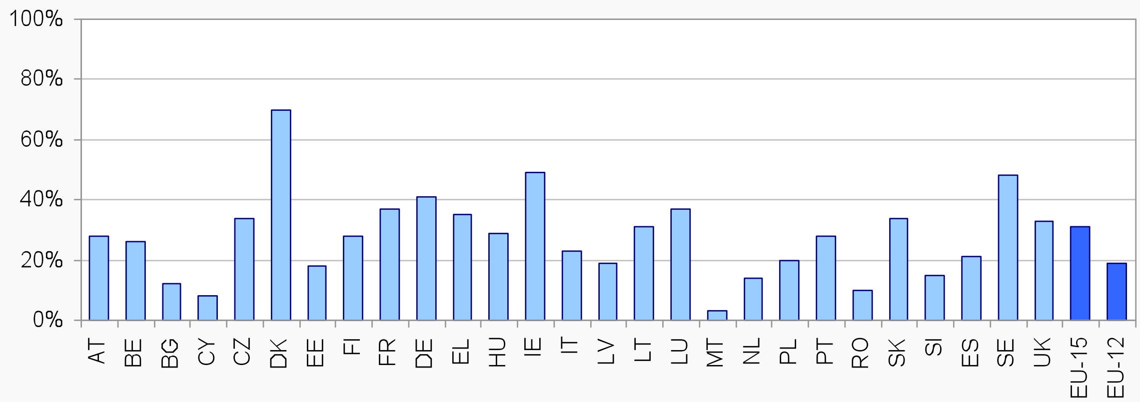
Direct payments are a very important contribution to farmers overall standard of living

These figures provide information for the whole agricultural sector. Analysis of the contribution of direct payments to agricultural income by type of farming also shows that this contribution varies greatly across agricultural sub-sectors.

To illustrate what the impacts would be from moving to a different system and changing direct payment levels, we have looked at a 'flat rate' as a possible option, i.e. giving the same amount of direct payment per hectare to each farmer in the 27 Member States. A flat rate has been a commonly voiced proposal in the public debate for how to reform the direct payment system. The main justification for this is that it is thought to be fairer to provide the same amount of support for every hectare, as every hectare of agricultural land is believed to provide the same service or benefit to the society, and to have the same need for income support.

At the farm level, a flat rate would imply that the amount support received would change considerably compared to today's situation. However, the distribution of support between individual farms would remain uneven, both within and between Member States. With a flat rate, the difference in support levels between farms would be entirely determined by the farm size. Some would therefore consider a flat rate to contribute to a better distribution of support among farms.

Figure 4: Share of direct payments in agricultural factor income (avg. 2007-2009).



Source: DG Agriculture and Rural Development.

It needs however to be considered that agricultural producers face very different economic and natural conditions across the EU so that an equal distribution of direct support may not necessarily be the same as an equitable distribution. The same level of payment does not have the same implications for all farmers in the 27 Member States. Farms operate in very different conditions, with respect to the economic context, the environmental challenges, and the social situation. As a result, a uniform hectare payment would have a different significance for a farm in a Member State where the general economic development and income levels are low, than for a farm operating in a Member State where they are high. Similarly, the payment would have a different significance for farmers located in Member States or regions where natural conditions are challenging for agricultural activity, than for those operating where there are favourable conditions.

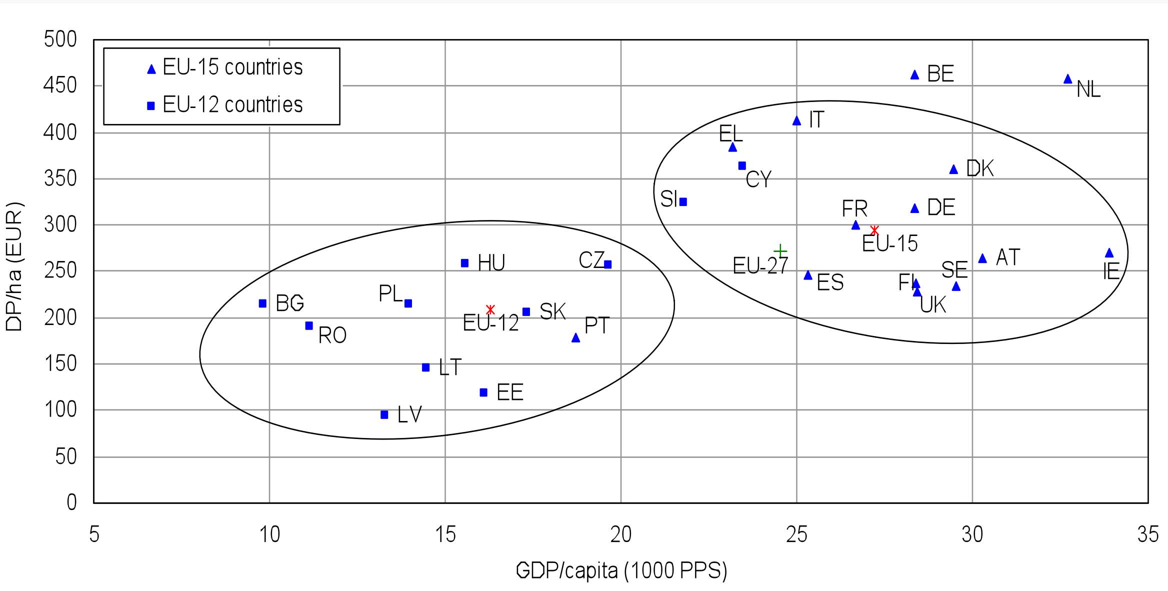
The first point is illustrated by figure 5, which shows that the current level of direct payments is not just reflecting past production of the supported sectors, but also to a significant degree differences in the economic situation of Member States. Therefore, the desired convergence in the respective levels of direct payment support becomes more difficult if this factor is ignored in the transition to a new system.

Two other elements will be important to be aware of when considering the timing and how to do the transition towards new levels of direct payments. First the redistribution of funds that a change to the direct payment level would imply and the related impacts on farms' asset values, and secondly the level of payments as such.

A change in the level of support would affect farms' assets. Current levels of direct payments have an impact on the structures and cost parameters of farms. Most important in this context is the fact that part of the direct support is, to different degrees, captured ('capitalised') in the value of assets – in particular land – which in turn influences the 'debt to equity'-ratio of the whole farm.

Current levels of direct payments have an impact on structures and cost parameters of farms

Figure 5: Direct payments per ha (2016) and GDP per capita (2007-2009 avg.).



Source: DG Agriculture and Rural Development.

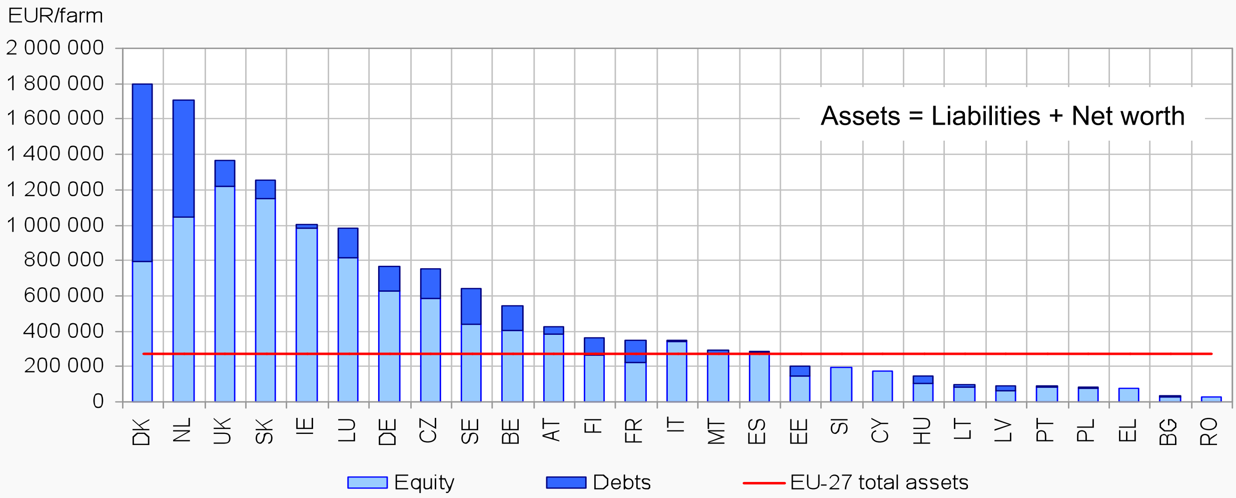
Note: ha = potentially eligible area; LU = 280 EUR/ha and 67 500 PPS/capita; MT = 802 EUR/ha and 18 800 PPS/capita.

The capitalisation of support in asset values is not uniform across Member States or across implementation models of direct payments chosen, and it is not a phenomenon that came with the introduction of decoupled direct payments. Rather, agricultural support (whether in the form of price support, area payments or decoupled payments) has always, and everywhere, to some extent been reflected in land prices.

As figure 6 illustrates, the 'debt to equity'-ratio of farms differs strongly between Member States. In some of the Member States with comparably productive and efficient structures, farms have a particularly high debt (linked to investment). Farms with high debt levels will be more likely to be affected by drops in asset values.

Changing the direct payment levels, and thus redistributing support, would strongly affect the economic and financial basis of farms. How strongly farms would be affected depends on the magnitude of the changes in their direct payment levels, as well as on how flexible the agricultural sector is in responding to these changes, for example through rationalisation and structural improvements. The impacts for farms who would receive a higher payment due to a flat rate would also be significant, where increased support could imply (sometimes steep) increases in the price of land and the value of farms. This implies that whatever changes are made to the direct payment levels, a transition period would be crucial in order not to disrupt farms' operation and viability.

Figure 6: Farm financial structure per Member State in comparison with EU-27 average in 2007.



Source: DG Agriculture and Rural Development - FADN.

Note: Total assets are represented in the figure by the length of the bar, including both liabilities and net worth. EU-27 total assets weighted average expressed by horizontal line.

List of EU countries' codes used in the graphs

AT	Austria	FI	Finland	LV	Latvia	RO	Romania
BE	Belgium	FR	France	LT	Lithuania	SK	Slovakia
BG	Bulgaria	DE	Germany	LU	Luxembourg	SI	Slovenia
CY	Cyprus	EL	Greece	MT	Malta	ES	Spain
CZ	Czech Republic	HU	Hungary	NL	Netherlands	SE	Sweden
DK	Denmark	IE	Ireland	PL	Poland	UK	United Kingdom
EE	Estonia	IT	Italy	PT	Portugal		

4. The debate on future direct payments

A lot of attention in the debate on the future CAP is already focused on the role of direct payments. In this debate, there are mainly two issues which will be important to clarify: the purpose of direct payments in the future, and their design and distribution.

As far as distribution is concerned, introducing changes to the direct payment level is more complex than it appears at first sight. It should be clear that a 'flat rate' would not make the distribution between small and large farms any 'fairer', as a flat rate would disregard the substantial differences in economic and environmental conditions that farms are facing.

Using historical production as a basis for deciding payment levels had the advantage that it, to some extent, reflected the conditions for agricultural production in a specific region. Although historical references only capture certain elements of the production conditions. A uniform rate has the advantage that it is easier to explain, and does not discriminate between producers based on history. However, in order to improve transfer efficiency, it could benefit from an element of adjustment for production conditions such as natural conditions and economic situation.

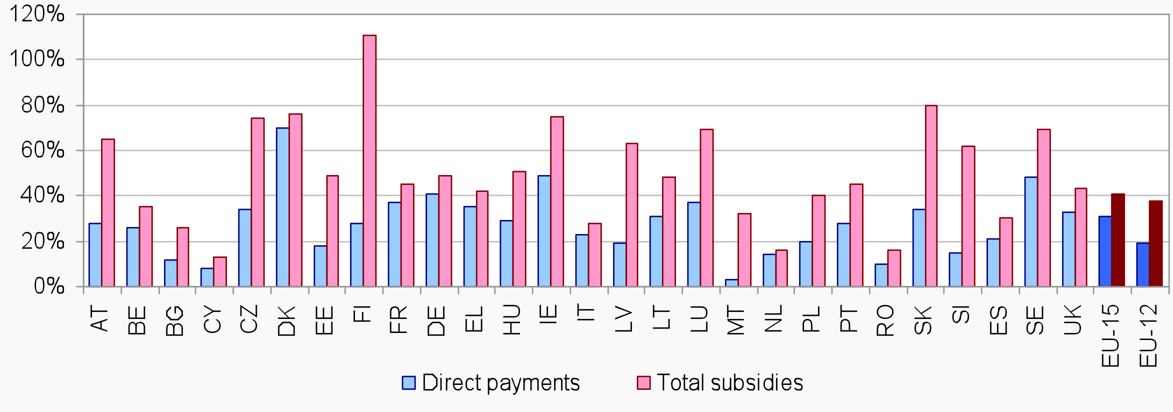
Thus, the fundamental question for the future of direct payments is how to reach a more equitable distribution that reflects, in a pragmatic, economically and politically feasible manner, the declared objectives of this support, while avoiding major disruptive changes which could have far reaching economic consequences.

This leads to the second aspect, the purpose of direct payments. As described in this *Brief,* direct payments provide a basic income support. Income support contributes to the delivery of basic public goods because it keeps farming in place throughout the EU, and because of the link between payments and cross compliance requirements. The two elements, income support and basic public goods, should therefore be considered as complementary rather than competing objectives of the direct payments.

Income needs and conditions for public goods delivery vary across Europe. A severe, immediate cut of payments, in order to introduce a new system for direct payments, would put some farmers under economic pressure, which could put them out of business. This could result in land abandonment with negative consequences for the delivery of public goods. It is therefore important that any change that is made to the direct payment system is done gradually, so that farmers have the proper time to adjust.

Finally, direct payments are only one piece of the CAP, and therefore changes to the direct payment scheme should be considered in the context of changes made to other parts of the policy. The level and distribution of direct payments should not be discussed independently of the level and distribution of other CAP payment, in particular those for rural development. (See figure 7). The debate about the future would benefit from reflecting the overall picture of the CAP with respect to all challenges European agriculture is facing and will face in the future.

Figure 7: Share of direct payments and total subsidies in agricultural factor income (avg. 2007-2009).



Source: DG Agriculture and Rural Development.