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The CAP and Future Challenges

1. The CAP and European integration

The CAP has undergone substantial changes since its inception but still remains the most extensive common policy, accounting for almost half of the EU's budget and almost half of the legislation. The CAP was a decisive component of European integration in the past, but what role should it play in the future? Formerly, having a common policy for agriculture was taken for granted especially as the policy mainly consisted of market interventions. However, taking into account changes in the policy itself, the agricultural sector, the economy at large and, not least, the string of enlargements, it is reasonable to ask the question whether the present CAP would pass the subsidiarity test. Since the CAP absorbs such a large share of the EU's budget, the discussion on the future of the CAP closely relates to the discussion about the future of the budget. Global crises such as food, financial and climate change provide additional cause to ask what the best use of scarce common resources is. It seems reasonable that the European Union – a large player on the global scene – should take steps to contribute to solving these problems. The question is what policies to initiate and what funds to commit?

A suitable test for determining the division of labour between the Member States (MS) and the Union is the principle of subsidiarity, which postulates that a policy should be located at the lowest level of government at which it can be efficiently delivered. Analyses based on fiscal federalism argue that budget expenditure should focus on funding European *public goods*[1] that would be underprovided if left to national governments and where EU intervention would create additional value. The budget can also play an important role in circumstances where it can enable MS to pool their collective resources to achieve economies of scale. Investment in human capital, especially higher education, and in research and innovation are clear cases in point. Common infrastructure programmes create cross-border effects as well (i.e. benefits to citizens in other MS). An additional candidate for consorted European action is a response to climate change and energy security. Implications of these principles for the CAP are discussed in the ensuing text.

There are of course other concerns of common policy than economic efficiency alone. Income redistribution from rich to poor countries constitutes a positive expression of European solidarity. Cohesion, it could be argued, constitutes a public good because it contributes to social stability which is vital for economic prosperity and harmonious development of the Union as a whole. Indeed, several of the common policies, most notably structural policy, are motivated by cohesion.

1.1 Purpose and outline of the study

This paper aims at providing a vision for a future CAP post 2013 in both longer and shorter term perspectives. The paper is based on work of the authors at the Agri-Food Economics Centre (formerly SLI) published as SLI Report 2007:4 and their involvement in joint research projects (e.g. IDEMA[2]). An assessment of the performance of the present CAP serves as a starting point for the analysis, bearing in mind the subsidiarity criterion defined above. As it is not possible, due to limitation of space, to provide an extensive evaluation of the CAP

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1 A public good (or service) is characterized by nonrivalry and nonexclusiveness in consumption meaning that one consumer's consumption does not affect the quantity available to other consumers and it is impossible/ prohibitively costly to prevent those who benefit from the good from consuming it (e.g. national defense and basic research). For these reasons it can be necessary for the state to finance production of the good.

2 IDEMA – The Impact of Decoupling and Modulation in the Enlarged Union: a sectoral and farm level assessment – a research project supported by the European Community's Sixth Framework Programme (Contract No SSPE-CT-2003-502171). See www.agrifood.se/IDEMA.

only the key elements of the policy will be scrutinised. The assessment differentiates between the two Pillars of the CAP since their objectives are fundamentally different. We then identify not only desirable long term goals and changes in CAP but also short term changes that would facilitate its long term evolution.

2 CAP goals, instruments and effectiveness

2.1 First Pillar: direct payments and market intervention

The single most important instrument of the CAP is the Single Payment Scheme (SPS) or decoupled payments. These payments alone account for almost 75% of the CAP budget (€54 billion annually) or 32% of the total EU budget (EU 2009). The analysis of Pillar I will, accordingly, focus on the SPS.

The 2003 decoupling reform of the CAP changes the basis of direct support. Instead of receiving a subsidy per unit of commodity output (e.g. €200/ha wheat) farmers now receive support based on a SPS. Member States were given some freedom to choose how to implement the SPS. It could be a regionalized payment with farmers receiving identical payments per hectare within a region, a farm-specific payment (e.g. France and Italy where payments are based on historical farm production levels) or a combination of both (e.g. Sweden and Germany). Common to all variations of the SPS is that payments are not related to the volume of commodity output. Rather farmers receive so called payment entitlements based on the area of agricultural land, the level of which varies according to the choice of SPS. To qualify for payment entitlements, farmers are required to keep agricultural land in "Good Environmental and Agricultural Condition" (GAEC) and respect relevant Statutory Management Requirements, together referred to as cross-compliance. In other words, there is no requirement to produce commodities, but farmers must at least maintain their land (and obey the law) which, in its simplest form, implies mowing grass fields on an annual basis. As a result the widely documented ill-effects of past policy should be avoided because farmers' output decisions will be guided by consumer demand, and not distorted by output subsidies.

2.1.1 Implications of decoupled payments

The impacts of decoupled payments on farm incomes, land values, structural change and production have been assessed in the EU research project IDEMA (Ekman & Rabinowicz 2007). Due to the heterogeneity of agricultural and socio-economic conditions in the EU, adjustments to decoupled policies are likely to vary widely between regions. To make the assessment feasible, a sample of 12 case-study regions reflecting the diversity of the enlarged EU were selected for analysis, ranging from very extensive northern conditions, to the intensive regions in the Mediterranean and large corporate farms in the New Member States (NMS). Impacts were quantified using a spatial agent-based modelling approach and empirical data on each region (Happe *et al*. 2006). Unique for the model is that it considers interaction between individual farmers on the land market and spatial effects which made it possible to evaluate even impacts on landscape.

The results show that the SPS has limited potential for supporting farm income, which is the official motivation of the support. If support was eliminated, land values would fall, structural change speed up and incomes from other sources grow, leaving the total income of farm households (remaining in the sector) more or less unaffected (Sahrbacher *et al*. 2007). The degree to which payments capitalize into land values depended on the degree of land market regulation (Latruffe & Le Mouel 2006).

Even if the SPS does not have an impact on farm incomes it might contribute to other objectives of the CAP. In regions with limited employment opportunities outside agriculture, the SPS contributes to higher employment by slowing down structural change. In marginal regions where costs of production are high, the SPS contributes to more biodiversity and landscape preservation: given appropriately defined GAEC obligations to ensure that land taken out of food production is kept under agricultural management (Brady *et al*. 2009). This issue is discussed further in the next section in relation to environmental support.

The SPS via GAEC also contributes to some extent to food security by reducing the profitability of transferring land to alternative uses such as forestry. However, under the present design of the scheme payments are highest in fertile (or competitive) regions, due to their origin as compensation for price cuts. Hence the bulk of the payments do not add to food security. Further, decoupled payments paid to farms in fertile regions do not augment positive external effects or contribute to the provision of public goods at either the European or national level. This is because market prices are sufficient to guarantee food production in these regions and hence maintenance of agricultural land.

It is often argued that common financing of payments is needed to guarantee a level playing field because MS would otherwise choose very different payment levels (subsidies) which, in turn, would affect the functioning of the internal market and create unfair competition. This very common argument is, however, flawed. High decoupled subsidies to fertile land, which would have been farmed in any case, do not have any impact on production and cannot, for this reason, distort ag-

ricultural markets. Decoupled payments can affect investments but this is only the case if capital markets are not functioning properly and profitable investments are hindered by credit rationing. This hardly applies to the richer MS who would also be more likely to offer higher subsidies to their farmers. Since payments under the SPS are linked to land and land is an immobile resource, any differences in subsidisation will manifest itself as differences in land values (all other things being equal).

Finally, high direct payments are, as our research shows, detrimental for competitiveness because they slow down structural change. MS choosing to subsidize more than other MS will in the long run impair their own competitiveness and enrich landowners rather than create an advantage for their farmers.

2.2 Second Pillar: competitiveness, environment and rural development

Pillar 2 has been gaining in size and importance but it still accounts for a minor share of spending on agriculture (approx. 20% of the total CAP budget) even if the national co-financing is included. Pillar 2 measures aim at enhancing competiveness, protecting the environment and promoting wider rural development, and consist at present of 26 optional programmes organised across three axes: competitiveness, environment and rural development. The question is whether these programmes are efficient given the respective programme goals.

2.2.1 Axis 1: Competitiveness

Measures aimed at enhancing competitiveness and productivity include: investment support, setting up young farmers, training, early retirement, investment in processing and marketing, food quality incentive schemes, food quality promotion, and other measures (land improvement, re-parcelling, establishing advisory services, marketing of quality products, development of infrastructure connected with agriculture) and meeting standards. About one quarter of funds was spent on these types of measures in EU15, 2000-2006. A precondition for this policy to be successful is that factor and product markets are malfunctioning and can be improved. Market intervention in the absence of imperfections is likely to result in displacement effects and generate distortions which hamper agricultural development. It is not clear, however, at least in official policy documents what market failures the policy is addressing. Furthermore, to justify common financing, the market failures must be of such a nature that they are best corrected at the European level.

Most of the measures are designed as capital grants. This is the case for investment support (agriculture, processing) and setting up young farmers (up to 40 years old) which account for the lion's share of the spending. Poorly functioning capital markets may result in underinvestment but it is a substantial overcorrection of the market failure in question to offer large investment subsidies to some farms/processing firms. Facilitating access to credit and improving infrastructure for rural finance is a better option. This is a suitable task for the MS. Creating a favourable business climate which is a fundamental precondition for investment activity lies entirely within national competency. Finally, there is strong evidence that the above mentioned measures in many cases simply replace investment that would have taken place in any case. These measures have been more successful in the NMS where credit markets are less well developed.

Some of the measures included in the first Axis can be justified on the grounds of market failures. Quality assurance schemes and setting up producers' organisations may improve functioning of product markets by reducing transaction costs and improving information. Advisory services provide an avenue for spreading new technology. Training of farmers, advisory services, land improvement and improvement of infrastructure enhances the quality of production factors in agriculture. Support to re-parcelling of land reduces transaction costs while labour mobility can be enhanced through education and broadening skills to other occupations. However, the use of these measures is relatively limited. Moreover, there are no cross-border effects present with the exception of R&D.

To summarize, most relevant measures are used to a very limited degree. These measures have the potential to improve efficiency but only to the extent that market failures are present which is most likely in NMS. Cross-border effects and European public goods are, by and large, absent. The main impact seems instead to be the transfer of income, especially in the cases of investment support, setting up young farmers and support to processing. There is considerable evidence of displacement effects (investments that would take place in any case), which is consistent with the absence of market failures.

2.2.2 Axis 2: Improving the environment and the countryside

Environmental degradation associated with modern farming practices is a classical example of a market failure due to external effects and can therefore motivate corrective policy. For example intensive use of agro-chemicals contributes to water pollution and degrades biodiversity, whilst field amalgamation and expansion can reduce landscape mosaic and destroy habitat. Spending on improving the environment and the countryside accounts for 44% of second Pillar support. Agri-environmental payments are designed to encourage farmers to protect and enhance the environment on

a voluntary basis by adopting environmentally-friendly farming techniques that go beyond legal obligations. These include payments to encourage extensification of farming, low-intensity pasture systems, organic agriculture, preservation of landscape and historical features, and conservation of high-value habitats and their associated biodiversity. In return, farmers receive payments that provide compensation for the additional costs or income foregone from adopting such practices.

In contrast to Pillar I support agri-environmental schemes may be designed at the national level in order to adapt to particular farming systems and local environmental conditions (referred to as targeting). Targeting is a prerequisite for achieving efficient environmental protection given the enormous variation in characteristics of European landscapes (Fraser 2009). In practice targeting is underutilized and schemes tend to be of a uniform character despite regional variation in environmental characteristics. That is, farmers are usually remunerated for carrying out particular management tasks rather than being rewarded directly for measured environmental outcomes and payment levels are general rather than being related to individual farmers' actual costs. Despite the importance of agri-environment schemes for the maintenance and restoration of farmland biodiversity in Europe, their ecological effects are poorly known. In their evaluation of these schemes across five MS, Kleijn *et al*. (2006) find that agri-environment schemes had marginal to moderately positive effects on biodiversity. Uncommon species benefited in only two of five countries and species listed in Red Data Books rarely benefited from agri-environment schemes. Hence scheme objectives may need to differentiate between biodiversity of common species that can be enhanced with relatively simple modifications in farming practices and diversity or abundance of endangered species which require more costly conservation measures.

2.2.3 Axis 3: Wider rural development

Measures in Axis 3 include: basic services for the rural population, renovation and development of villages, diversification of agricultural activities close to agriculture, encouragement of tourism and financial engineering. About 25.6% was spent on these measures 2000-2006. The aim of the measures is to promote wider rural development. The measures in question are based on the assumption that spontaneous development is not satisfactory and that it can be corrected by economic policy. Many rural regions are, indeed, facing considerable challenges such as continuous decline of the economic significance of agriculture, relatively high rates of unemployment, underemployment and the need to find new sources of income and employment. However, there are considerable differences in performance and a lot of rural areas are prosperous and performing well.

To what extent the development of marginal areas can be affected by the chosen policy measures is an open issue. There is strong evidence that the long term economic trends are favouring concentration rather than dispersion of economic activities. If agglomeration forces are locking regions into stable core-periphery systems, then there is little scope for policy to alter the spatial distribution of development. Many evaluations demonstrate that R&D measures have created jobs or helped to prevent depopulation, but none are able to demonstrate that these effects have been significant enough to influence the overall rural population or level of employment. Rural Development Programmes have not been sufficient to address marginalisation of regions lagging behind. Such programmes cannot, in particular, substitute for deficient national policies. Even if some measures, such as financial engineering and support to basic services may potentially have beneficial effects, the measures focus more on symptoms than on underlying causes of problems of these regions: remoteness, low productivity, lack of qualified labor and services. Project support (seed money) may overcome transaction costs but is useful *only* if commercially viable business ideas are present.

In general, cross-border effects are lacking for this type of policy and the prime motivation is cohesion. These policies appear also most appropriate in NMS. However, in contrast to cohesion policy, all rural areas are covered by the programmes.

2.3 CAP performance – efficiency and distribution

To summarize the discussion so far, CAP spending has weak rationale in terms of externalities and public goods. Moreover, *co-financing* applies for second Pillar measures where there are elements of European public goods or externalities, but *full financing* is provided for decoupled payments with little evidence of significant externalities or public goods. As a result CAP spending is primarily distributive. This is, in particular, the case for Pillar 1 support but the main impact of several Pillar 2 programmes is income redistribution as well. Since CAP spending is largely redistributive the issue; who the recipient is becomes highly relevant. Moreover, the CAP is often motivated by invoking cohesion.

The territorial distribution of CAP support has been examined by Shucksmith *et al*. (2005) for 1999 at the NUTS-3 level. They conclude that "total Pillar 1 support was distributed in such a way that it tended to benefit richer regions, regions with lower unemployment rates and regions with growing population." The authors have also analysed Pillar 2 support and found that "contrary to expectations, Pillar 2 support, as represented by FADN derived payments to farmers, is inconsistent with cohesion objectives, favouring the more economically viable and growing areas of the EU."

According to the Report on the distribution of direct aids to producers (financial year 2005, EU Commission), 7% of the beneficiaries in EU10 received 61% of the payments. In EU15, 20% of the beneficiaries received 80% of the payments. Beneficiaries receiving more than €50 000, who constituted 2% of recipients in EU15, absorbed as much as 30% of all payments. The regressive profile of the payments is even more pronounced when taking into account that payments are much higher in the old MS than in NMS. Considering that direct payments account for 75% of the CAP budget and the CAP budget accounts for a large share of the total EU budget, substantial amounts of European taxpayers' money is spent on a very few and very rich recipients. This hardly contributes to cohesion since poor taxpayers also contribute to financing these payments (Baldwin 2005).

3 CAP from a long term perspective – objectives and instruments

A suitable start for a discussion about the design of a new Common Agricultural Policy should be an inquiry about the reasonable objectives of such a policy. The official objectives, as stipulated in the Treaty of Rome, have not changed. The original list of objectives includes: to increase agricultural productivity by promoting technical progress; to ensure a fair standard of living for farmers; to stabilise markets; to assure the availability of food supplies and to ensure reasonable prices for consumers. Formally, these goals still apply even if other objectives have been added. Since the original objectives were formulated more than half a century ago, a revision may be in place. In the next section, we discuss what the legitimate objectives for the future CAP might be and what instruments are needed to achieve them.

Designing new measures is a challenging task and it should observe the principle of subsidiarity and be defensible against other legitimate uses of the scarce common budgetary resources. Usual rationale for policy intervention includes market failures such as public goods, scale effects, externalities etc., as well as the existence of cross-border effects and difficulties to deal with the issue by alternative methods such as delegation, legislation or coordination. The EU should spend more money in areas where cross-border effects are present and money is lacking (Korkman 2008). This implies plenty of room for investment in energy, environment and climate projects, and research to develop alternative energy sources, investment in human capital, notably higher education and research.

3.1 Reasonable prices for consumers

It is easy to appreciate that objectives to safeguard the financial interests of both farmers and consumers are not consistent with each other (i.e. high producer and low consumer prices). However, no formal hierarchy was ever designated. In reality, the consumer price objective was hardly taken seriously. For the sake of credibility, this objective should be removed. Keeping the consumer price objective and placing it on equal footing with the farm income objective, as was the case in Sweden prior to their accession, is a questionable option, at least from a moral perspective. Sheltering European consumers from high prices, which may seem reasonable at first sight, would have a very negative impact on poverty elsewhere taking into account the globalisation of the world food market and the share of the Union in global trade. In particular, application of export bans during the times of price spikes on the world market such as those experienced in 2007-2008 would simply imply protecting rich consumers in the EU at the expense of poor net importers, since export restrictions would increase global prices. Fortunately, export restrictions were not used by the EU in 2007-2008 but they have been applied in the past and the option to use them remains.

3.2 Supporting farm incomes

Supporting farm incomes has always been *the* objective of the CAP. An extensive literature shows that this objective is not attainable in the long run due to capitalisation of the support in asset values. Furthermore, according to statistics from the OECD, farmers do not have lower incomes than the rest of society. In Sweden, in particular, total income of farm households is more or less independent of farm size because smaller farms supplement their farm income with income from other sources. This demonstrates that farm households are able to secure the income they need. The distribution of payments, as described above, illustrates this point further. The peanuts which are distributed to many small farms cannot have any decisive influence on their livelihoods. Large farms, which account for a considerable share of the total payments, are hardly in need of income support. Those farmers have much higher incomes and, in particular, much higher wealth than the average citizen.

To be sure, a prosperous farm sector is vital for development of rural areas, preservation of the landscape and for assuring food security in the long run. But farmers should be paid by the market for delivering the private goods that consumers want and by public payments for public goods they otherwise would not produce.

If the farm income objective is retained it must be made coherent with social policy. This point is reinforced by the fact that direct payments, in contrast to price support, do not target the income of farmers as a collective but the income of individual recipients. At present, this is done without checking whether the recipient has a documented need to have their income supplemented, as is otherwise the case for social policy. The income

of agricultural recipients is not even measured. Since the bulk of support is now paid as *an individual income transfer* (i.e. the SPS), such a transfer should be subject to an individual means test rather than being conditioned on complying with environmental regulations, which again is at odds with principles and practice of social policy.

From the point of view of subsidiarity, the farm income objective is not suitable for a common policy. As argued above, if this objective is retained, it needs to be coordinated with social policy and this is only possible at the national level.

3.3 Competitiveness and productivity

Looking at the original wording in the treaty of Rome, enhancement of productivity was seen as a vehicle to achieve higher incomes in the agricultural sector. In the newer policy documents of the Union, competitiveness rather than productivity is referred to. This change of focus reflects the fact that even though productivity is a vital precondition of competitiveness, the latter is a broader concept. The competitive pressures on agriculture have increased and this trend is likely to continue in the future due to trade liberalisation and globalisation. Therefore, enhancement of competitiveness remains a reasonable objective of agricultural policy. This is also in accordance with the Lisbon strategy.

Most of the policies which are required to achieve competiveness in agriculture as well as in other sectors of the economy are more suitably allocated to the national governments. However, there is an added value at the European level when it comes to encouragement of innovation and technical change. Innovation is a key driver of economic growth. Thus the focus of the common policy should be on promoting innovation in agriculture. Due to similarity of economic, agronomic, environmental and social conditions across large regions of Europe economies of scale may be achieved by pooling research resources. Moreover the rate of return on investment in agricultural R&D is very high.

Innovation can be promoted by stimulating development of new suitable technology and diffusion and uptake of new technologies which may be hampered by incomplete information, adoption externalities and risk aversion. Dissemination of information about new technologies is critical to diffusion but is likely to be imperfect and hence there exists a presumptive argument exists for subsidies to activities that improve information flows, such as demonstration projects, testing and certification of new technologies, consultancy services and knowledge parks (Blackman 1999).

Second Pillar support to competitiveness should focus on the creation and dissemination of new technologies for agriculture, food technology and rural resources. Policies such as investment subsidies should be limited to NMS over a *transitional* period to allow for catching up. Instead, investment support should be transformed to innovation aid with focus on risky investments with high innovation potential, linked to accompanying research and advisory systems, based on benchmarking and embedded in a network of demonstration farms (Isemeyer 2008).

3.4 Stability

Another objective in the Rome treaty was that of stable markets for agricultural products. Since agriculture is characterised by inelastic supply and demand even minor disturbances may cause substantial fluctuation in product prices. A policy to stabilise markets reduces price volatility and, thus, the risk to producers. It might, therefore, be argued that it could serve to increase agricultural production and food security. The objective clearly passes the subsidiarity test as it would be very costly for a small country to neutralise variations in agricultural production on its own. Policy measures consist of import taxes and quotas, export subsidies, and purchases of agricultural products at pre-determined intervention prices. However, even at the EU-level the costs have been substantial as technological progress since the 1950's has increased productivity, leading to problems of excess production. Hence, subsequent reforms of the CAP (1992, 2000, and 2003) have reduced import taxes and export subsidies as well as intervention prices for most agricultural products.

It could be argued that these costs were the consequence of a policy aiming at stabilising markets at price levels that were too high and that the CAP reforms of 1992-2003 have successfully addressed the problem. Indeed, for several years excess production has not been a significant problem in the EU. Stocks of milk powder and butter have begun to build up again due to the present crisis but this may be a passing phenomenon caused by the unusually deep recession. Setting lower price floors would also be more in accordance with the competitiveness objective since competitiveness requires that resources are allocated efficiently which, in turn, requires that prices are allowed to vary to some extent to reflect changes in consumer preferences and production capabilities.

This begs the question of how low the intervention prices should be set. One suggestion is to base them on moving averages of international reference prices and set them at levels low enough to act purely as safety nets (Bureau and Mahé 2008). However, the authors note that even this may not be feasible in the long run since also a safety net requires some border protection and WTO negotiations may force EU to reduce tariffs below what is required to support such a solution.

One might, therefore, question whether stabilising markets by stabilising prices for agricultural products should be an objective for the CAP. Given that its ra-

tionale is derived from the need to protect farmers from risk, another option could be to find other means for this that avoid the problems inherent in price stabilisation and would pass the subsidiarity test. The issue of constructing a common risk management system that allows prices and quantities to fluctuate, while compensating farmers for the financial consequences of such variations, has been discussed in, for instance, European Commission (2001, 2005 and 2006a and 2006b).

It should be noted that compensating individuals for the financial effects of adverse outcomes makes risk management a private good which the market should be able to provide. A review by the Swedish Institute for Food and Agricultural Economics (SLI Report 2007) also revealed that market solutions do exist in the EU. Some of them are traditional (forward contracting, mutual funds, insurance), while others constitute new ways to address the problem (futures and options). However, there may be market failures caused by lack of, or asymmetric, information, implying an undersupply of risk management. Systemic risks (i.e. when individual risks are highly, and positively, correlated), may be another source of market failure. Risks could be made less systemic by including beneficiaries from different regions, with different production, or from sectors outside agriculture, in the system. However, this is likely to hamper competition, again implying that too little risk management at too high a cost is supplied. Futures and options may be regarded as a remedy to the latter problem but may not work well for individual farmers since they require knowledge of market conditions for the instruments themselves as well as for the agricultural products. A further complication is that products need to be standardised (Hull 1997). Thus, a common risk management system, could improve the situation provided that the EU has better information regarding the magnitudes and distribution of risks than private entrepreneurs, and is better situated to balance different kinds of risks than private entrepreneurs and individual MS.

It is, however, unlikely that the EU has better information on individual risks than private entrepreneurs or individual MS. In contrast to private entrepreneurs, the EU could use legislation to make participation in risk management systems mandatory to overcome problems of adverse selection. So could individual MS (indeed, insurance against production risks are mandatory in Cyprus and Greece), but it might be argued that uncoordinated actions by individual MS could disturb the internal market. This would limit the EU's involvement to these legal issues while the actual solution to the risk management problem could be left to the private market. As to systemic risks, problems with high insurance premiums could be alleviated by public subsidies. This could be left to the individual MS but it might again be argued that they would be likely to choose different levels of subsidies and, thereby, disturb the internal market. As argued above, this would limit the role of the EU to establishing the legal framework for the subsidies.

To protect agriculture from the consequences of unforeseen price falls in particular, another option is to use fiscal policy to provide opportunities of smoothing gains and losses over several years, as well as opportunities of obtaining interest-free loans. Since fiscal policy belongs to national policy this is, however, not a feasible objective for the CAP. Most MS also do provide such solutions already at present. In addition, all MS have national funds from which emergency aid could be granted in case of catastrophic events. At the EU-level, the European Veterinary Fund and the European Union Solidarity Fund, provide aid on top of the individual MS national funds to cover damages caused by, respectively, outbreaks of contagious animal diseases (epizooties) and natural catastrophes.

This suggest that the role of the CAP is limited to the use of market interventions to provide a safety net (in the short term), providing the legal framework for other risk management systems (subsidies to privately provided insurance, mandatory participation, etc.) and, maybe, to provide additional financial resources to emergency funds targeted at catastrophes (events that occur very rarely but have substantial and far reaching consequences if they do occur).

3.5 Food security

Food security is defined as the probability of being able to feed a population given uncertainty about the future. Global food security is the probability that the sum of global production and global stores will exceed global need. For this reason an individual country's or the EU's own food production not only contributes to national/EU food security but also to global security and hence is a trans-boundary public good. It is this characteristic of food production that is frequently used as a motivation for continuing agricultural support to the EU's farmers; and on the face of it, it has merit. However, since food is a private good the market is capable of coordinating the production of food and security simultaneously because they are "joint-products". The critical question is whether the market for food is also providing a desirable level of food security? Only if there is evidence that food security is being undersupplied by the market should it be used to motivate continued agricultural support (and presumably coupled to production).

What of the EU's role in achieving global security? To this end it is necessary to have an effective diversification of production around the globe as over specialization in any particular region, at the expense of less production in another, will raise the risk of global food shortage. From this perspective it is likely that support to the EU's farmers would come at the cost of crowding out production in other regions of the world, and hence reduce food security of net exporters. Even if lower

food prices on the world market, which would result from support to the EU's farmers, are to the benefit of poor food net importers (Matthews 2008), it is a poor argument for maintaining support to (inefficient) farmers in the EU. In contrast, the recent EU initiative to use unspent CAP money to stimulate growth of agricultural production in Africa could be seen as enhancing global food security.

It could be argued that the public good dimension of food security is more of a dynamic nature and relates to maintenance of the potential to increase production in the future. Future abundance of food should not be taken for granted. The combined effect of population and income growth in the world implies continuously rising demand for food. Albeit, there is good potential for expanding the land under cultivation such an expansion involves, *inter alia*, deforestation which in turn substantially increases GHG emissions. Accordingly, to meet world demand and thereby avoid future scarcities, the necessary production growth will have to come from rising yields. However, global agricultural productivity growth has been in decline since the Green revolution, and hence it is most important to increase R&D spending on agriculture research to reverse the decline in productivity growth.

3.6 Additional new objectives for the CAP

3.6.1 Environmental sustainability

Although there is sound motivation for agri-environmental policy the most efficient level to design policy is at the national level because of the need for targeted or differentiated schemes; between countries, between regions and possibly between farms. There is though a strong argument for a common policy to ensure efficient levels of trans-boundary externalities, i.e. public goods such as biodiversity and certain pollutants that have cross-border effects. For example, in cases where species migrate over national boundaries (e.g. fish and birds), or individuals have a willingness to pay to preserve species in other countries (existence value) or gain indirect benefits/services from large eco-systems, biodiversity is a cross-border public good. Historical agricultural landscapes are also recognized as holding aesthetic and cultural values. Use values such as tourism can hardly be recognized as generating cross-border effects because they are consumed within national boundaries. On the other hand option, existence and bequest values (if they exist) could be cross-border public goods if citizens of other EU countries have a willingness to pay for preservation without having the intention to actually visit a particular landscape. Pollution of air and water are obvious forms of cross-border environmental externalities or public bads. Examples include eutrophication of the Baltic Sea, nitrification of groundwater, pollution of large rivers, ammonium released from livestock holdings and last but not least GHG emissions.

The existence of negative externalities such as pollution implies that optimal agri-environmental policy needs to consider both public goods and negative externalities. In some regions negative externalities tend to prevail (e.g. intensive arable farming) and in others positive (e.g. extensive grassland management). For this reason it is difficult to defend general support to agriculture on the basis of the public good argument because this production might be of public 'bads'. In fact, a system of targeted support for public goods should be complemented with a system of environmental taxes on negative externalities to ensure optimal total environmental value (which is also in accordance with the Polluter Pays Principle [PPP], but which is not usually applied to agriculture, instead farmers are paid to reduce pollution). Further, even though farmers might be shown to produce a public good this is not argument in itself to remunerate them. The relevant question is whether there is too little of the good being generated. Since public goods are often produced jointly (i.e. in combination) with agricultural products, the product market might be sufficient to guarantee a desirable level of the public good. In the event of payments more than compensating for increases in production costs, the resulting pure rent or profit will capitalize into the value of land and over time, end up in the hands of land owners. In the long-run capitalization implies higher costs for European agriculture and reduced competitivemess. Consequently, payments for public goods should only cover the extra costs to farmers (as is intended with existing agri-environmental schemes).

A prerequisite for the market to organize optimal production of a good or service is that it can be traded on a market and hence generate a price. In the case of public goods this is usually impossible because one cannot prevent those who value the good, but do not contribute financially to its production, from consuming it: a free-rider problem arises. In situations with cross-border effects the free-rider problem occurs at the national level. This is the argument for a common policy to ensure efficient production of "public goods" and even equitable financial contributions from MS.

Conservation of biodiversity and associated ecosystem services are potentially not only European but also Global public goods. In many situations these public goods will also have a strong national dimension and common financing could give rise to strategic behaviour by MS to subsidize national public goods. To reduce the rewards to such behaviour any common financing scheme should require significant co-financing (e.g. 50% as the case with agri-environmental schemes). It is also argued that national governments might use "payments" to public goods to indirectly support production, which implies the need for the Commission to be able to distinguish, in practice and law, between genuine financing of public goods from cloaked protectionism. Since targeted

environmental policy is most appropriately designed by national governments the role of common policy should be to ensure the legitimacy of payments (e.g. through a legislative framework and mandating independent evaluation of objectives and effects of payments), but even equitable financing of cross-border public goods by benefiting MS could be an important role. Common rules and agreements would also be important for coordinating measures that provide mutual or cross-border benefits (e.g. the Natura 2000 network).

As pointed out above, agri-environmental schemes have been criticized for being inefficient and perhaps in practice functioning more as income support. There are however a number of promising avenues for improving the efficiency of these schemes. Harvey (2003) proposes quasi-market systems, such as conservation trusts strengthened by public financing, as a way to resolve the twin difficulties of valuing environmental services and providing these at least-cost. Other proposals include environmental auctions (Latacz-Lohmann & Van der Hamsvoort 1998) and tradeable habitat permits (COM 2007), but even increasing the regional differentiation of existing payment schemes would be a significant step forward.

Finally, even though climate change is, in the first place, a problem that should be addressed by environmnetal policy, the agricultural sector is likely to be important for cost-effective abatement of emissions. First agriculture constitutes not only a problem – accounting for 9% of European GHG emissions – but also a potential solution to global warming through carbon sequestration and producing green energy. Secondly, climate change calls not only for new research for abatement technologies but also adaptation of agriculture in the EU to new production conditions (e.g. development of new crop varieties tolerant to drought). Europe is otherwise lagging behind in agricultural research, especially in biotechnology. Financing policies that would facilitate the emergence and development of low-carbon technologies and adaptation to climate change seems therefore an appropriate use of common budgetary resources. As argued previously, economies of scale can be enhanced by pooling research resources.

3.6.2 Cohesion and wider rural development

Poverty is a reality of many rural regions of the EU, especially among the NMS and marginalised regions among the old MS even if many prosperous and high performing rural regions can be found as well. It is not uncommon that poorer regions are also more agricultural. It could be argued that it is a reasonable objective for a common policy for agriculture to contribute to reduction of poverty and cohesion. There are however, two dimensions of rural poverty: poverty of rural regions (when rural areas are compared with other areas) and poverty in rural areas (comparing the poorest strata in rural areas with other inhabitants of rural areas). It is reasonable for a common policy for agriculture to contribute to the former and not to the latter. Poverty in rural regions falls within the domain of social policy which is the proper responsibility of national governments.

When it comes to designing new measures to support wider rural development and cohesion, policy should focus on reducing poverty indirectly by enhancing growth and development potential of those regions rather than simply focusing on money transfer. Support to wider rural development should be based on the territorial approach and general policies rather than project support. Territorial policy means helping regions to develop their territorial capital and implies less emphasis on reducing disparities and more on developing potential and increasing territorial competitiveness. By comparison, it could be pointed out that the purpose of structural policy is to promote convergence of GDP per head, an aim that implies that it is primarily allocative in intent (Begg 2006). Possible policies should substitute for agglomeration benefits: enhance quality of rural labour (quality and diversity of skills), provide access to business services and technical expertise, improve infrastructure, and provide service and amenities. Investments in human capital, in particular, increase productivity of labour and enhance labour mobility between sectors and regions. Rural development policies need also to be co-ordinated with regional and national policies.

In contrast to other cohesion policies, which target poorer regions of the Union, rural development policy is applied to all regions including the prosperous ones even if the share of the NMS is high. The question that emerges is whether policies to support rural regions that do not have any cross national dimension should be applied in prosperous regions as a part of a common policy. Rich countries could easily afford such policies on their own. Moreover, in prosperous regions, such policies are likely to be redundant and only result in displacement effects. Possible counterarguments include claims that common policies may include elements of learning by sharing experience and better possibilities to prevent fraud. In any case, preference needs to be given to rural areas that lagging behind and NMS.

3.6.3 CAP in the long run – a summary

The objectives of the new CAP should include: environmental sustainability, contribution to competitiveness through promotion of innovation and technical change, protection against catastrophic risks and contribution to cohesion, whereas the objective to support farm incomes and to assure consumer's reasonable (i.e. low) prices should be abandoned. The discussion above does not lend any support to keeping the SPS (as presently designed) as a part of the common policy for agriculture

in the long run. These payments cannot be justified as income support or compensation for higher costs, or as food security. Undoubtedly, production costs in Europe are higher due to, *inter alia*, environmental and animal welfare regulations (Ekman and Gullstrand, 2006). However, the payments are offered even to those who choose not to produce. Finally, payments to fertile land do not enhance food security, nor can they be justified on environmental grounds.

Accordingly, the SPS should be phased out from the CAP. Many authors have argued that the money, instead, should be transfered to the second Pillar. However, the future size of the second Pillar should be based on the merits of the policies in question. Transferring funds will not automatically ensure that the environment will be protected or rural development enhanced. The present arsenal of measures can hardly be deemed appropriate for the task and need substantial revision. Moreover, new measures need to be devised. Support to innovation and development and dissemination of new technologies, especially in relation to climate change and conservation of biodiversity and associated ecosystem services have been highlighted. Food security should be attained by supporting continuous progress of agricultural technology and by aid to production efforts of poor, food deficient countries.

4 Continued reform in small-steps

Looking at the changes in the CAP since the early 1900s, the policy has been developing in the right direction but the pace of change has been slow. Taking this into account, it is not reasonable to expect such a fundamental change – as envisaged in the preceding section – to materialise very soon. The issue that emerges is how the CAP should change in the meantime. In particular, what shorter term changes would be consistent with the desired long term outcome? What changes should be made to avoid jeopardising further progress in the long run? In this section, we examine several issues invoked in relation to the short term development of the CAP in this respect: further modulation, capping of high payments, cross-compliance and whether the CAP should keep the present two-pillar-structure.

4.1 Modulation or uniform lower payments?

An important characteristic of the historical CAP reforms is that the distribution of payments between regions and farms has remained largely unchanged. Even today SPS payment levels are closely related to the compensatory direct payments introduced in 1992. For this reason the largest farms and most productive regions receive the most support. Through modulation, payments above 5 000 Euro are to be uniformly reduced by 10% in total by 2012 (with an additional cut of 4% on payments above 300 000 Euro).

As an alternative to further modulation, payment levels should be evened-out across regions and countries to correct the connection to bygone price cuts. By reducing all payments to a reference level, considerably lower than the present average payment, even the budgetary cost of CAP could be reduced (as apposed to raising payments to some reference level). This could also be seen as a necessary first step towards dissembling general support by eliminating the most excessive payments. Moreover, a reduction of large payments in this way would not have a negative impact on structural change, in contrast with capping, compare below.

As far as the use of the budget savings is concerned, priority should be given to the new challenges, as identified in the Health Check, in particular climate change. In spite of climate change being a challenge of unprecedented dimension, Europe's response to it has been very small! However, as argued previously, the fact that funds originate from historical agricultural spending should not preclude them from being spent on agriculture. Instead, each new policy needs to be introduced on its own merits.

4.2 Capping

Capping of large payments has several drawbacks as a reform strategy and should not be pursued. Marginal capping (as decided in the Health Check) will not fundamentally alter the distorted distribution of payments. A more substantial reduction of high payments may, on the other hand, affect economic efficiency. Capping the payments at some arbitrary level, may influence structural change by discouraging farms from growing, which in the long run has a negative impact on competiveness. Furthermore, these kinds of restrictions can be easily avoided by artificial division of farms or similar behaviour. More importantly, with exception of the highest payments, the connection between the size of the transfer and the income of the farm is not always simple. A full-time farm, which could be expected to receive more payments, may have lower household income than a part-time farm which receives a smaller payment. At the same time, even relatively limited income transfers to those with adequate incomes and wealth contradict the fundamental principles of social policy for society at large.

Finally, the discussion on capping focuses on the wrong issue. It is not the size of a payment that constitutes a problem but its purpose and effects. Large income transfers are questionable but environmental services provided on a large scale – that otherwise would not be generated – must be remunerated more than similar services provided in smaller quantities.

4.3 Cross-compliance

Cross-compliance was introduced as part of the 2003 CAP reform as a compulsory measure. In order to avoid

any possible reduction in the total level of direct aid received from certain CAP schemes, farmers must comply with 19 Statutory Management Requirements (SMR) and a number of minimum requirements for ensuring the 'good agricultural and environmental condition' (GAEC) of agricultural land. Member States must also maintain the extent of permanent pasture (as in a specified reference year) and establish a comprehensive advisory system to support cross-compliance. Cross-compliance has met considerable resistance from some farmers and its future has been questioned.

It could be argued that there are neither big or insuperable shortcomings, nor really big advantages with cross-compliance. The adjustments recently made in the Health Check have not changed this state. It is doubtful whether cross-compliance provides environmental benefits efficiently. Cross-compliance contains two elements – legislation and GAEC. Legislation is already in force and therefore can't be considered a motive for aid (in fact the reasoning is the reverse: farmers who do not follow relevant legislation should not be entitled to support). In marginal regions, the GAEC obligation in fact functions as environmental support and has consequently provided some environmental benefit (Brady *et al*. 2009).

As long as the present (or reduced) SPS payments are in place, it is reasonable to keep cross-compliance, but increasing the number of component parts should be avoided, as this would complicate the gradual phasing out of the SPS.

The question remaining is whether the CAP should still be organised in two pillars? The distinction between the Pillars has become blurred, not least because of the introduction of cross-compliance. For this reason, it is sometimes advocated, that the Pillars should be merged to one. There are obvious advantages in such a merger but the disadvantages outweigh them. In particular, merging the Pillars would create confusion and undermine the credibility of removing first Pillar payments, which is a desirable long term future development of the CAP.

5 Final comments

The last time the EU budget was substantially re-shaped was more than two decades ago in 1988. The CAP and SF continue to absorb the bulk of resources. In spite of fundamental economic and social changes in Europe, emerging global crises (climate change), and stated ambitions to transform Europe to the most dynamic and competitive knowledge-based economy in the world by 2010, redistributive rather than growth and efficiency-enhancing programmes dominate the spending. In the case of agriculture, the rich rather than the poor benefit from these.

Looking at the preferences of European citizens, as expressed in Eurobarometer 70 of December 2008, the present profile of spending does not correspond to the preferences of the citizens. Asked on which (maximised to four) listed areas they would like to spend the European Union budget, the respondents rank agriculture low. Public health, education and training, climate change/environment, energy, scientific research and defence and security rank higher. It could be argued that the European public has a better understanding of what is an appropriate use of European money than demonstrated by decision makers.

The budget allocations need to respond to emerging global crises, especially climate change, which is arguably the greatest challenge encountered by mankind. Science and technology are the keys to such a response since the present availability of low-carbon-technologies on a large scale is limited. Much less needs to be spent on agriculture and the remaining spending should concentrate on preservation of biodiversity and mitigation/adaptation to climate change.

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