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CAP reform beyond 2013: An idea for a longer view

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Foreword

The common agricultural policy (CAP), one of the most significant budget lines of the EU, has become a major european taboo. As the focal point of most crisis or periods of stagnation in the history of european integration, this policy draws dividing lines in european debates. This can be explained by the extreme diversity of visions of agriculture's role among member states. Some of them consider agriculture as a declining sector and the CAP as a useless and costly policy. Others depict it as an essential activity and stress the need for a strong common policy.

Recent hunger riots have dramatically reminded us of the essential role of agriculture. It is not only a way to organise our landscape or environment. It is also and primarily a way to feed the planet. We need a strong agricultural production but agriculture is not as other sectors of activity, it needs regulation to produce on a continuous and sufficient basis. We think that reforming and reinforcing the CAP, even more so in a worrying mid-term perspective of increasing agricultural prices, should be a priority.

The European Commission unveiled, on 20 November 2007, a Communication including proposals for reforming the European Union's Common Agricultural Policy. The Communication was presented as a preparatory document for the «Health Check» of the current CAP, based on the experience gathered since 2003. The Commission has launched a wide-ranging consultation with stakeholders and contributions from other European Institutions. This has led the Commission to propose modifications to a series of Regulations dealing with the CAP in May 2008. It is expected that the Council will adopt new measures by the end of 2008.

The primary objective of the Health Check is to assess whether the reforms of 2003 and the following years function or not. However, the Health Check should also be seen as an opportunity to initiate discussion on future reform, which should take place before the end of the current financial framework.

Notre Europe has been working on CAP issues since 2005, with the aim of participating in the debate on the future CAP triggered by the Health Check. The purpose of the Task Force, set up by *Notre Europe* to this effect, is not to discuss the different proposals made by the Commission under the Health Check, but rather to take a broader perspective. The ambition of the Task Force is to reconsider without any taboo the objectives of a European farm policy with a long view; to assess the instruments currently in place and, drawing lessons from the past, to make suggestions on how to design the future CAP due in 2013.

In this paper Jean-Christophe Bureau and Louis-Pascal Mahé propose pathways for reforms. They first define some general guidelines such as: defining targeting instruments on clear objectives; guaranteeing social return for public money and replacing assistance by incentives. Beyond these, they suggest:

- making EU agriculture more competitive, by adapting instruments and regulations to that purpose;
- replacing the current complex and cost burden payment schemes with a simplified and smaller one in which payments are strictly linked to three basic levels of services (basic husbandry of the countryside preserving farming landscapes; territorial services; environmental sensitive measures);
- maintaining public intervention to guarantee a floor price (or "safety net") restricted to exceptional circumstances, which should be WTO compatible;

- getting an agreement on intellectual property covering Geographical Indications before signing an agreement at the WTO on agriculture;
- sharing financial responsibility between the EU and the Member States according to the principle of subsidiarity and limiting the EU's domain of competence to the provision of European public goods.

We hope that this report will usefully contribute to the debate on the future of the CAP.

Tommaso Padoa-Schioppa

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Executive Summary

Introduction

A review of the CAP was scheduled within the major reform that took place in 2003. The agreement between EU members that led to the current financial framework also foresaw the re-examination of the CAP expenditures as well as of other EU policies.

The review of the CAP, called the *health check,* started with the publication by the Commission of a *Communication* on 20 November 2007.[1] The main objectives of the health check were to assess the implementation of the 2003 CAP reform and to introduce adjustments. The European Parliament and the Council adopted reports on the Communication at the beginning of 2008. Based on these indications as well as contributions from various stakeholders and the conclusions of an impact assessment, the Commission released proposals for modifications of several regulations dealing with farm support, market organisations and rural development in May 2008.[2]

1 Document COM(2007) 722 , 20 November 2007.
2 Council Regulation (EC) No 1782/2003 of 29 September 2003, Council Regulation (EC) No 1234/2007 of 22 October 2007, – Council Regulation (EC) No 1698/2005 of 20 September 2005 respectively.

Both in the November 2007 *Communication,* and in the legislative proposals released in May 2008, the Commission proposed adjustments rather than radical changes to the provisions adopted in 2003. The Commission was not asked to address longer-term objectives for the CAP. However, even such short term adjustments as those proposed by the Commission point implicitly to future, longer-term and deeper reforms. We believe that the design of a new CAP for the post-2013 period would be facilitated if member states could first agree on revised objectives and principles that a common policy should pursue. Indeed, without a consensus on the long-term objectives, debate on the CAP before the next financial perspective might be excessively driven by financial considerations. It might also be excessively contingent on market conditions prevailing at the time. Discussions about objectives and principles for the future CAP should start early.

The original objectives of the CAP have not formally been revised since the Rome Treaty. The Commission and the European Council nevertheless produced statements which amount to a reconsideration of these objectives and emphasise in particular that strong economic performance must go hand in hand with sustainable use of natural resources and levels of waste, maintaining biodiversity, preserving ecosystems and avoiding desertification. In this report, we first recall three broad functions served by agriculture: 1) the production of food and raw materials, which contributes to food security; 2) the utilization of natural resources in production processes which may conflict with other uses of the rural space and determine the character of EU agrarian landscapes; and 3) the procurement of economic viability for communities in rural areas.

A close look at the impact of the reforms implemented since 1999 shows that they have successfully addressed many important concerns. However, some of the original hopes, in particular regarding the reorientation of the budget towards the second pillar, have not become reality. A critical assessment of the current CAP, in view of the new demands from society and the socio-economic context, leads us to making recommendations that follow four principles of government intervention at the EU level: 1) to concentrate public intervention on essential market failures; 2) to convert support into incentives; 3) to allocate fiscal resources to targeted measures according to their returns in social value and services; and 4) to extend subsidiarity in the design and the financing of EU policies.

Our vision also recognizes, firstly, the limits of fine tuning policy tools due to transaction costs; secondly, the necessity to keep and develop instruments to enhance the efficiency of the food supply chain; and thirdly, the existence of both "European public goods" in rural areas and the legitimacy of the principle of cohesion, which both militate for maintaining an extensive agricultural policy at the European level. Clearly, the level of support and the budget sharing between member states should follow a clear understanding of future functions. But our analysis leads us to believe that expenditures should be scaled down, thoroughly reorganized and better shared between the European and the national budgets to curb opportunistic national strategies working at odds with the European public interest.

Part I. A somewhat new context and emerging concerns call for further CAP review

The recent boom in commodity prices, the political initiatives to develop biofuels, the growing concerns over global warming and water shortages and the rapid economic growth in emerging populous economies have led to expectations that world market fundamentals will differ structurally from those of past decades. It is unlikely that the CAP will face booming prices throughout the next two decades, but the sharp pace of decline in agricultural prices seems to be over and prices should remain higher during the next decade than in the previous one. Some have already argued that curtailing support to EU agricultural markets was an error in such a context and that stopping further changes is urgent. We believe, on the contrary, that the present period is an opportunity for reforms. But we also emphasize the necessity to preserve and enhance the productive capability and the competitiveness of EU agriculture.

A WTO agreement in the Doha round, whenever it occurs, is both a necessity and a further challenge. An agreement is important to save the EU from recurrent disputes and it should include a peace clause protecting its content from challenges under more general WTO provisions. The future agreement should preserve the spirit of the 2003 reform, in particular allowing for decoupled payments. Thanks to the 2003 reform, domestic support provisions are unlikely to require large changes in the CAP. Such an agreement will mean a ban on export subsidies, but this has already been foreseen by the Commission. The further opening of market access and the reduction of tariffs may however have more drastic implications. There is the danger of a serious threat to some grassland-based productions in European regions with natural handicaps. Regarding the priorities in the definition of sensitive tariff lines, the EU has to find a pragmatic and consistent approach to its domestic and border instruments in order to help preserve the essential features of European rural territories.

The demands of European society for agricultural goods and services are multiform. Availability of cheap and safe food for a large share of the population remains an essential objective. But increasingly well-off consumers are also looking for other qualities. They want food to be convenient, varied, authentic, and of higher quality. Wider concerns have also emerged regarding production methods and their impact on the environment, biotechnology, animal welfare and fair trade. European society expects traditional manmade landscapes to be maintained and protected, biodiversity not to be harmed further and the ecological richness of the countryside to be defended in a sustainable manner. Increasingly, agriculture is also asked to supply biomass for non-food purposes. An adequate response to these objectives and concerns is not an easy task as preferences vary widely across Europe. Concerns may conflict with each other or with competitiveness. Examples include (i) the restrictions on imports of genetically modified products, which cause artificial trade diversion and create an excessive burden on the animal sector, and (ii) stricter regulations on food safety, which favours concentration in the food industry and threatens farmers' markets – the result here is a loss of food variety for consumers and of opportunities for rural development.

Contradictions between the CAP and other EU policy objectives have long been pointed out. Adverse impacts on environmental protection, consumer purchasing power and the competitiveness of the food processing industry have been alleviated by recent reforms. The Rome Treaty addressed agricultural issues more than food policy. Correctives were introduced to limit hardship to the food industry, but some aspects of general food policy remained unaddressed. Not much was done for poor consumers, or to protect children from unhealthy food habits induced by advertising, for example. EU competition policy has a paradoxical relationship with the CAP which cannot be ignored. Some sectors are more sheltered than others from the discipline of competition policy, due to the variety in common-market organisations. Collusion between farmers to set prices and supply restraints in geographical indications are repressed, but excessive concentration seems accepted in the retail sector and in parts of the food industry. First-pillar measures of the CAP – which account for most of the budget – do not contribute much to the cohesion objectives, given their uneven benefits across countries, regions and sectors.

Institutional changes. During the 2005 debate on budget priorities the CAP proved to be a source of political tension rather than a factor of integration. Member states are divided on the future of the CAP budget. The new power of co-decision given to the Parliament in the Reform Treaty may lead to a balance of interests regarding the CAP which differs from that prevailing in the Council of Ministers. But the new balance of powers could also make it more difficult for the Commission to steer CAP reforms in the same long-term and consistent direction as the one followed since 1992. Emerging concerns and the increasing dissatisfaction in public opinion call for an exercise to take stock of the remaining shortfalls of the 2003 reform.

Part II. The record of the reformed CAP since 1993: merits and limits

The general orientation initiated and implemented by the Commission over the last 15 years offers few grounds for questioning. The reforms carried out since 1992 have largely been a success. Major disequilibria have disappeared, including the market imbalances for cereals, beef and dairy products. Sore relations with the EU's trading partners have to a large extent been soothed. Cuts in price support have reduced the incentives for intensification and its related environmental damage. Some criticisms blaming the CAP for unsatisfactory features of today's agricultural and food systems are greatly exaggerated – but, conversely, it is nonsensical to argue that the current world food scarcity recommends a return to the old CAP. The actual benefits of recent changes are yet to be observed; the previous reforms themselves led to a number of unconvincing results; and genuinely motivated dissatisfaction with the current CAP calls for new initiatives to make the future CAP better fit European expectations.

The reforms of the 1990s have not solved a number of problems.

• *Leakages to non-intended beneficiaries.*

The second stated objective of the CAP in article 39 of the Rome Treaty was to increase individual earnings. The "old CAP" showed poor transfer efficiency in this regard due to leakages to non-intended beneficiaries. In many countries, the benefits of farm programs were, *de facto*, passed on to the owners of primary factors such as land or production rights. Most direct payments boost labour incomes to a small extent and estate value more. The 1993 substitution of price support for compensatory payments did not address this problem since payment rights were still largely attached to the land.

• *The overall budgetary cost is large*, although its share in the total EU budget has been decreasing and is expected to continue to do so.

The budget savings on market management have not offset the large outlays on direct payments. Today, whether the sizeable payments are necessary and justified is an open question. The legitimacy of payments which were a generous compensation for policy changes which occurred 15 years ago is also challenged. Their individual size and the total amount have not been adjusted down in line with technical and structural changes. The CAP is a policy which benefits a small although sensitive sector, at the cost of a significant burden on the EU economy as diagnosed in the Lisbon exercise.

• *The direct payments are highly concentrated* on a minority of farms, which can collect hefty incomes.

The payments' political legitimacy is no longer defensible on equity grounds. Moreover, it is doubtful in many cases that the largest farms provide public goods in proportion with the payments received. The capping and modulation of payments has been proposed for a long time by the Commission but has yet to become reality, except for a limited modulation.

• *The mixed environmental and rural-development record of the reformed CAP.*

The cut in price support in the arable sector has curbed the incentives to intensify inputs and was expected to alleviate damage to the environment. However, the actual achievements in this area range from satisfactory to disappointing. Limited improvements were observed regarding the environmental footprint of agriculture (e.g. fertilizer and pesticide usage) but many indicators are still deteriorating (losses of grassland, biodiversity, wetlands, bird populations, water quality, rural landscapes, soil fertility). The agri-environment programs were a well-grounded initiative but empirical evidence shows barely tangible benefits and little efficiency, due to implementation costs and competition with the sizeable payments to conventional agriculture which emerged from the 1993 compensation principle.

• *Large disparities in the net CAP-related financial balances* between member states remain a bone of contention in the European construction.
The rules built in to the financing and expenditure system still restrict the ability of the EU to implement sounder policies. They generate large discrepancies in national financial balances due to the CAP, and these are both a source of political tensions and a cause of program inefficiency. The latter is due to compromises and packages introduced to placate national interests, which externalise the cost onto other member states without clear political justifications such as cohesion. The decision-making process within the Council is prone to putting national or particular interests before the public interest of Europe as a whole. It tends to create and perpetuate inefficient policies.

The additional steps made from 1999 to 2003 – the pursuit of decoupling, the obligation of cross compliance and modulation, and the new possibility of making direct payments more homogeneous across farms through regionalization – all should alleviate somewhat the remaining negative side effects of the CAP. The genuine shift of direct payments toward the second-pillar objectives, although rather timid, has been steady and should have positive effects on the environment and on rural development.

However, the *single farm payments* provide neither positive incentives to protect the environment nor efficient tools for rural development. They are substantial in comparison with pillar II measures and make the latter unattractive for conventional farmers with historical rights. The result is delay in the adoption of organic farming and other environment-friendly practices. Payments have kept their status of rights, both to receive public funds and to transmit them by sales or inheritance (revealed by the widespread use in French of *Droits à Paiement Unique* as a translation for SFP). As a consequence cross-compliance works only as a negative constraint and creates a control-threat syndrome which does not favour adhesion. Although they are further positive steps, the *single farm payments cum* cross-compliance beg the question of whether the measures are adequately distributed and induce farmers to implement sustainable production methods. The concentration of benefits inherited from the past is hardly altered by increased modulation, in spite of the loss of legitimacy. Compulsory transparency, recently approved by the Council, might bring some progress in this area. The limitation of the co-financing to pillar II measures does not ensure the desired responsibility of member states regarding their demands for CAP benefits.

In brief, the remaining shortcomings of the current CAP call for the design of a new conceptual framework.

Part III. A new conceptual framework: instruments to target objectives, a social return for public money, and incentives to replace assistance

Both the November 2007 *Communication* of the Commission and the legislative proposals of May 2008 aim to adjust the provisions adopted in 2003. While not intending to address the long term, they nevertheless open up a direction for longer-term CAP changes. Flatter levels of payments across farms are expected, at least in a regional context. Individual payments would be subject to lower bounds and an increased rate of modulation, with reductions for successive individual payments thresholds. Cross-compliance would be simplified but control and monitoring improved. Partial decoupling could be maintained for productions such as suckler cows, in selected regions and under circumstances favourable to rural development. More generally, member states would be allowed to use part of their direct-payments budget to target particular sectors and regions with specific needs of an economic, social or environmental nature. Supply-control measures such as set-aside and dairy quotas would be phased out. Market intervention would not be abandoned but rather its scope reduced in order to avoid the perverse effects seen in the past. Green-box-compatible risk management schemes could be supported from the second pillar. Regarding finances, discipline should ensure a decreasing ceiling of pillar I expenditures over the period 2007-13.

In their ensemble we consider these Commission proposals sound and relevant. Taking a long view for the CAP, however, requires a number of issues to be more thoroughly addressed. Modulation, even with individual thresholds, is not an adequate response to the need to make payment amounts more proportionate to the value of provided services and more equitably distributed. Taking for granted that the current allocation of the budget between member states should be maintained prevents funds from being used where their impact is highest. The suggestions regarding agri-environment measures and revised cross-compliance conditions do not address the inconsistency between sizeable SFP and smaller environmental payments. The problem will be aggravated by the new market conditions and the ensuing incentives to intensify production and accordant pressures on rural resources. A central issue in designing the future CAP is a better articulation between the SFP and the incentives for conservation and rural development included in pillar II programs.

Time for a new start. The current CAP is the outcome of a long historical process and an accumulation of policy devices in response to emerging problems. Inconsistencies, complexity and inefficiencies are unavoidable results of successive political compromises.

Following the signals of public opinion, the European institutions have extended the list of the Rome Treaty objectives – although not yet in a consolidated form. Broadly speaking the new objectives stress the preservation of rural public goods, food quality and ethical concerns regarding both production methods, and distributional equity between persons, regions and nations.

Our view is that a new conceptual framework for the CAP should focus on essential market failures and on the political goals of cohesion and ethics which rationalise a European dimension to the policy. To that end the framework should look for efficient instruments tailored for the desired goals, but it must also give full recognition to transaction costs and implementation limits. We propose the following essential benchmarks for the new CAP conceptual framework:

- targeting,
- differentiation,
- proportionality,

- consistency,
- simplicity and stability,
- freedom to contract and commitment,
- responsibility.

Essential market failures are prospective targets for action. Impediments for the competitiveness of European agriculture are among the first targets. Price volatility, an inadequate legal environment for structural change, innovation and fair competition are also priority areas for public intervention. Rural public goods are another broad area for action because of the embedded externality problem. Cohesion and equity are an area where social and political goals are likely to be undermined by markets. Since these domains are so different, a deliberate targeting of the identified market failures is a precondition in order to keep side effects under control.

Targeting means differentiation across farms, areas and techniques according to policy criteria. The design of instruments must firstly recognise the double heterogeneity of European agriculture: (i) the farm structure is widely heterogeneous with large commercial farms coexisting with small family or even part time farms, and a range of farming techniques and specializations coexist; and (ii) farming conditions and the value to nature of farmed land vary considerably between agricultural types and across Europe. A one-size-fits-all approach is no longer appropriate.

Since direct payments are now the main policy tool, both their individual amount and the total EU expenditures should be made more proportionate to the services provided by farmers and to the value obtained by society as a whole. Proportionality would allow an approach to the distributional equity problem which follows the rule, "What you get depends on what you do" – as opposed to modulation, which starts from payment rights inherited from the past and works at curtailing distribution anomalies. Improved consistency between policy tools should be a side effect of proportionality, as reduced or zero payments to farms without positive externalities would make agri-environmental payments more attractive and compatible with incentives.

Simplicity is becoming an urgent concern given the past accumulation of tools. It is recognized as such by the Commission and by farmers. Stability of the policy schemes should be an additional feature of the new CAP instruments, since the assessment of the Rural Development Programs have revealed transaction costs to be mostly sunk starting costs.

Freedom and commitment would be progress relative to the current open-counter approach, which has created in farmers' perceptions an a priori "right to receive payments". It is this right which has made the introduction of additional requirements (such as cross-compliance) and moderate adjustments (such as modulation) so difficult to accept. By introducing a freedom to contract, the willingness of farmers to abide by the requirements of good agri-environmental practices would be greatly facilitated: their commitment would become a counterpart to payments.

A competitive EU agriculture. Agriculture in many parts of the EU still needs structural changes to enhance somewhat sluggish productivity. Regulations regarding new technology should be assessed with regard to their long-term consequences. While stricter regulations on pesticide use are called for by the growing evidence of their long-term health effects, genetic engineering should be considered with neither ideological bias nor attempts to bias scientific evidence, to escape liability or to capture market share. Conservation programs should concentrate on areas of ecological or aesthetic interest. Large-scale production entities located elsewhere should not be discriminated against, provided effluent emissions are kept under control and external costs internalized.

Market and risk management. To address the market failures we propose to keep the intervention system and to reform it into a strict safety net for exceptional circumstances. An independent agency would be entrusted with the task according to rules based on world market trends and set in stone. To avoid political failure this might take its cues from the Central Bank or the European Food Safety Agency. Such a rules-based system would encourage the private sector to offer risk-management contracts to farmers. New market-based instruments of risk management are now available and, except in selected well-defined circumstances, the EU should avoid involving large-budget resources. In other cases, private risk-management programs could be supported temporarily in the manner of an infant industry.

Regarding external tariffs and the World Trade Organization (WTO), we suggest that the notion of sensitivity of tariff lines (which should allow some modulation of cuts across tariffs in the future WTO agreement) be based not on historically high levels or "political sensitivity" of tariffs but on accepted non-economic and policy objectives related to public goods. Legitimate criteria to take into account include the existence of environmental services provided by farms in sensitive rural areas, and the lack of harmonised worldwide norms on production methods affecting global common goods. However, in such cases it is important not to lose sight of the second-best nature of border protection. To preserve the non-price competitiveness of European quality food products, the EU should not accept a negotiation process whereby an agricultural agreement is signed separately from a fair protection of intellectual property attached to Geographical Indications.

A three-stage contractual payment scheme covering pillars I and II. Current direct payment schemes should be converted into a general contractual scheme in coherence with the recent experience of pillar II programs. A precise definition of these contractual payments needs to draw on the experience of past and existing programs in several EU member states. Lessons on empirical implementation could be drawn from some successful local agri-environmental and rural development experiences. As a general framework, the *contractual payment scheme* could include three levels of contractual payments: *basic husbandry payments* (BHP); *natural handicap payments* (NHP) and *green points payments* (GPP). These three categories of payments could replace the complex set of current payments, bringing simplification and coherence to the overall system of farm support.

In our proposal, the SFP is replaced by a contract which offers (decoupled) *basic husbandry payments* (BHP) subject to few but observable commitments regarding rural farming landscape, biodiversity and natural resources. The main justification for the payment rests with these commitments inducing farms to provide environmental services. The BHP would target commercial farms in areas considered as "ordinary" – i.e., with neither high environmental importance nor the threat of rural decay. The payments might still be given per hectare of managed land as an ad hoc rule, but they should be tied to the commitments accepted by the operator. They should be neither tradable nor transmissible to heirs in order to avoid or minimise the capitalisation of rents. The contract would cover a limited number of years. The payments would be substantially lower than the compensatory payments granted to crops in the 1992 reform. As they will be lower than current SFPs, the existing disincentive to subscribe to agri-environmental measures would disappear and the two contractual payments described below (belonging to pillar II logic) would become attractive.

Natural handicap payments would be contractual payments targeting farms in rural zones with natural handicaps; these farms cannot compete but are essential to the rural fabric. The payments may be coupled with production or animal heads under conditions of low inputs or low stocking rates.

Green points payments. Farms which use certain production techniques such as organic farming, or who commit to a higher level of environmental services, may be eligible for green points payments, which are a schedule of credit points associated with a number of commitments. GPPs would be prescribed for portions of rural territory which are environmentally sensitive or endowed with assets of high natural value. They could also contribute to reducing the footprint of agriculture in ordinary areas, by supporting organic farms.

It is expected that the redistribution of payments on these bases would allow farms located in areas with a particular social value (e.g. aesthetic) and in environmentally sensitive zones to be sustainable, to provide the expected identified public services and to contribute to food diversity.

Environment and rural development. The above-mentioned *contractual payment* scheme would develop a set of incentives for the delivery of positive externalities on the environment. Some of the commitments and techniques might also contribute to alleviating pollution in more sensitive rural areas. These measures will not be sufficient to control pollution by agriculture, either in areas where land is devoted to general crops or in areas with a heavy burden of animal production. This role is best ensured by environmental policies to control pollution through standards and taxes. The EU has adopted the "polluter pays" principle and several environmental directives on standards or zoning for conservation purposes. The framework water directive sets out the principle of cost recuperation from pollution sources. Enforcement is the problem in many member states.

Agriculture is an essential but not unique economic base for a successful rural development strategy. The shift of funds from pillar I to pillar II has not solved the agricultural bias built into National Rural Development Plans. Rural development requires a broader, better-targeted approach and a different institutional setting in order to catalyse bottom-up projects involving all stakeholders of rural areas.

The challenge is both to simplify the offer and the management of funds at the EU level and to help organise the demand at local levels in a manner which involves all the actors and users of the countryside. These are considerations that should be central in discussions and thinking about the CAP beyond 2013, given the simultaneous necessity to look again at the structural policies. There is an opportunity for member states to think about an improved link between agricultural and structural policies before the next financial perspectives.

Financial responsibility and cohesion. The current so-called financial solidarity principle has often led to compromise decisions in contradiction with the European general interest. Member states have to agree on which matters they want to regulate and finance together at the EU level, and which ones should be left to national or local governments. The experience of fiscal federalism points to the trade-off between information and incentives, to the procurement of local and European public goods, to political failure and to cohesion objectives. Against this background and with regard to the CAP, the EU could make efforts (i) to limit its domain of competence to European public goods and to leave the regulation of local public issues it to national or local governments, (ii) to curb inefficient outcomes for local communities which result from local political failure (inadequate decision-making at the local level) by setting rules and objectives agreed at the EU level, and (iii) to act when redistribution objectives (in favour of less well-off citizens, countries and regions) are at stake. The co-financing by the EU of current pillar II measures is clearly consistent with these principles; paradoxically, the current SFP – which supports private beneficiaries rather than European public goods – is totally EU funded. We propose to extend the co-financing rule to all direct payments and to involve local governments, in order to increase accountability and legitimacy in the use of public funds.

In this new conceptual framework, European agricultural policy is trimmed down, better targeted, more responsive to social concerns, more accountable with regard to national contributions and benefits. The framework would reduce tensions between member states and address the expectations of society at large. It should even receive the support of most farmers.

Our detailed proposals in the text include guidelines for future reforms and a selection of specific measures. A number (30) of initiatives which go beyond the Commission proposals are listed in the main text. Others, which endorse the Commission proposals are not repeated. We do not claim that they optimise all the stated criteria, since real world constraints do not allow this. Their ambition is to approach such an optimisation. These initiatives could form a basis for the CAP after 2013.

Introduction

After a steady process of reform initiated in 1992, the CAP has changed considerably. The objectives of the Rome Treaty reflect little the demands of society that have emerged during recent decades. Both the Commission and the Council have on several occasions produced statements which amount to a reconsideration of initial CAP objectives (particularly the Commission's *exposé des motifs* of the Agenda 2000). The European Council of Gotebörg (15 and 16 June 2001) provides such a formulation of additional objectives for European farm policy: "Strong economic performance must go hand in hand with the sustainable use of natural resources and levels of waste, maintaining biodiversity, preserving ecosystems and avoiding desertification. To meet these challenges, the CAP and its future development should, among its objectives, contribute to achieving sustainable development by increasing its emphasis on encouraging healthy, high-quality products, environmentally sustainable production methods, including organic production, renewable raw materials and the protection of biodiversity" (EC, 2006). However, the reformed EU Treaty does not contain a reformulation of the objectives of the CAP, beyond references to sustainable development, consumer protection and animal welfare.

The design of a new CAP for the post-2013 period would be facilitated if member states could first agree on revised objectives and principles that a common policy for agriculture should encompass. To identify policy objectives first requires reflecting on the roles and functions of agriculture in a European society which is affluent, urbanized and mostly densely populated. The domains where these functions have an important impact are the economy, the environment and the countryside.

Agriculture accomplishes three broad functions, which have been deeply affected by long-term changes in technology and the economy:

> **1.** production of food and raw materials;
> **2.** utilisation of natural resources in production processes which may conflict with conservation objectives and with other uses of the rural space, and which determine the character of the EU's agrarian landscapes;
> **3.** procurement of a living to communities in rural areas.

These functions are not policy objectives per se, but European society has demonstrated expectations and concerns regarding food, the environment and the countryside which have placed agriculture under scrutiny. Moreover, society has other concerns inspired by social and ethical values which frame general policy goals. If the market system governing European economies ensures that farmers can make a living and compete with foreign suppliers, function (1) may not require government intervention, support or protection. But will the European farm sector provide commodities in adequate quantity and quality? Will animals be treated in a manner compatible with now widely-held concerns over their rights? Security, safety, and diversity of food items are defensible objectives which may not be ensured at desirable levels without government intervention and regulations. Function (2) amounts to providing environmental services and amenities which are mostly public goods and hence cannot be delivered by private enterprises, since the market mechanism fails to reward the supply of these services. Function (3) recognises that agriculture is an essential basis of economic activity in most rural areas. This function is ensured as a side effect in well-endowed regions but not in remote and naturally handicapped parts of Europe. Clearly, new concerns have emerged from the fundamental changes in the relationship between agriculture and society; the right balance between free market and public intervention is a recurring challenge.

Any effort to take a longer view over the objectives of the CAP for the 21st century must address two questions:

- What types of market failures require a farming policy?
- Which policies should be designed and financed at the Community level?

Views on this matter vary widely across member states, both among public institutions and non-governmental organizations. One view is that market failures are minimal and that side effects are essentially of a local nature and better managed by national authorities. According to this view, agricultural policy should be restricted to pillar II subsidies, and market intervention should be scrapped and border protection set at minimal levels. The implication is that the current pillar I instruments of the CAP should be foregone and the Single Farm Payment (SFP) phased out. A considerable cut in CAP expenditures would result from the elimination of pillar I instruments and the freed resources could be transferred to programs mandated by the Lisbon agenda. At the extreme some even argue that pillar II measures should also be financed by the member states, following the subsidiarity principle – the CAP being reduced to a set of rules to ensure a level playing field in the single market.

At the opposite extreme, others have concluded from the current price boom and the expected new trends in world food demand that the priority is now to increase output and to stop the planned reform process with its potential damage to production capacities. Intermediate positions advocate a reconsideration of the objectives of the CAP and the allocation of more resources to second-pillar measures: in this view, the "high costs" of paying for public goods and services through the CAP are in fact lower than paying for them in a different way[3]. A particular vision that emerges mainly in non-governmental organisations and academic circles[4] advocates a dual agriculture, involving a sub-sector of farms and areas oriented towards competitive production and another sub-sector focusing on niches and environmental services. The latter would be accompanied by pillar II measures and would benefit from a quasi complete shift of budgetary resources from the first to the second pillar.

3 See the contributions by macmillan and ritson and, more generally a panorama of positions expressed under the «scrap the cap?»Debate organised by the food ethics council, www.Foodethics.Org, autumn 2007 vol 2.
4 Buckwell (1997); Mahé and Ortalo-Magné (2001); BirdLife (2007).

Taking account of the successes and failures of the CAP over the last 50 years and in view of the current concerns of European society – reflected in numerous statements of the European institutions – certain essential items should appear in a revised list of objectives for the future CAP. The list in the following box is not a precise proposal for the revision of EU Treaties but rather a summary of issues that should be discussed prior to fixing the long-term objectives of a food, agricultural and rural development policy.

A revised list of CAP policy objectives

Without considering explicitly whether these objectives should be formally part of the CAP or part of a rural development policy (which could be separated from the CAP in either a specific chapter or together with the aims of structural policy), we propose that the objectives of the EU policy consider the following points.

1. to foster the economic performance* and the competitiveness* of the farm and food-supply chain;
2. to provide a buffer against extreme market or natural conditions and exceptional price falls; and to assist in the development of self-sustained schemes to reduce income volatility*;
3. to ensure the availability of food supplies* and to contribute to food security**;
4. to ensure that food products reach consumers at competitive prices*
5. to meet consumer demands for safety and high quality food*;
6. to preserve the natural resources of rural areas and to control pollution, with specific attention to environmentally sensitive and high nature-value portions of rural territories, to biodiversity and to ecosystems** (note that the idea of considering organic farming according to its social benefits should be more explicitly mentioned).
7. to encourage a degree of farming activity in areas with natural handicaps**

Other items should also be included either as objectives for the CAP or for distinct policies dealing with food and rural policy:

8. to ensure that fiscal resources devoted to agriculture and rural programs are effective and that the CAP is consistent with EU priorities and with other EU policies***;
9. to harmonise effectiveness of support with equity among individuals and with cohesion across regions and member states ***;
10. to require methods and processes of food production to be consistent with European values and ethics ***.
11. to ensure a fair standard of living* and to expand earning opportunities** for rural populations.
12. to ensure that that the poorest or most deprived sections of the population have guaranteed access to food**;
13. to preserve the European heritage of food variety**
14. to preserve the rural heritage of EU member states**.

* reformulation of article 39 would be needed; ** new objectives would need to be set ; *** objectives already mentioned in the Treaty, that would be reformulated

Our vision is therefore akin to those who support shifting most financial resources to pillar II. But it recognises, first, the limits of fine tuning policy tools according to transaction costs; second, the necessity of keeping and developing instruments which enhance the efficiency of the food chain; and third, the existence of "European public goods" in rural areas and the legitimacy of the principle of cohesion – both of which militate for maintaining an extensive agricultural policy at the European level. The quality of the environment, the preservation of biodiversity, and even the heritage of European farm landscapes are both local and European common goods. The common external tariff, the ambition of a unified market, the implications of agreed standards of production such as organic farming and animal welfare all imply that subsidisation of farm practices for public benefit must be agreed at the European level. But our vision is also that expenditures now under the SFP scheme should be downscaled, thoroughly reorganized and better shared between the European and the national budgets, to prevent opportunistic national strategies which work against the European public interest – i.e., member states should be more financially responsible for the budget consequences of their negotiating positions in the Council.

As a result, the so called principles of the CAP need to be reformulated with regard to those internal and external developments which have shaped the history of the CAP: (i) WTO negotiations have forced the CAP to reduce its excessive border protections and to manage agricultural trade according to rules more responsive to third countries' interests; (ii) the notion of price unity has long been a fiction across a wide and heterogeneous Europe, in spite of the formidable apparatus of common market organisations, and there is no reason to maintain such a virtual principle[5] a single competitive market would suffice; and (iii) recurrent tensions between member states over the sourcing and distribution of CAP expenditures have destabilised the EU project throughout its history, as is illustrated by the issue of the UK rebate. A reformulation of the principles is urgently needed in order to reflect a more realistic set of foundations in the design of future CAP instruments.

5 Note that the remaining market measures might have to be fully paid by the EU budget because of the risk of market distortion.

New CAP principles

1. a degree* of Community preference* consistent with the CAP objectives and compatible with international responsibilities of Europe;
2. a single market with minimal distortion*;
3. financial responsibility of member states, i.e. the co-financing** of most, if not all CAP expenditures by member states.[A]

* adjusted old principles; ** new principle

Our basic approach rests on three essential observations regarding European agriculture:

- The farming structure is heterogeneous.
- The natural conditions of farming and the value to nature of farmed land vary considerably over the rural space and across Europe.
- A one-size-fits-all policy approach is no longer appropriate. A degree of differentiation across farms, farming techniques and areas is necessary, but fine tuning has high administration costs. Second-best instruments are sometimes preferable to theoretically optimal tools with high implementation costs. Such instruments can take advantage of the existing correlation between farm location and farm types (e.g. large efficient commercial crop farms are often located on the fertile great European plains).

The general direction of the reorientation of the CAP, proposed in part 3, is to combine measures to ensure that (i) the bulk of the farm sector remains competitive and sheltered from excessive hardship; (ii) financial measures target European public goods, and (iii) better rules of the game for the agricultural budget are introduced to avoid political failures. The logic is to focus the CAP apparatus on instruments which better target objectives, give higher social returns for public money and substitute general assistance for incentives to adopt practices favourable to the public interest.

Before considering detailed proposals for further reforms, it is first necessary to check whether the fundamentals that called for the past reforms are still relevant and to take into account recent economic, technological and political developments (part 1). A second section will examine the merits and the remaining motives for dissatisfaction with the post 1993 CAP (part 2). The expectations of European society and the way agriculture is still conducted diverge significantly. Some provisions of the current CAP still fall short of sound principles of public policy. Part 3 will attempt to identify tools capable of bridging these gaps, while paying attention to the limited availability of perfect-scenario policies and to implementation problems. The aim is «satisfactory» rather than «theoretically optimal» policies.

I - The post-2003 CAP in context

Before taking stock of the current CAP after several waves of reforms, it is necessary to review the new institutional and economic contexts in order to assess the need to pursue or stop the reform process initiated 15 years ago. In particular, future world market conditions might be rather different from the context of the recent CAP reforms. International relations, World Trade Organization (WTO) negotiations, new concerns emerging in European society, and the connections of the CAP to other objectives and policies of the EU all need to be taken into consideration.

1.1 - The health check in context

The *health* check arrives in a broader context with potential far-reaching consequences for the CAP. The Commission has been developing its approach to the budgetary review 2008/2009. This budgetary review will bring all EU expenditures, including the CAP, under close scrutiny. It is unlikely that the ongoing review process will lead to large changes for the CAP over the 2009-2013 period, since such changes would modify the current transfers between member states and require a reconsideration of overall financial priorities. However, the CAP, together with other large EU expenditures, will be at the core of the preparation of the future financial framework. The fundamental issue of budget priorities brought up by former UK Prime Minister Tony Blair, which questions the large agricultural budget, is more relevant than ever. Given that several issues are tightly linked (the modalities of calculating member states' contributions to the EU budget, the various «rebates», the structural funds, etc.) the consequences for the CAP after 2013 could be significant.

The institutional and political context also paves the way for important changes in the CAP in the longer term. The College of Commissioners will be renewed in 2009. The EU Reform Treaty should be signed by the heads of states and ratified before the European elections in June 2009. The future EU Parliament will have large powers over agricultural legislation. This could lead to a different decision-making process from the traditional game of compromises and coalitions within the Council on agricultural issues. On occasion these reflect specialised interests, while in principle the Parliament should reflect wider ranging concerns. However, the Parliament's new powers could also make it more difficult for the Commission to keep steering reforms in a clear direction, as has been the case since 1992, and agricultural budgets might become more sensitive to short-term considerations.

The reforms proposed by the Commission in its 20 November 2007 "Communication" and the legislative proposals of May 2008 include changes in direct payments; a phasing out of dairy quotas; more limited intervention, and mechanisms that cause budget transfers from the present direct payments towards funding of rural development; and guidelines to deal with new challenges such as risk management, climate change or sustainable water management. Even though the proposals only involve adjustments of the provisions adopted in 2003 rather than radical changes, they pave the way for future, longer term reforms.

1.2 - Recent market developments

A new environment for CAP reforms. The recent trends in grain markets are largely due to particular climatic conditions, but more permanent factors related to food and non-food demands are also at work. Changes in income and consumption patterns in very large emerging economies are steadily inflating the demand for meat and dairy products, with amplified effects on the demand for grain. Biofuels generate new competition for land between energy and food suppliers. So far, the consequences have been limited for the EU since the weak dollar has offset some of the effects of higher prices, but a reversal of this trend would add a further push to Europe's booming farm and food prices.

Experienced and official agencies involved in market outlook and forecasting expect agricultural prices to remain steady in the medium term. Such a prospect recommends considering the future CAP within a new market environment, since sustained steady prices would alter the economic and political logic of future reforms. Likely implications include the following:

- most market support and border instruments would become non-operant or meaningless except in structurally importing sectors with tariffied duties;
- the potential use of land for energy production could provide an implicit floor price for some starch and oilseed products, making public intervention less operant and therefore less costly, but also less needed;
- high prices could boost demand for land and threaten conservation and environmental programs;
- direct payments to commercial agriculture for purposes of income support would lose any remaining legitimacy, at least in the growing number of EU countries where farm incomes exceed average incomes;
- the burden of high food prices, not only for the net food-importing poor countries where food shortages have already taken their toll but also for the «poor among the rich» in the industrial world, could become a serious moral issue.

Shall we bet on high agricultural prices? It is not likely that the exceptionally high agricultural prices experienced in 2007 will last. The history of world markets has not lived up to the most pessimistic forecasts regarding world food shortages, and a look back to past exercises of price prediction suggests that future prices have often been overestimated. Production reacts quickly to higher prices: the EU-27 alone is expected to cultivate some 65 million hectares in 2008 compared to less than 60 million in 2007, as a response to high prices; world wheat production is expected to reach 656 million tons in 2008, a 50 million ton increase compared to 2007, again mainly as a response to high prices[6]. In the longer run, population growth is expected to slow to a modest 0.4 percent per annum around 2050. Scientific innovation is taking place at an impressive rate in biology and technical innovations are adopted quickly in a globalized environment. In spite of limited land of good quality, agricultural productivity is growing fast in China and large production potential also exists in Ukraine and Russia. There are still vast amounts of land that could produce more in South America, Central Europe and even Africa.

Policies can also change quickly. The version of the US Farm Bill currently under discussion seems to combine a novel mix of output incentives, from direct payments to generous insurance schemes, which might significantly boost US production. Part of the pressure on food prices is caused by the diversion of starch towards the biofuels sector. This policy is highly contingent on political decisions and fiscal preferences. If the spill-over onto food markets of fiscal incentives to switch agricultural resources to biofuels becomes excessive, a political U-turn in this area is likely. Other more environmentally efficient means of reducing CO_2 emissions would then be encouraged and would lead to lower agricultural prices.

It is broadly accepted that in the short and medium term the structural factors will lead to steady world prices, but considerable uncertainties remain with regard to particular rates of economic growth and exchange rates; the scenario of a return to lower world prices[7] cannot be dismissed. In such a context, the market situation for the next few years should be seen as a window of opportunity for passing CAP reforms, especially regarding market management and direct payments. It should not be seen as an opportunity for scrapping all safety nets or for locking the EU into policies that are tailored for shortage situations.

6 US Department of agriculture, 9 May 2008 estimates.
7 The broad consensus is that prices should remain steady in the short and medium run. In its recent assessment of the world food situation, the IFPRI (2007) concludes that: “slow-growing supply, low stocks, and supply shocks at a time of surging demand for feed, food, and fuel have led to drastic price increases, and these high prices do not appear likely to fall soon”. The EU commission (EC, 2007b) has recently issued a synthesis of available forecasts of world prices for the next decade relative to those of the period 1997-2006: Prices are expected to remain high, but for cereals, oilseeds and sugar they should not stay at their current or recent peak levels. For livestock products however, prices at the end of the decade would remain above the recent averages.”

1.3 - International agreements

The WTO Doha Development Round could also lead to an agreement on agriculture in 2008 or in 2009. The consequences of future trade agreements must be anticipated in future reforms. Large tariff cuts are expected. The end of export subsidies traditionally used by the EU to stabilise domestic prices will make market intervention unsustainable and might require significant reforms of a number of common market organisations.

If the Doha round of negotiation fails, external pressures will stay at a higher level. Recent WTO jurisprudence suggests that many aspects of the CAP could be challenged, not only under the Uruguay Round Agreement on Agriculture, but also under the – potentially broader scoped – provisions of the Agreement[8] on Subsidies and Countervailing Measures. Existing multilateral commitments could therefore encourage reforms to some common market organizations even without a new agreement. An agreement is important to save the EU from recurrent disputes and it should include a peace clause protecting its content from challenges under more general provisions of the treaty. In addition, a failure of the WTO would force the EU to pursue more active negotiations in the bilateral arena. The only significant alternative to a multilateral agreement is bilateral accords with countries which advocate agricultural liberalisation. Large regions with high growth rates, such as Asia, Latin America or Russia, would have a strong bargaining power for requesting agricultural concessions from the EU.

Tariff cuts. Draft modalities as well as the main proposals tabled in the WTO negotiation involve very large tariff cuts for the commodities that have traditionally been protected in the EU. As a result, large sectors of EU agriculture will be much more exposed to imports. In practice, the consequences for EU farmers will depend a lot on the world market situation. If the high prices expected for the next few years prevail, an agreement should be somewhat painless in many sectors, but others would face significant problems. These latter include beef, which would affect a

8 For example, the entry price system in the fruits and vegetable sectors could be challenged. This could also be the case of CAP provisions that impose local content (under the Subsidies and Countervailing Measures Agreement), e.g. in the processed fruits and tomatoes sector. A challenge of the refunds for non Annex 1 products would reduce the competitiveness of processed products made from protected EU agricultural material. The Single Farm Payment may be seen as violating the Agreement on Agriculture on some grounds. This might also be the case of selected common market organizations.

large number of farmers, and sectors with concentrated regional impacts (poultry, sheep meat, fruits and vegetables, sugar). If prices or exchange rates turn out to be less favourable to EU prices than expected, a larger number of sectors would be affected by the expected significant tariff cuts.

More specifically, except under very optimistic scenarios regarding world markets, a WTO agreement could hurt the suckler cows sector. This sector would bear most of the adjustment to larger imports from South America, since a large share of the EU supply of beef is still a co-product of the dairy sector and is therefore somewhat inelastic. The prospects for suckler cows raise concerns regarding both grassland landscapes in general and rural occupation in areas such as mountains which heavily rely on this production. Other sectors could be faced with similar problems, but the example of suckler cows (and most likely of sheep and goats as well) raises the issue of the relative optimal combination of border protection and domestic policies that is implicit to the EU policy of rural development. These prospects suggest that future reforms must address the need for specific measures to maintain production wherever joint amenities do exist.

Domestic support. Thanks to the 2003 reform, the EU has a large degree of freedom to accept significant cuts in its present maximum Aggregate Measures of Support. Domestic support provisions are unlikely to require large changes in the CAP. However, a WTO agreement would impose a narrower choice of future instruments. WTO constraints would rule out any new policy that does not match green-box criteria. Assuming for example that the EU wanted to consider replacing both the remaining intervention prices and the SFPs with a single system providing an income safety net based on a target price or revenue (e.g., trough deficiency payments), or to modulate direct payments according to the market situation in order to avoid making taxpayers and consumers pay twice (once for the cost of food and another time for the direct payments): in these cases compatibility with future WTO obligations would be uncertain.

Export refunds will be dismantled by 2013 if there is a Doha agreement. This too will constrain the design of the future CAP, since traditional instruments such as public purchase for intervention will no longer be sustainable unless intervention prices are limited to a safety net at levels that match the average world price, in order to avoid stock accumulation and disposal of surpluses. In some sectors, such as pork and poultry, export refunds have been useful to solve temporary crises and alternative instruments of risk management are likely to be needed. In any case, export refunds have been an instrument characterized by a very low efficiency ratio[9].

Taking advantage of international pressures. The EU experience with phasing out export refunds and decoupling direct payments is a reminder that an alleged «WTO constraint» has on many occasions been an opportunity to spur reforms which clearly serve the EU's self-interest but which prove difficult to agree on in the Council for political reasons. One challenge is for the EU to match future constraints in a way that maximizes its domestic benefits. For example, WTO negotiations tend to put pressure on the EU to reconsider the structure of its border protection, but will most likely allow a limited degree of flexibility for «sensitive products». It is up to the EU to classify as sensitive the products which need to be treated as such in the EU's own general interest. The rationale for concessions in the WTO negotiations should rest on a sounder basis than political feasibility (due to the size of the downward adjustment of the existing high tariffs). An example is to classify as sensitive those productions which may ensure land use is compatible with environmental services, rather than those benefiting from a large rent likely to be eroded. But it should also be clear that looking for limited cuts in the border protection of selected products produced with joint amenities can only be a supplementary and second best tool, because discrimination according to production methods is often out of reach[10].

1.4 - Demands from society, competitiveness of EU agriculture and the European model of food variety

Demands from citizens and consumers. Society's demands regarding agriculture are now somewhat at variance with the original objectives of the CAP. Food safety is high on the list of consumers' concerns. Regarding the environment, the CAP is expected at least to avoid further damaging such things as water quality and natural habitats. Ethical concerns, in particular regarding animal welfare, are becoming mainstream. Consumers are looking for more differentiated products,

9 i.e. the ratio of increase in producer income to the costs for consumers and taxpayers.
10 Suckler cows and sheep meat are cases in point. Lesser cuts for the corresponding tariff lines could reduce hardship in less favored areas but would also benefit more intensive production without externalities.

with a focus on high quality, taste and wholesomeness. Fair trade and ethical production methods are becoming significant attributes of quality, and opportunities for product differentiation. Organic agriculture has proved able to respond to durable demand from a non-negligible and growing section of the population.

New processes and methods of production using biotechnology, such as genetically modified organisms (GMOs), have triggered deep concerns in Europe. Public opinion and activist groups may be overreacting to the possible health and environmental risks of these technologies, but scientific uncertainties do exist. The efforts of biotechnology pressure groups to block meaningful liability rules on pollution (by both conventional and organic producers) can be seen either as a sign of a lack of confidence in the risk assessment or as an implicit claim to a free ride on external effects. It is important that citizens can be convinced that the social benefits of new technology are real. In order to restore trust, approval processes must be improved and the scientific evidence necessary for approval should be supplied by impartial sources. Moreover, the authorities should ensure that the protection of intellectual property rights does not translate into excessive concentration and market power for firms. This situation could result in meagre social benefits to farmers and consumers.

Regulations and competitiveness. Meeting such new societal demands is likely to conflict with other objectives, such as ensuring that European agriculture remains competitive and open. The main conflict emerges when the CAP attempts to address a number of consumer concerns, e.g. by promoting family farm production or environmentally friendly practices. In such cases there is often a contradiction with the fundamental objectives of making EU agriculture more competitive. The limitations to GMOs, or of dairy yield activators such as somatotropin (Bst/rGBH), can create a significant cost handicap for producers. Regulatory standards regarding animal rights, labour and the environment also result in a cost burden. It remains an open question whether unilateral and stringent regulations on pesticides, fertilizers, animal welfare, eco-conditionality and other issues of production are compatible with open borders in the absence of international harmonization[11].

11 The WTO does not allow restricting trade on the basis of production methods. Few if any tools exist to promote widely but not yet globally shared ethical values regarding production methods. In the context of global commons such as green house gases emissions, compensatory measures at the border to induce international cooperation and to curb free riding have been proposed in the literature (see O. Godard, 2007).

A typical example is the EU regulation on GMOs that, *de facto*, bans imports of US maize. In autumn 2007, the EU livestock sector had to import large quantities of corn[12]. This led to a trade diversion whereby countries able to segregate their corn exported conventional maize to the EU while importing US or Argentinean genetically-modified maize or supplying other clients with the latter sources. As a result of the EU regulation, the feedstuff industry paid a 30-percent price-equivalent rent compared with the situation where US maize was imported directly. The considerable amounts of money spent had no environmental benefit at the world level, given that it led to trade diversion between countries more than to a reduction in surfaces planted with GMOs. With a liberalization of meat trade, EU producers who must buy these more expensive feedstuffs clearly suffer from distortions of competition. More generally, detractors of genetic engineering clearly understate the long-term economic consequences of systematically banning these technologies that are increasingly used in countries such as Brazil and China.

The possibilities of levelling the playing field between foreign and domestic exporters are very limited under the WTO. A general principle of the GATT agreements and WTO jurisprudence is that discrimination may not be made against imported and domestic goods on the basis of the way they are produced but only on the basis of the quality of the final product. The exceptions in the Article XX of the 1947 GATT Agreement are limited and have always been interpreted in a narrow way. In addition, imposing additional tariffs based on methods of production would be extremely difficult, if not impossible, to implement[13]. Moreover, taxing imports would not reduce distortions of competition between European and, say, American or Australian products on third markets since the EU would not be able to affect the taxation imposed on its rivals. Neither would it help either the EU producers who use these products as raw materials, or as final consumers.

12 In November 2007, nearly 1 million tons of contracts for imported maize were concluded by the Brittany feedstuffs industry alone over a two months period. (source: Association des fabricants d'aliments bretons)

13 Consider the case of greenhouse gases emission. Even though empirical studies tend to conclude that «the pollution haven effect» and «ecodumping» are not serious problems, there is evidence that countries who have not implemented serious reduction programs of greenhouse gases emissions benefit from a significant cost advantage, in particular in the cement and steel industry. A similar situation could emerge if the EU implemented a more ambitious policy in the agricultural sector, which is responsible for 20 percent of greenhouse gases emissions in a country like France and which can no longer be left outside a general emissions discipline. Legal possibilities for taking correcting measures are limited (some possibilities might exist under GATT article XXg). The current WTO rules however leave unanswered the issue of the implications on global warming of the trade in off season and exotic food products which travel by plane to fetch the whims of affluent customers in the industrial nations.

The EU cannot remain inactive given the growing level of distortions. Relaxing domestic regulations is at odds with the increasing demands from consumers and citizens. Clearly, some red tape and uselessly restrictive regulations could be eliminated. A more systematic use of cost-benefit analysis before implementing regulations would help. But one cannot expect the EU to dismantle regulations so as to match the latitude given to Brazilian, Chinese or Indian producers on questions of the environment, labour or ethics. The EU could consider redefining the way it supports its farmers, using the more explicit objective of levelling the playing field. The WTO requirement that this support be eligible for the Green Box is a serious limitation. However, the EU also has some leverage within the WTO itself, since the regulations on standards based on process and methods of production are still under debate.

Non-price competitiveness. A number of other conflicts between consumers' demands and policy objectives are possible. One issue is to manage the existence of "niche" agriculture (organic products, specific quality goods such as geographical indications (GIs), farmers markets, local networks, etc.) and that of competitive commercial agriculture. The demand for more traceability requires a more integrated supply chain. This could result in concentration, market power and low price transmission to farmers and might also conflict with the promotion of local transformation. More stringent sanitary regulations could lead to standardization of production processes, reductions in product variety, and even a conflict with environmental regulations[14]. Stricter sanitary regulations also conflict with rural-development policies, including agri-tourism, when they require food to be processed within accredited institutions, farm products to be pasteurized, organic farm products to comply with mycotoxins standards that could be unachievable without fungicides, animals to be slaughtered in distant facilities, etc.

Since 1992 EU regulation has recognized labelling linked to the geographical origin of the products, thus allowing local producers to keep the rent associated with a geographical indication. This «niche markets» policy is often seen as a way for less favoured or remote areas to compete in a globalized market. There is a need for consistency between regulatory policy and rural development policy. If geographi-

14 Albeit anecdotal, an example is the regulations making mandatory to dispose dead animals in accredited facilities, which hampers the efforts to preserve the remaining population of scavengers (and conflicts with EU regulations on biodiversity which states that such carcasses should be left available for them).

cal indications and traditional products were to become more standardized, either because of EU regulations or because of liability concerns - for example by ruling out cheese from raw milk - then the «non price» form of EU agricultural competitiveness would be endangered.

Sector-wide conflicting objectives. The potential conflict between the CAP and the competitiveness of the food industry was identified from the very beginning. The CAP modalities were a handicap for the food industry in some cases and a support provided by regulatory instruments in other instances. Higher farm prices were potentially a serious disadvantage for food processors faced with expensive raw materials compared to their foreign competitors. Provisions to offset this effect in key sectors were incorporated into the CAP, but for technical reasons instruments often intervened at the first stages of transformation (dairy, sugar) so that downstream industries still had to bear a cost burden. The new CAP has helped to restore the competitiveness of the food industry, but a number of these issues remain. At the same time, the future discipline of international trade will make compensatory instruments granted to processors more difficult to implement (the future of both refunds on non-Annex 1 products and the additional agricultural components in tariffs is uncertain given the prospect of a WTO agreement).

1.5 - The need for coherence with broader policies

The CAP was primarily designed for the agricultural sector and for farmers. Given the magnitude of government intervention and of public expenditures, conflicts with other political objectives and policies are unavoidable.

CAP and poor consumers. The CAP is not primarily a food policy in today's sense. Since market support was the essential tool of the pre-1992 CAP, consumers took the essential burden of support. This conflict has been partly resolved by the recent reforms. However, the impact on the consumer's budget due the remaining border protection and price support is not negligible for the poorest section of the population of the richer EU member states or for a large part of the population in the less well-off new members of the EU. The current gulf between the EU transfers to farmers, some of whom are far from being poor, and the tiny grant to the charity organizations that run food programs for the poor is hard to justify (in France, the EU contributes only up to 30% of Food Bank resources). This deficiency stands in contrast to the defence of the CAP on grounds of global food security, which too often overlooks the individual food-security concerns of the poor. A sizeable program of food assistance targeting poor and deprived citizens as part of a more general agricultural and food policy would be more consistent with the declared food-security objectives than the current farm policy.

Incoherence with health policy? Some critics have charged the CAP with some responsibility in the food scares that have occurred in recent decades, on the grounds that it has favoured intensification and productivity at all cost. This claim is greatly exaggerated, even if the crisis management by authorities has on occasion given too much weight to business interests. However, areas of inconsistency between the CAP and health policy do exist. Subsidies to tobacco producers are a case in point[15].

Paradoxes with competition policy. Because of the common market organizations, the CAP has always been at odds with the general principles of competition policy. A questionable distinction is made between sectors where authorities intervene to prevent cartels (such as self-organization of potato producers) and other sectors which are sheltered by a common market organization (e.g. sugar and dairy) but where prices and quantities are still set as in a perfect cartel. Such situations make competition policies highly ineffective. On the other hand, competition policies may conflict with action to help the agricultural sector secure a better share of added value, such as the denominations of origin. Initially designed to enhance and protect quality standards, these are a particular form of cartelization which restrict market entry. Competition authorities are usually stricter with these quasi-cartels composed of many dispersed producers than with single dominant firms whose brands have gathered strong market power, possibly because collusion is easier to prove than excessive margins due to oligopolistic power.

15 Concerns have also been expressed that cheaper prices for sweeteners and fats due to the ongoing reforms of the sugar and dairy sectors may contribute to worsen the diets and further boost the increasing rate of obesity now observed in Europe. It is doubtful that prices are a significant factor in the development of unhealthy food habits. Second, using this argument to maintain high prices bears the risk to muddle issues and to blur policy design.

While not directly CAP-related, a similar inconsistency appears when the Commission is fighting farmers' unions' attempts to stop price slumps in an exceptional crisis context. Conversely, in the retail sector, extreme concentration and highly dominant positions of one retailer (e.g. Tesco) can seem acceptable, as can the control of nearly a whole production sector by a single cooperative (e.g. Danish Crown). There seems to be a contradiction between the close watch kept on selected small scale GIs who restrict supplies and the acceptance of high concentration in the industries of biotechnology or soft drinks. In these cases market power not only means higher prices and margins, but also excessive influence on the policymaking process or on food habits (e.g. by advertising targeted at vulnerable groups such as children). In this respect, it is perhaps not the CAP that should be made consistent with other policies, but competition policy that should be made consistent across sectors and stages in the food chain.

Incoherence with foreign assistance policy? The CAP has often been in conflict with the objectives pursued by the EU in its relations with third countries. The most active critics of the CAP were net exporters and the EU's competitors in world markets. The reforms and the WTO negotiations have considerably eased these tensions. Policy coherence should also be a concern regarding the CAP and the EU assistance policy to poor countries. Non-governmental organizations have long accused the CAP of hurting farmers in poor countries because of subsidies and export refunds. The reforms have alleviated many of these effects; with the current level of world prices, non-governmental organizations now complain more about the social cost of expensive food for poor consumers than about the low prices that unfairly affect producers in developing countries. However, recent reforms may contradict the stated objective of development assistance through trade opportunities. The sugar reform, which erodes the preferential access of the poorest countries, as well as the rents transferred to countries such as in the African Caribbean and Pacific group are cases in point. However, concerns for less developed countries make poor arguments for keeping unjustifiably high protections just in order to maintain trade preferences for selected countries. Further efforts are needed to design alternative instruments of assistance more consistent with sustainable development.

Incoherence with cohesion policies? Successive CAP reforms have resulted in a greater exposure of the sector to market forces. Possible contradictions with cohesion policies should be kept in mind. For example, the CAP developments favour consolidation of the industry, a source of increased productivity and competitiveness but also a cause of geographical concentration of production. This is apparent with the recent sugar reform, and it could occur in the dairy sector if quotas were dismantled. This contradiction is obviously a difficult issue. At the least, the most strikingly perverse side effects of the regional concentration need to be curtailed. Pork and poultry farms and processing industries in Brittany or in Brabant are examples of heavy concentration which do not bear their full environmental costs. More generally, a tighter connection between the CAP and cohesion policies is needed so that the various EU budgets complement each other and do not provide conflicting incentives.

1.6 - Changing political balance in public opinion; more pro-reform decision-making institutions

The history of the CAP has generated inertia and path dependency of the reform process. For decades it was virtually impossible to accomplish more than cosmetic changes even when economic fundamentals were calling for more drastic reforms. Foreign pressures have proved to be effective, at least to catalyze the changes in the CAP since 1992. Even The 2003 reform can be viewed as an anticipation of the adjustments requested by a possible agreement in the Doha round.

However, conditions are changing and the prevailing balance in favour of agrarian interests could be somewhat rocked by economic and institutional developments. Institutional changes, including the growing role of the EU Parliament, could alter the CAP decision-making process. Pan-European non-governmental organizations and the powerful advocacy potential of the internet are putting more pressure on the Council. Arrangements between government representatives will be more closely scrutinized, and better-informed EU taxpayers will be increasingly reluctant to accept a policy at odds with what they see as socially desirable objectives.

The idea that farmers deserve support, once widely accepted by opinion, has faded significantly in most EU countries. Public opinion, in general supportive of the cause of agriculture, has been somewhat shaken by criticisms made of the CAP (even those that rely on thin evidence, e.g. concerning the effects of the policy on developing countries, food safety and animal welfare). The adverse impacts of agriculture on the environment and the concentration of CAP benefits have fuelled criticisms. The degree of public knowledge on the matter is still low, but it will increase readily given that information on environmental indicators is becoming more accessible and that a recent Council decision obliges member states to publish the names of beneficiaries. The budgetary argument that the CAP diverts resources from alternative uses such as research or infrastructure is now widely accepted.

Between farmers themselves, some new fractures have appeared. A growing fringe of entrepreneurial, large-scale farms seem to be willing to give up historical policy instruments and play the world market, given the prospects for high prices. The gap between this group and the farmers whose incomes depend mainly on direct payments is widening. The gap is even broader within some of the new member states. The phasing in of direct payments in Romania – where a million farmers will receive nothing because they are too small or not in a position to fill out forms, while larger farmers will enjoy generally large payments – shows how the CAP exacerbates differences between the haves and have-nots.

Echoing the questioning of civil society, the attitudes of different governments towards the CAP have changed over the last few years. Time-honoured coalitions no longer work. Proposals that were seen as extreme only ten years ago, including the re-nationalization of the CAP, now find a increasingly favourable ear in many capital cities as well as within the European Parliament. The UK government has also managed to link closely the debate on the funding of the EU budget by member states and the debate on the future of the CAP. Because of the strategic interests of net contributors, and of the ones who benefit from a rebate in particular, it is no longer possible to address the much-needed reform of the contributions to the EU budget independently from the reduction of agricultural expenditures.

II - The record of the reformed CAP since 1993: merits and limits

Since the early McSharry proposal, CAP reforms have followed a consistent path towards greater market orientation. Reforms carried out since 1992 have largely been a success. Major disequilibria have disappeared, including the market imbalances for cereals, beef and dairy products. Sore relations with EU trading partners have to a large extent been soothed. Support to the farm sector through prices was substituted for direct payments. Even though this shift lacks ambition and has met opposition and implementation difficulties, a genuine movement of direct payments toward the second-pillar objectives has been initiated since 1999.

There is little reason for questioning the direction taken by the Commission over the last 15 years. There were few credible alternatives to the general orientation initiated in 1992. Pleas to guarantee «equitable prices», or «prices that cover production costs» are still made loudly by some farm groups. However, during most of the 1990s and early 2000s, such a policy would have required maintaining an ambitious intervention system incompatible with the elimination of the costly disequilibria induced by the CAP of the 1980s, when excess production was driven by high guaranteed prices. The only manageable way would have been generalized supply controls. However, the capitalization of high prices in the value of those virtual assets (quotas, land entitled to production rights) would have generated patrimonial effects with unwanted consequences such as support to non-farm asset owners (absentee landowners, retiring farmers, siblings benefiting from inheritance, etc.). Tradability of quotas would only have alleviated, not eliminated, some of these problems.

The general path towards greater exposure to market signals, reduced government intervention and more decoupled assistance to farmers was the lesser evil of all possible policies. However, as public intervention is now somewhat more limited than in the past, an assessment is needed before any moves to further reform.

After 15 years of reforms, the CAP is still criticized from many directions. That today's agriculture does not serve well enough the "novel CAP objectives" is hardly debatable. Not all the criticisms of the CAP are convincing, however. The CAP is in some cases considered the culprit where in fact other policies are involved, or where the rest of the economy dictates technical and structural changes which influence the links between agriculture, the countryside and resources. Criticisms that stress the role of the CAP in food hazards, or its negative impact on poor countries, rely on fragile evidence.[16] At the other end of the debate, farm organizations which use the market outlook to argue for a return to a system of managed prices underestimate the considerable problems that the «old CAP» caused.

More generally, today's critiques often seem to ignore the fact that the reformed CAP no longer generates distortions which approach in magnitude those of the production-oriented CAP of the 1980s. From 1993, increasingly decoupled payments and less market intervention have cut the incentives to boost farming intensification, with its adverse effects on the environment and surpluses. Agri-environmental and rural-development programs have opened opportunities to support forms of agriculture which better reconcile food production with newer objectives.

The 2003 reform unlinked payments from interference with agricultural markets and attempted to improve farm practices regarding the environment, through cross compliance. However, the actual benefits of these last changes are yet to be observed, the reforms themselves have sometimes led to unconvincing results,

16 See respectively Bureau (2007) on the first issue and Boüet el al (2005), Bureau et al (2006) on the second one.

and there remain genuine motives for dissatisfaction with the current CAP. A major issue is the distribution rules of the SFP and the relevance of the scheme to the new market fundamentals and to the long-term objectives of the CAP. The medium-term market outlook brings both favourable conditions and emerging threats to second-pillar objectives which make it necessary to reconsider the current SFP scheme.

2.1. Leakages and inefficiencies in the reformed CAP

Efficiency in supporting farm incomes. Regarding the objective of increasing individual earnings, the “old CAP” showed poor transfer efficiency. A large body of literature suggests that the least efficient of way of transferring payments to producers is export subsidies, followed by mandatory land set-aside, price support and coupled direct payments in general.

These “distorting” forms of support have not yet been fully eliminated, even though the current market conditions have made most market intervention instruments inactive. Significant administrative costs are borne by member states and by farmers themselves. There are still areas where the benefits of spending for society as a whole are doubtful (aid for the disposal of butter, distillation of wine, etc.). Some policies, such as support to cotton, still provide a considerable incentive to pollute and overuse water (IIEEP-OREADE, 2007). However, under the joint effect of CAP reforms and high market prices, the deadweight losses associated with CAP budgets have certainly been reduced. A rough calculation based on the year 2006 suggests that the size of the economic costs (deadweight loss) of the CAP transfer still reaches an order of magnitude of 0.2 to 0.4 % of gross national product per year.[17] These figures are not negligible.[18]

17 Assuming total support (from consumer and taxpayer) is about equal the Agricultural value added and that the magnitude of the dead weight loss is in the range of 10 to 20% of the support granted to farmers (both for price distortion or fiscal burden), and that agriculture is about 2% of GNP. Further evidence from the comparison of the value created by the sector and the transfers received has often been quoted as an indicator of overstretched expenditures. As the size of the value added in EU agriculture (difference between revenue and intermediate inputs and services) is smaller than total support as calculated by the OECD, the net social benefit of the CAP, i.e. the “added value” by this European policy in the parlance of the Lisbon exercise, turned out to be negative, at least in the early 2000s (stressed by Sapir, 2003 or Wichern, 2004).

18 A full assessment of the economic cost should also include a fraction of the environmental damages which could be ascribed to CAP incentives.

The shift towards direct payments ensures that more of the money spent by taxpayers and consumers reaches farmers.[19] Direct payments now represent a considerable share of farm income. Setting aside the year 2007 which we believe was somewhat exceptional with regard to future prices), incomes net of subsidies are negative in many sectors, including beef but also in the arable crop sector, even for the top recipients of payments. It is still unclear what conclusions can be drawn from such a worrying dependency on direct payments. To conclude that the concerned farms would disappear if the SFP were phased out is certainly a premature verdict. A margin of structural adaptation and cost savings does exist for the large arable farms. The prospects for such adaptations are darker for the grass-fed beef and sheep sectors. But the figures suggest that the focus on supporting incomes, rather than helping consolidation and building a more competitive sector, must be questioned.

In the case of direct payments from the second-pillar programs, management costs are a significant share of the payments received by farmers. Even though the overall efficiency of these schemes should be measured with supplementary criteria (since their environmental impact is positive, rather than negative as is often the case with intensive agriculture), one should keep in mind that they also perform poorly in terms of income-transfer efficiency (Falconer and Whitby, 2000; Bonnieux, 2007). Administrative costs are particularly heavy in the early stages of a program, since the management of these schemes implies sunk costs and economies of scale. The implication for policy design is that direct payments should include few and long-lasting schemes. This is the experience with the Rural Development Regulation programs and it should inspire guidelines for future direct-payment policies.

Leakage to non-intended beneficiaries. In many countries, the benefits of farm programs are, *de facto*, passed on to the owners of primary factors such as land or production rights (Duvivier et al, 2005).[20] These categories are not the intended

19 However, other things being equal, it is worth noticing that regarding the gross income transfer efficiency, price support through a small duty and direct payments may not so far apart that it has been often stated in the past by neglecting administration and implementation costs. In brief, efficiency of price support in transferring income is not particularly poor for low duties, but it is low for high duties. However, precisely targeting recipients through duties remains unfeasible.

20 With the move of support towards direct payments, the actual degree of capitalisation is actually a complex issue, as shown recently by Kilian and Salhofer (2007) and Matthews (2007), because of the tradability of SFPs. The actual capitalisation in land prices depends a lot on the option chosen by Member states and the freedom left to transfer SFP rights without land (some countries such as France have made such transfers very difficult, with a siphoning of half of the SFP rights traded) and on whether there is land available without entitlement in the Member state.

beneficiaries of the CAP, according to the Rome Treaty. The capitalization of support in land prices mainly benefits non-farmers where land has recently been redistributed to absentee landowners retrieving property rights lost to 20th century collectivization, or where a large proportion of land is rented.[21] Recent studies have shown that the direct payments of the new CAP were having considerable inflationary effects on land prices in a number of new member states. In these countries, the transmission of the policy's rents to landowners is strengthened by the constraints on farm credit; hence farmers end up with little benefit from these payments (Ciaian and Swinnen, 2007). Even in countries where farmers own the land they cultivate, land ownership makes little difference to the global picture. Labour keeps only a fraction of the support, given the transfers of assets out of the sectors at each generation (payments to siblings entitled to inheritance, purchase of quotas or land from farmers leaving the sector). Because direct payments tend to increase the cost of farming in the long run and raise barrier to entry, the reformed CAP is still a policy that favors those who leave the sector rather than those who enter farming (Henry de Frahan, 2007).

The concentration of benefits. Save, perhaps, the payments for less favoured areas, the CAP never aimed to reduce existing "natural" disparities. However, in several cases it has ended up increasing these inequalities: larger farms were benefiting more from price support, and, after the reform, received larger direct payments. The shift to direct payments has made more apparent the uneven degree of support that existed previously.

A major reason for the falling support of EU citizens for the CAP is the perception of this uneven distribution of its benefits, as is confirmed by the shift towards direct payments. Anecdotes about wealthy aristocrats or large corporations receiving direct payments help to turning public opinion against the CAP.

Anecdotal evidence on payments received by particular beneficiaries hides a more complex reality. Large payments may be granted to former collective farms with a large labour force in some new member states. The image of payments channelled to wealthy arable crop farmers in fertile areas should not overshadow the fact that

21 However in situations where the legal framework gives a strong bargaining power to the tenant such as in France, farmers may still retain a large part of the payments.

in less favoured areas payments often exceed agricultural income, and that other sectors still benefit from significant market-price support. However, the concentration of the payments cannot be denied.

Capping payments (as was initially proposed by the EU Commission under the November 2007 Communication for the health check) or other modulations (as proposed in the May 2008 Commission documents) would help to counter the most outspoken criticism of the present allocation of payments, by limiting the amount cashed in by the most visible recipients. Ceilings and degressivity would also raise funds that could be used for agri-environmental schemes. However, individual ceilings and even thresholds could be circumvented. And capping will not address the core of the issue, which is the lack of objective foundations for direct payments once the “compensatory logic” is no longer seen as appropriate. Ceilings, modulation, and alternative allocation criteria would also lead to redistributions whose legitimacy is equally questionable, in particular because they would unevenly affect different sectors (Butault and Rousselle, 2007; Chatellier 2007).

There is no consensus regarding what “fair” transfers should be within the EU and whether or not the CAP should have any distribution objective within the sector itself. In some countries, the fact that large farmers reap most of the benefits is not an issue: it is considered as “normal” that larger farms receive larger payments, given that they result from compensation for earlier reforms. The fact that less public support is given to smaller, barely viable, farms in less fertile areas than to efficient farms is not seen as particularly illogical either. Indeed, the very issue of “compensating for natural handicaps” even appears bizarre to some member states. However, those who deny that “fairness” criteria should interfere with policy management design fail to provide economic and political rationales which justify the current distribution of payments without identified counterpart. While the 1993 “compensatory payments” could be seen as a compensation for the rupture of an implicit contract between farmers and society, the trend towards decoupling has undermined the legitimacy of these payments in the longer run.

Finding an EU-wide common point of view on what constitutes a “fair” distribution and on how “equity” should be introduced in a sector-based policy would be difficult. New rules for payments, based in particular on the amount of services provided to society as a whole, and in particular environmental services, could help to solve the problem.

Remaining concerns about price volatility and unstable incomes. In the past, EU producers faced predictable prices thanks to the CAP mechanisms that stabilized the internal market, even though they might have done so at the cost of larger fluctuations for other countries (variable levies, export refunds, etc.). Now that EU producers are no longer isolated from the price signals of the world market, they have to make production decisions on the basis of less certain price expectations. Unless prices are strongly negatively correlated with yields, price fluctuations have a cost for producers. Globalized markets have made prices more exogenous and the natural hedging provided by the negative correlation between prices and quantities in a closed economy is no longer effective (i.e. a poor harvest is compensated by higher prices, transferring the cost of fluctuations onto consumers). As a result, a greater proportion of the social cost of fluctuations is now experienced by producers. Society as a whole might gain from stabilization. For example, the certainty equivalent (the price at which producers would accept to supply a given quantity without any uncertainty over prices) is often significantly lower than the average price at which they would supply this quantity given uncertainty. This suggests that stable prices also benefit consumers, who avoid paying this "risk premium" to producers.[22]

Globalized markets mean that price fluctuations will be absorbed on a larger basis. But with a multilateral cut in tariffs, it is likely that production will agglomerate in low-cost areas (e.g. sugar in Brazil, grains in North America) and that many of these will suffer from high yield variations. The 1970s attempts to stabilize world prices failed and any new attempt would run into the power of hedge funds, unless such funds are excluded from commodities futures markets. There has not been any serious attempt to tackle the issue at the world level (buffer stocks, etc.). The schemes that have been tried either at the national or the international level have failed to avoid the prisoner's-dilemma problem or the political perversion of stabilization into permanent excessive support, and they are unlikely to be revived (Dehn et al 2005).

22 Such a policy may actually benefit consumers more than producers. Indeed, the detrimental effect of a price floor on producers is seldom perceived by farmers' organisations. Because a price floor shifts the industry supply curve, it results in lower prices in good times, Dixit and Pindick (1994:chapter 9) show that this may result in a lower long run average price, and that price support policy may harm the very group it sets out to help.

In assessing the extent of risk exposure of the European farm sector under the current SFP scheme, the major buffer for farm incomes provided by the sizeable constant payments should not be overlooked. However, the SFPs are unevenly distributed and over-insure some farmers while leaving others exposed to revenue shocks. One further consequence of their fixed nature is that they are distributed even in times of high income, as it is presently the case – hence their role pertains to a ratchet effect rather than to stabilization.

2.2. The environmental and rural record of the new CAP: light and shadow

Incentives to pollute. Among the liabilities of the CAP, the questionable environmental record is one of the most compelling. While pollution due to agriculture remains limited compared to other sectors, agriculture is the main source of water pollution and one of the main sources of the destruction of biodiversity (as demonstrated by the dramatic fall in the bird population: about 30% in France, IFEN, 2006). Agriculture is also the most important consumer of water, a large share of it being used inefficiently given the absence of a charge on water use reflecting the value of the resource.

Crops are the main users of pesticides, followed by wine and horticulture; pork is among the major source of water contamination by nitrates. The last three of these sectors are not where the CAP has been the most interventionist and the policy should not bear the responsibility for all pollution due to agriculture. Yet the CAP bears some responsibility in environmental degradation. Where support capitalizes in land prices, relative prices contribute to a larger use of fertilizers and pesticides. The share of crops in the total agricultural area has steadily increased at the expense of permanent grassland, which has a high value for landscape and water filtration. In France, 600 000 ha of meadows were lost between 1993 and 2003, while arable land under annual crops gained about 100 000 ha (IFEN, 2006). This switch can be directly ascribed to the bias of CAP support in favour of crops, even after the 1993 reform. National governments have done little to alleviate the incentives to destroy habitats and pollute water. Subsidies to land consolidation, drainage or irrigation even enhanced the profitability of such degradations.

The limited environmental benefits of the 1993 reforms. The reformed CAP has not managed to reverse thoroughly these incentives in spite of repeatedly stated objectives and of partial decoupling. The 1992/1999 reforms did not cause a visible diminution of the negative externalities over the 1990s. Nitrate-vulnerable zones still cover about 37 % of the EU-15 total area (1.2 million km² of the total of 3.7 million km²). Implementation of the nitrate directive by member states is a complex process. So far only a minority of member states has fully applied the directive and the Commission has opened a number of infringement proceedings against member states for non-implementation.

The use of pesticides in France continued to increase up until 1999, but a significant fall of nearly 30% can be seen between then and 2004. In the 2000s, the use of fertilizers has also gone down, but it is in part due to price changes rather than to CAP reforms and the trend seems to be reverting according to the latest figures by the International Fertilizer Industry Association. The post-1993 CAP has maintained a link between payments and land which, by making land more expensive, still provides an incentive to substitute variable inputs for land. Farm practices are not preventing adverse impacts on the rural landscape. Silage maize was made eligible for payments and hence further encouraged. Not only have meadows regressed on a large scale but also groves and scattered trees. In spite of local efforts and undertakings, the trend does not seem to be changing.[23]

The shift of the budget towards more "environmentally oriented" payments is unconvincing. First, the "second pillar" budget remains limited and finances a large range of heterogeneous measures which are not environmental. In 2003 the EU budget for agri-environment measures was 2 billion € while expenditure on the SFP was about 40 billion € (EC, 2005). Second, the fundamental problem with transferring larger budgets to targeted recipients has not yet been solved, since these forms of support are much more complex and costly to monitor than an intervention mechanism. A number of programs were found by the Court of Auditors to involve costs of audit which exceed the amounts transferred to farmers. Beyond a certain limit, increasing the budget devoted to agri-environmental programs could either generate corruption or excessive costs of inspection and control. Preliminary

23 In France, area covered by hedges which had previously fallen sharply seems to have stabilized, but groves and scattered trees which are important component of rural landscapes have lost each about 100 000ha from 1993 to 2003, without sign of trend reversal (IFEN, 2006).

assessments of the Rural Development National Programs do confirm the significance of administration costs. Their content often targets agriculture more than rural development; in most cases agri-environmental measures had doubtful positive impacts, save for the premium on permanent pastures and less-favoured-area schemes.

Aids to good farm practices and amenities through the agri-environmental programs. The preliminary[24] evaluations of the agri-environmental schemes included in the Rural Development (RD) Regulation suggest that their effectiveness leaves something to be desired (e.g. EC, 2006; Barbut, and Baschet, 2005; Kleijn et al. 2005). According to these evaluations, most schemes applied under the umbrella of multifunctionality seem to have a limited impact on most targeted objectives, in particular in the case of biodiversity or landscapes (except perhaps in areas with low intensity livestock, and mostly in less-favoured areas). Preliminary assessment of the RD Regulation program in France suggests that a couple of measures probably had some impact, particularly in less-favoured areas (those targeting extensive pastures and organic farming). There was only scarce uptake of measures in favour of extensive grass-based livestock in flatland regions where intensive agriculture is dominant. This lack of effectiveness is attributed to the contradiction between pillar I (large payments per hectare) and pillar II (smaller payments). Although organic agriculture did benefit from the program, the intake and the share of this measure in the budget was limited except in the case of Denmark, Austria and Luxembourg.[25] Clearly, the relative magnitude of the payments to organic and to conventional agriculture is again a key explanation. Another major shortcoming of the agri-environmental measures was indicated in the evaluations: the insufficient or mediocre targeting of zones endowed with environmental qualities. The empirical evidence found no observable benefit regarding conservation and enhancement for resources included in the Natura 2000 network.

As regards pollution and damage due to agriculture, the subsidy approach to practices included in the agri-environmental schemes has been even more disap-

24 These evaluations are yet limited by the fairly recent system of monitoring and the general lack of reference data on the state of the environment in the zones covered by the measures.
25 EC (2005, p.13) Netherlands and UK also had a significant uptake. In France the share of organic farming improved but is still lagging behind EU average.

pointing.[26] A Commission report on agri-environment measures mentions that little evidence of the benefits for pollution abatement is found (EC, 2005). In many cases, farmers were compensated for maintaining current practices and almost no effect on pollution abatement was obtained. Even more frequently in regions with intensive production, polluting farms have been compensated for reducing their emissions, rather than for producing positive externalities. National programs to abate water pollution by nitrates have made large funds available to farmers to conform to existing norms, or even to reduce their emissions by the treatment of manure. These measures have been considered as inefficient, unsurprisingly given the consensus that subsidies to pollution abatement are in general inefficient. The incentive given by the subsidy tends to have perverse effects since it enhances the profitability and the expansion of polluting enterprises. This is an important reason for applying the polluter-pays principle.

The CAP and environmental policies. Environmental problems are to a large extent due to the lack of adequate environmental policy, rather than to the CAP. The new CAP instruments are in theory less contradictory to declared environmental objectives than the old ones, which provided incentives to use intensive techniques and irrigation, and encouraged silage maize and the destruction of permanent pastures.

However, the limited environmental benefits of the reformed CAP and new market conditions make it even more necessary to learn lessons from the past and to eliminate the bias against environment-friendly techniques that have survived the reforms (e.g. the conversion of permanent pastures into arable crops so as to anticipate future references, the longstanding biases against extensive pastures which led to the abandonment of valley meadows to fallow or bushes, the bias against organic agriculture caused by the calculation of historical rights, etc.).

The cross-compliance conditions for eligibility to the SFP made compulsory in 2003 are potentially an attractive manner to induce those farmers who are reluctant to fulfill their legal obligations regarding environmental protection and other social concerns. Much will depend on the determination of national governments in the

26 Both Barbut and Bashet (2005) and Vindel and Gergely (2005) report that the Evaluation committee of the French National RDP has pointed that the agri-environmental measures did not target the vulnerable zones and that articulation with other environmental policy instruments was missing, hence the weakness of pollution abatement.

implementation of the scheme. Farmers' organizations have fought hard to loosen the requirements and controls and to reduce the risk of penalties. It remains to be seen to what extent practices have changed since the introduction of cross compliance. Some member states have been particularly lenient in enforcing EU directives.

Major threats come from the new market environment. As long as prices remain high in the near future, the incentives to degrade the environment may come less from the CAP instruments than from the new market environment. More land is being placed under cultivation, and agri-environmental assistance will even be less attractive than it has been in the recent past. Preliminary information on French micro-economic data suggests that farmers are now significantly increasing the use of fertilizers and pesticides as a response to the higher prices observed in 2006/2007. The incentives to produce biofuels and the higher prices for commodities might increase intensification and ruin efforts at conservation.

2.3 - Disparities of national net financial balances and the role of the CAP in the politics of the EU

The disparities of costs and benefits generated by a sector-based policy such as the CAP has long been identified and led to the well-known rebate to the United Kingdom (UK), later extended to several other member states. The so-called "financial solidarity principle" produces predictable balance-of-payments transfers in favor of agricultural countries at the expense of those with a high gross national product and a relatively small farm sector. The move towards direct payments increased the transparency of the transfers between countries. On many occasions, Council decisions were damaged by the ulterior motives of ministers regarding the net financial return. The net contributors have shown political fatigue in several instances and in general are to be found in the camp of CAP reformers. The countries that cling to their benefits have paid a political price and suffered a loss of status in the European arena. These net balances are a permanent source of tensions and tend to bias the decision-making process in a way which follows national interests more than European society's long-term welfare. On occasions, the CAP has been a bone of contention in the European project.

Sharing the burden of spending raises the issue of which policies should be financed by the European budget and which by national budget resources. One way to approach such a question is to look at the public-good nature and the coverage of the objectives of the policies at stake. The co-financing of the second-pillar policies is consistent with this view. It is not clear that first-pillar policies do pursue objectives of that nature; still, they are the ones totally financed by European resources. A contrary solution with a co-financed first pillar and a second pillar financed by European funds would make as much sense as the current situation.

To sum up, besides the relevant corrections brought by the successive reforms and particularly by the 1999-2003 wave, there are serious issues and limitations of the current CAP which need to be faced.

- In a circumstance of volatile commodity markets the demand for stabilization has increased. The important income-buffer role provided by the current SFP should be emphasized and the need for supplementary schemes be assessed, systematically and on a sector-wide scale. This buffer role of the SFP remains heterogeneous across farmers and sub-sectors.
- The overall budgetary cost of the CAP remains significant and burdened by the historical decision to provide "compensatory" payments for price cuts. How this large budget outlay balances with the stated policy objectives remains to be better assessed.
- The payments have lost most of their original legitimacy. They are concentrated on a minority of farms that do not provide particular public goods and positive externalities. Their political legitimacy is no longer defensible. Individual payments have not been adjusted downwards according to technical changes, hence the persistent scale of total outlays.
- The payments introduced in 2003 have a higher transfer efficiency than the old CAP instruments and even the ones introduced in 1993. But it remains to be seen whether the partial severing of the link between the SFP and the land market will limit their transmission to non-active farmers.
- More money is now allocated in a way more friendly to rural development and to the environment. Payments to less-favoured areas are generally viewed as relevant instruments contributing to cohesion and rural development. However, the actual achievements in this area range from satisfactory to disappointing, in particular relating to the impact on biodiversity, wetlands,

bird populations and water pollution.

- Mandatory cross compliance was a well-chosen initiative in the 2003 reform. However, the implementation may fall short of expectations. A major limitation is that it works as an obligation to avoid creating damage and is contingent on the effectiveness of policing. It is a negative constraint rather than an incentive to do something positive for the environment. It tends to generate a control-threat syndrome which does not favour adhesion. The Single Farm Payment cum cross compliance neither gives the correct, well-tuned incentives to protect the environment nor efficient tools for rural development.
- Since the SFP are in general larger than the agri-environmental payments, the agri-environment programs are unattractive for intensive farms endowed with historical references. A built-in contradiction between the first and second pillar remains. The prospects for higher prices than the historical average make it urgent to prevent direct aids further reinforcing the incentive to neglect natural-resource conservation.
- Large disparities in the net CAP-related financial balances between countries remain a bone of contention in the European project.

III - Pathways for reform

3.1 - General directions: instruments targeting objectives, social return for public money and incentives replacing assistance

We believe that directions for reforms should be based on policy principles which benefit from a large international consensus. This imperative must be taken seriously if policy instruments are to be acceptable both to the domestic population and to international partners:

1. Address market inefficiencies, such as negative externalities or risk, but implement measures that preserve and even increase the competitiveness of the EU agricultural sector.
2. Eliminate or reduce contradictions between policy schemes – such as support to intensive farming and taxes on pollution, or high payments to standard arable land and small payments for agri-environmental measures.
3. Target instruments used on identified market failures or public social objectives, while recognizing that a one-to-one correspondence is rarely accessible and that targeted tools tend to spill over onto other issues – sometimes achieving two goals at once (e.g. the environment and extensive farming) and sometimes conflicting with other aims.

4. Agriculture has a very special relationship with landscapes and natural resources in rural areas. Society has expressed clear demands regarding environmental preservation. Society also seems to value the open space generated by farming landscapes and occupation of a substantial part of the landscape by viable communities.
5. Support to farmers is justified in as much as there exist market failures regarding these public services.
6. Equity is a social goal better addressed through global policies, but inequitable sector-based policies which do not enhance general welfare have little legitimacy.
7. Keep as close as possible to the "polluter pays" and the "provider gets" principles. Recognise administrative and transaction costs in the design of first- or second-best policies.
8. Pay attention to institutions that tend to generate prisoner's dilemmas and opportunist behaviour and thereby lead to inefficient decisions for the public good.

Given these main principles, the most patent failures remaining in the current CAP are essentially twofold. The current SFP scheme perpetuates a cost burden on new farmers and does not give the right incentives to enhance the environment in rural areas. But other market failures also remain, such as price volatility, whose importance may have been neglected in the recent policy reforms. Below, we mainly propose general directions for future reforms. However, in some cases we risk making specific suggestions which illustrate and reflect satisfactory responses to the impossible task of finding a single optimal instrument for each policy goal in all cases.

3.2 - A competitive EU agriculture

Productivity. Protection of the environment and effective contribution to rural development need a better place in the definition of the means and instruments of the future CAP. However, one central objective of EU farm policy should remain the promotion of competitive agriculture, able to feed the EU population at low cost and to be economically viable. The two objectives are not in contradiction. Resource conservation is a factor in long-term competitiveness, as is illustrated by the problems of fruit pollination due to the decrease in insect population in the United States, or the fact that certain major food exporters (such as Australia) could become net importers in a few decades due to their failure to protect soil and groundwater. However, rural development policies sometimes have an intrinsic Malthusian component, and finding the right policy mix remains a challenge.

Recent studies in certain member states have shown a worrying slowdown in total factor productivity growth (e.g. Butault 2006, 2008 for France). This is a serious concern, especially when compared to the trends observed outside the EU. It is unclear to what extent this reflects the slower adjustment to policies aiming at curbing input increases, or whether it reflects a slowdown of technical change, either caused by regulations or by the failure of the EU to invest enough in research and development.

It is not fully clear whether the "old CAP" actually performed well at boosting productivity (it might have led to some over-investment in equipment, in particular countries such as Germany; the numerous cases where income falls short of direct payments in the arable sector are a worrying sign). However, it is hard to find instruments in the "new CAP" that specifically contribute to an increase in productivity. The role of the "orientation" component of the FEOGA[27], that was supposed to help in this area, seems to have been scaled down. There is no significant budget, apart from a general framework that includes agriculture in the 7th Framework Program for Research and Development and some minor budgets in the EAFRD devoted to extension and education. The Single Farm Payments themselves have an ambiguous effect on productivity. By providing financial security, they do alleviate some of the credit constraints that may reduce the adoption of innovation. On the other hand, they delay the exit of ageing farmers. Ciaian and Swinnen (2006) even show that they may have a negative impact on the restructuring of production in new member states.

Regulations. Research and development policy clearly falls outside the CAP. However, extension, training and education are particularly important, not only for competitiveness but also regarding environmental compliance and the capacity

27 Fonds Européen d'Orientation et de Garantie Agricole, or EAGGF in English. EAFRD stands for European Agricultural Fund for Rural Development, which was set up in 2007.

to manage farms using modern technology and to sell products in a globalized environment. Infrastructure and communications are important to help build a competitive industry. Public policy regarding innovation should mandate a precautionary investigation of genetically modified organisms as a potential source of pollution for organic farms, but should not be directed by ideological considerations. More generally, cost-benefit analysis could be more central when defining regulations.[28]

Administrative costs resulting from the current CAP provisions are borne mainly by member states and by the farmers themselves. The latter complain that they spend a considerable time filling out forms, facing restrictions and constraints (set-aside, cross compliance, conditions for activation of the single farm payment rights, etc). They are particularly vociferous regarding eco-conditionality, animal welfare and other cross-compliance provisions.[29] Simplification of the CAP is one of the objectives of the Commission, underscored by both the European Parliament and the Council. Management techniques that identify bottlenecks and policies that offset each other should be used so as to carry out a drastic simplification of the various common market organizations. Farmers' organizations often criticize the bureaucratic nature of second-pillar measures, but they tend to overlook the inefficiencies caused by the contradiction between pillar I measures and the incentives provided by agri-environmental schemes.

Agri-environmental programs and conservation programs should be expanded in areas of ecological or aesthetical interest. In other areas, there should be a core of simple regulations, water should be priced according to availability and farmers should comply with environmental objectives while not being constrained on how they reach them. Large-scale production entities should not be discriminated against, provided that they inspect for pollution and internalise its costs. Simple criteria such as payments per hectare of natural pasture should be a basis for large-scale programs (see below regarding proposals for simplified environmental payments). The basis for receiving payments should be a contract and freedom should left to the farmer to subscribe to a contract or not. When the contract is

28 Note that under the Sustainable Development Strategy, a sustainable impact assessment of regulations has become more systematic. A focus on the cost efficiency of the measures can be seen as a part of the process.

29 One should acknowledge that the complexity also occurs because farmers are caught in a network of relations with suppliers and customers which now rely more and more on technical terms of references. Private standards often exceed the public regulations. In addition, recent work shows that the costs involved by cross-compliance for the SFPs are in general very small compared to the payments received (Jongeneel and Bezlepkina, 2007).

signed, the included obligations require supplying evidence of performance in the delivery of services or evidence of effective compliance.

Agencies that interfere with the land market to limit the expansion of farm size should be placed in question. Payments with a looser link to land, or to the obligation to keep farming status, may help farm mobility; this was demonstrated by the recent reform in Italy that lifted some restrictions on SFPs so as to make land more easily available to young farmers. A conversion of these payments into incentives to retire, similar to the 1992 “accompanying measures”, should be considered.

Farmers should be encouraged to differentiate products and take advantage of market mechanisms. Conflicting labels have introduced some confusion and need simplification. Regarding environmental claims, one single label should be allowed, i.e. the organic one, which reflects a comprehensive and consistent set of variables. Other labels mainly introduce confusion. With the exception of geographical indication and organic labels, the mainstream system of brand names should be the rule.

Implementing instruments to cope with risk. Farmers face several types of risk: price fluctuations, production fluctuations, sanitary and phytosanitary hazards, policy-change adjustment costs and, increasingly, liability risk.

Price risk is perhaps best dealt with a mix of private and simple public instruments. Stabilizing prices is not the best option for producers.[30] Keeping prices fixed over a multi-year period would in addition isolate producers from market signals and prevent responses to surplus and shortages in a way that maximizes collective welfare. However, a certain degree of stabilization might not run into these problems and could even smooth the functioning of markets. We believe that WTO negotiations provide enough political space to allow for the maintenance of market instruments, provided that floor prices act as a safety net only (see section 3.2.2).

There is a variety of market-based instruments that can be used by economic agents to alleviate the consequences of price fluctuations, from forward contracts

30 A more desirable situation for a producer is actually that prices fluctuate with a perfect negative correlation with production, as in a small closed economy where bad harvest leads to high price and the opposite, so that income remains constant. Perfectly stabilized prices would not allow farmers to absorb any production shock.

to futures, options and swaps. Forward contracts can be implemented at the farm-gate level but run the risk of default. Futures and options make it possible to spread highly correlated risks, such as those of agricultural production, to participants outside the sector. Because these instruments are traded on large markets, default is not an issue, but options and futures are more likely to be used by intermediaries or cooperatives than by individual farmers. Swaps could potentially make it possible to hedge on a multi annual basis. However, these instruments do not work well if products are not standardized "commodities". They are less likely to be satisfactory in the case of fruits, vegetables or hay than in the case of ethanol or sugar. In some cases, such as fodder, it is difficult to see them as a solution.

Contracting is not a macro-level solution since it is illusory to believe that a price can be set in advance for all production, and production itself is uncertain. However, contracting can be an efficient way for an individual farmer to diversify risk. The present situation, where a growing ethanol and biodiesel industry seems to be willing to contract for several years at a given price, provides some opportunity for hedging between a risky market and a risk-free one. Basic finance dictates that an efficient strategy for maximizing expected utility is, for each individual to adapt his portfolio to his degree of risk aversion, not by modifying the composition of the various risky assets in the portfolio but rather by adjusting the ratio between a typical portfolio of risky assets and a risk-free asset. Contracting at fixed price could therefore play the role of the risk-free asset and suit a large variety of producers with various degrees of risk aversion.

Climatic risk. Yield risks are highly correlated between individuals in the same geographical area, and do not match the optimum conditions for insurance. The variation in yields is not exogenous, but depends considerably on risk minimization behaviour, such as the use of pesticides. This might lead to considerable moral-hazard issues, since a farmer who is well insured or has a guarantee of income could end up taking considerable risks by reducing the level of some inputs or the scope of output portfolios, in a way that would be either too difficult or too costly to monitor. The case of US crop insurance, which is largely subsidized and has a very disappointing cost-efficiency ratio, also recommends a cautious approach. However, well-designed insurance could play a role and attract the large number of participants that is necessary for insurance to function well. It is particularly the case of index-based insurance (that calculates compensations as a function of a well-designed climatic or technical index in a particular area rather than on individual losses), which can minimise the problems caused by hidden information. A pan-regional insurance market can efficiently pool some of the production risks; given the existence of a truly global reinsurance market, it also makes the traditional arguments that agricultural risks cannot be insured without large public subsidies unconvincing.

*Public intervention***.** The use of fiscal policies, such as the possibility of smoothing losses and gains over several years and short term interest-free loans, are likely to be one of the least costly instruments from a social standpoint. However, it is one that is unlikely to address all needs, given that a large number of farms are faced with a moderate level of taxes due to limited profitability.

Practical problems for the generalization of instruments such as future markets could benefit from public policies. This includes the lack of knowledge of farmers and their lack of confidence in these instruments. The oligopolistic nature of the trading sector and the food industry might also be obstacles to the proper functioning of future markets and may need regulation. Disclosure of public knowledge and statistics may also be useful.

In some sectors, strategic default is a problem both in forward markets and in contracting. In contracting, this includes, for example, petty quality controls by the processor to avoid respecting commitments when market prices are low, or claims of poor harvests by producers when prices are high. Government participation in the design of contracts and the monitoring of their implementation could alleviate problems which arise due to unbalanced market power between farmers and retailers (e.g. in the fruit and vegetable sectors). It is true that the consolidation of farmers' bargaining power is a double-sided issue, since it may result in the classical "double marginalisation" problem and end up being costly for consumers. However, if common market organizations no longer play the role of guaranteeing stable prices and outlets, it is necessary to fine-tune competition law so that some degree of vertical contract with stable prices between private agents can fill the gap left by public authorities with regard to price stability.

Public management of catastrophic risk with a low probability of occurrence and large losses could help a private insurance market to work better. In order to ensure that insurers will offer contracts to all producers and not screen the most profitable ones, and to increase the rate of participation of farmers, some degree of subsidization may be needed. However, public intervention must be kept simple in the area of price and revenue risk. Indeed, the US program of revenue (as well as crop) insurance provides an example of an undesirable drift that leads to considerable budgets outlays, with only a small fraction actually benefiting producers. Rather than getting involved in complex price or revenue insurance schemes, public intervention would perhaps be less costly if it remained based on a simple price floor at least for a few key commodities able to drive prices in related markets.

The case for some market management. The prospects for high prices in the short to medium term are considered as an opportunity for a rapid and painless elimination of dairy quotas and the intervention system in most sectors.

However, as we mentioned earlier, a look back at Food and Agricultural Policy Research Institute or OECD projections shows that forecasters have always been wrong, with a net bias towards predicting higher prices than those that occurred. The consequences of dismantling all market instruments should be assessed under pessimistic scenarios regarding exchange rates, world prices, and the possibility of highly managed trade by exporters such as China, Russia and Ukraine (which exported wheat to the EU at a price that could not be explained by any market fundamental in the early 2000s). This suggests that the EU should at least keep safety nets or safeguards that could be triggered without having to reinstall complexes pieces of legislation. For example, the EU could decide to stop intervention for some or all products, but to keep the legal instrument in place (as was done in the case in the maize sector).

A floor price might help stabilize the expectations of producers and avoid large disruptions in the EU production sector. It may also help reduce insurance premiums, making it possible for private firms to offer revenue insurance contracts at lower costs to farmers, expanding the potential coverage of private insurance and in general reducing the need to subsidize insurance schemes.

This price should be set at levels that ensure that its role is limited to a safety net, for example on the basis of a moving average of an international reference price. To avoid any asymmetry in the management of crises and a perversion of the scheme, the rules of such a safety net price should be bound in legal texts, so as to avoid being prone to sliding in a crisis context. An independent agency could be entrusted with the task of managing the safety-net scheme according to rules based on world market trends and set in stone in a way inspired by the Central Bank or European Food Safety Agency, in order to avoid political failure. This implies lowering the current prices for grains, dairy and sugar. The Commission's proposal, of getting rid of the intervention system for coarse grains but maintaining some public intervention for wheat so as to have a reference for the market of starch products, is not in contradiction with this idea.

*WTO compatibility of intervention instruments***.** Public intervention to guarantee the floor price based on the moving average could not lead to stock accumulation and external-surplus disposal. However, intervention purchases even restricted to exceptional circumstances would hardly be possible without some degree of border protection (any intervention system would otherwise be flooded by imports). It is unclear whether the tariffs that remain after a Doha agreement would allow the EU to maintain a floor price with such an instrument, given the very large cuts that are discussed in particular in the 2005 US proposal.

If tariff cuts make such a safety net impractical, relying on some kind of target price and deficiency payment would make sense. This would also avoid a combination of high prices and high payments, such as the current one. Such a proposal is unlikely to be greeted enthusiastically by member states. Many are keen on taking advantage of the high current prices to get rid of the intervention system altogether, and few are willing to replace it with a US-style system whose record is as unimpressive as the EU one. In addition, because these deficiency payments would not be eligible for the green box, difficulties would arise in the WTO. The Commission has always refused to consider deficiency or counter-cyclical payments, arguing that the budget making procedure is ill-suited to unpredictable expenditures. It is true that any attempt to set aside a special fund would bear the risk of the fund being used for other policies when needed, this risk perhaps being exacerbated by the co-decision power given to the European Parliament. However, if the floor price is low enough and deficiency payments are used as a last-resort safety net, it should be possible to reach an agreement with the Council and the Parliament and to create a mandatory fund. Such a fund should be devoted to the specific purpose of dealing with exceptional circumstances but would be left untouched under normal conditions and reported on each year. Regarding the WTO constraints, the draft modalities issued by Chairman Falconer in February 2008 seem to allow some degree of freedom in this area.

The corollary is to consider the case of very high prices. Already, the high price of cereals is causing severe difficulties for EU livestock producers. History suggests that a sudden surge in prices has undesirable consequences for several years. (In the 1970s the skyrocketing price of feedstuffs led farmers to slaughter cattle, and the consequences on the cohort of livestock capital could be seen years later both in the dairy and beef markets[31].) Export taxes, as implemented by the EU in 1996, and embargoes, as implemented by the US in the 1970s destroyed the international credibility of these countries in the eyes of net food-importing countries. There has been so far little effort to limit export restrictions under the WTO. If export bans and taxes were subject to a discipline, the claim that fluctuations will be absorbed on a more integrated market would be more credible.

Instruments such as buffer stocks could be considered. But historical experience shows that the management of these buffer stocks is sensitive to political pressures that are asymmetric and tends to lead to stock accumulation. Adjustments in tariffs, such as the ones that took place in 2007, are ad hoc solutions, but such flexibility loses its interest if bound tariffs go down.

WTO negotiation, agriculture, international property rights and non-price competitiveness. Europe has diversified agriculture and enjoys a wide variety of food. The bulk of farming is devoted to staple goods and commodities, but specialty food products are also part of the European heritage. This is a source of wealth creation for the sector as a whole, an opportunity to export high-value products as revealed by the wine and spirits industry, and a valuable contribution to rural development. Europe did not negotiate efficiently during the Uruguay round in this area, possibly because it was bound to barely defensible positions on issues such as

31 See Drouet and Mahé (1978).

export subsidies. The end result was a fairly poor deal on the protection of geographical indications when compared to the firm protection granted to private brands and patents. The argument that Europe had been benign and negligent in leaving foreign firms to use European names in their marketing strategy had clear limitations (the grandfather clause might as well have been used to defend the indefensible trade measures of the EU). The experience should not be repeated during this round and Europe should not sign an agreement on agriculture before and separately from an agreement of intellectual property rights, one which provides legitimate protection to the geographical indications which supplement Europe's food-quality and rural policies.

Quotas and set-aside. The current market situation provides an opportunity for getting rid of quotas and set-aside. The main motivation for these policies, to curtail surplus disposal, is no longer valid. By limiting supply, they are perceived as a source of inflation in food prices.

Regarding the dismantling of quotas, the difficulty is in avoiding large-scale destruction of wealth for farmers. A progressive increase in the level of quotas, together with a decrease in the administered price of dairy and sugar, is necessary. This is the route followed by the Commission in its health check documents. Regarding set-aside, the challenge is to maintain the indirect environmental benefits of compulsory set-aside which acted as a way to preserve biodiversity. Specifically designed programs such as biodiversity refuges and corridors must be either made compulsory or funded on a long-term basis through agri-environmental programs. Funding equivalent surfaces on a voluntary basis may require large budgets. This is an area where the Commission's Communication of November 2007 did not sufficiently address.

Selected proposals regarding market management

1. Reform intervention into strict price-safety nets for exceptional crisis management, with rules based on world prices and set in stone for political resilience
2. Develop and temporarily support income-insurance schemes
3. Base the notion of "sensitive tariff lines" on productions eligible for natural handicap payments and green point payments
4. Do not sign an agreement on agriculture at the WTO before an agreement on intellectual property covering GIs
5. Phase out supply-control schemes and convert set-aside into a conservation measure integrated into the contractual payment scheme

Biofuel policy and the CAP. Innovation also involves finding new uses for agricultural products. It is possible to justify support to biofuels as an "infant industry". However, in the longer run, second-generation technology should lead to the production of ethanol from a variety of crops. The 'infant industry' argument is perhaps not appropriate to justify support to investments in the rapeseed/diesel industry, which use quite a different technology and different agricultural materials, and are probably located in a different type of region.

The present support to the first generation of biofuels is hard to justify. Promoting biofuels as a way to achieve energy independence makes little sense. In the most optimistic scenarios, domestic biofuels would replace less than 3% of imported petroleum products. The environmental balance-sheet of biofuels is in doubt and their positive externality does not seem to justify the current public support. While mandatory incorporation could be a way for consumers, rather than taxpayers, to fund the cost of the EU policy in member states that are willing to develop the use of biofuels, the support provided by the CAP lacks legitimacy. It seems to countervail agri-environmental measures in a number of arable crops areas by providing an extra incentive to grow crops that cause groundwater pollution. Energy crops on set-aside land also offset some of the ecological benefits of set-aside.

Altogether, the biofuel policy as a way to transfer income to farmers is particularly ineffective. The cheapest opportunities for producing biofuel will soon reach their limit. The present level of biodiesel consumption (amounting to 1.7% of transport fuel) is already creating serious tensions in the market for rapeseed and depressing the market of co-products (rapeseed cake), which raises the break-even point.

Given that any extra production of biofuels competes with the utilization of land for food products, and hence increases the cost of producing biofuels, support for extra production will mainly be dissipated in production costs.

The second generation could dramatically change the calculation for these products. The technology has yet to become cost-effective; this should take at least 10 to 15 years. However, budgets would perhaps be better used if allocated to research rather than to the promotion of the first generation. Our proposal is therefore to adopt a cautious approach in the launch of biofuel programs and to resist the temptation to use biofuels as a means of solving the adjustment problem of agriculture. The recent tension on the commodities markets shows the perverse effect of ceding to this temptation.

Guidelines in the biofuel sector

- Launch biofuel programs only on the basis of environmental and cost effectiveness and not as an indirect remedy for the CAP adjustment problem
- Targets for biofuel energy shares should be based on the comparative-benefit cost-analyses of various means of abating carbon emissions

3.3 - Direct payments: more homogeneous across orientations, differentiated according to services and locations[32]

The first imperative is to end the logic of compensatory payments, which should have been temporary, and to adopt the logic of an “incentive to provide” designated services. The second is to avoid the leakage of support granted through the current SFPs into land costs by cutting off the historical base. The third is to correct the imbalance in the distribution across sectors and farms. The fourth is to enhance the effectiveness of the closely-related environmental and rural development policies. Clearly, the size of the individual payments and hence of the EU farm budget that we propose should be calibrated so as to be in line with the economic benefits provided by the farm sector, both regarding positive environmental externalities and the husbandry of the countryside.

32 The reorganization of payments proposed is broadly consistent with the proposals put forward by the study group chaired by A. Buckwell (1997). Strict market stabilization was retained and two payments for services (Environmental and cultural landscape payments and Rural development initiatives) were to substitute for subsidies. First pillar subsidies were to become Transitional adjustment assistance. Here we emphasise the contractual and non marketable character of the payments, maintain a possibility to contract for a basic reduced payment over most of the territory, and stress the differentiation over the rural space. Payments for environmental services according to a scale of “Green stars” and a zoning of the rural territory were also proposed by Mahé and Ortalo-Magné (2001).

Regarding direct payments, we propose the following principles against which the new CAP conceptual framework should perform:

- targeting
- differentiation
- proportionality
- consistency
- simplicity and stability
- freedom to contract and commitment
- responsibility

3.3.1. A complete reshuffle of direct payments: a three-level "contractual payments scheme" (CPS)

Rights should no longer be entrenched into the CAP nor attached to the land (see horizontal clauses). In our proposals, they are attached to the functions of agriculture which amount to public services. To avoid excess complexity, some degree of imperfection of policy instruments is voluntarily accepted. Three levels of services are taken into account: (i) the basic husbandry of the countryside in order to preserve farming landscapes; (ii) the continuation of farming activity in areas and regions with natural handicaps (the territorial services); (iii) positive efforts to preserve and enhance natural resources in designated rural areas endowed with high nature value or with sensitive environmental attributes (environmentally sensitive areas).

First level: A basic husbandry payment (BHP). A basic payment per hectare of land farmed under certain conditions (e.g. 100 or 150€/ha, to give an order of magnitude; the issue is obviously subject to more detailed analysis). It is granted to all farms, including commercial and intensive farms, which accept a contract to manage the land and to preserve farming landscapes. This payment has features which foster the enforcement of environmental measures:[33]

33 The BHP could conceivably include a stabilizer component, variable according to the level of prices relative to a long run trend of world prices (crisis management component), to avoid granting too much support during price booms and too little in price troughs. However, such a variant would not meet current green box criteria. It mmay also contradict the development of income insurance contract by private firms. In addition, during periods of high world prices, the BHP would need to be high in order to continue to give farmers an incentive to protect the environment. That is, the BHP should not be seen as a countercyclical income support instrument.

1. *Decoupling*: the BHP is fully decoupled from productive inputs and outputs but it is coupled with services. Hence, the remaining part of coupled payments to crops and intensive livestock is abandoned over most farm land area (see infra for exceptions).

2. *Cross compliance*: BHPs are conditioned on maintaining good agricultural and environmental conditions and a few but easily verifiable environmental constraints such as river-bank pastures, a portion of land devoted to biodiversity, a degree of crop diversity and rotation, etc.

3. *BHPs* are designated for genuine “rural areas”. Areas around cities, densely populated recreation areas and portions of the rural space where land price is high compared to the national average (e.g. suburban municipalities), are not eligible.

4. *BHP* contracts extend over several years (perhaps 5 to 10) and are revised periodically to account for technical change or land planning adjustments.

Among the various options mentioned previously, the BHP follows the choice to maintain some general support but to reduce the current average level of the SFP by more than half. Contrary to the “bond scheme” which gives lump-sum compensation and fully exposes farms to the market, the BHP provides both a buffer income support and an incentive to farm the land according to good practices. To maintain reduced payments even for commercial farms after 2013 also reflects the difficult assessment of the adjustment margin of cost structures of these efficient farms where income is now often smaller than the total SFP received.[34] It also finds legitimacy in the constraints on production methods which are more severe than those imposed on most foreign competitors. These payments are at least as consistent with the green box as the current SFPs. Cost restructuring, technical progress, and inflation observed after a period of about 10 years may or may not open new margins to reduce these general payments, as should have been the case for the 1992 direct payments.

Second level: A “natural handicap payment” (NHP): A system of higher payments for areas with natural handicaps (sparsely populated, mountain, remote, northern, dry…). This payment may be coupled with farming activity inasmuch as produc-

34 In a typical rented crop farm the land share in the costs is less than 20%, which sets a clear limit on cost cutting offered by land costs.

tion and environmental services are credible complements.[35] In particular, dairy, beef and suckler cows, sheep and goats can be raised with a clear multifunctional role provided stocking rates are kept low. Cross-compliance conditions should in general rule out intensive production processes because these natural handicap areas are more environmentally sensitive than the areas eligible for the BHP.

Third level: Green points payments (GPP) for environmentally sensitive areas and high nature-value areas, i.e. for green zones: These are special contracts for designated environmental services of higher value than the basic commitments associated with the BHP. Farms located in environmentally sensitive areas in less fertile regions (but also in pockets of territories otherwise devoted to commercial farming) can be eligible on the basis of farm practices, including:

1. Land devoted to extensive-pasture, low-input techniques in river basins
2. Conservation and management of extensive pockets of biodiversity, of green corridors, of marshland; prevention of bush invasion, officially protected zones under Habitats and Natura 2000 directives, etc.
3. Organic farming
4. Extensive farming techniques requested in the production codes by GIs
5. Preservation of the traditional mosaic of landscapes and rural heritage
6. Fallow and set-aside land for resource conservation

The green payments are based on the incurred costs and on the capacity of farmers to contribute to environmental protection, but also on the value of the provided services as determined by society. A schedule of *green points* is established to grade and aggregate the delivered services into eligibility for payments. The total payment per farm cannot represent much more than the remuneration for a full-time job in the region.[36]

Lifetime retirement payments (LRP) are substituted for current SFPs for the older operators of very small farms which require amalgamation to reach minimal efficiency. This measure targets the new member states and parts of the (often southern) old member states' farm sectors where a retarded farm structure still

35 Hard statistical evidence of jointness is yet scarce but exists (OECD, 2001; Peerlings and Polman, 2004), a case of complementarity for extensive sheep can be found in Le Cotty et Mahé (2008)
36 Techniques that rely on the «bonus point system» for a variety of environmental actions or on the auctioning of a particular objective (such as providing refuge for birds over a designated number of hectares) could be developed to better tailor the payments on efforts required.

exists and where amalgamation is hampered by land-tied payments which substi tute for pensions. A condition for eligibility foresees that land is made available to viable larger farms, except for personal plots.[37]

With such a deep reorganization, support will put an end to most historical rents and will provide better incentives to farmers. Equity between farms and region will greatly improve. Classic farming will derive most of its income from market prices and the productive function. As an illustration, a "state of the art" farm with 200 ha of crop land would receive up to 30 000€ of direct aid; an extensive farm of 50 ha with handicaps or higher environmental commitments could receive up to 20 000 € (50 x 400 €). Both are viable. Farm products in Less Favoured Areas and High Natural Value areas will benefit from both better prices due to a quality premium and from an NHP-GPP premium. Farmers should be able to make a living in spite of higher costs. The granted support is designed for that very purpose and for the associated services supplied.

3.3.2. Horizontal clauses for financing and distributing direct payments

The horizontal principles are designed to enhance the performance of the *Contractual Payment Scheme* with regard to reformed CAP objectives and to avoid some of the undesirable side effects of the current SFP system. A first intention is to alleviate the perverse effects of the skewed distribution of costs and benefits across member states on decision-making regarding the CAP. A second intention is to prevent the capitalization of support into land values and farm assets and its implications listed in part 2. A third intention is to avoid generating competitive distortions in the single market.

Payments "rights" are intuitu personae, and neither tradable nor inheritable. The payments are granted to a person or an entity in exchange for commitments to adopt designated agricultural practices in designated areas over a stated period. The link to the person and not the land originates from the contractual nature of the possibility to receive payments. There is no "right" to payments *sensu stricto,* but conditions and commitments which offer eligibility to contract.[38]

37 As rights can neither be traded nor inherited there is no contradictory incentive to keep the land in hope to reap income flows or capital gains.
38 This is in contrast with the Single Farm Payment

This form of payments may appear to be in contradiction with the rule that payments are proportional to farmed hectares. But this rule is an *ad hoc* rule which reflects the empirical difficulty of assessing the value and the cost of the three services rewarded by the *contractual payment scheme*. This is particularly true for the first two payments (BHP and NHP). It may be less so for the *green point payments* since experience exists with farms in environmentally sensitive areas, Natura 2000, Fresh Water Catchments, Habitats, etc. It should be possible in the future to construct indicators based on the value of services and to aggregate them into a credit earned by a farm operator.[39] The payment per hectare is a second best which has the merit of simplicity. In this respect it is line with the widely-lauded objective of simplification of the CAP.

A time-limited contract. The historical base of "rights" to the SFP is foregone. All payments are granted for a given period to the farm operator in exchange for the provision of designated services, and not to the owner of the land. No eligibility-based right to receive payments is created that could be part of the immaterial capital of the farm. The contract is valid for a number of years.

Rights to payments cannot be rented nor sold at retirement or cessation, even with the transmission of land, since a new contract between the administration and the new operator is necessary for receipt of payments. The type and amount of payments offered to the new entrants may not be the same as those granted to the previous farmer in view, for example, of a revised classification by local authorities of the zone of interest, or because of policy development based on information gained from experience. If revisions are perceived as rare or unlikely, it is conceivable that the expectation to become eligible for payments might give some value to hectares for rent or sale on the black market. But the advantage of the system is that capitalization of the rent is made les automatic.[40]

The Achilles' heel of a *contractual payment scheme* is the bureaucratic burden of managing and monitoring the system. A continuous flow of new contracts would need monitoring due to permanent cessation and entry into farming. The current

39 Such environmental indicators which grant "sustainability points" to farm practices are considered in (Haldberg, 1999)

40 This intuitu personae and time limited feature would alleviate the obstacles currently raised by eligible beneficiaries when authorities want to change policy rules, payment levels or the vocation of pieces of land when land planning so requires.

system of SFPs is already quite complex, in particular the monitoring of transmission and sales of “rights”, with different rules and levies depending on whether land is transferred with the SFP. The control of the commitments in the contracts is not *a priori* more demanding than current cross compliance and it would even embody a degree of automatism due to the fixed duration of the contract. This monitoring could be conveyed to extension services that would be accountable to the state or to the EU authorities. This could have the advantage of relaxing the psychological pressure of the unexpected inspection in the current system, which in part explains that it is rarely enforced in many countries.

Another potential problem is that the voluntary nature of these contracts could lead to low participation when world prices are high. This would require that CAP budgets be large and flexible enough to match the participation objectives. In a price-boom context any policy seriously intending to protect the environment will need to be ambitious, given the incentives of world prices to produce more intensively. Our scheme leaves room for adjusting the balance between incentive-based and command-and-control approaches (see section 3.5.).

Rules for zoning the rural space are defined at the EU level. The classification of areas into the three categories amounts to a fine *zoning* of the whole rural territory. Experience of all zoning experiences shows that this is a contentious issue, as zoning inflates or curtails future windfall gain opportunities and influences land values. The process should draw from the experiences of naturally handicapped regions and Natura 2000. The further difficulty is that the grid of the zoning is finer in the present case for both the g*reen zones* and the *NH zones*. For example fertile plains of mountainous areas should be excluded from NH status. But hilly areas or valley-bottom areas where commercial farming dominates should be eligible for *green* status, with its consequences for eligibility.

As long as the payments are co-financed by EU resources, rules must be defined at the EU level, but final decisions and monitoring should involve local administrations and political institutions. The process cannot escape exposure to political sensitivity. These limitations and the burden of fine-grid zoning of the rural space should be balanced with the flaws of the current situation, which also generates equity problems and which to a large extent embodies a *de facto* zoning where rights to strain the rural resources are over-exercised.

A checklist of commitments and guidelines for control are defined at the EU level. EU decisions focus on rules and specified objectives. As the EU is co-financing the payments, it should have a role in verifying the effectiveness of the delivered services. Lessons can be drawn from the EU Nitrates and Water Directives: (i) setting rules which can serve as a basis for appeals to the European Court are of great help for enforcing resource protection when the local political authorities are unable to implement policy targets previously and officially accepted at the level of EU Council of ministers; (ii) clear and simple rules such as nitrate content in fresh water resources have proved easier to challenge in the courts than multiple and complex ones.

Precondition: Completion of CMO reforms. The *contractual payments scheme* is implemented when all CMO reforms for crops and animal productions are achieved. Except for tariffs it is the essential tool of government support; hence it offers a potential for CAP simplification.[41] The increased homogeneity of direct payments (BHP) across commercial farm orientations supposes an increased homogeneity of remaining price support across orientations. Unless this is obtained, the unbalance of support would be displaced in favour of productions such as dairy.

Capping of total payments per farm unit. Attempts to make the distribution of payments more "fair", such as by capping the payments per farm or by reducing the payments to the largest farmers and redistributing the budget to those that receive less have been recurrent in the CAP reform process, at least as far back as 1991 (in the leaked reform project). Capping farm payments has been retained in the US programs. It can be circumvented and may trigger fragmentation of large farms and the May 2008 health-check legislative proposals seem to consider that individual capping would unduly affect particular member states. The Commission has a long experience of attempts at introducing increased modulation of individual payments. The debate is fairly well known and amounts to finding a balance between social demands for equity and member states' opposition related to their incidence of very large farms. The demand for equity will increase with the progress made regarding transparency and public information (and not all member states have followed the same policy in this regard, but they will have to enforce the recently agreed rule to publish the names of the beneficiaries). According to the

41 An example of opportunities for simplification would be to include the initial subsidy to young farmers in countries where it exists within the initial contract at the start of the career.

logic of payments for services set out in this conceptual framework, total payments to a farmer should in principle be limited to his maximum capacity to supply such services. Modulation would lose legitimacy under our proposed scheme, since a major motivation for modulation under the current CAP (transfer funds from Pillar I to Pillar II) would become irrelevant.

Direct payments from public funds should in principle open a right for the public to access the countryside. Since the direct payments find legitimacy in the public nature of services brought by farm practices, some possibility for the public to enjoy the countryside should exist. Between the right to roam for everyone and everywhere and the refusal of farmers or landowners to allow the creation of footpaths along rivers or on their property, solutions must exist for ensuring some degree of organized access under designated conditions. The EU Commission might also envisage a directive whereby member states would greatly restrict the effective loss of publicly owned country roads and trails, which too often are sold to farmers who preclude future development of footpaths and turn heritage landscapes into uniform arable land. Where hunting is allowed and developed in a collective manner, it should not be possible as a rule to exclude the total area of the farm.

Financial responsibility of member states and subsidiarity. The principle of co-financing by national and regional governments is extended to all direct payments: the member states will co-finance subsidies now pertaining to current pillar I. Pillars I and II are merged into a single fund. National and regional *Contractual Payment Schemes* are submitted to the EU for agreement (see section 3.6 for more details). The latter clause takes advantage of the loss of the obligatory status of pillar I expenditures in 2013.

3.4 - Agriculture, environment and rural development

Agriculture, the environment and rural development are closely intertwined issues which are the concerns of major policies other than the CAP. The relation of the traditional CAP with these policies has been a conflicting one. The post-2003 CAP opens avenues for more complementarities between the three policies. Most objectives of both the EU environmental policy and rural development strategies are well identified and their principles are economically sound. For example the *polluter* *pays principle* is referred to in the legal texts and rural development is clearly viewed as relying on a wider economic base than agriculture. As a consequence, the scope for proposals including deep changes is more limited than for the core of the CAP. According to our evaluation of the remaining problems, implementation by member states and the complex institutional setting within the Commission (multiple European Funds) are the main shortcomings. Explanations can be found either in the novelty of pillar II schemes (e.g. agri-environmental and rural development measures) or in inefficient political action within member states (lack of measures against pollution and damages; poor implementation of directives).

The environment: more effective regulations and economic instruments. The relationship of agriculture to the environment has two polar components: a potential to provide amenities in the rural areas and a risk of damaging the environment. The amenity component is a clear case for targeted public support (hence the *contractual payment scheme*) to supplement all opportunities offered by the market to generate income on the basis of these amenities (hence the bottom-up rural development programs). The damage component is a case for binding instruments (hence the many directives on nitrates, water, pesticides etc.). A bridge between the two components was introduced by cross compliance (subsidy under conditions) and measures to support non-intensive farm practices.

This evidence supports the proposal put forward in the previous section to design a zoning of the rural space where high nature-value assets are identified and registered to serve as bases for the *green point payments*. In order to make agri-environmental measures more effective, the existing evidence calls for selecting the measures which are the most focused on important objectives, targeting the areas where the environment is at stake, improving the environmental expertise and reinforcing the implication of local and regional institutions in the implementation.

The *contractual payment scheme* proposed above develops a set of incentives for the delivery of positive externalities on the environment and includes features which improve consistency and effectiveness relative to the current SFP/agri-environmental measures system. Since the *basic husbandry payments* are lower than the SFP and the *green point payments* greater than the agri-environmental subsidies, the intake of GPP by farmers should increase relative to the agri-environmental measures. For example, organic farming and measures in favour of extensive pasture around water streams would become more attractive than under the current historical base for SFPs, which has given more credit to silage maize than to grass for example. The more systematic approach to defining zones of high nature-value in river valleys within the areas devoted to commercial agriculture and the associated, more attractive, payments both offer a potential for conservation which should gather momentum over time and avoid the dilution of the current agri-environmental measures. It will add a micro approach to the macro approaches of Natura 2000, Habitats, and similar directives.

The argument against subsidies to reduce pollution does not apply to the support granted to organic farming or to extensive pasture that we propose in the green points payments. An expansion of organic farming will not generate pollution; an excessive expansion would bump up against the limits of the potential market and regulate the size of the industry. Another benefit of focusing on organic farming is that monitoring is rather easy since the certification system already exists.

In principle, some of the commitments (in the BHP) and extensive techniques requirements (in the GPP) should contribute to alleviating pollution in more sensitive rural areas. In the health check the Commission has proposed to simplify the cross-compliance system and to reduce the number of "statutory management requirements". This concern for simplification is welcome and is an adequate correction to the impossible task for a single instrument of achieving so many objectives. The correct balance is to focus on key environmental targets and to make sure that the likelihood of controls is a sufficient deterrent, while ensuring that farmers are kept clearly informed of the rules of the game they are playing. This would be clarified under the BHP of the contractual payment scheme at the time of the signature of the contract – which offers an opportunity for information or training, a process which differs from the current SFP. In any case, cross compliance cannot be sufficient to control pollution by agriculture, either in areas where land is devoted to general crops or in areas with heavy loads of animal production.

Policies to control pollution through standards and taxes do exist in the EU. The competence for these policies is not integrated into the CAP. It belongs to different administrative bodies, both at the EU and national levels. The EU has adopted the *polluter-pays principle* and a large number of environmental regulations and directives regarding standards, practices or zonings. The framework water directive defines objectives of water quality and policy principles such as the recuperation of costs from the agents who are the sources of pollution. It appears that measurable objectives, standards and principles are set at the EU level and that member states can choose the detailed instruments. Enforcement is the problem in many member states. Some have used economic instruments such as taxes on inputs or on emissions to a sufficient extent, others have not. In the long run the cost-recuperation principle set into the water framework directive should force reluctant national governments to fall into line with the *polluter-pays principle*. The existing legislation has demonstrated some virtue as the Commission or national NGOs have been able to take national governments to the European Court of Justice for failing to ensure water quality at the level of the standards agreed previously and set into directives. But the use of "economic instruments" such as taxes and pollution charges has been neglected as regards agricultural pollution (Bonnieux, 2007). Such simple instruments could provide a real incentive to reduce fertilizer and pesticide usage. They cannot be wholly sufficient, since effective levels of taxation would have sizeable income effects, but they could supplement the existing set of regulations regarding homologation and practices.

Guidelines to improve the environmental effects of agriculture

Amenities

- simplify the number of measures and concentrate on issues of high environmental importance
- refrain from changing programs too often, since information gathering and administration is costly and costs are essentially invested at the launching stage
- focus on the provision of services rather than on changes in practices because of a lack of references
- identify environmentally friendly methods of production, in addition to organic farming, which are already certified (e.g. assessment of production commitments for conserving resources in selected GI products)

Pollution and damages

- reinforce the discipline and the monitoring of the principle of cost recuperation from the agents at the source of pollution
- identify EU rules regarding levels of pollution charges and taxes on fertilizers and pesticides to ensure minimum effectiveness
- revise the Nitrate Directive to generalize the ceilings for total application of nitrates (organic + mineral), as implemented in some member states

Rural development is concerned with the maintenance of viable communities in rural areas. Viability means that residents have access to services and an acceptable level of social life. The problems can be acute in sparsely populated portions of the territory; less so for rural communities near to cities, which have access to services and a job market and do not depend only on agriculture for their economic base. The existence of services of an adequate quality requires a critical mass to make a job (doctor) or a facility (school, sport and cultural facilities) either sustainable on a private basis or justifiable under a public-finance argument.

The most important economic bases for lively rural communities are agriculture, forestry and other extractive activities. But communities can also build on the services provided by natural resources for recreation, such as tourism or simply residence. Rural development can also be based on economic activities for which location is less important but the availability of labour and rural amenities may be attractive.

In most cases agriculture cannot be the only base of economic development. Data show that in the rural areas agriculture accounts for around 20% of jobs. In areas specialized in crops or in extensive grass-fed cattle breeding, there is a clear contradiction between the farm sizes required by efficiency and the objective of a sufficiently dense farming population. Therefore, agriculture should not be the only sector or target for rural development policy. Still, this has too often been the case up to now in the programs designed under the auspices of rural development. Most evaluations find a strong bias in favour of farming and little help for other rural actors.[42] This is particularly true for national and European programs under the Rural Development Regulation, a result of the shift from pillar I to pillar II.

It is a matter of fact that enhancing the attractiveness of rural areas is obtained through the procurement or improvement of infrastructure, public services and other public goods. Because of the public-good nature of these spending targets, they are not defended by lobbies as well organized and powerful as the farm pressure groups. Farm organizations prefer subsidies to land or to farms which are privately held and do not fall into the public domain. The mid-term evaluation of the Rural Development Plans, particularly regarding the measures financed by

42 EC (2006), Vindel and Gergely (2005).

resources from pillar I, reveals that agricultural measures (Less Favoured Areas and Agri-Environmental Measures) receive the major share and that the actors close to farm organizations were the most active in implementation.[43] Enhancement of the potential of local communities to create or attract economic activities and/or subsidies from national and European sources is therefore crucial for successful rural development programs. There is a clear shortcoming in the current institutional framework to manage the funds from pillar I savings in favour of a widely based rural development strategy. This has led many analysts to wonder whether rural development programs introduced after 1999 were more than simply a way to save the CAP (e.g. Jouen, 2007).

This is not meant to understate the role of agriculture itself. As it is often the primary economic base, there is a case for ensuring its viability, particularly in sparsely populated, less favoured areas or in environmentally sensitive areas. Following this rationale, there is an economic argument for direct payments on the grounds of land occupation and maintenance of the countryside as an open farming space, protected from land abandonment, bush invasion, general reforestation and farmed in an environment-friendly manner. Quality farm products such as those protected by geographical indications are valuable assets for sustaining rural development in many areas. The coherence between the quality schemes currently in force and other policy support could be improved through a sound definition of new competencies for producers' groups to better manage the product, to increase their bargaining power and the efficiency of their marketing strategies. From a broader perspective, the objective to strengthen the added-value creation process in rural areas for these kinds of specific products must be introduced more systematically in the National Rural Development plans. Agricultural market policies, specific quality products and rural development policies could accordingly be better linked.

In order to strengthen the basis for rural development, agriculture should not be a factor of the degradation of rural amenities and natural resources, which could be an alternative source of development on the basis of comparative advantage and natural factor endowments. Agricultural practices should therefore be regulated to enhance positive externalities on which tourism, residence and other recreation activities such as hiking, hunting, fishing etc., can draw value. For these activi-

43 Barbut and Baschet (2005)

ties based on natural amenities to prosper, a convergence of farm practices over a given territory is necessary; otherwise a polluting pig farm, for example, could ruin the attractiveness generated by a neighbouring extensive sheep farm on hilly lands close to a stream. Zoning or land planning could help to avoid such contradictions in areas where intensive techniques are a potential threat to natural resources (Mahé and Ortalo-Magné, 2001).

The Council Decision of 2006 on Community strategic guidelines for rural development for 2007-13 draws from recent experience and evaluations of national rural development plans. The new strategies are built around four axes: axis 1, on improving the competitiveness of the agricultural and forestry sector; axis 2, on improving the environment and the countryside; axis 3, on the quality of life in rural areas and diversification of the rural economy; and axis 4, on Leader (building local capacity for employment and diversification). While the first two axes necessarily focus on farming actors and can be considered as an mere evolution of the CAP, this is not so for the last two, which take a broader approach to rural development and call for greater implication of local non-farm actors. The challenge is both to simplify the offer and the management of funds at the EU level and to organise the demand at local levels in a manner which involves all the actors and users of the countryside. This is a challenge for many countries whose ministries have a history of strong farm policy and weak rural policy.

Guidelines and proposals for broad-based rural development

- Require that all rural stakeholders participate in the design and evaluation of National Rural Development plans
- Ensure that funds gathered from leisure activities such as hunting and fishing are used jointly with EU and rural development funds to design and reward resource-enhancing actions by farmers, in order to improve policy coherence.
- Curtail horizontal measures not differentiated over space. Ensure that Rural Development Plans target rural zones where development is lagging (such as Less Favored Area, zones classified by environment directives and pockets of economic decay included in regions without Less Favoured Area status)
- Simplify the EU offer of rural development programs.
- Make non-farm rural dwellers eligible for resource-conservation measures currently restricted to farmers, or design programs to create alternatives to the procurement of environmental services by farmers only
- Restrict the subsidy for young farmers entering the market, wherever it exists, to zones eligible for natural handicap or green point payments
- Design legal or economic tools to improve the share[2] of added value from agriculture benefiting

rural areas, with special attention to GI products

- Take advantage of the positive interaction between neighbouring farmers in adopting resource conservation and enhancement practices. Design special programs with a group bonus when farmers, tourism entrepreneurs, countryside user associations cooperate in a project covering a designated high nature-value area.
- Define rules for organized access to the land and to the countryside in areas benefiting from public subsidies.

3.5 - The funding of a reformed CAP: financial responsibility and subsidiarity

The sharing of competences between the Union and member states is a fundamental question in the European construction process. For a sector policy such as the CAP, a basic issue for member states is to agree on which matters they want to decide on and finance together at the EU level, and which should be left to national or local governments.

One approach is to draw guidelines from the theory and experiences of fiscal federalism, and from public choice. The principle of subsidiarity recommends decentralization when issues are better dealt with locally and centralization if there is value added by shifting power to the EU. This principle shifts the burden of proof onto the advocates of central or supranational governments. Demands for services are better known at the local level, but externalities between local communities can be better solved with centralization. As a consequence local public goods would be left to local governments and global public goods to the central authority. But specific cases still prompt debates regarding the right level of competence. Persson et al. (2005) argue that, taking into account political economy and coalition-formation considerations, clear-cut prescriptions are difficult to make. Moreover, given heterogeneity in preferences across local communities, normative results are contingent on strong value judgments. Other arguments for centralization are risk sharing and redistribution. The principle of cohesion in European regulations and directives is an illustration of the latter.

Against this background and with regard to the CAP, in general one would expect the EU to limit its domain of competence to European public goods and to leave it to national or local governments to regulate local public issues,

- unless an inefficient outcome for local communities is viewed as resulting from political failure (inadequate decision-making at the local level)
- when redistribution objectives (in favour of less well-off citizens, countries and regions) are at stake

European public goods include: the single market and its benefits such as economies of scale; the area of research and development, innovation etc.; food security and safety; risk sharing and risk management which benefit from a large market. Environmental quality across Europe both involves global common factors such as carbon emissions, or irreversible loss of biodiversity. Other amenities in the rural areas or water quality are mainly of a local public-good nature.

The initial CAP in the context of the 1950s was to some extent consistent with these principles. The single market which favours fair competition, specialization and economies of scale in the relevant sectors can be considered as a global public good. The common external tariff is a logical consequence of this market unity and EU competence on trade negotiations brings a bargaining power that no single member state could afford. Food security for consumers was another public good, and achieving income parity for farmers can be viewed as an anticipation of the cohesion objective. Even price stabilization could to some extent be considered as an acceptable common management of price risks.

However, redistribution effects were built into the system firstly as a result of the customs union (although non-visible), and then of the common financing of expenditures (increasingly visible). This has been the CAP's weak point ever since the first enlargement. It has triggered recurrent political crises in view of the large discrepancies of the net financial balances between member states. The most recent episode of tension between large net contributors and beneficiaries relating to the CAP occurred in 2005. The final agreement on the 2007-2013 budget included a review clause which invites the Commission "to undertake a full wide ranging review of all aspects of EU spending, including the CAP". The present distribution of the net contributions is no longer acceptable and the Commission has carried out a study on the "operation of the own resource system" which includes a general correction mechanism (EC, 2004). But this deals more with the net global financial balances to be corrected than with the sharing of competencies and financial burdens of specific policies such as the CAP. However, the CAP is the main bone of contention due to its large share in the budget; this explains why renationalization of the CAP now finds several advocates, not only among member states with negative balances[44] but also in academia.

Our view is that some of the *green points payments* can be eligible for EU co-financing, since biodiversity is a clear public good. Other actions such as extensive meadows, river-bank protection and limits on nitrates use to protect water quality have a predominant local public-good nature. An argument therefore exists for leaving them to subsidiarity in both decisions and financing. This is not the route chosen by the EU, which has adopted the principle of co-financing pillar II measures. This move seems to reveal fears of local political failures in the protection of local common goods; several environmental directives (nitrates, water) belong to the same paradox.

The *Natural Handicap Payments* find clear legitimacy in the principle of cohesion; hence co-financing is a logical implication. The difficulty is the definition of the relevant zoning and eligibility conditions of recipients. Local or national governments will have an inclination to overestimate the size of the eligible population even if the national budget is contributing. The criteria for the zoning should be strict enough to avoid such deviation, and lessons should be drawn from the *ex ante* evaluation of the Rural Development Plans to revise the current zoning and the definition of eligible farm populations.

The contribution of European funds to the financing of the *Basic Husbandry Payment* is more problematic to the extent that the corresponding services are partly local and partly of general interest. However, other policies which cover mainly local public goods are also within the competency of the EU. Regarding water quality, the EU has been granted competency while the public good at stake is clearly not global. The EU has even designed regulations on issues for which preferences vary across member states, such as animal welfare. In such areas the argument that setting higher common standards was to avoid competitive distortions between member states is a doubtful one. The problem of the right level of competency

44 (HM Treasury and DEFRA, 2005)

remains contentious and it seems to rest on a mix of logical arguments and political motives. Against this background and as a practical measure of progressive reform, we make the proposal to extend the co-financing of all direct payments. This would help solving the problem of the UK rebate and its re-examination. It would also represent progress compared to a scenario of reform under consideration whereby national or even regional envelopes of farm expenditures would be frozen. An increased involvement of local governments in the design and financing of these payments, and their future transparency[45], would improve the political equilibrium in farm-policy design. It would alleviate the risk of a "collusion effect" in, say, the complacent design of agri-environmental or natural handicap schemes (joint definition of lenient terms of references or of eligibility zoning between the local level and the national government). Hence we retain the following proposals:

Guidelines for financial responsibility

- **Extend the co-financing by member states to all direct payments**
- **Involve local government in the design of eligibility conditions for payments and in the co-financing by national governments**

45 On October 22 2007 the council agreed to publish the names of the beneficiaries of the SFP. On the site agri-news-digest@ec.europa.eu a list of 16 counties provide access to this information. Among the missing countries are France, Germany, Ireland, Greece. ..

Glossary of acronyms

BHP: Basic Husbandry Payments
CPS: Contractual Payments Scheme
NHP: Natural Handicap Payments
GPP: Green points Payments
CAP: Common Agricultural Policy
CMO: Common Market Organisation
FEADER: Fonds Européen Agricole de Développement Rural
FEOGA: Fonds Européen d'Orientation et de Garantie Agricole
GDP: Gross Domestic Product
GI: Geographical Indication
GMO: Genetically Modified Organisms
GNP: Gross National Product
LDC: Least Developed Country
LFA: Less Favoured Areas
NGO: Non Governmental Organisation
RDR: Rural Development Regulation
NRDP: National Rural Development Plans
PMP: Process and Production Methods
SFP: Single Farm Payment

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