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The CAP in Disarray: EU Commission Proposes Basic Direct Payments to EU Farmers

Direct payments were originally justified as a mechanism to compensate farmers for the income loss incurred due to reduced intervention prices. However, this rationale is not valid any more, and a new justification for basic income support by granting basic decoupled direct payments has been proposed by the EU Commission. The following paper identifies a number of problems related to this proposal.

EU expenditure on Agriculture and Rural Development makes up a high share of total EU expenditure. According to official information, the share was 41% of total EU expenditure in 2011 and amounted to €55.269 billion. The position "direct payments" was the most important budget outlay during the present financial framework. It amounted to €39.771 billion in 2011 and made up 72% of the total expenditure on Agriculture and Rural Development. This budget item came into existence in 1993 as the Council of Agricultural Ministers had decided in 1992 to reduce the intervention price for grain by about 33% and also to reduce the support price for oilseeds. There was a widely held agreement in 1992 that farmers should be fully compensated for the income loss incurred from the price cut. This item grew over time as institutional prices for other agricultural products had to be reduced due to international pressure. However, the income loss incurred by farmers due to further cuts was only partly compensated by additional direct payments. Thus, the first group of farmers was treated better than the following groups.

Even if there was agreement that farmers had to be compensated, there was a widely held understanding that a) it was compensation for the income loss due to reduced institutional prices and b) the compensation had to be tapered off over time. The importance of the development of market prices can be illustrated for the case of wheat. Figure 1 shows the development of intervention and market prices for wheat and the attributed direct payments. It is obvious that market prices did not decline as much as intervention prices, but the latter had been taken for the quantification of the income loss. Moreover, market prices in recent years have been even higher than prior to the price cut. Prices will most likely remain above the former price level in the coming years.[1] Moreover, independent of the development of market prices, direct payments can no longer be justified by the need for adjustment aid. That part of EU agriculture (the old member states) which suffered from price reduction has had nearly 20 years to adjust, which should be sufficient. It should be noted that a large part of EU agriculture (the new member states) has never been hit by a price cut. In fact, farmers in the new member states generally enjoyed a higher income due to the countries' accession to the EU in 2004 and 2007.

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A New Rationale

One may wonder why the EU Commission is still in favour of direct payments in spite of the evidence. Official statements clearly convey that the Commission is trying to put forward a new justification. It is amazing that the budget request for expenditure based on the new justification is practically identical to the past actual expenditure. The Commission seems to know that exactly the same amount of money is needed even if used to serve different purposes. The Commission proposes two payment components:

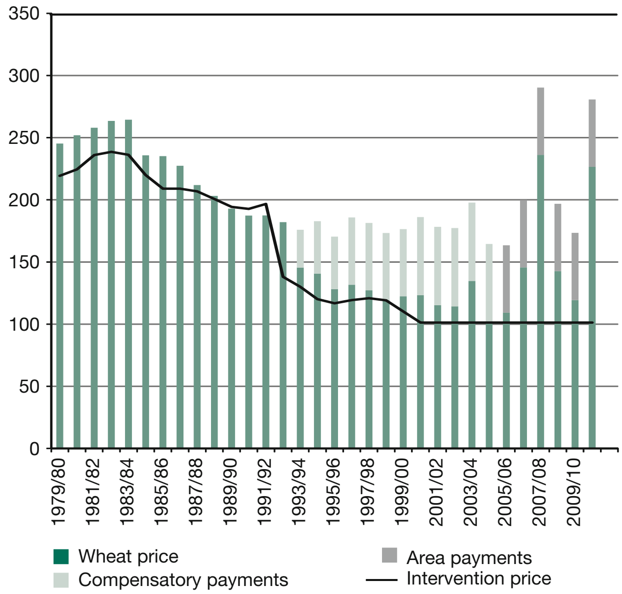
- "Basic income support through the granting of a basic decoupled direct payment, providing a uniform level of obligatory support to all farmers in a Member State (or in a region) based on transferable entitlements that need to be activated by matching them with eligible agricultural land, plus fulfilment of cross-compliance requirements."[2]
- A mandatory "greening" component to support environmental measures applicable across the whole of the EU territory.

It states: "The necessary adaptations of the direct payment system relate to the redistribution, redesign and better

1 See the projections by OECD and FAO. OECD – FAO Agricultural Outlook 2011-2020, Rome and Paris 2011.

2 Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the regions. The CAP towards 2020: Meeting the food, natural resources and territorial challenges of the future, Brussels, 18 November 2010, p. 8.

Figure 1
Wheat Prices and Attributed Direct Payments



Source: EU Commission.

targeting of support, to add value and quality in spending. There is widespread agreement that the distribution of direct payments should be reviewed and made more understandable to the taxpayer. The criteria should be both economic, in order to fulfil the basic income function of direct payments, and environmental, so as to support for the provision of public goods."[3]

The statement clearly supports the suspicion that the change is not primarily based on a diagnosis of the present situation and on the identification of market or policy failure. Instead, it is trying to convince the taxpayer that the exact amount of money which has been used to serve one purpose has to be used to deal with another supposed problem. Nevertheless, the new concept claims to be able to improve the targeting of support. In the following we limit the discussion to the rationale provided for basic payments.

The Commission argues that the average income of farmers is lower than the average income in other sectors (see Figures 2 and 3), and hence income support is needed. The taxpayer – even with little education in economics – may ask the following questions:

- Is it the task of the EU to provide income support for specific sectors?
- Is the proposed EU policy measure compatible with national social policies?
- Can the need for income support be based only on comparison of average incomes?
- Are there adequate data available for efficient policy measures?

The Treaty of Rome and all the following treaties did not mention that the EU has to provide income support for farmers. The Treaty of Rome only states that the first two "objectives of the common agricultural policy shall be:

(a) to increase agricultural productivity by promoting technical progress, the rational development of agricultural production and the optimum utilisation of the factors of production, in particular labour;

(b) *thus* to ensure a fair standard of living for the agricultural community, in particular by increasing the individual earnings of persons engaged in agriculture [emphasis added]".[4]

It should be noted that – according to the Treaty – the EU has to contribute first of all to higher agricultural productivity. As a consequence, the increase in productivity should ensure a fair standard of living. The ranking of the objectives is pronounced by the word "thus". Clearly, the treaties do not mention that the EU should be in charge of securing a basic income for farmers.

Indeed, it seems strange that the EU should be responsible for securing a basic income for a specific sector in the member countries. A policy which aims at securing a minimum (basic) income is obviously part of social policy. But social policy is generally in the realm of the member countries and not of the EU. Nevertheless, the EU Commission is putting forward a recommendation to implement social measures at the EU level. This proposal is not in line with the principle of subsidiarity

It should also be noted that the proposed payments will slow down structural change and productivity as compared to a situation without any payments. Marginal producers, i.e. those who are going to go out of production if revenue declines, will stay in production for longer, leading to inefficient use of resources. Disguised inefficient use of resources in the agricultural sector will continue.

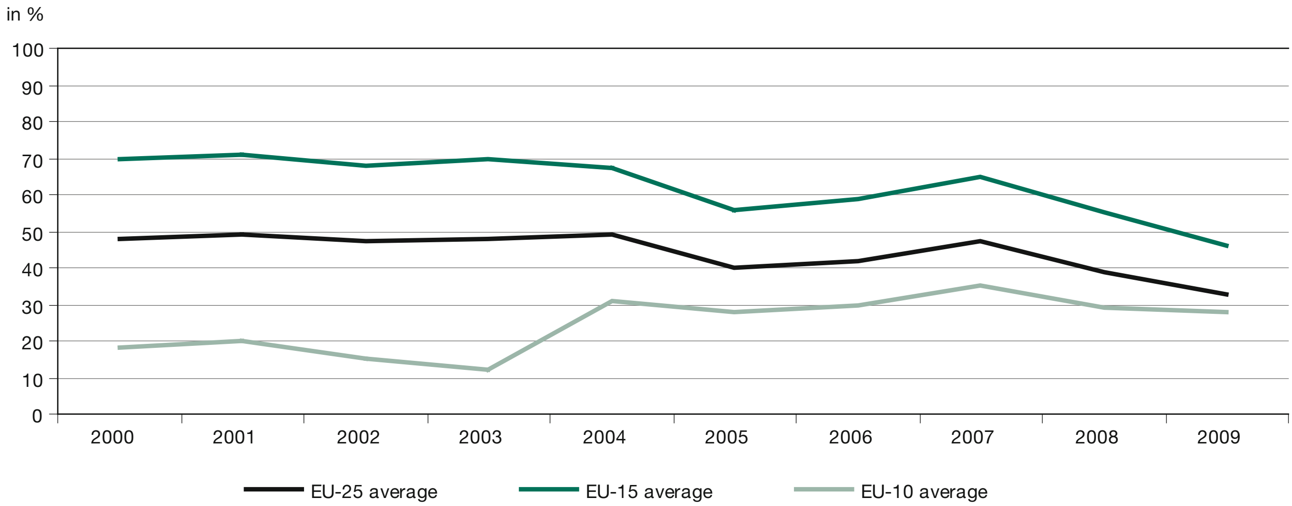
Compatibility with National Social Policies

The individual member countries of the EU have established social security policies. These policies do not provide support for specific sectors, but for people who suffer from poverty. In general, applicants for social assistance have to

3 Ibid.

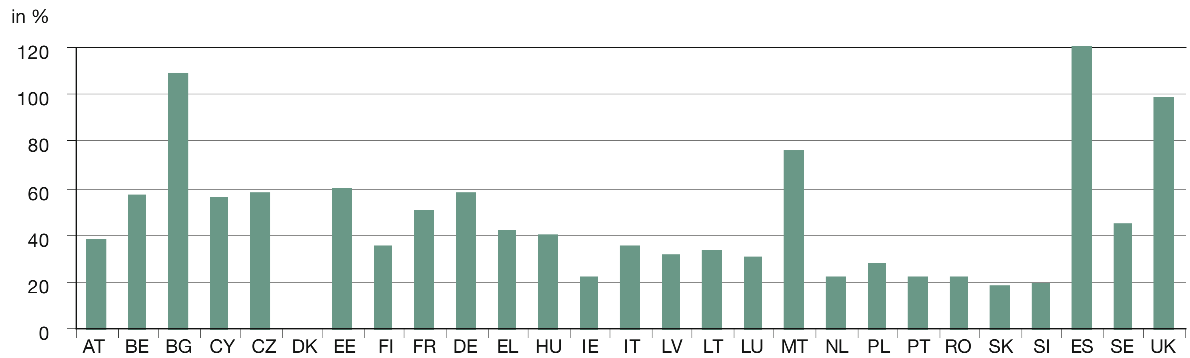
4 Treaty of Rome, Article 39.

Figure 2
Evolution of Agricultural Income as a Share of Average Income in the Economy



Source: ec.europa.eu/agriculture/cap-post-2013/graphs/graph3_en.pdf.

Figure 3
Agricultural Income as a Share of Average Income in the Country per Member State (2008-2009)



Source: http://ec.europa.eu/agriculture/public/app-briefs/01_en.pdf.

provide information about their household income as well as about the value of their property. Applicants who own property which can be sold are not considered poor. The EU proposes a completely new criterion for social assistance. All farmers qualify for basic payments, independently of their income. As the payment is related to the area of land cultivated by the individual farmer, owners of large estates will be entitled to higher payments than farmers who cultivate small estates. Hence, basic payments increase disparities within the agricultural sector. Moreover, some farms are managed by legal entities. Even these entities would qualify for basic direct payments. It is noteworthy that the average payment for legal entities amounted to € 385,000 in 2010. Where in the world are legal entities entitled for social payments? The EU seems to be an exception. This policy measure is not targeted at all. It is in serious conflict with national social policy measures.

It is absurd to justify the income support payments by comparing average agricultural incomes by sector and to support even farmers who are considered to be well-off by the societies in the member countries. It is known that farm incomes vary significantly across farms in the individual member countries and even more among farms in the EU. It is strange to justify the income support payments by a comparison of average incomes. If this criterion were applied to the population of a country, probably more than half of the population would be qualified for income support as their income would be below the average income in the country under consideration.

Proposal to Align Payments Across the EU

The Commission has proposed gradual alignment of direct payments across the EU member countries. This proposal is in conflict with the rationale presented for basic direct payments. If these payments should provide a minimum income for farmers, as argued by the Commission, the amount of money transferred to farmers in the individual countries should differ, as overall income and social assistance differs across the countries. It might be that farmers in the old member states require even more income support than they receive at present as the gap between average income and farm income may be larger in the old member states than in the new member states. However, the Commission does not present any data. Therefore, basic income support contradicts the gradual alignment of basic payments across member countries.

Lack of Information

The Commission has presented information comparing average incomes in agriculture with average incomes in other sectors (see Figures 2 and 3). Such comparisons are highly misleading. First, we do not have exact information on agricultural labour income, as most farmers do not have to submit a tax declaration.[5] At the EU level there is only information on agricultural value added, including the income of all factors of production, i.e. labour, capital and land. Eurostat defines the value added per work unit as labour income. However, not all factor income accrues to farm households. Tenants may have to pay rents to non-farmers and farmers may have to pay interest to non-farmers. Calculating this income, one may find a low income for labour, but the farm household may be well-off due to income from capital and land employed outside the agricultural sector. Hence, the calculated income does not inform about the income of farmers and thus on the need for financial assistance from the point of view of society at large. It has to be added that even accurate data on the income of farmers do not inform about the living standard of farmers as compared to the non-farming population. Farmers pay lower taxes than non-farmers on the same level of nominal income. Moreover, farmers generally own houses and do not have to pay rent. Finally, many of them own land and capital. Consequently, most farmers do not qualify for social security in their home country due to their income and due to the value of their property. What a strange situation: if the Commission's proposal is accepted, persons who are not eligible for social security benefits in their home country will be qualified to receive income support from the EU. Can that be acceptable?

Calculating income per work unit, as done by Eurostat and accepted by the Commission to support their reasoning, raises some additional problems. Eurostat provides information on value added at factor cost and agricultural labour input. Labour input is measured in work units where part-time and seasonal labour is converted to full-time equivalents.[6] Even if EUROSTAT had fairly accurate information on agricultural value added, it has no such accurate information on the actual labour force and on that part of the labour force which relies on income from agriculture only. It is known that the share of part-time farming is fairly high in some countries; hence, the information on labour income per person employed is highly misleading. Take, for example, the case of a full-time off-farm worker who owns a small farm cultivated by his wife. He may have a high income, but she may have a low income, even if much above the opportunity costs of part-time farmers who work with one third of their time on the farm. According to the methodology of Eurostat, the income of the husband is neglected and the income generated by the wife is multiplied by one third. Consequently, the wife earns an income below that in other sectors. Obviously, the derived information does not inform about the living standard of the family. It is needless to say that this household would not qualify for social security in any of the EU member countries.

Moreover, it is misleading to compare average income levels if the variance of income in the sectors compared is very high, as it is in agriculture. According to the Commission's data, 20% of farmers in the EU receive 80% of the present direct payments. Obviously, internal disparity is very high. How can the Commission propose providing a basic income support to all farmers if some – or even many – have an income which is much higher than the income of the average person in their societies? One should recall that these payments have to be financed by the ordinary taxpayer. The Commission has stated that the policy should become more targeted than in the past. The new proposal leads to conflicts with this objective.

Financial Stability of Farms

The share of direct payments in farm income is fairly high in some countries. The Agricultural Report of the Federal Republic of Germany highlights that the share of direct payments in farm income (profits and paid wages) amounted to 85.2% in 2009/2010. Based on this figure, policymakers and members of the Parliament argue that most farms would go bankrupt without payments. Hence, they conclude that payments secure the sustainability of farms. However, this conclusion is not well-founded. The calculated share is misleading. It is implicitly assumed that without payments the available income of the farms would be only 14.8%. It is overseen that there is a huge difference between the amount paid to the recipients and the amount transferred to the actu-

5 It is reported in Agra Europe, Germany, from 12 March 2012 that the German regulation which exempts farmers with farms up to a specific size from submitting a return of tax will be reconsidered.

6 The use of work units is justified if information about productivity is needed.

al beneficiaries. It is well known that a large proportion of the payments – mainly because they are tied to agricultural land and therefore increase land rental prices – is handed over to the landowners. Hence, a large share of the payments leads to higher farm expenses. The importance of the transfer of payments to landowners can be illustrated by the situation of the feed farms in Germany in 2009/2010. The share of direct payments in farm income (profit and paid wages) amounted to 126.6%. The share can only be higher than 100% if a part of the payments is transferred from recipients to beneficiaries (landowners). Hence, it is not adequate to judge from the share of direct payments in total income whether a farm is profitable or sustainable. The share of rented land in arable land is about 50% on average in the EU, but it varies significantly across EU member countries (see Table 1). The share is generally higher for larger full-time farms than for smaller part-time farms and increases over time as average farm size increases. The rental prices have increased significantly since the introduction of the direct payment system.[7]

Table 1
Share of Rented Land in EU Member States, 2007

Share of rented land	Member state
15-30%	Ireland (16.5%); Poland (27.5%); Denmark (28.3%)
30-45%	Austria (31%); Slovenia (31.8%); Portugal (31.8%); Spain (33.6%); Finland (34.8%); Italy (38.8%); the Netherlands (40.3%); Romania (41.5%); the UK (42.6%); Greece (43%); Latvia (44.6%)
45-60%	Luxembourg (50.7%); EU (52.5%); Sweden (53.4%), Estonia (59.8%)
60-75%	Lithuania (60.1%); Cyprus (64%); Hungary (67.2%), Germany (70.5%); Belgium (74.1%)
75-90%	Malta (81.2%); France (84.5%); Czech Republic (87.9%); Bulgaria (89%)
above 90%	Slovakia (96.3%)

Source: F. Střeleček, J. Lososová, R. Zdeněk: Farm land rent in the European Union, Acta univ. agric. et silvic. Mendel. Brun., Vol. LIX, 2011, No. 4, p. 310.

Is the CAP Too Expensive?

The EU Commission answers this question clearly. No, CAP expenditure at the EU level is only a small share of GDP. The CAP is the only supranationalised policy and the value generated for the money spent is high.[8] Whether a policy is too costly or not depends above all on how policy measures are targeted; the less targeted they are the less efficient they are. A policy is well targeted if it heals a market or policy failure more efficiently than any other policy measure. If the original justification of a policy has become obsolete, a continuation of the same policy is too costly. It is widely agreed that a continuation of the present direct payments system cannot be justified with the original arguments. Hence, this policy is too costly. The new justification for changing direct income payments to basic direct income payments clearly shows that a) there is no justification for such a policy measure and b) the justification presented by the EU Commission is based on inadequate information.

Summary

The EU Commission's proposal to introduce changes to direct payments is based on the perception that a new rationale for these payments is needed. Nevertheless, the new justification for direct payments proposed by the Commission is not convincing. This new instrument would not contribute to the officially stated agricultural objectives laid down in the Treaty of Rome and which have not been changed; on the contrary, the effects of the new payments would hold back growth in productivity, which is the first objective mentioned in the Treaty.

The Commission justifies the proposed payments with the need to secure a basic income. Hence, the instrument could be part of social policy. However, so far the individual member countries of the EU have been in charge of social policy. The introduction of the new instrument would not be in line with the principle of subsidiarity.

The new instrument would be in strong conflict with the principles of social policy in the member countries. Social policy is generally based on information about household income and also takes into account the value of the property. In contrast, the proposal aims at providing basic support to all farmers independently of their actual income and their wealth. As the proposed transfer would be related to the area used by the individual farms, the transfer to well-off farmers would be higher than to farmers with little land endowment. Disparity in agriculture would be higher with these transfers than without them.

The new justification put forward by the Commission is based on a comparison of average labour income in agriculture with labour income in the overall economy or in other sectors. Such a comparison can hardly be accepted for justifying socially motivated transfers. Such a policy has to be based on information about household income. Moreover, the Commission does not have adequate information about the labour income of full-time farmers in the EU. The obvious conclusion is that the Commission's present proposal cannot be accepted.

7 See D'Artis Kancs, P.C. and J. Swinnen: EU Land Markets and the Common Agricultural Policy, Centre for European Policy Studies, Brussels 2010.

8 Is the CAP an expensive policy? Section 5 in: European Commission: 2011, The CAP in perspective: from market intervention to policy innovation, p. 10.