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The CAP in perspective: from market intervention to policy innovation

This *Brief* will take you through the policy developments of the EU Common Agricultural Policy (CAP) that have taken place since 1992, when the first substantial reforms took place. With these achievements in mind, we then look at the challenges for the future CAP.

The EU Common Agricultural Policy, being one of the oldest policies of the European Union, is strongly rooted in the European integration project. Due to the CAP's long history, it is also a policy that has been reformed on many occasions, in particular during the past decade and a half. Today's CAP has been transformed into a multi-functional policy, supporting market oriented agricultural production throughout Europe, while also contributing to living and vibrant rural areas, and environmentally sustainable production.

The initial objectives of the CAP have remained unchanged over the years. However, the weight given to the different objectives has changed drastically, and sustainability has become an overall objective of the EU. Meanwhile the instruments to achieve the objectives have also changed considerably. The CAP has moved away from supporting product prices to supporting producers' income and rural development.

Whether or not the current objectives and instruments need to be changed in the future is now a hot topic in the agricultural policy world. In broad terms, there are three policy questions that have always been relevant when discussing the role of the CAP, and which will continue to be relevant when shaping the future CAP; these are: How can we contribute to stability for the agricultural sector and rural communities when there is volatility in the markets? How can we ensure efficiency and equal distribution of support? How are challenges such as preserving the environment and the countryside best dealt with?

Note: This *Brief* is a revision of the first version published on December 2009. Graphs and figures have been updated.

Before entering into a discussion about the CAP's future, it is important to be clear about where the CAP is coming from. The logic behind the policy in the past, how it has changed, and why, is explored in this *Brief*. And, most importantly, the aim is to clarify what the actual effect of these changes has been.

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http://ec.europa.eu/agriculture/analysis/perspec/app-briefs/index_en.htm

Contact: DG Agriculture and Rural Development, Agricultural Policy Analysis and Perspectives Unit
Tel: +32-2-29 91381 / E-mail: Agri-L1@ec.europa.eu

1. The CAP today and triggers of previous reforms

The CAP has undergone substantial changes since the early 1990s. We should be aware that today's CAP benefits society by

- encouraging the production of safe and high-quality food throughout the Union,
- supporting the upholding of thriving rural communities, and
- giving farmers incentives to take good care of the environment.

The CAP reforms have significantly improved the efficiency of CAP instruments

Some critics say the CAP is an expensive and trade distorting policy only benefiting a narrow section of the society. But the reality is that the CAP aims at ensuring that sustainable agricultural production takes place in the Union, sustainable both from an economic, social, as well as environmental point of view. And given that agriculture is an economic activity that occupies a large share of the European land, it is also a policy that affects all European citizens.

Put simply, the CAP can be described as having three policy dimensions. This structure ensures sustainability. The three dimensions supported through the CAP are: producer prices, producers' income, and rural development. The three policies are interconnected, and overall sustainability depends on the ability of the three policies to act collectively. For example, direct payments provide basic income support but also ensure the provision of basic environmental public goods. And rural development support encourages the provision of additional public goods, while also facilitating the structural adjustment of holdings that is necessary in order for European farmers to stay competitive.

The CAP has a predetermined maximum budget (as do all EU policies) which is fixed for 7 years at a time. This ensures a ceiling on expenditure but also predictability for farmers as to what is available. Successive CAP reforms have allowed to improve the efficiency of the tools available in achieving its objectives. Gradually the least efficient policy tools have been replaced with more efficient instruments, allowing the CAP to better respond to the needs of farmers as well as the requirements or demands of consumers and taxpayers.

Historical development of the CAP

Productivity →

Competitiveness →

Sustainability →

The Early Years	The Crisis Years	The 1992 Reform	Agenda 2000	CAP reform 2003	CAP Health Check 2008
Food security Improving productivity Market stabilisation Income support	Over production Exploding expenditure International friction Structural measures	Reduced surpluses Environment Income stabilisation Budget stabilisation	Deepening the reform process Competitiveness Rural development	Market orientation Consumer concerns Rural development Environment Simplification WTO compatibility	Reinforcing 2003 reform New challenges Risk management

The driver for change of agricultural policy in Europe has, since the early 1990s, been how to best achieve a symbiosis between supporting economic, social and environmental objectives, and agreeing on what tools are most efficient in achieving them. In specific terms, the drivers for change have been the desire to increase market orientation and to adapt to the emerging demands of society. The changing priorities of citizens as to what should be produced (quality instead of quantity) and how (according to higher environmental standards) have further triggered changes to policy. These changes have then influenced the EU's interactions with the rest of the world, through for example the WTO.

EU commodity exports were at a peak in the 1980s. The main instruments of the CAP at the time were intervention buying and export subsidies. Hence, since production was strongly driven by government incentives rather than market signals, the production surplus that occurred came at a high cost, both in terms of budgetary expenditures and in terms of the impact on our trading partners (and thus the EU's reputation in the rest of the world).

The budgetary pressure, as well as changing requirements from farmers and from society, stimulated calls for a reform from within the EU, while the impact on world market prices and on developing countries agricultural production provoked criticism from the rest of the world. Later on, demands from society for limiting the impact of agricultural production on the environment, as well as requirements on animal welfare, gained ground.

The accessions taking place in the 1990s, not to mention the huge enlargement in 2004 when 10 new Member States joined the Union all at once, put further pressure on the efficiency of the tools being used. Especially as the enlargement in 2004 was not accompanied by a corresponding budget increase for the CAP. In fact, the limited budget now had to be divided between almost twice as many farmers, as the number of full-time farmers increased from 6 to 11.5 millions with the accessions in 2004 and 2007.

The changes that these factors have triggered in the CAP instruments will be described in the following sections, on product support, producer support and rural development.

2. Moving away from product support…

The core element of the reform process of the CAP has been the shift from product support to producer support. Rather than ensuring a fixed price for agricultural products (and hence supporting farmers' income indirectly), the CAP today focuses on supporting farmers' income directly.

The core element of the reform process of the CAP has been the shift from product support to producer support

This change is important because product support led to overproduction. European farmers were largely isolated from market signals because the CAP used to guarantee fixed prices for certain products, thus incentivising this overproduction. In order to counter this, the CAP also had to introduce quantitative limitations, essentially for the dairy, sugar and arable crops sectors. This was a costly and inefficient manner of ensuring a fair standard of living for farmers.

Today, market instruments are instead used to provide market safety nets. Intervention prices are set at low levels which ensure that they are only used in times of real crisis. Intervention measures have not been abolished however because agricultural production differs from other sectors of the economy. Agriculture is more weather and climate dependent than many other sectors. Furthermore, in agriculture there is an inevitable time gap between demand signals and the possibility for supply responses, and small changes in the amounts produced can have big effects on prices, as our consumption of food is largely constant compared to other products. These business uncertainties justify the important role that the public sector plays in ensuring stability for farmers.

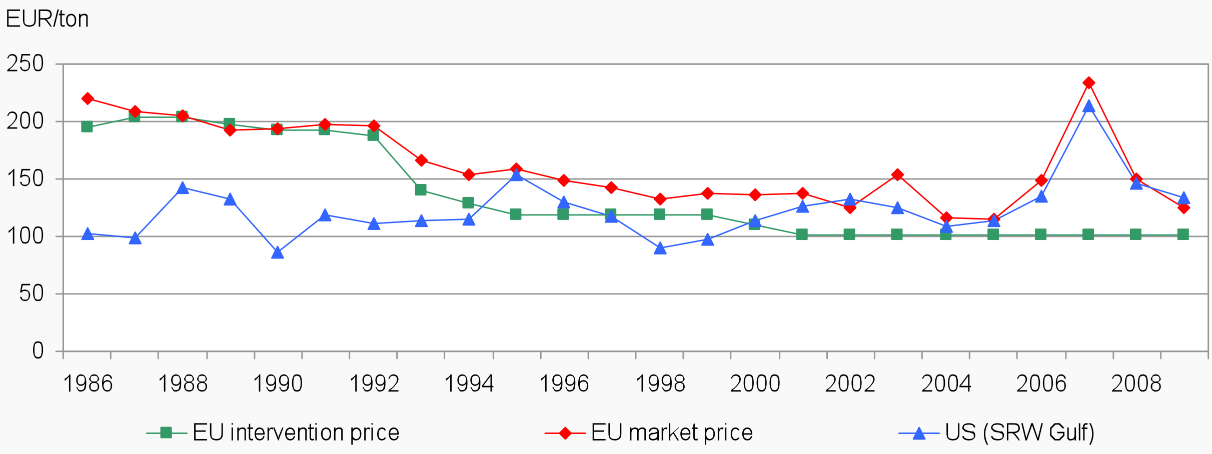
The EU has gradually moved away from high support prices over the past two decades. In 1992, support prices were cut for the first time, and then further cuts followed with subsequent reforms. Intervention buying provides for a minimum price for commodities. Often, but not always, the reduction of intervention prices leads to a drop of prices on the internal market. Therefore, the cut in intervention prices has bridged the gap between internal and world market prices. The example of wheat prices is provided below (figure 1). The US price development is provided as an illustration of world market price fluctuations.

A concrete result of the CAP reforms is thus that the guaranteed price European farmers receive for their wheat (from the public intervention buying) has been cut by almost 50%. The pattern has been similar for all sectors that have been reformed. For example, sugar prices have been reduced by close to 40%, and beef prices have been cut by almost 30%. Hence, market support prices have been severely cut, and intervention is no longer the main instrument of the CAP.

Before 1992, more than 90% of all EU agricultural expenditure went to market support including export subsidies; in 2009, that figure was down to 10% of the CAP budget

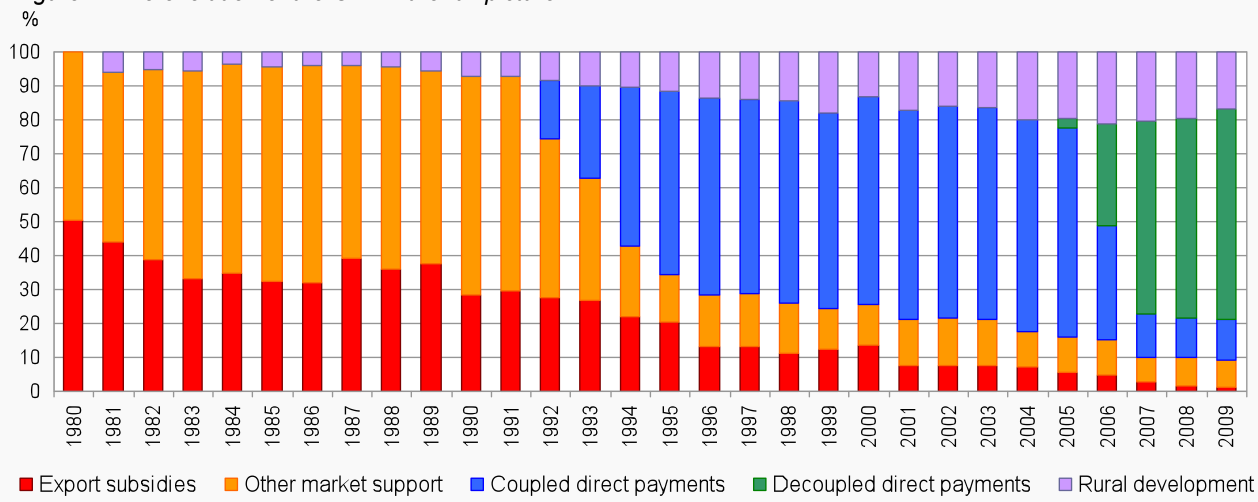
The decline in budgetary expenditure related to market measures tells the same story. Before 1992, more than 90% of all EU agricultural expenditure went towards market support and export subsidies; in 2009, that figure was down to 10% of the CAP budget. Figure 2, on the next page, depicts the evolution of CAP-support over the past three decades. While the market support development is described in this section, other support mechanisms are elaborated later in the *Brief*.

Figure 1: The evolving role of EU support prices – the example of wheat (in nominal prices; years are July-June market years).



Sources: DG Agriculture and Rural Development and World Bank.

Figure 2: The evolution of the CAP – the full picture.



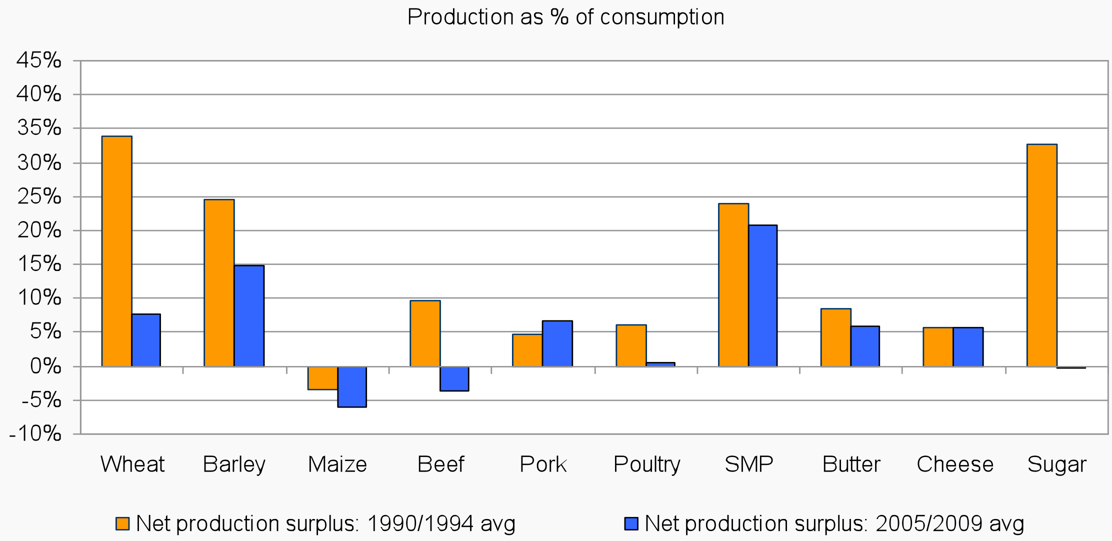
Source: DG Agriculture and Rural Development.

The impact of the cut in market support has been:

- a decrease in the gap between EU and world market prices;
- a decrease in the exportable surplus of all supported EU products;
- a decline in the level of stocks going into intervention, and thus less downward pressure on world market prices;
- a resolute move away from trade distorting measures, sending a clear message to our trading partners.

This is depicted in figure 3, which shows the development of EU production and exports for several products. Since farmers' production decisions are now based on market demand, the production surpluses have fallen sharply for several important sectors and net exports have decreased significantly. For beef and sugar, the EU has even switched from being a net exporter to a net importer. On the other hand, the more competitive sectors have increased their share of world exports. This development would not have been possible had support prices remained at distortive levels.

Figure 3: Impact of CAP reforms on EU net production surplus.



Sources: Eurostat and DG Agriculture and Rural Development.

3. … towards producer support…

The reduction in support prices implied a potential income loss for European farmers. So in 1994, this cut was accompanied by compensatory payments to farmers, referred to as 'direct payments', to ensure the economic viability of the European farming community. The payments were linked either to fixed areas (or fixed yields), or to a fixed number of animals – as such the payments were referred to as coupled direct payments.

This was a first step towards market orientation. European farmers received payments that allowed some flexibility in their production decisions, rather than support guaranteeing certain price levels for a specific type of production. For example, producers received a payment linked to arable crop production, enabling them to choose what arable crop to grow to maximise profits from the market.

However, as the payment was linked to a maximum number of animals or a maximum area, it created an unnecessary rigidity, especially for some sectors. This prevented structural development of the sector, and held farmers back from realising their full potential.

The next movement towards market orientation for the European agricultural sector came in 2003, when a major overhaul of the CAP was undertaken. The aim was to 'decouple' the majority of all direct payments from production. That is, farmers were no longer to receive payments related to a specific type of production. Instead, payments were linked to entitlements based on the value of historical subsidy receipts.

The decoupled direct payment ensures a basic income support for producers. The rest of the producers' income is determined by the market. In order to maximise profits producers must respond to market signals, producing products that are demanded by consumers. In fact, farmers are not required to produce on the land they receive support for, if they consider it more beneficial (for environmental or other reasons) to leave land idle.

The payments are linked to adhering to environmental standards, and standards related to animal and plant health. This system is referred to as cross compliance, and it applies also to land left idle.

Farmers maximise their income by responding to market signals

The current decoupled direct payment therefore not only ensures that farmers respond to market signals while providing income support. It also contributes to keeping sustainable farming in place by ensuring the longer term economic viability and a smooth structural adjustment of the farming sector. In combination with cross-compliance, direct payments contribute to providing basic public goods delivered through sustainable farming.

The reform agreed in 2003 has been gradually implemented since 2005. This development can be seen in figure 2. In just three years, 85% of the support has been decoupled, marking a major shift of EU agricultural policy. With the agreement of the Health Check (the latest reform of the CAP, agreed in 2008), by year 2013, that share will have increased to at least 92%.

In the WTO classification of agricultural support measures, these payments fall within the 'green box', which implies that they are not distorting trade between the EU and its trading partners. Thus, decoupled direct payments not only allow the EU to ensure a minimum stream of revenue to its farming community while encouraging the production of safe and high quality food, the support method chosen also ensures that the impact on the rest of the world is minimal.

As a result of the Health Check agreement, assuming that all foreseen direct payments are made, the distribution of expenditure for the period 2010-2013 would roughly be 69% for producer support (direct payments), 7% for market measures (product support), and 24% for rural development. This shows how far the CAP has come in allowing farmers to produce according to market signals (and not subsidy), and how the CAP has been adjusted to respond to new objectives while at the same time still meeting the farmers' needs.

Before the process of CAP-reform started, farm income was in steady decline. Reform has resulted in a stabilisation of income levels. Yet, despite structural adjustments in the agricultural sector and income support given, farmers' incomes remain below the average income levels of other sectors of the economy. Since 2000, the agricultural sector's income development is also lagging behind national income growth in EU-15. Meanwhile, in EU-10, farmers' income growth is moving faster than national income growth, because of the substantial boost to farm income since accession, but the income levels are still lower than other sectors of the economy.

The farming sector's income development implies that without some kind of income support, many European farmers would not be able to stay in business.

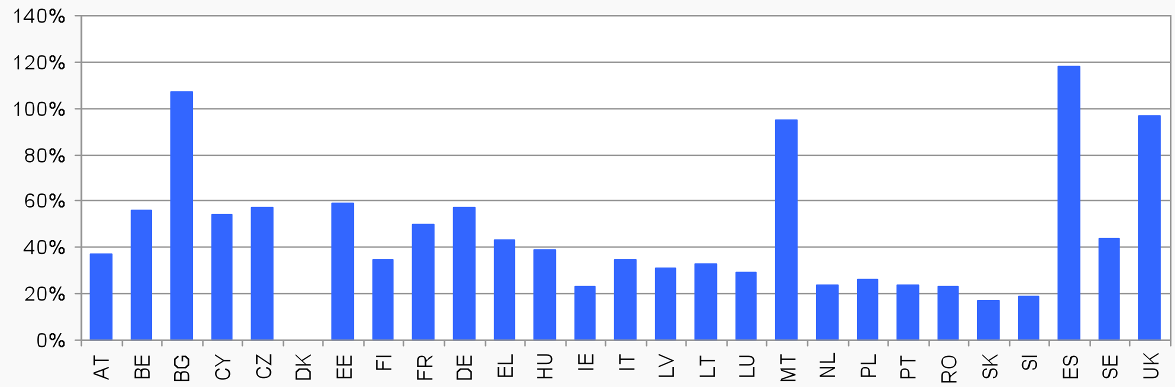
As a result, agricultural production would be concentrated in the most competitive areas, with negative economic, social and environmental consequences. The most competitive areas would suffer from increased intensification and pressures on natural resources such as soils and water. The less competitive areas would face negative consequences for their economic and social fabric, as well as adverse environmental consequences. The latter would follow from land abandonment leading to the degradation of land, increased risk of fires and other hazards, and the loss of biodiversity and semi-natural habitats.

Farmer's income remain below the average income levels of other sectors of the economy

In fact, research has shown that the absence of agricultural support in the EU would not drastically affect the overall level of production, but it would affect the territorial and environmental balance of production.

Hence, the benefits of dispersed and sustainable food production come at a price, but it is a price worth paying since it allows us to maintain a living countryside, in the knowledge that the products we consume have been produced in a sustainable manner.

Figure 4: Agricultural income as a share of average income in the economy per Member State (2008-2009 average).



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

The figures above reflect the agricultural entrepreneurial income/AWU as % of wages and salaries/AWU in the total economy. Note that these figures should be interpreted with care owing to conceptual differences between the measurement of farmers's income from agricultural activities and average wages in the economy, and to the lack of reliable data on full-time equivalent statistics for the total economy for some Member States. DK = -103%.

4. … and with the strengthening of rural development

Measures relating to structural adjustment of farming have been supported for a long time. These measures are now an important element of the part of the CAP referred to as rural development policy. In the last decade much stronger emphasis has been put on this component of agricultural policy, and rural development reform has been an integral part of the CAP reform process.

Rural development reform has been an integral part of the CAP reform process

The rural development policy is commonly referred to as the 2nd pillar of the CAP, whereas product and producer support is referred to as 1st pillar. (See figure 2 for spending on rural development measures.) The separation of the CAP into two pillars stems from the fact that they are funded through different budget envelopes with different rules. While pillar 1 is solely funded by the EU budget, pillar 2 is based on a multi-annual programming and Member States co-finance the programmes. However, the two pillars are both an integral part of the CAP, complementing each other in meeting the needs of farmers and rural areas.

Rural development policy is a common policy with strategic objectives set at EU level. The objectives are implemented through national (sometimes regional) programmes, addressing their specific problems and needs. Each programme includes three main areas of concern: (1) enhancing the economic viability of agriculture through investment and modernisation, (2) preserving the rural environment and the countryside, and (3) supporting the wider rural economy. Whilst Member States compose their programmes from the same list of measures, they have the flexibility to address the issues of most concern within their respective territory reflecting their specific economic, natural, and structural conditions. As an integral part of rural development programmes, the so-called 'Leader Approach' encourages local target setting, and the mobilisation of local people to deal with local issues. In order to ensure that the rural development policy is accountable to citizens and taxpayers, the implementation and performance of measures is followed through by a common framework for monitoring and evaluation.

Rural development 2007-2013

'Leader Axis'

Axis 1	Axis 2	Axis 3
Competi-tiveness	**Environment + Land management**	**Economic diversification + Quality of life**

Single set of programming, financing, monitoring, auditing rules

Single Rural Development Fund

With the intention of further strengthening the budget for rural development, a tool redistributing funds between pillars – called 'modulation' – was introduced. Modulation implies a cut in direct payments for all farmers receiving direct payments above 5 000 EUR, with the corresponding amounts channelled into rural development.

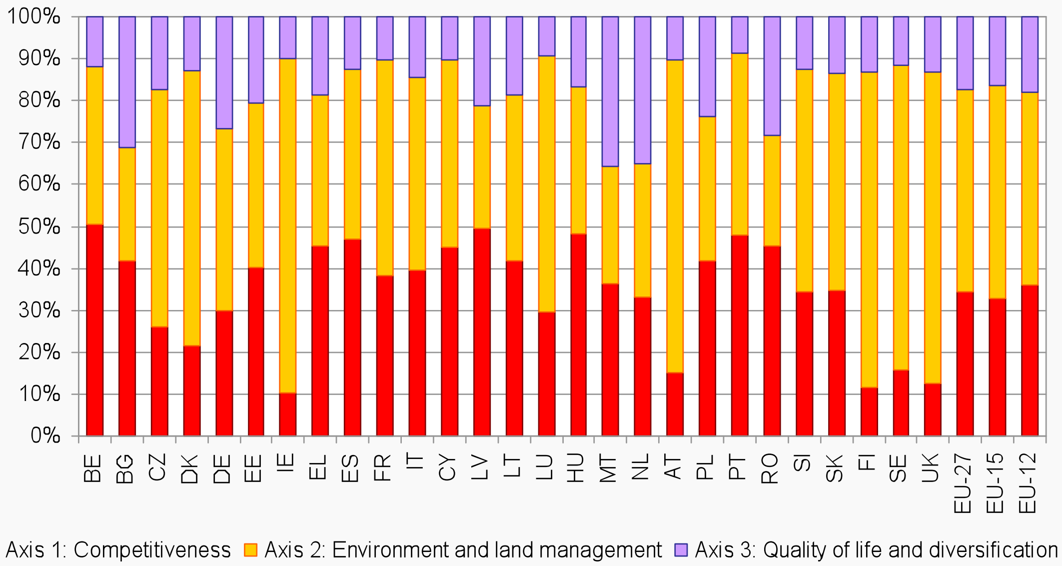
The size of the cut in direct payments has been progressively increased since its introduction in 2003, and will be at least 10% by 2013.

The share of support that farmers receive from the 2nd versus the 1st pillar varies between Member States, as does the share that Member States dedicate to the different axes. These differences are due to Member States individual and historical choices and preferences, and allow them to better target the programmes to regional needs. Consequently, rural development measures are complementary to the product and producer support, by supporting farmers' entrepreneurship, environmental undertakings, etc. Second pillar measures contribute to the competitiveness of European farms as well as creating incentives for sustainable land management.

Figure 5 reveals Member States' rural development priorities by depicting the share of their rural development spending dedicated to the different axes. Member States choose how to spend their rural development funds depending on regional needs, but are required to spend at least 25% on improving the environment and countryside (axis 2), 10% on the competitiveness of the agricultural and forestry sector (axis 1), and another 10% on the quality of life in rural areas and encouraging diversification (axis 3).

Despite the big differences between individual Member States' allocation of funds between the three axes, the overall allocation is very similar if one compares the choices made by EU-15 and EU-12 (the two bars to the far right in figure 6). The bulk of spending is dedicated to measures related to environmental care for both groups, whereas the newer Member States allocate slightly more to measures aiming at improving competitiveness. This is logical given the greater need in parts of these countries to catch up with productivity in the older Member States.

Figure 5: Relative importance of the three thematic RD axes by Member State for the programming period 2007-2013.



Note: Graph includes Leader actions contributing to each objective.

Source: DG Agriculture and Rural Development.

5. Is the CAP an expensive policy?

The budget dedicated to the CAP is considered by many to be the most controversial aspect of the CAP. Arguments such as 'half the EU budget is dedicated to the CAP' or 'a European dairy cow receives 2 EUR of support per day' are frequently voiced. These arguments do not properly take into consideration the EU budgetary mechanism or the objectives of the CAP.

It is true that the CAP takes a considerable share of the total Community budget, by 2013 less than 30% for the 1st pillar and 10% for the 2nd pillar. Yet, when measured as a share of total public expenditures in the EU, the share of the CAP is just about 1%. These are two different ways of looking at the cost of the CAP.

Firstly, the reason why the CAP accounts for a sizeable share of the EU budget is simply that it is one of the few policy areas where one common policy is financed by the EU budget. Most public policies are entirely financed by the Member States, whereas agricultural policy in the EU is to a large extent funded from the Community budget.

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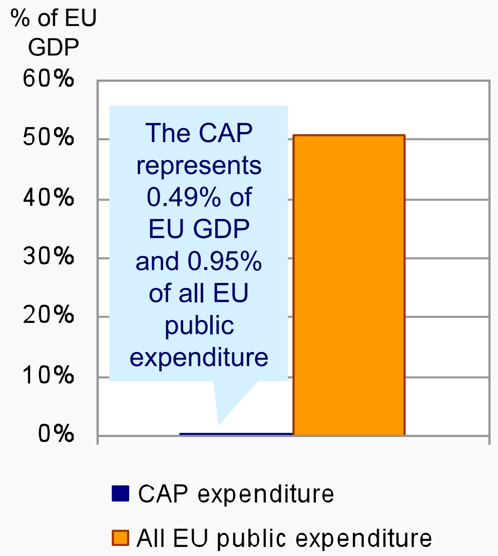
Secondly, as a share of the Community budget, the CAP has decreased very sharply over the past 20 years, from almost 75% to 41%. During this period 15 Member States have joined the Union (more than doubling the number of farmers), and as a result, the EU budget spending per farmer is much lower today than in the past. This is even more striking considering the structure of the economies in the Member States that joined since 2004, where the agricultural sector makes up a much larger share of the economy than was the case in the old Member States.

Figure 6: CAP expenditure and EU public expenditure in perspective (in 2009).

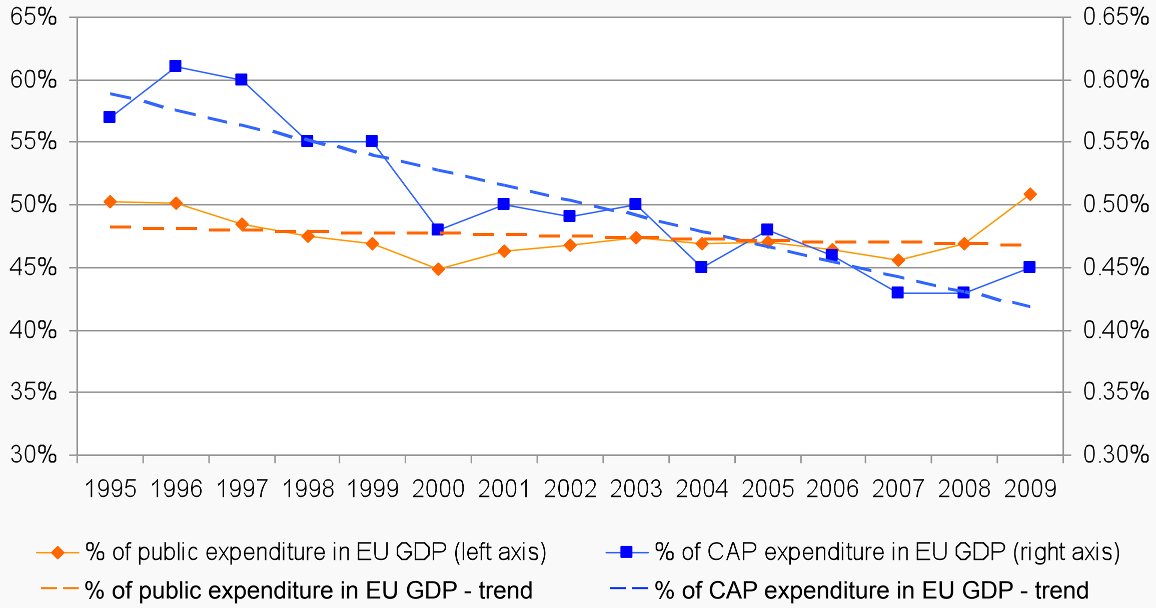


Sources: DG Agriculture and Rural Development, DG Budget and DG Economic and Financial Affairs.

This can also be seen in figure 7 (see next page), which puts CAP expenditures in context. While total public expenditure in the EU has been rather stable at around 46-47% of GDP over the past 12 years (left axis), CAP expenditure as a share of GDP has decreased from about 0.6% to less than 0.45% (right axis). The rate of change is even more significant. While the share of public expenditure in GDP has decreased by 0.45% annually, the corresponding CAP expenditure has decreased by more than 2% per year, contributing both to reducing the share of the Community budget allocated to the CAP, and the absolute amount of public support farmers receive.

The budgetary cost of the CAP should also be weighed against the benefits of the policy, where social and environmental concerns are top of the agenda. In the fixed budget environment in which the CAP operates, the decrease of funds over the years has simultaneously triggered the development of more efficient policy tools, as the budget is spread even more thinly to meet more objectives for more farmers.

Figure 7: Evolution of total public expenditure and CAP expenditure as a share of GDP.



Sources: DG Agriculture and Rural Development, DG Economic and Financial Affairs and Eurostat.

6. The future of the CAP

The Common Agricultural Policy continues to evolve. There is a broad acceptance of the need for an agricultural policy. The question more often asked in Europe is instead whether there needs to be a common policy for agriculture. We strongly believe that the commonality of the CAP needs to be maintained. A common policy provides territorial and environmental balance of EU agriculture. The risk in Europe is not that agricultural production will stop if there is no common policy; the risk is that the production would take place in an unbalanced manner. There is therefore a clear added value to all European citizens from the current structure, and hence impacts, of the CAP.

Figure 8, on the next page, depicts the agricultural policy discussion relevant for the future. The three main policy dimensions are: market measures, direct payments and rural development, and have been described in detail in this *Brief*. In the future it is important to consider the inter-linkage between the three policy dimensions, because none of them is a stand-alone policy.

Direct payments provide a basic level of income to all farmers throughout Europe, and market measures ensure a guaranteed price for some agricultural products. Changing one of these, without counter-balancing the other, thus affects the overall income level of producers. At the same time, the provision of a basic income payment to all farmers ensures the basic provision of public goods throughout Europe, by encouraging them to stay in farming. Rural development measures contribute to the additional provision of public goods by providing incentives for high-quality practices. Simultaneously, rural development support facilitates the process of structural adjustment of farms in Europe, which has been encouraged through the reform of market measures.

For more information about the future of the CAP:

http://ec.europa.eu/agriculture/cap-post-2013/index_en.htm

In brief, we consider the policy discussion for the future to be centred on the following questions:

- how do we adjust the Single Payment Scheme for it to be generally perceived as fairer, while still maintaining the payment as a basic income support and as a warrant for the provision of public goods?
- how do we deal with market crises in the future? How do we ensure that intervention is used as a safety net, and is there a need for a new tool in order to contribute to the stability of farmers' income?
- and in rural development, how do we increase the effectiveness of the policy while ensuring balance between supporting increased competitiveness, environmental concerns, and wider rural economy challenges? And how do we best tackle the concerns related to climate change?

This debate will take place in the context of the debate on future financing, which will not only concern the budget for the CAP, but the whole Community budget. Figure 9 depicts the current share of CAP expenditure by policy dimension. Today, the bulk of the CAP budget is spent on direct payments; part of this expenditure is transferred to rural development through the process of modulation. Market support is already the smallest share of the CAP budget. Given the objectives we set for ourselves in formulating the future CAP, the distribution of expenditure between the three policy dimensions, and the two pillars, will inevitably be part of the debate.

Ahead of us lies an interesting and intensive policy discussion!

Figure 8.

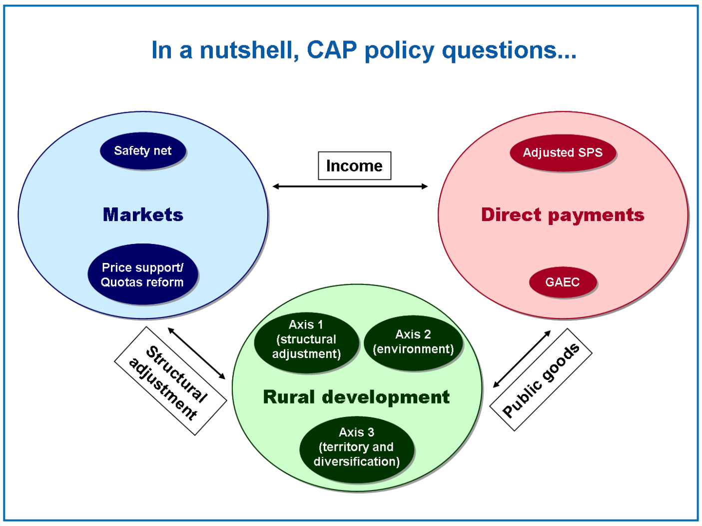
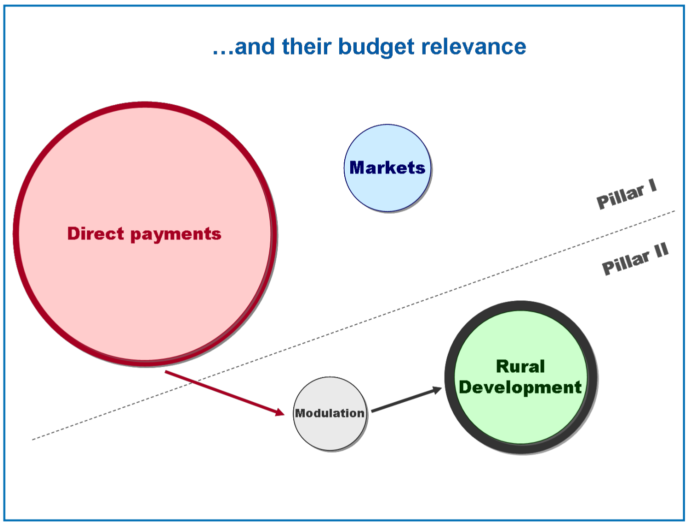


Figure 9.



7. Useful links

EU agriculture and CAP reform
http://ec.europa.eu/agriculture/index_en.htm

CAP Health Check
http://ec.europa.eu/agriculture/healthcheck/index_en.htm

Economic Analysis and Evaluation
http://ec.europa.eu/agriculture/analysis/index_en.htm

Agricultural Policy Analysis and Perspectives
http://ec.europa.eu/agriculture/analysis/perspec/index_en.htm