CAP: Thinking Out of the Box
Further modernisation of the CAP – why, what and how?
2017
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The Rural Investment Support for Europe (RISE) Foundation is an independent foundation which strives to support a sustainable and internationally competitive rural economy across Europe, looking for ways to preserve the European countryside, its environment and biodiversity, and its cultural heritage and traditions. It works as a think tank, bringing together experts to address key environmental/agricultural challenges in Europe and develops high quality accessible research reports with clear recommendations for policy makers. It draws on its extensive network of rural stakeholders to highlight innovative practices developed at the farm level and provides a platform for debate on issues that affect rural communities.

Report Authors

Report Director, Allan BUCKWELL, Professor Emeritus of Imperial College London
Alan MATTHEWS, Professor Emeritus of European Agricultural Policy, Trinity College Dublin, Ireland
David BALDOCK, Senior Fellow at the Institute for European Environmental Policy (IEEP)
Erik MATHIJS, Professor of Agricultural Economics and Director of SFERE, KU Leuven

The Report Advisory Committee

- Professor Tim BENTON, Dean of Strategic Research Initiatives, University of Leeds and Distinguished Visiting Fellow, Chatham House
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- Joachim VON BRAUN, Professor for Economic and Technological Change, Director of the Centre for Development Research (ZEF) University of Bonn, Germany
- Heino VON MEYER, Rural Development Expert, OECD, Berlin

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The RISE Foundation, Rue de Treves 67, Brussels 1040, Belgium
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Authors:
Report Director, Professor Emeritus Allan Buckwell
Professor Emeritus Alan Matthews
David Baldock
Professor Erik Mathijs

The RISE Foundation would like to thank the sponsors of this report for supporting us and giving us the freedom to develop this out of the box thinking project to find better policy solutions for a more sustainable European agriculture. As an independent public utility Foundation the work of the RISE Foundation is completely impartial and independent. Therefore the ideas and views expressed in this report are solely those of the RISE Foundation and do not necessarily represent in anyway the position of the sponsors.
The challenges we are facing in the 21st Century are increasing our individual and collective responsibility. We should turn the existing fragility and increasing risks to a more sustainable path. We should fix the broken compass. The international agreements, in particular the recent adoption of the Sustainable Development Goals (SDGs) and operationalisation of one of the goals through the Paris climate agreement, are important steps in the right direction. They are the recognition of the increased awareness of humanity that the transition to a more sustainable path is necessary and unavoidable and that we should work together to be able to achieve it.

The necessary transition is not limited to agriculture and not only to the European Union. It involves all economic sectors, all society, and it involves all nations facing these joint challenges in their specific way.

What is needed is a clear, agreed strategic approach, addressing these challenges, which would prevent us from being lost in details. All concrete decisions should be taken on the basis of that strategic vision and tested against its delivery. Europe’s Common Agricultural Policy (CAP) is, and will remain, a critical instrument to deliver that vision and it should be adjusted to support and enable the necessary transition. Appropriate governance structures should be introduced to make the transition viable.

These structures should be based on the principles of sincere partnership, joint ownership and joint responsibilities considering that only farmers are positioned to manage primary production in the food system. They are the largest group of natural resource managers in the world and are critical agents of change in the transformation of current consumption and production systems.

Recent news from the Netherlands has shown the difficult situation in which Dutch farmers are trapped after the expiry of a derogation from the EU’s nitrate rules, that allowed them to spread more manure than other European farmers, and the disappearance of milk quotas. The massive quantity of manure is a problem because it releases too much phosphorus, which contaminates groundwater, and the only realistic response is to cull the culprits. A lucky few cows could be sold abroad. There is no winner and solutions could be traumatic. Many are furious with the various politicians and experts who they say failed to foresee that the end of milk quotas would cook up phosphate trouble. One Dutch MEP has been quoted as saying “In 2006 we knew that we had a phosphate ceiling, in 2008 we knew that milk quotas would end; we all in the Netherlands did not act appropriately.”

Considering the challenges we are facing as humanity and if we want to help farmers in a sincere way, then we must do everything to avoid this kind of trap which emerges from short sighted logic and interests.

EU farmers are numerous and individually have a rather small resource base (land) with which to operate. They run their businesses sandwiched between the immense market power upstream of input suppliers and downstream food processors and retailers. These are vulnerable small businesses which are subject to wide biological (pest and disease) variability and risk, market volatility (trade embargoes) and weather risk. Technology helps them manage some of this variability and risk, raising the cost of labour and land productivity and systematically reducing the cost of food. However, the same technology has also in many cases led to large harmful external impacts on biodiversity, soil, water and landscape, and to emissions of greenhouse and other harmful gases many of which have only been noticed and measured relatively recently and which are complex and expensive to abate. Despite a generously funded, but badly targeted, agricultural policy and a relatively protective border regime of tariffs and
tariff rate quotas, for all but the most efficient and the largest farmers, the wafer-thin margins on agricultural commodity production have left them earning extremely low returns on capital invested and often with low and highly variable incomes from farming. Farmers therefore operate under intense economic pressures and are subject to much criticism about their environmental performance, and the lavish nature of the CAP. This leaves many farmers and their organisations feeling embattled.

Resolving the situation explained above requires much more than just changes to the CAP. Indeed, the challenges of over-consumption and resulting ill-health add to the pressures on the farm system. The long-term interests of farmers, landowners and environmentalists are the same: a sustainable and resilient food system. This should be our guiding principle. Complexity and the extent of challenges we are facing in the 21st Century do not allow us the luxury of short term behaviour and policies. The complexity of challenges also requires that we work actively together against the prevailing silo logic and approach. Food system challenges cannot be tackled only through the optic of agriculture, but must be addressed through system change approach addressing the entire food system.¹

That said, in this report we focus on the contribution CAP reform could make with an emphasis on the need to help farmers make the unavoidable transition. It was prepared by a small group of experts based on years of experience following the developments of the agriculture and environmental policy in the EU. In this highly condensed report, we do not deal with all aspects of agricultural policy but focus on the two areas where we believe that reform is most needed: land and risk management. It therefore has little to add to the wealth of ideas contained in the Cork 2 Declaration on Rural Development². Readers are urged to turn to the appendices which accompany this report which provide the evidence behind many of the assertions made and much fuller explanations of the reasoning and the concepts and ideas.

# TABLE OF CONTENTS

Executive summary – actions and recommendations ................................................................. 5

1 Introduction .................................................................................................................................................... 8

2 Why further reform? ............................................................................................................................................. 10

3 What reform is required? ................................................................................................................................ 13

  3.1 Balance and architecture must change .......................................................................................... 13

  3.2 A more integrated approach to land management .......................................................................... 14

  3.3 Managing volatility and risk ............................................................................................................ 18

4 How to propel such reforms .................................................................................................................. 20

References ....................................................................................................................................................................................... 22

The online pdf version of this report (http://www.risefoundation.eu/publications) contains the detailed background papers to the core of this report authored as shown

Appendix 1
Why further reform of the CAP is necessary, Alan Matthews

Appendix 2
Integrating environmental land management into a streamlined CAP, David Baldock.

Appendix 3
Managing volatility and risk in the CAP, Erik Mathijs
Executive summary
actions and recommendations

Summary

Further adaptation of the CAP is necessary to help EU farming become a well-structured industry which is economically viable and environmentally sustainable. The next 15 years will see a generational turnover amongst farmers as millions of farmers already over 60 retire. The new generation have before them the exciting challenge of embracing the wealth of new technology based on precision, digitisation, big data and even robotics which when applied to plant and animal genetics and nutrition can raise their productivity, and thus incomes, and equip them to combine Europe’s high quality food production with high and rising environmental performance as they steward our natural resources.

Europe’s agricultural policy has a key role in assisting this transformation. This inevitably requires change to the largest instruments in the CAP, the Pillar 1 direct payments. These payments currently account for over 70% of CAP expenditure and nearly 30% of the entire EU budget. The introduction of these direct payments and their later decoupling from production were important steps in the evolution of the CAP but the impression that they offered farmers a permanent entitlement to such support was a mistake. These payments are ineffective, inefficient and inequitable. They do not serve well the purpose of income support of those most needy, nor do they serve food security, efficiency of resource use, nor the delivery of rural environmental services and moving to a more productive and sustainable agriculture. The conclusion is that they should be systematically reduced and resources switched to provide targeted assistance, including transitional adjustment assistance, to help farmers adapt and rise to the specific challenges of improving productivity, resource efficiency and risk management, and to pay farmers to provide specific environmental and other public goods. For the land management aspect of the policy this should be done by replacing the concept of entitlements with contracts for services.

It is argued that the two principal aspects of the CAP requiring most attention are land management and risk management. The third main element of the CAP, namely rural development policy is less in need of radical over-haul. It was well analysed in the Cork 2 declaration so we do not address it here. Its important functions are to raise productivity and resource efficiency by improving skills and knowledge exchange, improve farm product marketing, encourage rural economic diversification and develop rural infrastructure. Likewise we do not dwell on the constructive proposals in the recent report of the Agricultural Markets Task Force on economic relations in the food chain whose recommendations we support.

The concern about land management is that current environmental standards are not being met. Progress on containing water and air pollution, soil and biodiversity degradation, have further to go and climate protection remains a key challenge. Unless agriculture’s GHG emissions can be further cut it will be exposed as contributing a steadily higher share of total EU emissions.

Key points to remedy these concerns include: the need to set clear strategic targets for farming so that farmers can better appreciate the task that confronts them; and to clarify the trade-off in reaching a low carbon strategy whilst

1 Agricultural Markets Task Force, 2016
also paying attention to soils, water and air quality and biodiversity conservation targets. It is stressed that this cannot be achieved by the CAP alone, but general regulation, plus advice, training, R&D and institutional development are needed. Importantly, a significant part of the action must in future be contributed by the private sector.

The CAP itself should be transformed to achieve this. It is argued that more targeting of the right measures, in a programmed, multi-annual, and cofinanced approach is required. But this also requires a new culture with more attuned modes of delivery emphasising engagement of the parties rather than heavy controls, inspections and sanctions. This suggests a redesigned, more integrated, tiered structure of supports. Four such tiers are suggested: at the base level, or tier, is transitional adjustment assistance with appropriate conditionality. Building on this are successively higher, more enduring, support tiers targeting: next, the marginal areas such as areas of natural constraints, then a tier providing agri-environment and climate schemes available to most farming systems and the highest tier providing support where more specific environmental or other management is required. Not all these supports require annual payments, an important building block will be investment supports to individuals or groups of farmers.

It is critically important to note that this work cannot be achieved by the CAP alone. The long-term objective must be to internalise the environmental costs of farming into food prices so that these better signal socially aware consumption patterns too. Thus sustainable sourcing by the big players in the food chain must become more than just a Corporate Social Responsibility gesture but a demonstrable reality. This requires the active engagement of the private food processing, food service and retailing sectors.

The core argument concerning risk management is that the present approach in the CAP towards market orientation has not gone far enough. The sheer scale of direct payments dwarfs and inhibits the development of a more appropriate and more comprehensive mix of tools. The present system has too many distorting elements which inhibit farmers from better mitigating the risks they face.

Risks will be far better managed if the full range of options available to farmers are brought to bear. These include: business diversification, using spot and futures markets, better specified contracts with buyers, improving relations with buyers, where appropriate more investment in value-adding downstream, and moving towards fuller vertical coordination. We demonstrate that different instruments are appropriate for catastrophic risk versus market risk versus normal business risk. Each of these, in turn, are best approached, respectively, at policy, market and farm level. A key consideration is that other policy instruments should not inhibit or ‘crowd-out’ the deployment of this range of measures. Unfortunately, at present the existence of substantial direct payments is doing just this and therefore restricting the use of the full canvas of risk mitigation measures.

The prescriptions which emerge from this analysis are that risk prevention demands appropriate technology, information systems and training; risk mitigation requires private risk management measures some of which would benefit from administrative support; and risk coping might justify a suitably structured and financed income stabilisation tool.

The report concludes by exploring if the kind of reforms being discussed are achievable within the current EU decision structures and procedures. Following the lessons of what has been described as the ‘perfect storm’ resulting in the helpful reform in 2003 and the ‘imperfect storm’ which resulted in the less well-received 2013 reform, it is suggested that further procedural changes and more work on conditioning the climate of opinion for reform would be helpful to increase the chance of the sort of reforms envisaged in this report. The most concrete such idea is that the necessary integration and coherence of these proposals will only be achieved if they are initiated by the joint inputs of several DGs within the Commission and then negotiated by joint agricultural and environmental Parliament Committees and Councils. This would enable each DG, Committee and Council to defend their natural constituency but within an integrated procedure better allowing trade-offs to be explored and settled.

Summary of actions and recommendations

Why reform?

1. The current policy is not optimal, it has not brought about viable farms that are sustainably managing Europe’s rural resources. It is not sufficiently helping farmers adapt to the challenges ahead, particularly climate change. It is important to redefine the development path for EU farming for the 2020s and to create an Agricultural Policy focused on results.

2. Excessive weight is given to inefficient, ineffective and inequitable direct payments in Pillar 1. They should be systematically reduced over a pre-announced period of time and resources switched to provide targeted assistance to help farmers face specific challenges of improving productivity, resource efficiency and risk management and to pay farmers to provide specific public goods.

3. The two aspects of policy requiring most adaptation are land management and risk management. The structural investment supports of Rural Development policy for innovation, productivity, human capital, improved marketing, quality production and wider rural diversification and development have already been widely discussed, notably in the Cork 2.0 Declaration, and are less in need of reshaping.
4. For land management aspects of the policy the concept of entitlements should be replaced by contracts for services.

What reform for land management?

5. The key rationale for policy intervention is the need to build more sustainable forms of agriculture and meet increasingly demanding goals for environmental land management in Europe.

6. Setting goals. European agriculture should be helped to make the transition to sustainability on an agreed pathway to 2030 and beyond. This requires a European plan for a lower carbon and more biodiversity friendly agriculture and food system, meeting environmental standards and rewarded with higher prices which recognize the full costs of production.

7. Refining policy tools and delivery. This requires a cultural change in the way that farmers are engaged with policy on the ground involving, inter alia, clearer goals and results orientation, incentives for innovation, wider landscape approaches, more advice and integration with food chain initiatives.

8. Integrated land management requires more than the CAP. It demands a combination of regulations, support through the CAP, strengthened advice, training and research and an enhanced role for the private sector.

9. The land management component of the CAP would grow and shift towards a tiered set of multi-annual contractual measures underpinned by the reference level of environmental and other regulations. The two-pillar model is no longer needed.

10. The first tier, Transitional Adjustment Assistance replaces basic payments to facilitate change. Tier 2 supports the marginal areas. Tier 3 pays for expanded agri-environment and climate measures. Tier 4 delivers higher more specific environmental services and restores natural capital.

11. In parallel, new private resources would be deployed to meet public goods objectives and improve returns for good land management through novel measures such as payments for ecosystem services and forward looking food supply contracts reflecting the cost of meeting higher standards.

What reform for risk management?

12. Agriculture is inherently a risky economic activity due to the biological nature of its production processes and its exposure to the weather, uncertainties that are amplified by a fragmented farm structure and price inelastic supply and demand functions.

13. We recommend a market and risk management policy based on building adaptive capacity making farms more resilient in undistorted markets. Therefore, we recommend only offering public support to market measures on a temporary basis for example to help meet the costs of producer organisations or the set-up of private insurance markets where these are underdeveloped.

14. Most attention should go to risk prevention, based on applying appropriate technologies, land management, information management and training. Government support should stimulate farmers to use appropriate technologies and land management strategies, which can be granted in the form of investment support for infrastructure, payments for ecosystem services and support for training.

15. Risk mitigation should be mainly based on private risk management measures. A comprehensive and coherent legal framework should be provided to enable the development and use of a wide set of private risk management instruments that spread, buffer, share and transfer risk, both horizontally (co-operatives, producer organisations) and vertically (in supply chains).

16. Residual risk not mitigated by private risk management measures can be covered by an income stabilisation scheme as a form of ex post risk coping strategy. The tool should be designed in such a way that private risk management measures are not crowded out.

How to reform?

17. Re-integrate the principal stakeholders in agricultural policy by inviting a joint initiative from Commission Directorates General for Agriculture and Rural Development, Environment and Climate to prepare the next reform proposals. Then conducting the ordinary legislative process through joint efforts of Agriculture and Environment Councils, and Agriculture and Environment committees of the European Parliament.
The context of this report is two sets of pressures on European farming. The first are the calls for global food production to adjust towards ‘resource-smart food systems’. Twelve of the 17 Sustainable Development Goals (SDGs) agreed in 2016 relate to the management of resources. According to a report of the International Resource Panel (UNEP, 2016), globally, “food systems are responsible for 60% of global terrestrial biodiversity loss, around 24% of the global greenhouse gas emissions, 33% of degraded soils, the depletion of 61% of ‘commercial’ fish populations, and the overexploitation of 20% of the world’s aquifers. These pressures on our natural resource base are expected to significantly increase with population, urbanization and supermarketization trends, as well as dietary shifts to more resource-intensive food. By 2050, an expected 40% of the world population will be living in severely water-stressed river basins and agriculture’s share of global greenhouse gas (GHG) emissions may increase from 24% to 30%.”

The way humankind is using resources, and producing and consuming food, risks pushing natural systems close to, or beyond, global tipping points. This particularly applies to management of nutrients (phosphorus and nitrogen), biodiversity loss and especially Greenhouse Gas (GHG) emissions, with potentially severe impacts on food production potential arising from climate change. Unsustainability of some food production systems is the greatest threat to global food and nutrition security. The EU is a zone with a relatively intensive agriculture, high rates of food wastage, and with diets rich in livestock products and sugars. It has high and growing incidence of obesity, diabetes and other non-communicable, lifestyle-related, ill health. The EU therefore has much to learn, and teach, about finding sustainable food production and consumption systems. As a signatory to the SDGs the EU and its policies, not least its Common Agricultural Policy (CAP), must fully adapt.

The operationalisation of Goal 13 on Climate Action at the top level has been speedily addressed through the COP21 Paris Climate Agreement. The challenge now is practical policy implementation on the ground. Agriculture cannot stand apart from this. Agriculture is a significant contributor to climate-damaging GHG emissions, mostly the non-CO₂ gases nitrous oxide and methane. This is a medium-term threat to agriculture itself. It necessitates a step change in resource use efficiency in crop and livestock production, including soil, nutrient and manure management to reduce these emissions. But agriculture has, potentially, also an equally significant positive role in managing, and increasing, soil carbon and providing sustainable renewable energy from biomass.

The second set of pressures is more immediately and directly felt by European farmers. They face challenges to become and remain competitive internationally, to achieve remunerative incomes, to manage a generational turnover introducing needed youth and energy, to master new technologies and to meet new societal demands beyond supplying their primary output, food. The environmental and resource management challenges
for agriculture have been well understood in Europe for some time. The reforms of the CAP since the late 1980s have slowly embraced the idea that a major purpose of agricultural policy is to deal with the provision of resource management services provided by farmers which are not rewarded by markets. Correcting these so-called market failures by paying farmers to provide public goods is increasingly the accepted language of policy reform. However, this process has much further to go.

Another important dimension of the context in which CAP operates is the complex trade regime. Although agricultural commodity trade has been liberalised and some of the most distorting domestic policies (such as former EU variable export subsidies) no longer operate, agriculture is still a relatively highly protected sector. Most agricultural production worldwide is consumed in the country it is produced, however trade flows are increasingly influential on EU markets. The EU is a member of the WTO and thus a signatory to the Agreement on Agriculture which limits trade distorting policy. Europe’s common external tariff includes some very high tariffs for agricultural products. However, the EU offers free access for many products within quotas (tariff rate quotas) and preferential access and freer trade under its numerous free trade and preferential trade arrangements with 48 countries around the world. Many more such arrangements are under discussion including with Mercosur which could have profound impacts for some sectors of EU agriculture. Food and agricultural commodity trade is also affected by numerous non-tariff, technical barriers to trade in the form of regulations on products and a wide range of processes and aspects of the production and processing of food. EU farmers are thus partly protected from globalisation, but they are also exposed to it through the concentration and globalisation of the companies providing their inputs (seeds, fertilisers, crop protection and animal health products and machinery) and, to a lesser but growing extent, the companies to which they sell their products.

It appears that the momentum towards more multi-lateral trade liberalisation has now evaporated. Even the move towards bilateral or regional trade liberalisation is meeting resistance. Meanwhile the UK is seeking to go global as it exits the EU while, depending on the actions of the new administration, the USA may turn its back on existing Free Trade Agreements such as NAFTA. This report therefore focusses on domestic agricultural policy reform of the CAP. Even within the status quo of trade agreements an unresolved issue which repeatedly plays into domestic agricultural policy is the treatment of environmental externalities. This shows up in two ways. First, farmers resist higher environmental standards, or demand compensation for respecting such standards, because it is feared that they will displace production to countries with lower standards (and lower associated costs) and thus export the pollution. Second, environmental groups point to the ‘virtual’ resources consumed by citizens of regions, like the EU, with a pattern of high imports of resource heavy products like food.

Within these global developments and responsibilities there are intense pressures in the EU itself. Many parts of the Eurozone still struggle with slow recovery and high unemployment stemming from the 2007/8 financial crisis. Furthermore, Brexit and other Eurosceptic movements have arisen in many Member States centring, inter alia, around discontent with migration levels and coping with the unprecedented flow of refugees in 2015 and 2016. In this context with current MFF discussions for the post-2020 period framed for a “budget focused on results” the value for money from expenditures under all EU policies, especially therefore the second largest spending policy, the CAP, is coming under intense scrutiny.

At the root of these challenges are farmers. For millennia in Europe they have managed our vital resources of land, its soil, much biodiversity and our cultural landscapes. Their activities utilise a high proportion of fresh water. The responsibilities on farmers have magnified as we have discovered the impacts on natural resources of feeding the human population that has quadrupled since 1900. However, the policies to help farmers better manage these resources whilst running viable private businesses have a long way to develop. Whilst EU farmers’ organisations are well aware of these broad global and European challenges it is important to recognise that individual farmers themselves are under a great deal of pressure. Their principal role as suppliers of primary agricultural produce has been considerably complicated by new societal demands. At the same time, they are trying to manage new technologies, some of which are resisted by society, and they are striving to achieve competitiveness in international markets. Understandably, farmers, confused by the cacophony of comment on what they do, focus on coping with the immediate very real market circumstances of low or even negative margins in several product areas (the latest cases being for milk and pork) and adjusting to what they see as unnecessary complexities of the current CAP.

This report necessarily should stand back from these immediate issues. It shows in Chapter 2 why the CAP has further to reform because too much of its expenditure is indefensible. Chapter 3 offers clear ideas about what reforms are needed in the two key areas of land management and risk management. The fourth and final chapter then offers some ideas of how the decision procedures and structures could be adapted to raise the possibility of earlier and more effective reforms. The intention throughout is to provoke discussion on more effective policy to assist farmers to rise to the challenges identified.

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2 Such as pollination, flood management, water holding and filtration, biodiversity, habitat and cultural landscape management and carbon sequestration. See Cooper et al., 2009 for a full account of public goods associated with EU agriculture.

3 See Matthews et al. (2017) for a comprehensive analysis of the trade impacts of EU policy for agriculture.
2 Why further reform?

The EU will spend €363 billion in 2011 prices on the Common Agricultural Policy (CAP) during the period of the 2014-2020 Multiannual Financial Framework (MFF), accounting for 38% of EU spending during this period. The then Commissioner for Budget and Human Resources Kristalina Georgieva questioned in the debate on the next MFF at the EU Presidency Conference in January 2016 whether the CAP as reformed in 2013 is achieving a sufficiently high degree of European value-added and whether the greening of the CAP is working. Close examination of the current design and scale of the CAP when measured against the objectives of the CAP suggests it is not fit for purpose and does not give the European taxpayer value for money. This suggests that further reform is required.

What are the objectives of the CAP? These were set out in the Treaty of Rome and have not been updated since. They are to increase agricultural productivity, thereby to ensure a fair standard of living for farmers, to stabilise markets and to ensure food security and fair prices for consumers. The CAP 2013 reform specified three broad policy objectives for the future CAP linked to the overall objectives of smart, sustainable and inclusive growth in the Europe 2020 strategy. These were (European Commission, 2010):

- Contributing to a viable, market oriented production of safe and secure food,
- Ensuring the sustainable management of natural resources, and
- Contributing to the balanced territorial development.

These objectives are being pursued under the Junker Commission’s priorities of jobs and growth. Specifically, Agriculture Commissioner Hogan was asked to pursue flexibility and simplification of the CAP instruments. In addition, following the September 2015 UN General Assembly, the 2030 SDGs now form the basis for the EU’s long-term planning including for sectoral policies such as the CAP for the next MFF period (European Commission, 2016). And the December 2015 Paris agreement on a global action plan to combat dangerous climate change will require significant changes in behaviour and incentives across most areas of human activity, especially agriculture.

How well does the CAP contribute to the achievement of these objectives? The analysis summarised here focuses on the Pillar 1 Direct Payments (DPs henceforth) for two reasons. First they make up 72% of the CAP budget and account for 28% of the EU budget. Second, although the CAP contains many structural and environmental measures especially in the Rural Development second pillar, and agriculture is also supported by border protection through the EU’s Common External Tariff as well as Common Market Organisation (CMO) regulations, it is the pre-
dominant role played by the first Pillar, area-based, direct payments which attracts most controversy.

Direct payments were introduced into the CAP in 1995 and overtly calculated and distributed as compensation for lower market price support. Since then they were mostly decoupled from production, consolidated for all supported commodities for each farm, and mostly paid on an area basis. Over two decades later it is very hard to justify such continued compensation for past policy change. They are now variously justified as contributing to higher farm incomes, as a necessary support for food security, as providing a safety net for farmers against unexpected market shocks, as compensating for higher regulatory standards, and as ensuring more sustainable management of natural resources. Each of these is an entirely legitimate objective of farm policy. But what is the evidence on whether the DPs as currently defined and distributed are an effective, efficient or equitable way of achieving such objectives? Briefly consider each of these five justifications offered for Pillar 1 direct payments.

Do DPs support farm income? They do indeed constitute a significant share of income from farming. This varies by farm type: from the relatively minor role on horticultural farms (7%), vineyards (9%) and a small but significant share on pig and poultry farms (granivores) (22%) to 61% on mixed farms, and 70% of the income on ‘other grazing livestock’ farms (predominantly beef and sheep). However, this picture is complicated by the fact that a great many farm families, encouraged by policy, have developed diversified alternative income sources. In addition, increasingly women have moved into paid employment contributing to household income enabling survival of otherwise non-viable farms. The result is that it is not clear that incomes in households headed by farmers are notably lower than those in society generally. Furthermore, there is evidence that decoupled payments slow the rate of structural change relative to a situation of no agricultural policy support. The CAP’s income support payments have discouraged some farmers from exiting agriculture and slowed the reallocation of land towards younger, more efficient farmers. In any case, there is considerable leakage of the supports to landowners outside agriculture, to suppliers of other factors of production and downstream to food processors and distributors. But particularly damaging for a social measure is that the DPs are not equally distributed among beneficiaries in the European Union. In 2014, on average, 80% of the beneficiaries received only 20% of the payments (DG AGRI, 2015).

More embarrassing still, for a social welfare measure is that decoupled payments attract the worry of dependence of some farm types on direct payments, again point to the conclusion that the worrying degree of dependence of some farm types on direct payments, again point to the conclusion that direct payments make the biggest contribution to risk reduction on those farms facing the largest income variability. Also, they are poorly designed to deal with variations in income over time. Payments are made to farmers when prices are low, but also when prices are high. Another objection to making generalised direct payments available to all farmers as a risk reduction instrument is that it makes farmers less likely to adopt other risk management strategies, and may even encourage them to increase the amount of risk that they take on. These concerns, and the worrying degree of dependence of some farm types on direct payments, again point to the conclusion that this instrument is an extremely blunt tool to manage risk which is likely to be crowding-out more effective actions.

Do they improve risk management and resilience? There is no doubt that direct payments help to stabilise farm income because they are a less variable part of income than market income alone. However, area-based payments paid to all farms, every year, do not distinguish between different lines of production, some of which are more vulnerable to production and price risks than others. Thus, it is not necessarily the case that direct payments make the biggest contribution to risk reduction on those farms facing the largest income variability. Also, they are poorly designed to deal with variations in income over time. Payments are made to farmers when prices are low, but also when prices are high. Another objection to making generalised direct payments available to all farmers as a risk reduction instrument is that it makes farmers less likely to adopt other risk management strategies, and may even encourage them to increase the amount of risk that they take on. These concerns, and the worrying degree of dependence of some farm types on direct payments, again point to the conclusion that this instrument is an extremely blunt tool to manage risk which is likely to be crowding-out more effective actions.

Do DPs compensate for higher regulatory standards? EU farmers are required to meet high food safety, environmental and animal welfare regulatory standards. Regulations in the fields of the environment, animal welfare and food safety can raise costs at farm level. Hence, the global competitiveness of European agriculture may be adversely affected by these standards. However, standards also raise the quality and reliability of EU food products, enhancing their reputation and making them more attractive to consumers on both home and export markets. The increasing role played by private standards deployed by the globalising food industry may mean that competitive conditions in food markets are actually more similar than differences in legislation between countries might suggest. Whether EU farmers are disadvantaged by a particular standard or not is an empirical question.

Higher regulatory standards are not always a reason for compensation. In many cases, the regulations are intro-
duced to prevent unintended costs being borne by other groups in society. There are thus a limited number of regulations which reflect societal preferences and where a case for compensation might be made for the higher costs that farmers may incur. However, decoupled area payments are not an efficient way to compensate farmers for these costs. Costs of compliance differ significantly across commodities and flat-rate per hectare payments bear no obvious relationship to these costs. Targeted payments may be justified on occasion. The need to meet high regulatory standards does not legitimise the continued payment of Pillar 1 payments to all farmers on all land.

**Do DPs contribute to environmental sustainability?**

The last two decades have seen significant development in the understanding of the complex and dynamic interaction between agricultural production systems and the environment. Everyone concerned is much more aware of the pervasive negative and positive externalities of farming. The negative effects arise from specialization and intensification and impact on biodiversity, habitats, soil, water, air and atmosphere; the positive effects arise in farming systems and practices which create and maintain many semi-natural habitats and cherished cultural landscapes found in rural Europe. The CAP itself has evolved strongly in the direction of seeking to integrate environmental land management into its structures. Some environmental indicators have improved but many standards are still not achieved. The gains have been helped greatly through instruments found in the Rural Development regulation such as: agri-environment and forestry payments, supports for farmers in agriculturally less-favoured and environmentally more favoured (Natura 2000) zones, high quality food marketing using geographical indications, and through encouragement of organic farming. Initial evidence suggests that Member States have devoted a substantial share of their 2015-2020 RDP Pillar 2 funds to environmental and climate measures with significant environmental benefits expected.

The controversy arises over the environmental role of Pillar 1 DPs. Farming organisations claim that only viable businesses can deliver sound environmental services, and the DPs are a key component of this ‘viability’. However, viability dependent on inappropriately distributed and targeted payments is not the basis for long-term business sustainability. A further argument is that the existence of direct payments provides leverage for adherence to critical EU and national environmental legislation through the operation of the cross-compliance conditions. This too is a dubious argument as it seems to contradict the polluter pays principle operating for other sectors. However, the most controversial development has been the ‘greening’ of Pillar 1 direct payments introduced as a key element of the 2013 reform. The introduction of greening in Pillar 1 was a highly significant recognition of the importance of incentivising more environmentally sensitive land management. However, it invited failure because to fit into the Pillar 1 framework it relies on simple, annual and generalisable actions, yet environmental management invariably requires system- and place-specific adaptation. Analysis of the greening obligations themselves, the exemptions built into the regulations, and the implementation choices made, first, by Member States and then the farmers themselves, has suggested that the expected environmental benefits from the greening payment in Pillar 1 are likely to be very limited. As the greening payments command twice the funding of the rural development measures devoted to environment and climate, this is a serious indictment.

This chapter has focussed on the Pillar 1 direct payments which make up over 70% of CAP expenditures. There is little evidence that decoupled area-based payments are an effective, efficient or equitable way of achieving the objectives of supporting farming incomes, food security, farmers’ resilience to shocks, adaptation to higher regulatory standards, or sustainable agriculture. It is unlikely any country would design from scratch an agricultural policy based heavily upon paying an annual lump-sum amount per hectare of agricultural land with minimal conditionality attached as the optimal policy. These direct payments do not therefore seem compatible with a budget focussed on results. Whilst European society has shown a willingness to provide substantial support its farming communities the current use of much of these funds is a wasted opportunity to devote resources to help farmers cope better with the immense challenges they face. In future, any such farmer supports should be much better structured and targeted and for land management and delivery of public environmental goods would be better deployed by switching away from payment entitlements to contracts for services. These ideas are taken up in sections 3.2 and 3.3 which follow.
3 What reform is required?

3.1 Balance and architecture of the CAP must change

To this point it has been argued that the CAP must continue to evolve. Despite the generous support of the CAP and EU agricultural trade policy too much of EU agriculture is still unviable, over-dependent on badly targeted direct payments, and struggling to cope with natural and market volatility. In addition, in some regions and production systems agriculture is not meeting statutory environmental standards such as the directives on nitrates, birds, habitats and water, and has much more to do to rise to the challenges of the SDGs and climate commitments. This analysis and the current public debate on the CAP point to two major aspects which most require further change, namely land management and risk management. At present the tools for addressing these issues are confusingly deployed in both pillars of the CAP.

The land management tools must respond to the pervasive market failures surrounding the management of rural land. The need for more coherent risk management partly arises from the structural market imperfections found in the food chain which puts the primary production sector in a weak position. These phenomena are not confined to the EU but apply globally. A result of these failures and imperfections is that consumers are not paying the full social costs of the food they purchase, and low-margin farming businesses cannot be expected to meet these costs either. Hence the need for collective action and policy reform particularly to rebalance the policy away from untargeted direct payments towards measures which meet the challenge of better environmental and risk management and to galvanise the private sector to internalize more of the externalities. How to do this is the focus of this chapter.

The CAP has many necessary and important measures; many of the investment instruments at the disposal of Member States in the Rural Development Regulation are performing vital functions. Agricultural markets policy requires investment measures to help improve productivity, product quality and protection of denomination of origin, to encourage formation of producer organisations, and to embrace proposals developed by the recent Agricultural Markets Task Force on market transparency, trading practices, farm product contracts and rules of competition. Specific Rural Development policy under the CAP has always had a limited, but important role, encouraging investment in environmentally friendly technologies, diversification, improving infrastructure (mobile connectivity and broadband), and developing local multi-stakeholder participation through LEADER. There are also much needed general horizontal measures for research and development, investing in human capital through knowledge exchange, training, skills development, innovation and pilot projects. These are not further developed here because it is assumed they should and will continue to be refined in the light of experience and to play a continuing constructive role in the CAP as was signalled and widely agreed in the 2016 Cork Conference.

To develop the CAP as a truly integrated policy for sustainable agriculture it is suggested that a clearer frame is needed. The distinctions between the two pillars of the CAP have been obscured and have lost purpose and should therefore be abandoned. Land management and risk management instruments are in both pillars, there are measures to help young and small farmers in both pillars with little obvious reasoning for these com-
plexities. There is much evidence from evaluations and audit that the array of instruments particularly for land management which evolved piecemeal over the last 25 years has become over-complex for farmers and policy administrators, lacking coherence and with questiona-
ble cost effectiveness. There is also no clear rationale explaining why some of these measures are located in the programmed, co-financed, multi-annual, voluntary Pillar 2 and others in the annual, 100% EU financed first pillar. The land management component of the CAP with its measures for improving environmental performance has grown in importance and is ripe for restructuring into a more coherent and integrated set of measures. This is the subject of the next section.

3.2 A more integrated approach to land management

This section suggests how the land management role of the CAP can and should be enlarged, better integrated and streamlined to deal with the pervasive environmental externalities which surround agriculture. It is emphasised that improving land management is not the totality of the CAP. This must be flanked by the investment measures summarized above in section 3.1 and risk management measures to be discussed below in section 3.3.

Market failures and public environmental goods.

The environmental consequences of agricultural production decisions on farms have been of growing concern and are perhaps clearer in Europe than in many other parts of the world because of the combination of relatively intensive agriculture, high population density and almost complete absence of wilderness. Meeting environmen-
tal goals in the farmed countryside is a large-scale enterprise, requiring sustained activity over a considera-
ble period and involving the whole agriculture sector to varying degrees. It is partly a question of reacting to mar-
ket failures: reducing negative externalities and produc-
ing positive environmental services for which markets fail to operate. Full environmental integration into agriculture involves a transition to a significantly different model of production where land managers must pursue a wider range of goals than in the past alongside their core role of food production.

Environmental sustainability implies both the establishment of production systems that are durable and resilient over the long term and they should make a substantial contribution to the attainment of wider environmental goals and the provision of ecosystem services in the countryside through appropriate land management. This can only be durable if these businesses earn sufficient re-
turns from the market for their marketed products and receive sufficient remuneration for their delivery of public environmental goods.

Important steps have been taken to integrate these environmental concerns into the CAP. The current instru-
ments in Pillar 1 with direct environmental purpose for agricultural land comprise: cross compliance, greening payments, and payments in Areas of Natural Constraints (ANC). The principal such instruments in Pillar 2 are the agri-environment and climate measures. But both Pillars also have other measures which have indirect or sec-
ondary environmental purpose and effects, and indeed some environmentally harmful subsidies. The piecemeal development of these instruments over many years has resulted in confused unclear objectives, the inclusion of measures which fail to deliver sufficient results, proce-
dures which are over-constrained by CAP rules and con-
trols and a system that does not engage with farmers in a user-friendly way. The integration should be taken very considerably further if current and emerging goals for sustainability are to be met.

Setting Goals. The big question is how the rather broad goal of the sustainable management of natural resources related to European agriculture can be translated into a set of more specific outcomes, especially at the EU level. Given the need to achieve and demonstrate clearer re-

positive environmental services for which markets fail to operate. Full environmental integration into agriculture involves a transition to a significantly different model of production where land managers must pursue a wider range of goals than in the past alongside their core role of food production.

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Setting Goals. The big question is how the rather broad goal of the sustainable management of natural resources related to European agriculture can be translated into a set of more specific outcomes, especially at the EU level. Given the need to achieve and demonstrate clearer re-
sults and show greater added value from the EU budget and the CAP, it would be timely to stipulate more concrete outcomes against which the success of interventions can be judged. Greater precision would also help to reveal and delineate trade-offs and synergies between objectives that can be important in the land management sector – for example as between the need to reduce GHG emissions from the ruminant livestock sector whilst maintaining appropriate grazing to manage semi-natural vegetation and secure the conservation values that are sought by environmental legislation such as the Habitats Directive.

The political and legislative messages currently presented to the agricultural sector do not provide the sense of the scale and significance of the challenges in a way that is helpful for land managers. There is a sense that current levels of food production in the EU are sacrosanct for reasons that are unclear and difficult to justify, and no recognition that unsustainable production methods themselves pose the greatest threat to food security. The challenge is to formulate a clearer more coherent set of strategic EU-level commitments and targets on water quality, integrated pest management, biodiversity protection, soil protection and reducing agriculture’s GHG emissions to 2030 and beyond. Ideally this would be accompanied by an indicative roadmap for achieving de-
sired goals.

Refining policy tools and delivery. This is needed because there are concerns about effectiveness and high transaction costs in some current measures. However, sufficient experience has been gained with integrating environmental measures into agricultural policy across the diversity of the EU Member States and farming sys-
tems to enable some important lessons and principles to be learned. Difficult balances should be struck between increasing the level of precision in environmental goals whilst allowing for uncontrollable influences (weather) and for the diversity of local conditions to be considered.
A key aim must be to reduce over-cautious behaviour amongst Member States because of the rigid enforcement culture operated by the Commission in its CAP monitoring and control rules.

Some suggested responses to these challenges are, first, to adopt policies that reward farmers directly in relation to environmental results where this is possible. Second, to specify preferred land management practices in more considered and precise ways, accompanying this with an appropriate delivery and support framework. The goals should be clear to the farmers involved as well as the rules, so the focus in their management is on the objectives rather than being driven by pure compliance. Third, to ensure the CAP framework does not inhibit Member States from introducing more innovative and creative schemes, as it can do now because national authorities fear disallowance of their CAP funds for minor failings emerging on farms. Fourth, to adopt new institutional models for scheme operation and delivery, for instance the use of group rather than individual farmer agri-environmental schemes where this can be devised. Fifth, it may be better in many environmental land management schemes to place greater focus on advice, facilitation, support and information alongside the payments rather than relying on paper systems and remote transactions; this may involve costs, but effectiveness will generally rise faster. Sixth, where possible environmental delivery should be integrated with food chain and other market initiatives. These lessons are not entirely new, but the further development of payments for delivery of public goods requires that they are pursued with renewed vigour.

Selecting policy combinations. The aim must be that the costs of running a sustainable EU farming system should ultimately be met primarily by the beneficiaries, including food consumers, water suppliers, leisure companies, farmers themselves and others. Public land management payments should be devoted solely to those public goods that are too difficult to attain by market routes, even if these are much more developed in future. In the interim, however, there will be a continuing need for public expenditure for both maintaining and enhancing aspects of agricultural land management. It is suggested that the strategic agricultural and land management goals and targets should be delivered through four sets of instruments: (A) An enhanced role for the private sector, (B) CAP supports, (C) Advice Training and Research, and (D) Regulations. Focus here is on the first two.

The CAP cannot be the only source of incentives for promoting sustainable land management and there is no assurance that it will be sufficiently well funded to secure the level of effort required on farmland over the coming decades. Where private resources can be harnessed more effectively this reduces calls on the CAP budget as well as being more efficient in broader economic terms. Several policy options are identified for harnessing more private resources, these include:

- At the most strategic level, an aim must be ultimately to reflect more of the costs of sustainable management of soil, water, carbon and other resources in the price of agricultural products. This is a process that will be spread over more than one decade, requiring planning and consensus building. Some actors in the food chain, including certain retailers and food manufacturers (such as Unilever) already are moving in this direction, including sustainable land management considerations in their contracts for raw material sourcing. In the meantime, other steps can lead us in this direction.

- Labelling and certification schemes for farm products. This aims to introduce more systematically a greater environmental dimension into new and existing EU and local labels, to more overtly connect the idea that product quality entails environmental protection, and in the process, build market demand and acceptance of the costs involved.

- Positive promotion of well specified Payments for Ecosystem Services (PES) schemes by actors outside the public sector such as water supply companies, mineral water companies and environmental NGOs who own or lease land. These could deliver improved resource management alongside flood management and clean water supplies. Such schemes could be funded outside the CAP budget but potentially linked to rural development programmes, especially at a local level.

- Offsetting schemes for biodiversity on farm and forest land that has been developed into urban space so that developers meet more of the costs of compensation, an example is the German eco-points scheme.

- Attracting private and charitable funds into land purchase for environmental management. This can be pursued by individuals, charities, trusts and businesses, and could be encouraged further by developing new investment mechanisms that allow wider participation in the ownership and management of forests for example.

Implications for the CAP

The overall concept for land management suggested is a tiered set of payments for public goods offered in a generally programmed, multi-annual, regionally-defined, co-financed approach to address the strategic goals expressed at regional/local level within a clear European framework. Farmers would enter contracts, which as far as possible would be multi-annual and enable them to receive funding under one or more of the tiers. Many elements of the policy would involve one-off contracts or investments, although some measures will require on-going annual payments. Of course, a radical restructuring of the kind suggested here is a major legislative and administrative undertaking. However, the shift of the principal interaction between farmers and national administration
from direct payment schemes with their clumsy and costly annual cycle of applications and control, to a phased-in, multi-annual (5 year?) contractual approach, once set up, offers a considerable saving in transactions costs for administrators and farmers.

The suggested four tiers of this approach would be built upon a Reference Level set of pre-conditions for public payments like the existing system of cross compliance but revised to ensure inter alia, the protection of soil carbon, especially avoiding damage to carbon rich soils. The four tiers are:

**Tier 1 Transitional Adjustment Assistance.** This replaces the current pillar 1 basic payment. It is annually paid, perhaps in a multi-annual contract, for which, in principle, all farmers are eligible. It would be compulsory for Member States to introduce these payments. It would have a modest ceiling payment\(^8\) and be overtly regressive tapering off to zero within an agreed period. This should be long enough, say 10-15 years, to give security to the large cohort of EU farmers who are likely to reach retirement during the period, and to give time to develop sustained market returns for rising standards of environmental management. Its justification is assistance to farms to make the necessary adjustments to their businesses or their lives to thrive under the new regime envisaged. Part of the transitional process is for farmers to become more knowledgeable, skilled and professional so that they could, especially avoiding damage to carbon rich soils. The scaling of such payments should reflect the true costs of these regions is in place. It would not be compulsory for Member States to introduce this tier, especially if it could be demonstrated that other means of achieving the desired outcomes had been put in place via the other tiers of support and through approaches outside the CAP.

**Tier 2 Payment for environmentally or socially important marginal areas.** An annual payment provided under a multi-annual contract to support the continuation of farming and appropriate rural land management, avoiding the abandonment of holdings and land and hence contributing to both rural vitality and the maintenance of cultural landscapes in such areas. This certainly embraces upland and mountainous areas, but also includes some lowland mostly pastoral grazing areas\(^9\) where environmentally acceptable alternative land uses are not viable.

The scaling of such payments should reflect the true opportunity cost of farmers remaining in such areas (i.e. compared to living standards they could achieve outside such marginal farming areas). This is a positive reinterpretation of the current negative concept of compensating for the additional costs relating to the constraints on agricultural production in the area concerned. Society would not generally compensate producers of tradable goods located in an area unsuitable to their production – such businesses would be helped relocate. The fact that we are willing to help marginal farming indicates that prime motive for these payments is not the agricultural production per se, but the environmental and cultural landscape benefits and social vitality of helping keep these historically farmed areas populated. Indeed, the interactions between livestock farming, carbon management, flood protection and other such services must be appropriately balanced taking account of the new priorities. If properly labelled and defined with appropriate environmental conditions, it will then be clear that such payments can only be made when appropriate environmental management of these regions is in place. It would not be compulsory for Member States to introduce this tier, especially if it could be demonstrated that other means of achieving the desired outcomes had been put in place via the other tiers of support and through approaches outside the CAP.

**Tier 3 Agri-environment and climate measures.** This is a base-level environmental land management scheme, appropriately tailored to different farming systems in a broad sense\(^10\). Payments would be for the environmental public goods that are associated with good management of these systems, with relatively simple rules and subject to some regionalisation. They would be annual for the period of a multi-annual contract and it would be compulsory for Member States to introduce this tier with elements corresponding to their requirements alongside EU objectives. Eligibility requirements, conditionality and packages of basic management options or desired outcomes would be identified for each farming system, tailored to the environmental priorities facing these farming systems in different regions. This could cover mainly maintenance activities but with some limited enhancement as well and should be designed to link easily with supplementary enhancement measures in Tier 4.

Advice would be available and wholly necessary to accompany the implementation of these schemes. It is envisaged that schemes would be designed for a wide range of farming systems, such as: organic systems, HNV grassland systems, agro-forestry systems, integrated farming systems, non-High Nature Value (HNV) grassland systems, arable systems – HNV and other, permanent crop systems – HNV and other, larger scale area based regimes for water catchments or landscapes, and specific extensively managed outdoor livestock systems not covered above.

**Tier 4 Higher level environmental payments.** These are targeted at achieving specific environmental outcomes/results beyond those sought in Tier 3 – the focus would be on enhancement and restoration, not mainte-

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8 The principles defining any ceiling payment require debate given the very different large farming structures in some Member States.

9 Lowland grazing farms have equally high dependence on public payments and just as low returns as upland and mountain farms, but defining which can be included in these supports is a challenge.

10 The authors have resisted investing a great deal of time and imagination into the name of this tier because the terminology and more descriptive label will not satisfactorily translate into different European languages, each Member State has to interpret these ideas with descriptors which best suit its purposes and local context.
nance. The requirements would go beyond the activities identified under Tiers 1 to 3. They will usually involve annual payments in a multi-annual contract, but they may also require one-off investments as well. It would be compulsory for Member States to offer this tier, although enrolment by farmers in them would be voluntary and subject to discretionary rules originated by Member State authorities. The types of measure envisaged here include: area based payments; complementary support for green and other non-agriculturally related investments; funding to support the development of management plans; and advice, training and capacity building.

Two over-arching challenges in further extending the operation of payment for public goods concern the administrative burden and payment rates. Excessive transactions costs to public authorities and land managers can stifle this approach. It is vital to allow, indeed encourage, positive engagement of land managers in defining, operating and controlling these schemes. Defining payment rates requires more holistic interpretation of opportunity costs and a full appreciation of the transactions costs. If the delivery of public environmental services is not remunerative, then farmers will simply decline to enrol. Farmers could expect to earn considerable sums per hectare in Tiers 3 and 4 of the proposed structure.

This integrated land management element of the CAP sits alongside two other key elements: risk management and safety net, discussed below, and innovation and investment which includes the measures discussed briefly in section 3.1 above. The land management element would be expected, at least initially, to engage practically the whole EU farmed area and it may absorb a high proportion of support finance. Figure 1, below, illustrates how the main components of the policy fit together.

![Figure 1: Proposed structure for a modernised CAP](image-url)

**Figure 1: Proposed structure for a modernised CAP**

**Source**: This is an adaptation of the figure in Hart et al. (2016)

### 3.3 Managing volatility and risk

The recent period of low prices for many sectors following the price spikes following the financial and commodity crises of 2007/8 has led to increased demands for the CAP more overtly to tackle volatility and risk. The Agricultural Markets Task Force set up in 2016 to examine and improve the position of farmers in supply chains made several recommendations including: to increase market transparency, to make the existing risk management toolkit more attractive and coherent, using simplified loss calculations and reimbursement options and even to shift resources from untargeted direct payments to “an approach which channels CAP money into a genuine and predictable safety-net for farmers to apply in times of market imbalance”11. This section takes up this challenge and suggests how the CAP can be adapted to help farmers manage volatility and risk in a more coherent and holistic way.

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The nature, causes and consequences of risks in agriculture. Agriculture is a particularly risky economic activity due to the biological nature of its production processes and its exposure to the weather; the atomistic (i.e. highly price inelastic) structure of the industry also makes risk management more challenging. In addition, agriculture is characterised by supply and demand functions that are highly price inelastic, with the effect that small market perturbations can generate large price effects. Risk in agriculture has been much studied. It is useful to categorise risks faced depending on whether they arise in production, in market interactions, from financial sources or legal/institutional change. For each of these the risks can be micro affecting individual businesses, meso (covariant) affecting groups of businesses or communities, or macro (systemic) affecting a whole region or nation. The impacts can be very local, specific and short lived, or enduring and widespread.

There is evidence that market-based price variability is higher than weather-induced production variability in N Europe, and the opposite in S Europe. However, price and yield tend to be negatively correlated so the income risk is to some extent moderated, although this natural hedge is diminished where prices are set through international trade. Evidence also shows that price risk tends to be systemic (OECD, 2011). In brief, the wide variety of causes and reach of risks in farming suggests that there will not be a single or small set of actions to manage risk, rather it is best approached with a wider coherent and comprehensive set of measures to be applicable at different levels.

Risk management approaches: principles. Broadly there are three ways of managing risk: prevention, mitigation and coping (Holzmann and Jorgensen, 2000). The best way is of course to prevent being exposed to a hazard in the first place. However, once exposed, farmers can try to mitigate or decrease their sensitivity to that exposure either ex ante or ex post. The third approach once exposed to hazard is that there must be a coping strategy to manage the impact on their business.

These three types of intervention can be activated at the level of the individual farm, collectively through the market, or through government action. In turn, the appropriate action will depend on the size of the risk. Normal risks occur frequently with relatively little damage, marketable risks happen sporadically but with moderate damage, and catastrophic risks occur infrequently but with large damage. Generally, good governance of risk would entail normal risks being managed by farmers mainly using on-farm strategies, middle range risks should be addressed using market tools such as contracting, insurance or futures markets and catastrophic risks should be dealt with by government both ex ante, and ex post, as they cannot be dealt with by farmers or markets unaided.

Farm-level strategies can be yield-focused e.g. using technology (genetics, biotechnology and ICT) and knowledge to deal with pests and resistance to disease, or investment in water storage and irrigation or income-focused through diversification of business activity including non-agricultural income activities. Farmers may also store produce to wait for better prices or transform produce into more durable, higher-value forms, such as cheese and juice. However, where there are significant scale economies in such storage or marketing activities they will tend to be more efficiently performed at a collective level. So, the individual private approaches merge into the wider collective action such as establishing cooperatives and producer groups to forward integrate into processing and marketing (e.g. dairy fruit & vegetables).

There are two critical policy judgements on risk management. The first is the role of government in addressing normal or market level risks. Some argue there is little or no such role, but a more pragmatic approach would suggest that awareness raising, information, training and skills, and even facilitation, encouragement and start-up assistance for farmer collective action can be justified as legitimate functions of government. The second issue is to set the boundary between marketable and catastrophic risk. Setting the boundary too low will result in deadweight losses of supporting farmers beyond that needed to deal with risk. Current low-level safety net use of public and private storage/stocking can be appropriate. On the other hand, ex ante measures in the form of insurance and mutual funds may reduce the need for crisis management ex post, so it may be efficient to stimulate insurance-based schemes.

Risk management policies in action in the EU. European farmers’ organisations often point enviously to the extensive risk management support given to farmers in the USA and Canada. US and EU policies on risk management are certainly very different. US policy draws mainly on insurance and on safety nets through counter-cyclical payments. In budget terms, EU policy is still largely based on direct payments. The risk management tools in the co-financed Rural Development pillar of the CAP are utilized by only 12 of the 28 Member States. These make up just 1% of the CAP budget. There are two other risk management measures in the CAP: the residual Commodity Market Organisations which allow emergency intervention to support markets in extremis, and Crisis Prevention and Management (CPM) measures which may be undertaken by producer organisations under the CAP Common Market Organisation in the fruit and vegetables and wine sectors. During the 2007-2013 period, CPM measures included market withdrawals, green harvesting or non-harvesting of fruit and vegetables, promotion and

12 These include: crop, animal and plant insurance, mutual funds for adverse climatic events, outbreaks of animal or plant disease or environmental incidents, a mutual fund-based income stabilisation tool.

13 The expenditures on public and private storage aids and other intervention measures, which mostly apply to cereals, sugar, wine and dairy produce, were €850m in 2005 and €750m in 2006 and considerably less in the following eight years. Expenditure has risen in 2015 and 2016 following disruption to markets caused by the Russian ban on imports of certain EU products. Overall, market intervention expenditure is generally less than 1% of annual CAP expenditure. See Matthews et al (2016).
What Reform is Required?

Communication, training measures, harvest insurance and support for administrative costs of setting up mutual funds. In addition to these CAP measures Member States have granted much more substantial quantities of State Aids to deal with catastrophic risks. During the period 2007-2013, a total of 13.5 billion euro of state aid expenditures were granted for crisis management, covering adverse weather events, animal and plant diseases and insurance premiums. Most (¾) of these payments were compensation for ex post crisis management, the rest funded ex ante insurance funds.

A more coherent and holistic EU Risk Management Policy. In the light of the principles summarised above the current EU mix of policies looks anything but coherent. It is no surprise EU farmers feel insufficiently prepared to cope with the undoubted risks they face.

The main aim of a EU Risk Management Policy (RMP) should be to enable farmers to deal with risk to stabilise their income. Such a policy must address five challenges. (i) It must be able to consider the heterogeneity of EU farmers in terms of size, cost structure and strategies. This suggests some degree of subsidiarity to allow for the diversity in the EU, yet this must not be allowed to undermine the integrity of the single market. (ii) An EU RMP should consider the problem of asymmetric information between the insurer and the insured (farmers) on the true amount of risk the insured is facing. The dangers are that insured farmers change their behaviour by taking more risk (moral hazard) or that those entering an insurance programme have a higher risk profile. (iii) A RMP should not crowd out private risk management strategies based on management measures or market-based instruments. (iv) A RMP should consider the interactions with existing policies. These may well crowd out farmers’ strategies. (v) The challenges of farm heterogeneity and asymmetric information require government to be able to deploy detailed data and this increases the transaction costs of an RMP.

These are not simple matters, without appropriate data and analysis there are dangers of inefficient, wasteful policy actions. It is already clear that the large CAP expenditures on direct payments and CMO measures in Pillar I are substantially crowding out private action at farm and market level. The operation of these schemes can also explain the low take-up of RMP measures, and may in future lead to over-insurance.

Based on the above challenges and principles we recommend that EU policy must be based on four key actions.

- **Constructing EU Risk Management Policy around three axes: risk prevention, risk mitigation and risk coping.** This should evolve so that most private and public resources mobilised are spent on risk prevention and the least on coping with risk. The share of government spending should be smallest in prevention (in order not to crowd out private action) and highest in risk coping. Further, risk mitigation should correspond with manageable risks, while risk coping corresponds with catastrophic risks.

- **Deploying the full set of potential risk mitigation measures.** Risk can be managed by transferring it to another party, either by vertically integrating into the next or even the final level of the supply chain, i.e. consumers, or by hedging. Risk can be buffered by setting up mutual funds, horizontally or vertically, or by borrowing or fiscal smoothing. Risk can be pooled and shared either horizontally (insurance) or vertically (contracts). And risks can be spread also by diversifying horizontally (enterprise diversification) or vertically (diversification through adding value and processing).

- **Focusing public support on the variability of farmers’ income and not the level of income and to deal with catastrophic risk.** Anything else risks crowding out private mitigation, or distorting markets. The best way to manage risk is to prevent risk from happening and to make farmers more resilient. Prevailing risk management approaches are too piecemeal, they attach too little attention on building long-term resilience, while paying too much attention on addressing short-term volatility.

- **Building adaptive capacity making farms more resilient in undistorted markets.** Public support on market measures should only to be offered for temporary support to the costs of producer organisations under the CMO. The focus of the CMO should be the collection and dissemination of market information for prices to be undistorted and thus play their signalling role.
Political economy of policy reform. Detailed studies of past reforms of the CAP have identified factors explaining the quite different results of CAP reform attempts in the last two decades (Swinnen, 2008; 2015). The conclusion of this political economy analysis is that three factors have critical impact on the success of reform efforts: favourable institutional settings, optimal conditions for reform given the institutions, and the numbers and quality of the key actors. The analyses concluded that the 2004 Fischler reform was necessary and highly significant whereas the 2013 reform is regarded as much less significant. Amongst others, institutional factors were highly influential in both stories. Changes such as the shift to qualified majority voting during the Fischler period (1995-2005) significantly assisted the success of this experienced two-term Commissioner. The changed institutional situation after 2009 with co-decision between the Council and Parliament and participation of 27 Member States following the Eastern enlargements were important factors explaining why the 2013 reform under the less experienced Commissioner Cioloș was much less successful.

These ideas lead to the proposition that future reform of the CAP will have a greater chance of success if new procedural approaches could be adopted. Of course, the decision processes and institutions of the EU cannot be arranged solely for agricultural policy. Changes in these arrangements can only be proposed and agreed by the highest political levels in the EU. The aim is to create the conditions and procedures for a positive, balanced, working relationship between all stakeholders, specifically, farmers and environmentalists.

Overcoming institutional inertia and antagonistic stakeholders. The issues surrounding farm policy are highly complex, detailed and technical. Non-farming interests rarely have the inclination or knowledge to get involved. The process therefore can be captured by agricultural interests at each stage which militates against deep reform. This challenge has been heightened by the fracture in relations between two key stakeholder interests in EU agricultural policy: farmers and environmentalists. The latter harbour a strong sense of betrayal following the experience of the 2013 reform14. Strong action will be required to bring them back together. Environmental organisations are therefore disinclined to engage in further negotiations with farmers and are seeking a ‘re-fit’ of the CAP and a separate environmental fund over which they might expect greater influence. However even if the latter is successful, this will not assist in improving the environmental management of EU agricultural land (40% of the EU territory) unless farmers are positively engaged.

Overcoming the breakdown of relations between farming and environmental interests could be helped by novel approaches to the decision-making procedures adopted in the process. One such idea could be to institute joint initiative and decision making from two or more Commissioners, Councils and EP committees. There seems to be a real challenge to persuade farmers and environmentalists to work constructively together. Farmers must accept that environmental interests have a

14 Agricultural, environmental and climate interests worked hard together in the MFF negotiations to make the case for retaining generous support for the CAP on the basis that an important part of the CAP reform was to be a significant greening of agricultural policy. However, once the funding was secured, the perception of environmentalists was that agricultural interests systematically, and effectively, worked hard to minimise the number of farmers required to take greening actions and to reduce the scale of those actions (see Swinnen, 2015).
legitimate stake in land management policy; and environmentalist correspondingly must accept that farmers have a legitimate right to expect to be able to manage viable businesses. A way of resolving the current impasse might be to require that for the sole purpose of discussing CAP reform; making proposals for new regulations and then negotiating them through the ordinary legislative process a novel procedural arrangement should be put in place. This is to require that the Commissioners (and their Directorates General) for Agriculture and Rural Development, for Climate and for Environment15, should be tasked to work jointly to produce the next reform proposals for adoption by the College of Commissioners. Following this, the co-decision process should be correspondingly adapted. This might involve the proposals being considered by an appropriate configuration of the Council Ministers who normally serve on the Agriculture, Environment or perhaps Energy Councils. Similarly, the consideration of the proposals in the European Parliament could be handled by an appropriate combination of members of COM-AGRI and COM-ENVI. The intention of widening the co-decision process in this way is to internalise the two main conflicted interests (and possibly others) within the decision process from proposals to negotiations and resolution. The fact that these procedures would be suggested by agreement of the Presidents of the institutions ensures the individual Commissioners, Ministers and Parliamentarians have no option but to work through and settle the differences which arise from their different perspectives.

This is not a revolutionary idea; indeed, it has been used in other areas of EU regulation which span the interests of different Directorates General, Councils and EP committees. For example, the preparations for the Climate & Energy Package for 2020 agreed in 2009 were made by DGs Energy and Clima, and the negotiations were handled by combined representation from the appropriate Councils and EP committees. Likewise, similar joint initiation and decision making was pursued by DG Environment and DG Development in the preparatory work for Europe’s input into the Sustainable Development Goals.

**Overall conclusion**

Europe’s Common Agricultural Policy has constantly evolved since its foundation in the 1960s, not least because the EU itself has expanded in membership and reach. Notwithstanding the constructive developments of the CAP since the mid-1990s, it is argued here that the current principal support expenditures, the Pillar 1 Direct Payments are inefficient, ineffective and inequitable in relation to stated objectives and these must be further reformed. This report identifies that land and risk management are the two areas requiring greatest further development and it recommends ways this should be done. However, there is a great deal of inertia in EU decision procedures and in the absence of something radical to break the current system, there is a danger of repeating the experience since 2005 of a sequence of inadequate, sub-optimal reforms, or even worse, reversals16. Ideas are offered to break the log jam and thereby offer a way of achieving a reform of the CAP which can fulfil its purpose of enabling a productive, resource efficient and economically viable agriculture, which is environmentally sustainable too protecting climate and biodiversity and embedded in thriving, integrated rural economies – over the whole EU territory.

15 Or, as appropriate, another combination of two or three Commissioner / Directorates General, which might include public health, food safety or internal market.

16 It can be argued that the 2000 – 2015 trend to switch CAP resources towards actions in, or akin to, Pillar 2 measures was halted and perhaps even reversed by the 2013 reform.
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