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Reforming the EU's Common Agricultural Policy: Health Check, Budget Review, Doha Round

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EU LEADERS ARE again debating the Common Agricultural Policy (CAP). The divisions appear to be bigger than ever. Alasdair Darling, the British Finance Minister, recently proposed to abolish tariffs and all other measures that keep EU agricultural prices above world market levels, as well as to end the direct payments that farmers receive irrespective of their output. This contrasts starkly with the opinion of CAP defenders. Horst Seehofer, the German minister in charge of agriculture, feels that the CAP is healthy and needs only some medicine drops to be strengthened. Michel Barnier, his French counterpart, even deems the CAP so effective that the policy should be exported to developing countries. Instead of continuing market-oriented reforms, he wants to wind back the wheel and stimulate agricultural production through the CAP. He has the backing of Nicolas Sarkozy who forged an alliance of EU member states threatening not to accept a WTO agreement along the lines of the Commission's position in the July 2008 WTO talks.

Three current developments have drawn attention to the CAP. The CAP has been top of the European agenda since the Commission tabled a reform proposal in May 2008, dubbed the 'Health Check'. A comprehensive Budget Review, which explicitly includes the CAP (one of the biggest spending items in the EU budget),

SUMMARY

Policy-makers are quarrelling about the future of the Common Agricultural Policy (CAP). France intends to conclude a CAP reform during its 2008 EU Presidency before a thorough Budget Review is due in 2009 that will revise CAP spending. The Doha Round of WTO negotiations might necessitate further decisions on agricultural tariff cuts at any time. This Policy Brief provides recommendations for agricultural policy reform in the EU. It argues, first, that all measures that distort market prices and production should be abolished. This includes production quotas, land set-asides, storage aids, export refunds, output payments, and area payments. Second, the Single Farm Payment (SFP), which provides income support to farmers independently of their current production decisions, should be phased out because it does not serve any societal need. Third, targeted subsidies that reward farmers for providing socially valued services that are not remunerated on the market, such as maintaining scenic landscapes, should be adapted. Many of these subsidies should be provided at the national or local level without or with little EU co-financing.

is also under way, preparing the ground for the next EU budget after 2014. And then there is the continuing Doha Round of WTO trade talks which, if ever concluded, would restrain future subsidy policies and slash agricultural tariffs.

Against this backdrop, this Policy Brief puts forward recommendations for reform of the CAP. Several key CAP policy instruments do not contribute efficiently to societal objectives – or are outright counterproductive. They do little to help poor farmers, while harming poor consumers who are facing higher food prices. They are distributed arbitrarily and unfairly among farmers. They fail to stimulate rural development in disadvantaged regions or to motivate environmentally friendly farming practices. They are inadequate to support food security. Last but not least, they distort the economy and reduce European welfare. These instruments do not reasonably serve any societal objective and should therefore be phased out. Since they currently play a predominant role, such a reform would profoundly change EU agricultural policies.

Limiting the CAP to those instruments that promote societal objectives efficiently would facilitate, and necessitate, devolving competencies from the EU to the member states. If subsidies are paid for landscaping, pollution control, animal welfare, and similar services exclusively, they will only minimally distort trade. In this case, the threat of trade distortions in the EU's internal market cannot serve as a justification for having a common agricultural policy. Agricultural subsidies could be largely left to national authorities that are in a better position to pursue local preferences, with locally responsive policies that are financially more responsible.

1. A STRUCTURE OF THE CAP

The CAP is a mess. For every product category and in every country, a different mix of policy instruments is used. To understand how the CAP works it is helpful to divide the entire system of protection in two categories: 1) untargeted policies and 2) policies targeted at socially valued but non-marketized preferences. Instruments vary within these two criteria and are intended to serve different purposes.

In the first category, policies linked to the production of specific goods are known as 'coupled policies'. They are not targeted at any other policy objective, or to different national or local needs. Coupled policies can grant farmers payments in addition to market prices. Such payments can come as a premium on production or on the area cultivated with a specific good or used for herding animals. Alternatively, coupled policies can raise market prices. Such interventions can take the form of private storage aids, so that less agricultural supply is released on the market when prices are low; they can be implemented through export subsidies which reduce supply on the EU market and thus drive up prices; or they can consist in tariffs that raise market prices by keeping out imports.

The Single Farm Payment (SFP) is another form of untargeted policy. It provides support that is decoupled from production. This means that these payments are not linked to farmers' current production decisions but based on historic entitlements.[1] The entitlements are calculated on farmers' production records at the time of the creation of the SFP in 2003 (and some even dating back to the CAP reforms of 1992). As a consequence, they do not correspond to individual farmers' income support needs.[2]

Targeted policies, on the other hand, are subsidies decoupled from production and specific to the societal objective they serve. Therefore, they do not benefit all farmers equally. Some are conditional on farmer characteristics (e.g. age, education, and income), others on circumstances (e.g. natural disasters), and some on farmers' willingness to produce a public good in exchange of support (e.g. wildlife protection). Targeted policies may not even involve transfers to farmers, as is the case with emergency planning to ensure food security.

In 2007, the EU spent 42 billion EUR on untargeted support to agriculture, and 9.5 billion EUR on targeted payments under the rural development program.[3] All CAP expenses amounted to slightly more than 40% of the EU budget.

2. CURRENT PRESSURES FOR REFORM

The Health Check proposal now tabled by the European Commission suggests a shift between these instruments. Untargeted subsidies should be further decoupled from production, and the share of targeted payments increased. This would facilitate the introduction of measures to tackle new challenges, such as climate change, water management, bio-energy, and the preservation of biodiversity. In addition to these shifts between instruments, some other reforms are proposed. Firstly, member states would be free to adapt SFP entitlements, moving away from historic claims based on past production to a rate that rewards maintenance of land in good agricultural conditions more equally. Second, set-asides of arable land, which were used to reduce supply, are to be abandoned as well as some other old-style market management instruments, such as the private storage aid for cheese. Third, the milk sector is to be prepared for liberalization through a gradual increase of production quotas.

A more thorough reform impetus can be expected from the Budget Review. In 2008/09, the Commission will present a report on all aspects of EU spending and financing with the aim of reorienting the budget according to new policy priorities. This will put pressure on the CAP: it is difficult to justify the CAP spending levels in times when additional funds are needed to cope with an aging population, to promote a competitive knowledge economy, and to deal with climate change. The question will also be raised whether the European level is the most efficient for designing agricultural policies, or whether more competencies and money should be transferred back to the member states. It is not clear how the Budget Review will play out and how its general recommendations will be translated into specific agricultural policies. But the result could be a fundamental transformation of the CAP.

The Doha Round is yet another context where agricultural policies are shaped. In July 2008, a nine-day negotiating marathon of trade ministers in Geneva resulted, once again, in deadlock. On the table were commitments that would have prevented the re-coupling of EU subsidies to production and, more importantly, a 60% average cut in agricultural tariffs as bound in the WTO. It remains to be seen if the Doha Round will resume and provide for a meaningful liberalization of agricultural policies. The EU has maintained its offers from the last WTO meeting, but if the current WTO round collapses entirely the EU will have to ask itself whether maintaining tariffs indefinitely is in its best interest - or whether it might be time for unilateral liberalization. Indeed, the EU has already, partly or fully, suspended many of its tariffs on cereals to respond to price increases.

The Health Check, the Budget Review, and the Doha Round require decisions on the short- and long-term future of EU agricultural policies. What are the sensible and reasonable options for a reform strategy?

In the following sections, the argument for more substantial CAP reform is laid out. Broadly, untargeted instruments should be phased out in favor of targeted policies. Eight criteria commonly found in EU debates about agricultural policies are used for the assessment: social equality, farm income stability, fairness, rural development, environmental protection, food security, market distortions, and administration costs.

3. SOCIAL EQUALITY

Ensuring a fair standard of living for farmers is a core objective of the CAP. One criterion for assessing agricultural policy instruments is thus how much of the support reaches farmers whose income is below the national average. The fragmented empirical evidence shows that farmers have above-average incomes and wealth endowments in several EU member states, for instance in the Netherlands, in Finland, and in Ireland.[4] Average farm income has been increasing in the EU in recent years and this trend is likely to continue in the future: output prices are forecasted to remain high, technology is improving, and labor is moving out of agriculture, raising the earnings of those who remain in the sector. However, income and wealth levels vary widely among farmers. Those farmers that own their land are much less in need of support than those who rent land or are hired farm workers. Farmers as a group are thus not a good target for income transfers; what is needed are policies that reach primarily poor farmers.

Untargeted instruments work in the exact opposite way. Coupled policies mean farmers receive transfers according to their level of production or area of cultivation. Therefore, the more they already have the more they get. Many poor small-scale farmers, especially in Eastern Europe, benefit even less than their production share would indicate as they consume much of their produce rather than selling it on the market. The SFP suffers from the same problem: its distribution based on historic entitlements fails to respond to farmers' different support needs.

Another disadvantage of both types of untargeted policies is that most of the money that consumers and tax payers contribute does not reach farmers. Coupled policies stimulate production and therefore the demand for land as well as for seeds, fertilizer, machinery and other agricultural input. Increasing demand in turn leads to higher prices for buying or renting land and for obtaining other input. Under reasonable assumptions, the share that finally ends up with farm labor could be as low as one-tenth for coupled payments that raise market prices, such as tariffs.[5] The SFP is even more inefficient as a mechanism for transferring income to farm labor. Since the SFP does not significantly stimulate production, demand and wages for farm labor remain largely unaffected. The money goes almost entirely into higher land values and the value of the historic entitlements upon which the SFP is based.

There is still another argument against using coupled policies that raise market prices for promoting social equality: they have a pernicious effect on the consumer side. EU agricultural policies have increased agricultural prices by 13% in 2007, transferring 37 billion EUR from consumers to producers.[6] This is particularly damaging to low-income households that spend a relatively high proportion of their income on food. For the quintile (20%) of EU households with the lowest income, food, beverages and tobacco constitute 25% of their expenditures, whereas this share is at only 15% for the quintile with the highest incomes.[7] Therefore, poor consumers foot a disproportional share of the bill.

The most straightforward way to raise low incomes is targeted at income. Governments have such mechanisms already in place, in the form of progressive taxes and social security benefits. These are less distorting and more efficient than agricultural subsidies and tariff protection.

4. FARM INCOME STABILITY

The Treaty of Rome lists stabilization of agricultural markets as one of the objectives of the CAP. This has been implemented through an intervention price system were the EU guaranteed farmers a pre-established minimum price. In the U.S., a different system can be found that stabilizes farm incomes through subsidies that are paid as a countercyclical response to current price levels. Such policies start from an accurate observation: Farm income is highly volatile. Production runs many risks – such as bad weather, pests or animal diseases – and prices for many agricultural products are notoriously unstable. But the conclusion that governments should stabilize farm income across the board through untargeted policies is wrong.

Farmers themselves have a variety of tools at their disposal in order to cope with these risks. They can influence their production risk through their planting decisions and preventive actions to protect plant and animal health. They can diversify their income sources through off-farm work and non-agricultural on-farm activities, such as tourism. They can share farm risks along the agricultural market chain through contractual arrangements, for instance with supermarkets. They can rely on risk-sharing in producer cooperatives, on capital and debt management, and on insurance and hedging on option/future markets.[8] Reducing price fluctuations through untargeted policies actually weakens farmers' incentive to lower their income variability: the more the state takes care of them, the less they will care for themselves. A typical case of 'moral hazard'. This has a chain effect: The less farmers demand private risk management tools, such as insurances, the less risk management markets will develop – making it more difficult for the willing to take care of their own income risks.

Another problem with across-the-board income stabilization schemes is that they are poorly targeted. Large commercial farms can be expected to use risk management instruments efficiently – or suffer the consequences like any other enterprise in a market economy. Households with small farm incomes are generally less able to use financial risk management instruments. But the higher share of their off-farm earnings makes them less dependent on their farm income. Finally, many of the gains from reduced price volatility go to rich households – for instance, to owners of land. Since they are already well-off, there is no reason for the public to worry about the smoothness of their income stream.

If society is willing to provide farmers an income-stabilization scheme, there are targeted instruments that are much less burdensome to the public. Governments could assist farmers in employing financial risk management tools, promote the creation of risk-sharing markets, and subsidize private insurance schemes. Such subsidies could focus on farmers whose low wealth levels and high shares of agricultural earnings in total household income make them vulnerable to fluctuations in their agricultural earnings.

5. FAIRNESS

What might be a 'fair' distribution of support across farmers? This question is a hard one. Luckily, it is not necessary to define the most appropriate standard of fairness in detail in order to see that coupled policies and the SFP cannot be considered as fair. It suffices to establish the basic standard that farmers in comparable situations should be treated similarly, and that differentiated treatment should be justified by social needs of farmers or the services they render to society. What could not be considered as fair by such a standard would be different treatment of farmers according to the products they grow or the country they live in (without reasonable explanations, such as different costs of living or average incomes across countries). Yet, this is exactly the case with untargeted policies.

Coupled policies are biased across agricultural sectors. Only some sectors benefit from coupled payments, such as storage aids, export subsidies, output payments, and area payments – for instance, sugar, milk, and beef. More importantly, tariffs, which provide the largest share of coupled support, differ drastically across products. Table one shows EU tariffs as bound in the WTO. Important groups of agricultural goods are presented, with the average tariff for each group and the highest/lowest tariff on any individual good within the group. As can be seen, EU tariffs vary tremendously across and within these groups. Yet, what is the moral justification for lending livestock and dairy farmers strong support but denying it to oilseed growers who produce animal fodder?

Table 1: EU bound tariffs for selected agricultural goods

PRODUCT DESCRIPTION	BOUND TARIFF
MEAT AND OFFAL	MAX : 398.16%
	AVG : 51.01%
	MIN : 0.00%
DAIRY PRODUCTS	MAX : 1412.85%
	AVG : 80.94%
	MIN : 0.00%
VEGETABLES	MAX : 184.72%
	AVG : 19.88%
	MIN : 0.00%
EDIBLE FRUIT AND NUTS	MAX : 62.10%
	AVG : 11.48%
	MIN : 0.00%
CEREALS	MAX : 136.25%
	AVG : 61.63%
	MIN : 0.00%
OILSEEDS	MAX : 236.36%
	AVG : 2.79%
	MIN : 0.00%
SUGAR	MAX : 205.25%
	AVG : 33.95%
	MIN : 0.12%

Source: www.MacMap.org

The SFP does not fare much better. Payment levels vary dramatically across countries: those that received high coupled subsidies in the past are compensated with higher decoupled payments, and the EU-15 countries will be treated more generously than their Eastern European counterparts until 2013. The same inequality can be found within many member states where some farms receive more than others simply because they had already received more under the old coupled subsidy regime.

When looking at the coupled policies and the SFP combined, the picture is startling: Farmers in Romania receive 57 EUR per hectare of utilized agricultural area on average per year between 2007 and 2013. Farmers in Latvia do barely better with 61 EUR. By contrast, a farmer in Slovenia gets 210 EUR and in Hungary 218 EUR per hectare. Portugal and Spain are at the lower end of the EU-15, with 156 EUR and 182 EUR per hectare, whereas farmers in Belgium rake 439 EUR and in Greece even 519 EUR per hectare.[9]

In sum, coupled policies and the SFP are a gift to farmers that is distributed highly unevenly according to unreasonable criteria. By contrast, most targeted payments have little value for farmers. The targeted payments that intentionally benefit farmers, for instance by helping young farmers with their installation in business, constitute only a small share. The basic idea of targeted policies is to reward farmers for contributing to socially-valued but non-marketized preferences, such as scenic variety and flood control. If implemented well, these payments compensate farmers for their additional expenses in providing the services society desires. They are just high enough to incline farmers to deliver on the societal objectives but they do not distort competition or favor one farmer over another.

Fairness also has an international dimension. Farmers argue that they deserve support because they need to comply with European production standards which are tougher than those imposed on their foreign competitors. They deem that this warrants tariffs and export subsidies to level the international playing field, or at least the SFP as a compensation for having to compete on 'unequal' footing. But imported food also has to meet many of the EU standards, notably those on human, animal, and plant health. The EU executes strict border controls, certifies reliable foreign suppliers, and even inspects production facilities abroad. Furthermore, the entire European economy is subject to relatively demanding standards. It would be unreasonable to compensate everybody. Those farmers that incur extraordinary compliance costs, for instance if they produce in an environmentally protected area, may have a legitimate claim for compensation. But such compensatory payments should always be contingent on the compliance costs of individual farms or at least certain types of farms. Asking for untargeted policies on fairness grounds is contradictory.

6. RURAL DEVELOPMENT

Rural development can mean anything that happens outside the centers of major cities. In the narrow sense, it deals with rural economic activity, employment and, consequently, rural settlement. The objective that government should influence where people work and live is in itself questionable. Conserving existing settlement structures against the changing preferences of the population is dubious in principle; more concretely, rural settlement increases costs for infrastructure and public services, while also contributing to environmentally harmful traffic. This does not mean that governments should do nothing to promote the rural economy, it only warns against misplaced conservatism and fear of change.

Coupled policies and the SFP are not suitable for rural development. First, agriculture constitutes only 13% of rural employment and 5% of rural value-added – with figures much lower in many rural regions, especially in the EU-15.[10] Even if agriculture is thriving, the regional economy may deteriorate. Second, coupled policies and SFP support drive up the prices of land and other agricultural input. As a result, much of the money does not stay with farmers but goes to land owners and input producers located in cities or abroad. This is an important aspect as roughly half of the cultivated area in the EU is rented and intermediate inputs eat up 58% of agricultural output value.[11] Third, important parts of the support go to companies further down the agricultural value chain, especially to those who process and brand agricultural products. The countryside benefits only from a share of these subsequent steps that add value to the primary produce. Fourth, income and employment levels differ significantly across rural areas. Similarly, birth, death, and migration rates vary across rural areas, and many regions have seen their population grow. But coupled policies and the SFP ignore these differences: they benefit the regions with the highest agricultural output or the largest SFP entitlements, instead of those with the greatest needs.

Efficient approaches to promoting rural development would be non-discriminatory across sectors. This is the case with investment into infrastructure, education, or vocational training. Alternatively, they would be targeted at the particular potential of each region, depending on its location, natural and cultural richness, entrepreneurial spirit, or existing industrial and service structure. In some regions, the preferred sector may well be agriculture – but even where this is the case, subsidies should go into enhancing farm competitiveness rather than just promoting agricultural production and farm income.

7. ENVIRONMENTAL PROTECTION

Agricultural production can have various positive environmental effects that are not remunerated on the market. Agriculture may preserve open spaces, enhance scenic variety, and maintain traditional landscape characteristics that carry cultural significance. Similarly, agriculture can promote biodiversity, for instance by offering a habitat to species that depend on (traditional) farming.

Agricultural policy instruments are not necessarily needed for this to be the case. In some areas, for instance, open landscapes would dominate even without tariffs and subsidies, and some additional forests would actually improve the amenity value in the eyes of most people. If markets fail, government intervention may be warranted – but not coupled policies. Their main environmental benefit is to keep farmland under cultivation that would otherwise be abandoned. Coupled policies do not guarantee that farmers will cultivate in a way that enhances the environmental value of their land. On the contrary, coupled policies exacerbate the negative side-effects of agriculture by stimulating more intensive production. The damages include water, air, and soil pollution; release of greenhouse gases; water and soil depletion; and the loss of biological diversity as a result of environmental degradation and monoculture. It is worth noting that agriculture is responsible for 9.2% of the EU's greenhouse emissions.[12]

The SFP does not (significantly) change production quantities or techniques. From an environmental perspective, the SFP is harmless but also useless. This is regrettable since targeted environmental payments can help immensely to improve the environmental performance of agriculture. One common scheme is payments for maintaining buffer strips, hedges, and stone walls. Other schemes compensate farmers for reducing the use of fertilizer and crop protection chemicals. In doing so, targeted subsidies can take the local valuation of the environmental services into account. Maintaining pasture will be valued especially highly in a tourist region, and avoiding excessive fertilizer use is especially important in an area with poor water quality or rich wildlife.

Similarly, they can respond to different local production costs of the environmental services. Maintaining the pasture mentioned above will be more expensive on a slope than on flat area, and farmers' losses from reducing fertilizer use will differ according to soil quality. Targeted payments can thus keep public expenditures low by reimbursing farmers their individual costs of providing environmental services.

8. FOOD SECURITY

In which sense could food security necessitate agricultural policies? If safe food is the concern, the right measure is sanitary and phytosanitary standards that equally ensure food safety of domestic and imported products. If the issue is access to food for the poorest, the adequate solution is endowing the poor with the requisite purchasing power through the social safety net. The only interpretation that merits further examination is the security of national food supplies in the case of crisis.

Bad harvests usually shrink European production by no more than a few percentage points. Even in the unlikely case that this shortfall could not be compensated through imports, nobody would have to go hungry in Europe. This would still hold true if the EU liberalized agricultural market access.[13] In the case of persistent and severe production shortfalls, production areas could be expanded, production methods could be intensified, and production patterns could be shifted to increase nutritional yields. In particular, curbing meat, milk, and dairy production could free up capacity for growing basic grains. 51 million hectares were used as pastures and permanent meadows in 2005, compared to 100 million hectares of arable land; in addition, much arable land serves feed stuff production.[14] In other words, the European production potential that could be easily unlocked is reassuring.

It is therefore hard to justify untargeted policies with the minimal risk of food shortages in the EU and fear of political dependence on food exporters. Coupled policies are not well targeted at sectors that are key to securing food supply in crisis events or towards crisis-resistant production techniques. The production-neutral SFP does not improve food security at all. Those worried about the remote possibility of food shortages should support targeted policies, such as contingency planning, public stockholding, or the maintenance of decentralized production capacity in agricultural goods that can be easily grown under crisis conditions and that have high nutritional yields.

A small aside to counter a misleading argument: Food is not oil. There are much fewer actual and potential suppliers of oil on the world market, and oil imports hinge on long-term contracts, pipelines, and suitable refineries. As a result, importers become dependent on their suppliers. Even if suppliers are reliable, oil deliveries can more easily be interrupted by third parties. Finally, the EU production potential in oil is much further away from autarky, causing incomparably graver problems should imports stay out. The analogy between food and energy security is a misleading populism.

9. MARKET DISTORTIONS

Agricultural policies can be used to correct market failures where farmers' incentives do not correspond to social interests. This is the case with environmental protection. Farmers are not remunerated or sanctioned for the positive and negative consequences of their farming practices on the market. Targeted policies that tax harmful and subsidize beneficial farming practices may thus improve market efficiency. However, agricultural policies may also distort markets that would work better without governmental intervention. Such distorting side effects reduce a country's economic welfare.

This is the case with coupled policies that stimulate agricultural production. As mentioned before, the coupled support differs significantly across agricultural goods. Table two (next page) shows the dispersion of WTO-bound tariffs, the most important form of coupled support, for important product groups. It illustrates how many products fall into different tariff bands. While 1569 products receive less than 20% protection, 149 receive more than 75%.

Table 2: Dispersion of EU bound tariffs by tariff bands

	Band I (<20%)	Band II ([20%;50%])	Band III ([50%;75%])	Band IV (>75%)
Meat and offal	127	50	22	34
Dairy products	33	44	44	54
Vegetables	109	7	2	4
Edible fruit and nuts	140	61	0	0
Cereals	19	23	7	6
Oilseeds	78	0	1	1
Sugar	30	6	2	9
Agricultural products	**1569**	**352**	**134**	**149**

Source: Jean et al. (2008)

Moreover, the EU's tariffs bias the economy in favor of agriculture – at the cost of non-agricultural sectors. The EU's average applied tariff in agriculture is estimated at 12.3% in the WTO's country profile of the EU (using 2005 data).[15] This contrasts starkly with the roughly 3% average on non-agricultural goods.

The dispersion of protection tells only part of the story. Even if protection was uniform across all goods, it would be economically costly because it would still distort trade. Coupled policies prevent countries specializing according to their comparative advantage. As a consequence, European farmers grow sugar beet that could never compete on a level playing field with much cheaper sugar cane from Brazil.

In several ways, coupled policies therefore distort the market signals that could guide an efficient allocation of the economy's resources. This speaks strongly in favor of policies that are decoupled from production.

10. ADMINISTRATION COSTS

Supporters of untargeted policies argue that targeting is nice in theory but not feasible at a large scale in practice. They are right with their claim that targeted payments are more difficult to manage than untargeted instruments: Policy objectives have to be determined and specified. Suitable policies have to be identified and designed in detail. Farmers' eligibility for targeted policies has to be verified. Then, farmers' obligations and payment entitlements need to be determined. Finally, farmers' compliance has to be monitored and the overall efficiency of the policy evaluated. All this costs time and money to public administrators and farmers.

But even administration costs that are higher than the sum transferred to farmers tend to be justified by the efficiency advantages of targeted payments.[16] In reality, administration costs for most targeted programs are significantly lower than this – and will decrease further in the future. One reason for this is that setting up targeted payments is expensive, but once the system is running and administrators and farmers have grown used to it, costs fall sharply. Since many targeted payments are still in their early phase, current figures overestimate long-term administration costs. Another reason is that targeted policies become more cost efficient as more farmers participate. This allows the fixed costs of designing the policy to be spread over many participants; and as farmers participate in several targeted schemes at the same time, the variable costs per contract of verifying eligibility, negotiating conditions, and monitoring compliance shrink. Further cost reductions can be attained from better employing information technologies, such as online information and administration for farmers or the computerized selection of test samples for on-site verification using all available data on farmers' non-compliance risks.

When assessing administration costs, it needs also to be noted that coping with the managerial challenge of targeted policies can be perceived as an investment. Public administrators collect valuable data on farming practices, landscape patterns, and eco-systems. Farmers learn about environmental problems and farming techniques that are environmentally preferable. Not all administration costs are wasteful bureaucracy.

11. POLICY RECOMMENDATIONS

Agricultural policies need to be re-assessed against these eight criteria: social equality, farm income stability, fairness, rural development, environmental protection, food security, market distortions, and administration costs.[17] Analysis using these criteria can be summarized in few words: *coupled policies are harmful, the SFP is wasteful, targeted policies can be useful*. So what follows from this for the decisions of the Health Check, the Budget Review, and the Doha Round?

In the short to medium term, leading up to the next long-term EU budget framework in 2014, policy makers should consider the following recommendations:

- All coupled payments and other market management instruments that distort supply, prices, and competition should be phased out. This includes production quotas, land set-asides, storage aids, export refunds, output payments, and area payments.
- When reforming the SFP – for instance by moving to a flat model that rewards payments equally per acreage (within a region, a member state, or the EU) – decision makers should be aware that this policy instrument should be phased out in the long run. Its previous reform should not be used as justification to impair its subsequent removal (i.e. 'Now that we have fixed it so nicely and with so much effort, we cannot simply abandon it.').
- As much money as possible should be transferred from untargeted to targeted policies.
- Overall spending levels should be cut significantly.
- As many tariffs as possible should be suspended unilaterally (as has already been partly the case with cereals).
- The EU offer on agriculture as part of a potential Doha agreement at the WTO is not a sacrifice that needs to be off-set by foreign market access gains. While it is certainly desirable that other countries also remove trade barriers, the proposed commitments – cutting tariffs and decoupling subsidies – are in the EU's own interest.

In the long-term, by 2020 at the latest, all coupled instruments, including tariffs, and the SFP should be abolished. Only targeted policies that promote societal objectives should remain. This warrants closer scrutiny of targeted payments than has been the case in the past.

- The targeted policies that form part of the agricultural budget should be refocused on agriculture. Those measures that are not closely related to agriculture should be removed. This pertains in particular to rural development measures that aim at diversifying the economy or improving the quality of living in rural areas. These payments would be better targeted as an integral part of the EU structural and cohesion policy.
- Among the targeted policies closely related to agriculture, only those should be retained that have a strong justification in societal objectives. This is likely the case with environmental payments. The justification of some payments that aim to improve the competitiveness of the agricultural sector – such as setting up young farmers or subsidizing the modernization of agricultural holdings – are more questionable.
- The EU co-financing rates should be adapted to the cross-border effects of each measure so as to reflect the European interest. Preventing pollution that spills across boundaries, such as nitrate in rivers, may justify financial contributions from the EU budget: as polluting member states do not face the full environmental costs, they will not invest sufficiently into clean farming practices on their own. The same applies to protecting species that are scarce or endangered from an EU wide perspective. Predominantly national or local objectives, such as enhancing scenic landscape values or offering early-retirement schemes for farmers, should not be financed through the EU.

Those steps together – abolishing coupled policies and the SFP, refocusing targeted payments to societal objectives with strong links to agriculture, and tailoring EU co-financing to the genuine European interest – would drastically shrink the CAP budget at EU level, possibly to below 10% of its current level. Responsibility would be handed back to the national and local level. The European Commission would have to find a new role: As a guardian of the internal market it would have to prevent national and local subsidy schemes distorting competition. And as a facilitator of lower-level authorities, it could promote policy-oriented research, knowledge transfer, best-practice benchmarking, and a joint IT-infrastructure for policy administration. These changes would mean the end of the bureaucratic and interventionist CAP as it has existed since 1962. The new era will be one of decentralized agricultural policies that combine free and fair market competition with targeted measures to promote societal preferences not sufficiently remunerated on the market.

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ENDNOTES

1 Although the SFP is formally decoupled from production, it is likely to stimulate production to some extent. One reason for this is that the SFP increases farmers' wealth so that they have more money to invest into modernizing and expanding production. This Policy Brief treats the SFP as production-neutral for reasons of simplicity.

2 A weak link between the SFP and societal objectives is established through 'cross-compliance': in order to be eligible for the SFP, farmers' have to comply with Statutory Management Requirements (EU regulation primarily for environmental and health protection) and maintenance of the land in Good Agricultural and Environmental Conditions (which are to be defined by the member states). This link is weak because most of the cross-compliance conditions are compulsory law. Those minor additional obligations that farmers need to fulfill in order to qualify for the SFP could easily be passed into compulsory law; they are not dependent on the existence of the SFP.

3 See European Commission (2008). The untargeted subsidies figure as Pillar I in the CAP budget discussions, the targeted policies constitute the Pillar II.

4 See OECD (2003).

5 Ibid

6 See OECD (2008)

7 See http://epp.eurostat.ec.europa.eu.

8 See Meuwissen et al. (forthcoming) and OECD (2003).

9 See Farmer et al. (2008). These differences cannot be explained by country-specific income levels or production patterns (countries with labor- and capital-intensive production could be considered as rightly deserving more support per hectare).

10 See European Commission (2007).

11 See Eurostat (2008). These figures include maintenance costs of materials and buildings, agricultural services, energy,

seeds, fertilizers, plant production products, among others. 39% of the intermediate costs are for feedstuffs and thus partly a transfer from livestock to crop farmers.

12 Ibid.

13 Most Computable General Equilibrium models simulate multilateral rather than unilateral EU liberalization, and their results vary considerably. What can be said is that EU agricultural production would shrink modestly (clearly less than 20%). Wheat production (which is especially important for food security) would be hit less than average agricultural production and might even expand. See Féménia and Gohin (2008) on unilateral EU liberalization and Anderson and Valenzuela (2007) on self-sufficiency rates of production after multilateral liberalization.

14 See Eurostat (2008).

15 Bureau and Matthews (2006) put the level even at 16.7 percent.

16 See OECD (2007).

17 Other important criteria are the impact on global poverty and repercussions on multilateral negotiations in the WTO. Analysis along those criteria adds further evidence in favor of the policy recommendations put forward in this Policy Brief.

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