Abstract

The European Union's Common Agricultural Policy continues to evolve. The public debate about its future post 2013 was launched in April 2010 and a formal Commission Communication on the future of the Common Agriculture Policy (CAP) is due in the Autumn/Winter 2010. Our paper contributes to this debate by re-visiting the CAP Bond. We argue that the CAP Bond should be considered as a core element of the development of the CAP and could contribute to the solution of several problems of the existing policy. We argue that the compensatory logic still embedded in the current CAP is now a hindrance to further development of the CAP, and is a major cause of debilitating uncertainty for the industry and its farmers. The Bond provides a coherent adaptive option for both the policy and the European agricultural sector and its farmers. Among the Bond's chief advantages is its capacity to reduce the uncertainty about both the needs for future policy intervention and about individual farmers' future family and business strategies.

Key words: Common Agricultural Policy, reform, direct payments, policy dependency, CAP Bond

JEL Classification: Q18, Q28, Q58

1. Introduction

With 2020 hindsight, CAP analysis in the 'good old days' seems to have been very straightforward. Beginning with Josling (1969) economic welfare analysis of the major instruments of the Old CAP (import levies, intervention and export refunds) was simple, at least in principle, and it was relatively easy to calculate/estimate the economic costs and benefits of the policy. Buckwell et al. (1982), for instance, were able to develop a coherent model of the economics of the CAP and demonstrate the costs and benefits in traditional economic terms. However, times have changed, and many of the more obvious anomalies of the Old CAP have long since gone.

Now, we are faced with more serious and multi-dimensional challenges. The CAP has evolved (e.g. Harvey, 1995), perhaps beyond the dreams of some early researchers, adapting and adjusting to much changed local and world environments. Its apparent scope has been constrained by the fact of the URAA and WTO governance of trade relations, whose introduction coincided with the beginnings of substantial CAP reform under Commissioner MacSharry in 1992. This reform trajectory has developed to embrace 15 new country members with substantially different policy needs from those of the founder and early members. The challenge, now, is to further reform the policy so that it is better fitted to the 21st Century, and makes a more positive contribution to further developing and sustaining the EU and its people.

A critical area of future CAP reform concerns direct payments. Although many issues are identified when considering the future of CAP, it is apparent that direct payments play a central role in the debate. While the original idea of the CAP Bond (Tangermann,1990) has been well discussed, especially by Swinbank and Tranter (2004), the idea has apparently and surprisingly disappeared from the current literature and debate (Jambor and Harvey, 2010). We revisit the Bond option in this paper, and re-examine its potential advantages in the current context.

Section 2 outlines the history of the CAP, which still encumbers the policy debate, concentrating on the development of direct payments. Section 3 outlines the critiques of direct payments and also highlights the major proposals being advanced for their future beyond 2013. Against this background, Section 4 outlines the CAP Bond option and the steps required for its introduction, and considers the application of the idea to the current situation. Section 5 concludes.

2. The CAP's Ancestry

2.1. The Early Years

Food policy – the price, availability and security of food – figures highly in the political calculus of all economies, especially those which are in the transition stages of development from predominantly agrarian to modern industrial/consumer societies. Especially for these economies, farming is a critical sector for policy, since very substantial proportions of the population are engaged in agriculture. Especially in Europe in the aftermath of WWII, starvation was a real threat, concerns about food security were heightened by the war experience, while agriculture was still a major employer, especially with demobilization. Agricultural policies were seen as essential, with support and protection of domestic supplies an obvious and apparently well suited response to the socio-political conditions of the time.

All European countries designed and implemented significant support and protection policies. The UK, with a Commonwealth and allied countries to consider, was obliged to provide this support at the expense of the taxpayer (through 'deficiency' payments) rather than the consumer (through increased domestic prices). Furthermore, with a substantially more commercial farm structure, and fewer people in farming than elsewhere, the UK did not need, and could not afford such generous levels of support as other European countries – especially Germany.

For the founder members of the EU, especially France and Germany, a common agricultural policy (implying a common food price policy) was also critical for the development of a single market within a customs union. The fears of France that Germany would dominate industrial trade were mirrored by fears in Germany that her fragmented agriculture would be dominated by France. The compromise, with the benefit of hindsight, was obvious – set a relatively high external tariff on food, thus raising money for the European budget from consumers, and give France the benefit of common preferential prices for food exports to the new Union, especially Germany. The principles of the CAP evolved from the negotiations on the formation of the Union: common market, free internal trade and common food prices; community preference (defended through a common external tariff); common financing (tariff revenues considered as the EU's own resource, not revenue for member states).

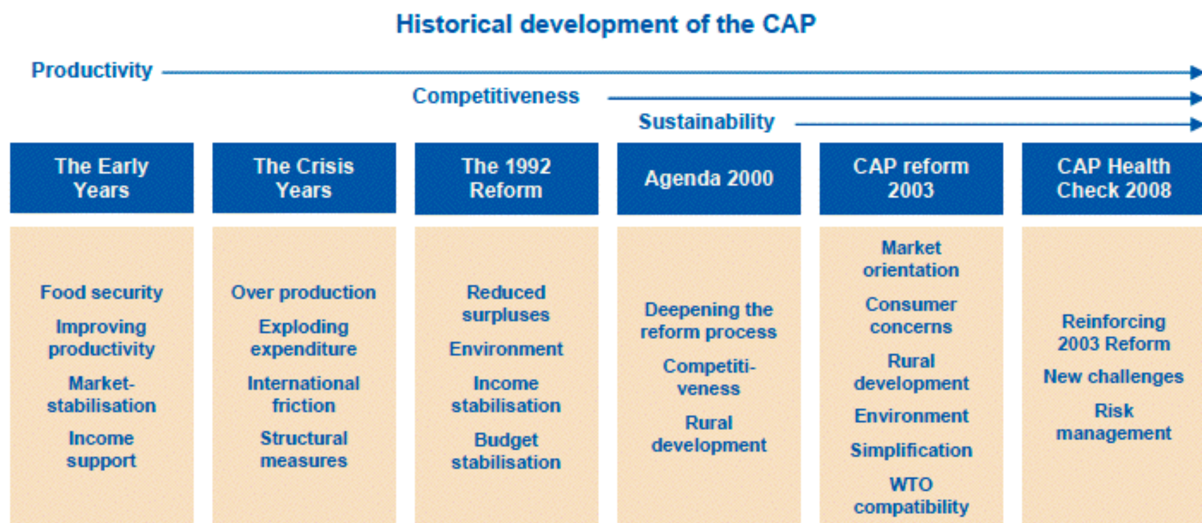
The European Commission (EC, 2009b) pictures the development of the CAP as shown in Figure 1. The "Early Years" reflect the socio-economic and political pressures of the founding of the Union. Farm income support – the focus of the policy – was to be generated by improved productivity encouraged and assisted by the market stabilisation and protection provided by the CAP.

2.2. The Crisis Years

As many economists predicted, setting and supporting prices above the market clearing level generated market surpluses – the 'Crisis Years'. While the net import position of the founder members disguised this outcome through trade diversion from the rest of the world to the internal market, it also promoted a longer run supply response, which substantially exceeded

the growth of internal demand. By the late 1960s, the CAP was generating surpluses within the original 6 member states. The European budget lost its 'own resource' revenue, and (by the common financing principle) became liable for surplus disposal. Mansholt (the European Commissioner for agriculture) tabled a plan for the substantial reduction in the number of farmers, which would allow farms to become more commercial and capable of surviving under lower prices, and which might also reduce the surplus production. It was roundly dismissed as impractical, that is, politically infeasible – though his proposed reductions in farm numbers actually proved rather accurate by the subsequent evolution of European farm structure.

Figure 1 Historical development of the CAP



Source: EC 2009b

The first solution to excess production, given that price reductions were politically unacceptable, was simple – expand the size of the Community to include a major food importer: the UK. President de Gaulle's objections to UK membership were over-ruled, and (against some scepticism in the UK), the UK, Ireland and Denmark were admitted in January 1973. As luck would have it, this event practically coincided with the world events of floating exchange rates (1971) and the 'first' oil and commodity price spike (73/75), which conspired to raise world prices dramatically. Although the UK had been granted a 7 year accession period, during which UK farm prices were to gradually adjust to the internal EU prices, the world price spike dominated market prices in the UK. Coupled with world-wide heightened anxiety that the Malthusian proposition of the species expanding until the food ran out, the price signals to UK farming were misinterpreted as the consequence of a major policy change, rather than as a temporary market fluctuation. As a result, farm costs rapidly increased (especially through investment in plant and equipment, and through escalating land prices – exacerbated by strong inflation in the UK) to meet and exhaust the substantially improved revenues, exactly as would be expected in a competitive market.

By the end of the 70s, the chronic surplus position of European agriculture had re-emerged, prompting a variety of policy responses, including Maximum Guaranteed Quantities, producer co-responsibility levies and 'prudent' support price increases. Despite these palliatives, surpluses continued to grow, and with them the cost to the embryonic European budget. By 1983, dairy surpluses seemed out of control, with butter and skim milk powder mountains threatening to overwhelm the CAP. Substantial support price reductions, however,

remained politically unacceptable. The only acceptable alternative – quotas on milk deliveries – was introduced in April, 1984.

Meanwhile, cereal surpluses continued to grow, and public anxiety about the despoliation of the countryside and wildlife, as a consequence of industrialized cereal production, increased the political pressure for radical change. In 1986, the Uruguay Round of GATT negotiations began with a commitment by the negotiators to address agricultural trade and trade policy for the first time. This commitment was a clear reflection of the condition of both the EU and the US agricultural policies at the time. Both were afflicted with rising budgetary costs, and each was critically conditioned by the state of world prices. Each major player had a major interest in reaching an agreement which would 'clean up' world markets, and so reduce the costs of their own farm policies.

2.3. The 1992 & Subsequent Reforms

The unification of Germany in 1989 altered the context and circumstance of the CAP. Whereas agriculture in West Germany presented a political face dominated by the small farms of the agriculturally disadvantaged areas of Bavaria, the 'liberalisation' of the large state and collective farms of the former East Germany substantially altered the political context, if not the calculus.[1] In any event, Ray MacSharry convinced the Council of Ministers of the need to 'de-couple' support from production in advance of the GATT Uruguay Round Agreement on Agriculture (URAA). In 1992, CAP cereal support shifted from product price support to fixed acreage payments, and set-aside was introduced to control excess production, as a (cross) compliant requirement for the receipt of the payments, mimicking US policy. This reform paved the way for European acceptance of the URAA in 1994.

The original idea behind direct payments was to *"compensate for the loss of income caused by the reduction of the institutional prices by a compensatory payment to those who sow such products."* (Council, 1992, §16). This compensatory aid was paid as an area payment determined by regional yields, implying that payments differed significantly from one region to another from the outset, reflecting climatic, geographical and technological differences. The amount of payments has changed over time, but from 2001/02, was fixed at €63/tonne. In addition, the original area payments were subject to the compliance requirement for setting aside a specific proportion of arable land. Besides direct payments, animal headage payments (in place since the 1980s) were also reformed in 1992, when the right to receive payments was limited by transferable quota.

In 1997, the European Commission commissioned an expert group to consider the future for the CAP. Arguably, the report of this expert group (the "Buckwell Report" - EC, 1997) spelt out the strategy subsequently followed, at least in part, by the development of the CAP. Professor Buckwell and his colleagues argued that there should be three major arms or strands to a 'Common Agricultural and Rural Policy for Europe (CARPE)' – *market stabilization*; *environmental and cultural landscape payments*; *rural development incentives*. In addition, this report also recognized that there would need to be *transitional adjustment assistance* (TAA) to enable and facilitate the adjustment of the farm sector to the proposed new conditions of market liberalization and re-directed public objectives.

In preparation for the Central European expansion of the Union, *Agenda 2000* extended decoupling to livestock products, except the dairy sector, by reducing internal price support in favour of increased headage payments, and made direct payments conditional on

[1] Although this shift seems obvious from the outside, there is no documented or reliable evidence of its actual impact or consequences in the debates and design of the 1992 reform.

environmental care. Agenda 2000 also created the CAP's 'Second Pillar', to be responsible for rural development and the 'multi-functionality' of the farming activities. This second pillar provided a home for, amongst others, agri-environmental schemes, support to the least favoured areas and early retirement programmes. 'Modulation' was also introduced[2], on a discretionary (voluntary) basis for Member States, to allow funds to be transferred from the First Pillar (market support and direct payments) to the newly established second pillar, signalling (at least to some) an intention to eliminate Pillar 1 over time. Pillar II support and assistance programmes are subject to Commission approval, within an established European framework of permitted measures, and are subject to national co-funding. Agenda 2000 also introduced the 'national envelope', under which member states are able to top-slice their direct payments to create a national fund for specific purposes under Member State control. As a result, direct payments have become dominant in the CAP Budget, accounting for 61% of total agricultural expenditures in 2000 (Swinbank and Tranter, 2004). By 2002, the European Commission had admitted that direct payments *"have lost part of their compensatory character after ten years of implementation and have instead become simple direct income payments. Therefore, the term 'direct aid' has replaced 'compensation payment'"* (EC, 2002, p.4).

The *2003 Reform* (following the Mid-Term Review of Agenda 2000) consolidated the area and headage payments into the Single Farm Payment (SFP), apparently re-enforcing decoupling. Farmers receiving the SFP have the flexibility to produce any commodity, while they are obliged to keep their land in good agricultural and environmental condition (GAEC) and also respect the Statutory Management Requirements (SMR), in so-called cross-compliance. Within the national discretion allowed for the specification and introduction of the SFP, some Member States have retained the coupled element, requiring continued production to receive the payments, apparently to avoid abandonment of land. Another significant 2003 reform was making 'modulation' compulsory for all Member States, at the rate to 5% per year for 2007-2013, progressively reducing the payments for larger farms, to finance the new rural development policy. In fact, the size of the modulation cut in direct payments has been progressively increased since its introduction in 2003, and will be at least 10% by 2013 (EC, 2009b).

Again, the design and specification of the SFP (otherwise known as the Single Payment System (SPS)) follows the Buckwell report recommendations for transition assistance: "should be *decoupled* from production, should be *non-distorting* as regards competition, and recipients should respect *environmental conditions*", also insisting that these payments should be for 'transitional adjustment assistance' and should be "finite and time limited" (section 7.4). Environmental and other non-commodity based supports for agriculture, forestry and rural development were also completely restructured at this time into the Rural Development Regulation (RDR) for the period 2007 to 2013. As Buckwell (2007, p.13) notes, the "intense and bad-tempered discussion (about the budgetary agreement for 2007-13) finally agreed, more or less, to maintain the budget for Pillar 1 (the market supports and SPS) until 2012, but only with the proviso that all EU spending policies as well as the structure and size of the budget would be reviewed in 2008/09."

The implementation of these reforms coincided, by design, with the entry of Central and Eastern European Countries (CEEC) into the EU in 2004 and 2007. According to the Copenhagen Agreement, New Member States (NMS) could choose between a simplified area-based payment system (SAPS), complemented with additional support for rural development,

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[2] The term reflects the fact that reductions in Single Farm Payments are limited to those receiving more than €5000.

and the EU-15 SFP systems. All the countries, except Slovenia and Malta, opted for the simplified payment system. However, on the dubious grounds that the CEEC farmers did not need compensation – at least not for support reductions - the rates at which SFPs were made in the NMS were set at 25% of the Old Member States (OMS) rates, only to increase by 5% points per annum (hence remaining at 70% or less for these countries by 2013)[3]. As some sort of compromise to reflect the considerable disappointment of expectations of the CAP in the CEEC, the new member states (NMS) were allowed to supplement these European payments with nationally financed payments (or by transferring funds from the rural development support) to the limit of 30% of the (western) European level – i.e. to a total of 55% of the 'European' level in the first year. All the NMS have opted to top-up their SPS payments (e.g. Gorton et. al., 2009). However, and in spite of the original 'agenda' for the 2000 & 2003 reforms, the specific and very different conditions in the NMS were, as Gorton et al. (2009) explain, completely ignored in these reforms (a critical point which will be returned to below).

The *Health Check in 2008* continued the trend towards decoupling, agreed the elimination of milk quotas by progressively reducing price protection and increasing total quotas to reduce quota rents to zero by 2015, and also eliminated compulsory set-aside. In 2008, an assistance program to sectors with special problems was also introduced together with several corrective measures strengthening the 'reform directions' agreed in 2003. The NMS applying the SAPS were allowed to continue to do so until 2013 (instead of 2010) as well as receiving another €90 million, making it easier for them to provide assistance to sectors with special problems, under Article 68. The common modulation rate was also revised in 2008 from 5% to 10% by 2012, while some further simplification of the cross-compliance system was also agreed.

2.4.Budgetary history of the CAP

The overall result of this history of reform in terms of budgetary allocation is shown in Figure 2, which clearly shows the extent to which direct payments (aids and decoupled payments) and (to a lesser extent) rural development assistance (Pillar 2) have taken over from coupled market support, at least as far as budget spending is concerned.

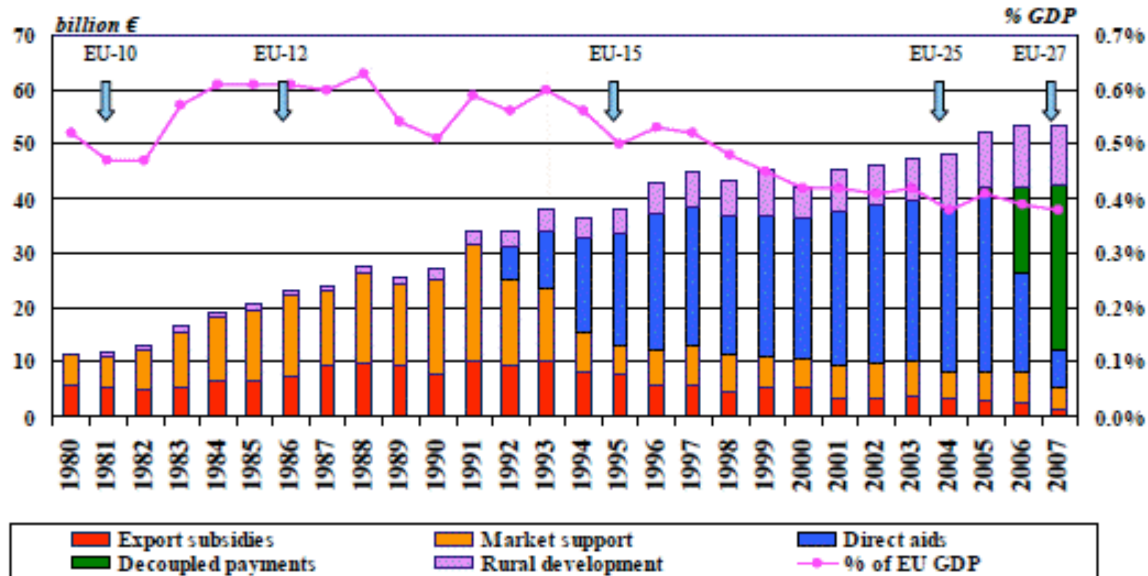
In addition to a major shift in the direction of budget payments, the CAP spending has also been reduced over the past 20 years from 75% of the total EU spend to about 45%, declining as a share of EU GDP as a consequence to less than 0.4% (less than most parish councils). At the same time, the EU has expanded by 12 member states, and the number of farmers and farm workers has more than doubled. As a consequence, the popular perceptions that the CAP is both a dominant EU policy in budgetary terms, and also continues to be both generous and highly protective of European farmers, are now both substantially misinformed and potentially highly misleading for EU politics. In fact, the extent of support per head and per hectare has declined substantially, especially with the accession of the NMS.

A similar picture, with one important difference, emerges from a comparison of the OECD estimates of Producer and Consumer Support Estimates (PSE & CSE), Figure 3. Although over a slightly shorter period, the story is one of substantial decline in the total PSE from 2003, and an even steeper decline in production related (coupled) support, being replaced by a rise in decoupled support, as the SFP system takes over. Figure 3 also shows the OECD's CSE (the Consumer 'Support' Estimate, here pictured as a Consumer 'Tax' estimate - i.e. as a positive % rather than a negative 'support'). In effect, the CSE is an estimate of the gross user tax as a proportion of farm gate revenues (which is the basis of all these estimates). It

[3] Without the nationally financed top-up supplement by the Member States.

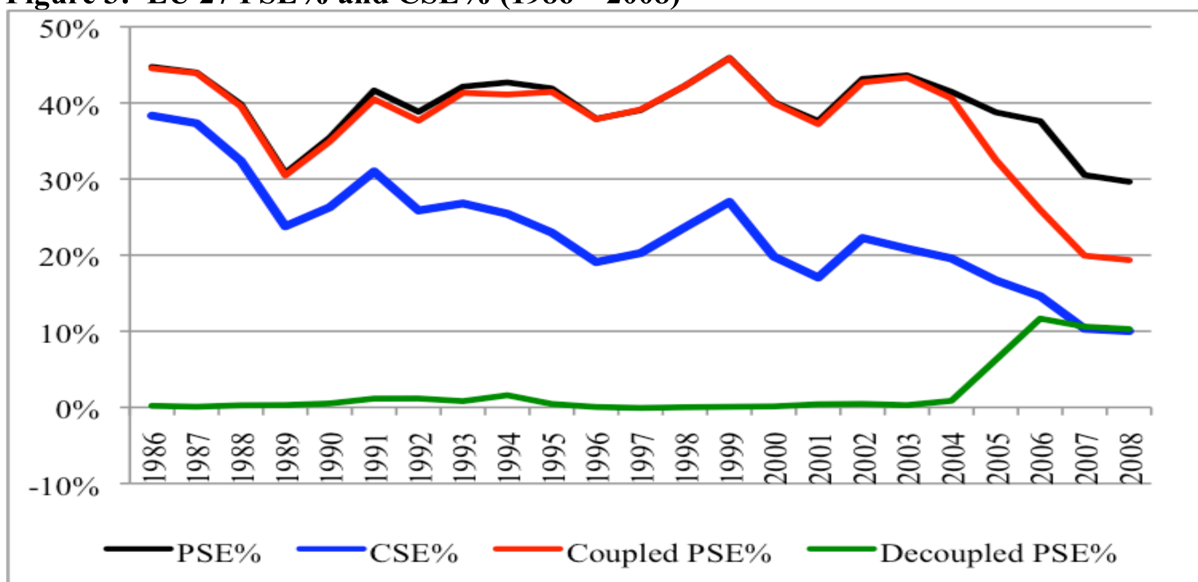
reflects the market support or protection measures still in place – mostly the effects of the EU import tariffs measured against actual world prices.

Figure 2: Budgetary history of the CAP, 1980 – 2007



Source: Haniotis, 2009.

Figure 3: EU 27 PSE% and CSE% (1986 – 2008)[4]



Source: OECD, Producer and Consumer Support Estimates, 1986-2008 database. Note: coupled PSE includes only product or production related support (OECD categories A, B, C and D), decoupled includes those support programmes which do no relate to products or production (categories E, F and G).

As can be seen, the effective consumer or user tax resulting from the CAP has been more or less steadily declining since 1986, from 40% to the current 10% of farm gate revenues, as world prices have tended to strengthen and as EU import tariffs have been reduced.

[4] It is, of course, well known that the PSE is generally a considerable over-estimate of the actual levels of support reaching the farmer as a consequence of the support policy (see, e.g. Harvey, 1997).

Consequently, the responsibility for the continued support of farmers now falls much more heavily on the EU budget and taxpayer (approximately the gap between the PSE and CSE in Figure 3). In this light, the decline in the proportion of EU GDP actually spent on agricultural support is even more remarkable – and reflects the fact that the treatment of farmers in the NMS is substantially less generous, and less common, than is the case in the EU15. Had the NMS been treated equally with the 15 as far as the SFP is concerned, the tax bill for the EU would have been substantially greater. EU Budget constraints effectively ruled equal or common treatment impossible. Indeed, an important 'financial discipline' of the present policy provides for the automatic reduction in SFPs in the event that the present budgetary framework is breached. This discipline would be invoked if the NMS payments were to be adjusted to the full EU payment level under the present budgetary framework.

Nevertheless, Figure 3 does show that the CAP continues to be an important component of EU farm incomes. Delivering a PSE of 30% of total farm revenues is bound to generate considerable dependency (Harvey, 2004) amongst farmers (and their political supporters and civil servants) on continued support, especially since this estimate is now much closer to the actual increase in producer receipts as a consequence of decoupling. Aspirations to substantially alter this flow of support, reducing it and re-directing it to other uses and targets, can be expected to generate very substantial resistance, as is already evident in the growing debate about the future of the CAP.

3. Direct payments in the European Union

3.1. Critiques of direct payments

Despite their obvious importance to European farmer accounts, the vast majority of the professional literature analysing the CAP (Jambor and Harvey, 2010) considers that direct payments are well past their sell-by date. Intellectually and academically, the case for continued direct payments, without very considerable re-design and much more careful targeting to specific objectives, is virtually non-existent (see, especially, Swinnen, 2009, Bureau and Mahé, 2008). According to Swinnen (2009), for instance, this policy instrument is not effective in any defensible dimension: (1) Agricultural employment is still decreasing despite large and increasing direct support; (2) the majority of farm household incomes come from off-farm sources, reflecting improved integration of rural areas and markets with the general economy; (3) the distribution of support is very uneven amongst farm sizes, with those perhaps most deserving or needing support receiving the least; (4) most support is dissipated to input suppliers and landowners, since payments are based on historical rights and linked to land use, driving land prices up as a consequence; (5) cross compliance is either largely ineffective or impossibly expensive as a means of paying for agriculturally-related public goods (conservation, amenity, recreation and environmental (care) goods and services)

Based on this logic, Swinnen (2009) well summarises the arguments that improvements in farm incomes due to support are temporary, which both history and economic logic demonstrate. Competition in the industry soon results in the revenue increase being capitalised in the value of farm assets, or being spent on increased costs of production. In either case, market competition ensures that total production costs will increase to match the supported increase in revenue. In effect, the benefits of support are frozen into higher costs for the sector and its businesses. Entrants to the supported industry have to purchase or rent their farm assets and pay the additional costs generated by the support, and are, consequently, no better off with the policy than they would have been without it.

Moreover, as evident from the 2007-08 food crisis, direct payments are unable to stabilise markets/incomes. There is no evidence that farm households in industrialised OECD countries have systematically lower incomes than other households, so policies to support

incomes across the whole sector are unjustified (OECD, 2003). A similar conclusion is drawn by a UK Government report (HM Government, 2010) analysing the price spikes for agricultural commodities in 2007/08. The report concludes that these spikes were exacerbated by poorly performing markets and that there is an urgent need to further open up international agricultural markets by phasing out agricultural subsidies such as Pillar 1 of the CAP. However, according to some analysts, phasing out of the current direct payments should be accompanied by phasing in new, or re-designed, policy instruments (Anania, 2009).

These views are strengthened by the fact that direct payments are neither evenly distributed by farm sizes, nor by geographical location (Gorton et al., 2009, Zahrnt, 2009, Vrolijk et al., 2010, Bureau and Witzke, 2010). The 80/20 rule applies – 80% of the support being received by 20% of farmers (recipients). Small farmers, especially, are handicapped in many ways. Though they are eligible for direct payments, due to the small farm size and administrative procedures, most of them receive marginal amounts or do not even participate in the system. As Zahrnt (2009) and others have also emphasised, payment rates per hectare are also widely dissimilar, ranging from €500+ in Greece to €174 in Portugal.

Furthermore and as already noted, following the EU Copenhagen agreement, direct payments were introduced at lower initial rates in the New Member States (NMS), which have still not reached the level of EU15. Indeed, the NMS are already supplementing their EU funded direct payments with national supplements to make good the difference, so the common status of these payments is violated. In a more general context, it has also argued that the CAP is not targeted effectively to the NMS, for four main reasons (Gorton et al., 2009): (1) the lack of convergence between rural areas in NMS and EU15; (2) differences in farm structures in terms of both size and organizational type; (3) an inappropriate balance between the two CAP Pillars (direct support and Rural Development); (4) inadequate policy to implement rural development measures in the NMS. Therefore, the system of direct payments, amongst other issues, should be changed and redirected to meet the needs of the NMS.

3.2. The future of direct payments?

What might justify the continuation of direct payments? A range of possibilities is considered in the reform literature. The most obvious are already identified in the axes of Pillar 2: competitiveness; the environment & land management; rural development & diversification. However, as is recognized in the design and implementation of Pillar 2, all of these justifications demand well-aimed targeting of payments towards specific objectives and conditions, and not to general, sector-wide payments to all farms. There is, perhaps, one argument for continued sector-wide support that at least some analysts find persuasive – the inherent volatility of agricultural markets and the need for some safety net or insurance/security provision. While there is some support for the provision of a safety net – to cope with ‘exceptional circumstances’ (Bureau and Mahé, 2008), there are also strong arguments (Swinnen, 2009, Antón, 2009) that private sector/market provision of insurance is likely to be both more efficient and effective, though perhaps requiring some public facilitation through information and extension. State provision of insurance is very likely to crowd out market provision. It should also be noted that the EU’s import tariffs (as reflected in the CSE element of support, Figure 3 above) continue to provide a substantial ‘safety net’ as far as world market prices are concerned, albeit that this protection can be expected to be reduced in the future as and when agreement is reached under the WTO Doha round. Nevertheless, at a gross value of some 10% of total farm revenues, this continued market protection and associated stabilisation remains substantial (especially for some products, such as dairy).

However, the European Commission makes it pretty clear that it is not willing to acknowledge the temporary nature of the SFP system, at least publically (EC 2009b, p.11). "*Direct payments provide a basic level of income to all farmers throughout Europe, and market measures ensure a guaranteed price for some agricultural products. Changing one of these, without counterbalancing the other, thus affects the overall income level of producers. At the same time, the provision of a basic income payment to all farmers ensures the basic provision of public goods throughout Europe, by encouraging them to stay in farming*."

It is apparent that the present system should be changed. The most commonly accepted idea in the professional literature (Jambor and Harvey, 2010) is to phase them out completely. However, various other ideas have been proposed. Swinnen (2009) suggests that new objectives are needed for the CAP and direct payments should be drastically reduced and be converted to a safety net. A similar idea is proposed by Bureau and Mahé (2008), who argue that the system of direct payments should be converted into a general contractual scheme of three levels: basic husbandry payments, natural handicap payments and green points payments. In each category, farmers would provide special environmental services, according to their contract for a fixed term ("what you get depends on what you do"). Moreover, these authors propose to extend co-financing to direct payments in order to increase accountability and legitimacy, and also suggest 14 objectives that the new CAP should meet.

Similarly, Heissenhuber et al. (2008) suggest a three-step scheme of basic payments, voluntary agri-environmental measures and regional support. Ribbe (2009) argues that all future subsidies, whether they are for investment or paid per unit of area, should be justified on values recognised by society, as an amplification of the cross compliance conditions, suggesting that future direct payments must be conditional on practical "services" rendered by farmers for the conservation of the natural environment, for animal welfare, as well as quality production and job creation. Zahrnt (2009) calls for complete elimination of Pillar 1, as well as exploring comprehensive reform of the distribution of CAP spending between member states. He argues that the two-pillar structure should be replaced by a discretionary and a public goods pillar, giving Member States flexibility in how they phase out the SFP, avoiding contentious EU debates about phase-out programmes. Zahrnt (2009) also notes that any far-reaching reforms will involve potentially substantial re-distribution of CAP payments across member states.

Two more recent reports, both prepared for the European Parliament, also conclude that the SPS is obsolete. *"One can consider the present situation one of transition to a new policy, but without a clear orientation. Presently, the support measures of the Common Agricultural Policy score badly in terms of EU value added due to a lack of efficient targeting and ensuing excessive opportunity costs"* (Ferrer and Kaditi, 2010, p3/4). Bureau and Witzke (2010) also consider that "*the EU budget for direct CAP payments should be reallocated towards the provision of public goods, which is the only uncontested reason why society should provide money to farmers in the long run*" (p. 11). This is the most comprehensive review of SFP and of alternative proposals yet produced. The authors are clear – the present SPS should be phased out over a transition period, and co-financing of the scheme over the phase-out period also recommended. Instead, European policy should be directed towards establishing a common framework for the payment for public goods, to ensure that "the boundary between what is part of the baseline (i.e. what is statutory for farmers) and what goes beyond and is eligible for EU payments remain consistent across Member States" (p. 12). Finally, Professor Tangermann (2010) has recently written a trenchant critique of the single payment system. As he says: "*Unless justification (for the SPS) is fully credible, it will not be politically sustainable. And if it is not politically sustainable, it will not stick, and then the uncertainty*

among farmers will persist. But policy uncertainty is just about the worst thing one can inflict on a sector whose health so much depends on long-term planning."

There is another potential idea for the future of direct payments: the CAP Bond. The idea has been well developed by Tangermann (1990) and Swinbank and Tranter (2004) but has interestingly largely disappeared from the mainstream of literature. Bureau and Witzke (*op. cit.*) are virtually the only analysts who even mention the option, and even so are curiously dismissive. "A rather ancient proposal, which still appeals to some governments, is that SPS should evolve towards a "bond scheme". The bond scheme is a proposal for CAP reform tabled by the Danish government in the early nineties. .. This scheme, however, is merely a way to ease the transition towards a dismantling of the SPS and can hardly be considered as a "new model" for SPS. It also raises some practical issues, given the differences between the ways in which Member States have implemented the SPS" (p77). However, these authors do not elaborate their practical issues, while the difficulties of agreeing revisions to the current direct payments distribution and payment levels apply whatever reform path is chosen.

4. The CAP Bond

The CAP Bond scheme was first formally proposed by Land Use and Food Policy Inter-Group (LUFPIG) of European Parliament in 1991 as a significant development of the concept of decoupled payments. The essence was to issue a bond through which the future stream of direct payments would be rolled up into a single, lump sum, once-and-for-all payment to existing farmers, and all rights to future compensation payments would be eliminated. The Commission plans for the 1992 CAP reforms included the bond scheme but it was not adopted (Swinbank and Tranter, 2004). The Commission also proposed a bond scheme in 1991 for the dairy sector and in 1996 for the tobacco sector but neither proposal was accepted by the Council of Ministers. The most comprehensive analysis of the Bond scheme is provided by Swinbank and Tranter (2004) who investigate the feasibility and practicality of introducing a bond scheme as an element of CAP Reform. We summarize the idea and its advantages briefly here, as a basis for reassessing the option for current conditions.

4.1. The Concept

Tangermann's (1990) original idea was based on the proposition that farmers would receive annual payments for a certain number of years to compensate for cuts in support prices (following, at least implicitly, the Buckwell report's (*op cit.*) idea of Transitional Adjustment Assistance). Bonds would be allocated to farmers on the basis of output in a reference period and future production decisions would not affect the value of the bonds, which anyway would be transferable and could be sold on the private capital market. Farmers could even retire and continue to receive the bond dividends (coupon payments). Tangermann suggested a 15-year duration of the bond, after which no further compensation is warranted. This time would be enough to adjust to new policies and market conditions. Moreover, Tangermann proposed that bonds be issued to farmers rather than landlords, to avoid capitalising bond payments and values in the value of the land. However, there were no initial proposals on the distribution between landlords and tenants.

Poole (1993) developed the idea further and introduced a new element called exit bond. In his proposal, a farmer could choose between an annual income bond with zero redemption value or a zero coupon without yearly income but a fixed capital sum on maturity. Both could be sold in the capital markets and could be introduced on a voluntary basis.

4.2. The steps of conversion

Swinbank and Tranter (2004) proposed six steps to convert direct payments into a bond scheme:

1. Decouple crop payments from current land use (already largely complete);
2. Decouple livestock payments from the number of animals kept (already largely complete);
3. Decouple payments from land and attach the entitlements to individuals;
4. Limit the duration of payments and possibly make them degressive over time;
5. Definitively fix the future level of payments;
6. Transform payments entitlements to bonds.

The authors argued that, to be most effective, these steps should be taken at the same time, and that, furthermore, the logical sequence should be preserved.

Swinbank and Tranter argue that the benefits of the bond would be that: farm incomes would rise (as markets adjust to unsupported conditions); the EU economy would be better off (as a result of efficiency gains and eventual lower tax costs); administration costs and effort would decrease significantly; farmers would have more flexibility on their land use decisions and more certainty about their future. Moreover, they argue, the bond scheme would help converting the CAP to something like the Buckwell Report's CARPE (*op cit.*), assisting the release of funds from Pillar1 to Pillar2; help to correct historical unequal support; help making the EU negotiation position stronger in the WTO. These benefits can be summarized in Table 1.

Table 1: Summary of the benefits of a bond scheme

Step	Benefits
1 and 2: Decouple payments from production	Allows farmers to make more productive use of their resources Alternative uses of farmland would become sensible Administrative controls could be dismantled Payments switch from the WTO's blue box to the green box
3: Decouple payments from land and attach the entitlements to individuals	Land prices are no longer distorted (artificially inflated) New entrants into agriculture no longer have the expectation of receiving payments
4: The period over which future payments will be made is fixed	Restores a level of certainty about policy, enabling more secure farm investment decisions.
5: The level of future payments is fixed irrevocably	Reinforces the level of certainty in the industry Removes the political uncertainty, and consequent dispute about future payments.
6: Introduction of bonds and the full transferability of payment entitlement	Locks-in policy reform, as payments can not be altered without impacts on bond holders Enables the original recipients to sell their bonds, releasing funds for productive uses.

Source: Own composition based on Swinbank and Tranter (2004), pp.65

Despite its apparent benefits, the Bond has never been introduced. The factors causing this failure, particularly in 1992, are well summarized by Swinbank and Tranter (*op cit.*): poor timing; lack of coalition building; scope and extent of the reform; interests of the Commission; interests of the (dominant) French-German axis.

The timing was poor because the Bond scheme was viewed as an alternative (perhaps over complicated and unnecessary) to the mainstream "compensation for price cuts" at the time. When the Bond scheme was first presented, the Commission mainstream proposal (decoupled support) had been discussed for more than a year and preparations for the reform had been going on for more than three years. It was too late to re-visit the basic principles of reform:

compensation via direct payments against the abolition of coupled support. The lack of coalition building arises from the fact that according to the Treaty of Rome, the Commission proposes and the Council decides. Commissioner MacSharry could only pursue his policy objectives with the support of the Council of Ministers, and no majority coalition could be built for the Bond. Swinbank and Tranter also argue that the scope and extent of the reform limited the scope for an even more radical (bond) idea. Path dependent reforms are much easier to adopt than path breaking reforms (Hall, 1993). Uncertainty about the consequences of the bond, as well as the potential loss of political power or administrative positions were always likely to militate against the more radical bond. Additional confusion was added by the potential extent of the concept (over three or more regimes) and its scope. Furthermore, and perhaps critically, the Commission has always feared re-nationalisation of agricultural policy, which it feared would have serious consequences for European integration. The bond scheme was seen as a proposal for such re-nationalisation, since any bond would have to be financed and implemented by the member states (the EU Budget cannot engage in capital transactions). The bond idea was strongly opposed for this reason (Kjendahl and Tracy, 1994). Finally, the French-German axis has always been central to a reform outcome. As both were strongly oriented towards the *status quo*, to preserve high prices or at least continued support, the bond scheme held no attractions for the dominant political players.

4.3. CAP Bond & the Future of the CAP:

Are things different now? We believe they are. The present SFP (SPS) system is intellectually indefensible without severe restructuring to pay for public goods and services. It is, as a consequence, becoming increasingly illegitimate and politically unsustainable. Furthermore, it is far from common – not only are the NMS responsible for co- funding their own programmes, in contrast with the 15, but also the payment rates show substantial and incoherent differences between and within member states. Bureau and Witzke (*op cit*.) note and illustrate both the substantial fractions of farm revenues accounted for by direct payments, and the wide variations between and within countries of these payments per labour unit (section 1.1.6, p 30 – 36). The system needs to be reformed, as all parties to the current debates about the future of the CAP beyond 2013 well recognize, if not fear.

However, it is also apparent that, for many farmers, the payments are practically indispensible. Without them, many would be effectively, if not actually, bankrupt. As a consequence, farm groups and politicians dependent on farmer support cannot be expected to argue or vote for substantial change. Vrolijk et al., 2010, estimate that only 18% of European farmers would continue to thrive without direct payments, in the sense that they would continue to earn positive incomes over and above competitive returns to their labour and capital resources. On the basis of farm income accounts (FADN) data for 2004 – 2006, they estimate that almost 65% might be able to survive with positive incomes, although these incomes would be lower than their labour, land and capital could earn outside farming. As a result, these farmers (or their heirs and successors) would be expected to leave the industry and do something else in time. 11% would experience negative incomes without direct payments, and 6% would find their already negative incomes made worse.

The Vrolijk *et al*. (*op cit.*) study (p 10) "makes clear that in some countries and regions the viability of farms is more affected by the abolition of direct payments than in general in the EU. The viability of farms in Spain, Poland, Lithuania, Latvia, Belgium and Austria is hardly affected, whilst farms in Denmark, Ireland Sweden and the UK, as well as farms of some types in France, Germany, Hungary and Slovakia are heavily affected. In these countries, abolition of decoupled payments results in a large share of farms with negative farm incomes."

Does this mean that European Agriculture as we know it cannot survive and prosper without direct payments? The answer is no. It is inconceivable that much of European agriculture, blessed with some of the world's best farm land and good agro-climatic conditions, surrounded by a large and rich market, and well-functioning supply and marketing chains, could not survive and prosper in free market conditions. Vrolijk et al. note the following *caveat* (p. 8) on their estimates: "It is important to note that the analysis illustrates only the first-order impact of the abolishment of subsidies, and this gives a 'worst-case' assessment. It does not take into account farmers' behaviour, although the past has shown that farmers do adapt to changes in the Common Agricultural Policy. It also assumes a fixed cost structure and abstracts from changes in factor prices and structural change, all elements which would reduce the impact of reform on farm incomes." Without direct support both farm households and businesses and the whole agricultural sector would adapt and adjust, and much would survive and prosper eventually. But this does not mean that the adjustment would be welcome enough to attract political support, or that there would not be substantial costs and effort associated with the adjustment. Virtually all analysts recognise this, and the typical, near universal, response is that any radical change, especially elimination, needs to be phased in over time, perhaps a long time (e.g. Bureau and Witzke, *op cit*., p 90).

In fact, as Swinnen (*op cit.*) argues, a primary reason for most agricultural support in the first place is precisely to ease and assist the transition from a predominantly agrarian to a commercial/industrial/urban economy. The natural economic signals for this transition are declining relative farm incomes, while the adjustments favour those who either have the greatest comparative advantage in farming (and hence are able to expand their businesses and incomes) or those who have the greatest transferable skills and capital base (and hence can more easily earn good livings doing something else). Those, perhaps many, with neither of these advantages become stuck in a declining industry with falling relative incomes, though with substantial political support. This political support easily translates to economic support, which in turn quickly dissipates into higher input and factor costs, and probably lower market prices as well[5], thus completely failing to achieve the political objectives of improving farm incomes. We end up in the present condition, with the agricultural system, including its politicians, dependent on support which fails to meet its social objectives and hence is commonly perceived, outside the special interest groups, as being illegitimate and obsolete.

Elimination of direct payments is the only sensible and sustainable option. However, does a phased elimination of support help farmers adjust? Time is not the major constraint on adjustment and adaptation of businesses or households. Timing, on the other hand, is often the critical impetus for change at the farm household level, as generations and successions change. Planning for such changes is often a priority for farm families, and a major difficulty in making such plans is the uncertainty about future market and policy conditions. Phasing out current direct payments, even, or perhaps especially, over a 7 or 10 year horizon (as suggested by Bureau and Witzke, *op cit.*, for example) is likely to make this uncertainty far worse, not better. Not only will the consequent adjustment of factor, input and product markets not be apparent until after the full adjustment or transition period, but also there will continue to be uncertainty about whether or not future governments will stick to the apparent commitment to carry through the full transition and not back-track. In fact, it makes economic

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5 There is good reason to suppose that the provision of pubic (government) support to farmers both encourages them to produce more than they otherwise would, hence depressing market prices, and also insulates the downstream food chain from full appreciation of the full economic costs of, and hence necessary prices to be paid for sustained food production.

sense for many farmers to contribute effort and funds to persuading governments to rescind the decision to abolish the payments, as the recent US farm policy experience well demonstrates.

If phased elimination does not appeal to the primary constituency (farmers), is a transition of the SPS to specific and targeted payments for public goods any better? In principle, this seems like a good idea, at least at first sight, and the option is well argued, for instance, by Bureau and Witzke (*op cit.*) among others. However, the devil is in the detail. Who should be paid how much for what particular public goods? There is absolutely no reason to suppose that the present payment rates to farmers, either by type, region or country are at all related to the value of the public goods they would otherwise not provide. In fact, there is no reliable information about what public goods would not be provided in the absence of direct payments – we can only make more or less educated guesses, about which there will be continued dispute. Similarly, there is no hard evidence about how much it would be necessary to pay to secure delivery or provision of the missing goods. Farm families have no way of making sensible projections of how much they might be able to earn or what sort of public (care[6]) goods and services they might be best advised to provide. Bureaucrats and governments have no way of determining, without continued contest, appropriate payment rates or even appropriate menus of environmental and ecological services, to say nothing of cultural provisions.

Even if some agreement could be reached about appropriate menus and payment rates for care services across the whole Union, presumably heavily differentiated by type, region and circumstance, the transition between present payments and the indicated care payments still presents very major problems, both for farmers, and for their representative politicians and member states. How should the losers from the necessary redistribution be compensated (or appeased)? Who should pay – the European budget or the member state exchequers? These difficult problems need solutions or negotiated compromises, but the difficulties of doing so strongly suggest a number of false starts and ongoing re-negotiation and change. None of this contributes at all to solving the necessary adjustment problems facing farmers and their families and the continued debilitating uncertainty about future conditions.[7]

A solution is to separate the quite distinct issues of adjustment to the removal of direct payment support from that of the appropriate mechanisms for delivery and provision of public goods. None of the present contributions to the CAP reform debate pursue this point, conflating (and confusing) some continuation of flat rate direct support payments with more or less cross-compliance with public good provision.

The inevitable negotiations about revising the payment rates, and hence the distribution both between farms and countries, of the continuing direct payments will be hard enough, without trying to encumber these with additional arguments about their relation to the provision of (European or national or regional or local) public goods. Why not restrict attention to the primary question – how to abolish the direct payments – before addressing the subsequent question – how to ensure provision of missing public goods? How? By using the Bond idea.

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6 Conservation, amenity, recreation and environmental (care) services

7 One of us has analysed elsewhere the (im)possibility of effectively reflecting either the social value or the social opportunity cost of care provision through uniform (even if differentiated) single farm payments (Harvey, 2003). This paper also proposes a possible resolution of these difficulties. This analysis strongly suggests that the devil in cross-compliance payments for care provision is not actually in the detail, but in the conception. The 'solution' to the problem of externalities and public goods is not a solution at all, but simply a re-specification of the problem.

We do not pursue the difficult and contentious details of the various possible proposals about which farmers/farms should get what levels of compensation, and hence who should get what particular value of bond. These negotiations will happen anyway, as an inevitable and unavoidable part of the post 2013 debate. Since at least temporary continuation of some form of single farm payments seems practically inevitable, the real debate should focus on the legitimacy of these payments. It is practically impossible to sustainably legitimise them on public good (care) delivery grounds, which are hopelessly and continually contestable. The critical issue is to gain acceptance for the principle that single farm direct payments are an obsolete anachronism, which fail to deliver any legitimate social objective, and hence should be abolished. Whatever the outcome of the reform negotiations, many will continue to hold this view, and (we argue) future experience with continued single farm direct payments will simply re-inforce the view and consequent harassment of the system. As a consequence, failure to accept the principle of abolition during this reform will simply postpone the inevitable. Meanwhile, the supposed beneficiaries will continue to be plagued by uncertainty about the future while being inappropriately and ineffectively supported in the present.

All this unnecessary, diversionary and wasteful debate and effort could be avoided by agreeing a commitment to elimination and abolition of (untied) direct payments. This commitment cannot be achieved without both compensating the losers adequately, and making it obvious that the means of compensation actually helps farm families and their dependents to adjust. Promises of continued direct payments for a limited period – the phased elimination option - do neither. Yet that is the practically inevitable outcome of the present reform discussions and negotiations. Our key and critical points are: i) simplify the inevitable debate and negotiations by restricting attention to the single objective of eliminating these payments – recognizing that this cannot be achieved without appropriate adjustment assistance; ii) having done so, follow the logic and the practicality of rolling up the stream of agreed time-limited of annual direct payments into a single, once-and-for-all payment – the Bond.[8]

In making these points, we do NOT argue that every and all payments to farmers should be eliminated – there are strong grounds for paying for public and social goods not otherwise provided by well functioning markets, and for specific assistance with infrastructure and institutional support for the better functioning of markets – some of which could well be best satisfied by making specific and targeted payments to specific farmers and/or farms. All we are arguing is that it is either foolishly difficult and expensive, or simply not possible, to get to such a system from where we are now in one (or even several) adjustments to the present SPS/SFP system.

How would elimination of direct payments really damage current farm businesses? The answer to this question indicates how the necessary compensation needs to be provided. The answer is that family businesses would suffer a major reduction in the value of their farm capital, the leverage this capital provides, and their ability to service their debt (much of which reflects the inflated value of land and farm capital because of the support). The consequence is that elimination of direct payments substantially erodes farm family pension

8 Based on 2007 payments (around €37 billion - EC, 2010), bonds would be issued to around five million claimants (FADN, 2010) and the initial annual payment would average €7400. However, there would be a very large number of small payments and a small number of large payments, of course. Payments would be made in euro in order to manage different exchange rates. The bond scheme would have a neutral impact on the EU`s Budget, however, administration costs would surely decrease. Moreover, member states would still have the right to tax the income from the bonds differently (the bond could be treated as unearned income).

and business adjustment funds. Appropriate compensation would replace this balance sheet damage with an equivalent and completely fungible asset – the CAP Bond.

The bond, and associated commitment to elimination of direct support, would provide the necessary and critical capacity for farm families and the farm sector to adapt and adjust to an essentially unsupported world. To do so, any family needs both the *confidence* and the *capital* to adapt and adjust appropriately. At present, there is no confidence because no one knows what an unsupported business and industry would look like, so many fear the worst. At present, there is very limited capital, and what there is (including the capacity to generate capital from current income) is obviously and substantially threatened by elimination of support. The Bond provides both the necessary capital, and the required confidence. The latter is especially critical. Only by actually generating the conditions of an unsupported industry can we hope to learn what sort of conditions actually emerge, and therefore what adjustments and adaptations are necessary and useful to cope. Only by providing the bond can we achieve this necessary experiment without compromising the livelihoods of the subjects of the experiment. How much insurance, or investment, or management practice, or market development, or business/family relocation is going to be needed in a future (unsupported) world? What will happen to product, input, land and capital plant and machinery prices? How much land will actually be abandoned, rather than bought up or taken over by others? How much ecological damage, or regeneration will happen? How will people respond to conditions without support, and what will be the consequences? We do not know unless we try, and we cannot afford to try because we do not know, and because it is our livelihoods we are experimenting with. The Bond provides the essential capability to undertake the experiment. The Bond is a serious answer to these critical questions, which are implicit in any and all discussions of CAP reform, and especially about the future of direct payments. No other proposal on the table comes close to answering these questions.

We note, finally, four strongly supporting points. First, the justification for the bond is explicitly the provision of necessary adjustment capacity for a presently dependent sector (collection of family businesses and livelihoods) who have, through no fault of their own, been encouraged and persuaded to stay in farming and go on doing what they have always done by (misguided) public policy. This argument applies to farmers in both the 15 and the NMS – the latter promised access to EU support, bolstered by their own governments. As already argued, the practically inevitable agreement to continue these payments already acknowledges the political logic of the justification, but notably fails to articulate a legitimate rationale (other than preservation of established interests). Second, the bond scheme would clearly meet the Commission's goal of simplification of the CAP (which seems an impossible aspiration under any other alternative option). In so doing, it would substantially reduce inherently unproductive bureaucracy and administration, and the similarly wasteful effort on continued debate about the future of direct payments. Thirdly, adoption of the Bond and elimination of direct payments would insulate the CAP completely from any possible policy disruption or challenge arising from present or foreseeable future WTO agreements. Finally, on expiry of the bonds, the European budget would be finally freed to concentrate on adding value to the Union, its people and markets, rather than continuing to pay obsolete and often counter-productive direct payments, currently only justified by 'squatters' rights' and vested interests.

5. Conclusions.

It is apparent that the tendency of the political system to preserve the *status quo* reflects the dependencies which the policy history has generated (Harvey, 2004). Reforming the policy

depends on 'weaning' the interested parties (farmers, their political representatives and the administrative bureaucracy) from this dependence. The common perception is that many farms would be bankrupted by elimination of the SFP support. As a consequence, it is usually argued that any proposal to do so must involve progressive and gradual change, rather than abrupt reform. One interpretation of the Commission's strategy (presuming there is one) for the reform of the CAP is that it has been progressively shifting the perceptions of European farmers towards a largely unsupported future. Conversion of support to direct payments, and subsequent incorporation into the SFP has focused attention on what the European taxpayer is supposed to be getting for this spending. As a result, it could be argued, many farmers are already aware of the pressures to reduce this spending and are already anticipating the eventual elimination of the SFP, or (at least) substantial conditioning of these payments on the basis of provision of public goods and services. If so, then it may become possible to actually eliminate the payments in due course, without raising irresistible opposition. On the other hand, this increased awareness of the pressures on SFP can also be expected to increase farmers' (and their representatives') actions and efforts to resist the pressure and preserve the payments.

There is no sound reason for continuing direct payments and there is an excellent option for getting rid of them - introducing the CAP bonds. The adoption of the original idea to current policy circumstances has shown several advantages. We have already made the first two steps on the 'path to bond scheme' by partial decoupling – why not going further and relieve the CAP once and for all from the old and obsolete compensatory logic? There will always be fears about radical new policy options and about conditions without support. But it is also clear that the uncertainties generated by the present condition – continued SPS, though with an increasingly indefensible future – are helping no one. In addition, there is no clear indication of what corrections and assistance an unsupported industry would really need to provide public goods.

The CAP Bond would solve several problems of the direct payments. First, farmers would both be compensated properly for the elimination of support, and given a chance to make the most appropriate adjustments to cope with an unsupported world. Second, the causes of uncertainty on the future of direct payments and their exact sums would be reduced, and their need for adjustment and adaptation would be better defined as the markets adjust. As the bond scheme would bring a continued certainty about the future of the present agricultural policy, it would help strategic decision making at the farm level.

Moreover, the bond scheme includes several benefits to the EU. First, such a system would result in significantly decreased administration costs enabling to decrease bureaucracy. It would also help cancelling the logic of historical unequal support once and for all. Furthermore, substantial funds would be released from Pillar 1 (once the bonds expire) and could be converted into Pillar 2, strengthening the role of rural development in line with the original idea of CARPE. Finally, the EU negotiation position would be much stronger in the WTO as problems with direct payments would entirely be eliminated.

Without a clean break of the CAP bond, it is likely that the policy will continue to generate wasteful argument, continued unnecessary uncertainty, and consequently unproductive policy instruments and farm adjustments.

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