

The Single Payment Scheme in the Impact Assessment of the CAP "Heath Check"*

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DRAFT

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***ABSTRACT:**Based on the comprehensive Impact assessment of potential changes to the CAP that accompanied the HC legal proposals tabled by the Commission on 20th May 2008, this paper focuses on the impact analysis of options for adjustment of the Single Payment Scheme. It is put in evidence the distributional implications of the current SPS models as well as the link between the payment distribution with structural variables. Open issues that lead to the need of adjusting the system are also presented. The economic impact of alternative options are analysed based on Eurostat, audit, and microeconomic data. Issues examined include the impact of options on the distribution of payments, on land values, and on farmers income by size and specialisation. Results put in evidence the need to allow MS to consider a targeted adjustment towards a flatter rate for payments, which would address the societal concerns of unequal distribution of payments between farmers.*

JEL: Q18

1. Introduction

With the 2003 Reform, the way support is granted to farmers has changed radically. Since then the vast majority of payments to farmers have been decoupled from the volume of production, and conditioned to the respect of environmental, food safety and animal welfare standards (cross-compliance). Some degree of coupling has been allowed to MS in order to avoid abandonment of production, under well defined conditions and within clear limits. Other important elements of the reform include the strengthening of the rural development policy with more EU money and new measures, the introduction of a mechanism of financial discipline, and the revision of market policies in the dairy, arable crop, rice, and other small sectors.

Although first appraisals of the 2003 reform indicated that a fundamental reform of the CAP for the remaining horizon of the present financial perspectives (i.e. until 2013) is neither necessary nor desirable experience gained so far from reform implementation have put in light adjustments needs that were not foreseen when the reform was carried out (European Commission, 2007).

The "Health Check" of the Common Agriculture Policy (CAP) has as objective to assess the experience of the 2003 CAP reform, and to introduce necessary adjustments to the policy. The policy issues addressed in Health Check (HC) of the CAP cover the three basic regulations of the CAP: i) direct support to farmers¹ ii) the Single Common Market Organisation (CMO)²; iii) the Rural Development (RD) Policy³.

This paper is based on the comprehensive Impact assessment of potential changes to the CAP that accompanied the HC legal proposals tabled by the Commission on 20th May 2008 (European Commission, 2008), but it focuses on the analysis of different options for adjustment of the Single Payment Scheme (SPS).

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¹ Regulation (EC) N°1782/2003.

² Regulation (EC) N°1234/2007.

³ Regulation (EC) N°1698/2005.

The first paragraph is devoted to the basic facts, functioning and distributional implications of the different implementation models. A picture of the current situation is depicted in paragraph two, where a link between payments distribution with structural variables is put in evidence. Open issues that lead to the need of adjusting the system are presented in paragraph 3. In paragraph 4, the economic impact of alternative options are analysed based on Eurostat, Clearance Audit Trail System (CATS), and microeconomic data from the Farm Accountancy Data Network (FADN). The last paragraph contains some concluding remarks.

2. The Single Payment Scheme: the basics

The introduction of the Single Payment Scheme (SPS) aimed at allowing farmers to follow the market signals, through a system as simple as possible from an administrative point of view, and compatible with WTO requirements for Green Box payments.

In implementing the SPS, member states could opt for a historic model (payment entitlements based on individual historic reference amounts per farmer), a regional model (flat rate payment entitlements based on amounts received by farmers in a region in the reference period) or a hybrid model (mix of the two approaches, either in a static or in a dynamic fashion). The new member States (EU-12) could choose to apply the Single Area Payment Scheme (SAPS), a simplified area payment system, for a transitory period until end 2010 (2011 for Bulgaria and Romania).⁴

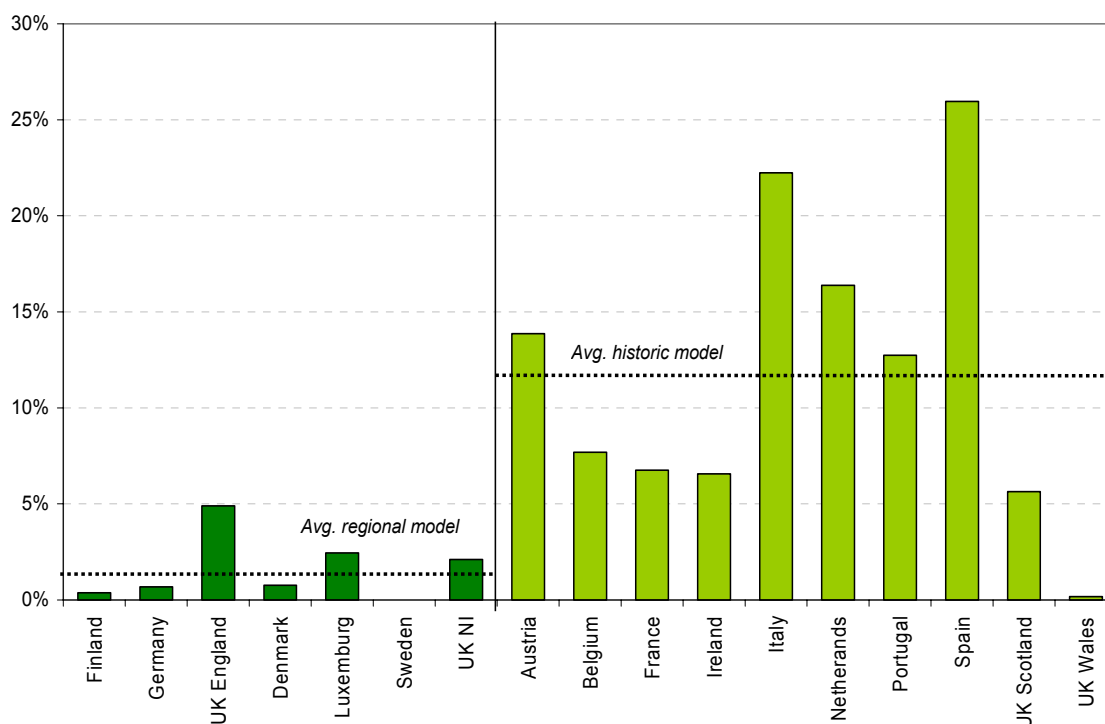
In order to receive payments, farmers have to activate their SPS entitlements by matching them with a corresponding number of eligible hectares. In the historic model the number of payment entitlements corresponds to the number of hectares that generated support payments in the reference period; thus eligible land not used to activate entitlements remains as "naked land". On the other hand, in the regional implementation the number of payment entitlements broadly matches the number of eligible hectares. As can be seen in Figure 1, the percentage of "naked land" is higher, on average, in MS applying the historic model.

Whatever the choice of model, both historic and regional approaches have a fixed reference in payments and in the area to which these payments correspond. The two models, and their variants, also have a significant difference with respect to the distribution of support, whether this is fixed in one shot (static) or gradually (dynamic).

- The historic model respects the previous level of support that farmers received, and leaves redistribution issues to be dealt with through modulation. As a result this SPS model uses the *farm as the fixed reference* for the allocation of payment rights (entitlements).
- The regional model, driven mainly by equity arguments since redistribution was significantly scaled down because of the limited extent of modulation, addresses issues of redistribution of support through the SPS. As a result, this SPS model uses the *area as the fixed reference* for the allocation of entitlements.

⁴ Denmark, Germany, Luxembourg, Finland, Sweden, UK - England and UK - Northern Ireland apply the hybrid model (some static, some dynamic). Belgium, Ireland, Greece, Spain, France, Italy, the Netherlands, Austria, UK – Scotland and UK – Wales apply historic the model. Malta and Slovenia apply the regional model. The rest of the EU-12 apply the SAPS. The single area payment of the SAPS is a flat rate payment per hectare at MS level. It is calculated by dividing the annual national financial envelope of the MS by the agricultural area under SAPS in a given year.

Figure 1: "Naked land" in historic and regional/hybrid SPS models (2006)



Source: DG Agriculture

In practical terms, MS choices led to an almost even split, in budgetary terms, between historically-based and regionally-based support. Both approaches achieved the objective of WTO compatibility, by introducing fixed references for the payments farmers receive. Although the initial implementation of the regional model proved to be more complex, once in place both models have similar implementation rules.

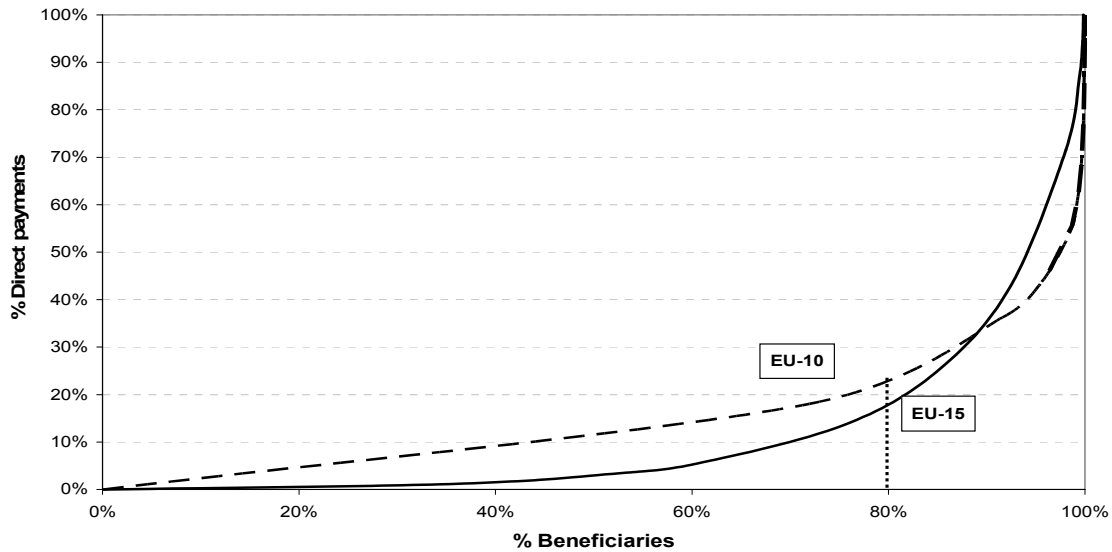
3. Current situation

The current distribution of support to farmers across EU is the result of a complex picture.

Firstly, it is often recalled that the distribution of direct payments among farms is “uneven”: 80% of beneficiaries receive roughly 20% of payments. Indeed, Figure 2 shows that, in the EU-15, 80% of beneficiaries receive almost 20% of payments while in the EU-10, the corresponding figure is slightly above 20%. Differences in payment levels reflect the different production structures across Europe as well as the level of previous support that generated such payments.

Secondly, the average payments also differ widely among MS whether the variable used as reference is the payment per area (hectare) or whether the payment is calculated per beneficiary.

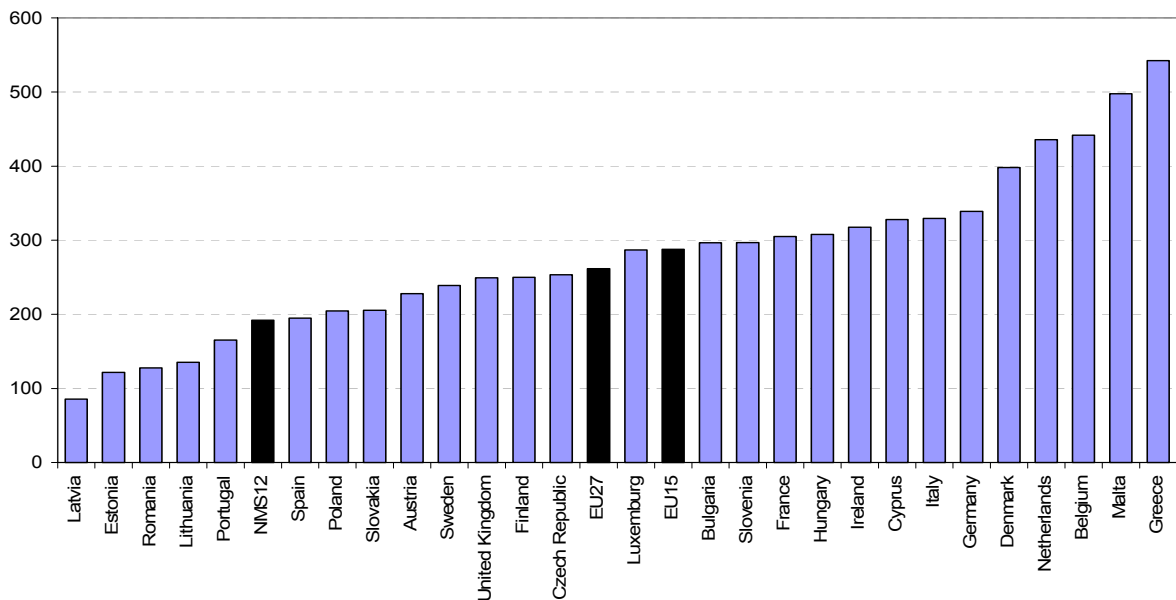
Figure 2: Distribution of direct payments among beneficiaries



Source: CATS data (2006 budget year)

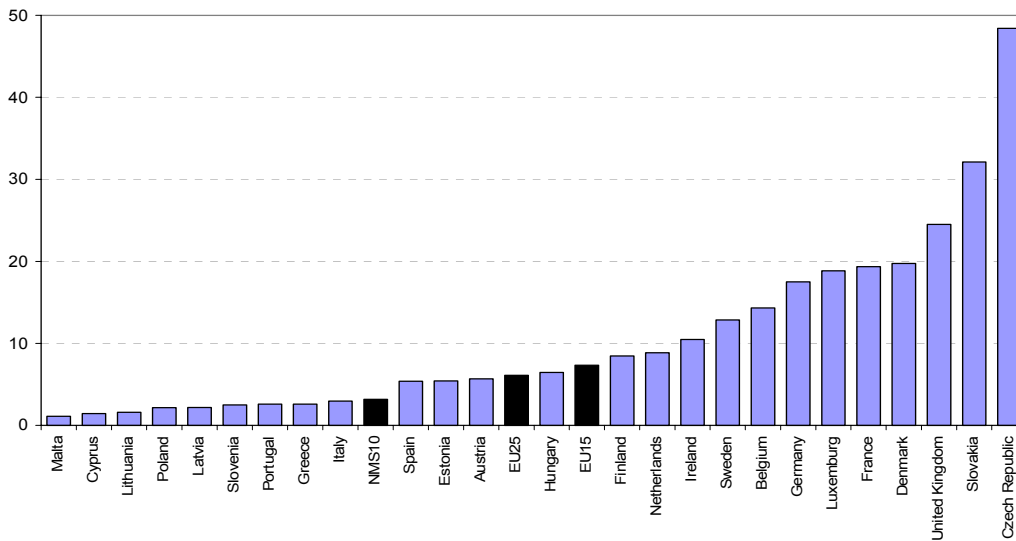
In Figures 3 and 4, to facilitate comparison, average farm payments were calculated in a simplified way based on the expected amounts of payments once all MS fully implement CAP reforms and new MS will be fully integrated into the CAP (2016). It is worth noting that the MS with the highest per hectare payments figure among those MS with the lowest rate of payment per beneficiary; on the other hand, the MS with the highest payment per beneficiary is around the EU average when area is the reference variable.

Figure 3: Average direct payment per MS (in € per hectare)



Source: DG AGRI calculations on the basis of Eurostat (UAA), Reg. 1782/2003 (national ceilings)

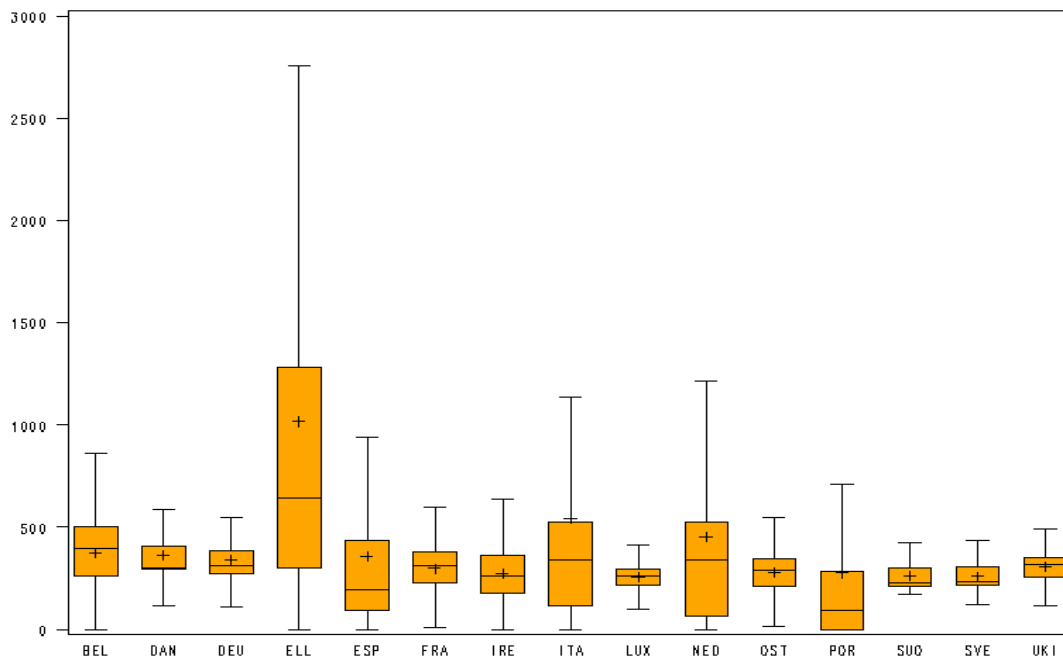
Figure 4: Average direct payment per MS (in €'000 per beneficiary)



Source: DG AGRI calculations on the basis of CATS (beneficiaries), Reg. 1782/2003 (national ceilings)

Thirdly, the distribution of payments per hectare based on FADN data structure for 2004, simulated for 2009 shows that the value of payments per hectare in EU-15 vary depending on what SPS model is implemented. In MS applying the historic model, the value of payments per hectare show a wider variation of their value per hectare than in MS implementing the regional model, both dynamic and static (Figure 5).

Figure 5: Distribution of direct payments in € per hectare under historic and hybrid models (Status Quo)⁵



Source: DG AGRI EU FADN simulation

⁵ Whiskers represent percentiles 5 and 95 / Box represents percentiles 25 and 75 / --- represents median / + represents mean / outliers are not represented

Finally, these graphs reflect existing equity issues directly related to production structures. It appears relevant to examine this issues also in relation to perceived equity problems, knowing that in some cases the gap between perceived and real equity issues could not always be solved. For example, it is possible that for some a "fair" distribution of payments will be a "20-20" distribution (20% of farmers receive 20% of payments). But the way to arrive at such a distribution may be entirely unrealistic: either by having every farmer with the same aid regardless of his/her farm area, or by somehow forcing every farmer to adjust their farm area in the way that they receive the same payments.

4. Open issues

There are two aspects of the SPS implementation that indicated there is space, and need, for adjustment.

First, under the current legislation there is no provision that allows MS to make adjustments to their SPS models. This nonetheless, there could be MS willing to introduce adjustments based on the experience gained so far from its implementation.

Second, the historic model allowed farmers to be market oriented while keeping their past support level while the regional model redistributed support to farmers in a way that the support per hectare is similar within regions. As time passes, the historic reference period for these payments becomes more distant, and thus individual differences in current SPS values become increasingly harder to justify.

It was found opportune to give MS the possibility to modify their chosen models towards flatter rates of support. Other objectives were to address concerns about the equity and distribution of payments among farmers, to preserve transfer efficiency, market orientation and sustainability of farming; to limit administrative burdens and to simplify the system where possible.

5. Options and expected Impacts

In the light of the above mentioned objectives, five policy options were analysed in the Impact Assessment that accompanied the proposals tabled by the Commission in May 2008 (Table 1).

Table 1. – Policy options - SPS model

<i>Option</i>	<i>SPS model</i>	<i>Description</i>
0	Status quo – baseline	No review possibility for MS; both historic and hybrid/regional models continue as present
1	EU-wide flat rate per eligible hectare	The same flat-rate payment entitlement per eligible hectare applies to all EU MS
2	SAPS for all MS	The Single Area Payment Scheme of new MS becomes the model for all EU MS
3	Regional flat rate per hectare	Move towards regional flat-rate entitlements applied to all eligible area
4	Regional flat rate per entitlement	Move towards regional flat-rate entitlements based on current entitlements

The most evident difference between the two SPS models lies in their distributional differences. Therefore, the starting point for understanding the impacts of a move towards a flatter rate was to assess the impact of various SPS options on this distribution. The analysis lies mainly in the economic and social sphere, although attention is also devoted to the environmental and administrative implications.

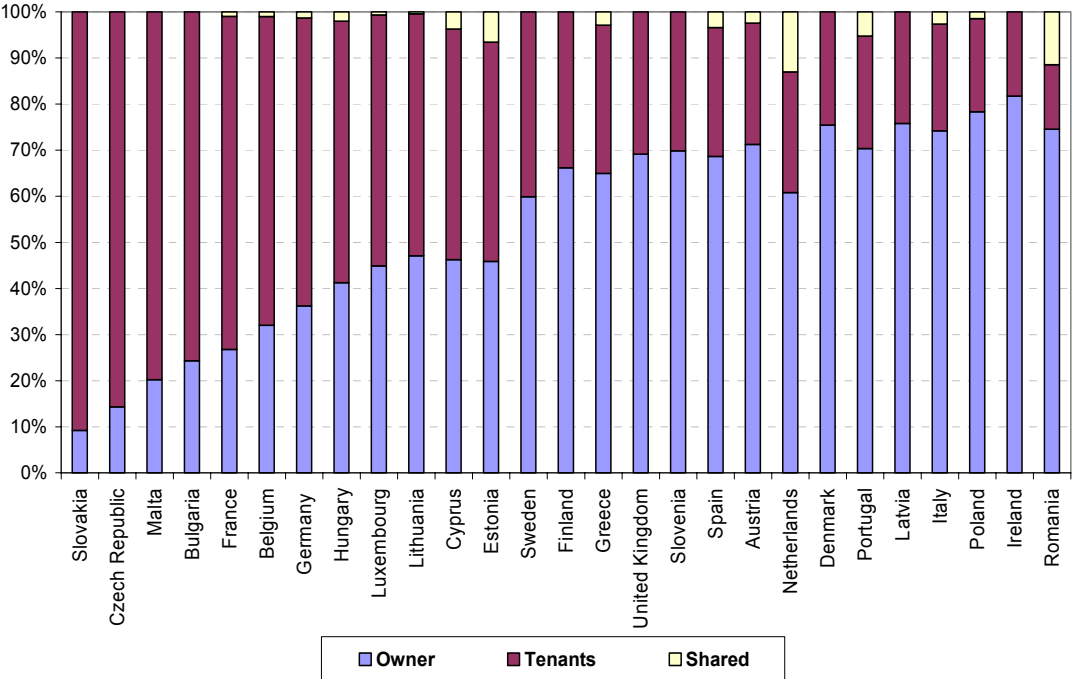
Option 0 - Status quo

The two broad SPS models, historic and regional, differ with respect to their equity/redistribution impact.

The historic model did not redistribute support between farmers, and thus asset values (especially land) of the farms have been little or not at all affected. Part of direct support is captured ("capitalised") in the value of land. Therefore, any redistribution of support would also affect land values. Capitalisation of support in land values should be the higher, the less "naked land" (eligible land not currently used to activate entitlements) exists. A very high transfer efficiency results from the fact that there is some "naked land", so support is better aimed at active farmers instead of landowners.

In the regional model payments can be adjusted to the conditions of the different regions which may be justified by differing natural conditions and cost structures. However, the redistribution of support among farmers in this model could have an effect on asset prices, which may induce a structural response of farms. Its implementation may have led to increased capitalisation of aid in the value of land which may result in a somewhat lower transfer efficiency of direct support as some of it may benefit non-farming landowners. This would have different impacts in MS, depending on their ownership structure, since as can be seen in Figure 6 there is a wide variety of situations across EU.

Figure 6: The structure of ownership of EU farm land (2005)



Source: Eurostat.

Experience with the regional model shows that, in most cases, the number of beneficiaries increased substantially already during the first year of implementation. This is quite different with respect to previous claims and is due to the fact that in the regional model everyone who declared eligible hectares in the first year of implementation received entitlements. On the contrary, in the historic model, only those who received support in the reference period received entitlements. As a result, the regional model led to a redistribution of payments, not only between farmers but also from "old" beneficiaries to newcomers.

Due to the higher degree of capitalisation of support in the regional model, it is to be expected that more support ends up with (possibly non-farming) landowners that under the historic model. Results of a 6th Framework Research Programme project⁶ indicate that the impact of direct payments on farm income is stronger in the historic model than in the regional model (Arfini et al., 2007). This is due to the fact that the stronger capitalisation in the regional model directs a larger share of payments from active farmers to landowners when land is rented.

Considering that various reforms have been completed since the introduction of the SPS, and more sectors⁷ have been entering into the system, the experience so far shows that certain provisions are unnecessarily rigid and complex and could be modified in a way that is neutral with respect to the model applied and does not negatively affect its functioning. For example, the reduction of the number of different types of entitlements, the elimination of restrictions on the transfer of entitlements received from the national reserve, and the elimination of restrictions on the transfer of entitlements without land, have been identified as some of the needed changes to the system.

Option 1 - EU-wide flat rate per eligible hectare

An EU-wide flat rate per eligible hectare would mean an equal payment per hectare across EU. Although this may be perceived as more equitable, in some of the biggest beneficiaries from such a move – e.g. the new MS - this option reverses the very logic of the Accession Treaty. Particularly, there is need to avoid huge distortions within the population deriving from the potential impact of the level of support in the rest of the economy.

The present level of support in the different MS is the result of a very delicate balance of budgetary transfers, among which fixed national SPS ceilings for payments defined within the framework of the existing financial perspectives. An EU-wide flat rate would violate the present financial framework.

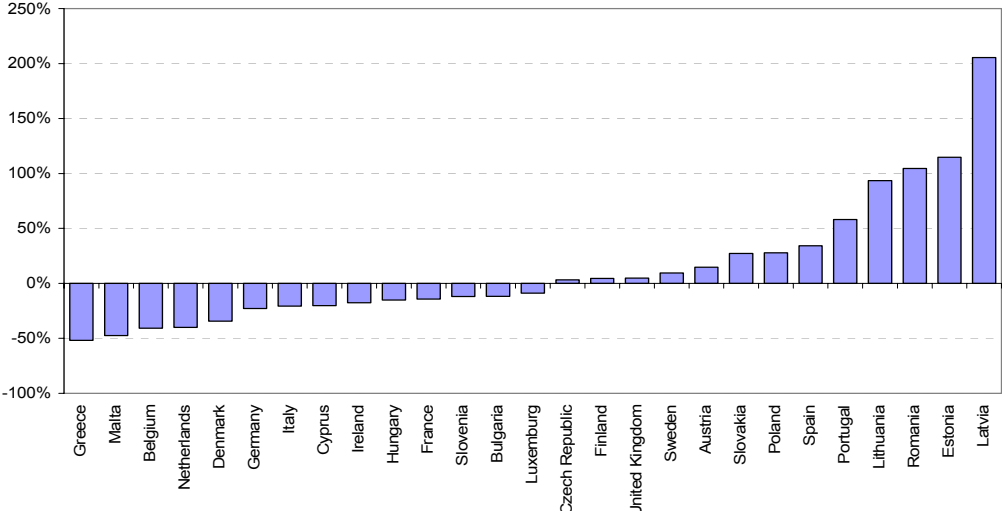
The national ceilings currently established in Regulation (EC) No 1782/2003 have been compared with the amounts they would receive if an EU-wide flat rate would be implemented. Results showed that a move towards an EU-wide flat rate per hectare would imply a substantial redistribution impact in all MS. In Figure 7 the % change in the overall amounts each MS would receive is indicated.

⁶ IV Framework Project GENEDEC, for details see <http://www.grignon.inra.fr/economie-publique/genedec>

⁷ Olive oil, cotton and tobacco (2004), sugar (2006), fruit and vegetables, and wine (2007).

Notwithstanding the change in the level of payments per farm is considerable in some cases, a flat (equal) support rate per hectare in the EU implies almost no change in the "uneven" distribution of support among farms at EU level⁸. This is because such a flat rate per hectare links the distribution of payments to the distribution of land among beneficiaries, and land is not evenly distributed between farms but tends to be as skewed as the distribution of production in the EU (which is the historic reference for payments).

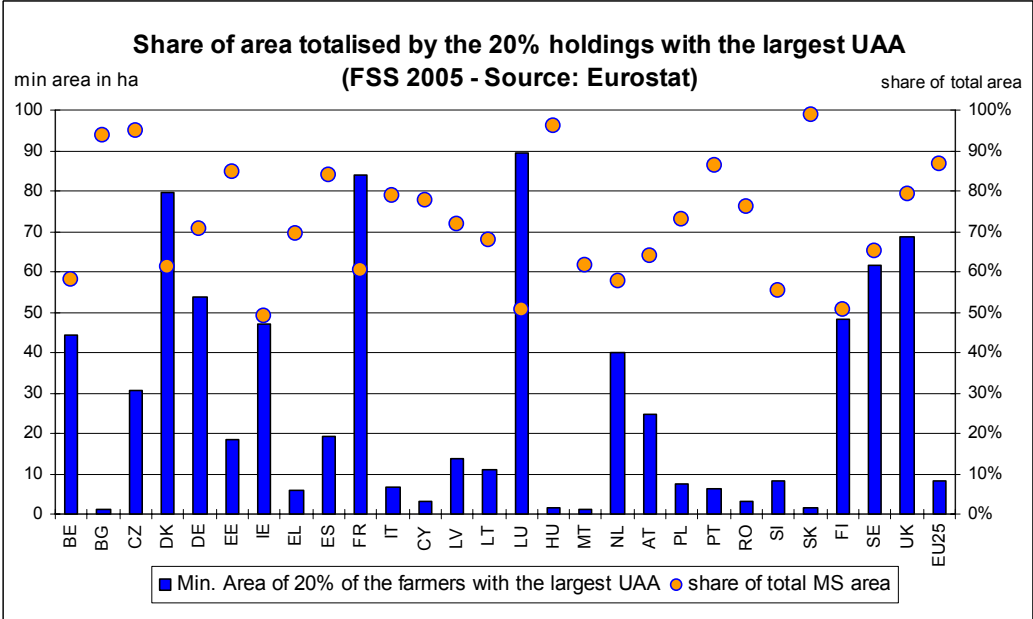
Figure 7: Redistribution among MS with an EU-wide flat rate



Source: DG AGRI calculations.

In the case of an EU-wide flat rate payment based on all Utilised agricultural area (UAA), the distribution of direct payments would correspond to the distribution of area in the EU-27 (Figure 8), i.e. in 2005, 20% of the farmers with the largest area had 8.2 ha and 87% of the EU27 utilised agricultural area.

Figure 8: Distribution of payments for EU wide flat rate on all UAA (2005)

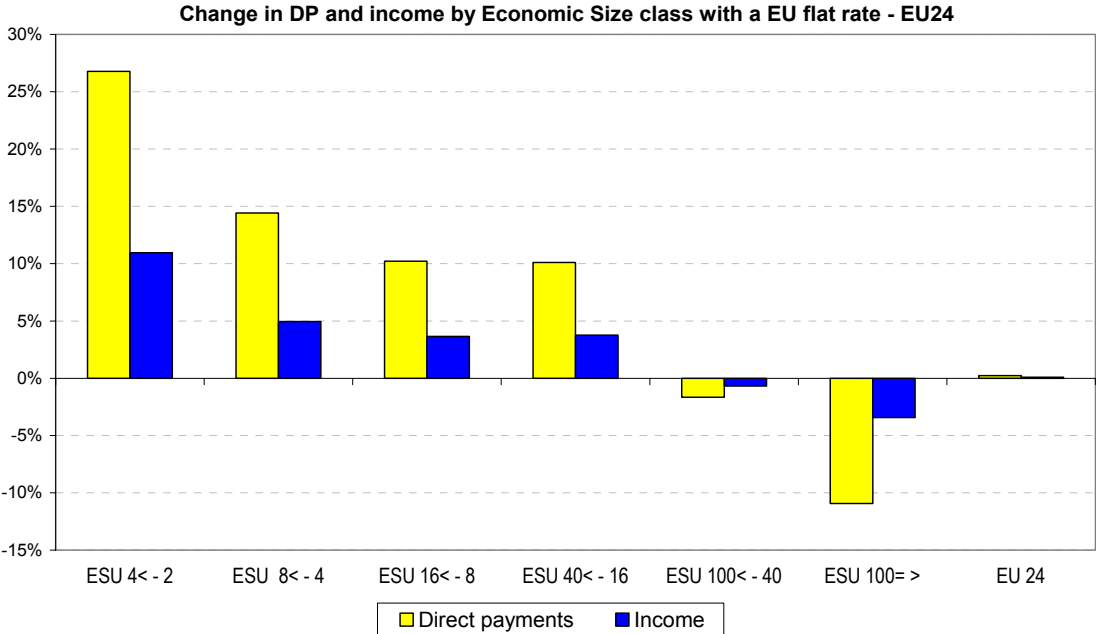


Source: Eurostat, Farm Structure Survey

⁸ Results are based on simulations made using FADN data.

Despite the low impact on the overall distribution, one expected effect of a EU-wide flat rate would be the reallocation of direct payments by economic size of farms. Simulations made with FADN data showed that payments per hectare and income per Annual worker unit (AWU) would decrease in the largest farms and increase in the lower size classes (Figure 9).

Figure 9: Effect of an EU-wide flat rate on economic size of farm classes



Source: DG AGRI EU FADN simulation (size classes based on ESU (European Size Units))

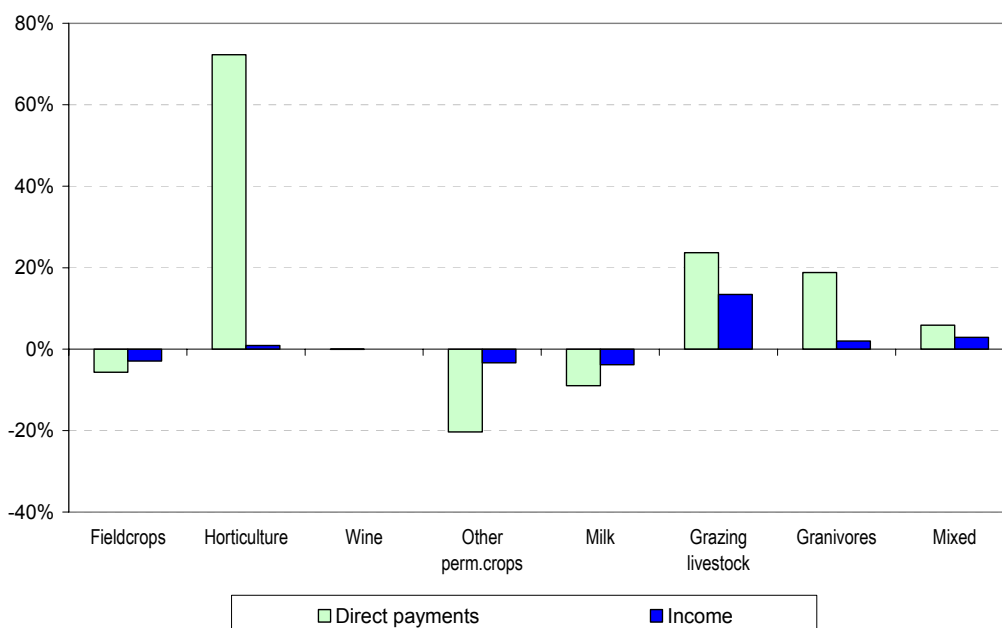
Another important aspect assessed using FADN data is the extremely different impact that an EU-wide flat rate would have on the various farm types. Both income and direct payments in milk specialists, field crops and other permanent crop specialists are negatively affected, whereas impacts on grazing livestock and granivore specialists, and horticultural farms⁹ would be positive. Impacts on the different types of farming differ substantially also among MS¹⁰ (Figure 10).

The impacts showed so far put in evidence that this option would imply a fundamental reform of the SPS, which goes beyond the scope of the Health Check exercise, but it has been analysed because it has found some proponents in the context of the public debate. Indeed, an EU-wide fat rate brings no benefits in terms of the declared objectives for adjustments to the SPS

⁹ Note that although the impact on horticulture seems large in terms of direct payments per farm, the average area in horticulture is very small, and thus the impact on income is small.

¹⁰ This effect regards MS applying the historic and MS applying the hybrid model of the SPS since the bulk of the envelope of payments distributed on a historic basis in hybrid models tends to come from beef, sheep and dairy.

Figure 10: Impact of EU flat rate on different types of farming



Source: DG AGRI EU FADN simulation

Option 2: SAPS for all MS

The Single Area Payment Scheme has been introduced in the new MS as a preceding step to the introduction of the SPS. This was justified by very the different and much lower levels of support to agriculture in the new MS, the lack of previous payment and area references and the consequent absence of control systems. As a transitional system, SAPS was designed to assist the integration of new MS in a smooth manner, given the very significant differences between general and rural economies within new MS and with respect to EU-15.

As the deadline for the expiration of SAPS approaches, and new MS consider their integration into the SPS, the possibility of extending this deadline to the end of the present financial framework, if they so wish, seems a natural choice. This specially if, at the same time, EU-15 MS were allowed to review their SPS implementation and opt to move towards a more flat rate model.

As a transitional scheme, SAPS clearly performed its intended role. Nevertheless, at times, SAPS has been considered as a system which should be applied to all MS, implying an inverse move from SPS to SAPS. Although such suggestions are not wide spread, they tend to confuse the policy debate since they fail to focus on the main difference between SPS and SAPS. In other words, the fixed entitlement reference of the former and the varying area reference of the latter.

The SAPS is a flat rate area payment per hectare at MS level, calculated by dividing the annual national financial envelope of the MS by the agricultural area under SAPS in a given year. While this is acceptable as a transitional scheme, as a permanent scheme it would contradict the philosophy of decoupled support because it would not be a system based on fixed entitlement references.

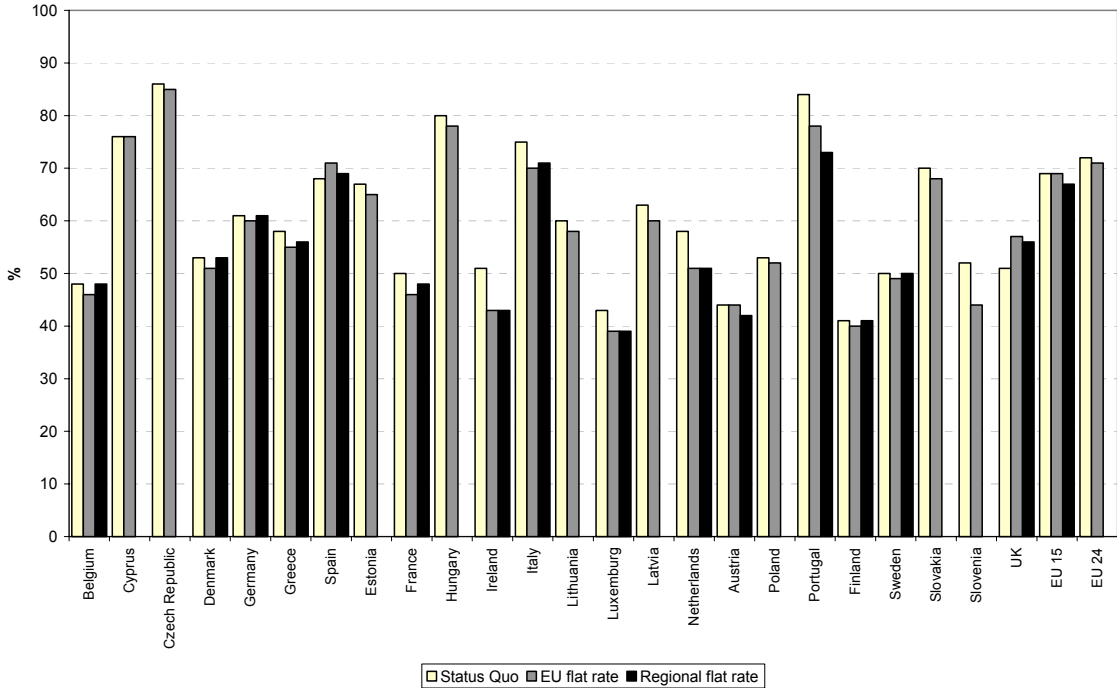
In terms of its impact on land values¹¹ and transfer efficiency, a SAPS for all MS would lead to substantial impacts on land prices within MS (due to redistribution among farmers) and higher capitalisation of support, resulting in decreased transfer efficiency. Due to the fact that the SAPS is an area payment that does not separate payment entitlements from land, it leads to a particularly high degree of capitalisation of support in land values. The distribution of payments among farms would mirror that of land and would, thus, continue to be skewed.

Option 3: regional flat rates per eligible hectare

Regional flat rates per eligible hectare may be perceived as more equitable than a regional model as they provide for the same per-hectare support for all farmers within a region.

However, like the EU-wide flat rate, a regional flat rate per eligible hectare does not change much the distribution of support among farms in the EU. As expected, it was observed that the share of direct payments received by the 20% beneficiaries with the highest direct payments would remain unchanged in the EU-15 with a regional flat rate, while in the other MS the share varies, although less than under option 1 (EU-wide flat rate)¹². In other words, in a number of MS improvements towards a more "even" or "uniform" distribution would be expected, with a reallocation of direct support from larger to smaller economic size classes of farms. These same results were obtained using other measures of range and concentration of direct payments (e.g. Gini coefficients)¹³.

Figure 11: Share of direct payments received by 20% of beneficiaries¹⁴



¹¹ An ongoing study "Review of Transitional Restrictions Maintained by New Member States with Regard to the Acquisition of Agricultural Real Estate" will provide some information on land price developments in the new MS.

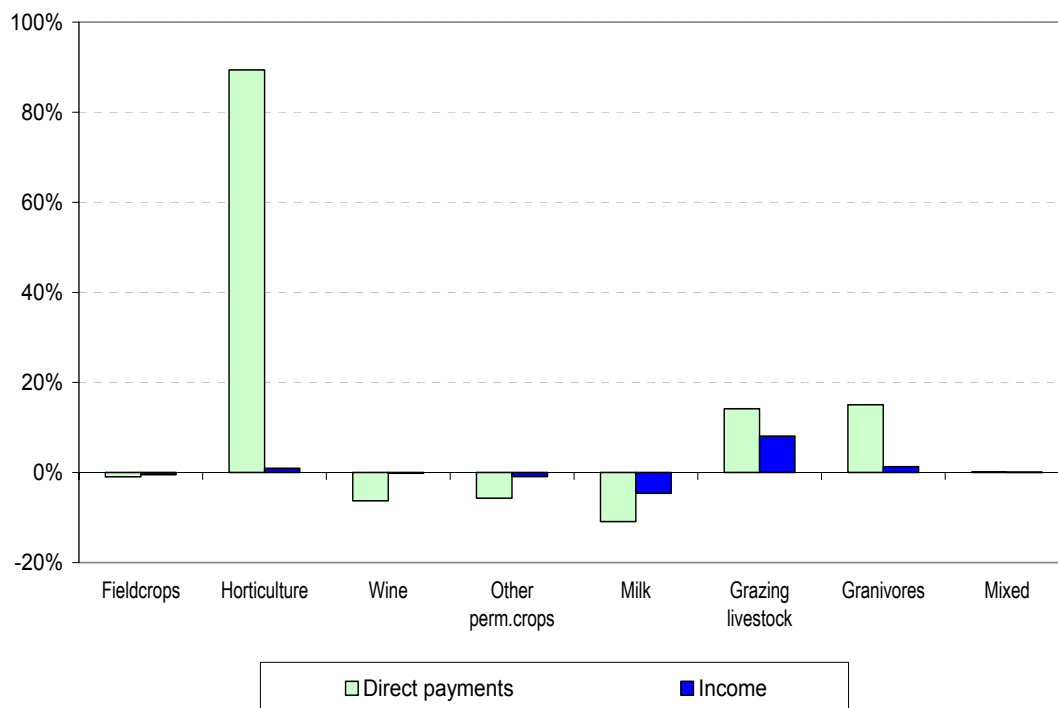
¹² However, it has to be noted that this is also due to the fact that only the EU-15 were regarded by this kind of flat rate.

¹³ For details see Annex F " Microeconomic (FADN) analyses" of the HC Impact Assessment, in: http://ec.europa.eu/agriculture/healthcheck/ia_annex/fl_en.pdf.

¹⁴ The slight difference for the EU-15 distribution as compared to figure 1 is due to different data sources: CATS for figure 2, FADN for figure 10.

The impact on this model on different farm types was also assessed, but it seems less pronounced than Option 1 (Figure 12). Milk specialists and other permanent crop specialists are negatively affected¹⁵, grazing livestock and granivore specialists and horticulture are positively affected.

Figure 12: Impact of an EU regional flat rate on different types of farming



Source: DG AGRI EU FADN simulation

A regional flat rate per eligible hectare would probably increase the number of beneficiaries and redistribute funds from "old" beneficiaries to newcomers.

A general flat rate could have significant redistribution impacts even within the same MS if its farm structures differ widely. However, such impacts could be mitigated with a targeted move towards a flat rate that takes into account such differences by harmonising payments in a regional context¹⁶. This can be done by dividing the total level of reference payments of the historic model in a region by the eligible area in this region.

In a move towards a regional model, the extent to which land remains "naked" becomes a crucial parameter. A regional flat rate per eligible hectare reduces the percentage of "naked land" leading to more capitalisation of support in land values.

¹⁵ In the case of wine, as a reminder: whatever the model (historic, hybrid or regional), vineyards were not eligible to direct payments in the reference period used for these calculations, and had no direct payments except for the area to produce dried raisins (important production in Greece). Moreover it is not rare that olive trees are associated to wine production. Hence, farms producing exclusively wine are not affected by the negative impact on direct payment shown in the graph. Due to the reference period used, these calculations do not take into account the consequences of the Council agreement on the wine reform achieved on 19/12/2007 which will allow eligibility of all vines from 01/01/2009 and allow grape wine producers to be granted entitlements.

¹⁶ This realisation seems to reflect the choice of England, where the ratio between the highest and the lowest flat rate is 7 to 1.

Option 4: regional flat rate per entitlement

It is possible to mitigate the undesired consequences of a redistribution of support favouring landowners and leading to new beneficiaries while still keeping the desired impact of more even payments among active farmers. This could be achieved with a move towards a flat rate that is based on the existing entitlements, e.g. dividing the total value of payment entitlements within a region by the number of existing entitlements.

With respect to overall redistributive effects, the effects of a regional flat rate per entitlement should be similar to those of a regional flat rate per eligible hectare¹⁷. However, there are some notable differences.

A flat rate per entitlement would not change the degree of capitalisation of support in land values with respect to the Status quo, since the amount of "naked land" would remain the same. The share of support of landowners and farmers would not be affected and the transfer efficiency should not be reduced. However, the existing capitalisation of support would still mean that the redistribution of support would lead to adjustments to farmers' land values under this option. Nevertheless, like in option 3, the impact on land values would be mitigated by the possibility to design appropriate regions.

6. Concluding remarks

The historic model of the SPS and optional partially coupled support enabled the smooth transition to decoupling in MS whose variable production structures implied a need for successive integration into the SPS in 2003. However, the time now seemed ripe to allow MS to consider a targeted adjustment towards a flatter rate for payments, which would address the societal concerns of unequal distribution of payments between farmers.

The legislative proposals tabled by the Commission contain 4 alternative ways of adjusting the current SPS implementation. MS applying the historic model may approximate the unit value of entitlements, setting a "regional flat rate per entitlement" (option 4). A second alternative allows MS applying the historical model to change over to the regional model, defining a "regional flat rate per eligible hectare" (option 3); while the third foresees that MS applying the hybrid model may review their decisions. Adjustments are optional so the last alternative is not to make any change (option 0).

In order to respect the general principles of Community law and the objectives of the CAP a series of conditions are set on the way adjustments should be introduced. Essentially they aim at allowing farmers to adapt reasonably to changes in the level of support, e.g. the definition of pre-established steps during an adequate transition period, the difference between starting and final values reductions.

The options MS will choose to adjust their SPS models will set the pace and dimension of adjustments, although changes in other CAP instruments may have a role as well. For example, the progressive component of modulation could be a way of addressing the uneven distribution of payments, while specific concerns and solutions could be tackled via changes in ex-article 69 of Reg. 1783/2003 (now article 68). The new provisions, indeed, may allow MS to use part of their available SPS support to target particular sectors and regions with specific needs. The shape and relative importance of both these instruments will be known once MS will reach a final compromise on the HC.

¹⁷ Due to technical complexities the specific analysis was not possible on the basis of FADN.

The presence (or not) of "pillar two" type of structural measures in article 68, or/and provisions allowing to retain certain coupled measures under specific conditions, as well as the actual amount of resources that will be shifted to the second pillar through modulation, will be determinant factors for the future. Firstly, influencing the debate around the budget review, and secondly, and obviously, defining the starting point.

On one side, a strong modulation (both basic and progressive) of funds to the second pillar could be seen much more acceptable by society, and by those in favour of much targeted rural development instruments. Although, due to complexities, leakages and implementation costs they may find resistance from farmers (and governments).

On the other side, a "heavy weighted" Article 68 will imply a broader Pillar I and will put much more pressure on the issue of how to justify support to agriculture with respect to a much stronger Pillar II in front of the overall society. The reform process would be then more gradual leaving more time for adjustment to farmers.

7. References

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