HOW DECOUPLED IS THE EUROPEAN UNION'S SINGLE FARM PAYMENT?

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1 Introduction

Measures agreed by the Council in June 2003, envisage a basic reform of the Common Agricultural Policy (CAP). With the new measures the CAP moves towards producer (income) subsidies instead of subsidizing production. Reduction of institutional prices, and replacement (of the significant part) of the existing and certain newly introduced direct payments with a single decoupled payment all point to that direction. The new payments are based on reference data, and because of the already compulsory cross-compliance, they are available only on condition that certain environmental, animal welfare food security and quality standards are met. The scope of rural development measures is widening and as modulation provides an opportunity to re-allocate resources, the total fund available for rural development is growing. If the CAP budget threatens to exceed the budget ceilings agreed in October 2002, a new financial discipline can be invoked to scale down payments.

Our paper focuses on the key element of the reform: on the single farm payment. The basic aim was to decouple direct payment from production decisions. Because of the widespread agricultural policy reforms (support producers with the least possible distortions) and of the on-going WTO negotiations, this is an issue attracting significant attention on behalf of agricultural economists. The principle is that policies should not distort decision making by producers and markets should adjust as if there were no policy in place. Different tools and different methodologies have been employed in the effort to better understand and rank policy measures in terms of their production and trade effects. Most of the literature classifies measures based on implementation criteria. Our paper assesses the decoupled nature of the single farm payment (SFP) based on WTO and OECD criteria.

Our paper is structured as follows. Section 2 describes the concept of the Single Farm Payment. Section 3 overviews the most important decoupling concepts. In Section 4 we confront the single farm payment (SFP) with the decoupling criteria described in Section 3, and finally there are some concluding remarks (Section 5).

2 The single farm payment as a key element of the 2003 June CAP reform

The most radical feature of the June 2003 CAP reform agreement is the decoupling of subsidies from production and their replacement by one farm payment, known as the Single Farm Payment (SFP). The new payments are based on reference data, and because of the already compulsory cross-compliance, they are available only on condition that certain environmental, animal welfare food security and quality standards are met. Through the instrument of modulation member countries can reduce the SFP for bigger farms up to 5 percent in order to finance additional rural development measures. If the CAP budget threatens to exceed the budget ceilings agreed in October 2002, a new financial discipline can be invoked to scale down payments.

Table 1: Maximum rate of coupled support, selected products

Supported product	**Maximum rate of coupled support (%)**
Cereals and oilseeds	25
Rice	42
Protein crops (supplementary)	100
Sheep	50
Beef	
Option 1	
Slaughter Premium	40
Suckler Cow Premium	100
Option 2	
Slaughter Premium	100
Option 3	
Special Beef Premium	75

Decoupling has been made less strict than the European Commission originally proposed. Member states can choose for a delay of its introduction until 2007 instead of 2005. More

important, member states are enabled to limit decoupling of income payments for a number of products, as they have the possibility to maintain a proportion of coupled policies (See Table 1).

As a new element the 2003 CAP reforms have provided a large space for national manoeuvre. The following elements of the reform fall within national competence:

- possibility of partial decoupling;
- determination of the date of introduction (2005-2007);
- re-allocation a part of the support through the national envelope;
- limited freedom to select the single farm payment (SFP) calculation model (historic, regional or hybrid).

As regards the SFP model there are two basic approaches. The *historic model* creates entitlements to support based on the average level of subsidies claimed in the livestock and arable sectors during the 2000-2002 reference period. The number of entitlements allocated to each farmer is set equal to the average area of land giving rise to subsidy plus all pasture land during that same period. The value of each of these entitlements is established by dividing the average amount of subsidy claimed by the farmer by the number of entitlements awarded.

The *regional (area based) model* operates by basing entitlements to farmers on the area of eligible land that they declare in their 2005 Integrated Administration and Control Scheme (IACS) returns. The value of all entitlements within a region would be set at a single, common rate. However, it is possible to create a third approach to decoupling by combining the historic and regional approaches into what is termed a *hybrid model*. This can be done in different ways to create various forms of hybrid. However, there are two broad hybrid classes – *horizontal* and *vertical*. A horizontal hybrid is created by putting a set proportion of the decoupled budget arising from each coupled regime into a regional element, with the balance of the budget allocated according to historical claims patterns. A vertical hybrid is created by

putting specific coupled schemes, or proportions thereof, into the area-based component, with the balance allocated according to historical claims patterns. Also the ratio of regional and historical elements of hybrid models can vary in later years. If the ratios do not change in the future the model is static, while if the model incorporates changing ratios the model is dynamic. Models chosen by member states are summarized in Table 2.

Table 2: National implementation models

	Historical	Regional	Static hybrid	Dynamic hybrid
Maximum possible coupling	F			
Partial decoupling	A, B, GR, I, NL, P, E, GB (Scotland)	M, SLO	DK, S	SF, D
"Full" decoupling	IRL, GB (Wales)		L, GB (NIRL)	GB (England)

Source: Halmai, 2004

5 Basic questions of decoupling

5.1 Different concepts of decoupling

The term decoupling is used for agricultural policy measures that do not affect relative prices of agricultural commodities or of the inputs used to produce them.

According to the final communiqué of OECD agricultural ministers' 1987 meeting market forces should be left to determine equilibrium prices and quantities. Policies should not distort decision making by producers (or consumers) and markets should adjust as if there were no policy in place. This restrictive concept of decoupling corresponds to the definition of a *full decoupling* given by Cahill (1997). (The agricultural policy measure "does not influence production decisions of farmers receiving payments, and it permits free market determination of prices for all producers receiving or not payments". This approach focuses on the adjustment process and not only on equilibrium values. Under this definition, the policy can be considered fully decoupled if the demand and supply functions remain unchanged after the introduction of the measure in question. There is no change in equilibrium prices and

quantities, and there is no difference in the response of the market to any exogenous shock arising on the demand or the supply side.

Requirement of decoupling is an important element of rules on domestic support in the *WTO Agreement on Agriculture* (AoA). The so-called *green box* measures (for details see AoA Annex II) were not taken into account when the Aggregate Measure of Support (AMS) was calculated. A key feature of these measures is that they *have no, or at most minimal, trade-distorting effects or effects on production*. The support excluded from reduction commitments shall be provided through a publicly-funded government programme (including government revenue foregone) not involving transfers from consumers (Annex II, points 2-13); and the support in question shall not have the effect of providing price support to producers; and they should also comply with certain subsidy specific criteria. International literature usually focuses on direct income support for producers. Annex II of the AoA defines decoupled income support in the following way:

- Eligibility for such payments shall be determined by *clearly-defined criteria* such as income, status as a producer or landowner, factor use or production level in a defined and fixed base period.
- The amount of such payments in any given year *shall not be related to, or based on, the type or volume of production* (including livestock units) *undertaken by the producer in any year after the base period.*
- The amount of such payments in any given *year shall not be related to*, or based on, the *prices, domestic or international*, applying to any production undertaken in any year after the base period.
- The amount of such payments in any given year *shall not be related to*, or based on, the *factors of production employed* in any year after the base period.
- *No production* shall be *required* in order to receive such payments.

These are the most commonly referred criteria of decoupling. (In fact, logics of the Agreement suggests, that all measures listed in Annex II, including the stockholding for the purpose of food security, domestic food aid, support for income security etc., can be classified as decoupled.)

The *AoA defined the criteria of decoupling based on the nature and design of the measures.* However, the same policy may result in different effects. E.g.: the same policy may result in different effects when implemented in different locations (Gohin – Guyomard – Le Mouël, 1999).

In fact, the impact on production and trade of a given policy is of great importance. It is not enough then to analyse only the design of a decoupled policy. It is essential to explore the effects of different agricultural policy measures having regard decoupling.

OECD defines decoupling in terms of policy effects (OECD, 2001a). This approach results in more restrictive definitions, and makes difference between full and effective full decoupling. (The following descriptions rest strongly on OECD analyses.)

According to the equilibrium approach decoupled measures do not have trade and production effects or they are at most minimal. *Effective full decoupling* does not result in a production level exceeding the one without the applied measure (Cahill, 1997). The measure may affect decisions of producers but does not result in higher production.

In fact, the package of tightly coupled measures should be examined. The package could have a zero net effect on equilibrium prices and quantities, even if the individual measures have a significant impact on equilibrium prices and quantities. (This is the case, e.g. when the production effect of a coupled payment is offset by a quantity restriction. A similar situation occurs when the same measure covers several products and the effect may be different product by product.)

An effective fully decoupled policy package (with a zero net effect on production) is *not necessarily fully decoupled in the restrictive sense*: they may have significantly different supply responses to exogenous shocks. (In this restrictive sense, zero market price support does not mean full decoupling of price support measures.)

The term effective in that way refers to the less restrictive equilibrium concept of decoupling. Full decoupling however, reflects the more restrictive adjustment concept. (Different concepts of decoupling are summarized in Table 3.) According to Cahil (1997) a policy is *fully decoupled* if it does not influence production decisions of farmers receiving payments, and if it permits free market determination of prices. That is, full decoupling is a very restrictive concept that requires no change in the way farmers and consumers take decisions.

Table 3: Different concepts of decoupling

DECOUPLED DESIGN
– The measure is part of a government funded program. – The support in question shall not have the effect of providing price support to producers. – The measure should also comply with certain subsidy specific criteria: payments are based on clearly-defined criteria; shall not be related to, or based on, the type or volume of production undertaken by the producer in any year after the base period; shall not be related to the prices applying to any production undertaken in any year after the base period; shall not be related to the factors of production employed in any year after the base period and no production shall be required.
DECOUPLED EFFECT
Full decoupling
There are no production and trade effects.
Effective full decoupling
Does not result in a production level exceeding the one prevailing without the measure.

4.2 Possible impacts of agricultural policy measures

It is very difficult to rank production and trade impacts of alternative policies. Countries implement a complex system of support measures, making difficult the empirical analysis.

The *mechanisms by which policies can affect production and trade* (OECD, 2001a) could be grouped as:

- *Static effects.* Whenever policies affect the prices of an agricultural output or input, there is a static production and trade effect. However, policies affecting only farm income — and not affecting prices — may also have static effects on production whenever markets work imperfectly or farmers make decisions under binding constraints.
- *Effects under uncertainty.* If farmers are risk averse, all policies reducing risk and/or increasing farm income may have additional effects on production and trade.
- *Dynamic effects.* Investments made in a supported framework affect production decisions in the following years. In addition, if there is uncertainty about future agricultural policies, present policies and government decisions may affect farmers' expectations of future policies and through these channels may affect current production decisions. Complex policy packages could easily affect farmers' expectations and the responsiveness of farmers to market shocks and policy changes.

The static relative price effects have a decisive role in assessing the effective degree of decoupling. The effects associated with risk and dynamics are more likely to be significant for assessing the degree of responsiveness with respect to external shocks.

All these static, dynamic and risk mechanisms are cumulative and can occur simultaneously in response to a single measure. Under this broad framework of analysis, it seems difficult to design a policy measure not having some production or trade effects.

4.3 Measuring the degree of decoupling

The concept of the degree of decoupling is an attempt to measure the production and trade impacts of different measures (OECD, 2001a). All policies affecting relative prices of

inputs or outputs have a direct effect on producers' decisions and they affect resource allocation.

It is very difficult to explore the above mentioned effects. Based on a partial equilibrium model Gohin, Guyomard and De Mouël (1999) conclude that *only payments based on fixed product-specific inputs are fully decoupled*. Payments based on the use of land are coupled to the extent they affect the allocation of land.

Under the Policy Evaluation Matrix (PEM) pilot project, the OECD (1999) shows that *the effects on production of payments based on the most rigid input are smaller than those induced by payments based on output*. But both are smaller than those induced by payments based on the most elastic input. This result is consistent with Gohin *et al*. (1999) and with the empirical studies of Cahill (1997), Moro and Sckokai (1998), Guyomard *et al* (1996) and Lin and Washington (1997).

Findings of the OECD PEM model (OECD, 2003a) show that payments based on the use of variable inputs and those based on output (market price support and output payments) are the categories with the greatest impact on production and trade. Conversely, *payments based on acreage are the most decoupled form of support.* Furthermore, the impact of such payments is all the lower where there is no obligation to grow specific crops on eligible land in order to receive the support. Finally, the study also reveals a positive correlation between the degree of decoupling of the relevant categories of measure and their efficiency in terms of income transfer to producers.

The latest results of the PEM model show that payments based on historical entitlements have the smallest market distorting effects, which are significantly lower than that of area based subsidies. This means that the degree of decoupling is the highest for this category. The latest sensitivity analyses (carried out in 2005) show similar results.

These analyses suggest that more decoupled forms of agricultural support are less distorting and they provide more efficient income transfer than the traditional output based subsidies. (Martini – Anton – Dewbre, 2005.)

4 Assessment of the SFP based on WTO and OECD decoupling criteria

In this chapter we confront the single farm payment (SFP) with the decoupling criteria described in Section 3.

4.1 Assessment of the SFP based on WTO decoupling criteria

During the midterm review of the CAP WTO concerns became crucial. The Commission (2002) acknowledges that there is a need to preserve farming incomes in a less trade distorting way, and decoupling of direct payments is seen the solution to that problem. The introduction of the SFP results in a reduction in the link between the payments and production. The EU argues that the payments do not distort trade and therefore should be placed in the green box.

The *WTO* Agreement on Agriculture (AoA) defines the *green box* criteria in the following way.

1. They have no, or at most minimal, trade-distorting effects or effects on production.

As the previous section suggests, payments based on acreage (and especially those based on historical entitlements) are the most decoupled forms of support. In that way they have no or at most minimal trade and production distorting effects. Furthermore, the impact of such payments is all the lower where there is no obligation to grow specific crops on eligible land in order to receive the support. *SFP meets both criteria*.

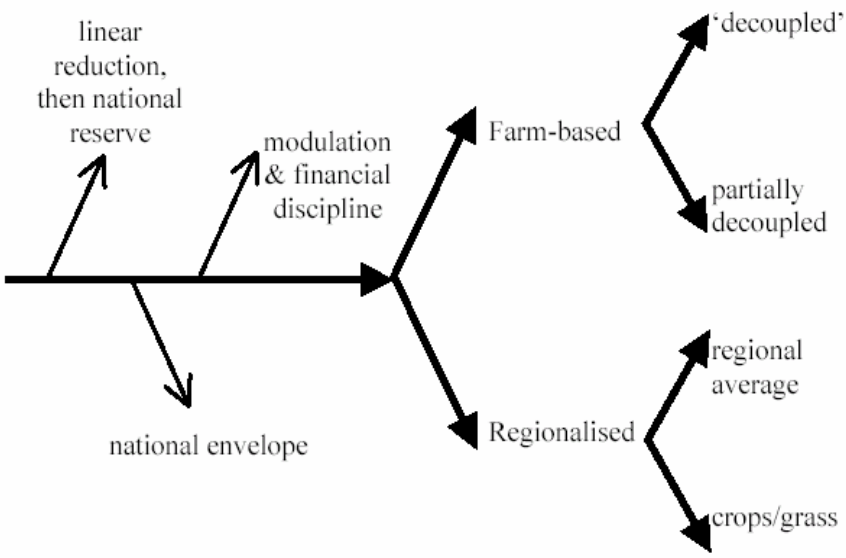
2. As the SFP is *financed from the EU budget*, it meets the criteria that payments shall be provided through a publicly-funded government program not involving transfers from consumers.

3. The SFP does *not* have the effect of providing *price support* to producers.

4. Payments should also comply with certain subsidy specific criteria. As regards direct income support Annex II of the AoA defines decoupled income support in the following way.

4a) Payments are based on clearly-defined criteria.

It was expected that single farm payment brings a significant simplification of the support system. However, different de-coupling models and the possibility of partial de-coupling have resulted in a *very complex system with a wide range of national diversities* (See Figure 1).



Source: Swinbank, 2005.

Figure 1: Overview of the SFP system

What is more, rather than determine payments for the farm on the basis of that farm's historic claims, regionalized schemes can apply. All of the money that would have been paid in a particular region (or country) can be pooled, and then paid on a flat rate basis on all eligible land in the region (with or without combination of arable and livestock payments) (Swinbank, 2005). The picture is more complicated if a hybrid of these to basic systems is applied.

4b) Payments shall not be related to, or based on, the type or volume of production undertaken by the producer in any year after the base period.

There are *two shortcomings* of the SFP as regards this point. First, the farmer in subsequent years would have to remain in agriculture and show that the land is still farmed or kept in good agricultural and environmental condition. Second, land on which fruit and vegetables were grown, or which was planted to permanent crops (e.g. orchards) could not be used to claim the SFP.

4c) Payments shall not be related to the prices applying to any production undertaken in any year after the base period. (See above at green box criteria.)

4d) Payments shall not be related to the factors of production employed in any year after the base period and no production shall be required.

It is very difficult to design a policy which does not influence the future use of inputs. Even when payments are based on historical acres and yields, expectations of the eventual reassessment of those bases can cause farmers to retain land in production of particular crops (See e.g.: OECD, 20005). Similarly, safety-net policies that reduce the downside risk of fluctuations in income clearly can have an effect of keeping resources in farming (Josling, 2004).

4.2 Assessment of the SFP based on OECD decoupling "criteria"

According to the equilibrium approach decoupled measures do not have trade and production effects or they are at most minimal. *Effective full decoupling* does not result in a production level exceeding the one without the applied measure. The measure may affect decisions of producers but does not result in higher production

Both the results of the PEM analysis (OECD, 2005) and analysis on transfer efficiency (OECD, 2002) suggest that the *SFP seems to be an efficient choice*. It is efficient as it

provides only minimal distortions and can meet the simultaneous requirement of income support of domestic producers and minimal distortions with the smallest cost.

As even decoupled programs can have indirect effects on farm production decisions and aggregate output, the system of *SFP can not be considered as fully decoupled*.

7 Concluding remarks

During the mid-term review the European Union (EU) made a significant step in the direction of a more transparent and less trade distorting agricultural policy. The 2003 reform of the CAP constitutes a major change in the way direct payments are made in the EU. The introduction of the SFP results in a reduction in the link between the payments and production. The EU argues that the payments do not distort trade and therefore should be placed in the WTO green box as a decoupled income support. Based on our analysis, this seems to be possible, as the SFP meets not only the current WTO (design based) criteria of decoupling, but can also be qualified as effective fully decoupled system using the OECD terminology.

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