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## A vision of the future of the Common Agricultural Policy

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### Abstract

The reforms proposed by the authors intend to ensure the economic, social and environmental sustainability of rural regions and place agricultural policy on a fundamentally different basis. The scope of community and state intervention will change. Payments linked to production will be cancelled and the provision of public goods will be rewarded instead. At the same time, measures aimed at enhancing the viability of the rural economy and society will become more significant. The depth of the changes calls for a new name expressing better the new approach, so instead of CAP the use of a more justified name is suggested: Common Agricultural and Rural Policy (CARP). This paper outlines the vision and the major proposals we suggest to meet the above mentioned goals.

### Keywords

CAP, reform, public goods, Common Agricultural and Rural Policy, vision.

### Preface

In the summer of 2007, a few experts gathered to talk about the future of the Common Agricultural Policy (CAP). Although there was an agreement that Hungary is a net beneficiary of the current system, in the long term (after 2013) the CAP undoubtedly has to be changed. The evolution is imperative for numerous reasons. The question is whether the Hungarian approach should be conservative, defensive – no change is necessary – (in which case the country would suffer the changes), or offensive. In the latter case Hungary should have its own proposal about the future of the CAP, which has to be a viable vision, tempting or at least acceptable for most of the Member States (MS). We prefer the second option. Through endless discussions an agreement was reached on the fundamental objectives of the proposed new common agricultural and rural policy. These are: sustainability, market-orientation, provision of public goods, improving competitiveness, focusing on rural areas, and simplicity and transparency<sup>3</sup>.

### Introduction

The CAP and especially the CAP-related expenditure in the common budget has been debated for a long time. The origins of the problems go back to the objectives of the CAP set out in the Amsterdam Treaty (modernization, income security, market stabilization and food security). Although these agricultural policy objectives have remained important, there has been a significant change in emphasis.

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Agricultural production has had significant objectives beyond direct food production (multi-functionality) from the very beginning in the EU member states: food safety, animal welfare, biodiversity, preserving the landscape, environment protection etc. As agriculture and forestry cultivate more than 80% of the European land surface, these multifunctional elements serve and will increasingly serve essential, cross-border externalities. All of these (that is, the fundamental factors of the European agricultural model) can be jointly classified as European public goods.

Tensions over the CAP budget can be explained by the fact that the current expenditure levels and mechanisms do not reflect the above mentioned shift in priorities. Not even the CAP reform introduced in 1992 and the further reforms in 2000 and 2003, and the modifications as part of the Health Check have brought the expected results. Although traditional market support (intervention, export support) has decreased, the new direct payments (which are mainly area based) have increased the CAP expenditure and the system has become more complicated than ever, and the significance of the second pillar has remained limited.

However we have to accentuate at least two facts:

- on the one hand, through the reduction of price support, the CAP reform increased the system's efficiency and decreased the consumers' burden;
- on the other hand, CAP expenditure has increased at a slower rate than the common budget, so its budgetary share is decreasing. (It will be slightly above 40% by 2013, while the percentage of the first pillar expenditure will be 32%.)

In spite of changes to the CAP, i.e. the reform processes up to now, the present system of the CAP is essentially criticized along the following lines:

- Decoupling (i.e. level of payments becomes independent of production (decisions)), a central element of the reform, is only limited;
- Direct payments are based on historical amounts which represent neither the needs of individual farmers nor the value of public goods produced;
- (Partially) decoupled payments may have significantly less distorting effect on the product markets. However a large portion of direct payments can get capitalized into land prices or land rental fees, i.e. it can distort the input markets and, at the same time, it can have an unfavourable effect on the transfer ratio of agricultural subsidies (i.e. ratio of one unit of subsidy received by the agricultural producer as opposed to the favourable position of the land owners);
- In a paradoxical way the reformed system has become a lot more complicated and bureaucratic than the original model. It may result in significant redistribution as well;
- The elements of quantitative regulations may still cause disorder, the mandatory set-aside is still in force and the elimination of the milk quota may be placed on the agenda only after 2013.
- In spite of the declarations the role of rural development has remained limited.

Furthermore it is worth mentioning that the system of CAP has been enlarged by ten new member states since 2004 (and two more since 2007). As far as support is concerned, significant disparities have evolved which have handicapped the new member states: while the large amount of payments under the first pillar are fully financed from the common budget in the case of the wealthier member states, the share of the poorer new member states is much smaller. Further difficulties can be expected because of the several new challenges the CAP (and in general the EU) faces (globalization, climate change and energy safety). At present, the main challenges for European agriculture and the EU's Common Agricultural Policy are the following:

- Due to the gradual but continuous liberalisation of the international agricultural markets imports from third countries continue to grow, market competition intensifies, and competitive pressure increases;
- Despite of the debate over the CAP, European society continues to demand the multi-functional services provided by rural areas. Provision of these rural services represents an implicit taxation for European producers, as well as a competitive disadvantage. Production of public goods, therefore, presumes budgetary financing: either from the common or from national budgets.
- Turning to climate and energy, agriculture could adapt various mitigation measures (substitution of fossil energy through biofuel production, increased carbon storage etc.), but agriculture will also have to adapt (growing seasons will change, agriculture will have to cope with different pests and diseases, there will be a shift in the geography of crops, possible water shortages etc.);
- The budget review may further limit the CAP's financial possibilities. Under the consultation process of the budget review, most of the contributions were very critical as regards the CAP and its common financing. Most of the contributions stress that European agriculture should be competitive internationally and should be able to answer the challenges of climate change, food safety and quality requirements. Most of the contributions urge significant reduction of agricultural expenditure and radical reforms especially as regards the first pillar. Several contributors would like to see the first pillar expenditure moving to the second pillar. There is no consensus on the future of direct payments (continue or abolish).

We can argue that in spite of the substantial changes, the present system of the CAP is still unsustainable. There is a widespread consensus that further reforms are necessary in order to accommodate the agricultural policy to the current priorities. Opinions however, differ on the extent of the reforms. Based on the literature the following options can be outlined.

- a) Consolidation, further corrections. Having approved the reform decisions, their implementation is a great challenge. Implementation of the decisions approved as a result of the Health Check (despite of their imminent contradictions) suggests a more efficient agricultural system. However, this reform (even it has several forward looking measures) cannot result in a sustainable CAP. Further changes are inevitable.
- b) Coherent (radical) reform. A radical deepening of the reform process could focus on sustainability from environmental, economic and social perspectives too. A Common Agricultural and Rural Policy, which respects both environmental values and competitiveness creates a chance for the evolution of a sustainable system. A radical reform could ensure the continuation of the common financing. However, if agricultural support financed from the common budget decreases, digressive support or national co-financing should be considered for Pillar 1.
- c) Re-nationalisation. The system of fully or partially renationalised direct payments forms an other alternative: national governments would have nearly full autonomy as regards the allocation of direct payments; however, they should respect EU competition policy and certain CAP regulations.
- d) Total liberalisation is also possible in theory. The common policy no longer functions and the same happens to the national policies. The implementation of this option would have drastic consequences in regions where agriculture is less competitive. Most of the farmed landscape would lose its maintainers.

Abolishing or radically lowering the common financing of the CAP would only result in a reduction in the common budget. Most likely, the re-nationalisation would simultaneously become possible, i.e. agricultural expenditure would increase within the national budgets. Should the financing of the agricultural policy be renationalised, individual member states could support their agriculture to very different degrees. This would jeopardise the smooth operation of the internal market and social-economic cohesion.

The prevalence of sustainability is critical, both from an economic, environmental and social perspective. We think that the European agricultural model can be renewed and its multifunctional content can be maintained (and even enhanced) through a radical reform. In the next sections we outline a possible vision for a CAP which is sustainable in the long term from economic, environmental and social points of view as well and is able to give efficient answers on the above mentioned challenges.

## **Vision for a new Common Agricultural and Rural Policy**

### **What should the new Common Agricultural and Rural Policy look like?**

The agricultural policy conducted in the past cannot be maintained any more. As caretaker of the European landscapes, it produces European public goods, and may even produce more of them following further reforms. The consistent pursuit of the reform process can contribute to creating a sustainable **Common Agricultural and Rural Policy (CARP)**, serving both environmental values and competitiveness.

**Real change is needed: radical reform of the CAP in order to focus on the provision of public goods.** The key features of the CARP's desired development are sustainability, market-orientation, public goods, competitiveness and the development of rural areas.

### **Sustainable**

The prime requirement of future European agriculture is **environmental sustainability**. The future CARP is aimed on the one hand at avoiding environmental damage, and on the other hand at encouraging farmers to assume a positive role in sustaining the rural landscape and environment. The CARP's fundamental objective is to promote agriculture's multifunctional role: the production of healthy and safe food, contribution to the sustainable development of rural areas and the conservation and improvement of the status and biodiversity of areas used for farming.

The reformed CARP has to be not only environmentally, **but also economically and socially sustainable**. Good soil fertility, low agrochemical residue levels, animal welfare, the ecosystem itself, and simultaneously economic and social sustainability are all key requirements. Economically non-viable farms are not capable of sustainable farming. It is crucial to improve their competitiveness. Acceptable agricultural wages are required and the unavoidable structural transformation has to be made tolerable for rural societies. From the perspective of social sustainability, the transparency of the system, its financeability and the smallest possible burden on consumers and taxpayers are vital.

### **Market-oriented**

A key factor of the reform is consistent and full decoupling. **Considering structural aspects, full decoupling separates direct support from production.** This system – unlike the construction based on the decision of 2003 – does not allow for partial re-coupling. At the same time, **quantity limitations**, and thus set-aside requirements, will also be entirely **abolished**. The fundamental rules of the system will be the same for the entire EU.

**Deepening market reforms** is also of crucial importance:

- institutional prices may decrease to the level of world market prices;
- intervention will cease;
- external protection will decrease, but community preference will be maintained;
- extensive agricultural development programmes will be carried out in the new MS (supported by the CAP, in addition to national resources), aimed at improving market transparency and agricultural bargaining power.

Among these conditions, **the role of market coordination becomes crucial.**

Falling prices, falling subsidies, more liberalised trade and changing consumer needs all represent risks. To maintain stability and competitiveness, **crisis and risk management** systems must be developed.

The future CAP system has to become more market-oriented by ensuring the prevalence of its multifunctional values. Implementing effective decoupling will enable transfers remunerating additional rural services offered by agricultural producers which do not distort the market (or only to a very slight extent).

### **Focus on public goods**

Agriculture has salient social and environmental effects on the land use, the environment, animal welfare, public health and rural life. These effects include both negative and positive externalities. Future agricultural and rural policy not only has to strive to decrease negative agricultural externalities, but also to ensure the predominance of positive ones. As a result, the new policy should focus on activities (including forestry) that actually produce public goods, and therefore social benefits offset costs.<sup>4</sup>

Within the CARP's framework, **the system of direct support undergoing transformation will reward public goods produced by agriculture**, which form the core of the European agricultural model: keeping the earth's land surface cultivated; producing safe food; complying with environmental, animal welfare and other standards which underpin relevant values for European citizens; conserving historical and cultural heritage; sustaining rural communities, etc.

In the future, direct support **will become increasingly separated from previous base values**. Firstly, direct support will partly be granted as flat-rate subsidies. Secondly, the proportion of targeted support (adjusted to the special conditions of given regions) will increase. We should stress here the importance of public goods produced by forestry and aquaculture as well. The strict and increasingly sophisticated condition for the granting of direct support is the fulfilment of environmental, food safety, animal welfare, etc. requirements, far stricter than those of competitors on the global market (improved cross-compliance).

<sup>4</sup> Buckwell (2007) calls this policy – focusing on public goods – the European Food and Environmental Security Policy. He deems the question of “whether the CAP should be further reformed, or whether a new policy, better suited to the coming half a century should be created” merits consideration.



One might ask to what extent cross-compliance can contribute to achieving environmental and other objectives. Cross-compliance can be achieved with uniform standards applicable on the entire territory of the Community. These standards, however, do not take into account diverging agricultural and environmental conditions. In the future, the cross-compliance system can be made more targeted (see Bennett et al., 2006). One might also ask how effective an instrument cross-compliance can be in case direct support is decreased. Tightening conditions for obtaining subsidies is acceptable up to the point where the majority of CAP subsidies are allocated through the first pillar. If direct payment gradually decreases over time while the cost of compliance stagnates or increases, producers will sooner or later leave the system. As highlighted by the OECD (2007), the drastic cutting of direct payment cannot be reconciled with increasingly ambitious environmental conditions (OECD, 2007).

This issue will become less important if the proportion of targeted support increases. As the OECD (2007a) report suggests, in case of policies aimed at correcting market failures (e.g. landscape, biodiversity), targeted support (especially if the amount of money saved through targeted measures are substantial) seems to be the most effective solution. Targeted policy is aimed at precise results, well defined by the policy's objectives, while minimising transfers to unwanted beneficiaries and negative spill-over effects. Targeted policies are better suited to the specific geographic, climate, social and environmental conditions of a given member state or region, and thereby contribute more effectively to the production of public goods.

The so-called "non-marketable" services, such as habitat preservation, a clean environment and the protection of biodiversity need better recognition and should be addressed by new and specifically targeted policies. Direct payment for environmental and other "non production services" which society expects farmers to provide can only be justified where they are not automatically delivered by normal profitable good husbandry. The single farm payment is certainly not the means of achieving this objective efficiently. Its linked *cross compliance* obligation has not achieved and is not likely to achieve environmental objectives by default.

By complementing each other, flat-rate and targeted support can jointly foster the provision of rural public goods needed by European society. According to the original compensation logic of direct payments, they offset the income loss stemming from the abolition of coupled support. Demand for compensation currently and in the future will increasingly be linked to the fact that community producers are subject to a growing number of stricter regulations compared to competitors. Direct payments should be increasingly considered as compensation for additional costs arising from the provision of multifunctional goods and services, compliance with animal welfare standards etc, not paid for by the market.

If payments are based on positive externalities or for structural changes and transfers flow from richer regions towards poorer ones without sectoral limitations, support will be more effective and transparent. Such support is socially more acceptable, in accordance with the WTO's requirements and has a positive effect on community cohesion.

### **Improving competitiveness**

Since the announcement of the Lisbon Strategy, improving competitiveness has been one of the major objectives of the EU. The CAP can contribute to this objective by facilitating economic adaptation (training, infrastructure-related investments, advising), and the support of research and development.

The reforms of the CAP and the international trade commitments equally lead towards the development of a **more competitive agriculture**. Along with the progress made by the reforms, market distortion has diminished substantially. Market competition has increased. Market-oriented farming has come to the forefront, which requires improved competitiveness. At the same time, adaptation is a complicated process. Production procedures take a relatively long time to get modified and also their transformation requires significant investment.

**Via the enhancement of competitiveness and by facilitating modernisation**, the CARP may contribute to providing an efficient response to challenges: to the better fulfilment of market needs via a more flexible adaptation, a more efficient utilisation of resources, quality improvement and by providing new products and services. At the same time, efficient responses must be found to the challenges presented by the protection of human health, food safety, environmental conservation, climate change, energy security and efficiency, innovation and the succession of generations. The enhancement of the competitiveness of forestry and aquaculture may receive more attention.

A key factor in improving competitiveness is the structural adjustment of the European agriculture. The precondition for this is the more flexible functioning of the resource markets (most of all, of the land market) and the special development of human capital (Blandford-Hill, 2006). At the same time, the adjustment processes also have a crisis preventing (proactive) effect. The adaptation potential of a fundamentally restructured European agriculture will be much greater.

On the other hand, the integrated crisis and risk management system built into the rural policy makes possible the handling of new challenges and unforeseeable, unexpected developments

The CAP has a comprehensive system of subsidies. These transfers are legitimate if the beneficiaries really need them or the transfer is in compensation for different services. The scheme of transfers which extensively support market players that are already competitive without receiving subsidies has been severely criticised. The non-allocation of grants to competitive market players would artificially keep the less competitive players alive and would restrict development opportunities available for more competitive players. Furthermore, setting brand new bases for these payments (e.g. direct payments) may bring about position shifts for market players that are difficult to forecast. By way of the decoupled payments, less competitive farms can, in principle, continue their operations for a longer period of time than without receiving them, as the payment will often cover their variable costs. However, due to increased competition, it is rather uncertain that these farms are able to operate in the long term.

With regard to improved competitiveness, it is of key importance that, in addition to economic growth, the multi-functional character of the sector also prevails and rural employment is either maintained or expanded. The continued support of innovation by the Community is important also with respect to economic and social sustainability, especially in such new areas as e.g. bio-energy. The concept of competitiveness in rural areas should be understood to include newer and newer economic activities producing non-product outputs.

### **Focusing on rural areas**

There is a basic need to determine what direction the CAP should take in order to have a more positive impact on the development of rural Europe. The understandably increased attention paid to the “second pillar” sometimes leads to the questioning of the agricultural policy: certain approaches press for regionalization of the economic policy and assimilation of the agricultural policy into regional economic policy.

In reality, however, **crossing the dividing line between the first and second pillars of the CAP is already possible today.** An important component of the second pillar is e.g. the agri-environment programme. Via the cross-compliance and other similar schemes, direct payments that form part of the first pillar today can increasingly serve the assertion of these aspects. The more „measures” are moved into the first pillar the more sources will remain for the more targeted subsidies of the second pillar.

In fact, there is a paradigm shift going on in the rural development policy of the EU. The point is the following: an agricultural policy aimed at food self-sufficiency and agricultural income parity seems to be replaced by a territorial rural policy that ensures sustainable development of rural areas. The shifting towards the new focal points is gradual but continuous. The concept of the „new rural economy” describes the above development.

The basic components of the new rural development paradigm are:

- regional, integrated (multi-sectoral) policy that ensures sustainable development of rural areas;
- focus on the improvement of competitiveness: the transformation of local peculiarities (environmental or cultural conditions, traditional products etc.) into a competitive advantage;
- promoting the production of rural public goods;
- agriculture plays a preferential role in the rural economy: it is the major consumer of local inputs and business services; the main provider of rural public goods; however, it is unable to fulfil the function of rural development on its own
- the main features of the „new rural economy”: improved accessibility and approachability via communication and supportive infrastructure (networks of entrepreneurs etc.); the improvement of the competitiveness of rural businesses by way of improving business management skills, product innovation and innovative marketing; the maintenance of an attractive rural environment and a high quality of life via the provision of public goods; tourism could become a determinant sector; the promotion of innovation (market niches, new products, innovative marketing); the possibility of a knowledge-based bio-economy; the development of human resources.

**The rural policy – via an integrated development strategy taking into consideration the role of agriculture – promotes the enhancement of the economic and social viability of rural areas.** Via the diversification of economic activities and the integration of the various sectors, viability and sustainability can be attained in a much more efficient manner than at the time when the focus was merely placed on agricultural policies.

With respect to making rural areas more viable and attractive, the basic goal is to develop the rural economy, improve the quality of life, retain rural population, strengthen the multi-functionality of activities and secure subsistence level.

The measures of the territorial policy aimed at supporting rural regions can be integrated within the framework of the new rural policy, via the strengthening of local responsibilities and decision-making possibilities (LEADER-approach). At the same time, the new rural policy could regulate, via the community guidelines, the basic factors which promote the maintenance and development of more viable and attractive rural areas.

### **Simple and transparent**

The problems arising from the complicated scheme of the CAP are concentrated in three main areas: they result in a high level of losses and transaction costs (both policy-related and non policy-related transaction costs); create opportunities for misuse (unentitled payments); constitute an entry restriction over the course of debates on the shaping of the policy (significantly restricting the number of participants efficiently contributing to the debate).

At the same time, one of the major problems is the inappropriate acceptance by society. In general, the criticisms of European society do not relate to the basic principles of the CAP but to its excessive complexity, the lack of transparency and the excessive administration of its regulation and implementation.

As regards the acceptance of the new CARP, it is of key importance that the regulation is simple, transparent and well-justified. The simplified regulation of the new policy requires the involvement of the regulatory and enforcement authorities. The simplification approach must cover the entire life cycle of the policy (planning, legislation enforcement, review). Better regulation will not only lead to lower costs but will also help prevent situations where market failures prevail. (Thus, the acceptance of the agricultural policy will increase.) The efficiency of the enforcement of community level regulation will be enhanced if there are no new rules or technical restrictions at national level and if best practices are shared. The replacement of market organisations by a single market organisation, full decoupling and the application of the European and international standards in force will result in significant simplification of the system. There is a need for fewer regulations that can be interpreted more easily and are in force in all the MS in the same form.

## **Major Proposals**

### **Common Agricultural and Rural Policy**

The reforms of the CAP we propose will ensure the economic, social and environmental sustainability of rural regions on a fundamentally different basis. The scope for community and state intervention will also change. Payments depending on production – on a historical basis – will be cancelled; instead of that the provision of public goods will be rewarded. At the same time, measures aimed at enhancing the viability of rural economy and society will become more significant. The depth of the changes calls for finding a new name and, instead of the Common Agricultural Policy, we should use the more appropriate name: **Common Agricultural and Rural Policy (CARP)** that expresses better the new approach.

### **The Structure of the new Common Agricultural and Rural Policy**

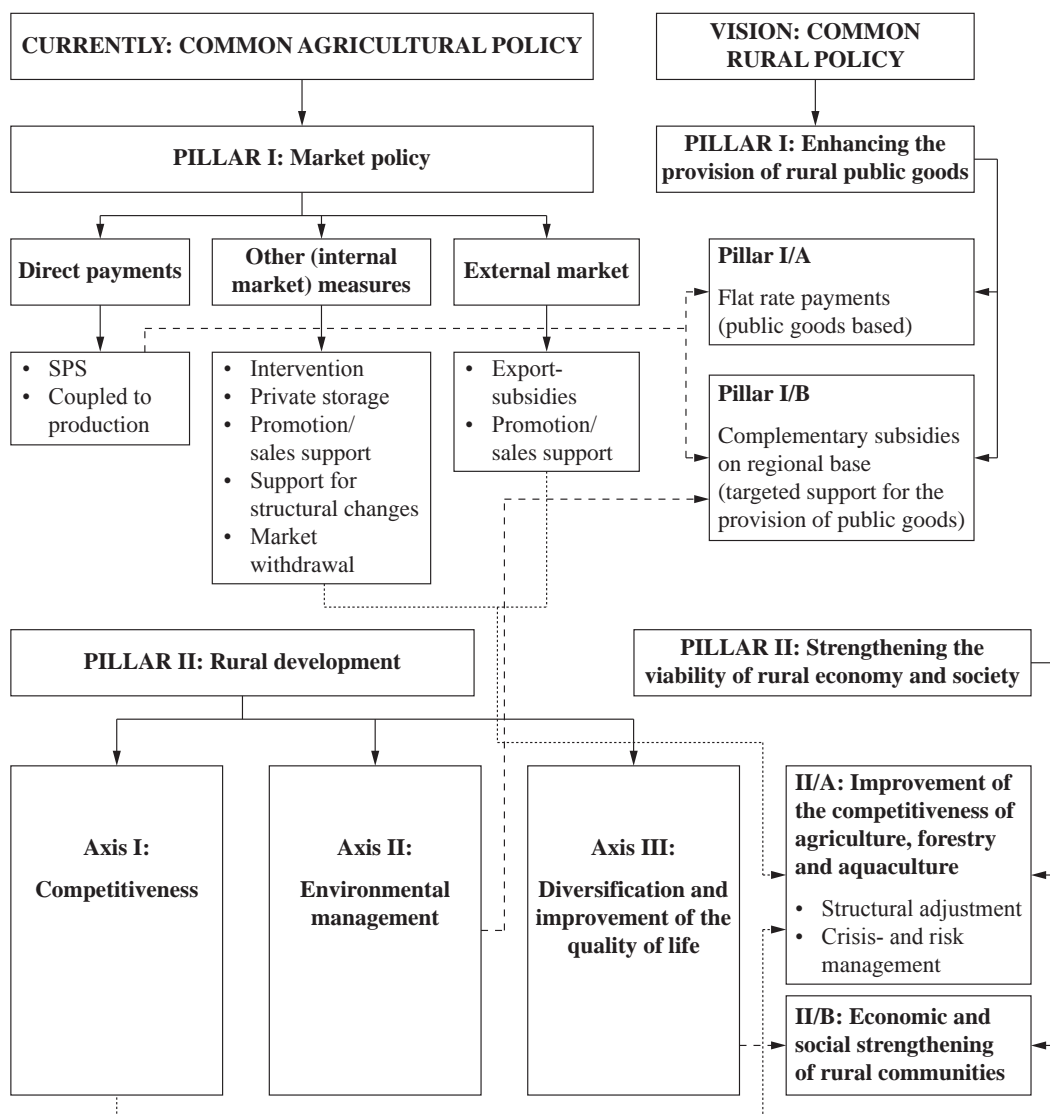
The changes in the structure of the agricultural policy, **the redistribution of tasks** and the **modified allocation of resources** are the most tangible indicators of the changes to the policy.

At present, the CAP has two basic pillars. The first pillar is the source of direct payments and market interventions. The second pillar is called rural development, which is divided into four axes (groups of measures). The first axis targets the improvement of the competitiveness of agricultural and food producers. The second axis finances support for agri-environmental operations, whereas axes 3 and 4 are aimed at rural development itself. In the new **CARP** this system will go through a fundamental change.

The proposed new CARP is also based on two pillars. As regards the first pillar, direct payments are replaced by **flat rate payments based on public goods and complementary subsidies on a regional basis**. Within the framework of Pillar 1/a, producers receive uniform („flat rate”) area-based payments within the entire EU. The amount of payments under Pillar 1/b would vary regionally, facilitating targeted provision of public goods. Thus, Pillar I fundamentally serves the compensation of producers on the basis of public goods.

Pillar II aims at enhancing **sustainable development of the rural economy and society**. Pillar II supports the improvement of competitiveness and structural transformation as well as economic and social development of rural communities. Within this, Pillar II/a supports structural transformation, as part of which, support in poorer countries are paid with a higher EU contribution, whereas in more affluent countries they are paid with a higher national contribution. These payments, in the long term, could be possibly redistributed into Pillar II/b. In addition, the new Integrated Crisis Management forms part of Pillar II/a too. The aim of Pillar II/b is to strengthen the viability of the rural economy and society, expected to gain growing importance in the future as the improvement of the quality of rural life, the preservation of the special peculiarities of a region, the support of local communities, the increased power of rural regions to retain the population will receive a role that is more significant than previously.

A major difference between the two pillars, in addition to the objective of providing support, is the nature of financing. Pillar I entirely relies on Community sources, whereas Pillar II is co-financed, which means that it is financed in part from Community and, in part, from national resources.



**Figure 1: The structural transformation of the Common Agricultural and Rural Policy**

Source: own work

### The transition

There are basically two solutions for the transition between the old and the new policies. One option is the application of a „shock therapy”, that is, the **introduction of the new system in a single step**. This would constitute the launch of the policy on 1 January 2014; that is, the tasks would be transformed instantly and the new structure and financing system would come into force with immediate effect. In the period between 2011 and 2013, a possibility may open up to prepare for the new policy. A switchover in this manner can be implemented quickly, it creates a predictable situation within a short period of time, is less complicated and easy to comprehend. However, the time for adapting to the major changes of the new system may be too short.

The other option for a transition is a **gradual phasing-in**. Experience shows that the CAP is characterised by cautious reforms that have been implemented slowly. Therefore, this option is closer to the former practice but it is more difficult. A gradual transition would mean that, as of 2014, we would switch over to the new system from the SPS over a transitional period (three or possibly seven years, that is, over a full budgetary period), involving several steps, complex re-allocation (possibly mandatory modulation), involving annual corrections of specific percentages. The main and perhaps the only advantage of this type of transition is that it leaves more time for adaptation. Its possible drawback is the possibly higher administrative costs or the application of complex transitional rules.

### **Pillar I (payments based on public goods)**

Under the new policy (with new theoretical basis) a **public goods-based financing** would replace the former area based subsidies, which would create the new **Pillar I**.

The proposed new **Pillar I, with respect to its objective, would remunerate public goods provided by the “maintainers” of rural areas (agriculture, forestry etc.)**, thus facilitating the continued provision of public goods needed by society. As this type of support would not be coupled in any way to production and would not require production at all, it represents a perfect *decoupling*, which would be received positively also at the international trade negotiations. At the same time, as this type of support would not differentiate between sectors, production methods, plants – or, in the case of Pillar I/a – countries, the programme would be neutral as regards competition. Thus, with respect to production decisions, the free will of producers could prevail. Production decisions would depend on market and climatic conditions, as well as on the accessibility and prices of resources. At the same time this approach could make agricultural production **more efficient for society**.

Pillar I is divided into two parts. The first (Pillar I/a) would include the **basic support that would compensate for the public goods, the provision of which could hardly be enhanced by targeted measures**. The public good-based flat rate support per hectare would be identical across the entire EU. In our view, the actual production of the public goods needed would be facilitated by a *cross-compliance* regulation that would be more comprehensive than today. Producers would only be entitled to this basic support upon compliance with these requirements.

The second part of Pillar I (I/b) would support **the provision of additional public goods** (with national and/or regional characteristics). Provision of these public goods is not mandatory; it could be undertaken on a voluntary basis and would increase social utility to an extent that would be higher than demanded by Pillar I/a. To facilitate this, certain MS and regions could apply special regulations if, in the given geographical region, social and environmental conditions require so. These requirements must be in excess of the *cross-compliance* regulations set forth with respect to all the producers (see later in more detail).

Determining the rate of support is not a simple task because, as it derives from the basic definition of public goods, these “products” (non-product outputs) do not have a market value or price. At the same time, there is a need for value determination as an intervention aiming at internalisation of externalities can only be efficient if the value of negative or positive effects is offset precisely. (Otherwise, market players will not react appropriately and will continue to produce too little or too much externality). Value determination is a difficult or even an impossible task in the majority of cases. Often the value is determined by assessing the costs of eliminating and rectifying the damage caused by negative effects. This method can be used relatively well e.g. in the case of environmental pollution. In case of positive externalities, however, it is more problematic to determine the price of

positive effects. The value of the public goods produced is determined by the utility it provides to the consumers, that is, society. However, this can be assessed only if, in one way or another, we know the preference system of the consumers.

In recent years, since the principle of a multi-functional agriculture has come into the forefront of interest, a number of research institutions (FAO, OECD, MEA-Scope, EU research projects within the framework of the EU FP6 programme) have dealt with determining the value of the positive externalities or public goods produced by agriculture. Although the conceptual steps of the method were elaborated, the basic issue (the precise evaluation of public goods and positive externalities) has remained an open issue.

A possible basis for evaluation could be the opinion of society. Although this could be assessed in practice by way of a questionnaire, this method raises a number of issues:

- Social judgement can vary based on the knowledge and economic situation of those asked, although, in principle, the value of public goods should be general.
- Assessing social judgement can only be based on asking the current population, although public goods will also influence the life of future generations.
- The precise gauging of public opinion would not only be questionable but also costly and complicated.

Consequently, we offer a simplified approach to resolve the issue.

Suppose, as a starting point, that at present the European agriculture produces public goods in an appropriate manner and at an appropriate level. Consequently a support level, of an extent similar to that of today, will be sufficient to ensure the continued maintenance of this level of provision. At the same time, the current amount of support covers other objectives (e.g. they ensure a proper income status to producers) too. Thus, in our opinion, the new basic payment should be of a rate lower than that applied until now.

In our view, the **basic payment should be uniform at the EU level**. This is important, first of all, with respect to the simple applicability and transparency of the system. This part of the support enhances the provision of general public goods that can be expected from any European producer. The value of these public goods does not differ from each other, irrespective of which part of the EU it was produced in. Most of the public goods have cross-border effects (e.g. lower rate of soil, water or air pollution), or can reach consumers via the food trade (production of healthy food) or although it is of local nature, from time to time, it provides value to other populations (e.g. landscape) too. As the new support system focuses on the provision of public goods instead of the production of agricultural products, the rate of support may not depend on the structure of production or a former or current income status.

At the same time, with respect to supplementary undertakings, it is **important to consider regional differences**, because the significance and role of several public goods varies according to region; they are embedded in different natural environment and landscape features, and the local population could have varying needs as well.

Payments under the second part of Pillar I (I/b) would remunerate the targeted production of public goods, and would be tailored to the unique social and environmental conditions of the individual member states and regions.



A policy that becomes targeted in this manner is aimed at specific results precisely determined by the objectives of the policy and minimises transfers to unintended beneficiaries as well as negative spill-over effects.

On a community level, only the amounts earmarked for MS (“national envelope”) and the framework conditions of support would be determined. During the calculation of the “national envelopes” aspects that are of special importance with respect to the potential provision of public goods should be considered. Such possible variables could be the following:

- The percentage of agricultural areas;
- The percentage of forests;
- The percentage of mountainous areas or those that are disadvantaged due to some other ecological aspects (LFA);
- ‘NATURA’ areas;
- Ratio of eco-farming areas;
- Number and area of nature reserves;
- Contribution of agriculture to GDP;
- Population density;
- GDP per person.

Our last axiom, in relation to the previous point, is that it is the MS themselves that are the most aware of their conditions, and the needs and expectations of society. The compilation of the national programmes enhancing the targeted provision of public goods would be the responsibility of the MS. They would determine the measures, set the rates of support and control the implementation. Of course, the Commission must approve the programmes as only those that meet the framework conditions set by the Commission would be eligible for support included in Pillar I/b; e.g. the following activities could be included:

- Production methods falling under the previous agri-environmental programmes (extensive cultivation, integrated plant protection, eco production),
- Environmentally-friendly maintenance of forests and silviculture,
- Production of raw materials for the bio-energy industry,
- Maintaining of the habitats of protected species,
- Gene preservation activities (maintenance and production of indigenous species and breeds) etc.,
- Maintenance and nursing of peculiar landscape components,
- Freshwater fishing activities,
- Game management serving the balance of the environment.

A further problem may be caused by the fact that different geographical areas and special needs can make the coordination of the strictly determined objectives difficult. In such a case, a project-like approach can help. It is necessary to mention at this point that major transaction costs may attach to targeted policies. However, these costs are compensated by the benefits that arise from such targeted policies: transfers of lower amounts, more efficient policies and reduced distortions.

To summarize, the essence of Pillar I is the following: The financial source of Pillar I/a **would be allocated to the MS according to the percentage of areas under agricultural cultivation**. All the (eligible) producers of the EU would receive the same rate of area payments in compensation for the public goods (positive externality) they provide. MS would enforce the fulfilment of this latter condition within the framework of an expanded *cross compliance* scheme.

**Pillar I/b would be allocated** on the basis of factors mentioned above. The MS would elaborate within their own scope of responsibility the programmes enhancing the additional provision of public goods in the given MS. The number of programmes to be elaborated will be decided at national level, just as the conditions of such programmes or the amounts of support. There may be no production requirement, the support may not influence production decisions and must actually serve the goal set (additional production of public goods). Compliance with the conditions would be ensured by the approval and supervision by the Commission of the national programmes of MS.

### **Pillar II/a: Improvement of the competitiveness of agriculture, forestry and aquaculture**

**As a result of the proposed reforms the market-oriented nature of agricultural production will increase**, which will result in a change of the production structure, the methods of land use and employment. The cross compliance requirements (related to environmental conservation, food safety, animal health and animal welfare) introduced as eligibility criteria will certainly improve the social acceptance of the system, but farmers are still negatively affected when compared to the producers of countries where less strict requirements are in force.

Measures aimed at structural change help the prevalence of comparative advantages in the individual MS which, in addition to sustainability, also contribute to the strengthening of economic and social cohesion.

Thus, the new Pillar II/a must specially contribute to eliminating the structural deficiencies existing in MS that have joined the EU recently as well as to their catching up. As regards subsidies to be offered within the framework of Pillar II/a, the difference between more affluent and poor countries (to be determined by their divergence from the average Community GDP per capita) **would determine the rate of co-financing**. Apparently, Community contribution in economically less developed countries would reach a much higher level, whereas, in the most developed MS, national resources would play a more important role.

Along with strong market competition, climate change also presents a major challenge for producers. The most affected areas are agriculture and tourism. Unpredictable weather conditions, the increasing frequency of droughts and floods and strong fluctuation of temperature may lead to a reduced agricultural output. [Stern Review, 2006]. We must prepare for a change in the structure of production, and species, and for the transformation of the water management system. In addition, agriculture must also contribute to the reduction of greenhouse gases by applying more efficient technologies and manure handling methods on the one hand and by increasing the production and utilisation capacities of renewable energy sources on the other.

The subsidies available from Pillar II/a not only include innovative and modernising technical-technological investments, although these developments are of key importance due to increased market orientation. This pillar could support (in line with the needs of the individual MS) among others the following measures: investments related to the infrastructure and the production of renewable energy, generational succession, investments that help to meet the cross-compliance requirements, to support cooperation between the players of the production chain, and to support dissemination of information and knowledge.

**In addition to structural adjustments and investment subsidies, an important component of the new Pillar II/a is the scheme of integrated crisis and risk management.**

### **Integrated crisis and risk management**

Market measures will practically cease to exist in the proposed new policy, because direct intervention into market processes is not an objective of the new common policy. At the same time, as it is known, risks in agriculture are higher than in other branches of the economy, thus the prevention of a crisis and the handling of crises and risks remain important issues.

The major factors that affect the economic standing of agricultural businesses beyond the normal business risks are the following (Commission of the European Communities, 2005):

- Price reduction because of trade agreements and market liberalisation;
- Low prices offered to producers due to the unbalanced relation of producers and purchasers;
- Food safety measures, diseases affecting animal or plant health;
- Climate change (extreme weather conditions).

Diversification of production and activities is one of the most obvious way of risk reduction. As regards the risk-sharing methods that serve the distribution of risks, sales contracts, production contracts, hedging transactions implemented in futures markets, participation in mutual (insurance) funds and insurance are the ones most commonly used.

Risks higher than average risks (which are in general systematic) necessitate state/Community intervention. In this respect, there are two possible ways of Community intervention. The use of market-oriented risk management tools is still very limited. Training could ensure the expansion of risk-related knowledge, development of risk management strategies and special know-how (futures and option transactions). On the other hand, subsidies are needed to counterbalance the fact that, due to the extremely high systematic risk that is typical in the agricultural sector, insurance companies only undertake insurance against an excessively high premium. Subsidies may be granted directly to producers to cover part of the costs arising from insurance and other risk reducing instruments or to the insurance companies through the introduction of state guarantee and/or reinsurance schemes. The solution selected must, however, meet the criteria set forth in the WTO green box.

Whereas risks can equally involve negative and positive outcomes, a crisis will always involve significant negative consequences. A crisis is an unforeseeable situation that threatens the viability of an agricultural enterprise either at a local level or in the entire production branch (Commission of the European Communities, 2005).

Economic crises must be handled at Community level. Although the scope of supply management and price regulation has significantly narrowed as a result of the reforms, the system of safety net operated in a number of common market organisations provides protection in the case of crises also today. However, along with the full elimination of market measures, this bridging solution will also cease to exist. On the other hand, due to the level of risks that are much higher than the average level of business risks, producers may not be left without any protection.

Back in 1974, the Community introduced a general measure on crisis management in the common market organisation of beef: If a significant price surge or drop is registered on the Community market which is expected to disturb or threatens to disturb the market, the necessary measures may be introduced. (Commission of the European Communities, 2005.) This general measure could be expanded, further developed and tailored to the criteria set forth in the WTO green box.

According to our intentions, the **single integrated crisis management system** would meet the requirements set forth by the WTO, would not impose an excessive burden on taxpayers and would not deteriorate the general competitiveness of the agriculture. Taking into consideration these objectives, the package of measures we propose would be based on the following components:

- Full elimination of production quotas and intervention.
- Maintaining private storage only in order to avert serious market disturbances.
- Setting up a common, central fund to reduce damage caused by natural disasters and to finance measures introduced to manage market disturbances (This fund would equal approximately 5 percent of Pillar II)

**The objective of crisis management is not an income-insurance for producers; it would only protect market players in case of major crises that cannot be prevented.** Consequently, the programme must correspond with the following aspects:

- The extent and method of support or the sectors to be covered would not be determined in advance in any manner.
- Measures would be specifically defined only on the basis of a natural disaster that occurs, or a serious market disturbance, on an ad-hoc basis, and the provisional eligibility would be withdrawn immediately upon the end of the crisis.
- The Community would take decisions on the necessity, method and extent of intervention and the release from the fund of any amount on the basis of proposals made by the member states.
- MS must back up the existence of a natural disaster or market disturbance with facts and statistical figures.

Under such conditions risk management would really serve the solution of crisis situations that occur unexpectedly, irrespective of the actions of producers, and would not offer income security to producers because it would not function in a pre-announced form. Neutrality of competition within the EU is ensured by way of central management and decision-making. Backing up with facts would not only verify the intervention but would also help to meet the requirements set forth in the WTO green box.

If, in a given year, the entire amount of the fund is not used, it could be carried over to the next year but, as of the second year, it could be released for use for other (even other than agricultural) purposes.

The financing of the new risk and crisis management tools does not require additional Community expenditure. The new measures are aimed at enhancing the competitiveness of the agricultural and forestry sector via the strengthening of the economic sustainability of agricultural operations, and thus can perfectly be fit into Pillar II/A. In this context, the MS could decide whether or not to introduce the risk and crisis management measures into their programmes aimed at the enhancement of the viability of the rural economy and society.

In their development plans, MS could freely determine which crisis and risk management methods approved by the Commission they intend to support. This flexibility would ensure that the tools applied can adjust to the highest possible degree of potential risks and the preparedness of those involved (beneficiaries, institution system etc.).

### **Pillar II/b, or the economic and social strengthening of rural communities**

The current measures of axes 3 and 4 would be integrated into Pillar II/b, the purpose of which is the economic and social strengthening of rural communities and the **target group of which is the entire rural population**. The new pillar will include all measures that play an essential role in rural development and can be implemented tailored to local needs. In this new, wider context, agriculture does not play an exclusive role; although it continues to be an essential component of the rural economy.

The enlarging EU becomes more and more colourful and diversified with various circumstances, conditions and issues with many aspects. Thus, a development policy with centralized management will not achieve the intended results at all times. In order to ensure that regions with varying conditions efficiently identify the niches required for their development, **initiatives coming from lower levels must receive more emphasis in Pillar II/b**. To facilitate the most efficient allocation of subsidies, the involvement of local and regional players and that of the key players in rural development outside the agricultural sector needs to be enhanced as much as possible (Dax et al., 2003). Local factors, local identity, venue-specific marketing activities, efficient local government and strong local businesses all form indispensable components of the process of a venue-specific rural development. Experience shows (Bryden, 2003) that rural areas with more developed local government and larger independence tend to be more successful. The LEADER programme and a number of other national rural programmes (e.g. the PRODER in Spain, the POMO+ in Finland, the Regionen Aktiv in Germany or the Calabria in Italy) serve similar goals (CNASEA, 2003). The local institutional structure and government is particularly weak in the new MSs (Bryden, 2003); thus, in these countries, the strengthening of local capacities must receive special attention.

As opposed to the previous policy, subsidies not only target a narrow class of the rural population (producers and businesses involved in agriculture); instead, they are based on territory, which means that the region will receive more importance. The **purpose of Pillar II/b is alleviating the subsistence problems of people living in rural areas and the improvement of the quality of their lives, maintaining the power of the countryside of preserving the population and supporting the local communities**. To facilitate the implementation of the above goals, one of the **most important tasks is** the expansion of rural work opportunities. Local communities must be supported to ensure that – utilising their peculiarities, local capacities and ideas – they can identify alternative solutions for creating jobs and ensuring sustainability in this manner. Economic diversification must be activated at local level, which will result in creating jobs in the long term via the use of local resources, targeted, venue-specific marketing activities and an attaching entrepreneurial readiness. Agriculture, despite its declining economic weight, may undoubtedly continue to play a determinant role in rural economy; at the same time, the multi-functionality of activities, locality as an approach must receive more emphasis.

The current subsidies serving agricultural and rural development are not sufficient to resolve the problems of the countryside. To facilitate a complex, venue-specific rural development, the sectoral approach must be replaced with a territory-based policy, that is, the various sectoral policies must be integrated at regional and local level. Accordingly, the measures of the Structural Policy that can be implemented at local level and play a role in reducing the social and economic problems of rural areas must be integrated. The integration of these measures is expected to provide an **efficient and targeted solution to rural issues**. The creation of jobs, the enhancement of the quality of rural life, the preservation of local peculiarities, the support provided to local communities and the increased power of the countryside to retain the population will receive a more significant role than previously.

The measures of rural development can be divided into three main areas:

- **Society:** the long term survival of local communities via the encouragement of cooperation, increasing the power of rural areas to retain their population;
- **Economy:** increasing the opportunities for those living in rural areas to find jobs, multi-functional activities and an improved security of subsistence via emphasizing the diversification of rural economies, support to small and medium sized enterprises and local initiatives;
- **Environment:** the preservation of the natural values of the rural environment, safeguarding biodiversity, the value of the landscape and the natural heritage.

Thus, Pillar II/b will comprise a new set of tools for strengthening rural communities, with a new support scheme and regulations. The new **rural development regulation** – which is a territorial policy – will identify at community level the major issues of rural economy and society that need to be supported, such as: employment, income, quality of life, health, education, infrastructure. Community guidelines and limit values will be determined. Then, a target value or an intended impact attached to a concrete objective or measure will be defined at national or regional level. The programme will facilitate compliance with the guidelines and the achievement of the target values set forth in the regulation. The **programme** will specify the measures proposed to be used and the objectives to be achieved in order to have the intended effect. The scope of issues determined at Community level, the nationally or regionally determined target value and the achievement along with the subsidies elaborated in detail in the programme are connected at this point. As a result, rural development would not only involve subsidies but would constitute a much more organised approach that is coordinated along the guidelines, is based on clear goals, is focused on local initiatives and is differentiated on a territorial basis (niche policy).

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