

## IS THE EUROPEAN UNION'S SINGLE FARM PAYMENT TRULY DECOUPLED?

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*Any form of subsidization has a distortionary effect on market outcomes. Ann Stillman evaluates the most recent EU agricultural reforms, assessing the status of the Single Farm Payment (SFP) and its relationship to production decisions. She acknowledges that the direct connection has been severed. However, by examining the indirect distortionary effects, she concludes that the Single Farm Payment cannot yet be regarded as fully decoupled from production.*

### Introduction

The issue of decoupling agricultural support from production has in recent years gained much momentum in both policy and academic circles. In the European Union (EU), this has coincided with the design and implementation of a series of Common Agricultural Policy (CAP) reforms which have effectively marked a shift from previously dominant market price-support centred policies towards a more decoupled form of support. The 2003 Mid-Term Review (MTR) of the Agenda 2000 Reforms, proposed by then Commissioner for Agriculture and Rural Development Franz Fischler, is the latest and perhaps most radical of these. Specifically, while the 1992 MacSharry and subsequent Agenda 2000 reforms initiated a process of partial decoupling—whereby coupled market-price support was progressively reduced while compensatory direct payments to farmers were increased—the MTR replaced all premia and arable aid payments with a consolidated Single Farm Payment (SFP). The SFP is tied, not to production volumes or yields, but to average historic payments received by farms in the base period 2000-2002, contingent only upon retention of entitlement acreage and a number of 'cross-compliance' criteria.

This paper will seek to assess the extent to which the SFP is truly decoupled. The question is underpinned by substantial ambiguity regarding the appropriate definition of 'decoupled' support. Therefore, the analysis will open

with a discussion of the relevant definitional issues. It will then go on to evaluate the SFP against this backdrop of conflicting conceptualisations, in order to determine how effectively the post-Luxemburg Agreement incarnation of the CAP meets its stated objective of decoupling agricultural support from production decisions.<sup>1</sup>

## **Definitional Ambiguities: varying perspectives on the true nature of decoupled support**

The debate on policy decoupling is characterised by a multiplicity of differing interpretations of what constitutes a ‘decoupled’ payment. Any critical assessment of the extent of decoupling must therefore explicitly consider these varying perspectives.

A first notable point in which definitions differ is in their adoption of *ex ante* versus *ex post* approaches. The former, often associated with policy-makers, focuses on the eligibility criteria attached to payments: policies are deemed to be decoupled if eligibility depends on a fixed historical base period, and direct payments are financed by taxpayers, not linked to current prices, production or factor use. This *ex ante* perspective has been articulated, for instance, by Burfisher and Hopkins [2003]. It contrasts with the latter approach, typically favoured by agricultural economists, which targets not policy design, but policy effect, and hence considers policies to be decoupled from production only if they have no influence on the relative prices and quantities of agricultural outputs produced or inputs used to produce them.

Considering the notion of decoupling from an *ex post* economic perspective, Cahill (1997), drawing on a large body of earlier writing (e.g. Andersson, [2004]; Baffes, [2004]; Beard and Swinbank, [2001]; Breen et al., [2005]; Swinbank et al., [2004]), has made an influential distinction between what he terms full decoupling and the less restrictive concept of effective full decoupling—respectively placing emphasis on adjustment or equilibrium. Fully decoupled policies, in his view, are those that ‘[do] not influence production decisions of farmers receiving payments, and that permit free market determination of prices’ (Cahill, 1997: 351). Effectively fully decoupled policies, on the other hand, are those that result in a level of production no greater than the equilibrium level of output that would be observed in the absence of the policy for any/all types of crop. This dual view of decoupling has been frequently cited

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<sup>1</sup> We will for the most part limit the scope of our discussion to only those reforms established in the original 2003 agreement.

in the literature surrounding the subject (e.g. Andersson, [2004]; Baffes, [2004]; OECD, [2001]; Rude, [2007]).<sup>2</sup> These definitions are not, however, without their limitations. In particular, the notion of fully decoupled policy measures is useful as a theoretical construct, but given the difficulty of establishing specific supply and demand schedules empirically, is of little practical utility for policy analysis. Effective full decoupling overcomes this issue to some extent—however, its asymmetrical focus solely on policy effects resulting in excess output, rather than both positive and negative production effects, is problematic.

Furthermore, any attempt to operationalise these definitions must establish some basis for quantifying decoupling. Cahill thus introduced the Degree of Decoupling index, defined as one less the ratio of the production effects of a policy over the production effects of a positive price change of identical magnitude (Cahill, 1997; OECD, 2001). This, in turn, raises a number of questions. In particular, the index measures the extent of decoupling against the benchmark of a fully coupled policy, which is taken to be market-price support. This is somewhat paradoxical—policy measures are evaluated according to their relatively inferior production-distorting effects rather than compared to unregulated equilibrium outcomes.<sup>3</sup>

There is also the question of whether policy measures should be evaluated in isolation or as a complete policy package. To this effect, the OECD (2001: 12), following Cahill (1997), has concluded that ‘the policy package matters’, and therefore investigations of decoupling should consider the specific effects of single measures as well as the overall effects of bundles of measures. Gohin et al. (2000) have further substantiated this analytically, concluding that policy impact varies depending on whether measures are implemented jointly. Finally, the discussion so far has centred on the production effects of agricultural policy; however, any analysis must not neglect potential policy impact on consumption, as both of these aspects can directly contribute to trade-distorting effects (OECD, 2001).

Elements of *ex post* economic conceptions have been combined with *ex ante* policy design focused elements into a more pragmatic legal or

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<sup>2</sup> In graphical terms, a policy that is fully decoupled according to Cahill’s terminology would have no effect on the shape of supply and demand functions, while one that is effectively fully decoupled would have no influence upon market equilibrium outcomes, although it might affect the shape of the supply and/or demand schedules and hence result in different responses to exogenous shocks (OECD, 2001).

<sup>3</sup> This can be seen as reflecting the path dependency phenomenon proposed by Kay [2003] and discussed by Swinbank et al. (2003). In this vein, Pierson has argued that ‘public policies [are] not only outputs of but important inputs into the political process, often dramatically reshaping social, economic, and political conditions’ (Pierson, 1993: 595).

administrative definition that is appropriate for prescriptive policy purposes. Under the World Trade Organisation (WTO) guidelines, agricultural policy measures have been categorised according to the extent to which they are 'decoupled' from production. Policies that comply with so-called 'Green Box' criteria are exempt from support reduction commitments under WTO rules provided they 'have no, or at most minimal, trade-distorting effects or effects on production' (URAA Annex 2, Art. 1). In addition to this fundamental *ex post* requirement, a number of *ex ante* conditions must be met in order for measures to qualify for Green Box status, among which are requirements for clearly defined eligibility criteria with a fixed historic base period, payments that are unrelated to the type or volume of agricultural commodity produced, market prices or inputs used in any other than the base year, and that payments are not contingent upon any production whatsoever (URAA Annex 2, Art. 6). These definitional issues are a persistent undercurrent to both policy-making and policy analysis, as will be apparent throughout the following section.

## **The Single Farm Payment: testing theoretical hypotheses on production effects**

### ***Ex Ante* Limitations of the SFP**

The CAP reforms of the last two decades have been hailed as indicative of a fundamental paradigm shift in European agricultural policy-making (Daugbjerg, 2003). The historic state-assisted paradigm, founded on the principle that: 'First, the agricultural sector contributes to national policy goals and therefore merits special attention; and, second, the price mechanism is a suboptimal means of achieving an efficient and productive agricultural sector' has, according to this view, given way to a market liberal paradigm in which market forces are the prime determinants of agricultural supply (Coleman et al., 1997: 275). However, an *ex ante* approach to reviewing the SFP already reveals several contradictions in the Commission's stated objective of enabling 'complete farming flexibility increasing market orientation' (Commission, 2002: 19). Most obviously, concessions made to member states in negotiations mean that the final legislation passed deviates significantly from the original proposal in permitting partially coupled support to be retained for some commodities and livestock (Binfield et al., 2004). In addition, land employed for the cultivation of fruit and vegetables was initially excluded from entitlement to the SFP (Commission, 2003). This incomplete decoupling is likely to affect farmers' resource allocation decisions, shifting production from fully decoupled towards partially decoupled commodities. Moreover, the persistence of import tariffs, export subsidies, and

intervention price guarantees undermines the community's commitment to market liberalisation (Matthews and Dixon, 2006).

In addition to these flagrant inconsistencies, labelling the SFP as 'decoupled' ignores the fundamental fact that, while no production is required, payments remain linked to the primary factor of production, land. Historical area-based payments, therefore, can impact on land purchase and rental costs, as the benefits of entitlement to direct payments is capitalised into land values. This, in turn, may distort production through increased barriers to entry and effects on farm profitability (OECD, 2005a). A substantial body of literature has emerged to support the significant long-run effects on land values of 'decoupled' direct payments (Bhaskar and Beghin, 2007). Similarly, coupling to land reduces incentives for farmers to exit the agricultural sector—mounting a barrier to exit—as this would entail the loss of SFP income. According to Gohin et al. (2001, cited in Rude, 2007: 7), 'If the amount of the direct payment exceeds the loss associated with a particular productive activity, then there may be a cross subsidization effect that will keep that producer in business'. This cross subsidization effect is consistent with research by Chau and De Gorter (2005). Although it applies primarily where payments are conditional on production, Rude (2007) has argued that cross-compliance requirements may have a comparable effect. Coupling the SFP to land thereby curtails the structural adjustment which is supposedly at the centre of agricultural policy reform objectives.

Furthermore, the so-called cross-compliance criteria—which make receipt of the SFP contingent on fulfilment of a number of statutory standards including maintenance of land in agricultural condition, environmental conservation, and public, plant and animal health and welfare requirements (Commission, 2003)—may influence production in so far as they restrict the scope of farmer decision-making in various ways (OECD, 2005b). Therefore, rather than reflecting what Isabelle Garzon has branded as a shift from a dependent to a multifunctional paradigm, this could be interpreted as an attempt to disguise and preserve the prevailing system of dependence and state assistance by restricting movement towards truly decoupled support measures (Potter and Burney, 2002).

To overcome these residual coupling mechanisms, early proponents of decoupling advocated the establishment of a transferable bond scheme. Perhaps most notably associated with Tangermann (1991), this would provide an annuity to farmers to compensate them for the reduction in coupled market-price support and would be entirely unconditional—decoupled from land and free from compliance requirements. Because bonds could be traded in a secondary market, the value of bonds would not filter into land prices or restrict farmers' decisions to hold land, produce, or otherwise adjust to market conditions. The Fischler

reforms took a small step in this direction by permitting farmers to sell their payment entitlements. However, because once sold entitlements had to be again linked to an equivalent area of eligible acres, payments remained coupled to land (Tangermann, 2003).

Lastly, even in its legal/administrative sense, characterisation of the SFP as decoupled is questionable. The MTR proposal stated that the SFP would 'provide a major advantage within the WTO, since the Green Box compatibility of the scheme will help secure these payments in an international context' (Commission, 2002: 19). However, the Upland Cotton Dispute brought before the WTO Dispute Settlement Body against the US has set an important precedent. In this case, the Appellate Body ruled that direct payments and other benefits to cotton farmers could not be classified as permissible decoupled payments under Annex 2 of the Green Box (Oxfam, 2004). While reforms to the fruit and vegetable regime in 2007 should in theory avert similar cases being brought against the EU's SFP Scheme, Swinbank (2007) has questioned whether cross-compliance criteria infringe upon the scheme's eligibility for Green Box status. Swinbank and Tranter (2005) have similarly concluded that the SFP may not fit within the Green Box due to the conditionality placed on eligibility. Therefore, departing from an *ex ante* perspective already reveals a number of limitations of the SFP as a truly decoupled measure.

## **Risk Effects**

### **Wealth and Insurance Effects**

Furthermore, if these limitations of the MTR are ignored and it is assumed for the sake of argument that the SFP is indeed entirely independent from market prices, with no conditionality attached to payment eligibility, several indirect production effects may persist. Foremost among these is the potential for 'decoupled' lump sum payments to distort producer decision-making via wealth or insurance effects. Assuming farmers are rational utility-maximising agents that display constant relative risk aversion (CARA), or decreasing absolute risk aversion (DARA), then lump sum direct payments such as the SFP will result in a fall in the coefficient of absolute risk aversion, increasing farmers' appetite for risk. Similarly, the SFP will smooth income variability in relative terms resulting in an insurance effect which, under the same conditions, will reduce absolute risk aversion (Bhaskar and Beghin, 2007). These effects have perhaps most notably been modelled by Hennessy (1998), who concludes that uncertainty regarding future agricultural outcomes e.g. yields, market prices, given DARA preferences, depresses production. Wealth effects of support policies will therefore have a

positive impact on production. Hennessy (1998: 49) also demonstrates that, ‘As with the wealth effect, the insurance [effect] fortifies the producer with the confidence to increase production when increased production is associated with increased risk.’ Further research is consistent with these findings (Sckokai and Moro, 2006). Indirectly, wealth effects may also influence farmers’ labour allocation decisions, both in terms of labour/leisure and on-farm/off-farm labour choices (Bhaskar and Beghin, 2007).

## **Dynamic Effects**

### **Investment Effects**

Wealth and insurance effects may furthermore be significant in a dynamic setting. Specifically, SFP may result in higher current savings and hence greater scope to increase future investment. To this effect, the OECD (2005b) has estimated that area payments, e.g. the SFP, have significant effects on investment, with insurance effects having a greater impact than wealth effects. Moreover, where credit constraints act as a limiting factor on farmer decisions, the capitalisation of direct payments into land values previously discussed, as well as the guaranteed income from direct payments will improve the creditworthiness of farmers and facilitate access to credit thus enabling increased investment (Goodwin and Mishra, 2006). These investments may increase production not only directly, if they are in yield-enhancing technologies, but also indirectly, if by lowering unit production costs they increase production incentives. In so far as greater asset holdings and values increase the overall wealth of the farm sector, this positive feedback perpetuates wealth effects over time (Westcott and Young, 2002).

### **Expectations**

Another key dynamic consideration involves the role of farmer expectations regarding future policy-making on production decisions. The underlying rationale is as follows: even if direct payments are decoupled from current production and based on a fixed historical period, farmers may anticipate, for instance, a future updating of the base period or re-coupling of payments so that decisions to reduce production or planted area now would result in a loss of entitlements to future support payments. Kydland and Prescott (1977: 486) have suggested that discretionary policy-making yields sub-optimal social outcomes due to their time inconsistency because ‘current decisions of economic agents depend upon expected future policy, and these expectations are not invariant to the plans selected.’ This is consistent with the findings of empirical and experimental evidence cited by Bhaskar and Beghin (2007). In addition, survey

data on Irish farmers presented by Hennessy (2004) and Breen et al. (2005) indicates a reluctance to alter production patterns in the farm sector in response to the MTR, which may well stem from expectations regarding future policy changes. Thus, farmers' reservations regarding the longevity of current policies or expectations of future policy shifts may hamper adjustment decisions and thus negate the effects of policy reforms.

## Conclusion

The above discussion has demonstrated that the SFP, in both policy design and effect, falls somewhat short of being truly decoupled. Limiting our assessment just to an *ex ante* conceptualisation of the term, it is already apparent that the SFP is by no means the 'no strings attached' payment it has been presented as. While the direct link of support to production has been removed, the payment remains coupled to land as well as to a number of conditions that place restrictions on farmers' freedom to respond to market incentives. Moreover, assuming the scheme did achieve its objectives of decoupling from an *ex ante* perspective, substantial evidence suggests that even unconditional lump-sum payments will have an indirect distortionary influence on production, via wealth, insurance, investment, and expectations effects. Thus, as Spriggs and Sigurdson have put it, 'the only truly decoupled program that there is,' is 'a program to eliminate subsidies completely' (1988, as cited in Baffes, 2004: 4).

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