

## ECONOMIC AND REGIONAL CONSEQUENCES OF DIRECT PAYMENTS UNDER THE CURRENT CAP PHILOSOPHY

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### Abstract

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The paper deals with one of the key instruments of the actual EU Common Agricultural Policy (the CAP), the direct payments. The economic as well as the regional implications of application for direct payments in the CAP strategy are evaluated there. The study deals with the economic costs, direct and indirect effects of such type of subsidy in general and a demonstration thereof in the context of the development of the European model of agriculture. Based on the economic principle of this type of transfer evaluation, the processes of the income redistribution in the framework of global/common policy in general is characterized. It explains the causes as well as the nature of implementation of this instrument in the reform processes in the last twenty years, focusing on the reasons and consequences of different application in the original and the new EU member states. It considers the question of whether this type of support to agriculture is truly a tool that does not interfere with market conditions affect the respective competitive ability of agricultural producers. In the context of changes to income support in agriculture in the CAP development process, the effect of decoupled payments on the pricing within the agricultural commodity markets is specified. At the same time the work deals with a broader social context and social impact of the differing forms of support in European regions.

agrarian policy, disparity, subsidies, the European model of agriculture, direct payment reform, the region

With over 56% of the population in the 27 Member States of the European Union (EU) living in rural areas, which cover 91% of the territory, rural development is a vitally important policy area. Farming and forestry remain crucial for land use and the management of natural resources in the EU's rural areas, and as a platform for economic diversification in rural communities. The strengthening of the EU rural development policy is, therefore, an overall the EU priority.

On the other side the efforts to implement the philosophy of the European model of multifunctional agriculture in the environment of global agribusiness, which is becoming more and more dynamic, open many issues of global and regional character. They concern the very substance of development of this industry in the qualitatively

new current conditions and in the long-term time frame. Such a situation of course enforces changes in the overall strategy of the EU's common agricultural policy (hereinafter referred to as "CAP") and in selecting the respective forms of a specific solution under such community policy. It leads to implementing such instruments that would allow the implementation of the EU's common goals in the environment, which are now very differentiated in 27 member states both regionally and with regards to efficiency. The decline of the direct (commodity) support for prices of agricultural products as the main instrument of support to farmers and the transition to systems of support integrated into rural development, which are "market-indifferent", but more complicated with regards to economic

substance and effects, is a typical indicator of the CAP changes.

A change of the overall strategy and selection of CAP tools is typical by the growth of the share of transfers/subsidies requiring income distribution. Nevertheless, this generally increases the dependence of farmer and rural support on expenditure of taxpayers. In the current stage, this applies in particular to allocation of support and use of the gradually balancing direct “decoupled” payments in compensation of lower income of the sector within the whole EU 27. The difference within the level of direct payments in agriculture of new member states, provided that they equal the original EU 15 only in 2013, is one of the problems directly concerning the comparability of conditions and possibilities of development of the Czech agriculture as a modern sector capable of competition within the common market. Under the today’s fall of the agricultural producers’ price level and the incomparable level of income compensation by means of other tools, the model of basic industry financing system does not contribute to this development.

Successful achievement of such intention is therefore conditional on higher levels of decentralization within a specific subsidy policy requiring making decisions on priorities within the meaning of income allocation and distribution criteria with knowledge of the real situation and regional conditions within the Union. Such an approach is undoubtedly a positive step, offering the chance to decide on solutions with knowledge of specific problems in agriculture and appreciation of its benefits for the development of specific regions and countries in the short- and long-term. However it requires a much higher engagement of member states in creating such a policy. In the present era, the issue of further support to such community policy after the year 2013 is the subject of strategic and positional documents being created in all member states. The form and criteria for direct payment applications is one of the key issues.

The paper is devoted to the economic and regional context of applications for the direct (decoupled) payments in the CAP strategy. It deals with economic costs, direct and indirect effects of such types of subsidy in general and a demonstration thereof in the context of the European agricultural model. It explains the causes and nature of the implementation of this instrument in the CAP reform process in the last twenty years and identifies the consequences of different applications of such an instrument in the original and new EU member states.

Methodologically it is based on an analysis of changes in the agriculture income support system in the CAP development process, and it defines the potential effect of decoupled payments on the environment of agrarian markets. It points out the conditional character of the statement on market indifference of an instrument of direct payment type in relation to the dynamics of business environment development and the creation of prerequisites for competitive ability of producers in the common market of agrarian commodities in Europe and throughout the world. The paper makes use of knowledge from processing the theoretical and methodological premises related to the investigation of the respective issues and some conclusions resulting from international comparisons of production development and price environment in the European agrarian market.

### Direct payment and its economic context in general

Direct payment can be defined from the viewpoint of general systematization as an aimed transfer of the total financial amount into the beneficiary’s (agricultural producer’s) income independent from its current production and prices of agricultural products. (OECD, 2001).

*If we understand subsidies in general as transfers reflecting changes in the redistribution of incomes not connected with the flow of goods and services, then in deciding on the extent and form of their use, it is necessary to assess not only the relation between the allocation effectiveness and the redistribution aims, but also their total economic costs.* Such costs do not express only the difference between the expenditures of the society for the respective subsidy and their reflection (benefit) in the beneficiary’s income, but they are also incurred as a consequence of

- *deformation effects* of the selected subsidy (relation to the development of market/price conditions and the distortion of market signals);
- *demands* to set an objective basis for distribution of subsidies<sup>1</sup>, which is usually connected with high *direct transaction costs* ex ante and ex post to collect high-quality and adequate information and realization of the transaction itself.

*Economic costs* of subsidies/taxes therefore include also the costs caused by their existence. They relate not only to deformation of the basis for application (including the effect on the behavior of economic entities), but also to the costs incurred in implementing and operating the system of instruments for the selected type of income redistribution, this means with the costs of the respective transaction.<sup>2</sup>

<sup>1</sup> i.e. a basis that the entity cannot influence.

<sup>2</sup> With regard to the difficult measurability of cost-deforming effects caused by the impact of the subsidy on the market conditions, only the remaining part of the costs is taken into account in the decision-making process, i.e. the direct transaction costs and amount of claims to budget funds considered in this context as indirect costs.

In the early 1990s policy instruments, which redistributed income to farmers without affecting the allocation of resources, has been defined as a lump sum transfers. OECD (OECD, 1994) generally characterises the *direct income payments that they should be directly financed by taxpayers; the size of direct income payment should either be fixed or, related to an agricultural production variable, be outside the farmers control; the size of direct income payment should not be determined by the volume of current or future production of specific agricultural commodities or the level of specific inputs used.*

Those imply in theory:

- avoid the existence of consumption effects,
- prevents the farmer from being able to affect the payment by production decisions,
- specifically rules out the use of measures that raise prices above international levels.

*Decoupled direct payments scheme* in general means that the predominant flow from public funding to agriculture will be paid independently from the volume of the present production (its amount and structure) and ought to make possible to choose the best structure of farm activities.

In the case of a *direct payment independent (separated) from production*, a form of support should be used, which has *theoretically* zero deformation effects from the viewpoint of the conditions of forming the marginal price in the agricultural commodity market. However it is generally acknowledged, (e.g. MUNK, 1994; SWINNEN, 1994, CONNOR, 2003; WESTCOTT and YOUNG, 2005) that they belong among the instruments whose application is normally connected with *high transaction costs*.

It concerns *two problems*:

- the *selection of allocation criteria*, in terms of conceptual promotion of restructuring, as a necessary condition for further growth of competitiveness on European and global markets, which is the key strategic problem of modern productive agriculture, and
- the *efficiency of subsidies* related to the determination of transfer forms/instruments and their economic costs.

The problem for decision-making should be share of the value of direct payments and if actual income the farmer gets from farming activity. This could be a sensible question relating to the future of the European agriculture products efficiency and competitiveness.

In theory, a *fully decoupled measure would not have any current condition or current parameter related to agricultural production or factor of production. A fully decoupled measure would not create any expectation that current production decisions could affect future payments.*

### Direct payments in the CAP concept

If in the beginnings of the CAP the main advantages for agriculture resulted from high support of producer prices, today it is the wider public opinion that determines to a considerable extent the form of budget expenditure in this sector.

Principal changes in the original CAP strategy and the related different choice of instruments of state interference in European agriculture were implemented as early as 1992 by the MacSharry reform, when support to producers' incomes based on high (guaranteed) market prices was considerably reduced. However in the respective stage it was practically substituted by the then member states for a compensation payment based on commodities.

The next introduction of the "decoupled" direct payments removes links between production and subsidies<sup>3</sup>. In addition to finding new directions and forms of support to incomes in agriculture, the share in support of structural changes was centrally handled in the same period as well. The so-called European Model of Agriculture started to be much more supported, with considerable strengthening of requirements to resolve the off-commodity benefits of the industry. It requires the production of public goods, maintaining conditions for sustainability, environmental protection, welfare of animals and the safety and harmlessness of products.

The main aims of the policy tools system were declared as follows:

- allow farmers freedom to produce to market demand;
- promote environmentally and economically sustainable farming;
- simplify CAP application for farmers and administrators;
- strengthen the EU's position in WTO agricultural trade negotiations.

Within the meaning of this strategy, *CAP Pillars I and II started to be formed under Agenda 2000, connected with principal change in the system of income support in agriculture specifically and in particular within the meaning of a multifunctional approach.*

By strengthening the role of structurally and environmentally profiled Pillar I with concurrent pressure on removing barriers in the global market, there was a space provided to widen the engagement of member states in creating agricultural support concepts. In 2003, the European Commission decided to adopt an offensive approach to negotiations about the agricultural chapter in the WTO and it used its mandate granted by the Council in order to prepare the 2002 *Mid-Term CAP Review*, in connection with other relatively major reform steps.

Negotiations were aimed at creating a better negotiating position for the EU in the WTO. The

<sup>3</sup> These measures had to react not just to the growing expenditures relating to the common agricultural policy, but also to the obligations from the Uruguay round of GATT and subsequent WTO negotiations.

issue of direct compensation payments by the EU was the basic problematic agenda point of the WTO negotiations; they were included in the “blue box” and due to their deformation effects on the agricultural commodity market, they were only temporarily tolerated (until the year 2003) in the then existing amount.

The European Commission therefore suggested a change in the direct payment character as to their separation from production (“decoupling”)<sup>4</sup>, so that such payments would be conditional on the fulfillment of many standards relating to environmental protection, animal welfare, food safety and food quality.

The entire historical period of reform of the CAP since 1980 and main changes in the targeting of basic tools are characterized by the following Figure 1.

The changes occurred in the era when the influence of global agribusiness became apparent also in the relatively closed and protected system of European agriculture, bringing a new agriculture model determined by demand (CONNOR, 2003; WITZKE *et al.*, 2008). Also the European policy *was forced in such a situation to respond to the new conditions of the business environment* and to reassess the original concepts including a return to certain decentralization in selecting and using the new range of applied instruments. Direct payments into farmers’ incomes appeared as a suitable basis for a solution.

In the European concept, in the respective stage, decoupled direct payments were undoubtedly

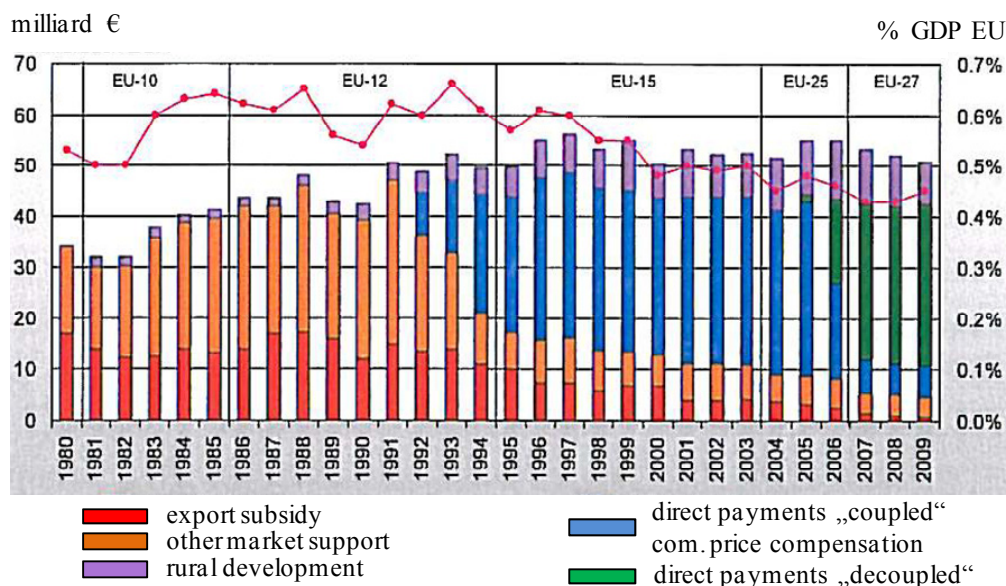
a response not only to the ever growing WTO pressure on liberalizing the agrarian market, but also to the need for a principal solution to the internal problems of overproduction in the common market in a period where the EU position was worsening in the global market.

The problem of financing agriculture in its productive and nonproductive dimensions was further complicated also by the massive expansion of the Union by new countries from Central and Eastern Europe in the year 2004, which did not have any considerable impact on further increasing the demands of the agricultural sector for the European budget.

### Sectoral and regional consequences

As discussed in last reports, (BEČVÁŘOVÁ, JUŘICA, 2008; BEČVÁŘOVÁ, 2009) our detailed analyses confirmed, that transfers of direct payment type are not a completely market neutral support. And not even from the market viewpoint. This type of tools has *significant social, sectoral and regional effects* in regards to principles and mechanism of income redistribution.

It can be derived from the mechanism of their application that it is a partial income redistribution from urban to rural households, which may *finally provoke changes in allocation of resources among sectors and regions within the respective economy*. In this context it is therefore necessary to cope with the dimension of this type of transfer (total amount of payment), but



1: CAP spending and strategy of changes in the usage and type of tools in the period 1980–2009

Source: Statistical and economic information DG Agri and rural development 2010

<sup>4</sup> In the respective stage, they were calculated as a support corresponding to an aggregate of the original individual direct (compensation) payments in the referenced period.



also the effects of utilizing it in the target industry and in a specific region.

If we accept arguments related to the specifics of agriculture as an industry in general and the legitimacy of subsidies in particular on the basis of production of positive externalities, then in evaluating the effects of direct payments under the CAP, a question arises if, to what extent and by what signals the current (asymmetrical) system of direct payments assesses such benefits. Concurrently, in relation to new types of market failures in the agribusiness environment, it is necessary to know the answer to the question, if it influences on a comparable basis the behavior of producers in the competitive environment of agrarian markets created in a such way (including production factors) in general, if and to what extent it really affects the producer's decisions on production and the prerequisites of competitive ability in the common market of agrarian commodities.

This means that the question is if and to what extent *direct payments affect production decisions* made by producers including decisions on allocation of resources within a time frame. The results of previous research confirm that in addition to the immediate effect – an increase in the beneficiary's income, such a *transfer considerably influences decisions on production itself*, in particular through

- influence on risk analysis and on the beneficiary's investment decisions;
- influence on consolidation/changes in entrepreneur structure/in the sector;
- selection of the criteria for making payments.

Permanent income in the form of a direct payment *regardless of the production level and structure* is an instrument contributing to the limitation or modification of production risk in agriculture. Provided proper selection of the criteria is made, there is a potential for decreasing the *aversion to risk* of beneficiaries of such payments, because it allows partial compensation of year-on-year fluctuation of production and market prices in the beneficiary's income. It also motivates successful producers to *invest* in innovations, in plant modernization, and new technologies and production systems, which leads to quicker adaptation of the production structure to demand signals and thereby to the precondition of competition ability of producers.

This effect should finally reflect in reducing the unit cost of production, and thereby also in a more advantageous position for primary producers within the commodity verticals and agribusiness networks.

From the viewpoint of the influence of direct payments *on changes in entrepreneur structure/consolidation* within the sector, two different tendencies can be identified, namely

- *decelerating the consolidation processes*, when thanks to direct payments, ineffective businesses are still surviving in the market (subsidies cover the losses of ineffective plants, they allow income to be generated from growing soil prices...),

- *accelerating the consolidation processes*, if the effective businesses use these funds for investing in new technologies and development of activities leading to an increase in effectiveness, which will increase the income and economic differentiation and speed up liquidation of plants that are not able to assert themselves in competition and are usually merged with successful companies.

However the decisive role in the practical use of direct payments for fulfilling the above-mentioned attributes in all EU member states is played by the still *different levels of such support* provided to the original and new member states.

Unlike the original EU 15 countries, which acquired the funds for the new type of support to the full extent by transferring the original compensation payments for selected commodities or commodity groups into national envelopes, the level of direct payments for the respective new member states was calculated on the basis of the quota and production limits negotiated during accession negotiations.

Moreover, they were not available to such countries to the full extent from the beginning of their membership in the EU. In the period of 2004–2013, their level was gradually unblocked from 25% in the initial period with the option of full withdrawal as late as in the year 2013. Even though national budgets take part in this type of payment (but just to the defined limit), *the basis or conditions for achieving comparable position of producers from the original and new member states in the market is deformed*.

Thereby, also this type of income support, which is theoretically independent from market, significantly reflects in the market environment conditions and influences the competitive position of producers both in horizontal relations of the common market and in agribusiness verticals.

As it follows from the results of research into the production and economic context of agriculture development in the today's 27 EU member states (BEČVÁŘOVÁ *et al.*, 2008,) the disparity in the levels and proportions of production of the decisive commodities in agriculture in the original (EU 15) and new (EU 10, respectively EU 12) member states is really apparent in the last fifteen years.

In the new member states in general, there is typically a *decrease in the production* of decisive agrarian commodities, while the EU 15 countries maintain or increase the original volume of production. On the other hand, the market prices and price levels of commodities within the EU common agrarian market are gradually equalizing, while there is apparent pressure in the new member states for a quicker rate of increase in prices of agricultural producers over the level of prices of the decisive producers in the EU 15 (BEČVÁŘOVÁ *et al.*, 2009).

We can legitimately assume that the asymmetry of creating income in primary production in the conditions of the original and new member states, where the *decisive role was played by direct payments, was one of the important factors of such development* (in

addition to limits and quantity restrictions during accession negotiations).

However we have to take into account the reality of changes in the business and market environment.

Under the conditions when the influence of the demand side of markets is considerably increased, a high price of basic raw materials *is not an advantage*. In the situation when price is determined by development in the follow-up markets within the whole commodity verticals and networks, the position of suppliers with a high price of basic raw materials is on the contrary becoming more complicated.

The globalization processes and the consequence of regionalization connected with them principally change the conditions, rules and criteria of agrarian market functioning in whole verticals, which now

often become global networks. They condition the successfulness of mutual relations between the productive and nonproductive roles of agriculture. They change conditions, structures and profiles of viable agricultural companies, providing the basis for a prosperous sector, being simultaneously an important representative of activities in rural regions. Today such entities have to not only stand the test of competition as a partner to vertical relations of the agribusiness asserting itself, but also face disparity in creating horizontal conditions of competition of agricultural producers in the European market. In such a context the possibilities are created for actual implementation of the potential benefits in creating an economic and social background to the development of rural regions.

## SUMMARY

The paper deals with one of the key instruments of current agrarian policy, the direct payments. It characterizes the economic principle of this type of transfer in the processes of redistribution of economic policy in general. It deals with economic costs, direct and indirect effects of such types of subsidy in general and a demonstration thereof in the context of the European agricultural model. It explains the causes and nature of the implementation of this instrument in the CAP reform process in the last twenty years and identifies the consequences of different applications of such an instrument in the original and new EU member states.

Methodologically it is based on an analysis of changes in the agriculture income support system in the CAP development process, and it defines the potential effect of decoupled payments on the environment of agrarian markets. It points out the conditional character of the statement on market indifference of an instrument of direct payment type in relation to the dynamics of business environment development and the creation of prerequisites for competitive ability of producers in the common market of agrarian commodities in Europe and throughout the world. The paper makes use of knowledge from processing the theoretical and methodological premises related to the investigation of the respective issues and some conclusions resulting from international comparisons of production development and price environment in the European agrarian market.

However such a conditional character is not only projected in the agrarian sector relations. In the current model, the productive activities of agriculture and its other nonproductive activities are narrowly connected with a complex network of interconnected conditional causes and effects in the development of society in all dimensions (economic, ecological, technological as well as human and social) and they thereby connect the issues of development of agrarian and regional policy.

They are substantial not only for the development of rural regions, but also – with regard to activities of the subsequent processing and distribution stages – urban regions. The target solution does have a long-term character but the dynamics of changes in the environment combined with the specific aspects of agricultural production make it necessary to select a complex approach from the very beginning of the solution including the permanent review of the effects of reform steps in the agrarian sector at production level as well as at non-production level. Based on the specific case of disparities in the implementation of direct payments under the European system draws attention to cross-market proposition for the utility indifference and formulates conclusions relating to the conditions of the business environment and competitiveness of the assumptions in the European common market in the horizontal and vertical connections of the progressive agribusiness.

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