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The Future of Direct Payments

This policy brief draws from the September 2011 IPC Discussion Paper "Farm Policy in the US and the EU: The Status of Reform and the Choices Ahead" by David Blandford, Tim Josling, and Jean-Christophe Bureau. The authors thank IPC Chief Executive Charlotte Hebebrand for her assistance with this brief. Funding for this set of papers was provided from both sides of the Atlantic: IPC is grateful for support from the RISE Foundation (www.risefoundation.eu), and for additional support from the Farm Foundation (www.farmfoundation.org) under its Small Grants Program.

The EU is preparing for further reforms to its Common Agricultural Policy (CAP) for the post-2013 period. One major issue is the future of the direct payments (DPs) that have become a major feature of the policy since the MacSharry reform in 1992. At the same time, the US Congress will be seeking to pass a new farm bill in 2012. One target for reductions in the budget for agricultural programs in the US is the direct payments program, introduced in the 1996 Farm Bill. **In both the EU and the US the central issue is the political viability of payments to farmers based not on current conditions but on compensation for policy changes made years ago. Without a convincing reason for such payments their place among the instruments of farm policy is uncertain.** This policy brief examines the debate in the EU and the US over the future of direct payments to farmers. The debate has important ramifications not only for the farm sector on both sides of the Atlantic but also for other countries who are impacted by developments in US and EU farm policy.

What are direct payments?

Both the US and the EU introduced direct payments as an alternative to intervention by the government in agricultural markets. Market intervention – maintaining high commodity prices by buying up and disposing of surplus production – had become a drain on government budgets and contributed to trade frictions. Among the more egregious aspects of such surpluses was the need for export subsidies to draw down surpluses, leading to depressed levels of international prices. To compensate for the withdrawal of such market intervention tools, "direct payments" were provided to farmers, so as to delink government support from production and price.

The US had introduced DPs in the 1970s, initially tying them to supply control. Farmers received such payments so long as they held cropland out of production. In 1996, the US decoupled DPs from current production and consolidated them across program commodities, mainly corn, wheat, soybeans, cotton, and rice. One attraction of this move was the "freedom to farm" that it introduced. Payments were based on historical crop areas and did not constrain output decisions.[1] Subsequent steep price declines for program crops, however, led to the addition of supplemental payments (at a time of a rare budget surplus) and these became consolidated as counter-cyclical payments in the 2002 farm bill. Counter-cyclical payments represented a step back toward price supports, though they were not related to current production. Direct payments and counter-cyclical payments were also maintained in the 2008 farm bill. Direct payments, now total around $5 billion per year.

The EU introduced direct payments with its 1992 CAP reform, along with a significant cut in the level of price support for cereals and oilseeds. In a further reform in 1999, the Agenda 2000 reform, direct payments became linked to environmental rules set as a condition for receiving them (known as cross-compliance). The production requirements to be eligible for these payments have since been relaxed, particularly in the 2003 Fischler Reform that introduced the Single Farm Payment scheme (SPS). This payment

1 Production of fruits and vegetables and wild rice was not however allowed on land included in the payment base.

is a consolidation of payments previously given on a crop basis, so that EU farmers also regained their "freedom to farm".[2] A large share of the overall CAP budget now goes towards direct payments in the EU: they grew from 10 billion euro (in 2007 prices) when introduced in 1992 to some 36 billion euro in 2008. The Single Farm Payments, make up the major part of all CAP funding.

The introduction of direct payments in both the EU and the US in the mid 1990s reflected a change in the domestic policy paradigm. At the same time the issue of the reform of the international trade rules was being discussed in the GATT Uruguay Round negotiations (1986-1994). The introduction of direct payments in the US and the EU dovetailed in with the new rules agreed in the Uruguay Round Agreement on Agriculture, initially occupying the "blue box" of measures that combined direct payments with obligations on farmers to restrict production. The US direct payments were notified as blue box in 1995, but as a result of the 1996 Farm Bill they were designated by the US as Green Box in subsequent years. The EU continued to notify direct payments as blue box until 2005, when as a result of the 2003 Reform they were considered (by the EU) to qualify as green box payments (Orden, Blandford and Josling, 2011).[3]

The introduction of direct payments decoupled from production and price has clearly contributed to the reduction in trade distortions in the past two decades. Though there are still questions about the full compliance of such payments with the provisions of the green box, the movement away from price supports is to be welcomed. **So it is necessary to ask whether the legitimacy gap of direct payments in the current debate spells an eventual reversion back towards price supports.** If so, the prospects for the multilateral trade system are sobering.

What is the debate over direct payments?

The terms of the debate over direct payments differ quite significantly between the EU and the US. In the US the pressure has come from intense scrutiny of the budget cost of federal programs and the desire by farm groups to maintain the core of the farm programs intact. The political vulnerability of the direct payments is acknowledged. From a taxpayer's perspective, it is clearly difficult to justify government payments to a small portion of the population that is enjoying record levels of income. A major reduction in direct payments, and even the elimination, is under active discussion. A divergence of opinion in the farm community is already apparent on whether reductions should be made in direct payments in order to accommodate a reduction in the overall budget for commodity support, or whether to press for the reallocation of funds to other programs. In most variants of this idea the funds saved from a reduction or elimination of direct payments would shift funding towards insurance programs, which would be consistent with the emphasis on the safety net as a risk management concept, although there are also calls for further reductions to crop insurance.

Politicians in the US have taken pains to point out the vulnerability of direct payments to rural constituents. A number of farm groups have indicated that they could live with an end of direct payments. Some farmers have already voluntarily given up their entitlement to direct payments in order to benefit from revenue insurance schemes such as the ACRE program. However other sectors (such as cotton) are urging for the continuation of direct payments, arguing that they cannot benefit from other risk management tools. Confusing the current debate is the issue of whether the budget outcome, if achieved in the near future, would mandate the changes in farm programs or whether they would indicate a particular cut in funding, to be realized as the House and Senate Agricultural Committees go about their business of crafting the 2012 farm bill.

The debate over direct payments in the EU is of a notably different character. The CAP presently relies on direct payments to satisfy demands for income support. Clearly, **the linkage of direct payments to cross-compliance, in essence justifying the payments as investments in the environment, has made direct payments less controversial in the EU than they have become in the US.**

2 There are in effect two schemes open to member states to implement the policy: the Single Farm Payment scheme, which is based on historical payment bases, and the Single Area Payment scheme that gives a particular per hectare payment to farmers regardless of previous output levels.

3 Notification of a support measure as blue or green box by the country concerned does not imply the agreement of other countries.

The payments are seen as a way of paying for public goods that the rural sector provides. **Yet, it is not clear whether this justification can last: there are voices in the EU who are arguing for more effective targeting and tracking of compliance, to ensure that the public goods are actually being delivered at a reasonable cost.** These demands, however, run into opposition from producers who are keen to maintain income support and are wary of further environmental requirements. But for the Commission, it could be a viable political compromise, given the reluctance of the member states to shift the pillar 1 budget to co-financed rural development measures (which also include targeted environmental programs).

There are also significant equity considerations around the distribution of direct payments in Europe. New member states argue that they reap much less benefit from the CAP than the EU15, even though the budget for their direct payments has been increasing over a 10-year transition period following adhesion. Many original member states have put forward arguments against a complete leveling of payments across the EU27 in order to avoid large transfers to the new members. As a result, it is likely that negotiations will end up with a compromise, with significant redistribution of pillar 1 payments between member states, but without a full harmonization of the level of payments per hectare. This will affect the way payments are designed, since some criteria will have to be found to take into account this implicit political constraint in defining the modalities of farm payments.

As in the US the argument that farmers receive payments whether or not incomes are high has been advanced in the EU. Proposals for making direct payments countercyclical have met a favorable echo from some farmers' organizations, cooperatives and some member states. The reduction of direct payments in times of high prices looks like a good idea to many observers. However, there are several problems with this proposal. The first obstacle is that large inter-annual variations in the direct payment budget would be incompatible with the current rigid appropriations in the EU budget that prevent large variations in expenditure. Even though many MEPs would like to have more flexibility and more Parliament control on the annual budgets, coping with several billion euro of inter-annual variations in the budget would require fundamental reforms of the EU budgetary procedure. Making direct payments dependent on the market situation would also shift such payments into the "amber box" of domestic support and raise compatibility issues with WTO commitments. It would also undermine the incentive for cross-compliance and therefore go against the "greening" of the first pillar. One might also argue that the benefits of having a public authority doing what farmers might be expected to do with a fixed payment (i.e., save some of in good years for harder times) seem trivial. But perhaps more important, it would be difficult to manage a countercyclical payment without going back to product-specific payments, which would involve a complete reversal of the current orientation of the CAP.

Advancing the Debate

The IPC welcomed the introduction of direct payments as a move away from market intervention, but with the understanding that they were intended to be temporary. Although they are clearly preferable to production-linked payments, the fact that DPs are provided both when prices are high and when they are low does not make them a plausible risk management tool. As rewards for the provision of public goods direct payments have some rationale in the EU, as a result of cross-compliance conditions, but the allocation of these payments needs to be carefully restructured to achieve that end. In effect, the EU system of direct payments is becoming a part of the complex distribution of funds among member states. The member states themselves have considerable flexibility in determining the use of those funds.

The system of direct payments in the US is under direct threat from the negotiations over deficit reduction. The main issue may be therefore that of devising a policy without direct payments. **If direct payments in the US were to be greatly reduced or eliminated, it will be important to ensure that those funds are not channeled into instruments that are directly linked to current production and/or prices.** No-one is suggesting a return to target prices and deficiency payments, but more producers could enroll in ACRE if direct payments were to be eliminated and ACRE payments are linked to current production and prices. The countercyclical payments will continue to vary with commodity markets, and the desirability of this policy is separable from that of direct payments. Tying direct payments more stronglyto conservation and other environmental practices does not seem a viable option in the US, where there is already much concern over the extension of regulations governing farming. Similarly, transferring funds from commercial agriculture (and more specifically the program crops) to rural development, conservation, nutrition or specialty crops is also politically unlikely. So the main choice is whether to attempt to switch some of the funds saved from a decrease in direct payments to insurance programs and towards research and development.

Direct payments in the EU are not likely to be eliminated, but questions are and will be raised about whether cross-compliance is an adequate "green" component for what is primarily intended to be income support. Though one could make the case that environmental objectives could stand on their own (and apply to all farmers regardless of whether they receive payments) the political cover has proven useful. However, it is not clear that the SPS is a stable policy in the longer run. **It seems inevitable that trading partners will continue raising questions about the considerable amount of income support provided to European producers in the form of direct payments and whether these can truly be considered non- or minimally trade distorting.** So a more internationally acceptable form of direct payment program may eventually emerge.

Conclusions

Meeting the multiple objectives of farm policy in the EU and the US will always be a complex task and hence make use of a variety of policy instruments. Both sides of the Atlantic (and much of the developed world) have abandoned the notion that maintaining high prices enables farm policies to be responsive to changing economic conditions. The maintenance of high commodity support prices was in any case not a successful way of supporting farm incomes in the longer run. The benefits were largely reflected in the price of land and other assets, and the burden on consumers (and the food processing sector) and the budget created tension within and among countries. The replacement of high support prices and government purchases by direct payments (though still reflected in land prices) resolved many of the problems but introduced others.

Both the US and the EU are grappling with what to do about direct payments now that their original justification is passed. In the US the arguments tend to be about strengthening safety net programs available to farmers: in the EU the discussion leans more toward adding more environmental and other conditions for receiving direct payments.

References

Orden, David, David Blandford and Tim Josling (eds.) (2011). WTO Disciplines on Agricultural Support: Seeking a Fair Basis for Trade. Cambridge, Cambridge University Press.

Key Recommendations for the US:

- The rationale for direct payments is weak, and they should be eliminated on policy grounds.
- If direct payments were eliminated, those funds should not be channeled into instruments that are directly linked to current production and/or prices.
- Money saved from eliminating direct payments should go towards increased R&D funding for productivity enhancement, to allow US farmers to compete effectively in world markets.

Key Recommendations for the EU:

- The case for continued direct payments in the EU needs to be made in a way that is convincing to the public, by strengthening the link with the provision of public goods.
- If this is not possible, they should be phased out.

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The International Food & Agricultural Trade Policy Council promotes the role of trade in creating a more open, equitable, productive and sustainable global food & agricultural system. IPC makes pragmatic trade policy recommendations to help solve the major challenges facing the global food & agricultural system in the 21st century—the need to promote global food security, to sustainably increase productivity, and to contribute to economic growth and development.

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