Cap Developments After 2013

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Working Paper 2010-08

AGFOODTRADE (*New Issues in Agricultural, Food and Bioenergy Trade*) is a Collaborative Project financed by the European Commission within its VII Research Framework. Information about the Project, the partners involved and its outputs can be found at www.agfoodtrade.eu .

Financial support received by the "New Issues in Agricultural, Food and Bio-energy Trade (AGFOODTRADE)" (Grant Agreement no. 212036) research project, funded by the European Commission, is gratefully acknowledged. The views expressed in this paper are the sole personal responsibility of the authors and do not reflect those of the Commission which has not viewed, let alone approved the content of the paper. The paper does not reflect the views of the institutions of affiliation of the authors either.

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(note: a revised version of this paper was publishe in QA Revista Dell'Associazione Rossi-Doria. 4-2009, pp 29-56., under the title "*CAP Payments After 2013 and Rural Public Goods*")

1. Introduction

The Common Agricultural Policy (Cap) reform initiated in 1992 has changed considerably the public intervention in the agricultural sector and the rural economy over the years. However, whether today's Cap is consistent with society's emerging demands and long run European priorities is a debated and important question.

Major adjustments occurred in 1999 and in 2003, when support was divorced from production. However, the 2008 Health Check process was meant to introduce adjustment rather than radical change. The longer term objectives of future Cap remain to be addressed in detail. Preparation of the new financial perspective to be introduced in 2013 and the institutional changes to accord with the new Treaty will bring these issues to the fore.

As is the case for any policy, the objectives of the Cap should be assessed against their rationale and the adequacy of the ways and means for achieving these goals. There is a widely held view, acknowledged by the various European institutions, that the list of objectives of the original Cap falls short of current expectations about European agriculture. On several occasions both the Commission, particularly in the *exposé des motifs* of the

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Agenda 2000, and the European Council, have issued statements implying a reconsideration of initial Cap objectives. Additional objectives for European farm policy were outlined in the European Council of Gothenburg (15-16 June 2001): “strong economic performance must go hand in hand with the sustainable use of natural resources and levels of waste, maintaining biodiversity, preserving ecosystems and avoiding desertification. To meet these challenges, the Cap and its future development should, among its objectives, contribute to achieving sustainable development by increasing its emphasis on encouraging healthy, high-quality products, environmentally sustainable production methods, including organic production, renewable raw materials and the protection of biodiversity” (EC, 2006b, p. 2).

However, the Reformed EU Treaty does not contain a reformulation of Cap objectives beyond reference to sustainable development, consumer protection and animal welfare. The official texts have shifted the focus of Cap objectives toward non-commodity issues. This shift reflects the demise of some of the central objectives of the Rome Treaty such as income support and price stabilization. The focus of this paper is not on these issues or on policies aimed at markets and products. The main instrument of the Cap is now direct payments, and the problem is to identify legitimate policy objectives for these payments. The rationale for Cap payments raises two fundamental questions. The first is related directly to agriculture and refers to why and how much public intervention is required. The second concerns Europe and how much of this government regulation and public funding should be related to EU competence.

In terms of agricultural policy, there are two broad areas to consider. The first is correction of market failure; the second is state objectives and equity issues. Food security is a prominent state objective which is mentioned here *en passant*: it deserves to be pursued through several instruments and it is certainly not limited to self-sufficiency. In relation to market failures, our assessment is that there is a widely accepted although not unanimous view among agro-economists, that such failures exist and can be important due to the close connection between agriculture and natural resources. In terms of equity, the dominant view is that social issues and a more even distribution of income are better addressed by the introduction of a general social safety net rather than through sector specific policy. In this respect, the Cap has lost much of its legitimacy, since the distribution of Cap benefits exacerbates rather than alleviates income inequality both within the sector and between agriculture and other comparable sector incomes. Income support is still proclaimed as a legitimate objective of the

Cap, either to maintain production capacity or to stabilize farm incomes, but this argument is not addressed in this paper. There is one equity aspect that is fairly widely recognized as being legitimate, that is, cohesion in Europe, which is aimed at reducing the gaps between rich and poor regions and across portions of the rural territories. This objective is closely related to the choice of economic development to be pursued in some rural areas that are suffering economic stress and where land abandonment is more likely to occur. We discuss this objective.

The European side of the issue concerns the search for an appropriate allocation of authority between the EU and national-local governments, which eventually will determine whether costs and tax burdens are shared reasonably among member states. This problem has been addressed in the European context by the principle of subsidiarity. It relates to the economic and political thinking on fiscal federalism. Two essential challenges related to the Cap after the decay of price support and market management, are survival of the single market and reorganization of the budget, the latter being sensitive, in terms of size and distribution, to the implications of the so-called principle of financial solidarity. Views differ widely across Europe and have provoked lively discussion in the Council of Ministers and been the cause of repeated political crises. This core problem in the Cap would benefit from academic research on fiscal federalism.

There is a view that market failures are minimal, that the side effects of agricultural production are essentially local in nature and best managed by national authorities, and that there is no need for a Cap in Europe. The opposing view is that the recent price rises and expected trends in world food demand will revive the rationale for enhancing production capabilities in Europe. This is the view of organizations and countries that benefit from the financial system in place. In our opinion, there are good arguments for maintaining some level of policy and EU authority, provided that political failure can be curtailed and real reform based on sound principles can be achieved.

This paper focuses on direct payments and rural public goods.[1] We assess the problems related to the existing Cap; we make some proposals for which we provide justifications. In the concluding section, we discuss some unresolved issues and the distance between our proposals and good policy principles.

1. The *Notre Europe* report (Bureau and Mahé, 2008) covers other aspects of the Cap such as stabilization, market and income policies.

2. The Reformed Cap Since 1993: Merits And Limits

The orientation of the Cap over the last 15 years has been clear. Since the McSharry proposal in 1991, Cap reforms have followed a consistent path towards greater market orientation, and the reforms since 1992 have been largely successful. Major disequilibria have been resolved, including market imbalances for core European agricultural market commodities such as grains, beef and dairy products.

There were few credible alternatives to the orientation adopted in 1992, but after 15 years of reforms, the Cap is a focus of criticism from many directions. That today's agriculture is not aligned with the "novel Cap objectives" is not really debatable. However, the policy is blamed rather unfairly for weaknesses in other policies and for technical and structural economic changes that have made the linkage between agriculture and rural resources less secure. Criticisms that stress the role of the Cap in food safety, and its negative impact on poor countries, are based on fragile evidence[2]. And the current critiques often do not acknowledge that the reformed Cap does not generate such huge distortions as occurred in the 1980s.

The 2003 reform imposed a further distance between payments and interference with agricultural markets and attempted to improve farm practices regarding the environment through cross compliance. However, the actual benefits of the most recent changes have yet to materialize and the reforms have led to disappointing results and provided real grounds for dissatisfaction with the Cap. The rules for the distribution of single farm payments (Sfp) are no longer defensible and the Sfp scheme in its entirety is not relevant to the new market conditions or the long run objectives of the Cap. The medium term market outlook includes both favourable conditions and threats to second pillar objectives which also call for a reconsideration of the current Sfp scheme.

2.1. Has Income Support Worked? Is It Working Better?

Regarding the objective of increasing individual earnings, the "old Cap"

2. See Bureau (2007) on food safety and Boüet *et al.* (2005), Bureau *et al.* (2006) on the impact of the Cap on poor countries.

showed poor transfer efficiency[3]. The shift towards direct payments does ensure that more of the funds derived from taxpayers and consumers reach farmers than in the past[4]. Direct payments now represent a considerable share of farm income. Setting aside 2007-08, which we believe was an exceptional period regarding commodity prices, incomes net of subsidies are negative in many sectors, including beef, but also arable crops, even for the recipients of the highest payments. It is unclear what conclusions should be drawn from such a worrying dependence on direct payments. To conclude that the beneficiary farms would disappear if the Sfp were phased out would be premature. There is a margin of structural adaptation and cost savings in relation to large arable farms; however, the prospects for such adaptations are less bright for the grass fed beef and sheep sectors.

In many countries, the benefits of farm programmes are passed on to the owners of the primary assets such as land or production rights (Duvivier *et al.*, 2005), which, according to the Treaty of Rome, should not be benefiting from the Cap. In a number of new member states, studies show that direct payments based on the new Cap had considerable inflationary effects on land prices. The capitalization of support in land prices mainly benefits the non-farming population, to whom land has been redistributed recently – to absentee landowners whose property rights were forfeit in the collectivization that occurred in the 20th century, or where a large percentage of land is rented[5]. In these new member countries, the transmission of policy rents to landowners is strengthened by the constraints on farm credit; hence the benefits to farmers from these payments are very small (Ciaian and Swinnen, 2007). Even in countries where farmers own their land, the picture is not much different. Labour attracts only a fraction of the support, given the transfers of assets out of these sectors (payments to siblings entitled to part of the inheritance, purchase of quotas or land from farmers leaving the sector). Because direct payments tend to increase the costs of farming in the

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3. Given the magnitude of the Cap budget and the ratio of support to value added, the deadweight loss is not negligible, even in terms of the economic cost of fiscal resources and various transaction costs (for recent sources, see Sapir, 2003, Wichen, 2004).

4. However, in terms of gross income transfer efficiency the better performance of direct payments is often cited, with no acknowledgement of the accompanying administration and implementation costs. The efficiency in transferring income of price support through a small duty is reasonable, but it is low for high levels of duty. However, precisely targeting recipients through duties remains unfeasible.

5. In situations where the legal framework gives strong bargaining power to the tenant, e.g. France, farmers may retain a large part of the payments. But new farmer candidates often pay some kind of fee to former tenants.

long run, and raise the barriers to entry, the reformed Cap still favours those who leave the sector rather than those entering farming (Henry de Frahan, 2007). With the move towards direct payments in 2003, and the possibility to transfer rights without land, theoretical studies show that the degree of capitalization has become more complex[6].

The concentration of benefits is a classic problem and cannot be hidden now that it is the taxpayer rather than the consumer that is footing the bill. With the exception perhaps of payments to less favoured regions, the core objective of the Cap was never to reduce existing "natural" disparities, and in several cases it has increased them: larger farms benefited more from price support and, after the reform, received larger direct payments.

Anecdotal evidence of wealthy aristocrats or large corporations receiving direct payments contributes to turning the public opinion against the Cap. However, the hefty payments collected by particularly well off recipients hide a more complex reality. In some new member states, large payments are granted to former collective farms endowed with a large labour force which might benefit to some extent from the European funds, although this remains to be assessed. The image of payments channelled to wealthy arable crop farmers in fertile areas, should not ignore the fact that in less favoured areas payments often exceed the level of agricultural income and that other sectors continue to benefit from significant market price support. However, the concentration of payments cannot be denied.

The extra modulation introduced in the Health Check, or the original proposition of the Commission to cap individual payments, only respond to the strongest criticisms of the present allocation of payments, by limiting the amounts going to some of the most visible recipients. However, ceilings can be circumvented and capping would not address the core issue which is the lack of objective foundation for direct payments now that the "compensatory logic" is obsolete.

There is no consensus regarding what "fair" transfers should be within the EU and whether or not the Cap should have any distribution objective within the sector itself. The very idea of "compensation for natural handi-

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6. Because of the tradability of Sfps, with or without land, the two markets are interdependent and outcomes depend on which one is the constraint (Kilian and Salhofer, 2007; Matthews, 2007; Courleux *et al.*, 2007). Actual capitalization in land prices depends a lot on the option chosen by the member state and the freedom left to transfer Sfp rights without land (some countries e.g. France have made such transfers very difficult, with a siphoning off of half of the Sfp rights traded) and on whether there is land available without entitlement in the member state.

caps" appears bizarre to some member states. However, those who deny that the "fairness" criteria should interfere with policy management design, fail to provide economic and political rationales for the current distribution of payments without an identified counterpart.

In the current context where the exposure of the European farm sector to price volatility has increased, the role of the sizeable constant Sfp as a major buffer to loss of farm income should not be overlooked. It is a poor solution to insuring farmers against market instability, but the European taxpayer should hope that, at the very least, the insurance schemes envisaged will not be subsidized without a parallel phasing out of the Sfp.

2.2. Environment and rural development: positive changes but challenges remain

Another of the most compelling problems related to the Cap is its questionable environmental record, although to a large extent this is due to deficiencies in environmental policy rather than the Cap. The contradictions between the two policies have long been a dominant feature of government intervention. While pollution due to agriculture is limited compared to that from other sectors, agriculture is the main source of ground water pollution and one of the main sources of reduced biodiversity (as demonstrated by the dramatic fall in bird populations: about 30% in France (Ifen, 2006)). Agriculture is also the major water user, much of which use is inefficient because the charges for water do not reflect the value of this resource.

The share of crops in total agricultural area has increased steadily at the expense of permanent grassland, which has high value in terms of the landscape and water filtration. In France, 600 000ha of meadows were lost in the ten years 1993-2003 while the area of arable land under annual crops increased by about 100 000ha (Ifen, 2006). This switch can be ascribed mostly to the bias of Cap support in favour of crops even after the 1993 reform when it was extended to silage maize. National governments have done little to alleviate the incentives to destroy habitats and pollute water. Subsidies for land consolidation, drainage and irrigation have even enhanced the profitability of such degradations.

The reformed Cap has not managed to reverse these incentives in spite of repeatedly stated objectives and of partial decoupling. The 1992/1999 reforms did not lead to a visible decline in negative externalities over the 1990s. Nitrate vulnerable zones still cover about 37% of the total EU-15 area (1.2 million km2 of the total of 3.7 million km2). Implementation of the Nitrate directive by member states is a complex process. So far, only a minority is fully compliant and the Commission has begun a number of infringement proceedings against member states for non-implementation.

Preliminary[7] evaluations of the agri-environmental schemes included in the Rural Development (RD) Regulation suggest that their effectiveness leaves much to be desired (e.g. EC, 2006a; Barbut and Baschet, 2005; Kleijn *et al.* 2006). Preliminary assessment of the RD Regulation programme in France suggests that a couple of measures probably had an impact – particularly in less favoured areas (those targeting extensive pastures and organic farming). The uptake of measures favouring extensive grass-based livestock in plains regions where intensive agriculture is dominant, has been poor. In terms of pollution and damage due to agriculture, the subsidy approach to changing practices included in agri-environmental schemes, has also been disappointing[8]. A Commission report on agri-environmental measures states that there is little evidence of the benefits for pollution abatement (EC, 2005). The evidence from the Espon (2004) project is consistent with this general picture.

This lack of effectiveness is attributed to the contradiction between pillar I (large payments per hectare) and pillar II (small payments). Although organic agriculture did benefit from the programme, the uptake and the share of this measure in the budget was limited except in the cases of Denmark and Luxemburg[9]. Clearly, the relative magnitude of the payments to organic and conventional agriculture is again a key explanation. Another major shortcoming of the agri-environmental measures was highlighted in the evaluations: the insufficient or poor targeting of zones with particular environmental conditions. The empirical evidence shows no observable benefit regarding conservation and enhancement of resources included in the Natura 2000 network.

The shift in the budget towards more "environmentally oriented" payments, therefore, is not convincing. First, the second pillar budget is limited

7. These evaluations are limited even more by the fairly recent system of monitoring and the general lack of reference data on the state of the environment in the zones covered by the measures.

8. Both Barbut and Bashet (2005) and Vindel and Gergely (2005) report that the Evaluation Committee of the French National RD Plan stated that the agri-environmental measures did not target the vulnerable zones and that articulation with other environmental policy instruments was missing, hence the weak effects on pollution reduction.

9. EC (2005, p. 13) shows that the Netherlands and UK had significant uptake. In France, the share of organic farming increased but is still lagging behind the EU average.

and finances a large range of heterogeneous measures which are not environmental. Second, the fundamental problem with transferring larger budgets to targeted recipients has not been resolved, since these forms of support are much more complex and costly to monitor than an intervention mechanism. A number of programmes were found by the Court of auditors to involve the costs of the audit, which exceeded the amounts transferred to farmers. Beyond a certain limit, increasing the budget devoted to agri-environmental programmes could generate either corruption or excessive costs of inspection and control. The magnitude of the transaction costs in pillar II could be reduced by some simplification and, because administrative costs are in large part sunk costs, by increased continuity and consistency in programmes. However, the experience of RD Regulation and Agri-environment Measures is reminiscent of the fundamental trade off between finely targeted instruments to heterogeneous agents (or areas) and transaction costs, and also possible bureaucratic deviations.

The cross compliance conditions for eligibility for the Sfp made compulsory in 2003 provide a potentially useful way to influence those farmers reluctant to fulfil their legal obligations regarding environmental protection and other social concerns. It remains to be seen to what extent practices have changed since the introduction of cross compliance. There is patchy evidence that only the most visible requirements, such as grass covered river banks, have been implemented.

2.3. Financial solidarity and subsidiarity

The disparities between costs and benefits generated by a sector-based policy such as the Cap are well known and led to the rebate paid to the UK, which was later extended to several other member states[10]. The net contributors have demonstrated political fatigue on several occasions, and in general are in the camp of Cap reformers. The countries that cling on to their benefits suffered political cost and loss of status in the European arena. These net balances are a permanent source of tension and tend to bias the decision process in a way that follows national interests more than long run European welfare. On occasion, the Cap has been a bone of con-

10. A strand of the literature is focused on this topic. The net cost for the UK was once substantial, but is less so now since the UK rebate seems largely to cover the net financial balance due to the Cap. See Mahé *et al.* (2007) who argue in favour of extending co-financing of all Cap measures by national or even local governments.

tention even in the European context.

Sharing the burden of the expenditure raises the issue of which policies should be financed by the European budget and which by national budgets. One way to approach this is to look at the public good nature and coverage of the objectives of the policies at stake. The co-financing of the second pillar expenses is consistent with this view. It is not clear that first pillar policies of the Cap do pursue such objectives. However, they are the ones totally financed by European resources. The reverse situation, with a co-financed first pillar and a second pillar financed by European funds would make more sense than the current situation.

The preservation of "national envelopes" in the context of modulation of direct payments, applied again in the context of the Health Check to facilitate compromises, is a sign of the major importance given by member states – including new ones – to the financial returns from the Cap. It is also a sign that European leaders have lost confidence in their ability to agree on how best to use the funds earmarked for the Cap.

To sum up, in spite of the deep reforms carried out since 1992, the Cap remains flawed: it has serious economic and political deficiencies. Sfp have lost credibility since they:

- worsen regional and individual income distribution;
- do not reward services regarding rural public goods or, if cross compliance operates, do so at a disproportionate cost;
- contradict agri-environmental measures;
- entail net financial balances between member states which tend to pollute the decision process at EU level.

3. A Concept for the Longer Run: An Incentive Role of Payments and Financial Responsibility in the Decision Process

We believe that reforms should be based on basic policy principles that are backed by an international scientific consensus. It would be a major asset for policy instruments to be acceptable to domestic societies and to international partners. This is more likely to be achieved through the selection of instruments targeting objectives, which seek social returns from public money and substitute incentives for assistance. We provide some suggestions for future Cap. It should:

- take account of the special relationship between agriculture and open spaces and natural resources in rural areas, society's demands regarding preservation of the environment, open rural space and farming landscapes, and a certain level of occupation in a major part of the territory by viable communities[11];

- account for two essential features of European agriculture, (i) that the farm structure is heterogeneous, (ii) that natural conditions of farming and the value to nature of farmed land vary considerably over rural spaces and across Europe; a degree of differentiation among farms, farming techniques and areas is necessary, but fine tuning has high administration costs;
- adjust public intervention effort and outlays to the magnitude of market failures and, in particular, establish a link between the size of the direct payments and the value of services to rural public goods;
- target the instruments used to correct identified market failures and increase public social objectives, though a one to one correspondence (e.g. between the environment and extensive farming) is rarely possible and even targeted responses may produce spillovers that can conflict with other aims; agricultural policies in Oecd countries are not targeted for the most part but should be more targeted in the future (Moreddu, 2007);
- adhere as closely as possible to "polluter pays" and the "provider gets" principles and allow for administrative and transaction costs in the design of first or second best policies;
- address equity and social goals through global rather than permanent sector policies and draw lessons from the loss of legitimacy deriving from the current inequitable distribution of the direct payments;
- pay attention to institutions that tend to generate a situation of prisoner's dilemma, opportunistic behaviour and inefficient decisions over a public good, at both European and local levels. It should foster institutions and collective action which help to organize the supply of local public goods or the protection of common property.

We propose the following principles for direct payments under the Cap:

- targeting;
- differentiation;
- proportionality;
- cost efficiency;
- consistency;
- simplicity and stability;

11. For a recent review of the joint effects of agriculture on rural public goods see Hodge (2006).

- freedom to contract and commitment;
- responsibility.

3.1. Complete reshuffle of direct payments: a three level "contractual payments scheme" (Cps) [12]

The general aim should be to make payments more homogeneous across orientations, and differentiated according to services and locations, and to dispense with the outdated logic of compensation and adopt the logic of "incentive to provide" services. A second aim should be to avoid leakage of the support granted through the current Sfps into land costs. While this is certainly not a panacea, cutting off tradability of "rights" and conditioning the payments to an effort for a certain duration in time would help. A third aim should be to correct the contradiction between large Sfp and smaller agri-environmental payments (and the imbalance in the distribution across sectors and farms) and finally the aim should be to enhance the effectiveness of the closely related environment and rural development policies through zoning or spatial differentiation. Clearly, the size of the individual payments and hence of the EU farm budget we are proposing should be calibrated to be in line with the economic benefits provided by the farm sector in terms of both positive environmental externalities and husbandry of the countryside.

It is proposed that rights should no longer be embedded in Cap history nor attached to the land (see horizontal clauses). In our proposals, they are attached to the functions of agriculture which amount to public services. But to avoid excess complexity, some degree of imperfection of the policy instruments must be expected. Three basic levels of services are considered: (i) basic husbandry of the countryside to preserve farming landscapes; (ii) continuation of farming activity in areas and regions with natural handi-

12. The reorganization of payments proposed is broadly consistent with the proposals put forward by the study group chaired by Buckwell (1997), which retained strict market stabilization and two payments for services (Environmental and cultural landscape payments and Rural development initiatives) to substitute for subsidies. First pillar subsidies were to become Transitional adjustment assistance. Here we emphasize the contractual and non-marketable character of the payments, retain the possibility to contract for a basic reduced payment over most of the territory, and stress differentiation over rural spaces. Payments for environmental services according to a scale of "Green stars" and a zoning of the rural territory were proposed also by Mahé and Ortalo-Magné (2001).

caps (territory services); (iii) positive efforts to preserve and enhance natural resources in designated portions of the territories endowed with high natural value or with specific environmental attributes (environmentally sensitive areas).

First level: Basic husbandry payment (Bhp). A basic payment per hectare of land farmed to be offered proportional to commitment (e.g. €100-150/ha). All farms would be eligible, including commercial and intensive farms, after signing a contract to manage the land and to preserve the farming landscape. This payment has features that foster the enforcement of environmental measures[13].

1. Decoupling: the Bhp would be fully decoupled from productive inputs and outputs but coupled to services. The remaining part of the coupled payments to crops and intensive livestock would be abandoned over most farm land area (see later for exceptions).
2. Commitments : Bhp would be paid based on contracts with those willing to make a few, but visible or easily verifiable environmental commitments, such as preserving river banks and pastures, portions of land devoted to biodiversity, to hedgerows, to groves and copses, to pockets of woodlands, a degree of crop diversity and rotation, etc. This would substitute for cross compliance and has similar goals, but different rules and rewards.
3. Bhp is aimed at genuinely "rural areas". Areas around cities, densely populated recreation areas and portions of the rural space where land prices are high compared to the national average (e.g. suburban municipalities), would not be eligible.
4. Bhp contracts would cover several years (e.g. 5-10) and be subject to periodic revision to account for technical changes or land planning adjustments.

In addition, Bhp will include the possibility for some general support, but should reduce the current average level of the Sfp by more than half. Unlike the "Bond scheme", which provides lump sum compensation and

13.The Bhp could conceivably include a stabilizer component, variable according to the level of prices relative to long run trend in world prices (crisis management component), to reduce support during price booms and increase it when prices fall. Such a variant would not meet current green box criteria and may contradict the development of income insurance contracts by private firms. More important, perhaps, introducing a countercyclical nature in the payment would contradict its fundamental nature of a contract for services.

exposes farms to the market, the Bhp will indirectly provide both buffer income support and an incentive to use good farming practices. To maintain reduced payments after 2013, even for commercial farms, involves the difficult assessment of the adjustment margin of the cost structures of those efficient farms where incomes are currently often smaller than the total Sfp received[14]. The Bhp would be fairer in terms of the constraints on production methods which currently are more severe than those imposed on most foreign competitors[15]. The proposed payments would be as consistent with the green box as the current Sfps. Cost restructuring, technical progress, and inflation after a period of say 10 years, may open new margins for reduction of these general payments, which should have been the case for the 1992 direct payments.

Second level: A "natural handicap payment" (Nhp): a system of higher payments for areas with natural handicaps (sparsely populated, mountain, remote, northern, dry, etc.) where there is evidence that agricultural activity provide social benefits. These payments would (or could be) coupled to farming activities inasmuch as production and environmental services are credible complements[16]. In particular dairy, beef and suckler cows, sheep and goats with a clear multifunctional role can continue to be raised, provided that stocking rates remain low. The eligibility conditions for Nhp in general should rule out intensive production processes because these areas are more environmentally sensitive than the areas eligible for Bhp.

The basis for setting the amount of payments cannot be full compensation for natural handicaps, which would amount to denying the role of comparative advantage in the spatial distribution of economic activity. The payments should aim at making viable a certain level of farming activity relative to the perceived social loss that the total disappearance of rural communities would entail.

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14. In a typical rented crop farm the share of land in costs is less than 20%, which sets a clear limit to cost cutting offered by land costs. But other cost items should offer cost cutting possibilities for the highest incomes with high marginal tax rates.

15. Although the green box allows for a sizeable margin of manoeuvre in this regard, the effects on trade of different regulations on processes and methods of production have been avoided by the World Trade Organization so far, but the debate may return to the agenda - at least in relation to global environmental damage.

16. Statistical evidence of jointness is scarce (Oecd, 2001); Peerlings and Polman (2004) find evidence of competition; cases of complementarity for extensive sheep rearing can be found in Le Cotty and Mahé (2007). Hodge (2006) provides a review of some other cases.

Third level: Green points payments (Gpp) for environmentally sensitive and areas and for high natural value areas, i.e. for Green zones[17]: special contracts for designated environmental services of higher value than the basic commitments associated with the Bhp. Farms located in environmentally sensitive areas, in less fertile regions (but also in pockets of territories otherwise devoted to commercial farming) would be eligible on the basis of farm practices, including:

1. land devoted to extensive pasture, low input techniques in river basins;
2. conservation and management of extensive pockets of biodiversity, of green corridors, of marsh land; prevention of bush invasion, officially protected zones under Habitats/Natura 2000 directives, etc.;
3. organic farming;
4. extensive farming techniques outlined in the production codes of geographical indication products;
5. preservation of the traditional mosaic of the landscape, and rural heritage;
6. fallow and set aside land for resource conservation.

Gpp would be based on costs incurred and on the contribution capability of farmers to environmental protection, and on the value of the services provided as perceived by society. A schedule of green points would be established to grade and aggregate the services delivered to decide on eligibility for payments. The total payment per farm should be roughly equivalent to the wages for a full time job in the region[18].

Lifetime retirement payments (Lrp) would substitute for the current Sfps for older operators of very small farms that require amalgamation to reach minimal efficiency. This measure targets the new member states and parts of the (often southern) old member states' farm sectors where the farming

[17] The issue of whether farms implementing particularly environmental friendly practice with a high level of environmental effort, in "standard" areas, with no particularly excpetional ecological or recreative value is an open issue for debate. Organic farming, for example, could be seen as eligible to such payments even in intensive cereal production areas such as the Paris Basin.

18. Techniques that rely on the "bonus point system" for a variety of environmental actions or on the auctioning of a particular objective (e.g. providing refuges for birds over a designated number of ha) could be developed to tailor payments better to efforts required. Several examples of systems akin to the Gpp already exist in the UK, Austria, Bavaria (Kulap), Baden-Württemberg (Meka), France (Cte/Cad) among others (Moreddu, 2007; Hodge, 2006).

structure is backward and cooperative farming is hampered by land tied payments, which substitute for pensions. A condition for eligibility would be that, with the exception of a small personally owned plot, land should be made available to viable larger farms[19].

Under such a radical reorganization, support would put an end to most historical rents and provide better incentives for farmers. Equity between farms and regions would improve significantly. Classic farming would derive most of its income from market prices and the productive function. For example, a "state of the art" farm with 200ha of cropping land would receive up to €30,000 of direct aid, and extensive farms of 50ha with handicaps or higher environmental commitments could receive up to €50x400=€20 000. This would make both types of farm viable. Farm products in Less Favoured and High Natural Value areas would benefit from better prices due to quality premiums and from the Nhp-Gpp premium. They should be viable despite their higher cost, one of the main aims of this support.

Such a reorganization of support would alleviate the current contradictions between payments, and specific environmental and rural development measures (e.g. Leader) which seem to be effective, would be integrated or enhanced by it.

3.2. Horizontal clauses related to financing and distributing direct payments

The horizontal principles are aimed at enhancing the effectiveness of the Contractual Payment Scheme with regard to redesigned Cap objectives and at avoiding some of the undesirable side effects of the current Sfp system. The first objective is to alleviate the perverse effects of the skewed distribution of cost and benefits across member states on decision making related to the Cap. The second objective is to prevent the capitalization of support into land values and farm assets. The third objective is to avoid generating distortions in competition within the single market.

*Payments "rights" are intuitu personae, not tradable or inheritable. Pay*ments would be granted to a person or entity in exchange for the commitment to adopt the designated agricultural practices, in the designated areas, for a stated period. The link to a person and not the land originates

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19. As rights can neither be traded nor inherited there is no contradictory incentive to retaining ownership of the land in the hopes of reaping income flows or capital gains.

from the contractual nature of the possibility to receive payments. There is no "right" to payments *sensu stricto*; there are conditions and commitments that provide eligibility for contract[20].

These payment rights conditions might appear to contradict the rule that payments should be proportional to farmed hectares (except through the modulation clause). However, the existing rule is an ad hoc rule that reflects the empirical difficulty of assessing the value and the cost of the three level services rewarded by the Contractual Payment Scheme. This is particularly true for the first two payments described (Bhp and Nhp). It may be less true for the Gpp since there is some experience with farms in environmentally sensitive areas – for example, Natura 2000, fresh water catchments, etc. It should be possible in the future to construct indicators based on the value of services, and to aggregate them into credits earned by a farm operator[21]. Payment per hectare is a second best option which has the merit of simplicity. In this respect it is line with the objective of simplification of the Cap.

A time limited contract. The historical base of "rights" to the Sfp would be sacrificed. All payments would be granted to the farm operator for a given period in exchange for fulfilling designated services, and not to the owner of the land. No eligibility right to payments is created that could be part of the immaterial capital of the farm. The contract would be valid for a set number of years.

Rights to payments cannot be rented or sold at retirement or cessation of operation, even with the transmission of land, since a new contract between the administration and the new operator would be necessary for receipt of payment. The type and amount of payments offered to new entrants would not necessarily be the same as those granted to the previous farmer; for example, due to a revised classification by the local authorities of the zone of interest, or because of changes to policies based on information gained from experience. If revisions are perceived as rare or unlikely, it is conceivable that the expectation to become eligible for a particular payment would give some value to the areas for rent or sale, on the black market. The advantage of the system is that capitalization of the rent would be less automatic[22].

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20. This is in contrast to the Sfp.

21. Environmental indicators that grant "sustainability points" to farm practices are considered in Haldberg (1999).

22. The *intuitu personae* and time limited features would alleviate the objections currently raised by eligible beneficiaries when authorities want to change policy rules, payment

The Achilles' heel of a Contractual Payment Scheme is the burden it places on the civil services to manage and monitor it. A continuous flow of new contracts would need monitoring for permanent cessation and new entry into farming. The current Sfp system is already quite complex and particularly in terms of monitoring the transmission and sale of "rights" with different rules and levies depending on whether land is or is not transferred with the Sfp. The control of the commitments in contracts would not a priori be more demanding than current cross compliance and would embody a degree of automatism due to the fixed duration of the contract. This monitoring could become the responsibility of extension services which would be accountable to the state or the EU authorities. This could have the psychological advantage of relaxing the pressure of unforeseen controls in the current system, which in part explains why in many countries they are rarely enforced.

Rules for zoning the rural space defined at EU level. The classification of areas into the three categories proposed would amount to a fine zoning of the whole rural territory. As the experience of all zoning experiences shows, this is a contentious issue since zoning inflates or curtails future windfall gain opportunities and influences land values. The process should draw on the experiences of naturally handicapped regions and Natura 2000 sites. A further difficulty is that the grid for zoning would be finer for both Green zones and Natural Handicap (NH) zones. For example, the fertile plains of mountainous areas would be excluded from NH status. But hillsides and valley bottoms in areas where commercial farming dominates would be eligible for green status and its effects for eligibility.

As long as payments are co-financed by EU resources, rules must be defined at the EU level, but final decisions and monitoring should involve local administrations and political institutions. The process will always be politically sensitive. These limitations and the burden of fine grid zoning of the rural space should be balanced against the current flawed policy, which generates equity problems and, which, to a large extent, embodies a de facto zoning, where rights to use the rural resources are overstretched.

Commitments and guidelines for control to be defined at EU level. EU decisions focus on rules and specified objectives. As the EU co-finances payments, its role in verifying the effectiveness of the services delivered is in order. Lessons can be drawn from the EU Nitrates and Water directives: (i) setting rules which can serve as a basis for appeals to the European Court are helpful for enforcing resource protection when the local political

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levels or the vocation of pieces of land when land planning so requires.

balance is unable to implement policy targets previously and officially accepted at the level of EU Council of ministers; (ii) clear and simple rules, such as nitrate content in fresh water resources, have proved able to help local environmental trusts to challenge, in the courts, lack of action by local or national authorities regarding European Directives.

Capping and modulation of total payments per farm unit. Attempts to make the distribution of payments more fair, such as capping payments per farm, or reducing payments to the largest farmers and redistributing the budget to those that receive less, have been frequent in the Cap reform process, going back at least as far as 1991 (in the leaked reform project). Capping of farm payments has been retained in US programmes. It can be circumvented and can trigger fragmentation of large farms. The Commission has long experience of attempts to introduce increased modulation of individual payments. We do not have much to add to this debate, which is fairly well known and amounts to finding a balance between social demands for equity and member states' opposition to the occurrence of very large farms. The demand for equity will increase with progress towards greater transparency and public information. According to the logic of payments for services, which is the basis for the present concept, total payments to farmers, in principle, should be limited to their maximum capacity to supply such services.

Direct payments from public funds should open rights to public access to the countryside. Since direct payments find legitimacy in the public nature of the services provided by farming practices, the possibility for the public to enjoy the countryside should exist. Between the right to roam for everybody, everywhere, and the refusal of farmers or landowners to allow the creation of footpaths along river banks or through their property, solutions must be found to ensure some degree of organized access under designated conditions. The Commission could perhaps issue a Directive to Member states to restrict the conditions of sale of publicly owned country roads and trails to farmers, which precludes future development of footpaths and turns genuine elements of the landscape inherited from previous generations into uniform arable land. Where hunting is allowed and developed in a collective manner, rules excluding the total area of the farm receiving payments from access should not be allowed.

3.3. Funding a reformed Cap: financial responsibility and subsidiarity

The sharing of competences between the Union and member states is fundamental to the European construction process. For a sector policy such as the Cap, it is crucial that member states should agree about which matters they want jointly to decide on and finance at EU level, and which should be the responsibilities of national or local governments.

One approach is to draw guidelines from the theory and experience of fiscal federalism, and from public choice. The principle of subsidiarity recommends decentralization when issues are better dealt with locally, and centralization where there is value added from shifting power to the EU. This principle shifts the burden of proof to the advocates of central or supranational governments. Demands for services are better known at local level, but externalities between local communities can be better solved centrally. As a consequence local public goods would be left to local governments, and global public goods to the central authority. But specific cases still prompt debates regarding the right level of competence. Persson *et al.* (2005) argue that taking into account political economy and coalition formation considerations makes clear cut prescriptions difficult. Moreover, in the presence of heterogeneity in preferences across local communities, normative results are contingent on strong value judgments. Other arguments in favour of centralization include risk sharing and redistribution. The principle of cohesion in the European Regulations and Directives is an illustration of these latter.

Against this background and in the context of the Cap, it could be expected that the EU would tend:

- to limit its domain of competence to European public goods and to leave it to national or local governments to rule on local public issues, unless
  - an inefficient outcome for local communities is viewed as resulting from political failure (inadequate decision making at the local level), and when
  - redistribution objectives (in favour of less well off citizens, countries and regions) are at stake.

European public goods include: the single market and its benefits such as the reaping of the benefits of returns to scale, including in the area of R&D, innovation etc.; food security and safety, risk sharing and risk management which benefit from a large market. Environmental quality across Europe involves global commons, such as carbon emissions or irreversible loss of biodiversity, while other amenities in rural areas and in relation to water quality are mainly a local public good.

The initial Cap in the context of the 1950s to some extent was consistent with these principles. The single market, which favours fair competition, specialization and returns to scale in the related sectors, can be considered a global public good. The common external tariff is a logical consequence of this market unity and EU competence on trade negotiations brings bargaining power that no single member state could afford. Food security for consumers is another public good and achieving income parity for farmers can be viewed as anticipating the cohesion objective. Even price stabilization to some extent can be considered an acceptable common management of price risk.

However, redistribution effects were built into the system as a result first of the customs union (although non-visible), and then of the common financing of expenditures (increasingly visible). This has long been a major problem for the Cap since the first enlargement. It has triggered recurrent political crises in view of the large discrepancies of the net financial balances among member states. In 2005 there was great tension between the large net contributors to and the major beneficiaries from the Cap. Final agreement on the 2007-2013 budget included a review clause which invites the Commission "to undertake a full wide ranging review of all aspects of EU spending, including the Cap". The present distribution of net contributions is no longer acceptable and the Commission has produced a reflection on the "operation of the own resource system" which includes a general correction mechanism (EC, 2004). But this reflection deals more with the net global financial balances to be corrected than with the sharing of competences and financial burdens of specific policies such as the Cap. However, the Cap is the main bone of contention given its large share in the budget, and this explains why renationalization of the Cap now finds several advocates, not only among member states with negative balances[23], but also from academia.

Our view is that some of the Gpp would be clearly eligible for EU co-financing since biodiversity is a clear public good. Other actions, such as extensive meadows, river banks protection and limits on the spreading of nitrates, which aim at water quality protection, have a predominantly local public good nature. Hence, there are arguments for leaving them to subsidiarity in both decision and financing. This is not the route chosen by the EU, which has adopted the principle of co-financing pillar II measures. This option would seem to point to fears of local political failures in the protection of local commons, and several environmental directives (Nitrates, Water) encompass the same paradox.

The Nhp find clear legitimacy in the principle of cohesion; hence co-

23. HM Treasury and Defra (2005).

financing is a logical solution. The difficulty lies in the definition of the relevant zoning and the eligibility conditions of recipients. Local or national governments will be inclined to over estimate the size of the eligible population even if the national budget is involved. The criteria for zoning should be strict enough to avoid these biases, and lessons should be drawn from the ex ante evaluation of the Rural Development Plans to revise the current zoning and the definition of eligible farm populations.

The contribution of European funds to finance the Bhp is more problematic, to the extent that the corresponding services are partly local and partly of general interest. However, other policies that cover mainly local public goods are also within the competence domain of the EU. On water quality, the EU has been granted competence while the public good at stake is clearly not global. The EU has even designed regulations on issues for which preferences vary across member states such as animal welfare. It is doubtful that the argument for setting higher common standards in this area was to avoid competitive distortions among member states. The problem of the right level of competence remains contentious and it seems to rest on a mix of logical arguments and political motives. Against this background, and as a measure of practicality and according to a strategy of progressive reform, we would propose extending the co-financing of all direct payments. This would help to resolve the problem of the UK rebate and its reexamination. It would also constitute progress compared to the reform scenario under consideration where national and even regional farm expenditure envelopes would be frozen. An increased involvement of local governments in the design and the financing of these payments and the transparency of payments (which has improved following the publication of the beneficiary's names) would improve the political equilibrium in farm policy design. It would alleviate the risk of a “collusion effect” in, say, the design of agri-environmental or natural handicap schemes (joint definition of lenient terms of reference or of eligibility zoning between local level and national government).

4. Discussion of the proposals and unresolved issues

We do not claim that our proposals are “the” solution to achieving an optimal agricultural and rural policy for Europe. First, there is a gap between the principles of public policy invoked for further reform of the Cap and the actual proposals listed, and second, there are some issues that remain unresolved to which we do not have clear answers.

The first problem is information. Hard evidence regarding the real value to society of farming landscapes and other rural public goods is clearly unavailable. Evaluation studies do show that a willingness to pay for these services exists, but a workable picture of these values across European rural space is not yet feasible. There is little doubt, however, that this value per hectare is nowhere near the size of the Sfp per hectare inherited from the crop or intensive dairy sectors.

This is particularly true for commercial agriculture in areas without any special attributes in terms of natural value. However, pure static profit maximization is unlikely to produce the type of countryside that society wants, for either the current or future generations. From water pollution to landscape degradation and biodiversity losses, there is ample evidence that the heritage value of the countryside may be hurt by unregulated agriculture. The Water Directives show that there is a wide consensus on water quality standards. Selected environmental indicators could be used as benchmarks, beyond which practices providing better services would be rewarded.

The limited knowledge available on the value of rural public goods makes the principle of proportionality of payments to the value of services virtually impossible to implement. Moreover a flat rate across "ordinary" agricultural land, such as envisaged by the Bhp, would not acknowledge the probable differences in public valuations of similar attributes across different locations. A flat rate per hectare for conventional agriculture as a counterpart to designated commitments could be justified in large part, based on two arguments: (i) simplicity and low administration costs; and (2) great improvement over the current Sfp.

Another difficulty is cost effectiveness or proportionality of the rewards to the costs incurred by farmers to meet their commitments. Differences in costs are likely to entail a rent to some and to allow others only to break even. At some stage in the future, or in some circumstances, a tender system might be implemented. There is some, but limited, experience with tenders. But would there be such a large cost gap between farmers in commercial agriculture and ordinary areas when commitments would for the most part consist of diverting portions of land from cultivation to preserving water and soil quality or to providing habitats and woodland to support biodiversity?

The second set of issues relates to co-financing the remaining Cap by European and national or local budgets. Views on this differ and we have tried to expose the pros and cons. Clearly, some member states do not see any point in EU involvement (HM Treasury and Defra, 2005), a view that is shared by most academics. An even more extreme view is that since rural public goods are essentially local, local collective action is the best response to provide just enough, at minimal cost. Harvey (2009) argues that without a solution to transaction costs, government action is more likely to be harmful than beneficial, and that it would be safer to rely on the conservation trusts that are developing, to avoid political failure. We feel that all possibilities of internalization of amenities and of pseudo market solutions should to be taken advantage of – as does the Leader programme for rural development. But we would also point out that the so-called Thiebout hypothesis – a pseudo market for local public goods can emerge through people voting with their feet and choosing location – has been challenged on several grounds. Hence, we maintain that government still has a role and that rules agreed centrally may curtail local political failure.

With this issue unresolved, we would end with two general remarks. One is that EU competence has not been contested in matters such as fresh water quality – a local public good – nor the ethical issue that provokes widely different responses across Europe, of animal welfare standards. This suggests that the EU process can generate objectives and rules that make policies more consistent with higher values. These values are probably at the root of the aggregation power deployed by the Union and felt strongly by so many in the world. Second, the Cap needs to correct its foundations, means of action and decisions rules, and prove itself less prone to political failure, or to fuelling deep European crises in the future.

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