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Alan Matthews*

National co-financing of CAP direct payments

Summary

The idea of national co-financing of the EU's income support to farmers was introduced into the debate on the next Multi-Annual Financial Framework (MFF) in June 2017. The European Commission mentioned the idea only in passing and it was immediately rejected by Agriculture Ministers, a stance that can be understood on political economy grounds.

This paper makes four arguments in favour of this policy instrument – for example that it would make better value-for-money choices in the CAP more likely – while also responding to some of the criticisms of the proposal. CAP Pillar 1 direct payments are unique among the major EU spending programmes in being 100% financed from the EU budget. This is the anomaly that must be explained and justified, rather than the case for national co-financing.

The paper concludes by recommending that national co-financing of CAP Pillar 1 direct payments should be included in the Commission's MFF proposal in May 2018, and the European Council should endorse it as part of its MFF conclusions in due course.

1 Introduction

At the time of writing (March 2018), preparations for the EU's next Multi-annual Financial Framework (MFF) for the period after 2020 are underway. The negotiations on the size and distribution of each MFF among the Heads of State and Government in the European Council are always amongst the most fraught and complex EU negotiations. On this occasion, the negotiations are made more difficult by the expected departure of the United Kingdom (UK) from the EU in May 2019.

The UK is, in absolute terms, the second largest net contributor to the EU budget. Consequently, its departure leaves a hole in the EU budget which the EU Budget Commissioner Günther Oettinger (2018) has estimated at €12–13 billion annually. At the same time, the EU is facing new priorities, for example, in the fields of security, migration, defence and youth unemployment, which will require additional expenditure if they are to be addressed. Mr Oettinger has indicated that he intends to propose an increase in gross contributions from around 1% of Member States' GNI to 1.1x% (in principle an increase of between 10 and 19%).[1] Several net contributor Member States have expressed their opposition to such an increase, in which case the alternative is much more severe reductions in existing expenditure programmes (such as the CAP) than Mr Oettinger currently envisages.

* Professor Emeritus of European Agricultural Policy, Trinity College Dublin, Ireland. Acknowledgement: I am grateful to Jonas Eriksson and Patricia Wadensjö for helpful comments on an earlier draft of this brief.

1 The parameters of the Commission's likely MFF proposal due to be announced on 2 May 2018 are discussed in Matthews (2018).

This debate is taking place in parallel with a debate on the future shape and direction of the EU's Common Agricultural Policy (CAP) in the years after 2020. This has been stimulated by the publication of a Commission Communication *The future of food and farming* in November 2017 following an extensive public consultation (European Commission, 2017a). In the light of this debate, legislative proposals are expected to be published towards the end of May 2018.

There are clear linkages between the debate on the future budgetary framework and the debate on the future direction of the CAP. The next MFF will, among other things, establish the expenditure ceiling for the CAP in the years after 2020. One of the issues that has been raised in the budgetary debate is whether there should be a move to national co-financing of CAP Pillar 1 payments.

As a reminder, the CAP is currently structured in two Pillars: Pillar 1 covers direct payments to farmers as well as market interventions and is financed by the European Agricultural Guarantee Fund (EAGF), while Pillar 2 supports rural development policy and is funded by the European Agricultural Rural Development Fund (EAFRD). The former accounts for around 75% of the CAP budget, while Pillar 2 accounts for around 25%.[2] However, while Pillar 1 expenditure is 100% financed from the EU budget, Pillar 2 expenditure is co-financed by the Member States.

> *"There are clear linkages between the debate on the future budgetary framework and the debate on the future direction of the CAP."*

In this brief, I set out the arguments in favour of extending national co-financing to CAP Pillar 1 direct payments,[3] while also answering to the arguments made in favour of maintaining the status quo. The brief builds on and extends arguments which I have made previously in a report to the European Parliament on the future of direct payments in October 2016 (Matthews, 2016). Whether or not to require co-financing of Pillar 1 direct payments would be a decision for the European Council in agreeing the next MFF based on the Commission proposal which is scheduled for 2 May 2018.

2 Modernisation of CAP and the next MFF

The Commission's recent proposals for the CAP are expected to lead to the modernisation and simplification of this policy. Modernisation is required to

- better help farmers to take advantage of new innovations;
- close the investment gap in agriculture;
- encourage a higher level of ambition with respect to resource efficiency, environmental care and climate action;
- improve the risk management tools available to farmers, in order to strengthen farm resilience;
- address market power imbalances in the food chain.

Simplification is demanded by both Member State administrations and farmers to make schemes less complicated and to reform the system of monitoring and controls.

One response of the Commission has been to propose a new delivery model for the CAP. The intention is to move away from a compliance-based approach, where detailed rules on the way Member States must implement CAP measures are prescribed in Brussels and set down in the basic legislation. Member States and farmers are then audited and inspected to ensure that the rules are followed, with the risk of disallowances if errors are made.

The Communication from November 2017 proposes instead to move to a performance-based approach, in which the Union would set the basic policy parameters (objectives of the CAP, broad types of intervention, basic requirements) while Member States would have greater responsibility and be more accountable for how they meet the objectives and achieve agreed targets. Member States would also be more accountable for providing credible performance monitoring and reporting, underpinning the assurance of the budget. The proposal would grant Member States more subsidiarity and flexibility to take account of their national and regional

[2] For a more detailed description of how the CAP works, see the European Parliament Think Tank Fact Sheets on CAP Pillar 1 (Massot, 2018a, 2018b) and CAP Pillar 2 (Negré, 2018).

[3] Market measures such as safety net intervention would continue to be 100% from the EU budget for obvious reasons.

specificities and to contribute to a more efficient delivery of the policy.

Initial reactions from the Agriculture and Fisheries (AGRIFISH) Council[4] and European Parliament's Committee for Agriculture and Rural Development (COMAGRI, 2018) have been cautiously positive, although concerns have been expressed about a potential fragmentation of the CAP among the Member States and the possible burden of drawing up programming documents.

3 National co-financing of Pillar 1 direct payments

How did national co-financing of Pillar 1 payments come into play? The current interest in this model arises because of the inclusion of one sentence in the Commission's *Reflection Paper on the Future of EU Finances* (European Commission, 2017b). The Reflection Paper noted that work was ongoing on the modernisation and simplification of the CAP. In that context, it noted that "One option to explore is the introduction of a degree of national co-financing for direct payments in order to sustain the overall levels of current support".

An early draft of the Commission's Communication in October 2017 contested this suggestion by arguing:

> Introducing a degree of national co-financing for direct payments, especially if made optional, would endanger the currently smooth functioning of the internal market for agricultural and food products without ensuring the balanced distribution of support we are aiming at. Therefore direct payments **should continue to be financed at EU level** (bolding in the original).[5]

However, this paragraph was removed in the final Communication, presumably on the grounds that the Communication was published on the explicit understanding that it "does neither pre-empt the outcome of this debate [on the future EU budget] nor the proposals for the next multiannual financial framework (MFF)".

When it comes to the arguments, the Commission's *Reflection Paper* made the worst possible case for national co-financing of Pillar 1 direct payments, namely, that it would help to sustain overall levels of current support. In this brief, I hope to show that the arguments for national co-financing are much more persuasive than that.

> *"While promising 100% EU financing of direct payments may have been politically astute at the time, it has resulted in important efficiency losses for the EU as a whole."*

Direct payments were introduced in 1992 and onwards to compensate farmers for a reduction in market price supports. Farm support provided through market prices as a result of import levies and export subsidies is, by construction, fully financed by the EU. In introducing their reforms, the Commissioners responsible for agriculture (Ray MacSharry, Franz Fischler and Mariann Fischer-Boel) never directly touched the distribution of resources between Member States for the good reason that otherwise they would never have got agreement on those reforms. (Even if arguably the shift from financing farm support by higher prices for consumers to financing it through tax revenue may have had some minor distributional effects between Member States.) By financing direct payments 100% from the EU budget, these Commissioners avoided distracting from their main objective (to change the nature of farm support) by introducing issues of redistribution between Member States.

While promising 100% EU financing of direct payments may have been politically astute at the time, it has resulted in important efficiency losses for the EU as a whole. There are at least four arguments why it is now time to introduce national co-financing of these Pillar 1 payments.[6]

CAP Pillar 1 payments are unique among the major EU spending programmes in being 100% financed from the

[4] The AGRIFISH Council's views on the Communication can be accessed through the webpage http://www.consilium.europa.eu/en/policies/cap-future-2020/. The Council adopted conclusions on the Commission Communication at its meeting on 19 March 2018.

[5] A copy of this leaked early draft of the Communication is available on the ARC2020 website http://www.arc2020.eu/cap-communication-leak-full/.

[6] There is limited academic literature on the topic. The arguments made in this brief are supported in a policy brief by Von Cramon-Taubadel and Heinemann for the Bertelsmann Stiftung (Von Cramon-Taubadel and Heinemann, 2017) and in the paper by Hofreither putting forward the case for 'progressive cofinancing' which deserves greater attention (Hofreither, 2013).

EU budget. This is the anomaly that has to be explained and justified, rather than the case for national co-financing. The reason for the 100% financing of Pillar 1 payments is the path-dependence of CAP reform, rather than any objective argument.

4 Defining co-financing

At the outset, it is important to be clear about what is meant by national co-financing, as there are a number of different models:

- *The compulsory model.* At its simplest, we can think of this model as taking the national ceilings for direct payments in each Member State set out on an annual basis in an Annex to the Direct Payments Regulation, and dividing the column for each into two, part to be contributed by the EU and part to be contributed by the Member State. However, this model is not legally possible, because the EU cannot oblige Member States to undertake specific items of expenditure. So this model should be taken off the table.
- *The ESIF voluntary model.* This is the model currently used in all of the European Structural and Investment Funds (ESIFs) including the European Agricultural Fund for Rural Development (EAFRD) which funds CAP Pillar 2 expenditure. EU funding is made available to Member States for particular programmes, but to draw down this funding the Member State must agree to make a national contribution to the programme. The percentage contribution can vary by Member State and by the nature of the measures included in the programme.
- *The 'top up' model.* This model was used for direct payments in the newly-acceding Member States following the 2004, 2007 and 2013 enlargements. In these countries, direct payments were gradually phased in, increasing from 25% of the agreed level in the first year to 100% over a transition period. In order to increase the overall direct payment support above the phasing-in level, these Member States were given the possibility to apply a Complementary National Direct Payment during this period. This model is also used by Member States in the context of rural development measures where there is a specific exemption from State aid rules with respect to the financing of rural development support (both the EAFRD part and the Member State part) as well as to any additional national financing on top of such support. In the latter case, the measure in question must be related to an agricultural activity falling within the scope of Article 42 of the Treaty on the Functioning of the European Union (TFEU).[7] It must also form part of the rural development programme.[8]

Both the voluntary and top-up models could have a role to play if national co-financing were extended to CAP Pillar 1 payments, as explained below.

5 Arguments in support of national co-financing Pillar 1 payments

In this section, four arguments are set out in favour of extending national co-financing to CAP Pillar 1 direct payments. The arguments deal with the following concerns:

- Ownership and efficiency
- Symmetrical incentives
- Recognition of EU value added
- Freeing up EU budget resources

Ownership and efficiency

National co-financing of Pillar 1 payments requires Member State governments to take greater ownership of agricultural policy, thus improving efficiency. National spending must be approved through a budgetary process where the national Ministries for Finance play a role. There is thus some oversight by non-agricultural interests of how agricultural funds are used. In the case of money which is 100% received from Brussels and earmarked for agriculture, decisions are made solely by Ministers for Agriculture that are principally accountable to their agricultural constituencies. With direct payments 100% financed by Brussels, the main interest of Ministers for Agriculture is in minimising the administrative hassle in ensuring these payments are made to farmers on time and in the simplest way possible. Member State contributions would give individual countries an incentive to maximise the value of spending compared to transfers financed 100% by Brussels because of the involvement of national Ministries of Finance.

[7] Article 42 TFEU regulates the application of the rules on competition to production of and trade in agricultural products. Agricultural products are defined in Annex 1 TFEU to include primary agricultural products plus some products that result from first stage processing and are further specified in Annex 1 to the Single CMO Regulation (EU) 1308/2013.

[8] Articles 81(2) and 82 of the Rural Development Regulation (EU) No 1305/2013 stipulate that State aid rules do not apply to payments made by Member States pursuant to, and in conformity with, Regulation (EU) No 1305/2013 or to additional national financing provided it relates to Annex 1 products within the scope of Article 42 TFEU.

This efficiency justification for co-financing assumes Member States have choices over how this money is spent. If the only option Member States have is to use the CAP Pillar 1 money for uniform decoupled per hectare payments, then their only real choice is to decide whether to draw down the money or not. But this is no longer the case. Greater flexibility in the design of Pillar 1 payments was introduced in the last CAP reform (greening payment, redistributive payment, small farmer payment, capping and degressivity, young farmer payment, Areas of Natural Constraint payment). Member States also have the option to shift CAP funds between Pillars, thus enlarging the scope of choice to include rural development measures.

This flexibility will be extended under the new delivery model proposed in the CAP Communication, especially where greening is concerned. Member States will be required to draw up a CAP strategic plan, in which they will set out targets for the CAP objectives identified in the basic legislation. They will then have flexibility in deciding on the measures they deem most appropriate in their national and regional circumstances to achieve those targets. This greater decentralisation and flexibility in administering the policy strengthens the argument for co-financing. Requiring Member States to contribute to these payments, by involving other actors at the national level other than the Minister for Agriculture, increases the likelihood that they will seek ambitious outcomes with respect to farm policy and environmental outcomes.

Symmetrical incentives

National co-financing of Pillar 1 payments puts Pillar 1 and Pillar 2 spending on an equal footing. The fact that Pillar 1 payments are 100% financed by the CAP budget while Pillar 2 payments are co-financed introduces a strong bias in the allocation of CAP funds in favour of the Pillar 1 budget. This is seen both in the bargaining over the division of the CAP budget in the MFF negotiations in the European Council, and in the incentives for Member States to use the flexibility to shift resources between Pillar 1 and Pillar 2 budgets.

For any given MFF budget, if a choice must be made between raising/cutting the CAP Pillar 1 budget or the Pillar 2 budget, Member States will always tend to favour smaller increases/larger reductions in the Pillar 2 budget because of the asymmetrical co-financing requirement. As Hofreither (2013) argues, Pillar 1 payments have a zero marginal cost for individual countries assuming a fixed EU budget and this leads to a strong preference for these payments. He recommends introducing co-financing in order to introduce a positive marginal cost in order to alter this behaviour 'at the margin'.

In terms of flexibility between Pillars, Member States have recognised that there would be no incentive to transfer funds from Pillar 1 to Pillar 2 unless, at the same time, the co-financing requirement was dropped. The way in which asymmetric co-financing requirements could potentially be used to bias the allocation of CAP resources was tellingly highlighted in the negotiations on the last CAP reform, as reported by the Institute for European Environmental Policy (IEEP, 2013).

> The Heads of State in their agreement on the Multiannual Financial Framework in February [2013] agreed that there was no necessity for national co-financing of funds switched from Pillar 1 to Pillar 2. This was welcomed by many because, although desirable in principle in that it would bring more funding into the rural development budget, the reality of the current financial situation is that such a requirement would act as a strong disincentive on Member States to use this facility. In practice, rural development funding would be very likely to shrink rather than grow. For this reason, the current call from some MEPs, principally from the EPP [European People's Party], to reinstate the requirement for co-financing such transfers is being backed strongly by farmers' organisations. They see this as a way of stopping fund switching to Pillar 2.

However, eliminating the requirement to co-finance transfers from Pillar 1 to Pillar 2 still leaves an anomaly: Member States that might be under financial pressure have an artificial incentive to transfer funds from Pillar 2 (which does require co-financing) to Pillar 1 (which does not require co-financing). In the last CAP reform, Member States had the possibility to transfer up to 15% of their Pillar 2 allocations to Pillar 1, and this could be increased to 25% in the case of Member States with average direct payments/ha below 90% of the EU average. As it happens, only five Member States (HR, HU, MT, PL, SK) made use of this possibility, but this still leaves open the question whether the amounts transferred would have been as great if similar co-financing requirements had been required in both Pillars.

This issue of the potential bias in allocating Member State CAP funds due to asymmetric co-financing requirements will be exacerbated by the proposals in the Commission Communication to give greater responsibility to Member

States in how CAP funds can be spent. The Communication proposes to replace the current green architecture of cross-compliance/greening payments/voluntary agri-environment-climate measures (AECMs) with a new conditionality model, where Member States would have greater flexibility to choose and design the combination of mandatory and voluntary measures that will lead to environmental improvement.

But at the moment, the greening payment is 100% financed from the EU budget and voluntary AECMs are nationally co-financed. Depending on whether the budget for the greening payment stays in Pillar 1 or is moved to Pillar 2, the continuation of asymmetric financing would seem to inevitably distort Member State choices on the design of their future green architecture, and on the balance between the environmental and other objectives of the CAP.

> *"Member States would have greater flexibility to choose and design the combination of mandatory and voluntary measures that will lead to environmental improvement."*

Recognition of EU value added

National co-financing of Pillar 1 payments allows EU value added to be recognised. By means of national co-financing, the EU can use its budget to drive Member State expenditure in the direction of priorities with higher European value added. Co-financing rates would, as at present, be differentiated by Member States' level of development. This ensures that poorer Member States are not at an unfair disadvantage in drawing down CAP funds. However, co-financing rates should also be adjusted to reflect European value added, as is the case at present to some extent in the differentiated rates prescribed in the Rural Development Regulation.

Voluntary coupled payments, for example, have dubious European value added because they support farmers in one Member State at the expense of farmers in other Member States. They might be financed largely by Member States (subject to rules set down in the CAP), whereas other payments might receive higher EU co-financing than the norm, such as area payments to assist farmers to convert to more sustainable agricultural practices (e.g. organic farming) or for environmentally sensitive permanent grasslands.

This could also be a way of addressing the unfair distribution of direct payments which has been identified as an issue to be tackled in the Commission Communication. It puts forward capping, degressivity and the redistributive payment as ways to improve the distribution of payments. However, the experience with the use of these instruments since the last CAP reform has not been encouraging.[9] Comments made by agricultural Ministers at the January 2018 AGRIFISH Council public debate supported capping but only if it was left voluntary for Member States, which of course largely makes it toothless.

The Commission should instead take the agricultural Ministers at their word. There is no justification for EU taxpayers to make substantial income transfers to better-off farmers. These farmers are usually located in the more advantaged regions in Europe and usually benefit from economies of scale, because of their size. Thus, there is no risk that this land will go out of production and they have less need for income support.

In 2015, just 121,713 holdings that were paid over €50,000 (out of the 10.8 million holdings in the EU and 6.7 million beneficiaries of direct payments) shared €12.6 billion in direct payments. This was 30% of the total CAP budget for direct payments and 9.2% of the total EU budget. The average payment per holding was €103,319 which was well above the median income of ordinary EU citizens even in the wealthier Member States (based on the data presented in European Commission, 2017c).

One could thus envisage in the next CAP reform that the EU budget would co-finance, say, 80% of payments under €20,000 (leaving the remaining 20% to be financed by national co-financing); 50% of payments between €20,000 and €50,000 (with the remaining 50% from national co-financing) and would provide 0% contribution to payments over €50,000 (leaving Member States to pay 100% of the amounts over this threshold if they wished). National payments could be capped to ensure that total support on a per hectare basis did not exceed thresholds decided at EU level.

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[9] Capping refers to an absolute ceiling on the amount of payment to any single beneficiary. Degressivity refers to the reduction of payments to beneficiaries above a certain amount by some percentage figure. Where this percentage figure is 100%, it is effectively capping. The 2013 CAP reform introduced degressivity at a minimum rate of 5% but possibly up to 100% for payments above €150,000 after deducting gross salary payments. The measure has had minimal impact (Matthews, 2016).

The thresholds are put forward to illustrate the idea and would obviously be open to further discussion. As argued earlier, the co-financing rates should also be adjusted for the GDP per head of Member States. The basic point is that national co-financing provides the opportunity for the EU to focus spending on areas of EU value added. This is not possible if the EU budget continues to provide 100% financing for all Pillar 1 direct payments.

> *"There is no justification for EU taxpayers to make substantial income transfers to better-off farmers […] Large farms would still be eligible for funding much more appropriate to their needs."*

This does not mean that large farms are excluded from receiving support from the EU budget. We are discussing here payments intended for income support. Large farms would still be eligible for funding much more appropriate to their needs, e.g. support for the provision of environmental and carbon sequestration services, as well as investment support, support for risk management and support for innovation.

Freeing up EU budget resources

National co-financing of Pillar 1 payments would free up EU budget resources. This is not the main argument for national co-financing, but in the current EU budget context which was described previously (facing the twin challenges of filling the financing gap left by the UK's departure and covering the financing needs of new priorities) it is not unimportant.

Discussing the MFF proposal with the Member States, Budget Commissioner Günther Oettinger has suggested that the CAP budget might face cuts of between 5 and 10%. These levels assume that Member States agree to increase their contribution to the EU budget by somewhere between 10 and 19%. However, as noted earlier, several net contributor Member States have expressed their opposition to increasing their contribution, in which case there would need to be much more severe reductions in existing expenditure programmes (such as the CAP) than Mr Oettinger currently envisages. In February 2018, the Commission circulated a Communication ahead of the European Council meeting on 23 February outlining the implications of different choices with respect to EU expenditure and financing in the forthcoming MFF (European Commission, 2018). The different scenarios for the CAP budget examined in this Communication included no change, a 15% reduction and a 30% reduction.

How much money might national co-financing of Pillar 1 direct payments make available? Suppose we assume the same differentiated pattern of co-financing set out in Article 59 'Fund contribution' in the Rural Development Regulation (EU) 1305/2013 would be applied to CAP Pillar 1 payments. On average, this leads to a 33% average co-financing rate by Member States for EAFRD funding in the current MFF period (national public expenditure of €51 billion excluding national top-ups compared to EU expenditure of €96 billion (initially) or €99 billion (after transfers between direct payments and rural development envelopes). Assuming Pillar 1 ceilings for direct payments of €44 billion before transfers to Pillar 2, this would make almost €15 billion available for other priorities in the EU budget.[10] It is, of course, purely coincidental that this is just slightly below the amount of 'new money' that Commissioner Oettinger proposes to raise by increasing the budget contributions of all Member States.

Finally, the Commission has argued that national co-financing of Pillar 1 payments could ensure continued transfers to farmers in the event of severe cuts in the EU CAP budget. This was the argument put forward in the Commission *Reflection Paper on the Future of EU Finances*. Agriculture Ministers and farm unions argue strongly that the CAP budget must be maintained at least at its current level. But suppose this did not happen and it were cut by 30% (following one of the scenarios put forward in the Commission's Communication to the European Council for its February 2018 meeting)? In this situation, it seems highly likely that there would be a willingness to accept that national contributions could make up the difference. This is not a positive argument in favour of national co-financing,

[10] This is an approximate figure given that Member States have differing co-financing rates and because the shares of Member States in Pillar 2 payments are different to their shares in Pillar 1 payments. So, for purely arithmetic reasons, we would not expect the average co-financing share in the two Pillars to be the same even if each Member State kept the same co-financing rate.

but it is obvious that farm unions would press for greater national support if the CAP budget were reduced by 30% or so.[11]

6 Response to the arguments against national co-financing of Pillar 1 direct payments

When the Commission raised the option of national co-financing of Pillar 1 direct payments there was an almost unanimous rejection of the idea by agriculture Ministers and the farm unions (see footnote 9). This negative reaction from those most closely benefiting from the Pillar 1 direct payments can be understood on political economy grounds. Agriculture Ministers do not want to have to negotiate with their national Finance Ministers for the additional resources to make direct payments to farmers. These payments are often made to relatively wealthy farmers and landowners, and might be difficult to justify in competition with claims for additional national spending on health services, education, higher pensions and unemployment benefits, or improved infrastructure. They must make this case at present for co-financing of Pillar 2 rural development payments. Here, the programming approach based on a menu of options means that Member States can tailor these programmes more closely to their own preferences, which minimises any opposition from Finance Ministries to the national spending involved.

However, Agriculture Ministers and think tanks such as Farm Europe (Madre, 2017) have advanced some specific objections which deserve to be considered. In this section, I respond to the more important criticisms. These are based on the following:

- The view that an EU policy objective should be financed by EU funds.
- The (feared) renationalisation of the CAP.
- The perceived weakness in the voluntary nature of national co-financing.
- The risk of funds being redistributed from poorer to richer countries.

Direct payments should be financed 100% by the EU as they implement EU policy. The argument here is that support to farmers is required by the EU Treaties, and particularly by Article 39 TFEU which sets the objective of "a fair standard of living for the agricultural community, in particular by increasing the individual earnings of persons engaged in agriculture". Because it is an EU policy objective, it should be financed by EU funds.

This is an unconvincing argument against co-financing of Pillar 1 direct payments. Article 39 foresees that the objective of a fair standard of living should be achieved by increasing agricultural productivity and adapting the structure of farming, and thus does not specifically mandate income transfers to farmers. Also, cohesion, research and connecting Europe policies all target objectives with high European value added, but co-financing of this expenditure is a matter of course. As previously underlined, CAP Pillar 1 payments are the exception in that they do not require national co-financing. Apart from the efficiency gains which national co-financing would bring, requiring Member States to contribute to a policy that implements EU objectives also reflects the benefits these countries receive.

National co-financing would lead to an unbalanced distribution of support and the renationalisation of the CAP. The Farm Europe paper asks "How is it possible to have national co-financing for direct aid and at the same time claim to be maintaining an effective internal market?" It continues: "[it] risks creating a significant disparity in the treatment of MS [Member States], between those which have the resources to provide substantial co-financing and a high level of aid to farmers and those which do not." [12]

The worry expressed that national co-financing would lead to the renationalisation of the CAP is often opportunistic. The same voices that oppose national co-financing often support national country-of-origin labelling, or coupled supports, that are much more detrimental to the internal market. Differences in payments per hectare between Member States

[11] At a press conference following the publication of the Commission *Reflection Paper on the Future of EU Finances*, the Commissioner for Regional Policy Corina Cretu is reported as saying that "governments would have to consider topping up direct payments to farmers". She said farmers don't mind whether CAP money comes from Brussels or national coffers: "I am sure farmers will be very glad to receive the money, and that will happen – they don't care if it's 95pc from European Union and 5pc from Member States." See Moran (2017).

[12] See also the comments by the Irish Minister for Agriculture Michael Creed (2017): "What is also very clear from [both today's discussions and] the Agri Fish Council last week in Brussels, is that Member States are not in favour of co-financing of Pillar 1 Direct Payments. This would be a retrograde step which could undermine the 'Single Market' and lead to 'nationalisation' of Agricultural Policy."

exist today. This can be explained by incomplete external convergence, but also by the fact that Member States have the flexibility to target Pillar 1 payments in various ways and the possibility to switch funds between the two CAP Pillars. Significant differences also exist between farmers within those Member States which opted for the 'historic' basis for the single farm payment in 2005 and which maintained this link for the basic payment in the 2013 CAP reform. The new delivery model proposed in the Commission Communication, by granting greater flexibility to Member States how to meet the specified EU objectives, will also lead to greater differentiation in the supports to farmers in the future.

The claim that co-financing of CAP would kick off a destructive race of national subsidies is partly based on a misunderstanding, as Von Cramon-Taubadel and Heinemann (2017) point out. Co-financing is merely a financing tool and does not imply any changes to the rules of the European agricultural market. If the direct payments per hectare remain at the same level in each Member State as they would be with 100% EU budget financing, then the money received by farmers is exactly the same. From the farmer's perspective, how the payment is financed is simply irrelevant.

> *"The claim that co-financing of CAP would kick off a destructive race of national subsidies is partly based on a misunderstanding."*

However, concern about renationalisation of the CAP is based on the fear that co-financing would lead to different levels of direct payments in different Member States. Maximum levels of aid per hectare could be established in the basic legislation to limit the level of income support farmers could receive if this were thought desirable. Nonetheless, the fear of 'renationalisation' is based more on the worry that, if direct payments are no longer funded 100% by the EU budget but are co-financed by Member States, then Union legislation could no longer require that Member States make these payments. It is argued that, in these circumstances, farmers in different EU Member States would no longer compete on a level playing field.

There are different ways to respond to this criticism. One can point out that this problem does not arise if generalised direct payments for income support are gradually phased out over time, as recommended in various reports (Buckwell 2017; Matthews 2016).

One can argue that the fear of renationalisation should be set against the desirability of giving Member States greater flexibility to use their resources in the ways that they think are the most effective ways to meet the common EU agricultural policy objectives. In this situation, it would be up to farm unions at the national level to argue the case for income support relative to the other instruments which can be funded under the CAP. In this national debate, farm unions could point to what they might see as unfair competition from farmers in receipt of higher direct payments in other Member States, but it would be up to the Member State to decide how best to respond. A Member State might decide to give higher priority to supporting innovation, or structural change, or risk management, or agri-environment measures, but it would be the Member State that would make the decision, within the boundaries and constraints set out in the CAP legislation which should be designed to protect and safeguard the benefits of the single market.

Finally, if these arguments are deemed too radical, Union legislation already binds Member States to spend co-financed rural development money in specific ways. For example, Regulation (EU) 1305/2013 requires that Member States spend a minimum of 30% of the total contribution from the EAFRD to each rural development programme on climate change mitigation and adaptation as well as environmental issues. Such spending should be made through different procedures: agri-environment-climate and organic farming payments; payments to areas facing natural or other specific constraints; payments for forestry; payments for Natura 2000 areas, and climate and environment-related investment support. If thought desirable, there could be a requirement for a specified minimum spend on direct payments for income support in a future co-financed EAGF.

Voluntary nature of national co-financing of Pillar 1 payments would mean some Member States might be unable to draw down these funds. Linked to the previous argument that national co-financing might lead to an unbalanced pattern of support across Member States is the fear that some Member States might be unable to fund the co-financing element and thus be unable to draw down these funds. According to the Farm Europe document "The large net contributing MS [Member States] will gain from the process but the others will not be able to find the necessary resources nationally".

The way to address this issue is to vary the co-financing rate according to a Member State's ability to pay, as is the case at present. Indeed, the EU lowered national co-financing rates and increased the EU contribution to the ESIFs during the economic crisis for Member States in financial difficulties precisely to take account of changes in their ability to pay.

How serious might this problem be? Research by the European Court of Auditors shows that, for existing programmes which require co-financing, there is no overall problem in finding matching funds (ECA, 2014). One measure of this is that commitments which are not absorbed eventually need to be decommitted. However, decommitments made by the end of 2013 were not significant. The total amount decommitted in cohesion spending up to 2013 was 0.19% of the 2012 cumulative target. For rural development spending the corresponding figure was 0.14% of the 2012 cumulative target. These are tiny amounts. Therefore, the argument that Member States would be unable to draw down EU funds because of national budget constraints is not substantiated.

National co-financing would redistribute funds from poorer to richer Member States. A final criticism of national co-financing is that it would have the effect of benefiting countries that are currently (or, after Brexit, likely to be) net contributors to the CAP Pillar 1 direct payments budget while disadvantaging those countries that are currently net beneficiaries of CAP Pillar 1 funds.[13]

This is the one criticism that has validity. As the net contributors tend to be the richer Member States and the net beneficiaries the poorer Member States, the effect would be to reduce the flow of resources from richer to poorer Member States within the Union. The consequences of this redistribution should be explicitly addressed in the MFF negotiations if national co-financing of CAP Pillar 1 payments were introduced.

Commission President Juncker and Budget Commissioner Oettinger plead that Member States should not approach the forthcoming MFF budget negotiations from a 'juste retour' perspective, meaning from the perspective of seeking to maximise what they receive from the budget and minimize what they pay into it. Their argument is that the EU budget is not a zero-sum game, and that the benefits to a Member State of budget expenditure at the EU level cannot be reduced to simply EU expenditure in that Member State.

Yet everyone knows, based on the experience of previous MFF negotiations, that this is exactly what will happen. The balance between a Member State's contributions and receipts from the EU budget takes on a political importance for national leaders which is far out of proportion to the sums of money involved. In part, this is because such a high share of the EU budget is pre-allocated to individual Member States through programmes such as cohesion policy funds, CAP direct payments, CAP rural development payments, the European Fisheries Fund, and the nuclear decommissioning assistance programme.

Commissioner Oettinger's strategy to 'sell' his MFF proposal to the European Council has focused on the arguments to increase the 'political ceiling' on the overall gross contributions to the budget. He has also highlighted the distributional implications of different models of allocating cohesion support between regions and Member States. However, he has been silent to date regarding the basis he will use to allocate CAP funds to individual countries. But this distributional debate cannot be avoided, regardless whether national co-financing of Pillar 1 direct payments is introduced or not.

For Pillar 1 payments, the debate centres on whether there should be a movement to full equalisation of payments per eligible hectare across Member States (external convergence). The Visegrad[14] and Baltic countries are pushing hard for full external convergence, but other Member States disagree. No objective basis for the distribution of Pillar 2 funds has ever been agreed (Matthews, 2013). The extent of the redistribution due to national co-financing will be mitigated by the fact that many net beneficiaries would benefit from a lower national co-financing rate on grounds of a lower GDP per head. Thus there would seem to be plenty of scope to trade off higher Pillar 2 allocations for lower Pillar 1 allocations in order to find a new political economy equilibrium and to avoid any net loss of resource flows to poorer Member States.

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[13] Net contributors and net beneficiaries can be easily identified by comparing each country's share of CAP Pillar 1 direct payment receipts with its share of EU GNI which is the marginal resource for financing the EU budget.

[14] The four Visegrad countries are the Czech Republic, Hungary, Poland and Slovakia.

7 Conclusions

Two important debates on future EU policies are currently running in parallel. The first is the debate around the size and priorities in the EU's next MFF, including the level of funding which will be made available for the two CAP Pillars. The second is the debate around the Commission's Communication *The future of food and farming* published in November 2017 which sets out ideas on how to modernise and simplify the CAP after 2020.

The idea of national co-financing of CAP Pillar 1 direct payments was introduced into the debate on the next MFF in the Commission's *Reflection Paper on the Future of EU Finances* published in June 2017. However, the idea was mentioned only in passing and there was no proper analysis of its consequences. The idea was immediately rejected by Agriculture Ministers but this political stance can be easily explained as a consequence of political economy motives. This paper provides a first analysis of the arguments in favour of this policy instrument, while also answering to some of the criticisms of the proposal.

CAP Pillar 1 direct payments are unique among the major EU spending programmes in being 100% financed from the EU budget. This is the anomaly that has to be explained and justified, rather than the case for national co-financing. The reason for the 100% financing of Pillar 1 payments is the path-dependence of CAP reform, rather than any objective argument.

Four arguments are made in favour of introducing co-financing Pillar 1 payments:

It would be a way of incentivising better value-for-money choices in the CAP by giving a greater role in CAP decisions to Finance Ministries in the Member States. It would remove artificial biases between CAP measures with different funding mechanisms. It would allow the EU budget to be used to drive those measures with greatest European value added. It would, in addition, free up funding in the EU budget for other priorities.

This paper has also responded to four arguments against the proposal.

First, the argument that Pillar 1 direct payments should continue to be fully financed from the EU budget because they are used to implement an EU policy objective set out in the Treaties. This is dismissed on the grounds that many other programmes based on Treaty provisions are co-financed.

Secondly, the fear that co-financing would lead to the renationalisation of the CAP is similarly faulty: co-financing is merely a financing tool and does not imply any changes to the rules of the EU single market. Differences in the level of direct support provided to farmers in different Member States will continue to exist, particularly under the new model of subsidiarity and flexibility proposed in the Commission Communication. The means to avoid these differences undermining the single market already exist, whether by setting minimum and maximum ceilings in the CAP basic acts or through the rules governing State aids to farmers.

Thirdly, the criticism that co-financing would mean that some Member States with limited public finance capacity might be unable to draw down EU funds to which they would be entitled can be addressed by varying the co-financing rate to consider a country's ability to pay. In any case, experience with other co-financed programmes shows that the rate of absorption of EU funds is virtually complete.

"The argument about the potential redistribution of resources should not be used against a desirable and progressive reform in the financing of the CAP."

Fourthly, the one criticism that has validity is that the introduction of national co-financing could lead to a reduction in transfers from mostly richer to mostly poorer Member States. Any undesired distributional consequences arising from the introduction of co-financing can be addressed by varying the parameters which influence the amounts of Pillar 1 and Pillar 2 spending pre-allocated to Member States in the MFF negotiations.

The argument about the potential redistribution of resources should not be used against a desirable and progressive reform in the financing of the CAP. The Commission should include it in its MFF proposal in May, and the European Council should endorse it as part of its MFF conclusions in due course.

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