February 2017

An update provide by the Brexit Working Party for the Yorkshire Agricultural Society

Paper 1: The future of Pillar 1 subsidies

By Professor Wyn Grant, University of Warwick

Scope of paper

This paper is concerned with what might happen to Pillar 1 subsidies after Brexit and what might replace them; and the consequences for farmers.

Objectives of domestic agricultural policy

One of the difficulties with the CAP has been that it has had multiple objectives which have not been organised in any hierarchy of priority and which to some extent have been contradictory with each other. For the purposes of this paper, it is assumed that the central objective of a domestic agricultural policy would be to support a profitable, productive and sustainable domestic farming sector.

The importance of the Basic Payment to farmers

The Basic Payment of the CAP, awarded on an area farmed basis, has been of crucial importance to the viability of farm enterprises, although its significance does vary by farm and by sector. In 2014-15, payments under the then Single Farm Payment scheme were equivalent to 56 per cent of total farm income. For the majority of farm businesses, the Basic Payment represents the difference between making at a profit and running at a loss.

Consultants Andersons have a 'Meadow Farm' model for a family run 154ha beef, sheep and arable holding. The pre-referendum projection for 2017 was a production loss of £166 per hectare, offset by subsidies of £188 per hectare, giving a business surplus of £22 per hectare. They have compared hard and soft Brexit scenarios (no access to the single market and continued access). Headline subsidy related figures are just given here, as assumptions are also made about variations in gross margins and overheads. Under soft Brexit, with subsidies assumed to fall by one-third by 2025 from present levels, the production loss is £131 per hectare, offset by subsidies of £139, giving a small business surplus of £8 per hectare. Under hard Brexit, subsidies are assumed to fall to one-third of present levels (this looks like a more realistic figure), producing a production loss of £240 per hectare which a subsidy of £71 per hectare, leading to a loss of £170 per hectare. (For fuller details, see: https://theandersonscentre.co.uk/uploads/Downloads/Outlook2017.pdf, p.16)

The competitive environment

Farmers in EU member states would continue to receive subsidies which, although they might reduce somewhat after 2020, would still be substantial. The Scottish Government wants subsidies to continue at present levels after 2020 (although there could be budgetary constraints, a subsequent paper will deal with the devolved administrations in more detail).

Farmers in the UK also face a highly competitive retail sector which puts downward pressures on their margins. Governments in general are reluctant to rein in this sector because it restrains food prices. This is particularly the case if there is a focus on families facing tight budgetary pressures.

Government policy intentions

The Treasury has long expressed opposition to CAP subsidies because of their public expenditure implications, the market distortions they create and their untargeted nature. The chances of retaining a general subsidy in the longer term are poor.

The Government has indicated that it will consider payments for ecosystem services such as supporting valued habitats, forestation or curbing the run off of water from land. As a stylised fact, these are likely to be of most benefit to upland farmers and a general move of subsidies 'up the hill' can be expected.

Reference has also been made to the possibility of capital grants. These could, for example, be for the use of innovative technologies related to precision farming. The Government has also looked favourably at crop insurance schemes. These are used in Australia, Canada and the US, but may be more relevant where the risk of extreme climatic variations is higher, e.g., drought in Australia.

In relation to price volatility, Andrea Leadsom has pointed out that farmers can now average their profits for income tax over five years instead of just two.

Transitional payments

If farmers are not to face a 'cliff edge' through an immediate cessation of Pillar 1 type payments, which could be highly disruptive to farm businesses and the production of food, some form of transitional payment will be required.

One possible option is a bond scheme. In essence this would give farmers a government backed bond which would either provide an assured income for a number of years or could be sold on the financial markets to provide a capital sum for investment in the farm business. There would be no repayment on expiry of the bond as its nominal value would then be zero. (The following discussion relies on Swinbank and Tranter, eds, 2004).

Figures in Swinbank and Tranter suggest an average annual payment of €6,600 a year, although 55 per cent of farms (including many British ones) would receive between €10,000 a year and €100,000. The capital value of a bond paying €10,000 in year one would be €93,610. It was assumed that there would be a flat rate payment for 10 years, declining for a further four, and a 4 per cent discount rate.

However, a difficulty is that the annual interest payment would mimic that on a government bond. Swinbank et al. refer to coupons of between 3.875% and 5.625%, but interest rates have fallen substantially since then. The Swinbank et al. policy was modelled on the market setting (and paying) the discount rate, not the government. Current market rates might not be sufficiently attractive, but bolstering them would require a substantial subsidy which would be politically difficult to justify.

An alternative would be to provide a phased reduction in the Pillar 1 subsidy over five years following Brexit, say, starting at 90 per cent of the amount paid in 2019 in Year 1, then 80 per cent, 60 per cent, 40 per cent and 20 per cent. Alternatively, this could be taken as an upfront payment of 90 per cent in Year 1, but this would have to be spent on capital equipment or land with receipts to support the expenditure). There would also need to be some limit on the total amount that could be paid to any one farm enterprise (there has been renewed criticism recently of the large amounts paid to the royal estates and to entrepreneurs from outside farming).

Without some arrangement of this kind, there could be untidy exits from the sector, not necessarily related to the viability of a farm business, but how leveraged it is and the stance of its lenders.

Reference: A. Swinbank and R. Tranter (eds.) (2004) *A Bond Scheme for Common Agricultural Policy Reform* (Wallingford: CABI).